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The Changing Social Contract: Implications for Financial Security Systems

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In the U.S. and in most industrialized countries, there is an elaborate set of financial security programs, linked to an understanding of the role of government, the employer, the family, and the individual in providing for individual security. Collectively, these understandings can be viewed as a "social contract."

A key element of the social contract can be found in the way the workplace and jobs are structured. This paper deals with the workplace and the financial security issues related to the employer-employee relationship. Historically, larger employers were often dealing with an entitlement environment, what seemed to be a mutual expectation (but no guarantee) of the availability of lifetime employment, and an expectation on the part of employees that the company would take care of them, often without a very clear definition of what that meant. Many larger companies offered eligible retirees lifetime medical coverage, paid for mostly by company dollars. During the last decade, the social contract as it applies to employment has changed radically, and responsibility has shifted to employees.

In this paper, I will focus on the private-sector elements of the social contract, primarily the employment relationship and the implications for benefits and financial security. The social contract is very important to the designers and managers of employee benefits, particularly retirement systems because, in effect, it is the "anchor" to which these programs are attached.

The Business Environment and the Social Contract

Global competition, technology, changing values, and demographics are all forcing businesses to respond quickly to change, to lower cost structures, and to be able to modify their product lines quickly. One can view the business environment of the 1990s as being strongly driven by customers. In turn, the rapid change is strongly encouraging employers to redefine the relationship between employer and employee. The traditional relationship was built around the paradigm that reasonable performers were secure in their jobs, and it was the individual who could decide whether or not to accept the company's offer of a lifetime job and security. The new paradigm is based on a job as long as the business supports it, and security has become the responsibility of the individual. Companies are bought and sold, and long-term job security no longer exists. To look at it another way, jobs exist only so long as customers are willing to pay for the services provided.

A June 13, 1994, article in *Fortune* titled "The New Deal" presents data to show the decline in employee perceptions about job security. The percentage of employees reporting that their job security was "good" or "very good" has steadily declined for both management and nonmanagement. The data are as follows:

	Management	Nonmanagement
1980–82	79%	75%
1983–85	71	72
1986–88	65	58
1989–91	64	61
1992–94	55	51

The long-term relationship was one that existed for life—during working years and retirement. Traditional retirement plans were designed to provide good benefits to career employees with the notion that it was the employees who chose whether to stay for a long time or leave early. These plans provided much lower benefits to those who left early, particularly before the early retirement age. Today, as markets are shifting leading to shifts in jobs, a retirement benefit structure is needed that will provide a fair benefit regardless of tenure at termination from each job.

The New Social Contract

There has been a great deal of focus lately on a "new social contract" or "changing employment relationship." Under the traditional approach, there was an assumption of job security, and it was assumed that lifetime employment was an option available to the employee, except in the event of very poor performance, or some discontinuity in the business. However, discontinuity in the business was seen as an exception rather than a norm.

The focus on an evolving social contract is a change of both culture and relationship. The communication with the employee in the traditional contract is top-down and one-way versus one that is much more two-way in the new contact.

The new social contract has implications both during periods of continued employment and when employment ends, either through discontinuation of the job or through the employee's leaving the company. During periods of continued employment, there is much more fluidity and employees move from task to task, with many more temporary assignments. Fixed, permanent job assignments are being replaced by much more fluid workplace arrangements, including work teams and task forces. Essentially, the employee must continually market him- or herself within the current organization in order to be assigned to new tasks.

The last decade has seen a tremendous number of companies go through changes in ownership, re-engineering and restructuring. Selling-off of business units that no longer fit is the norm rather than the exception. Most of the companies that would have been viewed as the bastions of employment stability including traditional banks, telecommunication companies, large steel and auto companies, and utilities have had substantial dislocation of portions of their workforces.

This has led to a focus on a new social contract. Table 1 contrasts some of the characteristics of the new and old social contracts.

TABLE 1

Traditional	New approach
A growing workforce	Downsizing and rightsizing
Stability	Change and uncertainty
Permanent employees	A mix of permanent and contingent employees; i.e., a flexible workforce
Paternalism and entitlement	Employee responsibility
Retirement as one-time event	Gradual retirement
Employee retention	Targeted turnover
Job security	Education/skill building to remain employable (here or elsewhere)
Learning at workforce entry	Lifelong learning

Compensation Systems

Traditional compensation systems for regular jobs are generally based on salary structure and job grades. Each job had a description and a salary range based on the job description. Merit increases were provided to salaried employees, as were promotional increases. Often, one found little differentiation in pay increases based on performance levels. Incentive plans were concentrated at higher management levels and for a few jobs. Market pricing operated in parallel and often was the real driver of pay.

