# Pension Security
## Has ERISA Had Any Effect?

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CONGRESS enacted the Employee Retirement Income Security Act (ERISA) in 1974 to reduce the long-term risk inherent in private pensions. Advertised as a major piece of worker-protection legislation, it was designed to convert pensions from conditional promises into the equivalent of wages. The law reflects the notion that workers pay for their pensions, either directly through contributions or indirectly through wages forgone, and should be entitled to the full value of their pensions when they retire or leave the firm.

ERISA's genesis was the common view that fraud was a pervasive problem in the pension market: firms reduced wages in exchange for pension promises, then failed to honor these obligations. The two central provisions of ERISA are the requirements that pensions vest after 10 years of service and that pension plan sponsors be covered by federal pension insurance.

This article summarizes the results of a study I recently completed which considers whether the underlying premise of ERISA is valid—that fraud was an important problem before the enactment of ERISA—and whether ERISA materially changed the pension contract to remove the potential for fraud. I also consider the broader economic effects of ERISA and identify the gainers and losers under the legislation.

A careful look at the pertinent pension and labor market data shows no indication that fraud was, or is, an important feature of the pension market. There is no evidence that older workers were routinely laid off or fired before vesting. Nor is there evidence that termination of pension plans or default were anything other than rare events. Moreover, it is difficult to uncover any convincing evidence that the real purpose of ERISA was to eliminate pension fraud. Certainly, the potential for fraud—if it was a problem—continues to exist under ERISA. The main impact of ERISA appears to have been a transfer of several billion dollars from the majority of pension plan participants, who are covered by well-funded pension plans, to a minority of participants, who are covered by underfunded plans in dying firms.

### Defined Contribution vs. Defined Benefit

In considering the potential for pension fraud, it is important to distinguish between the two kinds of pension plans: defined contribution plans and defined benefit plans. In a defined contribution pension plan, the firm deposits a portion of wages into each worker's account each year. After short vesting periods (usually three to five years), the account belongs to the worker,

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even if he leaves the firm. Concerns about the security of long-term pension promises do not generally arise.

Most pension participants are covered by defined benefit pension plans. In these plans, the firm promises the worker an annuity upon retirement, usually in proportion to final wages and years of service. The worker has a claim to promised benefits that is conditional on meeting the firm's vesting standard and on the firm continuing to operate the pension plan. Workers do not own pension assets as such. It is the defined benefit plan, therefore, that is the focus of ERISA.

Eighty percent of the 40 million workers covered by private pension plans are covered primarily by defined benefit plans. These plans account for two-thirds of the $1.5 trillion in private pension assets.

## Pension Security before ERISA

An underlying premise of ERISA is that firms routinely laid off or fired older workers so as to renege on pension obligations. If this is true, three things should follow. First, by making pensions payable to long-service employees whether or not they stay with the firm, ERISA's vesting requirement should have substantially reduced the number of late-age separations. The data, however, show that ERISA has had no significant impact on the layoff or firing of workers covered by private pensions. The probability of a late-age layoff or firing before ERISA was *lower* among pension-covered workers than among non-pension-covered workers, and it still is.

Second, ERISA's vesting requirement should have increased the probability that a pension-covered worker actually received a pension upon retirement. There is no evidence that it has, however. Among pension-covered workers aged 59 to 63, for example, the probability of receiving a pension upon retirement was about 85 percent before ERISA. ERISA has had no effect on this probability.

Finally, the enactment of ERISA should have caused firms to terminate defined benefit pension plans to prevent any transfer of pension wealth from shareholders to workers. The termination data, however, offer little support for this hypothesis. First, there is no indication that terminations were an important problem prior to ERISA. During the period 1950 to 1974, the cumulative probability that a pension participant would find himself in a terminated plan during any 10-year period was just 1 in 100. Second, there is no evidence of any unusual termination activity in the year or two prior to the enactment of ERISA. Third, while the evidence shows some increase in terminations after ERISA, these terminations affected only a very small number (no more than 3 in 1,000) of participants in defined benefit plans. This is an important finding in light of the fact that ERISA increased the cost of operating pension plans and, as discussed below, actually made it profitable for some firms to terminate their plans.

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There is an additional way to test the integrity of the pension contract before ERISA. If, over time, workers discovered that they essentially were paying for false promises (that is, they observed late-age layoffs and pension terminations with significant or increasing frequency), there should have been a shift toward more secure, defined contribution plans. Yet, there is no evidence that the share of pension coverage accounted for by defined contribution plans was increasing in any important way during the period preceding the enactment of ERISA.

