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The Usefulness of the Wind-Up Measure of Pension Liabilities: A Labor Market Perspective: Discussion

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DISCUSSION

DENNIS E. LOGUE*: Jim Pesando's paper represents one of the cleverest approaches to assessing the economic validity of an accounting measure I have seen in a long while. Moreover, I believe his conclusion is correct. Unfortunately, my belief was not strengthened very much by the empirical analysis.

The issue at hand is how best to characterize pension fund liabilities. A "wind-up" measure might be used. This is just the present value of the annuities employees will receive upon retirement, assuming no more years of service and no pay increases. On the other hand, measures that reflect an expectation of more years of service and/or future pay increases may be more accurate. The question arises because most pension plans are based on final pay, not career earnings; so the dollar size of employees' expected pension receipts increases more rapidly at the end of a career than at the beginning.

Professor Pesando tests the accounting measure by applying theories of the labor market. If the labor market is really a spot market with employees being paid exactly their marginal products in every period, the "wind-up" measure correctly characterizes the corporate pension liability. If, however, pensions really represent deferred compensation, a system in which total compensation early in one's tenure at a firm is less than marginal product and more than marginal product later, then a forward-looking measure of liabilities more sensibly characterizes the firm's obligation. This latter notion is consistent with the implicit contract view of labor markets.

From this observation, Professor Pesando constructs a test: if labor markets are spot markets, percentage pay increases for older workers should be small relative to those for younger workers. If the implicit contracts view dominates, percentage pay increases in the later years of a worker's career will be as large or perhaps larger than for newer workers.

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So far, no problem. When Professor Pesando gets to testing, some difficulties arise.

Professor Pesando finds pay increases for older workers exceed those for younger workers, hence concludes pensions are deferred wages and the “wind-up” measure of pension liabilities grossly understates the true value.

The sample upon which this inference is based consists of only seven companies. Moreover, as an earlier version of the paper showed, 4 of the 7 firms experienced declines in the number of workers covered by the plans. If this correlates with total employment, more than half the sample was declining firms, and these may behave aberrantly.

In addition, the number of covered employees in the firms was comparatively small in most cases. Five of the seven firms had less than 2,000 covered employees, and presumptively the number of employees in the older age groups were very small. If just a few of the older workers got promoted to very senior positions, e.g., company president, this could seriously skew the calculated percentage salary increase for the older cohorts. For instance, suppose there are only 10 to 20 employees in the older cohort. If one makes president and salary doubles, the measured average pay increase will be very large. We have no clue as to whether this may be the case because we do not know to what managerial level the particular plans apply.

The above are data problems, and we must be tolerant because only proprietary data are available. The researcher is thus at the mercy of those who collect them. There is a more troubling aspect to the empirical work, however.

The serious problem is the assumption that productivity increases are equal across age cohorts. Older workers of the sort included in these plans could, in fact, be increasing their productivity more rapidly than younger workers though this is assumed not to be true. It could be factual for several reasons but the one which comes most immediately to mind is the accumulation of firm-specific human capital. Older employees may very well be better at getting the organization to work efficiently. The tests presume either no value-to-firm-specific human capital or that it accumulates at a constant rate over a worker's career. Accordingly, the test may not really reveal very much about spot versus implicit contract labor markets because productivity was not explicitly held constant.

Despite its problems, other pension researchers should applaud Jim's effort. It raises many important issues and implies other neat topics for research. Let's suppose this work is correct. Early in a career (or the life of the firm), workers work for less than marginal product, later more. Somewhere there's a crossover point where employees' total compensation—wages plus pension benefits—just equal marginal product. If firms terminated pension plans at this point, they would increase shareholder wealth because from that time forward they could pay only marginal product, not the “catch-up” the deferred wage theory implies. Why don't we see more terminations? Is there an optimal time to terminate?

A second idea that it triggered in my mind is the difference between those organizations offering defined benefit plans and those offering defined contribution plans. Might defined benefit plans be more likely to prevail in organizations where firm-specific human capital is more valuable? Is this why universities typically give professors for whom firm-specific human capital is not worth much,

defined contribution plans, while complex corporate structures where firm-specific human capital may greatly enhance operating efficiency, provide defined benefit plans?

These and other questions are worth pursuit, and Pesando's work helps to motivate that quest.