Private Pensions in Crisis: The Case for Radical Reform

by

Edward J. Harpham

The University of Texas at Dallas

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National Center for Policy Analysis
12655 North Central Expressway, Suite 720
Dallas, Texas 75243
(972) 386-6272

PRIVATE PENSIONS IN CRISIS

EXECUTIVE SUMMARY

The American private pension industry is in crisis. Although this crisis arises in the private sector of the economy, it is not the result of voluntary exchange in the free marketplace. It is instead a crisis created by federal government policies.

Federal tax and labor laws have encouraged companies to adopt a particular type of pension plan called a **defined-benefit** plan. Under defined-benefit plans, employers promise to pay a monthly, fixed sum of money to workers once they retire. The size of the pension is related to the number of years of employment, and workers frequently lose their pension benefits if they change jobs.

This type of pension plan makes sense in a labor market where employees work for the same employer for their entire working lives, and where the employer remains a viable, profitable entity for this entire length of time. The reality of the U.S. labor market is a different story, however. In a dynamic, capitalist economy, companies rise and fall. In a highly mobile labor market, workers change jobs frequently over the course of a career.

Defined-benefit pension plans also have other problems. The 36 million workers covered by these plans bear most of the down-side risks, but rarely get any up-side benefits. If things turn sour because investments perform poorly or the company faces financial trouble, workers risk losing some or all of their promised pension benefits. But if things go better than expected and pension funds swell, employers often have ways of capturing the excess assets for themselves at the workers' expense. Moreover, because pension fund money usually is under the control of corporate managers or union officials, all too often these funds fall victim to corporate and union shenanigans which are not in the best interest of the workers.

To deal with the problems of the defined-benefit pension system, the federal government created a pension insurance program. This program has only made things worse. Companies with healthy pension plans are rushing to terminate them. Companies in financial trouble are finding ways to dump their pension obligations on the federal government. Unless this trend is reversed, we may create a nightmare comparable to Social Security--a future in which millions of workers look to the taxpayer to make good on pension promises.

A different type of pension plan is available to employees of most private colleges and universities. Under these plans, pension funds are placed in a trust independent of unions or management. The funds are secure in the event of employer bankruptcy, and workers carry their pension rights with them when they change jobs.

This pension system could become the model for the rest of the private sector to follow. But, it will require major changes in federal government policy.

PRIVATE PENSIONS IN CRISIS: THE CASE FOR RADICAL REFORM

The American private pension industry is in crisis. The crisis is not a temporary phenomenon confined to a few companies that face financial troubles. It is a crisis which is a permanent part of the economic landscape -- one which threatens the economic health of all major corporations and the retirement security of their workers.

Although this crisis arises in the private sector of the economy, it is not the natural and inevitable result of voluntary exchange in the free marketplace. It is instead a crisis created by federal government policies. The crisis can be ended only by changing the policies which give rise to it. This will require radical reform.

A TALE OF TWO PENSION SYSTEMS

The crisis in the American private pension industry can best be understood by considering two radically different types of pension plans: One is dominant in the for-profit sector of the economy and while the other is most common among non-profit educational institutions.

In the for-profit sector of the economy, the most prevalent type of pension plan is, as far as the ordinary worker is concerned, a "heads-I-win-tails-you-lose" plan. In this system, workers bear most of the down-side risks, but rarely get any up-side benefits. If things turn sour because investments perform poorly or the company gets in financial trouble, workers run the risk of losing some or all of their promised pension benefits. But if things go well and pension funds accumulate surplus assets, employers have ways of capturing the excess for themselves at the workers' expense. The defects of this system are made visible by the parade of headlines in our daily newspapers -- headlines which are appearing with increasing frequency.

A very different picture emerges among the pension plans of non-profit, higher educational institutions. The pension system which dominates this sector is virtually unknown except to those who participate in it. Unlike the other pension system, the reason why these plans get so little newspaper attention is precisely because they work so well.

A PENSION SYSTEM THAT WORKS

Employees at most non-profit educational institutions participate in a unique pension system. Under the plan, employees and their employers contribute to independent pension funds which make investments on the workers' behalf. By far the largest of these is the Teachers Insurance and Annuity

Association -- College Retirement Equities Fund, or TIAA-CREF. With about $25 billion in assets, the fund manages pension money for almost 800,000 people associated with over 3,400 educational institutions. These include most private colleges and universities, and research institutes such as the Brookings Institution and the National Bureau for Economic Research.1/

In many ways these plans resemble private savings plans more than they resemble the traditional concept of a pension plan. Workers contribute a certain percentage of their salary, and a portion of these contributions is matched by the employer. The funds are then invested by professional managers. Under this plan, workers cannot be certain what pension income they will receive during their retirement years; that depends on how much is set aside and how well the investments perform. Workers do enjoy a different kind of certainty, however. Contributions to the pension plan are the private property of the individual worker, and the funds are managed by people who are independent of the special interests of company managers and union officials.

These features of the pension system used by non-profit educational organizations lead to many advantages for the individual worker:

- **Protection from Adverse Contingencies: Layoffs, Injuries, and Job Changes.** Because pension contributions are the property of the individual workers, workers do not lose their pension benefits when they change jobs or lose employment due to layoffs, firings, sickness or injuries. Moreover, workers who switch to a new employer participating in the same plan simply carry their pension accounts with them.

- **Inclusion in a Worker's Estate.** Because workers own their pension contributions, the accumulated funds become part of the workers' estates and are passed to their heirs in the event of death.

- **Protection from Employer Bankruptcy.** Because employers do not control or own pension fund money, employees do not lose their promised pension benefits in the event of employer bankruptcy because contributions are fully paid at the same time as wages.

- **Protection from Employer Shenanigans.** Employer contributions to the pension plan are comparable to the payment of wages. Employers cannot decide to reduce these contributions simply because times are bad or in order to meet other company objectives. Nor can employers grab the excess assets of high performing pension funds by unilaterally terminating the pension plan, or use pension fund money to fight off mergers or purchase the company's own stock.

- **Protection from Union Shenanigans.** Pension fund money is independent of unions, just as it is independent of management. Corrupt union officials cannot line their pockets with fat management fees or divert funds to questionable investments.

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1. See, Christopher Conte, "More Schools Break Ties to Academe's Major Pension Fund," Wall Street Journal, September 19, 1983, p. 35.

- **Independent Investment Decisions.** Pension fund investments are made by independent professional managers with the same fiduciary responsibilities as the trust departments of commercial banks. Funds are managed for the direct financial benefit of the workers themselves and not for special interests of union officials or company managers.

- **Choice of Investment Strategy.** Within the TIAA-CREF plan, workers have the option to choose an investment strategy: all stocks, all bonds, or a combination of the two.

- **Choice of Investment Managers.** Although the TIAA-CREF fund still dominates the market, many educational institutions allow employees to choose among as many as 30 different funds. This creates a virtual financial cafeteria for workers who wish to exercise their own preferences about how their pension money should be invested. In addition, in many cases employees directly elect the trustees who manage the fund.

- **Protection from the Failure of Other Pension Funds.** When workers direct their own money to the pension fund of their choice, they cannot impose the cost of their bad decisions on others. Conversely, they are insulated from the bad decisions of other workers and other pension fund managers. Of greatest importance, employees of non-profit educational institutions are not required to subsidize the failures of less well-constructed pension plans in other parts of the country.

- **No Discrimination.** The employer's obligation is to contribute a fixed percent of a worker's salary to the pension fund. They do not promise any specific pension benefit upon retirement. For this reason, complaints of discrimination do not arise. Women live longer than men; whites live longer than blacks; non-smokers live longer than smokers. But these differences in life expectancy are irrelevant as far as the pension plan is concerned.

- **Guarantees of a Reasonable Pension.** If workers invest their funds conservatively in a broad range of stocks and bonds, they can be assured that their pension investments will reflect the good and bad fortunes of the economy as a whole. If the economy experiences high growth, pension assets will grow more rapidly. If the economy experiences low growth, pension assets will grow less rapidly. Upon retirement, however, workers can expect that their pension income will bear some reasonable relationship to the average income in the economy.

