EBRI ISSUE BRIEF

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February 1983 #15

PROPOSED CHANGES IN PENSION INTEGRATION COULD LEAD TO INEFFICIENT POLICIES AND REDUCED PRIVATE PENSION COVERAGE

Pension integration has been the subject of repeated legislative and regulatory policy debates. A lack of information on integration has interfered with our ability to assess present and proposed integration policies. To assist with this problem, EBRI sponsored a study on Pension Integration: Concepts, Issues and Proposals. Dr. James H. Schulz and Thomas D. Leavitt of Brandeis University conducted the research and authored the final study.*

I. Concepts

Integration is the coordination of employer pension plan benefits with Social Security benefits. Many believe that integrated benefits are more efficient, affordable and equitable than benefits from separate retirement income programs where there is no attempt to close benefit gaps or eliminate benefit overlaps.

Table 1 shows Social Security benefits for workers at four earnings levels. It also gives these workers' Social Security replacement rates; i.e., the portion of preretirement income that is replaced by Social Security benefits.

The Social Security benefit formula is tilted to favor low-income workers. This tilt produces the higher replacement rates shown for the lower earners in table 1. The replacement rate is 70 percent for workers with final average annual earnings of $6,000; it is 27 percent for those with final average annual earnings of $22,540. Integrated pension formulas are designed to help close such replacement rate gaps.

For example, some pension plans use an offset integration formula. In these plans employers: (1) calculate an employee's pension benefit based on the plan's benefit formula; and (2) subtract a portion of the employee's Social Security benefit from his calculated pension benefit. This determines the actual employer pension.

Table 2 illustrates an offset plan's impact on long-term workers. It uses a benefit formula that first calculates a benefit equal to 50 percent of final average earnings. In a second step, the formula subtracts 50 percent of the employee's Social Security benefit from the pension benefit calculated in the first step.

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* This issue brief was prepared by Patricia George Moore, EBRI's Education and Communications Director. It draws on information from Pension Integration: Concepts, Issues and Proposals. The study will be available for $10 in early April. For more information call or write to EBRI Publications, 1920 N Street, NW, Suite 520, Washington, DC 20036, (202) 659-0670.

TABLE 1

Social Security Benefits and Replacement Rates for Workers Retiring at Age 65 in 1982[1]

	Average Annual Earnings [2]	Final Year's Earnings	Social Security Benefit	Social Security Replacement Rate [3]
Worker A[4]	$ 6,000	$ 6,599	$4,611	70%
Worker B [5]	12,000	13,198	7,149	54
Worker C [6]	22,540	29,700	8,148	27
Worker D [7]	67,620	89,100	8,148	9

Source: James H. Schulz and Thomas D. Leavitt, Pension Integration: Concepts, Issues and Proposals (Washington, D.C.: EBRI, 1983).

1/ Assumed to retire at the beginning of 1982.
2/ Average of highest five years of earnings, which in these hypothetical examples are the last five years.
3/ Benefit divided by final year's earnings.
4/ Annual earnings are assumed to be $5,429 in the fourth year before retirement. Earnings are assumed to change at a rate of 5 percent per year.
5/ Annual earnings are assumed to be $10,858 in the fourth year before retirement. Earnings are assumed to change at a rate of 5 percent per year.
6/ Worker earns the taxable wage base in all years.
7/ Worker earns three times the taxable wage base in all years.

TABLE 2

Pension Benefits, Total Benefits and Replacement Rates for Workers in a Pension Plan with a 50 Percent Offset[1]

	Gross Benefit Prior to Offset (1)	Social Security Benefit (2)	Offset= (2)x.5 (3)	Final Pension Benefit= (1)-(3) (4)	Pension Replacement Rate[2] (5)	Total Benefit (2)+(4) (6)	Total Replacement Rate[2] (7)
Worker A	$ 3,000	$4,611	$2,306	$ 694	11%	$ 5,305	80%[3]
Worker B	6,000	7,149	3,575	2,425	18	9,574	73 [3]
Worker C	11,268	8,148	4,074	7,194	24	15,342	52 [3]
Worker D	33,804	8,148	4,074	29,730	33	37,878	43 [3]

Source: James H. Schulz and Thomas D. Leavitt, Pension Integration: Concepts, Issues and Proposals (Washington, D.C.: EBRI, 1983).

