

# The choice to cash out pension rights at job change or retirement

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## Abstract

Most pension plans allow a lump sum distribution upon job separation, enabling a subsequent cash-out. In the 1992–2000 HRS, 13% of entitlements were cashed-out, representing 5.3% of entitlement dollars. Among plans with a lump sum option, 20% were cashed out. Cash-outs can be rational and we broadly confirm hypotheses for cash-out determinants, but not that individuals with short expected longevity should wish to disproportionately cash out. Fears of adverse selection into the pool of pensioners with annuity income thus appear unfounded. While we find only limited leakage, it is concentrated among individuals vulnerable to poverty in old age.

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## 1. The issue

When workers change jobs or retire, they often have several options for the disposition of their pension rights. Many can settle the entitlement with a lump sum cash payment. Such cash-outs are likely to reduce consumption in retirement and may increase poverty among the elderly. This leakage undermines an important public policy that, at considerable expense, allows workers to defer taxes on income that is earmarked for consumption in retirement.

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This paper analyzes cash-outs and other dispositions of pension entitlements among mature workers who left their jobs between 1992 and 2000. We pay special attention to the choices that are available to individual workers, in particular whether they may take a lump sum distribution (LSD). Limited by available data, prior literature has typically analyzed cash-outs among only those pension entitlements that were settled with an LSD. Instead, we measure leakage from all pension entitlements, and analyze cash-outs among all workers with the option of cashing out.

The purpose of this paper is to better understand how workers make choices concerning the use of their pensions and retirement accounts. The remainder is organized as follows. Section 2 provides background, reviews prior research, and discusses the legal environment. Section 3 outlines our theoretical perspective and describes the Health and Retirement Study (HRS) data, and Section 4 presents and discusses the results. We conclude in Section 5 with implications for public policy and the potential problems posed by adverse selection behavior.

## 2. Background

In 1959, 35% of people aged 65 or older lived below the poverty line, more than double the rate of those under age 65. By 2001, poverty among the elderly had dropped to 10%, well below the rate among the non-elderly (Bureau of the Census, 2002). Despite this encouraging trend, some subpopulations remain particularly vulnerable. Poverty among those aged 75 and over was 11% in 2001, 14% for women only, and 28% for Black women, with Hispanics not faring much better. The rates were much higher for women living alone.

Private pensions play an increasingly large role in the elderly's financial resources. The share of pension wealth in total household wealth among people around age 60 increased from 11% in 1969 to 23% in 1992 (Gustman and Steinmeier, 1997). The relative importance of pensions is likely to continue its upmarch in light of increases in pension assets and benefits on the one hand

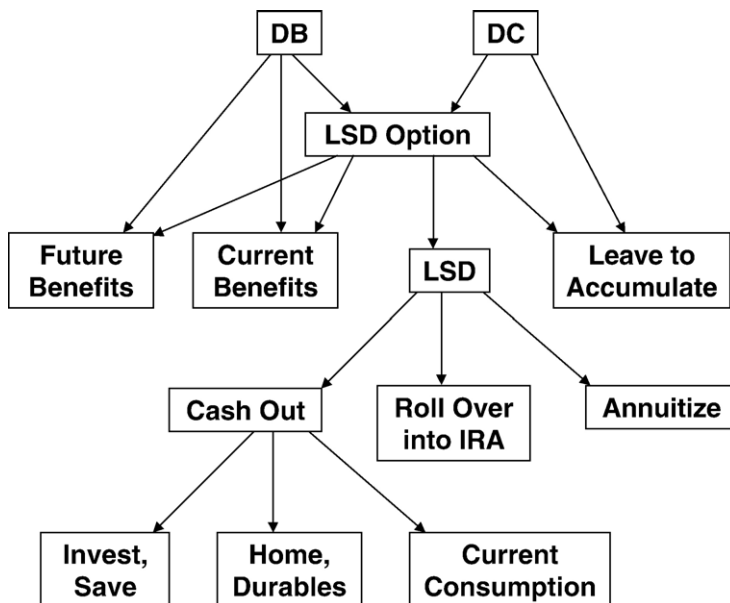


Fig. 1. Potential options for the disposition of pension entitlements.

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