

# **Securing Employer- Based Pensions**

*An International Perspective*

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## Chapter 9

# The Government's Role in Insuring Pensions

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James E. Pesando

In the event of bankruptcy of the sponsoring firm, a defined pension plan may be terminated when pension assets are less than accrued pension benefits. If so, governments may elect to provide, either explicitly or implicitly, plan termination insurance designed to mitigate the corresponding loss in pension benefits suffered by plan members.

There are two distinct aspects to the study of the government's role in insuring pensions. The first, which is analytical, is to examine whether governments *should* provide plan termination insurance and, if so, what steps should be taken so as to ensure the financial soundness of the insurance fund. The second, which is descriptive, is to document the international experience with plan termination insurance, to highlight the similarities and differences in the public policy response to the risk of bankruptcy.

In the United States, plan termination insurance is provided through the Pension Benefit Guaranty Corporation (PBGC). In spite of an ongoing series of reforms, the long-term financial soundness of the PBGC remains a major concern. Against this background, this chapter reviews the experience with plan termination insurance of five countries: the United States, Canada, the United Kingdom, Germany, and Japan.

The fact that opinion is divided as to whether termination insurance is required is most apparent in Canada. Of the 11 jurisdictions (10 provinces and the government of Canada) that regulate private pension plans, only one, the Province of Ontario, has introduced plan termination insurance. Further, within a decade of introducing plan termination insurance in 1980, Ontario was considering its removal. The level of insured benefits is far more modest in Ontario than in the United States. Yet there is a parallel concern regarding the long-run solvency of the

insurance system, in light of the risks posed by a relatively small number of poorly funded plans and the opportunities for strategic behavior.

This chapter is organized into three sections. The first briefly reviews the arguments for and against the public provision of plan termination insurance. The second examines the risks borne by plan members in the event of bankruptcy for the United States, Canada, the United Kingdom, Germany, and Japan. The third reviews the principal lessons to be learned from the international experience, using concerns expressed regarding the PBGC in the United States as a benchmark. This section includes an overview of the findings together with some implications for public policy.

### **The Public Provision of Plan Termination Insurance: An Overview of the Issues and the Policy Debate**

To some policy analysts, the need for plan termination insurance is self-apparent. In its absence, workers in underfunded plans will not receive their promised pension benefits in the event of the bankruptcy of the sponsoring firm. Corporate bankruptcies are highly correlated due to the systematic risk inherent in macroeconomic fluctuations. So, too, are the returns to pension fund assets. For this reason, private markets may not be able to provide plan termination insurance, even if demand for this insurance exists at premium rates that are commensurate with risk. This "market failure," in the view of many, provides the fundamental rationale for the public provision of plan termination insurance.<sup>1</sup>

To economists, however, the argument is less clear. Even if the difficulties — political as well as economic — in designing a financially sound system of termination insurance are ignored, the fundamental rationale for its provision merits critical scrutiny.

Virtually all pension analysts, whether economists or not, now accept the proposition that pension benefits represent deferred wages. In other words, it is widely recognized that workers "pay" for their accruing pension benefits, either by reduced wages or by concessions elsewhere in their compensation package. Yet, in a competitive labor market with well-informed workers, wages will internalize the degree of risk posed by underfunded pension plans (Pesando 1982). Other things being equal, firms with fully funded plans or firms with very low probabilities of bankruptcy will extract greater wage concessions for a given level of promised pension benefits. In the limiting case, workers in poorly funded plans with a near-bankrupt employer will grant few or no wage concessions in return for enhanced pension benefits (for example, a retroactive enrichment to a severely underfunded flat benefit plan).

Those who conduct public policy are inclined to evaluate pension

plans solely in terms of their ability to deliver retirement incomes. Even if workers have willingly borne the risks associated with plan termination, policy analysts may find this outcome to be unacceptable. If workers understand the risks associated with underfunded pension promises, the economic rationale for the public provision of plan termination insurance may reduce loss of pension benefits, such as increased burden on public assistance (Mitchell 1993). If so, the rationale for the public provision of plan termination insurance can be linked to this type of market failure.

The policy analyst may deem as unrealistic the assumption that workers (or their agents) understand fully the risks to which they are exposed, and hence that the appropriate adjustments have taken place elsewhere in the compensation package.<sup>2</sup> This point is reinforced by the recognition, emphasized by Bodie and Merton (1993), that workers (unlike, for example, shareholders) typically do not have well-diversified investment portfolios, and thus may not be well suited to bearing the additional risk of the loss of pension benefits in the event of the bankruptcy of their employer. However, if the government's primary concern is that workers misperceive the security of their contractual benefits, the preferred policy response is to require the disclosure of relevant information. Firms could be required, for example, to report to each worker the value of the worker's accrued benefit in the event of plan termination, with the presumption that this information would be used in formal or informal bargaining.<sup>3</sup> If policymakers view the market outcome as unacceptable, there remains the question of whether a substitute intervention is preferred to termination insurance. There are several obvious candidates. First and foremost, the government could impose tighter funding requirements. Reduced amortization periods for both experience deficiencies (i.e., actuarial shortfalls due to a divergence between assumptions and experience) and initial unfunded liabilities would reduce the scope for underfunding in the event of the sponsor's insolvency. This observation is especially relevant for Canada and the United States, where retroactive (and thus unfunded) enrichments to flat benefit plans in the union sector represent a major source of underfunding in the private pension system. A second alternative, for example, would be to elevate the legal status of unfunded pension benefits in the event of corporate bankruptcy.

If plan termination insurance is provided by the government, there is a strong economic argument for setting the insurance premiums so as to reflect the true risk posed to the insurance fund (Ippolito 1986; Pesando 1982; Turner 1993). Yet, as noted later in this chapter, no government that provides plan termination insurance has set premiums to reflect the true level of risk exposure. No observed premium structure, for example,

incorporates the risk of corporate bankruptcy, although *universal* capital markets assess this risk on a daily basis in the process of rating corporate debt. The absence of market-based insurance premiums raises fundamental concerns. First, as is readily apparent in the United States, well-known moral hazard problems and the strategic behavior of firms will place the long-run financial soundness of the insurance fund at risk. Second, in the absence of true risk-based premiums, there is no evidence that the demand for plan termination insurance exists at *market-determined rates*.<sup>4</sup> This observation merits emphasis, since, as noted, many proponents of the public provision of termination insurance implicitly assume that demand for insurance coverage exists at a price commensurate with risk.

Finally, one should note that the success of plan termination insurance in the political arena is not necessarily linked to efficiency concerns. Rather, its introduction may reflect the response by governments to political interests. Some analysts, for example, see the introduction and the subsequent evolution of the Pension Benefit Guaranty Corporation (PBGC) in the United States in light of the political objective of forestalling industrial decline. The cost of the pension benefits provided by firms in declining industries is shifted, in the first instance, to the third party insurer. Ultimately, this cost is shifted to prosperous firms through their inappropriately high insurance premiums, or, in the event of catastrophe, to taxpayers at large. This cross-subsidization, one should emphasize, is endemic to existing termination insurance schemes. In Ontario, the catalyst to the introduction of plan termination insurance in December 1980 (which was made retroactive) was a series of threatened plant shutdowns. Not surprisingly, there was no attempt to levy insurance premiums commensurate with the risks posed by these distressed firms. To levy such premiums might, in and of itself, force these firms into bankruptcy.<sup>5</sup>

The preceding review of the arguments for and against the public provision of termination insurance is, of necessity, brief.<sup>6</sup> In my opinion, four points stand out. First, there is as yet no persuasive evidence that demand for termination insurance exists at premiums commensurate with risk. Thus the "market failure" argument is, as yet, untested. Second, compensating wage differentials will, in a competitive labor market, internalize the risk associated with underfunded pension promises. Third, there are other policy initiatives — tighter funding requirements, improved disclosure, bankruptcy reform — that could serve as substitutes for termination insurance. The potential attractiveness of these alternatives is enhanced by the political and economic obstacles to designing a financially-sound insurance system in which premiums reflect the true level of risk posed to the insurer. Fourth, the success of plan termination

insurance in the political arena may reflect redistributive, rather than efficiency, considerations.

