Private Pensions: The Impact of ERISA on the Growth of Retirement Funds

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The Employee Retirement Income Security Act of 1974 (ERISA) has brought enormous changes to the environment within which pension plans are created and operated. The new law attempts to reduce the uncertainty which workers face in assessing the value of their pension plans. By regulating the vesting and participation requirements with which pensions may be offered to workers, ERISA guarantees workers who meet specified minimum age and seniority requirements, and whose employers have pension plans, that they will definitely be able to receive a pension if they survive until the plan's early retirement age. (The law does not mandate a minimum pension benefit, however, nor does it require firms which lack a pension plan to establish one.) To guarantee the security of vested benefits, pension fund trustees are required to act prudently and to diversify their investments, and firms must pay premiums to a new federally chartered corporation which insures the unfunded liabilities of defined benefit pension plans. Finally, changes in tax laws have made available to workers not covered under employers' pension plans the tax advantages of qualified plans.

This paper assesses the implications of this new pension environment for the growth of pension funds, and concludes that the effect of ERISA will be small. Thus, any pre-ERISA projections of pension fund growth need not be revised solely because of the new law.

The first part of the paper discusses in general terms the economic considerations which lead to the establishment of pension plans by employers and the features of the different types of plans. The second section reviews ERISA's provisions and how they change the costs of providing pensions and the relative costs of plan types, and, thus, the incentives which vitally affect the rate of accumulation of reserves in pension funds. Part III summarizes the arguments about the impact of ERISA on future pension fund growth.

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I. Basic Economics of Pension Plans

A. *Incentives for Employer Provision of Retirement Income*

Why is it that workers seek to have their retirement income provided by employer-sponsored pension plans rather than accumulating their own resources from their wages? There are at least three important reasons: tax advantages, efficiencies of group administration of annuities, and firms' greater ability to achieve a high rate of return on savings.

For many years, substantial tax advantages have been granted to pension and profit-sharing plans "qualified" by the Internal Revenue Service, and almost all existing plans are qualified. As long as the plans meet certain stipulations, firms can deduct their contributions to the plans, workers can defer paying taxes on these employer contributions until they are received as retirement benefits, and pension fund earnings are exempt from taxes.

Until ERISA allowed workers to establish Individual Retirement Accounts, no such advantage was available to the employee whose employer did not have a pension plan. (The implications of IRAs will be discussed below.) Thus, workers who wanted a private source of retirement income were motivated to find an employer who had a pension plan, even if that employer offered lower wages. And, as the average worker's marginal tax rate has increased in the last 30 years, this tax advantage has become progressively more important, with the increase undoubtedly adding to the pressure for employer-sponsored pension plans. The proportion of the private wage and salary labor force covered by pension or deferred profit-sharing plans grew from 22 percent in 1950 to 45 percent in 1974.[1]

Group efficiencies in the administration of annuities also help to explain why it makes economic sense for employees to seek out employer-provided pension plans. In the absence of such plans, most retired people would probably want to convert a portion of their assets into annuities, but since they would have to do this on an individual basis, they would undoubtedly be forced to pay high, individual rates to insurance companies. However, when a pension plan provides the annuities, the plan can either obtain lower group rates or the plan, itself, can administer the annuities, especially if it is large enough so that its members' mortality experience can be accurately predicted.

The third important basis for the provision of pension plans by employers is the fact that employers can, in many cases, obtain a higher rate of return on their pension funds than the average worker can. Because of the fund's ability to pool investment risks, it can earn a higher rate of return than can the average worker.

As we will see below, ERISA has reduced the advantage for employer provision of pension plans by reducing their cost advantage in all three areas.

[1]Alfred M. Skolnik, "Private Pension Plans, 1950-74," *Social Security Bulletin,* June 1976, pp. 3-17.

B. *Types of Pension Plans*

In order to analyze the effects of ERISA on retirement plans, we must first distinguish between defined benefit and defined contribution plans (the two main types offered) since some sections of the new law apply only to defined benefit plans.

(1) Defined benefit plans

Defined benefit plans promise workers a specified amount of retirement benefits generally based on their years of service and earnings. In recent years it has become increasingly common to use final, rather than career average, earnings in the determination of benefits. (Use of the average of the last five years' earnings is now the most common base in formulas which contain earnings).[2] This trend has increased employees' protection against inflation, since they can predict with near certainty the ratio of their immediate pre-retirement earnings to their retirement benefit. Even when the benefit formula does not explicitly contain earnings, there is a tendency for periodic upgrading, especially in collective bargaining situations. Of course, the inflation protection for workers is at the expense of the firm. Unexpected inflation (which is not reflected in the nominal yields available to the fund's investment managers) can sharply increase a firm's pension liabilities, since final pay is multiplied by *all* years of service in determining retirement benefits.

