Saving the Church's Pension Plan

New and retiring employees may benefit; mid-career denominational workers risk losses.

by C. Torben Thomsen

> *If only the brethren could have more faith and use those funds for evangelism, the work would be finished sooner and we wouldn't even need those retirement funds.*
>
> —Young college professor, 1959

> *If only our forefathers had been able to find a way to fund retirement benefits as they were earned, just think what we could put into evangelism today, instead of pouring tithe dollars into paying for benefits earned years ago.*
>
> —Retirement steering committee member, 1996

THE NORTH AMERICAN DIVISION HAS ACCUmulated a $1.4 billion unfunded liability for its sustentation or pension plan for church workers. This amount means that each member of the North American church would have to pay $1,600 to eliminate the division's obligations to its church employees. As will be shown later, not fully funding the pension plan is not an entirely unreasonable policy, but only if the church in North America grows fast enough.[1]

In light of this nearly billion-and-a-half dollar liability, the North American Division[2] voted in October of 1997 to switch the denominational retirement system from a *defined benefit* plan (in which the church promises a pension of 1.105 percent of an employee's annual pay for each year of service) to a *defined contribution* plan (in which the employer each year contributes about 4 percent of each employee's salary toward a mutual fund controlled by the employee).[3] Even under this new system, the unfunded liability will rise over 30 years to $3.2 billion.

For denominational employees, the switch to a defined contribution plan will mean:

- no decrease in payments to workers already retired;
- a decrease in expected retirement payments for most present workers, with the biggest decrease for workers about half way

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through a 40-year service life;

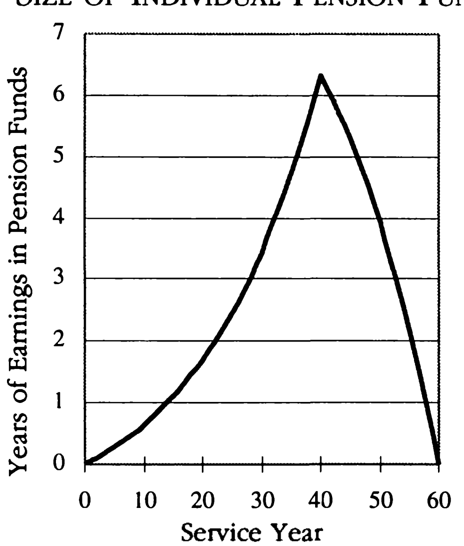
• a shift in risk from the church to the individual worker.

Who Benefits, Who Doesn't?

In general, employees are better off with the new *defined contribution* plan than with the old *defined benefit* plan. The reason is that the contributions in the early years of work yield a tremendous pension because the funds are earning interest for the employee's entire working life. Under the old *defined benefit* plan there was an implicit transfer between the young workers and the older workers. The younger workers received a right to a lower pension than they are entitled to, while the older workers received a higher pension for each year served.

However, in switching to a *defined contribution* plan with benefits frozen at a particular date, there is a heavy cost to existing workers. For example, workers with 10 years of service are hurt because the denomination's contributions to their mutual funds will earn interest only for 30 years instead of for 40 years. Also, the pension granted in the early years is not

SIZE OF INDIVIDUAL PENSION FUND



proportional to the future value of the contributions.[4]

A more equitable approach would be to treat workers as if they had been on the *defined contribution* plan from the beginning of their service to the church. This would assure that no present worker would receive a smaller retirement than with the present plan. I estimate that the cost[5] of such equitable treatment would be about $144 million, which is a relatively small amount compared to the total unfunded pension liability of $1.4 billion.

Incidentally, there is historical precedent for this equitable solution. The San Francisco General Conference session of 1930 voted a retirement scheme that granted a worker with 10 years of service a pension of 30 percent of current pay.[6] The present plan grants such a worker only 11 percent of current pay while the proposed equitable plan would grant 20 percent.

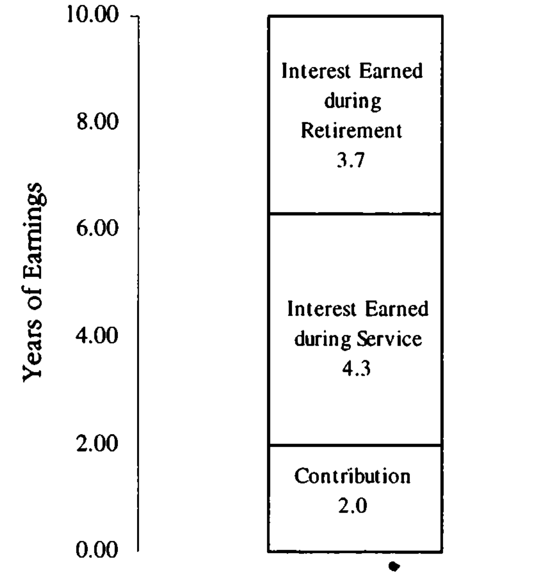
How Do Pensions Work?

