Factors affecting retirement income

Compared with their counterparts earlier in the century, today's Americans are working in different industries, retiring earlier, and living longer; yet these changes are not always recognized in the design of retirement income benefits

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Older Americans may receive income from several sources, including Social Security, employer-provided pension plans, savings, and current earnings. The trend over the last several years has been toward increased availability of income from employer-provided pension plans. In 1988, 55 percent of households headed by persons aged 65 and older received some income from such plans. That number is projected to reach 88 percent by 2018.[1] This increase is due in large part to the growing coverage of women by pension benefit plans. For example, the increase in the labor force participation of women in recent years, and the more widespread availability of survivor benefits for both men and women is likely to result in greater overall availability of pension benefits in the future.

The percent of total retirement income derived from employer pension plans is projected to increase much less dramatically, from 19 percent in 1988 to 25 percent in 2018. This apparent contradiction between the expanded coverage of future retirement income sources and the smaller expansion in the benefits they provide may be explained by decisions being made by today's work force. The worker's choice of employers, the decision to change jobs, or the decision to retire, may be made based on *current* circumstances, such as earnings, family obligations, or job satisfaction. Nonetheless, such decisions can affect both the availability and amount of *future* retirement income.

Concerns about retirement income will be heightened in coming years, as the population ages, but retirees are younger and healthier than ever before. Following are several trends in retirement plan design that will affect these future retirees, together with some facts about changes in the population in general, and the labor force in particular. Note that these trends are not always consistent.

- Employer-provided retirement plans are most prevalent among unionized workers in goods-producing industries, such as manufacturing. However, these sectors of the labor force are on the decline.
- The median job tenure for workers aged 55 to 64 was 12.4 years in 1991, having declined slightly in recent years. In contrast, traditional employer pension plans are designed to reward employees who spend their entire career with one employer.
- U.S. workers are leaving the full-time work force at earlier ages, yet these younger retirees often receive low postretirement benefits from all sources, and recent Social Security changes will provide even lower benefits in the future.
- These younger retirees have an increasing life expectancy, and will need income sources that maintain purchasing power for many years.

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Yet, not all current sources of retirement benefits are indexed for inflation.

There thus are several factors to consider when analyzing the U.S. retirement income system, including coverage, benefit amounts, job mobility, retirement ages, and personal savings. In many cases, these factors are closely related, with changes in one directly affecting another. This article explores these factors in light of changes in the population, the labor force, and retirement plan design.

Retirement income coverage

Nearly all working Americans are covered by Social Security,[2] while approximately half are covered by an employer-provided pension plan.[3] Employer pensions are almost universally provided to Federal, State, and local government employees, who account for about 17 percent of the labor force. For workers in private industry, employer pension coverage is less prevalent—about half of all workers have such coverage. Furthermore, pension coverage varies widely by the size of the establishment. While about 80 percent of full-time employees in larger private establishments (employing 100 workers or more) participate in an employer retirement plan, only about 40 percent of their counterparts in small establishments have such protection.

Traditionally, employer pensions in private industry have been more prevalent in goods-producing industries—especially mining and manufacturing—than in service-producing industries. In 1988, employer pension plans were offered to 66 percent of employees in goods-producing industries and to 53 percent of employees in service-producing industries. Among individual industries, even more striking differences were observed. For example, 75 percent of manufacturing workers had a pension plan available compared to 40 percent of workers in retail trade.[4] (See table 1.)

The prevalence of pension coverage in goods-producing, rather than service-producing, industries comes at a time when the proportion of U.S. employment in goods-producing industries is continuing to decline, as is the number of workers in these industries. In 1920, about half of all U.S. workers were employed in goods-producing industries. By 1970, these industries employed about one-third of U.S. workers, and by 1990, that proportion had dropped to slightly under one-fourth. (See table 2.) In addition, the size of the goods-producing labor force has remained constant or declined slightly in recent years. Mining, for example, lost one-third of its labor force during the 1980's, yet it is one of the industries with the most widespread pension coverage.

Table 1. **Percent of employees offered a pension plan, by industry and by union status, 1988**

Industry and union status	Percent with pension plan
Total	57.6
Industry:	
Goods-producing:	
Mining	70.2
Construction	35.4
Manufacturing, durable	75.1
Manufacturing, nondurable	72.5
Service-producing:	
Transportation and public utilities	71.4
Wholesale trade	55.7
Retail trade	39.7
Finance, insurance, and real estate	72.9
Services	50.1
Union status:	
Covered by a union contract	89.1
Not covered by a union contract	54.8

According to projections by the Bureau of Labor Statistics, this trend toward greater employment in service-producing industries, where pension coverage is less prevalent, is expected to continue, while goods-producing industries will see very little growth. Between 1990 and 2005, BLS projects that there will be about 23 million additional employees in service-producing industries.[5]

An additional determinant of pension coverage is unionization. While 90 percent of union workers participate in a pension plan, only 55 percent of their nonunion counterparts have such coverage. However, union representation in the labor force is at one of its lowest levels in recent years. In 1991, 16 percent of Americans were unionized, down from a high of 36 percent in 1945.[6] In part because of their union status, these workers enjoy widespread pension coverage but, again, the labor force trend toward a decreasing union presence in the workplace runs counter to factors promoting increasing pension availability.

