The Effects of Partial Privatization of Social Security upon Private Pensions

Kathryn L. Moore

Follow this and additional works at: https://scholarlycommons.law.wlu.edu/wlulr

Part of the Social Welfare Law Commons

Recommended Citation
The Effects of Partial Privatization of Social Security upon Private Pensions

Kathryn L. Moore

Table of Contents

I. Introduction ...................................... 1255
II. Interaction with Integration Rules and Integrated Plans ..... 1257
   A. Overview of Integration Rules .................... 1261
   B. Effect of Partial Privatization on Integration Rules ..... 1268
   C. Effect of Partial Privatization on Integrated Plans ..... 1273
   D. Summary .................................... 1275
III. Interaction with Other Links Between Social Security and Private Pensions .................................. 1275
   A. Demand for Defined Benefit Plans ................ 1276
   B. Employees’ Willingness and Ability to Contribute to Employer-Sponsored Defined Contribution Plans ..... 1278
   C. Employees’ Investment Behavior ................... 1282
   D. Investment Returns ............................. 1284
IV. Conclusion ...................................... 1286

I. Introduction

Social Security does not provide retirement income in a vacuum. Rather, commentators often refer to our national retirement income system as a three-legged stool, with Social Security representing one of the legs and employer-sponsored pension plans and individual savings representing the other two legs. Because changes in one leg of the stool are likely to have a direct

---

* Associate Professor of Law, University of Kentucky College of Law. The author is grateful to Merton Bernstein, Robert Myers, and Carol Weiser for their comments on earlier drafts of this Article. The author also thanks Jack VanDerhei for the valuable insights he provided in a conversation with the author.

1. This Article uses the term Social Security in its generally accepted sense as referring to the Old-Age, Survivors, and Disability Insurance (OASDI) cash benefit program.

2. For purposes of this Article, the terms "retirement plan" and "pension" or "pension plan" will be used interchangeably and will refer to both defined benefit and defined contribution plans.

impact on the other two legs, policymakers must not consider Social Security changes in isolation, but should take account of their effect on employer-sponsored pensions and individual savings.

This Article analyzes how one of the most popular proposals, partial privatization, would likely affect private pensions. For purposes of this Article (Olivia S. Mitchell et al. eds., 1999) ("The U.S. retirement income system has often been described as a three-legged stool, with the three supports of the stool being social security, employer-sponsored retirement plans, and individual savings."); see also Kathryn L. Moore, Privatization of Social Security: Misguided Reform, 71 Temp. L. Rev. 131, 165 n.202 (1998) (noting that economic security for elderly is provided through federal needs-tested program called Supplemental Security Income and private initiative, as well as Social Security) (citing Merton C. Bernstein & Joan Brodshaug Bernstein, Social Security: The System That Works 137 (1988)).

4. See ERISA Indus. Comm., The Vital Connection: An Analysis of the Impact of Social Security Reform on Employer-Sponsored Retirement Plans 13 (1998) ("Many reform proposals advocated today—such as the creation of individual Social Security savings accounts, investment of Social Security funds in the private sector, substantial reductions in the Social Security defined benefit, increases in the Social Security eligibility age, and increased taxes—will have a dramatic impact on the employer-sponsored plans and, indeed, on the employer-employee relationship."); U.S. Senate, 97th Cong., Comm., Linkages Between Private Pensions and Social Security Reform, An Information Paper Prepared for Use by the Special Committee on Aging, at III (Comm. Print 1982) [hereinafter Linkages] (asserting that "it is clear that changes in benefits or costs associated with social security will result in individual or employer decisions to change pension plan provisions, personal savings behavior, or employment choices").

5. Linkages, supra note 4, at III ("It would be a mistake to view social security financing in isolation, on the assumption that income from other retirement income sources would remain fixed in the event of changes in social security. . . . It is, therefore, important that these relationships be taken into account in reviewing social security policy options for the long term.").


8. The Article does not discuss pensions offered by state and local governments.
This Article first examines how partial privatization would likely affect the integration rules and integrated plans. It then considers how partial privatization would likely affect (1) employees' demand for defined benefit plans, (2) employees' willingness and ability to contribute to employer-sponsored defined contribution plans, (3) employees' investment behavior with respect to the assets in their employer-sponsored plans, and (4) investment returns available to employer-sponsored plans.

II. Interaction with Integration Rules and Integrated Plans

Section 401(l) of the Internal Revenue Code is the one area of retirement law that expressly coordinates private pensions and Social Security. In essence, the § 401(l) "permitted disparity" or "integration" rules permit Social Security benefits to be taken into account in determining whether a pension plan discriminates in favor of highly compensated employees. Section 401(a)(4) of the Internal Revenue Code requires that an employer-sponsored

10. See Nancy J. Altman, Rethinking Retirement Income Policies: Nondiscrimination, Integration, and the Quest for Worker Security, 42 TAX L. REV. 435, 437 n.7 (1987) (noting that "[f]or the most part, coordination even about nonbenefits matters").
11. The 1942 Revenue Act introduced the concept of "integration." The Tax Reform Act of 1986 substantially modified the "integration" rules and introduced the term "permitted disparity." For a detailed discussion of the legislative history of the integration rules and the changes wrought by the Tax Reform Act of 1986, see Geoffrey Kollman & Ray Schmitt, Effect of Pension Integration on Retirement Benefits 1 (Cong. Res. Serv., Pub. No. 94-974, 1994); Altman, supra note 10, at 475-94; Patricia E. Dilley, The Evolution of Entitlement: Retirement Income and the Problem of Integrating Private Pensions and Social Security, 30 LOY. L.A. L. REV. 1063, 1142-79 (1997). Although the Code currently provides for "permitted disparity" rather than "integration," this Article will use the term "integration" because commentators continue to use this term to refer to the § 401(l) rules. See, e.g., John H. Langbein & Bruce A. Wolk, Pension and Employee Benefit Law 318-26 (3d ed. 2000); Peter J. Widenerbeck & Russell K. Osgood, Cases and Materials on Employee Benefits 332-54 (1996); Rosann C. Millian, Integration, in Understanding ERISA 2000: An Introduction to Basic Employee Retirement Benefits (July 2000), available at WL 471 PLI/Tax 327 (2000); see also Dan M. McGill et al., Fundamentals of Private Pensions 323 n.3 (7th ed. 1996) ("Correlation" is perhaps a more descriptive term for the concept and process, but the word "integration" is too deeply embedded in pension literature and regulatory language to change the terminology. As noted below, however, the nomenclature is already changing, with Congress and the IRS adopting "permitted disparity" as the new term.").
12. See Millian, supra note 11, at 331 ("Integration is the recognition of social security benefits in the design of private pension benefits.").
retirement plan's benefits or contributions not discriminate in favor of highly compensated employees for the plan to qualify and thus be eligible for favorable tax treatment. Section 401(a)(5)(C) of the Internal Revenue Code provides that a plan shall not be considered discriminatory within the meaning of § 401(a)(4) merely because it discriminates in favor of highly compensated employees in a manner permitted by § 401(l) of the Code.

Based on data from the Bureau of Labor Statistics' 1996 and 1997 Employee Benefits Surveys, 49% of full-time workers in large- and medium-size firms who participate in a defined benefit plan are covered by a benefit formula that is expressly integrated with Social Security, while 44% of full-time workers in small firms who participate in a defined benefit plan are covered by a benefit formula that is expressly integrated with Social Security. Although "there are no published data on the prevalence of integration in defined contribution plans," it appears that defined contribution plans are much less likely to be expressly integrated with Social Security than are defined benefit plans.


14. The term "highly compensated employee" is defined in § 414(q) of the Internal Revenue Code and generally refers to employees who earn more than $80,000 (indexed for inflation) each year or own more than five percent of their employer. See 26 U.S.C. § 414(q)(1) (1994).

15. For a general overview of the qualified plan requirements, see, for example, Langbein & Wolk, supra note 11, at 234-39. For a more detailed discussion of these requirements, see, for example, Leonard S. Hirsch, Plan Qualification Requirements, UNDERSTANDING ERISA 2000: AN INTRODUCTION TO BASIC EMPLOYEE RETIREMENT BENSIFTS, available at WL 471 PLV-Tax25.

16. For an overview of the economic benefits of tax qualification, see, for example, Langbein & Wolk, supra note 11, at 229-32.


18. For discussions of the prevalence of integration in earlier years, see, for example, Kollman & Schmitt, supra note 11, at 7; Dilley, supra note 11, at 1166; Donald Bell & Diane Hill, How Social Security Payments Affect Private Pensions, MONTHLY LAB. REV., May 1984, at 15; Avy D. Graham, Coordinating Private Pension Benefits with Social Security, MONTHLY LAB. REV., March 1994, at 35.


defined benefit plans.\textsuperscript{22}

Some plans that are not expressly integrated with Social Security rely on integration to satisfy the nondiscrimination requirements. The Treasury regulations' "imputed permitted disparity" rules,\textsuperscript{23} which are based on the \S 401(f) integration rules,\textsuperscript{24} permit plans that are not expressly integrated with Social Security to take Social Security benefits into account in determining whether the plan discriminates in favor of highly compensated employees in general testing of the plan. Unfortunately, there are no reliable statistics on how many plans rely on imputed disparity to satisfy the \S 401(a)(4) nondiscrimination requirement.\textsuperscript{25}

Commentators typically offer two justifications for the integration rules.\textsuperscript{26} First, at least nominally,\textsuperscript{27} employers are required to pay one-half of the Social Security payroll tax,\textsuperscript{28} and the integration rules allow employers to offset at least part of this cost.\textsuperscript{29} Second, because Social Security replaces a larger

\textsuperscript{22} See Bender, supra note 21, at 37 n.4 (noting that based on data from the 1992 Health and Retirement Survey, only 7.6\% of workers solely covered by defined contribution plans have contribution formula expressly integrated with Social Security); see also Graham, supra note 18, at 35-36 (contending, based on data from 1991, that integrated defined contribution plans were quite rare while integrated defined benefit plans were more common); Chuck Slusher, Pension Integration and Social Security Reform, 61 SOC. SEC. BULL. 20, 22 (No. 3 1998) (finding, based on data from 1993 Employee Benefits Survey for medium and large private firms and 1992 Employee Benefits Survey for small private firms, that about 20\% of all full-time, private sector employees in United States in 1992-1993 participated in integrated defined benefit plan, while less than 2\% of workers aged 51-61 in 1992 ever participated in an integrated defined contribution plan based on data from 1992 Health and Retirement Survey).

