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This study examines the process of "incremental privatization" of retirement income—a slow decline in the proportion of retirement income from Social Security relative to retirement income derived from employer-provided pensions (private and government) and IRA-type Accounts. The findings reveal that since the mid 1970s the elderly in the bottom 40% of the income distribution experienced a minimal increase in retirement income from pensions other than Social Security, while those in the upper ranges showed steady gains in income from private sources. This trend is accompanied by increasing inequality in the ratio of retirement income of those in the lower quintiles to those in the upper quintiles.

Since the late 1970s, the reform of Social Security has become an issue of vital concern to the industrialized welfare states. The concern stems from mounting pressures on the fiscal integrity of Social Security systems, generated in the main by an increased ratio of retirees to employed persons, rising longevity, and the maturation of benefit levels, compounded by low rates of economic growth. These factors have precipitated a dramatic increase in Social Security expenditures; in the U.S. public spending on OASDHI rose from 3.7% of the Gross Domestic Product in 1970 to 6.9 in 1993 and is estimated to climb to between 10–13% of the GDP by 2050 (Steuerle and Bakija, 1994). Indeed, between 1995 and the middle of the next century, spending on old-age pensions as a percent of the GDP among the industrialized nations is projected to almost double in Denmark (6.8 to 11.5%),Germany (11.1 to 17.5%), Norway (5.2 to 11.5%), Spain (10 to 19%), Japan (6.6 to 16%), and the Netherlands (6 to 11.4%) (Roseveare, Leibfritz, Fore, & Wurzel, 1996). The rising expenditures reflect forecasts of a major demographic shift according to which the proportion of people over 65 in most OECD countries is expected to double between 1986 and 2040—amounting to 20–25% of their populations (about half of these elderly will be over 75) (OECD, 1988a).

Various reforms have been proposed and enacted in response to these pressures. These reforms may be viewed along a continuum ranging from measures designed solely to brace the public system, based most often on the universal pay-as-you-go model, to schemes for the complete privatization of retirement income. At one end of this continuum, efforts to restore the fiscal integrity of the existing Social Security system involve reforms intended to decrease benefits or increase revenue through measures such as raising the age of retirement, re-indexing benefits, taxing benefits, altering the coverage status of dependents, and increasing contributions. Reforms at the other end of the continuum are guided by government policies that explicitly incorporate private schemes, to varying degrees, as a source of funding in an overall plan for retirement income. The most comprehensive measures for intentional privatization can be found, for example, in Chile, which introduced policies in 1981 that replaced the state- and employer-supported public pension system with a new scheme of mandatory individual accounts, invested and managed through the private sector (Tracy & Pampel, 1991). The Chilean experience has attracted serious attention (Myers & Diamond, 1996; Turner & Watanabe, 1995; Queisser, 1995; Vittas and Iglesias, 1992). Institutions such as the Workd Bank (1994) and the CATO Institute (Borden, 1995) have promoted the Chilean model of privatization, emphasizing the favorable rates of return during the program's early years. In recent times, however, pension fund returns declined from the 12% average registered during the first 15 years to gains of only 2.5% to 4.7% between 1994 and 1997; in 1998 the Chilean stock market lost 25% of its dollar value and the pension funds were down an average of 5% (Kraus, 1998).

Also moving toward privatization, somewhat narrower measures were introduced in Britain, which has a two-tiered system of Social Security composed of a basic flat-rate public pension that is topped-up by a mandatory earning-related pension. The British Social Security Pensions Act of 1975 encouraged contracting-out the earnings-related portion of pension benefits to private sources (Glennerster, 1985; Daykin, 1995). The earnings-related portion of British pensions is growing and is expected to amount to one-third of social security costs by 2030 (Turner & Watanabe, 1995); Japan also allows contracting-out on the earnings-related segment of Social Security (Turner & Watanabe, 1995).

