Multiemployer Plans

Multiemployer plans have evolved in industries where workers necessarily change employers frequently without changing their industry or occupation, as in coal mining, construction, trucking, and the garment trades. Plans of this type are collectively bargained, and more than one employer contributes. Representatives of the union and the employers administer the plan. An employer contributes to the pension fund for each worker for the time that the worker is in the firm's service. A worker accumulates benefits and vesting rights so long as he or she is employed by member firms. Multiemployer plans comprise only 0.4 percent of all plans, but they are large ones, covering 13 percent of all participants in private plans in 1982. 18/ Most are defined benefit plans, but the employer contribution is normally assessed as a fixed amount per employee.

Plans for the Self-Employed and for Unincorporated Business

The unincorporated self-employed were for a long time unable to participate in pension plans because they were not considered employees. In 1962, specially restricted plans for the unincorporated self-employed (and their employees) were enacted. They were known as Keogh plans because of Congressman Keogh's efforts to secure their passage. The plans could be established as defined benefit plans but most were established as money purchase or profit-sharing plans. The Tax Equity and Fiscal Responsibility Act of 1982 eliminated most distinctions between Keogh and corporate employer plans. This was done in part by extending many of the special restrictions on Keogh plans to all "top-heavy" plans--that is, to those in which benefits accrue primarily to key employees. While there are no longer any differences between plans for the self-employed and other employer plans, the term "Keogh plan" survives, particularly with respect to single-person plans.

Requirements for Qualification

Since the Revenue Acts of 1938 and 1942, the tax code has placed substantial conditions on employer pension, profit-sharing, and stock-bonus plans if they are to qualify for the tax advantages. The conditions have two

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18. Ippolito and Kolodrubetz, *Pension Statistics*, pp. 63-64.

basic thrusts. One is to require that plans cover and pay benefits to the rank and file of employees as well as the highly compensated who have the most to gain from the tax advantages. The other is to limit the maximum amount of qualified saving by any one employee.

Requirements for sharing of benefits among the rank and file include limits on how many employees may be excluded from plans, minimum vesting periods, and rules for nondiscrimination in benefits or contributions. The nondiscrimination rules generally require that benefits or contributions not accrue at higher rates among higher-paid employees, with the exception of integration with Social Security. The extent to which an employee's benefits or contributions can be integrated with Social Security is restricted roughly to the employer's share of the payroll tax paid for the employee. More restrictive requirements are imposed on so-called "top-heavy" plans in which over 60 percent of plan benefits accrue to highly compensated employees and employee-owners.

Tax-qualified saving per employee is limited by restrictions on maximum benefits and contributions. Defined benefit plans cannot pay benefits greater than the employee's average salary over the last three years of service or $90,000, whichever is less. The $90,000 limit is reduced for those retiring before age 65. In defined contribution plans, contributions cannot exceed more than 25 percent of salary or $30,000, whichever is less. The defined benefit limit is to be indexed starting in 1988, but the defined contribution limit will not be indexed until it falls to one-fourth of the defined benefit limit, as specified in the Tax Reform Act of 1986. The act also placed additional limits on salary reduction plans. Employees can defer no more than $7,000 of annual pay, except in plans for nonprofit organizations, which can defer $9,500. The $7,000 limit is indexed and the $9,500 limit will be indexed when the $7,000 limit reaches it. Appendix B gives greater detail on the requirements for qualification, including the changes made by the Tax Reform Act of 1986.

HOW IRAs WORK

Any person can contribute to an Individual Retirement Account if he or she has earnings during the tax year of the contribution. An IRA can be held at nearly any financial institution regularly serving individuals, and the investment choices can be those normally offered by the institution. The maximum annual contribution is $2,000 or 100 percent of earnings, whichever is less. Contributions may also be made to the accounts of unemployed

spouses, provided that contributions for both spouses do not exceed either $2,250 or 100 percent of the working spouse's income.

Starting with the 1987 tax year, contributions to IRAs will not be tax-deductible for a higher-income employee who participates in an employer pension or whose spouse participates in a pension. The deduction phases out at between $25,000 and $35,000 of adjusted gross income on individual returns and $40,000 and $50,000 of adjusted gross income on joint returns. Nondeductible contributions will still benefit from the deferral of taxation on interest earnings, as described in Chapter I. Withdrawals are subject to normal income taxation and premature withdrawals to an additional tax of 10 percent (as discussed in Chapter V).

COMPARISONS AMONG PLANS

The effects of plans vary considerably according to their provisions. This section focuses first on the differences between defined benefit plans, on the one hand, and money purchase pensions and other traditional defined contribution plans on the other. These pensions and other nonelective plans are then compared to IRAs, salary reduction plans, and thrift plans.