Because of the pension plan's commitment to pay each worker a readily defined benefit, these plans typically give rise to unfunded liabilities. For example, when a defined benefit plan is established, at least several years of workers' service prior to this initiation are almost always included when the benefit is computed. Creation of "past service liability" is hardly ever accompanied by a corresponding lump-sum payment into the pension fund, so that the plan begins with expected liabilities greater than its assets. Unfunded liabilities are also created when pension plans are amended, since the changes are almost always retroactive.

If a pension plan is tax-qualified, its establishment and amendment are the only circumstances under which its managers are allowed to create unfunded liabilities. Even under pre-ERISA Internal Revenue regulations, plans not amended always had to receive employer payments sufficient to insure that unfunded liability always remained below the sum of those created from the initiation and amendment of the plan.

Thus firms desiring to put as little money as possible into the fund had to pay currently accruing liabilities ("normal cost") plus interest on unfunded liabilities into the pension fund each year. Still, firms had considerable flexibility in making their payments into the pension fund, since

[2] Harry E. Davis and Arnold Strasser, "Private Pension Plans, 1960-1969 — an Overview," *Monthly Labor Review*, July 1970, pp. 45-56.

they could go for several years without payments if previous payments had been greater than the minimum. The maximum amount deductible in any year was normal cost plus one-tenth of unfunded liability, so there was considerable spread between the minimum and maximum. It was quite common for firms to make high payments into the fund in years of unusually good profits and no payments in unprofitable years.

Interestingly, a large number of pension funds did not take advantage of the entire tax deduction allowed them; this behavior has two principal explanations. First, firms may have decided that the after-tax return on assets retained in the business was higher than the (tax-free) return of the pension fund. Second, firms may have believed that their plans would be terminated before the liabilities were funded. Before ERISA, none of a pension plan's unfunded liability was the company's liability. Almost all pension plans contained a provision allowing the company to terminate the plan under any conditions; in fact, business difficulty and merger were the two most common causes. When terminated plans had unfunded liabilities, at least some workers did not receive all the benefits they had been led to expect. A company which anticipated termination of its plan would be understandably reluctant to put more than the minimum required payment into the pension fund.

(2) Defined Contribution Plans

The other major category of plans is the defined contribution plan, under which the firm places a specific number of dollars (usually related to a worker's salary) into a pension account. The funds are used to purchase annuities from an insurance company or are simply pooled in an investment fund, the worker's share of which is converted into an annuity at retirement. In this arrangement, the worker's benefit is determined by the amount contributed and by performance of the fund, not by any explicit relationship with final pay. Workers, not firms, bear the risk of unexpected inflation, which can lower the ratio of their retirement benefit to their pre-retirement salary. Furthermore, firms do not have any unfunded liability, since their entire liability under the plan is discharged each year by making a specific payment into the pension fund.

Most defined contribution plans are deferred profit-sharing plans, under which the company's annual contribution to the fund depends on profits in each year. Each worker's share of the firm's total contribution depends on a fixed formula, which usually contains years of service and wage level. The flexibility of the annual cost of profit-sharing plans makes them much more popular with employers than "money-purchase" plans, under which the defined contribution to each worker's account is independent of profits.

II. The Provisions of ERISA

ERISA changes the pension environment in five areas: (1) by imposing requirements on the provisions of pension plans, such as the rules for vesting and participation, (2) by requiring firms to gradually eliminate unfunded liabilities over a specified period, (3) by requiring firms with defined benefit plans to participate in a plan to insure workers against the loss of unfunded liabilities if the plan should terminate, (4) by imposing standards on the conduct of the fiduciaries who control the pension fund, including limitations on the investments in which these funds can partake, and (5) by lowering the tax incentive for the creation and growth of employer-sponsored pension plans by allowing workers to establish Individual Retirement Accounts.

This section discusses the principal changes which ERISA effects and its likely influence on the development of pension funds. It should be emphasized that this survey of ERISA is by no means comprehensive. Many details of the law (such as the imposition of a maximum retirement benefit for qualified plans) affect only a small number of individuals, are likely to have a negligible impact on the growth of pension funds, and therefore have not been considered.

A. *Vesting and Participation Requirements*

ERISA imposes detailed regulations on eligibility requirements and vesting conditions for all private pension plans. Firms must comply with one of three vesting options; together, these options imply that all workers will be at least 50 percent vested after ten years or less and 100 percent vested after 15 years or less. Many of the largest plans had already instituted vesting conditions at least as liberal as those mandated by ERISA, but many others have been forced to rewrite their plans to give irrevocable pension rights to short-service workers who previously would have obtained nothing from the company's plan if they had left the company. In addition, the new law mandates that workers be given credited service for any years in which they work at least 1000 hours and that under certain conditions breaks in service not result in the forfeit of previously accumulated credits. For the purposes of computing benefits, ERISA dictates that the formula count all service after age 25, except the first year, (or the first three years if full and immediate vesting is offered). Thus, many workers who may have obtained nothing under their companies' pre-ERISA plans will receive at least small benefits, and many others will see their benefits increase.

