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PRIVATE PENSIONS

Portability and Preservation of Vested Pension Benefits

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The Honorable J. J. Pickle
Chairman, Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

Dear Mr. Chairman:

On February 8, 1988, your office requested that we study issues relating to the portability and preservation of private pension benefits. On July 12, 1988, we testified before your Subcommittee on the results of our work (GAO/T-HRD-88-24). We also submitted our testimony to the Subcommittee on Taxation and Debt Management, Senate Committee on Finance, which held hearings on pension portability and preservation on the same day (GAO/T-HRD-88-27). This briefing report expands on the information contained in those testimonies.

Pension portability and preservation are two different concepts. Portability refers to the ability to transfer years of service credits or pension benefits from one employer to another; it usually pertains to defined benefit plans. Pension preservation refers to encouraging workers to save cashed-out pension benefits for retirement income; in the context of our report, it usually pertains to defined contribution plans.

In responding to your request, we organized our work around three questions dealing with portability and preservation issues. These questions and our responses to them are summarized below.

How Can Job Mobility Adversely Affect Workers' Pension Incomes in Retirement?

Whether job mobility affects retirement income depends on the type of pension plan one has. For workers with defined benefit plans, changing jobs will usually result in lower retirement incomes compared to similar workers who stay in one plan throughout their careers. For example, mobile workers in plans that use final-pay benefit formulas can experience sizable reductions in pension amounts because (1) benefits and tenure under one plan are usually not transferable to another plan and (2) benefits are based on their earnings at the time they leave the plan rather than at retirement, when the earnings are likely higher. Since mobile workers have fewer years of credited service applied to their last job, the sum of the benefits that they receive from several defined benefit plans is often lower than the pension benefit they would have received by retiring from a single defined benefit plan.

In contrast, workers who participate in a series of defined contribution plans will not experience retirement income losses (assuming comparable rates of return) if their vested pension benefits remain in their previous plans or are rolled over into Individual Retirement Accounts (IRAS) or subsequent plans. However, pension preservation is a concern because, though financial disincentives currently exist, in the past many workers have spent rather than reinvested their cashed-out pension benefits when they left a job.

What Kinds of Portability and Preservation Arrangements Exist, and to What Extent Are They Used?

Some limited arrangements exist for allowing workers to transfer service credits and benefits from one defined benefit pension plan to another when they change jobs. Portability of service is allowed among multiemployer plans and networks of single-employer plans with reciprocity agreements, such as those covering the former Bell System companies. However, these plans cover less than 20 percent of private sector pension plan participants.

Portability of assets is more common than portability of service. Workers in most defined contribution plans are routinely allowed to cash out their pension benefits and have them transferred to another defined contribution plan. In contrast, defined benefit plans usually do not permit large cash-outs.

IRAS are available as a pension preservation mechanism to all workers who receive cashed-out pension benefits. After receiving cashouts, however, many workers have spent rather than saved their pension benefits. The option of transferring benefits to another employer's plan is usually not available. Only 6 percent of all pension plans accept assets transferred from other plans.

What Problems and Tradeoffs Are Involved in Implementing Proposals to Enhance the Portability or Preservation of Pension Benefits?

Implementing proposals to enhance the portability and the preservation of pension benefits will affect workers, employers, and potentially the federal government. Some portability proposals would give workers better retirement benefits but would also increase employer costs. Because most employer pension expenses are tax deductible, the federal government could lose tax revenues with increased portability.

Proposals aimed at increasing portability of service are more complex than preservation proposals. Portability of service could, among other things, (1) compel cost-sharing arrangements, (2) increase administrative burdens, and (3) require ways of translating pension credits between plans having different benefit formulas in order to allocate costs among employers. In addition, any federally mandated portability of service provision would probably have to consider whether to include federal, state, and local government workers.

It is not known how employers will react to increased costs that would result from improved portability of service. Employers could (1) switch from defined benefit plans to defined contribution plans, which are usually easier to manage; (2) establish new plans that reduce benefits to limit cost increases; or (3) become reluctant to hire older workers with long tenure in the work force. Also, because improved portability would reduce the pension losses of mobile workers, it is likely to increase labor mobility and reduce the usefulness of these plans as mechanisms to influence personnel retention. This may alter employers' personnel management practices.

Legislative proposals of the 100th Congress addressed preservation issues. They built on the concept of the rollover IRA, which allows an IRA owner who receives a distribution or cashout to deposit it in another IRA within 60 days without incurring a tax penalty. Some preservation proposals could increase the administrative burden on employers. However, they are less complex and costly than portability proposals.

Although the proposals considered by the Congress focused on preserving cashed-out pension benefits, which primarily affect participants in defined contribution plans, these proposals did not address the job mobility/pension loss issue affecting most plan participants in defined benefit plans. Of all active plan participants, 86 percent had a defined benefit plan; some in this group also had a defined contribution plan. Only 14 percent had only a defined contribution plan. Developing and implementing proposals that address the variety of issues dealing with the portability of defined benefit plans, however, is far more difficult than the proposals for dealing with pension preservation.