THE SOCIAL VALUE OF PENSIONS

Aside from the personal interest that workers have in their pensions, there are good reasons for society as a whole to place a high value on pensions. In general, pensions are important because the contributions to them are a form of private savings. They have important social value for two reasons. First, private savings are a source of funds for private investment, which is essential for economic growth. Second, private savings help insure that individuals do not present themselves destitute to society's doorstep during their retirement years.

The growing importance of private pensions as a form of personal saving is illustrated by the following facts:

- Twenty-eight percent of all new household saving each year is in the form of private pension and insurance reserves, up from 19 percent in 1970.[2]

- Private pension funds now hold 12.4 percent of all corporate stock and 24.3 percent of all corporate bonds.[3]

Moreover, because private pension reserves represent an increasingly important form of personal saving, pension benefits will become an increasingly important source of income for retirees.[4]

- On the average, new retirees today derive about 37 percent of their income from private pensions.

- By the year 2010, pension income will constitute 71 percent of the income of new retirees.

The private pension system institutionalizes private savings. It has important social value to the extent that it helps achieve the benefits that private savings potentially can provide. Indeed, the principal reason why the pension plans of educational institutions are desirable is because they closely resemble private savings plans.

The main social reason why pension plans in other sectors of the economy are defective is because they reflect certain private interests which are not consistent with the goal of promoting private savings. For example, many pension plans are structured so that workers who leave the company lose some or all of their pension benefits. These plans tend to tie workers to the firm by making it costly for them to quit and accept other job offers.

From the point of view of an individual company, pension plans with these features make good sense. In fact, from the point of view of any business enterprise, an ideal world would be one in which no competitor would ever be able to hire away its valuable employees.

What is in the private interest of the company, however, is not necessarily in the interest of society as a whole. From a social point of view, high labor mobility contributes to the efficient use of resources, and it is questionable

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2. Sophie M. Korczyk, Retirement Security and Tax Policy (Washington, D.C.: Employee Benefit and Research Institute, 1984), Table V.2, p. 68.

3. Sophie M. Korczyk, Retirement Income Opportunities in an Aging America: Pensions and the Economy (Washington, D.C.: Employee Benefit and Research Institute, 1982), pp. 46 and 49.

4. Sylvester J. Scheiber, Social Security: Perspectives on Preserving the System (Washington, D.C.: Employee Benefit and Research Institute, 1982) pp. 100 and 90.

social policy for government to promote pension plans which interfere with labor mobility. More importantly, a plan under which workers lose their pension benefits by changing jobs is a plan which is in conflict with one of the most important reasons for encouraging private savings: that all individuals make provision for their retirement years.

A PENSION SYSTEM THAT DOESN'T WORK

The pension plans of non-profit educational institutions are called "**defined-contribution**" plans. Under these plans, the employer is obliged to make specific, periodic contributions, but assumes no obligations to the worker during the retirement years. In contrast, the most prevalent type of pension plans found elsewhere in the economy are "**defined-benefit**" plans. Under these plans, which now cover about 30 million workers, employers promise to provide specific pension benefits during the retirement years, but make no specific commitment concerning annual contributions.

At first glance, it might seem that defined-benefit plans are superior, since the worker gets a promise of a specific retirement income. In fact, these plans are the cause of most of the problems in the private pension industry. One reason is that workers under these plans put all of their eggs in one basket: the financial health of their employer. Over a working career of 45 years, that can prove to be a risky decision. Another reason is workers do not have a property right in pension fund contributions. The pension fund money does not actually belong to them. Most important, pension fund investments frequently reflect the special interests of company managers and union officials, not the financial interests of the beneficiaries.

LOSS OF PROMISED BENEFITS

Workers can lose their pension benefits under defined-benefit plans because of a number of adverse contingencies: job changes, firings, lay-offs or loss of employment due to sickness or injury. Under these circumstances, workers lose their benefits unless they are "vested" (have been employed by the company for a minimum number of years). 5/

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5. Vesting refers to the requirements that an individual must meet in order to acquire a right to pension benefits. A worker is partially or fully vested after working a certain number of years for an employer. After becoming vested, a worker retains rights to certain pension benefits even if employment terminates before retirement. Longer vesting periods decrease the costs of a pension to an employer. Shorter vesting periods increase the cost.

Workers also can lose pension benefits because of another type of adversity: Companies may find themselves unable to pay promised benefits. Prior to 1974, there was no federal program to bail out financially troubled pension plans that were terminated by employers. The number of these terminations was not large, but they created serious hardships for the workers.6/

- Between 1942 and 1974, about 13,000 pension plans were terminated.

- About 45 percent of these plans were insufficiently funded, causing a loss of benefits to 114,000 people.

One of the most notable of these failures was the Packard Corporation's pension plan, which was terminated in 1958 when the company merged with Studebaker.7/

- Because of insufficient funding, the company unilaterally reduced benefits to retirees by 65 percent.

- While the payments to retirees were later raised to 85 percent of promised benefits, numerous unvested workers were left stranded with nothing to show for their years of service.

A similar, although much more severe situation arose in 1963 when the Studebaker automobile factory in South Bend, Indiana, shut down leaving thousands out of work.8/

- In the Studebaker case, only those already retired or on the verge of retirement got the full pension benefits they had been counting on.

- About 4,500 workers under the age of 60 with fully-vested pension rights received only 15 percent of the pension benefits they had been promised.

In 1974, new federal legislation provided for a way of bailing out financially troubled defined-benefit plans with funds collected from healthy ones. But under this system (discussed below), worker pensions are far from secure. The case of Braniff International Airways illustrates why.

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6. "Study Shows Pre-ERISA Benefit Losses Now Total $207.8 Million." Pensions and Investments Age (July 16, 1979).

7. Ralph Nader and Karen Blackwell, You and Your Pension (New York: Grossman Publishers, 1973), p. 60.

8. Congressional Quarterly, Congress and the Nation III (Washington D.C.: Congressional Quarterly Press, 1972), p. 228.

On May 15, 1982, Braniff filed for bankruptcy, leaving more than 7,500 employees out of work. A few months later, the company notified the participants of its four pension plans of its intent to terminate the plans.[9]

- The federal government estimated that it would have to assume unfunded liabilities of $47.7 million.

- By the company's own estimate, if full promised benefits were to be paid, the shortfall for all four plans stood at $148 million.

One problem with the federal bail-out was that the government sets a maximum on the pension it will pay to each retiree. As a result, some Braniff workers saw their pension benefits devastated:

- Retired Teamsters receiving monthly pension checks of $665 saw their benefits reduced to $434.

- Retired machinists saw their monthly pension checks cut from $700 to $590.

- Harding Lawrence, former CEO of Braniff, had been counting on a $306,000-a-year pension. Under the bail-out, his pension was reduced to $16,568 a year.

The final resolution of the Braniff pension affair was disappointing for many interested parties. Pension benefits were cut, in some cases drastically. The federal government took over responsibility for operating three of the four terminated plans and in the process assumed an unfunded liability of $47 million. Braniff, meanwhile, escaped almost unscathed.[10] Freed from an onerous pension burden, it was able to negotiate a new lease on life with the Hyatt Corporation and to return to the air by 1984.

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9. Dan Piller and George Wysatta, "Braniff Cuts Some Pensions," Dallas Morning News (September 1, 1982); Nancy Webman, "Braniff Plans Terminated," Pensions and Investment Age (August 30, 1982); "Braniff Files to Terminate Pension Plan," Aviation Week and Space Technology (August 30, 1982).

10. U.S. Pension Benefit Guarantee Corporation, Annual Report to the Congress, FY 82 (1982), p. 11.

TERMINATION OF HIGH-PERFORMING PLANS

The funding of a pension plan is determined by comparing projected liabilities with the assets in the pension trust fund. A plan which is underfunded has more liabilities than assets. A plan which is overfunded has more assets than liabilities. Growing interest in the financial health of private pension plans has led to public focus on their funding status. Workers who discover that their pension funds are overfunded may feel a sense of security. This sense of security is misplaced, however.

About $600 billion is invested in more than 650,000 private pension funds in the U.S. With increasing frequency, these funds are a tempting source of capital for companies with a need for cash. Under current law, companies with overfunded plans often are able to terminate them, buy annuities for retired workers and offer annuities or cash settlements to active workers. After paying off its pension obligations, the company often is able to pocket the difference.