How will these rules affect the total funds going into pension plans? Hardly at all, according to traditional labor market perspectives, which imply that the size of total compensation is determined independently of its division into wages and fringe benefits.

The basis of these perspectives deserves a short explanation. Suppose the labor market were perfectly competitive, so that each employer could pay no less than what the market indicated without losing all his employees. Further assume that because of the factors discussed in Section I, employers can save more efficiently than workers, that \$1 spent by employers ultimately provides more resources to the retiring worker than \$1 saved by the workers themselves. Assuming that individual workers desire to save something for their retirement, employers will soon discover that by putting some of their personnel budget into pension plans, they outbid any firm which offers all compensation as wages, since workers will value at least some of the dollars put into the pension more than the same money put into wages. The right mix of pensions and wages depends on the consumption-saving preferences of each employer's labor force; we would expect to observe a variety of combinations, corresponding to the variety of preferences workers might have. As part of this equilibrium, however, there is one important condition — that all employers spend the same amount on total compensation. If this were not true, then the high-paying employers, seeking to keep their labor costs to a minimum, would simply imitate the compensation arrangements of their competitors. As a result, any employers who offered higher than average pension benefits would offer lower than average wages, and, again, each employer would pay the same rate of total compensation to workers of given quality.

This logic seems convincing for a perfectly competitive labor market, but, of course, the real world is not perfectly competitive. Numerous statistical studies have confirmed that some employers pay more than others to given quality workers. Many of these differences, however, appear to be associated with well-defined institutional features of labor markets, such as the presence and strength of labor unions, the size of the establishment, and the location of employment. To the extent that these factors influence wages, however, they should influence other aspects of compensation. Thus two unions of equal strength should be able to secure the same total compensation, other things being equal. If one union decides to seek larger pensions than the other, then it should be forced to give up some wages or other benefits. Often this situation is made explicit in collective bargaining situations, in which negotiators first bargain for increases in total compensation and then for the division of that increase among the various forms of compensation. Thus, even when we recognize the existence of noncompetitive forces in the labor market, it still seems reasonable that, holding worker quality and institutional influences constant, firms which have more liberal pension plans should be observed to have lower wage rates.

ERISA changes neither worker quality nor the institutional influences which allow unionized workers or those in certain industries to receive more in total compensation than equal quality workers in lower-wage or nonunionized firms. Thus, the arguments above imply that ERISA should not change any workers' rate of total compensation. Any increases in pension benefit costs due to the prescribed vesting and credited service provisions in ERISA should cause reductions in either pension benefits or wages relative to what they would have been in the absence of the law.

The few empirical studies relevant to this question indicate that this theoretical viewpoint is not inconsistent with reality. In a paper I wrote with Schiller, data on the wages and pensions of a sample of workers in

33 firms suggest that, other things being equal, workers in firms with relatively good pensions receive relatively low wages. Other research suggests that workers who are exposed to low risk of injury, who receive high fringe benefits and who are satisfied with their jobs receive relatively low wages, holding constant all other influences.[3]

The proportion of this increased cost which will be met by reductions in pension benefits rather than reductions in wages will probably be quite high. Firms which had stringent or no vesting provisions before ERISA implicitly allocated very little of their pension budgets to their least senior workers, many of whom were probably quite satisfied to receive almost all of their compensation as wages. ERISA will now force these firms to give these workers irrevocable rights to pension benefits in which they will place very little value. The firms will therefore be under considerable pressure to maintain their wage levels, and the above arguments imply that they will accomplish this by reducing pension benefits relative to what they would have been in the absence of the law. At first, this may upset the workers who retire from the firm but eventually, many of them will have accumulated vested pension benefits from their previous employers and will not demand as high a benefit from their last one.

Even if the above arguments were entirely incorrect, the increase in overall pension costs resulting from ERISA's vesting provisions would probably be quite small. It has been estimated that perhaps as much as 20 percent of the total reserves of private insured and noninsured retirement plans belong to profit-sharing plans. Because of previous IRS rulings, almost all of these already conformed with ERISA's dictates. A study by the Bureau of Labor Statistics estimated that in 1969, the plans of 26 percent of the workers covered under pension plans (as opposed to profit-sharing plans) provided for vesting in ten years or less with no age requirement.[4] If we assume that this figure is a good estimate of the proportion of pension assets not affected by ERISA, we conclude that 41 percent [20% + (.26 x 80%)] of all funds belonged to plans totally unaffected by the new vesting provisions. The cost increases for the remainder depend on the plan population's turnover rates, the pre-ERISA vesting provisions and the other provisions of the plan. Two congressionally sponsored studies compute, under a variety of assumptions, the increased costs resulting from ERISA's provisions.[5] My very subjective combination of these computations and the BLS data on existing

[3]Randall D. Weiss and Bradley R. Schiller, "The Value of Defined Benefit Pension Plans: A Test of the Equalizing Differences Hypothesis," 1976; Richard Thaler and Sherwin Rosen, "The Value of Saving a Life: Evidence from the Labor Market," 1973; Charles Brown, "Equalizing Differences in the Labor Market," 1975.

