Conservatively, 1.9 million more workers would have been vested in 1985 if ERISA vesting standards were shortened to 5 years. The future cost would be between $1.4 billion and $4.7 billion annually.

Pension Vesting Standards: ERISA and Beyond

Vested pension benefits—those that are earned by an employee and cannot be revoked by an employer—are regulated by minimum standards set down in the Employee Retirement Income Security Act of 1974 (ERISA). Some indication of the effect of these vesting standards can be gained by tracking benefit entitlement rates for full-time private-sector wage and salary workers between 1972 and 1983. The entitlement rate increased from 32 percent of plan participants in 1972 to 48 percent in 1979 and 51 percent in 1983.

The vast majority of employees in medium and large firms are in defined benefit plans in which vested benefits are conferred after 10 years of plan participation. Data from the Bureau of Labor Statistics, however, indicate a slight downward trend (from 89 to 85 percent) in the percentage of participants in plans with 10-year cliff vesting and a slight increase in the percentage with other types of vesting provisions. Only 30 percent of defined contribution plans select 10-year cliff vesting; most offer faster vesting and 18 percent provide immediate vesting.

Lump-sum distributions and job mobility also have a large effect on retirement income. Workers typically hold 10 to 11 jobs over a lifetime, and they often cash out their vested benefits, which may be distributed in one lump sum when the employee separates from service.

The Economic Equity Act (S. 1169, H.R. 2472) and the Retirement Income Policy Act (S. 1784, H.R. 3594) would require that ERISA vesting standards be shortened to 5 years. EBRI conservatively estimates that such a change would have added 1.9 million more vested workers in 1985. Over one million more men and 766,000 more women would have been vested.

The nationwide annual cost of 5-year vesting is estimated at 2 to 7 percent of total private pension plan contributions, which would be between $1.4 billion and $4.7 billion. For some employers, however, with young work forces and high turnover, the cost could reach as high as 40 percent of current contributions.
Introduction

Vested benefits are those that are earned by an employee and cannot be revoked by an employer. Employees attain vested rights to benefits after satisfying specific service or age and service requirements. One of the key provisions of the 1974 Employee Retirement Income Security Act (ERISA) was to provide specific vesting standards to ensure that participants in employer-sponsored pension plans would eventually receive pension benefits at retirement. Since that time, there have been periodic proposals to change those original ERISA vesting standards to ensure that plan participants with fewer years of service would also benefit from pension accruals. In 1985, two major bills introduced in Congress proposed, in part, faster vesting than ERISA now stipulates. These were the Economic Equity Act (S. 1169, H.R. 2472) and the Retirement Income Policy Act (S. 1784, H.R. 3594).

This Issue Brief reviews vesting standards under ERISA and provides information on the distribution of actual vesting provisions used by plans since ERISA was enacted. The vesting rate among plan participants is tracked before and after ERISA to evaluate whether more workers are likely to be entitled to benefits at retirement. The relationships between age, on-the-job tenure, and plan vesting provisions are also reviewed. The use of preretirement lump-sum distributions is discussed in that context.

After describing the proposed vesting provisions found in the Economic Equity Act (EEA) and the Retirement Income Policy Act (RIPA), the potential effect of faster vesting is analyzed. Estimates are provided of (1) the number of plan participants likely to become vested under the new standards, (2) the costs of quicker vesting in terms of plan expenses and potential adjustments to the economy and (3) the dollar value of entitlements to participants.

Vesting is integrally related to other provisions of retirement programs, including the presence or absence of preretirement distributions. In short, vesting needs to be analyzed in conjunction with other factors. This Issue Brief identifies some of these factors and analyzes the policy proposals under consideration today. The recent tax reform debate in Congress1 makes analysis of these provisions particularly relevant as suggestions have been made that RIPA be substituted for the retirement and capital accumulation provisions of the Tax Reform Act of 1985 (H.R. 3838) recently passed by the House of Representatives.

Vesting Standards and ERISA

ERISA vesting standards were enacted because many felt that some pension plans had such long vesting periods that few employees would ever work long enough to receive a pension at retirement. According to a 1971 study by the Subcommittee on Labor of the Senate Committee on Labor and Public Welfare, "in the sample of plans studied, which had lengthy service requirements, only 5 percent of the millions of employees covered since 1950 had ever received benefits, only 8 percent had qualified for benefits, and while most of these employees had only worked a very short period of time (less than 5 years), there were substantial numbers of workers who had longer periods of service and failed to qualify for benefits." While others disputed these statistics as being overly pessimistic, a number of "horror stories" were cited in the months to come concerning workers who failed to qualify for benefits because of stringent vesting requirements then in effect under some plans.2 Regrettably, the political side of the public policy process frequently emphasizes horror stories more than analysis to shape perceptions and lead to change.

Three primary vesting rules were instituted in 1974 under ERISA contingent on the minimum plan participation standards which initially allowed plans to exclude workers under age 25, those working fewer than 1,000 hours annually and those within 5 years of normal retirement age (not to exceed age 65).

For most employees, these original ERISA standards determine the way in which nonforfeitable accrued benefits are derived from employer contributions. Plans have to state which of the minimum vesting standards they intend to follow. The three standards are (1) the 10-year rule, (2) the 5-to-15 year rule and (3) the rule of 45. Plans can, of course, allow participants to vest more quickly than the minimum standards set by law.

Under the 10-year rule, an employee's accrued benefit from employer contributions has to be 100-percent vested after 10 years of plan participation. In practice, this standard usually is implemented by 10-year cliff vesting in which the employee has no vested benefits for up to 10 years of service and is 100-percent vested after 10 years. Graded vesting standards are also possible, however, with the percentage of vested benefits phased in over the 10-year period.

The 5-to-15 year rule is a graded standard in which the employee must be at least 25-percent vested in the plan's accrued benefits after 5 years of plan participation, with increases in this percentage phased in over the next 5 years of service and reaching 100-percent vesting after 15 years.