We obtained information for this briefing report from congressional testimony, reports, and other pertinent documents at the Congressional Research Service, the Congressional Budget Office, the Departments of Labor and the Treasury, and advocacy groups and representatives for retirees.

We are sending copies of the report to other interested congressional committees, and we will make copies available to others who request them. The major contributors to this briefing report are listed in appendix I.

Sincerely yours,

Joseph F. Delfico

Joseph F. Delfico
Senior Associate Director

Contents

Abbreviations

CRS	Congressional Research Service
EBRI	Employee Benefit Research Institute
ERISA	Employee Retirement Income Security Act of 1974
IRA	Individual Retirement Account
PBGC	Pension Benefit Guaranty Corporation

Section 1

Introduction

Portability and preservation of pension benefits are of long-standing concern to the Congress and others. For example, the 1965 report of the President's Committee on Corporate Pension Funds and Private Retirement and Welfare Programs advocated, among other things, the establishment of a central clearinghouse to manage workers' cashed-out pension benefits. A similar proposal was included in the Senate-passed version of the legislation that became the Employee Retirement Income Security Act of 1974 (ERISA). Other proposals have been debated, considered, and studied since the passage of ERISA. Continuation of the discussion even today is evidence that, while the issues are difficult to address, congressional interest in them has not abated.

The primary motivation for portability and preservation proposals is the desire to promote adequate retirement incomes. The lack of pension portability may cause the retirement incomes of workers who change employers to be lower than if they had stayed with the same employer's plan for a full career. This could happen even if they are fully vested in each employer's pension plan. Because the Tax Reform Act of 1986 also shortened the vesting timetables (e.g., from 10 to 5 years), more workers are likely to have vested benefits in the future. Hence, the issue of portability of vested benefits is likely to take on added importance.

In addition, research has shown that when job changers have been given cashed-out vested pension benefits, most have used the money for nonretirement purposes. To encourage workers to preserve pension benefits for retirement income, provisions in the Tax Reform Act of 1986 provide less favorable tax consequences than in the past (see p. 21) when these funds are used for purposes other than retirement. The effectiveness of this legislation is not known yet.

The pension portability and preservation issues associated with the two categories of pension plans—those with defined benefits and those with defined contributions—are distinctly different. Of all active plan participants in 1980, 60 percent (about 30 million) were in only a defined benefit plan, 26 percent (about 13 million) in a defined benefit plan and at least one supplemental defined contribution plan, and 14 percent (about 7 million) in only a defined contribution plan. Although the majority of pension plan participants are in defined benefit plans, an increasing proportion of pension plan participants—and plan assets—are in defined contribution plans.

Defined Benefit Plans

A defined benefit plan uses a specific formula to compute workers' pension benefits. According to 1984-87 pension data, about 69 percent of single-employer, defined benefit plan participants belonged to plans that used "final-pay" formulas. These plans base benefits in part on salary immediately before retirement. For instance, the pension might be defined as 1 percent of "high-five" pay (the average of the highest 5 years of salary) times years of service. Other defined benefit plans base benefits on career average salary or pay a flat dollar amount per year of service. (The latter is typically used by union plans for workers whose salaries are similar to one another.)

Defined benefit plans help plan-sponsoring employers achieve various personnel management goals:

1. Employers can offset training costs for newer workers with relatively low pension contributions because benefits accrue slowly during the early years of plan participation (compared with defined contribution plans).

2. The benefit formula encourages workers to remain with employers during their prime productivity years because benefits accrue more rapidly during the later years of plan participation.

3. Employers can give workers past service credit when pension plans are set up mid-career so that workers' pension benefits reflect all years of service with the employer.

4. The employer can design benefit formulas to encourage older workers to take early retirement.

From the worker's point of view, defined benefit plans provide predictable benefits that typically are tied to earnings immediately before retirement. Further, such plans put the risk of investment performance on the employer, not the employee. That is, if the investment return on pension assets is not sufficient to provide promised benefits, sponsoring employers are required to make up the difference with increased contributions. Even if sponsoring companies go bankrupt without sufficient assets to meet their pension liabilities, some percentage of workers' vested benefits is generally guaranteed by the Pension Benefit Guaranty Corporation (PBGC).

Defined Contribution Plans

In contrast to defined benefit plans, the pension benefits from defined contribution plans are based on the amount of money accumulated in the participant's individual account, not on a predetermined formula. In a typical defined contribution plan, the employer annually makes a specific contribution to each participant's account—for instance, 10 percent of pay or a percentage of profits. Each account also is credited with its share of investment return, including any increases or decreases in the market value of the underlying assets. In some plans, participants also receive a pro rata share of contributions made on behalf of workers who separate before they are vested; these funds are known as forfeitures. A worker's pension at retirement or termination of employment may be paid in a lump sum, a life annuity (a sum of money payable yearly or at other regular intervals over the participant's life), or a series of installments until the account is exhausted.

