

# Pension coverage and retirement security

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# PENSION COVERAGE AND RETIREMENT SECURITY

BY ALICIA H. MUNNELL AND LAURA QUINBY\*

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## Introduction

Much attention has focused on the shift in the private sector from defined benefit to defined contribution plans, primarily 401(k)s. Often forgotten, however, is that, at any given moment in time, only about half of private sector workers are covered by any sort of employer-sponsored plan. This lack of coverage has two implications. First, a substantial proportion of households – roughly one-third – ends up with no pension coverage at all during their entire worklife and must rely exclusively on Social Security during retirement. And, even under current law, Social Security will provide less in the future relative to pre-retirement earnings than it has in the past. Second, with median job tenure of about four years in 2008,<sup>1</sup> many employees move in and out of coverage so that they end up with inadequate 401(k) balances.

This *brief* proceeds as follows. The first section describes the extent to which private sector workers are covered by any retirement plan. The second section explores the implications of the lack of universal coverage. The third section discusses policy initiatives to improve coverage. The key finding is that, absent a government initiative, pension coverage is unlikely to increase, which – coupled with declining earnings replacement under Social Security – means that many future retirees will end up with inadequate incomes.

## Trends in Pension Coverage

Workers can be associated with a plan in three distinct ways. They can work for an employer that *sponsors* a plan for any of its employees. They can be *covered* by a plan, but not be eligible for benefits. Or, they can actually *participate* in the plan. Coverage and participation are not the same, since, for example, one-fifth of workers covered in 401(k) plans choose not to participate.<sup>2</sup> Nevertheless, the terms “coverage” and “participation” are used interchangeably here, except in the discussion of 401(k) plans. The data on coverage trends in this section are primarily from the *Current Population Survey* (CPS). See Box for discussion of other sources of pension coverage data.

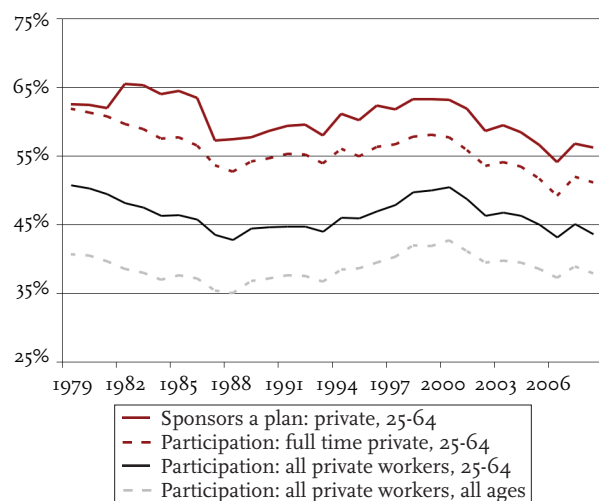
The percentage of workers covered by a pension declines as the definition of coverage narrows (see Figure 1 on the next page). For example, restricting the population to those age 25-64 and using employer sponsorship as the applicable criterion indicates that about 56 percent of the population had at least the potential for pension protection in 2008. At the other extreme, eliminating the age constraint and focusing on participation shows that 37 percent of private sector workers participated in a pension in 2008.

While the level of pension participation depends on definitions, the trend over time does not. Regardless of how the population is defined, pension

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FIGURE 1. PENSION SPONSORSHIP AND PARTICIPATION IN THE PRIVATE SECTOR, 1979-2008



Source: Authors' calculations from the U.S. Bureau of the Census, Current Population Survey (CPS), 1980-2009.

participation in 2008 was lower than it was in 1979. In each case, participation dropped between 1979 and 1988, rebounded between 1988 and 1999, then dropped again between 1999 and 2008. In 1979, 51 percent of nonagricultural wage and salary workers in the private sector age 25-64 participated in a pension plan; in 2008, that number was 44 percent.

