Issue Brief

Vanishing: Pensions and Savings

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Introduction

Since the creation of the first pension plan in the late 1880s traditional defined benefit pensions have played a significant role in retirement security for older Americans. Recently, however, defined contribution savings plans have been replacing defined benefit plans, which offer greater protection. The movement away from guaranteed benefits creates the potential for economic hardship for millions of Americans during their retirement years.

This report examines the shifting trends in employer-sponsored pension and retirement savings plans in the private sector[1]; and makes recommendations for protecting existing benefits and expanding coverage for those workers who are not participating in any plan.

Threats to Traditional Pensions and Retirement Security

The typical distinctions between traditional defined benefit, defined contribution and cash balance plans in the private sector can be seen at a glance in Table 1 and in more detail on page 4. Briefly, defined benefit (DB) is a pension plan, defined contribution (DC) is a savings plan, and cash balance (CB) is a hybrid between the two-a defined benefit with defined contribution characteristics. Collectively, they are referred to as employer-sponsored retirement plans.

Ascendancy of Defined Contribution (DC) Plans. The growth in retirement savings plans at the expense of defined benefit pension plans has led retirees and workers to take on more risk in their retirement incomes. Defined contribution plans were initially intended as added savings vehicles to supplement traditional pension plans but over the last 30 years they have been replacing rather than supplementing defined benefit pension plans as employers are encouraging workers to build up their own savings and bear the risk in DC plans such as 401(k)s.

The percent of workers in DB plans has declined by over one-third during the 1990s although maintaining a steady level around 20 percent since 1999 (see Figure 1). DC plans have grown steadily during the same time period with 35 percent of workers participating in a DC plan in 1990-91 rising to 42 percent in 2005, double the percentage of workers in DB plans. Some workers participate in both types of plans, though the decline in DB plans is slowly eroding dual coverage.[3]

Table 1. Characteristics of Retirement Plans[2]			
	Defined Benefit	**Defined Contribution/401(k)**	**Cash Balance**
Participation	Automatic	Voluntary	Automatic
Contributions	Employer	Employee and employer	Employer
Investment risk rests with	Employer	Employee	Employer
Benefits determined by	Years of service and career avg. pay*	Contributions and investment returns	Pay credits and interest credits
How benefits are typically paid	Annuity or lump sum	Lump sum	Lump sum**
Access to funds before retirement/termination of employment	No	Yes***	No
Guarantee by PBGC	Yes	No	Yes
Access to benefits after termination of employment/ before retirement	No	Yes	Yes

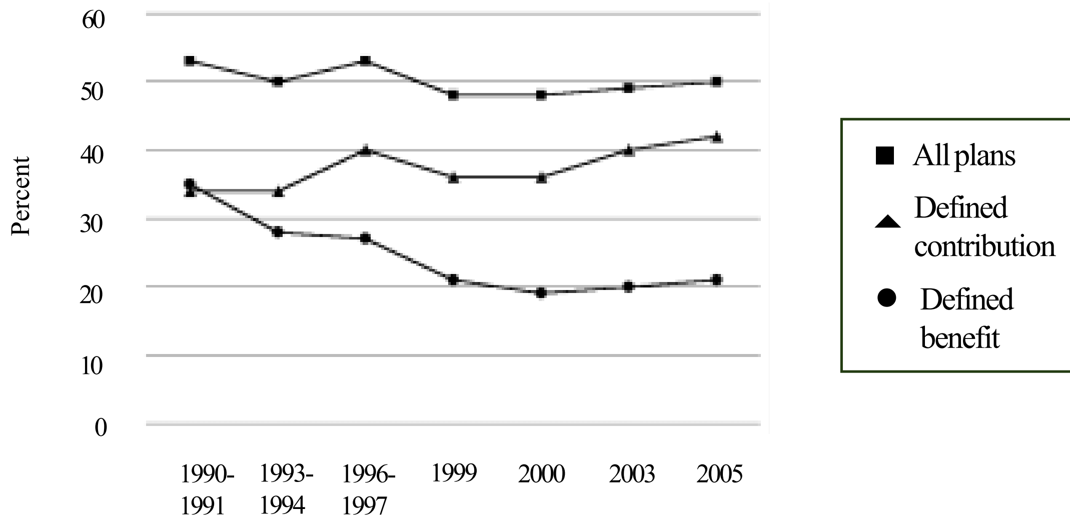
* In most collectively bargained plans, monthly benefits are a flat dollar amount (e.g., $30) multiplied by years of service.
**With the option to take an annuity
*** Loans and hardship withdrawals