### **International Experience with Plan Termination Insurance**

In this section, I briefly review the policies of governments in the United States, Canada, the United Kingdom, Germany, and Japan with regard to the provision and operation of plan termination insurance. The operation of the PBGC in the United States, reviewed first, identifies the issues to be addressed in the discussion of the other four countries.<sup>7</sup>

#### *United States*

If plans are fully funded (or nearly so), the potential loss of pension benefits in the event of bankruptcy is small, and the need for plan termination insurance is obviated. Further, the stated intent of United States government policy is to ensure that, ultimately, most defined benefit pensions (nominal) are fully funded. It is thus instructive to understand why, in fact, substantial underfunding of defined benefit pension plans does exist. As noted by Turner (1993), the degree of underfunding for some plans is dramatic. In 1988, there were US\$ 1.9 billion in unfunded liabilities in plans with termination funding ratios of 10 percent or less, and additional unfunded liabilities of US\$ 8.1 billion in plans with terminal funding ratios of 50 percent or less.<sup>8</sup> The typical claim on the PBGC, when valued using the PBGC's actuarial assumptions, arises from a plan that is 40 percent funded (Turner 1993).

There are several reasons for this degree of underfunding, including strategic underfunding by firms that are in financial distress. Of particular note, however, is the concentration of large claims against the PBGC among the flat benefit plans that predominate in the union sector. A flat benefit plan pays a fixed periodic amount (such as US\$ 20 per month) for each year of service. To offset the impact of inflation, and to provide real increases in pension benefits, flat benefit formulas are renegotiated upward on a periodic basis. Since these enrichments are always retroactive, new — and often quite substantial — unfunded liabilities are periodically created. United States tax law prevents these enrichments from being pre-funded. (It is not clear, if allowed, that firms would choose to pre-fund anticipated enrichments since this might weaken their position in future bargaining over the level of pension benefits.) In effect, flat benefit plans operate as “surrogate” final earnings plans, but without the pre-funding that accompanies the latter. Based on experience in the United States, one would expect that the amount of underfunding — and

hence the risk borne by the public provider of plan termination insurance — would be less if there were no flat benefit plans in the universe of defined benefit plans.

The premiums charged each plan for PBGC insurance (which are set through legislation, not by the PBGC) do not reflect the true risk posed for the insurance fund. Since 1987, underfunded plans do pay higher premiums than fully funded plans, although there is a cap on the premium surcharge.<sup>9</sup> There is, however, no allowance for the risk of insolvency of the plan sponsor, nor for the degree of investment risk in the pension fund. As a result, firms with a low probability of bankruptcy subsidize firms that are less stable.

Because the insurance premiums are not market-based, there exist opportunities for strategic behavior; that is, for plan sponsors to “game” against the interest of the PBGC. As its financial situation deteriorates, a firm may reduce its plan contributions (through, for example, revising certain of its actuarial assumptions or requesting a funding waiver from the Internal Revenue Service), grant enriched pension benefits, and/or assume more risk in its pension fund. The incentives created by non-market insurance premiums, together with the relatively low priority of the PBGC’s claim on a sponsor’s non-pension assets under current United States bankruptcy law, invite behavior that threatens the long-run solvency of the PBGC.

There is a limit on the maximum pension benefit that is insured by the PBGC. In 1993, the maximum insured pension was US\$ 2,420 per month, which is US\$ 29,250 per year. There are other ways in which plan members coinsure the risk of default. Unvested benefits and special supplements for early retirement benefits are not insured, and guaranteed benefits that are created by plan amendments less than five years old are phased in at a rate of 20 percent for each year subsequent to the plan amendment. Because of the “backloading” of pension benefits in most defined benefit plans (i.e., the tendency for pension accruals to rise sharply with age and years of service), there is substantial coinsurance by virtue of the fact that members’ benefits are frozen at the date of termination. Thus, in spite of the existence of termination insurance, plan members do risk a loss of pension benefits in the event of a plan windup due to the insolvency of the sponsor.<sup>10</sup> There is thus *some* market discipline on this account.

## Canada

The most revealing observation from the Canadian experience is that only one of 11 jurisdictions (Ontario, in 1980) has introduced plan termination insurance. Nine other provinces and the federal government

have chosen *not* to introduce such insurance. (The federal government has jurisdiction over certain designated industries, such as banking and telecommunications.) Like the PBGC, the Guarantee Fund was designed as a self-funding program financed by premiums paid by the sponsors of defined benefit plans. The Guarantee Fund was established six years after the PBGC, and was designed to preempt some of the more difficult problems that plagued the PBGC.<sup>11</sup> Nonetheless, by the end of the decade, the government of Ontario was considering abandoning the scheme (accompanied by tighter funding requirements, especially for flat benefit plans) as the result of concerns regarding financial soundness.

In Canada, as in the United States, flat benefit plans are typically less well funded than earnings-based plans. Thus the exposure of the Guarantee Fund, as revealed by unfunded liabilities measured on a termination basis, is largest in the flat benefit plans that predominate in the union sector. As in the United States, it is the periodic and retroactive enrichments of these plans that generate significant unfunded liabilities.

The premium structure for the Guarantee Fund resembles that of the PBGC. There is a flat premium per member plus a premium surcharge related to the degree of underfunding measured on a termination basis. As in the United States, insurance premiums do *not* reflect the probability of bankruptcy of the corporate sponsor, and thus are *not* set at market levels on this account.

There is a limit on the maximum pension insured by the Guarantee Fund. At present, the maximum insured pension is US\$ 750 per month, or US\$ 9,000 per year. This maximum insured pension is nominal, and has not been increased since the Guarantee Fund was introduced in 1980. The maximum pension insured by Ontario's Guarantee Fund is less than one-third of the maximum pension insured by the PBGC. To protect the integrity of the Fund, and to limit strategic behavior, certain enriched early retirement benefits and any benefit enrichment in effect for less than three years are excluded. Unlike the United States, there is no provision whereby a financially distressed firm can request a funding waiver from Revenue Canada, the equivalent to the IRS in the United States.

The most significant departure from the United States experience is the absence of plan termination insurance for all plan members in Canada except those subject to Ontario's jurisdiction. This result occurs in spite of the fact that pension law and regulations are very similar on all other accounts across the different jurisdictions.

To provide an economic rationale for this disparity is difficult. It seems unlikely, for example, that policymakers in Ontario reject the "rational worker" assumption implicit in the analysis of competitive labor markets, while policymakers in other jurisdictions accept this assumption. If there

is an unexpected reduction in pension benefits due to a plan insolvency, there may be an increased claim on Canada's income-tested public pension programs. Yet the most important of these programs, the Guaranteed Income Supplement, is operated by the federal government and is available to Canadian residents in all the provinces. There is no reason why Ontario, alone, should respond to this potential externality.

