

How Does Dipping into Your Pension  
Affect Your Retirement Wealth?

*Gary V. Engelhardt*

No. 22/2001

**Gary V. Engelhardt** is Associate Professor of Economics and Senior Research Associate, Center for Policy Research, in the Maxwell School of Syracuse University. His research focuses on households' saving decisions, the economics of pensions and Social Security, and the economics of housing markets.

Some of this research was sponsored by the U.S. Department of Labor under Contract No. B9374558.

The Policy Brief series is a collection of essays on current public policy issues in aging, health, income security, metropolitan studies, and related research done by or on behalf of the Center for Policy Research (CPR) at the Maxwell School of Syracuse University.

Single copies of this publication may be obtained at no cost from the CPR Web site at <<http://www-cpr.maxwell.syr.edu>> or from the Center for Policy Research, 426 Eggers Hall, Syracuse, NY 13244-1020.

© 2001, Syracuse University. This publication may be distributed freely for educational and researcher uses as long as this copyright notice is attached. No commercial use of this material may be made without express written permission.

## Policy Brief

---

How Does Dipping into Your Pension  
Affect Your Retirement Wealth?

*Gary V. Engelhardt*

# How Does Dipping into Your Pension Affect Your Retirement Wealth?

---

## Introduction

Although pensions, both public and private, are intended to provide income during retirement, a growing number of American workers receive part or all their employer-provided pensions in the form of a cash settlement, called a lump-sum distribution, when they change jobs. They have many choices of what to do with that money: for example, they can roll it over into an Individual Retirement Account (IRA), spend the money or pay off debt, transfer it to the pension plan of a new employer, or even leave the money with the old employer's pension plan. Policymakers are concerned that workers who spend their pension distributions on current consumption are depriving themselves of the financial resources they will need for retirement.

This policy brief describes some results from an ongoing study on the long-term economic consequences of lump-sum pension distributions.<sup>1</sup> The study uses detailed information on employment histories, pensions, and wealth from Wave 1 (1992) of the Health and Retirement Study (HRS), a nationally representative survey of individuals between the ages of 51 and 61.

The primary finding is that overall there is little evidence that dipping into pension funds significantly decreases retirement wealth, because workers typically consume pension distributions of relatively small value while preserving large pension accumulations for retirement. If pension assets that were spent had been preserved for retirement instead, they would have represented only about 10 percent of retirement wealth for the

## *Aging Studies Policy Brief*

typical household that spent the money. There is, however, a small group of households who would have benefited greatly if they had preserved all their pensions. About 2 percent of all households aged 51 to 61 in 1992 could have increased their retirement wealth by at least 25 percent if they had not dipped into their pensions.

## Background

Retirement requires individuals to have accumulated assets to maintain consumption..., income, whether in the form of state-provided retirement or disability benefits, private pensions, income from other family members, or assets. (Costa 1998, pp. 14, 32)

The concept of retirement as a complete, voluntary withdrawal from the paid labor force is relatively new in this country. Until well into the nineteenth century, the United States was primarily a rural, agricultural economy, where family members worked in and for the family according to their ability—age and health—throughout their lifetime. Because families derived no benefit from deliberately idling one of their members, there was virtually no “unemployment,” and “retirement” was the result of disability, not choice, among all but the wealthy. As recently as 1880, nearly 80 percent of men aged 65 and older were gainfully employed; that is, they claimed to have had an occupation in the year before the census was taken. By 1990, the proportion of employed and retirees among older men had flipped: more than 80 percent of men aged 65 and older were retired from the paid labor force. (For more information about the historical events that shaped retirement in twentieth century America, see Costa 1998 and Sass 1997.)

Today, most Americans rely on what has commonly been described as a “three-legged stool”—Social Security, private pensions, and personal savings—to provide retirement income. This policy brief uses the broader concept of wealth, the total accumulation of assets, to measure a household’s retirement resources.<sup>2</sup>

## *Pensions*

About half of all private-sector workers participate in a retirement plan, or pension (US DOL 1999). This policy brief focuses on the most important type of private pensions, those provided by firms as a benefit of employment. There are two types of employer-provided pensions.

The traditional **defined benefit (DB) pension** dominated the first three-quarters of the twentieth century. With this type of pension, benefits are based on a formula that usually involves some combination of final salary, age, and years of service. DB pensions were designed in part to encourage a stable, dependable, immobile workforce that stayed with one employer for a lifetime. Employees do not contribute to DB plans and, in the past, most DB plans did not allow employees access to pension funds upon job change. Federal law now permits these plans to cash out pension benefits upon job change (or plan termination) if the benefit amount is less than \$5,000.<sup>3</sup>

**Defined contribution (DC) pension** plans have grown in popularity in the last few decades, as the work environment has moved away from long-term commitments between employer and employee. With this type of pension, assets accumulate in individual accounts through contributions by the employer and/or employee, as well as through interest earnings. Almost all defined contribution plans allow workers to access their pension funds upon job change. New federal legislation enables workers to carry their pensions with them from job to job in many cases.

In 1975, 68 percent of all pension plan participants were enrolled in only a DB plan, 13 percent were in only a DC plan, and 19 percent were in both types of plans. By 1996, those figures were 19 percent, 50 percent, and 31 percent respectively (US DOL 1999).