### Coverage by Earnings and Sex

Figures 2A and 2B show that participation is closely correlated with earnings levels. In the top quintile, two-thirds of workers – both male and female – participate in pensions; in the bottom quintile, that figure drops to 12 percent for men and 9 percent for women.<sup>6</sup>

The evolution of pension coverage also varies by gender. The decline in pension coverage reflects a sharp drop in coverage for male workers at all earn-

## Do All the Surveys Tell the Same Story?

Pension coverage data come from both individual and employer surveys.

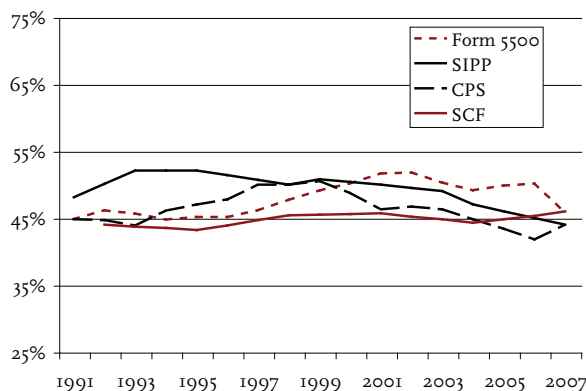
On the individual side, surveys with pension information include the CPS, which was discussed above, the *Survey of Income and Program Participation* (SIPP), the *Panel Study of Income Dynamics* (PSID), and the Federal Reserve's *Survey of Consumer Finances* (SCF).

Two surveys gather information directly from employers. Each year, all private pension plan sponsors are required to file a Form 5500 with the U.S. Department of Labor, which contains detailed information about their plan's finances and participants. The *National Compensation Survey* (NCS), conducted by the Bureau of Labor Statistics, uses a proportional sampling method to obtain data on compensation and benefits.

The Figure compares the data sets for which an extended series could be derived for overall participation rates among private wage and salary employees age 25-64.<sup>3</sup> The SIPP appears to be on the high side and the SCF on the low side, with the CPS in the middle. The PSID has pension data only

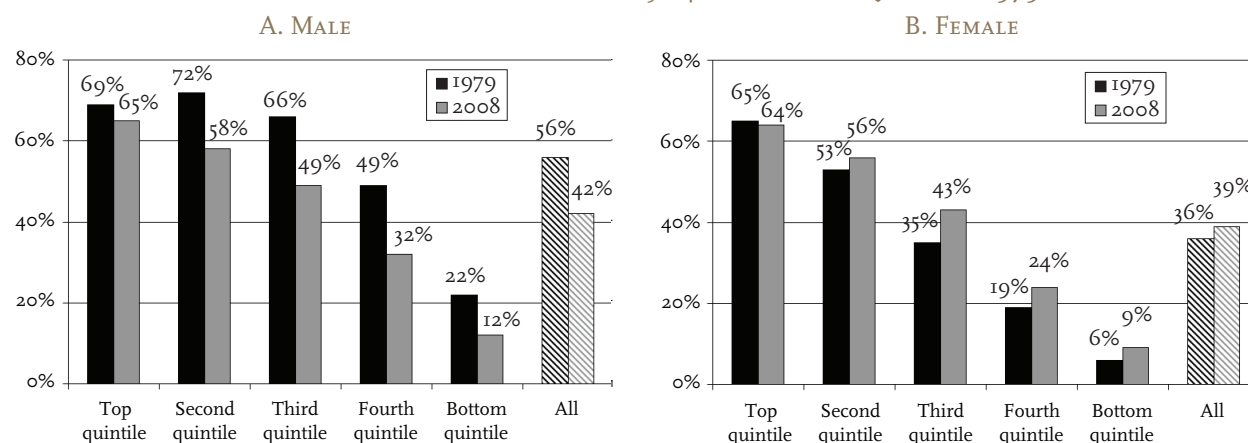
since 1999, but shows levels slightly below that of the SCF for comparable years.<sup>4</sup> Similarly, the NCS only releases continuous data for 2003 through 2006, but displays approximately the same trend as the Form 5500 for these years.<sup>5</sup> Taken as a whole, the data sets show pension coverage to have been within the 45-52 percent range between 1991 and 2008. No systematic difference appears between the employer and individual surveys.

