

BY DAVID MADLAND

## The seeds for the current decline in private-sector defined benefit pensions were sown at their inception. Is there hope for regeneration?

IN THE PAST FEW YEARS, companies in increasing numbers have cut traditional defined benefit pension plans and replaced them with defined contribution plans, such as 401(k)s. This process has shifted the risks of planning and saving for retirement from companies onto workers and unhinged the retirement plans of the millions who were dependent on their pension for a secure retirement.

# A Fragile Equilibrium: The Past,

History shows that three forces—the interests of management, the power of unions, and pressure from government—have been instrumental in both the growth and decline of defined benefit pensions in the United States. At the beginning, when the interests of management were the primary force behind private pensions, growth was slow and coverage inadequate. But as unions gained power and the government produced incentives for pensions (as well as threatening to create universal retirement programs that would reduce the need for corporate plans), private pension growth was strong and coverage relatively widespread. More recently, management interest in defined benefit plans has waned, unions have lost strength, and the government has pulled back. As a result, pension coverage has fallen significantly.

### The Origins of Private Pensions

In 1875, American Express became the first U.S. company to offer a pension, followed soon after by several firms, especially other railroad companies. From the management perspective, pensions enabled them to benevolently provide for their workers and fulfill social obligations. Early pensions were often little more than an informal practice of granting favored, long-term employees a small

retirement allowance. Such employees received a pension for giving their employer a “proper career.” Some companies also viewed pensions as a modern, effective management tool because they encouraged loyalty and hard work, while providing companies with a system for ushering out older, more expensive employees and replacing them with younger and cheaper workers.

Very few workers were unionized in the late 1800s and early 1900s, and labor unions didn’t have much power to negotiate for pensions. But as unions started to gain some traction with workers, they played an indirect role in driving the creation of pension plans. Companies felt that by voluntarily offering a pension, they would reduce worker demand for unions—a major preoccupation of American business at the time when, in some years, one in every five workers struck. And in the event such pre-emptive action failed, companies could deny benefits to anyone who participated in a strike.

Government pressure wasn’t much of a factor at this point. The U.S. government provided only a negligible social safety net, with most support for the poor and elderly coming from private charities. But public demand for government action grew through the 1910s and 1920s, starting with proposals for relatively

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# Present, and Future of Private Pensions

small, state-based pensions for the elderly poor, and dramatically expanded in the 1930s as the Great Depression took hold.

Huey Long, the populist governor of Louisiana, led the “Share Our Wealth” movement, which sought to provide every worker and retiree with a guaranteed income by confiscating wealth from the richest Americans. By 1935, Share Our Wealth—one of the most radical and popular movements of the time—had 27,000 local chapters with nearly 8 million members. Another popular proposal was the Townsend Plan, which sought to provide a government pension to every citizen age 60 and older by imposing a national sales tax. Ten million people signed a petition to Congress in support of the Townsend Plan.

President Franklin Roosevelt responded forcefully in 1934, stating that he would create government programs to “further the security of the citizen and his family through social insurance ... to provide at once against several of the disturbing factors in life—especially those that relate to unemployment and old age.” When Roosevelt made his announcement, over 30 other countries operated some form of social insurance program and 30 U.S. states had enacted some type of old-age pension program—though these state-based programs were generally considered inadequate, with only about 3 percent of the elderly actually receiving benefits.

### Early Pension Growth

In the face of demands for government action, U.S. employers began to value private pensions in new ways and increasingly adopted plans. Private benefits were now seen as a way to blunt the calls for big public programs. As Yale historian Jennifer Klein argues, business leaders felt that if they were solid corporate citizens, they could keep demands on government at a minimum and prevent the large, social welfare programs that European countries were adopting.

Large employers formed an alliance with private insurers to market private benefits as the “American Plan for Employers.” In their pitch to company executives, insurers highlighted the numerous advantages of employer-sponsored benefits over European-style government insurance, such as that company benefits would be controlled by employers, not the government, and could help displace labor unions.

