Retirement Plan Design and the Mobile Workforce

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Today's mobile workforce faces complicated rules and choices regarding the accumulation of retirement income benefits from employer plans.

Lord I was born a ramblin' man,
Tryin' to make a livin' and doin' the best I can.
And when it's time for leavin',
I hope you'll understand,
That I was born a ramblin' man.

While singing about "tryin' to make a livin'" in the 1970s, Dickey Betts and the Allman Brothers Band may not have worried too much about planning for retirement.[1] In contrast, today's "rambling" worker--only 31 percent of workers in 2004 had been with their current employer for 10 or more years[2]--may need to be concerned about the availability of retirement benefits as they move from job to job. Employer-provided retirement income plans, which were traditionally designed to reward those who stayed with the same employer for their entire career, have been modified in many cases to mitigate the effect of switching jobs. Still, employees must be aware of plan rules, because making the wrong move can be costly. For example, consider the following:

- Employees who switch employers typically cannot continue to accrue benefits in the same employer retirement plan.
- Rather, departing employees may have to "cash out" or transfer their accumulated benefits.
- Employer plans often require new employees to work for a period of time before they become a participant in a retirement plan and to complete an additional number of years of service before they gain a nonforfeitable right to their retirement benefits. These rules can limit the accumulation of benefits among job switchers.
- Benefits typically accumulate in employer plans on the basis of years of service, with greater benefits going to those who stay with the same employer for a number of years.

This is the first of two companion articles on the effect of job switching on employer-provided retirement income benefits. The focus of this article is plan features that can affect the benefits of those who switch jobs. The second article, scheduled for publication in the *October* issue of *Compensation and Working Conditions Online*, looks at the options available to employees once they have made the decision to leave an employer that provides retirement income benefits. This present article begins with some background information on job tenure. It then discusses various types of retirement plans and how they are affected by job tenure. The article concludes with a brief discussion of certain kinds of occupations that do not lend themselves to long service, such as limited-term political jobs or professional athletes. Data on employment and retirement income trends from the Bureau of Labor Statistics form the basis for much of this analysis.

Employee Mobility

The much-discussed "mobile workforce" is difficult to measure. Data from surveys of individuals indicate that the median time that workers had been with their current employer was 4.0 years as of January 2004. This median has risen slightly over the last two decades, from 3.5 years in 1983. (See table 1.) Among workers age 25 and over, the percent that have been with their current employer for 10 years or more has held fairly steady since 1983, at just over 30 percent. But these data mask the fact that the percent of men with such long tenure has declined while the opposite is true for women. Not surprisingly, the tenure data also show that as American workers get older, their tenure increases.[3]

Other sources of data describe the mobile workforce in different ways. BLS data on labor turnover from a survey of employers suggest that employees are changing jobs frequently. Over the past few years, for example, nearly 50 million hires and 50 million separations have occurred in any 12-month period.[4] In some cases, the same workers exited and entered the labor force multiple times. This "churning" of the labor force may make it difficult for such workers to accumulate retirement benefits.

Data from the National Longitudinal Surveys program on the job experience of younger Americans indicate that those born from 1957 to 1964 held an average of 10.2 jobs from ages 18 to 38. The data also show that as they grew older, these baby boomers changed jobs less frequently: They held 4.4 jobs from ages 18 to 22, 3.3 jobs from ages 23 to 27, and 2.6 jobs from ages 28 to 32. Still, many of these workers continued to change jobs fairly frequently well into their 30s. Among those who started a job from ages 33 to 38, 39 percent had ended it in less than a year, and 70 percent had moved on in less than 5 years.[5]

Retirement Plan Design

An individual covered by an employer-sponsored retirement plan who leaves that employer for another job may be impacted in a number of ways. First, many retirement income plans impose eligibility requirements; new employees are not allowed to participate in the plan until they have been working with the employer for a period of time, typically 1 year.[6] Those who switch jobs frequently may not be eligible for retirement benefits from some of their employers or may have gaps in coverage due to eligibility requirements. As table 2 shows, these provisions have been largely consistent over the past two decades.

A second feature of plan design is that plans often include a vesting requirement, which is the amount of service an employee must complete before they obtain a nonforfeitable right to the benefits of the plan. The length of vesting requirements has declined over the past 30 years, in response to changes in pension law designed to lessen the penalties imposed on short-service workers.[7] (See table 3.) Currently, most plans impose a 5-year vesting requirement. Those who leave their job prior to meeting this vesting requirement generally lose all rights to future benefits funded by the employer, although all benefits funded by the employee are fully vested.