FIGURE. PERCENT OF PRIVATE SECTOR WORKERS AGE 25-64 PARTICIPATING IN A PLAN, 1991-2007



Source: Update of Figure 1 in Sanzenbacher (2006).

FIGURE 2. PENSION PARTICIPATION FOR WORKERS, AGE 25-64, BY EARNINGS QUINTILE, 1979 AND 2008



Source: Authors' calculations from the 1980 and 2009 CPS.

ings levels (see Figure 2A). In contrast, participation for women increased across the board (see Figure 2B). This drop in male participation rates was caused by declines in union membership and employment at large manufacturing firms, and by the rapid growth of 401(k) plans that made employee participation in pensions voluntary.<sup>7</sup> Among women, the growth in pension participation was largely the result of improved earnings and an increase in full-time work and – to a lesser extent – increased union membership and employment at large firms. The remaining differential between men and women can be explained by their different work patterns. Among full-time, full-year workers, women actually have slightly higher levels of pension coverage than men.<sup>8</sup>

## Implications of Coverage Gap

The fact that only half the full-time workforce is covered by an employer-sponsored pension at any moment in time has two important implications. First, a significant portion of households end up at retirement entirely reliant on Social Security. Second, projections of 401(k) accumulations based on steady contributions are not realistic.

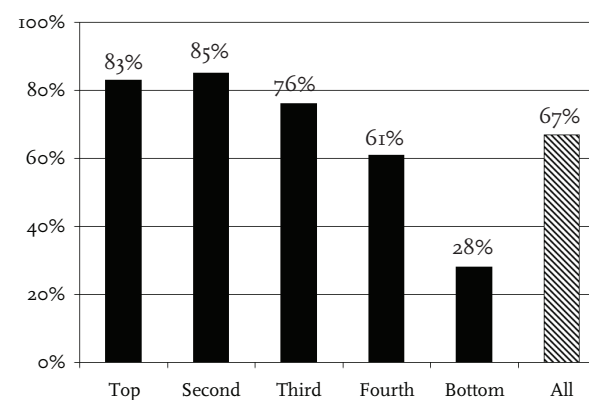
### *Reliance Solely on Social Security*

One-third of households end up at retirement never having acquired any pension coverage at all, according to the *Health and Retirement Study* (see Figure 3).<sup>9</sup> This figure is smaller than the 50 percent suggested by the CPS data for three reasons. First, it focuses

on households rather than individuals. Second, it includes public sector workers, who enjoy high levels of pension coverage. And third, private sector workers not covered in a given survey may pick up coverage at some time over their worklives. Nevertheless, one-third of households will be entirely dependent on Social Security; for low earners the figure is 72 percent.

The lack of pension income for low earners would not be a concern if Social Security provided enough income for them to maintain their pre-retirement standard of living. As a general benchmark, retirement income equal to 65 to 80 percent of pre-retirement earnings should be more or less adequate, with the specific target dependent on a household's characteristics.<sup>10</sup> For the low earner retiring at age 62

FIGURE 3. LIFETIME PENSION COVERAGE FOR HOUSEHOLDS AGE 63-73, BY INCOME QUINTILE, 2006



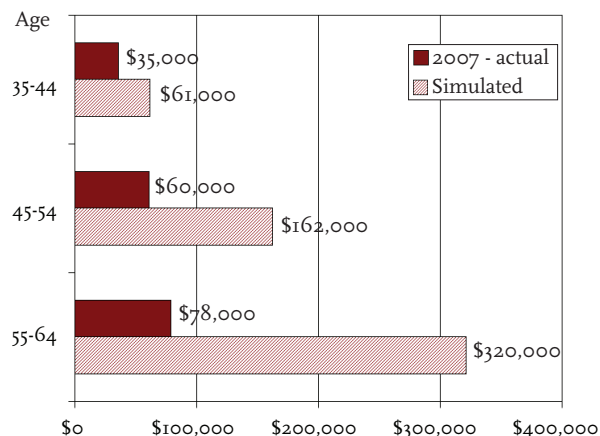
Source: Authors' calculations from the University of Michigan, *Health and Retirement Study* (HRS), 1993 and 2007.