1 See EBRI, "Tax Reform Passes House of Representatives" EBRI Issue Brief 50 (January 1986).


3 Ibid., chap. 1.
ERISA provides a statutory vesting schedule that clearly defines the vested percentages required between 5 and 15 years of service, with vesting increasing by 5 percentage points for each additional year of service.

The third vesting standard, the rule of 45, is the most complicated. Under this rule, an employee with 5 or more years of plan participation must be at least 50-percent vested when the sum of the employee's age and the employee's years of plan participation reach 45. In other words, a 30-year-old employee with 15 years of service must be 50-percent vested. In each subsequent year, the vested benefit percentage has to meet the following schedule:

<table>
<thead>
<tr>
<th>Years of Service</th>
<th>Sum of Age and Service</th>
<th>Non-forfeitable Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>5</td>
<td>45</td>
<td>50</td>
</tr>
<tr>
<td>6</td>
<td>47</td>
<td>60</td>
</tr>
<tr>
<td>7</td>
<td>49</td>
<td>70</td>
</tr>
<tr>
<td>8</td>
<td>51</td>
<td>80</td>
</tr>
<tr>
<td>9</td>
<td>53</td>
<td>90</td>
</tr>
<tr>
<td>10</td>
<td>55</td>
<td>100</td>
</tr>
</tbody>
</table>

Furthermore, an employee with 10 years of service must be at least 50-percent vested and must gain an additional 10-percent vesting for each subsequent year of service.

While these three rules are the generally recognized key ERISA vesting standards, standards determining benefit eligibility are actually more complex under current pension law. For instance, ERISA also states that unless the participant otherwise elects, benefits are to be paid on the date the participant attains age 65 or the normal retirement age specified under the plan or (in cases involving certain employees who become a participant at a late age) upon the tenth anniversary of the year in which the employee became a plan participant. The latter was inserted to ensure that an employee who became a participant at a late age would only have to receive plan benefits some time after normal retirement age.4

Through the courts, however, the latter benefit eligibility provision has been interpreted as superseding plan vesting standards in determining benefit entitlement.5

ERISA also stipulates shorter vesting schedules for the so-called “class year plans” that are defined as profit sharing, stock bonus, or money purchase plans which provide for an employee's rights to contributions for each plan year separately. In this case, the plan must ensure a 5-year vesting schedule for such employer contributions, with 100-percent vesting not later than the end of the fifth plan year after the contributions are made.6

Faster vesting standards are also required for plans designated as “top-heavy” under the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). This legislation was enacted to ensure that plans of smaller employers were consistent with the philosophy behind the deferred-tax treatment of pension accruals, i.e., to ensure that the plan provided broadly based benefits for all employees and not only for those with an ownership or management position.

A plan is deemed top-heavy if 60 percent or more of the accounts or accrued benefits under the plan are attributable to key employees. Key employees are officers of the firm (excluding those with annual compensation less than 1.5 times the defined contribution plan limits) as well as the 10 employees owning the largest share of the firm, those having more than a 5-percent interest in the employer or a 1-percent owner with annual compensation in excess of $150,000. Although these conditions are clearly spelled out, no estimate of the prevalence of top-heavy plans is available.

One of two vesting standards must be satisfied by top-heavy plans. The first standard requires that the employee be 100-percent vested after 3 years of service under the plan. The second option is a 6-year graded vesting in which the employee must be at least 20-percent vested in the plan's accrued benefits after 2 years of plan participation with a graded increase in this percentage after 4 more years of service resulting in 100-percent vesting after 6 years of service.

ERISA demands even more stringent vesting standards in certain cases. Immediate vesting is always required for accrued benefits deriving from the employee's own contributions. Similarly, contributions to simplified employee pensions (SEPs) have to be vested immediately. In these plans, the employer essentially makes contributions to an individual account on behalf of all employees who have been on the job for 3 out of the last 5 years. SEPs were authorized through the Revenue Act of 1978 to enable smaller employers to start pensions without the complexity and administrative expense.

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6 According to the Bankers Trust Company, only 1 percent of the savings and thrift plans surveyed used class year vesting based on participation of over 5 years. This suggests that ERISA may have ratified rapid vesting standards used by the preponderance of plans with class year vesting. For more information, see Bankers Trust Company, A Review and Comparison of Employee Savings Plans (New York: Bankers Trust Company, 1979).
of a usual corporate plan. Benefits for Keogh plans (those for the unincorporated self-employed and their employees) also used to require immediate vesting but that provision was removed after TEFRA. Keogh plans now must conform to the other ERISA vesting standards enumerated earlier.

**Vesting Standards in Force**

ERISA and subsequent legislation permit a wide range of vesting standards that plans may use and the opportunity for considerable variation among plans; before ERISA, the range of choice was unlimited. Using statistical information on actual plans, we can determine which vesting standards actually have been and are the most prevalent.

According to the 1980 Bankers Trust report, vesting standards changed considerably between 1960 and 1980 among the sample of large firms surveyed (table 1). Vesting provisions are presented for both pattern plans and conventional plans. Pattern plans are defined as those that have been adopted by certain international unions and are negotiated, with minor variations, with individual companies or groups of companies. In 1960, only 4 percent of pattern plans had 10-year vesting compared to 34 percent in 1970 and 100 percent in 1980 after ERISA was passed. Among conventional plans surveyed, only 5 percent had 10-year vesting in 1960, compared to 20 percent in 1970 and 90 percent in 1980. The vesting schedules that were replaced appeared to be more stringent than the 10-year standard. Nevertheless, even before ERISA was passed, there appeared to be a trend toward shorter vesting standards among the plans surveyed.

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**The vast majority of employees in medium and large firms are in defined benefit plans in which vested benefits are conferred after 10 years of plan participation.**

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The Bureau of Labor Statistics' (BLS) survey of employee benefits in medium and large firms now provides the most comprehensive information on plan vesting provisions for companies employing at least 100 or 250 workers, depending on the industry. The survey is comparable in scope to that used to evaluate federal pay. The findings from 5 years of survey data indicate a slight downward trend—from 89 to 85 percent—in the percentage of participants in plans with 10-year cliff vesting and a slight increase in the percentage of participants with other types of vesting provisions (table 2). Nevertheless, the stability in the distribution of vesting provisions during the 1980s is striking. The vast majority of employees in medium and large firms are in defined benefit plans in which vested benefits are conferred after 10 years of plan participation.

