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1 Introduction

In addition to a nearly universal Social Security system, the United States has a “voluntary” private pension system. Private-sector employers can generally decide whether and how to provide pension benefits for their employees; however, when employers do provide pensions, those pensions are regulated under the Employee Retirement Income Security Act of 1974 (ERISA).¹

The voluntary system has never achieved close to full coverage for U.S. workers. This chapter discusses how these employer-sponsored pension plans have changed over the past 25 years.

Part 2 of this chapter discusses, the most important change in the U.S., the shift away from traditional defined benefit (DB) pension plans and towards 401(k) plans and other defined contribution (DC) plans. Part 3 explains how the tax rules governing pensions have changed. Part 4 addresses a number of administrative issues of importance to DC plans. Part 5 discusses the implications of behavioural economics, financial literacy, and conflicts of interest for retirement savers. Part 6 discusses challenges that continue to confront the voluntary system of employer plan sponsorship. Part 7 presents conclusions.

2 The Transition from Defined Benefit to Defined Contribution Plans: Description and Analysis

When ERISA was enacted in 1974, most private-sector employees with workplace retirement benefits received those benefits through a traditional DB plan. These were supplementary occupational pensions. By 1994, the beginning of the time period of interest here, DC plans had

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2 In the U.S., many DC plans include a feature that allows an employee to choose between receiving cash currently or deferring taxation by placing the money in her retirement account according to 26 United States Code § 401(k) (a/k/a Internal Revenue Code [IRC]) (added by the Revenue Act of 1978, Public Law No. 95-600, 92 Statutes at Large 2763 (1978). The maximum annual amount of such elective deferrals that can be made by an individual in 2020 is $19,500, although workers over the age of 50 can contribute an additional $6,500. Internal Revenue Service, Notice 2019-59 (‘2020 Limitations Adjusted as Provided in Section 415(d), etc.’).
eclipsed DB plans both in the number of employees earning plan benefits and in total plan assets.\(^3\) Since 1994, growth of DC plans has continued to outpace DB plans.\(^4\) This part first examines why employers moved away from DB plan sponsorship, then considers why 401(k)-style plans have become popular. The part ends with a discussion of the rollover of assets from 401(k)-style plans to Individual Retirement Accounts (IRAs).

### 2.1 The Decline in DB Plans

Although much of the decline in DB plans occurred before 1994, it is useful briefly to consider the reasons for that decline before focusing on the evolution of the U.S. pension system between 1994 and 2019. Many factors contributed to employers turning away from DB plans, but those factors can be grouped into three categories: (a) funding and accounting requirements, (b) administrative and other costs, and (c) workforce-related demographic changes and preferences.

Pension plans make benefit promises that can extend many years into the future. Prior to ERISA, employers had no legal obligation to pre-fund DB plans. The bankruptcy of a major plan sponsor—and the plan’s subsequent inability to pay promised retirement benefits—frequently is cited as a primary motivator for ERISA’s enactment. The statute imposed complex minimum funding obligations on sponsors of DB plans, but it provided sponsors with considerable discretion


on how to calculate those obligations. Legislation changes in 1987 limited that discretion. It restricted employers from overfunding plans in good financial times and underfunding plans during challenging financial times. Accounting standards also changed in 1987. The new standards for the first time delinked financial reporting and the legal minimum funding rules, which required each plan to make two sets of complex actuarial calculations. The legal and accounting changes worked in concert to limit employers’ latitude and to make it easier for investors to compare pension costs across companies. Effective in 1995, the U.S. Congress again tightened the funding requirements.

In order to have sufficient assets to meet long-term DB obligations, pension plan sponsors must make current contributions and wisely invest those contributions. A plan must employ an actuary to determine how well the plan is funded and how much the plan sponsor must contribute each year. Actuaries base those determinations on the plan’s assumptions and the plan’s experience about such important variables as employee turnover, mortality, future salary, inflation, and investment returns. The long-term nature of the assumptions means that the calculations are complex and may not be correct. This is one of the reasons that DB plans can become underfunded. According to a 2019 study, the average funded ratio for the 100 largest U.S. corporate DB plan

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5 GELTER, above n. 3.

sponsors was just 87 percent.\(^7\) When a private-sector, single-employer DB plan becomes underfunded, the funding rules generally require it to make up the shortfall by making level instalment payments. Pertinent here, the Pension Protection Act of 2006\(^8\) toughened the minimum funding requirements; private-sector plans now must amortize their unfunded liabilities over seven years.\(^9\)

In addition to changes in the funding and accounting requirements, DB plans faced other headwinds. The complex funding rules and compliance with mandatory government reporting requirements create administrative costs to plans for lawyers, accountants, and actuaries. DB plan sponsors also must pay insurance premiums to a government-established entity that insures payment of plan benefits—the Pension Benefit Guaranty Corporation (PBGC).\(^10\) Over the years, PBGC premiums have increased, and now a portion of the premium varies depending on the level of a plan’s underfunding.\(^11\)

Workforce-related demographic changes and preferences also contributed to the decline in DB plans. Labour unions tend to prefer and bargain for DB plans. Private-sector unionization rates

\(^7\) MILLIMAN, ‘2019 Corporate Pension Funding Study’ (2019) Milliman, worldwide, Milliman


\(^8\) Public Law No. 109-280, 120 Statutes at Large 780 (2006).