– a common retirement age for low-wage workers – Social Security replaced 43 percent of pre-retirement earnings in 2002; by 2030, once the increase in the Full Retirement Age from 65 to 67 is complete, the replacement rate will be 39 percent.<sup>11</sup> For those low-income workers who must pay their own Medicare premiums – Medicaid covers the premiums for about half such earners – the net replacement rate is further diminished. Thus, Social Security alone does not provide an adequate level of retirement income. If low earners could work until 65 or 67, they would fare better. But many in this group are unlikely to be able to stay in the labor force for that long.

### *Intermittent 401(k) Accumulations*

The second implication of the lack of universal pension coverage is that projected 401(k) accumulations based on the prospect of steady lifetime contributions are not realistic. Moving in and out of coverage is likely a major factor contributing to the discrepancy between actual and projected accumulations. In theory, a typical worker who ends up at retirement with earnings of slightly more than \$50,000 and who contributed a steady 6 percent with an employer match of 3 percent should accumulate about \$320,000 (see bottom bar in Figure 4). According to the Federal Reserve's *Survey of Consumer Finances*, the typical individual approaching retirement had only \$78,000 in 2007, far short of the simulated amount. (Note that the reported amounts include holdings in Individual Retirement Accounts (IRAs) because

FIGURE 4. 401(k)/IRA ACTUAL AND SIMULATED ACCUMULATIONS, BY AGE GROUP, 2007



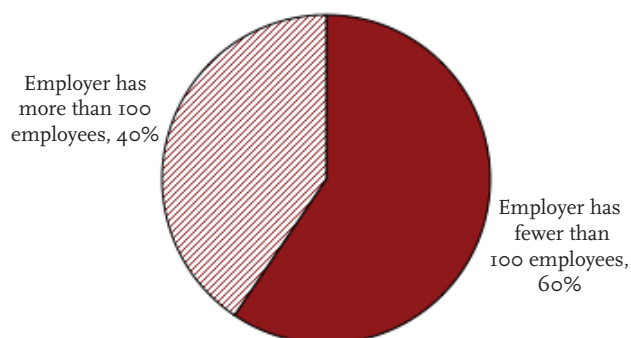
Source: Munnell and Sundén (2004 and 2006), and authors' calculations from the 2007 SCF.

these balances consist mostly of rollovers from 401(k) plans.) A number of factors contribute to this discrepancy – including failure to participate at young ages and a tendency to withdraw small balances – but moving in and out of covered employment is almost surely a contributory factor.

## Solving the Problem

The first step to solving the coverage problem is to identify those who do not have coverage. Of those not covered by a pension plan, roughly 20 percent work for an employer with a plan. The Pension Protection Act of 2006 targeted this group with provisions for automatic enrollment and automatic escalation in default contributions to 401(k) plans. Four-fifths of those without coverage, however, are employed by a firm without a plan. The bulk of these employees work for small employers (firms with fewer than 100 workers) (see Figure 5).

FIGURE 5. WORKERS WHOSE EMPLOYER DOES NOT SPONSOR A RETIREMENT PLAN, 2008

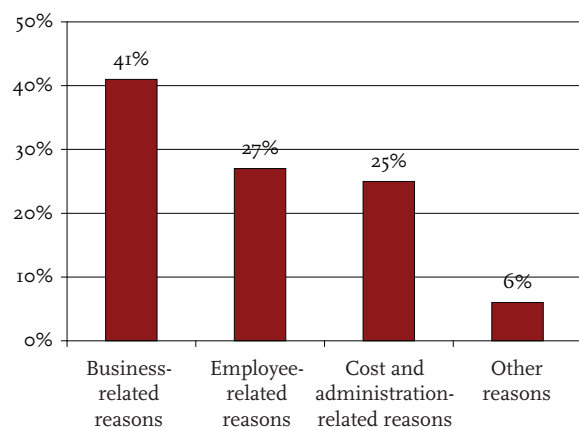


Source: Authors' calculations from 2009 CPS.

