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WHY DON'T LOWER-INCOME INDIVIDUALS HAVE PENSIONS?

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Introduction

About half of U.S. private sector workers do not participate in a retirement plan at their current job.[1] Not surprisingly, non-participants are more likely to have lower incomes. Low participation is becoming a more serious concern as individuals will need more retirement savings due to declining Social Security replacement rates and longer lifespans. In response, policy experts have proposed ways to expand participation in 401(k)s and similar employer-based savings plans. Assessing the potential of these options requires a precise understanding of *why* individuals, particularly those with lower incomes, do not have pensions, which is the topic of this *brief*.[2]

The discussion is organized as follows. The first section introduces the four links in the pension participation chain: having a job; working for an employer with a plan; being eligible for the plan; and taking up the plan. The second section describes the data and sample. The third section pinpoints the weakest links in the chain; and the fourth section assesses the potential of policy reforms. The final section concludes that the key reasons for the lack of pension participation among lower-income individuals are a lower likelihood of being employed and, if employed, of working for a firm that offers a plan. Take-up rates are less of a factor for today's older workers, but will become increasingly important as voluntary 401(k) plans continue to replace mandatory defined benefit plans. Thus, the most effective way to increase participation would be to provide all workers with access to a plan and automatically enroll them.

Mechanics of Pension Participation

Obtaining an employer pension involves four steps. First, to be associated with a plan, an individual must work regularly. Lower-income individuals, perhaps due to a lack of education and job skills, have weak labor force attachment and higher unemployment rates.[3]

Second, a worker must work for an employer that offers a pension to at least some of its employees; that is, the worker needs a "good" job with the prospect of fringe benefits. Previous research finds that lower-income workers are less likely to be at firms offering fringe benefits like health insurance, paid time off,

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and disability insurance.[4] But less is known about their likelihood of working for a firm offering a pension.

Third, if a pension is offered by the employer, the worker must be eligible for coverage. Many firms make pension plans available only to workers with sufficient tenure and hours worked. Though the concept of "vesting" – accumulating enough tenure to be eligible for a pension – is more common in traditional defined benefit plans, some defined contribution plans make eligibility for an employer match conditional on a minimum tenure length. In addition, part-time workers are less likely to be eligible for any type of plan.

Finally, to participate in a pension plan, the eligible worker must take up the employer's offer. This issue is not relevant for defined benefit plans, which typically require participation. But, in recent decades, pension coverage in the private sector has rapidly shifted to defined contribution plans, primarily 401(k)s. Participation in a 401(k) is voluntary, and many of the factors that limit 401(k) participation among workers at all income levels are particularly relevant for those with lower incomes. The net effect is that lower-income people are much less likely than their higher-income counterparts to participate in a retirement plan. The question is where are the weak links in the participation chain?[5]

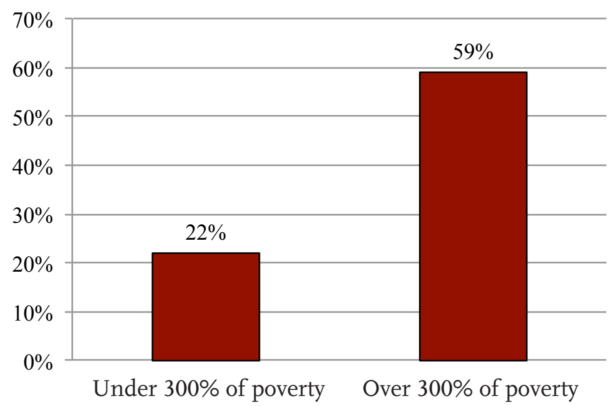
Data and Sample

The data are from the 1992-2010 waves of the *Health and Retirement Study* (HRS), a longitudinal survey covering households with members over age 50. The HRS contains data on an array of household characteristics, including labor force attachment, earnings, and pension coverage.[6] With respect to pensions, the HRS asks whether the respondent is participating in a plan. For non-participants, it asks whether their employer offers a plan, whether they are eligible to participate, and whether eligibility depends on full-time status.

The main sample consists of respondents age 50-58 who answered the pension questions and whose household income is less than 300 percent of the poverty line. While this level may be higher than the typical threshold for defining "lower-income," it is necessary to capture a sufficient share of individuals who are working and who have jobs that offer pensions.[7] The analysis compares older lower-income individuals to older individuals with household incomes of more than 300 percent of the poverty line.