Eligibility and vesting features are similar for both defined benefit plans (which specify benefits available to employees at retirement and require employers to provide sufficient funds to pay these benefits) and defined contribution plans (which specify contributions placed in individual employee accounts and identify retirement benefits as the accumulated contributions and earnings in the account). Another similarity between these types of plans is the effect of tenure on the ultimate benefit available from the plan. While plan contributions and benefit payments are structured differently, in each type of plan increases in service generally lead to increases in benefits. Some of the specific differences in the various types of plans are described in the paragraphs that follow.

In a *defined benefit* plan, the relationship between employee tenure and benefit accumulation is often straightforward--the more time you work, the greater the benefit you accumulate. This may be as simple as a one-to-one relationship between years of service and benefit accumulation. For example, a flat dollar-amount defined benefit pension, which is typically available to blue-collar workers covered under a collective bargaining agreement, might provide a monthly pension of $40 per year of service. Employees with 5 years of service would receive $200 per month; those with 6 years of service would receive $240 per month, and so on. Similarly, a flat percent-of-earnings plan, typical of white-collar worker plans, might provide 1 percent of final earnings times the number of years of service. Employees with 10 years of service would receive 10 percent of earnings; those with 11 years of service would receive 11 percent.

The relationship between tenure and benefit accumulation may be more complicated, with some defined benefit plans providing greater benefits for later years of service than for earlier years. For example, a plan may express benefits as 1 percent of final year earnings for each of the first 10 years of service and 1.5 percent of final year earnings for the 11th year and beyond. Under this type of plan, those leaving after 10 years of service would receive benefits equal to 10 percent of final earnings; those leaving after 11 years of service would receive benefits equal to 11.5 percent of final earnings.

The effect of these service-related formulas can be seen in the calculation of replacement rates--the percent of pre-retirement income that will be paid by a defined benefit plan. (See table 4.) Consider an employee who earns $40,000 in the year prior to leaving the employer. The available benefit will vary depending upon the plan formula and years of service. The replacement rate calculations consider three formulas--one a fixed percentage rate, regardless of the number of years of service, and two others that increase after a certain number of years. Two effects are evident in table 4. First, as the number of years of service increases, benefits increase. This is true regardless of the benefit formula. Beyond that, however, those formulas that increase with service provide greater benefits at greater years of service. At 30 years, the 1-percent formula provides a benefit of 30 percent of earnings; the formulas that increase with service provide as much as 45 percent of earnings.

Additional plan features can increase benefits even further as service increases. For defined benefit formulas that provide a percent of earnings (regardless of the formula), the plan defines how the earnings are to be calculated. Unlike the simple replacement rate examples described previously, most plans use multiple years of earnings and calculate an average of earnings to be used in the benefit formula. Among the earnings calculations found in defined benefit plans are an average of the highest 5 years of earnings or, less often, an average of the highest 3 years of earnings. Some plans add the complexity of looking at the highest 3 or 5 consecutive years of earnings or the highest 5 out of the last 10 years, or some other variation. Assuming that most workers get an increase in salary every year, using earnings in the years closest to the current year will generally provide the greatest benefit. The definition of earnings designated in the formula is yet another way that service affects retirement benefits.

A recent variation on defined benefit plans is known as a *hybrid plan*, which includes cash balance plans and pension equity plans. Hybrid plans identify a lump sum balance that is available to the employee upon retirement and require employers to maintain sufficient funds in the plan to pay the lump sum. In general, the balance in the plan increases with each year of service. And in many cases, the amount added to the balance gets larger as service increases. For example, a plan might specify an annual credit to an employees account equal to 2 percent of earnings for each of the first 5 years of service, 4 percent for the next 10 years of service, and 6 percent for each subsequent year.[8]

In a *defined contribution* plan, increased service results in more years that the employee and employer are making contributions to the employee's account. In addition, increased service means previous contributions have had more time to accumulate earnings. Chart 1 illustrates the effects of compounding on contributions to an employer retirement plan.[9]

In a small number of cases (3 percent of participants in 2002), plans provide greater employer contributions to those with greater service. A typical 401(k) savings plan might indicate that the employee can contribute from 1 percent to 16 percent of earnings, and that the employer will match 50 percent of the first 6 percent of earnings contributed. Thus, if the employee contributed 6 percent or more of earnings, the employer would contribute 3 percent of earnings. In a plan that varies with service, the employer contribution might be 50 percent of the first 6 percent of earnings contributed for those with up to 10 years of service; but it would rise to 75 percent for those with 11 to 20 years of service, and to 100 percent for those with more than 20 years of service. Under such a formula, the maximum employer contribution is 3 percent of earnings for the first 10 years of service, 4.5 percent of earnings for years 11 to 20, and 6 percent of earnings for more than 20 years of service.