For decades, policymakers have tried to solve the coverage problem by introducing simpler products that could be adopted by small business. The SIMPLE (Savings Incentive Match Plan for Employees of Small Employers) is a prime example.<sup>12</sup> Firms with fewer than 100 employees can offer a SIMPLE, which can be set up as an IRA for each employee or as a 401(k) plan. The SIMPLE has a number of advantages. Firms can either match employee contributions or contribute a fixed percentage of their payroll. Once established, the SIMPLE is administered by the employer's financial institution, and does not even require the employer to file an annual financial report.

Furthermore, most employers are eligible for tax credits for the first three years after starting the SIMPLE.<sup>13</sup> The trend data on coverage, however, clearly indicate that simplifying plan design will never lead to a major expansion of coverage. This outcome is not surprising in that costs and administrative considerations are not the main reason small businesses do not offer plans. Much more important are business-related concerns, such as uncertainty of revenue, and employee considerations, such as high turnover or a preference for cash wages (see Figure 6).

FIGURE 6. MOST IMPORTANT REASONS CITED BY SMALL EMPLOYERS FOR NOT OFFERING PLAN, 2003



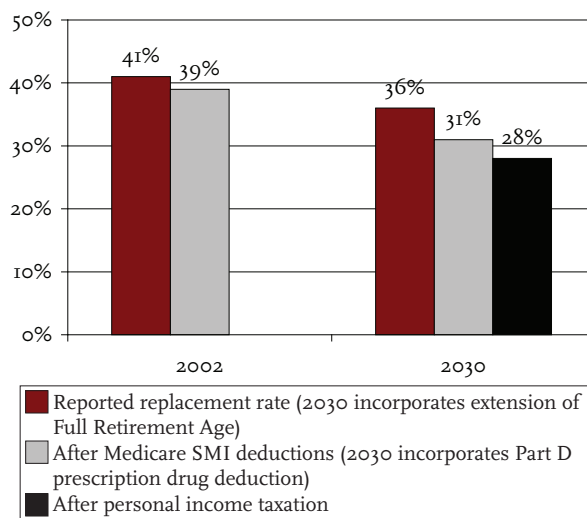
Source: Employee Benefits Research Institute (2003).

Recognizing the difficulty in getting small employers to introduce employer-sponsored plans, the Obama administration has proposed “Automatic IRAs.” IRAs are designed to provide those without an employer-sponsored plan an opportunity to save on a tax-deferred basis. Although IRAs hold enormous amounts of money, fewer than 10 percent of eligible workers make a tax-favored contribution to an IRA. The balances largely reflect rollovers from 401(k) plans. The recent proposal would automatically enroll those workers without workplace retirement plans in IRAs through payroll contributions. The contributions would be voluntary – employees would be free to opt out – and matched by the Savers Tax Credit for eligible employees.

The question is whether providing additional savings opportunities only for those without coverage is sufficient. The presumption is that those who currently work at employers with a 401(k) will end up with adequate retirement resources. As noted above

for low earners, at any given retirement age, Social Security benefits will replace a smaller fraction of pre-retirement earnings than in the past, and the decline will be more significant for middle-income workers than for those at the low end of the earnings distribution. While both groups will experience a drop in the replacement rate as the Full Retirement Age rises, middle-income workers will experience two additional effects. Premiums for Medicare Part B and for the new Part D drug benefit, which are automatically deducted from Social Security benefits, are slated to increase sharply due to rising health care costs.<sup>14</sup> And the taxation of Social Security benefits under the personal income tax will move further down the income distribution, as the exemption amounts in the Tax Code are not indexed to inflation. This combination of factors will reduce the *net* replacement rate for the median worker, who claims at age 65, from 39 percent in 2002 to 28 percent in 2030 (see Figure 7). And this figure does not include any additional benefit cuts that might be enacted to shore up the solvency of the Social Security program.<sup>15</sup>

FIGURE 7. SOCIAL SECURITY REPLACEMENT RATES FOR THE MEDIAN EARNER, 2002 AND 2030



Source: Authors' calculations based on Munnell (2003).