1/ Calculations assume workers retire at age sixty-five in 1982. Calculations also assume that the plan provides a benefit equal to 50 percent of final average earnings, minus 50 percent of Social Security benefits. Final average earnings represent the average of the highest five years, which in these hypothetical cases are the last five years. See table 1 for the value of the high-five average and final year's earnings in each case.
2/ Benefit divided by final year's earnings.
3/ Does not add to sum of column (5) and Social Security replacement rate in table 1 due to rounding.

The offset's effect is apparent in column (5). As earnings increase, the pension plan replaces a greater portion of preretirement earnings. Note, however, that the combined Social Security and pension benefit replacement rate--shown in column (7)--remains significantly higher for lower-income workers. Employers can also integrate pension benefits by using excess and step-rate integration formulas. Schulz and Leavitt provide examples demonstrating that these integration formulas produce replacement rate patterns similar to offset formulas.1/

Extent and Incidence of Integration Methods

Private and public employer pension plan surveys have been conducted to determine: (1) the extent of integration; and (2) the incidence of various integration methods.

Extent of Integration--Despite incomplete data, the surveys permit some generalizations about the extent of integration. For example:

(1) Private Plans

- (a) Over half of private pension plans are integrated.
- (b) Defined benefit plans are more likely to be integrated than defined contribution plans.
- (c) A greater percentage of smaller plans are integrated than larger plans.
- (d) Multiemployer plans generally are not integrated.

(2) Public Plans

- (a) The extent of integration among public plans is substantially lower than the extent of integration among private plans. In 1975, only 15 percent of public plans were integrated.
- (b) There are a number of reasons for this lower public plan integration rate.
  - (i) Approximately 30 percent of state and local government employees are not covered by Social Security. Even where employees are covered by Social Security, many public systems designed their plans before employees became eligible for Social Security participation.
  - (ii) Minimizing pension costs has not invariably been a public plan priority. However, this may be changing. Several large systems (e.g., New York City, Baltimore, Delaware and Maryland) have recently incorporated integration features.

1/In excess formulas, benefits are paid only on earnings above a certain compensation level. For example, a flat-benefit excess plan might pay a pension benefit equal to 37.5 percent on earnings above $10,800. No benefit would be paid on earnings below $10,800.

In step-rate formulas, benefits are paid on all earnings. However, a proportionately larger benefit is paid on earnings above a certain level than on earnings below that level. For example, a flat-benefit step-rate plan might pay a pension benefit equal to 10 percent on earnings below $10,800 and 40 percent on earnings above $10,800.

Incidence of Integration Methods--Available data offer conflicting information on the current incidence of various integration methods. Three surveys--the 1974 Congressional Research Service, the 1978 National Associates and the 1981 American Society of Pension Actuaries (ASPA) surveys--showed that among the private plans surveyed, step-rate formulas were more common than offset or excess formulas. A 1980 Bankers Trust and a 1982 Hewitt Associates survey suggested, however, that there were twice as many offset plans as step-rate plans. A 1978 A. S. Hansen survey found there were four times as many offset plans as step-rate plans. The differences among the various findings may result from one or more of the following:

(1) Some surveys focused on defined benefit plans, others considered both defined benefit and defined contribution plans. Since defined contribution plans do not use offset formulas, surveys that focus on defined benefit plans should show a higher percentage of offset formulas. On this point, however, the Hansen, Bankers Trust and Hewitt survey findings are inconsistent with the National Associates and ASPA surveys.

(2) Some surveys focused on large plans, others considered both large and small plans. The proportion of offset plans in a sample may be related to the sample's plan-size distribution. For example, small employers are less likely to have offset plans--possibly because such plans require additional actuarial services in conjunction with their need to estimate employees' Social Security benefits.

(3) Some surveys focused on plans serviced by the surveying organization. For a variety of reasons, the servicing organizations may favor a particular integration method, and this may be reflected in the survey findings.

Schulz and Leavitt note that many integrated plan sponsors offer minimum benefits or supplemental pension benefits to plan participants. The ASPA survey demonstrated that 40 percent of pure excess and 20 percent of the other integrated defined benefit plan sponsors offered supplemental coverage. If integrated plans are commonly supplemented by minimum benefits or additional plans, integration's impact may be less than is generally believed.

The study discusses the various surveys in greater detail. The authors caution that survey information is incomplete. Further research is needed on the incidence of integration methods before conclusions can be drawn.

