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SHIFTING RISK

Workers today near retirement more vulnerable and with lower pensions

by Lee Price

Twenty years ago, most employees approaching retirement could look forward to a traditional pension. Their pension benefits rose according to years of service and how far they had moved up the job ladder, but not according to changes in a fickle stock market. For decades prior to 1980, most large employers had steadily increased contributions to these traditional retirement plans and had borne the market risks—both up and down. Things have changed dramatically since then: employers have slashed contributions for their employees' retirement income, and just as dramatically, they have transferred most market risk from themselves to their employees.

There is a legitimate public demand for a retirement system that rewards work—years of service and job advancement—with guaranteed benefit levels without market risk. The Social Security system responds to that demand, but only on a modest scale. With the precipitous decline in jobs with traditional pensions, the federal government should be creating a robust, portable public pension system with benefits based on work and insulation from the vagaries of financial markets.

Instead, Congress is considering changes that would expose most workers to even greater risks in their retirement income, not just by privatizing the Social Security system, but also by adding more subsidies for 401(k)s and other private retirement accounts. This would compound the trend in private pensions by exposing lower- and middle-income Americans to the risks of a down market for stocks, bonds, or with annuities when they retire, or of high inflation that erodes the value of their savings.

The transferring of risk to employees

Traditional pension plans, known as defined-benefit or DB plans, promise employees a fixed monthly income in retirement based on years of service and earnings for a base period at the end of their career. In such plans, the employer is expected to underwrite the promised benefits regardless of the ups and downs of the markets and

regardless of how long the employee lives. Employees are told that they will retire with higher income by continuing to work longer or moving up the job ladder to a higher-paying job. Most DB plans provide some protection against inflation over a worker's career by giving most weight to earnings posted just before retirement. For that part of their retirement income, workers with DB plans do not have to worry about their own investment decisions, the state of financial markets when they retire, or inflation eroding the value of their early savings.

But many employers who provide a pension plan have been shifting to defined-contribution or DC plans. DC plans create individual accounts to which employees and employers contribute. Employees must make investment decisions for their accounts and face the consequences not only of bad decisions but also of drawing on the account when the market is depressed. And if workers do not purchase an annuity upon retirement, they run the risk of outliving their account balance. If they do buy an annuity, they run the risk of low interest rates at the time of purchase that causes lower annuity payments. Some employers provide only a DC plan, while others provide a combination of DB and DC plans.

The share of people between the ages of 56 and 64 with a DB plan has declined from 70% in 1983 to 47% in 2001 (**Figure A**).[1] But even this trend understates the extent to which employers have shifted risk to employees because the share with both a DB and DC plan has risen from 8% to 29%. Thus, the share with only a DB plan has plunged from 62% to 18%, while the number with only a DC plan has soared from 1% to 31%.

The decline in DB coverage is even greater for people between the ages of 47 and 55 (**Figure B**). Those with any DB plan dropped from 68% to 40%, and those with only DB coverage went from 55% to 10%.

Reduced employer payments on pensions

While employers have been shifting risk to their employees, they have also been cutting payments for retirement plans. Employer contributions to pension plans had risen steadily from 1% of total labor compensation in 1948 to 4.2% in 1977. The pension share of compensation stabilized through 1980 before plunging to 2.4% by 1990, the lowest level since 1966.

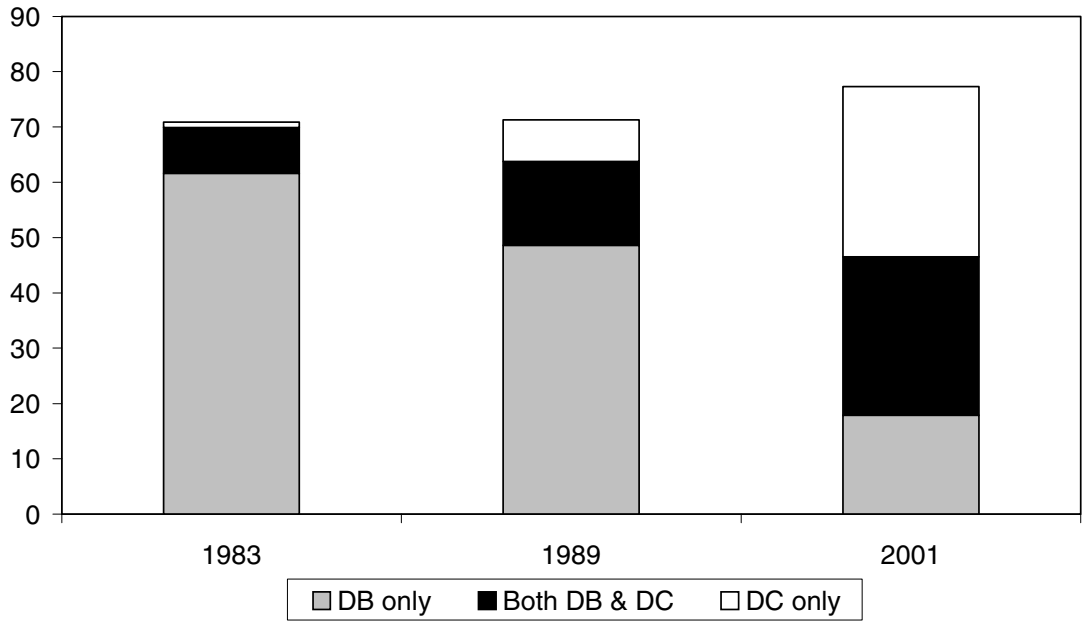
Unfortunately, the data available from the national income accounts do not separately track contributions to DB and DC plans prior to 1988. Because DB plans completely dominated coverage and costs around 1980, we can be confident that most of the 4.2% of compensation going to pension costs in 1980 was paying for DB plans. Thus, the reduction of the DB contribution to only 1.0% of compensation by 1988 reflects a dramatic cut in employers' DB contributions.

