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## Pension Policy

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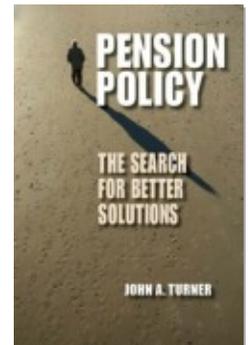
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# 4

## Labor Market Policy

### Portability and Retirement

Pension plans contain labor market incentives and disincentives that may affect important life decisions of workers. These incentives may affect whether workers change jobs and the age at which they retire. The incentives, and the resulting decisions, may affect the efficiency of the matching of workers to jobs in labor markets, impeding or encouraging attachment of workers to particular jobs.

#### PORTABILITY

Pension portability is an issue primarily for workers in defined benefit plans. It is the ability of workers to change jobs without losing future pension benefits. The extent to which this feature is part of a pension system depends on the particular design of the pension plans in the system, which may be affected by government regulations establishing minimum standards.

Two factors have made pension portability an important policy issue. First, U.S. workers have a relatively high level of job change. Second, Social Security benefits are relatively modest, which has led U.S. workers to rely more on employer-provided pensions than workers in most other countries.

Job tenure has decreased for older male workers. While average job tenure has increased when one considers workers of all ages, that has occurred because of the aging of the workforce, since older workers have higher average job tenure than younger workers. For male workers ages 45–54, their median job tenure declined from 12.8 years to 8.1 years, a decline of 37 percent, from 1983 to 2006 (Valletta 2007). Median job tenure increased for women, but because it is lower than

for men the influx of women into the labor market lowered average job tenure.

Portability losses vary by type of plan. Workers in defined contribution plans suffer negligible portability losses because their vested benefits continue to be invested the same as if no job change had occurred. Workers in multiemployer plans have no portability losses to the extent that they change employers within the plan. However, workers with single-employer, final-average-pay plans can suffer sizable portability losses (Turner 1993).

Workers who change jobs and are covered by defined benefit plans often suffer pension losses that result in reduced retirement income. Facing such a loss, a worker may decide not to make a job change that would otherwise be desirable, raising concerns for labor market efficiency. Because of penalties for workers who leave a job before retirement, defined benefit plans can inhibit workers from making job changes that would otherwise be desirable for them and for the efficient functioning of the labor market.

As well as affecting job changers, defined benefit plans can penalize workers who are laid off, suggesting the possible need for policy to protect those workers when healthy firms reorganize. Defined benefit plans may also penalize people who must quit jobs because of family responsibilities, which is particularly a problem for women.

This section describes ways that pension portability for U.S. job changers has been achieved. It describes both the minimum standards mandated by law and the arrangements that some employers have made that exceed those requirements. While it indicates the most commonly used methods to achieve portability, it discusses other, less commonly used methods because they are possible models for extending portability to more workers.

Portability losses are only one aspect of the risks facing workers who participate in pensions. While portability is achieved more readily in defined contribution plans than in defined benefit plans, risks also occur in defined contribution plans with respect to investment in financial markets and converting account balances to annuities that do not occur in defined benefit plans.

Pension portability has traditionally been considered to be the ability of a worker to carry a pension from one pension plan to another.

More recently, policy analysts have expanded its meaning to include the ability of workers to preserve the value of pension benefits at job change.

### **Defined Benefit versus Defined Contribution Plans**

Pension portability largely presents a problem only for traditional single-employer defined benefit plans. For defined contribution plans, such as 401(k) plans, portability is not a serious problem. Workers generally do not suffer portability losses in defined contribution plans once they have vested. “Vested” means that the worker has an irrevocable right to a future benefit.

The most common type of U.S. defined benefit plan is the single employer plan. Typically, workers who participate in that type of plan and who leave a job before they are eligible for retirement benefits suffer a loss in future benefits. There are two important exceptions, however—cash balance plans and multiemployer plans.

Cash balance plans are hybrids incorporating features of both defined benefit and defined contribution plans. Under U.S. pension law, all plans must be categorized as either defined benefit or defined contribution plans. It would be desirable to amend U.S. pension law to recognize hybrid plans, such as cash balance plans, as a separate category with its own regulatory framework. Cash balance plans are categorized as defined benefit plans because the employer must provide a promised level of benefits. They accrue benefits in a pattern similar to defined contribution plans, which is more favorable to short-term workers than the accrual pattern in traditional defined benefit plans. With a cash balance plan, each worker has an individual account to which contributions are credited, and interest is credited on the account balance. However, the individual account is purely an accounting entry, and thus is considered “notional.” No assets are assigned specifically to the account, and the crediting interest rate is not related to the return received on assets held by the plan. The plan differs from a defined contribution plan in that the interest crediting is fixed in advance or is tied to an index rather than being tied to the investment earnings on the assets held by the plan.

Multiemployer defined benefit plans are typically provided when one union has contracts with a number of employers. Multiemployer

plans are more common in some European countries than they are in the United States; they play an important role in the pension systems in Denmark, France, the Netherlands, and Sweden.

### **Causes of Pension Loss for Job Changers**

When workers change jobs or are laid off, they suffer a loss of benefits in single-employer defined benefit plans. Portability losses can be grouped into two categories: 1) loss of real value of benefits the worker has accrued to date, and 2) the worker's loss of the right to an increase in benefit generosity with increased job tenure. Some types of pension plans reward workers with long tenure, and loss of that aspect of benefit generosity causes many workers who change jobs to have lower pension benefits at retirement than those who stay with a single employer.

