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THE PENSION COVERAGE PROBLEM IN THE PRIVATE SECTOR

BY ALICIA H. MUNNELL, REBECCA CANNON FRAENKEL, AND JOSH HURWITZ*

Introduction

Pension discussions in the last few years have focused primarily on the financial health of state/local plans or on the shift from defined benefit to 401(k) plans in the private sector. Often forgotten is that while coverage at the state/local level is virtually universal, only 42 percent of private sector workers age 25-64 have any pension coverage in their current job. As a result, more than one third of households end up with no coverage at all during their entire worklives and others, who move in and out of coverage, end up with inadequate 401(k) balances.¹

This *brief* proceeds as follows. The first section describes the pension coverage problem in the private sector. The second section explores the implications of the coverage gap. The third section presents policy options to address the gap. The key finding is that, absent a government initiative to create a new tier of retirement saving, pension coverage is unlikely to increase and many – both with and without 401(k) plans – will end up with inadequate retirement income.

Pension Coverage

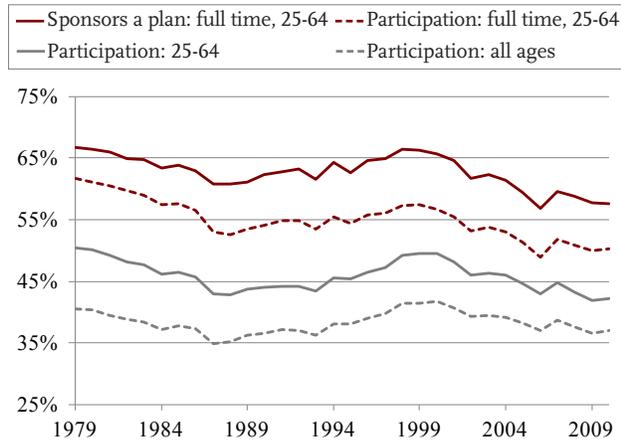
Coverage of private sector workers in employer-sponsored plans is shockingly low and shows no sign of improving on its own. The precise percentage of

workers covered depends on how workers are associated with the plan. They can work for an employer that *sponsors* a plan for any of its employees. They can be *covered* by a plan, but not eligible for benefits. Or they can actually *participate* in the plan. “Coverage” and “participation” are not the same since, for example, 21 percent of workers covered by 401(k) plans choose not to participate.² But the *Current Population Survey* (CPS), which is the primary source of data for this section, does not distinguish between the two concepts, so the terms coverage and participation are used interchangeably, except in the later discussion of 401(k) plans.

The percentage of workers covered by an employer-sponsored plan depends not only on the definition of coverage but also on the population under consideration. For example, restricting the population to full-time workers age 25-64 and using employer sponsorship as the applicable criterion indicates that about 58 percent of this sample had at least the potential for pension protection in 2010 (see Figure 1 on the next page). At the other extreme, eliminating the age constraint and focusing on participation shows that only 37 percent would be considered covered. The intermediate – and most cited measure of coverage – is all workers age 25-64 participating in an employer-sponsored plan, and that figure was 42 percent in 2010.

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FIGURE 1. PENSION SPONSORSHIP AND PARTICIPATION IN THE PRIVATE SECTOR, 1979-2010



Note: Population is restricted to private, civilian, non-farm wage and salary earners. Full-time workers are those working 50 or more weeks a year and 35 or more hours a week. Source: Authors' calculations from the U.S Census Bureau, Current Population Survey (CPS), 1980-2011.

While the level of pension participation depends on definitions, the trend over time does not. Regardless of how the relevant population is defined, pension coverage in 2010 was lower than in 1979. In each case, coverage dropped between 1979 and 1988, rebounded between 1988 and 1999, then dropped again between 1999 and 2010. In 1979, 50 percent

of private sector workers age 25-64 participated in an employer-sponsored plan; as noted above, the number in 2010 was 42 percent.