UNGUIDED PRIVATIZATION

At some point along the continuum, the line between legislative reforms intended to repair the public system and those designed to promote privatization begin to blur. The result is incremental movement toward privatization unguided by explicit policies to incorporate private schemes within an overall public plan for insuring retirement income. In the absence of an overall plan, the reforms operate simply to increase the relative role of the private sector within the existing framework of public and private pension alternatives. A process of what might be termed "unguided incremental privatization" begins to emerge around the mid-point of the continuum where a combination of policies that erode Social Security pension benefits are joined by policies that support private employer-related alternatives (Gilbert & Gilbert, 1989). The incremental process of privatization involves a slow steady decline in the percent of retirement income from Social Security relative to the percent of retirement income derived from employer-provided pensions (private and government) and IRA-type accounts. Although employer-related pensions for government employees partially financed by units of government are not "private" in the literal sense, in their diversity they resemble more the private exchange of fringe benefits for labor negotiated between employer and employees in the private sector than standard publicly mandated intergenerational transfer under universal Social Security programs. The process of incremental privatization is unguided when this slow steady movement occurs in the absence of national policies that specify and regulate the proportional relationship between Social Security and employer-provided benefits. This process is exemplified by reforms initiated in the United States since the 1980s.

The United States has adopted policies that encourage participation in employer-related and IRA-type schemes and that set regulatory standards for employer-related pensions. However, for the most part these federal policies neither specify the relationship between proportions of retirement derived from Social Security and employer-related pensions nor coordinate the pensions drawn from these sources within an overall system. (An exception is the effort made in recent years to coordinate benefits from Social Security and the Civil Service Retirement System.) The result places the emerging system of retirement income on a course of unguided incremental privatization—fueled by a combination of initiatives that have reduced Social Security benefits and encouraged participation in employer-related plans and IRAs.

The reduction of benefits started with the 1977 Social Security amendments and received a major thrust from the 1983 amendments, which introduced several measures to restore the solvency of this scheme (Steuerle & Bakija, 1994). These measures included: increasing the retirement age from 65 to 67; delaying the cost-of- living adjustment by 6 months in 1983; raising the employer-employee tax rate and increasing the taxable-earnings base; and imposing an income tax on Social Security benefits for retirees whose adjusted gross income plus half their benefits exceeds $25,000 if single and $32,00 if married (Gilbert & Gilbert, 1989; OECD, 1988b). While the payoff on public pensions was being eroded by the 1983 amendments, the Economic Tax Recovery Act of 1981 rapidly increased the number of participants in private Individual Retirement Accounts (IRAs) by extending eligibility for tax-exempt contributions to all wage earners; a few years later, the range of eligible wage earners was narrowed by the Tax Reform Act of 1986; in 1997, however, further incentives were introduced to expand participation in IRAs.

Long before the introduction of IRAs, indeed, even decades before the passage of the Social Security Act of 1935, private pension plans were introduced by employers seeking to increase workforce loyalty by offering benefits to old and faithful employees. (According to Stein (1980), the American Express Company is credited with establishing the first private pension plan in 1875.) Before the 1940s, private pension plans were prevalent in only a few industries, primarily railroads, banking, and public utilities. These schemes were designed mainly as an incentive to encourage employees who had built up valuable skills to remain with the company. After World War II, employer-sponsored private pensions began to spread, with the number of private plans multiplying from 7,311 in 1946 to 805,405 in 1985 (OECD, 1993).

By the mid-1970s, private plans had become an important social institution for retirement income security. The enactment of the 1974 Employee Retirement Income Security Act (ERISA) imposed comprehensive regulations on employer-sponsored pension plans to guarantee their sound operation—a legislative bench mark in modern pension history. Although employers have considerable discretion in how they structure private plans offered to employees, to receive favorable tax treatment, these private schemes must meet both the terms of the Internal Revenue Code and minimum standards of the ERISA regarding participation, vesting, nondiscrimination against lower paid workers, and other criteria (Turner & Watanabe, 1995).