\(^9\) IRC §§ 412, 430.


peaked in the 1950s and have declined since then. Between 1974, when ERISA was passed, and 2003, the percentage of private-sector unionized workers dropped from 29.9 percent to just 9.0 percent. Economists contend that much of the reduction in DB plan coverage occurred among the non-unionized workforce, which grew in relative importance over this period.\(^\text{12}\)

Research also indicates that employees who are more mobile tend to prefer DC plans. DB plans tend to discourage mobility, at least in part through the use of vesting requirements and backloaded benefit calculations.\(^\text{13}\) DB plans’ backloaded pension contributions reward long tenure workers because the benefit accrual rate is higher at higher years of tenure. Finally, unanticipated increases in longevity significantly increased the costs of DB plans because those plans typically pay benefits as annuities, lasting until the beneficiary’s death.\(^\text{14}\)

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In sum, the decline in DB plan sponsorship can be explained by a variety of regulatory and accounting changes, unpredictable funding fluctuations, higher administrative costs than in DC plans, and workforce-related demographic changes and preferences. During the same period that these changes were occurring, other factors enabled and encouraged plan sponsors to choose DC plans in lieu of or to replace DB plans.

2.2 The Growth in 401(k)-Type DC Plans

The most popular type of DC plan among private-sector employers is known as a 401(k) plan, named after a section of the tax code. The defining characteristics of 401(k) plans are that they must provide for employee-elective salary deferrals (voluntary employee contributions) and individual employee accounts. Typically, those plans also permit employers to contribute to the individual employee accounts. Regulations detailing the requirements of those plans were first issued in 1981. Thus, by 1987, when employers were faced with stricter funding and accounting rules for their DB plans, 401(k) plans offered a viable alternative. Originally, most analysts thought that 401(k) plans would be offered as supplementary pension plans on top of traditional, employer-sponsored DB plans; over time, however, 401(k) plans have replaced many of those traditional DB plans, and 401(k) plans are now the only retirement plan selected by most new plan sponsors.

For employers, 401(k) plans offer a number of distinct advantages over DB plans, including economic flexibility, lower risk, and decreased costs. First, consider economic flexibility. Funding requirements limit employers’ ability to determine the amount of their DB plan contributions in any given year. In contrast, an employer may prospectively increase or decrease its contributions

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15 See above n. 2.

16 Gelter, above n. 3.
to a 401(k) plan for any reason. This can be particularly important during times of employer financial stress.¹⁷

401(k) plans enable employers to transfer funding, investment, and longevity risks to their employees. In DB plans, employers assume the funding risk because they must fund the plan sufficiently to pay promised benefits. In DC plans, employees assume that risk—they must decide whether and how much they wish to contribute to the plan. Employees also assume the risk that their employer may decrease its future contributions to the plan. Employers bear the risk of poor investment performance in a DB plan. All else equal, the sponsor of a DB plan with poor or modest returns would have higher funding costs than the sponsor of a plan with high investment returns. In contrast, most DC plans are self-directed plans, meaning that the individual participants in the plans determine how their account assets are invested and bear the risks associated with their decision-making. Last, traditional DB plans guarantee retirees a lifetime annuity and, thus, assume the risk of greater-than-expected employee longevity. An individual with a 401(k) plan account risks depleting the account assets during the individual’s lifetime.¹⁸ In other words, the longevity risk lies with the individual because these plans generally do not offer annuities.

The administrative costs of 401(k) plan sponsorship are lower than those associated with DB plans. For example, there is no requirement to pay premiums to the PBGC to insure plan benefits since participants only are entitled to their account balances. No complex actuarial calculations are required to determine a plan sponsor’s funding or financial reporting obligations.

¹⁷ ZELINSKY, above n. 10.

¹⁸ Ibid.
From the perspective of employees, 401(k) plans can provide more secure and predictable benefits for mobile employees. All contributions made by employees are immediately vested and non-forfeitable, and vesting periods for employer contributions tend to be shorter than they are for DB plans.\(^{19}\) Moreover, as discussed in the next section, after changing jobs or retiring, participants have a variety of options with regard to their account assets.