For the core sample of lower-income individuals, the average pension participation rate at a current job was just 22 percent over the 1992-2010 period, well below the 59-percent rate for higher-income individuals (see Figure 1). Within the lower-income sample, those with pensions are substantially better educated, more likely to own their homes, have higher incomes and are more likely to have had a pension in their previous job. They are also more likely to work for a large employer, have a longer job tenure, and be in a white-collar job.

Figure 1. Average Pension Participation Rates for Individuals Age 50-58, by Household Income, 1992-2010

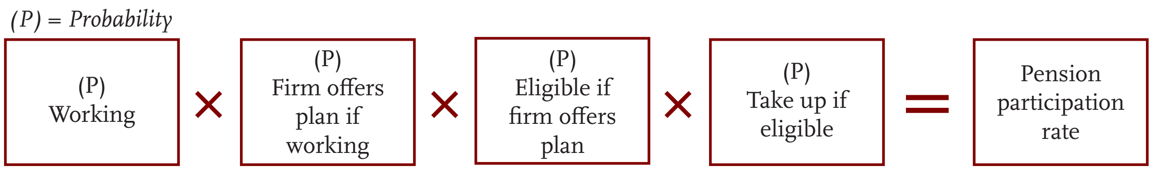


Source: Wu and Rutledge (2014).

Weak Links in the Chain

What is the relative importance of the four links in the pension participation chain: employment, employer offer, eligibility, and take-up? The question is addressed using a decomposition procedure that follows a technique previously used to analyze health insurance coverage.[8] The percentage of the sample employed is an unconditional probability; the remaining three elements are all conditional probabilities that rely on meeting the previous condition (e.g.

Figure 2. Pension Participation Chain



Source: Authors' illustration.

conditional on being employed, does the employer offer a pension plan to any of its workers). The four probabilities (P) multiplied together equal the percent who participate in pensions (see Figure 2).

The results of the decomposition show that the low participation rates of lower-income respondents are driven primarily by weak labor force attachment and working for a firm without a pension (see Table 1). Only about half of the lower-income individuals are working and, among those who are working, only about 60 percent work for firms that offer a pension. These figures indicate serious trouble spots for participation. Eligibility and take-up rates among the lower income also help to explain their low participation, but these factors are considerably less important as both are between 85-90 percent.

Table 1. Pension Participation Rate and Its Components, Individuals Age 50-58, 1992-2010

Condition	Under 300% of poverty line	Over 300% of poverty line
Individual is working	49%	79%
Firm offers pension if working	× 59%	× 82%
Worker is eligible if firm offers	× 89%	× 95%
Worker takes up if eligible	× 86%	× 95%
Pension participation	= 22%	= 59%

Source: Wu and Rutledge (2014).

How Much Could Policy Changes Help?

In considering how policy changes could expand pension participation, it is important to exclude the individuals in the sample who work for firms that offer defined benefit coverage.[9] The reason is threefold. First, as these plans are in the process of disappearing from the private sector, today's older workers are much more likely to be covered by defined benefit plans than tomorrow's older workers. Second, because defined benefit plans are not voluntary – meaning that take-up rates are essentially 100 percent – including them in the sample overstates the take-up rate. Third, policy options to expand coverage generally involve some type of defined contribution plan. So, defined benefit plans are simply not relevant to the reform discussion.

When the "defined benefit" workers are excluded from the sample, the take-up rate for lower-income workers drops from 86 percent to 78 percent (see Table 2). Therefore, from this vantage point, take-up rates are a weaker link than is apparent from looking at the full sample. The overall participation rate also drops because each link in the chain is weaker.

To assess the implications of policy reforms, the conditional probabilities for each link in the participation chain can be used for a back-of-the envelope

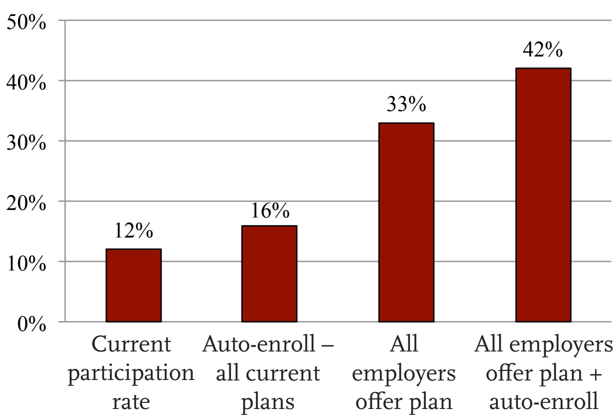
Table 2. 401(k) Participation Rate and Its Components, Lower-Income Individuals Age 50-58, 1992-2010