While most of the provisions just discussed demonstrate that longer tenure can be more advantageous to plan participants, there is at least one feature of defined contribution plans that favors short service employees. Employers may want to encourage defined contribution plan participation among newer employees to meet certain nondiscrimination tests. By law, pretax contributions to 401(k) plans must not unduly favor highly compensated employees.[10] Plan sponsors are required to comply with this rule by comparing the average pretax contribution of highly paid employees to the contributions of all other employees. Encouraging plan participation among newly hired workers, who typically will not be highly paid, can help plans to pass these nondiscrimination tests. Some plans have gone as far as automatically enrolling newly hired workers into a defined contribution plan, with an automatic contribution amount and an investment profile. While workers can opt out of such a plan, studies indicate that workers often maintain their participation.[11] BLS first explored this topic in its benefits survey in 2002 and found that 5 percent of those enrolled in 401(k) savings plans were covered by an automatic enrollment feature.

Short-service Occupations

A few unique occupations may not lend themselves to long service--for example, politicians and professional athletes. Politicians run the risk of not being re-elected, or may have legal limits imposed on their number of terms in office. For example, governors in many States are limited to two full terms in office (typically 8 years) and some State legislatures have similar limits. Professional athletes generally can maintain a high level of performance or endure the physical challenges of their job only for a limited number of years. In these cases, the occupations do not allow for an accumulation of a lifetime of service. The special circumstances of these occupations are taken into account in their retirement benefits.

Many government employee retirement plans have special provisions for elected officials to prevent them from being penalized for term limits or lost elections. For example, a plan may allow elected officials to be eligible for benefits at the plan's earliest retirement age (typically age 55) after only a few years of service. Nonelected employees may have the same retirement age requirement, but typically they would have to meet a longer service requirement. Similarly, the provisions of the National Football League retirement plan are designed to provide benefits to short-service athletes. Players must be on the roster of an NFL team for at least three seasons to qualify for benefits, with benefits increasing as the number of seasons increases.[12]

What Can A Worker Do After Leaving A Job?

So what about a worker who is not a governor or a quarterback but still had a short career with his or her last employer? Such workers face a decision regarding their accumulated retirement benefits. In the next issue of *Compensation and Working Conditions Online*, the companion article "Preretirement Distributions: Can you take them with you?" attempts to answer this question by looking at the consequences of leaving an employer and the various options available to such workers.

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Notes

1 "Ramblin' Man," words and music by Dickey Betts, Unichappell Music Inc. and F.R. Betts Music Co., 1973; from the album *Brothers and Sisters* by the Allman Brothers Band (Capricorn Records, released 1973).

2 See *Employee Tenure in 2004*, USDL 04-1829 (U.S. Department of Labor), September 21, 2004, table 2; on the Internet at http://www.bls.gov/news.release/pdf/tenure.pdf. The data in this news release are from the Current Population Survey (CPS); the cited figures are for wage and salary workers aged 25 years and over.

3 *Ibid*. For background information on the concept of employee tenure and how to interpret the data, see the technical note.

4 These data are from the Job Openings and Labor Turnover Survey. For more information on this survey, see Kelly A. Clark, "The Job Opening and Labor Turnover Survey: what initial data show," *Monthly Labor Review*, November 2004, pp. 14-23.

5 See *Number of Jobs Held, Labor Market Activity, and Earnings Growth Among Younger Baby Boomers: Recent Results from a Longitudinal Survey*, USDL 04-1678 (U.S. Department of Labor), August 25, 2004; on the Internet at http://www.bls.gov/news.release/pdf/nlsoy.pdf.

6 Unless otherwise indicated, all data on benefit provisions are from the BLS National Compensation Survey. See *National Compensation Survey: Employee Benefits in Private Industry in the United States, 2002-2003*, Bulletin 2573 (Bureau of Labor Statistics, January 2005); on the Internet at http://www.bls.gov/ncs/ebs/sp/ebbl0020.pdf.