The ERISA regulates two types of employer-sponsored pension, which receive favorable tax treatment: defined benefit plans and defined contribution plans. Defined benefit plans specify the level of pension benefit at retirement, whereas benefits from defined contribution plans will vary depending on the level of contributions, market performance and investment returns. As of 1993, 44 percent (51 million) of all civilian workers (118 million), participated in an employment-based retirement plan (Employee Benefit Research Institute, 1995). Among those participants, the majority have preferred defined benefit plans to defined contribution plans. However, employer-sponsored pension plans are markedly shifting away from defined benefit plans toward defined contribution plans. In 1993, 56 percent of full-time employees in medium and large establishments participated in defined benefit plans, while 49 percent of them participated in defined contribution plans. Some participated in both pension plans (EBRI, 1995, Table 3.9).

In addition to employer-sponsored private pension, a private scheme for the self-employed—the Keogh plan—was introduced by the Self-Employed Individuals Tax Retirement Act of 1962 to help unincorporated small business owners, farmers, and those in professional practice plan for retirement (Andrews, 1985). Tax-deductible contributions to Keogh plans were initially set lower than those for corporate pension plans, but they became the same by the Tax Equity and Fiscal Responsibility Act of 1984. However, the number of Keogh plans are relatively low; as only 5.6 percent of self-employed workers had established these plans by 1987 (OECD, 1993).

RETIREMENT INCOME: THE SHIFTING BALANCE OF SOCIAL SECURITY AND PRIVATE BENEFITS

What are the effects of the unguided incremental movement toward privatization of retirement income in the United States? In addressing this issue, we examine how changes in the contributions of Social Security compared to employer-provided pension and IRA accounts have impacted the composition of retirement benefits of the elderly from 1976 to 1992 . All the estimates in this analysis are based on a sample of aged units drawn from the March Current Population Surveys from 1977 to 1993. Aged units are defined as married couples living together, at least one of whom is 65 or older and non married persons 65 or older are used to represent the elderly population. The sample size of aged units ranges from 13,000 to 15,000 for each of the years surveyed.

As shown in Table 1, from 1976 to 1992, the average income of the elderly in real value has increased continuously with minor exceptions. Over this period the poverty rate in the elderly population declined from 15% to 12.9% (U.S. House of Representatives, 1994). The share of income the elderly receive from IRAs and employer-related sources has increased steadily from 13.1% in 1976 to 19.5% in 1992, while the share from Social Security benefits has remained at a fairly constant 40% during the same period. (Retirement, survivors, and disability benefits of OASDI and the Railroad Retirement Program are included in the calculation of Social Security benefits. The Railroad Retirement benefits are included because this program is the railroad workers substitute for OASDI, managed by federal government.) Meanwhile, the share of earnings from work has declined considerably (from 24.0% to 18.3%). The share of income from assets has fluctuated each year, ranging from 18.3% to 28.0%. Other income items including public assistance have remained a fairly constant percent of the aggregate income. Overall, these figures reflect an increase in the real value of retirement income and an increase in employer-related pensions relative to Social Security as a proportion of this income (compensating mainly for a decline in the proportion from earnings), which suggests a general trend toward privatization, as defined in this analysis.

However, the figures reveal a somewhat different picture when the data are analyzed for the elderly at different levels of income. From 1976 to 1992, Social Security benefits as a proportion of the aggregate income of aged units actually increased from 76% to 81% for the poorest group of elderly persons, those whose income was in the bottom 20% of all aged units. At the same time, the proportion of retirement benefits received by this group from sources other than Social Security showed a minor increase from 1.6% to 2.6% of aggregated income, while income from the public assistance has declined significantly (from 16.9% to 11.3%). Thus, since the 1970s there has been almost no privatization of retirement income in the bottom income quintile of the elderly. Instead, the major changes in income composition for this group reflect an increased proportion from Social Security benefits and the reduced role of public assistance.