\textsuperscript{23} See Treas. Reg. \S 1.401(a)(4)-7 (as amended in 2000).

\textsuperscript{24} See McGILL ET AL., supra note 11, at 325 ("The rules limiting the amount of disparity that can be imputed to employees are almost identical to the rules limiting the amount of disparity permitted in a plan's benefit formula.").

\textsuperscript{25} See Gregory, supra note 6, at 320 ("Statistics are not available on the number of plans that do not integrate their contributions or benefits with social security but that use permitted disparity in meeting the Internal Revenue Code nondiscrimination rules.").

\textsuperscript{26} For additional justifications for permitted disparity or integration, see, for example, KOLLMAN & SCHMITT, supra note 11, at 1 (noting that "private pensions and social security benefits should not be duplicative"); Bender, supra note 21, at 29 (stating that integration permits, within limits, higher pension benefits for highly-paid workers, thereby allowing firms to retain and motivate highly skilled workers).

\textsuperscript{27} Cf. ALICIA H. MUNNELL, THE FUTURE OF SOCIAL SECURITY 86-87 (1977) (noting that based on model of cost-minimizing behavior of firms, most economists believe that entire Social Security payroll tax is borne by employees even though half of tax is nominally placed on employers); WIEDEMIECK & OSGOOD, supra note 11, at 340 ("Treating one-half of social security as employer financed is naive, however, because the true burden of the FICA taxes (the economic incidence) is independent of the payment obligation (the legal incidence). ").

\textsuperscript{28} 26 U.S.C. \S 3101(a) (1994).

\textsuperscript{29} See, e.g., KOLLMAN & SCHMITT, supra note 11, at 1; LANGBEIN & WOLK, supra note 11, at 318; Altman, supra note 10, at 480; Bender, supra note 21, at 29; Dilley, supra note 11,
percentage of the pre-retirement earnings of the lower-paid than that of the higher-paid,\textsuperscript{30} some lower-paid workers might receive combined pension and Social Security benefits that exceed 100% of their pre-retirement earnings absent the integration rules.\textsuperscript{31}

This section begins by providing a general overview of the § 401(l) integration rules. It then explains how partial privatization would likely affect the integration rules and integrated plans. Because partial privatization proposals vary widely and details matter, the discussion focuses on two specific partial privatization proposals, the 1994-1996 Advisory Council on Social Security’s Individual Account (IA) plan\textsuperscript{32} and the Personal Security Account at 1074, 1140, 1164-65; Gregory, supra note 6, at 319. But see BERNSTEIN & BERNSTEIN, supra note 3, at 137 (1988) (objecting to integration rules because they "credit the employer with half of each employee’s lifetime FICA contributions made by all of that individual’s employers, an unduly favorable basic assumption. In contrast, the employer makes contributions only for its plan participants."); Dilley, supra note 11, at 1187 (contending that because Social Security benefits are based on earnings and not contributions, "the presumption underlying pension integration — that employers should get ‘credit’ in the private pension relationship for contributions to the public program — is per se invalid").

30. Specifically, for those reaching age sixty-two in 2001, the Social Security benefit formula replaced 90% of the first $561 of average indexed monthly earnings (AIME), plus 32% of AIME between $561 and $3,381, plus 15% of AIME above $3,381 up to the maximum possible AIME. See Social Security Administration, Cost-of-Living Increase and Other Determinations for the Year 2001, 65 Fed. Reg. 63663, 63666 (Oct 24, 2000). As a result of the application of this progressive benefit formula, Social Security benefits replace about 56% of the AIME of workers with low lifetime covered earnings, 42% of the AIME of workers with average lifetime covered earnings, and 28% of the AIME of workers with lifetime covered earnings at or above the maximum taxable wage base. See U.S. GEN. ACCOUNTING OFFICE, SOCIAL SECURITY: DIFFERENT APPROACHES FOR ADDRESSING PROGRAM SOLVENCY (15 n.7 (GAO/HEHS-98-33, 1998).

31. See KOLLMAN & SCHMITT, supra note 11, at 1 (stating that "without integration, combined pension and Social Security benefits for lower wage employees can exceed pre-retirement income"); Bender, supra note 21, at 29 (noting that "without integration, some low paid workers could be much more likely to receive combined pension and Social Security benefits that are greater than their pre-retirement earnings"); Dilley, supra note 11, at 1074, 1165 (positing that "integration in some form is necessary to prevent . . . retirement income from the combination of Social Security and private pensions exceed[ing] pre-retirement earnings"); Gregory, supra note 6, at 319; Daniel I. Halperin, Retirement Security and Tax Equity: An Evaluation of ERISA, 17 B.C. INDUS. & COM. L. REV. 739, 762 (1976) (stating that without integration, lower paid employees could receive annuities from private plans and Social Security in excess of pre-retirement income).

32. I U.S. ADVISORY COUNCIL ON SOC. SEC., REPORT OF THE 1994-1996 ADVISORY COUNCIL ON SOCIAL SECURITY 28-29 (1997) [hereinafter ADVISORY COUNCIL REPORT]. The highlights of the IA plan may be summarized as follows: The IA plan recommends that individual accounts (IAs) be established for participants, that the IA’s be funded by a mandatory additional employee contribution of 1.6% of covered payroll, that individuals’ investments be limited to government-managed index funds, and that the IA balances be converted to single or joint minimum guarantee indexed annuities upon retirement. Id. The plan further contemplates retaining the current 90% replacement rate for low earnings while decreasing the replacement rates for middle and high earnings from 32% and 15% to 22.4% and 10.5% respectively,
(PSA) plan. The Article focuses on these particular proposals because they fairly represent the range of proposals currently under consideration, and the Advisory Council traditionally has played an important role in policymaking.

A. Overview of Integration Rules

There are two basic approaches to integration: the excess approach and the offset approach. Under the excess approach, which can apply to both defined benefit and defined contribution plans, the plan provides higher benefits (in the case of a defined benefit plan) or contributions (in the case of a defined contribution plan) with respect to compensation above an integration accelerator and extending the currently scheduled increase in the normal retirement age, altering spouse and survivor benefits, and basing benefits on thirty-eight rather than thirty-five years of earnings. Id.

33. See id. at 30-33. The highlights of the PSA plan may be summarized as follows: The PSA plan recommends that personal security accounts (PSAs) be established for participants, that the PSAs be funded by reallocating five percentage points of the employee's share of the current OASI tax, that the PSAs be individually owned, privately managed, and subject to limited regulatory constraints, that the funds be freely available for withdrawal at age sixty-two, and that any funds remaining in the individual's PSA at death be includible in the individual's estate. The plan provides for a flat first tier benefit for all workers under age twenty-five in 1998 equal to $410 per month in 1996 dollars, or the equivalent of 65% of the current poverty level for an elderly person living alone or 76% of the benefit payable to a low wage worker retiring in 1996. Benefits under the new system would be phased in for workers between the ages of twenty-five and fifty-five in 1996. The PSA plan further contemplates accelerating and extending the currently scheduled increase in the normal retirement age and increasing the earliest eligibility age, and altering spouse, survivor, and disability benefits. The PSA plan's proponents recognize that the plan would involve "transition costs" that could be financed in a number of different ways. Id.

34. See authorities cited in Moore, supra note 3, at 149 n.108. The 1994-1996 Advisory Council, however, may play a less significant role in policymaking than previous Advisory Councils because "historically the importance of the Advisory Council was in large part due to its ability to reach consensus" and the 1994-1996 Advisory Council did not reach consensus. Id.

35. See 26 U.S.C. § 401(q)(3)(A) (1994); see also Treas. Reg. § 1.401(q)-1(c)(16)(i) (as amended in 1993) ("Defined benefit excess plan means a defined benefit plan under which the rate at which employer-provided benefits are determined with respect to average annual compensation above the integration level under the plan (expressed as a percentage of such average annual compensation) is greater than the rate at which employer-provided benefits are determined with respect to average annual compensation at or below the integration level (expressed as a percentage of such average annual compensation.").

36. See 26 U.S.C. § 401(q)(2) (1994); see also Treas. Reg. § 1.401(q)-1(c)(16)(ii) (as amended in 1993) ("Defined contribution excess plan means a defined contribution plan under which the rate at which employer contributions are allocated to an account of employee with respect to plan year compensation above the integration level (expressed as a percentage of such plan year compensation) is greater than the rate at which employer contributions are allocated to account of an employee with respect to plan year compensation at or below the integration level (expressed as a percentage of such plan year compensation.").
level than with respect to compensation at or below the integration level. Under the offset approach, which only applies to defined benefit plans, the plan provides that an employee's benefit is reduced or offset by a specified percentage of the employee's final average compensation up to the plan's offset level. An offset plan may be thought of as a simple formula of A minus B equals C, where 'A' is the annual pension accrual, 'B' is the social security benefit offset, and 'C' is the amount of the pension check. Over the past twenty years, employers have shifted away from defined benefit offset plans to defined benefit excess plans.

Regarding excess plans, § 401(l) imposes limits on the amount by which benefits or contributions with respect to compensation above the integration level may exceed benefits or contributions with respect to compensation below the integration level. With respect to offset plans, § 401(l) imposes limits on the amount by which benefits below the offset level may be offset. The limits are related but not completely tied to Social Security benefits.