These terminations frequently come as a big surprise to workers, who have been encouraged to think of pension fund assets as theirs. An especially unfortunate surprise greeted the employees of Harper & Row Publishers in 1981:

- Harper & Row ended its pension plan and set up a new one using surplus cash from the original plan to buy one-third of its outstanding stock.

- Fearing a hostile takeover, the company paid $20 a share for the stock when its market price was less than $13.

Outraged Harper employees took the company to court, but a federal court ruled that the company had a right to end its pension plan.

If employees get what is promised, why should they complain? The problem lies in deciding how much pension benefits are worth today, long in advance of their actual payment. In calculating the present value of pensions, the choice of an interest rate in making the calculations makes a big difference. A higher interest rate lowers the present value of future benefits and a lower interest rate raises the present value of benefits.[11/] For example, the choice of a seven percent interest rate rather than a 10 percent interest rate in most cases will raise the present value of benefits by at least 50 percent for a 35 year-old worker.

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11. Just as a higher interest rate will cause a sum of money invested today to grow to a larger amount in the future, so will a lower interest rate make a fixed sum of money promised in the future worth less today.

What is particularly controversial about the Harper & Row affair was that in calculating the lump sums to be paid to employees, the company assumed a 15 percent interest rate, rather than the eight percent rate assumed in the plan's yearly reports. The new assumption significantly lowered pension plan costs to Harper & Row. Although the employees had no desire to do so, they were helping Harper & Row achieve other corporate objectives, simply because they had no control over what was happening to their pension money.12/

Table I shows how other companies have gained in recent years by terminating overfunded pensions and capturing the surplus assets for themselves.

TABLE I

CASH FOR CORPORATIONS: SURPLUS REALIZED BY TERMINATING COMPANY PENSION FUNDS

Company	Surplus
Occidental Petroleum	$ 362.8 mil.
Stroh Brewery Company	95.0 mil.
M. W. Kellogg	58.0 mil.
Western Airlines	28.8 mil.
Timex	21.4 mil.
Continental Airlines	19.6 mil.
John Crane-Houdaille	18.5 mil.
Questor	13.3 mil.
Lane Bryant	12.3 mil.
Bank of Commonwealth	12.0 mil.
Seiko	11.5 mil.
Dan River	11.5 mil.
Dentsply International	11.3 mil.
A. G. Becker	11.1 mil.
Harper & Row Publishers	10.2 mil.

Source: Pension Benefit Guarantee Corporation, reprinted in U.S. News and World Report, February 6, 1984, p. 74.

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12. Randall Smith, "Firms Increasingly Top Their Pension Funds to Use Excess Assets," Wall Street Journal (November 29, 1983); "Is your Pension Safe From Company Shenanigans?", U.S. News & World Report (February 6, 1984).

QUESTIONABLE PENSION FUND INVESTMENTS

Under federal law, pension fund managers are required to act "prudently" and to make investments which are "solely" for the benefit of the beneficiaries. But as one actuary noted, "Trying to define prudence is like trying to define obscenity."[13]

Management Goals. With increasing frequency, the pension funds of defined-benefit plans are being used by company managers to pursue goals which are at odds with the financial goals of workers. More often than not, these actions take the form of using pension fund money to combat hostile takeovers or to acquire other firms.[14]

- In one case, two Dallas investors gained control of Keystone Consolidated Industries and appointed themselves pension fund managers. They then attempted to use the pension fund money to take over Amalgamated Sugar.
- In another case, the pension fund of Grumman Aerospace Corporation was used to buy nearly 1.2 million shares of the company's own stock in an attempt to prevent a hostile takeover by the LTV Corporation.

The Department of Labor went to court to try to stop both of these actions. But successful prosecutions in this area are difficult.

Federal law prohibits a pension fund from putting more than 10 percent of its assets into shares of the company sponsoring the plan. Nevertheless, the purchase of a company's own stock and assets is a frequent goal of management:[15]

- Republic Steel, American Airlines and Martin Marietta are firms that have contributed new issues of stocks and bonds (in lieu of cash) to their pension funds. In effect, these firms are "borrowing" from the employees' pension funds.
- In another case, the Department of Labor stopped the publishing company of Harcourt Brace Jovanovich from exchanging its new Florida headquarters for 40 percent of its pension fund assets.

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13. Quoted in Doron P. Levin, "Pension Bosses Hit for Role in Takeovers," Wall Street Journal, May 16, 1983, p.25.

14. See also, Randall Smith, "Firms Increasingly Tap Their Pension Funds to Use Excess Assets," Wall Street Journal (November 29, 1983); and Thomas G. Donlan, "Hands in The Cookie Jar: Why Companies are Tapping Their Pension Funds," Barron's (May 21, 1981).

15. "Is Your Pension Safe From Company Shenanigans?" U.S. News and World Report, February 6, 1984, p. 74.

Union Goals. For certain pension plans controlled by union officials, corruption and fraud have been common. The Teamsters Central States Pension Plan, the second largest in the United States, has developed a notorious reputation over the years for misusing pension plan funds.

- A recent investigation by the U.S. Senate's Subcommittee on Investigations revealed that between 1970 and 1975, of $5 million contributed by employers to purchase individual whole life policies for more than 14,000 Teamsters, over $3.7 million was paid in commissions and fees.

- In one union local, commission costs ran up to $800,000 for services that could have been provided for around $10,000 under other arrangements.

Not surprisingly, the subcommittee found that these commissions involved a great number of kickbacks.[16]

Social and Political Goals. A controversial 1979 study by Corporate Data Exchange found that much pension money was flowing into companies that were nonunion, were habitual violators of occupational safety and health regulations and equal employment guidelines, and were doing business with South Africa.[17] The study led to demands by labor unions to use social criteria to screen investments of pension money. The AFL-CIO called upon its member unions to consider the issue of social investment of pension money in future collective bargaining negotiations. In particular, it has asked that member unions consider using pension funds for creating new jobs for members and for promoting other "socially desirable" union objectives, such as low-cost housing for the poor and elderly.[18]

A 1979 agreement between the United Auto workers and Chrysler embodies many of the social investment ideas championed by organized labor in the 1980s. Under the agreement, 10 percent of new pension contributions are being invested in "socially desirable" projects such as residential mortgages where UAW members live, Health Maintenance Organizations, nursing schools, and nursing homes. In addition, the union has obtained the right to veto as many as five times when pension trustees seek to invest in companies that do business with South Africa.[19]

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16. For a discussion of the subcommittee's findings, see U.S. Congress, Select Committee on Aging, Fraud and Abuse in Pensions and Related Employee Benefit Plans: Hearing before the Select Committee on Aging, House of Representatives, 96th Congress, 1st session, November 4, 1981.

17. See Industrial Union Department, AFL-CIO, Pensions: A Study of Benefit Fund Investment Policies, (1980).

18. See "Statements Adopted by the AFL-CIO Executive Council," Chicago, Illinois (August 21, 1984).

19. "The UAW's $300 Million Kitty," Forbes (November 12, 1979).

Construction unions also have been active in the area of social investment. The Wall Street Journal reported in early 1984 that nationwide $460 million of union pension money was funnelled into union construction projects through the AFL-CIO Housing Investment Trust Fund, the Union Labor Life Insurance Company, and the union-controlled National Bank of Washington. In addition, construction unions have loaned $101 million to promote pro-union construction projects in Pompano Beach, Florida, and Buffalo, New York. In Southern California, trustees for major construction unions pooled some of their funds into the Development Foundation of Southern California. The goal of the foundation was to promote union construction projects.[20/]

There is evidence that in promoting "socially desirable" projects through these kinds of investments, unions are sacrificing the interests that workers have in maximizing the return on their pension funds.[21/] According to a study conducted by David Schulman of UCLA for the U.S. Labor Department, between May 1980 and February 1982, construction union pension plans in Southern California lost approximately $8 million in asset value by making mortgages, loans and commitments of $66.7 million at 2.4 percent to 5.4 percent below market interest rates. While the Building and Construction Trades Department of the AFL-CIO has contested these findings, the fact remains that union control of pension monies and union sponsorship of "social investment" is no guarantee the long-term interests of retired workers are protected.[22/]

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20. Randall Smith, "Use of Pension Funds to Create Union Job Raises Issue of Legality," Wall Street Journal (January 17, 1984).

