

# **Living with Defined Contribution Pensions**

## **Remaking Responsibility for Retirement**

Edited by

Olivia S. Mitchell and Sylvester J. Schieber

Published by  
The Pension Research Council  
The Wharton School of the University of Pennsylvania  
and  
University of Pennsylvania Press  
Philadelphia

Copyright © 1998 The Pension Research Council of the Wharton School of the University of Pennsylvania

All rights reserved

Printed in the United States of America on acid-free paper

10 9 8 7 6 5 4 3 2 1

Published by

University of Pennsylvania Press

Philadelphia, Pennsylvania 19104-4011

Library of Congress Cataloging-in-Publication Data

Living with defined contribution pensions : remaking responsibility for retirement / edited by Olivia S. Mitchell and Sylvester J. Schieber.

p. cm.

"Pension Research Council publications."

Includes bibliographical references and index.

ISBN 0-8122-3439-1 (cloth : alk. paper)

1. Defined contribution plans—United States. 2. Old age pensions—United States—Finance. 3. Pension trusts—United States—Finance. I. Mitchell, Olivia S. II. Schieber, Sylvester J.

HD7105.45.U6L58 1998

331.25'2'0973—dc21

98-13584

CIP

**Part I**  
**The New Responsibility of**  
**Defined Contribution**  
**Plans**

## Chapter 2

# **Pension Coverage Initiatives: Why Don't Workers Participate?**

---

Richard P. Hinz and John A. Turner

As the baby boom generation approaches retirement (the oldest will receive their first Social Security checks in a decade), concern is being raised that baby boomers are saving inadequately. Optimistic assessments conclude that, at best, baby boomers are saving at the same rates as their parents at an equivalent point in life.<sup>1</sup>

The private pension system provides a possible solution to the savings problem. The system has already made a huge contribution to the increasing affluence of the elderly, with income from employer-sponsored pensions increasing from 14 percent of the income for the elderly (age 65 and older) in 1958 to 19 percent in 1992, and the proportion reporting some type of benefit increasing from 14 percent in 1962 to 47 percent in 1992 (Chen 1992; Grad 1992). Whether additional retirement savings provided through the private pension system is a reasonable hope is a matter of considerable conjecture.

### **The Supply of Private Pension Coverage**

Despite its widely acclaimed success, the private pension system has its own problems. Following the creation of substantial tax incentives in the early part of the century and the emergence of organized labor as a powerful advocate, the proportion of the workforce covered by employer-sponsored pensions grew rapidly, increasing from 15 percent at the outset of World War II to 45 percent of all private wage and salary workers in 1975, the year after comprehensive federal legislation, the Employment Retirement Income Security Act (ERISA), was enacted. However, despite the efforts of three Republican and two Democratic administrations, twelve Congresses, three major recessions, the longest postwar expan-

## MORE THAN 50 MILLION WORKERS NOT EARNING A PENSION

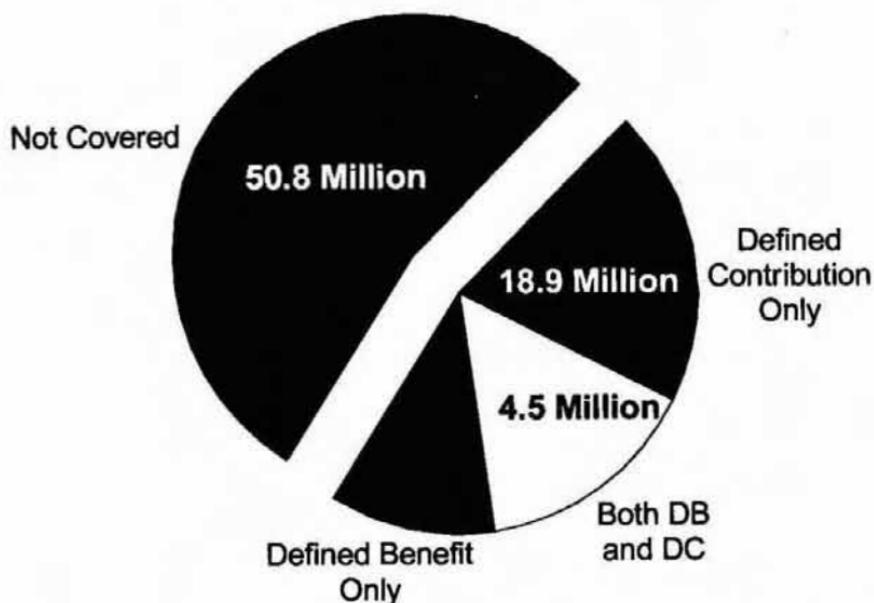


Figure 1. Private sector wage and salary workers by pension status, 1993. Source: USDOL (1994) and authors' computations using April 1993 CPS and Form 5500 filings.

sion, and the most enduring bull market in history, there it has remained. The result is the distribution of pension coverage shown in Figure 1. Among the roughly 96 million private wage and salary earners comprising the current workforce, nearly 51 million are not accruing benefits on their current job.

The stability of the pension coverage rate, varying by no more than a percentage point or two for more than twenty years, is remarkable. This is especially so in light of the fundamental changes in the size and composition of the workforce that have accompanied the aging of the baby boomers, the entry of women into the labor force, and the economic uncertainties that last year made workplace security an issue in presidential election politics. It is also remarkable given the major changes in the provision of pensions, with the decline in the percentage of the workforce covered by a traditional defined benefit plan and the rapid growth of 401(k) plans.

While inadequate to describe the complexity of the forces at play in

this stable (or stagnant) level of pension coverage, "standard economic theory" has effectively defined the available "policy levers" to address the perceived problem. It has essentially viewed the problem as a problem of supply.

