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Introduction

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At least since World War II, retirement income in the United States has relied on the so-called three-legged stool: Social Security, employer-based pensions, and private saving. Along many dimensions, this system has generated remarkable success. The incidence of poverty among the elderly has fallen dramatically over the last several decades, even as people retired at younger ages and lived to older ages. Millions of Americans enjoy well-funded retirements fueled by a combination of public and private retirement income. The ability of the private and public sectors to provide well-financed, lengthy retirement periods at the end of working lives is a historic achievement.

But substantial problems have also emerged. Policymakers' responses to the looming shortfall in Social Security finances, longer life spans, diminishing family networks, and low levels of personal saving will combine to challenge the adequacy of resources in meeting future retirement needs. Labor mobility has also increased, and the participation of many in the labor force has become more sporadic, increasing the difficulty of long-range retirement planning. For these and other reasons, ensuring adequate retirement income will be one of the most pressing public policy issues of the next several decades.

The looming insolvency of Social Security has been the focus of a huge number of studies and of public attention in recent years, while the role of private pensions in meeting future retirement needs has received less attention. Nevertheless, the private pension system already carries a large load: it accounts for

significant portions of the retirement income of the elderly and total net financial worth in the United States and for nearly all of the net personal saving since the mid-1980s.

The principal legislation regulating pensions today is the Employee Retirement Income Security Act (ERISA), which was passed in 1974 in a pension world that was far different from today's. In 1974 defined benefit plans dominated the pension landscape. In traditional defined benefit plans, participation is automatic, plan sponsors bear the risk, and workers receive benefits in the form of annual income payments—annuities—from the time they retire until they die. Benefits are not portable across jobs, though, and every worker in the plan receives the same structure of benefits.

Since the mid-1980s almost all of the growth in pensions has occurred through defined contribution plans, which is now the primary type of plan for the majority of pension participants. In defined contribution plans, the onus of participation, investment risk, and form of payout is placed on the worker. Benefits are easily portable across job changes, and workers have more choice about investment and distribution options. At the same time, however, the advent of defined contribution plans raises concerns about workers' ability to make appropriate decisions regarding participation, contribution levels, portfolio allocation, and withdrawals.

Some of the growth in defined contribution plans is attributable to ERISA's regulatory structure, which placed relatively heavier burdens on defined benefit plans. But defined contributions plans also grew as the result of shifts in the composition of industry and the labor force. Increases in job mobility also made the defined benefit plan, with its back-loaded structure, less appealing. And the superior performance of asset markets in the 1980s and 1990s made investing in defined contribution plans especially attractive.

While ERISA and subsequent legislation may have accomplished the goal of securing and perhaps even broadening the accrued benefit rights of participants in defined benefit plans, the pension system still contains weak spots. Pension coverage has stagnated since the early 1980s. Many low-wage workers are not covered. Most small employers do not offer pension plans.

Regardless of the relative merits of ERISA to date, the overarching point is that the features and problems of the pension world today are very different from those of the one in which ERISA was legislated. The papers in this volume are intended to address broad issues in the evolving pension system. The original versions of the papers were presented at a conference in the fall of 1999 and have since been revised. Since the conference, numerous additional factors have combined to influence pension outcomes. These include the substantial decline in asset prices since 2000, which reduced defined contribution balances and, in conjunction with falling interest rates, decimated the finances of defined benefit plans; the collapse of companies like Enron; continuing evidence that many

households approaching retirement are not preparing adequately, even given the existing Social Security and Medicare programs; and the likelihood that the latter programs will be downsized over time relative to currently scheduled benefits. Despite these recent events, the central issues facing pension policy remain the same: can the federal pension rules be reformed to expand employer interest in sponsoring—and employee interest in using—plans that generate adequate retirement income without jeopardizing protection for participants or the public fiscal position.

This book is part of a broader project intended to analyze these issues. This volume provides a framework for understanding the broad role of the pension system in the American economy and options for reform. A companion volume, *Private Pensions and Public Polices*, also edited by us and published by Brookings, delves into more of the "nuts and bolts" of pension reform issues.

The papers in this volume are divided into three sections. Papers in the first section explore the goals, features, and effects of legislation, as well as the causes and effects of the secular shift from defined benefit plans to defined contribution plans and, more recently, the shift among defined benefit plans from traditional plans to cash balance plans. Papers in the second section explore the role of pensions in the economy, in particular their influence on labor markets and on savings behavior and wealth accumulation. Papers in the third section present three proposals for broad-based pension reform, one emphasizing a substantial loosening of government regulations, one emphasizing a tightening of regulations, and one emphasizing the need to free employers of unnecessary legal and administrative burdens.