A growing sector of the labor force, "contingent workers," have limited employer pension coverage. Contingent employment includes a wide range of practices, including part-time work, temporary work, employee leasing, and contracting out. Workers in these jobs may choose such work because full-time work is unavailable or because it permits the accommodation of other personal or family obligations.[7] In 1991, about 20 million Americans worked in part-time positions; few of them had employer retirement income coverage.[8] What is more, employer pension plans often include minimum annual work hour requirements before benefits are earned;

contingent workers frequently fail to meet these requirements.[9]

The data suggest that a full-time unionized worker in a manufacturing plant stands a good chance of having employer pension coverage. Such workers—once a significant portion of the U.S. labor force—are becoming less prominent in the economy. Pension coverage continues to lag in those areas in which a growing majority of the labor force is found, including service-producing industries, part-time and temporary jobs, and nonunion worksites.

Amount of benefit

There are several issues involved in analyzing retirement income amounts. First what are the income needs of a retiree, and how do these differ from those of an active employee? Second, how much income can a retiree expect from various sources, and will that income meet the retiree's needs? Finally, will the retiree's benefits keep pace with the cost of living? This last question is especially important as Americans are living longer.

While there is no fixed standard for the amount of income that a retiree will need, studies indicate that income equal to at least 60 to 70 percent of preretirement earnings is necessary.[10] (Retirement income is often referred to in terms of "replacement rates"—the percent of preretirement earnings "replaced" by retirement income sources. According to the studies, a 60- to 70-percent replacement rate would be adequate for most retirees.) While this is a general estimate, workers at lower preretirement income levels might need a higher replacement percentage than would those at higher income levels.

These standards are based on changes in lifestyle and other assumptions about retirees. For example, it is generally assumed that retirees will no longer have children to support, and may have paid off their home mortgages. In addition, expenses associated with work, such as transportation and clothing, may be reduced. Data from the Bureau of Labor Statistics Consumer Expenditure Survey support these assumptions. In 1990, 60 percent of U.S. households headed by individuals aged 65 to 74 owned their own homes without a mortgage. This compares to 24 percent of households headed by persons of all ages. The number of children under 18 in a household declines with the age of the household head, and minor children are rare in households headed by those aged 65 and older.

In addition, overall expenditures drop significantly for households headed by persons over age 65. Expenditures for housing, transportation, and clothing are lower than amounts spent by younger households, although health care expenditures rise significantly. (See table 3.) Taxes also may be lower, due to advantages offered to older taxpayers,[11] a general reduction in income, and the availability of income that may not be subject to taxes, such as Social Security.[12] Of course, individual circumstances will affect the amount of retirement income needed.

In general, no one source of retirement income is designed to provide all the funds necessary for retirement. For persons aged 65, Social Security—which provides proportionately greater benefits for workers with lower preretirement earnings—replaces about 45 percent of earnings for an employee who earned $15,000 annually, and about 25 percent of earnings for an individual who earned $45,000 per year.[13] For persons aged 62,

Table 2. **Percent distribution of U.S. nonagricultural payroll employment, by industry, 1920–90**

Industry	Year							
	1920	1930	1940	1950	1960	1970	1980	1990
Total	100	100	100	100	100	100	100	100
Goods-producing	47	41	41	41	38	33	28	23
Mining	5	3	3	2	1	1	1	1
Construction	3	5	4	5	5	5	5	5
Manufacturing	39	32	34	34	31	27	22	17
Service-producing	53	59	59	59	62	67	72	77
Transportation and public utilities	15	12	9	9	7	6	6	5
Wholesale trade	—	—	6	6	6	6	6	6
Retail trade	—	—	15	15	15	16	17	18
Finance, insurance, and real estate	4	5	5	4	5	5	6	6
Services	9	11	11	12	14	16	20	26
Government	10	11	13	13	15	18	18	17

NOTE: Dash indicates data not available.

Table 3. **Average annual expenditures and related information, by age of head of household, 1990**

Item	All households	Household head aged—	
		65 to 74	75 and older
Pretax income	$31,889	$21,501	$15,435
Average annual expenditures[1]	28,369	20,895	15,448
Housing	8,886	6,591	5,527
Apparel and services	1,617	972	489
Transportation	5,122	3,466	2,132
Health care	1,480	2,197	2,223

[1] Total is not equal to the sum of individual items because data for only selected items are shown.

these Social Security amounts are about 20 percent less. For workers with no employer pension coverage, these benefits—well below the recommended total levels of 60 to 70 percent of preretirement earnings—may be their only source of retirement income.

Employer-provided pension benefits add considerably to the replacement rates. Traditionally, employer retirement plans have been *defined benefit pension plans*, which typically guarantee a specified monthly retirement benefit for life. In recent years, *defined contribution plans*, which establish individual accounts in which to accumulate retirement resources but do not guarantee a specific pension benefit, have become more prevalent. Approximately one-fourth of U.S. workers with employer retirement income coverage are enrolled in defined contribution plans, meaning they are not guaranteed a periodic retirement income.[14]

Typically, defined benefit pension amounts increase proportionally with years of service with an employer. For example, an employee retiring at age 65 with final earnings of $35,000 and 10 years of service with an employer can expect a pension to provide about a 10-percent replacement rate; with 30 years of service, the replacement rate would be close to 30 percent.[15]

When income from Social Security and employer pensions are added together, the total can amount to about 60 percent of preretirement earnings—the low end of the recommended retirement income level.[16] However, such a replacement rate assumes that retirement does not take place prior to age 65 and that the employee has been covered by the same pension plan for 30 years. For a younger person or one with less service, benefits will be less.