The **401(k) plan** is a defined contribution plan funded primarily by voluntary employee contributions. These were first authorized in 1978 but came into popular use after the IRS issued clarifying

### *Aging Studies Policy Brief*

regulations in 1981. Today, 401(k)s are the most common DC plan, covering over 30 percent of all private wage and salary workers, and about 65 percent of all pension covered workers (US DOL 1999).

The federal tax code discourages cash pension settlements before retirement or disability in several ways. First, pensions enjoy the benefits of tax deferral. Pension contributions of both employees and employers are tax-deductible and accrue at the pre-tax interest rate. As contributions and interest accumulate, they are not taxed until withdrawal. A worker with access to pension benefits upon job change who rolls them over into a tax-qualified plan preserves the tax-favored status of the money. Otherwise, it is taxed as ordinary income in the year of receipt. Those who spend their pensions thus forego the benefits of tax deferral. In addition, the Tax Reform Act of 1986 established a 10 percent penalty excise tax on distributions to workers under age 55 that are not rolled into a tax-qualified plan.

## The Health and Retirement Survey

Despite incentives to preserve pension assets until retirement, many workers dip into their pensions. To determine the effect of such behavior on retirement resources, I have assembled data from the Health and Retirement Study (HRS). The HRS is a nationally representative survey of individuals between the ages of 51 and 61. It was first conducted in 1992. A total of 12,652 individuals who comprised 7,607 households were interviewed that year. These individuals have been re-interviewed every two years since. Each series of interviews provides detailed information on employment, income, wealth, health, and pensions.

As a data source, the HRS has a number of advantages. First, it contains detailed data on household financial and housing wealth. Second, the study obtained detailed information from respondents about private pensions on current and past jobs. Third, respondents were asked permission to link their survey responses to administrative earnings histories and benefits records from the

*Gary V. Engelhardt*

Social Security Administration (SSA). With detailed information on financial, housing, pension, and Social Security wealth, the HRS is the only household survey to give complete coverage of the household portfolio. Finally, the survey was well timed. In 1992, the main respondents were centered around that critical age of 55, after which the law permits pension cashouts without penalty.

The primary disadvantage is that the HRS only interviewed individuals between the ages of 51 and 61 in the initial interview year 1992. This means that the people in this study were born between 1931 and 1941. This is an important group of Americans, but they are by no means representative of today's American workers. The HRS respondents look more like old-style workers. They are more likely to have worked in manufacturing, to be unionized, and to be covered by defined benefit plans than today's workers. Therefore, conclusions drawn from this group of workers may not apply to other workers. In particular, younger workers are more likely to have defined contribution pension plans and, hence, greater access to pension assets upon job change than the HRS workers did. This is discussed in more detail in the conclusion.

In the 1992 interview, on which this analysis is based, respondents were asked retrospective questions about what happened to pension assets for each important job they had at any point during their lifetime. A sample of 1,282 households was drawn; in each of them, a respondent reported both that they had left a job and had, at least once, received a lump-sum distribution when they left a job.

### **What Do Workers Do with Lump-Sum Distributions?**

Table 1 shows the disposition and size of lump-sum pension distributions for this sample. Column 1, panel A, shows the percent of all recipients by disposition. Most recipients cashed out upon job termination. Only 26.7 percent of distributions were rolled into an IRA or left to accumulate in the employer's plan.

*Aging Studies Policy Brief*

TABLE 1. Disposition and Size of Lump-Sum Distributions

Disposition	(1) Recipients (percent)	(2) Mean [Median] Distribution ( in 1992 dollars)	(3) Distribution (percent)
A. Individual Uses			
Rolled over into another tax-qualified plan or left to accumulate	26.67	59,136 [16,584]	52.79
Transferred to new employer's plan <sup>a</sup>	0.61	66,888 [28,094]	1.36
Converted to an annuity <sup>a</sup>	0.67	39,997 [38,152]	0.90
Cashed out:	67.63	17,753 [8,920]	40.19
Spent	33.62	16,931 [8,220]	19.05
Saved or invested	15.21	25,928 [13,762]	13.20
Paid bills or debts	8.57	12,509 [7,725]	3.59
Other	10.24	12,702 [6,106]	4.35
Other	4.42	32,421 [23,213]	4.76
Total	100.00	29,880 [11,081]	100.00
B. Type of Rollover			
Tax-Qualified	27.95	58,843 [17,458]	55.05
Wealth-Preserving	51.72	41,491 [13,429]	71.83

Note: All figures in the table were calculated using the HRS household analysis weights based on the sample of 1,282 households described in the text. When weighted, this sample represented 2,713,816 aggregate households. See glossary for definitions of terms.

<sup>a</sup>This category was not listed as a possible response on the questionnaire for those with non-DC plans.

Source: Author's calculations.

A total of 67.6 percent of distributions were received as a cash settlement, on which ordinary income tax and, when appropriate, penalty were paid. One-half of those who cashed out spent their distribution, about one-quarter saved or invested, and about one-eighth paid off debt. About one-sixth of those who cashed out

*Gary V. Engelhardt*

reported “Other” as the use. If one assumes that “Other” indicates uses that effectively were spending, then 43.9 percent (33.62+10.24) of all recipients and 64.8 percent (43.9/67.6) of those who cashed out spent their distributions.

