Joint Economic Committee Democrats

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Two-Tiered Pension System Protects Executives, But Not Average Workers

Introduction

Newspapers and magazines regularly report on the growing gap between executive compensation and the earnings of average workers. Less widely documented is the divergence between executive retirement packages and retirement benefits available to rank-and-file workers.

With fewer companies offering traditional pension benefits based on years of service and salary, workers are being asked to take on more investment risk and shoulder more responsibility for retirement planning. Recent increases in the number of pension plans at risk of defaulting further add to workers' uncertainty over their retirement prospects.

Executives, meanwhile, are receiving increasingly generous and more secure retirement benefits outside of regular pension plans. This two-tiered pension system exacerbates the insecurity facing average workers, because executives who are less dependent on the same pension plan as rank-and-file workers have less incentive to sponsor those plans and ensure that they can pay promised benefits.

The Changing Pension Landscape

In the past, executives participated in the same pension plan offered to the average worker. Upon retirement, everybody received the same type of guaranteed benefit, usually based on years of service and final average salary. Increasingly, however, companies have cut back or eliminated their regular, defined benefit pension plans, replacing them entirely or in part with defined contribution plans, which transfer most of the economic risk onto workers (See box, "Three Types of Pension Plans"). In many cases companies have converted traditional defined benefit plans into cash-balance plans, often at the expense of long-tenured employees. Newer

Three Types of Pension Plans

Under traditional *defined benefit plans*, employees are promised fixed monthly benefits typically based on length of service and final or average pay. The employer contributes to a pension trust from which the benefits are paid and bears the risk associated with the trust's investment decisions. If the trust has insufficient funds to pay the promised benefits, the employer is legally required to pay more money into the plan.

Defined contribution plans establish individual accounts to which both the employer and the employee can contribute. The amount of retirement benefits an employee receives is determined by the contributions to the account plus any investment gains or losses. Thus, the employee bears the investment risks under defined contribution plans.

Cash-balance plans are a type of hybrid plan with characteristics of both defined benefit and defined contribution plans. The employer makes contributions to the pension plan, but the accrued benefits are defined in terms of an individual account balance. Legally, however, the plans are defined benefit plans, because the employees do not actually own the individual accounts.

companies rarely offer traditional defined benefit plans, preferring instead to offer defined contribution plans, if they have any pension plan at all.

At the same time that companies have scaled back traditional defined benefit plans for average workers, they have preserved and enhanced the retirement security of their highest-paid employees by creating special executive retirement packages outside of their regular pension plans. For example, I.B.M. and Bank of America—both of which have recently been sued over cuts to their regular pension plans—have reportedly promised their CEOs annual pension benefits worth at least $3 million.[1]

How do Executive Retirement Plans Differ from Ordinary Plans?

Qualified Pension Plans. Traditional pension plans are generally considered "qualified" plans under the IRS rules that allow companies to deduct employee compensation as a business expense. For a company to deduct its contributions to a pension plan—which defers compensation until retirement—the plan must meet certain funding, contribution, disclosure, nondiscrimination, and other "qualifying" requirements. For example, qualified defined benefit plans are limited in the amount of annual income that can be counted in determining benefit levels.

For 2005, the salary cap is $210,000.[2] Thus, for example, a plan that promises annual benefits equal to 50 percent of each retiree's final annual salary could pay a retired executive no more than $105,000 annually, even if the executive's final salary was $500,000. Similarly, deferrals to qualified defined contribution plans are statutorily limited. For 2005, the employee contribution is limited to $14,000, while the combined employer and employee contribution is limited to the lesser of 100 percent of compensation or $42,000.[3]

Nonqualified Pension Plans. To circumvent the contribution and benefit limits and other requirements governing qualified pension plans, companies have established various types of nonqualified pension plans for their executives. Also known as nonqualified deferred compensation (NQDC) plans, nonqualified pension plans provide executives with retirement benefits more in line with their ever escalating pre-retirement pay packages. They also enable executives to shelter—at the company's expense—more compensation from income and capital gains taxes. NQDC plans may be designed either as defined benefit or defined contribution plans.

