The Ongoing Growth of Defined Contribution and Individual Account Plans: Issues and Implications

By Lynn Miller, EBRI Fellow

- This Issue Brief discusses the implications of the growth of defined contribution (DC) retirement plans and individual account plans and the subsequent impact on employers, employees, and retirement planning. It also presents a look at data regarding contributions to retirement plans, employer trends regarding retirement plans, and the potential impact of changes to the federal Social Security retirement system. The findings and data in this article are drawn from material presented at a policy forum sponsored by the Employee Benefit Research Institute Education and Research Fund (EBRI-ERF) Dec. 7, 2001, in Washington, DC.

- Today, prospective retirees need to be able to generate about 75 percent of their current income to maintain their standard of living in retirement, up from 63 percent of their income in 1997, according to the Replacement Ratio Study, by Aon Corporation and Georgia State University. However, the most recent data show a decline in the percentage of income that average employees are saving.

- While it is too early to quantify, it does not appear that the retirement provisions in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) are strongly influencing the movement to DC plans. However, employers appear very interested in the provisions of the new law with regard to both defined benefit (DB) retirement plans and DC plans.

- The number of large employers offering DB plans continues to decline, from 85 percent in 1990 to 73 percent in 2000, according to the Hewitt study.

- Although employers may have little influence over some factors that affect participation rates in voluntary retirement plans, they have various options to increase participation rates, such as “matching” employee contributions, offering loan features, and providing education to employees about the plans.
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Introduction

This Issue Brief discusses the implications of the steady growth of defined contribution (DC) retirement plans and individual account plans and the subsequent impact on employers, employees, and retirement planning. It also presents a look at data regarding contributions to retirement plans, employer trends regarding retirement plans, and the potential impact of changes to the federal Social Security retirement system. The findings and data in this report are drawn from material presented at a policy forum sponsored by the Employee Benefit Research Institute Education and Research Fund (EBRI-ERF) on Dec. 7, 2001, in Washington, DC.

The majority of families with a full-time worker under age 65—56.8 percent—participate in a pension plan at work. Of these families, 64.3 percent participate in a 401(k)-type plan. Of those family heads who have the option to participate in a plan, 77.3 percent do so, and of those families that choose not to participate, 40.3 percent are participants in a “traditional” defined benefit (DB) retirement plan. During the 1992-1998 period, the proportion of families with only a DB plan declined from 40 percent to 20.7 percent; the proportion with both DB and DC retirement plans remained steady at 22.4 percent. Nearly all workers are covered by Social Security.

Much of the growth in DC plan participation is due to the dramatic growth of 401(k) plans over the last 20 years, according to Kathryn L. Moore, of the University of Kentucky College of Law. The number of 401(k) plans offered by employers grew from fewer than 25,000 in 1984 to more than 250,000 in 1997. That number is expected to reach 435,000 by 2005.

The steady growth of DC retirement plans and lump-sum distributions from DB retirement plans raises many issues concerning both current and future retiree benefits, such as:

- Will workers who do not participate in these plans have enough money to maintain their standard of living in retirement?
- How much must a participant contribute to ensure that he or she has enough money in retirement?
- How much income will retirees need to supplement Social Security?
- How do federal laws influence savings and motivate contributions to tax-deferred retirement plans?
- What type of education and advice do individuals need in order to turn DC plans and lump sums into adequate retirement income?
- Will the retirement expansion provisions in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) influence the design of retirement plans?
- What percentage of accumulated assets can a retiree spend each year and not outlive his or her money?
- Should retirees use part of their accumulated money to purchase an annuity?
- What effects might partial privatization of Social Security have on both DB and DC retirement plans?

Trends

Retiree Income: What Do They Need?

As traditional DB plans give way to DC plans, an increasing number of employees and retirees try to determine what kind of nest egg they will need in retirement to maintain their current standard of living. According to the Replacement Ratio Study, conducted by Aon Consulting Corporation and Georgia State University, the answer is quite a bit—enough, combined with Social Security, to generate about 75 percent of their preretirement income. Figure 1 shows how this replace-
replacement ratio is calculated for a family earning about $50,000 annually. The replacement ratio, expressed as a percentage, is the portion of preretirement income needed to provide an equivalent standard of living after retirement.