Defined contribution plans can provide significant amounts of funds for retirement, although the actual benefit available from such plans is difficult to determine. The most prevalent defined contribution plans are *savings and thrift plans*, which allow employees to make voluntary contributions to an individual account. These contributions then are matched, in whole or in part, by employer funds. Funds in the account are invested, with the employee often having the choice of several investment options. At retirement, the entire value of the account is typically paid to the employee in a lump sum.[17]

An employee participating in such a plan and retiring with final salary of $35,000 could have an account worth up to $40,000 for use in retirement after 10 years with an employer, and up to $120,000 after 30 years with an employer.[18] Assuming further that the retiree used these funds to purchase an annuity that would provide a monthly income, such benefits would replace about 10 to 30 percent of preretirement earnings.[19] For those employees covered by both a defined benefit plan and a defined contribution plan, plus Social Security, replacement rates after 30 years may exceed recommended levels.[20]

As indicated earlier, retired Americans receive income from a variety of sources, including Social Security, employer pensions, earnings, and savings. The buying power of some of these sources of income may be severely reduced over time. Social Security is adjusted annually to account for increases in the cost of living.[21] However, such adjustments are much less likely to be incorporated in employer pension benefits. In 1989–90, fewer than 5 percent of full-time private sector employees covered by a defined benefit pension were in a plan that provided automatic cost-of-living adjustments. Among government employees covered by a defined benefit pension plan, automatic cost-of-living adjustments were more prevalent.[22] In both the private and public sectors, informal increases may be provided to retirees from time to time, and are generally more prevalent in times of rising inflation.[23] By and large, however, the pension amount that a retiree receives from an employer when he or she first retires is the same amount that will be received for life.[24]

The issue of the buying power of retiree income benefits over time will be especially important in the coming years, as the retirement-age population continues to grow. The aging of the "baby-boomers" will have an effect on the distribution of the population by age in the coming years. The following table indicates the percentages of the population aged 65 and older and aged 85 and older from 1970 to the present, and projected over the next 60 years:[25]

	Aged 65 and over	Aged 85 and over
1970	9.8	0.7
1990	12.6	1.2
2010	13.8	2.3
2030	21.2	2.8
2050	21.8	5.2

A similar story is revealed in data on life expectancy. In 1900, Americans were projected to live 47 years; by 1950, that estimate had risen to 68 years. Present life expectancy at birth is 75 years. Furthermore, Americans aged 65 currently have a life expectancy of 17 years.[26] Over such a period, benefits that are not adjusted for changes in the cost of living can erode rapidly. Even if inflation averaged 3 percent per year, an unadjusted pension would lose about 40 percent of its purchasing power over 17 years. Clearly, retirement income benefits that keep pace with price changes will be a primary concern of the growing aging population.

Retirement income and job mobility

The availability of retirement plan coverage and the amount of retirement income both are dependent on an employee's service with an employer. Employees with short service may not be guaranteed any benefit from an employer's pension plan, or may earn very small benefits that are payable only many years into the future. This section looks at Bureau of Labor Statistics data on length of job tenure, and compares these data with pension plan provisions and laws concerning length of service.

According to data from the January 1991 Current Population Survey shown below, the median job tenure with the current employer for employed persons aged 55 to 64 was 12.4 years.

Age	Years of— Mean job tenure	Median job tenure
Total, 25 years and older	8.2	5.6
25 to 34 years	4.1	3.5
35 to 44 years	7.6	6.0
45 to 54 years	11.3	10.0
55 to 64 years	14.6	12.4
65 years and older	16.0	11.1

This median—the point at which half of all workers had greater tenure and half had less—indicates that workers nearing retirement age can expect benefits from their current employer based on only about 11 years of service. (Such service, on average, would yield a pension benefit that replaced just over 10 percent of preretirement earnings.) About one-third of employed persons aged 55 to 64 had worked 20 years or more with their current employer. Furthermore, median job tenure for men aged 55 to 64 has declined slightly over the last few years.

Median job tenure for all employed persons aged 25 and over was 5.6 years in 1991. While these data do not provide any indication of an employee's ultimate tenure with one employer, they are nonetheless important as an indicator of future retirement income availability. Employer pension plans frequently provide a guarantee of future benefits to employees after 5 years of service; the job tenure data suggest that about half of all employed persons have not yet reached that threshold with their current employer.