Coverage by Earnings and Sex

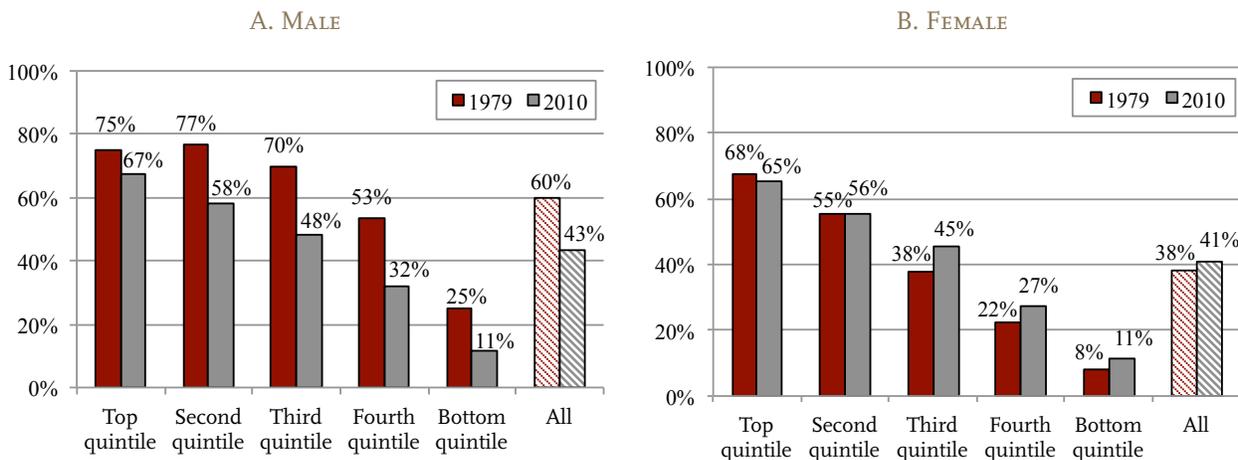
Figures 2A and 2B show two things. First, participation is closely correlated with earnings. In the top quintile, two-thirds of workers – both male and female – participate in pensions; in the bottom quintile, that figure drops to 11 percent.

Second, men have lost coverage, while women have gained. The 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. 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.³ Interestingly, data not shown in this figure reveal that pension participation among full-time, full-year workers is now equal for both men and women.

Implications of Coverage Gap

The fact that less than half of the full-time, full-year workforce is covered by an employer-sponsored pension at any moment in time has two important

FIGURE 2A. PENSION PARTICIPATION FOR WORKERS AGED 25-64, BY EARNINGS QUINTILE, 1979 AND 2010



Note: Includes private, civilian, non-farm wage and salary earners age 25-64. Full-time workers are those working 50 or more weeks a year and 35 or more hours a week. Source: Authors' calculations from 1980 and 2011 CPS.

implications for retirement income. First, a large share of households will end up at retirement without any pension and entirely reliant on Social Security. Second, projections of 401(k) accumulations based on steady contributions are not realistic.

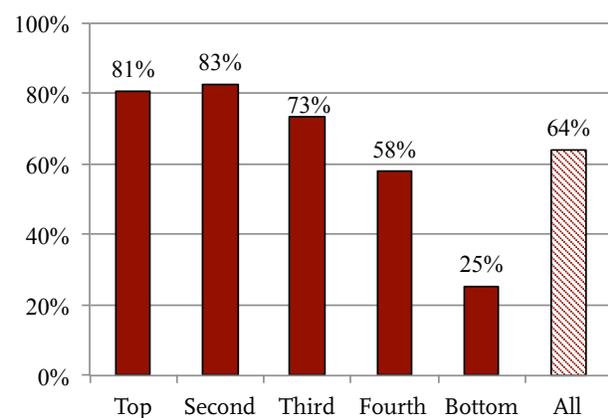
Reliance Solely on Social Security

The data presented above provide only a snapshot of pension coverage in 2010. With increasing job mobility, the question remains whether workers move into coverage at some point over their work life. The *Health and Retirement Study* (HRS), which asks respondents about coverage under employer-sponsored plans, shows that 64 percent of households end up with some type of employer-provided plan (see Figure 3).⁴ The flip side of this finding is that more than one third of households end up entirely dependent on Social Security. For low earners the figure is 75 percent.