**Loss of benefits accrued to date.** Portability loss for job changers includes the loss of pension assets because of lack of full vesting. This loss occurs in both defined benefit and defined contribution plans. When workers start participating in a pension plan, they begin accruing benefits, but they do not have full ownership rights to those benefits until they have vested. The loss of benefits due to a worker failing to vest is generally relatively small in defined benefit plans because workers accrue relatively little in the way of pension benefits in their first few years of work. That occurs in part because their wages are relatively low and in part because of back-loading, which, when calculating pension benefits, places relatively little value on earnings received early in life. However, as the worker approaches the point of vesting in a plan that requires five years of covered work for vesting, the size of the portability loss grows. For young workers, the loss in benefits that would have been received at retirement from the failure to vest a small account balance in a defined contribution plan can be substantial because of the growth in investment earnings over many years.

Portability loss also includes a loss in the real value of pension benefits accrued in a defined benefit plan at the point of job change compared to the value of accrued benefits at job change if the worker were to remain in the job until retirement age. In defined benefit plans,

when a worker changes jobs or is laid off, his pension benefit is based on his nominal earnings at the point of job termination. U.S. defined benefit plans do not index for inflation between the time of job change and the time the worker starts receiving pension benefits. Thus, inflation may seriously erode the pension's real value. Portability loss tends to be highest for long-term workers who change jobs or are laid off a few years before they are eligible for retirement benefits (Turner 1993). These workers have accumulated significant benefits, but they still have a number of years over which inflation erodes the real value of their accumulated benefits.

UK pension law requires defined benefit plans to index the benefits of vested terminated workers for inflation up to a maximum of five percent per year (Blake and Turner 2002). A similar requirement exists in Ireland. These requirements greatly reduce portability loss, both for job changers and for people who are laid off.

A simplified view of pension benefit loss for job changers may focus only on two factors. The first is the loss due to lack of vesting. The second is the loss in defined benefit plans due to the lack of inflation indexing between the point of job change and the point of commencement of benefit receipt of wages used to calculate the benefits of job leavers. Of these two factors, the lack of inflation indexing is far more significant as a source of portability loss. Ending that source of loss of pension benefits by requiring employers to price-index wages used in benefit calculations would go a long way toward eliminating portability losses in defined benefit plans, but also would be expensive for employers. In a voluntary pension system, policy changes that place added cost on employers may induce some to stop providing a pension plan.

A third aspect of portability loss not discussed in previous analyses is the problem of lost pensions and lost pensioners. When workers change jobs or leave the labor market and leave a pension benefit with a former employer, they ultimately may be unable to find that employer to claim a benefit at retirement age. This problem occurs in both defined benefit and defined contribution plans, but is more prevalent in defined benefit plans because they are less likely to provide portability (Bruce, Turner, and Lee 2005). The employer may have changed location, changed names, been bought out by another firm, merged with another firm, gone bankrupt, or simply gone out of business. Because

of these changes, workers may encounter difficulties finding their pension plans to claim benefits. Similarly, an employer attempting to find a former employee who has moved may be unable to do so.

The lost pension problem has been largely solved for Australian and British job changers. Both countries have national pension registries. The registries, however, do not solve the problem for workers who do not realize they are eligible to receive a pension. Pension portability helps to resolve the problem to the extent that workers are able to maintain a single pension plan with their current employer, or to maintain an IRA. Employees can readily claim their benefits from these plans.

**Loss of the option to receive future tenure-based accruals.** A more complete view of portability considers several other aspects of pension benefit loss. These aspects include features that cause benefits to accrue more rapidly for long-tenure workers or for workers near retirement than for short-tenure workers.

First, portability loss includes the job changer's loss of the right to generous future pension accruals when pension accrual rates increase with job tenure. This feature can occur in either defined benefit or defined contribution plans, but is much more common in defined benefit plans.

Second, job changers may suffer a benefit loss in a defined benefit plan because of the difference in generosity between normal and early retirement benefits. Job changers' benefits usually are calculated based on retirement at normal retirement age, rather than at early retirement age. Benefits at early retirement age often are more generous in terms of the lifetime value of benefits than those received at normal retirement age. Employers may structure benefit formulas this way to encourage workers to work until the early retirement age and then take early retirement. For example, a plan may specify that benefits are reduced by 6 percent per year before the normal retirement age if the worker leaves before the early retirement age, but only by 3 percent per year from the benefit receivable at the normal retirement age if the worker leaves at the early retirement age (Gustman and Steinmeier 1995).

## The Accrual and Transferability of Pension Benefit Rights

The following sections discuss portability issues for job changers relating to the accrual and transferability of benefit rights. The issues occur with both defined contribution and defined benefit plans.

**Vesting.** The benefit protection workers receive by vesting differs greatly between defined benefit and defined contribution plans. With vesting, workers in a defined benefit plan acquire a right to a nominal benefit (not indexed for inflation) that workers retain if they change jobs. In a defined contribution plan, workers acquire a right to their account balance. Since account balances in defined contribution plans continue to benefit from investment experience, they generally continue to grow in real value after a worker leaves a pension plan. The reverse happens for defined benefit plans, where inflation erodes the real value of the nominal earnings used to calculate benefits.

Vesting standards for private sector pension plans, set by U.S. pension law, establish the maximum period allowed before vesting occurs. Firms can choose to provide vesting earlier. U.S. pension law gives employers some flexibility in choosing how rapidly to provide full vesting. Under the standard many employers choose, workers must vest in their pension benefits within five years of participation in the plan. This vesting rule is called cliff vesting because the employer can provide zero vesting up to the time when the employee has five years of participation, followed by 100 percent vesting at five years. Under graded vesting, the employer must provide 20 percent vesting after three years of participation, following which the percentage of vesting increases by 20 percent a year, so that the employee reaches 100 percent vesting after seven years of participation. In either case, if a pension plan terminates, all employees fully vest immediately.