The Development of the Modern Pension System

Sylvester Schieber provides a historical, economic, and political overview of the development of pensions and, especially, public policy toward pensions. Schieber divides the 125 years of pensions in the United States into four periods: early development (1875–1920), spread of coverage (1921–64), pension policy concerns leading to the passage and implementation of ERISA (1965–81), and tax policy concerns leading to limitations on deductible contributions and other legislative and regulatory changes (1982–present). Overall, pensions have arisen and grown to address important employer and worker needs and have been alternatively encouraged and constrained by various manifestations of public policy.

According to Schieber, the first historical period established the essential form of pensions, reflecting the motivations of employers in sponsoring plans: the need to manage labor relations and productivity (especially by allowing and encouraging the dignified retirement of older workers) and to remedy the lack of life-cycle savings among rank-and-file workers.

The second historical period saw the development of some essential public policy features for pensions: tax-favored status, required nondiscriminatory treatment of workers, disclosure of information, assignment of exclusive benefit of pension assets to workers, and integration with Social Security. Schieber views this last feature as key to the spread of pension coverage in this period because the pay-as-you-go nature of Social Security and the generous, unfunded benefits given in the early years of the system provided a large subsidy to employers with integrated defined benefit pensions trying to encourage their older workers to retire. This time period, however, also saw the development of problems: benefit rights that workers misunderstood or perceived to be unfair (particularly arising out of long vesting schedules) and a lack of benefit security (arising out of lack of adequate funding for defined benefit plans). ERISA was implemented largely to address these concerns and led to improved plan funding and fairer rights to benefits.

The most recent historical period followed the development of the concept and estimation of tax expenditures as part of the federal budget process and coincided with large budget deficits arising from tax cuts. These intellectual and political developments focused increased attention on the significant tax benefits available to participants in pension plans and resulted, according to Schieber, in a tougher policy environment. In particular, pensions now face reduced permitted funding and lower allowable benefits for defined benefit plans, lower contribution limits for defined contribution plans, tighter nondiscrimination and integration rules, and lower maximum compensation levels in the calculation of benefits and contributions. Schieber claims that these changes have led to stagnant pension coverage, fewer defined benefit plans, less secure benefits, and benefit cuts for older workers (manifested most recently in the advent of cash balance plans). Schieber concludes that all the efforts to enhance retirement security could actually end up reducing the retirement security of the baby boom generation.

William Gale, Leslie Papke, and Jack VanDerhei focus on the substantial secular shift toward defined contribution plans. They document the magnitude of the change and of subsidiary shifts within defined contribution plans to 401(k) plans and within defined benefit plans to cash balance plans. They examine the implications for pension coverage as well as the possible causes and impacts on workers and employers. Gale, Papke, and VanDerhei show that the absolute number of defined benefit plans has declined dramatically. Because most of the defined benefit plans that were terminated were small, however, the impact on the number of active workers covered has been comparatively modest. As a share of the work force covered, defined benefit plans have declined significantly, because most new pension plans are defined contribution plans in general, and 401(k) plans in particular. More recently, many traditional defined benefit plans have been converted to cash balance plans.

From 1975 through 1985, the growth in defined contribution plans represented both replacement of and supplements to defined benefit plans. Since then, defined contribution growth has come almost entirely at the expense of defined benefit plans, according to statistics and formal studies cited by Gale, Papke, and VanDerhei.

The authors cite several types of evidence in examining the causes of the shift. Changes in the composition of the labor force and industrial make-up of the economy seem to be able to explain a significant portion of the decline in defined benefit plans, as unionized manufacturers and utilities, which naturally favor such plans, have experienced declines, in relative terms, in the economy. The increasing cost of complex and ever-changing regulations has also burdened defined benefit plans (and small plans of all types) more than large defined contribution plans. Finally, the flexibility of defined contribution plans seems to be increasingly important in a more competitive and faster changing business environment.

The impact on workers and employers of the shift from defined benefit to defined contribution plans is complex and uncertain, according to Gale, Papke, and VanDerhei. Issues for workers include the effects on the level and variability of retirement income, the liquidity of pension assets, job mobility, and the opaqueness of benefits. Issues for employers include matching worker preferences, the efficiency of work and retirement incentives arising from plan design, and administrative costs. The empirical evidence on many of these issues is mixed, and a summary measure of the "aggregate impact" of the shift from defined benefit to defined contribution plans considering all the issues taken together is not feasible. Gale, Papke, and VanDerhei conclude with a full description and analysis of cash balance plans, explaining why these plans are preferable for younger, more mobile workers, while an abrupt transition from a traditional defined benefit plan can adversely affect older workers.