Data from the National Longitudinal Survey of Mature Women suggest a correlation between a worker's concern for retirement income and his or her job tenure. Among women aged 50 to 60, average tenure was 12 years. For those women working for an employer providing pension coverage, the average was 16 years, compared with 8 years for those to whom no pension was available. While other factors may influence these findings, there appears to be some relationship between pension coverage and job tenure.[27]

The importance of job tenure varies significantly for different retirement income programs. Social Security benefits are earned through employment in nearly all private industry jobs and in many jobs in Federal, State, and local governments. Credits toward Social Security are based on an employee's earnings and service, and are not affected by workers' job mobility.[28] Employees can earn Social Security credits at any number of jobs and still qualify for benefits. Social Security is perfectly "portable"—the benefit moves with the employee regardless of the number of employers for which he or she has worked.

Defined benefit pension plans are much less portable. Because there is no central administrative agency, such as the Social Security Administration, and because benefits vary from plan to plan, pension plans must use other means of achieving portability. For example, they may use vesting schedules, cash-out provisions, and some limited portability provisions to guarantee benefits to workers who leave one job for another.

Vesting is the guaranteed right of a pension plan participant to future benefits. Pension plans seeking tax-qualified status from the Internal Revenue Service must include vesting provisions.[29] In most cases, employees who have participated in a plan for 5 years are fully vested, meaning that benefits will be paid to them even if they leave the employer's service.[30] The length of service required for employees to become vested has been declining in recent years. Prior to 1974, many pension plans did not include vesting provisions, meaning that an employee leaving a job prior to

retirement age, regardless of years of service, would receive no benefit. In 1974, the Employee Retirement Income Security Act (ERISA) required pension plans to guarantee a vested benefit for employees completing a specified service requirement, typically 10 years; this was lowered to 5 years in 1986. As noted above, about half of adult workers have been with their current employer fewer than 5 years. Thus, even if a pension plan is provided, many workers have not yet qualified for benefits.

Once vested, employees who leave an employer prior to retirement age will either have benefits deferred until retirement age or receive a cash-out of benefits earned. This decision is typically made by the employer based on calculations of the present value of future benefit payments.[31] If the present value is $3,500 or less, the employer may cash-out the employee without the employee's approval.[32] The employee receives the cash—which generally is taxable and may be subject to a tax penalty—and the employer has no further obligation. If the present value is above $3,500, the employer must make a future pension benefit available to the employee, although both parties can agree to cash-out the benefit.

If the benefit is designated for payment in the future, the benefit will be based on earnings and service on the date the employee left work, even if this was many years before the benefit is paid. In such a case, the buying power of the pension benefit is eroded even before such benefit is received.

A simple example can illustrate the effect of job switching on pension benefits. Assume two employees begin work on the same day in 1959, earn identical salaries, and receive identical salary increases over their 30-year careers. Each retires at the beginning of 1989. One employee has worked for a single employer for 30 years. That employer provides a pension equal to 1 percent of the worker's salary in the last year of employment, times years of service. The other employee works for three employers, for exactly 10 years each. All three employers provide pensions equal to 1 percent of salary in the last year of employment, times years of service.[33]

The following data indicate the annual salary that each of the two employees received at various points during his or her worklife:[34]

	Annual salary
1959	$8,967
1968	12,962
1978	24,565
1988	45,000

The individual who worked for one employer would receive an annual pension of $13,500, or 30 percent of final salary (1 percent x $45,000 x 30 years = $13,500 per year.) The individual who worked for three employers would receive an annual pension of $8,252, or 18 percent of final salary, computed as follows:

1 percent x $12,962 x 10 years = $1,296
1 percent x $24,565 x 10 years = 2,456
1 percent x $45,000 x 10 years = 4,500

Total . . . $8,252

In this case, the employee who worked for three employers received pension benefits that were about 40 percent less than those received by the employee who worked for one employer.

The preceding example demonstrates the effect of a vested pension benefit retained by a former employer to pay future benefits. Despite the loss of purchasing power inherent in such a situation, vested benefits retained by a former employer at least offer a guarantee that some retirement benefit will be received. When pensions are cashed out, they may be transferred to a new employer's plan or an Individual Retirement Account. The cash-out amounts are often small and may not seem adequate for starting a retirement fund, however, and are frequently used by recipients for current consumption.[35] A recently enacted law requires employers to provide more information to employees on the tax consequences of lump-sum distributions and to offer direct transfers of assets to a new employer's plan or to an Individual Retirement Account.[36]

In addition to vesting and cash-out provisions, new data from the Bureau of Labor Statistics indicate a small incidence of pension portability among employer pension plans. In 1991, 9 percent of employees with defined benefit pensions were in plans that included portability provisions.[37] Typically, these plans were multiemployer plans, sponsored by a union in a given industry. If an employee moved from one employer to another in the same industry, such as construction, and both employers contributed to the same union pension plan, the length of the employee's service with all employers was used to compute benefits. Similar arrangements exist for a limited number of specialized employees, such as those working for: subsidiaries of the same employer; employers that had had prior associations, such as the former Bell System companies; certain governments; and colleges and universities.

In these specialized cases, benefits are fairly easily transferable from one employer to another. However, most defined benefit pension plans are established by individual employers, who have no suitable direct relationship with other employers. Portability in such cases is difficult to maintain. To address the lack of portability in the U.S. pension system, several proposals have been advanced to

establish a national portability program.

