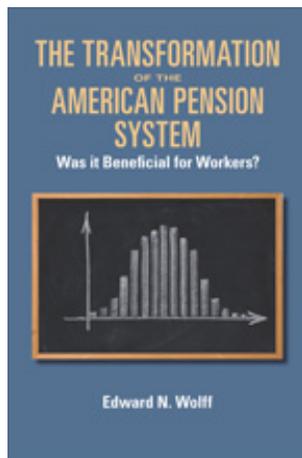

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Introduction

Edward N. Wolff
New York University



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The Transformation of the American Pension System: Was It Beneficial for Workers?

Edward N. Wolff

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Introduction

The last three decades have witnessed the radical transformation of the American pension system. In Wolff (2003), I call attention to this change which had been occurring since the early 1980s. I report that the share of households in the age group 47–64 with a defined contribution (DC) pension plan soared from 12 percent in 1983 to 60 percent in 1998, while the share with a defined benefit (DB) plan plummeted from 69 to 46 percent. Subsequently, in Wolff (2007c), I calculate that the share with a DC plan rose to 62 percent in 2001, while the share with a DB plan fell to 45 percent. I sometimes refer to this changeover as the “great transformation.”

This volume focuses primarily on changes in the U.S. pension system from 1983 to 2009. However, attention is paid to the entire retirement system, including the role of Social Security. In earlier papers, estimates were provided for the years 1983 to 2001 on the basis of the Federal Reserve Board’s Survey of Consumer Finances (SCF) (see Weller and Wolff 2005; Wolff 2002b, 2003, 2007a,b,c). With the availability of the 2004 and 2007 SCF, estimates of retirement wealth and retirement adequacy are updated here to 2007.

The primary question of interest is who gained from and who was hurt by the “great transformation.” Five major developments will be addressed: First, how has the transformation affected the pension holdings of workers? Second, how has it impacted both the pension wealth and the total retirement wealth (the sum of pension and social security wealth) of the average median household? Third, which demographic and income groups in particular gained in terms of pension and total retirement wealth, and which lost out? Fourth, has the transformation of the pension system led to greater overall inequality in pension wealth, in total retirement wealth, and in augmented wealth (the sum of net worth and retirement wealth)? Fifth, what implications does the transformation have for the adequacy of retirement income, as measured by the absolute level of expected retirement income, its replacement rate of preretirement income, and the expected poverty rate of future retirees?

Though the empirical analysis contained in the book concerns exclusively the *consequences* of the transformation of the pension system on the wealth and retirement adequacy of U.S. households, it might be useful to speculate on some of the *causes* behind this rapid transformation. There are three reasons why employers might prefer DC plans to DB plans: 1) DC plans allow firms to shift the risk to workers, 2) firms no longer have long-term pension liabilities, and 3) employers generally make lower contributions to DC plans than DB plans.¹

There were some pulls and pushes as well. With regard to the “pull,” the main reason was the availability of DC plans. Individual Retirement Accounts were first established in 1974. This was followed by 401(k) plans in 1978 for profit-making companies (403[b] plans for nonprofits are much older). Another reason was the option to convert DB pension plans to so-called cash balance plans (effectively, DC accounts). In 1999, a lawsuit was initiated by older IBM employees when IBM tried to convert its DB pension plan to a cash balance plan. Though the court initially ruled in favor of the employees, this decision was overturned on appeal, and regulations issued by the Internal Revenue Service (IRS) made such conversions legal. This probably helped to further expedite the elimination of DB plans.²

With regard to the “push,” the first reason for it was likely the passage of the Employee Retirement Income Security Act (ERISA) in 1974, which increased regulatory burdens on DB plans and made DB plans more costly. ERISA put restrictions on how companies could manage and administer their pension assets: it mandated that companies must put money into pension funds to meet future liabilities and must pay out benefits. ERISA also required companies to pay premiums to the Pension Benefit Guaranty Corporation, which was created in 1974 to insure their pension plans. A second was the Omnibus Budget Reconciliation Act of 1987, which established even tighter funding limits on DB plans. A third push came from the decline of unions in the United States. According to Current Population Survey data, the unionization rate fell from 20 percent in 1983 to 13 percent in 2001. Unions had been one of the bulwarks supporting the traditional DB pension system.³