Specifically, with respect to defined contribution excess plans, § 401(l) provides that employer contributions with respect to compensation above the integration level may exceed contributions with respect to compensation below the integration level as long as contributions with respect to compensation above the integration level (the "excess contribution percentage") do not exceed contributions with respect to compensation below the integration level (the "base contribution level") by more than the lesser of the base contribution level

---

37. See 26 U.S.C. § 401(l)(3)(B); see also Treas. Reg. § 1.401(l)-1(c)(25) (as amended in 1993) ("Offset plan means a defined benefit plan that is not a defined benefit excess plan and that provides that each employee's employer-provided benefit is reduced or offset by a specified percentage of the employee's final average compensation up to the offset level under the plan.").

38. KOLLMAN & SCHMITT, supra note 11, at 5.

39. See OLIVIA S. MITCHELL, NEW TRENDS IN PENSION BENEFIT AND RETIREMENT PROVISIONS (NBER Working Paper No. 7381, tbl.11, Oct. 1999), available at http://www.nber.org/papers/w7381 (basing findings on data from medium and large firms, showing that between 1980 and 1997, percentage of full-time participants covered by integrated defined benefit offset plan fell from 30% to 13% while percentage of participants covered by integrated defined benefit excess plan increased from 16% to 36%).

40. In addition, the Treasury regulations provide for maximum permitted disparity limitations where an employee participates in more than one plan maintained by the employer during a plan-year, and they provide for limitations on the total maximum disparity which may be provided with respect to an employee's total years of service either under a single plan or multiple plans of the employer. See Treas. Reg. § 1.401(l)-5(a) (as amended in 1995).

41. For a more detailed discussion of integration as applied to defined contribution plans, see, for example, MICHAEL J. CANAN, QUALIFIED RETIREMENT AND OTHER EMPLOYEE BENEFIT PLANS § 10.3; MCGILL ET AL., supra note 11, at 325-26; Pamela D. Perdue, Permitted Disparity, Basic Law of Pensions, Welfare Plans, and Deferred Compensation, available at WL SF04 A.L.I.-A.B.A. 147, 151-60 (July 2000).


43. Id. § 401(l)(2)(B)(i).
percentage\textsuperscript{44} or the greater of (a) 5.7 percentage points\textsuperscript{45} or (b) the percentage equal to the employer portion of the FICA tax attributable to old age insurance.\textsuperscript{46} Currently, the employer portion of the FICA tax attributable to old age insurance is about 5%,\textsuperscript{47} and "the Social Security Administration is to advise the IRS when the rate attributable to old age-insurance rises above 5.7%."\textsuperscript{48}

Thus, for example, the § 401(l) integration rules would permit a defined contribution plan to provide contributions equal to 4% of compensation below the integration level and 8% of compensation above the integration level because the excess contribution percentage of 8% would not exceed the base contribution percentage of 4% by more than the lesser of the base benefit percentage of 4% or 5.7%. On the other hand, the integration rules would not permit a defined contribution plan to provide contributions equal to 6% of compensation below the integration level and 12% of compensation above the integration level because the excess contribution level of 12% would exceed the base contribution percentage of 6% by more than the lesser of the base contribution percentage of 6% or 5.7%.

The 5.7% excess contribution allowance is tied directly to Social Security contributions: it equals the employer’s share of contributions to Social Security old-age and survivors and disability insurance in 1986 (when § 401(l) was amended to include this provision).\textsuperscript{49} Similarly, "the percentage equal to the employer portion of the FICA tax attributable to old age insurance" is expressly tied to Social Security, although it is not yet in effect because the employer’s share of FICA tax attributable to old age insurance is currently (as of 2001) less than 5.7%.

The Treasury regulations provide that if the integration level is less than the Social Security taxable wage base,\textsuperscript{50} then the 5.7% maximum excess contribution allowance is reduced.\textsuperscript{51} This reduction is designed to prevent dis-
crimination in favor of highly compensated employees and not to reflect employer contributions to Social Security. Similarly, the alternative base contribution percentage limitation is not tied to Social Security, but instead is designed to ensure that employers make some contribution on behalf of lower-paid employees. The limitation requires that employers provide contributions with respect to compensation below the integration level that are at least half the percentage of contributions made with respect to compensation above the integration level.

With respect to defined benefit excess plans, § 401(l) provides that the excess benefit percentage "may not exceed the base benefit percentage by more than the maximum excess allowance." It then provides that the maximum excess allowance with respect to benefits attributable to any year of service taken into account with respect to the plan is the lesser of the base benefit percentage or 0.75%. The maximum excess allowance with respect to total benefits is the lesser of the base benefit percentage or 0.75% times the participant’s years of service (not to exceed thirty-five years) taken into account taxable wage base but not more than amount less than taxable wage base, 5.7% factor is reduced to 5.4%).

53. As originally proposed, the Section 401(l) regulations would have required defined contribution excess plans to use the Social Security taxable wage base as the integration level because "a lower integration level creates a significant potential for discrimination in favor of the highly compensated." See Preamble, 53 Fed. Reg. 45,917 (Nov. 15, 1988). See WIEDENBECK & OSGOOD, supra note 11, at 348 for an illustration of this potential discrimination.


55. Cf. KOLLMAN & SCHMITT, supra note 11, at 5 ("TRA 86 contains provisions to ensure that all vested employees receive some pension benefits."); MCGILL ET AL., supra note 11, at 324 ("A second new purpose under the Tax Reform Act is to prevent plans from providing little or no contributions or benefits to the lower paid."); Altman, supra note 10, at 488-89 n.203 ("The basic ratio limits, however, are essentially arbitrary, having been developed merely to simplify the existing rules and ensure that all plan participants receive some benefit." (citing S. REP. NO. 313, at 596 (1986))). Prior to the 1986 amendment to the integration rules, employers could "contribute 5.7% to a defined contribution excess plan with respect to wages above the integration level and need contribute nothing on wages below the integration level." (citing Altman, supra note 10, at 487; see also WIEDENBECK & OSGOOD, supra note 11, at 334 (discussing rule in effect in 1978).

56. For a more detailed discussion of integration as applied to defined benefit excess plans, see, for example, CANAN, supra note 41, § 10.3; Perdue, supra note 41, at 160-70.


account under the plan.\footnote{60} Thus, for example, the § 401(l) integration rules would permit a defined benefit excess plan to provide a benefit of 0.5% of the participant’s average annual compensation up to the integration level for the plan year plus 1% of his average annual compensation for the plan year in excess of the integration level, for each year of service up to thirty-five years, because the excess benefit percentage of 1% does not exceed the base benefit percentage of 0.5% by more than the lesser of the base benefit percentage of 0.5% or 0.75%. On the other hand, the integration rules would not permit a defined benefit excess plan to provide a benefit of 0.5% of the participant’s average annual compensation up to the integration level for the plan year plus 1.25% of his average annual compensation for the plan year in excess of the integration level, for each year of service up to thirty-five years, because the excess benefit percentage of 1.25% would exceed the base benefit percentage of 0.5% by more than the lesser of the base benefit percentage of 0.5% or 0.75%.

With respect to defined benefit offset plans,\footnote{61} § 401(l) provides that a participant’s accrued benefit in an offset plan may not be reduced by reason of the offset by more than the maximum offset allowance.\footnote{62} The maximum offset allowance with respect to a participant for any year of service taken into account under the plan is the lesser of 50% of the benefit that would have accrued without regard to the offset reduction or 0.75% of the participant’s final average compensation.\footnote{63} The maximum offset allowance with respect to a participant’s total benefits is the lesser of 50% of the benefit that would have accrued without regard to the offset allowance or 0.75% of the participant’s final average compensation times the participant’s years of service (not to exceed thirty-five) taken into account under the plan.\footnote{64}

Thus, for example, the integration rules would permit a defined benefit offset plan to provide a normal retirement benefit equal to 1% of average annual compensation minus 0.5% of final average compensation up to the offset level, for each year of service up to thirty-five, because the offset percentage of 0.5% is not greater than the lesser of 50% of the benefit that would have accrued without regard to the offset allowance, which is 0.5%, or 0.75%. On the other hand, the integration rules would not permit a defined benefit offset plan to provide a normal retirement benefit equal to 1% of average annual compensation minus 0.75% of final average compensation up to the offset level for each year of service up to thirty-five because the offset per-

\footnote{61. For a more detailed discussion of integration as applied to defined benefit offset plans, see, for example, CANAN, supra note 41, § 10.3; Perdue, supra note 41, at 160-70.}
\footnote{63. See id. § 401(l)(4)(B)(i).}
\footnote{64. See id. § 401(l)(4)(B).}
The percentage of 0.75% is greater than the lesser of 50% of the benefit that would have accrued without regard to the offset allowance, which is 0.5%, or 0.75%.

Just as the 5.7% limitation for defined contribution excess plans is designed to approximate the Social Security employer contribution rate, the 0.75% factor for defined benefit excess and offset plans is designed to approximate the Social Security benefit accrual rate. According to James Holland, the Chief of the I.R.S. Pension Actuarial Branch in 1986, the 0.75% factor was derived from at least three different calculations.

First, it was the result of an extrapolation from the [then] current law rule with respect to unit benefit excess plans which limits the differential above and below the integration level, with respect to final salary plans, to one percent in the absence of ancillary benefits. The 1% is reduced to .75 of 1% to account for standard ancillary benefits. The reduction is necessary because ancillary benefits, which constitute the same percentage of the basic benefits of all beneficiaries, increase the percentage differential between the higher and lower paid, thus disproportionately benefitting the highest paid. (Assume that, without regard to ancillaries, wages above the integration level are eligible for benefits equal to 2%; wages below, 1%. If an ancillary benefit, equal to half the basic benefit is provided, the benefit becomes 3% and 2% [sic], respectively a differential of 1½%). Second, it resulted from at least two other calculations which actually produced a factor of .6 of 1% but which then was increased in order to not produce too harsh results. One calculation took the average replacement rate received by those earning at or above the Social Security taxable wage base (determined to be 43%), divided that average by 50% in order to credit only the employer’s portion and divided that by 35 in order to prorate the benefit over the work-life. Another calculation sought to relate the 37.5% factor, and the covered compensation level to [Average Indexed Monthly Earnings (AIME)]. That is, it was determined that 37.5% of covered compensation

65. See Altman, supra note 10, at 492 ("The .75 of 1% times years of service is intended to approximate the portion of Social Security benefits attributable to the employer.").

