Private Pension Reform

An Issue in Waiting

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The private pension system is an arena of continual activity. The types of pension plans offered to individuals have been changing rapidly, with 401(k)s, profit sharing, money purchase funds, individual retirement accounts, and other "defined contribution" arrangements continuing to grow relative to older "defined benefit" plans that set benefits in retirement according to years of work and salary rather than any set amount of contribution or deposit.

Few new firms are known to offer defined benefit plans. Meanwhile, "cash balance" plans with many of the features of defined contribution accounts—although they have been accepted so far as defined benefit plans—have been replacing other defined benefit arrangements in older firms, much to the consternation of some workers and the benefit of others.

Employers are also moving toward types of plans and institutional arrangements that will allow them to concentrate mainly on their own line of business. As my colleague, Pamela Perun, emphasizes, employers do not want to be liable for many of the separable problems of employees and their families, such as dividing up assets during a divorce. One way to try to move away from such liability is for the employer primarily to contribute on behalf of employees and to leave choices to employees and to try to push responsibilities and liabilities to outside administrators and funds.

But, as the saying goes: You ain't seen nothin' yet! Many people treat private pensions as if they are something totally separate from other public retirement policy. Perhaps that is because federal social security and health benefits have been growing for so many decades as a percent of gross domestic product that we have come to think of the private sector as simply providing an add-on, and then only for some people. But federal retirement policy itself is due for a serious shake-up, and the fallout cannot help but affect private pension arrangements as well.

New legislation is not even required to start the shake- up. For those turning 65 in 2000, the "normal retirement age" of 62 for social security will be increased for the first time in history—to 65 and 2 months. For future retirees, further increases are scheduled. Historically, private pension arrangements have adapted themselves to the social security world, setting retirement ages roughly in accord with social security normal and early retirement ages of 65 and 62. Some plans are even "integrated" with social security by setting their benefits according to the level of benefits provided by or level of contributions made to social security.

As people retired earlier and earlier on social security, private pensions often had less, not more, years to cover. And it became easier for private plans to allow even earlier private retirement, as long as the number of years until social security became available was kept to a minimum. As the normal retirement ages increase, however, social security will be providing a continually smaller percent of pre-retirement income if people don't retire later. Private plans may also begin to think about moving up their own retirement ages so as to maintain a minimum gap until social security normal benefits are available. In fact, recent cutbacks and elimination of early retirement benefits in some plans is one indicator of that type of change.

Much broader social security reform, however, is now on the national agenda. Elderly programs occupy so much of what the federal government is scheduled to do that we are likely to see a whole series of reforms in the future, not just one reform for all times. Many defined benefit pension plans are not designed for these contingencies. If I am right in predicting continual adjustment in federal policy, moreover, employee benefit planners cannot prepare simply by anticipating one particular type of change or another. They cannot depend on who wins one election or conclude that they can adjust to one piece of legislation (whenever it comes) and then be done with it. Instead, their plans must be adaptable to a wide range of potential and continually evolving sets of federal policy.

Yet another force for private pension reform will come from attempts by the federal government to provide some sort of defined contribution account itself. Neither major political party is fighting over whether to board this ship any longer. They are both on board now and are simply fighting over who holds the steering wheel. Right now, one party would pay for these accounts out of the social security tax, the other out of the income tax. There is also some dispute over whether some sort of match would be made to employee or employer contributions.

Regardless of the structure of such federally sponsored account arrangements, they could easily form a base on which many people will assess their private pension wealth over and above any monthly social security check from some basic program. Assets in these accounts will start to affect perceptions of how well or poorly private pension arrangements are themselves providing benefits and the types of assets that might be held in other accounts. Once such federal accounts are set up, there quickly will arise demands for thinking about how to merge such accounts with other private accounts and how individuals should plan for their future retirement by combining various sources.

Yet another major force placing pressure on existing private pension arrangements is the failure of the existing system to cover the population well. Less than half have any substantial amount of private pensions as they approach retirement, and it appears that the fraction will not be much higher in the future. Needless to say, those who have the least private pension wealth are usually those who need it the most, as they also have lower social security benefits and fewer assets of other types, such as housing. Regardless of the merit of recent private pension legislation, it has tinkered around with other issues and not really addressed this problem.

Finally, over and above all of this is what I perceive to be the powerful force of the labor market itself. The U.S. labor force has allowed earlier and earlier retirement over the postwar period primary by boosting the female employment rate even more than the male employment rate has fallen. As female labor force participation approaches male participation, those days are coming to an end. The net result will be an extraordinary demand for both older and younger workers that will change the fundamental character of the labor market and of the pension system applying to workers of all ages.

Other Publications by the Authors

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