Contrary to past expectations, the average retiree's spending declines only slightly in retirement, on average about $603 annually, according to the Aon study, which used data from the Consumer Expenditure Survey Data of the U.S. Bureau of Labor Statistics. Lower taxes and a decreased effort to save account for most of the decline, according to the Aon study. The replacement ratio also rises for both lower-income and higher-income employees, as shown in Figure 2. The ratio increases to 78 percent for a family with annual gross income of $30,000 and increases to 87 percent for a family with annual gross income of $250,000.

As might be expected, Social Security replaces a larger portion of preretirement income for lower-income families, as shown in Figure 3. Current tax policy influences this number because Social Security payments are not taxed at lower income levels, which reduces the portion of retirement income that otherwise would be needed to pay taxes. On the other hand, as much as 85 percent of Social Security benefits paid to higher-income retirees is taxed. Automatic indexing of benefits will continue to increase the dollar amount of those benefits, according to the Aon study.

The study also shows that retiree spending is rising. In a previous survey done in 1997 by Aon and Georgia State, a couple with preretirement annual income of $60,000 could maintain their standard of living on 67 percent of that amount, compared with the new study's average replacement ratio of 75 percent, as shown in Figure 4. At the same time, employees are saving a lower percentage of their income. In 1997, the average annual savings of a couple between age 50 and 65 who earned $60,000 a year was 5.1 percent. That has dropped to 4.2 percent today, according to the study.

The study also looked at replacement values for single persons, which are quite different, according to Fred Munzenmaier, senior vice president of Aon. At lower-income levels, single persons require less retirement income because they paid more federal income tax while working and they're accustomed to needing less income. For those with higher incomes who are retiring, “Much more of their retirement income has to come from sources other than Social Security, which are assumed to be taxable,” says Munzenmaier. “Therefore, at the higher income levels, a single person needs more retirement income than our baseline case.”

Retiree Income: What Form Will It Take?

A rapidly growing public policy
The United States is facing the challenge of ensuring that future generations of retirees, particularly those in the post-World War II “baby boom” generation, will have adequate retirement incomes. One reason is that Social Security alone is insufficient to provide an adequate retirement income. Another reason is that the age at which full Social Security benefits are paid is increasing. A third reason is the longer life expectancy, which means more savings are required to sustain income throughout retirement. These factors reduce the amount of life annuity benefits that future retirees will receive relative to current retirees, making other sources of retirement income—such as individual account plans (DC plans and individual retirement accounts, or IRAs)—more important for making up the difference.

The April 2001 EBRI Issue Brief highlighted changes in private pension plan participation for DB and DC plans and provided some possible explanations for them. It also presented results from the Employee Benefit Research Institute’s (EBRI) Retirement Income Projection Model that quantified how much the importance of individual account plans is expected to increase due to these changes. The results of the model are compared by gender for cohorts born between 1936 and 1964 in order to estimate the percentage of retirees’ retirement wealth that will be derived from DB plans versus DC plans and IRAs over the next three decades. Under the model’s baseline assumptions, both males (see Figure 5) and females (see Figure 6) are found to have an appreciable drop in the percentage of private retirement income that is attributable to DB plans (other than cash balance plans). As a result, retirees face the inevitability of making their DC retirement savings last long enough.

“We project that there will be a clear increase in the income retirees will receive that will have to be managed by the retiree,” said Jack VanDerhei, Temple University and research director of the EBRI Fellows program. “This makes the risk of longevity more central to retirees’ decisions about spending money.”

The implications of these model results for retirees are significant. First, individuals—rather than the pension plan sponsor—increasingly will have to manage their retirement assets and bear the risk of investment losses. Second, because most retirees’ non-Social Security retirement income will be distributed as a lump sum or in periodic payments (from a DC plan or IRA) rather than as a regular paycheck for life (from a DB plan), retirees will need to either purchase an annuity from an insurance company or carefully manage their individual rate of spending to avoid outliving their assets.