The standard assumption seems to be that there is an adequate level of demand for pension coverage by most workers. This inevitably results in a perspective that coverage expansions originate on the supply side, leading to a menu of alternatives that has become nearly exclusively oriented to facilitating the ability of employers to sponsor plans. This tendency is in no way reduced by the constant reminders from well-organized and funded employer groups (interestingly enough almost exclusively comprised of those already sponsoring plans) about costs, regulatory burdens, and their alleged effects on otherwise philanthropic tendencies toward workers.

While simple in construct and thereby efficient in communication, these implicit assumptions warrant scrutiny. The passage of ERISA would appear to provide a considerable price shock on the supply side. Yet the coverage rate remained unchanged.

Since then an alphabet soup of TEFRA's, DEFRA's, TRA's, and REA's has emanated from Congress.<sup>2</sup> While many of the legislative provisions were motivated more by revenue raising than by an interest in pension coverage, many had the effect of imposing significant new costs on plan sponsors by either accelerating funding requirements or limiting the scope of tax subsidies.

While the increase in employer costs has surely affected the reduction in the number of small firms sponsoring defined benefit plans, the overall coverage rate remains essentially unaltered. The periodic Employee Benefit Supplements to the Current Population Survey (CPS) yield a coverage rate for full-time private wage and salary workers that has remained at around 50 percent from 1972 to 1993.

At the broadest level, the available data on pension coverage provide what appears to be compelling confirmation of the supply side presumption. As Figure 2 shows, according to the April 1993 CPS supplement, slightly more than 59 percent of the private wage and salary workforce are employed in firms that offer pension coverage. One in five of those not covered is ineligible for the plan provided by his or her current employer. On the other hand, nine of ten workers in firms offering coverage report that they participate in the plan, resulting in a coverage rate of about 45 percent of workers.

Looking at the factors associated with the employers of the covered workers lends further credence to the second tenet of the conventional wisdom, that the supply problem is one of small firms and is a result of cost differences. Figure 3 shows what has perhaps become the most com-

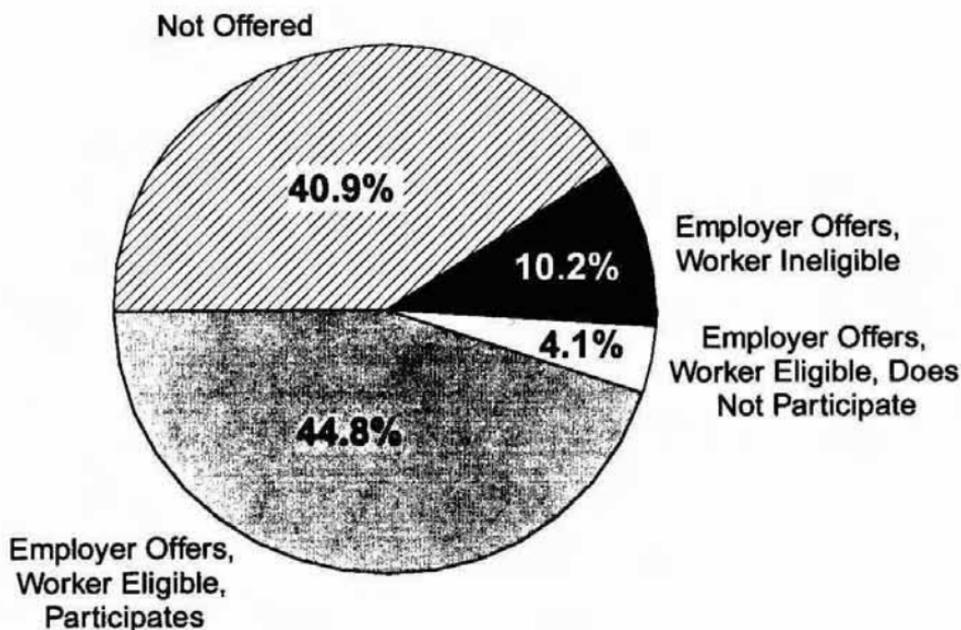


Figure 2. Pension plan sponsorship/participation categories, 1993. Source: USDOL (1994) and authors' computations using April 1993 CPS Employee Benefits Supplement.

monly cited statistic in the coverage debate, the relationship between firm size and pension coverage. This shows that for the smallest firms, those with fewer than 10 workers, the pension coverage rate is only about one-seventh that of the larger firms. The simplest way in which this relationship is usually described is to note that, while more than 70 percent of the workers in firms with more than 100 workers are earning pension benefits, the rate is less than 25 percent for employers with fewer than 100 employees (the most commonly used definition of small business).

The source of this outcome is easy to identify in examining by firm size intervals the proportion of workers whose employers do not offer a pension plan. While 86 percent of those working in firms that employ 10 or fewer workers do not work for an employer that offers a plan, only 11 percent of workers in firms with more than 1,000 employees face a similar limitation in access to the system.

A look at the relationship of administrative costs and size seems to readily indicate the cause for this inequity. Analysis by Hustead (this volume) of administrative expenses provides an estimate of the cost per participant. The per capita administrative costs for the smallest firms are

