

What Are Pensions?

Pension plans are benefits offered by many employers that provide workers with cash payments in retirement. In 2006, about 24 percent of Americans age 65 and older received pension benefits from past private-sector employers, and about 11 percent received benefits from past public-sector employers (Purcell 2007a). Median annual benefits in 2006 were about \$7,200 among older adults receiving private pensions and \$14,400 for those receiving pensions from government employers.

There are two basic types of employer-sponsored pension plans. Defined benefit (DB) plans, once the most common type, promise specific monthly retirement benefits that usually last until death. Defined contribution (DC) plans, which now dominate, function essentially as individual tax-deferred retirement savings accounts into which both employers and employees usually contribute. Cash balance plans are hybrids that combine features of DB and DC plans. Each plan type affects individual retirement incomes and employer costs differently and raises distinct public policy issues.

How Do Benefits Accumulate?

DB plans base payments on formulas that usually depend on earnings and service years. A typical formula in the private sector sets annual benefits equal to 1 percent of average annual salary for each year of service. Most public-sector plan formulas are more generous, with typical multipliers of around 1.5 percent. Sometimes the earnings base includes all years that the participant worked at the employer, but more commonly it includes only the most recent years, such as the last five. A few plans set benefit payments equal to some fixed annual amount per year of service, regardless of earnings.

DC plans do not promise specific retirement benefits. Instead, employers that provide 401(k)-type plans—the most common type of DC plan—contribute to a retirement account in the participant's name, usually as a specific percentage of salary.¹

Employees can also contribute to their retirement accounts and defer taxes on their contributions until they withdraw funds from their accounts. Employer contributions sometimes depend on how much the participant contributes. Some employers, for example, match worker contributions up to a specific amount, providing few benefits to employees who contribute little to their retirement plans. Account balances grow over time with contributions and investment returns.

Hybrid pension plans combine features of DB and DC plans. In cash balance plans, the most common type of hybrid plan, employers set aside a given percentage of salary for each employee and credit interest on these contributions. Interest credit rates are generally tied to some benchmark, such as the U.S. Treasury bill rate. Benefits are expressed as an account balance, as in DC plans, but these balances are only bookkeeping devices. Plans pay benefits from commingled funds invested in a pension trust on behalf of all participants.

In all plan types, participants must usually remain with the employer a specific number of years to receive subsidized benefits. Federal law limits how long participants must wait before their benefits “vest” and ownership transfers from the employer to the employee. In most DB and hybrid plans, benefits must fully vest within five years if vesting occurs all at once or seven years if it occurs gradually over time. In DC plans, employer contributions must fully vest within three years, or six years if vesting occurs gradually. Employee contributions, however, vest immediately and never revert to the employer.

How Are Benefits Received?

DB plan benefits are generally paid in monthly installments to retirees who have reached the plan's eligibility age, and payments last until death. Surviving spouses also receive benefits unless both partners waive survivor protection in exchange for higher payouts while the plan participant is alive. Federal law requires DB plans to offer these payment schemes, known as lifetime annuities, although some

DB plan sponsors permit retirees to receive benefits as lump-sum payments.² Few private-sector plans adjust benefits paid during retirement for inflation, although cost-of-living escalators are common in the public sector. Most DB plans also pay reduced benefits to participants who retire when they reach the plan's early retirement age.

Cash balance plans must also offer a lifetime annuity with an expected value equal to the participant's account balance. Most participants, however, choose to receive their benefits as lump-sum distributions (Schieber 2003).

DC plan beneficiaries receive the funds that have accumulated in their accounts, generally as lump-sum distributions. Few DC plan sponsors offer annuities. Beneficiaries can use their account balances to purchase an annuity from an insurance company, but few people do so, partly because the terms offered by insurance companies are not very favorable.

DC plan participants can collect whenever they separate from the employer. Distributions received before age 59½, however, are subject to a 10-percent penalty, unless they are rolled over into an Individual Retirement Account or lifetime annuity. Many plans allow departing employees to keep their balances in the plan and withdraw at a later date. People must begin withdrawing from their 401(k) plans once they reach age 70½, unless they are still working.

Benefits from DB, cash balance, and DC plans are generally subject to ordinary income tax when they are received. Participants can, however, deduct any after-tax contributions they made to the plan.

Who Pays for Benefits?

Employers that sponsor DB and hybrid plans set aside funds to cover expected future benefits. Employers invest these funds in a mix of equities and interest-earning securities. Most public-sector employees must contribute a percentage of salary to their DB plans, but few private-sector DB plan participants contribute.