Subsequent to the publication of these results, Congress enacted the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) which, inter alia, gradually increases the amount of before-tax elective deferrals that 401(k) participants are allowed to contribute and provided even larger increases for employees over age 50 whose employers implement the requisite changes to allow the plan to provide “catch-up” contributions. Although some of the consulting firms have surveyed their clients’ intentions to adopt these provisions, it is still too early to know with any precision the extent to which this adoption will actually occur. Figure 7 provides estimates of the increase in annual 401(k) contributions as a result of the new EGTRRA provisions under two assumptions.

In an attempt to estimate the lower-end of the increase, it is assumed that no employers adopt the catch-up provisions and the projected increase in annual contributions derives primarily from the increase in the Sec. 402(g) limits that apply to all employees regardless of age. The right-hand bars for each year illustrate the estimated growth under this assumption: It increases from an additional $2.06 billion in 2002 to an additional $4.55 billion in 2006, when the provisions are fully
Composition of Estimated Retirement Wealth for Males at Social Security Normal Retirement Age
Under Baseline Assumptions, by Birth Cohort

Source: Employee Benefit Research Institute, Retirement Income Projection Model.

Composition of Estimated Retirement Wealth for Females at Social Security Normal Retirement Age
Under Baseline Assumptions, by Birth Cohort

Source: Employee Benefit Research Institute, Retirement Income Projection Model.
phased in. An upper-end estimate was projected by assuming that all current 401(k) sponsors adopted the catch-up provisions and that 50 percent of the highly compensated employees age 50 or older were eligible for the catch-up contributions, whereas non-highly compensated employees at that age would be eligible only if they had already been contributing at the 402(g) limit. The left hand bar for each year demonstrates that under these assumptions, the additional 401(k) contributions increase by $4.62 billion in 2002 and increase to $11.37 billion in 2006.

Retiree Income: How Much Can They Spend?

When the baby-boom generation starts to retire in 2010, average life expectancy for a 65-year-old male will be an additional 22 years and for a 65-year-old female it will be an additional 26 years, according to Joe Healy, vice president of T. Rowe Price Group. Given the trend to DC plans, it is much more likely that they will be relying on the assets in their DC plans or lump-sum payouts—combined with Social Security and other savings—to fund their retirement, instead of a monthly benefit from a DB plan. This combination of extended longevity and greater responsibility to manage their money should prompt retirees to ask themselves the following questions, Healy said:

- What's the amount of income I can generate over the rest of my lifetime?
- How should it be invested both to limit risk and grow to protect against inflation?
- What is the likelihood that the income will last throughout retirement?
- How much income do I need or want?
- How much income can I have without running out of money?
- How much control do I want over my money?

Determining the answers to those questions and developing a financial plan that covers various contingencies is very complex and perhaps even beyond the ability of the average investor. It’s one thing to save the money; it’s another to create projections for how that money can be spent over the next 26 years or so to ensure a lifetime income.

In the experience of T. Rowe Price, Healy says that the average married couple, a 64-year-old man and 63-year-old woman planning a 26-year retirement period, can withdraw about 4 percent (or $4,000 for every $100,000 they bring into retirement) of their initial lump sum in the first year of retirement. That figure is derived using a variable rate of return, rather than an average rate of return, to project future earnings, he adds. That’s because two individuals assuming the same average rate of return will achieve different results based on the investment markets. For instance, an individual with a bear (declining) market ahead of a bull (rising) market will run out of money, while the individual with a bull market ahead of a bear market will end up very wealthy, says Healy.

Annuities, particularly indexed annuities, appear to provide better protection against inflation and longevity than investments in bonds or stocks over the
last 30 years, according to Ron Gebhardtsbauer, senior pension fellow for the American Academy of Actuaries. This is illustrated in Figure 8, measuring joint life minimum required distributions (MRD) using bonds and in Figure 9, using single life MRD using stocks. But currently, the low interest rates on U.S. Treasury bills and notes actually do not make them a good trade-off against taking a lump-sum distribution, Gebhardtsbauer said.