It may be useful to review how pension plans work in general, then explore the impact of the new, *defined contribution* scheme for North America's church employees. The basic principle is: An early sacrifice is rewarded by a later benefit. The modern economy has provided financial markets as a means for channeling small sacrifices into much larger benefits. This is entirely consistent with basic Christianity, where Christ "who for the joy that was set before him endured the cross."[7]

If you put aside 5 percent of your salary each month, earning 5 percent interest per year, you will have accumulated 6.3 years of earnings after 40 years of work. And that will be sufficient to sustain you for 20 years of retirement at 50 percent of your normal pay.

In other words, during your working life of 40 years, your sacrifice of two years of your earnings will be rewarded by 4.3 years earnings in interest (during your working life) and then rewarded by an additional 3.7 years of earnings (during retirement). A sacrifice of two years will yield a total benefit of 10 years (which will be sufficient to sustain you for 20 years at 50 percent of your salary). This means that your two-year contribution multiplied fivefold during the 60 years of your working and retirement life.[8]

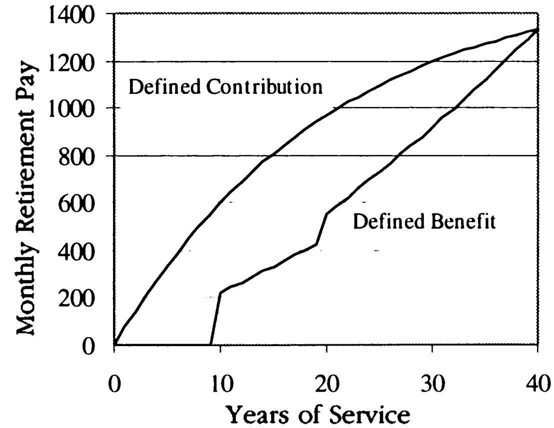
SOURCE OF INDIVIDUAL PENSION



All defined contribution pension funds behave in this manner. If funds are not systematically invested during the working life, the pension will cost 25 percent of payroll instead of only 5 percent.[9] The conferences in North America already pay about 20 percent of payroll for retirement.

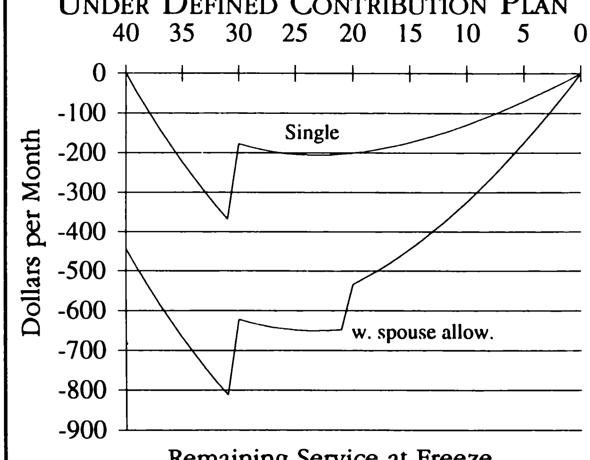
What is the effect on workers? It varies. For a worker with 40 years of service, earning the 150 remuneration percentage at the 1998 pay scale, the maximum monthly pension is $888 for an individual and $1,333 for an individual with a spousal allowance.[10] To fund pensions of this size for a retirement period of 20 years over a working life of 40 years requires annual contributions of 4.56 percent of current pay for an individual and 6.85 percent for an individual with a spouse allowance.