## Percent of Workers Covered by Plan

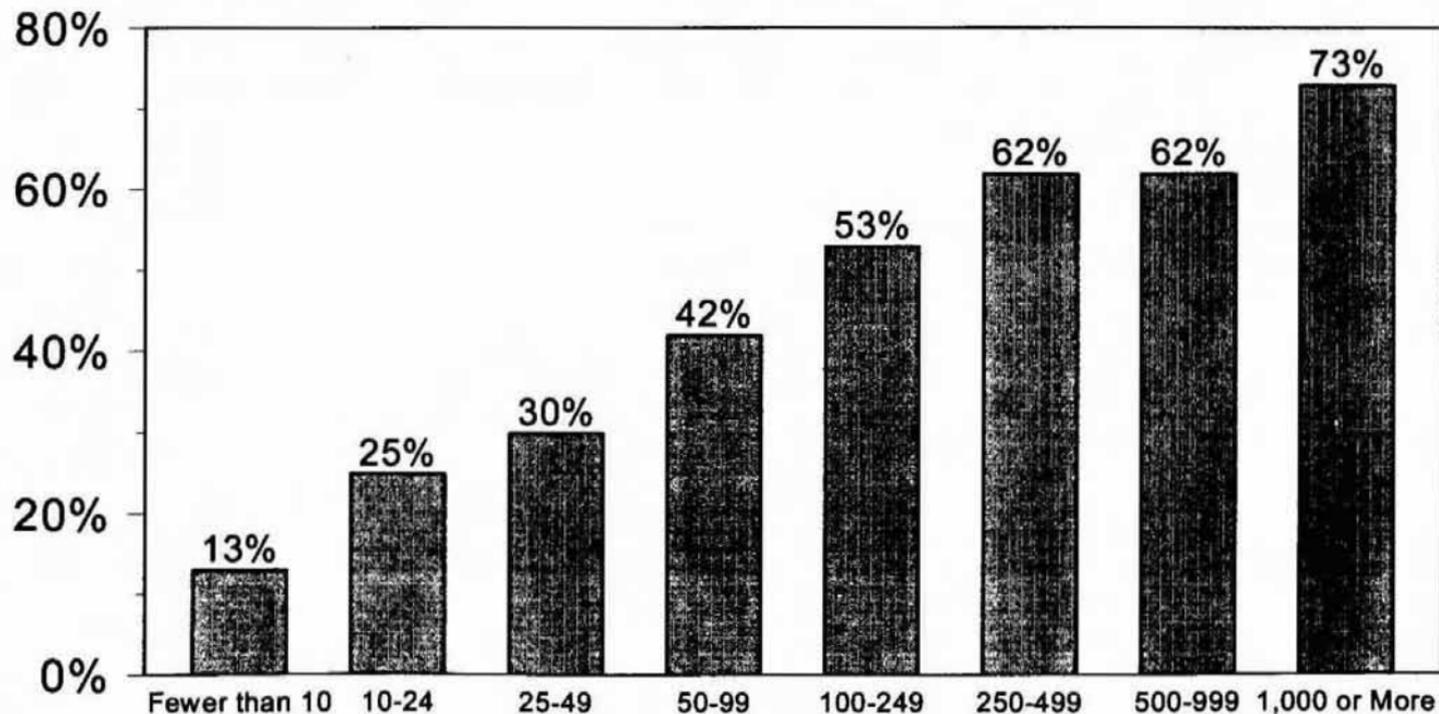


Figure 3. Pension coverage rates by firm size, 1993 (full-time private wage and salary workers). Source: USDOL (1994) and authors' computations using April 1993 CPS.

nearly eight times as great as those of the largest firms for defined contribution plans.

This analysis, both simple in construct as well as conveniently confirming policymakers' intuitive notions and the complaints of their most vocal critics, generally ends the diagnosis and dictates the prescriptions. Not surprisingly, on the rare occasions when coverage expansion rather than revenue enhancement has been a paramount concern, legislative initiatives have been guided by the desire to "level the playing field" for small firms.

### **The Demand for Pension Coverage**

However seductive in simplicity is the administrative cost explanation, a closer look at the data belies the notion that the origins of the pension coverage problem are so easily discerned. Stephen Long and Susan Marquis, using 1988 CPS data, provide a framework so straightforward in illuminating the limitations of the supply side analysis in the context of employer-sponsored health benefits that it merits replication with the 1993 CPS for pension coverage (Long and Marquis 1994).

Workers in firms that do not offer pension benefits share some notable characteristics. They are far more likely to be low-wage workers. More than two-thirds of workers earning less than \$10,000 per year are employed at firms with no pension plan. Similarly, they tend to be workers with short tenure. While 59 percent of workers with less than one year on the job are working in firms without a plan, fewer than one-quarter of workers with more than ten years of service have no access to the pension system through their own employer.

There is a considerable degree of interaction between earnings, tenure, and firm size. Small firms tend to be less profitable and employ more mobile and younger workers. They also tend to employ more part-time workers. Age, tenure, and earnings are factors that define the demand for pension benefits. Benefits from defined benefit plans are of less value for younger and shorter-tenure workers because of the lower probabilities that they will vest and because of the back loading of benefit accrual. Earnings provide a good proxy for the extent of the tax subsidy, an equally if not more powerful determinant of demand for deferred compensation.

An array of these variables permits inferences about whether the coverage issue is simply one of the distribution of opportunity or whether there is an equally powerful element of demand at play, in which workers with some group of attributes may be seeking employment at firms not providing coverage, preferring instead cash wages.

