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The Changing Retirement Paradigm

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The Changing Retirement Paradigm

Abstract
Labor market changes are driving employers, employees, and policymakers to confront the need for a new retirement paradigm. The old model assumed a relatively homogeneous labor force where employee benefits, particularly pensions, were designed to reward career employees after years of loyalty, effort, and productivity. When labor force growth was the norm, many firms favored hiring plentiful younger workers over retaining more costly older employees. It was in that context that employers developed defined benefit (DB) plans that benefited mainly fullcareer employees, while penalizing those who remained with the firm only a few years. Now labor force aging, combined with slower rates of workforce growth, suggest that jobs and pensions will have to be structured rather differently. This chapter overviews the factors driving the new model.

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The published version of this Working Paper may be found in the 2005 publication: Reinventing the Retirement Paradigm.

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Reinventing the Retirement Paradigm

EDITED BY

Robert L. Clark and Olivia S. Mitchell
Part I
The State of Play
A century ago, most workers spent 10 hours per day and six days per week on their jobs (Costa 2000). Today, the typical North American spends only five days at work per week and only 7–8 hours per day on the job; some Europeans enjoy an even shorter workweek of a mere 35 hours. This striking time-series decline in work effort has also been reflected in falling labor force attachment patterns, particularly at older ages. In 1880, for instance, 80 percent of men aged 65+ were in the labor force; only a century later, fewer than 20 percent of such older men worked or sought work (Costa 1998). These dramatic reductions in labor and effort are commonly interpreted as indicative of economic and political success. That is, as societies grew richer, and goods and services grew relatively less labor-intensive to produce, more people could afford to spend more of their lifetimes not working. This is perhaps illustrated most vividly in the dimension of leisure at older ages: people everywhere are retiring earlier, and living longer during retirement, than ever before in human history.

Yet many now believe that the race to shorten the work life is over. As the first wave of baby boomers moves into early retirement, it already is clear that some industries such as aerospace, utilities, and health care, face labor shortages. Some argue that life will change dramatically in the next two decades, particularly if employers do not find sufficient workers and if productivity fails to grow fast enough. One analyst, Steven Nyce (K@W 2004a), warns that ‘companies will not be able to meet consumption needs in society, and the result will be higher inflation’.

As a result of these labor force changes, employers and employees are having to confront the need for a new retirement paradigm. The old model assumed a relatively homogeneous labor force where employee benefits, particularly pensions, were designed to reward career employees after years of loyalty, effort, and productivity. When labor force growth was the norm, many firms favored hiring plentiful younger workers over retaining more costly older employees. It was in that context that employers developed defined benefit (DB) plans that benefited mainly full-career employees, while penalizing those who remained with the firm only a few years. These traditional pension plans typically included subsidized early retirement provisions that encouraged senior employees to retire in their fifties.
As a new retirement paradigm emerges, its outlines look quite different from the old model. Several factors are key. For one, the workforce now has higher levels of labor market turnover, higher rates of female participation, and more diverse needs due to employees in increasingly complex family situations. All these changes imply a new set of expectations about the role of work and the nature of employment, including the role of company-provided benefits. Developments are occurring in the pension sector as well. Many companies must now refashion their offers so employees can accumulate retirement saving even while changing jobs, or as they move from full-time work to complete retirement. In addition, important changes in accounting standards, funding requirements, and government regulations are driving plan sponsors to revisit whether they wish to offer retirement benefits, and if so, how these benefit offers will be structured.

A key motivation for rethinking the retirement paradigm is that many people and the societies they live in cannot afford to finance twenty, thirty, or more years of inactivity. Social Security and old-age medical programs face insolvency, and many fear they will not be able to make ends meet in the very near future. A related issue is that older workers are in better health than their predecessors, and their jobs are less physically demanding than in the years gone by. These factors, combined with employees’ growing attention of the many risks they face in retirement, are driving a rethinking of the types of benefits promised at the workplace.