7 For more information on changes to vesting schedules, see John W. Thompson, "Defined Benefit Plans at the Dawn of ERISA," *Compensation and Working Conditions Online*, March 30, 2005.

8 For more information on hybrid defined benefit plans, see Kenneth R. Elliott and James H. Moore, Jr., "Cash Balance Pension Plans: The New Wave," *Compensation and Working Conditions*, Summer 2000, pp. 3-11; and L. Bernard Green, "What is a Pension Equity Plan?," *Compensation and Working Conditions Online*, October 29, 2003.

9 For a study on the effect of compound interest on employer defined contribution plans, see Michael Bucci, "Contributions to savings and thrift plans," *Monthly Labor Review*, November 1990, pp. 28-36.

10 Section 401(k) of the Internal Revenue code identifies a feature of defined contribution plans that allows employees to contribute pretax funds. Most often, 401(k) features are part of savings and thrift plans, with employee pretax funds matched (in whole or in part) by employer funds. Such plans are often referred to as "401(k) plans." Another feature of these plans is that they do not discriminate in favor of highly compensated employees. To ensure this, plans are required to conduct nondiscrimination tests to compare pretax contributions of different groups of workers. For information on these tests and recent changes to them, see "Treasury and IRS Finalize Comprehensive Rules for 401(k) Plans," JS-2171 (U.S. Department of Treasury), December 28, 2004.

11 For more information on automatic enrollment plans, see Brigitte C. Madrian and Dennis F. Shea, "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior," *The Quarterly Journal of Economics*, (November 2001), pp. 1149-87.

12 One example of special provisions for elected officials is the special treatment of members of Congress within the Federal Employees Retirement System (FERS). For details on these special provisions, see the website of the U.S. Office of Personnel Management at http://www.opm.gov/fers_election/ri_90/f_seg.htm, visited August 6, 2005. For more information on the National Football League retirement plan, see the NFL website at http://www.nfl.com/news/story/5356696, visited August 6, 2005.

Table 1. Employee tenure with current employer, employed wage and salary workers, 1983-2004

	January 1983	January 1987	January 1991	February 1996	February 1998	February 2000	February 2002	January 2004
Median years of tenure by age group								
16 years and over	3.5	3.4	3.6	3.8	3.6	3.5	3.7	4.0
25 years and over	5.0	5.0	4.8	5.0	4.7	4.7	4.7	4.9
25-34	3.0	2.9	2.9	2.8	2.7	2.6	2.7	2.9
35-44	5.2	5.5	5.4	5.3	5.0	4.8	4.6	4.9
45-54	9.5	8.6	8.9	8.3	8.1	8.2	7.6	7.7
55-64	12.2	11.6	11.1	10.2	10.1	10.0	9.9	9.6
65 and older	9.6	9.5	8.1	8.4	7.8	9.4	8.6	9.0
Percent of employees 25 years and over with 10 or more years of tenure by gender								
All workers	31.9	30.7	32.2	30.5	30.7	31.5	30.8	30.6
Men	37.7	35.0	35.9	33.1	32.7	33.4	32.6	32.4
Women	24.9	25.7	28.2	27.6	28.4	29.5	28.8	28.6

Source: Employee Tenure in 2004, USDL 04-1829 (U.S. Department of Labor), September 21, 2004, tables 1, 2.

Table 2. Eligibility requirement information for retirement plan participants(1), 1982-2002

Year	Percent required to work a specified length of service	Average service requirement
Defined benefit plans		
1982	57	-
1983	60	-
1984	60	-
1985	56	-
1986	56	-
1988	63	-

Footnotes:
(1) Data are generally for full-time workers in larger private industry establishments.
(2) Data are for savings and thrift plans, which typically have been the most prevalent type of defined contribution plan.

NOTE: Dashes indicate data not available.

Year	Percent required to work a specified length of service	Average service requirement
1989	61	-
1991	67	-
1993	62	11.2 months
1995	66	11.6 months
1997	65	11.7 months
2000	68	11.8 months
2002	67	11 months
Defined contribution (savings and thrift) plans (2)		
1985	86	-
1986	89	-
1988	84	-
1989	84	-
1991	80	-
1993	79	10.8 months
1995	67	11.3 months
1997	75	10 months
2002	75	9.1 months

Footnotes:
(1) Data are generally for full-time workers in larger private industry establishments.
(2) Data are for savings and thrift plans, which typically have been the most prevalent type of defined contribution plan.