**The Impact of EGTRRA**

DC retirement plans are continuing to grow, but so far, EGTRRA appears to be more of a catalyst to a movement that’s been under way for many years than the source of renewed interest in such plans. In a recent survey of 900 large organizations, Hewitt Associates found that while nearly half of the respondents said they were moving away from traditional DB plans to individual account-based and DC plans, only 1 percent cited EGTRRA as the reason. Among large firms, traditional DB plans continue to play an important role, according to Rob Reiskytl of Hewitt Associates. Among very large employers, the prevalence of DB plans has declined from 85 percent in 1990, to 80 percent in 1995, and to 73 percent by 2000, according to Hewitt data. But while the decrease is dramatic, Reiskytl points out that “among the large plan sponsors, DB plans are still fairly prevalent.”

Still, EGTRRA provides various incentives for both DB and DC plans, Reiskytl notes, although the current economic downturn may be limiting EGTRRA’s effects for now. This may be why a large number of employers expect to re-evaluate their organization’s retirement plans within the next 18 to 36 months, as shown in Figure 10. “You’ve got the ‘early-adopters’ who wanted to move very quickly and take advantage of as much as they could in the new tax law,” says Reiskytl. “Those are a minority of employers, and others are just looking for the very minimum that they need to do to comply with the new law.”

EGTRRA raises the maximum compensation limit in DB plans from $140,000 to $160,000 and also will allow highly compensated executives to receive more from qualified plans than previously allowed. In terms of DC plans, EGTRRA authorizes tax-preferred “catch-up” contributions for employees age 50 and older, higher contribution amounts, greater portability among different types of plans, and “default” IRAs. Employers appear to be very interested in the catch-up provisions, although it will take some time to determine to what degree employers will implement the provision and eligible workers will utilize it. About 80 percent of those sur-

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**Figure 8**

**“Do It Yourself” Distributions vs. Lifetime Pensions/Annuities: Joint Life MRD, Bonds**

- **Single Life Pension — 3% COLA**
- **Single Life Pension — No COLA**
- **Joint Life MRD (MD/8) — Bonds**

The indexed life annuity insures against inflation and longevity the best. It generally exceeds the MRD even if returns on fund = 9% (and Standard Deviation of 20%).

This one has no inflation protection and no Death Benefit, but does beat MRD using bonds.

Min. Distribution = Balance/Life Expectancy

It gives more to heirs when retiree dies early. It’s not as good for those who live longer, unless retiree doesn’t need income, and prefers money go to heirs.

Source: Ron Gebhardtsbauer, American Academy of Actuaries.
veyed intend to provide for a catch-up provision and 16 percent are considering it. “The catch-up contribution is the first thing that employers want to talk about,” says Reiskytl. “It’s been a favorable piece of the new legislation and is relatively easy to put in place.” Employers also appear to be interested in increasing savings plan limits, the deductibility of employee stock ownership (ESOP) dividends, communicating EGTRRA changes to employees, and “revisiting” their retirement plan structures (Figure 11).

Another trend is the movement away from traditional accrual-annuity-based DB plans to cash-balance and pension equity plans. From 1996 through 2000, “There has been slow erosion of the traditional final average pay design, with the account-based DB systems experiencing a slow and steady increase, whether it’s cash balance or pension equity,” says Reiskytl. One reason, according to Reiskytl, is that employers want to include more profit-related or variable designs, particularly given the uncertainty of the

Figure 9

“Do It Yourself” Distributions vs Lifetime Pensions/Annuities: Single Life MRD, Stocks

![Graph showing comparisons between different retirement options.](source)

Source: Ron Gebhardtsbauer, American Academy of Actuaries.

Figure 10

**Q: Do you anticipate that EGTRRA\(^a\) will contribute to a broader re-evaluation of your organization’s retirement plans within the next 18-36 months?**

<table>
<thead>
<tr>
<th></th>
<th>Yes</th>
<th>No</th>
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<tr>
<td><strong>Respondent</strong></td>
<td>44%</td>
<td>56%</td>
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economy. For example, employers might change the plan’s design to reduce the guaranteed accrual, but add a variable element to the design that allows them to increase contributions in years that the organization does well financially. Reiskytl also sees more focus from employers on examining the overall retirement benefit structure.

Additionally, in recent years some distinct changes have emerged in the value of what is being delivered to employees from large employers, as shown in Figure 12. While the number of DB plans has remained fairly consistent among large employers, there has been a reduction in retiree medical benefits (largely due to new accounting rules) among large employers and a decline in retiree medical benefits offered by new firms. At the same time, the number of DC retirement plans continues to grow.