The goal of this volume is to provide structure and new insights for the debate on the shape of the new retirement paradigm, and to help key elements of retirement policy reform. In this chapter, we review the key policy challenges, provide evidence on retirement patterns, old and new, and offer elements of the new mix. We conclude with observations drawn from the rich international experience.

Retirement Policy Challenges

Before evaluating some of the innovative practices fashioned by employers and employees confronting these new challenges, it is useful to take stock of the influential role of governmental regulation and oversight regarding the changing retirement environment. This is particularly important in the US context, since employers who offer pensions do so voluntarily. As a result, company-based pension coverage is far less than complete. Indeed, only half the civilian workforce currently has a company pension, a fraction that has remained stable for more than four decades.

Over that time, however, DB plans providing retirees with annuity payments have been supplanted by defined contribution (DC) plans such as 401(k), which offer workers incentives to save but do not require annuitization nor protection from capital market risk. Many DB plans encouraged early retirement, but today that incentive structure is often seen as a vestige
of a labor surplus era. By contrast, DC plans are increasingly popular due to their portability and age-neutrality (K@W 2004a).

One of the major problems in the policy arena is that trust has eroded between plan sponsors and workers participating in the pension system. This is partly the result of the ongoing fallout from the Enron debacle (along with various other firms suffering earnings shocks in the last five years). The result is that regulators tend to give plan sponsors too little flexibility regarding how plans are designed and operated.

Chapters 2 and 3 discuss the current outlines of pension regulation and examine potential paths for future reforms. In Chapter 2, Klein posits that more regulatory flexibility would be desirable, in exchange for possibly harsher penalties in the event of rule violation. He also suggests the value of negotiated rulemaking. Currently, regulators ask for a wide range of views on regulations and return with a final set of regulations, where there is little room for adaptation. By contrast, a negotiated system would result in a situation where ‘the parties would have greater faith in the system knowing they were more involved in the process’ (K@W 2004a).

In Chapter 3, Perun and Steuerle point to the fact that the pension system has become inordinately complex over time. Currently, more than 110 private pension plan types are slated to come on line by 2006: a plethora of options that is simply overwhelming for most pension participants and many employers. This suggests that simplification must be high on the agenda in the near future. Two reform proposals are explored in some depth, including a more traditional ‘nip and tuck’ approach which tinkers with many elements of the law but does not change the fundamental framework, and a second, more fundamental approach proposed by the Bush Administration which includes Lifetime Savings Accounts (LSAs) and Retirement Savings Accounts (RSAs). The latter are simpler and tend to undermine company-based saving versus individual accounts. As Perun says, ‘neither proposal is satisfactory’; indeed she states that ‘we don’t need more innovative savings tools; we just need one that works’. The authors’ preferred middle way would boost saving incentives for a simple DC plan and would also reform the social security system to increase benefits for low-wage workers.

Looking ahead, it seems clear that policymakers must do better to clarify how pension assets are protected, prevent plan sponsor malfeasance, and provide strong incentives for the establishment and maintenance of group-based retirement plans. Yet these policies must also be assessed against the need for new retirement behaviors.

Retirement Patterns—Old and New

Important changes in the older worker labor market are evident along several dimensions. First, workers themselves are more diverse, inasmuch
as they are more mobile, better educated, and healthier than ever before, even as they grow older as a group (Mitchell et al. 2003). Second, transitions in retirement patterns and expectations are beginning to emerge. For instance, in most developed nations there are rising fractions of working women spending ever greater portion of their lifetimes attached to work outside the home. At the same time, there have been dramatic increases in the number of minority workers, workers in nontraditional families, and workers with no families. These facts, combined with slower labor force growth, are altering the age structure and demands of the labor force, making it more difficult for firms to find young workers and increasing the likelihood that employers will want to retain older workers.

