The History of Retirement Benefits

Over the years, retirement responsibility has shifted from the employer to the employee. How can benefits managers help employees retire smarter and more financially secure?

Our retirement is not our parents' retirement. For many American employees in their generation, a good job meant access to a secure retirement income they could not outlive. Employers took center stage, assuming most of the financial risk of funding that retirement with employees largely removed from the process. Today, employers are far more likely to be facilitators of retirement saving, playing a critical supporting role while the employee is the star planner of the retirement show.

How did the idea that employers should offer secure retirement benefits through defined benefit plans, or pensions, evolve? How and why did this change over time to put more of the responsibility on employees to save through defined contribution plans such as 401(k)s? And how can benefits managers use new savings tools and employee benefits available today to help their employees retire smarter, happier and more financially secure?

The U.S. Retirement System

Retirement is a fairly modern concept with origins in military history. Until the late 1800s, those who had to work to earn their living worked their entire lives. Historians credit the Roman Empire with conceiving the idea of an income that continued after work service by offering pensions to retiring soldiers during the first century B.C. While this initiated a long tradition of military pensions, the concept of ceasing to work in later life didn't begin to spread to the rest of the workforce until the 19th century.

Today, we think of a pension as a series of payments to be made to workers after the end of their working years. In the United States during the mid-1800s, a "pension" also referred to disability and survivor benefits. During the middle of that century, larger cities began to offer disability and retirement income benefits to police and firefighters. This trend expanded over time among public sector workers.

In 1875, The American Express Co. created the first private pension plan in the U.S. for the elderly and workers with disabilities. According to the Pension Research Council, by 1926 approximately 200 private pensions had been established by larger employers in the United States. Early pension benefits were designed to pay out a relatively low percentage of the employee's pay at retirement and were not designed to replace the employee's full final income.

The idea that employees should have some kind of a defined benefit in retirement gained traction during the boom decades that followed World War II. Large corporate employers took a paternal approach to their workers and offered pensions as part of their talent recruitment and retention efforts.

And it worked. It was not uncommon for workers to spend their entire careers at the same company back then. Compare that to 2014 when the U.S. Bureau of Labor Statistics reported the average employee tenure was 4.6 years.

Benefits grew richer over time, with many pension plans offering replacement incomes that covered more of the employees' average pay. By 1970, 26.3 million private sector workers (45 percent of all private sector employees) were covered by some kind of pension plan. Participation held steady for several decades with 43 percent of private sector employees still covered by 1990.

With a traditional defined benefit plan, employees had little direct control over their retirement. To earn higher lifetime benefits in the plan, they could work longer, make a higher salary or live longer — but the employer controlled the contribution formula and the investments, and generally made all the contributions to fund the plan.

The '70s brought America staggering inflation, disco, and legislation that changed retirement forever. In 1978, Congress passed The Revenue Act of 1978 in which

Section 401(k) cleared the way for the establishment of defined contribution plans. The idea was revolutionary: Employees would be able to contribute their own money in a tax-advantaged way to an account to supplement any other retirement benefits they had with tax incentives for the employer to also contribute. The upshot? Over the past 38 years for the typical U.S. employee, the responsibility for developing a sustainable retirement income has shifted from the employer to the individual.

A “defined contribution plan” takes its name from the ability of the employee and/or employer to contribute a fixed sum to the plan. Over time, different types of plans evolved to serve different types of employees: 401(k) plans for private sector employees, 403(b) plans for nonprofit and public education employees, 457 plans for state and municipal employees and the Thrift Savings Plan for federal employees.

Today, the traditional pension is an endangered species. For the past decade, employers have been terminating defined benefit plans in record numbers and moving toward defined contribution plans. According to the Employee Benefits Research Institute, by 2011 69 percent of employee participants in a retirement plan at work were participating in a defined contribution plan, 24 percent were participating in both a defined contribution and a defined benefit plan, and just 7 percent were in a defined benefit plan only.