21. For a further discussion see Hilet Gray, New Directions on the Investment and Content of Pension Funds, Washington, D.C. (Investor Responsibility Research Center, 1983).

22. Randall Smith, "Use of Pension Funds."

DISCRIMINATION

There are radical differences in life expectancy between males and females, and blacks and whites. As Table II shows, these differences in life expectancy translate into big differences in expected pension benefits for workers entering the labor market at age 21:

- If pension benefits begin at age 65, a white male can expect to receive five times more monthly pension checks than a black male. A white female can expect to receive almost 50 percent more checks than a black female.

- A white female can expect to receive twice as many benefit checks as a white male and about 6.5 times as many checks as a black male.

These differences in life expectancy also mean that it is impossible to devise a defined-benefit pension plan that does not discriminate on the basis of race and sex. If all workers at the same income level are promised the same monthly pension benefits, the plan necessarily will discriminate in favor of women over men, in favor of whites over blacks. Likewise, if promised pension benefits are adjusted so that the same contribution leads to higher benefits for men than for women, and more for blacks than for whites, then individuals will be favored or penalized simply because they happen to be a member of a particular group.

TABLE II

NUMBER OF YEARS OF EXPECTED BENEFITS

21-year-old	White	Black
Male	7.4	1.5
Female	14.5	9.8

Source: Calculated from Life Expectancy Tables, *Statistical Abstract of the United States, 1982-83*, Table 107, p. 72.

THE STRUCTURAL FLAW IN DEFINED-BENEFIT PENSION PLANS

Aside from these defects, there is a more basic problem with defined-benefit pension plans: They are based on a flawed view of world.

The defined-benefit pension system is based on an image of the labor market in which workers work for the same employer for their entire working

lives, and the employer remains a profitable, viable entity for this entire time period. Indeed, on what other assumptions would a 21-year-old worker want to contract with an employer to pay a pension 45 years hence?

This image stands in stark contrast to reality. In a dynamic, capitalist economy, companies rise and fall. In a labor market where there is high mobility, workers change jobs frequently over the course of a career.

- The average length of time required in order to achieve full vested pension benefits in defined-benefit plans is 10 years.[23]

- On the average, a male worker in the U.S. economy has been working for his current employer for only 6.9 years.[24]

- A female worker in U.S. economy has been working for her current employer for only 4.8 years.[24]

Table III shows the average number of years workers have been working for their current employer. Even among those nearing retirement, workers, on the average, have been working for their current employer for less than one-third of their adult working life.

TABLE III

**MEDIAN NUMBER OF YEARS
WITH THE CURRENT EMPLOYER**

Age	Men	Women
16 to 24	1.1	1.1
25 to 34	3.4	3.1
35 to 44	7.7	4.6
45 to 54	13.4	6.9
55 to 64	17.0	10.5
all ages	6.9	4.8

Source: Bureau of Labor Statistics, U.S. Department of Labor, March 1, 1984.

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23. Lawrence J. Kotlikoff and Daniel E. Smith, Pensions in the American Economy (Chicago; University of Chicago Press, 1983) p. 189.

24. Data obtained from the Bureau of Labor Statistics, U.S. Department of Labor.

The very nature of the defined-benefit pension plan makes it least attractive to those sectors of the economy where there is high labor mobility and short job tenure. This fact may explain why:25/

- In the mining industry, 75 percent of workers are participating in a private pension plan. In manufacturing and transportation, the figure is 71 percent.

- In the construction and service industries the figure is 40 percent, and in agriculture only 23 percent of workers are participating in a private pension plan.

For the U. S. economy as a whole:26/

- Almost half of all workers in the private sector are not participating in a private pension plan.

- Of those who are participating, almost half have not been vested and would lose their pension benefits if they changed jobs.

Clearly, the defined-benefit pension system is inappropriate in a dynamic economy which places a premium on having all workers provide for their own retirement.

SOCIALIZING THE PENSION INDUSTRY

With the passage of the Employee Retirement Income Security Act (ERISA) in 1974, the federal government intervened in the pension industry in a dramatic way. Among the key provisions of the act was the requirement that defined-benefit pension plans in the private sector be funded according to accepted actuarial calculations. Unfunded past service costs were required to be amortized in equal installments over a 40-year period for plans already in effect, and amortized over a 30-year period for newly established plans. Employers who failed to comply with the funding standards set down by ERISA were subject to a five percent tax on the accumulated funding deficiency. This tax would be increased to 100 percent if the deficiency continued.27/

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25. Report of the President's Commission on Pension Policy, Hearing Before The Subcommittee on Savings, Pensions and Investment Policy of the Committee on Finance, United States Senate, (Washington D.C.: U.S. Government Printing Office, May 15, 1981), Table 13, p. 55.

26. Report of the President's Commission on Pension Policy, Table 13, p. 55 and Table 14, p. 56.

27. For a more detailed discussion see Jack L. Traynor, Patrick J. Regan, and William W. Priest, Jr., The Financial Reality of Pension Funding Under ERISA (Homewood, Ill.: Dow Jones-Irwin, 1976).

Some of the earliest problems ERISA introduced into the private pension industry arose from its complicated rules and regulations as well as its burdensome and expensive reporting requirements. Separate reports usually had to be filed with the Labor Department, the Treasury Department, and the Pension Benefit Guarantee Corporation (PBGC). Moreover, because of the overlapping jurisdiction provisions of the act, employers often found themselves facing conflicting agency interpretations of exactly what was required under ERISA. Congressman Frank Horton of New York captured the mood of many disgruntled employers when he commented, "ERISA -- probably so much more than any other federal law -- is virtually synonomous with bureaucratic confusion, unnecessary paperwork and understandable frustration."[28] Recent reforms of ERISA have been designed to make the regulatory environment slightly less hostile to plan sponsors. But complicated rules and regulations remain an integral part of the private pension world.

More serious problems were created by another key provision. Under ERISA the federal govenment set up the PBGC, a federally chartered, non-profit corporation. It was designed to do for the pension industry what the Federal Deposit Insurance Corporation does for commercial banks. The PBGC currently assesses "premiums" of $2.60 per employee for single-employer plans and $1.80 per employee for multiple employer plans.[29] In return, the PBGC acts as an "insurer," which assumes the liability (up to a maximum amount) for pension plans which default. To discourage companies from terminating underfunded plans, the PBGC makes employers liable for a percentage of their company's net worth in the event that its pension liabilities are transferred to the PBGC. For single-employer plans, the maximum liability is 30 percent of net worth. For multiple-employer plans, the liability can reach 100 percent.

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28. Quoted in Congressional Quarterly, Congressional Quarterly Weekly Report (March 17, 1979): p. 454.

29. For a discussion of the difference between single-employer and multiple-employer plans before and after ERISA, see Pension Benefit Guarantee Corporation (PBGC), Multi-employer Study (Washington, D.C.: 1978), Part II.

SINGLE-EMPLOYER PLANS

The system set up by the PBGC is generally thought of as a federal insurance program for private pensions. But any similarity between it and genuine insurance is purely superficial. Under the PBGC, every company is assessed the same premium regardless of the benefits promised by its pension plan, and regardless of the plan's financial health. As a result, fully-funded plans pay the same insurance premium as do plans in financial trouble.

This system does not eliminate the risk of pension plan failure. It merely transfers the risk to others. When an underfunded plan terminates, a certain portion of the benefits, the so-called "basic benefits," are guaranteed by the PBGC and paid for through premium income. But, because PBGC insurance rates do not take into account the risk that a particular plan might be terminated, healthy plans effectively are underwriting unhealthy plans that either are terminated or are on the verge of termination.

Far from being genuine insurance, the PBGC system is a take-from-the-rich-give-to-the-poor scheme under which plans that are fully funded or overfunded have much to lose, and plans which are seriously underfunded have much to gain. As with any socialized scheme, the financially prosperous search for ways to opt out, and the financially destitute search for ways to unload their burdens on the public purse. Not surprisingly, as healthy plans have been terminated and unhealthy plans turned over to the federal government, the PBGC's premiums have proved to be inadequate.

- In 1977, Congress raised the single-employer plans premium from $1 per employee to $2.60 -- a 160 percent increase in three years.

- Currently, the PBGC is asking Congress for a further increase to $6 per employee, an increase of 500 percent over the 1977 level.