However, to evaluate the long-term effect on retirement wealth, it is important to know the extent to which cash settlements are put to “wealth-preserving” uses. The obvious way to preserve wealth is through a rollover into another tax-qualified pension plan. However, this definition may be too narrow. For instance, workers may choose to pay taxes and penalties on a lump-sum distribution and invest in a non-pension asset (start a business, buy a house, etc.) or pay off debt. In these cases, cash settlements represent shifts in the composition of the respondent’s wealth portfolio, but they do not constitute changes in total wealth. These funds are preserved (albeit not in pensions) and potentially could provide for income or a higher standard of living in retirement.

Naturally, there are a number of caveats that come with this definition of “wealth preservation.” First, it assumes that the assets purchased with pension funds will be a good store of value until retirement (e.g., purchase of a house) and that the debt that was paid off was incurred in the process of asset acquisition (e.g., paying down mortgage debt). But clearly, paying down credit card debt with pension money is not “wealth preserving.”<sup>4</sup>

In the analysis that follows, it is not possible to determine whether dipping into pension money was the only difference between the two groups. Those who did (“spenders”) may have been fundamentally different from those who did not (“savers”) in ways that were not measured. For example, “savers” may have had better access to credit markets and may have borrowed to finance their big-ticket purchases, whereas “spenders” may have had poorer access to credit markets and, hence, used their pension money as recourse. The economic information in the HRS is the most detailed to date, but not detailed enough to account for such differences across households.

*Aging Studies Policy Brief*

Panel B in Table 1 gives summary statistics by the type of rollover: tax-qualified and wealth preserving. Tax-qualified rollovers are distributions rolled to another tax-qualified plan, transferred to a new employer, or converted to an annuity. None triggers federal income tax or penalties. Wealth-preserving rollovers include tax-qualified rollovers as well as after-tax cash settlements that were reported saved or invested, or used to pay bills or debts. As column 1 shows, only 28 percent of all recipients had tax-qualified rollovers, but 51.7 percent had wealth preserving rollovers.

Based on these figures, 23.7 percent of recipients used their after-tax cash settlement to increase assets or reduce debts, and from panel A, it is clear that most was for asset accumulation. This is somewhat surprising, because these recipients were required to pay the penalty tax and income tax on their cash settlements.

Column 2 shows the mean distribution by disposition. The median, in square brackets, is the value for the middle household, with one-half of the households in the sample above it and the other half below. All figures are in real 1992 dollars, deflated by the Consumer Price Index. In the bottom row in panel A, the mean and median distributions for all uses were \$29,880 and \$11,081, respectively. In comparison, the mean and median distributions for those recipients who rolled over to an IRA were significantly larger: \$59,136 and \$16,584, respectively. All after-tax cash settlements had a mean and median of \$17,753 and \$8,920, respectively. Within this category, settlements that were saved or invested were much larger than those that were spent or used to pay bills or debts.

Column 3 gives the percent of all distributions by type of disposition as a measure of incidence. These dollar-weighted frequencies cast a more favorable picture of the preservation of pension wealth upon job change. Larger distributions were more likely to have been saved. In panel B, 55 percent of all distributions were tax-qualified rollovers, and 71.8 percent were wealth-preserving rollovers. Therefore, even though only about

half of the recipients had wealth-preserving rollovers, almost 72 percent of the pre-retirement distribution dollars were saved.

### Are “Spenders” Less Wealthy than “Savers”?

One common finding of previous studies in this area is that individuals who save their pension assets differ *at the time of job change* from those who spend them. In particular, “spenders” tend to be younger, less educated, earn less, and have shorter job tenure and smaller pension accumulations. Unfortunately, the HRS did not ask retrospective questions about personal wealth at the time of job change, so we do not know if “spenders” were systematically less wealthy than “savers” at that time. However, the HRS did ask about personal wealth in 1992, so we can answer a related question: whether those who spent distributions in the past are *currently* less wealthy (i.e., in 1992) than those who saved their pension assets.

Panel A of Table 2 shows the mean current wealth of households who ever spent a pension distribution versus those who saved all distributions. Medians are in square brackets.<sup>5</sup> Surprisingly, spenders had *more* current pension wealth than savers: about \$8,900 and \$4,200 more at the mean and median, respectively. However, these differences were not statistically significant.<sup>6</sup>

A unique feature of the HRS is that respondents were asked permission to link their survey responses to administrative earnings histories and benefits records from the Social Security Administration. This has allowed for the construction of Social Security wealth for each survey household.<sup>7</sup> Spenders have about \$12,000 and \$7,000 less in Social Security wealth than savers at the mean and median, respectively. Both differences are statistically significant. However, when retirement resources are measured as the sum of current pension and Social Security wealth, there is no statistically significant difference between the groups.