“Unless we get things better, we may be driven to the European system of social insurance. ... Unless we want to go to that extreme, we must ... strive to the limit to bring it about that American industry shall take care of its own,” stated the National Industrial Conference Board, a leading business organization, in urging employers to provide more benefits to workers or face the alternative of large government programs beyond their control.

Even during the Depression and despite financial hardship, American businesses were determined to promote private benefits and stave off public programs. From 1929 to 1932, only 3 percent of workers who had company pensions saw their plans discontinued, and new plans were created at an unprecedented rate, with the number of company pension plans increasing by 15 percent. By 1929, 400 companies had some form of pension plan, including most large profitable companies, such as DuPont,

General Electric, and AT&T.

Despite this rush of private pension creation, only a small percentage of workers were covered by employer-based retirement plans, and even fewer ever received benefits. In 1930, about 2 percent of retirees received a company pension, though nearly 40 percent of companies offered some kind of retirement pensions. Pressure for public programs continued.

Most businesses adamantly opposed the creation of Social Security, but a few influential business leaders recognized that some form of social insurance was necessary. Instead of rejecting Social Security outright, they worked to keep the new government program as small as possible and ensure a prominent place for private benefits, according to UCLA historian Sanford Jacoby. They argued that the government should provide only a small safety net because employers—especially if they were assisted by tax incentives—would supplement public benefits with private ones, and together the two would provide a high level of protection for American workers. Marion Folsom, a Kodak executive and a leading proponent of a dual system of public and private benefits, testified to Congress in 1935 that public programs should be limited, stating that the government should provide only “basic minimum protection and should not be intended to cover all the needs of everyone.” Similarly, an insurance company executive argued that: “Private and social insurance are complementary rather than conflicting ... each having its part in providing old-age security for the country as a whole and neither being able to do the job alone.”

When Social Security was passed in 1935, the logic of a dual public and private retirement system prevailed. Social Security benefits were relatively small, and the system largely adhered to the vision of business leaders like Folsom. Thus, employer-sponsored benefits would retain an important role in providing economic security to workers.

### Rapid Rise

In the decades that followed Social Security’s creation, the number of companies offering retirement benefits grew dramatically as the forces of government and unions both strongly supported pensions. Social Security coverage and benefits were being expanded, keeping pressure on companies. The program provided incentives for businesses to create pensions for their higher-paid employees. In addition, during and immediately after World War II, wages were frozen by wartime regulations, so fringe benefits, such as pensions and health care, became a way to increase compensation. From 1935 to 1945, the number of private pension plans increased twentyfold—at the end of World War II about 20 percent of private-sector employees had a pension.

And unions began to increasingly demand pensions, driving coverage still higher. In 1948, courts ruled that unions—which were gaining strength in America’s growing industrial economy—could bargain with employers for pensions, not just wages. This court ruling, combined with the belief of many union leaders at the time that they would have more success providing coverage for workers through negotiations with employers rather than by trying to pass new government programs, spurred on a great

increase in the number of workers covered by employer-sponsored benefits. Nonunion companies—fueled by many motivations, including the desire to reduce worker demand for a union and to attract top employees—also increasingly offered pensions and health care. From 1950 to 1960, the number of workers covered by pensions nearly doubled, rising from 10 million to 19 million.

Up until this time, retirement benefits were largely unregulated by the federal government—though they did profit from favorable tax treatment. But in 1963, Studebaker's pension plan collapsed in the wake of the company's bankruptcy and became the "poster child" for pension reform, as pension scholar James Wooten argues in his extensive history of pension law. The failure of the Studebaker pension brought significant public attention to pension plan financing and created a 10-year push for federal legislation, which culminated in passage of the Employee Retirement Income Security Act of 1974 (ERISA).

ERISA, which has been amended several times since 1974, requires that companies adequately fund their pension plans, mandates that workers vest their pension benefits after a minimum number of years, and provides some government guarantees if a pension plan is terminated. Major amendments to the law in 2006 tightened funding requirements but didn't fundamentally alter the regulations set up in 1974.

