Changing Landscape of Employment-based Retirement Benefits

by William J. Wiatrowski
Bureau of Labor Statistics

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As the types of retirement benefits provided by employers have changed, so too have plan features.

Retirement income comes from many sources, but except for the independently wealthy and those with large inheritances, the various sources of retirement income for most Americans have some relationship to their work. Social Security is funded by employer and employee payroll taxes. Employment-based retirement benefits, including defined benefit and defined contribution plans, are part of the compensation package of many workers. Personal savings can be built up over a lifetime, but often include Individual Retirement Accounts, which are only available to those who have earnings from work (and nonworking spouses). Further, earnings from current employment have become an increasingly common source of income for older Americans in recent years. This brief review of sources of retirement income will focus on employment-based retirement plans, with an eye toward changes in the types of plans available and changes in how these plans are structured.

It is well documented that the prevalence of defined benefit plans is declining; in many cases, such plans have been replaced by defined contribution plans.[1] As a refresher, defined benefit plans specify a formula for computing benefits that will be received during retirement, typically in the form of an annuity over the lifetime of the retiree and spouse. In the private sector, such plans, when offered, are almost always fully funded by the employer, with employees automatically enrolled in the plan after completing an initial eligibility period, such as 1 year. Such plans are funded as a single account by the employer; to meet certain tax standards, the employer must contribute sufficient funds to pay future benefits promised by the plan, taking into account various actuarial assumptions about the work-life, salary, and life expectancy of the participants. The employer assumes the risk of varying investment returns. Employer contributions change over time, based on those returns and on changes in the demographics of plan participants. State and local governments provide similar plans, often with a contribution required by the participant. Again, it is typical that employees are automatically enrolled in the plan. Depending upon the state, such plans may or may not have requirements to maintain sufficient funds to pay future benefits.[2]

Defined contribution plans have certain features, such as which party is assuming risk, which can be looked at as the opposite of defined benefit plans. In these plans, the amount contributed to the plan—often by both the employee and employer—is specified, while the future value of the plan is unknown. Funds are placed into individual accounts for each employee, with periodic contributions added to the account. The employee assumes the risk of investment gains and losses. When employees retire (or otherwise leave employment), provided they have met any vesting requirements imposed on employer funds, they receive the value of their account.[3]

While both types of plans have existed for many years, defined benefit plans grew in prominence after World War II, while defined contribution plans became increasingly popular in the 1980s, with the advent of 401(k) plans. Such plans allow employees to defer paying taxes on the funds contributed to the plan until the funds are withdrawn. When 401(k) plans were first introduced, they were sometimes supplemental to existing defined benefit plans. The status of defined contribution plans changed over the past 20 years, as the prevalence of defined benefit plans has declined and defined contribution plans have increasingly become the primary source of employment-based retirement benefits for todays and tomorrows workers.

