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Visions of the golden years dim as pension promises fade

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By Robert Gavin, Globe Staff | September 17, 2006

ESSEX JUNCTION, Vt. -- After the collapse of Digital Equipment Corp. cost him a 16-year career, Larry Millette started over, taking an entry-level factory job at the IBM plant in this Vermont village.

The pay wasn't great. But to Millette, then in his late 40s, IBM offered something more valuable: a generous pension. By working another 15 years or so, then cobbling together his IBM and Digital pensions, Millette figured he could yet enjoy a decent retirement.

But Millette's hopes have vanished in recent years as IBM all but abandoned the pension first promised to him. Today, after 11 years of 12-hour shifts, Millette has just $30,000 in his IBM pension account. He also has a new retirement strategy: ``Work until I can't work anymore."

Millette, now 59, is among hundreds of thousands of workers whose dreams of long, comfortable retirements are getting upended as US corporations shed both the costs and responsibilities of traditional pensions. Faced with intense competition in a global economy, and huge obligations as baby boomers retire, many of the nation's biggest companies are rewriting the social contract that for 60 or more years has bound them to workers.

Since last year, at least a dozen corporations with nearly 1 million US employees either froze pension benefits for current workers, eliminated pension plans for new ones, or both. Today, just over one-third of Fortune 100 companies still offer traditional pensions to new employees, down from one-half in 2002 and 89 percent in 1985, according to Watson Wyatt Worldwide Inc., an Arlington, Va., consulting firm.

The decline reflects a broader retreat by corporate America from its long-standing role as a provider of social safety net programs such as pensions and health insurance. Under pressure from investors to produce bigger profits and global competitors that don't provide similar benefits, US firms are withdrawing from these obligations and shifting risks, responsibilities, and costs to their workers.

The shift comes as both corporate profits and executive pay soar. Combined profits of the nation's 500 biggest public corporations are at record levels, having grown at double-digit rates for three years, according to Thomson First Call, a Boston research firm that surveys stock analysts and tracks corporate earnings. In about the same period, the average compensation of chief executives at these companies jumped more than 40 percent to $11.7 million a year, according to the Corporate Library, a research firm in Portland, Maine.

At IBM, for example, profits rose 7 percent in 2005, while Chief Executive Samuel J. Palmisano's pay jumped 29 percent to $11.4 million, including salary, bonus, and incentives, according to Securities and Exchange Commission filings. Palmisano, 55, who has worked more than 30 years at IBM, will receive a pension of about $4 million a year when he retires.

Certainly, by today's standards, IBM remains a generous employer. For example, unlike many companies that neglected to set aside enough money to cover future pension payouts, IBM has contributed $6.4 billion in the past four years to keep its US plans well-funded.

IBM once epitomized the old social contract of employee loyalty and corporate paternalism, refraining from layoffs during the Great Depression. The company promised lifetime employment, cradle-to-grave benefits, and a relationship built on the principle ``Respect for the individual."

But in the tumultuous 1990s, battered by changing technology and fierce competition, IBM began to reduce pensions and to redefine its relationship with workers. During a major pension redesign in the late 1990s, company memos described the need to ``eliminate the concept of retirement to the extent possible'' and ``not create long-term incentives to remain at IBM.''

The traditional pension was the cornerstone of the old paternalism. Companies made contributions to pension funds on their workers' behalf; managed the investment of the funds; and assumed the risks of generating enough income to support retired workers until death. Regardless of market conditions, retirees got their pension checks each month.

Now companies are replacing traditional pensions with saving plans such as 401(k)s, which can cut companies' costs by as much as half. Employers make set contributions to individual retirement accounts, and they're done. Choosing investments, navigating the ups and downs of financial markets, and putting aside enough money to last through retirement become the problems of workers.

Given disciplined savings, smart choices, and especially time, 401(k)s can produce greater retirement income than traditional pensions. But for Millette and other workers nearing retirement, time is something they don't have.

Millette knew the world was changing when he joined IBM. His layoff from Digital had taught him that. Still, during his orientation at IBM, which included an entire day to explain benefits, Millette was assured he could yet find security.

``They kept telling us, `If you're a good employee, a loyal employee, and you do your job, you're going to get all these benefits','' Millette said. ``Then someone signs a paper, and you get almost nothing.''