One proposal calls for establishing a clearinghouse for pension benefits. When a vested employee leaves an employer, the present value of future benefits would be transferred to the clearinghouse and ultimately to a subsequent employer. In this way, benefits attributable to service with multiple employers would be accumulated. Alternatively, proposals have been advanced to deposit the present value of benefits into a retirement account for the employee. Even if an employee had several employers throughout a career, all pension funds would end up in an individual account for the employee's retirement. None of these proposals has advanced very far to date.

As the data suggest, defined benefit plans are designed to provide the highest replacement rate to workers who are covered by one plan throughout their worklife. In contrast, defined contributions plans—the less prevalent but fast growing type of retirement plan—have features that are more beneficial to employees who work for several employers. Defined contribution plans establish individual accounts for each employee. The emphasis is on accumulating funds, rather than determining future pension payments. The worth of the account—the accumulation of employer and employee contributions and investment earnings—at any given time is known.

In defined contribution plans, employer contributions and associated earnings are subject to vesting requirements, just as they are in defined benefit plans.[38] Should a vested employee choose to leave the employer, typically the account can be cashed-out.[39] Here again the employee can invest the money for retirement or use it for current consumption. Mobile employees who invest distributions from all employers throughout their worklives could accumulate a large fund to provide retirement income.

However, even when employer-provided pension plans are available, many working Americans have not been with their employers long enough to be eligible for guaranteed benefits. For those who have met vesting requirements, job tenure may still be so short that the resulting benefit will be small. Furthermore, vested employees leaving an employer typically receive only a small cash payment or must wait years to receive a small pension whose value has been substantially eroded by inflation.

Retirement ages

Traditionally, Americans have remained at work until age 65 —"retirement age." This threshold age is even written into the law: Federal income tax provisions are more generous for those aged 65 and older, and full Social Security benefits become available at age 65. Retirement ages are shifting, however, due to changes in the law, changes in pension plan provisions, and changes in worker choices. These changes, however, are not all going in the same direction.

One change affecting retirement ages is the abolition of mandatory retirement. Age discrimination laws in effect since the late 1960's have increasingly protected U.S. workers from forced retirement. At first, such protection was available only until age 65. Many employer pension plans included mandatory retirement provisions, forcing employees to retire at that age.[40] In 1978, the protection against mandatory retirement was extended to workers until age 70; in 1986, all mandatory retirement was abolished.

At the same time that mandatory retirement was being phased out, allowing employees to choose later retirement, employer pension plans were lowering the age at which full pension benefits could be received. In 1974, about one-half of pension plan participants could receive full benefits prior to age 65; by 1989, three-fifths could do so.[41]

In addition, employer pension plans frequently discourage continuation of employment after a certain age. In the past, this was done by denying pension credits to employees working beyond the traditional retirement age. In effect, an employee gained no additional pension benefit for working beyond age 65. Such practices were prohibited by law in 1986.[42] Nonetheless, other means of discouraging continued employment after retirement age still exist. For example, pension plans often limit the number of years of service that can be credited to an individual. Once that limit is reached, continued employment yields no additional benefits. In addition, pension plans rarely provide actuarial increases in benefits to employees who choose to work beyond retirement age, even though benefits will typically be received over a shorter lifetime.[43]

Social Security also sought to encourage earlier retirement by making benefits available prior to age 65. In 1956, Social Security made "early retirement" benefits—equal to 80 percent of the "age 65" benefit—payable at age 62 for women. Such benefits were made available to men in 1961.

Largely reflecting these changes in the availability of Social Security and pension benefits, the percent of Americans in the labor force currently drops significantly at age 62. In 1991, for example, 71 percent of men aged 60 were in the labor force while 51 percent of men aged 62 were working. (See table 4.) This drop in labor force participation at age 62 has become more pronounced over time. In 1963, 80 percent of men aged 62 were in the labor force; by 1975 the rate

dropped to 64 percent and to 51 percent by 1991.[44]

Those older Americans who stay in the labor force frequently switch to part-time schedules. Among all workers, 17 percent work part-time. Among those aged 60 and older, 36 percent work part-time, as do 52 percent of those aged 65 and older:

Age	*Percent working part time*
60 and older	36
60 to 64	23
60 to 61	19
62 to 64	27
65 and older	52
65 to 69	49
70 to 74	56
75 and older	62

This tendency toward part-time employment may reflect the fact that older Americans—healthier and better able to work than ever before—are attempting to compensate for the erosion of pension benefits over an increasing life expectancy.

Individuals may receive both Social Security and employer pension benefits at age 62, but benefit amounts may be limited. Payments are often reduced based on actuarial assumptions designed to account for a longer period of receipt of benefits. Social Security is reduced by 20 percent for persons aged 62. In addition, only 60 percent of pension plan participants can expect full benefits at age 62—and even then, only after meeting a long service requirement.[45]

The effects of reducing retirement income benefits—both Social Security and employer defined benefit pensions—to account for their receipt over a longer period are illustrated by the following examples. At age 65, an employee earning $35,000 per year and having worked 30 years with an employer can expect Social Security plus employer pension benefits to replace just under 60 percent of preretirement pay. For a retiree aged 62, the same circumstances would yield a replacement rate of about 50 percent. What is more, employees with 15 years of service with the same employer—the mean job tenure at age 62—could expect only 30 percent of their salary to be replaced by retirement benefits.[46]