A PRÉCIS OF THE BOOK

This section provides a brief synopsis of the book’s principal findings in order to help the reader navigate through the rather dense set of empirical research presented in the ensuing chapters. There are six major questions in the book:

- 1) With the “great transformation,” did pension coverage expand or contract over time?
- 2) Did the value of pension wealth increase or decline?
- 3) Did overall wealth inequality rise or fall?
- 4) Did the retirement prospects of middle-aged Americans improve or worsen?
- 5) How did the “great transformation” affect different demographic groups?
- 6) How did these effects vary between the 1980s, the 1990s, and particularly the 2000s?

The results are very sensitive to time periods and particularly to movements in the stock market. The stock market boomed during the 1980s and especially the 1990s but softened during the 2000s. The elimination of DB plans in the 1980s hurt workers in terms of pension coverage, particularly among the elderly, but because of the rapid growth of DC plans in the 1990s, overall pension coverage expanded. In contrast, during the 2000s, pension coverage suffered a mild contraction. However, at least among current workers, the pension coverage rate for females increased from 1989 to 2007, while the rate for men declined.

The value of DC pension plans is especially sensitive to stock market developments, and the defined contribution pension system works very well when the stock market booms. DC pension wealth gained in the 1980s and then grew enormously in the 1990s as coverage expanded and the stock market roared. However, as coverage slackened in the 2000s and the stock market weakened, gains in DC pension wealth slowed down. When the stock market tanked from 2007 to 2009, DC pension wealth actually plummeted. The period 2001–2009 was indeed

a “lost decade” in terms of DC pension wealth, with absolutely no net gains over the decade.

Despite the elimination of many DB plans, overall pension wealth (the sum of DB and DC pension wealth) continued to grow in the 1980s, 1990s, and even during the years 2001–2007, though gains during the early and mid-2000s were much smaller than those in the preceding decades. However, overall pension wealth during the entire decade of the 2000s showed a sizable decline. One group that did well over that decade was the elderly, mainly because many of them remained “legacies” of the traditional DB pension system, in which by law their pension benefits could not be reduced.

The story is not complete without considering the ancillary role of the Social Security system. Social Security fills many holes in the rather porous private pension system. Social Security wealth, like (private) pension wealth, grew strongly in the 1990s. However, during the 2000s, its gain slowed markedly. Retirement wealth, the sum of pension and Social Security wealth, showed marked improvement in the 1990s but, again, much slower advances in the 2000s.

When standard net worth is added to retirement wealth to produce augmented wealth, this addition creates the most comprehensive measure of retirement resources. The results show that mean augmented wealth grew very strongly in the 1990s but that gains were much weaker in the 2000s. Indeed, *median* augmented wealth showed almost no change among middle-aged and elderly households and actually declined in absolute terms among younger households. Indeed, younger households were found to be particularly vulnerable as a group, and their retirement prospects appear to have faded over time.

In the case of inequality trends, there is not much differentiation between the 1980s, 1990s, and 2000s. One notable finding is that DC pension wealth is distributed much more unequally than traditional DB pension wealth. As a result, the transition from the DB system to the DC system resulted in higher levels of inequality of pension wealth, retirement wealth, and augmented wealth. In particular, there was an increase in the overall inequality of augmented wealth between 1989 and 2007. This result contrasts with almost no change in the inequality of net worth over these years.

In 2007, there were large gaps in pension wealth, retirement wealth, and augmented wealth between minority households and the white

majority, between single females and married couples, and between college graduates and other educational groups. However, minority households generally showed strong progress in terms of pension, retirement, and augmented wealth relative to white households. Likewise, single female households generally showed gains relative to married couples in these three dimensions. In contrast, less educated households generally lost out relative to college graduates in terms of pension, retirement, and augmented wealth.

CHAPTER OUTLINE

Chapter 2 provides an update of wealth trends on the basis of the standard definition of net worth: marketable assets less debts. This sets the stage for the remainder of the book. The chapter first discusses the sources and methods for the data used in this study. The data sources used for this study are the 1983, 1989, 2001, and 2007 SCF conducted by the Federal Reserve Board. Each survey consists of a core representative sample combined with a high-income supplement. The SCF provides considerable detail on both pension plans and Social Security contributions. The SCF also gives detailed information on expected pension and Social Security benefits for both spouses.