Research by Mulvey and Nyce (Chapter 7) reported here points out that by 2010 the US will experience a seven percentage point worker shortfall, which is forecasted to grow to 13 percent by 2020. Furthermore, all baby boomers will be older than 55 by 2020. Nevertheless, many retirement plans have encouraged workers to retire before the age 65. Partly as a consequence, the analysis by Abraham and Houseman (Chapter 5) finds that many companies today have become quite interested in employing older people. ‘Employers are concerned about the ability to recruit workers,’ says Abraham. Yet the data show that many employees indicate that they would like to work beyond the firm’s retirement age, but few in fact do so. Indeed, only one-quarter of older workers surveyed said they planned to stop working entirely at the firm’s normal retirement age; of the rest, 18 percent said they planned to work fewer hours, 5 percent said they wanted to change jobs, and the rest said they had no plans. It is of interest that, when they were interviewed two years later, most of those who planned to stop work actually did so, but most of those who planned to work fewer hours had not followed through. Abraham believes that the ‘disconnect’ may have to do with available jobs: most of the slots are not particularly more attractive than before.

Mulvey and Nyce go on to note that, while the US Employee Retirement Income Security Act (ERISA) of 1974 guaranteed accrued DB plan benefits, that law did not require employers to continue to provide future pension accruals. Insofar as employers offer pensions voluntarily to minimize turnover and receive certain tax benefits, at the same time they have faced soaring administrative costs over time, with costs tripling over the last two decades. As a result, almost two-thirds of companies with fewer than 1,000 workers dropped their DB plans between 1990 and 2002; among larger companies, 11 percent dropped their DB plans (K&W 2004a). Mulvey also notes that more than 20 percent of DB participants are now in hybrid plans, which combine elements of DB and DC plans which cater to a more mobile workforce. While some critique hybrid plans, suggesting that they cut employee benefits, her data indicate hybrid plans add costs to employers and protect older workers. Nevertheless some employers cannot provide any pensions because of regulatory constraints.
The question of whether employers can and do adjust their human resource policies to provide older employees more flexible work schedules is taken up again in a related study by Robert Hutchens and Kerry Papps (Chapter 8). They see phased retirement as a way to encourage older workers to extend their time in the labor force, permitting workers to transition from full-time to part-time work without changing employers. A clear advantage of such a model is that the worker would be able to curtail work hours while maintaining existing skills and job relationships. It is therefore interesting that some employers require the workers to ‘officially’ retire before rehiring them for shorter work hours jobs, and sometimes the time interval between official retirement and rehire is only a day.

Drawing on a special establishment survey, Hutchens and Papps find some fascinating results. First, employers favor informal arrangements regarding the rehiring of retired workers or phased employment. Second, employers who do permit some form of phased retirement do not usually restrict it to rehiring of retirees; indeed, most employers indicate they would permit informal hours reductions both before, and after, official retirement. Last, they find little support for the claim that pensions or hours constraints drive firm preferences. Instead, it appears that employers and employees find ways to reduce work hours in flexible ways, and they predict that individually negotiated arrangements will become an evermore important element of the evolving retirement paradigm.

Employers have other ways to change their incentive plans for those nearing retirement that could help extend work lives. For instance, Mulvey and Nyce suggest that employers consider offering elder care programs that assist with the care of older relatives, and phased retirement programs that allow older workers to cut back on their hours without losing benefits. In their survey, one-quarter of the women who retired early were responsible for caring for an older relative, Mulvey notes (K@W 2004b); ‘These are the softer side of benefits, but they matter and they’re not too costly to implement.’ She also finds that men are less responsive to phased retirement programs.

Elements of the New Mix

As a result of these fundamental environmental changes, corporate as well as public sector retirement policies must also evolve. How will this new retirement paradigm be developed? Who bears the responsibility for changing the framework for retirement decisions? Answers to these questions require a new perspective regarding the role of workers, firms, financial services providers, and the government, in the provision of retirement security.