II. Integration Issues

Integration and Retirement Income Adequacy

Since integration affects retirement income, one major concern is whether integrated pension benefits offer retirees adequate income. Some define "adequate retirement income" as the combined pension and Social Security income necessary to satisfy a retiree's minimal needs. Others define it as the combined pension and Social Security replacement rate necessary for a retiree to maintain his preretirement standard of living.[2]

2/ For an in-depth review of retirement income adequacy issues, see: EBRI, Retirement Income Opportunities in an Aging America: Income Levels and Adequacy (Washington, D.C., 1982). For additional information on Social Security's role in providing adequate retirement income, see: Sylvester J. Schieber, Social Security: Perspectives on Preserving the System (Washington, D.C.: EBRI, 1982).

Underpensioning and Lower-Paid Employees--Underpensioning issues associated with lower-paid employees are concerned with whether integrated pension benefits satisfy a retiree's minimal income needs. Some believe that integrated benefits do not satisfy minimal need requirements. They argue against integration on the following grounds:

(1) Integration permits employers to establish pension plans that provide low or no benefits to lower earners.

(2) Pension plans are often created in response to government-provided tax incentives. In return for this tax treatment, employer-sponsored plans should contribute toward minimal income goals for lower earners.

Proponents of integration do not dispute that integration sometimes reduces or eliminates lower earners' pensions. However, they argue:

(1) Past Social Security benefit changes (e.g., ad hoc increases, wage indexing and cost-of-living adjustments), along with Social Security's benefit formula tilt, result in Social Security benefits that meet or exceed minimal income standards for most employees.

(2) The Supplemental Security Income (SSI) program and in-kind benefit programs such as Food Stamps, Medicaid and Medicare also provide benefits to low-income persons. When these benefits are added to a low earner's Social Security benefits, total income generally reaches an adequate level.

(3) Insuring retirees of a minimal standard of living may be the appropriate primary goal of government-sponsored social programs. It is not necessarily the primary goal of private-sector pension plans. The private sector must focus on affordability, productivity and efficiency. Two major private plan goals are to: (a) encourage productive workers to remain with firms; and (b) provide older workers with reasonable financial alternatives to continued employment. Regulations that interfere with these goals weaken private-sector incentives to offer voluntary pension coverage.

(4) Only a small number of covered workers in integrated plans will receive little or no pension benefits. Surveys indicate that large pension plan sponsors use integration methods that do not significantly disadvantage low earners.

(5) The 1982 Tax Equity and Fiscal Responsibility Act (TEFRA) has taken a major step in correcting small plan benefit deficiencies. This act requires that small, top-heavy plans (i.e., plans which primarily benefit employers' key employees) provide a minimum benefit to all plan participants.

Underpensioning and Higher-Paid Employees--The underpensioning issues associated with higher-paid employees are concerned with whether integrated benefits provide retirees with sufficient income to replace preretirement living standards. Proponents of integration argue:

(1) Social Security replaces a higher portion of preretirement income for lower-paid employees than for higher-paid employees. Integration helps to counterbalance Social Security's benefit tilt by raising private pension replacement rates for higher-paid employees.

(2) Even with integration, many higher-paid employees receive a combined pension and Social Security benefit that does not replace a substantial portion of preretirement income.

Critics of integration challenge these views. They contend:

(1) The most important goal is to satisfy minimal income needs. Replacement rate discrepancies for higher-income retirees are not a primary concern--especially if correcting these discrepancies would exacerbate lower-earners' problems.

(2) Higher earners are more likely to have multiple retirement income sources; e.g., private savings, IRAs and other personal investments.

Edwin F. Boynton presented an analysis to the President's Commission on Pension Policy in 1979, which suggests that underpensioning of high-paid employees may be a problem in all types of integrated plans. Boynton's analysis shows, however, that high-paid employees receive substantially larger spendable income ratios (i.e., the ratio of postretirement disposable income to preretirement disposable income) from integrated plans than they would receive from only Social Security. Schulz and Leavitt discuss Boynton's analysis in greater detail.

Overpensioning and Public Workers--Due to the rising costs of all retirement income programs, policymakers are increasingly concerned about overpensioning. Overpensioning sometimes occurs because pension benefits are not integrated with Social Security benefits. This is especially a problem in the public sector. For example, a person may enlist in the military at age seventeen and retire with a military pension at age thirty-seven. He may then work as a state or local government employee and become entitled to another pension. This person would have been covered by Social Security while in the military and may also have received Social Security coverage in his state or local government job. At age sixty-two, he could receive benefits from three nonintegrated public plans--Social Security, military, and state or local government pensions.