Given the decline in replacement rates under Social Security and the modest balances in 401(k)s, a case could be made that both those with and without coverage will need additional retirement saving. A more comprehensive solution would provide an additional tier of retirement saving for both those with and without employer-provided coverage.

## Conclusion

While employer-sponsored pensions can provide an important source of income for some retirees, they cover less than half of the private workforce at any given time. This lack of coverage creates two types of problems. First, about a third of households are not covered at all during their entire worklife and are therefore entirely dependent on Social Security in retirement. With Social Security providing less in the future than it has in the past, this reliance is likely to produce inadequate retirement income. The second problem is that with a mobile workforce, people are moving in and out of employer-based coverage, leading to far smaller accumulations than what one would expect based on spreadsheet calculations.

Clearly more retirement saving is needed. Designing simpler plans in the hope that they will appeal to small business has not worked in the past and is unlikely to work in the future. “Automatic IRAs,” which automatically enroll those with no employer-sponsored plan and require nothing more than payroll deductions by the employer, would help. But given the decline in Social Security and the modest balances in 401(k) plans, a more comprehensive solution may well be warranted.



## Endnotes

1 U.S. Department of Labor, Bureau of Labor Statistics (2008).

2 Munnell and Sullivan (2009).

3 The SIPP data and the SCF data are available only in select years; the SCF every third year from 1992 and the SIPP in 1991, 1993, 1996, 1999, 2004, and 2007. The CPS and Form 5500 are available annually. The SCF does not distinguish between private and public workers, but the percentage from the SCF was adjusted to reflect only private workers by using the SIPP to calculate the percent of the workforce in the public sector and the percent of those workers with pensions.

4 Authors' calculations from the University of Michigan (1999-2007).

5 The NCS data are available in 1999, 2000, 2003, 2004, 2005, and 2006.

6 Earnings also appear to be more important than race in explaining pension participation. For example, Munnell and Sullivan (2009) find that earnings – along with other socioeconomic and plan characteristics – has a statistically significant effect on 401(k) participation, while race does not (except in the case of Asians, who were found to have higher participation rates).

7 Even and Macpherson (1994) showed that the growth of 401(k) plans caused participation rates to drop most for young and less educated workers.

8 Copeland (2009).

9 The HRS is a nationally representative data set with a core sample of about 12,600 individuals from about 7,600 families that provides detailed information on income and wealth holdings. Conducted by the University of Michigan's Institute for Social Research, the HRS interviews individuals age 51-61 in 1992 and their spouses, with the first interview taking place in 1992 and subsequent interviews taking place every other year. See Juster and Suzman (1995) for a detailed overview of the survey.

10 Most analysts assume that retirees do not need to replace 100 percent of pre-retirement earnings, because they pay less in taxes (particularly the payroll tax), they have lower housing costs because they have generally paid off their mortgages, and they have less need to save. The target replacement rate varies by income level and household type. For further information, see Palmer (2008).

11 Replacement rates are from the U.S. Social Security Administration (2002). Under legislation enacted in 1983, the increase in the Full Retirement Age began with those born in 1938 (turning 62 in 2000) and will be fully phased in for those born in 1960 (turning 62 in 2022).

12 SIMPLE plans, which were introduced in 1996, generally replaced SARSEPs (Salary Reduction Simplified Employee Pensions), which were the earlier pension provisions for small employers.

13 U.S. Department of Labor and Internal Revenue Service (2009).

14 The premium for Medicare Part B is projected to increase from 9 percent of the average Social Security benefit in 2007 to 12 percent in 2030 (according to unpublished data from the Centers for Medicare and Medicaid Services, 2008).

15 For married couples – and most Americans retire as part of a married couple – Social Security already replaces a significantly smaller share of household earnings than it did as recently as 1990, and will replace even less going forward (Munnell, Sanzenbacher, and Soto 2007). The reason is that the dramatic increase in the labor force participation of married women increases the household's pre-retirement income but increases Social Security benefits only to the extent that benefits based on the wife's earnings records exceed the 50-percent spousal benefit.



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CENTER FOR  
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