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401(k) Plans and Women: A "Good News/Bad News" Story

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Introduction

Over the past two decades, coverage under employer-sponsored pension plans has shifted from traditional defined benefit to 401(k)-type defined contribution formats. This shift has many important implications for retirement security. This brief examines the differential impact of the transition for men and women.

For women, the shift from defined benefit to 401(k) plans is a "good news/ bad news" story. When women are employed and accruing retirement income benefits, the news is good. 401(k) plans are better for short-tenured workers, and women are more likely than men to have short tenures. Therefore, more women are likely to end up with more benefits and their benefits are likely to be larger when they have a 401(k) plan rather than a traditional defined benefit plan. The bad news arrives when women retire. As women tend to live longer than men, their 401(k) balances must provide an income stream over a longer stretch of time. Should they wish to annuitize a portion of their 401(k) accumulations at retirement, they will find that insurance companies compensate by providing smaller benefits to women, and larger benefits to men. In defined benefit plans, men and women with comparable work histories would get the same monthly benefit.

Women who rely on their husband's earnings and pension benefits are also affected by the shift from defined benefit plans to 401(k)s. Under traditional defined benefit plans, the government requires that the worker receive a joint-and-survivor annuity at retirement, unless the spouse specifically waives the requirement. This provision gives the wife a legal claim on her husband's pension benefit. No such automatic claim exists with 401(k) plans.

At this point, it is unclear whether the good news or bad news will carry the day. But the outcome is extremely important because women have not done well in our retirement income system. Among elderly women without a husband, more than one in four is poor or near poor. Among single women age 85 and over, the figure approaches one in three.

To date, elderly women have relied heavily on Social Security, but in the future Social Security will replace a far smaller share of pre-retirement earnings than it does at present. Fortunately, women's labor force participation, earnings, and participation in employer plans have all increased significantly over the past three decades. Their retirement income security thus will depend increasingly on 401(k) plans, so it matters a lot whether the good news in the accumulation of benefits sufficiently outweighs the bad news in the payout of benefits.

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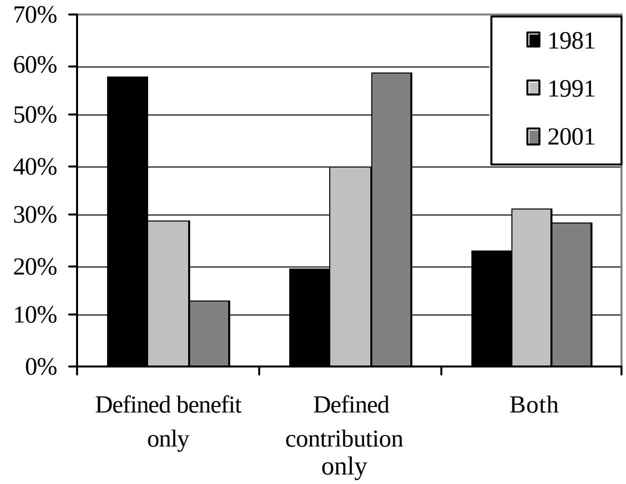
Coverage Has Shifted to 401(k)s

The nature of employer-sponsored private pension coverage has changed dramatically over the past twenty years. In 1981, roughly 60 percent of those with pensions relied exclusively on a defined benefit plan; in 2001, the percentages had reversed and nearly 60 percent relied solely on a 401(k) or similar defined contribution plan (See Figure 1).

Figure 1. Perecent of Wage and Salary with Pension Coverage, by Type of Plan, 1981-2001



Source: Munnell and Sundén (2004).

The two types of plans differ along a number of dimensions. Under a defined benefit plan, the employee receives a pension based on years of service and earnings just before retirement. The benefit is usually paid as an annuity over the employee's remaining lifetime. The employer finances these benefits by making pre-tax contributions into a pension fund; employees typically do not contribute. In contrast, 401(k) plans are savings accounts. Generally, the employee, and often the employer, contributes a specified percent of earnings into the account. These contributions are invested at the direction of the employee, mostly in mutual funds consisting of stocks and bonds. Upon retirement, the worker generally receives the balance in the account as a lump sum.

Several aspects of the shift in pension coverage are likely to affect men and women differently.

