WORKING PAPER
*Executive Summary*

JULY 2006, WP# 2006-15

CENTER FOR RETIREMENT RESEARCH AT BOSTON COLLEGE

# EFFECTS OF PUBLIC POLICIES ON THE DISPOSITION OF LUMP-SUM DISTRIBUTIONS: RATIONAL AND BEHAVIORAL INFLUENCES

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Upon changing jobs, many workers can choose whether to leave their existing, vested pension balances in the pension plan they had been enrolled in or to take the funds as a lump sum distribution (LSD). If taken as an LSD, the funds may be "rolled over" to another qualified plan, or may be cashed out and used for some other purpose. With the continued growth of defined contribution plans, where pre-retirement cash-outs are more widely available, a better understanding of how public policies affect LSD choices is essential to developing a retirement income system that can adequately address the needs and constraints of the modern work force.

We use data from the Health and Retirement Study to measure the impact of policy changes on patterns of LSD behavior in the period 1981-1998. Our analysis expands on the existing literature both in both in the number of policies that can affect LSD choices and the years examined. In particular, the set of policy changes reflected in our data allows us to distinguish between "hard" incentives that affect budget constraints, and "soft" incentives or program features that need not affect the household's budget constraint but nevertheless may be powerful mechanisms for directing households to make particular choices. We also address the potential interactions between these policies.

Federal policy uses a variety of financial incentives and other strategies to discourage pre-retirement pension withdrawals. Funds that are cashed out are subject to taxation as ordinary income, as are all pension benefits. From 1987 onward, they are subject to an additional 10 percent penalty tax for workers up to age 59.5 if the distribution is taken prior to job termination, and for workers up to age 55 if the distribution is taken as part of a job termination. Since 1993, employers have been required to offer departing employees the option of directly transferring lump sum distributions into another qualified retirement plan or IRA. Also since 1993, firms have been required to assess a withholding tax of 20 percent on any cash distribution not transferred directly into a qualified account.

In our empirical work, we focus on LSDs from defined contribution plans. By tabulating the share of workers in different age groups who cashed out their pensions at job separation, we gather evidence on the behavioral response to the above changes in the legal treatment of LSDs. The 1987 introduction of the 10 percent penalty tax was effective in discouraging cash-out among workers subject to the penalty. For households aged 59 and younger, the changes enacted in 1987 — which increased the effective tax rates by closing off income averaging and by imposing a penalty on early withdrawals — raised the likelihood that recipients would leave the funds in the tax-preferred pension system by between 3 and 14 percentage points.

The withholding changes enacted in 1993 similarly increased the likelihood of keeping the funds in the tax-preferred system by 11 percentage points for households aged 45-59 who would otherwise have faced penalties. For households aged 60 and older, the 1993 changes had no effect on the likelihood of keeping the funds in the pension system, since penalties did not apply to this group. Thus, the results are consistent with important interaction effects between default specifications and withholding rules, which do not in themselves affect the ultimate tax liability, and the previously existing effective tax rates and penalties.

Interestingly, the 1993 change had no effect on households aged 35-44. To examine this issue, we split the data to look at LSDs that are above and below $3,500 in value. Small-balance LSDs are particularly prevalent among the younger groups of recipients. After 1986, trends in LSD disposition diverged depending on whether the balance was above or below $3,500: cash outs of all plans fell, and cash outs of larger balances fell, but cash outs of small balances rose.

Presumably this occurred because, starting just before 1986, employers were allowed to choose unilaterally whether to cash out small balances, and they did so: this change seems to have swamped any response to the penalty tax. After 1993, when withholding taxes were imposed on non-rollover activities, cash-outs of small plans fell precipitously. This is consistent with the view that the withholding tax has an immediacy and saliency that taxes imposed as part of the annual income tax reconciliation process do not. Similarly, the fact that this change in disposition behavior coincided with the introduction of direct rollover suggests that effort and other transaction costs may previously have deterred LSD recipients from saving their distributions.

To test the robustness of these patterns in LSD behavior, we estimate a series of linear probability models. Adding controls for household demographic characteristics and income levels, occupation and industry, and real plan balance do not alter the post-1993 results, though they slightly weaken the already marginal pre-86 results. In other words, the effects of withholding taxes imposed in 1993 – which do not change the tax payments, just make them more salient — are more robust to the inclusion of other controls than the effects of higher tax prices imposed in 1987.

The above results demonstrate the responsiveness to various types of policy changes of workers' LSD decisions to withdraw pension balances at job separation. This study joins a growing body of evidence that both "hard" tax incentives and "soft" features of the policy environment, like requiring firms to offer a rollover option and creating a withholding tax on non-rollover choices can affect behavior. Moreover, we document some interesting interactions between the two, suggesting that effective financial incentives must be designed in light of less binding but perhaps more salient policy details.

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 The research reported herein was performed, in part, pursuant to a grant from the U.S. Social Security Administration (SSA) funded as part of the Retirement Research Consortium. The findings and conclusions expressed are solely those of the authors and do not represent the views of SSA, any agency of the Federal Government, the Brookings Institution or Boston College.

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