## Potential for Pension Losses after ERISA

If firms were intent on depriving unsuspecting workers of the full value of their pensions, could they successfully pursue this strategy under ERISA? The answer is yes. Pension contracts are virtually always written either explicitly or implicitly in real terms: pension benefits are related to wage levels in the worker's final years with the firm. (A typical plan, for example, might award a benefit equal to 1 percent for each year of service, multiplied by the average of the three highest wage years.) Yet, ERISA vests nominal benefits. This means that workers can still bear large losses if fired at inopportune times.

To see this, suppose a 54-year-old worker earns $10,000 per year. With expected wage growth of 8 percent annually (roughly the

experience in the 1970s), his salary at age 65 would be $24,000. If the worker stays with the firm until retirement, his service would be indexed to a final salary of $24,000 to determine his pension. If, on the other hand, he is fired or laid off at age 54, his pension would be indexed to his current salary of $10,000, even though pension payments would actually begin at age 65. If he gives up cash wages in anticipation of receiving a pension indexed to wages at age 65, the layoff at age 54 would translate into a reduction in accumulated pension savings of roughly 60 percent. Using various separation ages and rates of wage growth, it can be shown that the magnitude of potential pension losses is large; workers can easily lose over half the value of their pensions and, in some cases, virtually the entire amount.

With ERISA's vesting rules written in nominal terms, they do little to prevent the kinds of inequities that purportedly existed prior to the law. Had ERISA been intended to eliminate these inequities, the rules could easily have been written to require firms to vest real benefits, that is, to index benefits to changes in prices or wages. But there is no requirement for indexing and, absent evidence of real abuses, there is no reason to add one.

**Do Firms Exploit Their Legal Rights?** As indicated above, the evidence does not support the notion that older workers were fired prior to vesting at late ages. The possibility remains, however, that workers were vested at younger ages but were fired prior to retirement age, thereby absorbing large pension losses like those described above. The data offer no support for this hypothesis: in a large sample of workers with 20 or more years of service, only 1 percent had left their firms prior to the earliest permissible retirement age, and this figure includes people who had left voluntarily. The cheating of long-service workers, to the extent it existed at all, was a rare event indeed.

### Potential for Company-wide Pension Losses

Just as individual workers bear pension losses if fired, a company's entire work force bears losses if the pension plan is terminated. This is because at the time of termination, workers become vested (a rule previously enforced through the Internal Revenue Code) and benefits are frozen in nominal terms. That is, legal benefits are equal to nominal, not real, benefits. Terminations therefore cause precisely the same losses for workers as discussed above.

To illustrate the magnitude of these losses, I calculated the average portion of real pension benefits that would be preserved upon termination of the typical pension plan over the period 1950 to 1983. As a result of increasing inflation rates, the portion of preserved benefits has been falling more-or-less continually since 1960. Whereas in 1960 the termination of a pension plan would have cost workers roughly 25 percent of their pension wealth, in 1980 it would have cost them 60 percent. In general, workers' susceptibility to terminations is much greater now than it was before ERISA.

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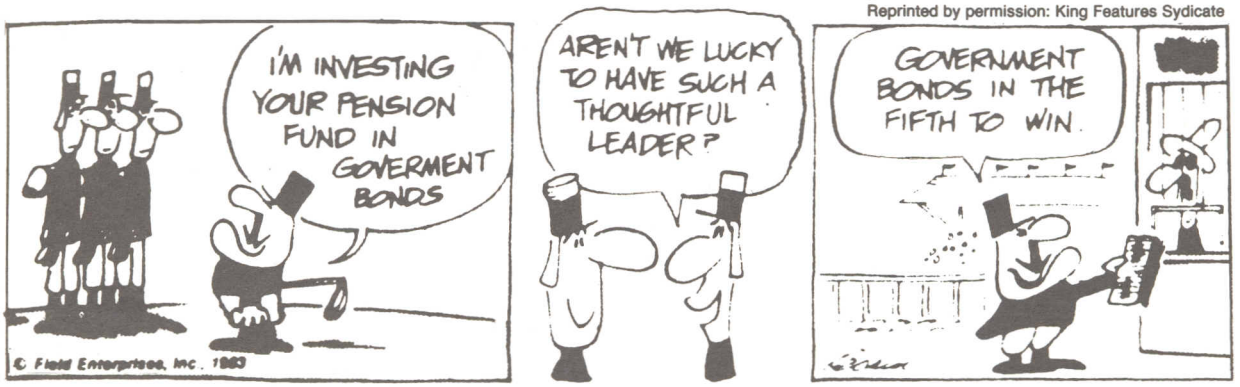


