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Statement

Before the Committee on Small Business of

The U.S. House of Representatives

Hearing on

Pension Plan Issues

by

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STATEMENT OF DALLAS SALISBURY
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SUMMARY

- EBRI has undertaken extensive analysis over the past 12 years to track and assess pension trends. Three facts emerge: first, small employers are moving away from defined benefit plans; second, they are not immediately replacing them with defined contribution plans; and third, the cost of administering plans relative to the amount that can be contributed has been eroding.

- Since the enactment of ERISA, a steady stream of legislation has greatly influenced pension programs. From the Revenue Act of 1978 to the Omnibus Budget Reconciliation Act of 1989, Congress has changed some aspect of the retirement system almost annually. It is complicated and expensive to maintain a plan. Simplification of the law and regulations could make a difference.

- Pension legislation has served to increase the security of benefits for those with coverage, and it has created many jobs. It has not led to an increase in the proportion of workers covered by pension plans.

- Employer-sponsored pension plans represent an important source of retirement income for most working Americans. According to EBRI tabulations of the May 1988 Current Population Survey employee benefit supplement, in May 1988, 62 million civilian workers, or 54 percent of all such workers, worked for an employer that sponsored a pension plan. Three-fourths of all workers covered by an employer plan, or 47 million workers, actually participated in the plan; two-thirds of all these participants, or 32 million workers, were entitled to a benefit at retirement.

- Increasingly, there has been a trend toward the establishment of defined contribution plans, especially with the advent of 401(k) cash or deferred arrangements and employee stock ownership plans. By 1987, the number of defined contribution plans represented 73 percent of all plans, up from 68 percent in 1975. By comparison, defined benefit plans represented 28 percent of all plans in 1987, down from 32 percent in 1975.

- The gap in private-sector pension coverage for workers is largely among small employers. The latest data indicate that more than 68 percent of full-time employees in companies with 250 or more employees participate in retirement plans, while, by contrast, only 16 percent of full-time employees in companies with less than 24 employees do so. The reduced tax rates of TRA 1986, combined with the funding limitations of OBRA 1987, have made plans much less attractive from the tax perspective. Small employers have never sponsored plans in large numbers and the present environment makes it unlikely that this will change.

- Pending legislative proposals such as joint trusteeship, regardless of the merits, would add cost and complexity. While it is unlikely that the proposal itself has influenced behavior, adoption certainly would.

- Portability concerns are merited, but only if those concerns lead to preservation of pension dollars into retirement. Today, nearly all defined contribution plans provide for lump sum distributions upon job change. Over 40 percent of private defined benefit plans provide for lump sums, and the number is growing each year. Individuals, however, do not roll-over distributions (13 percent did in 1988). Legal changes which have increased the number of lump sums (such as five year vesting) have served to discourage pension sponsorship as small businesses state a preference to pay longer service workers extra cash rather than watching pension dollars walk out the door with short service workers.

- Finally, it should be stressed that the pension system is in a strong financial position today and that it is one of the most heavily regulated financial "institutions". Comparisons to the situation with Savings and Loans are without merit. Pension fund participation in mergers and acquisitions has largely been by public pension funds, which are not subject to the fiduciary provisions of ERISA. The agencies charged with administration of ERISA have worked hard to regulate fully and fairly, even though greater clarity and brevity in regulations and guidance, and prospective application when changes are made in policy, would serve to encourage plan sponsorship and continuation.

STATEMENT OF DALLAS SALISBURY
PRESIDENT
EMPLOYEE BENEFIT RESEARCH INSTITUTE
BEFORE THE COMMITTEE ON SMALL BUSINESS OF
THE U.S. HOUSE OF REPRESENTATIVES
JUNE 5, 1990

I am pleased to appear before you this morning to review the rules governing private pension plans and their possible impact on pension participation and coverage. My name is Dallas Salisbury. I am the president of the Employee Benefit Research Institute (EBRI), a nonprofit, nonpartisan, public policy research organization based in Washington, DC. EBRI has long been committed to the accurate statistical analysis of public policy benefits issues. Through our research, we strive to contribute to the formulation of effective and responsible health, welfare, and retirement policies.

Pension Law

For over 50 years, the federal government has sought to encourage the establishment of pension plans through tax incentives. At the same time, public policy has been directed toward ensuring that plans are financially sound and equitable. Some observers have questioned whether these changes are having the unintended effect of impeding pension growth. Because pension plan administration has become such a complex and expensive field, some fear that recent legislation has eroded employers' incentives to provide pension plans. Others suggest that since plan provision is very limited in small businesses, additional incentives are needed to bolster pension coverage in the future.