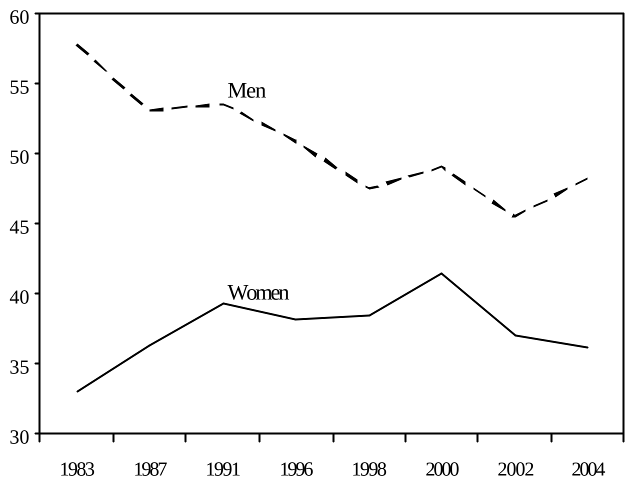
Women Workers Likely to Acquire More Benefits in 401(k) Plans

One key difference between traditional defined benefit plans and 401(k) plans is the extent to which people can take their benefits with them when they move from job to job or in and out of the labor force. Basically, workers with 401(k) plans can take their full accumulations with them when they leave, while workers with traditional plans suffer a loss when they shift jobs.

Workers with defined benefit plans who change jobs, even among firms with identical plans and immediate vesting, receive significantly lower benefits than workers with continuous coverage under a single plan. The reason is that benefits for job changers are based on earnings at the time they terminate employment. Workers who do not change jobs see their earnings rise over their career due to inflation, productivity growth, and promotions. They gain, relative to job changers, from the increase in retirement benefits due to this growth in earnings. For example, consider a plan that pays 1 percent of final earnings for each year of service. The worker who leaves with 15 years of service and a $50,000 salary at age 45 will be entitled to an annual benefit at age 60 of $7,500 (15% x $50,000). If the worker had remained with the firm to age 60 and retired with a final salary of $90,000, he would have received an annual benefit of $13,500 (15% x $90,000) for those *same* 15 years of service. Thus, shifting jobs is costly with defined benefit plans.

In contrast, a worker with a 401(k) plan can take the full value of her own contributions and her employer's contributions, once vested, when she moves from one job to another. As a result, workers with 401(k) plans do not forfeit any benefits when they change employers. That is, for any given level of pension expenditure, 401(k) plans favor the mobile worker. Women workers tend to have shorter tenures than men. As shown in Figure 2, in 2004 about 35 percent of women aged 45-49 have been on their current job for ten years or more compared to almost 50 percent of men. Because women generally have less tenure and are more mobile, they gain from the shift from defined benefit to 401(k) plans.

Figure 2. Perecent of Workers 45-49 with 10 Years or More of Tenure with Their Current Employer, Selected Years 1983-2004



Source: Bureau of Labor Statistics (2003).

Women Likely to Need More Assets in 401(k) Plans

While women workers gain from the portability resulting from the shift to 401(k) plans, they lose from the fact that benefits are distributed as lump sum distributions.

A key decision all elderly households with 401(k) plans must make is how to draw down those assets and create a stream of retirement income. A major risk is "longevity risk" — that is, individuals cannot accurately predict how long they will live. This risk poses two vexing alternatives. The first is outliving their assets — that is, they use up their nest egg too quickly and then lack the resources needed to support themselves or their surviving spouse. The second is that they worry too much about outliving their assets, deprive themselves of things they want or need to the point of hardship, and die with a substantial amount of money on hand. To eliminate longevity risk, households would have to use at least a portion of their assets to purchase an annuity, which provides beneficiaries an income for the remainder of their lives.

The shift to 401(k) plans has made longevity risk a serious problem. As noted above, while traditional defined benefit plans pay out benefits as annuities, 401(k) plans pay lump sums. Today, women at age 65 are expected to live about 3 years longer than men, which means they have a significant chance of living in retirement to very old ages; for example, 31 percent of women age 65 will be expected to live at least to age 90 (see Table 1). As a result of these extended life expectancies, women will need money for a very long period of time. The payment of 401(k) benefits as lump sums will particularly hurt women by exposing them to longevity risk.

Table 1. Percent of 65-Year-Olds Surviving to a Given Age

Age	Male	Female
70	88	92
75	74	82
80	56	69
85	36	51
90	17	31
95	6	13

Source: Unpublished data from the Social Security Administration as reported in Munnell and Sundén (2004). These percentages are for people born in 1935 who reached age 65 in 2000.