Figure 4 shows worker tenure in relation to the pension participation

## Percent of Workers With Short Tenure

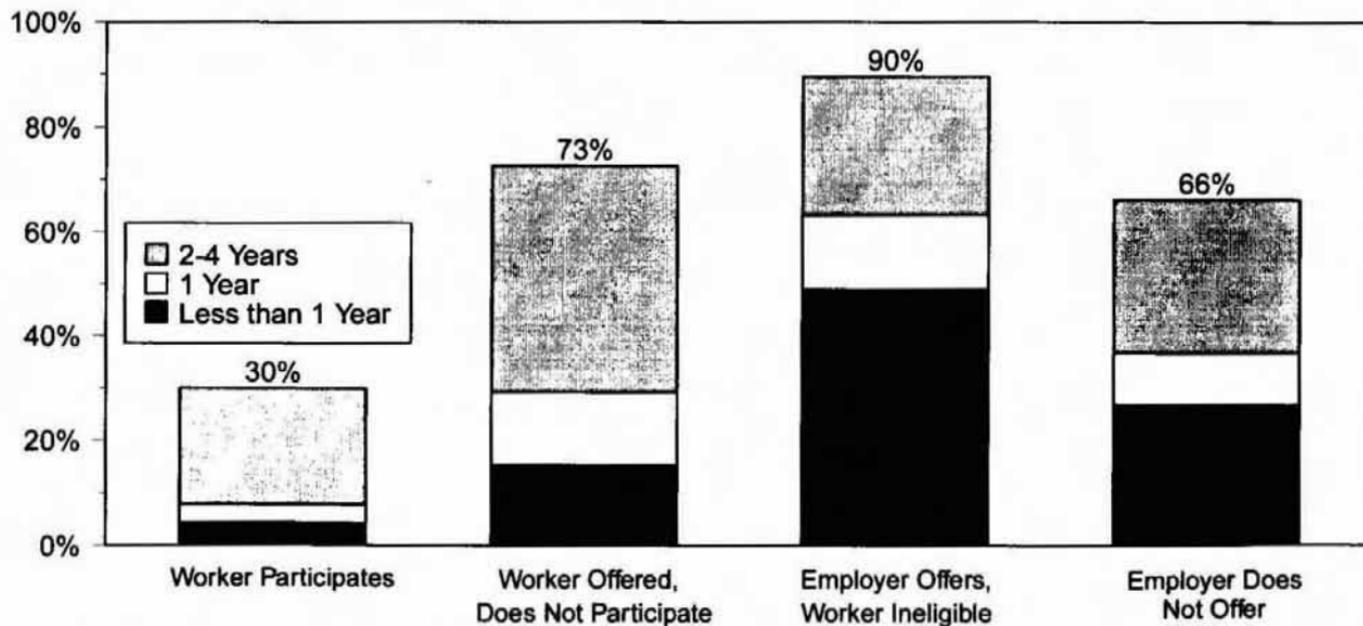


Figure 4. Sponsorship/participation categories by tenure, 1993. Source: USDOL (1994) and authors' computations using April 1993 CPS Employee Benefits Supplement.

status of workers in April 1993. The first column indicates the percentage of workers whose employer offers a plan and who participate in it; the second shows the percentage of workers who turn down an offer to participate; the third, those who are ineligible; and the fourth column, the proportion of those whose employer does not offer a pension plan. Viewing the coverage from this perspective leads to two general conclusions. The first supports the conventional wisdom. There are evidently a number of workers who are substantially "frozen out" of pension coverage due to the terms of eligibility imposed by their employer. More broadly, however, workers at firms that do not offer pension coverage share many of the attributes of those who decline to be covered even when offered the opportunity. This raises some question about whether workers would elect coverage even if their employer could be induced to sponsor a plan.

As the foregoing discussion illustrates, pension coverage is determined by a complex interaction of factors both on the supply and demand side, with workers and firms sorting so that workers with low demand for pension coverage tend to work in firms where the cost of providing pension coverage is relatively high. Small employers appear to be significantly disadvantaged in their ability to offer coverage due to the economics of scale. These same firms have a concentration of workers with attributes that suggest a low demand for compensation in the form of retirement benefits. We need look no further than the response to offers of 401(k) participation to confirm the latter. In 1993, only 65 percent of workers in firms with a 401(k) offering reported coverage. This is largely driven by low-wage and younger workers' turndowns.

### **Uncovered Workers**

The low coverage of employees at small firms may be due in part to characteristics of those employees, such as low wages, that cause them to have low demand. Because of their low wages, many employees working for small employers may prefer wages to benefits.

To illuminate that issue, we examine characteristics of workers who are offered pension coverage by their employer but turn it down. This situation arises in 401(k) plans where employee contributions are required for employee participation. Some workers turn down participation in 401(k) plans but participate in a defined benefit plan offered by their employer. Because those workers are covered, while our focus is on workers not covered, we do not consider them.

Workers in firms that offer 401(k) plans that turn down participation and do not participate in another plan offered by their employer ("401(k) turndowns") tend to be younger than participants, to be female, and to have lower education, earnings, and tenure (Table 1). In

TABLE 1 Characteristics of 401(k) Plan Participants Compared with Other Workers (all private wage and salary workers age 16 or older)

	<i>Characteristic 401(k) turndowns</i>	<i>All pension nonparticipants</i>	<i>401(k) participants</i>	<i>All private sector pension participants</i>
Median age	31	33	39	40
Median job tenure	3	2	7	8
Median annual earnings (\$)	18,200	13,700	31,400	27,300
Percent female	51	49	40	41
Percent that work full-time, full-year	84	65	93	92
Percent employed in firms with 1,000+ workers	54	22	60	56

Source: Authors' computations using the April 1993 CPS; N=19,380.

those respects, the turndowns are more similar to other nonparticipants than to 401(k) participants.

While pension nonparticipants and 401(k) turndowns are more similar to each other than to participants, pension nonparticipants have lower tenure and earnings than the 401(k) turndowns, and are less likely to work full time, full year, less likely to work in a firm with 1,000 or more employees, and less likely to have graduated from college. Because nonparticipants are less likely than 401(k) turndowns to have these characteristics associated with coverage, many nonparticipants would probably turn down coverage if their employer were to offer it.

While in most respects 401(k) turndowns resemble other pension nonparticipants, they are more similar to 401(k) participants in two respects: they are more likely to work in large firms and are more likely to work full time, full year. Firm size is an important determinant of which firms offer pension plans. Full-time, full-year status is an important determinant of eligibility in firms that offer pensions.

Among 401(k) turndowns and nonparticipants, particularly striking is the low tenure of both groups. The median job tenure of turndowns is three years, compared to two years for all pension nonparticipants and eight years for pension participants.