Many employer retirement plans allow early retirement before age 62, although the resultant benefits are often quite small. In 1989, nearly all defined benefit pension plan participants could retire at age 55 with 30 years of service, and two-thirds could retire at age 55 with only 10 years of service.[47] Pensions would replace about 20 percent of preretirement earnings for those with 30 years of service, and less than 10 percent of earnings for those with 10 years of service. Such retirees would not be eligible for Social Security until age 62.[48]

While increasingly early retirement is permitted, and perhaps encouraged, typical benefits in such situations will be small. To further complicate matters, recent changes in the Social Security law will raise the age at which full benefits will be available and, more importantly, increase the penalty for early receipt of benefits.[49] Beginning in 2000, the age at which unreduced Social Security benefits will be available will rise gradually to age 67. Early retirement benefits will still be available at age 62, but with a 30-percent reduction of the full benefit to account for early receipt. Thus, employees are permitted to retire earlier, and are in fact doing so, at the same time that benefits payable to such retirees are small and diminishing.

Table 4. **Labor force participation rates of men, by age, 1963–90**

Year	Age			
	55	60	62	65
1963	92.8	88.1	79.7	54.4
1965	93.0	86.0	78.7	55.9
1970	91.8	83.9	73.9	49.9
1975	87.6	76.9	64.4	38.7
1980	84.9	74.0	56.8	35.2
1985	83.7	71.0	50.9	30.5
1990	85.2	70.5	52.5	31.9

Personal savings

Perhaps the biggest unknown when studying retirement income is the extent of personal savings. As has been shown, even under the best of circumstances, Social Security plus employer pension benefits may not meet the replacement rates thought to be adequate for retirees. And, what if a retiree has greater-than-average needs, such as for family, shelter, or medical expenses? Additional sources of income may be vital. In U.S. society, personal savings has long been considered the vehicle to provide that cushion.

The percent of disposable income saved by Americans has been declining for several years.[50] However, this fact alone does not provide a clear view of trends in personal savings. As the "baby boom" generation ages, it may develop new concerns for savings and retirement income that are not revealed in current savings rates. Perhaps more importantly, opportunities for saving through employer-based vehicles are more widely available than ever, and may make up for declines in other types of savings.

Defined contribution plans may be considered a form of employee savings, as most plans require

or permit employee contributions.[51] As noted earlier, the most prevalent type of defined contribution plan is a *savings and thrift plan*, which requires employee contributions that are then matched by employer contributions. Furthermore, savings and thrift plans and other defined contribution plans frequently include *Internal Revenue Code* section 401(k) features that allow deferral of income taxes on employee contributions. This feature provides an incentive to save, and also imposes restrictions that encourage employees to leave the funds in place until retirement.[52]

A savings vehicle similar to a 401(k) is an *Individual Retirement Account* (IRA), which allows workers to save on a pretax basis. IRA's have been available for about 20 years, but frequent changes in eligibility requirements have limited their use.[53] Employees can transfer lump sums from 401(k) plans to IRA's when they leave an employer. In fact, IRA's or similar vehicles have been proposed as the cornerstone of a nationwide pension portability program, with cashed-out benefits transferred to an individual employee account designed for retirement.

What the future holds

Concern about the availability and adequacy of retirement income is widespread. Each year, policymakers consider many proposals to revise or expand certain retirement income programs. Part of that debate should include an examination of recent trends in retirement programs, and of developments among the population as a whole, and the labor force in particular. For example, employment opportunities have been shifting to industries in which pension coverage traditionally has been less prevalent. With such industrial shifts expected to continue, what can be done to encourage expansion of pension benefits for these workers?

When employees do have employer pension coverage, provisions frequently favor those workers who spend their career with a single employer. But data on job tenure suggest that Americans—even those nearing retirement age—have not stayed with a single employer throughout their worklives. Can plan provisions be altered to limit the penalty associated with job mobility?

For retirees, the earlier availability of benefits and increased life expectancy mean reliance on retirement income benefits for longer periods. Yet, some of these benefits are not indexed for inflation, and can lose considerable purchasing power over time. What changes in plan provisions are needed to accommodate the receipt of acceptable levels of benefits over longer retirement periods?

Finally, what changes are needed in policies regarding cashed-out benefits and individual retirement savings? With data suggesting that retirement benefits may not replace the recommended share of the preretirement income, how can savings be encouraged?

Footnotes

[1] For detailed information on sources of retirement income, see Emily S. Andrews, "Gaps in Retirement Income Adequacy," paper prepared for the Pension Research Council, April 1992.

[2] Social Security coverage is extended to nearly all employees in private industry, as well as to many employees in Federal, State, and local government. For a comprehensive discussion of all Social Security provisions, including employee coverage, see Robert J. Myers, *Social Security* (Homewood, IL, Richard D. Irwin, Inc., 1985).

[3] Data on employer pension plan availability are provided by the Bureau of Labor Statistics from two sources: The Employee Benefits Survey and the Current Population Survey. The Employee Benefits Survey, a survey of establishments, provides information on the availability and characteristics of benefits, including pension plans, provided to employees. The Current Population Survey, a survey of households, provides information on the demographic and economic characteristics of individuals, including whether or not they have pension coverage. There are some differences in scope, methodology, and data between the two surveys.