EBRI has undertaken extensive analysis over the past 12 years to track and assess pension trends. Three facts are particularly clear: first, small employers are moving away from defined benefit plans; second, they are not immediately replacing them with defined contribution plans; and third, the cost of administering plans relative to the amount that can be contributed has been eroding.

Early legislation such as the Revenue Act of 1921 and the Revenue Act of 1926 first provided tax-deferred status to pensions. In particular, profit sharing plans gave employers the flexibility to forgo contributions in those years in which profits were low. The Self-Employed Individuals Tax Retirement Act of 1962 allowed small unincorporated business owners to start pension plans for themselves and their employees for the first time through Keogh plans.

The Employee Retirement Income Security Act of 1974 (ERISA), however, represents the most important landmark in pension legislation. ERISA provided participation and vesting standards, fiduciary and funding requirements, and it strengthened reporting and disclosure rules. In general, ERISA focused on safeguards for pension plan participants.

Since the enactment of ERISA, a steady stream of legislation has greatly influenced pension programs. From the Revenue Act of 1978 to the Omnibus Budget Reconciliation Act of 1989, Congress has changed some aspect of the retirement system almost annually.

The Revenue Act of 1978 expanded the opportunity to save for retirement on a tax-preferred basis by permitting employers to establish 401(k) arrangements. Through

401(k) arrangements, participants may contribute a portion of compensation to a qualified employer-sponsored plan. Typically, the contribution is made as a pretax deduction in (or deferral of) salary that is paid into the plan by the employer on behalf of the employee.

The Revenue Act of 1978 also created simplified employee pensions (SEPs) as a low cost way for small employers to start a pension plan.

The Economic Recovery Act of 1981 (ERTA) raised Keogh plan contribution and benefit limits and the dollar limit on SEP contributions.

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) placed self-employed businesses on an equal footing with corporation by making contribution and benefit limits the same for all pension plans. Under TEFRA, so-called "top heavy" plans—those in which more than 60 percent of benefits were going to "key" employees—were required to provide minimum benefits or contributions to rank-and-file workers, provide for faster vesting standards, and placed stricter limits on allowable benefits for key employees.

The pace of legislative change continued with the Deficit Reduction Act of 1984 (further reducing the limits on maximum plan contributions and benefits), the Retirement Equity Act of 1984 (reducing the minimum age of plan participation from 25 to 21), and the Single-Employer Pension Plan Amendments Act of 1986 (restricting the terms under which pension plans can terminate and increasing the termination insurance premiums that single-employer plans must pay).

The Tax Reform Act of 1986 (TRA '86) marked a reversal in U.S. retirement policy, reducing incentives for retirement savings. It capped the amount of allowable individual pretax contributions to a 401(k) at $7,000 (indexed), significantly reduced the overall limits on both defined benefit plans and defined contribution plans, narrowed the circumstances under which money can be withdrawn from defined contribution plans, increased taxes on preretirement withdrawals in some cases, restricted income averaging, and modified the tax treatment of capital gains.

Pension changes were also included in budget bills in 1986 and 1987. In 1986, plans were required to continue benefit contributions or accruals regardless of age for workers participating in defined contribution or defined benefit plans. In 1987, the single-employer defined benefit termination insurance premium was raised and funding rules were changed substantially.

Pension legislation has served to increase the security of benefits for those with coverage, and it has created many jobs. It has not led to an increase in the proportion of workers covered by pension plans.

During the budget negotiations of 1989, various proposals that would affected pensions and retirement income, including those calling for joint trusteeship, user and exit fees, Pension Benefit Guaranty Corporation (PBGC) premium increases, and ERISA penalty fees, were carefully considered. Many of these proposals were not enacted in 1989, but continued scrutiny of their administration and design is anticipated in 1990.

Trends in Pension Coverage

Employer-sponsored pension plans represent an important source of retirement income for most working Americans. According to EBRI tabulations of the May 1988 Current Population Survey employee benefit supplement (CPS EBS), in May 1988, 62 million civilian workers, or 54 percent of all such workers, worked for an employer that sponsored a pension plan. Three-fourths of all workers covered by an employer plan, or 47 million workers, actually participated in the plan; two-thirds of all these participants, or 32 million workers, were entitled to a benefit at retirement.