As pensions are often a collective bargaining benefit, union workers are nearly five times more likely to be participating in a DB plan than nonunion workers (72 percent vs. 15 percent) and slightly more so in DC plans (43 percent vs. 41 percent).[4]

Within limits, workers with DC plans decide how to invest the assets and bear the risk of returns. Many workers, however, lack financial acumen for making investment decisions. Workers in DC plans do not have the insured protection of the Pension Benefit Guaranty Corp. (PBGC) and are particularly vulnerable to poor market returns. Because DC plans pay benefits out as lump sums and very few workers use their DC benefits to purchase annuities, workers also bear longevity risk—the risk that they will outlive their savings.

Underfunding of DB plans. DB plans are insured by the PBGC with limits on benefits, adjusted each year. The 2005 maximum PBGC insured benefit for a 65-year-old individual is $45,614.[5] Sponsors of DB plans pay annual flat and variable rate premiums to the PBGC for its coverage.[6] A number of events and practices, however, have led to the PBGC running a deficit.[7] Many pension plans are underfunded as a result of large stock market declines since 2000 and the concurrent drop in interest rates to historically low levels. Widespread bankruptcies in the steel and airline industries led to the termination of many pension plans in those industries with significant unfunded liabilities. Some employers began to look for ways to avoid their obligations or shift some of the risks to workers by terminating their DB plans.

Figure 1. Percent of Private-Sector Workers Participating in Employer Retirement Plans, Select Years



Sources: U.S. Department of Labor. Bureau of Labor Statistics. "Documenting Benefits Coverage for All Workers." May 26, 2004; and "National Compensation Survey, March 2005," August 2005.

This has put a tremendous financial strain on the PBGC. While the PBGC had $9.7 billion more than needed to pay benefits in all plans in its single employer program at the end of fiscal year 2000, the federal agency reported a record actuarial deficit of $23.3 billion at the end of fiscal year 2004.[8]

There are proposals under consideration in Congress that would require employers to fully fund their plans as well as pay higher premiums to the PBGC.

Lump Sum Distributions. Both DC and CB plans, and increasingly DB plans, allow for lump sum disbursements at retirement or when a worker changes jobs, instead of the standard monthly annuity. In DC plans, workers may borrow against their accounts or withdraw assets while they are still working under certain circumstances. When changing jobs, most workers take a lump sum payment if available even with tax penalties rather than transferring to an individual retirement account (IRA) or other tax-advantaged retirement account. Workers at retirement typically take the account as a lump sum. To convert an account to an annuity, a periodic payment that typically lasts as long as the annuitant lives, a worker has to purchase it separately from an insurance company. Those who do not convert to an annuity take a chance they will outlive their retirement assets. With DC plans, few workers transfer their accounts when changing jobs and few retirees buy annuities.[9] DB and CB plans must, by law, provide annuities as the default form of benefit, but they can offer lump sums as an alternative benefit form.

Conversion to Cash Balance Plans. In addition to a shift from DB to DC plans, there has also been a shift from traditional DB to cash balance plans.[10] The proportion of DB plans that are cash balance has risen from 4 percent in 1996-7 to approximately 20 percent today.[11]

Retirement Plan Basics

Defined Benefit. A traditional pension plan that uses a specific predetermined formula to calculate the amount of an employee's future benefit, usually a calculation of the number of years of service and a measure of the worker's average salary over a career or the number of years service and a fixed dollar amount. Employers make the contributions, make the investment choices and bear the direct financial risks. Taxes are deferred until benefits are paid. Benefits are insured by the Pension Benefit Guaranty Corporation (PBGC) and usually paid as an annuity. A 2004 law, however, requires automatic rollover to an IRA for small distributions under $5,000.

Defined Contribution. Under the most common type of DC plan, known as a 401(k), employees contribute a predetermined portion of their earnings (on a tax-deferred basis) to an individual account, all or part of which may be matched by the employer. These plans do not have the insured guarantee of the PBGC. At retirement, the worker receives the account balance-the total of deposits and investment income-usually in a lump sum, which is subject to taxation unless the money is transferred to an IRA or another job-based retirement plan.