Unfortunately, the BLS survey only covers vesting provisions of primary pension plans in medium and large firms. The vesting provisions of defined contribution plans, whether they are primary or secondary plans, are not included. Current comparable data on vesting provisions among small employers and for defined contribution plans are not available on an ongoing basis.

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8 The cut-off is generally 100 or 150 workers, depending on the industry, but it dips to a minimum establishment size of 50 workers for selected services. For detail about this survey, see U.S. Department of Labor, Bureau of Labor Statistics, Employee Benefits in Medium and Large Firms, 1984 (Washington, DC: U.S. Government Printing Office, 1985).
Table 2
Vesting Schedules of Private Pension Plans in Medium and Large Firms: Percent of Full-Time Participants by Type of Vesting Schedule Used in Primary Plan, 1980–1984

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cliff vesting after</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>10 years</td>
<td>89%</td>
<td>88%</td>
<td>88%</td>
<td>87%</td>
<td>85%</td>
</tr>
<tr>
<td>other</td>
<td>0</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td>4</td>
</tr>
<tr>
<td>Graduated vesting,</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>with full vesting after</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>15 years</td>
<td>5</td>
<td>4</td>
<td>4</td>
<td>4</td>
<td>4</td>
</tr>
<tr>
<td>other</td>
<td>6</td>
<td>9</td>
<td>8</td>
<td>9</td>
<td>10</td>
</tr>
</tbody>
</table>


* Generally includes firms with at least 100 to 250 employees. Definition varies by industry.

b Because plans may offer alternative vesting schedules, sums of participants covered by individual vesting schedules may exceed 100 percent.

c Differences across years may in part reflect improvement in survey procedures and techniques.

Information based on initial ERISA disclosure filings has been tabulated on a one-time basis by Kotlikoff and Smith. Tabulations of vesting standards for defined benefit plan participants (among those standards classified by the authors) indicate that at the time of the original filing of plan characteristic information with the Department of Labor, 86 percent of all defined benefit plans had 10-year cliff vesting (chart 1). This proportion is somewhat lower than, but very close to, that which BLS found for large and medium employers in 1980. Differences may reflect more rapid vesting in smaller firms.


According to Kotlikoff and Smith, defined contribution plans have faster vesting schedules than defined benefit plans, with only 30 percent of all plans selecting 10-year cliff vesting and 18 percent of plans providing immediate vesting for their employees (chart 1). Other cliff vesting options and graded-vesting options are more prevalent among defined contribution plans. We do not have data, however, on whether defined contribution vesting standards have become even less stringent in recent years with the advent of the TEFRA top-heavy rules.

Small plan participants are less likely to have 10-year cliff vesting than are participants in larger plans, and they are more likely to have immediate vesting, shorter cliff-vesting provisions and graded-vesting options, according to Kotlikoff and Smith (table 3). Similarly, union plan participants are

Table 3
Percent of Participants in Private Defined Benefit and Defined Contribution Plans by Vesting Schedule and Number of Plan Participants, Original ERISA Filing†

<table>
<thead>
<tr>
<th>Number of Plan Participants</th>
<th>Immediate</th>
<th>10-year</th>
<th>Other</th>
<th>10 years</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>1–24</td>
<td>23%</td>
<td>15%</td>
<td>10%</td>
<td>24%</td>
<td>28%</td>
</tr>
<tr>
<td>25–49</td>
<td>8</td>
<td>45</td>
<td>5</td>
<td>30</td>
<td>12</td>
</tr>
<tr>
<td>50–99</td>
<td>2</td>
<td>64</td>
<td>3</td>
<td>18</td>
<td>13</td>
</tr>
<tr>
<td>100–999</td>
<td>8</td>
<td>69</td>
<td>4</td>
<td>6</td>
<td>12</td>
</tr>
<tr>
<td>1,000 or more</td>
<td>5</td>
<td>74</td>
<td>7</td>
<td>3</td>
<td>10</td>
</tr>
</tbody>
</table>


† These findings are based on the National Bureau of Economic Research/U.S. Department of Labor EBS-1 subsample excluding responses not classified by Kotlikoff and Smith.
Chart 1

Percent of Participants in Private Defined Benefit and Defined Contribution Plans by Vesting Schedule and Plan Type

Vesting schedule

- 10-year cliff
- Immediate cliff
- Other cliff
- 10-year graded
- Other graded


Note: These findings are based on the National Bureau of Economic Research/U.S. Department of Labor EBS-1 subsample, excluding responses not classified by Kotlikoff and Smith.
more likely to have 10-year cliff vesting (84 percent) compared to nonunion plan participants (63 percent) (table 4). Although some of this difference may reflect greater secondary-plan coverage among nonunion participants, these findings support statistical analysis indicating that nonunion workers in smaller firms are more likely to be vested in their pension plans than union workers in larger firms with the same service under the plan. Yet, coverage generally is more widespread in unionized firms.

A one-time survey conducted by the American Society of Pension Actuaries (ASPA) for the President’s Commission on Pension Policy in 1980 indicates shorter vesting standards among participants in smaller defined benefit plans. This suggests that the small-firm/large-firm findings of Kotlikoff and Smith are not simply the result of the greater prevalence of defined contribution plans among small firms. While the majority of plans with 100 or more participants in the ASPA survey had 10-year cliff vesting, this percentage dropped sharply for plans with fewer than 100 participants to less than 20 percent of firms with 11 to 25 participants under a 10-year standard and less than 2 percent of plans with 10 participants or fewer. Graded options are more prevalent among small defined benefit plans. Among the smallest plans, participants are more likely to be fully vested by 5 years of service.

Despite considerable variation in the options provided under ERISA and subsequent legislation, the evidence suggests that the overwhelming majority of employees must be plan participants for 10 years to be entitled to a benefit at retirement.