Pensions are born
Millette works seven 12-hour shifts over the course of two weeks. He's on the manufacturing floor of IBM's semiconductor plant by 6:45 a.m., 15 minutes before his shift starts.

Dressed head-to-toe in a white ``bunny'' suit, he spends 10 of the next 12 hours on his feet in an IBM clean room, shuttling between nine tools that plate silicon wafers used in computer chips. When Millette gets home shortly before 8 p.m, he can barely stay awake another hour.

Millette never had big plans for retirement. He just looked forward to puttering around his home in Milton, Vt., tending to the tomatoes, cucumbers, and peppers in his garden; pruning the fruit trees he planted; making wine from his home-grown fruit. He thought he'd see more of his four grandchildren, and maybe even take a trip with his wife of 31 years, Rose.

``You know,'' he said, ``just enjoying whatever time we had left.''

The idea of retirement as a time to relax, travel, and pursue interests put aside during working years is a modern phenomenon. A century ago, two of three men worked past the age of 64. The average age of retirement was 74. The average length of retirement: three years.

``If you look at people in the past, they continued to work in incredible amounts of pain,'' said Dora L. Costa, an MIT economics professor and author of ``The Evolution of Retirement.'' ``When they couldn't work anymore, they moved in with their children.''

Social Security, enacted in 1935, began to change the nature of retirement. At the time, pensions were unusual. But with the outbreak of World War II and the drain on the labor force, more firms offered pensions, health insurance, and other so-called fringe benefits to attract and retain workers.

Meanwhile, high tax rates to finance the war made these programs attractive to both companies and workers, since firms could deduct their contributions and workers didn't have to pay income taxes on the benefits. The system eventually became institutionalized in company policies and union contracts. The result: Corporate-sponsored cradle-to-grave social insurance.

In 1950, the average retirement age was still 70. By 1983, it had slipped to 63, where it remains. Many analysts, however, now expect the age to rise as pension benefits dwindle and health-care costs increase.

Dreams of security

Millette's views of retirement were shaped by his late father, Joseph, who worked for 35 years as a toolmaker at General Electric Co. in Burlington, Vt., retiring nearly 20 years ago with a pension, health benefits, and the economic security the next generation of workers would come to expect.

Millette grew up in Burlington, one of six children. He dropped out of high school to join the Army and spent four years in the service, including a tour in Vietnam. Stationed at a medivac hospital that came under regular mortar fire, he fought in the Tet Offensive, the fierce 1968 attack by North Vietnam that changed the course of the war. He returned home with two service medals, a general equivalency diploma, and a hearing loss that requires him to wear a hearing aid.

In 1977, after several modest jobs, he heard Digital Equipment Corp. was opening a plant in South Burlington. Like IBM, which had opened its Essex Junction plant in 1957, Digital boasted good pay, generous benefits, and a chance for the long-term security that Millette's father had earned.

``The attitude then was, `Thank you for working for us, for being a loyal employee,' " recalled Millette, who still has his Digital badge, No. 61763, and proudly notes he was Digital's 62 d hire in Vermont. ``I thought if I worked hard, did a good job, I wouldn't have anything to worry about."

Millette started at $2.85 an hour, but double-digit raises came every six months as Digital grew rapidly. He was promoted from solderer to inspector, technician, supervisor, and manager. He bought a three-bedroom home on a half-acre, for $41,000.

At the time, Millette's brother, John, worked for IBM, making for explosive family get-togethers. The brothers would argue the superiority of IBM or Digital with the intensity of Yankees and Red Sox fans. Eventually, their relatives imposed a new rule: No more talking about work.

``We both thought we worked for the best companies in the world," John Millette said. ``I ate, slept, and drank IBM. It was all first-class. If you worked hard and kept your nose clean, you had opportunity. You had a job for life."

Enter the `new economy'

Thomas J. Watson Sr., a one-time traveling salesman, built IBM from a struggling conglomerate that made scales, time clocks, and mechanical accounting machines. Assuming the company's leadership in 1914, he forged IBM into a progressive employer, offering good pay, reasonable hours, safe conditions, and even vacations in an era before such policies were common. He once lectured executives that their prime duty was to employ people.