Because contributions to NQDC plans are nonqualified, a company cannot deduct either the contribution amount or the investment income that the contributions generate. NQDC plans therefore result in higher corporate income tax liabilities for the company during the executive's working years. The company does not take a deduction for the withdrawals until the executive retires. At that point, however, the shareholders have essentially subsidized the executive's tax deferral on amounts contributed to the plan and investment income earned on those contributions.

In addition to their nonqualified status, NQDC plans differ from their qualified counterparts in several other important ways. For example, unlike most qualified defined benefit plans, nonqualified defined benefit plans generally include annual cost-of-living adjustments. In addition, while many workers still covered by regular defined benefit plans have recently seen their benefits frozen or otherwise reduced as the number of underfunded pension plans has increased, many companies have set up special trusts to protect executives' nonqualified defined benefits in the event of financial distress or bankruptcy.[4]

Like qualified defined contribution plans, nonqualified defined contribution plans allow executives to defer a portion of their pre-tax income into a retirement investment account. However, whereas employee contributions to qualified defined contributions are statutorily limited, there are no legal limits on how much executives can shelter in nonqualified defined contribution plans. Some companies allow executives to defer up to 100 percent of their salary and bonus packages.

Another important difference between qualified and nonqualified defined contribution plans is that executives participating in the nonqualified plans are typically immune from the investment risks inherent in qualified plans. That is because nonqualified defined contribution plans typically *guarantee* a specified rate of return, sometimes well above market rates.

Prevalence of Executive Retirement Plans

According to its 2004 annual survey of Fortune 1000 companies, Clark Consulting found that 94 percent of

respondents provided an NQDC plan, up from 62 percent in 1994. Respondents cited the loss in regular pension benefits due to the statutory compensation cap as the primary reason for establishing such plans.[5] The survey results demonstrate the increasing popularity of executive retirement plans over the past decade and a half. For example, 84 percent of companies offering NQDC plans in 2004 had adopted them since 1990.[6]

What is Behind the Rise in Executive Retirement Plans?

Nonqualified executive retirement plans became popular beginning in the late 1980s after Congress imposed a cap on the amount of compensation that could be considered in calculating benefits, amended the nondiscrimination rules, and made other changes to the rules governing qualified pension plans.[7] These changes were intended to give companies an incentive to enhance benefits for all employees in order to maintain executive benefits. Some companies, however, decided that increasing ordinary pension benefits was too expensive, and created NQDC plans instead.

The prevalence of NQDC plans increased significantly over the last decade and a half, for several reasons. First, Congress lowered the salary cap again in the early 1990s, further limiting the benefits an executive could receive from a regular pension plan.[8] As executive compensation soared, companies used special retirement plans to provide benefits more in line with those compensation levels. Second, Congress also prohibited companies from deducting an individual employee's compensation in excess of $1 million.[9] Because they defer executive compensation until retirement, NQDC plans provide a vehicle for companies to circumvent the tax deduction limit, which only applies to current employees.

Third, nonqualified executive retirement packages enable companies to camouflage the true value of executive compensation. The rise in executive compensation has been criticized by economists, shareholders, the media, and the general public, especially following recent corporate governance scandals. Given the weak disclosure rules governing executive retirement plans, their true value is largely hidden. By channeling more compensation through such "stealth wealth" vehicles, companies are able to deflect some of the public criticism of executive compensation levels.

Weak Disclosure Rules Mask the True Value of Executive Pensions

Weak disclosure rules make it impossible to get a full accounting of the prevalence and magnitude of executive retirement packages. The Securities and Exchange Commission (SEC) requires companies to publish annual compensation tables for each of their five highest paid executives. However, in the case of nonqualified defined benefit plans, companies are only required to disclose the formulas under which the benefits are calculated, not the actual present value of the benefits during the executive's working years. Without finance or accounting expertise, it is difficult for outsiders to calculate the expected payouts an executive will eventually receive. Moreover, once an executive retires, disclosure requirements end, as the executive is no longer a current employee.