From the employer's standpoint, because defined contribution plans involve less federal regulation, they are not as burdensome as defined benefit plans. For example, actuarial valuations (estimating the funding needed to meet future benefit payments) and insurance premiums paid to PBGC—mandated for certain defined benefit plans—are not required for defined contribution plans.

From the worker's point of view, compared with a defined benefit plan, the value of defined contribution plan assets builds at a faster rate during the early years of a worker's participation, but at a slower rate during later years. Also, the vesting schedules are usually shorter, and as described later, workers' benefits are generally unaffected by changing from one employer's plan to another. The main disadvantage of defined contribution plans for workers is that workers bear the risk associated with the investment performance of the pension assets in their individual accounts. This means there is (1) no set relationship between a worker's salary immediately before retirement and the size of the pension benefit and (2) no guarantee of the size of the benefit.

Objectives, Scope, and Methodology

At the request of the Chairman of the Subcommittee on Oversight, House Committee on Ways and Means, we reviewed recent studies and legislative proposals relating to pension portability and preservation for workers vested in pension benefits. In particular, we reviewed (1) studies prepared by actuarial firms and pension consultants on the effect of job mobility on pension benefits, (2) reports issued by the Congressional Research Service (CRS), (3) research on the use of lump-sum pension payments by terminating workers, (4) analyses of and proposals on pension portability and preservation issues by pension experts and lobbying and service organizations, and (5) congressional testimony submitted by the Department of the Treasury, the Department of Labor, and several advocacy groups for retirees. Although we used data generated from these studies, we did not verify the data contained in these sources.

We decided to organize our work around three questions that address portability and preservation issues. These questions are listed below.

1. How can job mobility adversely affect workers' pension incomes in retirement?

2. What kind of portability and preservation arrangements exist, and to what extent are they used?

3. What problems and tradeoffs are involved in implementing proposals to enhance the portability or preservation of pension benefits?

Workers' career patterns can affect their pension income in a number of ways. For instance, workers who do not remain with an employer long enough to meet its plan's vesting requirements will receive no pension income from that employer. Also, workers who incur breaks in pension coverage because of temporary unemployment or part-time employment (less than 1,000 hours per year) will accumulate lower pension incomes than comparable workers with continuous coverage. For this report, we considered only how mobility among employers or among pension plans (in the case of multiemployer plans or companies with more than one plan for different types of workers) affects workers with vested pension benefits.

Our discussion is limited to the effect that labor mobility has on pension income. We realize that pensions are one component of the total financial compensation package—others could include salaries, bonuses, paid vacations, and health benefits—that employers offer to workers. However, evaluating whether workers improve their overall financial position by switching jobs was outside the scope of our effort.

In analyzing how job mobility affects workers' pensions, we considered numerous types of plan designs. The research we examined indicated that the incidence and degree of pension losses due to job mobility is greatest for workers in final-pay plans. Moreover, the majority of defined benefit pension plan participants are covered by final-pay plans.

Therefore, to isolate the dynamics of job mobility loss and simplify the presentation, we restricted our discussion to cases in which individuals were vested under a series of identical defined benefit plans using final-pay benefit formulas and defined contribution plans of equal cost.

Our illustrations (see pp. 16 and 18) of the potential effect of job mobility on pension benefits are based on two examples developed by CRS. The pension plan examples incorporated a joint and survivor annuity benefit that provided a 50-percent survivor benefit for a spouse. One example compares the pension incomes of two hypothetical retirees under identical defined benefit pension plans who differ only in job mobility. The other example contrasts the pension incomes of the aforementioned two retirees with a third retiree vested in one or more defined contribution plans of equal costs. The two defined benefit plans and the defined contribution plan are assumed to cost the sponsoring employer about 6.2 percent of payroll expenses.

The individuals are assumed to have started working full-time at age 23 at an entry salary of $20,000 and to retire at age 65 with a final salary of $48,700. All amounts are in 1988 dollars. The workers receive promotions and general wage increases over their 42-year career.

Both CRS examples are based on the same underlying economic assumptions. Specifically, CRS assumed that wages would grow at a constant 5.4 percent per year, whether or not the worker switched employers, and that the investment return on the defined contribution plan fund would be 6 percent a year. CRS also assumed an inflation rate of 4 percent to convert the future pension income to 1988 dollars.

The defined benefit plan formula used by CRS was integrated with social security. Recognizing employers' contributions to the social security system, the tax code allows employers to coordinate pension and social security benefits in computing workers' retirement benefits. This coordination, known as pension integration, compensates for the social security system's tilt toward lower paid workers by giving proportionately more pension benefits to higher paid workers, and is a common private sector practice. The CRS formula provides a benefit of 1 percent of final average pay for salary up to the average social security taxable wage base (about $45,000 in 1988) and 1.5 percent for salary above it for each year of service. This type of pension integration is called the step-rate method.

