Supplementing retirement until Social Security begins

Nearly all employees covered by a pension plan can begin receiving benefits before they are eligible for Social Security payments; a few pension plans provide supplements until Government payments begin

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The term "three-legged stool" is commonly used to emphasize that retirement income derives from three primary sources: Social Security, employer-sponsored retirement plans, and workers' savings. If workers retire before age 62, however, the first leg of the stool, Social Security payments, is missing. To compensate, some private pension plans provide extra payments until a retired worker is eligible for this Government benefit.

According to the Bureau of Labor Statistics 1988 Employee Benefits Survey of medium and large firms in private industry, 1 in 8 defined benefit pension plan participants was in a plan that provided such supplemental payments. These special benefits usually continued until the retiree reached age 62, the earliest age at which regular Social Security benefits may commence.[1] Benefit payments ranged widely, but most commonly were a uniform dollar amount for all plan participants regardless of salary or length of service.

The 1988 survey studied full-time employees in a sample of 2,500 establishments, which represented approximately 107,000 establishments employing 31 million full-time workers. Separate data were developed for three broad occupational groups: professional and administrative, technical and clerical, and production and service workers. The first two groups are referred to collectively as white-collar workers, the third as blue-collar workers.[2]

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Retirement ages

The ages at which employees may begin to receive retirement benefits from employer-sponsored pension plans and from Social Security frequently do not correspond. To understand these age differences, it is useful to contrast the benefit approaches of private plans with those of Government programs. In 1988, 63 percent of employees in medium and large firms in private industry participated in defined benefit pension plans.[3] A defined benefit pension plan specifies a formula (for example, a percent of the employee's earnings or a dollar amount for each year of service) and also specifies age and length of service requirements that must be met before an employee is eligible for either normal or early retirement benefits. *Normal retirement* benefits are the full annuities yielded by the pension plan's benefit formula, without reduction due to age at retirement. *Early retirement* benefits are systematically reduced because they begin at an earlier age and, on average, will be received over a long period.

Traditionally, most private pension plans adopted age 65 as the normal retirement age. In 1969, 69 percent of workers in pension plans had to work until age 65 to receive normal retirement benefits, and only 9 percent could receive such benefits prior to age 60.[4] This corresponds with Social Security, which, at its

inception, established 65 as the age for full benefits. The age for receipt of full Social Security benefits is currently 65, although the required age will rise beginning in 2003, as discussed later.

More recently, private pension plans have lowered the age at which retired workers may receive unreduced normal benefits. In 1988, nearly 60 percent of the participants of defined benefit pension plans could retire before age 65 with full benefits.

In addition, early retirement provisions covered nearly all participants of defined benefit pension plans in 1988. Age 55 is the most common minimum age for early retirement, and almost all participants can retire with reduced benefits by age 60. Furthermore, some employers offer incentives to retire early by moderating the reductions in benefits imposed upon early retirees; fewer than a fifth of pension plan participants now face a full actuarial reduction in annuities.[5]

While these data suggest that private pension plans tend to encourage earlier retirement, Government policy appears to be just the opposite. In 1985, the Federal Government outlawed mandatory retirement for most workers.[6] The next year, in response to ongoing court challenges, the Congress required employers to credit years of service worked after age 65 toward future pension benefits.[7] And, currently, the Congress is debating removing the limit on income that can be earned by recipients of Social Security, a restriction which, many believe, discourages older Americans from continuing to work.[8]

In addition, future Social Security policy will encourage people to work longer and retire later.[9] Presently, full Social Security benefits may be received beginning at age 65, and reduced benefits at age 62. However, beginning in 2003, the normal retirement age will climb 1 month per year, reaching age 67 in 2027.[10]

The earliest age that Social Security retirement benefits may be received will remain at 62, although benefit reduction for early receipt will increase. Currently, benefits are reduced $6\frac{2}{3}$ percent per year for receipt prior to the normal retirement age of 65. This yields a 20-percent reduction at age 62. Beginning in 2003, the reduction will be $6\frac{2}{3}$ percent per year for the first 3 years and 5 percent per year beyond 3 years. Once the normal retirement age reaches 67 in 2027, the age 62 benefit will be reduced 30 percent. In addition, the *increase* in benefits provided to those who postpone receipt of Social Security until after normal retirement age will rise gradually from the current 3 percent per year to 8 percent per year.