Defined Benefit Plans Compared with Nonelective Defined Contribution Plans

Money purchase plans resemble individual savings accounts except that the deposits are in the form of invariant employer contributions over which any one worker typically has little direct control. Traditional profit-sharing or stock-bonus plans also operate as nonelective savings accounts, except that the amount of employer contributions can vary from year to year. Defined benefit plans are less like individual savings because they specify benefits rather than contributions, and because those benefits accrue in ways that encourage employees who start with a firm to continue until they reach the firm's early-to-normal retirement ages. These features of a defined benefit plan make a person who leaves too soon or stays too long worse off than he or she would be in a money purchase or similar plan. However, the employee who stays until retirement is guaranteed a target replacement rate, while the payments from a money purchase or similar plan depend on the success of the plan's investments.

The incentives in a defined benefit plan may reflect to some degree the needs of employers with complex production processes, as well as the

ability of some employers to carry investment risks better than individuals. If the incentives are effective in securing long-term commitments from employees, they may raise productivity and make possible retirement benefits above what long-term employees could otherwise receive under a money purchase or similar plan.

Incentives to Stay. Defined benefit plans encourage long-term employment by tying the pension benefit to final pay. Pay tends to rise with time on the job; the longer a person remains, generally, the greater the value of the service credit earned by each year of service. In contrast, most money purchase plans create no incentive to stay on the job beyond the vesting period since annual contributions depend only on earnings each year and not on length of service.

An example will demonstrate the effect that tying pension benefits to final salary has on pension benefits. Table 6 shows the outcomes for three people who start with the same employer at age 22. The three stay for different lengths of time with the first employer, but all earn the same salary each year they work until they retire at 62. The first employer uses the defined benefit pension formula presented earlier with 10-year cliff vesting but without integration. Employee A leaves the first job after 9 years and works the next 31 years with a second employer who has the same pension plan and pay scale. Employee B works with the first employer 20 years and then switches to the second employer. Employee C works 40 years for the first employer.

The upper half of Table 6 shows the pensions and replacement rates for the three employees, assuming a 3 percent inflation rate. Employee C, who has been with the same employer for 40 years, earns a pension that replaces 60 percent of his or her final pay. Employee A's nine years with the first employer earn him nothing because of the 10-year cliff vesting, but his 31 years with the second employer earn him a replacement rate of 46.5 percent of his final five-year salary average. Employee B, with 20 years at each employer, earns pensions that replace 30 percent of final pay at each job. However, B's final five-year salary average on the first job is much below that of his second job, so the sum of his pensions from the two jobs is well below that of Employee C and it is even below employee A's despite A's loss of vesting. Employee B's replacement rate is only 41.1 percent, showing that the incentive provided by tying the pension to final pay can be even stronger than the vesting incentive.

Tying pension benefits to final pay serves as inflation protection as long as the employee remains at the firm, but it leaves separating

employees fully subject to erosion of their deferred annuity pensions. The lower half of Table 6 shows the effect of doubling inflation from 3 percent to 6 percent. The two workers receiving their full pension benefit from their last employer have the same replacement rate as at the lower inflation rate. Employee B, though, finds the pension from his first employer replacing less of his final pay at age 62 because of the greater inflation between quitting the first job and retiring. As a result, Employee B's two pensions together replace only 36.2 percent of final pay at the higher inflation rate.

A change to five-year vesting raises the replacement rate for Employee A very modestly, and highlights the disparity between vested short- and long-tenure workers under a defined benefit plan. With five-year vesting, Employee A earns a pension for his first nine years of work, but it raises his total pension income from 46.5 percent to only 48.9 percent of his final pay, assuming 3 percent inflation. At 6 percent inflation the replacement rate rises to only 47.5 percent. The effect of five-year vesting on the replacement rate is modest because Employee A's pay after his first nine years of work is far below his pay when he retires. 19/ Under five-year vesting, all three employees receive pensions based on 40 years of service, but receive substantially different replacement rates because of their different tenures for a single employer.

Tying pension benefits to final pay creates an incentive to remain with the employer, but the size of this incentive depends heavily on inflation, a factor beyond the control of the employer, rather than on the increase in productivity from longer-term employment.

When a defined benefit plan is terminated, all employees pay the penalty that Employee B paid when he or she left before retirement age. The benefits of all employees under the terminated plan are frozen at current pay levels. Pay and inflation may rise considerably over the rest of the employees' work lives, but those years of service under the terminated plan will never earn higher benefits--just as they did not for Employee B in Table 6. Only if the employer establishes another plan that grants credit for past service can the employees recoup their losses. If the employer estab-

19. After the first 9 years of work, the five-year average pay is 18 percent of the five-year average after 40 years of work, assuming 3 percent inflation. At 6 percent inflation, the earlier average is 7 percent of the later average.