The federal government's Pension Benefit Guaranty Corporation (PBGC) insures private DB and hybrid plans, assuming responsibility for pension payments up to a certain amount if the employer declares bankruptcy. (In 2007 PBGC guaranteed annual benefits up to \$49,500 per participant to those who began collecting at age 65 but less to those who collected earlier.) In return, plan sponsors must pay

PBGC monthly premiums and adhere to specific funding requirements. Because of certain exceptions, however, many private-sector plans are underfunded, with insufficient reserves to cover expected payouts. In 2006, the shortfall among underfunded single-employer plans totaled \$350 billion, about 28 percent of total liabilities (PBGC 2006).

State and local government DB plans are not federally insured and are not subject to federal funding requirements. In 2006, 20 states had less than 80 percent of the funds necessary to cover long-term pension obligations, and the total shortfall for all states reached \$361 billion (Pew Center on the States 2007).

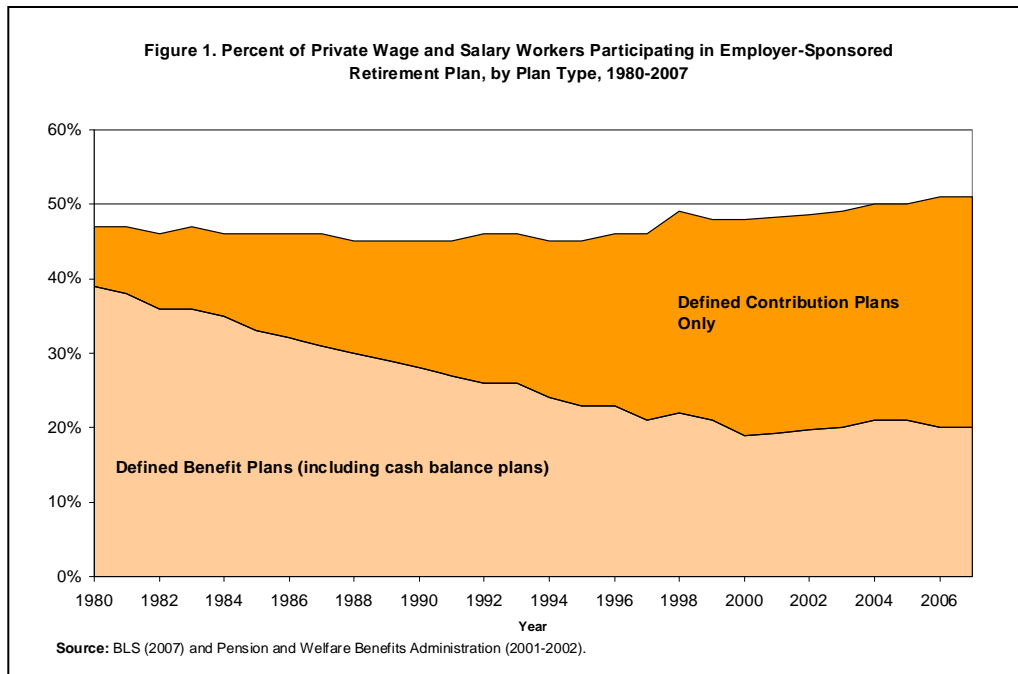
Funding issues do not generally arise in DC plans because they do not promise specific benefits. Instead, participants receive whatever accumulates in the account. Employees usually have some control over how the funds are invested.

As with all employee benefits, workers ultimately pay most pension costs. Employers combine salary and benefits to compensate workers for their productive activities, offsetting higher benefit costs with lower salaries. Because DB plans promise specific benefits, however, employers with DB plans generally end up paying more if investment returns fall short of expectations or workers live longer than anticipated and thus collect benefits longer.

How Do Pension Plans Affect Retirement Decisions?

Most traditional DB plans encourage early retirement and penalize workers who remain on the job after they become eligible to receive pension benefits. DB benefit formulas typically pay more for more years of service, but workers forgo a year of retirement benefits for every year that they remain on the job past the plan's retirement age. The increase in annual benefits from an additional work year does not fully offset the loss from the reduction in the number of pension payments, lowering lifetime benefits. These retirement incentives may become counterproductive as the workforce ages and firms strive to retain older workers.

DC and cash balance plans do not discourage work at older ages because they express benefits as account balances that can continue to grow throughout the worker's career. In fact, workers in



DC plans generally retire about two years later than those in DB plans (Friedberg and Webb 2005).

Who Participates in Pension Plans?

In 2007, 51 percent of private-sector workers—about 57 million people—participated in employer-sponsored retirement plans (Bureau of Labor Statistics [BLS] 2007).³ In the public sector, pension coverage is nearly universal (Munnell and Soto 2007a). Private-sector coverage rates are higher among unionized workers and full-time workers, and rates are lower among low-wage workers, blacks, and Hispanics. In 2006, for example, 55 percent of non-Hispanic whites participated in employer-sponsored pension plans, compared with only about 44 percent of non-Hispanic blacks and 28 percent of Hispanics (Purcell 2007b).