The growth in 401(k)-type plans and the decline in DB plans have affected men and women differently. For example, DB plans tend to favour long-service workers because their benefit formulas are backloaded, which favoured men relative to women because men, on average, have longer job tenure than women. Moreover, because women tend to be more risk-averse in their investments, they tend on average to receive lower rates of return in DC plans than men.\(^{20}\)

### 2.3 Rollovers from 401(k)s to IRAs

By contrast to employer-sponsored occupational pensions, Individual Retirement Accounts (IRAs) in the U.S. are plans that individuals can establish on their own with a financial services provider, such as a mutual fund company.\(^{21}\) Employers do not serve as intermediaries in most IRAs, although as explained below exceptions exist. IRAs are included in this chapter because of a major trend in the U.S. pension system. As discussed in the previous two sections, most private-

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\(^{21}\) IRC § 219.
sector employees in the U.S. who have employment-related pension plans have a 401(k)-style DC plan. A subsequent development is that, after changing jobs or retiring, a substantial number of plan participants transfer (rollover) their account assets from employer-provided DC plans into IRAs.

When a worker with an employer-provided DC plan, such as a 401(k) plan, changes jobs, that person typically has four options. The worker can keep the plan with the former employer; the worker can take a lump sum payment (paying a 10-percent penalty if this is done before age 55); the worker can roll over the account assets to the plan of a new employer if the plan of the new employer so permits; or the worker can roll over the account assets to an IRA. An exception exists for individual accounts with very small balances: in that situation, the employers can elect to distribute those small balances to the departing employees or roll them over into IRAs.

Rollovers from employer-provided DC plans to IRAs have resulted in such a massive outflow of pension assets from employer-provided plans that IRAs now hold more assets than do employer-provided DC plans. This is true even though people rarely contribute to IRAs, other than through rollovers. In 2017, only around 11 percent of eligible taxpayers made non-rollover contributions

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22 IRC § 72(t)(2)(A)(v).

23 IRC §§ 402(c), 408(d)(3).

to an IRA. At year-end 2018, however, IRAs held $8.8 trillion in account assets, compared to $7.5 trillion in all employer-sponsored DC plans.

While inertia has been observed among pension participants in other contexts, this lack of inertia with rollovers may be explained in part because the financial services industry has worked actively to overcome that inertia. Three different approaches have been used. First, a person can be influenced to rollover a 401(k) plan to an IRA by their personal financial adviser. Second, they can be influenced by an advertising campaign to “roll over your old 401(k)”. Third, they can be influenced by communications from the plan record keeper or another plan service provider, if that service provider also offers IRA accounts.

While participants lose fiduciary and other statutory protections when they move their assets to IRAs, rollovers are not always a bad idea. In particular, participants in small plans, which tend


26 INVESTMENT COMPANY INSTITUTE, above n. 4, p. 159 figure 8.5.

to have relatively high fees, may find that a rollover to an IRA can result in lower fees. For some wealthy individuals, IRAs can provide useful estate planning and diversification benefits.  

3 Changes in the Tax Treatment of Pensions

The U.S. uses its tax system to encourage American employers to provide DB and DC pensions for their workers and to encourage workers to contribute to DC plans (and IRAs). Pertinent here, the U.S. federal government relies heavily on individual and corporate income tax for its revenue, and it does not have a value-added tax system (although 45 states and Washington, D.C. do collect modest state-wide sales taxes).  

Historically, the U.S. only used the Exempt/Exempt/Tax (EET) approach to encourage pensions and other retirement savings, an exception being employee non-deductible contributions to IRAs and 401(k) plans. Basically, employer contributions to a pension are not taxable to the employee; the pension fund’s earnings on the investment of those contributions are tax-exempt; and employees pay tax only when they receive distributions of their pension benefits.

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28 MUIR, above n. 24.


30 IRC § 402.

31 IRC § 501(a).

32 IRC §§ 72, 402.
Nevertheless, the employer is allowed a current deduction for its contributions (within limits).\(^{33}\) Distributions from a pension plan, other than those required starting at age 72, generally may be rolled over tax-free to another pension plan or to an IRA.\(^{34}\)

Similar EET rules generally also apply to IRAs. Almost any worker can set up an IRA, in which case contributions are deductible if the worker is not participating in an employer-sponsored plan, the earnings on the investment of those contributions are tax-exempt, but distributions are taxable.\(^{35}\) Pertinent here, various provisions of pension law permit employers to use IRAs to provide tax-exempt retirement savings for their workers. For example, an employer could set up payroll-deduction IRAs for its workers. In addition, small employers can set up Savings Incentive Match Plan for Employees (SIMPLE) plans that use IRAs to hold employer and employee contributions.\(^{36}\)

More recently, however, the U.S. has also permitted some pension plans and individuals to instead use the Tax/Exempt/Exempt (TEE) approach. Since 1998, individuals have been permitted to set up Roth IRAs.\(^{37}\) Unlike regular IRAs, contributions to Roth IRAs are not deductible; instead, withdrawals are tax-free (and like regular IRAs, Roth IRA earnings are tax-exempt). While Roth

\(^{33}\) IRC § 404.

\(^{34}\) IRC §§ 219, 402(c).