Defined benefit plans have historically been the cornerstone of the private pension system with an estimated 38 million participants and beneficiaries, and $1.36 trillion in trusteed assets. But recently, an increased number of defined benefit terminations, a slower rate of defined benefit plan formation, and fundamental redesign of traditional "final pay" defined benefit plans into "cash balance" defined benefit plans suggests that U.S. employers are reevaluating the appropriateness of these plans.

Increasingly, there has been a trend toward the establishment of defined contribution plans, especially with the advent of 401(k) cash or deferred arrangements and employee stock ownership plans. By 1987, the number of defined contribution plans represented 73 percent of all plans, up from 68 percent in 1975. By comparison, defined benefit plans represented 28 percent of all plans in 1987, down from 32 percent in 1975 (chart 1).

The nature of this apparent shift in emphasis from the traditional defined benefit plan to the newer defined benefit and defined contribution plans has been a source of continued evaluation. Experts offer varying observations on the potential reasons: increased regulation of traditional defined benefit plans, increased

administrative cost due to regulation, an increasingly mobile work force who may be better served with a "cash balance" or defined contribution plans, federal tax laws that have created incentives for new defined contribution arrangements, and the lowering of basic income tax rates, which has reduced the effective tax incentive for plans.

Many maintain that government regulation has made defined benefit plans too costly, prompting plan sponsors to offer no pension plan or to shift to generally less burdensome defined contribution plans (see EBRI, *What is the Future of Defined Benefit Pension Plans?*, 1989).

One of the most significant trends in pension coverage has been the tremendous growth of 401(k) plans over the past decade. More than 27.5 million workers were covered by 401(k) plans in May 1988, up from 7.1 million in May 1983. These figures represented 24.2 percent and 7.1 percent of all workers, respectively. Participation grew from 2.7 million workers (2.7 percent of all workers) in 1983 to 15.7 million (13.8 percent of all workers) in 1988.

An increasing number of workers are relying on 401(k) plans as their primary employer-based retirement plans, especially 401(k) participants at small firms. The 1988 CPS EBS found that more than 49 percent of 401(k) plan participants reported that this was their primary employer pension plan. Among 401(k) participants working for employers with 250 or more employees, 43.5 percent had a primary 401(k); this proportion increased to 79.5 percent for 401(k) participants in establishments with fewer than 10 employees.

The future of 401(k) sponsorship and participation is uncertain. Passage of TRA '86 does not appear to have slowed 401(k) plan growth, although that possibility remains as more restrictive provisions of the law become fully effective. Final regulations addressing hardship withdrawals and loans, released in August 1988 and July 1989, respectively, could arguably be a deterrent to employee participation and create administrative problems for some employers. However, this cannot be assessed fully until the provisions have been in effect longer.

Pension Coverage by Small Employers

The gap in private-sector pension coverage for workers appears to be largely among small employers. The latest data indicate that more than 68 percent of full-time employees in companies with 250 or more employees participate in retirement plans, while, by contrast, only 16 percent of full-time employees in companies with less than 24 employees do so (chart 2).

Some members of Congress and other policymakers have indicated concern about potential costs to society and to future retirees themselves if employer-sponsored pension coverage fails to continue the expansion of the past 15 years, supplementing Social Security and private savings.

To meet this challenge of providing additional coverage, a number of legislative proposals specifically aimed at small employers have been introduced in Congress in recent years. But the benefits that small employers provide must be viewed within the context of the nation's retirement income system and the economy as a whole if we are to judge whether national needs are being met.

The Economics of Regulation

In a recent EBRI study, *Pension Policy and Small Employers: At What Price Coverage?*, author Emily Andrews examines the impact of pension legislation on pension plan growth based on the economic theory that employers will balance the costs of instituting a pension plan against the benefits they receive.

According to Andrews, the favorable tax treatment provided pension plans reduces the costs of plan sponsorship. Since pension contributions are treated as current business expenses, funded plans are a good business decision. Pension plans are also regarded favorably by employees because they can defer individual income taxes on pension contributions until retirement. By making benefits more secure, ERISA may have increased the demand for pensions among employees. The provisions that may have made pension coverage more attractive include funding standards, PBGC insurance, vesting and participation standards, and better information about plans through summary plan descriptions.

Since pension law encourages different types of plans, employers can match pension sponsorship to their business situation. In particular, developments such as Keogh plans, 401(k) plans, and SEPs may have made tax-favored pensions more attractive to small employers.

Other provisions may impose additional costs on employers, however. Funding and fiduciary standards reduce the employer's flexibility to finance corporate expansion through retained earnings. PBGC premiums are a direct cost imposed on a per participant basis for defined benefit plans. Plan descriptions and other reporting requirements also directly increase the administrative costs of the plan.