How Job Mobility May Result in Lower Pension Incomes

Whether job mobility affects retirement income depends on the type of pension plan one has. Workers vested under a series of defined benefit plans often receive lower pension benefits than workers with comparable pension plans who work their full career for one employer. In contrast, the vested pension benefits of workers participating in comparable defined contribution plans are generally not affected by job mobility. Even though workers in defined benefit plans who change employers have disadvantageous prospects for future pension income, such plans offer employers and workers advantages not provided by defined contribution plans.

Defined Benefit Plans and Job Mobility Loss

A worker vested under a series of defined benefit pension plans can accumulate lower pension benefits than a comparable worker who remains under one pension plan for a full career. This is true even if all the plans have the same benefit formulas and the workers have identical salary and work histories. Under defined benefit plans, pension benefits often are tied to the highest salaries received in the last few years of employment. Typically salaries increase throughout a worker's career but are reflected only in the benefit calculation for the period of time a worker is covered under the pension plan.

For this discussion, we refer to the reduction in pension benefits caused by changing employer-sponsored pension plans as job mobility loss. A loss occurs, for example, when a worker leaves a final-pay plan before retirement age. In this case, pension benefits are based on the worker's final average earnings at separation from one employer, rather than at retirement age, when the earnings are likely higher with the last employer.

Under defined benefit plans, the formula used to calculate terminated workers' deferred pension benefit is not applied to salary or wage gains granted to these workers by future employers. Growth in workers' earnings over a period of years reflects inflation increases, productivity gains, and career advances. We used these components to describe the composition of the job mobility loss below:

- Inflation loss. When workers in defined benefit plans change employers and leave their pension plans, their vested pension benefits usually are retained by the employer and payment is deferred until retirement. Between the time the worker leaves a plan and benefit payments begin, the amount of the deferred benefit is frozen. As a result, its purchasing power is eroded by inflation. An inflation rate of 4 percent, for example, would reduce the real value of a pension benefit deferred for 15 years by about 44 percent.

- Real earnings-growth loss. For various reasons, over their careers, workers generally receive increases in wages and salaries that exceed inflation. One reason is that the longer workers perform the same job tasks, presumably the more efficient and effective they become. Within-grade pay adjustments for federal workers are an example of productivity growth increases. Another reason is that employers offer large wage and salary increases (promotions) during the later stages of a worker's career to provide suitable incentives for younger workers. Job mobility losses happen because future wage and salary gains are not recognized in calculating deferred retirement benefits.

A 1988 study sponsored by the Department of Labor estimated that about 59 percent of the individuals included in its portability model incurred a job mobility loss.[1] For these workers in all types of defined benefit plans who experienced a job mobility loss, the average loss was about 23 percent. Forty-eight percent of these workers had losses between 10 and 39 percent. For workers in single-employer final-pay plans who had two or more jobs, the loss averaged about 34 percent. These estimates were based on a work-force model that used current pension coverage patterns and job histories of a representative sample of the U.S. work force.

The size of the job mobility loss depends on the type of defined benefit plan in which a worker participated before switching jobs. For example, mobile workers covered under final-pay plans can experience the maximum job mobility loss because employers do not consider future wage and salary gains when calculating deferred benefits. In contrast, although protected from losses in real earnings growth, mobile workers in career-average salary plans can experience inflation losses because they are usually excluded from periodic benefit formula updates.[2] Finally, workers leaving flat-dollar plans can experience inflation and productivity losses because they are usually excluded from any later renegotiated increases in the plans' dollar bases.[3]

[1]Hay/Huggins Company Inc., The Effect of Job Mobility on Pension Benefits, report to U.S. Department of Labor, July 1988.

[2]Career-average salary pension plans are defined benefit plans that base pension benefits on average earnings in all years of credited service.

[3]Flat-dollar pension plans are defined benefit plans that provide a specified dollar amount for each year of service.

For illustrative purposes, we calculated the job mobility loss using two hypothetical cases. In performing the calculation we adopted the method used in the 1988 report for Labor. To isolate the dynamics of job mobility loss and simplify the presentation, we restricted our discussion to cases in which individuals were vested under a series of defined benefit plans with identical benefit formulas. We first totaled the benefits that a hypothetical retiree—who had been a mobile worker—would receive from each previous employer and divided it by the pension benefit that the retiree would have received if the last employer calculated the pension benefit based on the individual's full career service. Then we subtracted this percentage from 100 percent.

Using an example developed by CRS, we compared the annual pension benefits of two hypothetical retirees with identical salary histories and pension plan provisions, but different job mobility patterns (see fig. 2.1).[4] Each pension plan provides a retirement benefit equal to 1 percent of high-five pay for the salary up to the social security taxable wage base, and 1.5 percent above it (a common private sector practice called integration), multiplied by years of service. All amounts shown are in 1988 dollars. Under this final-pay benefit formula, one retiree worked 42 years for the same employer, while the other retiree worked for five different employers (2 years with the first employer, 5 years with the second, 10 years with the third, 10 years with the fourth, and 15 years with the fifth).