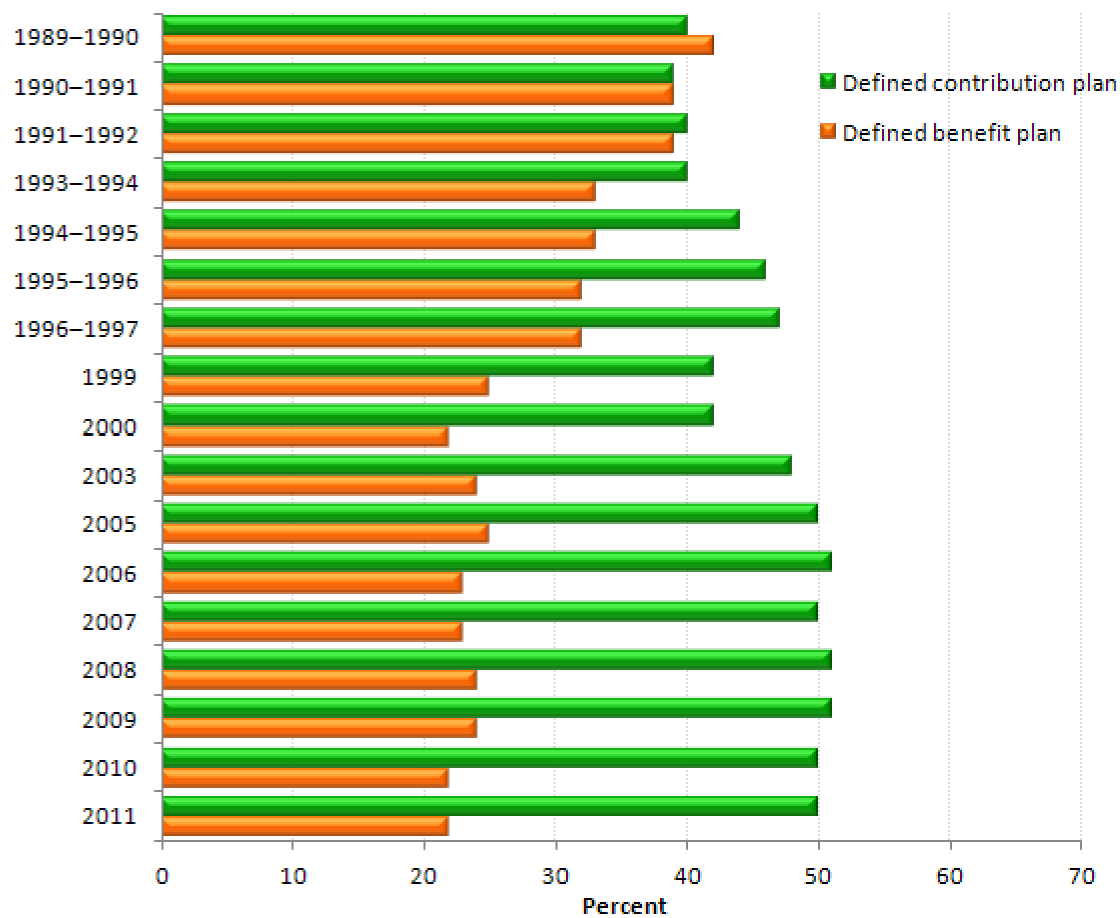
Benefit Incidence

There are various sources of data that can be used to track the shift between defined benefit and defined contribution plans. The BLS National Compensation Survey (NCS), along with its predecessor surveys, captures data from employers on the availability of benefits.[4] These data are published as the percentage of workers who participate in various retirement plans and, more recently, the percent of workers who have access to such plans. While available for almost every year since 1979, the groups of workers for which data are available (private industry, state and local government, full-time workers, etc.) have varied from year to year. The most complete data are for full-time private industry employees; these data can be tracked from the late 1980s until the present. More recent data identify differences in retirement plan coverage for various worker and employer characteristics, such as occupation and industry.

The percentage of full-time private industry workers participating in a defined benefit plan has declined from 42 percent in 1989—90 to 22 percent in 2011. Recent data suggest that this proportion may continue to decline, as 1 in 4 participants in private industry defined benefit plans are in plans that have imposed some type of freeze. This generally entails closing the plan to new workers and potentially ending benefit accruals for current workers. While defined benefit participation has declined, participation in defined contribution plans for full-time private industry workers has increased, from 40 percent in 1989—90 to 50 percent in 2011.

While these numbers show changes in participation by type of plan, it is interesting to note that overall retirement plan participation among full-time private industry workers has been relatively stable. From 1989—90 to 2011, overall retirement plan participation varied from 55 to 62 percent of full-time private industry employees, and currently stands at 59 percent. This acknowledges that many defined contribution plans introduced in the 1980s were provided to workers who already had defined benefit plans; over time—as can be seen in chart 1—these *supplemental* plans (or some subsequent version of these plans) became the primary (or only) retirement plan.