Chapter 2 then analyzes trends in median and mean wealth, the inequality of wealth, wealth composition, stock ownership, and wealth by race, ethnicity, and age group. An update of household wealth to mid-2009 is also provided on the basis of movements in stock and housing prices. The chapter will thus serve as a backdrop to the analysis of retirement wealth and enable us to see what differences in wealth trends are engendered by the introduction of both pension wealth and Social Security wealth to the definition of household wealth.

As will be seen, there was very strong growth in both mean and median net worth during the 2000s (2001–2007), as there was during the 1990s (1989–2001). There was a dramatic shift in the household portfolio away from liquid assets like savings accounts and money market funds and into DC plans instead. The early and mid-2000s also witnessed sharply rising family indebtedness, as the debt-to-income ratio by 2007 reached its highest level in almost 25 years, particularly among

the middle class. In contrast, wealth inequality remained flat during the 1990s as well as from 2001 to 2007. An update to mid-2009 indicates a very sharp drop in mean net worth and, particularly, median net worth, as well as a sharp rise in wealth inequality.

Chapter 3 reviews some of the relevant literature on pensions and Social Security, which is important in order to provide a context for my later empirical findings. It focuses on the evolution of pension coverage rates, pension and Social Security wealth, and replacement rates for each. The chapter also discusses how pensions and Social Security wealth affect inequality, both overall and between different demographic groups.

The chapter is divided into six parts. The first part reviews studies that have documented changes in pension coverage in the United States, particularly the decline in DB and the corresponding rise in DC pension coverage among workers since the early 1980s. It asks, did the great transformation raise or lower the level of pension wealth and retirement wealth in general? The second part surveys work on trends in both the level of retirement wealth as well as its degree of inequality.

One ongoing controversy is whether DC plans such as 401(k) plans have, on net, added to total household savings, or whether they have simply substituted for other forms of savings. These studies are reviewed in the third part. Have workers saved enough (or will they save enough) to meet their needs during retirement? The fourth section delves into the literature on measuring retirement adequacy. In more general terms, how have the elderly fared over time? The next section reviews some of the studies that have attempted to measure the economic status of the elderly. How did families fare during the “great recession” of 2007–2009? The final part of Chapter 3 reviews studies that have tried to measure the effects of the 2007–2009 recession on the pension wealth holdings of households and their anticipated retirement behavior.

In Chapter 4 I turn to the empirical analysis of pension and Social Security wealth. How did the great transformation affect pension coverage in general? I first analyze how pension coverage developed over the period 1989–2007 among individual workers and then investigate trends in pension coverage on the household level over the more extended time interval, 1983–2007. If we now add pension wealth

to standard net worth to obtain what I call “private accumulations,” how has the level of private accumulations and its degree of inequality changed over time?

In Chapter 5, I extend the empirical results reported in Chapter 4 by considering Social Security wealth, retirement wealth in general, and augmented wealth. Did Social Security wealth grow over time? What happened to total retirement wealth, the sum of pension and Social Security wealth? These are the first two topics considered in the chapter.

I next introduce the concept of total (augmented) household wealth, the sum of net worth, pension wealth, and Social Security wealth. While net worth is a limited measure of resource availability, augmented wealth provides the most comprehensive measure of the full set of resources available to families for retirement. When I later consider retirement adequacy, I shall once again rely on the concept of augmented wealth. How then did augmented wealth and its degree of inequality change from 1983 to 2007? This is the next set of topics to occupy us in the chapter. Finally, what happened to pension wealth and augmented wealth during the great recession? The last section of Chapter 5 provides an update on these estimates to mid-2009 on the basis of changes in stock and housing prices.