The job mobility loss in this example is about 49 percent. Total pension benefits from the five plans would be $9,800, or about 51 percent of the nonmobile individual's single-plan pension income of $19,100.

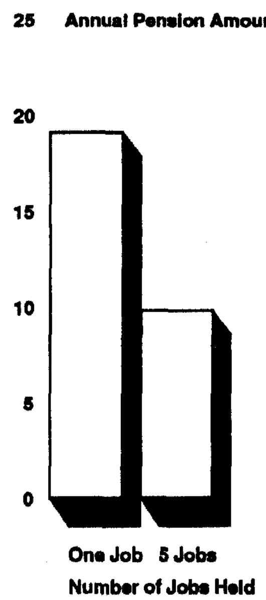
Other recent studies, also using hypothetical examples and applying different assumptions, depicted job mobility losses higher and lower than shown in the CRS study.[5] The job mobility losses in these examples ranged from 15 to 68 percent.

Job mobility does not always result in lower pension incomes. For example, workers vested in defined contribution plans who switch employers and later retire under defined benefit plans can receive higher pension

[4]CRS, Pension Portability: What Does It Mean? How Does it Work? What Does it Accomplish? Report for the Congress, June 1988.

[5]Employee Benefit Research Institute, Pension Portability and What It Can Do for Retirement Income: A Simulation Approach, Issue Brief No. 65, July 1986. Mercer-Meidinger-Hansen, Pension Portability Analysis, December 1987.

Figure 2.1: Effect of Job Mobility on Benefit Amounts in Defined Benefit Pension Plans of Equal Cost



Note: Amounts are based on retirement at age 65 with 42 years of service, starting pay of $20,000 and ending pay of $48,700.

Source: Congressional Research Service.

incomes than workers who remain in comparable defined benefit plans over their entire careers. However, the 1988 study conducted for Labor estimated that only about 3 percent of the mobile workers in its survey improved their pension benefits by switching plans.

Also, although a job mobility loss of 49 percent is possible, this example probably overstates the loss for many workers, for the following reasons:

1. Many pension plan sponsors using final-pay formulas have maximum years of service provisions. Specifically, 30 years of service is a common limit imposed by plan sponsors when they determine pension benefits. Our example uses 42 years of service.

2. Research suggests that the majority of pension recipients work 20 years or more at their final job. The length of time in a worker's last job—when earnings typically peak—is important as defined benefit plans yield higher benefits per year of service for workers who retire

with long plan tenure. Our example assumes that the mobile worker spends 15 years in the final job.

3. The 49-percent loss would be smaller for (a) mobile workers whose pension coverage is not exclusively in defined benefit plans that use final-pay formulas or (b) workers with fewer job changes, slower salary growth, or an earlier retirement age.

4. For workers who receive a second pension from a supplemental defined contribution plan, which is unaffected by job changes, the proportion of pension income that is subject to job mobility loss would be smaller.

Defined Contribution Plans and Job Mobility Loss

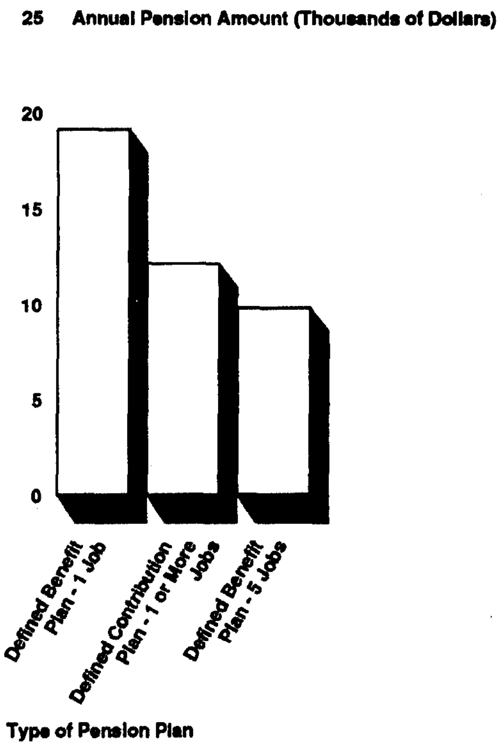
Workers in a series of defined contribution plans who are vested when they leave their employers' plans will avoid a job mobility loss if their pension benefits remain in the plans or are rolled over into an Individual Retirement Account (IRA) or a subsequent plan. This assumes the rate of return on the funds is the same no matter who manages them. The loss is avoided because the ultimate value of the pension assets, and hence the pension they can provide, is based solely on employer contributions and the market performance of an investment fund, rather than benefit computations that are frozen when the worker separates.