ERISA purported to change the dynamics of pensions, shifting power to workers and away from employers. But instead, it perpetuated a retirement system heavily reliant on employers' voluntary provision of private pensions. Though ERISA made pensions slightly less attractive to management—because of the new requirements it placed on business—coverage continued to grow slightly, peaking in the 1970s and early 1980s when nearly 60 percent of the workforce was covered by a retirement plan.

### Pension Decline

Over the past several decades, and especially in recent years, employer-based retirement coverage has declined significantly. Now, less than half of workers earn retirement benefits—and these are increasingly defined contribution plans, such as 401(k)s, rather than defined benefit pensions. As a result, less than a quarter of workers now earn a pension from their current employer.

Labor unions, which once had the power to negotiate with companies and set high industry standards for retirement benefits, have been declining in size and power. The percentage of private-sector workers who are unionized has dropped from nearly 30 percent in the early 1970s to just 8 percent today. As a result, unions have lost some of their power to directly negotiate with employers for pension benefits. And nonunion companies have less reason to fear that they will become unionized if they don't provide pensions.

At the same time, the desire of elected officials to increase the scope of government benefits and support collective programs has waned, and governmental social welfare programs have become less generous. Some analysts consider the passage of ERISA in 1974 to be the high point of liberal government action in the United States.

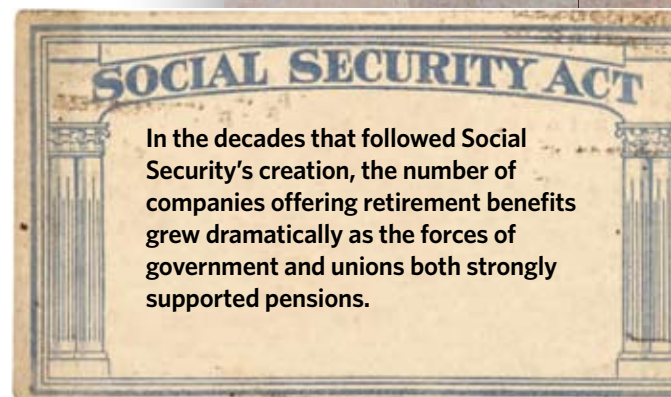
With diminishing pressure from unions and minimal fear of government welfare expansion, pensions are subject almost completely to the changing interests of management. And that interest decidedly has shifted away from maintaining defined benefit pensions. The ability of pensions to retain valuable employees is less certain. And because pension obligations can vary based on factors such as interest rates, stock market performance, and insurance rates, employers increasingly view pensions as a possible financial risk. At the same



**Huey Long, the populist governor of Louisiana, led the "Share Our Wealth" movement, which sought to provide every worker and retiree with a guaranteed income by confiscating wealth from the richest Americans.**



**Franklin Delano Roosevelt with Harry Hopkins and his daughter. Hopkins was a close adviser of Roosevelt's and one of the architects of the New Deal.**



**In the decades that followed Social Security's creation, the number of companies offering retirement benefits grew dramatically as the forces of government and unions both strongly supported pensions.**

time, cutting retirement benefits for workers can boost a company's bottom line (and often the salary of top executives).

"Certainly benefits are getting very expensive," writes Nell Minow, editor of the Corporate Library, a corporate governance watchdog. "But we are aware of and interested in the juxtaposition between cuts in benefits and increases for top executives. They cut benefits to make the balance sheet look stronger. The executives then reap the benefit of the stronger balance sheet by paying themselves better."

Companies gain from retirement benefit cuts in two ways. First, eliminating a pension enables a company to reduce expenditures, even if the pension is replaced with a 401(k). Though defined benefit pensions are more efficient and enable companies to provide higher benefits with lower average contributions, most 401(k) plans provide significantly fewer retirement benefits and are less costly. Companies typically contribute about 7 percent of payroll to support DB plans but only about 3 percent for 401(k) plans.