How Has Coverage Changed?

Although overall pension coverage rates among private-sector workers have remained fairly steady over the past three decades, there has been a dramatic shift from DB to DC plans. Between 1980 and 2007, the share of private-sector workers participating in DB plans fell from 39 to 20 percent, while the share participating in only DC plans increased from 8 to 31 percent (figure 1). Assets in private DC plans nearly

doubled between 1997 and 2007, growing from \$2.3 trillion to \$4.4 trillion, while private DB plan assets increased only modestly, rising from \$1.8 trillion to \$2.4 trillion (Investment Company Institute 2007). Private-sector DB plan coverage remains high, however, among unionized workers (67 percent) and workers in firms with 100 or more employees (32 percent) (BLS 2007).

The decline in the heavily unionized manufacturing sector, recent increases in the administrative costs of complying with the complex federal regulations that govern DB plans, and accounting rule changes that now require employers to report pension liabilities on their balance sheets have contributed to the erosion in DB plan coverage (Ippolito 1995; Munnell and Soto 2007b).

Conversions to cash balance plans, which are classified as DB plans for legal and regulatory purposes, have compounded the decline in traditional DB plans. Cash balance plans, which did not exist before 1985, provided coverage for 23 percent of all private-sector workers in DB plans in 2005 (BLS 2005).

DB plans continue to dominate in the public sector, which employs about one-sixth of the workforce. In 2004, 86 percent of state and local government employees, and nearly all federal government employees, participated in defined benefit plans (Munnell and Soto 2007a). The federal

government and some state and local governments also offer supplemental DC plans. Recent efforts by some jurisdictions, including the state of California, to move to DC plans have not been very successful, primarily because of the opposition of powerful public unions. Only two states, Michigan and Alaska, require new hires to join a DC plan (Munnell et al. 2008).

How Has the Decline of Traditional DB Plans Affected Retirement Security?

There are advantages and disadvantages to both DB and DC plans, and the net effect of the shift to DC plans is not yet clear. By providing a guaranteed benefit that lasts from retirement to death, DB plans offer retirement income security for workers who remain with single employers for most of their careers.

Workers who often change employers, however, do not earn many benefits in DB plans. DB plan benefits accumulate rapidly in the years immediately before retirement age. Additional work years increase benefits not only by adding an additional percentage of pay but also by raising the value of previously accumulated benefits by both real wage growth and inflation. Consequently, workers in DB plans generally lose substantial benefits if they are laid off or the firm goes out of business late in their careers. The federal government insures DB benefits that have already been earned, but participants forgo the rapid run-up in pension benefits that they would have received if they had remained employed until the plan's retirement age.

Workers in DC plans, by contrast, don't necessarily lose benefits if they change jobs because their account balances can continue earning investment returns after they separate from their employer. DC plans, then, are well suited to today's increasingly mobile workforce.

DC plan participants face other kinds of risks, especially the uncertainty surrounding investment returns. Workers with bad investment luck or who make unwise choices may end up with little retirement income. Another drawback is that workers generally have to sign up with their employer to participate in DC plans and then agree to have funds withheld from their paychecks. Only 77 percent of eligible private-sector workers at firms that offer DC plans participated in 2007 (BLS 2007), and only 6 percent contributed the maximum amount allowed by law in 2003 (Kawachi, Smith, and Toder 2006).

To accumulate substantial retirement savings, DC plan participants must also resist the temptation to cash in their account balances when they change jobs. For example, only 45 percent of people age 21 to 57 in 2003 who received a lump sum distribution from an employer plan rolled any part of it into another retirement account (Verma and Lichtenstein 2006).

DC plan retirees also run the risk of spending their balances too quickly, leaving them with inadequate income at very old ages, or spending too slowly and not making the most of their retirement savings (Butrica and Mermin 2007). DB plan beneficiaries do not generally face these risks because most receive lifetime annuities that provide regular monthly payments from retirement until death. Relatively few employers allow DC plan participants to convert their balances into lifetime annuities, and annuities purchased from insurance companies are expensive because only those people who live the longest tend to purchase them.

Although the growing popularity of cash balance plans among employers has been controversial, these plans may provide more retirement security than either DC plans or traditional DB plans (Johnson and Uccello 2004). Unlike in traditional DB plans, benefits in cash balance plans accumulate gradually over the career, enabling workers who change jobs frequently to accumulate substantial retirement benefits. They also contain many advantages of traditional DB coverage, including automatic enrollment, federal government insurance of benefits, and mandatory annuity options for benefit payout. Additionally, benefits in cash balance plans are subject to less investment risk than DC balances.