In the case of nonqualified defined contribution plans, companies are required to disclose information about plans that provide "above-market" rates of returns. However, they are only required to report the above-market interest earned in a given year, not the full value of plans or the size of the deferrals themselves. Further, companies are often able to exploit the SEC's definition of above-market by continually readjusting their guaranteed rates of return. Again, once the executive retires, reporting requirements end.

Not surprisingly, few companies volunteer information about the value of their executive retirement benefits. Nevertheless, survey data from executive compensation consulting firms indicate that the prevalence of these so-called "stealth wealth" retirement packages has grown significantly over the past two decades. Their rise is part of the larger trend of skyrocketing executive earnings and the widening gap between the pay of executives and that of average workers (See box, "Executive Compensation"). If the value of executive retirement benefits were included in the executive compensation data that are available, the pay gap would be even greater.

Retirement Prospects for the Average Worker Are More Uncertain than Ever

While executives receive ever larger, more secure retirement packages, many ordinary workers are facing increasing insecurity over their retirement prospects. Over 40 percent

Executive Compensation

Average Executive and Worker Pay, 1980-2004 (in 2004 dollars)

Year	Average Annual Pay		Ratio of worker to executive pay
	Executives[a]	Workers[b]	
2004	$9,600,000	$27,485	1:349
2003	$8,523,068	$27,623	1:308
2002	$7,772,967	$27,642	1:281
2001	$11,738,169	$27,367	1:429
2000	$14,369,258	$27,401	1:524
1999	$14,055,377	$27,259	1:516
1998	$12,267,817	$26,964	1:455
1997	$9,154,352	$26,319	1:348
1996	$6,930,003	$25,726	1:269
1995	$4,611,331	$25,573	1:180
1994	$3,632,247	$25,616	1:142
1993	$4,944,942	$25,331	1:195
1992	$5,069,555	$25,237	1:201
1991	$3,335,678	$25,182	1:132
1990	$2,736,714	$25,454	1:108
1989	$2,731,430	$25,864	1:106
1988	$3,107,702	$26,032	1:119
1987	$2,862,312	$26,197	1:109
1986	$1,973,222	$26,466	1:75
1985	$2,009,251	$26,527	1:76
1980	$1,357,036	$27,184	1:50

Source: Linda Levine, "A Comparison of the Pay of Top Executives and Other Workers," Congressional Research Service Report for Congress 96-187, updated May 19, 2005.
[a]Average salary, bonus, and long-term incentives of highest-paid executives at the largest companies, as reported by Business Week.
[b]Average earnings of non-management, private nonfarm sector employees as reported by the establishment survey of the U.S. Bureau of Labor Statistics.

Since 1980, the gap in pay between executives and rank-and-file workers has exploded. As shown above, in 2004 executive compensation was 349 times the take-home pay of the average worker. On average, annual pay for the average worker has increased by only 0.05 percent per year over the past two decades, after accounting for inflation. Over the same period, executives saw average annual gains of 8.5 percent. From 2003 to 2004, average worker pay actually declined by 0.5 percent, while executive pay soared by 12.6 percent. Scholars who have studied the issue find that the explosive growth in executive compensation over recent years far exceeds what might be explained by changes in company performance or other market factors.[11]

The actual pay disparity is likely even wider than this table suggests, because the executive compensation figures generally do not include nonqualified pension plans and other executive perks whose values are largely hidden from the public. For that reason, the decline in executive pay between 2000 and 2002 may not accurately reflect the actual experience of most executives. Given their increased prevalence in recent years, it is likely that nonqulaified pension plans and other forms of "stealth wealth" made up for at least some of the apparent decline in executive compensation in those years.

of private-sector employees lack any kind of employer-sponsored pension coverage. A growing share of those who are covered participate in defined contribution plans, where they bear the full risks of managing their investments. Yet, as recent pension defaults demonstrate, even workers covered by traditional defined benefit plans are not immune from risk. With the rise in underfunded pension plans, workers face the threat that their employers will also default on their promises.

