

## **Interview with Professor Stanford M. Jacoby of UCLA, Special Associate Editor of JJAS**

**Professor Hoshino:** Would you talk about your recent interesting topic, corporate governance in the US?

**Professor Jacoby:** Governor Schwarzenegger of California has a plan to go the voters in November and ask them to approve a change in pension plans in California essentially convert the public employee pension to a defined contribution plan. And that would mean effectively the end of CalPERS, and it would gradually disappear over time.

And I think an important reason he's trying to do this is budgetary. It's less expensive and less risky to have a defined contribution plan. And a secondary reason, not as important but still a reason is that there are some business people who've been complaining to Schwarzenegger, that CalPERS is too involved in business activities. There is a big supermarket strike in California, here in southern California last year. The head of the board of CalPERS, a man called Sean Harrigan who came from a union background, spoke out during the strike and complained about one of the grocery companies and he said we won't buy stock in your companies, you are not behaving properly during this strike. And many people in the community felt that CalPERS stepped over the line. That it's ok for CalPERS to talk to companies about corporate governance and problems with their profitability, but it's not ok to become involved in a labor management dispute. And this man Sean Harrigan was forced out from the presidency of CalPERS. But even so there are some people in the business community who would be very happy to see CalPERS disappear. So it is a very interesting time, CalPERS has a very different face in California, in the United States, than it does in Japan. In Japan, CalPERS is seen as the symbol of the American style of corporate governance and share holder value. But in the United States sometimes, and especially in the last few years, CalPERS is seen as representing a kind of socially responsible investment orientation. Putting a lot of money into low income community investments, they become involved in the supermarket strike, they refuse

to put money in certain countries that are considered authoritarian and not democratic and so on. So there is this way in which CalPERS has two faces. The face you see in Japan and the face you see in California. But in both countries, the business community does not like CalPERS. They don't like CalPERS.

Earlier in the 90s, CalPERS was more focused on corporate governance issues here in the United States. In the last few years it has become more political and more activist in a socially responsible, or some would say socially irresponsible, way and this brings us to the third reason that Schwarzenegger is trying to terminate CalPERS. Schwarzenegger wants to run for governor again. His main opponent probably would be a man called Phil Angelides. Phil Angelides is the treasurer of the State of California and because he is the treasurer, he also serves on the board of CalPERS, and he has said he would like to run for governor against Schwarzenegger in 2006.

And I think Schwarzenegger would like to take away some of his power and also criticize the policies that Angelides has been the champion of at CalPERS. Angelides is the man that has pushed very hard to make CalPERS more social-issue-oriented in the last 3 or 4 years. By hurting CalPERS Schwarzenegger hurts Angelides. By hurting Angelides, he makes him a less threatening opponent in the coming election. So it's interesting economics and interesting politics. Unfortunately a lot of the discussion about the future of CalPERS concerns political issues and the level of economic analysis is pretty low.

For example, whether it's a good idea or not to have a defined benefit plan for government workers, is never discussed. It is assumed that the argument is made. Well private sector employers are converting from defined benefit to defined contribution plans. So California government should do the same, maybe yes, maybe no. If you believe the ideas of Edward Lazear, a Stanford economist, sometimes there are good economic reasons to have a defined benefit pension plan. It's a very effective way to force people to retire, and government jobs are the kind of jobs that people work in for a long time. They're good jobs, they offer a lot of security. And at some point you want people to leave. And a defined benefit plan is calculated in such a way that when you are to 60 to 65, it make sense to retire. You would be a

fool to not. Because if you stay longer you will not receive as much benefit.

**Professor Hoshino:** Even in the United States you say 65. I thought there is no retirement age in the United States. And recently I saw an article, by Peter Drucker, he's still professor at Claremont Graduate School, which is close to this campus. Maybe one hour.

**Professor Jacoby:** One hour, one hour. He is 85.

**Professor Hoshino:** No 95 years old.

**Professor Jacoby:** 95!

**Professor Hoshino:** Yes I checked. Maybe 96. I don't know the exact day and month, but this year he will be 95.

**Professor Jacoby:** This is the Lazear point. If you can not fire all the workers, how do you get them to retire? You can't fire them. So what to do? Well one thing that you do is you have a pension plan that has a sweet spot. We say a sweet spot like in tennis. You know a tennis racket is designed there is a certain place where it's best to hit the ball. Well the way pension plans are designed there is a certain number of years of service in the age formula, so that some where in the region of 60 to 65 years old or 30 to 35 years old of service, it makes economic sense to retire. Because you will not have any more pension benefits.

**Professor Hoshino:** Could you give us some examples. Say the age average of the professors that retire, after working 35 years.

**Professor Jacoby:** The interesting thing is there are two types of professors in public universities in California. There is the California state university system, like Cal State LA. And those professors are covered by CalPERS. Their pension comes from CalPERS. They are public employees, and their pension fund is CalPERS. University of California professors have their own pension plan, also defined benefit plan called university of California retirement system UCRS. But the ideas are very similar. In both, CalPERS and UCRS plan there is a

complicated formula for determining your retirement benefit that includes both your age and the number of years of service that you have, which of course are highly correlated. And the optimal time for retirement, if you want to get a large pension, is some time in your mid 60s. That's when most people retire, that's also when you're eligible to collect social security, the government basic minimum pension from the federal government. Most professors retire somewhere between 60 and 67. Of course there are some professors for whom work is not a disutility but instead it gives them utility and they prefer to continue working as long as they can. The expression is they die with their boots on. Boots that you wear like when you ride a horse or you work. So they will die in their office. This creates a problem, because you can't fire them. The incentive to retire from the pension plan is clearly not enough for them to stop working, so the University of California realized, we might have a problem here, with older faculty who don't want to stop teaching, don't want to stop coming in to work every day. How do we get them to retire if they start to become senile, not completely mentally competent any more. What do we do?