As a result of such changes, there has been a shift in responsibility for retirement saving from employers to workers. According to Department of Labor statistics, workers in 1978 made only 11 percent of total retirement savings contributions, while corporations contributed the rest. By 2000, the share was split 50-50.

Cutting retirement benefits also enables a company to reduce future liabilities, a move that can sometimes generate profit—at least on paper. Accounting practices assume that workers will continue earning pensions at the same rate they previously have, but when they are prevented from doing so by a cut, freeze, or termination, some future liabilities are reduced, making profits appear larger. When Berkshire Hathaway froze a subsidiary's pension, the company recorded a gain of \$70 million. When IBM cut pension benefits in a cash balance conversion, the change boosted company profits by about \$200 million a year, much of it used to fund pensions for executives (these paper profits also increased the value of stock options held by top executives).

In recent years, a two-tiered pension system has begun to emerge: one for executives and another for the rank and file. Even as companies cut pensions for most of their employees, they sometimes increase pension benefits for top executives in separate pension plans. At BellSouth, pension obligations for ordinary workers have edged down 3 percent since 2000 but have increased 89 percent for executives over the same period. McKesson Corp. established a pension plan for executives in 1995 but froze those of other workers two years later. Allied Waste Industries froze its pension plan for salaried workers in 1999 but four years later adopted a pension plan covering 10 executives.

The law requires that standard pensions be funded years into the future, but executive pensions don't need to have assets set aside to pay for them. The idea behind the law was that executives could better shoulder the uncertainty of these presumably riskier pensions. But because executive pensions don't require advanced funding, they appear less costly on financial disclosures. As a result, companies often don't separately report the costs of executive pensions but instead combine the liabilities of the two plans. This typically makes pension finances appear worse than they are—something that companies may want to do to make it

seem as though they are being forced to cut benefits.

In 2006, IBM announced that it was freezing its pension because of "costs, volatility, and unpredictability." As the *Wall Street Journal* reported, IBM "didn't mention that a quarter of its U.S. pension expense last year resulted from pensions for ... its highest-paid people." Similarly, Time Warner reported that its pension plans were underfunded by 7 percent, but its pension for regular employees actually had a surplus and could pay benefits well into the future. Its executive pension plan was short \$305 million. At GM, the pension plans for most workers have enough assets to pay benefits and, in fact, contain \$9 billion more than is needed to meet obligations, but GM's executive pension plan has a liability of \$1.4 billion.

During bankruptcy, executives are often able to protect themselves and their retirement benefits while passing on costs to regular workers. A *New York Times* examination of prominent bankruptcy filings found that executive benefits were preserved in every case reviewed, though benefits for workers were cut nearly every time. During United Airlines' bankruptcy, Chairman Glenn Tilton protected his \$4.5 million retirement fund in a trust, even as pensions for workers were eliminated.

"There are lots of corporations that have figured out that ... loopholes permit companies to make promises to a few sophisticated creditors to lock up all the assets of the business so that if the company ultimately fails, there won't be any sharing of the pain," writes Elizabeth Warren, a Harvard Law School professor and bankruptcy law expert. "The sophisticated guys will walk out with everything, and the employees and pensioners will be left with nothing."

### The Future

A look back in time shows that the rise and fall of private pensions has been determined by the interests of management, the power of unions, and pressure from government. While history doesn't necessarily predict the future, it does indicate that changes in one or more of these three areas are necessary to restore retirement security. It seems there are three possible ways for defined benefit pensions to grow again:

- ▶ Management needs to revalue the ability of pensions to retain personnel during prime working years and lose its financial incentives to cut retirement benefits;
- ▶ Unions need to grow again and regain the level of influence they had in the middle part of the 20th century;
- ▶ The government needs to consider proposals that expand Social Security or provide universal retirement security through other means—either directly providing benefits or driving companies to increase their retirement benefits.

