ERISA at 30: Where Is the Employer-Sponsored System Going?

Dallas L. Salisbury
April 14, 2004
Keynote to the 2004 American Bar Association JCEB Symposium

ERISA marked a turning point for the employer-sponsored system. Pre-ERISA pension design generally focused on those who were with an employer for 30 years, or at normal retirement age, and sought to allow retirement with meaningful income replacement. The programs still in existence today that are closest to this vision are those for the uniformed services. A 1970 book from the American Enterprise Institute underlined this focus from both defined benefit plan sponsors and from TIAA-CREF.

ERISA standards, as amended—particularly those related to participation, vesting, joint and survivor, and funding—moved the focus to accrual and entitlement and cost for even short service workers. This led to redistribution of cost and cost increases if benefit formulas were to be maintained. It also led to conceptual “equality” of defined benefit and defined contribution designs and purposes, and to the introduction of the first hybrid DB designs in the early 1980s.

Design began to focus mostly on employee understanding and appreciation, influence on attraction and retention of young workers, issues of cash portability, and the delivery of a termination lump sum. EBRI policy forum books from the early 1980s tracked this change of focus and philosophy, and resistance to it by elder statesmen from plan sponsors, actuarial firms, and elsewhere, who were still primarily focused on adequate income replacement in retirement.

The feds followed ERISA with major re-design of the pension system government employees.

In the mid-1980s, the federal government made a major cut in the defined benefit formula and added a rich voluntary participation 401(k)-type plan. It gave its blessing to a shift in benefit strategy from a focus on income replacement levels to an emphasis on expense management, competitive measurement, and delivery of far more of the employer dollar to short-service workers. To a large extent, the private-sector employer-sponsored system followed the federal lead.

By the mid-1990s, unions were negotiating the revision of defined benefit plans based on the new model and the addition of supplemental defined contribution plans. The GOP revolutions of the 1980s, 1990s, and today, focused on deregulation of domestic and international markets, released genies that will never be put back into the bottle.

The new century has moved almost entirely away from a focus on designs to achieve income replacement to designs focused on wealth accumulation and individual control. President Bush has termed this “a culture of responsibility.” He continued in a recent
speech: “We’re changing the culture of this country from one that has said, if it feels good, do it, and if you got a problem, blame somebody else, to a culture in which each of us is responsible for the decisions we make in life.”

The early 90s GOP “Contract With America” underlined late-70s themes of a greater emphasis on individual markets and individual accounts. President Bush has termed this “an ownership society.” In recent speeches, he has identified individual ownership of housing, retirement accounts, and health insurance as central to this vision.

The recent Medicare prescription drug law moved the system another step along with health savings accounts, and recent guidance from IRS and Treasury clearly seeks to speed their adoption by employers.

Attention given to “off-shoring” and “out-sourcing” underline the new primary drivers of employer-sponsored benefits design: cost minimization in general and elimination of uncontrollable volatility of expenses in particular.

The economic status of today’s 65+ population can be viewed either as being “as good as it gets,” or as a state that should easily be surpassed by individual responsibility, a focus on ownership, and workers making decisions based upon a clear picture of economic prospects. You are the judges.

First, what is the status of the private employer-sponsored system today? Here are some facts:

- There were 27 million active participants in private defined benefit plans in 1974, or 44% of private-sector wage and salary workers. There are 20 million today, or 17% of private-sector wage and salary workers.

- There were 11 million active participants in private-sector defined contribution plans in 1974, 18% of private workers. Today, there are 64 million active participants in all private-sector DC plans, or 58% of the workforce; limiting the numbers just to 401(k) type plans, 47% of the workforce.

- Workers of long tenure and continuous participation have accumulated an average of about $175,000 in these plans, or enough to purchase an annual annuity of about $6,100, or a monthly payment of $510. Across all participants, the median is about $40,000, enough to produce an annuity of $116 per month.

- Today, 42% of families include a participant in some type of employment-based retirement plans—more than in any prior year.

- Today, 19% of all workers age 21 and over have some money in an IRA. Last year, 2.7% of tax returns reported a deductible contribution to an IRA. The median IRA balance was $15,000, enough to produce a monthly annuity of $44 per month.
Second, what is the status of the 65+ population today? Here are some more facts:

- 15.9% of 65+ retirees were getting private pension annuity income in 1974. The number peaked at 24% in 1998, and in 2002 it was at 22.8%.