For those in the second 20% of the income distribution, Social Security benefits continued to account for about 78% of the aggregated income of aged units since 1976, while income from employer-related pensions has increased consistently from 2.8% to 7.5% of the aggregated income during the same period. The increased share of retirement benefits from employer-related sources and IRAs offset the decreased share of public assistance in this income quintile. Although the absolute share of private retirement benefits is still less than 10% of the aggregate income, the rate of increase from this source is notable. Thus, the data indicate a perceptible movement toward privatization in the second income quintile; but it is a movement in which the relative role of private sources has increased without a corresponding reduction in the relative contribution of Social Security to the aggregate income.

The elderly units in the middle and upper-middle income groups have experienced similar changes in the composition of their retirement income during the period under study: Social Security benefits were reduced by 5-to-10% as a proportion of

Table 1

% Shares of Aggregated Income of Aged Units: 1976–1992

	1976	*1978*	*1980*	*1982*	*1984*	*1986*	*1988*	*1990*	*1992*
Retirement Benefits	53.3	52.9	54.3	53.5	52.6	53.6	55.3	55.0	59.2
Social Security	40.2	39.7	40.1	39.9	38.4	38.3	37.9	36.4	39.7
Pension & Annuity	13.1	13.2	14.2	13.6	14.2	15.3	17.4	18.5	19.5
Earnings	24.0	24.2	20.4	18.8	16.7	18.0	18.3	19.1	18.3
Income from Assets	18.3	19.0	21.8	25.0	28.0	25.7	24.1	23.4	19.8
Public Assistance	2.0	1.7	1.5	1.1	1.1	0.9	0.8	0.8	0.9
Other Public Income	1.9	1.6	1.5	1.2	1.1	1.2	1.0	1.1	1.3
Other Private Income	0.6	0.6	0.6	0.4	0.6	0.5	0.5	0.6	0.5
Total %	100	100	100	100	100	100	100	100	100
Average Annual Income*	7,008	7,320	7,101	7,750	8,309	8,526	8,605	8,872	8,369

*Average annual income is measured in constant dollar value of 1976.
Sources: Authors calculations from U.S. Department of Commerce, Bureau of the Census, *Current Population Survey: March Data*, each year. Note: Figures may not add up to 100 due to rounding.

aggregated income, while retirement benefits from employer-related sources rose by 7-to-8% in both groups. With the proportional decline of Social Security and growth of income from private schemes, these two quintiles seem to be on a steadfast course of incremental privatization.

It is important to note that the real dollar value of Social Security benefits increased in these two income quintiles from 1976 to 1986, at the same time that these benefits declined as a proportion of aggregated income (Table 2). Thus, up to 1986 the movement toward privatization occurred without any reduction in the value of public pension benefits. However, the dollar value of Social Security benefits declined slightly in these two income quintiles in 1988 and 1990. If erosion of the real value of Social Security benefits becomes more frequent in the future, the rate of privatization in these two income quintiles can be expected to accelerate.

For the wealthiest elderly people, those with incomes in the top 20% of aged units, IRAs and employer-related pension benefits increased considerably as a proportion of the aggregate income, while Social Security benefits remained at a fairly constant 20%; indeed by 1992 pension benefits from sources other than Social Security accounted for more of this group's aggregate income than Social Security benefits, a reversal in the relative importance of these sources of income since 1988 (Table 3). However, it should be noted that compared to other income groups, the wealthiest 20% of the elderly population were least dependent on retirement income. Instead, earnings and income from assets account for the largest proportion of the aggregate income of this group.

PRIVATIZATION AND INEQUALITY

How has the differential increase in private pension benefits in each of the quintiles influenced the degree of equality in the distribution of retirement income? As Table 4 shows, the ratio of retirement income for each of the first four income quintiles to the retirement income of the highest quintile has continuously decreased with minor exceptions from 1976 to 1992. For example, the ratio of retirement income of the bottom quintile to the retirement income of the highest quintile declined from 22.6% in

Table 2

Dollar Amount of Social Security & Pension Benefits in the middle & upper-middle 20% of Aged Units: 1976–1992*