The Exodus of Healthy Plans. It did not take the managers of fully-funded pension plans long to realize that they had nothing to gain by participating in the PBGC's insurance scheme:[30/]

- From the passage of ERISA in 1974 through 1977, 18,000 pension plans were terminated.

- This amounted to about 29 percent of the defined-benefit pension plans that were in existence when ERISA was enacted.

- Significantly, 98 percent of those terminated plans were fully funded.

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30. U.S., Pension Benefit Guarantee Corporation, Annual Report to the President and Congress, FY 1977 (Washington, D.C.: 1977), p. 11.

Most of the terminated plans were sponsored by an employer who remained in business and who replaced the terminated plan with another retirement plan, such as a contributory Individual Retirement Account plan or a profit-sharing plan. In doing so, these companies opted out of the PBGC insurance scheme.

One of the incentives to opt out of the PBGC insurance scheme has already been mentioned: Companies with overfunded pension plans can capture the surplus in their pension fund after the plan has been terminated.31/

- Since the beginning of 1980, 294 large pension plans have been terminated, allowing the companies to capture $2.8 billion in surplus assets.

- Currently, there are 90 companies with requests pending to terminate their plans and recapture a total of $1.1 billion in surplus assets.

But even companies that have no surplus assets in a pension fund have found plenty of reasons to avoid the PBGC insurance scheme. Among companies starting new pension plans, the plan of choice is defined-contribution.32/

- In the years immediately following the passage of ERISA, creation of new defined-benefit plans virtually came to a grinding halt.

- In recent years, there has been some renewed interest in defined-benefit plans, but most companies still choose to avoid the PBGC. In 1983, 67 percent of all new pension plans were defined-contribution.

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31. Bill Keller, "Another Stab at Pension Reform," The New York Times, July 15, 1984. For a further discussion, see Alicia Munnell, "Guaranteeing Private Pension Benefits: A Potentially Expensive Business," New England Economic Review (March/April 1982).

32. Dallas L. Salisbury, "Development and Design of Private Employer Pensions." Printed as an appendix to Foreman Federal Pensions Part 2 -- The Retirement Income System: Design Issues. Subcommittee on Civil Service, Post Office, and General Services of the Committee on Governmental Affairs, U.S. Senate, February 16, 1984.

TABLE IV

(NET) NUMBER OF NEW PENSION PLANS
(Plans Created Minus Plans Terminated)

Year	Defined Contribution	Defined Benefit
1974	24,599	30,002
1975	11,162	10,769
1976	14,187	-4,180
1977	17,985	1,616
1978	45,295	5,103
1979	33,548	12,488
1980	41,511	14,552
1981	48,842	19,253
1982	47,054	23,146
1983	30,672	14,900

SOURCE: Employee Benefit Research Institute, based on IRS data.

The Growing Burden of Financially Troubled Plans. As the managers of financially healthy plans found ways of opting out of the federal government's pension insurance scheme, the managers of financially troubled plans discovered ways of unloading their pension obligations on the federal government.[33]

- In 1975, the PBGC assumed trusteeship for three pension plans serving 386 vested participants.
- This increased to 48 plans covering 6,700 participants in 1976, and to 145 plans covering 16,000 participants in 1977.
- In 1977, over $19.8 million in guaranteed benefits were being paid out by the PBGC to retired individuals under ERISA's termination insurance programs. In addition, by the end of fiscal year 1977, the PBGC had identified another 230 terminating plans for which it potentially would assume trusteeship, and found itself with a net deficiency in assets of $95.3 million.

Even with the increase in premiums from $1 to $2.60 in 1977, the PBGC faced an increasing burden:[34]

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33. Pension Benefit Guarantee Corporation, Annual Report, FY 1977.

34. Pension Benefit Guarantee Corporation, Annual Report, FY 1981.

- In 1978, the net liability of the PBGC rose to $137.8 million.

- In 1979, it reached $146.4 million.

- While the net liability declined to $94.6 million in 1980, the following year it swelled to $188.8 million.

In 1981, the single-employer program faced the highest total of claims for terminated plans that the PBGC had recorded in any single year since its inception. The termination of the White Motor Company's pension plan alone involved an estimated $58.3 million claim on the PBGC, the largest claim in the history of the single-employer program.

A number of studies conducted in the late 1970s and the early 1980s discovered that the potential liabilities confronting the PBGC were a serious threat to the program.[35] According to a 1979 study conducted by Standard and Poor's Compusat Services, the total unfunded vested benefits of the top 100 U.S. corporations rose 5.5 percent during 1978 to over $20.3 billion. In the same period, the total unfunded prior service costs rose 16 percent to over $40 billion. General Motors, for example, had the largest amount of unfunded vested benefits ($3.9 billion) and the largest unfunded prior service costs ($8 billion) of all major corporations. Bethlehem Steel had the second largest unfunded vested benefits ($1.25 billion). Ford, on the other hand, had the third largest unfunded vested benefit ($1.17 billion) and the second largest unfunded prior service costs ($3.7 billion), while Chrysler had the fourth largest unfunded vested benefits ($1.1 billion) and the fourth largest unfunded prior service costs ($1.81 billion).

The current status of a particular company's unfunded vested benefits or unfunded prior service costs is not necessarily worrisome to the PBGC. Some companies' unfunded pension liabilities are well below the 30 percent claim on net worth that the PBGC potentially possesses. Moreover, the unfunded prior service costs for General Motors, Ford and other companies can be covered almost entirely by the previous year's pre-tax earnings. Some companies, however, pose serious problems. For example, Bethelem Steel's $1.25 billion unfunded vested benefits in 1979 totaled 53 percent of its net worth. If Bethlehem Steel had terminated its pension plans in 1979, the PBGC would have found itself responsible for at least $287 million in unfunded benefits above and beyond its 30 percent lien on the company's net worth. If Bethlehem Steel had gone bankrupt and its net worth had plunged to zero, the liability passing to the PBGC would have been even greater.

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35. See in particular "Unfunded Pension Liabilities: A Rein on Their Growth for Now," Business Week (August 13, 1979): pp. 84-9; "Pension Survey: Unfunded Liabilities Continue to Grow," Business Week (August 25, 1980): 94-6; Alicia Munnell, "Guarantee Private Pension Benefits: A Potentially Explosive Business," New England Economic Review (March/April 1982): pp. 24-47.

In 1982, the PBGC assumed responsibility for an additional $203 million from terminated plans. Among the estimated liabilities assumed by the PBGC from major pension plans were:

White Farm Equipment Co.	$50.3 million
Braniff Airways, Inc.	47.7 million
Rath Packing Company	33.9 million
McLouth Steel Company	22.7 million
Facet Enterprises, Inc.	8.6 million
John Steel and Wire Co.	8.2 million

While these losses were offset in part by an increase in investment income due to a rising stock market, the accumulated deficit of the single-employer program rose to a disturbing $322 million by the end of 1982. A five-year forecast of the program projected a total deficit of $938 million by 1987.

The Incentives to Shift Pension Liabilities to the Federal Government. The financial problems confronting the PBGC's insurance program reveals a major flaw in ERISA's approach to pension reform: The federal government subsidizes underfunded pensions and taxes fully-funded ones. This creates perverse incentives for individual companies.

Despite new funding requirements recently put into the law, underfunding of pension plans is still possible in a number of ways. First, by manipulating actuarial assumptions, companies can reduce their pension contributions considerably. Second, because of lengthy mandatory vesting provisions, employers often do not have to realize pension liabilities until years after the liabilities have been incurred. Finally, the Internal Revenue Service is empowered to grant waivers for pension contributions to companies undergoing other financial problems. On the plus side, these waivers temporarily free companies from burdensome pension payments so they can survive and continue to sponsor their pension plans. There is an accompanying risk, however. If the company finally goes under and terminates its pension plan, the liabilities assumed by the PBGC are significantly greater.

The Braniff case again provides a revealing insight into the problems plaguing the system. The IRS granted Braniff a waiver for the 1980 calendar year. The waiver effectively gave Braniff an additional $25 million to meet current operating expenses. The waivered contributions were never repaid to the pension funds, however. Indeed, Braniff did not contribute into any of its pension plans after January 1, 1980. Interestingly, the PBGC, the institution responsible for assuming responsibility for Braniff's unfunded liabilities, could do little more than watch the granting of the waiver and wait for its effect to be felt.[36]

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36. Laurence H. Gross, "Officials to Examine Pension Funds," Dallas Morning News (September 14, 1982).