Chart 1. Percent of full-time employees participating in defined contribution and defined benefit plans, private industry, 1989–2011



Source: U.S. Bureau of Labor Statistics, National Compensation Survey

Supplemental defined contribution plans were introduced during the 1980s as a way for employers to provide an additional benefit to employees and often as a means of getting employees to invest in employer stock. Some defined contribution plans still function as supplemental plans, while others serve as the only retirement plan offered by the employer. At the same time, another potential supplemental plan, a defined contribution plan with no employer contributions, is available to 1 in 5 private industry workers and to over half of state and local government workers. Table 1 offers a look at the extent of defined benefit plans and defined contribution plans (with and without employer contributions), as well as combinations of plans, for a variety of worker and employer characteristics. These results reveal some clear trends. For example, defined benefit plans are found most often among workers in large establishments and those covered by collective bargaining agreements. And while defined contribution plans are widespread across a variety of populations, such plans with no employer contribution are seen widely in state and local governments.[5]

Table 1. Percent of employees with access to various retirement benefits, by selected characteristics, 2011

Characteristic	Plans funded at least in part by employer				Defined contribution plan with no employer contribution (2)
	All retirement	Defined benefit plan	Defined contribution plan	Both defined benefit and defined contribution plans (1)	
Private industry	64	20	58	14	19
Full time	73	23	68	18	21
Part time	37	10	31	4	13
Union	90	70	53	33	25
Nonunion	61	14	59	12	18
Lowest 10th percentile of wages	28	5	25	2	9
Highest 10th percentile of wages	87	38	82	33	26
Establishments with fewer than 100 workers	49	9	46	6	11
Establishments with 100 workers or more	81	32	73	24	27
Establishments with 500 workers or more	86	46	77	37	31
Good-producing industries	73	28	66	21	16
Service-providing industries	62	18	57	13	19
Educational services industry	73	16	67	10	32
State and local governments	90	84	30	24	55
Full time	99	92	34	27	60
Part time	41	38	10	7	30
Educational services industry	91	88	26	23	57

Footnotes:
(1) The percent of workers with access to both a defined benefit and a defined contribution plan is calculated as the sum of the percent of workers with separate access to a defined benefit plan and a defined contribution plan minus the percent with access to any retirement plan.
(2) Data for defined contribution plans with no employer contribution are not included in the "all retirement" data.

These data establish which groups of workers have which types of plans. The next step is to examine how plan features are changing, with a specific focus on how features once unique to defined benefit or defined contribution plans are becoming more widespread.

Plan Features Morphing

To look at a variety of changes in plan features, this section will trace the life of a retirement plan for an individual employee, from being hired in the organization through retirement. Tables 2 and 3 provide a summary of these changes.

Table 2. Examples of changes to defined contribution plans

Defined benefit plan traditional feature	How defined contribution plan has emulated defined benefit feature
Employees enrolled in the plan as a condition of employment	Introducing automatic enrollment, where the employer enrolls new employees into the plan
Plan assets are invested in the best interest of plan participants	Allowing employees to make investment decisions more often, but also offering more stable investments (such as lifecycle funds) and reducing investments in employer stock
By distributing benefits in the form of an annuity, plan ensures that employees will not outlive plan benefits	Introducing lifetime annuities as an optional form of distribution

Table 3. Examples of changes to defined benefit plans

Defined contribution plan traditional feature	How defined benefit plan has emulated defined contribution plan
Individual accounts established for each employee, allowing current value of plan to be tracked at any time	Introduce cash balance plans, which specify the current value of each employee’s benefits
When leaving the employer, the value of plan account can be transferred to another employer account or to an Individual Retirement Account (IRA)	Some plans have portability provisions, allowing the transfer of credits or assets. Cash balance plans specify the present value of current benefits, which may be paid in a lump sum when an employee leaves.
Account values are typically distributed as a lump sum	Some plans are adding the option of taking some or all accrued benefits in a lump sum.