We further examine the low coverage rate of low-tenure workers. For each year increase in job tenure at low levels, the percentage of the labor force covered by a pension plan of any type, or by a 401(k) plan, increases (Table 2). The pension coverage rate rises from 9 percent for workers with less than one year of tenure to 52 percent for workers with 5 years.

These statistics illustrate the correlation between high turnover jobs

## 26 Why Don't Workers Participate?

TABLE 2 Pension Coverage Status of Short-Tenure Workers (% of all private wage and salary workers age 16 or older, except as indicated)

Pension status	Job tenure (%)					
	<1	1	2	3	4	5
Covered	9	20	7	40	49	52
401(K) covered	5	10	15	21	28	27
Offered 401(k) but not participating*	73 (13)	59 (14)	44 (12)	39 (13)	30 (12)	26 (10)
Employer does not offer†	63	53	52	42	38	39

Source: Authors' computations using the April 1993 CPS; N = 11,497.

\*Percentage of all workers in parentheses.

†Includes "don't know."

TABLE 3 401(k) Contributions for Low- and Middle-Income Workers Contributing to 401(k) Plans, 1993

Annual earnings	Mean contributions (\$)
Under \$10,000	503
\$10,000-14,999	782
\$15,000-19,999	1,000
\$20,000-24,999	1,418
\$25,000-29,999	1,746
\$30,000-34,999	2,198
\$35,000-39,999	2,784
\$40,000-49,999	3,242

Source: Authors' computations using the April 1993 CPS; N = 16,120.

Note: These figures represent employee contributions only.

and lack of pension coverage. This correlation indicates that defined benefit plans would not appeal to many workers lacking pension coverage because they have high job turnover and would suffer portability losses in a defined benefit plan. Thus, policies to expand coverage may be more successful if they focus on defined contribution rather than defined benefit plans.

The percentage of workers offered a 401(k) plan that chooses not to participate decreases sharply with tenure, from 73 percent with less than one year tenure to 26 percent with 5 years tenure.

Andrea Kusko, James Poterba, and David Wilcox (this volume) provide further evidence concerning 401(k) turndown and eventual job tenure. Using data from a single large firm, they find that the participation rate among new hires was lower than among other workers: only about 50

percent participated, versus 80 percent overall. The participation rate among new hires in 1989 who left the firm in 1990 was only 6.5 percent.

In sum, the typical characteristics of workers turning down 401(k) participation suggest that public policies designed to affect the supply side of pension coverage (i.e., employer's costs) may have limited effect. Even when employers offer pension coverage, workers with low tenure and other characteristics typical of nonparticipants frequently choose not to participate.

When low- and middle-income workers do participate in 401(k) plans, their contributions are generally low (Table 3). Low- and middle-income workers generally contribute far below the maximum they are allowed to contribute.

### **A Predicted Probability Analysis of Nonparticipants**

To extend the analysis of nonparticipants, we estimate a logistic regression on pension coverage. Our concern is whether noncovered workers would choose to be covered by a pension plan if their employer offered one. To investigate this, we estimate a standard regression on the probability of participating in a pension plan. Because we are focusing on worker demand for coverage, we used as explanatory variables gender, age, race, education, work status (full versus part time), earnings, and tenure. We then calculated individual prediction probabilities for all observations that appeared in the regressions, and we sorted them from low to high probability separately for covered and noncovered workers.

There is little overlap between covered workers and noncovered workers in terms of the predicted probability of coverage. Among noncovered workers, those at the top quartile in probability of coverage have a 46 percent probability of being covered. By comparison, among covered workers, those at the bottom quartile have a 48 percent probability of being covered (Tables 4, 5).

From the predicted probabilities of coverage for noncovered workers, it appears reasonably likely that 10 percent of noncovered workers would participate if offered a pension. The top 10 percent of noncovered workers have a predicted probability of coverage of at least 67 percent.

Conversely, discrimination rules may be expanding coverage among workers who have a low probability of being covered but who work for large firms. Among workers whose personal characteristics place them in the bottom quartile of predicted probabilities of coverage but who are covered, 50 percent work for firms with 1,000 or more employees.

Examining further the role of firm size in explaining low-probability coverage and low-probability lack of coverage, covered workers in the

## 28 Why Don't Workers Participate?

TABLE 4 Predicted Probability That Workers Would Participate in a Pension if It Were Offered, 1993

<i>Percentile</i>	<i>Covered workers</i>	<i>Noncovered workers</i>
10	.326	.038
25	.484	.106
50	.696	.251
75	.840	.461
90	.924	.672

*Source:* Authors' computations using the April 1993 CPS.

TABLE 5 Percentage of Workers by Quartile of Predicted Probability of Coverage, Coverage Status, and Firm Size, 1993

<i>Firm size</i>	<i>First quartile (%)</i>		<i>Fourth quartile (%)</i>	
	<i>Yes</i>	<i>No</i>	<i>Yes</i>	<i>No</i>
Fewer than 25	13.2	42.3	5.9	43.6
25-249	24.5	24.2	16.4	31.7
250-999	11.9	7.1	12.8	7.4
1,000+	50.3	26.5	64.9	17.3

*Source:* Authors' computations using the April 1993 CPS.

lowest earning quartile are more than twice as likely to work for a firm with more than 1,000 employees that are noncovered workers in the highest earnings quartile (Table 6). In most other respects, noncovered workers in the highest earnings quartile have characteristics that make them more likely to be covered than do covered workers in the lowest earnings quartile. These statistics suggest that some high-income workers would be covered by a pension if they worked for an employer that offered one, but are not because they are working for a smaller employer that does not offer a plan.

