

“Reforming the Defined-Benefit Pension System”

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Defined-benefit pensions typically expose workers to a form of financial risk that they are ill positioned to bear and unable to hedge. If workers understand that risk, they will offer employers a lower “price” (in the form of salary concessions) than the capital markets would offer for the same cash flow. The resulting financial inefficiency reduces the value of the firm sponsoring the pension plan. The paper identifies reforms that would essentially eliminate the financial risk borne by workers and hence the financial inefficiency inherent in risky pensions. It would also essentially eliminate the substantial financial exposure currently borne by taxpayers. The key reform elements are tighter rules governing funding and portfolio investment, market-oriented pricing of the insurance offered by the Pension Benefit Guaranty Corporation, and improved disclosure of information related to pension plans in firms’ public financial statements, in the federal budget, and in statements provided to workers.

JEL classification codes: G23, G28, J32, J38