What Are the Key Policy Issues?

- **Promoting Retirement Savings among Workers without Employer-Sponsored Plans:** Recent attention has focused on boosting retirement savings for the nearly two-fifths of private-sector workers employed at firms that do not offer retirement plans (BLS 2007). One approach has been the recently enacted saver's credit, which provides federal government matches of up to 50 percent of the first \$2,000 in retirement savings by low-income adults. The government contribution, however, comes as a nonrefundable tax credit and thus does not benefit savers who do not earn enough to pay taxes.

Some proposals would expand the saver's credit by providing a refundable tax credit to low-income savers. Other proposals would require employers to allow workers to make payroll-deduction deposits to Individual Retirement Accounts or 401(k) plans, perhaps with a government match (Calabrese 2007; Iwry and John 2006). These proposals would not force employers to contribute.

- ***Boosting DC Plan Participation and Contributions:*** The 2006 Pension Protection Act (PPA) made it easier for employers to enroll workers in DC plans automatically, which can substantially increase participation rates (Choi et al. 2004; Gale, Iwry, and Orszag 2006). Only about one-third of employers automatically enrolled participants in 2007, although about half of remaining employers said they were at least somewhat likely to do so in the coming year (Hewitt Associates 2007).

PPA also made recent increases in 401(k)-plan contribution limits permanent. In 2008, individuals can contribute up to \$15,500 a year to their 401(k) plans, and participants age 50 and older can contribute an additional \$5,000. Some argue that these limits should be raised even higher, but higher contribution limits do not appear to boost savings much (Kawachi et al. 2006). And about 70 percent of the tax benefits from new DC-plan contributions in 2004 went to the fifth of tax filing units with the highest incomes; more than 50 percent of the benefits went to the top 10 percent (Burman et al. 2004).

- ***Promoting Sensible Distributions from DC Plans:*** Because few DC plans allow participants to collect their benefits as lifetime annuities, the decline in DB plan coverage may substantially reduce the future number of retirees with guaranteed payment streams outside Social Security. One solution might be to promote deferred annuities that begin at age 80 or 85, insuring people against the risk of running out of money if they live to very old ages.
- ***Preventing Leakages from DC Plans:*** Tightening rules that permit workers to dip into their retirement savings when they change jobs could increase resources available for old age. Some workers, however, may be less likely to contribute to retirement plans if they could never access their funds at earlier ages.

- ***Improving Financial Literacy:*** As responsibility for retirement planning falls increasingly on families and individuals, the ability to make informed financial decisions is becoming increasingly urgent. People need to decide how much to save in DC plans, how to invest their contributions, and how to convert their account balances into payment streams that will support them in retirement. Yet, only 43 percent of surveyed workers in 2007 said they have tried calculating how much money they will need for retirement, and many appear to underestimate retirement needs (EBRI 2007). Better access to professional investment advice at work could improve retirement planning.
- ***Shoring up Finances of Private-Sector DB Plans:*** Employer bankruptcies could force the PBGC to assume responsibility for many unfunded pension liabilities, threatening the agency's solvency and raising the possibility of a taxpayer bailout. PPA tightened funding requirements and increased the insurance premiums paid by plan sponsors to fund PBGC, improving the agency's financial outlook. But added regulation could lead more employers to terminate their DB plans and further undermine traditional pension coverage.
- ***Bolstering Financial Condition of State and Local Government Plans:*** Large unfunded pension obligations in the public sector, which are not insured by the federal government, could eventually force state and local governments to raise taxes, renege on their pension promises, or cut back on other services. Rising retiree health benefit costs will likely further strain state and local government finances.
- ***Improving Phased Retirement Options:*** Many workers say they would prefer to switch to part-time work with their current employer as they grow older, rather than moving directly from full-time work to complete retirement (AARP 2003). At the same time, few workers can afford to cut back their hours without collecting retirement benefits. Federal law limits employers' ability to make DB plan payments to active workers. PPA recently eased these restrictions, but most employers are still unable to pay DB plan benefits to workers on the payroll younger than age 62.

Notes

1. Other DC plans include deferred profit-sharing plans and employee stock ownership plans. Only private for-profit firms may offer 401(k) plans, named after the section of the tax code that governs them. Equivalent plans are known as 403(b) plans in the nonprofit sector and 457(b) plans in the public sector.
2. DB plans do not have to offer an annuity, however, if the expected lifetime benefit value does not exceed \$5,000.
3. This total excludes the self-employed, workers in private households, and government workers.

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