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The potential aggregate loss from pension terminations is huge. In 1982, for example, the assets of defined benefit pension plans exceeded the legal liabilities of these plans by $248 billion; the real or economic value of pensions exceeded legal liabilities by $317 billion. This means that if all defined benefit pension plans had been terminated in 1982, stockholders could have pocketed $248 billion in cash—the amount of legal excess assets—while canceling $317 billion in pension promises. Terminations such as these are legal.

**Do Firms Exploit Their Legal Rights?** Stockholders have not taken advantage of the opportunities under ERISA to profit from pension plan termination. Occasionally firms terminate pension plans to gain access to the legal excess assets. (ERISA prohibits direct withdrawals.) From 1979 through 1986, a total of $16 billion was taken in this way. In virtually all of these cases, however, the firms engaged in legal transactions that went beyond the requirements of the law. Capital losses to workers from plan terminations were generally offset by increased benefits in newly created plans, and real pension benefits were protected.

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These data do not suggest altruism on the part of firms, but rather an incentive among firms to maintain their reputations in labor markets. This appears to be a sufficiently strong incentive to enforce contracts for benefits that are more generous than those legally required. Thus, it is hard to make the case that regulation is required to improve the functioning of the pension market.

## Providing Insurance or Transferring Wealth?

The evidence offers little support for the notion that fraud was an important problem in the pension market in the sense of firms firing older workers or terminating pension plans at opportune times. Even if it had been a problem, ERISA, as written, would not have remedied it. ERISA could have required pensions to be indexed to wages at retirement age or it could have made pension plan trusts irrevocable up to the amount of real pension liabilities. It does neither.

Despite the rhetoric surrounding the enactment of ERISA, perhaps the real motivation behind the legislation was to provide insurance against pension default, not fraud. Perhaps the purpose of ERISA was to insure against an unacceptable level of risk of failure among firms with underfunded pension plans.

Prior to ERISA, workers in a failed firm were entitled to the assets in the pension plan or nominal pension benefits, whichever was lower. If the plan had zero assets, for example, the failure of the firm caused workers to lose *all* benefits, not just the difference between real and nominal benefits. ERISA created a federal insurance program to guarantee payment of nominal benefits regardless of a pension plan's funding ratio (the ratio of assets in the trust fund to pension liabilities). Pension insurance is offered by the Pension Benefit Guaranty Corporation (PBGC). The insurance pool is funded by premiums levied on plan sponsors in relation to the number of plan participants.

The PBGC is not a bona fide insurance company, as evidenced by several factors:

- *The premium is not economic.* The current PBGC premium is $8.50 per participant. Based on past claims, the flat-rate premium required to pay for the expected claims flow is at least $50. The PBGC deficit, which is measured as liabilities accepted minus assets on hand, is $4 billion.
- *Premiums are not risk related.* Plans that are 300 percent funded, in healthy firms and growing industries, pay the same premiums as plans that are 10 percent funded in dying industries.
- *Firms hold "put" options against the PBGC.* A troubled firm can terminate its pension plan and "put" its underfunded pension liability to the PBGC in exchange for 30 percent of its net worth. The Single Employer Pension Plan Act of 1986 made this option less valuable, but only for some firms.
- *Firms can obtain funding waivers at will.* Firms that are experiencing financial difficulty can obtain permission to set contributions to the plan to zero for any 5 out of 15 years.
- *Firms can deteriorate funding levels.* Even without waivers, minimum funding rules do not prevent firms from reducing

funding levels during years immediately preceding plan termination.

• *Participation is mandatory.* Large, healthy firms with well-funded pension plans—which pay most of the premiums—are forced to participate when they could self-insure or buy private insurance at lower rates.

No bona fide insurance company would exhibit these characteristics. At virtually no cost, troubled firms can essentially determine the timing and magnitude of the insurable event, pension default. That Congress did not leave the insurance function to the private market suggests that it intended to use the PBGC to redistribute pension wealth.

**Who Benefits from the Transfers?** The beneficiaries of pension insurance are easy to identify. They are unionized workers in dying industries. Plans covering union workers have significantly lower funding ratios than those covering nonunion workers—by about 30 percentage points. In fact, virtually all systematic underfunding in private pension plans occurs in plans covering union workers. These plans also have a significantly higher chance of failing. Based on a sample of plans in the period 1978 to 1983, the probability of failure for plans covering union workers was six times higher than the probability for plans covering nonunion workers.