[4]Davis and Strasser, *op. cit.*

[5]Donald S. Grubbs, Jr., *Study of the Cost of Mandatory Vesting Provisions Proposed for Private Pension Plans,* Subcommittee on Labor, Senate Committee on Labor and Public Welfare, 1973; Howard E. Winklevoss, *Estimates of the Cost of Vesting in Pension Plans,* Subcommittee on Labor, House Committee on Education and Labor, 1973.

vesting provisions yield a guess of an average 5 percent cost increase for the 63 percent of funds less liberal than ERISA. These figures imply a 3 percent increase in the level of contributions to pension funds, which is rather small in relation to the 15.6 percent average annual growth in contributions during 1970 to 1974.

In summary, the vesting standards will cause very little future increase in pension costs. First, theoretical arguments imply that the workers who did not want vested pensions as soon as provided under the ERISA options will not accept the new, vested pension rights as a perfect substitute for wages. But since the sum of pension and wage costs will not rise, pension benefit levels will have to be reduced to allow these workers to come close to maintaining their previous wage levels. Second, even if this theory is completely incorrect, the vesting provisions of ERISA would increase pension costs very little. Similar considerations apply to the effect of the new participation standards, but with a much smaller possible impact.

B. *Funding Standards*

Before ERISA, tax-qualified defined benefit pension plans were subject to the requirement that unfunded liability could never go above the sum of the initial level, plus any amounts that were added when plans were liberalized. Thus, firms desiring to put as little as possible into their pension plans over a period of years would simply contribute the currently accruing liability (actuarially estimated "normal cost") plus interest on the unfunded liability (calculated using the interest rate assumed in the actuarial framework of the plan). Firms which had put in more than the minimum in previous years could skip contributions, just as long as total unfunded liability did not exceed the maximum permissible level. IRS regulations had little to say about recognition of differences between the assumptions about rate of return, mortality, turnover, and wage increases and the actual experience of the plan in these areas. Thus, for example, several decreasing years in the stock market would make it unlikely that a plan whose assets were heavily invested in common stock would achieve the return assumed in the actuary's calculation of unfunded liability and normal cost; since IRS allowed assets to be valued at cost, however, these circumstances did not require any change in the minimum contribution. Even when losses were recognized, they could simply be added to unfunded liabilities. Conversely, experience gains (such as actual return or actual mortality higher than assumed) could be recognized frequently and be credited in full, immediately, against the unfunded liability. In general, these rules allowed firms considerable leeway to adjust their contributions to the condition of their cash flow.

ERISA dictates a higher minimum contribution for plans which have an unfunded liability. The new minimum schedule of payments for plans which already existed when ERISA was enacted is the sum of normal cost and a level payment sufficient to amortize the unfunded liability over 40 years. Unfunded liabilities established either through plan initiation or amendment after the effective date of ERISA will have to be amortized over either 30 years (single employer plans) or 40 years (multi-employer plans). Even more important is the change that ERISA mandates in the recognition of experience gains and losses. Gains and losses must be recognized at least every three years; losses must be amortized over no more than 15 years, while gains can be recognized no more quickly than in even credits over 15 years. (These periods are 20 years for multi-employer plans.) As before, plans which contribute more than the minimum in one year can contribute correspondingly less in future years.

Of these two changes — amortization of unfunded liability and recognition of experience gains and losses — the former will probably be much less significant. There is considerable evidence, mostly from the 1966 survey of Griffin and Trowbridge, that many pension plans were funding their unfunded liabilities at least as fast as ERISA now mandates.[6] These data do not even reflect the impetus provided by Opinion Number 8 of the Accounting Principles Board in 1966, which required that for the purposes of profit-and-loss statements, firms show as a cost that amount necessary to fund vested liabilities over a 40-year period. Although this did not require firms to actually make such outlays, it probably encouraged such a practice.

Thus a majority of workers in pension plans probably belong to plans whose funding practices will not be changed by ERISA. Even for the remainder of firms, however, these funding rules will not cause a large change in the minimum contribution, which consisted of two components — normal cost and interest on unfunded liability. For a typical employee group, the interest is likely to be about 50 to 60 percent of this minimum contribution.[7] But at a 6 percent interest rate, (this is the median rate used in a sample of large plans recently surveyed by Bankers Trust), the annual payment necessary to amortize the principal in 30 years is only 14 percent more than the interest payment alone.[8] The increases in the minimum contribution, therefore, would be about 8 percent for new liabilities and even less for old liabilities, which can be amortized over 40 years.

