Working Paper

Executive Summary

June 2003, WP # 2003-13

CENTER FOR RETIREMENT RESEARCH AT BOSTON COLLEGE

The Outlook for Pension Contributions and Profits in the U.S.

By Alicia H. Munnell and Mauricio Soto

The bear market that began in 2000 has focused attention on two issues – pensions and profits. The pension problem is the big decline in individual 401(k) plans. The profit issue is misconduct and stock options. In fact, there is another compelling issue involving both pensions and profits that has received less attention – the impact of the bear market on defined benefit pension plans. The outlook for defined benefit plans is the focus of this paper.

The simplest part of the defined benefit story is the effect of the stock market decline on future contributions. Plan sponsors are in effect target savers. That is, they have a projected benefit liability, and to the extent that rising asset values cover this liability, they contribute less to the plan. Between 1982 and 2000, stock prices rose at an annual nominal rate of 16.9 percent compared to 7.6 percent between 1963 and 1981, the previous 18-year period. As stock values soared during this extended bull market, contributions virtually disappeared as a corporate expense. Now that stock values have fallen by 50 percent, sponsors for the first time in decades have to contribute to their pensions.

The complicated component to the story is that even without the decline in the stock market, sponsors of defined benefit plans were going to face increased pension contributions in the coming decade. The reason is a host of regulatory and legislative changes in the late 1980s that slowed or limited pension contributions. Most of these changes forced plan sponsors to shift contributions from the first half of an employee's work life to the second half. This shift in the timing occurred when the large baby boom generation was roughly age 20 to 40, and thus had a powerful effect. Now the baby boom is age 40 to 60, and the deferred contributions are coming due.

Our analysis suggests that in the absence of the stock market boom and the regulatory and legislative changes that reduced funding, the average firm's contribution to its pension plan would have been 50 percent higher during the 1982-2001 period – 9.9 percent of payroll instead of 6.6 percent of payroll. The downturn in contributions had a significant impact on corporate profits. Lower pension contributions, all else equal, will produce a dollar-for-dollar increase in before-tax profits. Our analysis implies that corporate profits were roughly 5 percent higher than they would have been otherwise.

Higher profits produce a feedback effect as they lead to further capital gains and further reductions in contributions. Given the current bear market and an aging workforce, the feedback now goes in the opposite direction. How much will corporate contributions have to increase now that the stock market bubble has burst? Our analysis suggests that contributions relative to wages would return to their pre-1982 levels of about 10 percent. This implies that – on a permanent basis – contributions would double from their current level of $40 billion to $80 billion. Assuming that investors view the increase as permanent, the feedback effect would lower the value of equities held by pension funds by $20 billion. In short, as the economy emerges from recession and the bear market draws to a close, firms and investors must be prepared to contend with a strong headwind from pension funding obligations that could slow the recovery.

 The research reported herein was performed, in part, pursuant to a grant from the U.S. Social Security Administration (SSA) funded as part of the Retirement Research Consortium. The opinions and conclusions expressed are solely those of the authors and should not be construed as representing the opinions or policy of SSA or any agency of the Federal Government, or the Center for Retirement Research at Boston College.