America's pension time bomb

Commentary: Workers, employers, taxpayers, governments. Meet the key players in the coming battle.

By Geoffrey Colvin, FORTUNE senior editor-at-large
January 13, 2006: 11:03 AM EST

NEW YORK (FORTUNE) - Some of the nastiest conflicts in America's future have recently begun to reveal themselves. Let's call them, broadly, the pension wars.

They will be fought on a wide range of battlefields, involving not just workers and their employers but also governments at all levels, regulators, accountants and taxpayers. And these wars will be bitter -- because the combatants will be desperate.

A hint of what's to come could be seen in the New York City transit strike. Most of America didn't notice exactly what sparked the first such strike in 25 years, costing businesses, individuals and the city hundreds of millions of dollars. The answer is pensions. The transit authority and the workers were agreed on virtually everything except how much new employees would contribute toward their pensions--6 percent of wages vs. 2 percent -- and neither side felt it could give an inch on that.

The reasons illustrate the larger problem. The transit authority, like many private and public employers, is watching its pension costs rocket as longer-living retirees increase in number. That burden will become unbearable. On the other side, union members are watching employers nationwide dumping or cutting their pensions just as Social Security starts to look shaky. They figure retirement security is the one thing they cannot sacrifice. Result: war.

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New York's transit strike also illustrates an important reason that the pension wars weren't headed off long ago. The truth about pensions has been systematically hidden, with all parties collaborating in the deceit. Public-employee pensions have never been accounted for like those run by private employers. No government is required to tell you its pension liability the way, say, General Motors is, on the theory that governments can always just extract more money from the taxpayers to pay retirees.

But this year the Governmental Accounting Standards Board, which sets the rules for the public sector, is changing its regulations. State and local governments will now have to reveal their pension liabilities, which may be underfunded by $1 trillion or more.

Private employers, while required to account for their pensions, have played sophisticated games with the numbers -- all within the rules. For example, they can assume the pension fund increased in value when it actually declined. They can assume it will continue increasing in value at a rate that is almost certainly way too high. They can even jack up their reported profits based on that assumed, though nonexistent, increase in pension-fund value.

But eventually actual dollars must be paid out, a prospect that has seriously spooked private employers. Just this month IBM (Research) announced that it would join the long list of companies (Verizon, Hewlett-Packard, Motorola) that have frozen their pension plans, instead increasing 401(k) contributions for employees. And the 18-month negotiation between UPS and its pilots has come down to just two points: whether outsourced pilots overseas must be union members, and (you guessed it) pensions.

The pension wars will inevitably include Congress, which is working out a way to increase funding for the federal Pension Benefit Guaranty Corp., now deeply in the red as huge companies like UAL, parent of United Air Lines, dump their pension plans on it. Since the PBGC is an insurer, the logical move is to raise the premiums companies pay, especially for the riskiest plans.

But if Congress mandates a premium hike, as it probably will, then more companies will just dump their plans on the PBGC, redoubling the need for more funds, leading to more premium hikes, and so on. If you can see any way taxpayers will not get billed for a giant bailout, please e-mail Congress immediately.

And then there's the greatest pension crisis of all: Social Security. We've stayed in denial thanks to the so-called trust fund, that magical place where the plan's annual surpluses are sent to be invested until we need them. But since those surpluses must by law be invested in government bonds, they have simply been handed over to the U.S. Treasury and spent by Congress.

The trust fund is in fact meaningless, a bit of marketing hooey cooked up in the '30s. When Social Security's annual surpluses end in just six or seven years, the battle over whose ox to gore in order to cover the plan's obligations will be truly epic.

The hard reality is that for decades we haven't told ourselves the truth about pensions. Now, as the first baby-boomers turn 60, we must finally confront reality -- and absolutely no one will like it. In New York last month, transit workers and management compromised; employees will make small contributions toward health insurance premiums but will keep one of the richest retirement deals around.

Soon those compromises simply won't be affordable. And that's when the pension wars will explode.

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