For information on the Employee Benefits Survey, see *Employee Benefits in Medium and Large Firms, 1989*, Bulletin 2363 (Bureau of Labor Statistics, 1990); *Employee Benefits in Small Private Establishments, 1990*, Bulletin 2388 (Bureau of Labor Statistics, 1991); and *Employee Benefits in State and Local Governments, 1990*, Bulletin 2398 (Bureau of Labor Statistics, 1992). Detailed tabulations of pension data from the Current Population Survey are available in John A. Turner and Daniel J. Beller, eds., *Trends in Pensions 1992* (U.S. Department of Labor, 1992).

[4] A detailed discussion of differences in benefits coverage by industry, based on the Employee Benefits Survey, may be found in Thomas P. Burke and John D. Morton, "How firm size and industry affect employee benefits," *Monthly Labor Review*, December 1990, pp. 35–43.

[5] For more information on employment projections, see Ronald E. Kutscher, "New BLS projections: findings and implications," *Monthly Labor Review*, November 1991, pp. 2–12.

[6] For detailed data on union membership, see "Union Members in 1991," USDL 92-61, Feb. 10, 1992.

[7] For a discussion of the contingent labor force, see Anne E. Polivka and Thomas Nardone, "On the definition of 'contingent work'," *Monthly Labor Review*, December 1989, pp. 9–16.

[8] Retirement income coverage for these workers is difficult to measure. Data from the Current Population Survey indicate that about one-third of employees working 20 hours or fewer per week have pension coverage. The Employee Benefits Survey indicates that about one-fourth of part-time employees, as so designated by the employing establishment, have such coverage.

[9] *The Internal Revenue Code* allows pension plans to restrict credit for years of service to those employees who have worked 1,000 hours in a 12-month period. Employees not meeting this threshold in any year may be denied pension

credit for that year. For many contingent workers, this may lead to a situation in which they are officially covered by a pension plan but may never earn any service credits toward future benefits. While information on retirement plans is not available, data from the Bureau's Industry Wage Survey of employees in temporary help agencies indicate that, even where other types of employee benefit plans are offered, very few of those eligible actually worked enough hours to receive benefits.

[10] For a complete discussion of retirement income needs, see *Coming of Age: Toward a National Retirement Income Policy* (President's Commission on Pension Policy, Feb. 26, 1981).

[11] For Americans aged 65 and older, the standard deduction applied in computing Federal income taxes is greater than that applied to younger taxpayers.

[12] Up to one-half of a recipient's Social Security benefits are subject to Federal income taxes if the recipient has earnings above a specified threshold.

[13] These Social Security benefits were calculated in conjunction with computations of replacement rates from employer pension plans. For complete details, see William J. Wiatrowski, "New survey data on pension benefits," *Monthly Labor Review*, August 1991, pp. 8–22.

[14] See Turner and Beller, *Trends in Pensions 1992*.

[15] See Wiatrowski, "New survey data on pension benefits."

[16] For employees with final earnings of $25,000 or less, replacement rates are generally higher. This is because Social Security replacement rates are skewed to provide a greater percent of preretirement earnings to lower paid workers.

[17] For more information on savings and thrift plans, see *Employee Benefits in Medium and Large Firms, 1989*.

[18] These data assume that employees contributed the midpoint of permissible contributions throughout their careers. Data also assume a steady salary increase, and investment of account at a 6-percent interest rate. For more information, see Michael Bucci, "Contributions to savings and thrift plans," *Monthly Labor Review*, November 1990, pp. 28–36.

[19] These benefits were calculated based on investment of the lump sum at a 6-percent interest rate, and periodic receipt of payments over 17 years, the current life expectancy for Americans aged 65.

[20] In 1989, 45 percent of full-time employees in medium and large private establishments who participated in a defined benefit pension plan also participated in a defined contribution plan, generally a savings and thrift plan.

[21] Each January, Social Security benefits are adjusted based on the increase in the Bureau of Labor Statistics Consumer Price Index. For more details, see Myers, *Social Security*.

[22] See *Employee Benefits in Medium and Large Firms, 1989*; *Employee Benefits in Small Private Establishments, 1990*; and *Employee Benefits in State and Local Governments, 1990*.

[23] Twenty-two percent of defined benefit pension plan participants received an ad hoc postretirement adjustment during the 5 years preceding the survey, according to data on full-time employees in medium and large private establishments. For more details, see *Employee Benefits in Medium and Large Firms, 1989*.

[24] Because defined contribution plans generally pay a lump sum at retirement, there is no provision for adjusting benefits for inflation.

[25] Data, including projections of population growth, are from *Current Population Reports* (U.S. Department of Commerce, Bureau of the Census), various issues.

[26] Life expectancy data are from *Health United States, 1991* (U.S. Department of Health and Human Services, 1992).

[27] Unpublished data from the U.S. Department of Labor, Bureau of Labor Statistics, *National Longitudinal Survey of Mature Women for 1988*. Note that no such data are available for men.

[28] Social Security credits are based on earnings. An employee can earn a maximum of 4 credits per year and generally must earn 40 credits (typically over 10 years) to be eligible for benefits. See Myers, *Social Security*.