The results of Chapters 4 and 5 show a huge increase in pension wealth during the 1990s despite the collapse of the DB pension system, mainly because of the enormous take-up rate in DC pension plans (as discussed above) and extremely robust gains in the stock market (as we see in Chapter 2). However, in the 2000s, there was a marked slowdown in advances in pension wealth, as both the share of households with pensions declined a bit and stock prices advanced more slowly. Private accumulations, which also showed substantial gains in the 1990s, showed smaller increases in the 2000s. Social Security wealth, likewise, jumped in the 1990s but was largely unchanged in the 2000s. As a result, both total retirement wealth and augmented wealth climbed sharply in the 1990s but showed only very modest gains in the 2000s. Finally, while the inequality of net worth remained largely unchanged from 1989 to 2007, the inequality of augmented wealth rose over the period, as more unequal DC wealth replaced more equal DB wealth.

How did different demographic groups fare with regard to relative gains in pensions, retirement wealth, and augmented wealth? Chapter

6 investigates these issues for the period 1989–2007. For purposes of analysis, three divisions of the population are made: 1) race/ethnicity, 2) marital status, and 3) educational attainment. As will be seen in this chapter, there was a remarkable turnaround in the relative fortunes of minorities, though significant gaps between them and the white majority still remained in 2007. Differentials in retirement wealth and augmented wealth also generally narrowed between single females and married couples, though once again very large gaps remained in 2007. In contrast, differences in retirement and augmented wealth by educational group splayed out over the years, with college graduates in particular increasing their lead over the other educational groups.

What was the level of retirement adequacy among households close to retirement in 2007, and how did this change over time from 1989 to 2007? These are the subjects of Chapter 7. Retirement adequacy is measured in three different ways: 1) by calculating the stream of retirement income that today's older workers can expect at retirement from their accumulated wealth at the time of retirement, 2) by comparing their expected retirement income to the poverty line in order to measure the expected poverty rate at retirement, and 3) by the so-called replacement rate, which calculates the ratio of expected retirement income to preretirement income. All three measures of retirement adequacy are computed for individual age groups and by race/ethnicity, marital status, and educational attainment.

The results of Chapter 7 show strong gains in expected retirement income for the age group 47–64 during the 1990s but a marked slowdown in its growth from 2001 to 2007, even before the financial meltdown of 2007–2009. These findings are consistent with the pronounced decline in the rate of advance of augmented wealth between the 1990s and the 2000s (see Chapter 5). Households in this age group also saw a large reduction in their expected poverty rate at retirement from 1989 to 2001. However, there was no further reduction in the expected poverty rate from 2001 to 2007. In contrast, the percentage of households with at least a 75 percent replacement rate rose somewhat more in the 2000s than it had in the 1990s, though the gains were quite modest in both periods.

The last chapter, Chapter 8, presents a summary of the principal findings of this study, considers the policy implications of the study, and offers pertinent policy recommendations. I argue in favor of uni-

versal pension coverage. For current workers, I propose guaranteed employer pension coverage for all workers in the company. For non-workers below the age of retirement, I advocate a mixture of Individual Retirement Accounts and Individual Development Accounts supported by the federal government. I also make the case that the current Social Security system should be left largely intact.

Notes

1. Ghilarducci, Sun, and Nyce (2004) estimate that DC plans, on average, cost the employer less than traditional DB pension plans. They investigate the pension choices of over 800 firms between 1988 and 1996 using data on pension plan finances from the Internal Revenue Service Form 5500 and on firm finances from Compustat. They calculate that a 10 percent increase in the use of 401(k) plans reduced pension costs per worker by 1.8 to 2.0 percent. However, it is not clear whether this reduction in pension costs could be reflected in higher wages paid to workers. See also Wolman and Colamosca (2002) for more discussion of these points.
2. However, Gustman and Steinmeier (1992), examining the 1977–1985 period, conclude that regulatory changes could account for no more than half of the shift from DB to DC plans, at least over this period.
3. Another factor that has been mentioned is greater worker mobility in the 1990s than in the 1980s. The argument is that because DB pensions are not portable between employers, workers who switch jobs may prefer DC to DB plans. Such an argument is made by Friedberg and Owyang (2004) using a contract-theoretic matching model with moral hazard. In their work, they show that a decline in the value of existing jobs relative to new jobs reduces the expected match duration and therefore the desirability of DB pensions. They find that this explanation is consistent with observed trends in DB pension coverage. However, according to Farber (2001), there was virtually no change, on average, in the degree of job tenure between the 1980s and the 1990s, casting some doubt on the increased worker mobility argument.