In many countries, it seems clear that pensions must be restructured to facilitate innovative retirement plans while still providing insurance and risk management features for both workers and firms. In this new
environment, workers and their families will be asked to assume greater responsibility for their own retirement saving. Since retirement wealth accumulation is a lifetime responsibility, workers must be induced to start planning and saving when young, and monitor these retirement plans throughout their working careers. This is a time-intensive process, requiring frequent updating of saving targets and behavior. The retirement plans of twenty-first century workers should also embody some notion of likely changes in government benefits such as Social Security and Medicare, along with changes in company-provided pension plans and retiree health insurance.

The changing patterns of work and retirement are already creating pressures for pension reform. Innovative plan designs along with better fund management are being seen in both the public and private sectors. Ambachtsheer’s study (Chapter 11) of DB pension plan investment practices suggests that pension management was guided by a set of rules that appeared to work well during the 1980s and 1990s. During this period, equity risk premiums were generally positive; equity market dips were short and soon reversed themselves, and nothing happened that a 60–40 equity-bond mix policy could not deal with. But the ‘perfect pension storm’ of 2000–2 developed deep cracks in the old retirement lens. DB plan surpluses turned to serious deficits, and stakeholders began to realize that the asset mixes adopted during the 1990s exposed the stakeholders of DB balance sheets to material mismatch risk. As a result, pension organizations can no longer be guided by the ‘old’ paradigm, but rather they require a new lens through which to see the world.

In his analysis of the pension plan type question, David McCarthy (Chapter 6) notes that recent developments in numerical analysis help researchers assess different pension plan designs using an economic framework realistic enough to assist researchers and practitioners who study and design pension plans. He develops a framework to design pension schemes to evaluate the best ‘pension design’. He uses a financial economics approach to the problem of pension design, recognizing that compensation arrangements can have very distinct impacts on employees covered by these plans. In particular, pension contracts alter workers’ risk exposures and the allocation of compensation over the lifecycle. As a result, having a pension changes the value that employees ascribe to different pension and compensation arrangements. His model implies that a DB plan magnifies workers’ risk exposure to salary risk, while both DC and DB pension arrangements defer pay to later in the work life. As a result, younger workers therefore value DC plans because they have immediate cash needs. By comparison, DB pensions are a relatively cost-effective way to compensate older, less well-educated employees. He also concludes that underfunding the DB plan is an expensive way to pay employees, as is giving workers with 401(k) plans restricted company stock. Finally,
McCarthy suggests that a hybrid scheme might be designed to better suit
both types of employees. Donald Elbaum, director of pension actuarial
studies at Ford Motor Co., suggests that the idea of reducing early retire-
ment subsidies is gaining ground in national pension plans around the
world and in private schemes (K@W 2004a).

In their analysis of US public sector pension plans, Anderson and Brai-
nard (Chapter 12) provide useful observations for private plans, based on
their assessment of the successes of public sector pensions. They note that
public sector plans in the USA cover 14 million state and local government
sector participants (10 percent of the US workforce) with assets of over $2
trillion. These public sector pensions evolved before, and outside the
purview of, much federal pension legislation, making their different ex-
periences invaluable for private industry. The authors conclude that the
economic boost afforded to public pension benefits will rise as Baby
Boomers retire and public retirement systems distribute increasingly larger
amounts. Unlike the social security system, which is mainly a pay-as-you-go
program, public pension funds are almost entirely funded. The $2.3 tril-
lion in assets have a significant, positive effect on financial markets and the
economy, and the plan structures have enabled public employers to
achieve important objectives related to the recruitment and retention of
quality workers.

