WHY PENSIONS MATTER

The history of defined benefit pension plans in the United States of America

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CALIFORNIA'S EXPERIENCE DEMONSTRATES WHY PENSIONS MATTER

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Today the National Public Pension Coalition released the following report titled *Why Pensions Matter*. This report examines the critical role public pension plans have played in providing retirement security for teachers, firefighters, and other public employees. Public pensions are always an important topic in California because there are millions of working families that rely on California's robust public pension systems for financial security in retirement.

California is the most populous state in the United States, containing 12 percent of the nation's overall population. Not only that, but California's economy is the sixth largest economy in the world. For a state of that size, it makes sense that the state would have large public pension plans. The California Public Employees' Retirement System (CalPERS) is the largest public pension plan in the United States and the 7th largest in the world. Additionally, the California State Teachers' Retirement System (CalSTRS) is the largest teachers' pension plan in the United States and the 11th largest public pension plan in the world.

CalSTRS was one of the first public pension plans in the United States, being established in 1913. As the following report details, the first states began operating public pension plans in the 1910s and many of those were for teachers. CalPERS was not established until the 1930s, following an amendment to California's constitution and passage of a state law creating the plan.

Public pensions are particularly valuable to California's public workers because many public employees in the state don't participate in Social Security. For these workers, their pension may be their only source of retirement income. As is detailed in the report, there is a long and complicated history regarding the participation of public employees in Social Security. While the majority of public employees nationwide do participate in Social Security, those in some states, including California, do not.

Each month, over 600,000 retirees and beneficiaries receive benefit payments from CalPERS. The average monthly benefit for all service retirees is $2,627, enough for a modest, but secure retirement. CalSTRS provides monthly retirement benefits to over 250,000 retirees, who receive an average monthly benefit of approximately $4,000.

The following report documents the important role that public pensions play in the lives of working families across the country. Especially in states like California, where many public employees are not enrolled in Social Security, traditional pensions are even more valuable. This is why state legislators and other policymakers must understand the history of public pensions when they are making decisions about their future.

Pensions, in the broadest sense of the term, have existed since ancient Rome. Soldiers in the Roman army could earn pensions through their military service. The value of these pensions to Roman soldiers helped to maintain the power of emperors such as Augustus. Pensions for military service have continued to exist in one form or another in the two thousand years since.

Public pensions for teachers, firefighters, police officers, and other civilian public servants in the United States are a more recent development. In fact, public pensions as we know them are just over one hundred years old. Governments began offering pensions because they are the most effective and cost-efficient way for working families to prepare for retirement. Unfortunately, many people today have forgotten the true value of pensions and why they are so important. This report will explore the history of defined benefit public pensions in the United States, why they were implemented in the first place, and why they continue to remain today.

I. What is a Pension?

A pension is any form of payment, other than wages, paid at regular intervals for past service, age, injury, or other reasons. When we think of public pensions, we are almost always referring to defined benefit pension plans. These pensions pay a fixed amount at regular intervals, usually monthly, following an event such as retirement or disability. The fixed amount, or defined benefit, of the pension is calculated based on a formula that factors in years of service, salary while working, and a benefit multiplier. The generosity of this benefit formula varies depending on the public pension system.

Pensions can take other forms. A defined contribution plan, such as a 401(k), is not a pension, but rather a retirement savings plan. In a defined contribution plan, the worker can contribute a certain amount while working in order to accumulate savings for retirement. The worker's contributions to their 401(k) may or may not be matched by their employer. Retirement savings in a defined contribution plan can be paid out in a lump sum at retirement, as well as in fixed, monthly amounts by purchasing an annuity. For the purposes of this report, the term "pension" refers to defined benefit pension plans.

II. Early Public Pensions

The first public pension plan in the United States was established in New York City in 1857.[1] That pension plan provided a lump sum payment to New York City police officers injured in the line of duty. In 1866, that same coverage was extended to New York City firefighters. In 1878, the plan was changed to provide a lifetime pension for police officers at age 55 after 21 years of service. Thus, the first public pension plan was born. Around this same time, in 1875, American Express created the first private-sector pension plan for its employees.[2]

Public pension plans continued to grow throughout New York. In 1894, the first pension plan for teachers was established in Manhattan. Public pensions increased significantly during the Progressive Era. During the 1910s, six states established teacher pension plans:

- North Dakota and California in 1913
- Massachusetts in 1914
- Connecticut and Pennsylvania in 1917
- New Jersey in 1919

In 1911, Massachusetts became the first state to establish a pension plan for general state employees.[3]