All these statistics ultimately leave those charged with formulating policies for addressing what the Committee for Economic Development (1995) recently proclaimed to be a "looming crisis" with four essential insights. First, the conventional view of coverage gaps as a supply problem originating in small firms explains part of what is happening. Second, there is also a demand side problem. Third, there is a mismatch of some workers with high-demand characteristics in low-supply firms. The fourth point is the most vexing to the economists' attempts to explain labor market and savings behavior. There are apparently many workers whose behavior does not comport with rational optimizing models. Some workers rationally do not seek coverage because social security benefits pro-

TABLE 6 Characteristics of Workers in the Highest Earnings Quartile Who Do Not Have Pension Coverage and Workers in the Lowest Quartile Who Do

<i>Characteristic</i>	<i>Highest earnings quartile—nonparticipants</i>	<i>Lowest earnings quartile—participants</i>
Median age	37	37
Median job tenure	3	5
Median annual earnings (\$)	39,520	9,880
Percent female	27	72
Percent who are full-time full-year workers	95	49
Percent employed in firms with 1,000+ workers	20	55
Percent college graduates	43	9

Source: Authors' computations using the April 1993 CPS; N = 1,889.

vide a high replacement rate for low-income workers, because pension saving is illiquid and thus cannot be used as precautionary saving, or because the life cycle model suggests that young workers will have low savings. Pension coverage, however, is essentially a highly regimented form of savings, and there is evidently a substantial part of the population whose behavior may be predicted more on some deeper psychological imperative than the current economic model incorporates.

### **What Is Wrong with the Traditional Economic Model?**

The traditional economic model of pension coverage is based on the supply and demand for pension coverage. The demand for pension coverage is determined by workers' demand for retirement savings, which is determined by the life cycle model of retirement savings.

The supply-demand model is usually extended to recognize that coverage at a firm is not entirely an individual decision but is determined by the collective demand of workers at the particular firm. Individual workers who wish pension coverage may not be covered because they work for a firm where other workers have a low demand for coverage. Nondiscrimination rules require that most workers at a firm be covered if any are covered. That point is seen when examining characteristics of workers in the highest earning quartile without coverage and workers in the lowest earnings quartile with coverage (Table 6).

The traditional supply-demand model for expanding pension coverage focuses on changes in prices. Policies based on this model focus largely on the supply side — on reducing the cost of providing benefits.

If households act as the life cycle theory of saving predicts, absent the

distorting effect of other government programs, public policy initiatives to encourage pension coverage would be unnecessary. Households would save adequately for retirement, and there would be no need for public policy to encourage retirement saving. However, transfer programs conditioned on lack of savings, such as college scholarship programs, discourage families from saving.

Further, while the life cycle model may predict the behavior of sophisticated workers who save adequately for retirement based on its principles, the life cycle model is unlikely to predict retirement savings for many workers as Thaler (1994) argues. Figuring out how much to save and the optimal savings path to take are difficult problems. With risk aversion by households causing them to weight undersaving more heavily than oversaving in utility calculations, it is not evident, however, that the difficulty of determining the optimal amount to save leads to undersaving. The preference of present over future consumption may cause households to err on the side of undersaving when they are uncertain as to how much to save.

Also, given that people only save for retirement once, the opportunities for learning by doing and correcting mistakes in subsequent repetitions are minimal. This problem is mitigated to the extent that people can adjust their hours worked, their savings rate, and their retirement date as they approach retirement and are better able to judge the amount of savings they need. However, many workers find that their labor market opportunities become more limited as they approach retirement, which decreases their flexibility in making adjustments.

The only plausible ways in which people might approximate an optimal savings plan are by learning from others (role models or experts) or by using good rules of thumb. Learning from the experience of others is difficult because changes in social security and private pension benefits make the experience of current retirees of limited value for current workers. Simple rules of thumb do not exist because the amount saved to meet a target income replacement rate depends on the age at which the savings program starts and the expected return and risk of the investment portfolio.

A further problem with the life cycle theory stems from the human failing of lack of self-control. Even if an individual could calculate the optimal amount to save in order to maximize lifetime utility, he or she might not resist the temptation of current consumption versus consumption 30 or more years hence. Rational discounting of future consumption by the probability of being alive at a distant future date also reduces the incentive to save. Insufficient self-control, however, may prevent households from saving through pension plans when theory predicts they would.

It is psychologically easier to save in some situations than others. In the past, when defined benefit plans were more prevalent, workers did not face a decision as to whether or how much to save through their pension plan. Given that they worked for an employer offering a pension plan, coverage and saving were automatic. Currently, with 401(k) plans, more burden is placed on the worker to determine how much retirement saving is needed.

Ippolito (this volume) provides an alternative explanation for why workers do not participate in pension plans. He argues that some workers have high discount rates. For them, the life cycle model does not work because they heavily discount future periods. It seems that some workers heavily discount the future because they place a low utility on future events.

### **Reasons Workers Do Not Participate in Pension Plans**

Critics of the life cycle model suggest that some workers do not participate in pension plans because of psychological factors. Economic studies indicate characteristics of workers who choose not to participate when offered a pension plan, but do not tell us specifically the reasons why they choose not to participate. A survey of federal government workers covered by the Thrift Savings Plan in 1990 provides evidence on that issue. It asked why workers choose not to contribute the plan (Table 7). In terms of standard price theory, it is difficult to understand why workers who expect to vest and who would receive dollar-for-dollar matching contributions would not contribute. The matching contribution guarantees a high rate of return on their contribution. The most common response, given by more than a fourth of men (29 percent) not contributing and more than a third of women (34 percent), was that they could not afford to contribute. While for some that response may reflect a liquidity constraint, for others it may reflect a lack of self-control in saving for retirement.

Factors other than income clearly are among the determinants of the response that a workers is unable to contribute. Eighty-one percent of the workers in the lowest income quartile do not give that response, while 7 percent of the workers in the highest quartile responded that they cannot afford to contribute (Table 8).