Cash Balance. A cash balance plan is a hybrid pension plan-a defined benefit plan that has some characteristics of a defined contribution plan. The employer makes the contributions and investment choices and bears the investment risk. The employee's promised future benefits are stated as a hypothetical account balance, which grow with annual pay and interest credits. Unlike in a DC plan, benefit levels are unrelated to the actual investment performance of the plan's underlying assets. In almost all CB plans, workers may take a lump sum distribution of their account or transfer it to an IRA or another job-based retirement plan at termination of employment or retirement. Income tax must be paid when benefits are withdrawn. Benefits are insured by PBGC.

Cash balance plans have been controversial because of their impact on older workers, although other court decisions upheld conversions. In 2003, a federal district court ruled that the basic design of a cash balance plan at IBM violated the age discrimination rules.[12] Furthermore, conversions from traditional DB plans to CB plans frequently have resulted in reduced future benefits for older workers, depriving them of a large part of the benefits they expected to earn, as well as resulted in periods of years in which some older workers earn no new benefits under the plan.

Inequalities in coverage.[13] Those who lack retirement plan coverage generally are workers in part-time or low-wage jobs or who work for smaller companies. Among service workers, only 7 percent participate in a DB plan and 18 percent participate in a DC plan. Similarly, only 9 percent of part-time workers participate in a DB plan; 14 percent in a DC plan.[14]

Even when an employer has a retirement savings plan that covers all employees not all may participate. Low-wage workers in particular have a lower participation rate than high-wage workers. While participation is automatic for workers covered by DB plans, it is usually optional under DC plans. Many workers do not participate because of age, service and number of hours requirements that hinder participation.[15] However, one-quarter of workers with an available plan say that they choose not to participate.[16] And if they do participate, they typically contribute a smaller percentage of their pay than higher wage earners.

Automatic enrollment in a retirement plan is one means of encouraging participation by moderate and low-income workers. A recent analysis showed that, before the adoption of automatic enrollment, only 12.5 percent of workers with annual earnings under $20,000 participated in a 401 (k) plan but after adoption of automatic enrollment, 70.5 percent participated.[17]

Three-fourths of uncovered workers are employed in small companies without a pension plan. Only 10 percent of employers with fewer than 100 employees offer a DB plan and 47 percent offer a DC plan whereas 32 percent of large employers (over 100 employees) offer a DB plan and 87 percent offer a DC plan.[18] In response to reports that small employers do not offer a retirement plan because of cost and administration related reasons, Congress enacted legislation in 1978 to encourage small employers to establish Simplified Employee Pensions (SEP). In 1996, Congress authorized the Savings Incentive Match Plans for Employees of Small Employers (SIMPLE). Both require little paperwork and no government reporting if certain rules are followed. While this has increased coverage by small employers somewhat, additional incentives may be needed.

Pension integration. One of the most unfair provisions in retirement plans, pension integration allows an employer to deduct part of a beneficiary's Social Security payments—up to 50 percent from promised pension benefits in order to reduce plan payouts.[19] Integration particularly adversely affects women who are the majority of low-wage workers.[20]

Corporate Fraud. Tens of millions of retirees and workers have lost or had 401 (k) benefits severely reduced because of corporate fraud and abuse such as the Enron and WorldCom scandals of 2001-02. Despite these events, workers still are heavily invested in company stock and susceptible to corporate exploitation. One study by Hewitt Associates found that more than one in four workers in large companies held half or more of their 401(k) balances in employer stock; many are not diversifying by selling company stock and one in five are not contributing enough to qualify for the employer match.[21]

Pension assets should be considered the property of the employees. ERISA legislation states that pension plan money must be used exclusively for the benefit of workers and retirees. All assets of a pension plan, including employer contributions, are deferred wages. Deferred wages are trade-offs for a promise of a pension that is expected to continue and grow in value and provide adequate retirement income for long-service employees. Workers need representation on the boards of trustees to ensure protection.