His son and successor, Thomas Watson Jr., brought the company into the computer age, stressing his father's principles of loyalty, dedication, and corporate responsibility. ``I wanted IBM to be recognized as one of the most generous employers in America," the younger Watson wrote in his memoir.

Watson Jr. retired as chairman and CEO in 1971. By the 1980s, IBM and its core product, the mainframe computer, were under assault from new technologies and new competitors, such as Microsoft Corp.

The ``new economy" firms had different relationships with employees, market-based rather than paternalistic. Instead of security, they offer the chance of big payoffs through stock and stock options. Instead of the stability of traditional pensions, they offered the growth potential and mobility of 401(k) plans.

The 401(k), a tax-deferred savings plan, was created in 1978 and named for the section of the US tax code in which its rules are spelled out. A 401(k) is a ``defined contribution" plan, because employers contribute a set amount to employee retirement, often tied to how much workers themselves contribute. Ultimately, this form of retirement plan depends heavily on workers' investment decisions and the performance of financial markets.

A traditional pension, on the other hand, is known as a defined benefit plan. Employers promise to pay workers a set benefit for life after they retire, based on earnings and years of service.

As the cost to companies has escalated, the number of defined benefit plans has fallen by half since 1980, while defined contribution plans have quadrupled, according to the Center for Retirement Research at Boston College. Sixty-five percent of workers with pensions were covered by defined benefit plans in 1980, compared to 30 percent in 2003, the most recent data available.

Several factors are driving the transformation. Many companies view 401(k)s as more attractive because workers, now more mobile, can take the money they build up with them to new jobs. A 401(k) typically costs less for companies. Perhaps most important, the costs, essentially fixed by contribution levels, are predictable.

That's hardly the case with traditional pensions. To meet long-term obligations, companies invest pension funds in stocks and bonds, and make additional contributions as needed. But the amounts can swing wildly, with rising markets reducing corporate contributions and declining markets having the opposite effect.

During the bull markets of the 1980s and 1990s, US corporations made average pension contributions of about $30 billion a year, according to the Center for Retirement Research. When the stock market crashed, the contributions jumped to $45 billion in 2001, and $100 billion in each of the next two years.

Many analysts expect the recently enacted pension reform law to accelerate the shift to 401(k)s, because the law requires bigger corporate contributions to underfunded pension plans and increases exposure to market swings.

``Firms want to get rid of uncertainty, and they're basically shifting it to employees,'' said Jack VanDerhei, a fellow at the Employee Benefit Research Institute, a think tank in Washington.

Handing out layoff notices

In the early 1990s, the same competitive forces buffeting IBM slammed Digital Equipment Corp. After nearly 16 years at Digital, Millette had risen from the factory floor to a manager's office. Now, he was handing out layoff notices.

``What do you mean?'' he still remembers stunned co-workers saying. ``I'm doing my job.''

Millette's own layoff came at the end of 1992. A few months later, Digital shuttered its Vermont plant.

Millette was 45, and, for the first time in his life, worried about retirement. He had always counted on a 30-year career at Digital and the healthy Digital pension, so he hadn't saved a lot. His wife, then a self-employed hair dresser working in her own small shop in Burlington, had no pension at all.

Millette soon found a job in quality control at a pharmaceutical company in St. Albans, near the Canadian border. But two years later, when he heard IBM was hiring in Essex Junction, east of Burlington, he jumped at the chance.

The commute was shorter and he preferred working in technology. Most important, the entry-level job, although paying about half his last Digital salary of about $23 an hour, offered a pension that would help fund his retirement.

``You get to a point in life where you say, `I'm 40-something-years old, and I'm looking for a job,' '' Millette said. ``I needed a bridge to retirement. IBM gave me an opportunity to recover from my layoff.''

Changes begin at IBM

By the time Millette joined IBM in 1995, it was undergoing dramatic changes. Two years earlier, bleeding revenues, profits, and market share, IBM abandoned its no-layoff policy and began slashing tens of thousands of jobs. The company then turned to Louis V. Gerstner Jr. to save it from collapse.

Gerstner, the first outsider to lead IBM, arrived via RJR Nabisco Inc. He engineered what became a legendary turnaround. He also re-engineered the relationship with workers. In 1997, IBM launched a redesign of the employee pension plan that cut benefits, laying the groundwork for further reductions later.