	1976	*1978*	*1980*	*1982*	*1984*	*1986*	*1988*	*1990*	*1992*
Middle 20%									
Social Security	3,128	3,200	3,142	3,384	3,524	3,634	3,615	3,552	3,611
Pension	385	486	503	500	713	735	893	927	927
Sum	3,513	3,686	3,645	3,884	4,237	4,369	4,508	4,479	4,538
Upper-Middle 20%									
Social Security	3,717	3,865	3,723	4,055	4,094	4,172	4,145	4,057	4,326
Pension	1,238	1,304	1,307	1,343	1,605	1,828	2,167	2,088	2,119
Sum	4,955	5,169	5,030	5,398	5,699	6,000	6,312	6,145	6,445

*Annual dollar amount is measured in constant dollar value of 1976.

Sources: Authors calculations from U.S. Department of Commerce, Bureau of the Census, *Current Population Survey: March Data*, each year.

Table 3

% Shares of Aggregated Income in the highest 20% of Aged Units: 1976–1992

	1976	*1978*	*1980*	*1982*	*1984*	*1986*	*1988*	*1990*	*1992*
Retirement Benefits	35.1	34.5	37.1	36.4	35.1	36.3	38.8	39.3	42.5
Social Security	19.2	18.9	19.9	20.0	19.4	19.2	19.0	18.1	20.2
Pension & Annuity	16.0	15.6	17.2	16.5	15.7	17.1	19.8	21.2	22.3
Earnings	38.2	38.1	31.4	28.5	25.3	27.8	27.6	28.4	28.6
Income from Assets	24.8	25.6	30.1	34.1	38.4	34.5	32.5	30.9	27.3
Public Assistance	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other Public Income	1.1	1.0	1.1	0.6	0.5	0.8	0.8	0.8	1.1
Other Private Income	0.6	0.7	0.5	0.4	0.7	0.6	0.4	0.6	0.5
Total %	100	100	100	100	100	100	100	100	100
Average Annual Income*	17,798	18,643	18,009	19,848	21,297	21,997	21,787	22,981	21,424

*Average annual income is measured in constant dollar value of 1976.

Sources: Authors calculations from U.S. Department of Commerce, Bureau of the Census, *Current Population Survey: March Data*, each year. Note: Figures may not add up to 100 due to rounding.

1976 to 17.3% in 1992. Although the retirement income ratio of the four lower income quintiles declined relative to the highest quintile over the seventeen year period, they varied in relation to each other. Most significantly, there was no change in the ratio of the middle quintile to the upper middle quintile, while for the bottom 20% the rate of inequality in the ratio of retirement income widened in relation to all the other income groups.

TRENDS AND IMPLICATIONS

To sum up these developments, over the 17 year period from 1976 to 1992 dependence on Social Security for retirement benefits is very high and increasing (ranging from 76% to 81% of aggregated income) for aged units in the bottom quintile of the income distribution; dependence is also high and stable (around 78%) for those in th e second lower quintile of the income distribution; in the middle and upper-middle income groups dependence on Social Security benefits is lower and declining (66% ~ 59% and 49% ~ 40% of their aggregate income); and for the those in the top quintile of the income distribution dependence on Social Security is very low, accounting for about only 20% of their aggregate income, but stable. During the same period, retirement benefits from private sources increased as a percentage of aggregate income for every category, but the increases were largest in the middle and upper-middle income categories. These trends are illustrated in Table 5. Here we see that the erosion of Social Security benefits occured in the middle and upper-middle income quintiles while the supplementation of benefits from private plans was apparent in all income quintiles except the bottom one. The middle and upper-middle income quintiles which have experienced both erosion of Social Security and supplementation from private plans are well on the course of incremental privatization, a course along which the highest quintile has already moved to the point that private pension benefits are dominant. In contrast, the bottom income quintile, which experienced no erosion of Social Security benefits and insignificant supplementation from private plans, remains largely dependent on public pensions for retirement income. In fact, analysis of the data shows that from 1976 to 1992, Social Security benefits actually increased from 76%