Today's fast-moving business climate fits poorly with past traditional pay and classification systems. Market pricing remains important, but equally important are systems that "walk the talk" of the new organizational culture. Many organizations have been working for the last few years to design new pay systems that would provide incentives for performance throughout the organization and be much more flexible. New systems include broadbanding, which flattens hierarchial systems, and competency and skill-based pay, which focus more on the individual and what the person is able to do versus the immediate assignment. Pay practices are evolving to include more incentives to a wider group of people and more pay at risk, less rigid job descriptions, and new methods of slotting employees.

The Evolving Contract and Rationale for Termination of Employment

Under the old way of thinking, termination could be at the employer's request for cause or for poor performance, but termination for poor performance was relatively uncommon. In addition, it was relatively rare to look carefully at the fit of the individual and the job. The individual was free to and often chose to leave for a better opportunity, but the option of long-term employment existed. Depending on the organization and industry, many employees chose very long-term employment. Under this system, a pension plan that rewarded and encouraged long service worked well to assist those employees who stayed for many years with a company. Relatively lower pension benefits to early leavers were seen as appropriate.

Under the new paradigm, companies are reorganized frequently, and jobs tend to be reorganized if they do not fit the needs of the organization as it goes forward. The reasons for termination have expanded to include reorganization and downsizing, in addition to cause and performance. Organizations are also much more likely to take action on poor performance. The decision to remain with an organization or to leave is no longer the employee's choice. It is much more often the company's choice. Under this system, it seems fairer to both parties to have a pension plan that is more portable.

In the past, retirement benefit plans were designed for high benefits for those who stayed to normal retirement age and for low benefits for those who left early on or after a decade or two. But that was not a problem because those who left early did so by their own choice. Today, this pattern is seen as more of a problem by both employers and plan designers.

The Evolving Contract and Periods of Continued Employment

Under the old way of thinking, planning and expecting change were not part of the social fabric. Under the new way of thinking, change is to be expected and is part of the environment.

Under the old way of thinking, although there was ongoing training, its importance to both the individual and the company had not been recognized. Under the new way of thinking, maintaining human capital is a major issue to both. Under the old way of thinking, much structure and hierarchy could be found. Under the new way of thinking, there is a much flatter organization and less hierarchy.

The evolution in the employer-employee contract means that pay systems need to be more flexible. Many pay systems are moving to include a higher component of incentive compensation.

The transition to different cultures is difficult, both for employees and for employers. For the employee over age 45 with long service, this is particularly difficult because many of these employees built their lives based on expectations that grew out of the old culture and a different social contract. One human resource officer in looking at the accrual pattern under a traditional defined-benefit plan expressed the needs of the new environment with two statements:

1. We need to offer a plan such that if an employee leaves at any point in time we are square and treat the employee fairly.
2. We need to protect our employees in the event we are acquired. In our industry, 25 percent to 33 percent of the employees will usually lose their jobs after an acquisition.

That human resource officer was very uncomfortable with the traditional defined-benefit plan with its steep accrual pattern.

Social Contract and Employee Benefits

The social contract can be seen as the anchor or foundation for employee benefits. Employers have viewed themselves as having a role and responsibility toward their employees and their families. Traditional benefit plans in larger employers have been designed with several goals:

- Protect employees and their dependents in the event of medical expenses, and for loss of income from death, disability, and retirement.
- Strengthen the ties between company and employee.
- Offer a competitive employment environment.
- For many, retirement benefits have been structured to reward long service, making it relatively easy for

employees who were in their sixties and had spent a career with the company to retire with an adequate income.

Plans were designed to allocate benefit dollars more heavily to those with families and to those who were older, but for many years, these design features were largely hidden from employees and were not explicitly recognized or discussed by most plan sponsors.

Then, in the 1970s with the growth of health care costs and the emergence of global competition, more focus was placed on what was being spent for benefits and for whom. In the 1980s, with the growth of flexible benefit plans, focus increased on what was spent and how it was allocated to different employee groups. Flexible benefit plans offered a way to let employees take what was being spent for benefits and allow employees to make different choices.