[29] Employer contributions to a pension plan are tax deductible if the plan is "qualified" by the Internal Revenue Service. To gain such status, the plan must include specific provisions, including vesting provisions, that are enumerated in the *Internal Revenue Code*.

[30] In place of full vesting after 5 years, a plan may provide gradual vesting, with full vesting after no more than 7 years. Multiemployer plans may provide 10-year vesting. Public sector pension plans are not covered by vesting laws. For a detailed discussion of vesting, see Avy D. Graham, "How has vesting changed since passage of Employee Retirement Income Security Act?" *Monthly Labor Review*, August 1988, pp. 20–25.

[31] The present value is the amount of funds that must be invested today at an assumed rate of return to provide the guaranteed benefit. This calculation includes assumptions about the life expectancy of the employee and his or her survivors.

[32] See *Internal Revenue Code*, section 411(a)–11.

[33] About two-thirds of the full-time employees participating in a defined benefit pension plan in private establishments in 1989–90, and all of those in State and local governments in 1990, received a benefit based on earnings in the final years before retirement.

[34] The salary history was constructed by first assuming that the employee's final-year salary was $45,000, and then projecting back 30 years. Nationwide increases in average salaries, as determined by the Social Security Administration, were used to determine each year's salary.

[35] For data on the uses of lump-sum distributions prior to retirement, see "Preservation of Pension Benefits," *Employee Benefit Research Institute Issue Brief*, No. 98, January 1990.

[36] Included in the Unemployment Compensation Amendments, enacted in July 1992, were requirements that employers notify employees of the tax consequences of receiving retirement plan payments before retirement. The law also requires employers to withhold income taxes on such payments.

[37] Data are for full-time employees in medium and large private establishments. See "BLS Reports on Employee Benefits in Medium and Large Private Establishments, 1991," USDL 92–764, Dec. 9, 1992.

[38] Vesting requirements in defined contribution plans are generally shorter than those in defined benefit plans. For more information, see *Employee Benefits in Medium and Large Establishments, 1989*.

[39] Once again, such a distribution may be subject to income taxes, as well as tax penalties. Certain accounts can be rolled over into an Individual Retirement Account without immediate taxation. See the section on personal savings.

[40] For information on the prevalence of mandatory retirement and changes in the law, see Dorothy R. Kittner, "Forced retirement: how common is it?" *Monthly Labor Review*, December 1977, pp. 60–61; and Julia E. Stone, "Age Discrimination in Employment Act: a review of recent changes," *Monthly Labor Review*, March 1980, pp. 32–36.

[41] Data for 1974 are from a small sample of selected larger pension plans. See Evan L. Hodgens, "Key changes in major

pension plans," *Monthly Labor Review*, July 1975, pp. 22–27. Data for 1989 are from *Employee Benefits in Medium and Large Firms, 1989*.

[42] The Budget Reconciliation Act of 1986, P. L. 99–509, prohibits pension plans from ceasing or reducing benefit accruals or allocations on the basis of age.

[43] Data from the 1989 Employee Benefits Survey in establishments employing 100 workers or more indicate that maximums were imposed on years of credited service for about two-fifths of full-time workers with defined benefit pension plans. Increases to reflect work beyond retirement age were provided to about one-tenth of pension plan participants. See *Employee Benefits in Medium and Large Firms, 1989*.

[44] For a discussion of labor force participation rates of older Americans, see Philip L. Rones, "The retirement decision: a question of opportunity?" *Monthly Labor Review*, November 1980, pp. 14–17.

[45] See Wiatrowski, "New survey data on pension benefits."

[46] This assumes 15 years of service for both the employer's retirement plan and Social Security. If the employee had 30 years of service under Social Security, the total benefit would be closer to 40 percent. Pension benefits from a prior employer would also add to this total.

[47] See Wiatrowski, "New survey data on pension benefits."

[48] For a small percentage of workers retiring with employer-provided pension benefits, supplemental payments are available until Social Security is received. For more information on these special benefits, see William J. Wiatrowski, "Supplementing retirement until Social Security begins," *Monthly Labor Review*, February 1990, pp. 25–29.

[49] See Myers, *Social Security*.

[50] U.S. Department of Commerce, Bureau of Economic Analysis, The National Income and Product Accounts of the United States.

[51] About two-thirds of defined contribution plan participants were required to contribute to their plan in 1989. See *Employee Benefits in Medium and Large Firms, 1989*.

[52] For a detailed discussion of savings and thrift plans and 401(k) provisions, see *Employee Benefits in Medium and Large Firms, 1989*.

[53] IRA's first were introduced into the *Internal Revenue Code* in 1974, although they were limited to individuals not covered by an employer pension. In 1981, eligibility was extended to all working Americans. Restrictions imposed in 1986 and currently in place allow pretax contributions only for those individuals not covered by an employer pension plan or for those covered by an employer pension plan but earning less than a specified earnings threshold.

A note on communications

The *Monthly Labor Review* welcomes communications that supplement, challenge, or expand on research published in its pages. To be considered for publication, communications should be factual and analytical, not polemical in tone. Communications should be addressed to the Editor-in-Chief, *Monthly Labor Review*, Bureau of Labor Statistics, U.S. Department of Labor, Washington, DC 20212.