A number of the reasons given in the survey for not participating do not fit into the economic framework of financial reasons for nonparticipation. Nearly one in six men and women (16 percent) did not contribute because they did not understand the Thrift Savings Plan, and nearly as many (12 percent of men and 15 percent of women) did not invest because they did not have enough information. A tenth (10 per-

## 32 Why Don't Workers Participate?

TABLE 7 Reasons for Not Contributing to the Federal Thrift Savings Plan  
(percent of sample not contributing)

<i>Reasons for not contributing</i>	<i>Men</i>	<i>Women</i>
Can't spare the money	28.7	34.2
Prefer other investments	24.2	19.7
Too close to retirement	16.7	13.1
Don't understand the Thrift Savings Plan	15.7	16.0
Don't want money tied up	14.2	14.2
Don't have enough information	12.0	14.5
No confidence in the plan	10.3	5.8
Haven't considered the Thrift Savings Plan	10.1	9.6
Never got around to it	7.3	13.7
May not stay in federal government	3.9	3.8

*Source:* Authors' computations from 1990 Federal Retirement Thrift Investment Board data; N = 1,042.

*Note:* Respondents could check all applicable reasons.

TABLE 8 Workers Responding They Cannot Afford to Contribute to the Thrift Savings Plan, by Income Quartile

<i>Quartile</i>	<i>Male</i>	<i>Female</i>	<i>All</i>
(1) \$25,000 or less	17.1	21.0	19.4
(2) \$25,000-\$35,000	11.4	13.4	12.2
(3) \$35,001-\$55,000	12.6	4.8	10.0
(4) More than \$55,000	3.8	10.1	6.5
All	11.9	14.7	13.1

*Source:* Authors' computations from 1990 Federal Retirement Thrift Investment Board data.

cent) of both men and women not contributing did not contribute because they had not considered contributing to the plan. More than one-eighth of the women (14 percent) but fewer men (7 percent) did not invest because they had not bothered to do it. Thus, lack of knowledge and inertia are important reasons why workers did not contribute.

A recent study provides further evidence that the complexity of the problem of determining how much retirement income is necessary for maintaining one's standard of living in retirement may cause some people to save inadequate amounts. A Putnam Investments survey found that almost two thirds of Americans said they were "not worried" about having enough money to live on during retirement, despite not knowing how much retirement income they will need (Putnam Investments 1995). Supporting the evidence as to lack of knowledge about the amount of

saving necessary for retirement, a survey by the Employee Benefit Research Institute (EBRI) found that 70 percent of survey respondents did not know how much they needed to save for retirement (Yakaboski 1995). These reasons suggest that better participant education by plan sponsors may increase pension coverage (Bernheim, this volume).

### **What Can Public Policy Do?**

Legislative initiatives in recent years have reflected a growing (although rarely explicit) recognition of both supply and demand elements of pension coverage. By 1990, legislation designed to expand pension coverage had been sponsored by members of Congress from both parties, including such luminaries as Senator Lloyd Bentson, then chairing the Senate Finance Committee, and Representative Dan Rostenkowski, presiding over the House Ways and Means Committee. Their efforts originated with the concept of "pension simplification," whose lineage was readily traceable to the so-called "tax simplification" efforts of the mid 1980s. These multipronged initiatives ultimately culminated in the passage of H.R. 11, the Revenue Act of 1992, shortly before the presidential election.

That bill directly addressed two of the limitations to coverage outlined above. It sought to expand the sponsorship of defined contribution plans by easing perceived limitations for small employers. And by providing simplified rules for nondiscrimination testing, it tried to address the problem of the high-demand worker in a firm with workers with a lower propensity to participate in a pension plan.

These objectives were approached in two ways. The bill would have expanded the availability of Salary Reduction Simplified Employee Plans (SARSEPs, or essentially employer-organized IRAs with higher contribution limits) by permitting firms with up to 100 employees to sponsor the plans. It would also have relaxed the nondiscrimination rules by allowing contributions to these plans even if fewer than 50 percent of the sponsor's employees elected to contribute. It also would have provided two alternative ways of satisfying the 401(k) nondiscrimination rules: by permitting sponsors (1) to match 100 percent of the first 3 percent of elective deferrals and 50 percent of employee contributions up to the first 5 percent of salary, or (2) to provide an employer contribution of 3 percent for each non-highly compensated participant.

Returning from Houston following his defeat by Bill Clinton, however, President George Bush vetoed the bill on the basis of the tax increases it also contained.

In June 1995, the Clinton administration announced its version of pension simplification. That bill, however, met the same fate as its pre-

decessor, its demise resulting from the fact that it was included in a legislative package emerging from the new Republican majority's grand plans to balance the budget by extracting unprecedented changes in the structure and spending on entitlement programs, most notably Medicare. Much like President Bush before him, while apparently continuing to support the objectives of the pension simplification measures, President Clinton vetoed the bill in late 1995.

The first two rounds of legislative failures, with similar bills passed by Congresses dominated by both parties and vetoed by both a Republican and Democratic president, demonstrated the capacity for consensus on the issues, if not a practical resolution.

Despite this history, or more likely because of the continued popularity of the approach, in early 1996 President Clinton announced an expanded version of the earlier pension proposals, and in August 1996, he signed the Small Business Job Protection Act. This act established a new type of pension plan, the Savings Incentive Match Plan for Employees—or SIMPLE. Employers with 100 or fewer employees earning \$5,000 or more in the previous year are eligible to establish this type of plan. A SIMPLE pension is a salary reduction plan that allows employees to contribute up to \$6,000 of pretax pay per year (the amount to be indexed for inflation in \$500 increments). The employer must either (1) make a 100 percent matching contribution, not to exceed 3 percent of compensation, or (2) make a 2 percent nonelective contribution to all eligible employees with \$5,000 or more in compensation the preceding year. For the nonelective contribution, there is a compensation ceiling of \$150,000. All contributions vest immediately. This plan is intended to reduce the administrative and financial burden on small employers associated with establishing and maintaining a pension plan.