TABLE 6. EFFECT OF LENGTH OF SERVICE ON DEFINED BENEFIT PENSIONS

	Length of Service (In years)		Pension (In dollars)			Replacement Rate on Final Five-Year Salary Average (percent)
	First Job	Second Job	First Job	Second Job	Total	
3 Percent Inflation						
Employee A	9	31	0	86,000	86,000	46.5
Employee B	20	20	20,500	55,500	76,000	41.1
Employee C	40	0	111,000	0	111,000	60.0
B's Final Five-Year Salary Average at Age 42					68,200	
B's Final Five-Year Salary Average at Age 62					184,900	
6 Percent Inflation						
Employee A	9	31	0	249,600	249,600	46.5
Employee B	20	20	33,500	161,000	194,500	36.2
Employee C	40	0	322,100	0	322,100	60.0
B's Final Five-Year Salary Average at Age 42					111,700	
B's Final Five-Year Salary Average at Age 62					536,800	

SOURCE: CBO computations assume a starting salary of $20,000 at age 20, with annual increases for inflation, productivity gain of 1 percent, and merit increases falling from 5 percent at age 21 to almost zero at age 61. The pension plan pays 1.5 percent per year of service on an average of the last five years of service.

lishes a plan that does not recognize past service, as some have done, or if the employer goes out of business, all employees pay B's penalty. 20/

Money purchase and other nonelective defined contribution plans, on the other hand, impose no cost on vested employees who leave or on any employee if the plan is terminated. As long as the terminating employee leaves accrued funds in the plan, or rolls them over to another tax-advantaged account, they continue to grow from investment returns at the same rate as if the employee had remained on the job. When inflation increases, investment returns generally increase as well, so the accrued funds grow more rapidly and their purchasing power is protected.

Incentives to Retire. Defined benefit plans also have financial incentives encouraging fairly uniform retirement ages. The plans guarantee a pension payment independently of investment performance, and typically adjust those payments so that their expected lifetime value peaks between the ages of early and normal retirement.

Guaranteeing the payment means that employees reaching retirement age will not have any incentive to speed up or delay retirement because the value of their investment portfolio is unexpectedly high or low. In contrast, a person with a money purchase plan might want to alter the timing of retirement depending on the performance of the investments. This apparently was a problem when stock prices fell in the 1970s, creating delays and hardships for retiring employees in firms whose defined contribution plans were invested heavily in stocks. Two major retailers switched to defined benefit retirement plans after this experience.

Defined benefit plans also encourage a fairly uniform retirement age by setting the pension accrual rate so that the expected lifetime value of payments peaks between early and normal retirement. People quitting before early retirement age usually must wait until they reach the plan's normal retirement age before getting any payment, and they suffer the disincentives discussed above from having their pension set in terms of their salary at the time they quit. People retiring between early and normal retirement ages often get a subsidized benefit, and until 1989 people retiring after normal retirement age frequently get no increased benefit even though they have a shorter expected lifespan. (In 1989 and after, bene-

20. The few employees whose benefits exceed the amounts insured by the PBGC, $21,477 per year in 1986, may face even greater losses if the plan is underfunded; they could lose benefits already accrued.

fits must rise until the plan's maximum benefit is reached.) Under this existing arrangement, the total value of expected lifetime pension payments rises with the age at which an employee quits until early retirement is reached, stays steady or declines slightly until normal retirement age, and then drops rapidly for later retirement. 21/ In contrast, the value of assets in a money purchase or similar plan continues to grow until normal retirement because of regular contributions and interest earnings. Even if contributions stop after that age, the account continues to grow from interest earnings until the employee retires.

Why Incentives? The employment incentives of defined benefit plans may have been designed to encourage long-term employment and regular retirement patterns. Long-term employment is clearly advantageous when the costs of hiring and training are high, and employers may also prefer a fairly uniform retirement age so as to avoid the necessity of making evaluations among employees.

On the other hand, the incentive to stay may be an unintended side effect of protecting employee pensions from inflation. Certainly the strength of the incentive depends on the rate of inflation, and that rate is not controlled by the employer. At high rates of inflation, some employers may find the incentive to stay too strong for efficient production. While the incentive to stay may be unintended, the incentive for uniform retirement ages is an intentional feature of defined benefit plans, since it would be costless for funded plans to provide actuarially fair increases in benefits for delayed retirement.