A rough estimate of the percentage of fund contributions affected by the new standards can be derived. Data on insured plans indicate that 38 percent of 1973 contributions into these plans went into deferred group annuities, individual policy pension trusts, HR 10 plans, and tax-sheltered

[6]Frank L. Griffin, Jr. and Charles L. Trowbridge, *Status of Funding Under Private Pension Plans* (Homewood, Ill.: Richard D. Irwin Co., 1969).

[7]This figure is consistent with the actuarial cost illustration presented in Dan M. McGill, *Fundamentals of Private Pensions*, 3rd ed. (Homewood, Ill.: Richard D. Irwin Co., 1975).

[8]Bankers Trust Company, *ERISA Related Changes in Corporate Pension Plans*, 1976.

annuities, all of which are essentially undisturbed by this section of ERISA.[9] Multiplying this figure by the proportion of all pension contributions going into insured plans (29 percent) and adding the estimated proportion of funds in profit-sharing plans, we find 31 percent of contributions unaffected. Of the remaining funds probably no more than a third were not following ERISA's dictates; this represents about 23 percent of all contributions. Even if this group had previously been making only the minimum payment into their pension funds, their 8 percent increase in contributions would imply only a maximum 2 percent change for retirement plans as a whole.

The effect of the new rules regarding recognition and amortization of experience gains and losses will depend on the experience of particular plans, of course, but the rules are likely to cause a liberalization in actuarial assumptions. Because experience gains can now be credited much more slowly, employers will probably insist that any actuarial assumptions so conservative as to have consistently given rise to experience gains in the past, be revised to be more accurate. (And, of course, actuaries tend to be conservative in their assumptions.) This revision of actuarial assumptions will probably cancel out most of the increase which would be mandated by more liberal vesting and increased funding. A 1/2 percent increase in the assumed interest rate will, on the average, lower normal cost by 12 percent.[10]

These rule changes will also have other effects. First, the experience gain and loss rules will probably cause a decrease in the proportion of pension fund assets invested in the stock market; plans will favor bonds because they can be valued at cost during their lifetime, while stocks must be valued at market value. Thus, a pension fund containing only bonds will have quite predictable outlays, since changes in interest rates will not generate changes in the minimum contribution. Three years of a declining stock market, however, could cause a large increase in the mandatory minimum contribution of a fund whose assets were entirely in stock; this, of course, could be very badly timed from the company's point of view if its profit experience has been correlated with the market. The second important effect of these provisions of ERISA will be to increase the cost of defined benefit plans relative to defined contribution plans, especially for firms that chose a previous funding policy which did not conform to ERISA, since defined benefit plans are the only ones affected by these funding provisions, as well as by the insurance provisions discussed below. ERISA will therefore promote the relative expansion of defined contribution plans; these can be used as supplementary plans and are therefore likely to be the vehicle for a large part of the future growth in pensions. Since defined contribution plans rarely give credit for past service, the rate of growth of total pension liabilities will be slowed by this substitution.

[9]Institute of Life Insurance, *Pension Facts, 1975.*

[10]McGill, *op. cit.*, p. 324.

In summary, then, the new provisions of ERISA affecting the minimum contribution to pension funds are likely to have very little, if any, effect on the flow of funds into pension funds. Plans covering at least half of the workers covered by pensions will not be affected, either because they are not defined benefit plans or because they had already been following the rules ERISA dictates. Among the remainder, liberalizations in actuarial assumptions in response to the experience recognition rules will probably cancel out the effect of quicker funding. Even if this does not happen, though, 30- or 40-year amortization of the unfunded liability will add very little to pension fund contributions. (For those who like long-run projections, I feel reasonably confident that any increase which does occur will be offset, in the long run, by a reduction 40 years from now.)

C. *Insurance of Unfunded Liability*

Another ERISA section which affects only defined benefit plans is that which establishes the Pension Benefit Guaranty Corporation. This institution will gradually insure the unfunded liabilities of plans, so that workers can collect what they have been expecting even when their plans terminate because of a merger or financial difficulty of their employer.

Although the initial (mandatory) premiums for this insurance will not add significantly to cost, the experience of the corporation may show that premium rates may have to be raised substantially. Perhaps more important, however, is the fact that for the first time, a company's unfunded liabilities, up to 30 percent of its net worth, are a liability of the company. This occurs because PBGC has recourse to the company for up to this amount in case of plan termination. Although this contingent liability will be insurable beginning in 1979, the provision definitely adds to the cost of providing defined benefit pensions, since it eliminates the possibility that a healthy corporation can escape its pension liabilities by merging with another company and terminating its plan.