### **Policy Impact**

CPS data can be used to assess the likely increase in coverage that would result from various policies. Policies that take a supply side approach attempt to encourage small firms with relatively high costs to act more like large firms with relatively low costs. An estimate of the maximum effect of such policies, including the maximum effect of the SIMPLE plan, can be obtained by assuming that workers in small firms are actually in large firms. We recalculated the predicted probability of coverage for small firm workers assuming they were employed in large firms, of more than 1,000 workers. The predicted probability calculations were done by removing the effects of variables whose estimated coefficients were statistically insignificant at the 5 percent level. The predicted probability of

participation for small firms (fewer than 100 workers) more than doubles from 0.22 to 0.53. When this increase in probability is applied to the 1993 CPS weighted population of nonparticipating workers in small firms, an increase in coverage of 9.7 million workers is predicted. Because this estimate uses 1993 worker counts, it underestimates the likely effect of a policy change occurring in a later year.

The second type of policy considered focuses on reducing or eliminating the requirements of nondiscrimination in small firms so that high-demand workers in those firms could obtain coverage. The effect of such a policy can be estimated by calculating the number of workers in small firms who are not covered, but have a high predicted probability of coverage. There are 6.2 million workers in firms of 249 workers or fewer who are not covered with a predicted probability of coverage of 74 percent or higher.

Third, there is the large group of workers in both small and large firms who are predicted to be covered but are not. We estimate that there are 7.7 million workers in firms of all sizes with a predicted probability of coverage of 80 percent or higher, who are not currently covered. This figure provides an upper bound estimate on the number of workers who are predicted to be covered on the basis of economic and demographic variables but who are not covered, perhaps because of psychological reasons or because of economic reasons not currently recognized in empirical models. Combining that figure with the figure for workers in small firms who are not covered but probably would be if they were in large firms involves some double counting, but provides an upper bound estimate of 17.4 million additional workers who might be covered by pension coverage initiatives.

## **Conclusion**

More than 50 million Americans do not participate in a pension plan at their current job. This is the result of a complex array of factors that include lack of opportunity to participate in such plans, a low level of demand for compensation in the form of pension benefits by many workers, and limitations related to the composition of workers within many firms. Recent years have seen a fairly narrow range of legislative initiatives directed toward enhancing coverage, although these have increasingly recognized the demand side of the coverage equation.

At best, we can expect legislative changes to extend coverage to a quarter to a third of currently uncovered workers, with actual results likely to be considerably lower. The apparent dynamics of pension coverage indicate that achieving greater results is likely to require efforts to

address the psychological elements that limit workers' capacity or motivation for saving to as great an extent as they are directed to by economic considerations. In this respect, we have, as Winston Churchill said, reached "not the beginning of the end, but rather the end of the beginning" in our efforts to achieve universal coverage.

The authors gratefully acknowledge the assistance and comments of Daniel Beller, Susan Benner, David McCarthy, Phyllis Fernandez, and William Ross. The paper represents the views of the authors and does not represent the position of the U.S. Department of Labor or of the International Labor Office.

### Notes

1. The issues related to the debate over the savings of the baby boom generation are surveyed in Hinz and Turner (1994).
2. Tax Equity and Fiscal Responsibility Act of 1982, Deficit Reduction Act of 1984, Tax Reform Act of 1986, and Retirement Equity Act of 1984.

### References

- Bernheim, B. Douglas. "Financial Illiteracy, Education, and Retirement Savings." This volume.
- Chen, Yung-Ping. "The Role of Private Pensions in the Income of Older Americans." In John A. Turner and Daniel J. Beller, eds., *Trends in Pensions 1992*. U.S. Department of Labor, Washington, D.C.: USGPO, 1992: 343-417.
- Committee for Economic Development. *Who Will Pay for Your Retirement? The Looming Crisis*. New York: Committee for Economic Development, 1995.
- Hinz, Richard P. and John A. Turner. "Baby Boomers in Retirement." *Contingencies* (March/April 1994): 20-23.
- Hustead, Edwin C. "Trends in Retirement Income Plan Administrative Expenses." This volume.
- Korczyk, Sophie M. "Pension Coverage Gaps in Firms with Coverage." Report to the U.S. Department of Labor, Pension and Welfare Benefits Administration, 1994.
- Kusko, Andrea L., James M. Poterba, and David W. Wilcox. "Employee Decisions with Respect to 401(k) Plans." This volume.
- Long, Stephen H. and M. Susan Marquis. "Gaps in Employment-Based Health Insurance: Lack of Supply or Lack of Demand." In U.S. Department of Labor, Pension and Welfare Benefits Administration, *Health Benefits and the Workforce*. Washington, DC: USGPO, 1994.
- Putnam Investments. "'... Like There's No Tomorrow': Examining Americans' Attitudes About Retirement and Saving." Boston: Putnam Investments, 1995.
- Thaler, Richard H. "Psychology and Savings Policies." *American Economic Review* 84 (May 1994): 186-92.
- U.S. Department of Labor, Pension and Welfare Benefits Administration. *Pension*

*and Health Benefits of American Workers: New Findings from the April 1993 Current Population Survey.* Washington, DC: USGPO, 1994.

U.S. Small Business Administration. *The Annual Report on Small Business and Competition.* Washington, D.C.: USGPO, 1993.

Yakoboski, Paul. "Are Workers Kidding Themselves? Results of the 1995 Retirement Confidence Survey." *EBRI Issue Brief* No. 168. Washington, D.C.: Employee Benefit Research Institute, 1995: 1-3.