Nevertheless, the growth of defined contribution plans for both primary and secondary coverage should lead to an increased proportion of participants with some vested benefits in the future. Furthermore, the shift from highly unionized manufacturing to less unionized service occupations should also lead to faster vesting for those employees who work for companies with pension plans. Unfortunately, without new data on vesting provisions among small employers and for defined contribution plans, these expected trends in vesting cannot be confirmed.

**Trends in Employee Vesting**

Some indication of the effect of ERISA vesting standards can be gained by tracking the percentage of full-time private-sector wage and salary workers between 1972 and 1983 who have reported that they are entitled to pension benefits at retirement from their employer-sponsored plan. This entitlement rate increased from 32 percent of plan participants in 1972 to 48 percent in 1979 and 51 percent in 1983. The rate for women working full-time in the private sector rose from 26 to 44 percent between 1972 and 1983. The entitlement rate for men increased by 20 percentage points between 1972 and 1983 to 54 percent.

Part of this increase probably derives from increases in tenure among workers in firms sponsoring pension plans as the pension system has matured. It also stems partly from post-ERISA improvements in defined benefit vesting provisions, which have led to prevalent usage of the 10-year cliff-vesting standard.

**How Workers Become Vested**

The public policy objectives of employer-sponsored plans would be met if most older workers covered by a pension plan were entitled to benefits at retirement age. Plan benefits are linked to service rather than age, and with 10-year cliff vesting being the most prevalent, the relationship between age and years on the job has to be strong for most employees to get pension benefits.
Practically no one under 25 years of age has 10 years on the job (table 5). By contrast, over half of all nonagricultural employees age 60 to 64 have worked for their present employer 10 years or more. The proportion of the work force with 10-year tenure meeting ERISA participation standards in 1983 increases from 14 percent of all employees 25 to 34 years of age to 67 percent of workers age 55 to 59 and 70 percent of workers age 60 to 64.

Patterns of employment over a lifetime explain this phenomenon. Estimates made by Hall indicate that men and women typically hold 10 to 11 jobs over a lifetime. By age 24, the average worker will have held 4 jobs out of 10. The next 15 years will contribute another 4 jobs.

Whether an employee works for an employer sponsoring a pension plan varies relatively little by age except for the youngest and the oldest workers. Vesting increases considerably with age, however, reflecting the relationship between age and job tenure (table 6). On average, 51 percent of covered private-sector employees are vested in their pension plans. Workers age 35 years and older are much more likely to have qualified for vested benefits. In the private sector, the percentage of employees with vested benefits increases to 70 percent for workers age 55 to 64. Rates decline for persons working beyond normal retirement age.

Workers meeting ERISA participation standards are also more likely to qualify for vested benefits. In the private sector, 60 percent of the "ERISA work force" have vested benefits with rates peaking at over 70 percent for workers over age 45.

### Table 5

The Cumulative Distribution of Years of Service by Age: "ERISA Work Force" and Nonagricultural Wage and Salary Workers, May 1983

<table>
<thead>
<tr>
<th>Age</th>
<th>15 or more</th>
<th>10 or more</th>
<th>5 or more</th>
<th>One or more</th>
<th>All tenures</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>100.00%</td>
</tr>
<tr>
<td>Nonagricultural Wage</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>and Salary Workers</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>All ages</td>
<td>15.6%</td>
<td>26.8%</td>
<td>45.4%</td>
<td>80.6%</td>
<td>100.00%</td>
</tr>
<tr>
<td>Less than 25</td>
<td>b</td>
<td>b</td>
<td>7.3</td>
<td>59.3</td>
<td>100.00%</td>
</tr>
<tr>
<td>25 to 34 years</td>
<td>1.2</td>
<td>10.8</td>
<td>37.3</td>
<td>80.2</td>
<td>100.00%</td>
</tr>
<tr>
<td>35 to 44 years</td>
<td>18.9</td>
<td>36.9</td>
<td>57.8</td>
<td>86.6</td>
<td>100.00%</td>
</tr>
<tr>
<td>45 to 54 years</td>
<td>36.1</td>
<td>51.5</td>
<td>69.9</td>
<td>91.6</td>
<td>100.00%</td>
</tr>
<tr>
<td>55 to 59 years</td>
<td>45.5</td>
<td>60.1</td>
<td>75.5</td>
<td>91.7</td>
<td>100.00%</td>
</tr>
<tr>
<td>60 to 64 years</td>
<td>46.5</td>
<td>64.2</td>
<td>79.1</td>
<td>94.4</td>
<td>100.00%</td>
</tr>
<tr>
<td>65 years and older</td>
<td>35.6</td>
<td>52.3</td>
<td>69.9</td>
<td>92.5</td>
<td>100.00%</td>
</tr>
<tr>
<td>&quot;ERISA Work Force&quot;</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>100.00%</td>
</tr>
<tr>
<td>All ages</td>
<td>23.1%</td>
<td>39.5%</td>
<td>64.9%</td>
<td>100.00%</td>
<td>100.00%</td>
</tr>
<tr>
<td>25 to 34 years</td>
<td>1.6</td>
<td>13.9</td>
<td>47.2</td>
<td>100.00%</td>
<td>100.00%</td>
</tr>
<tr>
<td>35 to 44 years</td>
<td>22.7</td>
<td>44.1</td>
<td>68.2</td>
<td>100.00%</td>
<td>100.00%</td>
</tr>
<tr>
<td>45 to 54 years</td>
<td>40.5</td>
<td>57.3</td>
<td>77.3</td>
<td>100.00%</td>
<td>100.00%</td>
</tr>
<tr>
<td>55 to 59 years</td>
<td>51.0</td>
<td>66.6</td>
<td>83.1</td>
<td>100.00%</td>
<td>100.00%</td>
</tr>
<tr>
<td>60 to 64 years</td>
<td>51.5</td>
<td>69.8</td>
<td>85.0</td>
<td>100.00%</td>
<td>100.00%</td>
</tr>
</tbody>
</table>


* The "ERISA work force" consists of workers age 25 to 65 working 1,000 hours or more per year with at least one year on the job.

b Number of workers too small for rates to be calculated reliably.