Not surprisingly, being more highly paid and having longer tenure on a job are the key variables that drive voluntary participation in DC plans, as employees with more disposable income would be expected to be both able to afford saving for retirement and interested in reducing current taxes. And over the long term, as real wages rise and workers age, participation rates should be expected to rise as well. But participation rates also are driven by employee attitudes to planning, as well as reaction to the specific provisions of the employer plan, according to Steve Utkus, director of the Vanguard Center for Retirement Research.
For example, workers who are considered successful planners (about 21 percent of the work force) participate at much higher rates in voluntary plans than do “live-for-today” workers (about 14 percent of the work force) who avoid planning, as shown in Figure 13. Short of requiring all employees to attend financial counseling sessions, employers may not have much influence on those employees who will not take an interest in or responsibility for their financial future.

But employers can increase participation rates through the structure of the retirement plan, Utkus says. The employer match in a 401(k) plan is crucial to influencing both participation and the amount of contributions. “The stronger the match, the better, but 50 percent [of the employee’s initial contribution] is thought to be optimal,” he says. Plans with a loan feature also tend to appeal to younger workers, and educating employees about the plan can increase participation about 12 percent on average, Utkus adds. And while smaller companies tend to have higher 401(k) participation rates than larger firms, companies with a strong advocate for the plan—either among employees or at the managerial level—also tend to have higher participation rates.

Participation rates in 401(k) plans appear to have peaked at about 80 percent, according to Utkus, and it remains to be seen whether automatic enrollment can boost participation rates higher. With automatic enrollment, new employees must opt out rather than opt into the retirement plan. Automatic enrollment appeals to employers because it provides some protection from the government’s so-called “nondiscrimination” test (between lower-paid and higher-paid participants), and uses the inertia of employees for their own benefit (Figures 14 and 15). Participation rates increased from 75 percent to 84 percent in a small sample of employers that tried automatic enrollment, Utkus noted (Figure 16). Similar results have been found by studies conducted by the Profit Sharing/401(k) Council.

But automatic enrollment isn’t a panacea to boost participation rates, for several reasons. First, administrative costs can increase if a company suddenly adds a large number of very small accounts to the plan. “The profitability of your account really changes, and your plan provider [will be] asking you difficult questions about fees,” Utkus said. That’s a particularly
difficult problem for companies with high employee turnover, he adds, because short-term employees typically do not increase their savings rates and remain in very conservative investments such as money market funds, which are more costly for plan administrators to provide. One possible solution is to automatically increase the deferral rate by a specific percentage each year on the employee’s anniversary. One manufacturing firm that did this tripled plan savings rates in three years, Utkus said. Another option is to select a balanced or “lifestyle” fund as the default option under automatic enrollment.

Automatic enrollment also can run up against state laws that may deter employers from adopting the feature. In states where this may be a problem (such as California, which has adopted “anti-garnishment” laws), it is unclear whether the state law takes precedence or whether the federal Employee Retirement Income Security Act (ERISA), which regulates retirement plans, prevails and would allow for automatic enrollments.

Market Volatility and Asset Allocation: Managing Risk

No investment is without risk, and even DB plans cannot guarantee that a promised pension won’t dwindle to a minimum payment from the Pension Benefit Guaranty Corporation (PBGC) if a pension fund is depleted. As demonstrated by the Enron bankruptcy and losses suffered by thousands of employees who had invested their participant-directed 401(k) retirement savings in Enron stock, even seemingly strong stocks can suddenly collapse. As DC plans become even more dominant in the retirement marketplace, more and more employees and retirees face the challenge of managing investment risk in their retirement portfolios. That challenge is complicated by increasing longevity, the impending retirement of the baby boomers, and attitudes toward investments.

For example, retirees place a high value on the certainty of a lifetime income, as shown in Figure 17. They crave certainty, but also want independence, or the “freedom to change.” This desire for autonomy tends to be consistent—“whether you’re looking at our individual retail investor or participants who are coming out of 401(k) plans,” says Healy of the T. Rowe Price Group. “What we find is that Americans are so used to controlling their assets now that in all but those who are extremely worried about lifetime protection, the need for control trumps the certainty of having the insurance company take the risk,” Healy says. Thus, many retirees face an inherent conflict between wanting both certainty and autonomy. This conflict becomes even more important as longevity increases, as shown in Figure 18.