Low earners' sole reliance on Social Security would not be a problem if the program provided them with sufficient income to maintain their standard of living. But Social Security replacement rates – benefits as a percent of pre-retirement earnings – fall far below the generally accepted benchmark of 80 percent.⁵ For a low earner retiring at age 62 – a common retirement age for low-wage workers – Social Security currently replaces 40 percent of pre-retirement earnings

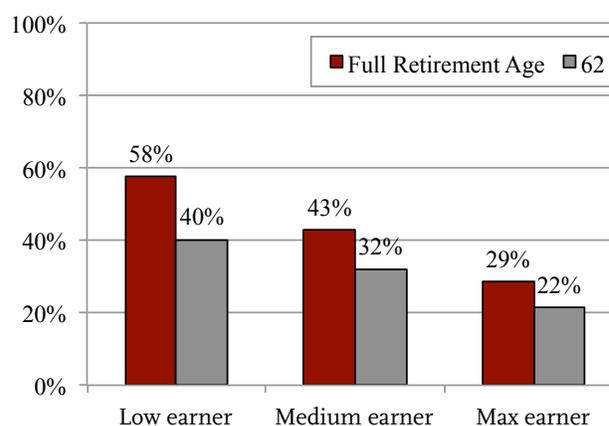
(see Figure 4).⁶ If those low-income workers must pay their own Medicare premiums out of their Social Security benefit – Medicaid covers the premiums for about half such workers – the net replacement rate is further reduced. Thus, Social Security alone does not provide an adequate level of retirement income. Working until the Full Retirement Age would produce higher replacement rates, but many people in this group are unlikely to be able to stay in the labor force that long.

FIGURE 3. LIFETIME PENSION COVERAGE FOR HOUSEHOLDS WITH HEAD AGED 63-73, BY INCOME QUINTILE, 2010



Source: Authors' calculations from University of Michigan, *Health and Retirement Study* (HRS), 1993 and 2010.

FIGURE 4. SOCIAL SECURITY REPLACEMENT RATES IN 2012, BY EARNINGS LEVEL



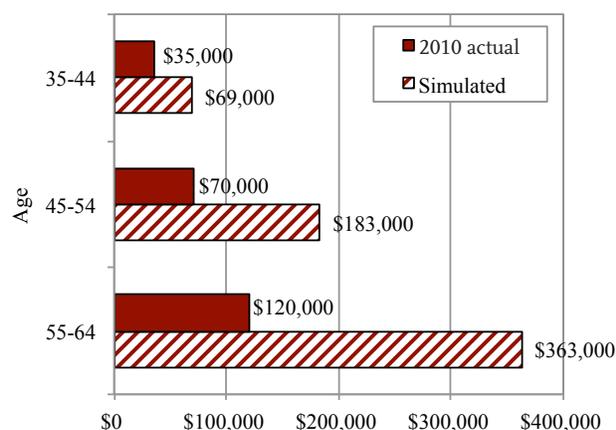
Source: Authors' calculations from U.S. Social Security Administration (2012).

Inadequate 401(k) Accumulations

The second implication of the lack of universal coverage is that workers will move in and out of coverage. As a result, their 401(k) accumulations will be a lot lower than projections based on the prospect of a steady lifetime of contributions. For example, a typical worker (with earnings of about \$65,000 at retirement) who at age 30 began contributing a steady 6 percent with an employer match of 3 percent should accumulate about \$363,000 (see bottom bar in Figure 5 on the next page). According to the Federal Reserve's *Survey of Consumer Finances*, the typical household approaching retirement had 401(k)/IRA balances of only \$120,000 in 2010, far short of the projected amount for the individual. (Note that the reported

amounts include holdings in Individual Retirement Accounts (IRAs) because 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 surely a contributory factor.

FIGURE 5. MEDIAN 401(k)/IRA BALANCES FOR HOUSEHOLDS WITH 401(k) PLANS AND SIMULATED ACCUMULATIONS, BY AGE GROUP, 2010



Source: Munnell (2012).