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12 Those meeting ERISA standards are defined as workers age 25 to 64 working 1,000 or more hours per year with at least one year on the job.

These distributions, at the discretion of the employer, can now be up to $3,500. Younger workers expect lump-sum distributions more often than older workers and may be likely to cash out their vested benefits if they change jobs before retirement. Younger workers also may be more likely to work for firms with defined contribution plans.

Estimates show that over one million more men and 766,000 more women would have been vested in 1985 had there been a 5-year vesting standard.

How vested benefits are paid out influences their effectiveness in providing future retirement income. Within the "ERISA work force," 21.4 percent of employees with current-vested benefits and 57.3 percent of persons with past-vested benefits will receive or have received them as a lump-sum distribution. Close to 85 percent of all preretirement lump-sum distributions were for amounts of less than $5,000 (table 7). How preretirement cash outs are used depends on the dollar amount of the distribution. Only 26 percent of persons receiving preretirement distributions worth less than $5,000 used some for savings, compared to 87 percent of persons receiving distributions worth more than $20,000. Over half of all persons receiving cash outs in the $5,000 to $9,999 range spent some or all of the distribution. A substantial proportion of benefits provided by employer-sponsored plans before retirement are never translated into retirement income.  

Legislative Proposals to Change Vesting Standards

Considerable discussion about appropriate vesting standards took place before the passage of ERISA; the three primary standards adopted were not the only alternative suggestions. In fact, the May 1972 William-Javits bill called for a graded-vesting schedule starting with 30 percent after 8 years and reaching 100 percent after 15 years. 15 Earlier, the Nixon Ad-

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Table 6
Vesting Among Private-Sector Nonagricultural Wage and Salary Workers and the "ERISA Work Force" by Age and Sector, May 1983

<table>
<thead>
<tr>
<th>Age</th>
<th>Covered Workers (000's)</th>
<th>Total percent vested of covered</th>
<th>Percent expecting future pension</th>
<th>Percent expecting lump sum only</th>
</tr>
</thead>
<tbody>
<tr>
<td>All ages</td>
<td>36,458</td>
<td>51.0%</td>
<td>40.3%</td>
<td>10.7%</td>
</tr>
<tr>
<td>Less than 25</td>
<td>5,285</td>
<td>19.6%</td>
<td>11.9%</td>
<td>7.8%</td>
</tr>
<tr>
<td>25 to 34 years</td>
<td>11,516</td>
<td>42.8%</td>
<td>29.5%</td>
<td>13.3%</td>
</tr>
<tr>
<td>35 to 44 years</td>
<td>8,576</td>
<td>59.8%</td>
<td>48.6%</td>
<td>11.2%</td>
</tr>
<tr>
<td>45 to 54 years</td>
<td>6,185</td>
<td>67.4%</td>
<td>56.5%</td>
<td>11.0%</td>
</tr>
<tr>
<td>55 to 59 years</td>
<td>2,912</td>
<td>69.9%</td>
<td>62.5%</td>
<td>7.4%</td>
</tr>
<tr>
<td>60 to 64 years</td>
<td>1,520</td>
<td>70.0%</td>
<td>64.9%</td>
<td>5.1%</td>
</tr>
<tr>
<td>65 years and older</td>
<td>465</td>
<td>51.3%</td>
<td>45.8%</td>
<td>5.5%</td>
</tr>
<tr>
<td><strong>&quot;ERISA Work Force</strong>*</td>
<td><strong>27,550</strong></td>
<td><strong>60.1%</strong></td>
<td><strong>48.2%</strong></td>
<td><strong>11.9%</strong></td>
</tr>
<tr>
<td>25 to 34 years</td>
<td>9,883</td>
<td>46.8%</td>
<td>32.3%</td>
<td>14.5%</td>
</tr>
<tr>
<td>35 to 44 years</td>
<td>7,779</td>
<td>63.1%</td>
<td>51.4%</td>
<td>11.7%</td>
</tr>
<tr>
<td>45 to 54 years</td>
<td>5,756</td>
<td>70.1%</td>
<td>58.7%</td>
<td>11.7%</td>
</tr>
<tr>
<td>55 to 59 years</td>
<td>2,708</td>
<td>73.1%</td>
<td>65.4%</td>
<td>7.8%</td>
</tr>
<tr>
<td>60 to 64 years</td>
<td>1,424</td>
<td>71.0%</td>
<td>65.9%</td>
<td>5.1%</td>
</tr>
</tbody>
</table>


* The "ERISA work force" consists of workers age 25 to 65 working 1,000 hours or more per year with at least one year on the job.

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14 For further discussion, see G. Lawrence Atkins, "Distributions from Employer Sponsored Pension Plans at Termination: Implications for Retirement Income and Tax Policy" (Ph.D. dissertation, Brandeis University, 1984).

15 Much of the information in the next two paragraphs has been derived from material presented by Michael S. Gordon, "Overview: Why Was ERISA Enacted?"
ministration had endorsed a “rule of 50” in which an employee must be at least 50-percent vested when the sum of the employee’s age and the employee’s years of plan participation reach 50 with 100-percent vesting required 5 years later.

Apparently, there was no unanimity on vesting schedules on the part of organized labor either. According to Michael Gordon, a Senate staff member when ERISA was drafted, organized labor “failed to present a united front, with representatives of the craft unions continuing to maintain that their multiemployer plans should be exempt from vesting, causing Javits to confront them with a sheaf of letters written by former participants in multiemployer plans who had complained of failure to qualify for vested benefits despite longer years of service.” On the other hand, other representatives of labor, in particular, the United Steelworkers of America, indicated that the Williams-Javits bill was too cautious in restricting vesting.

The mid-September 1972 Williams-Javits bill permitted plans to opt for 100-percent vesting after 10 years of service. As we have seen, this is the predominant vesting standard preferred by plans today. The committee did not grant multiemployer plans any general exceptions from vesting.