Some policy analysts have argued for shorter vesting requirements, such as are in place in some European countries, which permit short vesting periods. Vesting occurs after nine months in Denmark, one year in Belgium, and two years in Ireland and the United Kingdom (Commission of the European Communities 2002).

Employees accruing creditable service for vesting must work a minimum number of hours in a year. That minimum is set in pension

law at no greater than 1,000 hours, which is approximately half-time work for a year. With this minimum, a worker could work a substantial amount of time for many years and never be covered by the plan provided by his or her employer. Some participants' advocates have argued for lowering the exclusion level to 750 hours per year.

Employee contributions (both voluntary and mandatory) to their pension plans vest immediately. If employees change jobs, they can receive refunds of those contributions plus the earnings on those contributions. Employee contributions are common in defined contribution plans but rare in U.S. private sector defined benefit plans because employee contributions to defined contribution plans are exempt from taxable income but contributions made to private sector defined benefit plans are not. Most public sector defined benefit plans require employee contributions, and those contributions are tax deductible for state and local government employees. Tax deductible employee contributions are common in pension plans in Canada, the Netherlands, and the United Kingdom.

Employers often make matching contributions in 401(k) defined contribution plans. These contributions match contributions made by employees where, for example, the employer contributes up to three percent of pay when the employee contributes an equal amount. Employer matching contributions must vest within three years for cliff vesting, or with graded vesting must be 20 percent vested after two years, increasing in 20-percentage-point increments up to full vesting after six years.

Defined contribution plans often provide vesting after shorter periods than required by law, while defined benefit plans generally do not. Thus, defined contribution plans tend to provide quicker vesting than defined benefit plans. The reason for this difference may be that employers tend not to use defined contribution plans as a personnel tool to encourage worker attachment to their firms, while they may view defined benefit plans as serving that purpose. An alternative explanation may relate to the need to encourage the participation of low-wage workers in order to meet nondiscrimination rules.

**Transferability of benefit rights—rollovers.** One advantage to workers of pension portability is convenience: it is simpler for workers

to keep all their pension assets in a single plan rather than in multiple plans, including plans from former employers. It is also more efficient for workers to have one larger pension account rather than several smaller ones, because of economies of scale in the cost of managing accounts. This results in lower total fees.

A pension rollover occurs when a worker transfers pension assets from one plan to another plan. The transfer of assets from one pension plan or individual account to another occurs without current income tax liability to the pension participant. It allows job changers to consolidate their pension plans. Rollovers occur more commonly from defined contribution plans than from defined benefit plans because not all defined benefit plans permit them. They almost always are made to defined contribution plans.

Rollovers generally are voluntary. Workers voluntarily make them. Firms voluntarily offer them as an option to departing workers. Plans voluntarily accept them from new workers.

**Portability across persons.** The concept of portability usually refers to portability across plans for a given worker, but it can be extended to include the transfer of pension benefits between people. The Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 expanded the types of pension plans that are eligible for rollovers from survivors. A surviving spouse now has the same rollover opportunities as the participant would have enjoyed. For example, surviving spouses can roll their deceased spouse's pension plan benefits into their own defined contribution plan if the surviving spouse's employer's plan permits it. Portability between persons could be expanded further by allowing it between same-sex partners, between parents and children, or between any two persons.

Permitting rollovers from defined benefit plans to defined contribution plans may eliminate benefits for surviving spouses. In a U.S. defined benefit plan, a joint and survivors' annuity must be an option. Furthermore, the worker must choose that option unless the worker's spouse signs a notarized statement waiving his or her right to that option. When the funds are transferred to a defined contribution plan, however, survivors' benefits are not provided. However, defined benefit plans do not typically provide benefits for surviving children, although

the remaining account balance can be inherited by the surviving children of a single parent.

### **Back-loading of Benefits**

Portability broadly means that both short-tenure and long-tenure workers receive pension benefits of roughly equal generosity relative to their compensation. Generosity of benefits received by short-tenure workers depends on the extent to which benefits are front-loaded or back-loaded. Front-loaded benefits accrue relatively more rapidly for workers beginning their careers, while back-loaded benefits accrue relatively more rapidly later in one's career. To protect the benefit rights of short-tenure workers, pension law limits the extent of back-loading.

In defined benefit plans, the extent of back-loading of accruals depends on the benefit formula. The law specifies that plans must satisfy one of three tests. One of the tests is that the accrual rate in any future year of service may not be more than one-third higher than the accrual rate for the current year. Benefits amounts under this test may be expressed as dollar amounts or as a specified percentage of compensation. This rule must be used for all defined benefit plans having a career average formula.

Plans based on final average earnings are back-loaded and may be of little benefit to employees who change jobs several times during their careers. These plans are back-loaded because the benefits accumulate at a more rapid rate relative to compensation later in a worker's career. As a worker gains more experience, one larger amount—the worker's pay, which generally grows over his or her career—is multiplied by another rising amount, years worked. The multiplication in the benefit formula of two factors that are both growing with tenure yields benefit accrual rates that increase with tenure.