66. Ancillary benefits, also referred to as "derivative" or "auxiliary benefits," are benefits provided to certain family members of retired, disabled, and deceased workers. See 42 U.S.C. § 402(b)-(h) (1994).

67. At the time that § 401(f) was enacted, the employer portion of the Social Security benefit for workers who earned the maximum benefit was calculated to be 37.5%. See Rev. Rul. 71-446 § 5, 1971-2 C.B. 187 (1971). "The justification in the regulations for the 37.5% figure is: The OASDI benefit is considered to be equal to 70% of employees' average monthly wages. Half of that, or 35%, is considered to be attributable to employer contributions." Altman, supra note 10, at 482 n.188.

68. The AIME are the average adjusted earnings on which Social Security benefits are based. The AIME are calculated "by taking the best 35 years of earnings adjusted for past wage inflation, adding them together and dividing by 420 (the number of months in 35 years)." Moore, supra note 59, at 986; see 42 U.S.C. § 415(b) (1994).
EFFECTS OF PARTIAL PRIVATIZATION ON PRIVATE PENSIONS

(taken to be $16,000) was 26.65% of the maximum AIME for 1986. The 26.65% was then divided by 35 (again to prorate the result) which produced .76 of 1%. That amount, which was then reduced to take into account ancillary benefits, was determined to be approximately .6 of 1%.69

Treasury regulations provide that if the integration level exceeds covered compensation, defined as the average of the employee’s taxable wage base in effect for each year of the thirty-five year period ending with the year in which the employee reaches the Social Security retirement age,70 the 0.75% factor is reduced.71 The reduction in the 0.75% factor is designed to reflect the fact that the Social Security replacement rate declines for compensation in excess of the covered compensation (because such compensation generates no additional old-age benefits)72 and to prevent discrimination in favor of highly compensated employees.73 Like the alternative base contribution percentage limitation for defined contribution excess plans,74 neither the alternative base benefit percentage limitation for defined benefit excess plans75 nor the alternative limitation of 50% of the benefit that would have accrued without regard to the offset for defined benefit offset plans76 are tied to Social Security. Instead, both are designed to ensure that employers make some contribution on behalf of lower-paid employees.77

72. See WIEDENBECK & OSGOOD, supra note 11, at 346 ("Congress intended that the reductions for higher integration levels will reflect the decreasing percentages of compensation replaced by the employer-provided PIA under social security as compensation increases above covered compensation." (quoting STAFF OF THE JT. COMM. ON TAX'N, 100TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 (1987))).
73. See WIEDENBECK & OSGOOD, supra note 11, at 348-50.
75. See id. §§ 401(l)(4)(A), 401(l)(4)(B).
76. See id. § 401(l)(4)(B).
77. Cf. Altman, supra note 10, at 492 ("[U]nder the new rule, employers who use an offset formula must, in effect, offer a minimum benefit equal to half the percentage of the benefit provided to the highest paid employees. While this change, again, redistributes employer benefits to the lower paid in comparison to the current law rule, it fails to address coherently the question of how to mesh Social Security with private pensions."). As in the case of defined contribution excess plans, integrated defined benefit plans prior to the 1986 Act could provide benefits with respect to wages above the integration level without providing any benefits with respect to wages below the integration level. See KOLLMAN & SCHMITT, supra note 11, at 4, 9.
B. Effect of Partial Privatization on Integration Rules

Partial privatization would likely require modification of the integration rules. The extent of modification, however, depends on the specifics of the partial privatization proposal.

All partial privatization proposals would fundamentally restructure the current Social Security system by adding second tier prefunded individual accounts. Thus, the first issue partial privatization raises is how the integration rules should handle the second tier individual accounts. That, in turn, depends on how partial privatization is structured.

If, as in the Advisory Council's Individual Account (IA) and Personal Security Account (PSA) plans, the second tier individual accounts were financed solely by employee contributions, then second tier individual accounts should be disregarded for purposes of integration. One of the principal justifications for integration is that, at least nominally, employers pay one half of the Social Security payroll tax. If employers do not pay any part of the second tier benefits, then employers should not be entitled to any credit for these benefits for integration purposes.

If, on the other hand, a partially privatized system provided second tier benefits that were financed, at least in part, by employer contributions, then current integration policy suggests that employers should be given credit for second tier benefits for integration purposes. To the extent that those benefits were funded by an increase in the employer portion of the Social Security tax, the current integration rules for defined contribution plans would automatically adjust to any increase in employer contributions required to fund such benefits. The current integration rules for defined benefit plans, however, would not adapt as easily to the creation of second tier individual accounts. Because the second tier individual accounts would constitute defined contribution plans rather than defined benefit plans, it would be quite difficult to calculate the credit employers should be given for second tier benefits. Like all defined contribution benefits, second tier individual account benefits would be based on contributions to the individual accounts and any earnings and losses on those accounts; there would be no way to know in advance how much any particular worker would receive from her individual account. The § 401(a)(4) cross-testing rules, however, might provide some guidance in

78. For a more detailed discussion of how partial privatization fundamentally differs from the current system, see Moore, supra note 7, at 346-51.

79. See Advisory Council Report, supra note 32, at 28-29 (setting forth IA plan).

80. See id. at 30-33 (setting forth PSA plan).

81. See supra note 29 and accompanying text.


determining how contributions to the second tier individual accounts should be converted to benefits for purposes of calculating the credit employers should be given for integrated defined benefit plans.

Partial privatization also raises questions about how the integration rules should handle the first tier benefits. That, in turn, would again depend on the structure of partial privatization and how it would affect the current system's funding structure and promised benefits.

If partial privatization were financed by an increase in employer payroll taxes, then the current integration rules for defined contribution plans would automatically adjust to any increase in employer contributions. If, on the other hand, partial privatization did not change employer payroll taxes, then the integration rules for defined contribution plans would remain the same. The integration rules for defined contribution plans are tied solely to employer contributions and would not be affected by any change in promised benefits.

Unlike the integration rules for defined contribution plans, the integration rules for defined benefit plans are tied to promised benefits. They would not, however, automatically adjust to any change in promised benefits. Instead, the current integration rules for defined benefit plans would likely have to be expressly amended if partial privatization were to alter benefits promised under the current system.

Partial privatization proposals differ widely in the extent to which they would modify benefits promised under the current system. The Advisory Council's IA plan, for example, would make relatively modest alterations in the benefits promised by the current system. Specifically, the IA plan would modify the current benefit formula by gradually reducing the replacement rates for middle and high earnings from 32% and 15% to 22.4% and 10.5%, respectively, and basing benefits on thirty-eight years of wages rather than thirty-five years of wages as under the current system.

84. Depending on how the transition costs of the PSA plan were financed, adoption of the PSA plan might result in the percentage of the employer portion of the FICA tax attributable to old age insurance exceeding 5.7%. The PSA plan proponents would prefer to finance the transition costs through a broad-based consumption tax. See ADVISORY COUNCIL REPORT, supra note 32, at 32. They note, however, that the transition costs could be financed by a 1.52% supplement to the payroll tax over the next seventy-two years. Id. If the transition costs were financed by the later increase in the payroll tax and one-half or more of the increased tax were imposed on employers, the employer portion of the FICA tax attributable to old age insurance would likely exceed 5.7%.

85. If, however, the PSA plan were adopted, it might be appropriate to repeal the integration rules for defined contribution plans as well as defined benefit plans. See infra text accompanying notes 105-07.

86. For an explanation of how Social Security benefits are currently calculated, see Moore, supra note 59, at 985-90, and authorities cited therein.

87. See ADVISORY COUNCIL REPORT, supra note 32, at 29.
plan would modify the current system’s benefit formula by accelerating the currently scheduled increase in the normal retirement age (NRA) so that the NRA reaches sixty-seven by the year 2011, and increase the NRA thereafter in conjunction with increases in life expectancy.

Unlike the IA plan, the Advisory Council’s PSA plan would dramatically alter benefits promised by the current system. Specifically, the PSA plan would replace the current system’s weighted benefit formula with a first tier flat benefit equal to $410 per month in 1996 dollars for workers with full careers who were under the age of twenty-five in 1998. The PSA plan contemplates that the first tier flat benefit of $410 monthly in 1996 dollars would fully apply to workers under age twenty-five in 1998, but that it would be slowly phased in for workers age twenty-five to fifty-four in 1998. For these workers, the accrued benefit would be calculated under present law as of January 1, 1998, and would be wage-indexed until the year the worker becomes eligible to retire. In addition, "[t]he flat benefit would be prorated to reflect the proportion of potential work-years (out of [forty] years between [twenty-two] and [sixty-one]) that occur under the new system." Like the IA plan, the PSA plan would accelerate the currently scheduled increase in the NRA and increase it thereafter in conjunction with increases in life expectancy. The PSA plan would also raise the earliest age at which benefits are available.

Arguably, the IA plan’s modification of the weighted benefit formula could call for a recalculation of the current § 401(l) 0.75% maximum allowance for integrated defined benefit plans because the 0.75% factor is designed to approximate the current system’s benefit accrual rate and the IA plan would modify the benefit accrual rate. On the other hand, a strong argument can be made that adoption of the IA plan would not require modification of the 0.75% factor because the IA plan only modestly changes the current system’s benefit

88. Under current law, a retired worker is entitled to receive unreduced Social Security benefits at the NRA, 42 U.S.C. § 402(a), which is sixty-five for workers reaching age sixty-two before 2000 and is scheduled to increase gradually to sixty-seven by 2022. See 42 U.S.C. § 416() (1994).
89. See ADVISORY COUNCIL REPORT, supra note 32, at 28-29. The IA plan would also reduce benefits for dependent and surviving spouses, id. at 29, but those changes are not relevant for integration purposes.
90. id. at 31.
91. id.
92. id.
93. id.
94. id.
95. id.
96. id. The PSA plan would also alter benefits for spouses, surviving spouses, and disabled workers, although those changes are not relevant for integration purposes. Id.
formula and the 0.75% factor is merely an approximation of the current Social Security benefit accrual rate, not an exact figure.\textsuperscript{97} If, however, the 0.75% factor were modified, it would probably be increased to permit more integration because the IA plan reduces benefits for middle- and high-income earners and thus increases the level of redistribution compared to the current system.