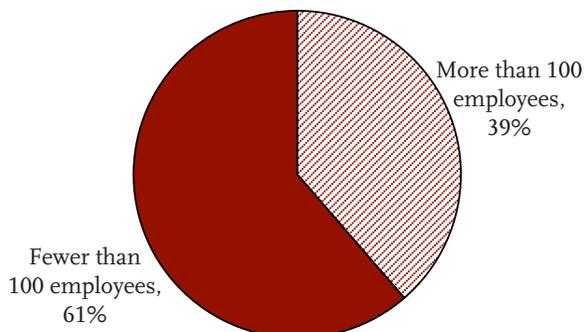
Solving the Problem

Solving the problem is a two-step process. The first step is to identify those who are not covered by any employer-sponsored plan and the reasons for the lack of coverage. The second step is to design solutions for the coverage problem.

Identifying the Uncovered

The CPS data show that, of those not covered by a pension plan, roughly 16 percent work for an employer with a plan. The larger problem is for workers whose employers do not offer any coverage; most of these workers are with small employers (firms with fewer than 100 workers) (see Figure 6).

FIGURE 6. WORKERS WHOSE EMPLOYER DOES NOT SPONSOR A PENSION PLAN, 2010



Note: Figure shows full-time, full-year, civilian, non-farm, private wage and salary earners age 25-64.

Source: Authors' calculations from 2011 CPS.

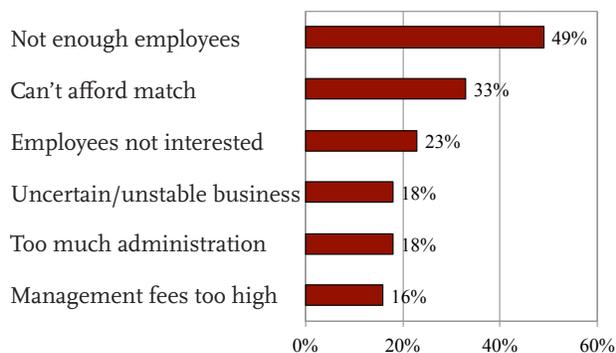
Proposals to Improve Coverage

Policymakers have tried to close this gap by introducing streamlined products that can be adopted by small businesses. For example, the SIMPLE plan, which is administered by the employer's financial institution, does not require the employer even to file an annual financial report. These simplification initiatives, however, have clearly not reversed the trend toward declining coverage. This outcome is not surprising given that administrative considerations are not the main reason small businesses do not offer plans. Too few employees, lack of employee interest, unstable business, and other factors are cited as more important concerns by small employers (see Figure 7 on the next page).

Policymakers have begun to recognize that more than simplification is required to solve the coverage problem and have put forth a series of proposals to expand coverage.

Auto IRAS. President Obama has repeatedly proposed – most recently in his 2013 *Budget* – “Automatic IRAs.” Under the plan, employers with more than 10 employees and no pension coverage would be required to withhold 3 percent of an employee's salary and place it in an IRA. Employees may choose

FIGURE 7. REASONS CITED BY SMALL EMPLOYERS AS THE MOST IMPORTANT FOR NOT OFFERING A RETIREMENT PLAN, 2007



Source: Sharebuilder Advisors, LLC, *Small Business Annual Retirement Trends Survey*, 2007.

between a Roth and a traditional IRA, but the Roth, which allows low-income workers who may need the money to withdraw funds without penalty, is the default. The withheld savings would qualify for the Saver's Tax Credit. Additionally, the proposal provides a tax credit to help small businesses with implementation costs. The employee could opt out of the plan.

Harkin Plan. Senator Tom Harkin (D-Iowa) recently proposed "Rebuilding Pensions: Promise Funds," which would create a government-mandated, privately-managed defined contribution pension program.⁷ This plan would automatically enroll and withhold earnings for all workers whose employer does not provide an employer-sponsored plan that meets a minimum standard for generosity. The contributions would be invested in a commingled portfolio, thereby spreading the risks among all participants and relieving the individual of the burden of making investment decisions. Payments from the plan would be in the form of an annuity, so that retirees would not have to worry about outliving their savings. Again, workers would be able to opt out.

Proposals From the Public Sector. State and local workers, most of whom continue to be covered under traditional defined benefit plans and have substantially better benefits than their private sector counterparts, recognize that their retirements are at risk as long as a large gap persists between public and private

sector benefit protection. In response, several entities have proposed using the public sector infrastructure to enhance private sector benefits.