Cash balance plans provide workers greater portability than traditional defined benefit plans. Workers have a readily determinable balance in their accounts, and the value of the balance is not affected by job change. With cash balance plans, benefits generally accrue more rapidly for short tenure than is typically the case in traditional defined benefit plans. The extent to which these plans favor short-tenure workers compared to other defined benefit plans, however, depends on the

plans' parameters. With cash balance plans, for a given level of generosity over a full career, the greater the contribution rate and the lower the crediting rate, the more favorable is the plan to short-service workers. For a given level of generosity, the higher the crediting rate, the more back-loaded the plan. Also, however, most cash balance plans provide pay credits that increase based on the participant's age or service, which adds an element of back-loading. A survey of cash balance plans provided by Fortune 1000 companies found that only 35 percent paid level pay credits for all participants, meaning that all workers received the same crediting rate relative to their compensation. For example, one plan provides annual pay credits of 3 percent for participants having four years of service or less, with incremental increases up to 9 percent for participants with 25 or more years of service (GAO 2000).

### **Portability in Defined Contribution Plans**

The growing importance of defined contribution plans is improving the portability provided by the U.S. pension system. Once a worker has vested in a defined contribution plan, that worker may change jobs with no loss of accrued benefits.

Many workers, particularly those with short tenure and small account balances, when they change jobs, take the money out of their pension plans. Pension law has changed the default so that when a worker leaves a job with a small amount in his pension account—between \$1,000 and \$5,000—the employer rolls it over into an Individual Retirement Account (IRA) rather than the worker cashing it out. This policy is designed to discourage workers from cashing out their 401(k) accounts and to encourage them to keep their accumulated pension assets in the retirement income system. When a worker leaves a job with a larger amount, it might be desirable for pension plan sponsors to make automatic rollover into an IRA the default to discourage workers from taking the account balance as a lump sum.

Pooling assets across employers is easily achievable for defined contribution plans. Because generally no portability losses are associated with vested assets in defined contribution plans, pooling of assets is mainly a convenience so that workers do not maintain account balances in different plans. Pooling across employers is achieved for

most university professors through the Teachers Insurance and Annuity Association and the related College Retirement Equities Fund (TIAA-CREF), which both offer defined contribution plans. TIAA-CREF covers 12,000 nonprofit institutions, including government and private universities, other educational institutions, nonprofit research organizations, and some museums. In this network, U.S. university professors can change jobs among most colleges, universities, and nonprofit research institutions and maintain their defined contribution pension account with TIAA-CREF.

Individual Retirement Accounts (IRAs) are not tied to a particular employer. When a worker changes jobs and receives a preretirement distribution from his or her pension plan, that distribution can be deposited into the worker's IRA without tax consequences, as long as it is done within a certain number of days after receiving the distribution or it is sent to the IRA directly by the plan of the former employer. A large part of the assets in IRAs are due to these deposits. If a worker declares bankruptcy, IRAs are not protected from the worker's creditors, while other pension plans are protected. Thus, a worker loses bankruptcy protection by rolling over an employer-sponsored pension into an IRA.

### **Portability in Defined Benefit Plans**

Portability in defined benefit plans can be achieved three ways: 1) preserving the real value of benefits or assets within a single employer plan, 2) pooling pension assets across employers in a multiemployer plan, and 3) transferring pension assets or credited service between plans.

**Preserving the real value of benefits or pension assets in a single employer plan.** For most U.S. single-employer defined benefit plans that are not cash balance plans, workers suffer a portability loss when they change jobs. This loss occurs in part because the benefits accrued to date but received later at retirement are based on the worker's nominal earnings at the point of job change, which are not indexed for inflation between that time and the date at which the worker reaches retirement age and is eligible to collect those benefits. In a cash balance plan, by contrast, the worker has an account to which interest continues to be credited after he changes jobs.

**Pooling assets across employers in a multiemployer plan.** Multi-employer plans offer a number of positive features for workers. Pooling assets across employers occurs when multiple employers establish a multiemployer pension plan in which their employees may participate. Pooling pension assets across employers may help employers reduce administrative costs because of economies of scale. This type of pooling arrangement allows workers to change jobs among employers participating in the plan without changing plans and without a portability loss. U.S. multiemployer pension plans are predominantly defined benefit plans. They provide portability of service in that workers can change employers within the plan and their service with the different employers counts without penalty towards the accrual of retirement benefits.

U.S. multiemployer plans generally are established as a result of a collective bargaining agreement between a union and a number of employers. They cover many occupations in one industry, or one occupation in many industries. They tend to encompass a limited geographic area, such as the metropolitan area associated with a large city. In recent years, some multiemployer plans have merged; combining in this way provides enhanced portability across jobs because more jobs are covered within a single plan. This trend may have been facilitated by developments in computer technology that have simplified the administration of plans with many employers.

Multiemployer plans tend to develop in industries with many small firms. The workers in the industry generally are skilled, and all of them belong to the same labor union. The industry tends to have both a high turnover of firms and a high turnover of workers across firms. In the construction industry, for example, carpenters and plumbers typically work on one project until it is completed, then work on another project with a different employer. The decline of unionism has reduced the importance of multiemployer plans.

An example of a geographically based multiemployer plan is the Unified Food and Commercial Workers Fund in Northern California. The International Ladies' Garment Workers' Union and the Amalgamated Clothing and Textile Workers Union merged in 1995 to form the Union of Needletrades, Industrial and Textile Employees (UNITE), which covers production workers in the needle trades. By contrast, unions for the sheet metal workers, bricklayers, carpenters, and other

building trades have funds that cover particular trades in many industries (Ghilarducci 2001).

Years worked for different employers participating in the same multiemployer plan all count toward vesting. Once vested, workers continue to be vested if they work for other employers within the plan. A further advantage of such pooling arrangements is that there may be economies of scale in plan administration and investment management, particularly compared to each participating employer's having a separate plan. Pooling is also an advantage to small firms because it overcomes the problem of providing pension benefits that arises after the short lifespan of many small firms.