Further discussion about vesting before the passage of ERISA included a detailed study of the cost of vesting provisions by actuary Donald Grubbs. The study included 5-year and 3-year cliff vesting. In 1980, EBRI published a study on the benefits and costs of shorter vesting standards. It also included 3-year and 5-year vesting.

Current legislative proposals concentrate on shortening the 10-year standard to 5 years. In 1985, both the Economic Equity Act (EEA) and the Retirement Income Policy Act (RIPA) proposed 5-year vesting for private-sector pension plans. The House version of EEA (H.R. 2472) is a compilation of 22 bills intended to improve the economic security of women. It was introduced on May 13, 1985, by Rep. Patricia Schroeder (D-CO) and 80 cosponsors. The omnibus bill is divided into five titles. The retirement security provisions include what is commonly referred to as the “VIP” bill, which...

16 Ibid., p. 21.


addresses pension vesting, integration and portability. This bill (H.R. 2622) was introduced by Rep. Barbara Kennelly (D-CT). The VIP bill is similar to a draft proposal disclosed at the end of the 98th Congress by former Rep. Geraldine Ferraro. At that time Ferraro supported the concept of a 5-year vesting standard stating that "many industries, particularly high-tech industries, actually encourage workers to change employment every few years."

Many vested workers — 12 percent of those covered by a pension plan and meeting ERISA standards — anticipate cashing out their benefits before retirement in the form of a lump-sum distribution.

EEA (S. 1169) was introduced in the Senate by Sen. Dave Durenberger (R-MN) and others. He stated that "statistics show that women have been less likely to receive pensions than men, and when they receive them, their benefits are lower than those of men. This disparity has many implications for women, particularly lower-paid workers. This is of particular concern due to the increased mobility of the work force." EEA provisions would reduce to 5 the number of years a pension plan participant must complete in order to be 100-percent vested. Nevertheless, it would permit multiemployer pension plans to retain 10-year vesting provided there is complete reciprocity for workers who move from one regional pension plan to another within the same industry. This provision brings to mind the reluctance on the part of some multiemployer plans to accept any vesting standards when ERISA was originally introduced. It also suggests that at least some plan sponsors would consider 5-year vesting costly to their plans.

RIPA was introduced by Sen. John Heinz (R-PA), Sen. John Chafee (R-RI) and Rep. William Clay (D-MO) on October 23, 1985. The legislation (S. 1784, H.R. 3594) departs from ERISA and its subsequent amendments by making a distinction between retirement plans and other savings plans. It states that an employer may not maintain a nonretirement savings plan unless at least one retirement plan is maintained in which the employee is eligible to participate. Retirement plans would be those designed primarily to accumulate assets for retirement and to pay benefits at that time. Plans designed to accumulate capital for no specified purpose would be considered nonretirement savings plans.

RIPA proposes different vesting standards for retirement and nonretirement plans. Retirement plans would have to provide 100-percent vesting to participants after 5 years of service; 5-year cliff vesting would be the longest vesting period allowable. Nonretirement savings plans would be subject to stricter vesting standards. For example, a participant with one year of service would have to be 100-percent vested. Because this type of plan is envisaged to encourage savings for a variety of purposes, faster vesting is required to make accumulations readily available to participants. RIPA also makes a distinction between single-employer and multiemployer plans. It permits multiemployer plans to continue 10-year cliff vesting for retirement plans whether or not they have regional reciprocity.

The Effect of Quicker Vesting Standards

Faster vesting is proposed, in part, because of observed reductions in average job tenure among workers. It is also proposed because of observed differences in job tenure between men and women. In fact, job tenure has decreased from a median of 5.7 years for men (and 3.0 for women) in 1963 to 4.0 for men (and 1.5 for women) in 1981. These statistics must be used carefully, however, because they hide the effect of changes in the age distribution of workers.

A substantial proportion of benefits provided by employer-sponsored plans before retirement are never translated into retirement income.

Among men ages 45 to 54, tenure has decreased very slightly from a median of 11.4 years in 1963 to 11.0 years in 1981. In both years, median tenure was above the 10-year cliff-vest-


Chart 2

Estimated Increase in Number of Vested Workers
Due to 5-Year Vesting Standard, 1985


ing standard. Furthermore, tenure for men in this age group has increased considerably from 1951 when it was only 7.6 years. Nonetheless, 5-year vesting would provide greater protection to those men who had less than 10 years on the job.

Faster vesting would also mean that men age 35 to 44 would also be more likely to be vested. Job tenure in this age group declined from 7.6 years in 1963 to 6.6 years in 1981. More men in this group would have been vested under a 5-year standard.

Tenure patterns for women also show a similar slight decline from 6.1 years in 1962 to 5.1 years in 1981 for those age 45 to 54. Tenure has risen sharply since 1951, however, when median tenure was only 4 years. Due to differences in career patterns, most women nearing retirement do not have sufficient years of job tenure to vest in a pension plan under current 10-year vesting standards. Moreover, most women age 35 to 44 would not be able to reach even a 5-year standard since their median on-the-job tenure is only 3.5 years.

Because recent trends in job tenure are not more pronounced and because workers in a number of age groups hover around 5 years of tenure, the effect of 5-year vesting on current participants is difficult to forecast. In our analysis of these issues we have attempted to overcome a number of statistical problems to produce a reasonable estimate. If 5-year cliff vesting had replaced the current 10-year standard in 1985, our conservative projection indicates that 1.9 million more workers would have been entitled to vested benefits (chart 2). A shift to 5-year cliff vesting would have added 1.1 million men and 766,000 women according to our conservative projection. Although fewer women are affected, this change would help women relatively more. It would represent a 7-percent gain in the number of vested male workers and a 10-percent gain in the number of vested female workers. In the absence of a 5-year standard, a greater proportion of the estimated number of newly vested women than newly vested men with 5-year vesting would probably never become entitled to benefits in their current job.