Workers who become vested in two or more defined contribution plans during their careers may do better than mobile workers vested in two or more consecutive defined benefit plans, as shown in figure 2.2.

This figure, also developed by CRS, contrasts the earlier example of the two retirees under defined benefit plans with a retiree under a defined contribution plan of equal cost.[6] The individual covered under the defined contribution plan, regardless of the number of job changes, would have an annual pension benefit of $12,100, or about 23 percent more than the mobile worker's total pension income of $9,800 under the defined benefit plans.

[6]The defined benefit plans are assumed to cost the plan sponsors about 6.2 percent of payroll. The defined contribution plan is based on an equivalent employer contribution that earns a 6-percent return on investment.

Figure 2.2: Effect of Job Mobility on Benefit Amounts in Defined Benefit and Defined Contribution Plans of Equal Cost



Note: Amounts are based on retirement age of 65 with 42 years of employment, and starting pay of $20,000 and ending pay of $48,700.

Source: Congressional Research Service.

Limited Portability and Preservation Arrangements Exist

We have identified several examples of public and private pension plans that provide pension portability for mobile workers. In addition, current law permits all workers who receive cashouts to use IRAs to preserve pension benefits until retirement.

Portability of Service

Portability of service—allowing workers to transfer years of service credit from one defined benefit plan to another—exists only in limited cases in the private sector.

The social security retirement income program is an example of a purely portable pension system. It bases benefits on earnings over an employee's entire career, no matter how many times the worker changes employers. However, employment in positions not covered by social security results in no credit for that service. Since its inception in 1935, coverage under social security has expanded considerably, currently including almost all workers in the economy.

By contrast, portability of service in the private sector generally involves transferring service credits within limited groups of employers. Multiemployer plans are examples of portability of service in the private sector. These pension plans are maintained under a collective bargaining agreement that covers the employees of more than one employer. Generally, the various employers are not financially related but engage in the same industry.

Networks of single-employer plans with portability or reciprocity agreements also are examples of portability of service. In 1985, about 6.3 million individuals, or about 16 percent of all active private pension plan participants, were covered by about 3,000 multiemployer plans. The plans covering the former Bell System companies provide examples of reciprocity agreements. Only about 8 percent of all single-employer pension plans have reciprocity agreements with unrelated employers, however, according to a 1981 study sponsored by the Department of Labor.[1]

Portability of Assets

Portability of assets refers to the practice of giving workers a lump-sum cashout of their vested pension benefits when they leave a company's pension plan rather than deferring payment until retirement age. The cashout represents the present value of future benefits from defined

[1] Donald Grubbs, Study and Analysis of Portability and Reciprocity in Single-Employer Plans, report submitted to the Department of Labor, 1981.

benefit plans or the vested account balance from defined contribution plans. Portability of assets is more common than portability of service.

Cashouts of assets generally take place at the plan sponsor's option. A cashout may occur under either a defined benefit or a defined contribution plan. An estimated 30 percent of participants in defined benefit plans and 82 percent of participants in defined contribution plans in 1984 were in plans that permitted cashouts of vested benefits under at least some circumstances, according to a 1986 Employee Benefit Research Institute (EBRI) study.[2] Generally, cashouts from defined benefit plans were not large. Of the defined benefit plans that permitted cashouts, only one-third permitted cashouts over $1,750, according to the EBRI study. By contrast, most defined contribution plans routinely cashed out separating workers, regardless of the amount involved.

Pension Preservation

The issue of preservation arises when workers receive cashouts upon leaving pension plans. Currently, workers may preserve their pension benefits for retirement by transferring them into IRAs or (rarely) other qualified pension plans. Only about 6 percent of all pension plans accepted assets transferred from prior plans, according to the 1981 study for Labor. In any event, most workers who left their employer with cashed-out pension benefits (about 95 percent) did not roll over the money into other retirement vehicles; only about 30 percent used the funds for any kind of investment, according to the 1986 EBRI study.

If a worker receives cashouts several times during a career, and chooses not to roll them over into an IRA or a subsequent plan, the cumulative effect on his or her pension income could be significant, even though the individual cashouts are not large. According to hypothetical examples contained in another study, workers who fail to roll over cashouts from defined contribution plans could lose up to 70 percent of the pension benefits they would have received.[3]

Generally, potential losses are larger in defined contribution plans than in defined benefit plans because (1) in defined contribution plans, pension benefits build up faster during early years of plan participation, when workers are most likely to change employers (see fig. 2.2), and

[2]Lawrence Atkins, Spend It or Save It? Pension Lump-Sum Distributions and Tax Reform, Employee Benefit Research Institute, 1986.

[3]Pension Portability and What It Can Do for Retirement Income: A Simulation Approach, Employee Benefit Research Institute Issue Brief No. 65, April 1987.