Firms must cooperate with one another to coordinate the establishment of a multiemployer plan. Because of the difficulty of doing this among firms competing against each other in the same industry, most multiemployer plans are coordinated by a union or are in a nonprofit setting. Another disadvantage is that the arrangements are voluntary. When one firm sees itself as subsidizing other firms, it has an incentive to leave the plan (Ghilarducci 2001).

An example of portability having a different structure from that provided by most multiemployer plans is the arrangement for musicians. Many professional musicians belong to the American Federation of Musicians, a labor union affiliated with the AFL-CIO. Musicians often work part time. They may work for a number of employers in a year, doing short-term jobs, some not lasting more than a few hours, and receiving pension contributions paid by their employers to the union. Thus, this pension plan provides portability for highly transient workers. In this situation, the portability feature is part of the contract provided to employers hiring musicians for union-related jobs. The monthly benefit at retirement is based on a crediting rate, which varies by age at retirement. The crediting rate is applied to the total of contributions made to the plan on behalf of the worker. This type of benefit formula is unusual, but it provides an alternative approach for achieving portability.

### **Transfers of Service or Assets across Plans**

Transfers across plans for job-changing workers, depending on the two plans, can include transfers of service and transfers of assets. The transfer of assets directly to another plan, instead of to the worker in

the form of a lump sum distribution, is rare in defined benefit plans, affecting less than one percent of employees in private sector plans (BLS 2000).

**Transfer of service.** In a defined benefit plan, benefits are generally based on the worker's years of service and earnings. Therefore, one way portability can be achieved is through the transfer of service credits from one plan to the next. With transfer of service, participants are allowed to count their years of service with a previous employer when determining benefits from a subsequent employer. For example, one plan, either a defined benefit or a defined contribution plan, may recognize that a worker achieved vesting in another plan and automatically vest the worker in the new employer's plan. The employee ultimately receives benefits from both plans.

**Reciprocity agreements.** Reciprocity agreements are transfer arrangements for workers changing jobs among two or more plans. Those agreements allow the transfer of benefits, service, or assets among plans when the employee changes jobs (Harris 1998). In some cases, each plan counts the service in both plans when determining vested status or benefits. In other cases, plans transfer the full credit and the funds for that credit. In this way, the final employer is responsible for the full benefit. Reciprocity agreements are common among multiemployer plans covering members of local unions within the same international union, where the plans agree to give pension credit for service under any of the plans. The agreements benefit both employers and employees in the construction industry, allowing employees to move from areas where construction work is scarce to areas where it is booming.

Both transfer of service and reciprocity agreements are rare. They are discussed here not because of their prevalence but because of the possible model they provide. Nonetheless, they are difficult to arrange because of differences between defined benefit plans that complicate the calculations of equivalence.

**Purchase of service credits in defined benefit plans.** A defined benefit plan may establish the rule that it recognizes the service in another plan only if the worker buys service in the new plan. If both plans are defined benefit plans and the new plan is more generous than the

old one, transferring assets directly from one plan to the other would buy less service than the worker had accumulated in the old plan, but comparable benefits.

Workers' ability to purchase service credits in a defined benefit plan using accumulated retirement savings in a defined contribution plan is one way to make benefits portable between the two types of plans. Similarly, a government plan participant who terminated employment without sufficient tenure to vest, but was later rehired, may repay any contributions or investment earnings that were refunded earlier because of having terminated employment. Workers typically would receive a refund of their own contributions, possibly with interest, if they terminated employment before vesting. Payment may be made to that plan or another plan maintained by a state or local government employer within the same state.

**Transfer of assets out of a defined benefit plan.** Portability may involve the transfer of assets out of a defined benefit plan, generally as a lump sum distribution or as a rollover, into a defined contribution plan.

When an employer calculates a lump sum payment or transfer from a defined benefit plan, U.S. pension law requires that its value be at least the present value of the annuity if it had been taken at normal retirement age. The plan, at its discretion, can base the lump sum on a subsidized early retirement benefit, which would provide workers a larger lump sum benefit. To protect participants from plans using unfavorable assumptions that would reduce the value of their benefits, ERISA specifies discount rate and life table valuation factors in discounting retirement benefits. In calculating the value of a lump sum benefit, U.S. pension law requires that the plans use the same mortality rates for both males and females, even though the actual mortality rates for females are lower. The present value of the annuity computed using this interest rate and mortality table is the minimum that the plan can pay a participant. Using unisex mortality rates in this case is advantageous to men, since those rates produce a higher present value of benefits than would male mortality rates.

In calculating the amount of assets to be transferred, defined benefit plans are not required to take into account future cost-of-living adjustments unless those are written into the plan, which is rare but does

occur in some plans. A plan may have an unwritten policy of making ad hoc cost-of-living adjustments depending on the extent of inflation. It would not be required to take this practice into account in calculating the value of benefits for someone changing jobs.

When assets are transferred out of a defined benefit plan for a worker who has terminated his employment, though the minimum value allowable is regulated by law, the question sometimes arises as to the appropriate calculation of the lump sum amount that the worker has accrued. A study in 2002 by the Inspector General of the U.S. Department of Labor found that 22 percent of companies studied that had converted defined benefit plans to cash balance plans had given workers who had changed jobs too little in pension benefits as a result of errors in calculating how much in benefits workers were owed from their cash balance plans (USDOL 2002). The errors occurred at least in part, however, because of complexities of cash balance plans that do not apply to other types of plans. The study found that for the traditional defined benefit plans maintained by companies in the sample, there were no problems in calculating the benefit amount to be transferred. However, it did find that in two plans the present value calculation was based on constant value annuities, although the plans specified that the benefit would increase with inflation.