As a February 1998 IBM draft memo explained, new retirement policies should ``move away from entitlement focus; eliminate the concept of retirement to the extent possible;" and ``not create long-term incentives to remain at IBM."

The memo was one of many filed as evidence in an age discrimination lawsuit brought by employees after IBM completed the pension redesign in 1999. A federal appeals court in Chicago recently ruled IBM's plan did not discriminate, but plaintiffs plan to appeal to the Supreme Court.

The revamped pension adopted by IBM is known as a cash-balance plan, which has features similar to 401(k) s. Companies essentially make annual contributions to individual employee retirement accounts, which grow at interest rates tied to short-term Treasury bills.

When workers retire, they can take their pension earnings as lump sums or convert them to annuities, which provide monthly payouts for life. As with 401(k)s, workers also can take these retirement accounts with them when they change jobs.

Employers, in turn, get more predictable costs, typically lower than traditional pensions. IBM, for example, estimated the cash-balance conversion would cut pension costs by as much as $472 million annually in the first 10 years, according to IBM memos filed in the age-discrimination suit.

IBM was one of several companies converting to cash-balance plans in the 1990s in the face of projections that pension obligations would balloon. Retirees were living far longer than they did when traditional plans were adopted, and the approaching retirement of some 78 million baby boomers only promised to add costs. What's more, the company was locked in competition with younger technology companies that had never offered traditional pensions.

The problem with IBM's pension plan, an undated memo argued, was that it provided ``benefits that substantially exceed" IBM's competitors while continuing ``to reflect a lifetime employment model, which is no longer presumptively the right model." Instead, IBM needed to expose its workers to market forces, so they would ``share in the rewards and risks, along with IBM's shareholders," according to the February 1998 draft memo.

IBM executives also said they were competing for talent, and the portability of cash-balance would appeal to younger workers who didn't expect or seek lifetime employment. But, they acknowledged, it wouldn't be so good for older employees -- particularly those with short tenures, such as Millette, who could lose nearly half their benefits.

IBM officials declined to comment on the memos because the case is still in court. But generally, said Randy MacDonald, IBM's senior vice president for human resources, the company has changed benefits as the competition and workforce have changed.

Executive pay soars

With a job at IBM, Larry Millette's life had at last stabilized. His performance ratings were high. Raises followed. His benefits seemed solid. He was perfectly content working on the manufacturing floor.

As he settled onto IBM's production line, taking less than one sick day a year, Millette had no idea executives were embarking on a course that would cut his promised pension in half. There was little reason to suspect it.

Gerstner's turnaround strategy had succeeded. Profits totaled about $20 billion from 1997 to 1999, and IBM's stock price hit new highs. The pension fund was healthy, too. At the end of 1997, shortly after IBM began efforts to cut pension costs, the fund had a surplus -- $8 billion more than needed to cover obligations.

The pension fund, in fact, was generating profits for IBM. Under accounting rules, pension fund investment returns that exceed current and some previous costs increase a company's earnings, just as investment returns that fall short of such costs reduce earnings. By 2001, excess returns grew to 13 percent of IBM's profit, up from 8 percent in 1999, when the cash balance plan was put in place.

The impact of pension income on IBM's bottom line was important to company executives, whose compensation was increasingly based on IBM's financial performance. Gerstner believed executives should face the same risks as shareholders, and tied compensation to profits and stock price through bonuses, stock options, and other incentives.

During his tenure, the top five executives, Gerstner included, were awarded options for around 6 million shares, valued at the time between $300 million and $900 million, depending on possible appreciation, according to SEC filings. These executives received the most options in 1997, just as the project to cut pension costs got underway.

Gerstner, through an IBM spokesman, declined to be interviewed. MacDonald, the human resources executive, said potential stock gains for executives never played a role in pension changes. ``To suggest a quid pro quo is completely irresponsible," he said.

Still, surging executive pay in boardrooms across America has likely played a role in the erosion of traditional pensions, said Alicia Munnell, director of the Center for Retirement Research. Employee pension plans cap benefits at about four times average wages to qualify for federal tax breaks. But as CEO pay soared to nearly 400 times average wages, these benefits became inconsequential to executives.

``The conventional pension system is really not something they relate to," Munnell said.