Adoption of the IA plan would, however, require modification of the current law's requirement that no more than thirty-five years of service be taken into account in determining the maximum allowance in the case of total benefits.\textsuperscript{98} Because the IA plan bases benefits on thirty-eight years of earnings, rather than thirty-five years as under current law, the thirty-five years of service limitation should be extended to thirty-eight years. Similarly, the definition of covered compensation should be amended to extend from "the [thirty-five] year period" to "the [thirty-eight] year period ending with the year in which the employee attains the social security retirement age."\textsuperscript{99}

Although adoption of the IA plan would not require a recalculation of the 0.75% factor, adoption of the PSA plan would mandate a recalculation. Unlike benefit accruals under the IA plan, benefit accruals under the PSA plan, at least once the system is fully phased in, would bear no resemblance to benefit accruals under the current system. Thus, benefit accruals under the PSA plan would bear no resemblance to the 0.75% factor. The benefit accrual rate of the PSA first tier benefit "attributable" to employer contributions, once fully phased in, should be relatively easy to calculate because the first tier is a flat benefit, and the vast majority, if not all, of the first tier flat benefit would be attributable to employer contributions.\textsuperscript{100}

Calculating the benefit accrual rate attributable to employer contributions during the PSA plan's lengthy transition period, however, could be much more difficult. To the extent that transition benefits are attributable, at least in part, to employer contributions, it could be quite difficult to calculate the proper integration factor during this long transition period. On the other hand,

\begin{itemize}
\item \textsuperscript{97} See supra notes 65-69 and accompanying text (explaining derivation of 0.75% factor); see also Altman, supra note 10, at 482 n.188 (noting that prior to 1986 amendment to integration rules, employer portion of Social Security benefit for workers who earned maximum benefit was calculated at 37.5% from 1942 through 1988 (when 1986 rules went into effect), even though Social Security benefits had been adjusted over one dozen times during that period, not including annual indexing that began in 1974).
\item \textsuperscript{99} See id. § 401(j)(5)(E)(i).
\item \textsuperscript{100} See ADVISORY COUNCIL REPORT, supra note 32, at 30 (noting that "the tier I retirement benefits, spouse benefits, and survivor and disability benefits would be financed by the 7.4 percent of payroll tax not used to fund PSAs," and that 6.2 percentage points of this tax would be attributable to employer contributions, while only 1.2% would be attributable to employee contributions).
\end{itemize}
it is not clear that any of these transition benefits would be attributable to
dp employer contributions. The proponents of the PSA plan contemplate financ-
ingen the transition costs by a combination of Federal borrowing and increased
taxes.\footnote{See id. at 32.} They note that the Social Security Administration actuaries project
that a 1.52% supplement to the payroll tax for seventy-two years could finance
the transition costs.\footnote{See id.} The PSA proponents, however, state that they would
prefer to use a broad-based consumption tax rather than increasing payroll
taxes to finance the transition costs.\footnote{See id.} In addition, President Bush has barred
payroll tax increases as one of his six basic principles underlying Social
Security reform.\footnote{See Jackie Calmes, \textit{Bush Social Security Panel Doesn't Fear Painful Solutions}, \textit{WALL \textit{ST. J.}}, May 10, 2001, at A20 (noting that one of Bush's six principles bars payroll tax in-
creases).} To the extent that the transition costs would not be funded
by any employer contributions, employers should not be given any credit for
integration purposes. Instead, even during the transition period, they should
only be given credit for the flat first tier benefit.

Moreover, even though it would be relatively easy to calculate the benefit
accrual rate for the flat first tier PSA benefit attributable to employer contribu-
tions, it is not clear that employers should be permitted such a credit. One of
the justifications typically given for integration is that because Social Security
replaces a larger percentage of the pre-retirement earnings of the lower-paid
than that of the higher-paid, some lower-paid workers might receive combined
pension and Social Security benefits that exceed 100% of their pre-retirement
earnings absent integration.\footnote{See supra note 31 and accompanying text (noting justification for Social Security).} Given the extremely low level of the first tier
benefit guaranteed by the PSA plan -- $410 monthly in 1996 for workers under
age twenty-five in 1998, which is the equivalent of 65% of the current poverty
level for an elderly person living alone\footnote{Cf. Altman, \textit{supra} note 10, at 495 ("The law should permit qualified private pension
arrangements to be integrated with Social Security in only one situation. That situation is when,
without coordination, benefits from Social Security and qualified retirement plans in combina-
tion will result in overpensioning a segment of the work force."); Slusher, \textit{supra} note 22, at 25
("If a reform proposal provides benefits that are not weighted in favor of low earners then the
validity of providers' stated motivation for integration - to counterbalance the progressiveness
of Social Security -- would be diminished.").} the first tier benefit hardly raises
a realistic concern of overpensioning low-wage earners. Thus, if the PSA plan
were implemented, there would be a strong argument for repealing the integra-
tion rules for both defined benefit and defined contribution plans.\footnote{ADVISORY COUNCIL REPORT, \textit{supra} note 32, at 31.}
C. Effect of Partial Privatization on Integrated Plans

If partial privatization were to require modification or even repeal of the current integration rules, partial privatization would likely cause employers to amend the terms of their plans in order to adjust to the new rules. How employers would amend the terms of their plans, however, depends on the form partial privatization would take and how it would change the integration rules.

For example, if the IA plan were adopted, employers with integrated defined contribution plans probably would not change the terms of their plans because the IA plan would not increase the payroll tax imposed on employers and would not require a change in the integration rules for defined contribution plans. Employers with integrated defined benefit plans, on the other hand, would likely change the terms of their plans because adoption of the IA plan would likely lead to a change in the integration rules for defined benefit plans.

If the 0.75% factor for integrated defined benefit plans were increased to reflect the IA plan's reduction of benefits for middle- and higher-wage workers, employers that integrate their defined benefit plans at the 0.75% factor might reduce benefits for wages below the integration level to take advantage of this increased level of permissible integration. If, on the other hand, the 0.75% factor were not modified, then employers that integrate their defined benefit plans at the 0.75% factor would not be permitted to increase their level of integration. If the IA plan were adopted and Social Security benefits were based on thirty-eight years of wages rather than the current thirty-five years, then employers who currently base benefits on thirty-five years of earnings might amend their plans to base benefits on thirty-eight years of earnings. Because wages tend to rise over time, basing benefits on thirty-eight years of earnings rather than thirty-five years is likely to reduce retirement benefits for most, if not all, workers in defined benefit plans with career earnings formulas.

108. Because the IA plan would increase the payroll tax on workers, workers might decrease their voluntary contributions to 401(k) plans. See infra Part III.B (discussing employees' willingness to contribute to employer-sponsored defined contribution plans). Such plans, however, cannot be integrated plans. See Treas. Reg. § 1.401(k)-1(a)(4)(iii) (2001) (barring availability of §§ 401(a)(5)(C) and 401(l) for elective contributions under § 1.401(k)-1(g)(3)).

109. Employers, however, with integrated excess defined benefit plans that rely on an alternative base contribution level or with integrated offset plans that rely on the 50% benefit that would have accrued without regard to the offset reduction would only be able to take advantage of the higher permissible integration level if they increased benefits for lower-wage workers as well as higher-wage workers.


If the PSA plan were adopted, and no change were made to the integration rules for defined contribution plans, then employers probably would not make any changes to their integrated defined contribution plans. If, however, the integration rules were changed, then employers might change the terms of their integrated plans to adapt to such changes. For example, if the PSA plan were adopted and financed by an increase in employer payroll taxes, then employers that rely on the 5.7% maximum excess allowance in integrating their defined contribution plans might increase their level of integration to take advantage of the increase in the permissible allowance. Moreover, if the PSA plan were adopted and financed by an increase in the employer payroll tax, employers who do not currently integrate their defined contribution plans might elect to integrate their plans in order to offset some of this increased cost.

If the PSA plan were adopted and the 0.75% factor were modified, then employers with integrated defined benefit plans that rely on the 0.75% factor might modify the terms of their plans to adjust to the change in the 0.75% factor. How employers would adapt to such a change would depend on the new integration factor. Because the PSA plan would dramatically reduce guaranteed Social Security benefits, the PSA plan might result in a significantly decreased level of permissible integration. Alternatively, because the flat first tier benefit would represent an even larger percentage of low-wage earnings relative to high-wage earnings than does the benefit provided by the current system, the PSA plan might actually result in a higher level of permissible integration, if it did not result in the repeal of integration.

In addition, again depending on how the 0.75% factor were modified, employers with integrated defined benefit plans that do not rely on the 0.75% factor might also modify the terms of their integrated plans to adapt to such a change. Specifically, if the 0.75% factor were reduced to permit less integration, then this lower permissible integration factor might require plans that are currently limited by the alternative base benefit percentage limitation for defined benefit excess plans or the 50% of benefit that would have accrued without regard to the offset reduction limitation for defined benefit-offset plans to reduce their level of integration.

Security benefits on all earnings for ages twenty-two through sixty-six rather than on highest thirty-five years of earnings as under current law would reduce Social Security benefits for all individuals); Memorandum from Keith Fontenot, Assistant Deputy Commissioner for Policy, Social Security Administration, to Jane Ross, Deputy Commissioner for Policy, Social Security Administration, tbl3 (May 18, 1999), available at http://199.173.225.108/policy/pubs/mem DistImp.pdf (showing that basing Social Security benefits on highest thirty-eight or forty years of earnings rather than on highest thirty-five years of earnings would reduce Social Security benefits for all individuals).