- About 7% of the 65+ retirees were getting public pension annuity income in 1974, and about 11% are today.

- Employer provision of retiree health insurance hit a high in the early 1980s of about 34% of workers. Today, it is heading below 15%.

- For those with a private DB annuity income, total median income from all sources was $17,952 per year or, $1,496 per month.

- The DB annuity at median added $6,000 for the 7.7 million retirees with this income source, or $500 per month. At age 65, a retiree could purchase this annuity with a lump sum of about $170,000.

- This income is on top of median annual Social Security income of $11,880 per year, or $990 per month. At age 65, a retiree could purchase this annuity with a lump sum of about $339,000.

- Income from an IRA, Keogh or 401(k) was reported by 8% of those 65+, with a median reported income of $3,000 a year (or $250 per month). This amount could be purchased by a retiree at age 65 with a lump sum of about $86,000.

- For the 66% of the 65+ population without income from either a private or public defined benefit plan annuity, the median total annual income in 2002 was $10,782 per year (or $898 per month), and Social Security provided a median of $8,988 per year (or $749 per month). Thus, 83% came from Social Security at the median. At age 65, a lump sum of about $256,000 would produce this annual income.

- For the 65+ population, median financial assets outside of housing were $51,000; with housing, it was $168,300.

What do I see as the future of the employer-sponsored system?

I should first stress that this is a descriptive statement of what 30 years of research and experience suggest, not what I would want the system or the future to look like. I assure you, I would paint a very different picture.

When ERISA became law, employer-sponsored plans were almost entirely the province of the personnel department. Today, they are increasingly the province of the finance department, and that is likely to increase in the future. Personnel has become “human resources,” “human capital,” and “people.” The focus has become one of “being a business partner,” “contributing to the bottom line as a profit center,” and “helping the
firm to focus on its core expertise.” Thus, “outsourcing” of benefits and human resources functions continues to accelerate, and a drive to make benefits costs “predictable” accelerates as well.

Thus, the future of the employer-sponsored system is increasingly becoming one of worker education and facilitation of individual action. As with all change, this transformation will extend over several decades, but the genies are out of the bottles, and the bottles have been smashed. Costs (including tax rates in the public sector), driven by demographics and global reality, have moved us past the tipping point. Public plans will be the last to change. Negotiated plans will be the last to change in the private sector. Other private sector plans may continue for decades, but increasingly they will not include new employees. They will become true closed group wasting trusts. Some of these will continue accruals for the closed group, while others will freeze accruals.

Employer-sponsored defined benefit retirement and health plans will continue to decline in all sectors in relative importance.

Lump-sum distributions will continue to grow as the employee and employer-favored form of distribution as health advances continue to extend life expectancy.

Individual health accounts combined with catastrophic coverage will become the model for base programs, and the basis for setting the maximum cost contribution of employers should the worker choose an alternative health benefit design. Alternative designs will not go away, but as employers shift more and more cost they will see a necessity in offering a low employee premium cost option.

Intranets and the Internet will take this individual choice structure to the worker and the family for all savings plans. It will be administered by a small number of agents, acting as total human resources agents for employers, and will provide portability by workers during their full work lives. Consultant and service firm consolidation has already been extreme, but there will be more. These administrative agents will provide access to, and choice among, many asset managers as well as directed brokerage accounts and many insurers, like the model of the Federal Employee Health Plan and the most robust 401(k) plans. Ultimately, a government-sponsored savings clearinghouse, which has been introduced in the past by Senator Bingaman, and an FEHBP-type health clearinghouse, which has been proposed by many, may be included in this economywide portability system, making use of the payroll tax and income tax withholding systems as a means of contribution and premium payment collection.

The concept of a “normal” retirement age will increasingly recede, replaced by a concept of phased retirement, a concept of savings for life flexibility (similar to proposals of former Secretary of Labor Robert Reich), with temporary or permanent work force departure tied to individual assessments of personal needs, including re-education, life expectancy and financial preparation. Social Security, Medicaid, and Medicare will increasingly be understood as the resource-based “floors of protection” against elderly poverty that they have always been. Financial literacy and education programs,
combined with tools and projections provided by employers, the government, and non-
profits, and annual Social Security benefit statements, will hopefully lead the population
to understand that life expectancy extension means either saving a lot in order to leave
the work force with a reasonable lifestyle, or not leaving the work force at all. Should the
knowledge not be absorbed, elderly poverty could rise and workforce participation of the
old and the old-old could rise as well.