The PBGC has little control over the industry it is supposed to regulate. Unlike the FDIC it was modeled after, the PBGC lacks the resources as well as the authority to regulate the pension industry closely.[37] Decision-makers in the private sector are the individuals primarily responsible for deciding if and when a particular pension plan is to be terminated. Given the numerous incentives motivating some of these decision-makers to shift their pension plans' long-term liabilities to the federal government, the PBGC finds itself threatened by the very industry it sought to stabilize.

Some Case Histories. The fact that companies may have to hand over up to 30 percent of their net worth to the PBGC in order to get out from under their pension liability might seem like an effective deterrent. But, in many cases, pension liabilities may exceed, and in some cases greatly exceed, 30 percent of net worth. In these cases, the company has every incentive to transfer its pension liability to the federal government.

The case of Facet Enterprises provides a revealing example. Facet was spun-off from the Bendix Corporation in 1976 in order to settle an antitrust suit. While shifting $70 million in pension liabilities to Facet, Bendix initially transferred only $18 million in assets. Through later litigation, Facet received an additional $14.7 million from Bendix. But even then, the difference between assets on hand and liabilities in the pension plan remained burdensome to Facet. In an attempt to remedy the situation, Facet sought to terminate the debt-ridden plan in 1982 and to start up a new defined-contribution plan in its place. In its 1981 report, Facet estimated that termination would cost the company between $4 million and $14 million due to the PBGC's lien on its net worth, but the company also would free itself of $33 million in unfunded liabilities. Initially, the PBGC denied Facet the right to terminate its plan, and Facet filed suit in federal court. Finally, a complex agreement between Facet and the PBGC was reached. Facet was allowed to terminate its pension, but a complicated payment schedule was arranged whereby Facet agreed to contribute some of its future profits to the PBGC.[38]

The story of AlloyTek, a small producer of jet engine components in Grand Rapids, Michigan, provides another revealing case history. In 1979, AlloyTek faced financial troubles and a $4.5 million pension liability. The company argued that it had no net worth, and since 30 percent of nothing is nothing, it managed to transfer its entire $4.5 million liability to the PBGC. Afterward, the company started contributing to Individual Retirement Accounts on its workers' behalf --a procedure free of PBGC regulations.[39]

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37. See Munnell, "Guaranteeing Pension Benefits," p. 47 for a brief discussion of this problem.

38. PBGC, Annual Report FY 1982, p. 11; "PBGC Settles Controversial Facet Enterprises Suit," Labor and Investments (October 1982): pp. 4-5.

39. Geoffrey Calvin, "How Sick Companies are Endangering the Pension System," Fortune, October 4, 1982, p. 74.

Other companies may find it in their financial self-interest to follow suit. Alicia Munnell has updated some of the figures on the unfunded liabilities of U.S. pension plans to determine potential PBGC exposure. The results are striking. As of 1980, 86 firms had potential claims on the PBGC's single-employer program totaling $4.3 billion, and that is after the deduction of the 30 percent lien on their net worth.[40/] Moreover, the Munnell study showed how some heavily underfunded plans had strong financial incentive to transfer their liabilities to PBGC. Details of these potential gains are presented in Table V.

TABLE V

SELECTED COMPANIES THAT COULD "PROFIT" BY TERMINATING PENSION PLANS
(Figures in millions; 1980 data)

Company	Unfunded Liability	30% of Net Worth	Potential Profit from Termination
Chrysler	$1,275.3	$286.0	$989.3
International Harvester	1,079.0	214.6	864.3
American Motors	226.0	34.2	399.0
Pan American	221.9	89.4	132.5
Republic Steel	223.0	132.3	90.7
Bethlehem Steel	420.2	339.0	81.2
Goodrich	189.5	126.7	57.8

Source: Alicia Munnell, "Guaranteeing Private Pension Benefits: A Potentially Expensive Business," New England Economic Review (March/April 1982)

High interest rates in the early 1980s along with the strong economic recovery of 1983-84 have changed the financial status of many private pension plans, generally for the better. But while the numbers contained in Table V may be somewhat outdated, the structural problems that they point to remain. Lower interest rates or economic recession could easily recreate a situation resembling that of the late 1970s.

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40. Munnell, "Guaranteeing Private Pension Benefits," pp. 40-6.

Political Pressure to Bail Out Troubled Firms. One problem with the current system is that it gives the federal government an incentive to bail out, or subsidize, troubled firms simply to prevent having to assume responsibility for their unfunded pension plans.

The case of Chrysler provides a striking example. In the fall of 1979, Chrysler found itself facing imminent bankruptcy and appealed to the federal government for assistance. It ultimately received a large loan guarantee that enabled it to stay in operation. One of the arguments used in favor of the bail-out pointed to the precarious state of Chrysler's pension fund. At that time, it was estimated that while the value of Chrysler's unfunded vested benefits covered by the PBGC was $2.3 billion, pension fund assets totaled only $1.4 billion. In the event of bankruptcy or plan termination, the PBGC would have been left with approximately $900 million in unfunded pension liabilities.[41] Even taking into account the 30 percent lien that the PBGC would have had on Chrysler's estimated net worth of $2.7 billion (a figure that could decline easily and quickly), the claims resulting from bankruptcy could have seriously drained the PBGC's resources. Robert Nagle, the PBGC's executive director, addressed the problem directly when he noted that a Chrysler bankruptcy alone could lead to an $8 increase in the annual premium for single-employer pension plans. Even then, he warned, serious financial problems would continue to plague the PBGC well into the future.[42]

The federal government did not allow Chrysler to go under in 1979. Guaranteed loans were forthcoming and the company was able to limp its way through 1982 without terminating its pension plan. With the help of voluntary import quotas, Chrysler was well on the road to recovery by late 1982 and the likelihood of the PBGC having to take over its pension plans faded from view. However, the fact remains that some other company with a large unfunded benefit program like Chrysler might go bankrupt in the future. As one special counsel to the Senate Labor and Human Resources Committee noted, the bankruptcy of a corporation like Chrysler "would sink the insurance program almost completely. The PBGC is simply not designed to handle a catastrophic business death."[43]

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41. For a discussion of the Chrysler case see Peter Bohr, "Chrysler's Pie in the Sky Plan for Survival," Fortune October 22, 1979): pp. 46-57; "The Huge Pension Fund Mess if Chrysler Goes Bust," Business Week (September 24, 1979): pp. 58-9.

42. "What the UAW Will Give to Help Chrysler," Business Week (November 5, 1979): pp. 55.

43. Quoted in "The Huge Pension Mess," Business Week, pp. 58-9.

MULTI-EMPLOYER PLANS

Multi-employer plans usually cover individuals who work for companies in the same industry, and who live in a specific geographic area. These plans are maintained through collective bargaining agreements. A board of trustees is responsible for establishing a plan's level of benefits based on projected retirement patterns, workforce turnovers, and future levels of employment.

When ERISA was enacted, it was generally believed that multi-employer plans were considerably more stable than single-employer ones. A study conducted by the Labor and Treasury departments discovered a rather low rate of multi-employer terminations from 1965 to 1971.[44] The study also showed that of those plans which were terminated, only three percent were due to financial problems.

That rosy picture did not stand up in light of the economic reality of the 1970s. Far from being more stable than single-employer plans, multi-employer plans proved to be particularly sensitive to the downturns in the nation's economy.

Unlike single-employer plans, the fiscal soundness of most multi-employer plans is directly tied to the stability and growth of an industry's workforce. Any long-term decline, such as that experienced by the steel and auto industries in the 1970s, puts serious financial stress on the pension plan as a shrinking workforce is forced to try to support an increasing number of retirees. The so-called "declining industries" problem became evident to the PBGC as early as 1977, when coverage was extended to three related multi-employer plans in the New York millinary industry, and to one plan in the New Jersey milk industry.[45]

The plight of the milk industry pension plan revealed much about the nature of the declining industry problem. The pension plan began in 1961 with 75 contributing employers and 2,660 active employees. From 1961 to 1976, most of the participating employers either went out of business or left the area as demand for home milk delivery declined. As the number of contributing employers and active employees fell, the number of retirees receiving pension benefits increased correspondingly. By 1976, only 20 employers and 80 working employees remained active in the program, while 1,450 retirees were drawing benefits from it. Higher levels of pension contributions thus were required in each new collective bargaining agreement. This, in turn, made it more difficult for employers to compete with out-of-state companies and helped to drive even more of them out of business. With the exit of more firms, the pension plan was further weakened. Finally, the point was reached where the pension fund costs could no longer be absorbed by the employers. The plan was terminated in early 1977.