In designing plans, it became clear that subsidies were inherent in traditional plans. It became much more difficult to hide them, and many employers sought to reduce them as they changed their benefit structures. At the same time, many recognized that the workforce was not homogenous and that employees varied by family type.

Public Policy and the Social Contract

The Clinton administration has recognized that the evolution of the social contract creates threats to the security of many Americans. Former Secretary of Labor Robert Reich spoke of the "good corporate citizen," and legislation was introduced to reward companies who meet the definition of "good corporate citizens." This definition focuses on security for employees and the employee benefits that the companies provide.

The proposal called for eliminating the current corporate income tax and replacing it with the two-tiered "business activities" tax system. Companies that meet certain criteria would be taxed at a lower rate (such as 11%) whereas companies that do not meet it would be taxed at a higher rate (such as 18%). The tax base would be determined by including all business receipts and subtracting payments to other businesses for good and services. Compensation would not be deductible.

To qualify for the tax breaks, a company would have to meet all criteria. It was proposed that they include the following benefits and compensation requirements:

- Contribute at least 3% of payroll to and offer to its U.S. employees a multi-employer or multiple-employer pension plan.
- Offer to all U.S. employees (permanent and temporary employees working for more than three months) a health care plan based on a model health benefits plan drafted by the National Association of Insurance Commissioners, and pay for at least half of cost.
- Contribute at least 2% of payroll for certified training or education of U.S. employees.
- If a for-profit entity, provide either an employee profit-sharing plan, an employee stock option plan, or an employee stock ownership plan (ESOP).
- Companies offering an ESOP would have to have at least 50% employee participation, with the plan managed by an employee-elected trustee and all full voting stock.
- Maintain a compensation plan where the compensation of the highest-paid employee is no more than 50 times the compensation of the lowest-paid full-time employee.

Additional requirements have been proposed in areas such as research funds and how they are spent, occupational safety, and membership in certified industry associations.

Traditional Retirement Plan Choices: Do They Work Today?

Traditional retirement plan designs included defined-benefit and defined-contribution plans. The traditional defined-benefit plan used a final average earnings formula, so that benefits would be a percentage multiplied by years of service and average earnings in the final five years of employment. In contrast, defined-contribution plans offered an individual account based on amounts credited to an employee account and accumulated with interest.

The relevance of traditional plans is not a new subject. The death of defined-benefit plans has been declared periodically over the last 50 years because they are old fashioned and too complex, younger employees don't appreciate them, and they are too risky. Nevertheless, larger employers (those with over 1,000 employees) have continued using these plans. Their frequency of use has changed very little, even though the number of employees covered has declined as employment patterns shifted. The principal reasons for this are the following:

- They are efficient. They have delivered the most dollars for those who stay to retirement for every dollar the employer invested. (That was the goal of many employers in their retirement plans.)
- The risk inherent in defined-benefit plans carries reward with it, and the employers who have managed their assets well have been rewarded well for taking that risk.

The Social Contract and Plan Design Choice

As the social contract changes, the issues in plan design choice focus on what happens if people leave at different times during their careers and on growing employee responsibility for retirement security plans. The key differences in the traditional plan designs include the following:

- *Benefit accrual.* Traditional defined-benefit (final average earnings) plans that provide for heavy benefit accruals late in the employee's career are seen as fitting the old social contract, whereas defined-contribution plans and cash balance designs provide for much heavier benefit accruals earlier, and therefore they fit better with different employer contracts.
- *Method of Payment.* Traditional defined-benefit plans usually offer payout as monthly income fitting the entitlement orientation of the old social contract, whereas cash balance and defined-contribution plans usually offer payout as lump sums, which better fits the new social contract. All plan types can offer other forms of payout as options.

Plan Choices of the 1990s

For those employers who believe that, because the social contract has changed, the old options don't work well today, new options supplement traditional defined-benefit and defined-contribution plans. Hybrid plans offer features of both traditional defined-benefit and defined-contribution plans. The cash balance plan is the most popular hybrid plan. A cash balance plan is a defined-benefit plan in which the benefit is defined as an account within the plan. The plan specifies the rates of contribution and investment return (independent of plan asset performance) to be credited to the participant's account. This plan looks like a defined-contribution plan for benefit accrual purposes. This paper focuses on cash balance as a new solution. Table 2 compares the characteristics of cash balance plans, traditional final average pay defined-benefit plans, and traditional defined-contribution plans.