As pensions plans change, financial literacy and knowledge increases in
importance as workers are asked whether they will participate in a retire-
ment saving or pension plan, as well as how much to contribute and also
how to invest the funds. In this new environment, employee knowledge and
financial planning become extremely important. Arnone (Chapter 9) takes
up the issue of who should bear the responsibility for providing financial
education, describing educational programs currently being provided.
Arnone, who runs employer-investor education programs, said that com-
panies began offering financial literacy programs in the early 1980s as they
encouraged workers to take early retirement. He believes that ‘the ration-
ale was that if these older employees did the calculations, they would
conclude they were better off (taking early retirement).’ He adds: ‘I think
we’re going to have a resurgence, only now they are going to conclude, “I
cannot retire as soon as I thought I could” ’ (K@W 2004a). Arnone states
that fewer than 20 percent of large employers initiated financial education
programs. Indeed, his own firm once offered financial planning but found
that other benefits, including pet insurance, were more popular.

Among investors who manage their own retirement accounts, some of
the common problems include questionable asset allocation, failure to
rebalance periodically, and an overconcentration in employer stock. Approx-
imately 20 percent of DC participants have outstanding loans and
many cash out at time of termination. ‘The latest, biggest, hottest thing
now is professionally managed 401(k) plans’, says Arnone.
International Experiences

The triple challenges of an aging population, a slowly growing labor force, and increasing life expectancy confront many developed nations, and indeed most other developed countries are further along this path than is the USA. Fertility is much lower in Japan and in most of Europe and life expectancy is considerably higher in many of these countries. Many developed countries are already experimenting with reforms to their national Social Security programs and employer-based pensions. It seems likely that policymakers in all developed countries should learn from each other.

Sundén on Sweden (Chapter 14), Usuki on Japan (Chapter 15), and Pozzebon on Canada (Chapter 13) provide interesting insights into how these countries are modifying their retirement programs to address the challenges of the twenty-first century. Turning first to Sweden, Sundén notes that the Swedish Parliament passed pension legislation in 1998 transforming that country’s public pension scheme from a pay-as-you-go DB plan to a notional DC. In addition, that reform introduced a second-tier DC individual account plan. This reform fundamentally changed the provision of public pension benefits and redefined the benefit promise. For instance, in the new system, government-provided benefits are closely tied to contributions, and lifetime earnings determine benefits. The reform also recognized that increased life expectancy should influence the system’s financial stability, and so it built in an automatic benefit adjustment process that responds to changes in longevity. Finally, the new system also introduced a funded individual-accounts component.

In the process, Swedish policymakers recognized a fundamental and very interesting insight: namely, that pension systems are dynamic institutions which must adjust to constantly evolving demographic and economic circumstances. So as to limit political risk, the reformers proposed automatic adjustments to contribute to system stability. The downside was that the notional DC approach has all adjustments operate through changes in benefits; raising contributions is not an option since it also increases promised benefit. We also note that the Swedish system offers a minimum guaranteed benefit well above the poverty level. For such countries, pension schemes in which adjustment take place both on the benefit and the contribution side might be preferable.

In related work, Usuki points out that Japanese DB plan managers have become extraordinarily disappointed with the ineffectiveness of pension plan asset managers of late, in large part due to the narrowing risk premium in capital markets since 2000. Increasingly, they turn their eyes to the field of liability management and benefit design, seeking to control the financial risks of the pension plans offered. Recent measures taken include DB plan termination, DB benefit cuts, the put-back of the contracted-out portion, and adoption of cash balance or DC plans. As a consequence, we
conclude that Japanese pension plan sponsors are using financial criteria to drive important pension outcomes. Usuki reports that determinants of DB plan termination include the volatility of return on shareholder equity, the pension plan funding ratio, and the size of pension assets and liabilities relative to the size of the plan sponsor. In addition, plan size also influenced decisions to terminate many Japanese employee pension funds (EPFs.) Turning to the decision to put back the contracted-out portion of the EPF, he again concluded that plan type choice is an important part of corporate risk management when the portfolio includes pension liabilities. Those findings imply that financial risks will remain a main concern for Japanese pension plan sponsors, with higher plan terminations and putbacks of the contracted-out portion of EPFs in the future, as well as additional conversions from traditional DB to cash balance and DC plans.