A 1981 Urban Institute study revealed that many state and local governments offered combined pension and Social Security benefits which replaced more than 100 percent of a worker's preretirement disposable income. In a sample of state and local plans where employees also participated in Social Security, the weighted average replacement rate was 125 percent. One plan replaced 149 percent of preretirement disposable income.

Overpensioning in public plans places a substantial financial burden on governments and taxpayers. Those interested in controlling government costs are examining more closely such pension practices.

Overpensioning and Private Workers--Overpensioning in private plans appears to be less of a problem than in public plans. For private-sector workers, overpensioning is associated primarily with low-paid workers--especially those with nonworking spouses. This is caused by Social Security's benefit formula tilt.

The President's Commission on Pension Policy recommended a set of income replacement rates for workers retiring in 1980. For married employees with nonworking spouses and final earnings of $10,000, the commission recommended an income replacement rate of 78 percent. Schulz and Leavitt examine hypothetical workers who retire at age sixty-five in this income and marital category. They note these employees would receive Social Security benefits which replace 74 percent of earnings. Using the commission's 78 percent replacement rate criteria, almost any pension benefit, when added to these workers' Social Security benefits, would result in overpensioning.

Some pension experts do not believe overpensioning is a problem. They point out that most analyses of overpensioning focus on career employees rather than short-term employees. Combined pension and Social Security benefits are much lower for short-term workers than for career workers. Additionally, concerns about overpensioning generally focus on replacement rates at the time of retirement. They do not consider inflation's effect on pensions over the full retirement period. Alternatively, others argue that low-income workers' benefits are better protected from inflation than high-income workers' benefits, because Social Security is fully indexed and provides the largest share of low-earners' retirement income.

Integration and Retirement Income Financing

Most employers believe integration is necessary to: (1) control total employer retirement income costs; and (2) design efficient retirement income programs that help correct overpensioning and underpensioning. Employers justify their integration objectives--i.e., to control employer costs and develop efficient benefit programs--on the grounds of their substantial financial contributions to Social Security and pensions.

Some challenge this view. These critics argue that Social Security is an intergenerational income redistribution system; i.e., it redistributes income from one generation of workers to another generation of retirees. They see no direct correlation between an employer's contributions and his employees' Social Security benefits. Others argue that employees--not employers--bear the costs of Social Security and pensions. They believe employees pay for Social Security and pensions through lower wages, slower wage growth and greater restrictions on other employee benefits.

Integration and Tax Policy

Employer contributions to qualified pension plans are a deductible business expense. Employer contributions as well as interest on employee and employer contributions are not considered taxable income to the employee until he receives retirement benefits. Some believe this "favorable" tax treatment is a form of government investment and, therefore, the government should expect a return on this investment.

Some believe this investment should be used to encourage voluntary establishment of employer pension plans. In this case, government's investment returns are voluntary pension plans that contribute to overall retirement income adequacy, capital formation, higher worker productivity and national economic growth.

Others feel government should require pension plan sponsors to provide benefits to all workers--especially to lower-paid workers. Those who oppose this view argue that pension plan contributions are legitimate business expenses. They are used to attract and retain talented, productive employees. Consequently, tax deductions are normal--not favorable--and the government should not require employers to design pension plans that meet government-decreed social goals.

A third group contends that pension plan tax treatment redistributes income from lower earners to higher earners. They refer to tax-qualified plans as tax shelters. Many disagree with this view. They note that higher earners' pensions are heavily taxed and are not as large as some suggest. They also argue that higher benefits for higher earners is a fair price for providing all workers with equitable benefits at a reasonable cost.

III. Recent Integration Proposals and Future Research Needs

Executive Branch and Congressional Proposals

(1) The 1978 Carter Proposal--This proposal was intended to: (a) provide higher private pension benefits to lower-paid workers; and (b) simplify integration-related Internal Revenue Service (IRS) tax qualification rules. The Carter proposal would have: (a) eliminated pure excess plans; (b) placed greater restrictions on offset plans; and (c) required step-rate plans to provide lower-paid workers with significant benefits relative to higher-paid workers' benefits.

(2) The 1981 Retirement Security Portability Act--This initiative reintroduced portions of the Carter proposal. It also proposed: (a) a cap on combined pension and Social Security benefits equal to 90 percent of a worker's highest year earnings; and (b) a minimum benefit of 4 percent of compensation, up to the Social Security wage base, for all plan participants.