The use of defined benefits instead of defined contributions may also "buy" some firms more employee satisfaction per dollar of pension cost. Large firms, and firms in stable and growing markets, generally have the financial ability to offset short-term swings in the value of the retirement fund. When values fall, they can increase their contributions sufficiently to sustain pension benefits and compensate by reducing funding in years when returns are above normal. Employees near retirement have much less flexibility in offsetting swings in investment returns and therefore probably place a higher value on that guarantee than it costs these employers to provide. Money purchase plans would have to invest in shorter-term and less risky investments to avoid swings in asset values, but these investments would provide a lower return than those available to firms with longer investment horizons.

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21. Lazear, *Pensions as Severance Pay*, pp. 57-58.

Firms with long-term investments in equipment may also find defined benefit plans advantageous in their wage negotiations. Such a plan raises the employees' stake in the firm's future because the value of their pensions will be frozen if the firm goes out of business. This increased stake may help to moderate wage demands.

The foregoing reasons why firms may favor defined benefit plans apply more strongly to larger firms, where the plans predominate. Another reason based explicitly on size is that the fixed administrative costs of defined benefit plans are higher than for money purchase plans. Large firms are able to spread this cost over more employees and make the average cost per employee less prohibitive than for small firms.

Traditional Pensions Compared with Thrift and Salary Reduction Plans and IRAs

Defined benefit, and nonelective money purchase, profit-sharing, and stock-bonus plans are the traditional vehicles through which tax advantages for retirement saving have been available. These plans require almost uniform contribution or benefit accrual rates among individuals. IRAs and salary reduction plans are recent departures that give individuals control over the size of their contributions, while still offering the full tax advantages of traditional plans. Employer thrift plans have long offered employees discretion in the amount saved, but on less favorable terms than salary reduction plans and IRAs.

Uniform or Flexible Contributions. IRAs increase opportunity and flexibility. They increase opportunity by giving all employees the option of contributing independently of what their employers may choose to do. Thrift and salary reduction plans give the employer the option first, and only afterward does the individual have a choice. IRAs also increase flexibility by allowing individuals to choose the amount of their contribution up to the legal limit, although that limit is low compared with contributions permitted in employer-sponsored plans. Thrift and salary reduction plans also provide this option.

Letting individuals determine their own contributions allows them to tailor their retirement saving to their own particular circumstances. It also allows them to adjust their retirement saving over the life cycle, as their family obligations permit. People who want to retire early may choose to save more, while those who prefer later retirement can save less.

The danger is that some people may be shortsighted and not save enough to support themselves in retirement. Social Security partially meets this need, but retirement income from Social Security is not enough to maintain preretirement living standards for many better-paid workers. The federal government has taken an interest in protecting people from the consequences of their own ill-considered actions, as in discouraging smoking or requiring seat belts. Retirement saving, with its long planning horizon, may be another such area. Further, some have argued that a policy of encouraging pensions and other qualified plans reduces the pressure on Social Security and other government programs for the elderly.

One way to allow individual decision making while mitigating the results of shortsighted choices is to add an IRA, salary reduction, or thrift plan to a traditional employer plan. Such a combination insures that all covered employees supplement Social Security to some minimum level while allowing those who want to save more to do so in tax-advantaged accounts. Many employers offer such combinations. While the combinations preserve some benefits of both the traditional employer plan and the newer flexible plan, they also fail to achieve the full benefits of either. The traditional plan limits the ability of participants to adjust saving to their own needs, while the flexible saving add-ons will probably mean lower levels of support in the traditional plans. For example, as salary reduction plans spread rapidly among those covered with traditional plans, they are likely to cause employers to reduce the benefits that the traditional plans provide.

The protection that mandatory pensions provide against inadequate retirement saving is lost on short-term employees. Employees who leave before vesting get no benefit from mandatory pension coverage, and even those who vest in a defined benefit plan before leaving will have their deferred benefit eroded by inflation unless they are near retirement age.

Inclusion in or Exclusion from Social Security. Employer contributions to pension plans are not counted as wages for Social Security purposes. They are not subject to the payroll tax, nor do they count in determining Social Security benefits. On the other hand, wages contributed to IRAs or to thrift and salary reduction plans are treated as Social Security wages. Some employees will gain more by escaping the payroll taxes and forgoing the Social Security benefits; the reverse will hold for others.

When an employer contributes a dollar to a pension plan, the full dollar is invested. When the employer allocates the dollar to wages, the payroll tax must be paid and only the remainder can be invested. As long as the remainder is invested in an IRA or salary reduction plan it will receive

the same tax advantages as the employer pension contribution. The main difference is that the amount of the payroll tax earns investment returns in the case of the pension contribution, and it "earns" Social Security benefits when paid as wages.