In the North American context, Pozzebon notes that the Canadian public pension system has long been seen as one of the best in the world. Indeed, to protect against the pressures of an aging population, the public system has become partially funded leading to a feeling of greater confidence among the Canadian population. Nevertheless, while some might believe that Canada’s retirement system stands on reasonably solid ground, it still faces many daunting challenges. In particular, the private sector component appears to have weakened substantially during the last decade. The gradual shift from DB to DC, with a parallel move away from retirement saving arrangements covered by pension regulation, portends increasing insecurity for tomorrow’s retirees. The author concludes that review of pension governance rules and analysis of the plan sponsor liability environment would strengthen the multi-pillar foundation of Canadian retirement income.

Fore (Chapter 10) illustrates how global accounting standards may influence US pensions substantially. The long phase in pension profitability came to an abrupt end in March 2000, with the bursting of the stock market bubble and the onset of the bear market. As many have noted, the fact that interest fell sharply also made matters worse, boosting the present value of DB pension liabilities. DB plan underfunding grew phenomenally: for standard and poor (S&P) 500 firms, around 70 percent of which offered DB plans, these plans were around $300 billion overfunded in 1999, but by mid 2003 were underfunded by $340 billion. Furthermore, many of those firms had an older workforce and many annuitants; most rapidly approach the day when they will begin paying out large pension cash flows on a sustained basis. Such an abrupt shift in DB plan funding status raises the question of whether pension accounting rules are consistent with the principles of pension finance.

The movement to require US pension sponsors to conform to global standards illustrates how international trends can affect retirement policies in other nations. As standard-setters move toward international
convergence, it now seems clear that this trend will continue. On the whole, this new accounting paradigm appears to the author to be an improvement over the old paradigm, with its emphasis on smoothing and its decoupling of risks from returns. Opponents of fair value standards have argued that switching to these will introduce excessive volatility to financial statements for little or no benefit to users and issuers of statements. These arguments continue, yet the standards are set for adoption in Europe from 2005.

Conclusions

The new retirement paradigm must fit the realities of population aging, rising life expectancies, and the need to finance adequate retirement income. Many questions have been addressed regarding the meaning of retirement in a world with very different expectations. Slower growth in the labor force, combined with new definitions of work and retirement, clearly imply that traditional DB plans will not meet many stakeholders’ needs in the labor force of the future. As a result, fewer firms will offer early retirement subsidies to encourage workers to retire in their fifties in the future; instead, company retirement policies must be amended to fit new needs. All of this is taking place against the backdrop of anticipated changes in national social security rules to improve financing, encourage continued work, and delay retirement.

A key problem noted by Rep. Earl Pomeroy (D-N Dakota) is that the US Congress tends to think in two-year bursts, which becomes a problem when it comes to legislating pension reform. ‘This mismatch in long-term liabilities and short-term fiscal planning has never been starker in any period in our history,’ he points out. ‘Our children will pay the price’. Another is that the DB pension funding situation has become rather bleak in the US and around the world. Even with a reasonably good economy, it will take many years before these systems can be restored to solvency. And as the contributors to this volume point out, immediate application of a fair value framework would run the risk of massive DB plan terminations. On the other hand, improved disclosure rules will aid users of financial statements, and they in turn will make their voices heard concerning the quality of information disclosed.

A powerful engine driving the reform of retirement income security systems in the next decade will probably be convergence—the movement to a common approach for reporting plan assets and liabilities. This will surely change the way DB plan investments are managed and the way benefit formulas work, and it will make fixed-income investment strategies more consistent with immunization and duration than in the past. In the USA, where many DB plans have relatively old demographic structures, plan sponsors and investment managers may concentrate more on investment strategies attuned to the timing of retirement benefit cash flows.
While the old accounting conventions may have encouraged DB plan sponsors to invest too much in equity, some will claim that the new standards will encourage too much fixed income in pension fund portfolios. Ultimately, accounting rules work best when they are neutral with respect to economic decision-making, when they acknowledge that returns are coupled with risks of a long-term nature.

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