\(^{35}\) IRC § 408. In 2020, individuals can contribute and deduct up to $6,000 to an IRA, although individuals over age 50 can contribute and deduct another $1,000 (for a total of up to $7,000).

INTERNAL REVENUE SERVICE, above n. 2.

\(^{36}\) IRC § 408(p).

\(^{37}\) IRC § 408A.
IRAs are less popular than traditional IRAs, they provide an option that is appealing to some people. In addition, since 2006, employers have been permitted to set up Roth 401(k) plans.\textsuperscript{38} Contributions to these plans are taxable to employees, but neither the plan’s investment returns nor distributions are taxable.

Marginal tax rates have declined in the U.S. over time due to tax reforms, and many low-income workers do not pay federal income taxes, both factors causing some workers to have little or no tax incentive to participate in a pension plan. The result is that benefits from the annual tax expenditure on retirement benefits primarily accrue to the wealthy. Some commentators have observed that the tax incentive to encourage wealthy individuals to accrue wealth for retirement is unnecessary because economic analysis shows they would be likely to save without the tax incentive.\textsuperscript{39} Commentators have also criticized Congress for varying the level of support for the pension system that is provided through tax expenditures based on concerns about revenue rather than concerns about retirement policy.\textsuperscript{40}

4 Administrative Issues

DC plans pose a variety of administrative challenges for the employers that sponsor plans and the employees who contribute to them. This part discusses issues that have developed as the U.S. DC plan system has evolved.

4.1 Funding

\textsuperscript{38} IRC § 402A.


As compared to the complex DB plan funding rules discussed above, minimum funding (contribution) rules are fairly simple for DC plans. The plan sponsor meets those requirements by contributing what it has promised. For example, a plan sponsor that promises to contribute 10 percent of compensation meets its funding obligation when it deposits 10 percent of compensation in the individual worker accounts.

Plan sponsors often make matching contributions to 401(k) plans as a percentage of the amount contributed by plan participants, with the typical match being around 3.5 percent of salary.\(^{41}\) Plan sponsors may prospectively change their rates of contribution after giving appropriate notice to plan participants. Employer contributions often fluctuate depending on economic conditions.

In 1985, approximately 52 percent of participants automatically received matching contributions in employer stock.\(^{42}\) This enabled companies to avoid liquidity concerns while continuing to make plan contributions. However, it also resulted in participants being under-diversified. After participants at some companies brought legal claims because they lost much of the value in their 401(k) plans when their employers went bankrupt, fewer plans matched contributions using employer stock. By 2005, the percentage of participants automatically


receiving employer stock in matched contributions had decreased to 24 percent. In 2006, Congress amended ERISA to grant participants the right to diversify their plan investments.\footnote{IRC § 401(a)(35).} As a result, the percentage of 401(k) assets in the stock of the employer sponsoring the plan has declined further.

\section*{4.2 Automatic Features}

All pension plans involve a series of decisions, some of which may be made for plan participants and some of which those participants may elect to change. For example, a plan may provide that a worker be automatically enrolled in a DB plan (typically the case).

Professor Richard Thaler won a Nobel Prize in economics in part for his behavioural economics work on how changes in a DC plan’s automatic (also known as default) settings affect whether an individual who has a choice participates in a plan.\footnote{See, e.g., R.H. THALER and C.R. SUNSTEIN (2009) \textit{Nudge}, Penguin Books Ltd., London.} He argues that inertia keeps some people from enrolling in a plan, while if they are automatically enrolled, inertia tends to keep them in the plan. Madrian and Shea showed empirically that if 401(k) plans automatically enrol participants who then can take action to opt out, plan participation rates will be dramatically higher than if workers must take an affirmative action to enrol in the plan.\footnote{B.C. MADRIAN and D.F. SHEA, ‘The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior’ (2001) 116(4) \textit{Quantitative Journal of Economics} 1149.}

401(k) plans that automatically enrol workers must set an automatic contribution rate. Plans may automatically increase a member’s contribution rate over time, and relatively few participants...
will override the increase. Such a plan also must choose an investment vehicle to hold the member’s assets. As discussed above, most 401(k) plans must retain account assets even after a participant leaves employment unless the participant directs otherwise. Finally, a plan must establish whether benefits ultimately may be taken as an annuity, a lump sum, or some combination of the two, and on what schedule. Few 401(k) plans offer annuities.