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The data also show that as a result of underfunding and poor financial performance, plans covering union workers receive a disproportionate share of PBGC transfers. Over the period 1978 to 1983, the probability that a plan covering union workers received a transfer was two-and-a-half times higher than the probability for a plan covering nonunion workers. Union workers, who account for roughly one-third of pension participants, are the beneficiaries of 95 percent of all claims against the PBGC. Fully 63 percent of the claims are attributable to participants covered by the United Auto Workers and the Steelworkers of America, two of the most vocal supporters of ERISA insurance.

From an economic perspective, it is possible to explain why pension plans covering union workers might have been systematically underfunded and why they have had unusually high failure rates over the years. Organized as a group through a union, workers pose an economic threat to the shareholders of firms. This is particularly true if the shareholders must invest in specialized durable capital, such as heavy machinery usable only in, say, steel production. Once such an investment is made, union workers can appropriate a portion of the returns to capital by raising their wage demands.

**By supporting a government regulation that guarantees a portion of pension benefits, unionized workers can extract noncompetitve wages and still collect a substantial portion of their pensions.**

Faced with this dilemma, shareholders would be reluctant to make investments in unionized firms that require large, nontransferable capital expenditures. Production processes involving specialized, durable investments do not make economic sense unless opportunistic behavior by organized workers can be controlled. Before ERISA, the underfunding of pension plans was one such control mechanism. If the union tried to capture some of the returns to capital by raising wages, shareholders could threaten to abandon the firm, thereby imposing large pension losses on workers. By underfunding pensions, the firm gave unionized workers a stake in its long-term viability. The prospect of pension losses upon firm failure helped discipline union wage demands throughout the period of investment. There is substantial evidence that supports the notion that underfunded pension plans provide the economic function of bonding unionized workers against an opportunistic "hold up" of shareholders.

From this perspective, it is clear why unionized pension participants would support ERISA insurance. By supporting a government regulation that guarantees a portion of pension benefits, unionized workers can extract noncompetitive wages and still collect a substantial portion of their pensions. Some unions that had disregarded the consequences of high-wage policies (failure of the firm and loss of pensions) could

now reclaim the pensions they were about to lose; other unions could raise their wage demands without fear of losing their pensions. ERISA offered some unionized workers, on a one-time basis, substantial economic rents.

**Who Pays for the Transfers?** These transfers are paid for by participants in the vast majority of pension plans that are stable and well funded. The cost of these transfers is gradually becoming apparent as the PBGC's deficits accumulate.

It is interesting to consider the PBGC's implicit tax scheme in light of the stated goals of ERISA. Underlying ERISA and its legislative history is the idea that workers can suffer large losses if a firm makes pension promises without proper funding. If the intent of ERISA was to prevent this activity, it could have assessed liabilities directly against owners of the firm; for example, it could have tightened funding standards or changed the bankruptcy laws. (Underfunded pensions, unlike wages, are treated as unsecured liabilities in a bankruptcy; only about 10 percent of such commitments are paid.) Instead, ERISA taxes workers in some firms to offset the deficiency in pension contributions by shareholders or workers in other firms.

## Economic Distortions

Aside from transferring wealth to some union workers, ERISA's system of pension insurance undermines long-term economic efficiency. The system reduces the incentive of unions in troubled firms or industries to reduce wage demands, making capital investments less attractive than they otherwise would be. At the same time, it allows firms with a higher probability of failure to offer deferred wages that are paid, in part, by the PBGC. In effect, the government subsidizes wages in failing firms, artificially prolonging the economic life of inefficient firms at the expense of efficient firms.

The system also has adverse effects on pensions. Risky investment or funding strategies are encouraged since large losses are covered for free by the federal insurance program. In addition, new successful firms are discouraged from establishing defined benefit plans because these plans carry an implicit—and growing—liability in the form of future expected taxes to retire the PBGC deficit. Unsuccessful firms are encouraged to switch from defined contribution to defined benefit plans to take advantage of the expected wage subsidy. The current policy thus distorts firms' choices among pension contracts, and at the same time, creates a self-selection problem for the PBGC (that is, the PBGC is likely to find that a disproportionate share of the plans it covers are high risk plans).