Conclusion
The 1970 AEI volume, Private Pensions and the Public Interest, was filled with
optimism for the future. The introduction noted that 20% of those over age 65 were
getting pension annuities from private employers, and that this number would grow
continuously in the future. The volume included leading actuaries’ reports that defined
benefit plans tied to final pay and payment of life annuities could meet income
replacement targets for retirees and protect against life risk. The adoption of such plans
by all employers was a clear goal of the attendees at the AEI conference. The president
of TIAA-CREF argued that defined contribution plans that paid benefits in the form of
variable annuities could also meet these goals as long as they were built around full
career contributions and portability across employers.

The reality of the present is different from that 1969 vision. Thirty-three years later, in
2002, 22.8% of those 65+ had defined benefit annuity income. Thirty-three years later,
at least 23% of defined benefit plans are hybrids that primarily pay lump sums, and
nearly half of the remaining plans offer a lump-sum distribution option. And, a majority
of those offered the option, take-it. Thirty-four years later, TIAA-CREF distribution
options other than a life annuity. They report that in 2001, 42% took a life annuity within
one year of having retired, the balance had not. Many others may still select a life
annuity, but patterns are clearly changing.

The painful reality is that for the vast majority of Americans, beyond the floor of
protection from poverty represented by Social Security, Medicaid, and Medicare, this
nation has always been an “individual responsibility” society. Between one-fifth and
one-third of the population was able to enjoy a more paternalistic environment from
about 1950 until 1980. That one-fifth is most heavily concentrated in the retiree
population over the age of 74. Below that age, the receipt of paternalistic benefits
(annuities) is already dropping among new groups of retirees. The highest rate of
pension annuity income now reported is among current retirees over the age of 80.

Let me take a moment to move to a more normative stance of what I believe would be the
ideal for the individual. I need look no further than my own parents, soon to be 88 and
91. They both worked and they both earned near the Social Security tax cap prior to final
workforce departure in 1978. The Social Security benefit is, as a result, about as good as
it gets. They have a monthly defined benefit payments that add one-third the value of the
Social Security. They have an employer provided Medigap policy that covers whatever
Medicare does not, paid for by a former employer. They have a paid for home. They
have no debt. They could have a better situation in one area, as they do not have a joint
and survivor annuity for the defined benefit plan. They had a choice, and like so many
they did not select the J&S. They had a profit sharing account, but those funds were gone many years ago. They would have been better off to either purchase an annuity or annually recalculate what they could take out. But, they just didn’t think they would live this long. Life expectancy risk and is the primary reason I have believed for my 30 years in this field that defined benefit promises were what a worker was best off getting. I am a paternalist. The fewer choices the better when it comes to the provision of basic lifetime protection for income and health care, with full survivor protection.

My parents’ world does not exist for me, or for two of my three siblings. Based upon the data, it never applied to more than one-third before the decline began. For one of my brothers, 62 and retired - the lucky dog on both counts - it does. As the statistics I presented tonight indicate, it exists for fewer and fewer Americans each year. Few things would make me happier than to see the trends I have outlined here turned on their head. Given the demographic time-bomb that continues ticking away, the increasingly competitive domestic and world economies, the “ownership society” that has so many focused on this quarter’s results, the “consumption driven” economy that is powered by the highest rates of individual borrowing in history, employers that no longer believe themselves able to suggest that they can provide life-time employment, and workers that no longer would trust the promise if given, I do not see the trends reversing.

The dream of ERISA may have been to extend the protective blanket of paternalism and risk protections to a much broader population, but it has not worked out that way. Transparency has now come to financial security. New employer-sponsored designs seek to allow the best-off one-fifth to one-third to still achieve financial security, and at the same time promise a higher probability that many in the other two-thirds to four-fifths will find financial security. As the reality of individual responsibility for the majority sinks in, and the myths for the majority of full careers, gold watches, good pensions, and paid retiree health benefits sink from our minds, greater numbers of Americans may actually begin to Choose to Save.®

1 Based upon initial comments I have changed the withdrawal rate assumption to a 3.5% rate instead of a 5% rate. The actual size of a purchased annuity payment will vary from the numbers in this paper, and they will vary over time as rates and annuity life expectancy tables change.