4.3 Efficiency—Fees and Costs

Unlike a DB plan, which guarantees a specified benefit that is typically based on the worker’s earnings and years of service, participants in a 401(k) plan are only entitled to the assets in their plan accounts. Thus, the U.S. shift to DC plans has magnified the importance to plan participants of the fees and costs associated with those plans. All else being equal, a member who pays higher account and investment fees will accumulate less in account assets. The U.S. Department of Labor, Employee Benefits Security Administration, stressing the importance of fees on investment outcomes, provides the following example:

Assume that you are an employee with 35 years until retirement and a current 401(k) account balance of $25,000. If returns on investments in your account over the next 35 years average 7 percent and fees and expenses reduce your average returns by 0.5 percent,


your account balance will grow to $227,000 at retirement, even if there are no further contributions to your account. If fees and expenses are 1.5 percent, however, your account balance will grow to only $163,000. The 1 percent difference in fees and expenses would reduce your account balance at retirement by 28 percent.\textsuperscript{48}

Scholars such as Ayers and Curtis have documented the relatively high costs of the investment alternatives offered in some 401(k) plans.\textsuperscript{49} Two approaches have been used to combat high plan fees. First, regulations imposed in 2012, require all providers of services to plans to disclose the costs of their services to the plan fiduciary. Likewise, 401(k) plans must disclose costs, including the costs of investments, to plan participants for their use in making investment decisions. Second, lawsuits have alleged that plan fiduciaries failed to fulfil their duties of loyalty and prudence by offering high-cost investments through the plan. Although the vast majority of those lawsuits have been dismissed or settled, they have called attention to the issue of plan fees.\textsuperscript{50}

Whether because of increased transparency, participant lawsuits, or other factors, on average 401(k) plan fees have decreased over time. For example, average expense ratios for equity mutual

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\textsuperscript{48} U.S. DEPARTMENT OF LABOR, EMPLOYEE BENEFITS SECURITY ADMINISTRATION, ‘A Look at 401(k) Plan Fees’ (2013, August) pp. 1–2


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funds decreased from 0.77 percent in 2000 to 0.45 percent in 2017.\(^5\) On average, large plans are more efficient from a fee perspective than small plans because of the economies of scale.

**4.4 Complexity**

While simplicity is often a desirable aspect of pension policy, complexity is not necessarily a bad aspect of pension policy. It is a matter of trade-offs to find the best level of complexity. If a pension situation is too complex, participants and plan sponsors will make errors resulting in bad decisions. If a pension situation is too simple, for example, where there is no choice, it may be that a more complex arrangement would be better because it would allow for greater individualization.

This section examines changes in the complexity of the pension system for employers and participants as the U.S. has moved from a DB to a DC system.

*4.4.1 Employers*

As discussed in a previous section, the switch from DB to DC plans has involved a shift of financial market and longevity risk from employers to employees. Employers still, however, face some complex issues relating to their provision of DC plans. One of those issues is the selection of the investment menu in the 401(k) plan. Optimally, plans would provide a sufficient set of options so that workers can construct diversified portfolios, but plans should not offer too many options as that would overwhelm many participants. Another related complexity issue, discussed in the previous section, is the level of fees that participants are charged for the investment options.


Employers have been found to violate their fiduciary duty in the selection and monitoring of investments and the fees associated with those investments when, for example, a plan offers a high-cost class of a fund when a lower-fee class of the same fund is available.

4.4.2 Participants

For participants, the move from DB to DC plans has increased the complexity they face both in the pre-retirement period and during retirement.

Pre-retirement. With traditional DB plans, participants bore no responsibility for investment decisions. With 401(k) plans, participants now are generally expected to make financial decisions concerning how their pension account is invested. Turner et al. explain that because of low levels of financial literacy, most participants are poorly equipped in terms of the knowledge needed to make good decisions.52

Financial service providers, recognizing the challenges that this situation poses for many participants, have developed investment products to simplify the investment decisions participants face. With a target date retirement fund, participants can pick a single, diversified investment fund for their pension investments. The target date is the date the member expects to retire. However, there can be a trade-off between simplicity and individualization. Target date funds assume that all participants with the same expected retirement date have the same level of risk preference. Sophisticated participants can choose an earlier or later target date fund to adjust to their level of risk preference, but most participants are not financially sophisticated. Arguably, target date funds

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have gone too far in the direction of simplicity, and plans would be improved by offering a riskier and less risky option in addition to the central option for each target date.\textsuperscript{53}

In addition, participants often need to figure out how much to contribute to their 401(k) plans in order to have adequate savings for retirement. It appears that many participants are under-saving in their DC plans, resulting in them having insufficient assets at retirement.

The automatic settings for enrolment and contribution escalation, discussed above, have done much to address these complexities. They are a good example, however, of the loss of individualization that can occur when complexity is decreased. When many people have low levels of financial literacy and are not able or interested in figuring out what would be a good decision for themselves, the loss of individualization is less of an issue.

\textbf{Retirement.} With DB plans, all retirees needed to do was decide when to retire and whether to take a single life or a joint-and-survivor pension, with a joint-and-survivor pension being the legal default.\textsuperscript{54} The move to DC pensions has made the problem of how to receive benefits in retirement much more complex for retirees. Most retirees choose not to purchase an annuity, and thus they must decide on a drawdown strategy over their remaining lifetime, with the possibility that they could live considerably longer than expected.