The Civil Service Retirement Act of 1920 created the federal civil service pension plan. This plan provided a maximum pension of 60 percent and a minimum pension of 30 percent of average salary over the last 10 years of service.[4] Interestingly, one of the primary reasons given for the establishment of the federal civil service pension was to encourage the retirement of elderly, long-serving government employees. According to an April 1941 bulletin from the Social Security Administration, the problem of federal employees serving well into old age had plagued the federal government since its founding. In 1899, the federal Civil Service Commission began recommending the creation of a retirement program for federal civil service employees. Passage of the 1920 Civil Service Retirement Act was spurred, in part, by the end of World War I and the need to reduce the number of federal civilian employees.[5]

III. Social Security Act and the New Deal Era

The growth of public pension plans accelerated during the New Deal era. The stock market crash of 1929 and ensuing Great Depression cast millions of elderly Americans into poverty. Responding to this crisis, Congress passed the Social Security Act in 1935. Originally, the Social Security Act excluded employees of state and local governments from participating in the Social Security program. This was due to a constitutional question of whether the federal government could tax state and local governments, in this case levying an employer payroll tax to cover the cost of participation in Social Security.[6] This exclusion spurred more state and local governments to establish public pension plans for their employees. Between 1935 and 1950, roughly half of the larger state and local government pension plans in the United States were established.[7]

In 1950, Congress added Section 218 to the Social Security Act.[8] This section gave states the option of enrolling their public employees in Social Security, if those employees were not participating in another retirement program. In 1951, Wisconsin became the first state to allow public employees to participate in Social Security.[9] Eventually, further provisions were added to the Social Security Act to allow state and local government workers to participate in both Social Security and a public pension plan. Now, employees of state and local governments are required to participate in Social Security, unless they are enrolled in a public pension plan that does not include Social Security coverage. This has created a situation where about a quarter of state and local government workers nationwide are not participating in Social Security, although they are highly concentrated in a few states, especially California, Texas, and Ohio.[10]

Throughout the postwar era, more cities and states established public pension plans to provide retirement security to their employees. During this period, they also revised the structure of their pension benefit formula. By the 1970s, most public pension systems had simplified their benefit formula to age, service, and salary, after employing more complicated formulas earlier in their history.[11]

IV. Pensions in the Private Sector

Defined benefit pensions also became more common in the private sector during the postwar period. Particularly as manufacturing jobs increased during the postwar economic boom, those jobs often came with a middle class salary and benefits, including a defined benefit pension. Workers who were employed by a company for 20 or 30 years would be able to retire with a reliable and secure pension. At one time, 88 percent of private sector workers, who had a workplace retirement plan, had a pension.[12]

During the 1950s and 1960s, private sector pension plans were largely unregulated. This sometimes led to unfortunate consequences when businesses closed down. The most notorious example was the closure of the Studebaker Company in 1963. When the famous automobile manufacturer shut down its plant, it did not have the money to pay promised pension benefits to its former employees. Throughout the 1960s, the U.S. Senate conducted numerous hearings on corporate pension plans and union benefit funds. Though a number of bills were introduced, no major legislation affecting private sector pension plans was ever passed.

In September 1972, NBC aired *Pensions: the Broken Promise*, a television special that examined the consequences of poorly funded corporate pension plans. This spurred more congressional hearings and legislation around pensions. Eventually, Congress passed the Employee Retirement Income Security Act, which President Ford signed into law on Labor Day in 1974. ERISA, as it is commonly known, was a landmark piece of legislation affecting the retirement security of working families.

It's important to note that ERISA and its provisions do not apply to public pension plans. ERISA has also been amended numerous times as the retirement landscape has continued to change. ERISA regulates how an established pension plan operates, including vesting requirements and the survivor benefits for spouses. It also created the Pension Benefit Guaranty Corporation, which acts as a backstop for closed pension plans that do not have the funds to pay promised benefits. ERISA also established minimum funding requirements for pension plans, in order to prevent incidences like the closure of the Studebaker pension plan.