Figure C also provides insight into the motivation of employers for scaling back DB plans. As noted above, with DB plans, employers bear the risk of market downturns. In addition, the rules for DB plans effectively require employers to raise contributions when stocks decline in value. Stock market reversals no doubt contributed to the steep rise in total pension plan costs in the late 1960s through the 1970s and in DB costs from 1990 to 1994 and again from 2001 to 2003. The contrast between the volatility of DB costs since 1988 and the flat trend in DC costs clarifies the appeal of DC plans for employers.

Note that, despite the doubling of DC coverage over the period, employers did not increase their contribution to DC plans as a share of total labor compensation. This suggests that employers have reduced the match rate for their contributions to DC plans.

FIGURE A

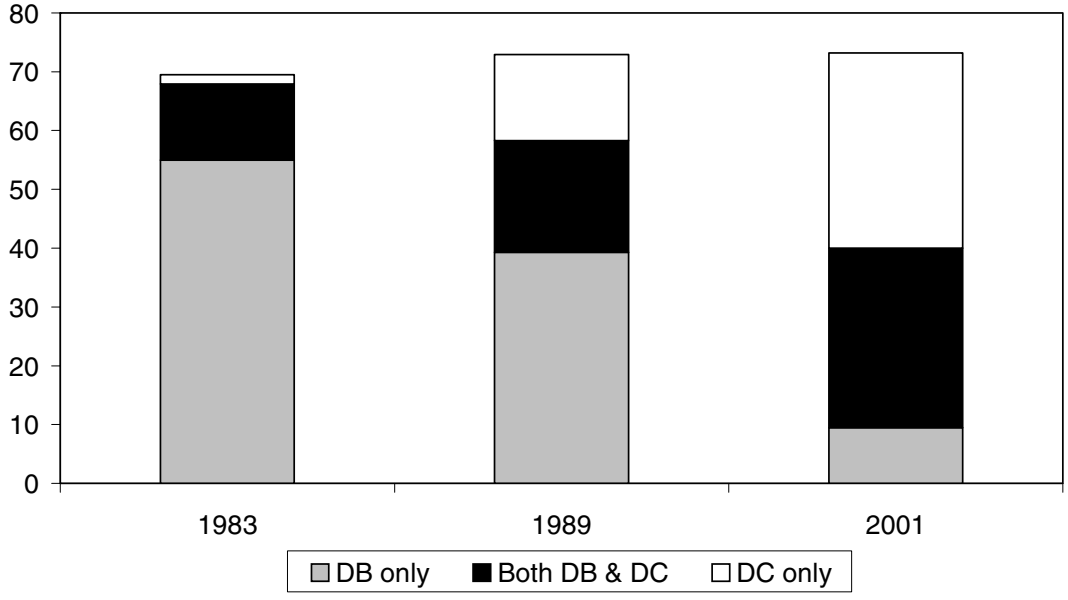
Shift from DB to DC coverage, age 56-64



Source: Weller and Wolff (2005).