D. *Fiduciary Responsibility and Reporting Requirements*

ERISA imposes Federal standards on the reporting of retirement plan information to participants and on the conduct of the fiduciaries who control the plans' assets. These provisions apply to all pension plans and will moderately increase the cost of providing a pension to a firm's workers. Under previous law, fiduciaries were prohibited from engaging in activities which led to a conflict of interest and in certain other prohibited transactions, but the penalties were administered either by the states, whose enforcement activities were uneven, or by the Internal Revenue Service, whose only available penalty was the removal of the plan's tax-qualified status. The IRS was reluctant to use this power, since it could have harmed the plans' participants more than the company. ERISA imposes even stronger standards of conduct on plan fiduciaries and makes them personally responsible for any losses which occur as a result of their not adhering to these standards. The law now requires that assets must be invested with prudence and diversified to avoid risks of large losses. Although companies can insure fiduciaries against this liability, a recent poll of pension fund managers indicates that overall investment strategy has become more conservative as a result of this provision.[11] Defined benefit plans are also subject to an additional restriction — no more than 10 percent of their assets may be invested in the stock of a contributing employer. ERISA also imposes reporting requirements on employers; annual financial and actuarial reports, as well as individual statements of vested rights, must be given to employees.

Thus, these provisions of ERISA increase the cost of pension plans in several ways. The fiduciary responsibility rules will increase the conservatism of plan investments and thus lower their overall return. The necessity of insuring fiduciaries and of providing various annual reports will increase the administrative cost. And the limitations on investment in employers' stock will increase the relative cost of defined benefit plans.

E. *Individual Retirement Accounts*

Before ERISA, the only way that an employee could engage in fully tax-sheltered saving for retirement was through an employer-sponsored pension plan. It seems to me, in fact, that this monopoly of tax savings by employers was largely responsible for the passage of pension reform legislation, since it was very costly for individual employees to guard against the risk of pre-vesting separation from their employers by doing their own saving. Ironically, ERISA ends this monopoly. It allows workers who are covered by a contributory pension plan but who choose not to join and workers whose employers have no pension plan to establish Individual Retirement Accounts. Each year a worker may contribute up to 15 percent of his salary, but no more than $1,500, to an IRA in a bank, credit union, savings and loan association, insurance company, or to the purchase of special U.S. Government retirement bonds. The new tax law also allows couples to establish an IRA for nonworking spouses. This contribution is deductible from U.S. income taxes in the year in which it is made, and its subsequent earnings are exempt from taxes until the funds are withdrawn (which can be done after age 59 without penalty.) Only Social Security and some states' income taxes have to be paid on IRAs, so that they enjoy almost all of the tax benefits of tax-qualified plans. Workers who leave a job are also allowed to establish an IRA into which they can place their previous contributions to their former employer's plan.

This change removes one of the major sources of growth in pension plans discussed in Section I. For some workers, it may be more advantageous than a traditional pension plan, since all contributions are fully and immediately vested. Although the annual limitation of $1,500

[11]"Pension-Fund Managers Made Wary by 1974 Law," *Wall Street Journal,* August 4, 1976, p. 13.

may appear too low to make the IRA a universal alternative to the employer pension plan, recent surveys have indicated that firms which have pension plans contribute an average of 4 to 5 percent of payroll to their funds.[12] Thus, an individual with a $30,000 income who contributed $1,500 a year to his IRA would be able to provide himself with the equivalent of a respectable contribution pension plan. On the other hand, IRAs do not provide group rates for annuities and may earn less than the average pension fund (although the 8.17 percent annual yield currently being offered on 6-year savings certificates probably compares favorably with current pension fund returns.)

It is quite likely that the existence of IRAs will cut sharply into membership among younger workers in contributory plans in which workers have an option to join and will increase withdrawal of contributions by workers who leave a job in which the pension plan was contributory.[13] This will happen because a worker's pension contributions are usually a constant percentage of his salary over his entire career, while the present value of the pension benefit he buys with this contribution rises sharply with age and service. For young, recent entrants the contribution is greater than the value of their accrued benefit. They have an incentive, therefore, not to join the plan or to withdraw their contribution when they leave. Although this is already common among contributory plans, it will become an even more common practice.

It is thus conceivable that IRAs could provide stiff competition for employer pension plans, especially defined contribution plans. The advantage of full and immediate vesting could be quite important to many workers, since average job tenure, even among older workers, is low enough so that many workers in companies with plans will not be vested even under the new ERISA standards.[14] Although defined benefit plans with the final-pay benefit formulas still provide the worker with advantages which cannot be matched by the IRA, the existence of this option will probably reduce the pressure for growth in coverage of workers whose employers do not now have a plan. Still another possibility is an increasing pressure for defined benefit plans to be contributory so that the large number of unvested workers could contribute to IRAs. If a large number of low seniority workers contributed to IRAs, the cost of the plan to the firm would be reduced, which would allow firms which had strict vesting conditions before ERISA to make up for the reductions in benefits that ERISA may initially cause.

[12]Skolnik, *op. cit.*

[13]Somewhat less than one-third of covered workers have plans in which employee contributions are either required or optional. See Skolnik, *op. cit.*

[14]Of all covered workers in 1972, 56 percent had less than ten years of service on their current job. (*Coverage and Vesting of Full-Time Employees Under Private Retirement Plans: Findings from the April 1972 Survey,* U.S. Bureau of Labor Statistics, Report No. 423).