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44. Departments of Treasury and Labor, Study of Pension Plans, 1974, (Washington, D.C.: 1974).

45. The following is drawn from U.S. Senate, Committee on Labor and Human Resources, Multi-Employer Pension Plan Amendments of 1979, Hearings before the Committee on Labor and Human Resources, 96th Congress, 1st session, June 26 and 27, 1979 p. 665.

By the end of 1977, the claims rising from the PBGC's coverage of the three millinary pension plans and the milk industry plan amounted to $21.9 million, $12.6 million more than the assets the PBGC had collected from premiums and investments.46/ This deficiency in assets was only the tip of the iceburg.47/

- A 1977 study conducted by the PBGC discovered that about two percent of all multi-employer plans were undergoing extreme financial hardship and were likely to terminate within five years. The total unfunded liabilities of these plans exceeded $350 million.

- The study also reported that another 10 percent of all multi-employer plans were undergoing significant financial hardship and might eventually terminate within 15 years. The unfunded liabilities of these plans totaled a staggering $3.5 billion.

A second study conducted by the PBGC tended to confirm these general figures. It also reached the troubling conclusion that ERISA's multi-employer insurance program might encourage further pension plan terminations by giving employers an incentive to withdraw from the plan early enough to escape responsibility for any outstanding unfunded liabilities. As the study explained, "Since the insurance program would cover most, if not all, of the participants' vested benefits, it may be to the mutual economic advantage of the employers, the union and the active employees to terminate the plan."48/

Recognizing the problems confronting the multi-employer termination insurance program, Congress passed amendments to ERISA in 1980. The goals of the 1980 amendments were to limit the financial exposure of the PBGC and to place multi-employer plans on a sounder financial basis. But there were troubling unintended side effects as well. Business periodicals reported unprofitable trucking companies staying in business too long because the new withdrawal provision made it too expensive to go bankrupt.49/ Takeover attempts fell apart in the eleventh hour due in large part to pension plan considerations.50/ Throughout the early 1980s numerous proposals were presented to Congress for yet another revision to ERISA. None passed.

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46. See the relevant PBGC Annual Reports.

47. U.S., Pension Benefit Guarantee Corporation, Multi-Employer Study (Washington, D.C.: 1978).

48. PBGC, Multi-Employer Study, p. 23.

49. Richard Greene, "More Hidden Liabilities," Forbes (March 2, 1982).

50. "The High Toll of Quiting the Trucking Industry," Business Week (May 10, 1982).

IF DEFINED-BENEFIT PLANS ARE SO BAD, WHY DO WE HAVE THEM?

If it weren't for federal income tax laws and federal labor laws, it is not clear whether employers would provide pensions to workers, any more than they provide them with houses, refrigerators or swimming pools. Payments to pension plans are a fringe benefit, and the alternative to fringe benefits is higher wages.

All other things being equal, workers generally would prefer to have a dollar in wages today, rather than a dollar promised to them in the future in the form of a pension benefit. This is particularly the case when the promise is made through a pension plan that is significantly underfunded. Given underfunding, a company may or may not be able to deliver on the promise it makes to its workers concerning their retirement. All other things being equal, workers probably would be unwilling to accept the risk that accompanies an underfunded pension plan. Nevertheless, the fact remains that workers do accept pension promises in lieu of wages and willingly participate in plans that may be significantly underfunded.

Why do workers accept labor compensation packages that offer a pension promise instead of a cash wage? Why do they accept the risk that accompanies an underfunded pension plan? These questions can be answered by looking at how federal government policies have helped to make pension promises and the uncertainty which accompanies them a major feature of the U.S. labor market.

THE TAX CODE

Prior to 1921, employers usually could deduct contributions to private pension plans as ordinary and necessary business expenses. However, the contributions were taxable to the employee at the time of the contribution. At the time, the tax laws did not provide either employers or employees an incentive to put money into pension plans as an alternative to wages.

Then, with passage of the Revenue Acts of 1921, 1926, and 1928, the incentives began to change. These laws made employer contributions to pension trusts as well as the income earned by the pension trusts tax-exempt to the employee until benefits are distributed. In addition, the 1928 act permitted employers to make tax-deductible contributions to pension trusts for past service costs. The Revenue Acts of 1938 and 1942 further affected the development of the private pension system by defining rather rigorously what constituted a tax-exempt pension plan.

These changes in the tax code created incentives that made it in the interest of employers and employees to set up employer-sponsored pension plans and to substitute contributions to these plans for the payment of wages. First, the employee is taxed on contributions to a private pension plan at the time benefits are received, not at the time contributions are made into the pension fund. This means the employee is taxed on the money during the retirement

years when the worker is typically in a lower tax bracket. The ability to defer taxable income to the retirement years lowers the total taxes an individual will pay.

Second, interest and dividend earnings in a qualified pension trust are not taxable at the time they are earned. A dollar in pension trust thus is worth more than a comparable dollar set aside for retirement in a private savings account, all other things being equal.

Third, there are other tax benefits linked to qualified pension plans. For example, in certain circumstances part of a lump-sum distribution from a pension plan may be taxed at capital gains rates instead of higher income tax rates. Similarly, death benefits paid under a qualified plan are given favorable estate tax treatment.[51]

Besides encouraging employers and employees to set up pension plans, the tax law also encourages the creation of a specific type of plan: the defined-benefit pension plan. Under defined-benefit plans, employers can vary the amount they contribute from year to year. By varying the assumptions upon which actuarial calculations are based, employers can vary the contributions that by law they are required to make. During profitable years, pension contributions can be increased. During unprofitable years, pension contributions can be decreased. This enables an employer to reduce the total amount of income subject to corporate income taxes, and increases overall corporate profits. This means the financial pie to be divided by labor and management is larger.

By far the most important assumption built into actuarial calculations of required pension fund contributions is that concerning interest rates. By raising the interest rate assumption, companies can lower significantly the amount they must put into a pension plan in order to meet future obligations. Conversely, by lowering the interest rate, companies can increase the amount that they are allowed to put into a pension plan, and take a greater tax deduction. The interest rate assumptions used by different companies vary considerably. One recent study places the range of assumptions for pension plans sponsored by Fortune 1000 companies anywhere from five percent to 11.3 percent.[52]

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51. There are numerous discussions of the impact of the tax code on the development of the private pension system in the United States. See Rainard Robbins, Impact of Taxes on Industrial Pension Plans (New York: Industrial Relations Council, 1949); Charles L. Dearing, Industrial Pensions (Washington, D.C.: The Brookings Institution, 1954); Alicia Munnell, The Economics of Private Pensions (Washington, D.C.: The Brookings Institution, 1982), Chapter 3. Employee Benefit Research Institute, Retirement Security and Policy (Washington, D.C.: EBRI, 1984), Chapters 2 and 3.

52. Kotlikoff and Smith, Pensions, pp. 330-335.

Interest rate assumptions have become particularly important in the 1980s with fluctuating interest rates.

- In 1981, two-thirds of General Motors' $333 million in profits was due to a change in the interest rate assumptions for the company's pension plan.

- By raising the interest rate assumption from six percent to seven percent, General Motors lowered pension contributions by $210 million.53/

- In 1981, Eastern Airlines saved $5.9 million by changing the interest rate assumptions of their pension plan from seven percent to nine percent.54/

Other companies that increased their profits in 1981 by changing the interest rate assumptions of their pension plans included Ford, Chrysler, American Airlines, United Airlines, and Firestone.55/

Currently, the special treatment of pension contributions (i.e. their tax-exempt status) translates into $56.3 billion for taxpayers as a whole.56/ However, this "tax subsidy" is not shared equally among all workers:57/

- Among employees age 25 to 34, the six percent who earn more than $50,000 will realize 22 percent of the tax-subsidy benefits.