Cash balance plan designs offer some of the features of both defined-benefit plans and defined-contribution plans in three ways: Benefits accrue as in a traditional defined-contribution plan (or in a pattern selected by the employer). Lump sums are the usual form of benefit payout. Benefits are communicated as an "account

TABLE 2

	Traditional Defined Benefit	Cash Balance	Traditional Defined Contribution
Allocation of dollars	Heavily to later years of service	Heavier to early years of service (can modify with formula)	Heavily to early years of service
Who bears investment	Employer	Employer	Employee
Ability to grandfather prior defined-benefit formula inside plan	Yes	Yes	No
Ability to offer early retirement windows inside plan	Yes	Yes	No
Investment choices available to employees	No	No	Yes
Ability to vary accruals by age/length of service	Formula does automatically, but not obvious	Yes, subject to passing nondiscrimination tests	Yes, subject to passing nondiscrimination tests
Ability to base benefits on profits	No	No	Yes
Inflation risk	Usually employer	Employer	Employee

balance." These plans are like defined-benefit plans with regard to the following:

- Assets are pooled in a single fund; there are no individual investment accounts. This reduces record-keeping requirements.
- The employer retains the investment risk on plan funds. Depending on objectives, this can be seen as an advantage or disadvantage, but overall funds in which employers have made the investment decisions generally have had better performance.
- There is PBGC insurance on the benefits. Again, depending on the point of view, this might be viewed as an advantage or a disadvantage. Most employers would view this as a disadvantage.
- In the calculation of costs, the employer can recognize expected terminations of employment, and so on. Initial costs are lower than under defined contribution because nonvested terminations are recognized through actuarial assumptions rather than after they occur.
- Increases in benefits for past periods can be granted, and early retirement window benefits can be offered inside the plan.

Cash balance and defined-contribution plans both support an environment of increased flexibility with regard to retirement, timing, and work schedules before retirement. Traditional plans are a barrier to phased retirement because they focus on average pay in a limited period, usually three or five years. This average pay affects benefits for all years. On the other hand, in both cash balance and defined-contribution plans, each year is considered separately in the benefit accrual process, so that these plans provide no barrier to the employer or employee considering alternative arrangements. The type of advisor and types of needed expertise depend on asset level, ability to save, and age.

Financial Planning for Retirement

Many Americans do not have the skills or interest in savings and financial planning to develop and execute a regular program of savings. For them, the new environment is one of major challenge. They need to save early, plan, and be able to evaluate options. Some employers offer support for planning today, but that is relatively isolated.

With personal computers new software is available at modest cost. Employers can be expected to encourage employees to do financial and retirement planning, and some will sponsor educational programs for that. The outlook for the effectiveness of these programs varies greatly. For individuals lacking basic understanding of financial matters such as budgeting and compound interest, it is unlikely that such programs will be helpful. However, for better educated people, they may be extremely helpful.

For individuals not able to execute personal retirement plans on their own, personalized professional help is available. Employees do not provide such personalized advice, but these services are provided by fee-based planners and by individuals who sell products and are paid on commission. Some fee-based planners also sell products and receive commissions. Accounting firms also frequently provide financial, tax, and estate-planning services on a fee basis, generally targeted at higher income individuals. It is very important for individuals to be careful in choosing advisors and to be aware of the implications when the advisor is paid based on products sold. Many of the people selling such products and services are competent and ethical, but others are not.

The primary need for retirement planning education is very different depending on asset levels. Table 3 summarizes key issues.

The Future

Change is the biggest characteristic of the 1990s, and inevitably there will be more change. The evolving social contract is but one evidence of this change. Change is reflected in organizational structure, culture, compensation, and benefits. As a result of the ongoing change, many employers are reexamining their reward strategies. The questions they are asking include "Why do we offer this program?" "Do we get value from it?" and "Is it a good way to spend our money?" The environment and the emphasis have shifted. Employers are concerned about employee appreciation and about implementing the evolving social contract.