Interestingly, Ontario has always been considered Canada's "industrial heartland," and the existence of termination insurance *only* in this province is entirely consistent with a political explanation that is frequently cited in the United States: that is, that an important, although unstated, goal for plan termination insurance is to subsidize the cost of pension benefits (and thus employee compensation) in declining industries.

### United Kingdom

State Retirement Pensions in the United Kingdom have two parts. The first is a fixed benefit component, with a maximum value for a single person in 1994–1995 of US\$ 86 per week, which is US\$ 4,472 per year. The second part is linked to the worker's earnings, and is known as the State Earnings Related Pension scheme (SERPs). If an employer-sponsored plan meets specified criteria, the employer may contract out of SERPs. In this event, both the employer's and the employees' National Insurance contributions are reduced between the lower (about 18 percent of national average earnings) and upper earnings limits (7½ times the lower limit). Salary-based (defined benefit) plans that contract out are required to provide the additional earnings-related pension known as the Guaranteed Minimum Pension. The Occupational Pensions Board, a statutory body, has the responsibility for monitoring plans that have contracted out, and issues the contracting out certificate. At present, about 50 percent of workers in the United Kingdom are covered by an occupational pension plan, and 90 percent of these members have contracted out of SERPs. In the private sector, 78 percent of members of occupational pension plans have contracted out.

In the United Kingdom, there is, at least for the present, no formal system of plan termination insurance. In the event of the insolvency of the plan sponsor, any deficiency in plan assets relative to accrued benefits is treated as a debt of the employer. *If* this debt is not repaid, the trustees of the plan must reduce benefits, according to the priorities established in the trust deed. The protection of plan members thus relies on the fiduciary responsibility of the plan's trustees, to ensure that pension assets are sufficient to meet accrued pension benefits.

The absence of a formal system of plan termination insurance, however, is potentially misleading. If the sponsor of a contracted out plan

goes bankrupt, the Guaranteed Minimum Pensions of its members will be restored upon transfer of the corresponding plan assets to the state scheme, even if plan assets are inadequate for this purpose. In effect, there is *implicit* termination insurance for Guaranteed Minimum Pensions, but not for benefits in excess of these amounts. No premiums are levied for this implicit insurance, implying (for example) that there is a potential cross-subsidy from the employers and employees of financially sound firms to their counterparts in less stable firms.

Occupational pension plans that contract out of SERPs usually provide benefits in excess of the Guaranteed Minimum Pension. Thus, in spite of the implicit termination insurance described above, most members of contracted-out defined benefit plans are at risk in the event of their employer's insolvency if pension assets are less than accrued pension liabilities. The trustees of the plan, in order to serve the interests of the beneficiaries of the trust (i.e., the members of the plan), have an obligation after each actuarial valuation to ensure that steps are taken to eliminate any shortfall of assets relative to accrued liabilities.

For perspective, it would appear that the *effective* level of termination insurance in the United Kingdom is close to that provided in Ontario, but well beneath the level that exists in the United States. Christopher Daykin (Chapter 2, this volume) notes that the target replacement rate for SERPs is 25 percent of average earnings in the range between the lower and upper earnings limits. The lower limit is (about) 18 percent of national average earnings, and the upper limit is 135 percent of national average earnings. The Guaranteed Minimum Pension, which is protected by implicit plan termination insurance, is thus equal to (about) 30 percent of national average earnings.<sup>12</sup>

If the sponsor of a contracted-out plan goes bankrupt, then those pensions that replace social security pensions are treated as if bought back into SERPs, even if the plan's assets are insufficient to do so. To protect the integrity of SERPs, the Occupational Pensions Board has the statutory responsibility to ensure that employers fully fund the accrued liabilities in respect to Guaranteed Minimum Pensions. If a plan fails to demonstrate that it has adequate resources, the Occupational Pensions Board may withdraw the right to contract out of SERPs. At present, the only funding requirement set out in regulations is that the pension plan have assets at least equal to the Guaranteed Minimum Pensions of its members. No statutory requirement is imposed, in general, if the funding level of the plan is less than 100 percent as established by its actuarial valuation. Further, the actuarial valuation, which must be made at least every three and a half years, need not provide the details of the method or the assumptions used in the calculation.

Following the highly publicized shortfalls in the Maxwell pension

plans, policy analysts in the United Kingdom have recently revisited the question of plan termination insurance. The Pension Law Review Committee has recommended that a compensation fund be established, to cover shortfalls (*only*) if there has been fraud or theft of assets. The Committee has made a number of other recommendations designed to enhance the security of promised pension benefits.

From a North American perspective, two additional observations merit note. First, the problem of underfunding, so evident among distressed firms in the United States, does not appear to be a major problem in the United Kingdom.<sup>13</sup> This may reflect the fact that the members of defined benefit plans are in plans in which pensions are linked to salary at or near retirement. There are, apparently, no flat benefit plans whose periodic (and retroactive) enrichments are the primary source of underfunding in Canada and the United States. Second, at least for benefits in excess of Guaranteed Minimum Pensions, statutory funding and monitoring requirements appear to be less stringent than in either Canada or the United States.

### Germany

In Germany, the book reserve method is the primary system for financing employer-sponsored pension plans.<sup>14</sup> Unlike the United States, Canada, and the United Kingdom, pension liabilities are *not* secured by pension assets held in a separate trust. In Germany, the employer has a direct liability to pay promised pension benefits, and these benefits are paid out of company, not pension, assets. Financing takes the form of the accrual of book reserves.<sup>15</sup> To protect the promised pension benefits in the event of the employer's bankruptcy, the book reserve system is accompanied, since 1974, by mandatory insolvency insurance. Insolvency insurance is provided by the Pensions-Sicherungs-Verein (PSVaG), a mutual insurance corporation.

In the event of bankruptcy, the PSVaG is required to pay all the pension benefits due under the terms of the employer's plan. These include pensions that are currently in pay, together with the pension benefits that are legally vested at the time of the bankruptcy. The PSVaG is not required to pay a monthly pension in excess of three times the Social Security Contribution Ceiling. However, this is a very large amount, equal to US\$ 165,000 per year. Certain pension benefits—such as enrichments granted in the last year prior to insolvency that exceed the benefits granted in the prior year—are excluded from coverage. This is analogous to steps taken by the PBGC in the United States and the Guarantee Fund in Ontario to limit the scope for strategic behavior against the interests of the public provider of termination insurance. Insured bene-

fits are paid in full even if the bankruptcy involves criminal behavior on the part of management, and even if the firm is not current in its required contributions to the PSVaG.

Employers are required by law to make contributions sufficient to finance the insolvency insurance on a pay-as-you-go basis.<sup>16</sup> Required contributions are based on the size of the employer's pension liabilities, including pensions in pay to retired workers. The contribution rate, like its counterparts in North America, is *not* linked to a measure of the likelihood of the firm's insolvency. For this reason, the insurance premiums levied by the PSVaG are not market-determined rates; that is, the true risks of a claim on the insurance fund are not internalized into insurance premiums. There is thus a cross-subsidy, as in North America, from stable to less financially secure firms. The annual contribution rate is set equal to the ratio of the capital required in the year by the PSVaG to the total amount of employers' liabilities for pension benefits. In 1975, the contribution rate was set equal to 0.15 percent. Since then, it has fluctuated from year to year. To date, the highest contribution rate occurred in 1982, at 0.69 percent; the lowest, in 1990, was at 0.03 percent (Peter Ahrend, Chapter 3, this volume). The high contribution rate in 1982 reflects the claim arising from a major company in the electronics industry.