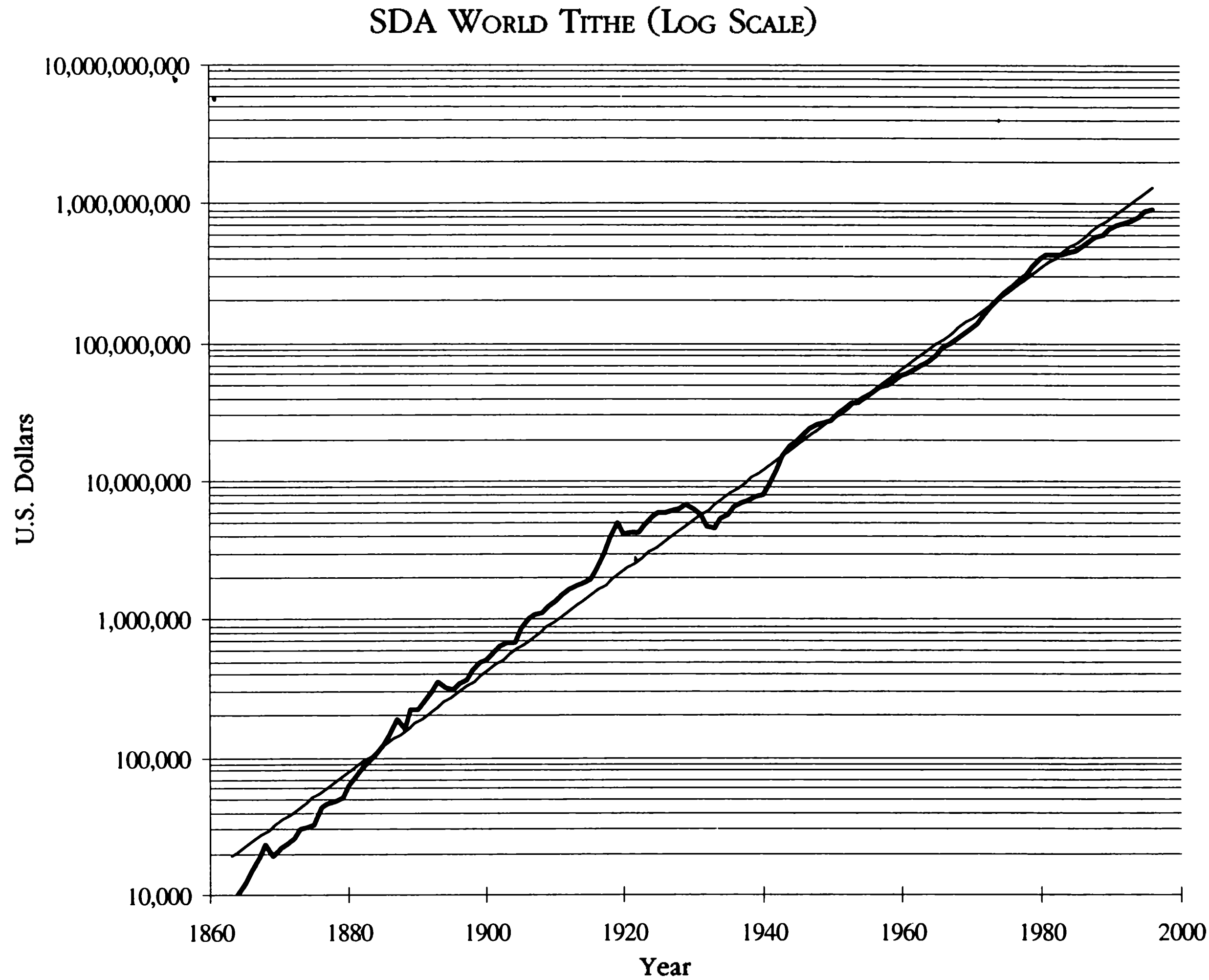
DEFINED CONTRIBUTION VS. DEFINED BENEFIT



On the other hand, for a worker with 10 years of service and 30 remaining years of service, the old, *defined benefit* pension would be $222 per month. The new, *defined contribution* of 4.56 percent of current pay for the remaining 30 years equals $92 per month. Investing the $92 per month at 5 percent per year for the remaining 30 years of service will build a pension fund of $74,900, which will be sufficient to sustain a monthly pension of $489 for 20 years. The pension earned up to the freeze, plus the pension from the defined contributions, add up to $711 per month, which falls $177 per month or 20 percent short of the $888 that would have been earned under the old *defined benefit* plan.