Restrictions that cap contributions and benefit payments also make pension plans less appealing, particularly for those motivated by the tax deferral on contributions.

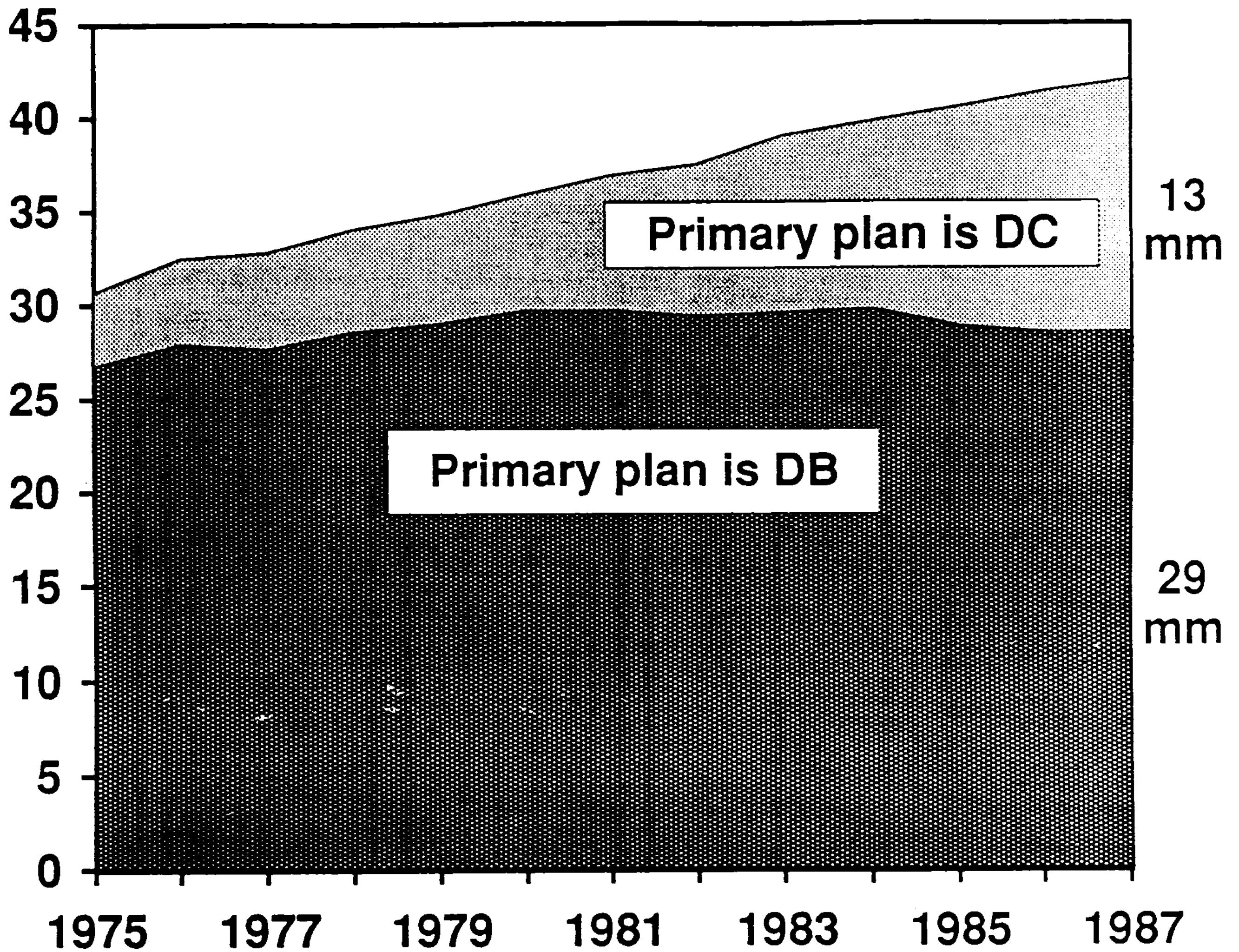
The Retirement Equity Act of 1984 also may have raised the costs of plan provision for some employers. The required five-year break-in-service provision increases recordkeeping costs, particularly in firms with high employee turnover.