*Aging Studies Policy Brief*

TABLE 2. Mean and Median Wealth and Lifetime Earnings for Households that Spent versus Saved Lump-Sum Distributions (in 1992 dollars)

Variable	(1)	(2)
	All Households (n=1,282)	
	Spent Any Distributions (n=659)	Saved All Distributions (n=623)
A. Measure of Wealth		
Non-Housing Wealth		
	96,173	87,237
Pension Wealth	[22,853]	[18,623]
	17,341*	47,770
IRA and Keogh Wealth	[0]*	[12,000]
	113,604	135,007
Pension, IRA, and Keogh Wealth	[42,114]*	[58,959]
	143,544*	155,415
Social Security Wealth	[137,097]*	[161,011]
Pension and Social Security Wealth	239,717	246,114
	[186,747]	[194,077]
Pension, IRA, Keogh and Social Security Wealth	257,148*	296,033
	[200,339]*	[225,064]
	156,511	216,763
Other Non-Housing Wealth	[41,000]*	[54,000]
	63,647	78,855
Housing Wealth	[50,000]	[57,000]
	477,306*	605,570
Total Wealth	[342,897]*	[405,817]
B. Measure of Lifetime Earnings		
Social Security Average Indexed Monthly Earnings (AIME)	2,345*	2,577
	[2,360]*	[2,650]

Note: Medians in square brackets. An asterisk indicates a statistical significant difference between the figures in columns (1) and (2) at the 5 percent level. All figures were calculated using the HRS household analysis weights. When weighted, the subgroup of 659 represented 1,556,433 aggregate households and the subgroup of 623 represented 1,525,737 aggregate households. See glossary for definitions of terms..

Source: Author's calculations.

The differences in mean and median non-housing wealth are large, about \$60,000 and \$13,000, respectively, and statistically significant. In contrast, the two groups look similar in terms of housing wealth. The differences in housing wealth are economically small. The last measure in panel A is total wealth, defined as the sum of Social Security, pension, non-housing, and

housing wealth. Overall, spenders are substantially less wealthy than savers. Even measured by the median, households that spent distributions have about \$62,000 less in wealth than households that saved distributions.

Panel B compares the lifetime earnings of the two groups measured by the Social Security Administration's Average Indexed Monthly Earnings (AIME, which equals the average of a person's highest 35 years of income). Households that spent distributions had lower AIME by \$232 and \$290 per month, or \$2,784 and \$3,480 per year, at the mean and median, respectively. These differences are statistically significant and economically important.

### How Much More Would "Spenders" Have Available for Retirement?

How much more in retirement resources would households that dipped into their pension assets have had had they instead saved that money? To quantify this, I define *PVS*, the household's "present value of spent lump-sum distributions." It is the amount of wealth that all spent lump-sum distributions would have grown to today had they been rolled over to a tax-qualified plan and invested rather than cashed out and spent. The "present" is 1992. Specifically, for unmarried individuals in the sample, *PVS* was calculated as follows. First, for each past job with a spent distribution, the present investment value of that distribution was calculated. This required knowing the year and amount of the distribution (given in the HRS) and the periodic real rate of return. Based on historical returns in Ibbotson Associates (1997), annual real rates of return were calculated for three investment strategies: 100 percent investment in corporate bonds; 50 percent in corporate bonds and 50 percent in stocks; and, 100 percent in stocks. For married couples, *PVS* was calculated for the individual and spouse and then summed.

Table 3 gives the distribution of *PVS* for the sub-sample of 659 households in the 1992 HRS with a member who spent at least one pre-retirement lump-sum distribution. The figures in columns

*Aging Studies Policy Brief*

1-3 reflect the three assumptions about the investment mix just outlined. The mean present value of spent lump-sum distributions was \$37,002 if invested solely in bonds. With a higher risk-return investment strategy of 100 percent stocks, this increased to \$54,643. Like other measures of wealth, *PVS* is right-skewed (because very wealthy people raise the mean) and the mean greatly exceeds the median. At the median, *PVS* was \$17,065 and \$23,167 if invested all in bonds and all in stocks, respectively.

TABLE 3. The Present Value of Spent Lump-Sum Distributions and Pension Wealth, 1992 Dollars

Percentile	Present Value of Spent Lump-Sum Distributions (1992 dollars)			Current Pension Wealth	Counterfactual Pension Wealth
	(1)	(2)	(3)		
	100% Bonds	50%/50% Bonds/Stocks	100% Stocks		
10 <sup>th</sup>	2,583	2,994	2,994	0	7,746
25 <sup>th</sup>	5,714	7,042	7,874	0	22,924
50 <sup>th</sup>	17,065	21,125	23,167	22,853	77,921
75 <sup>th</sup>	42,857	49,339	56,824	119,247	173,009
90 <sup>th</sup>	79,692	100,923	120,748	290,063	350,588
Mean	37,002	45,807	54,643	96,173	141,981

*Note:* All figures were calculated using the HRS household analysis weights. These statistics were calculated on the subsample of 659 HRS households that ever spent a lump-sum distribution. When weighted, this subsample represented 1,556,433 aggregate households. A total of 69 percent of these households had positive current pension wealth in 1992 and 31 percent had no current pension wealth. Counterfactual pension wealth in column (5) is the sum of actual pension wealth and the present value of spent lump-sum distributions assuming an investment mix of 5 percent bonds and 50 percent stocks. It represents the pension wealth the household would have had had it not spent past distributions. See glossary for definitions of other terms.

Column 4 gives the distribution of current pension wealth. Mean and median current pension wealth were \$96,173 and \$22,853, respectively. In addition, column 5 displays “counterfactual” pension wealth. This is sum of current pension wealth and the present value of spent distributions with an investment mix of 50 percent bonds and stocks, respectively. It represents the pension wealth the household would have had currently had it not spent any past distributions and instead rolled them over. Mean and median counterfactual pension wealth were \$141,981 and \$77,921, respectively.<sup>8</sup> Measured in absolute terms, it is clear that pension wealth would have been significantly higher for some households had distributions been rolled over.