The rise of executive retirement plans threatens to exacerbate these trends. As fewer executives rely on regular pension plans, their interests are no longer aligned with those of the ordinary worker. Moreover, because executive compensation is increasingly linked to performance measures such as profits, executives may actually have an incentive to cut regular pension benefits. Freezing, eliminating, or converting traditional pension plans all have the effect of wiping away large pension obligations. That translates into increased company earnings, which in turn justifies higher levels of executive compensation. In fact, a review of SEC filings by The Wall Street Journal found that many companies adopted nonqualified executive retirement plans at the same time that they were reducing regular pension benefits.[10]

Legislation to address these concerns has been introduced in both the Senate and the House. The Pension Fairness and Full Disclosure Act of 2005 (H.R. 2233, Miller; S. 991, Kennedy) would establish a ‘termination fairness standard” whereby companies whose regular pension plans are significantly underfunded, terminated due to bankruptcy, or converted to a cash balance plan would be penalized for funding NQDC plans or allowing executives to accrue benefits under such plans. The Pension Security and Transparency Act of 2005 (S. 1783, Grassley) would also prohibit companies from funding NQDC plans under certain circumstances, including bankruptcy, significant underfunding of regular pension plans, or the termination of an underfunded regular pension plan.

Conclusion

Given their total compensation prior to retirement, executives are better able than the average worker to comfortably save for their retirement. Yet even as retirement benefits for the average worker are squeezed, executives are receiving increasingly generous retirement packages. Better disclosure rules and tighter restrictions linking the fate of regular pension plans with executive retirement plans would mitigate the widening disparity between the retirement security of executives and that of rank-and-file workers.

Endnotes

[1] Dash, Eric, “The New Executive Bonanza: Retirement,” *The New York Times,* April 3, 2005.
[2] The cap is adjusted annually for inflation. See Internal Revenue Code section 401(a)(17). IRC section 415(b)(1)(A) also limits the maximum annual benefit (the inflation-adjusted limit for 2005 is $170,000).
[3] See Internal Revenue Code sections 415 and 402(g).
[4] Francis, Theo and Ellen Schultz, “Guess Whose Retirement Benefits Aren’t Endangered? Many Companies Set up Trusts to Protect Huge Pensions for Top Executives,” *The Wall Street Journal*, April 5, 2003.
[5] Clark Consulting, Executive Benefits Survey, 2004 and 1999 Results, available online at http://www.clarkconsulting.com/knowledgecenter/surveys/executivebenefits.
[6] Clark Consulting, “Eleventh Annual Survey of Current Trends Finds Prevalence, Popularity of NQDC Plans Continues to Grow,” Executive Topics, Fall 2004, available online at http://www.clarkconsulting.com/knowledgecenter/newsletters/executivetopics/2004_q3/article1.shtml.
[7] The Tax Reform Act of 1986 (P.L. 99-514) set the compensation cap at $200,000; capped 401(k) contributions at $7,000; amended the nondiscrimination rules regarding coverage, participation, and benefits; and made other changes designed to encourage employers to provide higher benefits to rank-and-file workers.
[8] The Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66) lowered the cap to $150,000 (with annual inflation adjustments; for 2005 the cap is $210,000). The lower limit applied both for computing benefits and for determining compliance with the “nondiscrimination rules” governing qualified pension plans. Under a lower salary cap, an executive’s pension benefits would now
represent a greater percentage of compensation, which might violate the nondiscrimination test.
[9] See Internal Revenue Code section 162(m). The limits were included in the Omnibus Budget Reconciliation Act of 1993. Companies can, however, deduct compensation in excess of the $1 million limit so long as it is “performance-based.”
[10] Schultz, Ellen, “Big Send-Off: As Firms Pare Pensions for Most, They Boost Those for Executives,” *The Wall Street Journal,* June 20, 2001.
[11] See, for example, Bebchuk, Lucian and Yaniv Grinstein, “The Growth of Executive Pay,” John M. Olin Center for Law, Economics, and Business Discussion Paper No. 510, April 2005, Cambridge, MA: Harvard University.

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