Termination and Freezing of Plans. Plan termination can occur not only in bankruptcy situations but also in cases where an employer simply wants to limits its financial outlays. A growing number of employers are cutting off traditional pension plans by freezing benefits particularly for young employees and not offering its pension plan to new hires.[22] By freezing pensions, workers retain the benefits they have already accumulated but lose the potential for further accruals. In a termination, an employer closes down a plan, and defaults to the federal government or moves the pension funds into an insurance policy that will eventually pay out to workers. According to the consulting firm, Watson Wyatt Worldwide, this is a growing phenomenon—the percentage of companies with a frozen or terminated plan rose to 11 percent in 2004, up from 7 percent in 2003, 6 percent in 2002, and 5 percent in 2001.[23]

Low Personal Savings. Personal savings in the United States cannot be much lower. Savings by individuals has declined from 7.2 percent in 1980 to 0.9 percent in 2004.[24]

Employers can encourage more savings by making a substantial match to 401(k)s and other savings accounts. One study found that workers increase their contributions to Individual Retirement Accounts (IRAs) by four times when they receive a 20 percent match to their contribution and they boost their contributions by eight times when they receive a 50 percent match.[25]

A "Saver's Credit" provision was included in the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 to encourage low and moderate-income workers to save for retirement.[26] However, since the credit is nonrefundable, it does not provide incentives to save for those whose income is so low they do not file income tax returns. The credit phases out at modest incomes and it is scheduled to expire at the end of 2006.

Recommendations

The primary goal of any pension reform should be to expand coverage and participation while protecting existing rights of current and future retirees. The following recommendations address that goal.

Expand Coverage and Participation. The lack of pension coverage for a significant segment of the workforce is a serious matter. Low and moderate-wage earners in particular end up without any significant source of retirement income other than Social Security. If adopted, whether by Congress, regulators or employers, the following measures would advance coverage and participation significantly.

- Advance the earliest possible vesting of employer contributions.
- In workplaces with no retirement plan, encourage the creation of hybrids such as cash balance plans that combine the best features of DB and DC plans.
- Institute automatic enrollment in workplace retirement plans, whether DB, DC, or hybrid. Workers could still opt out but would need to take specific action to do so.
- Encourage workers to commit a portion of future pay raises to retirement plan.
- Establish greater tax incentives for employers who start plans or agree to cover all their workers.
- Establish a national educational campaign for employers that explains the importance of starting pensions and retirement savings plans for workers.
- Create more incentives for employers to adopted Simplified Employee Pensions (SEPs).
- Increased employer to employee education about a plan's benefits.

Preserve Current Coverage and Increase Savings.

- In conversions from DB plans to cash balance plans or similar hybrids, older workers must have protections to avoid loss of valuable benefits.
- Expand the Savers Credit limit and make it refundable, permanent and available to those with somewhat higher incomes than currently allowed.

Protect Workers' Interests

Although Congress enacted legislation in 2004 (P. L. 108-218) that addressed some pension issues it did not go far enough. Stricter governance and oversight of retirement plans and those who administer them are still necessary.

- Workers should be encouraged to not cash out or borrow against their DC plans.
- There should be representation of workers and retirees on the boards of trustees of defined benefit pension plans, 401(k) and similar retirement savings plans. The trustees should be insured in the event they are found to have acted unlawfully and plan participants need to be made whole.
- Loopholes that allow companies to underfund pensions should be closed. Plan sponsors should be held accountable for adequately funding their plans.
- Full disclosure of the financial status of the fund and explanation of participants' rights should be provided by the plan sponsor.
- Those who provide financial education and investment advice to plan participants should be free of conflicts of interest.
- There must be special protections for workers when employers make retirement plan contributions in the form of their corporate stock and ample notice before employers institute lockdowns.[27]
- A national ombudsman to protect the rights of plan participants should be established within the Department of Labor.
- Workers should have a voice in the use of terminated pension assets.
- Require workplace education program conducted by impartial third parties.
- Eliminate pension integration.

Conclusion

Social Security, pensions, and personal savings and assets have long been recognized as the three legs or sources of retirement security. Recent developments in the pension and savings arenas—underfunding, stock market volatility, poor investment decisions, corporate fraud and abuse-underscore the importance of maintaining Social Security's guarantee of risk-free, inflation-adjusted lifetime protection. Nevertheless, Social Security was never meant to be the sole source of retirement income. It works best when complemented by an employer-sponsored pension and personal retirement savings. Any reforms in the retirement system must first and foremost expand coverage and participation and protect the interests of workers and retirees.

Endnotes

[1] There are thousands of public pension plans for state, county and municipal employees and several federal plans for federal workers. There are no uniform standards for public pension plans; rules determining the rights of beneficiaries are left to the discretion of each sponsoring jurisdiction. Thus, public pensions are beyond the scope of this brief.