To determine whether these absolute amounts would have supplemented actual retirement resources significantly, they

should be compared to broader measures of household wealth. Therefore, the relative importance of erosion is measured as

$$\frac{PVS}{W},$$

where the denominator,  $W$ , is a measure of the household's retirement wealth.

TABLE 4. The Present Value of Spent Lump-Sum Distributions as a Percentage of Broader Measures of Wealth

Percentile	(1)	(2)	(3)
	100% Bonds	50/50 Bonds/Stocks	100% Stocks
A. As a Percentage of Social Security and Pension Wealth			
10 <sup>th</sup>	1.16	1.27	1.37
25 <sup>th</sup>	2.87	3.53	3.80
50 <sup>th</sup>	8.13	9.73	11.17
75 <sup>th</sup>	23.73	27.25	32.06
90 <sup>th</sup>	58.91	65.30	74.50
B. As a Percentage of Social Security, Pension, and Non-Housing Wealth			
10 <sup>th</sup>	0.69	0.81	0.97
25 <sup>th</sup>	1.91	2.28	2.54
50 <sup>th</sup>	5.36	6.42	7.27
75 <sup>th</sup>	14.91	17.94	20.47
90 <sup>th</sup>	37.72	44.29	50.72
C. As a Percentage of Total Wealth			
10 <sup>th</sup>	0.63	0.71	0.79
25 <sup>th</sup>	1.62	1.93	2.17
50 <sup>th</sup>	4.52	5.24	6.43
75 <sup>th</sup>	12.53	14.99	17.06
90 <sup>th</sup>	28.64	35.38	41.15

*Note:* All figures are percentages and were calculated using the HRS household analysis weights. These statistics were calculated on the subsample of 659 HRS households that ever spent a lump-sum distribution. When weighted, this subsample represented 1,556,433 aggregate households. See glossary for definitions of terms.

Table 4 compares  $PVS$  relative to three broader measures of household wealth. The first, in panel A, is the sum of current pension and Social Security wealth. Erosion is modest because spenders had significant Social Security wealth (as shown in Table 5). The median household could have increased its retirement wealth by 8 to 11 percent had it rolled over. However,

*Aging Studies Policy Brief*

for a small fraction of households, having saved the distribution would have significantly increased resources for retirement. For example, 25 percent of the households would have had at least 25 percent more in retirement wealth, and 10 percent of households would have had at least 59 percent more.

Because households could have saved for retirement outside of public and private pensions, panel B uses the sum of Social Security, pension, and non-housing wealth as a measure of retirement wealth. Importantly, non-housing wealth includes IRA and Keogh wealth, which could be significant sources of retirement income. By this metric, spent distributions become less important. The median household with a spent distribution could have increased its retirement wealth by about 6 percent had it rolled over the distributions. One-quarter of the households would have had at least 15 percent more in retirement wealth, and one-tenth would have had at least 38 percent more.

Finally, because, in principle, housing equity can provide resources for retirement, panel C uses total wealth (the sum of Social Security, pension, non-housing, and housing wealth) as a measure of retirement wealth. By this metric, spent distributions become even less important. The median household with a spent distribution could have increased its retirement wealth by about 5 percent had it rolled over the distributions. One-quarter of the households would have had at least 12 percent more in retirement wealth, and one-tenth would have had at least 29 percent or more.

Overall, Table 4 suggests consumed distributions did not result in significant erosion of retirement resources broadly measured for the great majority of households that spent their distributions. However, because of heterogeneity among those that spent distributions, there is a small group of households that could have raised their retirement resources substantially (those in the 75th percentile and higher in Table 4) had they rolled over. However, it should be emphasized that this subgroup represents only 2.25 percent of all households between the ages of 51 and 61.

TABLE 5. The Present Value of Spent Lump-Sum Distributions as a Percentage of Wealth, by Race and Education

Percentile	(1)	(2)	(3)	(4)	(5)	(6)	(7)
	Investment: 50% bonds, 50% Stocks						
	Race		Education				
	White	Nonwhite	High School Dropout	High School Diploma	Some College	Bachelor's Degree	More than College
A. As a Percentage of Social Security and Pension Wealth							
25 <sup>th</sup>	3.54	3.63	2.68	2.56	3.55	4.48	6.97
50 <sup>th</sup>	9.73	9.87	6.60	8.91	9.49	12.45	20.20
75 <sup>th</sup>	26.47	33.76	15.32	23.95	29.06	36.11	32.47
B. As a Percentage of Social Security, Pension, and Non-Housing Wealth							
25 <sup>th</sup>	2.18	2.64	2.06	1.94	2.27	2.66	3.48
50 <sup>th</sup>	6.21	8.13	5.30	6.21	6.61	5.32	10.32
75 <sup>th</sup>	17.74	22.46	13.60	16.16	20.85	18.76	21.48
C. As a Percentage of Total Wealth							
25 <sup>th</sup>	1.88	2.21	1.86	1.76	1.96	2.36	2.71
50 <sup>th</sup>	5.19	7.30	4.78	5.19	5.42	4.75	9.80
75 <sup>th</sup>	14.41	20.38	11.03	12.96	17.23	16.77	18.25

*Note:* All figures are percentages and were calculated using the HRS household analysis weights. These statistics were calculated on the subsample of 659 HRS households that ever spent a lump-sum distribution. When weighted, this subsample represented 1,556,433 aggregate households. Race and education are that of the individual in the household who received the lump-sum distribution that was spent. If more than one member of the household ever spent a distribution, then the race and education are that of the individual designated the HRS primary respondent. See glossary for definitions of other terms.