FIGURE B

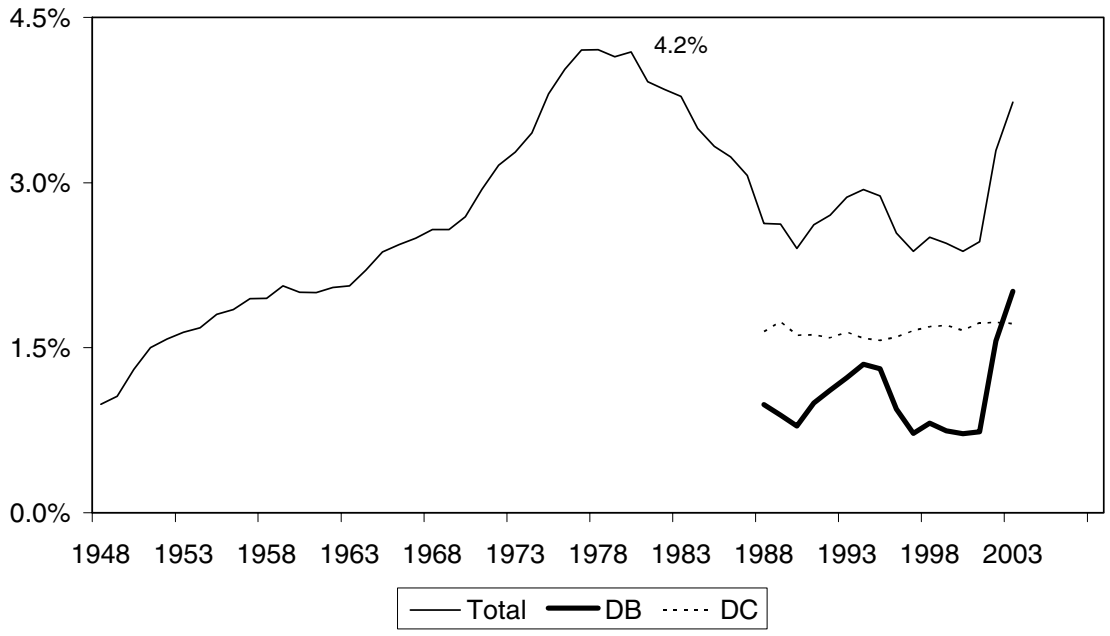
Shift from DB to DC coverage, age 47-55



Source: Weller and Wolff (2005).

FIGURE C

Employer pension contributions as a percent of labor compensation



Source: Author's analysis of Bureau of Economic Analysis data.

Private pension gains go to the top, not the middle earners

Changes in the pension system have kept the typical American approaching retirement from enjoying a gain in retirement wealth over the last two decades. The stock market boomed from 1982 to 2000. Yet the combined DB plus DC pension wealth for the median person in the 56 to 64 age range actually declined by 13% over those 18 years, from $55,400 in 1983 to $48,000 in 2001 (Weller and Wolff 2005, Table 4).

The shift from DB to DC plans has had major consequences for the distribution of wealth and retirement income. One measure of increased inequality comes from the contrast between trends in mean and median pension wealth. Because people at the top saw large gains in pension wealth, the average value of combined DB and DC pension wealth rose by 53% from 1983 to 2001.

In addition, the most widely used measure of distributional inequality, the Gini coefficient, shows that the distribution of wealth in DC pensions is substantially more unequal than for DB pensions. The Gini coefficient for DC plan wealth remained at a high level between 1983 (0.732) and 2001 (0.714). As DB coverage has eroded, DB wealth has become more unequal, although notably less unequal than DC wealth. The Gini coefficient for DB wealth rose from 0.530 in 1983 to 0.617 in 2001.

Lessons from the so-called "ownership society"

Policy makers often claim that the displacement of DB plans by DC plans and the privatization of Social Security represent a logical expansion of the United States' "ownership society." The American public has strongly

supported policies to promote ownership, particularly of homes and small businesses. There are definite reasons, however, explaining why Americans strongly support more "ownership" in one area of public policy but not in the area of Social Security and traditional pensions. For one, when people become home or business owners instead of renters or employees, they invest their own time and energy to improve their homes and businesses. In addition, as owners, Americans have more knowledge and generally make better decisions than outside experts about how to invest their time and money. Finally, the investment decisions made by owners of homes and small businesses improve their day-to-day lives.

None of these three reasons to value ownership of homes and small businesses applies to private retirement accounts. Most Americans do not think about preparations for retirement income in the same way that they think about homes or small businesses. Their overriding concern is an ample and secure retirement income far in the future. Unlike their homes or workplace, people do not live with their retirement income portfolios on a daily basis. In fact, they would prefer not to deal with it constantly. They understand the large risks in managing an investment portfolio and welcome experts making the decisions.

People would like to know that they can succeed with hard work and perseverance in what they do best, and at the end of their productive work lives, they will be able to live relatively free from worry about financial market risks. People have far more control over how many years they work and how far they advance up the ladder than they do over the stock and bond markets. If they work harder or longer, then they are rewarded with higher benefits under Social Security and traditional pensions, but an ill-timed financial market downturn can wipe that out in a system of private accounts. The "ownership" created by DC plans and private Social Security accounts is one fraught with risks beyond the typical worker's control. With only a modest capacity to save, most lower- and middle-income Americans do not welcome the ownership of those additional risks.

Conclusion

The private pension wealth of the typical American nearing retirement is both smaller and riskier than it was a decade or two ago. The trend of employers to reduce pension contributions and shift risk from themselves to their employees is continuing and possibly accelerating. The president's proposals for Social Security would effectively cause our public pension program to mimic the trend among employers: cutting costs and shifting the risk of market downturns to individual retirees. A more appropriate response to the dramatic changes among employers would be for the federal government to expand Social Security, not as a DC system, but as a DB system that rewards work and limits the financial market risks borne by workers.

Endnote

1. All the data on coverage and distribution of private pensions in this report come from Weller and Wolff (2005).

Reference

Weller, Christian and Edward Wolff. 2005. *Retirement Income: The Crucial Role of Social Security.* Washington, D.C.: Economic Policy Institute.