In the United States, the PBGC levies premiums based, in part, on the amount by which pension assets fall short of pension liabilities. In Germany, there are no pension assets if the employer uses the book reserve system. From this perspective, the fact that the PSVaG levies premiums on the full amount of the employer's pension liabilities is a parallel policy, since this is the amount by which pension liabilities exceed pension assets. Ironically, there is nothing analogous in Germany to the major concern of policy analysts in the United States: the apparent success of firms in financial distress to underfund their pension liabilities, to the detriment of the PBGC.

From the perspective of North America, the apparent lack of concern regarding the financial soundness of the PSVaG is surprising. In large part, this may reflect the relatively favorable experience of the PSVaG, at least to date. From 1988 to 1992, for example, the required contribution rate averaged 0.07 percent. This is one-half the average contribution rate (0.14 percent) required during the five years (1975–1979) immediately following the creation of the PSVaG.

Yet, if a small number of large firms were to experience financial distress, the required contribution rate could rise sharply. (In 1982, the contribution rate rose to 0.69 percent, more than triple the contribution rate in 1981.) Further, adverse selection would appear to present more of

a problem than in the United States, since the cross-subsidy from secure to less stable firms appears to be more pronounced. Perhaps, the tax-subsidized self-financing available to secure firms who use the book reserve method provides a strong enough incentive to prevent their seeking to exit the system by adopting a different type of financing arrangement for their pension plans (such as setting up a pension fund). In Germany, benefit enrichments in the year immediately preceding bankruptcy that exceed those granted in the previous year are excluded from insurance coverage. Yet this response to the moral hazard problem seems to be less onerous, and thus less of a constraint on strategic behavior, than does the five-year phase-in rule imposed by the PBGC.<sup>17</sup>

## Japan

Historically, a distinguishing feature of the Japanese pension system has been the Lump Sum Retirement Benefit plan, financed on a book reserve basis. Tax Qualified Pension Plans (TQP) were introduced in 1962 and Employees' Pension Fund (EPF) plans were introduced in 1966. As a result, there are a number of possible financing arrangements for defined benefit pension plans in Japan. This fact, together with continued changes in the retirement income system, complicate the task of assessing the role of termination insurance in Japan.

A TQP plan must be funded through a financial institution, such as a life insurance company. An EPF is a contracted-out plan — more specifically, a plan that is a substitute for the earnings-related component of the Employees' Pension Insurance. The latter is the earnings-related public pension plan that covers the majority of workers in the private sector. To qualify for contracting out, the employer must establish the EPF as a legal entity separate from the plan sponsor, and provide a pension benefit that is at least 30 percent more generous than the social security benefits that are being replaced. An EPF, unlike a lump sum plan, is advance-funded. Like TQP plans, most EPF plans are managed by life insurance companies or trust banking companies. Firms that provide a book reserve plan may also provide a TQP or EPF.

The risk borne by plan members in the event of insolvency varies with the type of plan to which the member belongs. Since 1976, employers who sponsor book reserve plans have been required to guarantee this amount with a financial institution. In fact, Noriyasu Watanabe (Chapter 4, this volume) reports that the majority of employers do not guarantee their book-reserve plans, as the regulations are laxly enforced. As a result, it would appear that the lump sum payments due plan members remain at risk in the event of the insolvency of their employer.

There is no termination insurance for TQP plans, so members remain at risk in the event of the bankruptcy of their employer. For these plans, however, this risk is mitigated by the requirement of advance funding.

In 1989 the Pension Guarantee Program was established to provide plan termination insurance to members of EPF plans. EPF plans are required to make contributions to the insurance program. Noriyasu Watanabe (Chapter 4, this volume) indicates that the contributions required of plan sponsors reflect the statistical likelihood of termination as well as the unfunded liability if the plan is terminated. As previously noted, insurance premiums in the United States, Canada, and Germany do *not* attempt to distinguish among firms on the basis of their differing probabilities of bankruptcy. It would appear that the proxy for financial soundness in Japan is simply the size of the employer, as the required contribution per participant declines gradually as the number of participants increases. As of 1994, there had been only one plan termination under the Pension Guarantee Program, and this plan was sufficiently well funded that there was no claim on the insolvency insurance program. Consequently, unlike the case in Canada and the United States, there is no apparent concern regarding the solvency of the insurance fund.

### **An Overview of the International Experience**

In spite of an ongoing series of reforms, the long-term financial soundness of the PBGC remains a major concern in the United States. Indeed, many analysts (Bodie 1992; Smalhout 1993) draw attention to the potential parallel with the Federal Savings and Loan Insurance Corporation (FSLIC), which ultimately failed at tremendous cost to the United States taxpayer. Common concerns include, for example, the lack of market discipline, the opportunities for strategic behavior by the insureds, and regulator forbearance.

The purpose of this chapter is to provide a comparison of international experience with plan termination insurance, with particular attention to common problems and attempts at their solution. In this context, the PBGC provides a useful benchmark against which the experience of other countries can be compared. The most salient observations are summarized below.

With the exception of Germany, the level of benefits insured by the PBGC (a maximum of US\$ 2,420 per month or US\$ 29,040 per year in 1993) is high by international standards. The higher the level of the insured benefit, the higher is the value of the protection afforded to plan members, other things being equal. On the other hand, the higher, too, is the potential exposure of the public provider of termination insurance.

The risk exposure of the PBGC is concentrated among collectively

bargained flat benefit benefits, where retroactive benefit enrichments generate new unfunded liabilities on a periodic basis. The experience in Ontario is similar. In the United Kingdom, the Guaranteed Minimum Pensions in contracted-out plans are earnings-related and, as a result, less likely to be underfunded. In Germany, the type of defined benefit formula is not an issue, since there is no advance funding with the book reserve system.

A major concern in the United States is the apparent ability of financially distressed firms to underfund their pension plans, thereby increasing the risk borne by the PBGC. There is no advance funding by those firms in Germany that adopt the book reserve method of financing their pension plans, so this dimension of strategic behavior is simply not relevant. Yet, as of 1994, there appears to be no public policy concern in Germany regarding the financial soundness of the PSVaG.

In Ontario and Germany, as well as in the United States, there is no attempt to incorporate the probability of bankruptcy into the setting of insurance premiums. As a result, there is a potentially large cross-subsidy from financially secure to less secure firms. In the United Kingdom, an analogous situation exists with regard to the implicit insurance provided to Guaranteed Minimum Pensions in contracted-out plans. In Japan, there appears to be an attempt to incorporate the likelihood of bankruptcy into the setting of insurance premiums, but only to the extent that the size of the firm (as measured by the number of plan participants) is used as a proxy for the firm's financial soundness.

To contain the evident moral hazard problem, recently granted enrichments to pension plans are not immediately covered by plan termination insurance. It would appear that Germany has the least demanding requirement. Yet, as previously noted, there seems to be little public concern about the financial soundness of PSVaG.

The problem of adverse selection is relatively unimportant in the United States, Ontario, and the United Kingdom, where participation is compulsory. In Germany, firms may choose *not* to use the book reserve method. By setting up a pension fund, the firm can avoid participation in the PSVaG. Presumably, other things being equal, financially sound firms have the strongest incentive to avoid participating in the PSVaG.