As Alex Sussman of the Seagal Company pointed out,
out, even young workers with lots of time to accumulate savings still face the unknown of how the investment markets will be functioning when their retirement savings are needed. “Like the great Rolling Stones song says, ‘Time is on your side, yes it is, yes it is,’” Sussman said. “But timing is not on your side—no it’s not, no it’s not.”

In particular, he warned, many people who experience a serious market decline during their retirement may not have the time to ride out the downturn, and as a result may see their nest eggs unexpectedly depleted. “There’s more at risk because it’s more than the volatility that’s at risk. It’s one’s own living standard that’s at risk,” Sussman said. “Clearly, participants will have to manage risk throughout their lives, and that brings implications of investment advice and education and continuing investment advice and re-education.”

Seagal Co. studies show that defined benefit plans provide more dollars of income per unit of cost than do defined contribution plans, such as 401(k)s. However, DB plans also face far greater administrative and regulatory costs than do DC plans. As a result, Sussman said, “the best approach in our opinion, is a combination of the defined benefit plan for reliable income and the defined contribution plan for capital accumulation.”

While there are well-known economic risks associated with the retirement of the huge post-World War II baby-boom generation, Sussman believes that the “bright side” of demographics—increased longevity, phased retirement, longer careers, and longer time for savings—will help avoid the danger of a “demographic melt-down” caused by labor shortages and investment changes (see Figures 19 and 20).
The Impact of Rollovers

Over the years, one of the major issues concerning DC plans has revolved around whether employees who terminated employment would keep their contributions in the plan, roll them over to another plan, or cash them out and pay the taxes and penalty for early withdrawal. According to a new study of slightly more than 8,000 plans and 7.1 million participants in 2000 by FMR Corporation, on average, 67 percent of terminated employees in 2000 kept their accounts in the plan; 29 percent rolled their accounts into another tax-deferred plan; and only 5 percent of terminated employees cashed out, as shown in Figures 21 and 22. Of those who cashed out, on average 32 percent had retirement accounts valued at less than $10,000, and 13 percent had accounts valued between $10,000 and $49,000. The report showed that the value of an employee's retirement account is a significant factor in the choice to cash out.

But several other factors influence the decision to keep the assets in the plan, roll it over, or cash out, according to John Kimpel, vice president and pension counsel for FMR Corporation. As shown in Figure 23, the age of the terminated employee also is an important factor: “The older people are, the more likely they are to keep their money in the system, either in the plan or in another plan or an IRA,” he said. However, even employees in their 20s appear to want to keep their funds in tax-deferred plans. “Even with people as young as 20 or 29, 85 percent of the money—not 85 percent of the people—is staying in the system,” Kimpel added.

The small number of employees cashing out holds across industries, and those in professional services have even lower numbers of rollovers, he says. That may be because many states do not give IRAs bankruptcy protection, while retirement plans (such as 401(k)s) covered by ERISA do have such protection, Kimpel speculated. “Professionals, particularly doctors, are very reluctant to take their money out of the qualified plan when they potentially lose that bankruptcy protection.”

In terms of staying in the plan or rolling retirement assets to an IRA, the size of the plan also appears to be a determining factor, as shown in Figure 24. Significantly more former employees of large employers keep their accounts than do those previously with small employers. Some reasons may be that they are given a better

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**Figure 20**

*The Bright Side of Demographics*

- While many baby boomers are now in their 50s, most are younger. Peak birth years were 1954–1964.
- This means that most baby boomers will be saving for retirement (i.e., buying stocks) for the next 20+ years.
- After that, even as the youngest baby boomers age out, the total boomer group may or may not become a net seller of stocks.

Source: Alex Sussman, The Segal Group.