When working, the strategy of dollar-cost averaging works well for contributions. With that strategy, each period the member contributes the same amount to their pension plan. They automatically purchase more shares of stock when the price is low and fewer shares when the price

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\textsuperscript{54} IRC §§ 401(a)(11), 417.
is high. In retirement, dollar-cost averaging of withdrawals works badly. It means that members are withdrawing the same dollar amount each period. However, with that draw-down strategy they are withdrawing more shares of stock when the price is low, and fewer when the price is high, which causes them to deplete their assets more quickly than if they did the opposite. Retirees presumably want to have a relatively constant stream of consumption, but that desire is in conflict with the negative outcome from making a constant stream of pension withdrawals. Retirees thus face a trade-off between a constant stream of consumption and a withdrawal strategy that causes them to sell more shares when their price is low.

They also face a related complex intertemporal issue of how much to withdraw given uncertainty as to life expectancy and uncertainty as to end-of-life expenses. These issues are not nearly as difficult for participants in DB plans because those participants receive benefits until death, although participants without inflation-adjusted pensions will see the real value of their benefits decline.

BlackRock, using longitudinal data from the Health and Retirement Study, found that more than 30 percent of those who entered retirement with $200,000 or less in non-housing liquid assets had spent down their assets by 80 percent or more after 17 or 18 years in retirement.55 For people retiring at age 62, that means they will be close to running out of assets by age 79 or 80. Data from the Survey of Consumer Finances shows that in 2016, the median net worth for the population age


55-64 was $187,300, which, combined with the BlackRock study, suggests that the majority of people will spend down their assets in retirement.\textsuperscript{56}

4.5 Liquidity

Changes in tax laws over time have increased the liquidity in the U.S. pension system. Until 2006, it was not possible for a worker to receive in-service benefits from a DB plan, meaning that a worker could not continue working for an employer and receive DB payments from the employer. To facilitate partial retirement, in 2006 Congress amended ERISA to allow workers to receive in-service benefits starting at age 62 (now age 59½).\textsuperscript{57} Questions remained as to whether workers could receive subsidized early retirement benefits while continuing to work; however, the Internal Revenue Service (the tax-collecting authority) subsequently issued regulations that permit payments of DB plan benefits to workers still working if those workers are at least as old as the normal retirement age in the pension plan, which can be set as low as


age 55, so long as that age is consistent with the typical retirement age for the industry. Relatively few industries have typical retirement ages that low.

The move from DB to DC plans has also increased the amount of liquidity for participants in the pension system, causing concern about pre-retirement leakage from the system. Argento et al. found that pre-retirement withdrawals are equal to 30 to 45 percent of annual pension contributions, with the amount varying across years. It is noteworthy that this study differs considerably in its findings from a study done 14 years earlier by Poterba, which concluded that, “Cashouts typically reduce average 401(k) assets at age 65 by only about 5 percent.”

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<https://benefitslink.com/articles/washbull070611a.html> 11.02.2020. An exception is made for police, firefighters and emergency medical personnel, for whom the normal retirement age can be set as low as age 50.


that pre-retirement withdrawals from 401(k) plans have become more frequent as the importance of 401(k) plans has grown. We expect that as other systems, such as those in the UK, Poland, Ireland, and Germany, transition to DC schemes and auto enrolment, that they also will experience leakage from pre-retirement withdrawals.

While participants in DB plans cannot obtain loans from their plans, participants in DC plans usually can borrow money from their plan accounts. Loans are limited to 50 percent of the member’s account balance, up to a maximum of $50,000.\footnote{61 IRC § 72(p).} In addition, while participants in a DB plan cannot cash out their benefits pre-retirement if they change jobs, that option is open to participants in DC plans, although there is a 10-percent tax penalty if the member is under age 55.\footnote{62 IRC § 72(t)(2)(A)(v).} While the greater liquidity can help participants in some instances, it also raises the possibility that participants will make withdrawals that will reduce their future retirement income.

Participants take cash outs and loans for a variety of reasons, from short-term spending needs to investments in education or homes. A 2012 study by the National Association of Realtors found that 9 percent of recent home buyers used money from a 401(k) plan or pension plan to help make a down payment.\footnote{63 S. BLOCK, ‘Borrowing From Your 401(k) to Finance a Home’ (2013) Kiplinger <https://www.kiplinger.com/article/real-estate/T010-C000-S002-borrowing-from-your-retirement-plan-to-buy-a-home.html> accessed 11.02.2020.} Another survey found that 29 percent of Millennials—those born between the early 1980s and the mid to late 1990s—used money from a 401(k) plan or IRA to make the down

\[\text{\footnotesize\cite{61 IRC § 72(p).}}\]
\[\text{\footnotesize\cite{62 IRC § 72(t)(2)(A)(v).}}\]
payment for a home purchase.\textsuperscript{64} While purchasing a home is desirable for financial security, it is not a good substitute for a pension for retirement security.