Condition	Under 300% of poverty line
Individual is working	42%
Firm offers 401(k) if working	× 44%
Worker is eligible for 401(k) if firm offers	× 84%
Worker takes up 401(k) if eligible	× 78%
401(k) pension participation	= 12%

Source: Authors' calculations.

calculation. For example, if all existing 401(k)s offered full-scale auto-enrollment – applied both to new hires and to current workers on an annual basis – it could increase the potential take up among eligible lower income individuals from 78 percent to as much as 100 percent. The 100 percent is an upper bound as individuals would still be able to opt out. To calculate the participation rate under such a policy change, the four probabilities in Table 2 are multiplied together. The participation rate would be, at maximum, .42 (working) x .44 (firm offer) x .84 (eligible) x 1.0 (take-up rate) = 16 percent (see Figure 3). Compared to the baseline rate of 12 percent, this type of auto-enrollment policy is an improvement but it only helps those who already have access to a plan.

Figure 3. Potential Upper-Bound Effects of Policy Alternatives on 401(k) Participation Rates of Lower-Income Individuals Age 50-58



Source: Authors' calculations.

A more ambitious proposal would be to require all employers to offer pensions to their workers, similar to a universal IRA. In this case, both the offer rates and eligibility rates are assumed to rise to 100 percent. If the take-up rate remains unchanged from the baseline of 78 percent, the potential participation rate would increase to 33 percent (.42 x 1 x 1 x .78).[10] Taking it one step further, if all workers were eligible *and* they were auto-enrolled, the participation rate would be, at most, 42 percent (.42 x 1 x 1 x 1).[11] These policies could also be paired with features like automatic-escalation in the saving rates to help ensure that participants are putting enough aside. Of course, providing universal pension coverage in the workplace would still leave a large fraction of lower-income individuals without coverage due to their low employment rates. Thus, the only way to further expand participation would be through measures to boost employment.

Conclusion

Among today's older lower-income individuals, the most important reasons for low pension participation rates are a lack of employment and employment with firms that do not offer any pensions. Going forward, as defined benefit plans disappear from the private sector, low take-up rates will also become a significant contributor to low coverage rates among older workers. Overall, these findings suggest that the most potent approach for boosting pension participation would be requiring employers to offer *all* workers access to a retirement saving plan that includes auto-enrollment. Such a policy would, however, not help lower-income individuals of working age who are not employed. Tackling this thornier issue would require measures to boost employment.

Endnotes

1 Munnell and Bleckman (2014).

2 This *brief* is adapted from a recent study by Wu and Rutledge (2014).

3 Holzer and Martinson (2005).

4 Farber and Levy (2000); Phillips (2004); and Levy (2004).

5 Previous research has confirmed that lower-income people have lower 401(k) participation rates, but the exact reasons are less clear. See Bassett, Fleming, and Rodrigues (1998); Huberman, Iyengar, and Jiang (2007); Munnell et al. (2009); Butrica et al. (2009); and Poterba, Venti, and Wise (2010). Karamcheva and Sanzenbacher (2014) focus on pension participation decisions among lower-income workers; they conclude that those most likely to participate tend to seek out jobs that offer coverage.

6 Throughout this *brief*, "household" refers to the individual and his spouse, if present, ignoring the characteristics of any other household member.

7 For more details on the data and sample, see Wu and Rutledge (2014).

8 Buchmueller et al. (2007).

9 Some workers are covered under both defined benefit and 401(k) plans. These workers are excluded in the analysis discussed in this section.

10 Karamcheva and Sanzenbacher (2014) suggest that lower-income workers who are *not* currently eligible for a pension plan would be more likely to opt out than the lower-income workers who *are* currently eligible. In other words, their take-up rate could be considerably less than 78 percent.

11 This example is similar to the "Automatic IRA" proposal offered by President Obama that was never adopted. President Obama's new MyRA program differs in that it is a strictly voluntary plan; employers can choose whether to offer it.

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