Table 1. Full-time participants in defined benefit pension plans with supplemental payments, by method of determining payment, medium and large firms in private industry, 1988

[In percent]

Method	All participants	Professional and administrative	Technical and clerical	Production and service
Normal retirement				
Total	100	100	100	100
Flat dollar amount	41	35	38	45
Dollar amount per year of service	25	33	28	21
Total benefit equals a flat dollar amount[1]	30	27	21	33
Total benefit equals a dollar amount per year of service[1]	4	5	13	1
Early retirement				
Total	100	100	100	100
Flat dollar amount	14	13	13	14
Dollar amount per year of service	29	31	26	29
Total benefit equals a flat dollar amount[1]	44	33	35	50
Total benefit equals a dollar amount per year of service[1]	12	20	22	7
Formula not determinable	1	3	4	(2)

[1] Plan specifies that the pension payment plus the supplement will equal a specified total.

[2] Less than 0.5 percent.

NOTE: Because of rounding, sums of individual items may not equal totals.

Supplemental private pensions

In 1988, 12 percent of participants were in private defined benefit pension plans that provided supplemental payments, generally designed to augment benefits received prior to receipt of Social Security. Production and service workers were the most frequent beneficiaries of such provisions, in part, because of the prevalence of supplementary benefits in several large collectively bargained plans. The following tabulation shows the percent of full-time participants in defined benefit pension plans by provisions for supplemental payments in medium and large firms in 1988:

	All participants	*Professional and administrative*	*Technical and clerical*	*Production and service*
Total	100	100	100	100
With supplement[1]	12	11	7	16
Normal retirement	8	7	5	10
Early retirement	9	7	5	12
Without supplement	88	89	93	84

[1] The total is less than the sum of the components because some participants could receive supplements to both normal and early retirement benefits.

Supplemental payment provisions are about evenly divided between those that supplement normal retirement benefits and those that augment early retirement benefits. The approach of a specific plan generally reflects the age at which it makes available normal and early retirement benefits. For example, if a plan offered normal retirement at age 62 and early retirement at age 55, the supplement would apply to the early retirement benefit because Social Security is available at age 62. If, however, normal retirement were available at age 60, the supplement might apply to normal retirement. It is also possible to have payments supplementing both normal and early retirement benefits.

Requirements. Plans may impose special age or length-of-service requirements, or both, on eligibility for supplemental payments. Therefore, a person retiring with full benefits (but still too young to receive Social Security) may receive a supplement while a person retiring with reduced early retirement benefits (and also too young to receive Social Security) may not. Seventy percent of participants in plans supplementing normal benefits did not have to meet special eligibility requirements for the supplement; the remaining 30 percent, however, faced age or service reqirements more stringent than those for normal benefits.

Additional requirements were more common when supplemental payments were tied to early retirement benefits. For example, one large manufacturing plan offers early retirement to workers at any age with 30 years of service, or at age 55 with 10 years of service. The early retirement supplement is available to all employees with 30 years of service, but is available to employees age 55 only if their age plus service totals 85. (This means that, essentially, the supplement is limited to employees with 30 years of service.) The following tabulation examines whether plans impose additional requirements to receive supplemental benefits at early retirement—it shows the percent of participants in plans that impose the same requirements or additional requirements for receipt of supplemental benefits as for early retirement benefits:

	Requirements	
	Same	*Additional*
All participants	52	48
Professional and administrative	38	62
Technical and clerical	32	68
Production and service	62	38

Benefit amounts. While defined benefit pension plans routinely base annuities on either a percent of the retiree's earnings or a flat dollar amount for each year of service, all of the supplemental payments found in the survey were expressed as dollar amounts, either flat amounts or amounts per year of service. (See table 1.) Prior earnings, therefore, do not affect supplemental payments. There are two reasons: first, many of the supplemental payments are part of unionized blue-collar plans, which typically specify benefits as a dollar amount per year of service. Second, the Social Security payments, for which the supplements are a substitute, decline as a percentage of salary for higher-paid workers, and are limited to a maximum dollar benefit. To base a supplement on earnings could provide payments to higher paid employees beyond that which Social Security combined with private pensions would pay.

Supplemental payments were expressed in several ways. Payments could be a flat amount, such as $300 per month, or an amount times years of service, such as $5 per month times years of service. Alternately, benefits were expressed as a guaranteed total benefit, the sum of the basic payment and the supplement. For example, the supplement, when added to the basic benefit, will yield a monthly payment of $1,000, or a monthly payment of $25 times years of service.