Table 5 repeats the tabulations in Table 4 by race and education categories for an investment mix of 50 percent bonds and stocks, respectively. Measured in terms of current pension and Social Security wealth (panel A), there was little difference in erosion by race. When wealth was measured more broadly, as in panels B and C, nonwhites had slightly greater erosion than whites. For example, in panel B, columns 1 and 2, the median white household with a spent distribution could have improved retirement resources (excluding housing) by 6.2 percent, whereas the median nonwhite household could have improved by 8.1 percent.

Erosion rose with educational attainment (columns 3-7). For example, in panel A, the median high-school-dropout household with a spent distribution could have improved retirement resources by 6.6 percent compared to 12.5 percent for the median bachelor's-degree household, and 20.2 percent for the median

more than college household. Erosion was greatest for the most educated.

## Conclusion

The primary finding is that overall there is little evidence that dipping into pension funds significantly decreases retirement wealth, because workers in the sample typically consumed pension distributions of relatively small value while they preserved large pension accumulations for retirement. If pension assets that were spent instead had been preserved for retirement, they would have represented about 10 percent of retirement wealth for the typical household that spent the money. However, there is a small group of households that would have benefited greatly if they had not dipped into their pensions. About 2 percent of all respondents between the ages of 51 and 61 in 1992 could have increased their household retirement wealth by at least 25 percent had they not dipped into their pensions. This suggests that proposed policy mechanisms that would enforce pension rollovers may not raise the retirement income security of the average American household, but could provide some protection for a limited number of households.

There is an important caveat to these findings. This study was based on a national sample of individuals 51 to 61 years old in 1992. These data have significant advantages over those used in previous studies. However, resulting policy statements are most accurately applied to individuals and households of roughly the same age. If younger individuals have different attitudes toward saving, view pension assets as less dedicated toward retirement, or have greater access to funds, then this analysis may underestimate the erosion to retirement income security for younger workers.<sup>9</sup>

This policy brief briefly describes what I believe to be a crucial step in formulating a model of the long-run implications of lump-sum distributions on the adequacy of retirement income benefits. Such a model should be the ultimate goal of this line of research.

## Endnotes

1. A complete, detailed analysis can be found in Engelhardt (2001).
2. “A household’s economic well-being depends on both its income and its asset accumulation, often referred to as its wealth. While income is the flow of resources to a household, wealth is the level of resources at any point in time. Wealth, also called net worth, is a particularly important dimension of well-being for some subgroups of the population such as the elderly, who tend to have lower retirement incomes but higher asset holdings” (Eller and Fraser 1995, p. 1).
3. Under current law, plans may automatically distribute the account balance of any employee who terminates with a retirement plan balance of \$5,000 or less. Such forced distributions may generally be rolled over and the plan administrator must provide a written notice of this and the related tax consequences before making the distribution. The new law [the Economic Growth and Tax Reconciliation Act of 2001 (P.L. 107-16), recently signed by President Bush] requires that for forced distributions greater than \$1,000, a direct rollover to an IRA designated by the current plan administrator will be made, unless the participant affirmatively elects otherwise. This will go into effect as soon as the Department of Labor issues final regulations interpreting the automatic rollover provision, and the DOL must issue such regulations within three years (TIAA-CREF 2001). This appears to be an effort to reduce consumption of small lump-sum distributions.
4. This is especially the case for any borrowing done in anticipation of getting access to pension money. If an individual took a vacation after leaving a job and paid for it from pension

money, then that money is considered spent under the definition above. However, if the same individual borrowed (say, on a credit card) to pay for the vacation in anticipation of access to the pension money, and then subsequently used the pension money to pay off the credit card debt, then the money is considered preserved under the above definition. Both scenarios have the same economic consequences, but are measured differently. Unfortunately, the questions asked in the HRS were not detailed enough to separate out these two different scenarios.

5. Technically, pension wealth is defined in Table 2 as the present value (in 1992) of the household's claims to assets in defined benefit and defined contribution plans and the present value of any annuitized pensions. It does not include the value of any lump-sum distributions that were rolled into an IRA. It was calculated by Venti and Wise (2000).

6. Technically, statistical significance is defined at the 5 percent level here.

7. Technically, the measure used came from two sources. For individuals with matched Social Security earnings histories, Social Security wealth came from the restricted access Earnings and Benefits File (EBF) for the 1992 HRS (Wave 1) from the Institute for Social Research at the University of Michigan. The calculation of Social Security wealth in the EBF is described in Mitchell, Olson, and Steinmeier (1996). For individuals without matched Social Security earnings histories, Social Security wealth was imputed using self-reported information on earnings histories in the 1992 and 1996 HRS (Waves 1 and 3) following the method in Gustman and Steinmeier (1999).