Plan enrollment. Defined benefit plans, whether funded entirely by the employer or requiring some employee contribution, generally cover all workers (or all workers in certain groups, such as all permanent, full-time employees) as a condition of employment. In contrast, the most prevalent type of defined contribution plan, the savings and thrift plan, leaves the choice of plan enrollment to the employee. (Savings and thrift plans, as defined by BLS, match employee contributions with employer matching funds. These plans almost always have pretax features under section 401(k) of the Internal Revenue Code.) A new and expanding feature of savings and thrift plans is automatic enrollment, where new employees are covered when they begin employment (or after a short eligibility period) unless they decline. By enrolling all workers, defined benefit plans provide automatic retirement income protection; the extension of automatic enrollment provisions to savings and thrift plans provides the same protection.

Automatic enrollment features designate a default contribution amount and default investments, although employees are free to alter these defaults. Recent data from the BLS show that about 1 in 5 private industry employees covered by a savings and thrift plan are in a plan with automatic enrollment features, with a slightly higher proportion among the largest establishments. A typical default contribution amount is 3 percent of earnings, which usually results in less than the maximum employer matching funds (the median plan matches up to 5 percent of earnings). Some plans go beyond this initial enrollment and automatically increase the default contribution over time, such as an increase of 1 percent per year for the next 3 years.[6]

Individual accounts. Once in the plan, employees have various means of identifying the current value of their plan benefits. Defined contribution plans establish individual accounts that employees can review to track the deposit of periodic contributions and the results (positive, negative, or neutral) of investments. The typical defined benefit plan does not have such accounts and lacks an easy way for employees to understand the value of future benefits. In a defined benefit plan that computes benefits based on a percent of earnings and years of service, employees in their early working years would be hard-pressed to translate that formula into a dollar amount of periodic benefit at retirement, beyond a rough percentage (45 percent of final earnings at 30 years of service, for example). But a new type of defined benefit plan helps employees to understand the value of their benefits.

Cash balance plans are a type of defined benefit plan first identified in the 1990s. BLS data indicate that about 1 in 3 private industry employees covered by a defined benefit plan are currently covered by a cash balance plan. These plans are often described as hybrids between defined benefit and defined contribution plans, although they are officially a defined benefit plan under IRS plan qualification rules. As with other defined benefit plans, the plan establishes a formula. In the case of cash balance plans, the formula is an amount of employer contribution and an interest rate. Periodically, the employer contribution (such as 1 percent of earnings) and the interest rate (a fixed percent or based on some index) are credited to each employee; employees have the ability to see the value of their account at any time. The individual plan value is essentially the present value of the future benefits; at retirement, the account value could be paid in a lump sum or turned into a lifetime annuity.

While the individual account feature of a cash balance plan makes such plans resemble defined contribution plans, from an employer perspective these plans are defined benefit plans. The employer does not actually fund the individual accounts but rather keeps a common fund sufficient to pay all future benefits (the same as all other defined benefit plans). Funding of the plan as a whole takes into account the demographics of the employee group, actuarial assumptions, investment results, and other factors. Despite this, the plan provides an account value that is unavailable in other types of defined benefit plans and also offers greater flexibility for distributing benefits. More details on plan distribution features are discussed below.

Plan investments. Investment of plan assets differs between defined benefit and defined contribution plans. In defined benefit plans, plan fiduciaries (those responsible for managing the plan) must act “solely in the interest of plan participants.”[7] Regulations restrict certain investments, such as having too large a percentage of funds invested in company stock. In defined contribution plans, each individual account may be invested differently. Some plans may be designed for specific investments, such as Employee Stock Ownership Plans and Stock Bonus plans, where the intent is to invest in employer stock. In other types of defined contribution plans, investments can vary from employee to employee.