While the incidence of supplemental payments among survey respondents was insufficient to allow an extensive survey of benefit amounts, some typical payment amounts can be used to examine the extent to which supplements substitute for Social Security. Flat dollar amount supplements typically ranged from $200

Table 2. **Full-time participants in defined benefit pension plans with supplemental payments, by duration of payments, medium and large firms in private industry, 1988**

[In percent]

Duration	All participants	Professional and administrative	Technical and clerical	Production and service
Normal retirement				
Total	100	100	100	100
To age 62	70	82	69	65
To age 65	15	5	7	21
For specified number of months	8	10	12	6
For life	8	3	12	9
Early retirement				
Total	100	100	100	100
To age 62	81	69	62	90
To age 65	9	10	8	8
For life	10	21	30	1

NOTE: Because of rounding, sums of individual items may not equal totals.

to $400 per month; dollar-per-year formulas typically ranged from $5 to $10 per month times years of service. For the employee with 30 years of service, this amounts to between $150 and $300 per month. From another perspective, in plans providing both a basic and a supplemental benefit expressed as a dollar amount per year of service, the supplemental payment generally was equal to half or more of the basic payment.

How do these typical supplemental payments compare with Social Security payments? One way of comparison is to look at typical Social Security benefits. Data were computed for employees reaching age 65 in 1988, with final year earnings of $25,000 and 40 years of service under Social Security. The Social Security benefit for these workers was estimated to be $772 per month.[11] However, Social Security benefits are reduced $6\frac{2}{3}$ percent per year when benefits are received prior to age 65. So, a 20-percent reduction (to age 62, the earliest age benefits are available) would yield a Social Security payment of $618 per month.

However, this is not a realistic comparison because the supplement could begin as early as age 55 or 60. Using a standard actuarial table to compute equivalent present values of future streams of income beginning at different ages, payments at ages 55 and 60 would be 45 and 65 percent, respectively, of an age 65 benefit.[12] When such reductions are applied to the $772 Social Security benefit, the payments are reduced to $347 at age 55 and $502 at age 60. Using these assumptions, the typical supplemental payments come close to replacing these reduced Social Security benefits.

Duration of benefits. Supplemental payments were most commonly available to retirees without an age requirement or at an early age, such as 55. Benefits most commonly lasted until age 62, when reduced Social Security benefits became available. (See table 2.) Some plans in this group specified "eligibility for reduced Social Security benefits" as the duration of benefits.

Other durations specified for supplemental payments include age 65, a specified number of months, or for life. These provisions suggest the supplemental payments provided by plans are not intended only to replace Social Security. Supplements lasting for life are generally available only to employees meeting added age and service requirements, and are often reduced after age 62. Actually such payments are not supplements, but additions to the basic benefit formula.

Alternative benefits

The move toward later Social Security retirement ages may leave an increasing gap between the time an employee begins receiving employer-sponsored retirement benefits and the time Social Security begins. While supplemental pension payments help bridge that gap, they are available to relatively few retirees.[13] A few other employer practices, however, are currently being used to help retirees augment basic pension payments.

One method is to offer additional employee benefit plans that provide retirement income. In the 1988 survey, 41 percent of defined benefit pension plan participants were in another plan for accumulating funds, most commonly a savings and thrift plan. Such plans provide incentives for employees to save, establishing an account generally payable at retirement. (How such plans affect personal savings is unclear; if individual savings are adversely affected, the net result may simply be a shifting of retirement funds from personal to employer-sponsored sources.[14])

Within a defined benefit pension plan, another method of bridging the gap before Social Security begins is to offer benefits payable under a "level-income option." Such an option alters the basic pension payment to provide greater benefits before Social Security is payable, and reduced benefits thereafter. These options are rare.

Finally, employers wishing to encourage early retirement occasionally provide "open windows," limited periods during which employees are offered special incentives to retire. The incentives granted in these offers may include lump-sum cash payments, moderation or elimination of early retirement reductions, more favorable benefit formulas, or supplemental pensions payments until Social Security begins. Early retirement open windows were available in the last 5 years to at least some of the employees in plans covering 14 percent of defined benefit pension plan participants in 1988. □

Footnotes

[1] Although age 62 is currently the earliest age at which Social Security may be received by workers who retire because of advancing age, other benefits, such as those for disabled employees and survivors, may be received at earlier ages.

[2] The Employee Benefits Survey is an annual study of the incidence and characteristics of employee benefits. In addition to retirement plans, the survey provides data on health care, life and disability insurance, paid and unpaid leave, and a variety of additional benefits. Results of the most