22 See Andrews, The Changing Profile of Pensions in America, Appendix C.
23 Extremely optimistic projections suggest that as many as 2.6 million additional workers might have had vested benefits under a 5-year cliff vesting standard in 1985.
24 While these figures do not include young nonvested plan participants included by the 1984 Retirement Equity Act, only 7 percent of all workers under age 25 had 5 or more years of service with their employer in May 1983.
Five-year vesting would have approximately the same effect on union and nonunion workers if multiemployer plans were not exempt from the standard. The number of both union and nonunion participants with vested benefits in their pension plans would have increased by about 7 percent if 5-year vesting were in force in 1985. This represents a gain of 1.3 million nonunion vested plan participants and 593,000 union vested plan participants. Although union workers are likely to have longer tenure, nonunion vesting standards are likely to be shorter. Consequently, 5-year vesting would have a similar impact on both types of employees. Of course, if multiemployer plans were exempt from the 5-year standard, union workers would gain less from 5-year vesting.

The effects of other standards can also be estimated in terms of additional workers likely to secure vested rights to a pension. A more modest shift to a 7-year standard would have added, conservatively, only 865,000 additional workers to the ranks of the vested in 1985. It is extremely hazardous to venture a guess about the effect of 3-year cliff vesting or immediate vesting on plan participants, because those with fewer years of job tenure are much less likely to know whether they are entitled to vested benefits. Consequently, the error involved in the projection increases. Suffice it to say that because many more workers have less than 5 years of tenure, the impact of immediate or 3-year cliff vesting would be greater unless increased costs led to compensating terminations of pension plans.

“Statistics show that women have been less likely to receive pensions than men, and when they receive them, their benefits are lower than those of men.”

Under RIPA, nonretirement savings plans would be scheduled to go to one-year vesting. Presumably, these plans would be primarily secondary defined contribution plans. Other primary defined contribution plans would either adjust to the retirement savings criteria of the bill, lose their tax qualification or terminate. According to Labor Department economist Richard Ippolito, about 29 percent of all private-sector plan participants are included in more than one plan. In 1985, there were probably somewhat over 10 million employees with second plan coverage, i.e., coverage of plans that supplement a defined benefit or other primary retirement plan. Information filed at the time of ERISA suggests that only 18 percent of all participants in defined contribution plans were in plans granting immediate vesting. Consequently, over 8 million of these participants in second plans would have been likely to have fuller entitlement to their savings plans if RIPA had been enacted in 1985 and all secondary coverage had remained in effect.

Pension contributions would have to have increased by $1.4 to $4.7 billion in 1985 to take care of first-year costs of 5-year vesting. In subsequent years, they would represent a similar percentage increase in total contributions.

The Costs of 5-Year Vesting

According to actuary Donald Grubbs, “studies indicate that requiring full vesting after 5 years of service for plans already subject to ERISA’s requirements would create increases in costs for most defined benefit pension plans, ranging from zero to 7 percent of present plan costs and from zero to 0.2 percent of compensation of covered employees.” The 1980 study by EBRI using the consulting firm ICF, Incorporated’s actuarial forecasting model suggests that the average cost increase required for a shift from 10-year to 5-year vesting as a percent of annual plan contributions would be 2.4 percent for defined benefit plans and 5.3 percent for defined contribution plans.

With these figures as guidelines, cost increases amounting to 2 to 7 percent of total private pension plan contributions illustrate the estimated nationwide cost of 5-year vesting. Pension contributions would have to have increased by $1.4 to $4.7 billion in 1985 to take care of first-year costs. In subsequent years, they would represent a similar percentage increase in total contributions. For some employers, however, with young workforces and high turnover, the cost could reach as high as 40 percent of current contributions.

In view of the relatively high costs and large number of workers involved, the indirect economic effects of legislation liberalizing vesting may be larger than those of other ERISA


27 Employee Benefit Research Institute, Analysis of Alternative Vesting Requirements for Private Pensions, pp. 17 and 20.

reforms, such as the 1984 Retirement Equity Act and proposals to require post-65 accruals.28 The costs of 5-year vesting could be borne by workers in the form of lower wages and benefits. Some firms may not be able to adapt to these cost increases if many of their employees are in the 5-year tenure range. They could be forced to realign their benefit structures or terminate their plans, providing higher wages or other employee benefits instead. The impact of such adjustments would be difficult to estimate without further study.

The Effect of 5-Year Vesting on Benefit Receipt

Five-year vesting is intended to increase future retirement income receipt. ICF, Incorporated estimated the effect of 5-year vesting for future retirees in public and private pension plans.29 They note that for "workers currently age 40 to 44, 5-year vesting would reduce the proportion of covered workers who fail to vest from 6 percent to 4 percent; and the proportion of uncovered workers who fail to vest in future employment from 21 to 17 percent."30 Such legislation could have an even greater effect on younger workers.31

Average benefits for married couples age 40 to 44 at the time of the study would increase from $5,590 to $6,090 in 1981 dollars, and those for unmarried individuals would increase from $3,580 to $3,660. The smaller increase for unmarried men and women stems from the greater proportion of newly entitled shorter-service workers in that group. Benefit receipt rates for unmarried men and women would increase by 6 percentage points, compared to an improved reciprocity rate of 3 percentage points for married couples. Presumably, 5-year vesting would have a greater impact on younger workers who have longer working lives in which to gain pension benefits from jobs lasting 5 to 10 years.

The effect of 5-year vesting on future benefit reciprocities is likely to be greater if preretirement lump-sum distributions from pension plans are no longer used for current consumption. To meet that goal, the proposed RIPA insists that lump-sum distributions from retirement plans be rolled over into an individual retirement account (IRA). Premature distributions from IRAs would be subject to a 20-percent tax. This action would affect distributions from defined contribution retirement plans and from defined benefit plans, including distributions of $3,500 or less that can be made at the employer's behest.

The combined effects of 5-year vesting and penalties on the use of lump-sum distributions for consumption rather than savings are difficult to evaluate. EBRI's 1980 study indicates that under reasonable assumptions the present value of benefits from a defined benefit plan vary according to age and years of service at separation (table 8). Based on these benefits and representative work-force distributions, the value of

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28 See Andrews, The Changing Profile of Pensions in America, chaps. VII and VIII.