DEFICIENCY IN MONTHLY RETIREMENT PAY UNDER DEFINED CONTRIBUTION PLAN




SDA WORLD TITHE (LOG SCALE)
U.S. Dollars
10,000,000,000
1,000,000,000
100,000,000
10,000,000
1,000,000
100,000
10,000
1860
1880
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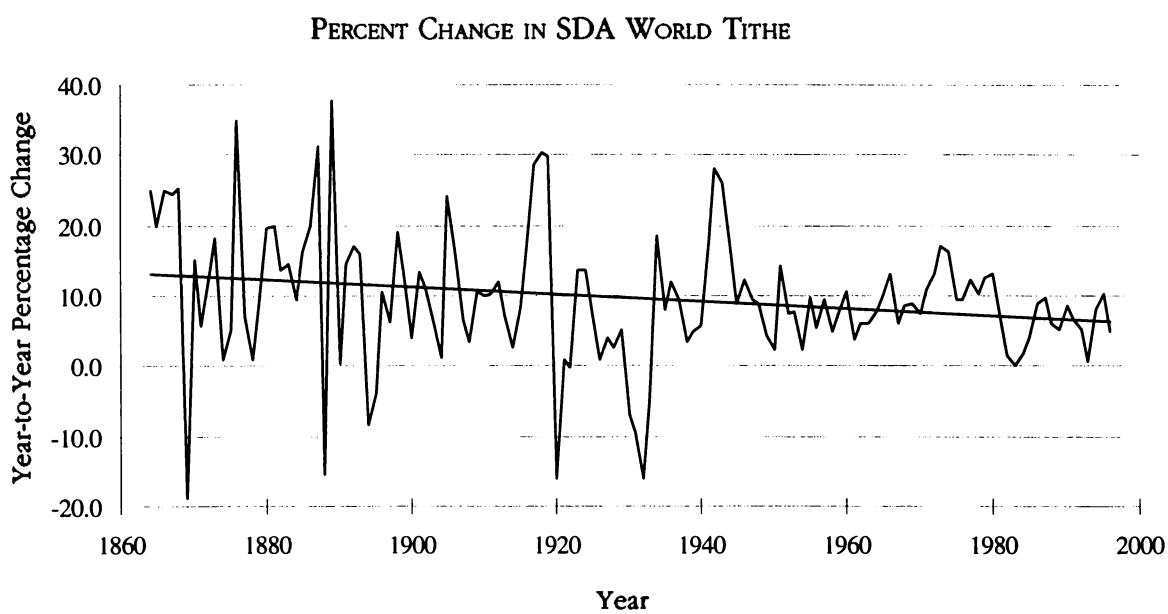
1920
1940
1960
1980
2000
Year


PERCENT CHANGE IN SDA WORLD TITHE
Year-to-Year Percentage Change
40.0
30.0
20.0
10.0
0.0
-10.0
-20.0
1860
1880
1900
1920
1940
1960
1980
2000
Year

Can the Church Grow Fast Enough to Actually Pay Pensions?

If an organization is growing, each year more new workers will be hired and the retirees, which were hired many years ago in small numbers, will be a relatively small group. (For example, if an organization grows at 7 percent per year, there will only be five retirees for every 100 workers and a pay-as-you-go pension system would require only 2.7 percent of payroll.) For a growing organization, it is therefore tempting to take the cheap route and use a pay-as-you-go system. The inevitable consequence of doing that will be the accumulation of a huge unfunded pension liability. Since its inception, the Seventh-day Adventist Church has been oriented toward growth.[11] In the spirit of "take no thought for the morrow"[12] and "lay not up for yourselves treasures upon earth"[13] the pension plan was not fully funded. It functioned essentially on a pay-as-you-go basis, with a fund containing only the estimated expenditures for the next three years.[14] That is not a problem if the Second Coming is at hand, or the church grows spectacularly.

And Adventism's growth has been remarkable. Starting with tithe income of $8,000 in 1863, that amount has doubled 16 times since then, amounting to $929 million in 1996.[15] A logarithmic plot[16] of tithe reveals a steady upward trend of 8.7 percent. (If the numbers lie close to a straight line, there will be a relatively constant percentage increase from year to year.)[17] Over that period of time, inflation has averaged about 2.2 percent per year, so the real growth in tithe over the history of the Seventh-day Adventist Church has been 6.5 percent. Since the 1800s, the U.S. stock market has grown at a remarkably steady 6.6 percent.[18] The stock market and the Adventist Church parallel one another.

When looking at a graph of *Percent Change in SDA World Tithe*, one is struck by the paroxysmal changes prior to World War II, and the more sedate changes since then. One also observes a declining long-run growth rate (note the straight line superimposed on the graph). Indeed, there has not been a decline in tithe for the past 63 years. But the years from 1929 to 1933 saw a total decline of 33 percent in tithe. And a look at the history of change in tithe indicates that the church has not been immune to financial turbulence.