## How to Fix the System

The security and efficiency of private pensions would be improved by eliminating federal pension insurance and repealing other key ERISA regulations. Given that a subsidy system is in effect, however, it is unlikely that Congress will simply abandon the current system. Any action that reduces expected transfers will trigger a strong reaction, especially from firms in the front of the queue for transfers. Listed below are several options for gradually improving the efficiency of pension insurance while leaving intact the PBGC and some of its transfers.

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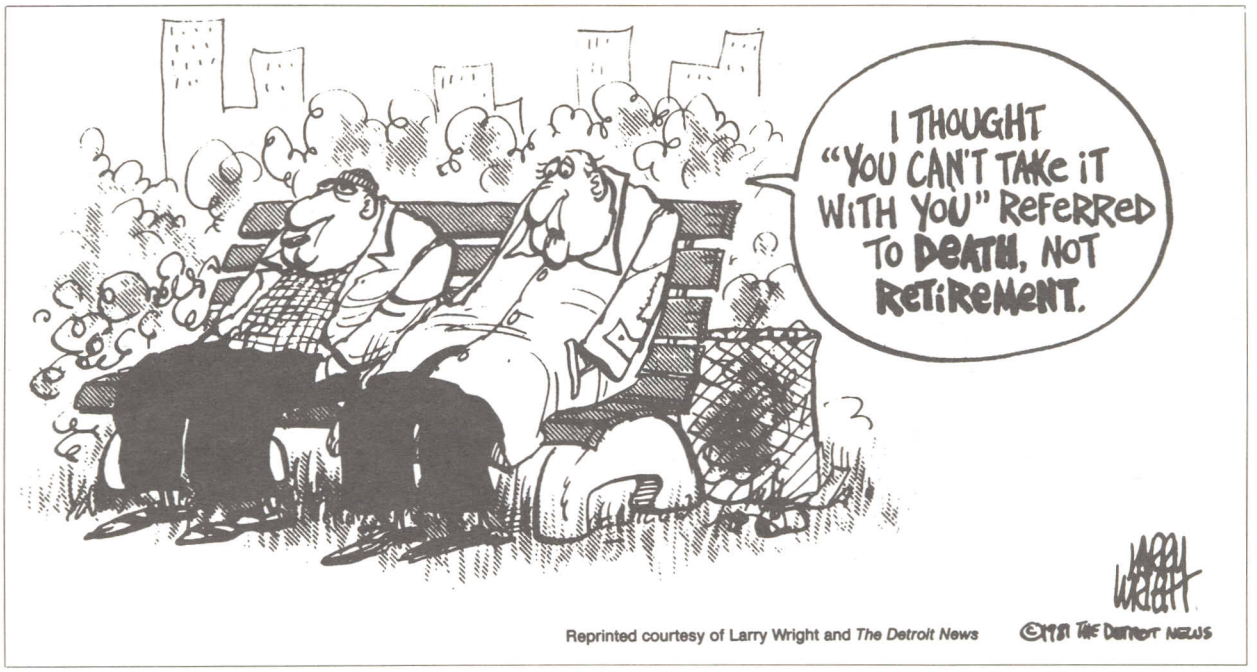
**Exempt New Plans.** One easy step would be to freeze PBGC coverage for existing defined benefit plans. This would remove the prospect of large PBGC tax increases for new firms, and thereby eliminate the disincentive for these firms to establish defined benefit plans. At the same time, it would eliminate the incentive for other firms to establish defined benefit plans with the purpose of "gaming" the PBGC.

For new pension plans, efficiency would be enhanced by eliminating any insurance requirement. Plan sponsors could be permitted to choose funding levels and pension insurance protection depending upon the market conditions they face. This policy could be combined with a requirement of full disclosure of pertinent financial information to workers. The next-best solution would be to require plan sponsors to purchase coverage through private insurance companies, with no accompanying regulation of insurance prices.




**Charge Economic Premiums.** Another step would be to set the PBGC premium at a level which is sufficient to cover the true cost of the public insurance. This would translate into an increase in the flat-rate premium to at least $50. Thereafter, the premium should be adjusted automatically to reflect claims experience. Such a policy would inform pension plan sponsors of the true cost of the insurance, and this, in turn, would build support for desirable reforms.