Conclusion

A constant theme reiterated by employers is their concern about regulatory complexity and frequency of legislative change. Large employers can and do afford the costs, which can be small on a per employee basis. For small employers, however, complex regulations require costly expert advice in establishing and maintaining a pension plan and the costly revision of plan documents. Changing regulatory and enforcement approaches by regulatory agencies add to both the cost and confusion. Thus, no matter what the nature of the change, if it is frequent or complex, it will be costly. When combined with laws and regulations that make it increasingly difficult to fund a plan, attractiveness fades further. And, when considered against other tax preferences, in light of today's low tax rates, the reluctance of small employers to expand pension coverage may be quite understandable.

Chart 1

Growth in private pension participation is all DC

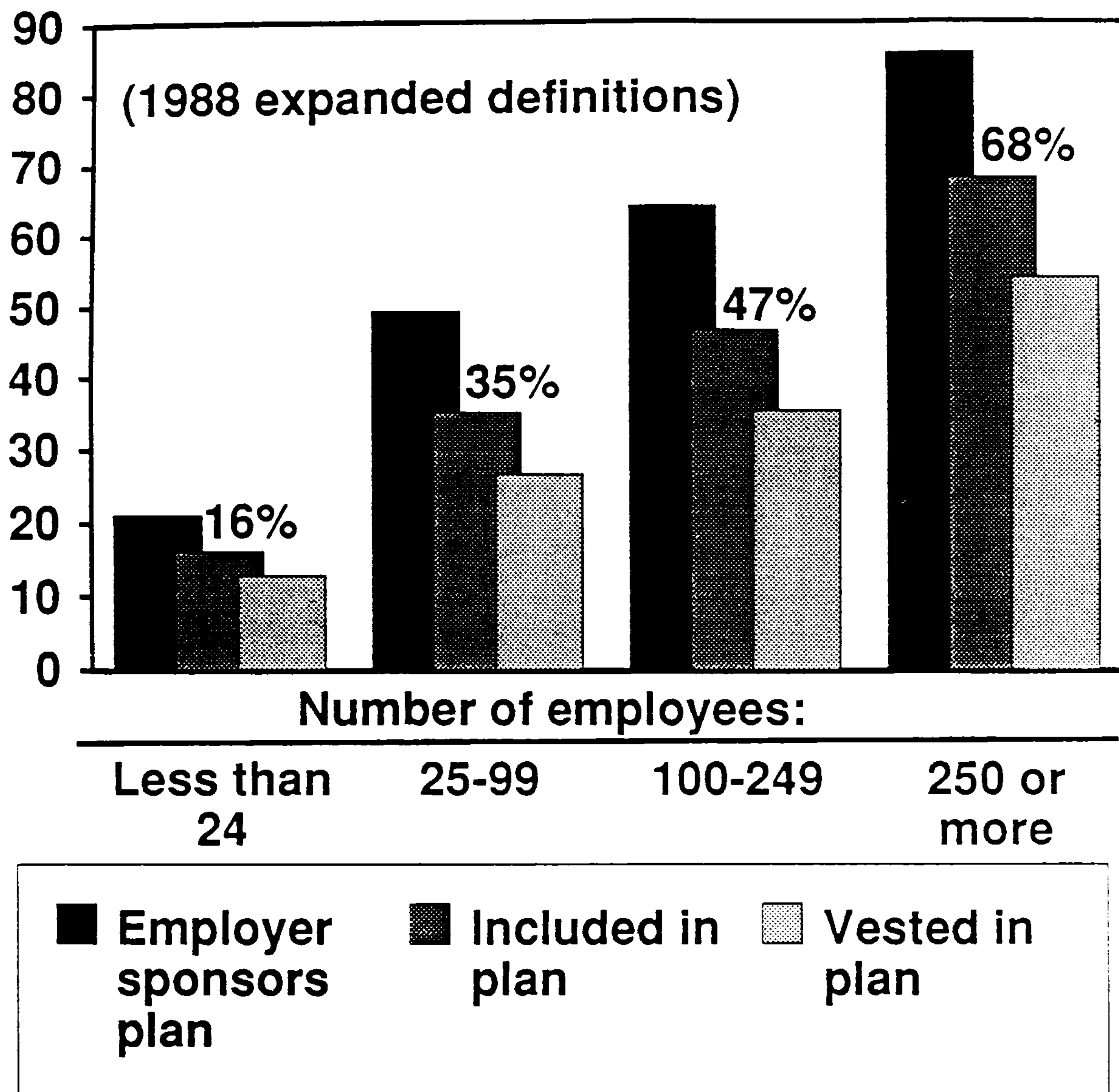


Source: Employee Benefit Research Institute

Chart 2

Firm size remains a key factor in pension coverage

Percentage of private-sector,
full-time workers in 1988



Source: Employee Benefit Research Institute