30 Ibid., p. 35.

31 Ibid., p. 36.
The value of vested benefits was calculated under a 3-year vesting standard. Only 15 percent of all workers with less than 10 years of service could expect to accumulate a benefit valued, in 1980 dollars, at $2,000 or more at a $10 unit benefit accrual rate; only 6 percent could have accumulated a benefit of $3,000 or more (Table 9). Based on a more generous formula (a $20 unit benefit accrual rate), only 23 percent of separated vested workers would have accumulated a benefit valued at $3,000 or more. In other words, most separating workers would have relatively small vested benefits under reasonable assumptions. But such separations from a number of different jobs could add up to a larger sum.

In defined contribution plans, the value of vested benefits accumulated by young, short-service workers under shorter vesting may be larger than in equivalent defined benefit plans, because such plans accumulate relatively larger benefits in the earlier years of service. Consequently, for defined contribution plans with a contribution rate of 5 percent on earnings below the Social Security wage base in 1980, a representative worker was calculated to have accumulated a vested benefit of $1,750 after about 2 1/2 years of service.\(^{32}\)

Recently reported work by ICF, Incorporated for the Department of Health and Human Services, now in draft form, provides an upper-bound estimate of increased benefit reciprocity and annual pension income under a scenario of 5-year vesting and no consumption of lump-sum distributions in any circumstances. Their findings suggest that with complete 5-year vesting and no cash outs of any lump-sum distributions, the percentage of families receiving income from employersponsored pensions among those headed by a member reaching age 67 between 2011 and 2020 (essentially the baby boom) would increase to 81 percent from the 63-percent rate forecast for that generation under current law. Average pension benefits received by those baby-boom families with pension income would increase to $13,700 from the $12,300 forecast under current law.

This "best case" scenario is aided by several factors not included in RIPA, however. First, the simulations assume that all state and local plans will also institute 5-year vesting and that multiemployer plans will reduce their vesting standards as well. Second, the simulation provides that no current and newly formed defined contribution plans have any preretirement cash-out rules. Presumably, the majority of secondary defined contribution plans sponsored by an employer would not be classified as retirement plans. Furthermore, RIPA only specifies that lump-sum distributions be rolled over into an IRA. Undoubtedly, even in the face of a 20-percent penalty tax, some families will spend these distributions for other purposes. The modelling of defined contribution plan contributions also may be optimistic.

Even in the face of these criticisms, legislation like RIPA, which would combine 5-year vesting with lump-sum distribution spending constraints, would have a greater impact on future retirees, particularly those of the baby boom, than would 5-year vesting alone. Future EBRI analysis of the income of

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\(^{32}\) See Employee Benefit Research Institute, Analysis of Alternative Vesting Requirements for Private Pensions.
the aged will investigate the impact of this legislation in a more focused way. Nevertheless, it may still be difficult to predict whether any employers will cancel their plans in the face of the new cash-out requirements.

♦ Conclusion

Vesting under ERISA is primarily based on three vesting standards, although other vesting standards apply to particular cases, such as “top-heavy” plans and SEPs. Despite the potential diversity in vesting options, the majority of participants in defined benefit plans are in plans with 10-year cliff vesting. There is a considerable difference between vesting provisions in defined benefit and defined contribution plans, however. Defined contribution plans generally have faster vesting standards, with 18 percent of defined contribution plans since ERISA reporting immediate vesting. While some evidence suggests that defined benefit plan participants may be somewhat more likely to have had faster vesting in recent years, the overwhelming predominance of 10-year cliff vesting continues.

♦ ♦ ♦

Under 5-year vesting, average benefits for married couples age 40 to 44 are estimated to increase from $5,590 to $6,090 in 1981 dollars, and those for unmarried individuals would increase from $3,580 to $3,660.

♦ ♦ ♦

By retirement age, most private-sector plan participants are vested in their pension plans, despite what appears to be a stringent 10-year vesting standard. While many young workers do not have enough years of employment to be vested in their pension plan, by retirement age job tenure tends to meet vesting standards. Workers meeting ERISA participation standards are particularly likely to have enough years on the job to have earned a pension at retirement. Most workers tend to have many jobs when they are young and to stay with an employer for longer when they are older. In this way, the pension system provides retirement benefits for many employees.

Nevertheless, evidence suggests that some workers will not be able to meet a 10-year vesting standard even by retirement age. In particular, women are more likely than men to be on the job for less than 10 years. For these reasons, both the Economic Equity Act and the Retirement Income Policy Act, among other provisions, suggest that ERISA vesting standards be shortened to 5 years.

♦ ♦ ♦ ♦

Statistics indicate a slight downward trend in the percentage of participants in plans with 10-year cliff vesting and a slight increase in the percentage of other types of vesting provisions.

♦ ♦ ♦ ♦

EBRI estimates conservatively suggest that such a change would add 1.9 million more participants to the ranks of vested workers. Relatively, but not absolutely, women will be aided more than men. Union and nonunion workers would have equivalent percentage gains unless 5-year vesting is implemented in the manner in which it is currently proposed, i.e., to exclude multiemployer plans. In that case, 5-year vesting would provide greater gains, both relatively and absolutely, for nonunion workers.

Cost estimates based on percentages calculated by two earlier studies suggest that if 5-year vesting had been instituted in 1985, pension contributions would have had to increase by $1.4 to $4.7 billion to take care of first-year costs. In subsequent years, they would represent a similar percentage increase in total contributions. These relatively high increases may be large enough to create indirect economic effects in at least some cases but these are difficult to estimate. Employers could realign their benefit structures or terminate their plans and provide higher wages or other employee benefits as substitutes.

Five-year vesting in conjunction with some sort of embargo on the consumption of pension distributions prior to retirement, such as the provisions found in the proposed RIPA, would have a greater impact than 5-year vesting on a standalone basis. While we now have estimates for the most optimistic scenario for such a policy combination, more work is needed to focus on a “most-likely” case. Additional research to understand the costs and benefits of proposed changes to increase benefit reciprocity and pension income for future generations of retirees should be particularly valuable to policymakers at this time.
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