Many companies, including IBM, created separate executive pension plans to provide retirement benefits above the cap, further disconnecting corporate officers from employee pensions, Munnell said. In Gerstner's case, his $1.1 million-a-year pension was negotiated in his contract, and unaffected by changes to the employee and executive pensions.

Gerstner retired from IBM in 2002, at 60, having engineered one of the greatest corporate turnarounds in history. On top of his pension, he was granted 125,000 shares of IBM stock, with an estimated value of about $14 million, and a 10-year consulting contract that gives him access to IBM perks, such as corporate cars and aircraft. As a consultant, he gets daily fees based on his final salary of $2 million a year. He also held nearly $150 million in unexercised stock options.

`The rules have changed'

IBM unveiled the cash-balance plan in 1999, but it sparked such outrage among employees that the company allowed those over 40, with at least 10 years of service, the choice of keeping the old pension. Millette, with only four years at IBM, didn't get the choice. He was 52.

Today, seven years later, Millette's pension is changing again, and he's not sure it's for the better. In January, IBM said it would freeze pension benefits at the end of 2007 and put in place one of the nation's most generous 401(k) plans, more than doubling IBM contributions to employee accounts.

The company projects that that move and changes in other countries will cut pension costs by as much as $3 billion through 2010. MacDonald, the human resources executive, said IBM faces competitors from Asia and Latin America with far lower costs. If IBM fails to control costs, MacDonald said, the company risks the fate of US steelmakers, automakers, and airlines, which have plunged into or near bankruptcy, slashed tens of thousands of jobs, and, in some cases, abandoned pension obligations altogether.

``We have to evolve with our competition," MacDonald said. ``In the end, our employees understand, this is all about their employment security."

The 26,000 employees still in the traditional-type plan feel the greatest impact from the freeze. But IBM estimates 401(k) contributions -- up to 10 percent of pay -- and investment returns will offset benefit losses. Most of these workers will lose 5 percent or less of their retirement benefits, IBM said.

For employees in the cash-balance plan, IBM will contribute the same amount to their retirement -- up to 8 percent of pay -- but all of it will go into 401(k)s, instead of being divided between cash-balance and 401(k) accounts.

But not ending up worse is cold comfort to Millette, who lost about half his promised pension in the cash-balance conversion.

Millette's retirement problems really began with his Digital layoff. Traditional pensions are structured to gain their greatest value in the final few years of a 30- or 35-year career, so Millette never had the chance to earn those benefits. And he could never make them up.

When the IBM pension freeze goes into effect at the end of next year, Millette will be 60. Using his current earnings of about $40,000 a year, and assuming an annual rate of return of 8 percent, Millette would have to work at least 12 more years before IBM's additional 401(k) contributions equal the benefits he would have received at 65 under the pension he was first promised. That would make him 72.

Millette once thought he might be able to stop working at 62 or 63, but not anymore. Still, he considers himself lucky. He at least has some pension benefits coming from IBM as well as nearly $800 a month from his Digital plan. He has also boosted his 401(k) savings to 17 percent from 15 percent of his pay.

Still with his retirement increasingly dependent on Wall Street, it's hard to feel very secure, Millette said. In addition, health care costs are surging, and could very quickly gobble up retirement income.

``We're comfortable and I'd like to keep this same comfortable feeling,'' said Millette's wife, Rose, 56. ``I'm worried we won't be able to.''

Sitting in the living room of their home, Millette recalled his early days at Digital, when everything seemed secure, and the day he was hired at IBM, when it seemed all right again. Today, Millette says he feels lucky to have a job at all.

IBM laid off hundreds of workers in Vermont a few years ago, and has shed some manufacturing operations. Last year, for example, IBM sold its personal computer unit to Chinese computer maker Lenovo, which later cut 1,000 jobs.

IBM arrived in Essex Junction a half century ago, providing new hope to a community reeling from the shutdown of three textile mills. A job at IBM quickly came to mean good pay, expansive benefits, and lifetime employment.

In recent months, as Millette pulled into work in dusk of early morning, he was reminded how much things have changed. Stretched at the entrance of sprawling complex, a sign advertised for temporary manufacturing workers. Length of job: No more than three years.

``My father, he was in the generation where you worked for a company your whole life, and everything was taken care of,'' Millette said. ``But all the attitudes have changed. All the rules have changed.'' ■

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