**Portability network or clearinghouse.** A portability network or clearinghouse can facilitate the transfer of assets between plans. It holds pension funds and combined benefits from multiple plans. Some networks, such as the National Automobile Dealers Association, were started by employer associations. These networks cover a single industry's workers and permit service portability for workers transferring between employers in the network. Portability clearinghouses are widely used in the Netherlands to transfer deferred vested benefits in defined benefit plans.

### **Portability Policy Options**

With a voluntary pension system, government is limited in what costs it can impose on employers by the employers' willingness to continue offering pension plans. Thus, while it may be considered desirable

from the public policy perspective to mandate a feature that would increase the portability of pensions, if doing so causes employers to stop offering pension plans, the indirect consequences of the policy would outweigh the direct beneficial consequences. This consideration needs to be borne in mind in when considering the following policy options:

- Encourage development of industry-based multiemployer plans. Industry-based pensions allow workers to change jobs within their industry without changing pension plans. The usefulness of this policy, however, is limited by the extent that the workforce is unionized, because these plans generally are sponsored by unions.
- Encourage development of cash balance plans. Among defined benefit plans, cash balance plans provide better portability than single-employer defined benefit plans. A policy encouraging the development of cash balance plans would need to protect the benefit rights and future benefit accruals of older workers when a traditional defined benefit plan is converted to a cash balance plan.
- For workers who are laid off by financially healthy employers, require price indexing of benefits in defined benefit plans for inflation up to the participant's early retirement age. This change would protect laid-off workers from portability loss for a job change that they had not initiated.

## **Summary**

This section discusses ways that pension portability has been achieved by describing relevant aspects of U.S. pension law and surveying the existing portability arrangements that pension plans provide. Pension portability is achieved most easily through defined contribution plans. It is generally difficult to achieve with traditional single-employer defined benefit plans. Cash balance plans, however, provide better portability than do other single-employer defined benefit plans. Multi-employer defined benefit plans allow workers to change jobs among participating firms and suffer no portability loss. Portability for single employer defined benefit plans could be improved by requiring price or

wage indexing of wages used in calculating pension benefits at retirement, but that would be expensive for employers and probably would cause some employers to stop offering defined benefit plans.

Portability losses are only one aspect of the risks facing workers who participate in pensions. While portability is achieved more readily in defined contribution plans than in defined benefit plans, risks also occur in defined contribution plans that do not occur in defined benefit plans with respect to investment in financial markets and converting account balances to annuities.

## **RETIREMENT**

This section considers ways that pensions affect older workers' decisions to reduce their hours of work or to retire.

### **Phased Retirement**

Phased retirement allows workers to gradually transition into retirement (Latulippe and Turner 2000). Some older workers may suffer poor health or develop a physical disability that limits their ability to work. Other people may have to provide caregiving services to family members. These concerns may be eased by employment and pension arrangements that allow workers flexibility to gradually retire by phasing out of work over time.

Phased retirement also may help workers who need to work past their desired retirement age to supplement their retirement benefits. Others may wish to work to enhance their standard of living or for non-financial reasons, such as for the social interactions that work provides. For these purposes, many people would prefer not to work full time.

Surveys corroborate that some people prefer retiring from work gradually rather than abruptly. For example, according to the 2001 Retirement Risk Survey, sponsored by the Society of Actuaries, two-thirds of preretirees (66 percent) and almost half of retirees (47 percent) said they were or would have been very or somewhat interested in being able to gradually cut back on the hours they worked at their current

job, rather than stopping work all at once. Moreover, almost two in ten retirees (19 percent) described their retirement process as closest to “gradually reduced the number of hours you worked before stopping completely” (Society of Actuaries 2004).

Phased retirement may provide benefits to workers and society. For many workers, a gradual transition is better than one that is abrupt. For society, such an arrangement could offset the expected labor force shortage with the retirement of the baby boom generation. It also helps contain the cost of pensions. And from a business perspective, it may be important to retain and use long-service employees to mentor and train younger workers.

Despite their positive effects, formal phased retirement arrangements are rare. That is at least in part because of barriers to their implementation. An employer wishing to offer flexible employment faces numerous hurdles arising from tax law, as found in the Internal Revenue Code; pension law, as found in the Employee Retirement Income Security Act (ERISA); and age discrimination law, as found in the Age Discrimination in Employment Act (ADEA) [Chen and Scott 2003; Penner, Perun, and Steuerle 2007].

The Pension Protection Act of 2006 permits distributions from defined benefit plans to workers still working for the employer sponsoring the pension, starting at age 62. This change in law was designed to make phased retirement feasible, with receipt of a pension and continued work, but the implementing regulation largely vitiated the effect. Because it is often difficult for workers to collect a pension while phasing out work, people may retire earlier than they really want to, doing so to access their pension.

Though in principle hardly anyone opposes phased retirement, it seems workers do not find employers’ offers for phased retirement attractive (Hutchens and Chen 2007). Among the legal issues associated with some options for phased retirement are issues concerning extending health insurance to phased retirees, when that is not part of a formal program but is done in special circumstances where employers especially want a full-time worker to stay on working part time. An example of “special circumstances” might be a worker who moves from full-time to part-time employment after attaining a minimum of, say, 10 years of job tenure. Since the main barrier to this proposal is

the nondiscrimination rules promulgated by the IRS, the issue is about whether this enhanced health insurance for phased retirees favors high-wage workers.