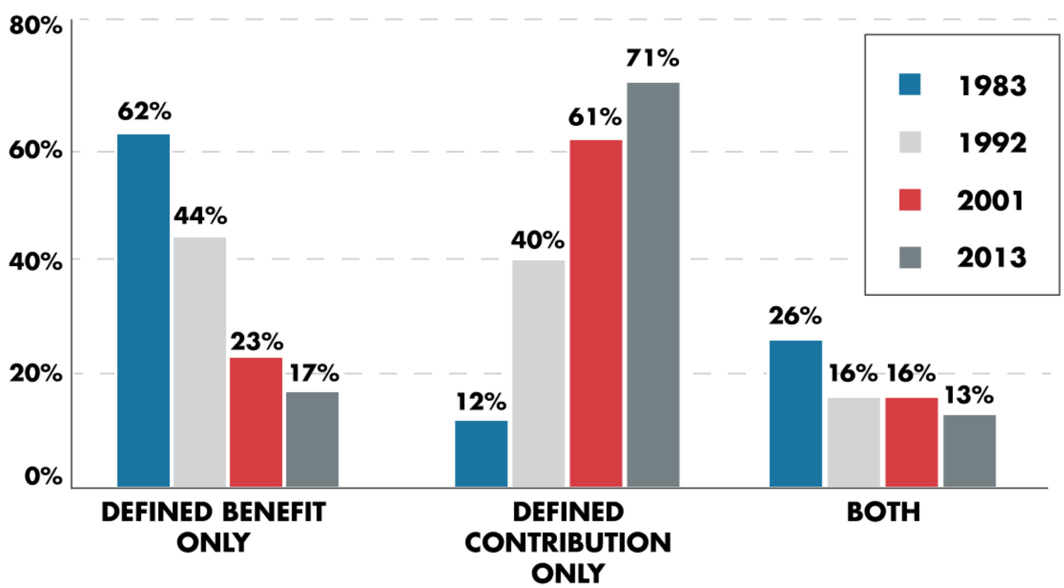
During the postwar economic boom, defined benefit pensions represented the closing chapter of a solid middle class life. The American dream was a steady job with a middle class salary, decent benefits, and the promise of a pension in retirement. For many, but not all, Americans this dream was a reality. A worker with a high school education could get a job on the line at a steel factory and live that middle class lifestyle. Other workers found job security and a good salary through serving their community as a teacher or firefighter or librarian. For a period of time, pensions were accepted as a key element of middle class life in the United States. This started to change in the 1980s.

V. The Birth of the 401(k)

One of the most consequential laws relating to retirement plans in the United States was the Revenue Act of 1978. This legislation contained a minor provision creating Section 401(k) of the tax code. This provision was passed to give well-paid corporate executives a way to save some of their high earnings in tax-advantaged savings accounts. For the first few years of its existence, the 401(k) provision went unnoticed. However, following Ronald Reagan's election as president, the IRS changed the regulations regarding 401(k) plans and dramatically increased their popularity in the private sector. Defined contribution plans existed prior to the 401(k), but they were much less common than defined benefit pension plans. In 1983, among employees with a workplace retirement plan, 62 percent participated in a defined benefit plan; only 12 percent had a defined contribution plan; and 26 percent participated in both defined benefit and defined contribution plans.[13]

FIGURE 1

WORKERS WITH RETIREMENT COVERAGE BY TYPE OF PLAN 1983, 1992, 2001, AND 2013



Adapted from '401(K)/IRA Holdings in 2013: An update from the SCF', Center for Retirement Research at Boston College

During the 1980s, following the change in regulations of 401(k) plans, an important change in thinking about workplace retirement plans occurred. According to the Center for Retirement Research:

> "When 401(k) plans began to spread rapidly in the 1980s, they were viewed mainly as supplements to employer-funded pension and profit-sharing plans. Since 401(k) participants were presumed to have their basic retirement income needs covered by an employer-funded plan and Social Security, they were given substantial discretion over 401(k) choices, including whether to participate, how much to contribute, how to invest, and when and in what form to withdraw the funds. Even though 401(k)s are now the primary plan for most workers, they still have almost complete discretion over 401(k) choices."[14]

How did the 401(k) become the primary retirement plan for most workers? The change in IRS regulations did open up 401(k) plans to greater participation, but that alone does not account for the change. A series of laws passed during the mid-1980s increased the regulatory burden on private sector defined benefit pension plans.[15] Specifically, these laws increased the volatility of pension fund contributions from year to year. They did this by increasing the funding requirements, shortening the amortization period, and restricting the amount of time in which employers can calculate the interest rates on their assets and liabilities. The less consistent contribution levels have a negative impact on a firm's cash flow and overall balance sheet. In fact, multiple surveys have shown that private companies did not abandon their pensions due to the inherent cost of the pension itself, but rather because of the complex regulatory burden they faced.[16] Once they did close their pension plan, however, companies used it as an opportunity to cut costs. One study found that when companies switched from defined benefit pensions to defined contribution plans, the amount they contributed on behalf of each employee was cut almost in half.[17]

By making it more burdensome for private employers to provide pensions to their employees, these laws encouraged companies to close their defined benefit plans and move their employees into defined contribution 401(k) plans. The change has been dramatic. In 2013, only 17 percent of private sector employees participated solely in a defined benefit plan; 71 percent participated solely in a defined contribution plan; and only 13 percent participated in both.[18] This is quite the change from 1983 when the numbers were almost reversed.