8. The means in columns 2 and 4 sum to that in column 5. But because the median of a sum is not necessarily the sum of the medians, the median in column 5 is not the sum of the medians in columns 2 and 4; this is true for the other percentiles shown as well.

9. For example, when offered a 401(k) plan, younger workers are far less likely to participate than older workers. This has led to a decrease in overall pension coverage among younger workers. For fulltime workers under age 25, the pension coverage rate decreased from 31 percent in 1972 to 21 percent in 1993. Among workers age 55 to 59 the coverage rate increased from 53 percent in 1972 to 59 percent in 1993 (US DOL 1999).

## Glossary

**Annuity:** A contract by which an insurance company agrees to make regular payments to someone for life or for a fixed period. **Fixed Annuity:** A traditional insurance investment vehicle, often used for retirement accounts, that guarantees principal and a specified interest rate and may also offer dividends. **Variable Annuity:** An annuity, the value of which fluctuates based on the market performance of an underlying securities portfolio. Unlike fixed annuities, there is no guarantee of principal or rate of return.

**Average Indexed Monthly Earnings (AIME):** The average of an individual's 35 highest yearly earnings—used in calculating the monthly benefit at Social Security's full retirement age.

**Defined Benefit Plan:** In a defined benefit plan, each employee's future benefit is determined by a specific formula, and the plan provides a guaranteed level of benefits on retirement. A private defined benefit plan is typically not contributory—there are usually no employee contributions, no individual accounts are maintained for each employee. The employer makes regular contributions to the entire plan to fund the future benefits of the entire cohort of participants. The employer bears the risk associated with providing the guaranteed level of retirement benefits. Usually, the promised benefit is tied to the employee's earnings, length of service, or both. (This and several other definitions in this glossary are from The American Savings Education Council Web site <<http://www.asec.org/terms.htm>>. ASEC is part of the Employee Benefit Research Institute Education and Research Fund, a 501(c)(3) non-profit charitable organization.)

**Defined Contribution Plan:** In a defined contribution plan, employers generally promise to make annual or periodic contributions to accounts that are set up for each employee. Sometimes there are only employer contributions, sometimes only employee contributions, and sometimes both. The current contribution is guaranteed but the level of benefits at retirement is not. The benefit payable at retirement is based on money accumulated in each

## *Aging Studies Policy Brief*

employee's account. The final retirement amount reflects the total of employer contributions, any employee contributions, and investment gains or losses.

**Employee Retirement Income Security Act of 1974 (ERISA):** ERISA was designed to secure the benefits of participants in private pension plans through participation, vesting, funding, reporting, and disclosure rules and the creation of the Pension Benefit Guaranty Corporation. ERISA provided added pension incentives for the self-employed through changes in Keoghs and for persons not covered by pensions through individual retirement accounts (IRAs). It established requirements for plan implementation and operation.

**401(k) Plan:** A cash or deferred arrangement (CODA) that lets an employee contribute pretax dollars to a company investment vehicle until the employee retires or leaves the company.

**403(b) Plan:** Similar to a 401(k), a cash or deferred arrangement (CODA) that lets an employee of a tax-exempt education or research organization or public school contribute pretax dollars to an investment pool until the employee retires or terminates employment.

**Individual Retirement Account (IRA):** An IRA provides individuals an opportunity to save for retirement on a tax-deferred basis. Individuals may contribute up to \$2,000 per year in an individual account; for spousal accounts the limits are \$4,000 if both spouses work and \$2,250 if one spouse works. The amount that is tax deductible varies according to an individual's pension coverage, income tax filing status, and adjusted gross income. Account balances distributed from one IRA or from a qualified retirement plan may be rolled over to another IRA.

**Keogh Plan:** A Keogh plan is a qualified retirement plan for self-employed individuals and their employees to which tax-deductible contributions up to a specified yearly limit can be made if the plan meets certain requirements of the Internal Revenue Code. Keogh plans, also called H.R. 10 plans, may be defined benefit or defined contribution plans.

**Lump-Sum Distribution:** Under a qualified retirement plan, the distribution of a participant's entire account balance (under a defined contribution plan) or of the entire value of a participant's accrued benefit (under a defined benefit plan) as a single cash payment to the participant (or, under certain circumstances, to another designated party). The availability and payment of lump-sum distributions are subject to certain legal restrictions, and premature receipt of such distributions can have adverse tax consequences. The term **present value of spent lump-sum distributions** as used in this Policy Brief is described in the text and uses historical returns from Ibbotson Associates (1997).

**Pension:** A series of periodic payments, usually for life, payable monthly or at other specified intervals. The term is frequently used to describe the part of a retirement allowance financed by employer contributions. A pension plan is a plan that provides benefits, after retirement, from a trust or other separately

maintained fund, by the purchase of insurance, or from general assets (unfunded plan). The amount of benefits is either specified or can be calculated in accordance with a set formula based on various factors such as age, earnings and service, but not profits. The amount of annual contributions needed to provide the specified benefits can be estimated actuarially and does not depend upon profits (IFEBP 2000). **Pension wealth** is the household's present value of claims to pension assets in 1992, based on self-reported pension data, and is taken from Venti and Wise (2000).

**Rollover:** An employee's transfer of retirement funds from one retirement plan to another plan of the same type or to an IRA without incurring a tax liability. The transfer must be made within 60 days of receiving a cash distribution. The law requires 20 percent federal income tax withholding on money eligible for rollover if it is not moved directly to the second plan or an investment company.