**Change the Minimum Funding Standard.** Currently, minimum funding rules are so liberal that firms which anticipate taking advantage of the federal insurance system can maintain low funding levels indefinitely. Moreover, by simply changing actuarial assumptions, firms can reduce funding levels at will. Federal rules give firms virtual control over their exposure to the insurance system. These rules should be rewritten to require firms to calculate their pension underfunding on a standardized basis, and to amortize these obligations over a horizon shorter than the current 30 years. This would have the effect of gradually forcing all underfunded pension plans to reduce their exposure to the PBGC. The U.S. Department of Labor has submitted a legislative proposal to Congress that essentially would accomplish this purpose.

**Change the Insurable Amount.** Above and beyond maintaining large exposure levels, firms can increase benefits and accumulate huge additional net claims on the PBGC while waiting in queue for transfers. The PBGC guarantees benefits except for some increases in the five years prior to termination (benefit increases are phased in 20 percent per year until they are 100 percent guaranteed). In addition, the Internal Revenue Service grants contribution waivers to firms that are in economic distress. Thus, for example, five years from termination, the firm can increase benefits, then obtain premium waivers from the IRS for the next five years. Moreover, firms can create "shutdown" benefits (additional pension benefits in the event of firm failure) which are not required to be funded.

**By simply changing actuarial assumptions, firms can reduce funding levels at will.**

To solve these problems, several steps could be taken. First, funding waivers should not be given without obtaining collateral. Second, the rules about guaranteed benefits should be changed. No benefits which are payable only upon firm failure should be guaranteed; more generally, benefits which are not recognized in the minimum funding rules should not be eligible for PBGC insurance. Third, reductions in funding levels during the five years preceding a

termination, other than those attributable to changes in the market value of the average asset allocation held by all pensions, should not be covered by the insurance company.

**Base Premiums on Risk.** An alternative to strict funding rules is to impose risk-related premiums; that is, premiums based on the risk of pension plan failure, which is a function of both the size of unfunded pension liabilities and the risk of firm failure. Firms would then bear the full cost of any decisions that threatened the solvency of their pension plans.

The PBGC has submitted legislation to Congress that would establish a rate system based on the amount of underfunding. Rates would be capped, however, and would not incorporate the risk of default, separate from exposure.

**Change the Bankruptcy Laws.** Pensions could be made the equivalent of wages in bankruptcy proceedings. This would give commercial lenders an immediate stake in the magnitude and security of pension promises; their concern would be manifest in the rates charged for ordinary loans. Such a change could be made prospectively by limiting its applicability to underfunding after a particular date.

## A Feasible Way to Eliminate the PBGC

Implementation of any one of these policies would substantially reduce the inefficiencies in the pension insurance system. The problem generally is that these solutions would take a long time to become fully effective.

Another approach would be to simply eliminate the PBGC, while retaining a sufficient portion of expected transfers to make the change politically feasible. This could be done by requiring termination of pension plans as of some announced date as a condition for PBGC coverage. Pension promises outstanding at the time of termination would be vested in nominal terms and guaranteed by the PBGC, as under present law, while new pension promises, including indexation of terminated benefits to future wages, would accrue under the new pension plans. All continuing plans either would be exempt from insurance coverage or would be required to purchase insurance at market rates in the private sector. Minimum funding rules would continue to apply to the terminated plans. This approach would retain some transfers to firms now in queue, but would prevent these firms from building further claims. Owing to inflation, the real value of outstanding claims against the PBGC would erode over time.

At the time the terminations occurred, a calculation of expected payouts could be made. A lump-sum tax applied to all participants in defined benefit plans could then be assessed to pay for these remaining transfers. Since the transfer scheme would be limited through the termination procedure, the lump-sum tax would be considerably smaller than the present value of the tax implied by continuation of the current system. In return for this "exit fee," all plan sponsors would be separated from the PBGC.

As a final step, the PBGC should use its exit fees to purchase annuities from private insurance companies for all liabilities already assumed and for liabilities accepted during the phasedown period. This would ensure an orderly transfer of all remaining PBGC functions to the private sector.

## Conclusions

ERISA appears to provide a classic regulatory problem. The legislation was ostensibly enacted to reduce fraud in pension contracts—and thereby improve the security of private pensions—yet there is no evidence that fraud was an important problem. Moreover, the way in which the regulations were written virtually ensured that pension fraud, even if it were a problem, would be unaffected. What the regulations succeed in doing is transferring billions of dollars from the majority of workers to a favored few in failing firms. These transfers and the tax scheme to pay for them have created potentially serious economic distortions that were not present prior to ERISA. In short, ERISA has not enhanced the security of private pensions, and it may be seriously eroding the defined benefit pension system it was designed to protect. ■

**Selected Readings**

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