III. The Impact of ERISA on the Growth of Pension Funds

The implication of the above analysis of ERISA's main provisions is that the new law will make little, if any, difference in pension fund contributions. This section summarizes the law's effect on two potential sources of growth: extension of pension plans to workers not currently covered, and expansion of already existing funds.

In all these areas discussed in Section I, ERISA reduces an employer-sponsored retirement plan's advantages as a vehicle for a worker's savings. The new IRA option reduces the tax advantage, the fiduciary conduct rules reduce the rate of return advantage, and the various reporting requirements the administrative cost advantage.

It should be noted that many of the establishments which have no plans are relatively small, and that these are the firms which will react most strongly to the costs of reporting and of insuring fiduciaries.[15] Companies will be discouraged from establishing defined benefit plans by the additional burdens imposed by the insurance plan, by the creation of a contingent liability if the plan commences with an unfunded liability, and by the reduced flexibility in the timing of contributions. IRAs will be a good substitute for defined contribution plans, especially because the fiduciary conduct rules may lower the return which plan managers are able to achieve and because they offer full and immediate vesting.

It is unlikely, however, that IRAs will generate a large volume of new retirement savings. The establishment of pension plans before ERISA was not difficult; workers who desired to commit savings which could not be tapped until retirement could find an employer willing to establish a plan. Thus, the workers not covered under a private plan, many of whom were young or had relatively low wages, did not want to divert any of their current income into assets so illiquid that they could not be touched until old age. The IRA option, therefore, will probably not induce much new retirement savings among these workers.

ERISA will probably have only a small, positive effect on the growth of pension funds which already exist, especially if the above argument about the impact of vesting changes is correct. The new vesting rules will increase slightly the unfunded liability of some plans, and the new funding rules will speed up the funding of this liability by some plans, but the total effect, as I have indicated above, will be quite small. Even a little liberalization of actuarial assumptions will eliminate any net impact. The insurance and funding provisions will encourage some shift from defined benefit to defined contribution plans, especially among single employer plans. It is quite possible that future growth in pension benefits will take place almost entirely in the form of supplementary defined contribution plans; workers will be guaranteed a basic defined benefit, but will derive much of their retirement income from a defined contribution scheme.

[15]Emerson Beier, "Incidence of Private Retirement Plans," *Monthly Labor Review*, July 1971.

Since past service is rarely recognized in defined contribution plans, this trend will discourage the creation of past service liabilities from plan amendments, which has been a major source of growth in pension funds in the past.

Discussion

Roger Murray*

Given the flexibility of what might be described as generally accepted actuarial principles, there are many variables about which we lack experience. That is to say, we lack experience in the new environment that has been created by the Employee Retirement Income Security Act of 1974. Working with these uncertainties, I think Professor Weiss has made a very careful and valid analysis of the impact of the Act on private pension funding. His conclusion that the effects on the growth rate for defined benefit plans are likely to be partially offsetting and not material in the aggregate is well supported by what we know now.

He correctly points to the fundamental change in the thrust of pension regulation. Formerly, we lived in a world in which the Internal Revenue Service objected to low interest rate assumptions and tried to find any form of reserve account or device to accelerate the funding of pension liabilities. The IRS, of course, saw every contribution to a plan as a tax deduction which in their view eroded the revenue base. They were quite happy with minimum levels of funding. It remains to be seen how this very basic change in the regulatory climate will affect future funding decisions. Professor Weiss has made, it seems to me, an excellent analysis of the factors at work.

Let me speak briefly on just a few points that he raised. Since the Individual Retirement Account is, as far as I can tell, my brainchild, you can rest assured that I regard it as a major breakthrough. But I have some reasons beside pride of authorship. As long as the private pension system covered only about one-half of the eligible work force, the case for replacing much of it with a public OASDI system designed to be "adequate" could be persuasively argued. If the coverage of IRA plans goes as far as it may, it will remedy a basic and fundamental weakness in the narrow coverage of the private system.

A second point, it seems to me, about retirement saving generated through IRAs is that they will be considerably less than a complete substitute for other forms of saving. They will represent therefore, some net addition — possibly a substantial amount — to the accumulation of capital in contractual saving form. I don't know how to predict the volume of

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IRA saving some years from now; but if one-half of the eligible participants put one-half of the $1500-a-year limit into IRAs, the total would amount to $11 1/4 billion a year or 50 percent more than some recent years' additions to private pension plans. It is not inconceivable that the $1500 limit will be increased further as it already has been on a very modest scale. The fact that upwards of $2 billion has already been contributed to IRAs suggests that such levels of accumulation could occur in a few years' time. This would, of course, represent some displacement of defined benefit plan assets for the reasons which Professor Weiss has given. My clearly prejudiced conclusion, then, is that Professor Weiss is eminently sound in emphasizing the role of the Individual Retirement Accounts in the future pattern of retirement saving. If deposit institutions and life insurance organizations continue to dominate the IRA market as they have thus far, the net effect on the capital markets will presumably be some shift to bond and mortgage investments and away from variable assets like common stocks.