In those countries where explicit termination insurance exists (i.e., all countries except for the United Kingdom), there is no distinction between insurance claims that do or those that do not arise from fraud or other employer malfeasance. In the United Kingdom, the Pension Law Review Committee has recommended that a compensation fund be established to protect promised pensions *only* in the event that there has been fraud or theft of assets.

The "big" question regarding plan termination insurance is whether,

in fact, it is needed. In a competitive labor market with well-informed agents, the wages paid to workers will internalize the risk of promised pension benefits. This seems to be a persuasive argument in the case of collectively bargained plans, where underfunding in North America is concentrated. The apparent willingness of younger workers to accept the risks associated with underfunded flat benefit plans should be seen in the context of other objectives — in particular, the goal of encouraging and facilitating the retirement of older workers in order to enhance job security.<sup>18</sup> In the alternative, policy makers might deem the loss of pension benefits to be an unacceptable outcome, even if this possibility has been appropriately internalized into the compensation packages of affected workers. In this event, there remains the policy option of using tighter funding requirements as a means of reducing the risks that workers can, in fact, choose to bear. This could be accomplished, for example, by requiring very rapid amortization of any unfunded liabilities created by retroactive enrichments to flat benefit plans.<sup>19</sup>

As noted, Ontario began to consider the abandonment of plan termination insurance within a decade of its introduction. As the Ministry of Financial Institutions writes:

There is a risk that the PBGF will lack sufficient funds to meet current and future liabilities and that its potential liabilities cannot be known with certainty. As a result, the government is considering whether to maintain the Pension Benefits Guarantee Fund, possibly on a restructured basis designed to balance the potential liabilities and Fund assets, or whether to eliminate the Fund and strengthen the responsibilities of plan sponsors and plan members to provide for protection of benefits. (1989)

If the Guarantee Fund were eliminated, Ontario would take additional steps to improve the funding position of poorly funded plans.<sup>20</sup> In this context, the Ontario government highlights the special concern with underfunded flat benefit plan (Ministry of Financial Institutions): "The Superintendent of Pensions could be given the authority to deny approval of benefit enhancements which increase plan liabilities where the plan is funded at less than a prescribed level. This would not include statutory benefit improvements, but would require that supplementary benefits be adequately funded. It is recognized that such a restriction might be opposed as undue interference in the collective bargaining process and in some cases could impose limitations on negotiated benefits. However, for poorly funded plans it would represent an important safeguard to protect the benefits of both active and retired plan members."

With the change of government in Ontario in 1990, the question of whether the Guarantee Fund should be terminated is no longer under active consideration. However, the maximum insured benefit has re-

mained at US\$ 750 per month since the creation of the Guarantee Fund. The *real* value of this ceiling has declined sharply, by 49 percent since 1980 and by 13 percent since 1989. In the United States, by contrast, the maximum insured benefit rises by the same factor used to escalate social security benefits. From this perspective, the importance of plan termination insurance in Ontario has effectively declined through a policy of benign neglect.

## Conclusion

The "market failure" argument for the public provision of plan termination insurance is, at least superficially, appealing. In the absence of termination insurance, members of underfunded plans will suffer a loss of pension benefits if their employer goes bankrupt. Further, the public provision of plan termination insurance *has* met with considerable success in the political arena.

Economic analysis, however, suggests that the fundamental rationale for insurance is less clear. Equally important, no country has, as of 1994, sought to levy insurance premiums commensurate with the level of risk. In the United States, this fact underlies the continuing concern about the long-run financial soundness of the PBGC. The fact that market-based insurance premiums have never been levied indicates that the "market failure" argument has not been tested: there is as yet no evidence that the demand for insurance exists at premiums commensurate with risk. Since bankruptcy risk is not incorporated into the premium structure, profitable firms effectively subsidize unprofitable firms. This fact, in turn, invites the interpretation that the success of termination insurance in the political arena is due to redistributive, rather than to efficiency, considerations.

I am indebted to John Turner, Olivia Mitchell, Carolyn Weaver, and Dallas Salisbury for useful suggestions.

## Notes

<sup>1</sup>Ippolito (1986, 1989) discusses possible efficiency arguments in support of introducing plan termination insurance (the PBGC) in the United States. He discusses, as well, the possibility that the PBGC was designed to benefit unprofitable firms with poorly funded plans at the expense of profitable firms with well-funded plans.

<sup>2</sup>Inman (1982) provides evidence that some public sector workers in the United States, whose benefits are not insured by the PBGC, receive higher wages in poorly funded plans.

<sup>3</sup>In light of a topical concern in the United Kingdom, one should note that

there is no suggestion in this formal analysis that wages will internalize the risk of funding shortfalls due to fraud perpetrated by the employer. While information on the funded status of the pension plan is readily disclosed, such is not the case for information regarding the likelihood of employer malfeasance. This does not, however, necessarily provide a rationale for government intervention. Ippolito (1986), for example, points out that private markets can and do insure against fraud or incompetence among pension fund managers.

<sup>4</sup>As noted by Ippolito (1986) and others, plan sponsors could be required to obtain insurance for their pension liabilities in private markets. This requirement would ensure that insurance premiums are set at market levels. The role of the government in this system would be to provide reinsurance in the event of system-wide adverse experience. Weaver (1993) proposes that the insurance function, as distinct from the transfer functions, of the PBGC be shifted to the private sector. In the absence of market-based pricing of insurance, and again as emphasized by Weaver (1993), the financially secure firms that subsidize their less healthy counterparts face a continuing incentive to opt out of the system by (for example) terminating their defined benefit plans and replacing them with defined contribution plans. Finally, the difficulties of the public insurer in setting risk-related insurance premiums merit emphasis. It is well known, for example, that the financial strength of the plan sponsor and the degree of underfunding should both be reflected in the premium structure. As emphasized by Bodie (1994), the mismatch between the degree of risk of the insured benefits, akin to (nominal) long-term debt, and the degree of risk of the pension assets is an important determinant of the long-run exposure of the public insurer. This factor, too, should be reflected in the insurance premium.

<sup>5</sup>The unwillingness of Ontario to levy risk-based insurance premiums eliminates the alternative strategy of mandating insurance coverage and inviting private insurers to enter the market. Ontario's insurance was made retroactive, for ongoing plans, to 1965. This is the year in which the Pensions Benefit Act of Ontario came into effect.

<sup>6</sup>Additional issues include, for example, the complications posed by the fact that termination insurance may cover only nominal (i.e., not real) pension benefits, together with the possibility that underfunding per se may provide efficiency gains by ensuring that workers have an important stake in the financial solvency of their employers (Ippolito 1985, 1986). To the extent that plan termination insurance subsidizes the compensation of older workers in declining industries, the public provision of this insurance may entail significant intergenerational transfers. The transfer of resources across generations, whether planned or not, has received increased attention by economists in recent years. Finally, an argument in support of pension insurance pertains to the market for "lemons." There are some "lemons" in the pension market, but workers have difficulty distinguishing them from reputable pension promises. As a result, workers give up smaller wage concessions to good firms than they would if they were assured that there is little or no risk to the pension promises of those firms. For good firms, the "unfair" pension insurance is the price they pay to assure their workers that their pension promises are reliable. For risks taken while young, individuals can offset losses through their labor market behavior as well as through their consumption. For risks taken later in life, however, individuals must absorb losses through reductions in consumption. Because they are less able to bear risk while old, workers are more likely to favor low risk retirement assets. For this reason, workers may prefer pension benefit insurance even though they are willing to accept other risks.