(3) The 1981 Retirement Income Incentives and Administrative Simplification Bill--Representative Erlenborn reintroduced this bill in the House and Senator Nickles introduced a similar bill in the Senate. The bills would simplify integration guidelines. They included a general provision requiring that combined Social Security and pension replacement rates should not rise with earnings levels. Additionally, they specified two methods for achieving pension integration without discrimination:

   (a) Under the first rule, a plan must satisfy two conditions. First, benefits to lower-paid participants must total at least 50 percent of preretirement earnings. Second, total Social Security and pension benefits to higher-paid participants may not result in a higher earnings-replacement rate than the replacement rate for lower-paid participants.

   (b) An alternative rule allows plans to cap benefits at a level where no participant receives total benefits exceeding 80 percent of average annual compensation.

(4) The 1982 Pension Equity Tax Act--Representative Rangel introduced this bill specifying new integration rules. To become eligible for IRS tax qualification, integrated defined benefit plans would have to use one of two methods:

   (a) The first method would restrict the amount of an employee's benefit that can be reduced for integration. The maximum benefit reduction would be equal to the annual pension benefit that could be purchased with employer-paid Social Security taxes for each employee. The Treasury Secretary would be responsible for developing regulations to convert Social Security taxes into equivalent annual pension benefits.

   (b) An alternative method would require that: (i) the benefit accrual rate on earnings between $30,000 and $60,000 could not exceed twice the benefit accrual rate on earnings below $30,000; and (ii) the benefit accrual rate on earnings over $60,000 could not exceed the rate on earnings below $30,000.

For integrated defined contribution plans, the allowable difference between contribution rates above and below the maximum earnings level

would be equal to the employee contribution for Old-Age, Survivor and Disability Insurance (OASDI).

Critics argue that these proposals attempt to shift social responsibility to voluntary pension plan sponsors. Some contend such proposals do not consider the role of the total retirement system in providing reasonable income replacement rates. And others do not believe the number of participants with low or no benefits is large enough to justify major legislative changes. Most of the criticism, however, focuses on the consequences of implementing such proposals. Many employers would have to amend their plans. Amendments would be costly and time consuming. If these proposals are implemented, a large number of plan sponsors might choose to terminate plans or lower benefits.

The Society of Actuaries Subgroup Integration Proposal

In 1979, the Society of Actuaries Committee on Pensions began an integration study. Based on this committee's work, a subgroup published a paper that presents a different approach to integration. Unlike current regulations, this proposal would integrate pensions based on benefits received rather than benefits costs.

The proposal presumed that total retirement benefits should not exceed the amount needed to maintain preretirement living standards. In developing replacement rate estimates, this group considered the effects of Social Security and federal income taxes on reducing preretirement income. They did not consider similar effects of state and local taxes or of work-related expenses, because these expenses vary among individuals and states. The committee estimated the combined Social Security and pension replacement rate should be somewhat lower than 80 percent of final income for those who earn $12,500 to $50,000. Replacement rate estimates were slightly larger for lower and higher earners.

The 1982 Tax Equity and Fiscal Responsibility Act

TEFRA incorporated the defined contribution plan integration provision that had previously been introduced in the 1982 Pension Equity Tax Act. The new maximum contribution limit becomes effective for plan years beginning after December 31, 1983. At that time, the OASDI tax rate will be 5.7 percent. Thus, the allowable difference between contribution rates above and below the maximum earnings level will be significantly lower than the present 7 percent.

Beginning in 1984, top-heavy plans must provide minimum, nonintegrated benefits or contributions to plan participants who are not key employees. The minimum benefit for non-key employees in defined benefit plans is 2 percent of average annual compensation for each year of service--not to exceed 20 percent of average annual compensation. The minimum contribution for non-key employees in defined contribution plans is the lesser of 3 percent of compensation or the highest contribution rate for a key employee.

Future Research Needs

Pension Integration: Concepts, Issues and Proposals also identifies critical aspects of integration where research is needed. Future pension integration policy discussions will be better informed, and more effective policies will be developed, if additional research is conducted to provide answers to the following questions: (1) What is the actual extent of integration? (2) How many workers are covered by each type of integrated plan? (3) What are the trends in integration usage? (4) What impact have current pension regulations and Social Security legislation had on integration trends?

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