Pensions and the Economy

Robert Clark and Joseph Quinn focus on the impact of pensions on labor productivity and job mobility during employees' working years and on the timing and nature of retirement at the end of the work cycle. After describing the different rates of benefit accrual over the work cycle in defined benefit and defined contribution plans and explaining how these accrual patterns might differentially affect productivity, mobility, and retirement behavior, they examine previous evidence on the nature and size of the effects. Economic theory suggests that there should be a trade-off between wages and benefits, as the employer should peg total compensation to the marginal productivity of workers. The empirical evidence, however, ranges from mixed to negative on this hypothesis. This empirical finding, in turn, may suggest that pensions have a positive effect

on worker productivity, allowing the employer to raise total compensation when it sponsors a pension plan. Other evidence is somewhat supportive of this view, as pensions, especially defined benefit plans, reduce worker turnover and presumably enable the employer to conduct on-the-job training and still recapture its investment in its workers.

Clark and Quinn find even stronger evidence of the impact of pensions on retirement behavior. Defined benefit plans in particular provide large financial incentives for workers to retire at specific ages, and workers respond strongly to these incentives. Clark and Quinn conclude, however, by noting the increasingly fuzzy notion of retirement, as more and more workers leave their career employer and take on a part-time or full-time bridge job with the same or another employer.

William Gale provides a critical review of the large theoretical and empirical literature on the impact of pensions, including 401(k) plans, on household wealth accumulation. This is an important public policy issue because it relates to the key questions of whether and how pensions can contribute to raising national saving and improving retirement preparedness. In this regard, information on heterogeneity across households in the response of savings to pensions is particularly pertinent to pension policy questions; participation and nondiscrimination requirements are in large part meant to encourage saving by and ensure retirement preparedness of low-income workers.

In the simplest theoretical model of life-cycle saving, workers save only for retirement. Increases in pension wealth would therefore be offset completely by reductions in other wealth. Other factors complicate the theoretical analysis considerably. Empirical studies generally find that pensions have little or no offsetting effect on savings, a somewhat surprising set of results given the basic theoretical model. Stated another way, savings are raised about a dollar for every dollar invested in a pension, according to these studies. Gale points out, however, that several biases lurk in these studies, including controlling for cash earnings rather than total compensation, omitting retirement age as an independent variable, assuming that pensions are exogenous with respect to saving behavior, and reporting pension wealth gross-of-taxes. Correcting for these biases would, according to Gale, produce a larger estimate of the offset of pensions on savings.

Gale also summarizes results indicating that groups that are more likely to have high demands for precautionary saving, to be borrowing constrained, to be economically literate, or to have low tastes for saving show less offset of pensions on other saving. This implies, according to Gale, that expanding pension coverage in the current environment may be an effective way to raise national saving because most households currently not covered by pensions may be in the groups that exhibit little offset between pensions and other wealth.

Comprehensive Pension Reform Proposals

The final section of the book contains three proposals for large-scale reform of the private pension system. The basis of the first two proposals is an agreement that it is unreasonable to expect that the private pension system would or should provide universal coverage. Both sets of authors (Theodore Groom and John Shoven, and Daniel Halperin and Alicia Munnell) advocate instead the creation of a government-sponsored system of individual accounts for all workers, although they disagree strongly on the methods of funding these accounts and any connection to reform of the Social Security system. They also disagree on the extent of actual penetration of pension coverage into the lower tail of the wealth distribution, and therefore the extent of the "failure" of the current pension system. For the most part, however, their differing approaches to pension reform do not reflect different facts, but rather differing philosophies of the role of government in the retirement income system.

The central policy argument advanced by Groom and Shoven is that pensions should not be viewed as a tax subsidy; rather the tax treatment of assets in qualified pension accounts should be considered as consistent with a consumption tax. Groom and Shoven prefer this approach to the classic income tax approach because in their view the latter taxes savings too much, promoting current consumption. They would theoretically prefer a complete conversion to a consumption tax (such as a national sales tax or a value-added tax), but they recognize that political and practical considerations make this change impossible. Therefore, as a second best alternative, Groom and Shoven favor the elimination of most of the current detailed tax requirements governing pensions, thereby expanding and liberalizing their use in the direction of consumption taxation. They note that the complex nondiscrimination rules and contribution limitations that currently apply to pensions largely do not burden the other main area of economic activity for households currently using consumption tax principles—homeownership.