NOTE: Dashes indicate data not available.

Table 3. Percent of participants in defined benefit pension plans by vesting provisions, 1980-2002

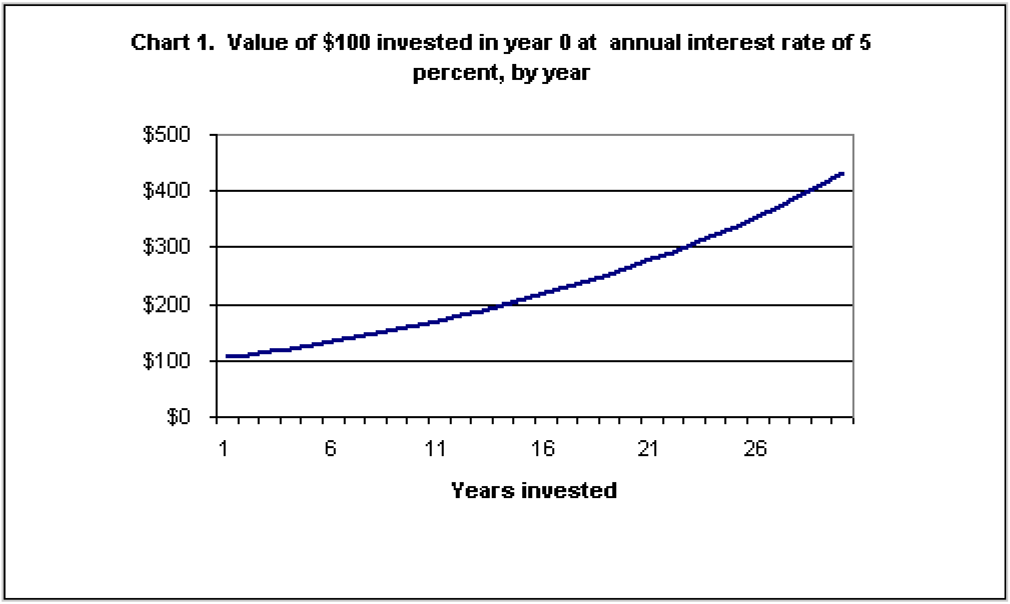
Year	10 year cliff vesting(1)	5 year cliff vesting(1)	Other vesting provision(2)
1980	89	-	11
1985	86	-	14
1989	38	50	12
1995	6	90	4
2000	1	91	8
2002	1	82	17

Footnotes:
(1) Under cliff vesting, no benefit is available until the specified years of service are met.
(2) Other vesting provisions include cliff vesting at different years, graded vesting (which gives employees the right to an increasing amount of benefit over time), immediate vesting, and cases where the vesting provisions are unknown.

NOTE: Dashes indicate data not available.

Table 4. Example of replacement rates from defined benefit plans with differing formulas

Benefit formula	Benefit amount/Amount replaced	10 years	11 years	20 years	30 years
1 percent	Annual benefit	$4,000	$4,400	$8,000	$12,000
	Replacement rate	10 percent	11 percent	20 percent	30 percent
1 percent up to 10 years; 1.5 percent thereafter	Annual benefit	$4,000	$4,600	$10,000	$16,000
	Replacement rate	10 percent	11.5 percent	25 percent	40 percent
1 percent up to 10 years; 1.5 percent up to 20 years; 2 percent thereafter	Annual benefit	$4,000	$4,600	$10,000	$18,000
	Replacement rate	10 percent	11.5 percent	25 percent	45 percent
Note: All calculations assume final earnings of $40,000 per year.					



Data for Chart. Value of $100 invested in year 0 at annual interest rate of 5 percent, by year

After Year Number...	Value
1	$105.00
2	$110.25
3	$115.76
4	$121.55
5	$127.63
6	$134.01
7	$140.71
8	$147.75
9	$155.13
10	$162.89
11	$171.03

After Year Number...	Value
12	$179.59
13	$188.56
14	$197.99
15	$207.89
16	$218.29
17	$229.20
18	$240.66
19	$252.70
20	$265.33
21	$278.60
22	$292.53
23	$307.15
24	$322.51
25	$338.64
26	$355.57
27	$373.35
28	$392.01
29	$411.61
30	$432.19

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