VI. Defined Benefit Plans Continue in the Public Sector

The overwhelming shift to defined contribution plans has not occurred in the public sector. Many public employees still participate in a traditional defined benefit pension plan. There are several reasons for this. For one, the laws that increased the regulatory burden on private sector pension plans do not apply to public sector plans. For another, state and local governments value a stable workforce. In professions like teaching, firefighting, and policing, employees gain skills and increase in effectiveness over time. Frequent employee turnover hurts these professions. Additionally, there are not private sector equivalents of many public sector jobs. It is much more difficult to find employees with the skills to start doing these jobs on day one, whereas a private company might find it easier to replace one engineer with another. Therefore, it is in the best interest of these employers to maintain an experienced, long-term workforce.

Critics of public pensions often complain that these pension plans have long vesting periods and reward the longest serving employees. That is intentional. In public education, for example, most research points to teachers dramatically increasing their effectiveness during their first few years of teaching and then maintaining that effectiveness throughout their career. They do not lose their effectiveness the longer they continue in their profession. They are more likely to continue teaching at their peak effectiveness rather than decline. Structuring retirement plans to reward teachers that only teach for three or four years does not make sense because that would reward teachers who leave before reaching their peak effectiveness, often to be replaced by someone without any experience. Similarly, with firefighting and policing, there are a lot of sunk costs that go into training new recruits. It is not in the interest of these departments for their new employees to leave right after training, so their pension plans are structured to promote long-term commitment to the profession.

One of the major issues surrounding public pensions is the question of why taxpayers should pay for them. It's important to be clear about exactly what that means. Public pension funds get money from three sources: employee contributions; employer contributions; and investment returns. In the public sector, the employer is a state or local government entity, such as the local police department or public school system, and, therefore, the money to fund that government entity comes from taxpayers. On average nationwide, public sector employers contribute about a quarter of public pension fund revenues.[19] The majority of pension fund revenues comes from the employee's own contributions and the investment returns on the combined contributions. Taxpayers are only paying for a small part of the cost of public pension plans.

State and local governments offer defined benefit pensions to their employees in order to attract the best and brightest to public service. Public employees earn less on average than their counterparts in the private sector, so job benefits like pensions are a proven way to recruit top talent. Also, as discussed above, pensions play a key role in retaining employees in professions like teaching and firefighting.

The important question that does not get asked in this discussion is: why do private companies not offer defined benefit pensions anymore? Defined benefit pensions are more efficient and cost-effective than defined contribution plans and provide a more secure retirement. Public pensions should not be considered the outlier in the retirement security landscape. Instead, workers should be asking why their company is not offering a pension plan.

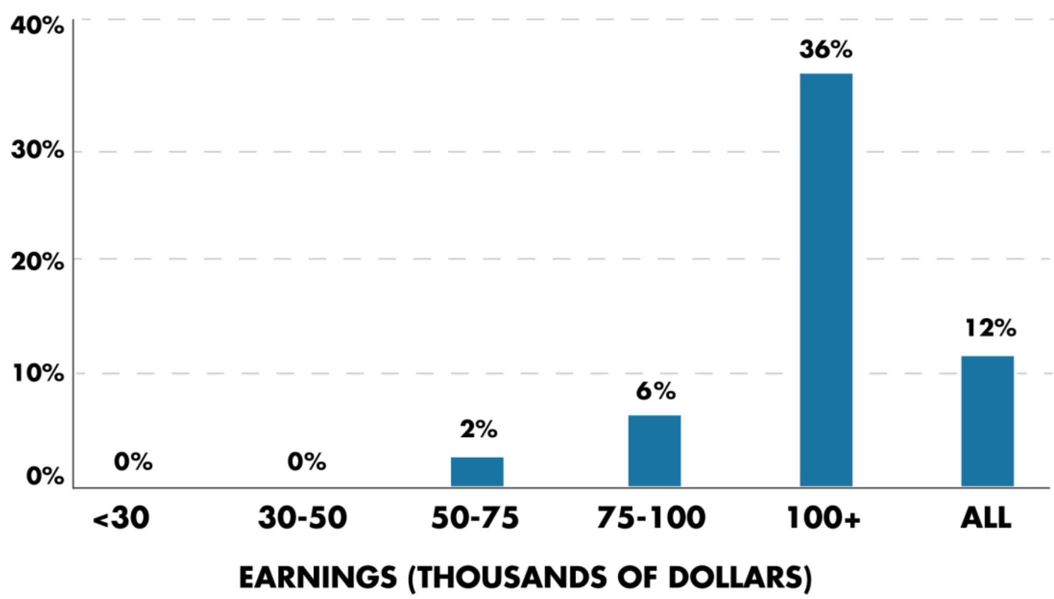
VII. The Decline of Retirement Security in the Private Sector