Whether the payroll tax amount earns more invested in the employer pension than in Social Security benefits depends on a person's work history and pay. Social Security Administration projections show payroll taxes for today's average worker earning about the same return as they would if they were invested in pension funds (assuming that the employer and employee taxes come out of wages). However, large differences can occur for short-term workers and for lower- and higher-paid long-term workers. Short-term workers who fail to vest or who vest but have their benefits severely eroded by inflation can expect a higher return from Social Security contributions than from investing the same amount in a pension. Lower-paid long-service employees are also likely to get a higher return from investing in Social Security because the tilt in the benefit formula gives them a higher return than they could expect from market investments. However, the tilt also means that employees whose wages approach the maximum Social Security wage earn a higher return on a market investment than on contributions to Social Security. Employees earning more than the Social Security maximum wage would be unaffected by a shift from employer pension contributions to employee IRA or salary-reduction contributions because they would pay no payroll tax on shifted compensation.

IRAs Compared With Thrift and Salary Reduction Plans. As noted above, IRAs are available to all employees, although they are deductible only for those without pension coverage for themselves or their spouses. Thrift and salary reduction plans are available only at the discretion of the employer.

Contribution limits are normally stricter for IRAs than for thrift and salary reduction plans. Contributions to IRAs can be 100 percent of earnings but no more than $2,000. Employers commonly allow deferral to salary reduction plans of 5 percent or more of pay, which at low pay levels can be surpassed by IRA contributions. However, people at low pay levels are unlikely to contribute much more than 5 percent of pay to retirement saving unless they receive substantial support from a spouse or a non-wage source. Those earning $40,000 or more can save more through the typical salary reduction plan than through an IRA. Contributions to salary reduction plans are legally limited to $7,000 ($9,500 in plans for nonprofit organizations). In thrift plans, employers commonly allow contributions of 5 percent to 10 percent of pay, and the legal maximum is $30,000.

One reason that public policy generally allows higher contributions to thrift and salary reduction plans may be that these employer plans are subject to nondiscrimination rules. The rules require that contributions by and on behalf of lower-paid employees must not fall too far below contributions for higher-paid employees. Employer matching contributions serve as inducements to attract sufficient saving from the lower-paid to meet the nondiscrimination rules. In this way, salary reduction and thrift plans may induce more saving from lower-paid employees than IRAs do, thus reducing the number who save too little. (Preliminary evidence reported in Chapter III suggests that contributions are higher in salary reduction plans than with IRAs.) But the nondiscrimination rules apply only to groups of employees and not to contributions by or for individuals, who are not required to participate in salary reduction and thrift plans.

Different Plans for Different People

Each method of tax-deferred retirement saving has its own strengths and weaknesses. Preferences among them will vary by worker and employer. In a competitive environment, workers will gravitate toward jobs with pension plans they prefer, and employers will offer plans that attract the kinds of workers they want and that provide the incentives they need for efficient production. Of course, both employees and employers are motivated by many other factors as well.

Workers who wish and expect to remain with an employer until retirement, and who place a greater value on a guaranteed pension replacement rate, will be more likely to end up at firms with defined benefit plans. Likewise, firms wanting to attract a stable work force and encourage uniform retirement ages will tend to offer defined benefit plans. Moreover, because administrative costs are higher and the risks to employers greater with defined benefit plans, small firms will be less likely to offer them.

Workers with unique skills or extensive general training, such as engineers and lawyers, often prefer to be able to shift employers as demands for their skills shift. New, small firms in higher-risk industries may not want the administrative cost or financial risk of guaranteed pension benefits, although their higher-wage employees want the tax advantages of deferred savings. Money purchase, salary reduction, and other defined contribution plans better suit these workers and employers. Consequently, small and high-technology industries generally rely more on defined contribution plans.

Still others, including students, some spouses, and the elderly, are only temporarily in the labor market and are not interested in pension saving. Firms not requiring extensive skills or long on-the-job training can attract these workers without the cost of a benefit plan, as does the retail industry. Workers in this group who want tax-advantaged savings can use their own IRAs.

Market forces of this kind can match a variety of pension plans to the needs of employers and employees better than a single mandatory system could. Some people, however, will be left without retirement benefits other than Social Security, including those who change jobs under defined benefit plans and those who fail to save and are not covered by a mandatory employer plan. IRAs and salary reduction plans can help to fill the gap for those who want to save more than their employers provide, but those who are shortsighted about saving for retirement may fail to make use of them.