<sup>7</sup>For the United Kingdom, Germany, and Japan, the discussion draws heavily on Daykin (Chapter 2, this volume), Ahrend (Chapter 3, this volume), and Watanabe (Chapter 4, this volume). See also Clark (1991) for additional details regarding the retirement system in Japan. Other countries with plan termination insurance include Sweden, Finland, and Chile.

<sup>8</sup>These statistics are based on single employer plans with 100 or more members.

<sup>9</sup>In 1992 the premiums for fully funded plans were equal to US\$ 19 per participant; for underfunded plans, US\$ 19 per participant plus US\$ nine for each US\$ 1,000 of unfunded vested benefits per participant, to a maximum of an additional US\$ 72 per participant. A plan with a large unfunded liability could thus be charged an insurance premium up to US\$ 91 per participant. See Turner (1993) for further details. See Munnell (1982) for a discussion of the PBGC as structured at the time of its introduction.

<sup>10</sup>In a widely discussed and controversial case, LTV Corporation established, in 1987, follow-on plans that provided its workers with substantially the same benefits as in the underfunded plans that LTV wound up in 1986, transferring significant unfunded liabilities to the PBGC in the process.

<sup>11</sup>In Ontario, for example, the insured event has always been the *insolvency* of the plan sponsor. Further, the Guarantee Fund in Ontario has a lien on employer assets equal to the *full* amount of the insured shortfall of pension assets. There is no provision, unlike the United States, for funding waivers if the employer is experiencing financial difficulties. In spite of these steps, the potential for a financial crisis is both real and acknowledged. For the year ending March 31, 1993, the Guarantee Fund reports that there were 37 potential claims relating to the closure of 31 companies, with a potential liability to the Fund of US\$ 27 million.

<sup>12</sup>This figure is equal to 25 percent, the target replacement rate, times 117 (i.e., 135 less 18) percent of national average earnings.

<sup>13</sup>This observation is, of necessity, tentative. Daykin (1991) reports that there is no centrally gathered information on the funded status of private sector plans.

<sup>14</sup>Ahrend (Chapter 3, this volume) reports that book reserves presently account for about 70 percent of the funds set aside to provide for employer-sponsored pension benefits.

<sup>15</sup>The book reserve appropriations made by the employer are tax-deductible. When pension benefits are paid, book reserves are reduced and the firm's taxable profits rise accordingly.

<sup>16</sup>The PSVaG does not pay insured benefits directly. Rather, the PSVaG buys the requisite annuities from a consortium of life insurance companies. For pensions in pay at the time of bankruptcy, the PSVaG purchases the necessary annuity contracts immediately from the consortium of life insurance companies.

<sup>17</sup>In theory, a firm facing imminent bankruptcy in the United States might grant benefit enrichments far in excess of those that it would grant if it were solvent. In spite of the five-year phase-in rule, the firm could succeed in enriching its workers at the expense of the PBGC.

<sup>18</sup>There remains, of course, the question of whether young workers (in particular) understand the nature of their employer's pensions (Mitchell 1988). As noted, Ippolito (1986) has argued that the underfunding of flat benefit plans serves to make union members resemble bondholders of the firm, thereby providing union members with a strong incentive to ensure the firm's solvency.

<sup>19</sup>If tighter funding requirements were to replace the public provision of termination insurance as a means of reducing the risk of employer-sponsored pen-

sions, the nature of the public policy debate might shift in new directions. For example, the government might consider issuing indexed bonds as a means of facilitating the preservation of real pension benefits during retirement. (In the United Kingdom, and more recently in Canada, government index bonds already exist.) In this context, it is worth emphasizing, for example, that the PBGC in the United States insures nominal, not real, pension benefits.

<sup>20</sup>There is, of course, no reason to view such initiatives solely as a *substitute* for plan termination insurance. Such initiatives could, evidently, *complement* a system of plan termination insurance.

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## *Comments by Carolyn L. Weaver*

In light of the growing concern over the solvency of the United States pension insurance system, and the potential for a savings-and-loan-style taxpayer bailout of the Pension Benefit Guaranty Corporation, James Pesando has written a timely and important chapter on how five major nations have chosen to deal with securing employer pension promises. He provides a wealth of information on, and documents a fairly significant degree of variation in, pension insurance arrangements in other countries. This variation in arrangements suggests some fruitful avenues of future research.

In the United States, there is a formal system of pension insurance operated on a monopoly basis by the federal government and based only loosely on insurance principles. By contrast, most of Canada operates without pension insurance; the United Kingdom relies on an implicit system in which the government guarantees a minimum pension (with no explicit pricing of that guarantee or financing of the implied debt), requires full funding of that pension, and imposes on employers liability for any pension fund shortfalls in the event of bankruptcy; and Japan operates a system that is a hybrid of the United States and the Canadian systems, with some pensions uninsured and some pensions insured by the government with (apparently) some attempt to risk-relate premiums. This variation would lead any good economist to long to see the next study — the one that attempts to quantify, empirically, the effects of these institutional differences on underfunded plan terminations and on the solvency (or implicit debt) of pension insurance systems. It leads a political economist like myself to long to see the study that attempts to explain the variation in institutions across countries.

Given the more limited purpose of this chapter, which is to compare and contrast institutions, some critical details about the design of pension insurance systems warrant further elaboration. For example, what precisely is the event against which countries are attempting to insure, referred to loosely as the "insolvency" of insured plan sponsors, and how

much discretion do sponsors retain over the timing of that event? Is it financial distress (how much distress?), negative net worth, or bankruptcy and liquidation, and how much pension debt can the company pile up as that event approaches? What kind of claims do workers (or the government insurer) have on the non-pension assets of plan sponsors, and what is the status of these claims in bankruptcy proceedings? How are minimum funding requirements monitored and enforced? What are the restrictions, if any, on investment practices? More generally, since all countries (with the possible exception of Japan) reject risk-based pricing, how precisely is moral hazard controlled other than by limiting benefit guarantees? While Pesando addresses some of these issues for some of the countries, a more thorough exposition would be helpful.

As a related point, I would have found it helpful to see some concrete data on the actual and expected future claims experience in other countries. In the United States, for example, the concentration of large claims in unionized firms offering flat benefit plans tells us a great deal about the efficacy of our funding rules and premium structure as well as the probable political purpose of pension insurance.

Were we to try to draw inferences from a study such as this about the effects of public pension insurance on, say, the retirement income choices open to workers, the ability of firms to respond flexibly to changing market conditions, the security of retirement incomes, or, more generally, economic efficiency, we would need to know still more. In particular, what is the tax, legal, regulatory, and labor market environment within which private pensions exist? How important are defined benefit pensions to retirement income saving? Are close substitutes available for insured pensions?

In the United States, for example, we have an enormous, well-developed private pension system, a variety of tax-preferred means of saving for retirement, competitive labor markets, and a mobile workforce.<sup>1</sup> These factors tend to limit the costs that can be imposed on the private sector through a poorly designed public program, while simultaneously creating a potentially large adverse selection problem for the government insurer.

While these latter questions go well beyond those that Pesando attempts to address, they are critical to evaluating the likely costs and benefits of pension insurance.

This brings me to Pesando's discussion of the economic rationale for pension insurance. Although he makes clear that his purpose is *not* to evaluate why governments *should* adopt pension insurance, he nevertheless touches on this subject and, in so doing, leaves unresolved a number of important issues.