Employers apparently prefer to provide phased retirement through ad hoc arrangements rather than through formal programs. Ad hoc arrangements may provide employers greater flexibility as to who is eligible for phased retirement.

While taking phased retirement has some advantages for workers, they may find that it is disadvantageous in two respects. First, if they are covered by a defined benefit plan based on the highest years of salary, the extra work at a relatively low annual salary because of the reduced hours may not affect their defined benefit plan benefits.

Second, if they have already worked 35 years under Social Security, they may find that the extra work also does not affect their Social Security benefits, even though they continue paying Social Security taxes. If the wages from their part-time work are less than their indexed covered earnings in their previous years of work and they already have 35 years of covered work, the extra work, and extra Social Security payroll taxes paid, will not affect their Social Security benefits. Thus, workers taking phased retirement could pay thousands of dollars in Social Security taxes without raising their benefits.

### **Benefit Receipt While Working**

Benefit receipt while working permits workers to take partial retirement, receiving income both from part-time work and from a pension. Allowing partial retirement, with part-time work and receipt of a pension, permits workers to gradually reduce their work hours and adjust their lifestyle as they approach full retirement. Arrangements for partial retirement can be provided more easily in a defined contribution system than in a traditional defined benefit system because partially annuitized benefits can be provided more easily in a defined contribution system. Partial receipt of benefits from a defined benefit system would require complex actuarial calculations.

Phased retirement is facilitated in defined contribution plans by the possibility of receiving in-service distributions from a defined contribution plan at age 59 ½. In-service distributions cannot be received from

a defined benefit plan until age 62. As an aspect of leveling the playing field between the two types of pensions, the ages should be equalized. With phased retirement options, it is not known whether, on balance, workers reduce their hours of work earlier than they otherwise would, whether they continue working longer than otherwise, or whether some workers may be affected one way and other workers affected the other way.

In most pension plans, older workers can retire and receive pension benefits from a former employer while working for a different employer. However, in collectively bargained plans, the worker's benefit can be suspended if he or she works for any employer in the same industry, even if it is a nonunion job. This policy is an example of disparate treatment of workers in similar circumstances, and thus consideration should be given to changing it.

In Sweden, Chile, and the United Kingdom, workers can continue working while receiving benefits. The Swedish workers can claim full or partial (one-quarter, one-half, or three-quarters) benefits from the mandatory individual account system starting at age 61. They can continue working while they draw benefits, in which case they would continue contributing.

Chilean workers need not stop working to collect benefits if they meet minimum requirements. This feature allows workers to take partial retirement or phased retirement, combining either full-time or part-time work and the receipt of pension benefits. As a tax incentive to continue working, workers receiving benefits from the individual accounts system do not need to continue contributing to the system. Since 1988, workers could receive benefits but continue working once their replacement rate reached 50 percent of their own wage and 110 percent of the minimum benefit guarantee. In 2004, these limits were raised to 70 percent of their wage and 150 percent of the minimum benefit guarantee to encourage workers to accrue higher benefit levels. A high proportion of workers have met these conditions in their early 50s (James, Martinez, and Iglesias 2006).

British workers can continue working while receiving benefits. The United Kingdom permits the phased purchase over time of annuities. Workers can draw down the rest of the pension fund gradually after retirement.

Because women are more likely to work part time than men, receipt of benefits while working may be an option that is particularly valuable for women.

### **Defined Benefit Plans and Phased Retirement**

This section considers how defined benefit plans hinder or facilitate phased retirement. Early retirement in physically demanding occupations can be facilitated by defined benefit pensions. Discussions of retirement age policy often focus on people with physically demanding jobs where postponed retirement would be difficult (Turner and Guenther 2005).

**Early retirement age.** Social security systems establish a minimum age (62 in the United States) at which benefits can first be received. Without such a minimum age, some shortsighted people would take their benefits at an earlier age, which they would later regret because they would have insufficient money to finance their long retirement period. A policy trade-off exists, however, between raising the retirement income of people who might take benefits too early versus giving people the ability to allocate their lifetime consumption as they see fit (Liebman 2002).

With continued increases in life expectancy at older ages, the annual benefit that a given account balance can finance decreases for successive cohorts. The level of payments is reduced to take into account increasing life expectancy at retirement. With increased life expectancy, for a given account balance the level of annual benefits for future cohorts will fall. Eventually, benefits will fall so much that the replacement rate that they provide relative to preretirement income will fall below the level deemed acceptable by policymakers and retirees. At that point, policy options include increasing the age at which benefits could be received, or imposing the attainment of a minimum benefit level as a qualifying condition for benefit receipt.

Because picking the appropriate early retirement age is a complex problem, many countries follow a rule of thumb for their social security programs. The rule of thumb most countries used originally to pick an age was that the age be divisible by five—55, 60, 65, and, in the ear-

lier years of the last century, 70 (Turner 2006). Since establishing their original retirement ages, the systems have been incrementally modified, and the prevalence of ages divisible by five has decreased.

### **Retirement Age**

Defined benefit plans often provide subsidized early retirement benefits. In addition, some plans favor retirement at a particular age by structuring the benefit formula so that increased years of work are penalized by relatively little increase in annual pension benefits and a decrease in the lifetime value of benefits. Thus, these plans reward workers who have long careers and retire at the early retirement date. For that reason, these plans tend to favor high-wage males over low-wage workers and females. High-wage workers who have other job opportunities are more likely to retire at the early retirement age and change jobs, doing similar work for another employer. Workers whose alternative job opportunities are not as favorable relative to their current job are more likely to continue working past the early retirement age and not to benefit from the early retirement subsidy. Thus, these plans can have adverse incentives from the perspective of the employer, encouraging the best employees to retire and the less productive retirees to continue working. These plans are also adverse to women, who are less likely than men to have a long career that continues through to the early retirement age.

