

## **Pension Plan Discrimination Against the Short-Lived**

Many pension plans pay out benefits over a worker's remaining life. Perhaps inadvertently, they then discriminate against groups with shorter life expectancies. Losers include those with poorer health, less education, and more physically demanding jobs. Racial groups with higher mortality rates, like blacks, also lose. This discrimination, however, can largely be overcome with compensating mechanisms.

Retirement plans are of two types. One type revolves around deposits to such accounts as 401(k) plans and individual retirement accounts (IRAs). Typically, when employers pay compensation to this type of retirement plan, the benefits are proportional to cash wages and of equal benefit to all workers at the same wage level. The more classic pension plan, on the other hand, has a formula for "replacing" wages over a worker's remaining life. For instance, a firm might pay workers with 30 years of service an annual benefit equal to 20 percent of pay earned during their highest earning years.

At first the classic pension plan might appear to treat equally those workers with the same jobs, wages, and time with the firm. But it does not. Why the discrimination? Converting benefits to annuities gives those with shorter lives fewer benefits than those with longer lives.

Generally speaking, we want to encourage annuities. They do a lot of good things. As death is a random event, most pensioners are happy to get the extra protection in case they live long lives. Annuities help prevent our living standards from falling as we age. Social Security, for these reasons, pays out benefits as an annuity to meet its social policy objective of "insuring" for those with long lives.

Still, consider the extreme case of George, who is in poor health throughout his life, works for a firm for 30 years, gets no survivor benefits, and dies at eligibility age. The firm would pay George zero pension benefits. Meanwhile, Paul, who is in very good health and can expect to live a long life, receives substantial pension benefits. The discrimination isn't just among individuals, like George and Paul, but also among groups. Blue-collar workers might do worse than white-collar workers and blacks worse than whites.

Social Security shows us that it is possible to deal with this type of discrimination through offsetting mechanisms. For instance, Social Security has a progressive benefit formula that provides higher benefits relative to past lifetime earnings (higher "replacement wages") to those with lower-than-average lifetime earnings. Because lower earnings are correlated with lower life expectancy, people from educational, racial, and other groups with lower life expectancy are more likely to get equal returns on their Social Security contributions or taxes

Unlike Social Security, classic pension plans don't have access to lifetime earnings records, so they can't use the same offsetting formula. To provide equal pension pay for equal work, other offsetting mechanisms must be tapped. A simple example is life insurance, which tends to favor those with lower life expectancies. An adequate amount of life insurance provided in addition to the classic pension plan could compensate some of those who lose out because of the annuity feature of the plan. However, such life insurance would need to carry forward beyond employment years since people with shorter life expectancies often do make it to retirement age.

Another simple compensating device would be to require that annuities contain a certain minimum number of years of payments to heirs if the worker dies. Such "life certain" policies can insure, for instance, that even if a worker dies at retirement age, at least 15 years of payments would be made. These rules could also be used to insure more equal treatment of those with lower-than-average life expectancies who convert their 401(k) and similar balances into annuities. Firms sometimes increase the probability that benefits will be paid for at least some years by providing survivor benefits, but those benefits often don't help single workers.

While classic pension plans have been on the wane in the private sector, millions of government workers participate in such plans. Federal, state, and local governments could examine and amend these pension plans to reduce discrimination among their own workers. Similarly, protections should be put in place for those purchasing annuities with their 401(k) and similar accounts. Future retirement and pension plan reform must start to address this discrimination. Short lived shouldn't mean short changed.

***The Government We Deserve* is a periodic column on public policy by [Eugene Steuerle](#), a senior fellow at the nonpartisan [Urban Institute](#) and a former deputy assistant secretary of the Treasury. To subscribe or unsubscribe to *The Government We Deserve*, click [here](#), or simply reply to this e-mail with a request in the subject line.**

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