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**Figure 21**

*Choice, by Assets, by Account Size*

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<th>Account Size</th>
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</table>

Source: FMR Corp. 2001.
choice of investment options, a higher level of service, and lower fees than smaller plans, Kimpel said. "The fiduciary role that the employer plays may have some very real positive impacts on what employees are doing," says Kimpel. "If you look out there at the thousands of different investment alternatives that are available to people, one of the nice, comfortable things about being inside the employer plan even after you’re gone is that there is somebody in a fiduciary capacity who has narrowed that range of options down to a manageable few. The second thing is that American workers still trust their employers and that they appreciate the role that employers are playing in this."

Kimpel also believes the laws governing DC plans have been effective at keeping money in the system in three ways. "One is that you cannot push participants out of the plan if their account balances are more than $5,000," he explains. "Second, with respect to all distri-
Contributions, whether from a qualified plan or from an IRA, if you’re younger than 59½, there is a 10 percent penalty. And most recently, but in many ways most importantly, are the unemployment compensation amendments of 1992—which impose a mandatory 20 percent withholding on distributions that weren’t rolled over.”


Although it is doubtful that any reform of the Social Security system will occur in the 2002 congressional election year, some benefits professionals find it useful to project the likely impact on retirement accounts and private pensions if there is partial privatization of the program—as President Bush’s Social Security advisory commission prominently lists as an alternative. Although proposals vary, most center on partial privatization of the system to prefund individual accounts through which some benefits would be provided after retirement. According to Kathryn L. Moore of the University of Kentucky College of Law, partial privatization of Social Security would be likely to:

- Increase the demand by employees for DB plans.
- Make it less likely that lower-income workers would be able and prone to contribute to voluntary plans.
- Cause employees to invest more conservatively in other retirement accounts, such as 401(k) plans.
- Increase the demand for equities and subsequently raise their prices.
- Have a significant impact on the tax-integration rules and plans that are integrated with Social Security.

In terms of the first possible outcome, the degree to which employees would increase their demand for employment-based retirement plans would likely depend on how partial privatization would shift investment risk. “The greater the mandatory shift of investment risk, the more likely employees will want more defined benefit plans,” says Moore. And the reason that partial privatization would lower other voluntary contributions to savings accounts is twofold. First, lower-income workers covered by 401(k) plans are less likely to contribute to such plans than are higher-income workers, Moore says, “and when they participate, they tend to vest a smaller percentage of their income.” Partial privatization accompanied by an increase in the payroll tax would further reduce those contributions, and that could affect the contributions of higher-income workers.
"If lower-income workers were to reduce their contributions to 401(k) plans, the ability of higher-income workers to use 401(k) plans to defer income might be reduced" because of the IRS nondiscrimination rules, says Moore. While employers could use the 401(k) “safe harbor” provisions in the tax code to avoid this adverse effect on higher-income workers, it would be expensive, she adds.

Moore also believes that partial privatization could prompt employees to choose more conservative investments to lower the risk that partial privatization would impose on their future retirement income. The current Social Security system, she says, is similar to a DB retirement plan in that it places investment risk on the plan sponsor (the government), not the participant. Partial privatization would “graft a defined contribution layer of prefunded individual accounts onto the first tier defined benefit and shift investment risk to employees,” she says. In that case, employees might seek to lower their risk by shifting to more conservative investments in other tax-deferred accounts.

Partial privatization also is likely to affect the price of equities. Moore cited data showing that as of 1995, private pensions held about $2.7 billion in assets, of which 42 percent was invested in equities, 27 percent was invested in bonds, 7 percent was held in cash items, and the remaining 24 percent was invested in other assets. If Social Security were partially privatized, it would likely affect the rates of return available on these assets, she maintained, although the effect is not entirely clear.

And finally, with regard to DB plans that are integrated with Social Security, privatization would require changes in the rules for integration of such plans. The specifics would depend on the privatization plan, Moore says, noting that about 50 percent of full-time workers in large- and medium-size firms who participate in a DB plan are covered by a benefit formula that is expressly integrated with Social Security. Although there are no published data on the prevalence of integrated DC plans, it appears that DC plans are much less likely to be expressly integrated with Social Security. Based on data from the 1992 Health and Retirement Survey, only 7.6 percent of workers who are covered by a DC plan have a contribution formula that is expressly integrated with Social Security, according to Moore.

Endnotes


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