The most prevalent type of defined contribution plan, the savings and thrift plan, has gradually changed in recent years to offer participants more control over investments and more opportunity to move away from investment in employer stock. When first introduced in the early 1980s, often as supplemental to defined benefit plans, some plans offered a choice of investments for employee contributions while fewer plans offered a choice of investments for employer matching funds. Often, these matching funds were automatically invested in employer stock. Where employees did have a choice of investments (for either employee or employer funds), employer stock was a frequent investment option. Over time these plan features have changed. In recent years, a greater proportion of plan participants are able to choose how to invest employer matching funds and a smaller proportion have employer stock as an investment option.[8] At the same time, there has been a growth in investment choices designed to provide a balanced portfolio and to take account of an employees age and time frame for needing the funds. Further, there has been an expanded emphasis on investment education for plan participants. These changes may help to manage the risk of defined contribution plans investments, not unlike the responsibilities imposed on defined benefit plan fiduciaries help to manage the risk of those plans.[9]

Portability. Defined contribution plans, with their individual accounts, are designed to be portable. Employees can maintain the value of their retirement account, subject to vesting requirements imposed on employer funds, even if they leave their current employer. Upon separation from the employer, employees are given options for the distribution of their account value, including transferring funds to an Individual Retirement Account or to a similar defined contribution plan of a subsequent employer. Many employers accept such rollover of plan funds from other plans. By maintaining account values from multiple jobs, employees can continue to build their total retirement savings, whether in a single account or in multiple accounts.

Such portability of plan values is more difficult to achieve in a defined benefit plan, where assets are combined into a single account for all participants and are based on the unique plan features and actuarial make-up of the entire covered population. BLS data from the late 1990s indicate that only a small percent of defined benefit plan participants are covered by portability provisions; no recent data are available. The 1990s provisions were often restrictive, only allowing the plan value (either assets or credits) to be transferred to certain similar plans. For example, plans from related employers (perhaps subsidiaries or as the result of a merger or acquisition) or in related industries may have reciprocal arrangements allowing workers to be transferred from one plan to another. Such arrangements are commonly observed among state and local government defined benefit plans. A unique portability provision applies to certain workers covered by multiemployer pension plans, which are generally established by a union in industries where employees move from one employer to another, such as construction. In these plans, funding and credits are provided by each affiliated employer to the pension fund; the employees pension is the result of all of these funds and credits, often from several employers.

Cash balance plans offer a different method of portability by maintaining a known account value at all times. Employees who leave their employer may receive their account value in a lump sum, subject to certain restrictions. Much like distributions from defined contribution plans, the value of a cash balance plan can be transferred to another tax-deferred account, such as an IRA, and continue accruing earnings to be used for future retirement benefits.

Plan distributions. At retirement, the default distribution method for defined benefit plans is typically an annuity, providing periodic payments for the life of the retired employee (and often a designated survivor), whereas the default distribution method for defined contribution plans is typically a lump sum. For both types of plans, there is evidence that these default distribution methods are changing. About half of defined benefit plans now offer the option to receive benefits as a lump sum, calculated as the present value of the future stream of benefits. (Or, put another way, as the amount needed to purchase an annuity.) Lump-sum distribution options are especially prevalent in cash balance plans, where the lump-sum value is always known.

Conversely, defined contribution plans are offering the option of receiving benefits in the form of a periodic annuity, rather than as a lump sum. Much like the move to automatically enroll workers in defined contribution plans to help them save for retirement, the move to distribute benefits in the form of an annuity is designed to help ensure that sufficient funds will be available throughout retirement.[10]

Putting It All Together

Employment-based retirement benefits remain an important component of total retirement income. Despite changes in plan types and features, about 40 percent of all Americans age 65 and over receive some income from an employers defined benefit or defined contribution plan.[11] The variety of plan trends identified here fall under the heading of mitigating risk. By encouraging employees to begin savings for retirement, by offering some protection against investment risk, by providing greater information on the current and future value of benefits, and by providing options to ensure that retirees dont outlive their benefits, retirement plans are attempting to help employees begin planning for retirement at an early age and to continue that planning throughout their work life.

