EDITORIAL COMMENTARY

Going for Baroque

Arcane provisions of tax law drive the abuses of deferred compensation

By THOMAS G. DONLAN
Updated July 14, 2003 12:01 a.m. ET

THE OLD ECONOMY and the New Economy have met in the middle of trouble. General Motors, an ancient company with an aging work force, faced up to some of the $19 billion in pension promises that exceed its pension assets. Microsoft, a visionary company with a young work force, faced up to the economic distortions arising from its use of stock options.

Last month, GM borrowed more than $17 billion in the public markets and said it would put most of the cash proceeds into its pension plans. The car company thus signaled the beginning of the end of an era of legal pension scamming that made it, like hundreds of others with defined-benefit pension plans, seem more profitable and secure than it really is.

With its disavowal of stock options, Microsoft last week faced up to some of the roughly $30 billion of invisible expenses and tax dodges that have helped to make the software company, like hundreds of others excessively relying on stock options, seem more profitable than it really is. It will issue shares of stock, though it will be restricted stock with sales rights vesting over five years.

These actions are a commendable start at repairing huge faults in the corporate economy, old and new. The fundamental fault, however, does not belong to the New Economy or the Old Economy, to Microsoft or General Motors. Both companies and their shareholders fell victim to the perverse provisions and incentives of the U.S. corporate tax code.

The Bush Administration showed some responsibility on the pension side last week with a proposal that might shore up some of the biggest defects in a system that endangers companies, shareholders and workers alike. But neither the administration nor any of its agencies has yet done anything to fix the stock-option problem the government created.

Pension Mess

The American system of employer-sponsored defined-benefit pensions is a mess of corporate finagling and clumsy government regulation. Employers long have been tempted to provide the illusion of deferred compensation without the reality of making payments. Government has tried almost as long to protect workers by setting minimum funding standards and mandating federal pension insurance.

This unstable combination has been inadequate. Even companies approaching bankruptcy have been able to pacify workers and their unions by offering big pension increases. Congress and the regulators have never had the courage to forbid companies with underfunded plans from making new pension promises. Quite the opposite: To protect U.S. Treasury receipts, Congress limited tax-deductible pension contributions.

As the law stands, excessive overfunding is illegal while excessive underfunding is regrettable, and the consequences are everywhere.

During the late lamented stock-market boom, cause and effect chased each other. Rising equity returns tempted fiduciaries to put more pension assets into stocks, while increasing pension investments helped push the stock market higher. Then, the higher the stock market went, the bigger the balance in corporate pension funds, and the less new cash corporations had to tuck away for participants. Since this reduced required pension expense, it boosted reported earnings, and that also pumped the stocks.

From the beginning of 1996 to the end of 2000, the companies in the S&P 500 boosted earnings this way to the tune of more than $300 billion, estimates accounting analyst Jack Ciesielski, an occasional contributor to this page. During that period, the 500 companies reported earnings of $1.6 trillion, so pension fiddling boosted earnings by nearly 20%. (Some of the S&P 500 don't have defined-benefit plans; the earnings distortion at the companies with plans was close to 25%.)

Employers also abused surplus pension assets to pay for other expenses, from unexpected retiree health-care benefit costs to the costs of terminating unneeded employees. They played with their pension rules, converting regular defined-benefit plans to "cash-balance" plans that won't pay out so generously, thus reducing required pension contributions.

When they could get away with it, many employers terminated defined-benefit plans and replaced them with defined-contribution plans, This put all the investment risk on the participants instead of the employers. After paying a federal exit tax, the employers even could recapture some funding surpluses.

Fiddling with investment assumptions made some of these strategies even more lucrative, and created other attractive possibilities. Actuarial calculations of required pension contributions are very complex, but they have one simple dimension: High assumptions about the return on investment of pension assets reduce funding requirements; low assumptions increase funding requirements. During the past 20 years, falling interest rates should have forced companies to adopt lower assumptions about investment returns; most were slow to do it.

Crystal Palace

Some critics are saying that the GM bond is nothing more than a gambler's arbitrage -- borrowing at one rate while hoping the pension funds' investments will earn a higher return. There's something in that, especially when applied to reasonably perpetual institutions like the state of Illinois, which recently issued a $10 billion bond issue of that nature. But corporations frequently don't live as long as human beings. It should be an open question whether GM is going to survive long enough to pay off the bond. If General Motors does succumb, its pensioners will be glad that their plans had cash to invest instead of the company's empty promises.

A British analyst with a gift for finding the perfect word has described the GM strategy as "crystallizing" the company's pension obligation. Just as a crystal seems to come from nowhere out of a super-saturated solution, as if by magic, so GM's bonds have been taken up by a market hungry for yield, as if by magic. Underwriters actually received bids for $30 billion of bonds. Even more appropriately, crystal is wonderfully fragile. Adding $17 billion of debt to a company teetering on the edge of losing its investment-grade ratings is a lot like dropping a wine glass over a hard floor and wondering if it will break.

Microsoft, on the other hand, is under no such strain. The company has more than $50 billion in cash, even after spending $17 billion to buy back stock in the past three years. It can afford to do almost anything to keep its workers happy.

Happy Millionaires

The main thing it has done is make a lot of them millionaires with stock options. On the down side, it has also used stock options to fluff up reported earnings, which of course pushed up the stock price and made the options more lucrative.

Because tax law and accounting principles have missed the boat, granting stock options is not considered an expense, even though it's compensation for labor, and a company gets a tax deduction when an employee cashes in the options, even though the employee pays income tax at that point.

Bill Parish, a financial adviser in Portland, Ore. who wrote an "Other Voices" in April about this and other oddments of Microsoft-style high finance, has calculated that from 1995 to 1999, Microsoft actually would have posted $28 billion of losses instead of $19 billion of profit, had all the tax deductions and labor compensation rolled up in its options been paid in cash. This is not wholly realistic; the employees probably would have worked for a lot less than they actually made. But it's realistic enough that stock options have become a bugaboo of corporate governance, and that Microsoft has responded to the pressure by getting out of the business of issuing stock options.

Correctly so. Stock options have become an over-used tax dodge at many corporations, even though all companies ought to follow Microsoft's basic intent to partly pay all workers with an equity stake. Restricted stock is an improvement, although it may also become an over-used tax dodge.

Tax considerations drive GM, Microsoft and the whole issue of deferred compensation. Perhaps, one day, the people and government of the U.S. will see the corporate income tax for the unequal and inefficient sales tax that it really is. Perhaps they will one day see that taxing individual savings is an enormous drag on economic growth and that deferred-compensation schemes are inadequate substitutes.

To fix these problems, we need tax reform to replace our foolish income-tax system with a value-added tax on business and a consumption tax on individuals.

Editorial Page Editor Thomas G. Donlan receives e-mail at tg.donlan@barrons.com