**Salary Reduction Plan (Cash or Deferred Arrangement (CODA)):** A CODA is a defined contribution plan that allows participants to have a portion of their compensation (otherwise payable in cash) contributed pre-tax to a retirement account on their behalf. The following are types of CODA plans named after the section of the Internal Revenue Code that establishes the rules for the plan. **401(k)** - CODA plan for the for-profit sector of private industry. **403(b)** - CODA plan for the not-for-profit sector of private industry. **457** - CODA plan for state and local governments.

**Savings or Thrift Plan:** A defined contribution plan in which participants make contributions on a discretionary basis with limits and to which employers may also contribute, usually on the basis of fully or partially matching participants' contributions. Contributions are commonly made with after-tax earnings.

**Tax Deferral:** Postponing taxes due on an amount invested and/or its earnings until they are withdrawn from the investment.

**Tax Qualified Plan:** Often used to refer to plans established under sections 401(k), 401(a), or 403(a) of the Internal Revenue Code. More commonly, any retirement plan that meets IRS criteria that allow employers to deduct pension costs as a business expense and defer current income tax on its earnings and allow employees to defer income tax on the employer's contributions and earnings.

**Wealth:** All goods and resources having value in terms of exchange or use (*American Heritage Dictionary of the English Language*, 3rd edition). Several categories of wealth are used in this Policy Brief. **Pension wealth** is the household's present value of claims to pension assets in 1992, based on self-reported pension data, and is taken from Venti and Wise (2000). **Other non-housing wealth** includes non-pension, non-housing wealth in forms other than IRAs and Keoghs. **Social Security wealth** is the household's expected present value of claims to Social Security in 1992 and is taken from the HRS Social

## *Aging Studies Policy Brief*

Security Earnings and Benefits File and from Gustman and Steinmeier (1998) as described in the text. **Total wealth** is the sum of pension, Social Security, IRA, Keogh, other non-housing, and housing wealth.

## References

- Costa, Dora L. 1998. *The Evolution of Retirement: An American Economic History, 1880-1990*. NBER Series on Long-Term Factors in Economic Development. Chicago and London: University of Chicago Press.
- Eller, T.J., and Wallace Fraser. 1995. *Asset Ownership of Households: 1993*. U.S. Bureau of the Census. Current Population Reports, P70-47. Washington, DC: Government Printing Office.
- Engelhardt, Gary V. 2001. "Pre-Retirement Lump-Sum Pension Distributions and Retirement Income Security: Evidence from the Health and Retirement Study." Center for Policy Research, Aging Studies Program Paper 23. Syracuse, NY: Syracuse University. <<http://www-cpr.maxwell.syr.edu/agpanser/age23abs.htm>> accessed July 2001.
- Gustman, Alan L. and Thomas L. Steinmeier. 1999. "Effects of Pensions on Savings: Analysis with Data from the Health and Retirement Study." *Carnegie-Rochester Conference Series*. 50: 271-326.
- Health and Retirement Study (HRS) and Asset and Health Dynamics Among the Oldest Old (AHEAD) are nationally representative longitudinal data collections that examine retirement and the aging of society. <<http://www.umich.edu/~hrswww/>> accessed July 2001.
- Ibbotson Associates. 1997. *Stocks, Bonds, Bills, and Inflation 1997 Yearbook*. Chicago: Ibbotson Associates.
- International Foundation of Employee Benefit Plans. 2000. *Employee Benefit Plans: A Glossary of Terms*. Tenth

Gary V. Engelhardt

edition. Brookfield, WI: IFEBP. <<http://www.ifebp.org/glossary/default.asp>> accessed July 2001.

- Mitchell, Olivia, Jan Olson, and Thomas Steinmeier. 1996. "Construction of the Earnings and Benefits File (EBF) for Use with the Health and Retirement Survey." HRS/AHEAD Documentation Report No. DR-001, Institute for Social Research, University of Michigan.
- Sass, Steven A. 1997. *The Promise of Private Pensions: The First Hundred Years*. A Pension Research Council Book. Cambridge and London: Harvard University Press.
- Smith, James P. 1997. "The Changing Economic Circumstances of the Elderly: Income, Wealth, and Social Security." Center for Policy Research, Policy Brief No. 8. Syracuse, NY: Syracuse University. <<http://www-cpr.maxwell.syr.edu/pbriefs/pb8.pdf>> accessed July 2001.
- TIAA-CREF. 2001. "Pension Reform Enacted at Last." <[http://www.tiaa-cref.org/siteline/gen0106\\_090.html](http://www.tiaa-cref.org/siteline/gen0106_090.html)> accessed July 2001.
- U. S. Department of Labor, Pension and Welfare Benefits Administration. 1999. "Changes in the Private Employment Based Pension and Health Systems over the Past 25 Years." Fact Sheet. Washington, DC: PWBA. <<http://www.dol.gov/dol/pwba/public/pubs/factsht2.htm>> accessed July 2001.
- Venti, Steven F., and David A. Wise. 2000. "Choice, Chance, and Wealth Dispersion at Retirement." NBER Working Paper No. W7521. Cambridge, MA: National Bureau of Economic Research. <<http://papers.nber.org/papers/W7521>> accessed July 2001.