More specifically, Groom and Shoven believe the diversity of limits and restrictions across different types of plans makes no sense; they think that the only sensible distinction is between broad-based employer-sponsored plans and individual plans. Groom and Shoven would eliminate the current complex and mechanical nondiscrimination requirements in favor of a simple requirement that each feature of a plan be currently or effectively available to all workers. They would significantly liberalize limits on employer contributions and plan benefits and would somewhat liberalize limits on employee contributions. Groom and Shoven would eliminate the minimum distribution requirements. While they believe that pension coverage and benefit provision currently extend quite deeply into the lower end of the wealth distribution, they recognize the

importance of Social Security to this segment of workers and are concerned about the future solvency of the system. Groom and Shoven would therefore create a system of personal security accounts funded by an additional payroll tax.

Groom and Shoven would also make changes in the nontax regulations governing pensions. They advocate the elimination of the Pension Benefit Guaranty Corporation (PBGC), or at least they would require that market annuities be purchased for all terminated defined benefit plans, and they would restrict the PBGC's ability to intervene in arm's length business transactions. Consistent with their belief in the importance of participant education, Groom and Shoven would limit the liability of plan sponsors who select providers of investment advice by use of a good faith, rather than a fiduciary, standard.

Halperin and Munnell take as given the premise of existing tax law that qualified plan treatment is an exception to the norm and is warranted only to the extent necessary to provide adequate retirement income to rank-and-file workers. They believe that pensions already have generous tax incentives and are not currently giving much retirement income to lower-income workers. Hence, they generally would tend to decrease these tax incentives or strengthen restrictions. Halperin and Munnell would agree to increase incentives only as part of the political give-and-take needed to achieve a comprehensive reform of the system.

Halperin and Munnell advocate a number of changes meant to increase participation and benefits for those who work for employers that already offer pension plans. More specifically, they advocate shortening the vesting period and substantially strengthening the nondiscrimination requirements by mandating that a plan sponsor provide uniform coverage and benefits to all full-time employees and more part-time employees. They would require equal benefits or contributions at all income levels without regard to Social Security (effectively eliminating integration). They would also require sponsors of elective plans—such as 401(k)s—to make a substantial contribution for all participants. In general, Halperin and Munnell prefer defined benefit plans; in acknowledgement of the mobility problem these plans represent for many workers, they favor career average and cash balance plans as well as inflation adjustment of accrued benefits in final average plans. They also generally dislike the cashing out of retirement assets and favor incentives for annuitization and the requirement that plans offer an inflation-indexed annuity distribution option.

Halperin and Munnell would agree to the increase of current contribution and benefit limitations only as part of comprehensive reform package. This package would include most of the changes mentioned above as well as the creation of a government-sponsored system of universal retirement accounts, a type of national 401(k) plan. The accounts would be financed largely through the imposition of a 5 percent tax on the investment earnings of private and government pension plans. In acknowledgement of the likely sufficiency of Social Security and these accounts for providing retirement income to lower-income

workers, Halperin and Munnell would agree that workers earning less than $20,000 annually could be excluded from employer-sponsored pension plans.

While the Groom-Shoven and Halperin-Munnell proposals focus on contrasting approaches to the role of government in ensuring outcomes, a third proposal, by Pamela Perun and Eugene Steuerle, focuses on changing the role of the employer. Currently, employers are expected or required to perform many roles, from the simplest facilitation of saving—through payroll deductions and wiring the funds to an account, for example—to extremely complicated regulatory tests involving funding rules, contribution limits, nondiscrimination standards, and the maintenance of fiduciary standards. There appears to be no logical reason why employers should be saddled with such responsibility under defined contribution plans, especially since such plans are similar to other products offered by the financial services industry that do not face such rules. In addition, pension rules on all of these concerns in general, and fiduciary standards in particular, are inconsistent across types of plans.

Perun and Steuerle would encourage firms to do more—that is, increase coverage and contributions—by requiring them to do less—that is, relieve them of fiduciary responsibilities. In particular, they would maintain and emphasize the role of the employer in facilitating saving behavior by workers. This includes providing payroll deductions, simplified enrollment, periodic reports, investment education, and matching contributions, and serving as an intermediary between their employees and the financial services industry. But employers would also move the defined contribution system toward a system of individual accounts that are held, managed, and administered by the financial services industry. Under this approach, tax law would continue to encourage employers to offer plans and make contributions, but employers would do what they do best, and the financial services industry would provide the other services, which represent its comparative advantage. Overall, the plan would take the pension system back to a pre-1974 standard and away from the standards and practices that have developed since the passage of ERISA in 1974.

Conclusion

The papers in this volume provide a sound basis for developing a broad, bird's-eye view of the pension system's features, trends, strengths, and weaknesses and of alternative paradigms for reform. Although new proposals and concerns will inevitably arise over time, we suspect that the issues, evidence, and conclusions addressed in the volume will continue to play a key role in providing a framework for analysis of pension policy alternatives.