(2) as we noted earlier, defined contribution plans generally cash out workers when they leave their employers. By contrast, in defined benefit plans (1) pension benefits build up faster in later years of participation, when workers' salaries and years of service are higher, and (2) only about 11 percent of single-employer defined benefit sponsors allow terminating workers to receive lump sums that exceed $3,500. Workers who receive and spend cashouts of under $3,500 from defined benefit plans can lose about 24 percent of their pension benefits, according to hypothetical examples contained in the 1988 study for Labor. This loss is only 1 percent more than the pension loss experienced by mobile workers who preserve cashouts for retirement purposes.

More workers may preserve pension benefits in the future because of the Tax Reform Act of 1986. The law raised the cost of spending cashed-out pension benefits before age 59-1/2 in at least two ways: (1) it eliminated 10-year averaging for income tax purposes and (2) it imposed a 10-percent penalty tax on pension plan benefits that are not rolled over into an IRA or other qualified plan. This essentially makes the treatment of lump-sum payments similar to the treatment of early withdrawals from IRAs. Because of these changes, more workers may save their pension benefits for retirement purposes.

IRAs are a mechanism that allows mobile workers to preserve their cashed-out pension benefits. Certain restrictions, however, limit the amount of cashed-out benefits that workers can roll over into an IRA. For example, under current law, workers may not roll over their own previously taxed contributions into a successor plan or IRA.

Problems and Tradeoffs in Implementing Portability and Preservation Proposals

There are many proposals that seek to (1) maintain the value of pensions from defined benefit plans, (2) increase the portability of pension assets, and (3) encourage workers to preserve their cashed-out pension benefits. Their primary goal is to help ensure adequate retirement incomes. Some are included in bills introduced in this session of the Congress, while others can be found in earlier legislative proposals or discussions in technical studies, the popular press, or other forums.

Legislative proposals of the 100th Congress generally considered options for encouraging the preservation of pension benefits and, to a lesser extent, portability of assets. They did not address portability of service.

Maintaining the Value of Benefits From Defined Benefit Plans

Portability of service and indexing vested deferred benefits are two methods for maintaining the value of mobile workers' pension benefits from defined benefit plans.

Under portability of service, workers' final employers would credit their workers' years of service with previous employers in determining pension benefits. Under this option, the final plan sponsor would pay a single pension in lieu of the pensions mobile workers would have received from previous plans. Another option would require the final plan sponsor to pay the portion of the benefit in excess of deferred vested benefits from other employers. In both instances, the entire job mobility loss would be eliminated because it would effectively grant to all workers the higher benefits accruing to nonmobile workers. For this reason, portability of service would cause a substantial increase in employer pension costs.

Alternatively, plan sponsors could index vested pension benefits. By using an inflation indicator (such as the Consumer Price Index) as an index, plan sponsors would protect workers' pension benefits from inflation losses. By using an average earnings index, such as the social security average wage index, pension benefits would be protected from losses associated with both inflation and general productivity gains. Indexing deferred pension benefits would substantially reduce—but not eliminate—job mobility loss if workers' earnings over a career increased faster than inflation and general productivity gains. According to the Congressional Budget Office estimates, indexing vested deferred pension benefits would raise the liabilities of a typical plan by 6 to 28 percent.[1]

[1]Congressional Budget Office, Tax Policy for Pension and Other Retirement, April 1987.

To offset the increased cost of portability of service or indexing, employers might reduce future pension benefits, or even terminate their plans. For example, benefits to be earned in the future by workers could be reduced or benefit increases could be delayed to offset the higher benefits earned by mobile workers. Thus, nonmobile workers would implicitly subsidize the cost for portability of service and indexed deferred vested benefits. Or, given the potentially higher pension costs that would result from these two measures and the additional regulatory burden associated with defined benefit plans, defined benefit plan continuation and plan formation may be discouraged.

Some experts question whether the increased labor mobility likely to occur with greater portability of service or indexing of deferred vested benefits is good for the economy. They argue that employers need to be able to recoup investments in recruiting and training workers. Accordingly, one advantage of defined benefit plans to employers is that they help influence turnover in the firm's work force. Diminishing employers' control over turnover that would accompany portability of service could (1) threaten the role that defined benefit plans play as an instrument of personnel policy and (2) substantially reduce an employer's incentive for having a defined benefit plan.

In addition, the various proposals on portability of service would pose substantial administrative problems:

- Special cost-sharing arrangements would have to be implemented to avoid shifting the entire economic consequences of preventing job mobility loss to workers' final employers.
- The paperwork burden on plans would be increased because plan sponsors (or a central clearinghouse) would have to keep track of workers' service under various employers and allocate costs among these employers.
- When plans have different formulas or different actuarial assumptions, translating the pension credits of one plan into those of another for cost-allocation purposes would be complicated.
- Inclusion of federal, state, and local government workers in any portability or reciprocity scheme would have to be considered. Currently, state and local pension plans are exempt from many federal regulations.