Pesando presents three economic rationales or so-called "market failure" arguments for pension insurance:

- Imperfect information in labor markets, whereby workers (or their agents) can not properly perceive the risks of an underfunded termination and thus wages do not fully internalize these risks;
- Paternalism, whereby workers properly perceive the risks and wages adjust, but we (somebody!) nevertheless wish to protect them from the loss of pension wealth; and
- An externality for taxpayers, whereby losses of pension wealth from unanticipated, underfunded terminations result in increased public assistance expenditures.

As a student of public finance and public economics, these rationales raise three questions in my mind:

- Are they sound market failure arguments, worthy of attention in this chapter?
- If so, what specific public policies would they suggest?
- Are the benefits of government action likely to outweigh the costs? In other words, as James Buchanan has taught me to ask, how does the supposed market failure stack up against the potential for government failure, recognizing that public policies emerge from imperfect political institutions?

From this perspective, it is quite a stretch to get from any of these supposed market failures to a compulsory system of pension insurance organized around a monopoly public supplier, such as was created in the United States and to a greater or lesser degree in Ontario and the other countries studied.

As Pesando notes, the imperfect information argument (weak on its face in competitive labor markets) suggests policies designed to improve the information available to workers. For example, firms might be required to disclose workers' accrued benefits in the event of bankruptcy and the proportion of benefits that could be met with pension fund (or other) assets on hand. Pension insurance, by contrast, which shields workers from the loss of pension wealth, tends to weaken incentives to become informed about the ability of employers to back up their pension promises.

The second rationale, paternalism, is very nearly illogical on its face as a market failure argument. It implies that there is an identifiable group of people (i.e., paternalists) who cares about and is willing to pay some price to protect workers from pension losses even though these workers have already been compensated for the risk of loss through the wage premiums they extract from companies offering riskier pensions. While it is clear who comprises the recipient group, presumably the millions of

workers who are or may one day be covered by pensions, who are the paternalists? Taxpayers other than workers? If so, it is not clear how pension insurance would be financed so that the true costs would be borne by paternalists rather than by the intended recipients. It is also not clear why the concerns of paternalists would not extend to workers covered by defined contribution plans who knowingly expose themselves to more investment risk than participants in defined benefit plans.

It would probably be more constructive to think in terms of the gains that might accrue to self-interested workers seeking to reduce the variability of pension outcomes. As Zvi Bodie and Robert Merton (1993) have explained, even if wages adjust to reflect the riskiness of pensions, workers may still prefer less pension risk because of the large, non-diversifiable stake they typically have in the firms in which they work. Since, in their view, the primary function of defined benefit pensions is to offer a specified benefit at retirement, it follows that "the function is less efficiently performed if the contract . . . calls for the benefit to be paid in the joint event that the employee retirees *and* the firm is still solvent."<sup>2</sup>

From this perspective, no paternalists are required to generate a demand for institutions to reduce the risk of default, and there are market-based responses or, at least, less costly government responses. For example, plan sponsors could reduce default risk by contracting with life insurance companies to provide pension annuities. Alternatively, pension claims could be given priority over the claims of other creditors in bankruptcy proceedings (Keating 1991; Lindeman 1993; Bodie and Merton 1993), or firms could be required to demonstrate their ability to meet promised benefits by purchasing a guarantee from a private financial institution (Weaver forthcoming; Smalhout 1993).

Finally, the externality rationale cannot properly be described as a *market* failure since the underlying problem is a pre-existing government program — public assistance. There is a fiscal externality, but it is created by government. As the history of the Pension Benefit Guaranty Corporation amply demonstrates, much justification for government intervention derives from trying to fix problems created by earlier interventions. This fiscal externality, moreover, has been used to justify everything from mandatory private pensions to social security and thus provides little guidance as to the appropriate policy response.

As some measure of the importance, empirically, of this rationale, Pesando makes the interesting observation that in Canada, where the major public assistance program is national in scope, neither the national government, nor nine out of ten provinces, have been moved to control this potential fiscal externality through pension insurance.

In sum, even if a market failure existed and it were demonstrated to be empirically important, a government-run pension insurance program

that hews to insurance principles in name only—which is the only model we have of explicit pension insurance in any of the major countries studied—is probably the least appropriate policy response. Apart from the economic inefficiencies that are likely to result, such a program will (through mispricing and other problems) tend to discourage new companies from adopting defined benefit plans and encourage healthy companies with well-funded plans to discontinue them, thereby undermining rather than securing the defined benefit pension system. Information disclosure requirements, superpriority status for pensions in bankruptcy proceedings, and requirements that employers guarantee their pension promises through private financial institutions all appear to be policies that would address the same basic problems with fewer economic distortions. That we do not see much political demand for policies like these underscores the fact that *rationales* for government policy rarely constitute *explanations*.

Pesando's discussion of pension insurance in Ontario, Canada's "industrial heartland" makes clear that he is aware of this important distinction.

Pension economists would do well to move beyond the normative question of why we *should* have pension insurance to how we can bring about constructive reform of existing programs that redistribute wealth in predictable ways to entrenched political interests (Ippolito 1989; Weaver forthcoming). The political interests I have in mind are workers and shareholders in unionized firms in declining industries. Few pension analysts today would dispute the fact that, at least in the United States (and apparently in Ontario), pension insurance is a form of industrial policy—a system of cheap pension guarantees (to use a phrase coined by Bodie and Merton) designed to prop up unionized firms in declining industries.

Elsewhere I have argued for moving toward a system of private, competitively supplied pension insurance for all new companies and for existing companies that are commercially insurable (Weaver forthcoming). Companies with poorly funded plans and an unusual risk of default would continue to receive subsidized "insurance" from the government, only the subsidies would be financed from the general fund of the Treasury (rather than from workers and shareholders in other companies) and limited by strict standards that precluded any deliberate increases in exposure. For most companies, this new arrangement would amount to privatizing the supply of pension insurance subject to a government mandate.

Canada offers yet another model of privatization—apparently pure privatization—where workers in most provinces are compensated for pension default risks through the wage offers they accept (and may be

protected by employers in other ad hoc ways) but are not formally insured in the event of pension losses. Unfortunately, none of the countries of the world offers an example of how to structure a transition back to a private system or to one explicitly disciplined by market forces once having taken the path of government-administered insurance.

## Notes

<sup>1</sup>As noted in Ippolito (forthcoming), the most important of these, in terms of providing a close substitute for defined benefit plans, may be the 401(k) plan, a type of defined contribution plan into which employers can shift compensation and yet retain some of the bonding (or tenure) effects of defined benefit plans.

<sup>2</sup>See Bodie and Merton (1993). For an alternative view of pensions, see Ippolito (1987, 1988), who argues that workers and shareholders both stand to gain from some degree of default risk arising from underfunding. In his view, underfunding gives workers a stake in the long-term viability of firms and thus tends to align the interests of workers and shareholders.

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## *Comments by Dallas L. Salisbury*

The discussion of PBGC and the guaranty programs it administers has at times been heated. The more normative the commentator the more oriented he or she will be toward a casualty insurance model that is more critical of the program.

Agree or not, Congress intended a social insurance model—that is, explicit subsidy within the defined benefit system. The original bill included far more than present law. The Contingent Employer Liability Insurance (CELI) called for by the original statute, and amended out of the law in the 1980s, would have raised far larger issues had it been implemented.