Table 4

Retirement Income Amount in Each Income Quintile and its Rate to the Retirement Income of the Highest Income Quintile: 1976–1992*

	1976	*1978*	*1980*	*1982*	*1984*	*1986*	*1988*	*1990*	*1992*
Bottom 20%									
Retire. Income	1,415	1,651	1,939	2,456	2,836	2,983	3,450	3,659	3,895
Ratio**	22.6	22.4	20.1	20.0	20.9	19.4	19.6	17.7	17.3
Second-Lower 20%									
Retire. Income	2,533	3,012	3,717	4,699	5,250	5,729	6,367	7,235	7,629
Ratio**	40.5	40.9	38.5	38.4	38.5	37.3	36.3	34.9	33.9
Middle 20%									
Retire. Income	3,513	4,223	5,274	6,583	7,733	8,417	9,372	10,295	11,203
Ratio**	56.2	57.3	54.6	53.7	56.7	54.8	53.4	49.7	49.8
Upper-Middle 20%									
Retire. Income	4,955	5,921	7,280	9,149	10,400	11,561	13,125	14,127	15,914
Ratio**	79.2	80.3	75.3	74.7	76.2	75.2	74.7	68.1	70.7
Highest 20%									
Retire. Income	6,254	7,374	9,664	12,254	13,650	15,365	17,566	20,734	22,495
Ratio	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

*Retirement Income is composed by Social Security and Private Pension Benefits. It is measured in current dollar value of each year.
**Ratio = Retirement Income of Each Income Quintile as a % of Retirement Income of Highest Income Quintile
Sources: Authors calculations from U.S. Department of Commerce, Bureau of the Census, *Current Population Survey: March Data*, each year.

Table 5

Privatization of Retirement Income in Income Quintiles Resulted from Changes of Relative Roles of Social Security and Private Pension in Income Composition of the Elderly

Income Quintile	*Retirement Income*	*Trends of Relative Role*	*Privatization of Retirement Income*
Bottom 20%	Social Security Private Pension	increasing ↑ stable →	insignificant privatization/ public dominant
Second-Lower 20%	Social Security Private Pension	stable → increasing ↑	minimal privatization
Middle 20%	Social Security Private Pension	decreasing ↓ increasing ↑	incremental privatization
Upper-Middle 20%	Social Security Private Pension	decreasing ↓ increasing ↑	incremental privatization
Highest 20%	Social Security Private Pension	stable → increasing ↑	incremental privatization/ private dominant

to 81% of the aggregate income of the elderly in the bottom 20% of the income distribution.

The relative role of private pension benefits in retirement income has been increased without reducing real dollar amounts of Social Security benefits in most cases. Thus, privatization of retirement income has helped to improve the adequacy of income for the elderly in all quintiles. However, the differential rates of unguided incremental privatization have widened the inequality of retirement income among the elderly, particularly for those in the lowest quintile. And the aged units have not yet born the full impact of the 1983 reforms, particularly the erosion of Social Security's contribution to retirement income that accompanies the rising age of eligibility for benefits. The trend toward incremental privatization, of course, can change in velocity and direction. Recent proposals to permit individuals to invest a portion of their Social Security contributions in private accounts, for example, would accelerate the trend and lend greater specification to the public/private mix of retirement income than is indicated under present policy. But if the trend continues along current lines, several implications may be drawn regarding the future course of events. First, the middle and upper income groups reliance on Social Security for retirement income will diminish, which may dampen their political support for this program. (At the same time, increasing reliance on employer-related pensions may heighten the need for public regulation of these schemes.) The diminishing stake in Social Security will present less resistance to the future erosion of benefits. And any across-the-board reduction in Social Security benefits is likely to have the most adverse impact on low-income groups—who continue to rely almost entirely on these benefits for retirement income—enlarging the inequality gap. From a policy perspective this scenario suggests the need to address the drift toward privatization with an eye to the vulnerabilities of the low-income elderly.

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