Increasing Portability of Assets

Cashing out terminated workers' vested pension benefits would permit workers to consolidate benefits from two or more plans in an IRA or (under some proposals) an account managed by a central clearinghouse.

One option would permit these benefits to be transferred directly to a worker's IRA. Consolidating pension benefits could simplify workers' recordkeeping and retirement planning. It also would allow them or their estates to gain access to these benefits in the event of disability, death, or other contingencies.

From the plan sponsor's point of view, paying cashouts would save plans the trouble of making small benefit payments in the future. Also, defined benefit plan sponsors would not have to pay premiums to PBGC to insure the benefits of vested separated participants.

Portability of assets, however, generally would not increase mobile workers' total benefits from defined benefit plans. This is because the cashouts are calculated on the basis of the workers' final pay (or dollar units, in the case of flat-dollar plans) when they leave their plan. That pay is generally lower than their final pay at retirement.

Pension experts who have examined proposals to increase portability of assets have identified the following problems with these proposals.

- Increased portability of assets would necessitate increased liquidity in pension funds. Also, it would complicate funding of defined benefit plans insofar as the plans' actuaries normally act on the assumption that the plan will begin to pay benefits at retirement age, not at the date of separation, which is more difficult to predict. Furthermore, defined benefit plan sponsors would incur an additional administrative burden in calculating appropriate cashout amounts.
- If portability of assets involves rolling over benefits from a defined benefit plan to the worker's IRA (the most likely scenario), there would be a shifting of investment risk from the plan to the individual. This would make the retirement income of workers less certain.
- Workers who were cashed out of a defined benefit plan at termination of employment would forgo any ad hoc postretirement benefit increases that might be granted to the plan retirees.
- Workers may be made worse off by accepting cashouts because cashouts are reduced to reflect the probability of their dying before retirement. In addition, the spouses of workers who receive cashouts forgo preretirement death benefits that are required by the Retirement Equity Act of 1984.
- Encouraging plan sponsors to give workers cashouts from either defined benefit or defined contribution plans might increase diversion of pension

benefits to nonretirement purposes. This could occur even if these benefits are initially rolled over into an IRA, unless measures to encourage preservation of pension benefits are also implemented.

Encouraging Preservation of Pension Assets for Retirement

Proposals aimed at preserving cashed-out pension benefits for retirement income seek to encourage or require workers to roll over cashouts into an IRA or other investment vehicle to make it more likely that pension benefits will not be spent before retirement. These proposals include:

- Establishing a national portability clearinghouse to manage workers' pension benefits from previous employers.
- Making it possible for plan sponsors to transfer cashouts directly to IRAS or other qualified retirement plans, rather than having to give pension benefits to separating workers.
- Restricting workers' ability to spend cashouts before retirement, or providing less favorable tax treatment associated with consuming cashouts.
- Allowing workers to roll over previously taxed employee contributions into IRAS or successor plans.
- Requiring retirees to receive their pensions in the form of lifetime annuities rather than lump sums to insure that they have a reliable source of income for the duration of their retirement.

Preservation proposals generally do not pose the same tradeoffs as portability proposals for the operation of pension plans because they relate to benefits that already have been distributed from pension funds. However, certain practical issues need to be addressed in considering preservation proposals:

- Workers' spending pension benefits before retirement may be less of a problem in the future because of the new rules contained in the Tax Reform Act of 1986. As it is too early to determine the impact of these new rules, the potential benefits of further restrictions are unclear.
- When workers have discretion as to how much money they contribute to a plan (e.g., 401[k] salary-reduction plans), additional restrictions on spending of benefits may discourage them from using the plan to save for retirement.
- Several experts have expressed concern that, if a central clearinghouse is established as the repository of cashed-out pension benefits, the decisions concerning how to invest the assets of such a federally controlled fund could become a political issue.

- Encouraging or requiring pension benefits to be rolled over into successor plans and IRAs might increase retirement savings, but it also would likely reduce the revenue to the Treasury. This is because fewer early withdrawal penalties would be collected, and the investment income on these funds would accumulate tax-deferred.

Observations

In our assessment of the portability proposals currently under discussion, we found that they could entail difficult economic tradeoffs by employers, workers, and the federal government. For employers, more pension portability could mean greater liabilities, additional administrative expenses, and an increase in labor turnover. As a result, employers could react in various ways. For example, if employers had to pick up a substantial portion of the additional cost, they might decide to shift to defined contribution plans as their primary pension plan. If this occurred, workers' retirement income would depend on the rate of return on their pension contributions rather than on a largely predictable benefit under a defined benefit plan. Some would find this course of action objectionable because the retirement income security of workers will be less certain.

Pension preservation proposals would have less of an effect on the pension system, unless greater portability of assets is also required. Increasing pension preservation would constrain workers from using pension benefits for nonretirement purposes. However, requiring defined benefit plans to cash out pension benefits whenever a worker terminated employment may complicate funding and add administrative burdens.

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