Some employers interested in downsizing, such as General Motors and Chrysler, have used defined benefit plans to encourage early retirement. They have offered generous lump sum benefits through the pension plan to encourage eligible workers to retire. Because these benefits are offered through the pension plan, workers are able to take the lump sum and roll it over into an IRA, thus avoiding having to pay taxes at that point on the amount. By contrast, if the company had paid them the lump sum from outside the pension plan, the workers would have had an immediate tax liability, at a relatively high marginal tax rate.

While it is often assumed that defined contribution plans do not affect retirement decisions, empirical evidence suggests otherwise. Workers postpone retirement during economic downturns because of the decline in their account balances, possibly destabilizing labor

markets by increasing labor supply at a time when demand is reduced (Hermes and Ghilarducci 2007). From the perspective of workers, however, this behavior offsets the capital market risk they face because of reduced account balances in their pension plans.

**Maximum age for first receipt.** Some countries set a maximum age by which workers must receive benefits. They do so to assure that retirees use benefits to finance retirement consumption rather than to bequeath wealth to survivors.

The issue of wealthy participants accumulating bequeathable pension wealth does not arise in the Swedish system because workers cannot bequeath their account balances to their survivors. Chilean workers, by contrast, are allowed to bequeath their account balances. A maximum age for first receipt is a feature that generally only affects upper income workers, and for this reason is more likely to affect men than women.

### **Countries That Have Raised the Earliest Age at Which Employer-Provided Pension Benefits Can Be Received**

Some countries have raised the earliest age at which benefits from employer-provided pensions can be received. This survey indicates international experience with respect to the earliest retirement age in occupational pension plans.

**Australia.** In June 1992, the Australian government announced that it would increase the retirement age for the mandatory employer-provided pensions, called the superannuation benefit, from 55 to 60. The new rules took effect on July 1, 1999. The minimum retirement age is 55 for both men and women born before July 1, 1960. For those born after that date but before July 1, 1961, the minimum age is 56. In similar fashion, the minimum age rises by one year for every subsequent annual birth cohort until it reaches age 60 for persons born after June 30, 1964 (Kehl 2002).

**Belgium.** In 2003, a pension law was passed in Belgium stipulating that occupational pension benefits cannot be paid before age 60. Previously benefits could be received at age 58 or earlier. For all existing

plans, current rules are applicable until January 1, 2010 (Watson Wyatt Worldwide 2003).

**Switzerland.** In 2005, Switzerland raised the early retirement age for employer-provided pension plans to 58.

**United Kingdom.** The United Kingdom has raised the minimum age at which occupational pensions can be received from 50 to 55.

### **U.S. Defined Benefit Plan Responses to Increased Worker Longevity**

With increasing life expectancy raising pension costs, it might be expected that defined benefit plan sponsors would adjust by raising the plans' early and normal retirement ages. The "early" and "normal" retirement ages do not refer to the ages at which workers retire or start collecting benefits, but rather to ages specified in pension plan documents. Employers could argue that employees are healthier and more able to work at older ages than in the past, and that work is less physically demanding for many workers, which are factors that make it feasible for workers generally to retire at older ages.

Other factors, however, have also changed. The large increases in life expectancy that workers have experienced at older ages have been accompanied by, and probably are in part due to, large increases in per capita wealth. Thus, the resulting positive wealth effect on the demand for leisure might translate into pressure to maintain current pension plan retirement ages to ensure a longer retirement period for workers.

While large increases in life expectancy have occurred, U.S. pension law has not raised the minimum age at which benefits can be received, and has not raised the maximum normal retirement age, which is age 65. U.S. pension plans have generally not raised their early retirement ages, though they could do so. Several hypotheses may explain that result.

Employers have a number of cost-cutting options to respond to the increased pension costs caused by increased life expectancy. They cannot reduce benefits that workers have already earned, defined in terms of annual benefits at the normal retirement age, but prospectively they can reduce benefits received at normal retirement or cut early retirement benefits.

While the move by employers from traditional defined benefit plans to cash balance plans may be done primarily for other reasons, it eliminates the impact of increased worker life expectancy on the plans' liabilities because benefits are accrued in the form of an account balance. In addition, most conversions to cash balance plans involved ending subsidized early retirement, which was a feature of the defined benefit plans that were being replaced.

Employers could raise the early retirement age, but making this change is administratively complex when done for current employees. It could be done more easily for new employees. Such an approach would be legal under pension law, and might be viewed by employees as fair, since it would become part of their labor agreement at time of hire. Alternatively, employers could reduce the generosity of benefits for new hires. Some companies have done this a couple of times over the past decade.

## CONCLUSION

Workers who participate in defined benefit plans and who change jobs or are laid off by their employers suffer benefit losses. They suffer benefit losses because their benefits are frozen in nominal terms at the point of job termination, and the real value of those benefits is eroded by inflation between that point and the point at which they qualify for retirement benefits. Plans can make these workers wait until age 65 to receive benefits. For laid-off workers, the loss of pension benefits can be more serious than the loss of wages, while providing an actuarial bonus to employers. This suggests that, at least for healthy employees, it would be desirable to require price indexing of benefits up to retirement, as is done in the United Kingdom for workers leaving before being eligible to receive benefits.

As life expectancy at older ages has increased, a number of countries have raised the earliest age at which pension benefits can be received. Doing so has been part of a policy to encourage workers to retire at older ages.