The original multi-employer program carried risks. It was changed with two initial results: protection of PBGC and no new multi-employer pension plans. Now that many of those plans are fully funded, employers are leaving. PBGC was protected; benefits promised will be paid but the system froze. Is that in the public interest? Is there no room for risk? Should we seek the same type of “stability” in the single employer defined benefit area? I do not claim to have the answers, but I do think we sometimes rush to judgments that are not in the long-term interests of economic security.

Much is said about PBGC and incentives. The existence of the program raises some interesting questions:

- Has government interest in having plans well funded to protect the PBGC in any way balanced desires to reduce tax incentives?
- Does the program in effect place some break on benefit increases and better funding to avoid higher premiums?
- Does the program encourage strong employers to care more about the practices of others and to pay more attention to pensions when mergers, acquisitions and spinoffs are being discussed?
- Does the program serve to enhance confidence in the economy and the pension system, thus leading to a stronger economy?

- Does the program make elected officials and citizens feel better?
- Given that public policy is at base paternalistic, do PBGC and defined benefit plans serve to hold down other government spending?

I would also harken back to the issue of privatization of the PBGC program. I served on groups that looked into this issue. They were created by advocates who concluded it would not work. Why? Because the underwriting standards the insurers said they would need went too far. The conclusion was that the strong would drop plans and the weak would not be able to obtain insurance at a price they could afford and would "leave" also. A short field day in the courts and for the servers, but an ultimate loss for participants, beneficiaries, and the public interest in economic security.

Against this backdrop, I suggest that the chapter by James Pesando provides a good summary overview of the pension termination guaranty programs in major industrial nations.

Pesando aptly points out that many policy analysts concerned about pension security see the need for such programs as self-evident. Without such programs, as the author notes, benefits might be lost. As critical to advocates of defined benefit pension arrangements is the relative public policy stability that such a program makes possible. The United States program resulted from public upheaval over the bankruptcy of the Studebaker auto company in 1954. Workers and employers were able to compromise on the concept of "social insurance" as a price for having defined benefit pension plans.

Economists question the need for a pension guaranty program, Pesando states, because of a belief that pensions are deferred wages. As such, the loss of a pension is the worker/retiree's problem. It may be true that "virtually all pension analysts . . . now accept the proposition that pension benefits represent deferred wages." As for "non-" analysts, I think many of them accept the proposition in theory in bargained situations, but in many other situations its acceptance is far less clear in the case of defined benefit plans, which may go many years with no new contributions, than with defined contribution plans, which make regular contributions. Present cash compensation practices pay little attention to the benefits promised in assessing the cash necessary to meet the competition. Discussion of "total compensation" continues, but few actually practice it, even though "in the long run" it may work its way through the labor market as deferred wages.

Pesando suggests that the program may simply be a form of paternalism. I would suggest it is both that and a kind of political necessity, a means of maintaining social peace. Employer surveys for decades have shown that younger workers have little appreciation of the defined bene-

fit plan. They look for a market wage and possibly health benefits. They are unlikely to have knowingly accepted a lower wage for the pension promise. Disclosure would do little good at a practical level since other research indicates that little of the distributed material is read until the worker feels a problem. As we have seen in the area of retiree medical insurance in the United States, disclosure of the employer's right to take the plan away does not make workers accept an employer's doing it.

Pesando cites a number of areas where design of the program allows abuses to arise. Several legislative efforts have sought to correct these areas, and relative to the original 1974 statute much progress has been made in the United States. The author could not be more correct in suggesting that efficiency concerns are not linked to public policy and the program. I do agree with the tie to industrial decline, as the program allows smoother economic transitions and less political and social upheaval as a result. The creation last year of a new guaranty program for the retiree medical benefits of retired miners is further evidence of this line of argument.

Having been involved in the earliest studies in 1976 of the premium structure of the U.S. program, I note that the history of the program is a series of compromises aimed at maintaining a defined benefit pension system. The objective has been a PBGC that is solvent in the long run, not one made insolvent overnight by policy change that drives any employer with a well-funded plan to drop it. This desire for balance can be seen in the PBGC reform debates of the last 20 years.

Pesando states in his review of the United States' system that the stated intent is to ensure that ultimately pension benefits are fully funded. His review of ways in which this occurs is accurate. They also reveal why the law is what it is. The objective is retirement income and funding to pay the benefit when due, not a fully funded plan every day. Investment policy that emphasizes equities with high volatility suggest that it is assumed that at times the market will be down and unfunded liabilities will exist. Advocates of full funding have argued for all bond "immunized" portfolios for this reason. The sponsors of plans have rejected this logic. The original law contemplated the cross-subsidies the author identifies and each amendment of the law has reinforced that intent. At the same time, each amendment has sought to adjust the abuse potential he identifies.

Canada sought advice early from the PBGC on the advantages and disadvantages of such a program. Ontario was the leader in interest, and, as Pesando notes, the only province to take action. I agree with him that the union influence was significant, as it was in creation of the PBGC.

The unique characteristics of the system in the United Kingdom were the price to be paid for the concept of contracting out and the creation of individual pensions. The absence of flat dollar plans is a reasonable

explanation for well-funded plans in the United Kingdom. Another, which may not last, has been tax laws that have given sponsors more flexibility than in the United States to fund as much as they wish in profitable years. These laws have taken on a more American restrictiveness in recent years, which may show up in poorer funding in the future.

German employers have been willing to finance a system with annual assessments. Therefore, the system is always funded on a current basis but does not require projections of future economic health. Because the event for payment by the agency is insolvency of the enterprise, there is limited incentive to game the system. I would argue that insolvency in Germany is a far more effective moral hazard protection than the system in the United States. And German firms do prefer putting capital to work inside their firms, rather than in the broader economy. If they cannot generate higher internal returns, why remain in business?

I would speculate that if the United States changed to a system of an annual accounting and an insolvency basis, much of the present angst would go away. There is not a general taxpayer guarantee to the PBGC, yet it is the "fear" of possible taxpayer liability that seems to drive much of the United States concern.

Discussion of the PBGC in comparison with the Federal Savings and Loan Insurance Corporation is fundamentally flawed since the promises, and the payment method for those promises, are so different (as is the underlying investment base of the pension system versus the dominance of real estate). Those with the greatest stated concerns do not find comfort in the social insurance aspect of the PBGC that was intended by Congress. "Reform" of the PBGC would happen quickly if many others did not find the social component a critical part of the program. This social factor is also the major reason that the program would be favored by many even if employees had been offered explicit cash compensation reductions in exchange for the pension promise. PBGC represents a balance of economic and social logic. One circumstance under which PBGC might go away or change fundamentally would be a decision by unions to drop defined plans in favor of defined contributions plans rather than maintaining a continued clear preference for the former.

## Conclusion

The future of the PBGC can only be determined after Congress articulates its goals for the program. Many of the proposals put forth by analysts today advocate a mission and goals different from those set forth in ERISA (as amended).

The program was legislatively established with social insurance goals. A move to the casualty insurance model may well be justified, but it carries

with it a fundamental change of mission. Too many analysts fail to begin their work with an articulation of why Congress was wrong and why they should change the mission. Instead, they analyze the program against a casualty model and declare the program in need of reform. By so doing, they confuse rather than enlighten. The time for clearer presentations is long overdue. Those who want change should be clear that they are advocates as well as analysts—advocates for a change of mission, not for more effective implementation of the present mission. The present mission is social insurance. Against that mission the PBGC has been a very successful agency.

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