112. To the extent that maximum integration level is limited by the alternative base contribution percentage, employers would not be permitted to take advantage of any increase in the 5.7 percent maximum excess allowance under 26 U.S.C. § 401(f)(2)(A) (1994).
Finally, if the PSA plan were adopted and the integration rules were repealed, some employers might terminate their integrated plans or at least reduce plan benefits, including benefits for lower-wage workers. Because participation in the current private pension system is purely voluntary, any change in the law that has the effect of increasing the cost of plans or reducing benefits for higher-paid workers may encourage some employers to reduce or eliminate pension benefits.\textsuperscript{113}

\section*{D. Summary}

Partial privatization of Social Security is likely to require a change in the current integration rules and the terms of integrated plans. The significance of the changes, however, depends on the specifics of the partial privatization proposal. The more partial privatization would alter the terms of the current Social Security system, the greater the changes partial privatization would likely impose on the integration rules and integrated plans.

\section*{III. Interaction with Other Links Between Social Security and Private Pensions}

Although integration is the only area of the law where Social Security and private pensions are coordinated expressly, private pensions may be

\begin{flushright}
\footnotesize\textsuperscript{113}. \textit{Cf.} II REPORT OF THE 1994-1996 ADVISORY COUNCIL ON SOCIAL SECURITY: REPORT OF THE TECHNICAL PANEL ON TRENDS AND ISSUES IN RETIREMENT SAVINGS 46 (1995) [hereinafter TECHNICAL PANEL] ("More recent studies tend to confirm that pension savings are sensitive to tax policy, although the estimates are imprecise because of the difficulty of obtaining individuals' marginal income tax rates along with pension savings information."); STEPHEN WOODBURY & WEE-SANG HUANG, THE TAX TREATMENT OF FRINGE BENEFITS 139-40 & tbl.4.13 (1991) (finding that eliminating tax preference for benefits would cut employer contributions to pensions by half with low-wage workers feeling greatest reduction in pension savings); Gregory, \textit{supra} note 6, at 314 ("To the extent that an employer's business circumstances restrict the amount of resources that profitably can be allocated to compensation, increased social security taxes — or, for that matter, any other increased cost to the employer as a result of social security reform — will result in reductions in other components of the compensation package, including employer sponsorship of and contributions to retirement plans."); Daniel I. Halperin, \textit{Special Tax Treatment for Employer-Based Retirement Programs: Is It "Still" Viable as a Means of Increasing Retirement Income?}, 49 TAX L. REV. 1, 5-6 (1993) (noting that "there may be limits to how far one can push a voluntary program. No employer is required to have a pension plan. Tax benefits may encourage adoption of a plan that otherwise would not exist, but if the availability of tax benefits depends upon satisfying significant requirements, there may not be enough takers."); Colleen E. Medill, \textit{Targeted Pension Reform}, 27 J. LEGIS. 1, 97-99 (2001); see also Firestone Tire & Rubber Co. v. Bruch, 489 U.S. 101, 114 (1989) (noting that "Firestone and its \textit{amicus} also assert that a \textit{de novo} standard would contravene the spirit of ERISA because it would impose much higher administrative and litigation costs and therefore discourage employers from creating benefit plans").
\end{flushright}
linked explicitly or implicitly to Social Security in a number of other ways. For example, defined benefit plans may define their normal retirement age as the Social Security normal retirement age or they may provide early retirement benefit subsidies that are eliminated upon the availability of Social Security benefits. In addition, employees' demand for particular types of private pensions may depend on the structure of their Social Security benefits, and their investment behavior may be linked to the level of Social Security benefits that they are guaranteed.

This section discusses how partial privatization is likely to affect private pensions based on the explicit and implicit links between Social Security and private pensions. Specifically, it considers how partial privatization is likely to affect (1) employees' demand for defined benefit plans, (2) employees' willingness to contribute to employer-sponsored defined contribution plans, (3) employees' investment behavior with respect to the assets in their employer-sponsored plans, and (4) investment returns available to employer-sponsored plans.

A. Demand for Defined Benefit Plans

In the last twenty years, the type of pension plan employers offer their employees has shifted dramatically. In 1980, 80% of all workers with an

114. Cf. U.S. Gen. Accounting Office, supra note 6, at 17 ("Because Social Security has a central role in providing retirement income, almost all pension plans are implicitly linked to Social Security, insofar as their design takes into account the provisions of and benefits provided by Social Security."); Samwick, supra note 6, at 22 ("Whenever there is a change to Social Security, employers are induced to change their pension plans because, in light of the change, another plan design may better achieve the savings objectives of the workers. All pension plans are therefore implicitly linked to Social Security, since the optimal use of the tax advantage of the pension depends on the other resources available to retirees."); Gregory, supra note 6, at 319 (asserting that "virtually all employer-sponsored retirement plans assume their participants will receive social security benefits under a structure similar to the current program. Thus, while discussion of integration tend to focus on plans whose formulas are formally linked in some way to social security benefits, in the broadest sense almost all plans are integrated.").

employer-sponsored pension were covered by a defined benefit plan. By 1999, the majority of workers with an employer-provided pension were covered by a defined pension plan; only 40% of workers were covered by a defined contribution plan.

If Social Security were partially privatized, it too would shift the structure of retirement benefits toward a defined contribution system. The current Social Security system is a purely defined benefit system. Partial privatization would graft a defined contribution layer of prefunded individual account benefits onto the first tier defined benefit.

Defined benefit plans differ fundamentally from defined contribution plans in that defined benefit plans place investment risk on the plan sponsor, while defined contribution plans place investment risk on the plan participant. If Social Security were partially privatized, employees might increase their demand for employer-sponsored defined benefit plans as employees seek to offset some of the increased investment risk that partial privatization would place on them.

(questioning whether there really has been shift from defined benefit to defined contribution plans: "While the net number of private defined benefit plans has declined and the net number of defined contribution plans has increased significantly, there is little evidence of a shift from defined benefit to defined contribution plans.


117. See id. at 80 & n.4 (stating that workers are considered covered by defined benefit plan if they are covered by both defined contribution and defined benefit plan and that worker is only considered covered by defined contribution plan if worker is only covered by defined contribution plan). Olivia Mitchell and Sylvester Schieber offer four reasons for the growth in defined contribution plans: (1) both employers and employees view defined contribution plans as "flexible," (2) employers can target their matching contributions to reward specific behaviors and types of employees, (3) defined contribution plans are often perceived as less expensive than defined benefit plans, and (4) proponents of defined contribution plans contend that they are less risky than defined benefit plans because defined contribution plans must always be fully funded. Olivia S. Mitchell & Sylvester J. Schieber, Defined Contribution Pensions: New Opportunities, New Risks, in LIVING WITH DEFINED CONTRIBUTION PENSIONS, supra note 115, at 4-10. For additional theories explaining the shift toward defined contribution plans, see Colleen E. Medill, The Individual Responsibility Model of Retirement Plans Today: Conforming ERISA Policy to Reality, 49 EMORY L.J. 1, 6 n.24 (2000).

118. See Moore, supra note 7, at 348.

119. Id.

120. Id. at 347-48.

121. See ERISA INDUS. COMM, supra note 4, at 64 ("Shifting Social Security from a defined benefit program toward a defined contribution program where individuals bear market risk by the creation of individual Social Security accounts, could impose greater pressure on employers to provide more benefits under defined benefit than under defined contribution plans—precisely the opposite of current trends."); SAMWICK, supra note 6, at 13-14 ("Restoring financial solvency
The extent that partial privatization would increase demand for defined benefit plans would likely depend on the magnitude of the investment risk it would place on workers. Some partial privatization proposals, like the IA plan, would only shift a relatively modest amount of investment risk to workers. Other partial privatization proposals, like the PSA plan, would shift substantially more risk on to workers. The greater the amount of risk partial privatization would shift to workers, the more likely partial privatization would cause workers to increase their demand for employer-sponsored defined benefit plans.

B. Employees' Willingness and Ability to Contribute to Employer-Sponsored Defined Contribution Plans

Much of the recent shift towards defined contribution plans is attributable to the dramatic growth of 401(k) plans over the last twenty years. The number of 401(k) plans offered by employers grew from fewer than 25,000 in 1984 to more than 225,000 by 1996, and the pension industry says that it expects this growth to continue.

401(k) plans differ fundamentally from most other employer-sponsored retirement plans because they are funded principally by employees' voluntary contributions. Although employers are permitted to contribute to 401(k) plans, they are not required to do so; funding of 401(k) plans typically depends principally on employee choice and ability to save.

may also change the features of Social Security (e.g., reducing the annuitization of benefits), causing a greater demand for these features in private pension plans.

122. The IA plan would be funded by a relatively modest additional 1.6% payroll tax imposed on employees. ADVISORY COUNCIL REPORT, supra note 32, at 28; see supra notes 86-94 and accompanying text (describing IA plan's changes to weighted benefit formula).

123. For a detailed discussion of this growth, see, for example, Medill, supra note 117, at 7-9.


126. Although most other employer-sponsored pension plans are funded solely by employer contributions, employees may be permitted to contribute to a few other types of employer-sponsored pensions such as § 403(b) annuities and § 408(p) simple retirement accounts. Cf. 26 U.S.C. § 402(g)(3) (1999).


128. See id. §§ 401(k)(12), 401(m)(4) (1999) (allowing employer to make matching contributions to fund).

129. Indeed, Colleen Medill refers to 401(k) plans as the "individual responsibility model" of retirement savings. See Medill, supra note 117, at 4.
Partial privatization of Social Security could have an impact on the willingness of employees, particularly lower-income employees, to contribute to 401(k) plans. Even now, lower-income workers covered by 401(k) plans are less likely to contribute to such plans than are higher-income workers, and when they participate, lower-income workers generally contribute a smaller percentage of their income than do higher income workers. If partial privatization, like the Advisory Council's IA plan, were accompanied by an increase in the payroll tax imposed on employees, employees, particularly lower-income employees, might be even less willing and able to make voluntary contributions to their 401(k) plans.