I predict the following changes in the employment environment:

- Skills development and maintenance will be a critical factor in defining employability and, therefore, in financial security. Employers and employees alike will recognize this factor and develop strategies to meet ongoing needs. Employees will have primary responsibility for seeking out and building new skills. Employers are likely to support this activity when they see a direct benefit from doing so.
- Performance measurement will grow in importance, and companies will work hard to improve such

TABLE 3
KEY ISSUES FOR RETIREMENT-PLANNING-RELATED FINANCIAL EDUCATION

Asset Level	Age	Primary Education Need
Under $100,000	Preretirement	Budgeting and having to save more
$100,000–$600,000	Preretirement	Effective investment of assets and how to save on ongoing basis
$600,000 +	Preretirement	Effective investment of assets, tax, and estate planning
Under $600,000	Retirement or later	Needs over retirement years and effective use of funds; impact of death of spouse or inflation
$600,000 +	Retirement or later	Effective investment of assets, use of funds over retirement uses, tax and estate planning

measurement. Measurement uses will go beyond setting pay increases. Employees will seek out good measurement to help them plan their careers.

- The best employee-employer partnerships will support greater productivity and efficiency and will promote greater understanding of the company needs, business, and culture. Reward systems will be designed to reinforce these cultures.
- Flexibility in work schedules and benefits will be valued by many employees. As work expectations continue to rise, time off will be valued more and more.
- Employee responsibility for retirement will increase. Financial planning at the personal level will be much more widespread. Personal security will depend heavily on what the individual has done about planning.
- More employers will use cash balance and other hybrid pension plans.
- Employers will reduce their support for medical coverage and increase their focus on managed care.
- For retirees, medical benefit plans will be trimmed, or there will be an increase in employee contributions for retiree health. There will be an increased focus on Medicare risk contracts as a way to cover retiree health.
- Disability, worker's compensation, and time off will be integrated into coordinated time-off programs.
- There will be fewer tax advantages for benefits, and benefits will be designed less around tax laws than around basic principles.
- The employer will serve as a purchasing agent when it can secure a better deal for employees.
- Corporate restructuring and accompanying elimination of jobs will continue. Savings will be an important way to help finance the period between jobs. Individuals will increase their focus on second and third careers.

Discussion by Richard V. Burkhauser

I agree with your view that on average women have not been protected by the Social Security system to the same degree as men have. The statistics are clear on this. As Burkhauser, Duncan, and Hauser (1994) show, despite massive Social Security expenditures, older women remain the most vulnerable members of our society, in part because of the substantial drop in the level of Social Security protection they receive following the death of their spouse.

No one consciously "planned" for Social Security to overprotect married couples and underprotect survivors, most of whom are women. But policymakers, like the rest of us, are to some degree trapped by their own experiences. Social Security policymaking has been dominated by married men who have created a system that offers the greatest level of protection to married men. Usually a male marries a younger woman. He is the primary earner in the family, and he dies on average at least a decade before his wife. Hence, in making choices among different ways to expand Social Security protection—an earlier retirement age, higher benefits while both husband and wife are alive, or higher benefits to the survivor—it is not surprising that the first two have been preferred over the third.

Historically, the replacement rate—the amount of wages replaced by Social Security benefits in the first year of retirement—has been the most important measure of Social Security protection. In the early 1970s, when the generosity of the Social Security system was dramatically expanded, replacement rates were substantially increased. Thanks in large part to those increases, the poverty rate of older married couples plummeted and is now extremely low. This is true even though the average age at which men begin to receive Social Security benefits has slipped from around age 65 to about age 62 over the past two decades. Because yearly Social Security benefits are actuarially reduced by 20 percent for workers who accept them at age 62, the current level of income security enjoyed by older married couples is even more remarkable. Unfortunately, the tremendous success of Social Security policy in allowing men to retire earlier and still evade poverty during their retirement years has not been shared by their widows.

My revenue-neutral solution to this mismatch in Social Security protection is to shift part of the current benefits going to married couples to survivors. Small reductions in replacement rates at retirement would allow substantial revenues to flow to survivors via higher survivor replacement rates following the death of a spouse. Furthermore, part of the drop in the replacement rate at retirement could be made up by short delays in retirement by men. My specific plan is detailed in Burkhauser and Smeeding (1994). A variation of this plan was included in the final report to the 1994–1996 Social Security Advisory Council by the Technical Panel on Trends and Issues in Retirement Savings (Mitchell and Quinn 1995), of which I was a member.

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