- Those who earn between $20,000 and $50,000 make up 34 percent of this age group. They will realize 54 percent of the tax-subsidy benefits.

Moreover, as we already have noted, almost half of all workers have no private pension plan. Among those who do there are many who will never receive all of the pension benefits they expect -- either because they will never fully vest, or because of pension plan termination.

Labor Law also has played a major role in distorting the development of private pensions. Under the Wagner Act of 1935, the federal government compelled employers to collectively bargain over wages, hours, and other terms and conditions of employment. However, it was not until 1949 that the courts decided pensions should be included in the area covered under mandatory

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53. Investment Age study cited in "Paper Profits from Pensions," Labor and Investments (March 1982), p. 2.

54. "Eastern Boosts Assumptions, Creates Profit," Labor and Investments (July/August 1981), p. 7.

55. "Paper Profits from Pensions," p. 2.

56. Office of Management and Budget estimates, reprinted in Korczyk, Retirement Security and Tax Policy, p. 61.

57. Ibid., p. 59.

collective bargaining.[58] In Inland Steel Company v. United Steelworkers of America, the National Labor Relations Board held that the Wagner Act required employers to bargain with employee representatives over pensions. The effect of the Inland Steel ruling was to create a collective bargaining environment in which an employer could not set up, terminate, or alter a pension plan without prior consultation and good faith bargaining with the labor bargaining unit.

It is important to keep in mind that the specifics of a pension plan generally are not negotiated by individual workers. Instead, they are negotiated through union representatives in the collective bargaining process. Yet, the interests promoted by labor union representatives are not necessarily the interests of all workers participating in a pension plan. While these representatives have a legal duty to represent fairly all members, a union may still make a contract that unfavorably affects some workers. Union representatives tend to represent the financial interests of older, more senior workers.

Seniority rules are perhaps the most striking example of the sort of bias allowed under federal labor law. A bias in favor of senior workers over junior workers can be found in many of the pension plans bargained by union representatives over the years.

In a recent study for the National Bureau of Economic Research, Richard B. Freeman discovered that pension plans sponsored by unionized companies tend to benefit senior workers in a number of significant ways.[59] First, union pension plans tend to pay benefits on a flat rate basis, dependent on years of service, rather than pay benefits based on earnings. Under the flat rate formula, senior union members with lower wages tend to get more than higher paid junior members. Second, union pension plans generally tend to have much stricter vesting requirements than non-union plans. By denying benefits to workers who leave their employers early, strict eligibility requirements lower actuarial costs to the plan and enable more senior union members to get higher benefits. Third, union plans are overwhelmingly defined-benefit plans rather than defined-contribution plans. Defined-benefit plans tend to provide higher benefits to older workers nearing retirement and to workers already retired. The result is that younger workers end up subsidizing the pension of older workers.

Under defined-contribution plans, it is more difficult for senior workers to take advantage of younger workers. Under defined-contribution plans, employers make specific contributions on behalf of individual workers, and each worker's share in the pension fund is earmarked for his exclusive benefit. By contrast, under defined-benefit plans, the money is pooled.

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58. See Dearing, Industrial Pensions, Chapter 4.

59. Richard B. Freeman "Unions, Pensions, and Union Pension Funds." Working Paper Series. No. 1226. National Bureau of Economic Research (November 1982).

There is a significant difference between plans covering unionized workers and plans covering workers who are not unionized. As Table V shows:

- Among pension plans covering unionized workers, 86 percent are defined-benefit plans.
- Among pension plans covering non-unionized workers, only 30 percent are defined-benefit plans.

TABLE V

Unionization and Type of Pension

1977

	Union Plans	Non-Union Plans
Defined-Benefit	20,413	121,105
Defined-Contribution	3,210	286,866

Source: Kotlikoff and Smith, Pensions in the American Economy, p. 170.

Freeman's findings point to a reason why underfunded plans emerge out of the collective bargaining process. Simply put, unions are more concerned with maximizing the benefits being paid to their older members than they are with minimizing the risks facing their younger members due to underfunding. In speaking out for the interests of their membership in the collective bargaining process, unions have done so with a bias toward senior members.

One reason why union representatives may succeed with such tactics is that workers often do not know very much about their pension plan or about the risks they assume by participating. As Kotlikoff and Smith have noted, in order to estimate both the level of future pension benefits and the risk of receiving these benefits, workers need to formulate fairly precise expectations about the course of inflation and real interest rates. They need to understand the probabilities that determine life expectancy and the chances of experiencing employment termination prior to retirement age. Finally, workers need to be able to calculate the present value of future benefits and assess the risks with respect to variations in the inflation rate, potential changes in employment conditions, and other factors.[60]

The complexity of private pension plans may explain why workers often are not fully aware of the financial condition of their plans.[61]

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60. Kotlikoff and Smith, Pensions, pp. 14-5.

61. Kotlikoff and Smith, Pensions, p. 15.

- According to the 1980 U.S. Census Survey, 8.05 percent of wage and salary workers in the private sector "didn't know" if they were covered by a pension. In addition, about 20 percent "didn't know" whether they had been vested or not.

- In the age group of 18-25, 27.85 percent "didn't know" whether they had been vested or not.

Proceedings from the Braniff bankruptcy brought the problem of lack of information to light. Court documents reveal that scores of retirees were unaware of their legal rights or the nature of their contractual commitment that Braniff had made to them. Some expressed shock over the way the plans were administered in the final years before the Braniff bankruptcy, and the impact that termination had upon their benefits. In the end, there was a wide gap between what benefits the workers thought they were going to receive and the benefits they actually got.

One reason why workers may know so little about their pension plans is that individual workers have very little incentive to acquire such information. This is because there is very little a worker can do with the information after he has made the investment of time and effort necessary to acquire it. In large companies with defined-benefit plans negotiated by union representatives, an individual worker realistically cannot expect that his own knowledge and actions will lead to any fundamental change in pension plan arrangements.

REFORMING THE SYSTEM

The American pension system is not the result of unfettered competition and voluntary exchange in the free marketplace. It is instead a system which is the product of tax subsidies and government regulation. Clearly, the current system does not work well and needs reform.

It is the contention of this report that the way to correct the problems of the private pension system does <u>not</u> lie in propping up the existing system with another series of reforms that further distort the marketplace and force the government to assume additional financial burdens. The time has come to rethink the assumptions upon which federal private pension policy has operated over the last 60 years, and to construct a new federal policy that will maximize individuals' control over their retirement decisions.

What would be the characteristics of a private pension system that minimizes uncertainty and maximizes individual control?

First, workers would know exactly how much money has been set aside for their retirement.

Second, workers would acquire immediate rights to pension money and would have these rights preserved even when switching jobs. They would not have to depend upon the largesse of employers who may or may not be able to make good on their pension promises. In this way, the uninformed would be protected from falling victim to the complicated rules and regulations embodied in most pension plans.

Third, individuals would decide where and when the money set aside for their retirement is invested. Individual preferences, not the agendas of corporate or union officials, would guide the investment strategies of pension portfolio managers.

Fourth, the federal govenment would be spared the increasing financial and regulatory burdens that it finds itself coming under as it tries to prop up the existing system.

Interestingly, the elements of an optimal private pension system already exist. For example, Individual Retirement Accounts provide a tax shelter up to $2,000 a year. IRAs provide workers with considerable control over the funds set aside for their retirement, along with a significant amount of flexibility in designing a retirement portfolio to meet their individual needs and concerns.

Elements of an optimal pension system also can be found in the pension plans of non-profit educational institutions described in the beginning of this report. Like IRAs, these plans provide considerably more control and flexibility to the individual worker than most other private pension plans.

Basing pension reform on the principles which have guided the operation of these plans will grant individuals more control over their own lives. It also will avert the arrival of a day when millions of Americans look to U.S. taxpayers to make good on their pension promises.

NOTE: Nothing written here should be construed as necessarily reflecting the views of the National Center for Policy Analysis or as an attempt to aid or hinder the passage of any bill before Congress.

ABOUT THE AUTHOR

Edward J. Harphan is assistant professor of government and political economy at the University of Texas at Dallas. He is the editor of The Political Economy of Public Policy and The Attack on the Welfare State and has numerous articles in scholarly journals. He is currently working on a book on the political economy of retirement.