William J. Wiatrowski
Economist, Office of Compensation and Working Conditions, Bureau of Labor Statistics.
Telephone: (202) 691-6300; E-mail: Wiatrowski.William@bls.gov.

Notes

1 The U.S. Department of Labor compiles data on retirement plans provided by plan sponsors, including information on number of plans and number of active employees participating in plans. These and many additional statistics showing trends in retirement plans over many years are available at http://www.dol.gov/ebsa/pdf/historicaltables.pdf.

2 One source of information on government employee retirement systems is the Government Accounting Standards Board, www.gasb.org. Recent proposals to change accounting standards for government retirement systems include background information on these plans.

3 The availability of employer funds may be subject to vesting rules, which require that employees participate in the plan for a certain number of years. The length of vesting schedules for defined benefit plans has declined over the past quarter century, with full vesting now typical after 5 years. Todays defined contribution plans have a number of different vesting provisions, including some that provide immediate vesting of all employer funds and some that vest funds gradually, with full vesting after 3 or 5 years.

4 For more information on the National Compensation Survey, see the NCS home page on the BLS website at http://www.bls.gov/ncs/.

5 The percentage of workers with access to both a defined benefit and a defined contribution plan can be calculated as the sum of the percentage of workers with separate access to a defined benefit plan and a defined contribution plans minus the percentage with access to any retirement plan. The results of this calculation are shown in table 1. For more information on retirement plans with no employer contributions, see William J. Wiatrowski, “The Structure of State and Local Government Retirement Benefits, 2008,” *Compensation and Working Conditions On-Line*, posted February 25, 2009, http://www.bls.gov/opub/cwc/cm20090218ar01p1.htm.

6 There has been ongoing debate about the effect of automatic enrollment features on plan participation and on the level of contribution. For a discussion of this topic, see “401(k) Law Suppresses Retirement Savings,” *Wall Street Journal*, July 7, 2011, http://online.wsj.com/article/SB10001424052702303365804576430153643522780.html?mod=WSJ_hp_MIDDLETopStories.

7 The Employee Benefits Security Administration, an agency of the U.S. Department of Labor, regulates the activities of retirement plan fiduciaries. Details about the responsibilities of fiduciaries, including restrictions on investments in employer stock, are available at http://www.dol.gov/ebsa/publications/fiduciaryresponsibility.html.

8 More details on changes in investment options in defined contribution plans are available in “401(k) Plans Move Away from Employer Stock as Investment Vehicle,” *Monthly Labor Review*, November 2008, pp. 3—10, http://www.bls.gov/opub/mlr/2008/11/art1full.pdf. More recent data are available from the BLS Program Perspectives, “Defined-Contribution Plan Investment Choices,” June 2011, http://www.bls.gov/opub/perspectives/program_perspectives_vol3_issue5.pdf.

9 U.S. Department of Labor information on defined contribution investments is available at http://webapps.dol.gov/FederalRegister/HtmlDisplay.aspx?DocId=13321&AgencyId=8&DocumentType=2.

10 The U.S. Department of Labor is exploring options to encourage the distribution of defined contribution accounts in the form of lifetime annuities. Information on recent Department of Labor activities on this issue is available at http://www.dol.gov/ebsa/regs/cmt-1210-AB33.html.

11 *Income of the Aged Chartbook, 2008* (Social Security Administration, April 2010), http://www.socialsecurity.gov/policy/docs/chartbooks/income_aged/.

Chart 1. Percent of full-time employees participating in various retirement benefits, private industry, 1989—2011

Year	Any retirement plan	Defined benefit plan	Defined contribution plan
1989—1990	62	42	40
1990—1991	60	39	39
1991—1992	61	39	40
1993—1994	58	33	40
1994—1995	60	33	44
1995—1996	61	32	46
1996—1997	62	32	47
1999	56	25	42
2000	55	22	42
2003	58	24	48
2005	60	25	50
2006	60	23	51
2007	60	23	50
2008	60	24	51
2009	61	24	51
2010	59	22	50
2011	59	22	50