If partial privatization were to cause lower-income workers to reduce their contributions to 401(k) plans, it could have serious implications for highly compensated employees who use such plans to defer income. As discussed above, § 401(a)(4) of the Internal Revenue Code requires that the contributions of an employer-sponsored retirement plan not discriminate in favor of highly compensated employees in order for the plan to be qualified and thus receive favorable tax treatment. Section 401(k) imposes special nondiscrimination rules for 401(k) plans. In essence, the nondiscrimination rules require

---

130. Once pay exceeds $75,000 per year, contribution rates may decrease as salary increases. See, e.g., Robert L. Clark & Sylvester J. Scheiber, Factors Affecting Participation Rates and Contribution Levels in 401(k) Plans, in LIVING WITH DEFINED CONTRIBUTION PENSIONS, supra note 115, at 69, 81 & tbl. 8.

131. See, e.g., ALICIA H. MUNNEL et al., WHAT DETERMINES 401(k) PARTICIPATION AND CONTRIBUTIONS 14 (Ctr. for Ret. Research at Boston Coll. Working Paper 2000-12, 2000); REPORT TO THE CHAIRMAN, SUBCOMM. ON SOCIAL SECURITY, COMM. ON WAYS AND MEANS, HOUSE OF REP., 401(k) PLANS: MANY TAKE ADVANTAGE OF OPPORTUNITY TO ENSURE ADEQUATE RETIREMENT INCOME 6, 23 (GAO/HEHS-96-176 1996); Clark & Scheiber, supra note 130, at 74, 80-81 & tbls.7-8; Richard P. Hinz & John A. Turner, Pension Coverage Initiatives: Why Don't Workers Participate?, in LIVING WITH DEFINED CONTRIBUTION PENSIONS, supra note 115, at 24-27 & tbls.1, 3; Andrea L. Kusko et al., Employee Decisions with Respect to 401(k) Plans, in LIVING WITH DEFINED CONTRIBUTION PENSIONS, supra note 115, at 106-07 & tbl.3.

132. At the symposium, Governor Gramlich, Chair of the 1994-1996 Advisory Council of Social Security and proponent of the IA plan, contended that the 1.6% of payroll used to fund the IA plan's individual accounts did not constitute an increase in "payroll taxes" because the 1.6% of payroll would be used to fund individual accounts, not current benefits. Regardless of whether this 1.6% of payroll is characterized as a "payroll tax" or a mandatory savings contribution, it would impose an additional cost on employees that could affect their willingness to contribute to employer-sponsored pension plans.

133. Cf. Hinz & Turner, supra note 131, at 31-32 & tbl.7 (noting that most common reason workers give for not contributing to the Federal Thrift Savings Plan is that they "can't spare the money").

134. See supra Part II.

that contributions for highly compensated employees not exceed contributions for non-highly compensated employees by too great a percentage.\[136\] If lower-income workers were to reduce or even eliminate their voluntary contributions to 401(k) plans, then the ability of highly compensated employees to use 401(k) plans to defer income and thus, taxes might be reduced or even eliminated.\[137\]

Reduced voluntary contributions by lower-paid employees, however, need not affect the ability of highly compensated employees to use 401(k) plans to defer income and thus, taxes. If employers want to ensure that highly compensated employees may use their 401(k) plans, then they can draft their plans to satisfy one of two statutory safe harbors.\[138\] Under these safe harbors, a 401(k) plan will automatically satisfy the nondiscrimination requirement if the plan provides that either (1) the employer will contribute at least 3% of compensation to all eligible non-highly compensated employees under the plan regardless of how much, or whether, they voluntarily elect to contribute to the plan\[139\] or (2) the employer will make a matching contribution equal to 100% of each non-highly compensated employee’s elective 401(k) contribution in an amount up to 3% of the employee’s compensation plus 50% of the amount the employee contributes between 3% and 5% of compensation.\[140\] Satisfying the statutory safe harbors, however, is not costless to employers. It requires that they provide either nonelective contributions or matching contributions.\[141\] To the extent that employers are willing to bear these costs and

\[136\] In order to satisfy the special nondiscrimination requirement, either (1) the actual deferral percentage for eligible highly compensated employees must not be more than the actual deferral percentage of other eligible employees multiplied by 1.25 (125% test) or (2) the excess of the actual deferral percentage for eligible highly compensated employees must not be (a) more than two percentage points more than the actual deferral percentage of all other employees and (b) more than twice the actual deferral percentage of all other eligible employees. See 26 U.S.C. § 401(k)(3)(A) (1999). The actual deferral percentage is defined as the average of the ratios (calculated separately for each employee in such group) of the amount of employer contributions actually paid over to the trust on behalf of each such employee for such plan year, to the employee’s compensation for such plan year. See id. § 401(k)(3)(B). For a more detailed discussion of the nondiscrimination requirement, see, for example, CANAN, supra note 41, § 3.92.

\[137\] Reduced contributions by lower-paid workers would not necessarily cause 401(k) plans to be disqualified. Section 401(k) permits plans to return excess contributions to highly compensated employees in order to avoid disqualification of the plan. See 26 U.S.C. § 401(k)(8) (1999).


\[139\] Id. § 401(k)(12)(C).

\[140\] See id. § 401(k)(12)(B). For a more detailed discussion of the § 401(k) statutory safe harbors, see, for example, CANAN, supra note 41, at 241-46.

\[141\] Some of the increased cost, however, may be offset by reduced administrative costs because employers would no longer need to test their plans each year to ensure that they satisfy the nondiscrimination requirements.
draft their plans to satisfy the safe harbors, partial privatization of Social Security need not affect higher-paid workers' ability to contribute to and to receive the tax advantages of 401(k) plans.

Second, even if partial privatization were not accompanied by an increase in the payroll tax imposed on workers, partial privatization could have an impact on all employees' willingness to contribute to 401(k) plans. The increased investment risk partial privatization entails could encourage employees to increase their contributions to 401(k) plans to offset some of this risk.\(^{142}\) In addition, partial privatization could encourage employees who currently contribute little or nothing to 401(k) plans to increase their contributions as they gain knowledge and experience as investors.\(^{143}\) On the other hand, partial privatization could reduce employees' willingness to contribute to 401(k) plans as they see their Social Security individual account balances grow.\(^{144}\) Relatively little is known about what motivates employees to save in general and to contribute to 401(k) plans in particular.\(^ {145}\) Thus, it simply is not clear

---

142. See SAMWICK, supra note 6, at 32 (contending that if Social Security were partially privatized, "the added risk will encourage a greater level of total saving, particularly among patient workers who are already saving for retirement. They will seek to increase their contributions to pensions to provide this higher income in retirement when their total income is subject to more risk.").

143. Cf. EMPLOYEE BENEFITS RESEARCH INST., ISSUE BRIEF NO. 183, A FRAMEWORK FOR ANALYZING AND COMPARING SOCIAL SECURITY POLICIES 18 (1997) [hereinafter EBRI ISSUE BRIEF NO. 183] ("If the new Social Security program has a defined contribution component with educational efforts, will this increase workers' awareness of the necessity and benefits of saving as well as the potential effects of inflation and thereby increase worker participation in employment-based pension plans?"); SCOTT WEISBENNER, DO PENSION PLANS WITH PARTICIPANT INVESTMENT CHOICE TEACH HOUSEHOLDS TO HOLD MORE EQUITY? 11 (1999) (finding that households covered by pension plans in which employees have investment choice are more likely to hold stock outside of their retirement plan than are households covered by pension plans with employee investment choice); Moore, supra note 7, at 362 & n.86 (citing studies that "show that employer-provided retirement education increases both the number of employees who participate in retirement savings plans and the amount that they save in these programs.").

144. Cf. EBRI ISSUE BRIEF NO. 183, supra note 143, at 18 ("If private investment accounts are incorporated into Social Security, would workers, upon seeing large accumulations in their Social Security accounts, be less likely to invest in employment-based plans?"); Gregory, supra note 6, at 324 ("Will employees be motivated to increase their savings in 401(k) and other plans as they see their account balances increasing in their social security account? Or will they assume that the social security account will be sufficient and decrease their other retirement savings?").

145. See TECHNICAL PANEL, supra note 113, at 43 (stating that "researchers do not yet have a fully unified theory of why people save."); Alan J. Auerbach & Laurence J. Kotlikoff, The Impact of Demographic Transition on Capital Formation, in DEMOGRAPHY AND RETIREMENT: THE TWENTY-FIRST CENTURY 163, 168 (Anna M. Rappaport & Sylvester J. Schieber eds., 1993) [hereinafter DEMOGRAPHY AND RETIREMENT] ("Whatever the cause, the sobering lesson of the
what effect the creation of individual accounts would likely have on workers’ willingness to contribute to 401(k) plans.\textsuperscript{146}

C. Employees’ Investment Behavior

As the private pension landscape has shifted toward defined contribution plans in general and 401(k) plans in particular,\textsuperscript{147} employees’ responsibility for investing the assets in their employer-sponsored retirement plans has increased. Although the law does not require that workers make the investment decisions with respect to their 401(k) plan assets, most 401(k) plans authorize employees to decide how to invest the assets in their 401(k) plans. For example, in 1997, 86\% of 401(k) plans offered by medium and large establishments to full-time employees permitted employees to choose investments with respect to their own contributions, and 65\% of such plans permitted employees to choose investments with respect to their employer’s contributions as well.\textsuperscript{148}

Partial privatization could have an impact on how employees choose to invest the assets in their employer-sponsored defined contribution plans. Specifically, partial privatization could cause workers to invest their 401(k) plan assets more conservatively as they seek to reduce the increased risk partial privatization would impose on their retirement income.\textsuperscript{149} Ideally, to

\textsuperscript{146} Cf. \textsc{Technical Panel}, supra note 113, at 47 (stating that "it is far from clear how aggregate savings and retirement patterns would be affected by radical changes in Social Security; for instance, if... all or part of the Social Security system were replaced with a national defined-contribution system").