Annuities are the most efficient instrument for managing longevity risk, but the shift from defined benefit to 401(k) plans has significantly changed the relative price of annuities for women and men. The reason is that annuities provided under defined benefit and 401(k) plans are regulated by different legal regimes. Federal labor law covers annuities provided through defined benefit plans and requires equal pay for equal work. The Supreme Court has interpreted this law to mean that a man and woman with equal earnings histories should receive equal monthly benefits, even though women live longer on average than men and thus would be expected to receive higher lifetime benefits.

In contrast, retirees who want to annuitize a portion of their 401(k) account balances must take their money to an insurance company. (401(k) plans may offer an annuity withdrawal, which would also be required to provide equal benefits to men and women. But few 401(k) plans offer such an option.) Insurance companies, which are regulated by state insurance law, provide a smaller monthly benefit to women than to men, all else equal, to compensate for their longer life expectancy. According to online quotes in December 2004 from Immediateannuity.com, a 65-year-old woman purchasing a $100,000 lifetime annuity contract could expect to receive $616 per month where a man of the same age would get $654 per month.

Both federal and state regulators are attempting to be "fair;" they simply look at the issue differently. Insurance companies use average life expectancy to calculate the income provided under an annuity contract. On average, life expectancy at 65 is 19 years for women and 16 years for men. Insurance companies thus pay a larger monthly benefit to men, since on average they expect to make fewer such payments to men than to women. In the end, insurers expect that the present value of the amounts paid out to men and women will be equal.

In contrast, the Supreme Court considered the full distribution of mortality rates, and the uncertainty implicit in the distributions, instead of average life expectancy. Figure 3 shows that the death ages of men and women overlap significantly. In fact, it is possible to match 86 percent of the death ages of these two groups, the shaded area in the figure. Because of this overlap, the Court disallowed the use of sex as a predictor of an individual's life expectancy, and instead required equal monthly benefits for equal contributions.

Regardless of the rationale, the upshot of the shift to 401(k)s is that a woman will have to pay more for an annuity (or conversely receive a lower payment for a given lump sum) when she takes her money to an insurance company than she would have if she had received an annuity through a traditional defined benefit plan.

FIGURE 3. DEATH RATES FOR MEN AND WOMEN PER 100,000 LIVES AT AGE 65

Source: U.S. Department of Health and Human Services (1999).

Wives Lose Claim to Husband's Accumulations

Married women who rely on their husband's earnings and pension benefits are much less protected in a 401(k) world than they were under defined benefit plans.

Under a defined benefit plan, a married woman has a legal claim on her husband's benefit. This was not always true. In the old days, when men retired and started collecting their monthly benefits, husbands could choose between a single-life or joint-and-survivor annuity, which provides benefits for the wife after her husband dies. Husbands typically selected the single-life annuity, probably because it pays higher monthly benefits. The wives, who typically outlived their husbands, then lost all pension income when their husbands died. In 1974, the government required that all pension plans that provide annuities automatically pay married couples in the form of a joint-and-survivor annuity. (In 1984, the government toughened this protection by requiring the spouse's notarized signature when the joint-and-survivor option was rejected.) Instituting the default significantly increased protection for wives.

Married women currently have no legal right to control the disposition of their husband's 401(k) assets. This is a serious problem as married women are generally younger than their husbands, live longer, and typically suffer a sharp decline in living standards when their husbands die. Married women thus have much greater need for a retirement income they cannot outlive. Most likely they have a greater stake in putting some funds into an annuity. Their husbands, however, typically have earned more and have accumulated the majority of the couple's 401(k) assets. The lack of a legal claim to her husband's plan inevitably weakens the woman's role in controlling the dispensation of the couple's 401(k) accumulations. In this regard, the shift in pension coverage to 401(k) plans has made retirement less secure for married women.

Conclusion

Coverage under employer-sponsored pension plans has changed dramatically. Beginning with the baby boom generation, workers will largely rely on 401(k) plans for retirement income security. 401(k) plans are definitely better than defined benefit plans for short-tenured workers, and women tend to have shorter job tenures than men. On the other hand, the change in plan structure means that women must stretch their benefits over longer life expectancies and bear significant longevity risk. And if they want to convert their retirement wealth into an annuity, they now pay a higher price. Finally, the shift to 401(k)s has eliminated the rights of married women established when the joint-and-survivor annuity became the default in defined benefit plans. Women live longer than men, and any impediment to their being able to annuitize at least some of the household's pension wealth puts them at risk in their 80s and 90s. This is of particular concern given the projected decline in earnings protection through Social Security—the mainstay for most older women at the end of their lives.

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