[2] Table is adapted from similar tables in Gale, William G. and Peter R. Orszag. "Private Pensions: Issues and Options." Discussion Paper No. 9. Urban-Brookings Tax Policy Center. April 2003; and Cahill, Kevin and Mauricio Soto, "How Do Cash Balance Plans Affect the Pension Landscape?" Center for Retirement Research at Boston College, December 2003.

[3] U.S. Department of Labor. Bureau of Labor Statistics. "Documenting Benefits Coverage for all Workers." May 26, 2004; and "National Compensation Survey, March 2005," August 2005.

[4] U.S. Department of Labor. Bureau of Labor Statistics. August 2005. There are two types of DB plans insured by the PBGC: single and multi-employer. Multi-employer pension plans are created by collective bargaining agreements covering two or more employers in an industry and represent about 22 percent of workers in DB plans.

[5] The PBGC provides insurance protection for both single-employer and multi-employer defined benefit plans. According to the Government Accountability Office (GAO), this includes over 29,900 single-employer pension plans, covering 34.6 million people. Multi-employer plans cover approximately 10 million participants.

[6] The flat rate premium has been set at $19 per participant since 1991. The variable rate premium was added in 1987 to provide an incentive for sponsors to better fund their plans—for each $1,000 of unfunded vested benefits, plan sponsors pay a premium of $9.

[7] In 2003, GAO placed the PBGC single-employer insurance program on a high-risk list of government operations facing significant vulnerabilities.

[8] U.S. Government Accountability Office. "Private Pensions: Recent Experiences of Large Defined Benefit Plans Illustrate Weaknesses in Funding Rules." May 2005.

[9] Gale, William G. and Peter R. Orszag. op.cit.
[10] In addition to attractive design features of cash balance plans, many employers wishing to terminate their traditional DB plan, have found that converting to a cash balance plan has greater tax advantages than converting to a DC plan.
[11]U.S. Government Accountability Office. "Comptroller General's Forum: The Future of the Defined Benefit System and the Pension Benefit Guaranty Corporation." June 2005.
[12] Cooper v. IBM. So.District of Ill. IBM is appealing the decision.
[13] Coverage and participation have different meanings—coverage means an employer has a plan but the employee may not be in the plan; participation means the employee is enrolled in the plan. In DB plans, enrollment is automatic so it is often used synonymously with coverage. In DC plans, there is a distinction.
[14] U.S. Department of Labor. Bureau of Labor Statistics. August 2005.
[15] The minimum participation provisions of the Internal Revenue Code allow employers to exclude employees under age 21 or with less than one year of employment with the employer.
[16] Munnell, Alicia H., et. al. "How Important Are Private Pensions?" Center for Retirement Research at Boston College. February 2002.
[17] Gale, William G. et al. "Improving Tax Incentives for Low-Income Savers: The Saver's Credit." Tax Policy Center. June 2005.
[18] U.S. Department of Labor. Bureau of Labor Statistics. August 2005.
[19] Through integration, employers are able to take credit for the fact that their Social Security contributions for lower-income workers "buy" proportionately more generous benefits than their contributions for higher earners.
[20] OWL, the voice of midlife and older women. "The State of Older Women in America."
[21] Associated Presss. "Participation Climbs in 401(k) Accounts." May 10, 2005.
[22] Companies that have frozen or terminated their pensions include Hewlett-Packard Co, IMB Corp., and Sears.
[23] Associated Press. "Pensions Freezing Out Younger Workers." July 24, 2005.
[24] Eschtruth, Andrew and Robert Triest. "National Saving and Social Security Reform." Center for Retirement Research at Boston College. April 2005.
[25] Retirement Security Project. May 9, 2005.
[26] The Saver's Credit provides a government matching contribution in the form of a nonrefundable tax credit for voluntary contributions to 401(k) plans, IRAs, and similar retirement savings arrangements up to 50 percent for as much as $2,000 in contributions for married couples earning less than $30,000 and single filers earning less than $15,000.
[27] Lockdowns are periods when workers are prohibited from selling the employer's stock.

This is the seventh in a series of issue briefs from the Alliance for Retired Americans Educational Fund on issues and programs that should be considered at the White House Conference on Aging scheduled for December 11-14, 2005 in Washington, D.C.

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