\textsuperscript{147} Thrift and savings plans are not the only kind of defined contribution plan an employer can offer. See \textsc{Bureau of Labor Statistics}, U.S. Dep’t of Labor, \textit{Employee Benefits in Medium and Large Private Establishments 1997}, at 115 (1999) (identifying five different types of defined contribution plans that employers can offer). Nevertheless, employees are much more likely to participate in a thrift and savings plan than any other type of defined contribution plan. \textit{See id.} at 5 tbl.1 (illustrating that 39\% of workers participated in savings and thrift plans compared to 13\% in deferred profit sharing plans, 4\% in ESOPs, 8\% in money purchase plans, 1\% in stock bonus plans, and 1\% in others).

\textsuperscript{148} \textit{See id.} at 135 tbl.177.

\textsuperscript{149} \textit{See Samwick}, supra note 6, at 32 (contending that if Social Security were partially privatized, "workers will attempt to reduce the riskiness of their other financial asset portfolios to temper the amount of total risk that they face. Defined contribution assets can be expected to shift toward safer assets.").
test this hypothesis, a study would examine any change in employees' investment behavior when an employer with both a defined contribution plan and a defined benefit plan eliminates the defined benefit plan. Unfortunately, no such dataset is currently available.\textsuperscript{150}

As a second best alternative, Cori Uccello of the Urban Institute compared how employees with an underlying defined benefit plan invested their 401(k) assets relative to employees who had no underlying defined benefit plan. She found that 401(k) participants with an underlying defined benefit plan tended to invest their 401(k) assets more aggressively than 401(k) participants with no underlying defined benefit plan.\textsuperscript{151}

Unfortunately, the Uccello study is subject to a number of data limitations. First, it only provides three categories of investment: "(i) mostly or entirely in stocks (including company stock), (ii) mostly or entirely in interest earning assets (referred to hereafter as bonds), or (iii) split between stocks and bonds."\textsuperscript{152} Second, it does not separately account for company stock.\textsuperscript{153} Finally, it is not clear whether participants are referring to allocations of contributions or account balances.\textsuperscript{154} Despite these data limitations, the study supports the proposition that by reducing guaranteed benefits, partial privatization of Social Security could cause workers to invest their 401(k) assets more conservatively,\textsuperscript{155} and it is the best study that is currently available to assess the likely effect of partial privatization on employees' investment decisions.

\textsuperscript{150} Telephone Conversation with Jack L. VanDerhei, Associate Professor of Risk Management and Insurance, Fox School of Business and Management, Temple University (Mar. 21, 2001).


\textsuperscript{152} \textit{Id} at 73.

\textsuperscript{153} \textit{Cf.} \textit{Sarah Holden & Jack VanDerhei, 401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 1999, EBRI Issue Brief No. 230, 14-15 & tbl.8 (2001)} (showing that 57% of participants who do not invest in equities funds invest in their own company's stock).

\textsuperscript{154} See Uccello, \textit{supra} note 151, at 73. This, however, may not be a significant data limitation. See Vickie L. Bajtelsmit & Jack VanDerhei, \textit{Risk Aversion and Pension Investment Choices, in Positioning Pensions for the Twenty-First Century} 45, 60 (Michael S. Gordon et al. eds., 1997) (finding that same factors affect both allocation of contributions and allocation of balances).

\textsuperscript{155} See Uccello, \textit{supra} note 151, at 78 ("[I]f the implementation of a Social Security individual account system is offset by a reduction in the defined benefit nature of the program, participants might direct their account assets more conservatively than they do in the current 401(k) system.").
D. Investment Returns

As of 1995, private pension plans held about $2.7 billion in assets,156 42% of those assets were invested in equities, 27% were invested in bonds, 7% were held in cash items, and the remaining 24% were invested in other assets.157 If Social Security were partially privatized, it could significantly affect the rates of return available on those assets.

In the short run, partial privatization would likely increase the demand for equities and thus raise the price of equity investments.158 The short run effect of partial privatization on the demand for and value of U.S. treasury bonds would depend on how partial privatization were financed. If individual accounts were funded by additional payroll taxes, as in the Advisory Council's IA plan, then partial privatization would likely have little effect on the short run demand for and value of U.S. treasury bonds, unless many workers chose to invest their individual accounts in U.S. treasury bonds rather than private equities. On the other hand, if partial privatization simply were funded by diverting payroll taxes from the current Trust Fund, then partial privatization would likely cause the demand for and the value of U.S. treasury bonds to decrease in the short run.

In the long run, partial privatization's increased demand for equities could cause the long-run rates of return on equities to fall,159 particularly if

156. EBRIDATADbOOk ON EMPLOYEE BENEFITs 100 tbl.11.3 (4th ed. 1997).
157. Id.
158. Cf. Bone, supra note 3, at 344 (noting that proposal to invest Social Security trust assets in private domestic equities "would appear likely to increase short-term demand for equities and so raise value of current equity investments"). This assumes that some workers are constrained and thus currently invest less in the equities market than they would under a partially privatized Social Security system. See John Geanakoplos et al., Would a Privatized Social Security System Really Pay a Higher Rate of Return? 22 (Nat'l Bureau of Econ. Research, Working Paper No. 6713, 1998) (noting that if there is large number of constrained households, then Social Security diversification would cause "an increase in the demand, and thus in the price of stocks and a corresponding decline in their expected return").
159. Cf. Bernstein & Bernstein, supra note 3, at 245 ("Increased stock prices reduce earnings."); EBRIIISUE BRIEF No. 183, supra note 143, at 15 (maintaining that "higher demand for equities might mean that equity prices could be bid up, causing their long-range rates of return to fall"); Geanakoplos et al., supra note 158, at 22 ("The most important general equilibrium effect of diversification would be an increase in the demand, and thus in the price, of stocks and a corresponding decline in their expected return."); Robert J. Myers, Privatization of Social Security: A Good Idea?, J. AM. SOC"Y OF CLU & CHFC, at 45 (July 1996) (asserting that "[i]f such huge amounts of money were available for investment in common stocks, then it is likely that rates of return will be lower than historical ones. Such massive new investment would probably produce some desirable economic growth, but there are limits to this effect. Moreover, the vast majority of the private contributions would go into the secondary capital markets, rather than into issues which would generate new capital.").
large numbers of individuals seek to sell their equity investments at the same time.160 Demand, however, is not the only relevant factor in long run rates of return. As two leading researchers have noted, "[c]apital markets are worldwide, interest rates are determined by both supply and demand, and forecasts of financial rates of return some 30 or more years into the future are futile."161 Thus, determining the long run effects of partial privatization on rates of return is an extremely complex macroeconomic question that depends, among other things, upon whether partial privatization would lead to increased national savings,162 and cannot be readily answered.163 Thus, this Article will not attempt to determine how partial privatization of Social Security would likely affect long run rates of return on assets held by private pensions; suffice it to say that partial privatization could have a substantial effect, although it is not clear what that effect would be.

160. See Sylvester J. Schieber & John B. Shoven, The Aging of the Baby Boom Generation 18-20 (1996) (noting that retirement of baby boomers could cause rate of return on equities to fall by roughly 5% per year between 2010 and 2030, but contending that presence of global capital market, rational expectations, and fact that corporate assets are cash-generating depreciable property is likely to alleviate at least some of that decrease).


162. See Henry J. Aaron et al., Can America Afford to Grow Old? Paying for Social Security 119 (1989) ("Over the long run, privatizing OASDI would raise national saving only to the extent that it leads to the accumulation of increased pension reserves or to smaller deficits on other government programs. If private pensions invest in risker assets and generate correspondingly higher rates of return than OASDHI reserves earn, some secondary economic effects would follow similar to those resulting from a policy of investing OASDHI reserves in risky assets.").

163. Cf Geanakoplos et al., supra note 158, at 22 n.38 (arguing that "Social Security diversification would bring some indirect benefits to the economy, if there were many constrained households. Unconstrained households would end up holding less stock, because some of it would be in the hands of social security accounts held by constrained households who could not buy stock previously. Thus unconstrained households would bear less risk. They would be inclined to shift the mix of investment projects undertaken toward more risky ones. This might in turn raise future GDP."); Peter A. Diamond, What Stock Market Returns to Expect for the Future?, 63 SOC. SEC. BULL. 38, 49-50 n.45 (2000) ("One can also ask how changed policies might affect future returns. A change in portfolio policy that included stocks (whether in the trust fund or in individual accounts) would plausibly lower the equity premium somewhat. That effect could come about through a combination in a rise in the Treasury rate (thereby requiring a change in tax and/or expenditure policy) and a fall in expected returns on stocks. The latter depends on both the underlying technology of available returns to real investments and the effect of portfolio policy on national saving. At this time, research on this issue has been limited, although it is plausible that it is not large." (citations omitted)); see also Aaron et al., supra note 162, at 106-14 (discussing macroeconomic effects of investing Social Security reserves in private market).
**IV. Conclusion**

Partial privatization of Social Security would likely have an impact on private pensions. First, partial privatization could have a significant impact on the tax integration rules and integrated plans, although the impact depends on the form partial privatization takes and how significantly it would affect benefits promised by the current Social Security system. Second, contrary to current trends, partial privatization would likely increase the demand for employer-sponsored defined benefit plans. Third, partial privatization could decrease the willingness of workers, particularly lower-income workers, to contribute to 401(k) plans, particularly if partial privatization were funded by an increase in the payroll tax imposed on workers. Fourth, partial privatization could cause workers to invest their 401(k) assets more conservatively. Finally, partial privatization could affect the rates of return available to assets held by private pensions, although it is not entirely clear what the effect would be.