The U.S. employer-provided pension system generally offers greater liquidity to participants than pension systems in other countries. For example, of the six countries that Beshears and coauthors compared—the U.S., UK, Canada, Australia, Singapore and Germany—only the U.S. provides a considerable amount of liquidity in its pension system before age 55.\textsuperscript{65}

Changes in tax laws have made IRAs more liquid over time. While not initially possible when IRAs were first established, a 1997 statutory amendment made it possible to withdraw money from an IRA for the purpose of buying one’s first house.\textsuperscript{66} People who have not owned a home in the past two years are considered to be first-time homeowners. Roth IRAs, discussed above, permit account owners to withdraw their own contributions at any time without penalty because they have already paid taxes on those contributions.\textsuperscript{67}

\textsuperscript{64} A. SHELL, ‘Risky Behavior: 1 in 3 Millennials Dipped into 401(k) or IRA to Finance Home Purchase’ (2018) \textit{USA Today} \\


\textsuperscript{66} IRC § 72(t)(2)(F).

\textsuperscript{67} IRC § 408A(d).
In 2018, Congress enacted rules that make it easier for participants to take hardship withdrawals.\textsuperscript{68} Participants are no longer required to prove to their employer that they face a hardship, but only certify that that is the case. In addition, previously participants had to first exhaust the use of plan loans before they could take hardship withdrawals. Now they can bypass plan loans and directly request a hardship withdrawal. These rules may further increase the amount of liquidity in the form of pre-retirement withdrawals from pension plans. Unlike a plan loan, a hardship withdrawal does not have to be paid back to the plan. Previous experience suggests that people tend not to take hardship withdrawals because they are embarrassed to admit to their employer that they are facing a financial hardship. However, these new rules are part of a trend in legislation that is turning 401(k) plans into generalized savings plans.

Liquidity for plan participants has also increased during retirement because of the decline in annuitization of pension benefits associated with the shift from DB to DC plans. Most DC plans pay out assets on retirement as a lump sum or as a series of periodic payments.\textsuperscript{69}

5 Behavioural Economics, Financial Literacy and Conflicts of Interest

All the factors of complexity, combined with many DC participants having low levels of financial literacy, mean that participants who can afford it often turn to financial advisers for advice. When they do, they frequently encounter an adviser who has a conflict of interest. The advice that provides the adviser the most income is not necessarily the advice that is in the best


\textsuperscript{69} FORMAN, above n. 11.
interest of the participant. That situation often occurs when an adviser advises a client to roll over from a low-fee 401(k) plan to an IRA that the adviser manages and thus receives income based on the advice.

6 The Challenges Ahead

6.1 Expanding Coverage and a Movement Away from Single-Employer Plans

With pension coverage provided by DB plans declining and pension coverage provided by DC plans increasing, that leaves open the question of what has happened to pension coverage rates over all. Munnell et al. examined private-sector pension coverage rates for households where the head was ages 51–56 over the period 1992 to 2010. Their data covered every person who has any assets in a DB or DC plan sponsored by their current or any past employer. They found that the pension coverage rate in 2010 was substantially lower than in 1992, 1998 or 2004, declining from 68 percent of households ages 51–56 in 1992 to 63 percent in 2010.70

One technique used to encourage participation in DC plans is for employers to offer to match employee contributions, though the match rates are generally capped and may not be on a one-to-one basis. Despite both the tax incentive and the incentive provided by the employer matching contributions, some employees who have the opportunity to participate in their employer’s plan fail to do so. The next innovation undertaken by employers to encourage coverage was automatic

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enrolment of employees with the option of opting out, which was described above. While each of these innovations has had some effect in raising DC coverage rates, many policy analysts and government policymakers feel that more needs to be done.

It is likely we will see a variety of approaches to expanding coverage in the coming years. One approach would involve expanding the use of payroll-deduction IRAs. For example, the federal government might require or encourage employers without pension plans to offer automatic payroll-deduction IRAs to their employees. Given the opposition to employer mandates, it is more likely that the federal government would seek to encourage employers to offer plans. Pertinent here, a number of U.S. states are creating state automatic enrolment IRA programs for those employers in their states that do not already provide pensions for their employees. Some of the state programs exclude small employers from the requirements. It is not yet clear, however, whether these state programs are legal under ERISA.71

While multiemployer plans, discussed later, exist in unionized industries, such as the construction industry, another approach would be to increase the utilization of multiple employer plans (MEPs)—qualified pension plans that are permitted to cover employees of unrelated employers. A MEP is designed to provide employers with a pooled plan arrangement that relieves them of much of the administrative, fiduciary, and regulatory burden associated with a single-employer plan. Recent legislation has made it easier for unrelated small employers to band together to use of MEPs.72


72 See, e.g., IRC § 413(e) (added by Public Law No. 94-116, 133 Statutes at Large 2534 [2019]).
6.2 Auto-portability

Although DC plans are by their nature more portable than DB plans, the requirement that 401(k) plans retain assets of people who no longer work for the plan sponsor means that people can end up with numerous 401(k) plans. Having multiple accounts increases the risk that people will lose or forget that they have accounts, or that they die and their heirs might not be aware of the accounts. Moreover, small accounts may not be able to take advantage of economies of scale to reduce the account fees paid by participants.