If an organization slows down its growth, or even begins to downsize, the unfunded liability will haunt it. As an extreme example, if an organization declines at a rate of 4.9 percent per year there will be 200 retirees for every 100 workers, which will require that 100 percent of the payroll be turned over to retirees, leaving the current workers with nothing! With a fully funded pension plan, the organization will not be burdened with embarrassingly excessive payments. The *defined contribution* pension system shifts the risks and uncertainties to the workers and thus gives them a powerful lesson in individual responsibility and accountability.

Such a system has been implemented in the secular world on a large scale in several South American countries. In 1980, Chile replaced its pay-as-you-go system with a privately administered national system of Pension Savings Accounts.[19] The success of the system encouraged Argentina, Peru, and Columbia to follow in the steps of Chile.

Starting in 2001, the North American Division will adopt a similar *defined contribution* pension plan. The adoption of the new plan does not solve the problems of paying off the debts of the past. As we have seen, even with the new system, the unfunded liability will rise over the next 30 years from $1.4 billion to $3.2 billion. The honorable discharge of that obligation will be a dramatic challenge for the Adventist Church in North America to keep growing.

NOTES AND REFERENCES

1. This unfunded liability means that, besides the funds already on hand, an additional $1.4 billion is needed plus interest—about $100 million per year at 7.5 percent (5 percent real return and 2.5 percent allowance for inflation)—to meet the obligations that have already been earned by the workers to date.

2. The specific facts and figures in this article apply to the North American Division only. But the general principles are applicable worldwide.

3. Carlos Medley, "NAD President Calls for New Growth Strategies," *Adventist Review NAD Edition* (November 1997), pp. 21, 22.

4. For example, the contributions for the first year of service for a worker, who will give a total of 40 years of service, would by themselves yield a pension of $49 per month for 20 years. But the defined benefit plan only grants the young workers a pension of $22 per month for their first year of service.

5. The average shortfall per worker is about $8,900, assuming that the workforce is uniformly distributed over number of service years. Since that is probably not the case, the final cost of the equitable distribution would be somewhat higher or lower.

6. *The Advent Review and Sabbath Herald* 107:33 (June 11, 1930), p. 184.

7. Hebrews 12:2 (KJV).

8. This illustration and all subsequent ones assume no inflation. If inflation is present, the 5 percent rate of return that is earned on investments should increase by the amount of inflation.

9. If one worker is hired each year, the organization will have 40 workers and 20 retirees. The 20 retirees get 50 percent pay, which is equivalent to 10 workers and represents 25 percent of the pay of the 40 workers.

10. Each year's service adds 1.3 percent of the monthly U.S.A. Pension Factor of $1,709. This factor is 85 percent of the 150 remuneration percentage level of $2,010 (current pay). This works out to be 1.105 percent of current pay for each year of service, up to a maximum of 44.2 percent for 40 years of service. You will only receive a pension after at least 10 years of service. The spousal allowance is only received after 20 years of service and climbs to a maximum of 50 percent of the regular pension after 40 years of service. The maximum pension for a worker with a spousal allowance is thus 66.3 percent of current pay. The spousal allowance is reduced by any other pension that the spouse may be earning and will therefore not be relevant for most workers in the future.

11. While the pension issues in this article relate strictly to the North American Division, the following statistics relate to the world church, which grew out of the North American church.

12. Matthew 6:34 (KJV).

13. Matthew 6:19 (KJV).

14. By comparison, the Social Security system trust fund in the United States is only roughly equal to the payments for one year. For an excellent reference on the future of the Social Security system, see *Social Security in the 21st Century*, Eric R. Kingson and James H. Schulz, eds. (New York: Oxford University Press, 1997).

15. The world tithe data are from *The 134th Annual Statistical Report—1996: General Conference of Seventh-day Adventists* (Silver Spring, Md., 1997).

16. In a logarithmic chart, each big step represents a tenfold increase over the previous step.

17. A regression of the logarithm of tithe against time from 1863 to 1996 yields a slope of 0.0363, which translates into an annual growth rate of 8.7 percent. The correlation coefficient for the logarithmic regression is 0.99.

18. Peter Brimelow, "Stocks Versus Taxes and Inflation," *Forbes* (July 28, 1997), pp. 46, 47; and Jeremy J. Siegel, *Stocks for the Long Run* (Irwin Professional, 1994).

19. José Piñera, "Empowering Workers: The Privatization of Social Security in Chile," *Cato's Letter #10* (Washington, D.C.: The Cato Institute, 1996).