In the private sector, the shift from defined benefit pensions to defined contribution 401(k) plans over the past three decades has harmed the retirement security of working families. This is because most working families accumulate far less in retirement savings with a defined contribution plan than they would with a defined benefit pension. By their nature, 401(k) plans favor high-income workers; that is, after all, for whom they were created. For 401(k)s to be effective as a retirement tool, a worker must contribute a significant amount of money to them, consistently, over the course of an entire career. For high-income workers, like corporate executives, this is easy to do because they have the disposable income to contribute the maximum amount to their 401(k) account every year. For lower-income and even many middle-income workers, this is much harder to do. It does not help anyone that the rise of 401(k)s has coincided with a historic period of wage stagnation over the past three decades.

According to Vanguard, 36 percent of workers who earn over $100,000 a year made the maximum contribution to their 401(k) in 2013.[20] This is six times the number of upper-middle class workers (6 percent) who maxed out and eighteen times the number of middle class workers (2 percent) who maxed out. Among low-income workers, virtually no one contributed the maximum amount to a 401(k).

FIGURE 2

PERCENT OF PARTICIPANTS MAKING MAXIMUM CONTRIBUTIONS, BY EARNINGS, 2013



Adapted from '401(K)/IRA Holdings in 2013: An update from the SCF', Center for Retirement Research at Boston College

The Center for Retirement Research at Boston College has crunched the numbers on retirement plan contributions since the creation of 401(k)s in the early 1980s. They found that the percentage of salary contributed to workplace retirement plans has declined slightly with the shift from defined benefit to defined contribution plans, but the accumulated assets of workers in retirement plans have not changed.[21] However, as they point out, individual workers now bear all the risk and they must figure out how to use their accumulated assets. Additionally, the rise of defined contribution plans has coincided with an increase in wealth inequality, i.e., more retirement income being shifted to the top. People at the bottom of the income scale are worse off now than they were when defined benefit pensions were more prevalent. There is evidence that this retirement inequality is occurring. In 2013, families in the top income fifth accounted for 63 percent of total income, but 74 percent of total savings in retirement accounts.[22] Some might argue that there is nothing wrong with rising income inequality. However, there is ample evidence that rising income inequality drags down the economy, prolonging recessions. When the economy slows, everyone suffers, not just those with pensions.[23]

It is also important to note that only half of workers have access to a workplace retirement plan at any time. From 1989 to 2013, the percentage of all workers without a workplace retirement plan, whether defined benefit or defined contribution, has remained constant in the mid-50s percentage.[24] In the public sector, retirement plan coverage is more widespread, since most public employees are automatically enrolled in their retirement plan, especially if that plan is still a traditional defined benefit pension. However, public sector employees represent only a small portion of the overall American workforce (approximately 15 percent). For many American workers, especially low-income workers, they do not have access to any kind of retirement plan, whether it is a 401(k) or a pension.

When talking about the retirement security crisis, the main discussion must involve the move from defined benefit pensions to defined contribution 401(k) plans. That shift has demonstrably decreased the retirement security of working families. There is no doubt that if the percentages of workers with pensions were the same today as they were in the early 1980s, more workers would have a secure and dignified retirement. This point is important to remember when pension critics advocate for moving public sector employees into 401(k)-style defined contribution plans. The retirement security crisis has been alleviated to the extent that public employees can still enjoy a modest, but secure retirement due to their public pension. Moving public employees into 401(k)-style plans would only exacerbate the retirement security crisis and further a race to the bottom of who can provide the least generous retirement benefits. When states have switched to defined contribution plans, it has had predictably bad results.[25]

VIII. Conclusion

Right now there is a growing retirement security crisis in the United States. There are a number of reasons for this. For one, the Baby Boomer generation is beginning to retire. The Baby Boomers are one of the largest generational cohorts in history, so just in absolute numbers there are more people of retirement age now than there have ever been before. Also, half of all workers don't have access to a retirement plan through their employer. These workers are accumulating next to nothing in retirement savings. Additionally, the value of Social Security benefits has eroded over time. Differences in life expectancy between high-income and low-income workers weakens the progressive benefit structure of Social Security.

The Spanish philosopher George Santayana once said that those who do not remember the past are doomed to repeat it. This is why we must look at the history of pensions in the United States. History clearly shows that providing workers with a secure and dignified retirement through a pension is good for workers, taxpayers, society and the economy.

Endnotes

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