For a final observation on the effects of ERISA, let me challenge, or at least suggest that we examine carefully, the conventional wisdom about the effect of ERISA on asset management which I believe Professor Weiss has generally adopted in his paper. The conclusion in a short form is that private pension plans will shift away from variable assets like equities and concentrate more heavily on fixed income assets. The reason why I think this trend should be questioned, even if not denied, is that a major part of what has been happening to asset managers is the aftermath of the trauma of 1974 which has conditioned them to worry about a shrinkage of market values. Also, a good deal of scary legal advice is in circulation; all of us know that the best technique to establish and perpetuate a high retainer for a law firm is to present the most worrisome picture imaginable and then show how the client is being saved from disaster almost daily.

With the development of ERISA all kinds of scary headlines are devoted to what this new monster, the Pension Benefit Guaranty Corporation, is about to do. A provision in the law says that PBGC can determine that its own long-run loss would increase unreasonably if a plan were not terminated. From that passage, you can picture sleuths and examiners fanning out from PBGC and looking over the shoulders of pension managers. At the first sign of market depreciation or weakness, they come marching in and say, "We are terminating your plan because it presents the possibility of unreasonably large loss to us as guarantors." Suddenly PBGC has become the counterpart of the FDIC. I have found this most extraordinary. In 18 months spent with the staff, the committees, and other people of PBGC, I found no such organization and no such inclination. On the contrary, the people of PBGC seem to have read that other provision of the Act which says that one of its primary purposes is "to encourage the continuation and maintenance of voluntary private pension plans for the benefit of their participants."

The other factor at work is that in due course PBGC can offer for sale to the employer what is in essence a put. For a premium, the employer will be able to shift to PBGC the contingent liability up to 30 percent of net worth for an insufficiency in the plan. In the past, perhaps not as a legal matter but as one of a going concern, the company stood behind the delivery of promised benefits to present and future employees without having access to such a device to limit losses as is contemplated in the PBGC insurance program. Other things equal (they are probably not entirely equal in this case), therefore, one should be better prepared to take those risks associated with the prudent expert's fiduciary responsibilities of asset management than before.

Also, there is a significant development in the whole concept of determining what is a sufficient plan. The concept which PBGC has so far applied is that all assets and liabilities are valued at market. According to present policy for the determination of a plan's liabilities PBGC is committed to using the market rate of interest adjusted as frequently as necessary to bring it in line with the prevailing environment. That is to say, you can comfortably buy a long-term bond because if it declines in value, the amount of your liabilities will be reduced by the higher rate of discount reflected in the depreciation of your bond.

It is a somewhat more difficult step for PBGC to apply the same reasoning to equities. In the fall of 1974, when worry and pessimism were widespread, it wasn't easy for PBGC to sit down and say, "Don't worry about the depreciation in your stock account. We know now that at this level the expected return is somewhere around 18 percent per annum and we will use that in calculating the present value of your liabilities. The fact that the market value of your assets has shrunk does not give rise to a major problem because your liability structure has been similarly adjusted to market rates of expected returns."

There is a critical question, obviously, as to how the Act is administered and how liabilities are determined. But one should not assume that we are stuck with the old traditional approach of accepting an interest rate for all time and applying it indiscriminately in all different kinds of market environments. At least so far, PBGC has been rational and realistic in determining the rate for calculating liabilities. Its initial rate, as you may all know, was 8 percent which is some evidence of realism.

If it becomes increasingly apparent that much of the legal counsel given to corporate decision-makers is unrealistic and in the scare category, it seems to me that the effect of ERISA on asset management and on the division between fixed and variable assets will be quite modest. We are likely to return to rational decision making.

The final observation that we might also keep in mind is the interesting question of what would happen if ERISA were extended to state and local government retirement systems. Here the significant matter, entirely apart from the questions of funding requirements, would be the application of the standards of the prudent expert and of fiduciary responsibility to the trustees of these retirement systems who have stood quietly by and watched a series of what would be prohibited transactions under ERISA take place. The trustees of the New York City Retirement System have stood by and watched the erosion of their funds with complete disregard for the primary purpose of ERISA: to invest the funds for the exclusive benefit of the present and future participants in the retirement plans. My feeling on this issue is that there are all kinds of good reasons for extending at least some major provisions of ERISA to state and local government systems; but it is most unlikely that the Congress will in fact comply with the provisions of the law that require a complete and thorough study of this matter. They will not wish to take up what they regard as a political "hot potato." The Congress will eagerly seek to postpone and avoid this issue as long as conceivably possible.