While none of these outcomes is imminent, any is possible. ●

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# Estimates of Pension Losses



## PENSION BENEFITS

are based on an implicit contract between employer and employee that workers will earn benefits over their tenure with a company and that the company will pay out those benefits when a person retires. With the exception of certain types of losses that can be suffered when companies go bankrupt, pension benefits that have already been earned cannot be reduced. However, benefits that workers expect to be able to earn in the future can be reduced by terminating the plan or by changing the way benefits are calculated. Workers receive what they have earned up to the point of change, but not what they would have earned had the employer continued the old pension plan.

Because typically most benefits are earned toward the end of person's career, "expected" benefits are significant. Middle-aged workers with significant tenure in a company but years to go before retirement—those who are midstream in the implicit pension contract—have the most to lose. Those with little service haven't earned much. Workers nearing retirement have already earned most of the benefits they expect to earn.

The number of people who have lost expected pension benefits and how much they have lost can only be roughly estimated—pensions vary across companies, can be cut in numerous ways, and don't affect everyone equally. However, the best studies show that 8 million people, one in four workers with defined benefit pensions, has seen benefits significantly cut since 2000.

The Employee Benefit Research Institute (EBRI) estimates that when a pension plan is frozen (or terminated when fully funded), the typical, married 40-year-old man loses nearly \$5,000 of expected benefits in each year of retirement, or a total of over \$95,000 assuming an average life span in retirement. (It should be noted that these estimates do not include replacement with a 401[k]). Losses can be much greater

for employees who earn higher salaries and have a long tenure with their company.

When the Pension Benefit Guaranty Corp. (PBGC) recently took over four large pension plans that were terminated in bankruptcy, workers and retirees lost \$6 billion of earned, vested pension benefits, or around \$20,000 per person. However, these losses don't include the value of what workers lost because they were no longer able to continue earning benefits in the terminated plan. If you added that lost value, a typical mid-career male worker in a terminated plan probably drops nearly \$100,000 in benefits. Under a cash balance conversion, each year of service is rewarded equally instead of having the later years worth more. Though such a change doesn't necessarily need to reduce pension benefits, a comprehensive review by the U.S. Government Accountability Office (GAO) found that most people, including younger workers, were worse off because cash balance formulas are usually less generous than previous formulas. According to EBRI, a typical married 40-year-old man loses nearly \$1,500 per year in retirement, or approximately \$28,000 in lifetime losses, during a cash balance conversion.

PBGC records show that nearly 2 million people had their pension plans terminated in the period between 2000 and 2007 and that the number of people with cash balance pension plans increased by 3 million from 2001 to 2005. Because most people lose during a cash balance conversion, it's safe to assume that over the past seven years, more than 3 million people were hurt by a transition to a cash balance plan. The GAO estimates that more than 3 million people currently have frozen plans and private data indicate that the vast majority of these freezes were quite recent.

Adding these different types of pension cuts together means that 8 million people have lost significant pension benefits in recent years. And that's probably a low estimate as evidenced by a June 2005 survey conducted by the Heldrich Center for Workforce Development at Rutgers University, in which 13 percent of workers reported that their retirement benefits had been cut. That represents approximately 16 million people, not including retirees. A May 2006 AARP survey of adults age 40 and older found that 34 percent of workers had their pension plan frozen, cut, or eliminated.

## Estimated Pension Losses, 2000-2007

Type of Reduction	Pension Freeze	Pension Termination—In Bankruptcy	Pension Termination—Standard	Cash Balance Conversion
Estimated Number of People Affected	3,300,000	1,000,000	800,000	3,000,000
Estimated Loss per Mid-Career Worker	\$74,000	\$94,000	\$74,000	\$21,000

Source: Author's estimate based on government and private studies

Note: Estimated dollar losses are based on current dollars using the following assumptions: 60 percent of people with pensions are married, 20 percent are single men, and 20 percent are single women. Life expectancy for a 65-year-old is an additional 17 years for a man and an additional 19.7 years for a woman. These figures very likely underestimate the dollar loss, because singles are counted as never having been married, and thus ignore benefits for divorced or widowed spouses.