Retirement savers have multiple ways that they can consolidate their 401(k) account assets. Although, as discussed above, they often are not the best choice, participants can roll over 401(k) assets into an IRA. Increasing numbers of 401(k) plans now permit new employees to roll over assets from plans of their prior employers into the new employer’s plan. Employers and regulators are experimenting with various ways to encourage plan-to-plan rollovers, including offering assistance to new employees to do so and using a clearinghouse to simplify the process.\(^\text{73}\)

6.3 Funding Multiemployer Plans

As well as dividing pension plans by whether they are DB or DC plans, and by whether they are employer-provided or individual plans, the employer-provided DB plans can be divided into three categories, varying by the type of plan sponsor. Those categories are private-sector single-employer plans, private-sector multiemployer plans, and government plans. Most of the discussion thus far has focused on private-sector single-employer plans. Of these three groups of plans, that group’s DB plans have the highest funding rates.

\(^\text{73}\) Muir, above n. 24.
The group with the most serious funding problems is multiemployer DB plans. A multiemployer plan is a pension plan created through agreements between multiple employers and a union. While many multiemployer plans currently have deficits that threaten the ongoing viability of the plans, that has not always been the case. For example, historical data show that in 1988, in aggregate multiemployer DB plans had investment earnings of $22.6 billion and benefit expenses of just $9.5 billion.\textsuperscript{74} In 1986 and 1987, multiemployer DB plans in aggregate were overfunded, with a funding ratio of 106 percent in 1987.\textsuperscript{75}

Currently, multiemployer plans are on average considerably more underfunded than single-employer DB plans.\textsuperscript{76} For example, in 2015, multiemployer plans were only about 46-percent funded on average and had a total underfunded liability of $560.3 billion.\textsuperscript{77} Thus, the funding status of multiemployer plans deteriorated considerably over the time period covered by this chapter. In 2018, Congress created a Joint Select Committee on Solvency of Multiemployer Plans to try to


solve the multiemployer funding problem; however, that committee was unable to come up with a bipartisan solution.\(^{78}\)

Legislation currently makes it possible for underfunded multiemployer plans to reduce the benefits already accrued by participants, but this legislation is highly restrictive so that many underfunded multiemployer plans are unable to take advantage of it.\(^{79}\) Without major benefit cuts, the serious problem of multiemployer plan funding will not be easy to resolve because of the more than half-a-trillion-dollar shortfall.

**6.4 Lifetime Income Solutions**

A consequence of the move away from DB plans is that there is less annuitization of retirement income. This is part of a general trend of shifting risks from employers to plan participants. In 2014, U.S. regulators began amending regulations to enable 401(k) plans to provide participants with the option of using a portion of their account assets to purchase an annuity that would begin after normal retirement age. At least one study predicts that these partial annuities would benefit many participants.\(^{80}\)

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\(^{79}\) Joint Committee on Taxation, above n. 76.


7 Conclusions

A number of important changes have occurred in the U.S. pension system over the past 25 years, with the most influential being the shift to a DC system. In an effort to increase pension coverage, the federal government, some state governments, and employers have all initiated changes that increased the incentives for employees to participate, made participating easier through automatic enrolment, or mandated that employers offer plans to their employees.

The decline in DB plans that predated this period continued, with those plans being replaced by DC plans, primarily 401(k) plans. However, encouraged by the financial services industry, large numbers of pension participants have left the employer-provided retirement income system, rolling over their accounts from the plans of previous employers to IRAs, which do not have the fiduciary protections that employer-provided pension accounts have. Because of these rollovers, IRAs have grown to be the most important type of private-sector plan in terms of dollars of assets.

As a consequence of the shift in pension assets to 401(k) plans and to IRAs, the pension system has become more complex for pension participants. It has become more complex both during the pre-retirement period—when participants generally must make investment decisions, and during the retirement period—when they must figure out a way to make their savings last over an uncertain lifetime. Because of behavioural biases and a lack of financial literacy, many participants are poorly prepared to deal with these issues. Thus, the lack of financial literacy of plan participants has become an increasingly important problem. A further consequence of the shift from DB to DC

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plans is a shift of risk from employers to employees, with employees bearing investment risk and longevity risk in DC plans.

Another change resulting from the shift to DC plans is an increase in liquidity in the U.S. pension system, both pre-retirement and during retirement. The increase in liquidity during retirement is a consequence of a decline in the annuitization of pension benefits. The increase in liquidity pre-retirement has resulted in increased pre-retirement leakage from the system, thus reducing the amount of money workers have saved for retirement.