The National Conference on Public Employee Retirement Systems (NCPERS) has proposed a cash balance defined benefit plan for private sector workers ineligible to participate in employer-sponsored plans. These plans would provide modest guaranteed returns and would be managed alongside state public pension funds.⁸ Several states have proposed programs similar to the one suggested by NCPERS.

California is currently debating SB 1234, the "California Secure Choice Retirement Savings Trust Act." The original proposal in February 2012 would have required employers with more than five employees to enroll their employees at a 3-percent withholding rate in a cash balance type defined benefit plan. The bill has been amended several times and, as of August 2012, the employee withholdings would be placed in insurance-protected individual IRA accounts. Employees would be able to opt out of the arrangement.

Similar plans have been proposed in Connecticut, Illinois, Maryland, Michigan, Pennsylvania, Rhode Island, Vermont, Virginia, Washington, and West Virginia.⁹ Massachusetts recently passed legislation (H. 3754) that allows non-profit organizations with fewer than 20 employees to opt into a defined contribution plan that will be managed as a trust with commingled assets overseen by the Treasurer's office.¹⁰

Assessment. The strength of all these proposals is that they address the serious coverage problem in the private sector and that most of the proposals use the power of automatic enrollment to ensure high levels of participation. The problem with auto IRAs and the public sector initiatives – less so with the Harkin plan – is that they implicitly assume that people with 401(k) coverage will end up with adequate retirement income. Such an assumption is at odds with the fact that the typical household approaching retirement (55-64) has only \$120,000 in 401(k)/IRA balances. Assuming that the household purchases a joint-and-survivor annuity, its monthly income would amount to only \$575. Given this modest amount and the low levels of Social Security replacement rates, it seems clear that both those with and without pension coverage need additional saving. The Harkin plan comes closer to a more comprehensive solution in providing an additional tier of retirement saving for all workers with inadequate employer-sponsored plans.

Conclusion

Only 42 percent of private sector workers are covered by any type of employer-provided retirement plan. This lack of coverage creates two types of problems. First, more than a third of households are not covered at all during their whole worklife and are entirely dependent on Social Security in retirement. Given the low level of Social Security replacement rates – particularly for those who claim benefits at 62 – 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 modest accumulations in 401(k) plans.

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. The United States needs a new tier of retirement income. The President's Automatic IRAs, Senator Harkin's Promise Funds, and state proposals to use public plan infrastructure to improve private sector coverage are all welcome initiatives. But given the modest replacement rates from Social Security and the low level of 401(k) balances, the more comprehensive the additional tier the better.

Endnotes

- 1 This *brief* updates Munnell and Perun (2006) and Munnell and Quinby (2009).
- 2 Munnell (2012).
- 3 Even and Macpherson (1994) examined the decline in pension coverage among men in the 1980s. They found that young men and men with less than a high school diploma are less likely to participate in 401(k)s.
- 4 The HRS is a nationally representative sample of older American households. This study began in 1992 by interviewing about 12,650 individuals (ages 51-61) from about 7,600 households and their spouses (regardless of age), and the survey has been re-administered every two years since 1992. The HRS is conducted by the Institute for Social Research (ISR) at the University of Michigan and is made possible by funding from the National Institute on Aging. More information is available at the ISR website: <http://hrsonline.isr.umich.edu>.
- 5 Palmer (2008). This benchmark applies to single workers with pre-retirement earnings of \$50,000. For single workers with \$20,000 and \$90,000 in pre-retirement earnings, the benchmarks are 88 percent and 81 percent, respectively.
- 6 Replacement rates are from the U.S. Social Security Administration (2012). Under legislation enacted in 1983, the Full Retirement Age is increasing from 65 to 67 beginning with those born in 1938 (turning 62 in 2000) and will be fully phased in for those born in 1960 (turning 62 in 2022).
- 7 Harkin (2012).
- 8 National Conference on Public Employee Retirement Systems (2011).
- 9 For a description of these plans, see *Governing: The States and Localities* (2012). Connecticut H.B. 5313 (2012) and H.B. 5337 (2012) were to establish a task force to consider the idea of a state-run retirement program.
- 10 See Society for Human Resource Management (2012) for an overview of the Massachusetts plan for non-profits.

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