So a few years ago, the university developed a new policy for determining if a professor is demonstrably incompetent, that's the phrase which is used. And if after following the procedure, there is an investigation and a report is written. If it's determined that the professor is demonstrably incompetent then he can be dismissed, he can be fired.

As far as I know, this is not happened yet. But there are some university administrators who are worried about professors that might stay too long, and much longer than they should be. Usually that doesn't happen. Of course when the age discrimination law was first written, in the United States, they had an exemption for university professors and they allowed universities to force retirement of university professors at the age of 65 or 70. That exemption no longer exists. So university professors can not be forced out simply on the basis of age.

But for most people, work is a disutility, and that's the economist's perspective and generally, I think it's correct. And so the employer does give us a tool of human resource management when the employer shifts from define benefits to define contribution plan. It's

harder to encourage people to leave. As labor mobility increases in the private sector, you don't see people working for long periods of time for a single company, as much as it used to. You don't see the Japanese pattern anymore. So it's not as difficult as it used to be to have people leave. People are coming and going all the time, even older workers. But the public sector is different. There people do work for life, there is kind of permanent employment, and you say in Nihongo, Syusin Koyou. So similar in the public sector.

**Professor Hoshino:** But there is a retirement age, not all life.

**Professor Jacoby:** Yes not all life. The same in the government in the United States. And then pension helps to take people out. It's calculated, so that when you are around 60 or 65, if you're rational and you say, I will retire now, because if I work another year I will not get more pension benefits. So the pension gradually increases and then suddenly it goes up in the early 60s and then it stops.

**Professor Hoshino:** But if you work longer then you will get more.

**Professor Jacoby:** No.

**Professor Hoshino:** I mean the total amount of money you receive.

**Professor Jacoby:** No, you will get more but a declining rate.

**Professor Hoshino:** The rate is declining but the amount itself.

**Professor Jacoby:** The steps become very small. So it's pretty flat until you're in your early 60s and then it goes up significantly and then it stops and then it goes up just a little bit. And you say, wow, if I work another year my pension is going to go up only 3 dollars a month it's not worth it, I should stop now.

But with the defined contribution, it doesn't work like that. You can't create that incentive to retire. So my feeling is if you take the politics out of it and you talk to

the managers in California. What would they say? Would they say they want defined benefits or defined contribution? Of course nobody is asking them, it's becoming a political dispute. And finally the fourth element that I didn't mention is that it's possible that Schwarzenegger would run for president. Of course the Constitution would have to be changed, to permit him to run for president. Because he was born in Austria, he was not born in the United States. He was born in Austria.

**Professor Hoshino:** The same as Drucker.

**Professor Jacoby:** I think so, yes. But Drucker was born much earlier.

**Professor Hoshino:** Yes much earlier.

**Professor Jacoby:** And so Schwarzenegger wants to create a good image for himself in the Republican Party. Of course what is Bush is trying to do right now with Social Security, he is trying to convert Social Security essentially to defined contribution type plan with a individual accounts. And so if Schwarzenegger is successful in terminating CalPERS he can say to Republicans in the United States, look I did the same thing in California that President Bush is trying to do with Social Security for the entire United States. And it would help his popularity. And he can also say that he has the same philosophy as the President. There are some Republicans that are suspicious of Schwarzenegger they think he's in the middle of the road, that he's not conservative enough. This is the way to show that his ideas and the ideas of the President are aligned, the same ideas. Ownership society, people will have responsibility for their retirement. Not the state, not the company but the individual. Bush wants to do it through individual accounts for Social Security, Schwarzenegger wants to do it for public employees in California through defined contribution pension plan that each employee would manage on their own.

So those are some other reasons behind the proposal by the governor to terminate CalPERS. Of course the voters will decide in November. In California we have a peculiar system of allowing voters to decide major political issues, it's called the proposition system. And, a lot of money

will be spent, by the opponents and the proponents of this idea between now and November, hundreds of millions of dollars. And we will see, it will be very interesting. And if Schwarzenegger is successful this will make a big change in the world of institutional investing. Because no longer will the large public employee pension funds be able to swing their weight to exercise voice with companies, whether in the United States or in Japan or in Europe. You will no longer have these big blocks of capital that are controlled by a large pension fund. Instead the money will be in mutual funds and the mutual funds are much less activist than the pension funds. So it would be a big change.

Of course Japan is trying, there is legislation for converting defined benefit pension plans to defined contribution that was adopted in 2001, but as far as I know this is in the private sector in Japan. Most companies have not adopted defined contribution plans.

**Professor Hoshino:** The 401?

**Professor Jacoby:** Yes, I think I saw a figure, maybe about 3 billion dollars in 401s, which is not a lot of money. Yes when I say defined contribution I mean 401. Although it has a different number if you work in public sector, but it is the same idea, 401.