RESEARCH
Brief

University of Michigan Retirement Research Center

Post-Retirement Adjustments in Defined-Benefit Pensions

Charles Brown* December 2010

Virtually all private defined-benefit (DB) pensions, and many public sector plans, promise a benefit at retirement that remains constant in nominal terms over the life of the retiree. Even as pension plans came to allow early retirement at younger ages, life expectancy was increasing, which increased the potential for a fixed nominal benefit to be seriously eroded by inflation. For example, a worker who retired at age 62 in 1992 (at the first wave of the Health and Retirement Study) would be 80 today. Despite relatively low annual inflation rates, the real value of a fixed monthly pension would have been reduced by a third in real terms over this period – and with average life expectancy our retiree has about eight and a half more years of possible inflation to worry about.

While most pension plans were not legally required to adjust benefits in response to inflation after retirement, data collected by the Bureau of Labor Statistics (BLS) repeatedly showed evidence of such behavior in the 1970s and 1980s, with voluntary adjustments offsetting 10 to 50 percent of Consumer Price Index (CPI) increases. With declining inflation rates, BLS stopped reporting data on voluntary adjustments in its studies of pension plans, so we have little evidence on the importance of such adjustments over the last two decades. Nonetheless, even modest CPI increases cumulate to a substantial real benefit reduction for older retirees, so the continued existence or gradual elimination of such adjustments is potentially important for understanding the current and future well-being of retirees.

This paper uses data on pension benefits reported by Health and Retirement Study (HRS) retirees. Given that adjustments to pension benefits are likely to be modest and survey reports of pension benefits are subject to reporting error, we find that we cannot credibly measure the wave-to-wave benefit changes of individual retirees. Measurement error, including simple rounding, dominates true changes at the individual-respondent level. In the aggregate, in contrast, individual-level reporting errors will cancel out, so mean percentage increases contain useful information (though one may still want to be careful about outliers that might distort even mean values).

We find that, on average, upward adjustments in pension benefits offset about 30 percent of the inflation experienced by HRS respondents since 1994.

Dividing the sample in various ways can provide interesting detail and useful cross-checks on the validity of the data. For example, our primary interest is in post-retirement adjustments of benefits provided by defined-benefit plans, rather than changes in pay-outs from defined-contribution (DC) plans. The strong majority – but certainly not all – of HRS respondents reporting "pension" benefits are reporting benefits from DB plans. Determining whether a particular respondent's pension is a DB or DC plan is notoriously difficult – because even those nearing retirement are often ill-informed or have trouble relating what they do know to standard survey questions. Nevertheless, we are able to consider several strategies for identifying DB plans. All lead to the conclusion that adjustments to benefits under DB plans offset about one third of CPI increases. This is because most "pension" benefits reported to HRS appear to be coming from DB plans, and because pay-outs from DC plans appear to be increasing at about the same rate.

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Most of the pensions reported by HRS respondents can be linked to the job at which the pension rights were earned. Dividing the sample by industry shows that adjustments were essentially zero in manufacturing, largest in public administration, and smaller but still significant in the residual "other" industry category. Perhaps surprisingly, adjustments were no larger in jobs covered by collective bargaining agreements than in the non-union sector.

From a policy perspective, one important finding is that post-retirement benefit adjustments are not dead. One might have conjectured that with all of the well-publicized difficulties that employers have had in meeting their pension obligations, voluntary adjustments would have gone the way of the Walkman and the rotary dial phone. Evidently, they have not. In each wave, over 40 percent of those receiving pensions report that their pension is automatically adjusted for inflation. This proportion exceeds the incidence of formally indexed benefits reported by BLS, which suggests that respondents are including informal indexing as an "automatic" adjustment.

While the conjecture that post-retirement adjustments have vanished is incorrect, it is also true that the glass is only about one-third full. Over the HRS sample period, benefits reported by respondents have in fact increased, offsetting roughly one third of the CPI increases they experienced. Moreover, adjustments are appreciably larger in the Standard Industrial Classfication industry "public administration" than in the rest of the economy, where they amount to only 20–25 percent of inflation. Because not all public sector jobs are included in "public administration," post-retirement adjustments in the private economy are probably smaller still.

While defined-benefit pensions are becoming less common, they remain important in the financial future of those who have already retired. If inflation returns to the moderate but positive level that has characterized most of the last 20 years, the declining real value of pension benefits will again be a source of justifiable anxiety for retirees and policy-makers.

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