

ASSET BUILDING PROGRAM

FACING UP TO THE RETIREMENT SAVINGS DEFICIT

From 401(k)s to Universal and Automatic Accounts

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Five years ago Congress enacted modest improvements for employer-sponsored pension and 401(k) plans. Since President Bush signed the Pension Protection Act of 2006, little progress has been made in narrowing the nation's retirement savings deficit. Most workers are simply not saving enough over their life course to supplement the meager benefits they will receive from Social Security. America's real retirement security crisis is not Social Security solvency or the many big firms freezing or terminating their traditional pension plans. The larger problem is that the majority of American adults do not participate in any retirement saving plan—whether pension or 401(k) or Individual Retirement Account (IRA). Participation in employer-sponsored plans peaked in the late 1970s and appears to be at its lowest level in more than 30 years. Employer-sponsored plans cover fewer than half of all private sector workers, leaving a projected majority of baby boomers and Generation Xers even more dependent on Social Security than their parents' generation is today.

This paper explains our retirement security crisis by describing the limitations of the existing employer-based system and the extent of the current household savings deficit. It then presents a critique of an alternative "Automatic IRA" proposal, supported by President Obama, and identifies five additional features that would dramatically strengthen the proposal. One conclusion that should be abundantly clear: Now is the time to face up to the nation's retirement savings deficit and focus policy efforts on making sure that all Americans are included in a retirement security system that is capable of helping everyone save over their life course and to achieve a secure retirement.

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Introduction

In the 2008 presidential campaign, then candidate Obama outlined a “Plan to Strengthen Retirement Security” that highlighted opposition to raising the Social Security retirement age, stronger retirement saving incentives for lower- and middle-income earners, and the creation of an “automatic workplace pension plan” that would use payroll deductions to help workers save. Commonly known as Auto-IRA, this proposal would require employers that do not sponsor a retirement plan to automatically enroll most of their employees in a payroll-deposit IRA account.

Variations of this proposal had been debated since 1999¹ and previously had been introduced in the House and Senate on a bipartisan basis.² To make contributions to these saving plans more valuable for workers, candidate Obama proposed expanding the existing Savers Credit “to match 50% of the first \$1000 of savings for families that earn under \$75,000” and to make the credit refundable so that lower-income workers without income tax liability to offset could still receive a tax break for voluntary saving in any qualified retirement account.³

Unfortunately, progress on this agenda to facilitate saving among the majority of workers who lack an automatic workplace pension has lapsed into a sort of tactical retreat. A legislative push to adopt even an incremental version of the Automatic IRA has twice been put on hold, first in

deference to a focus on passing the Affordable Care Act, expanding health coverage; and, since the 2010 elections, due to the the Congressional focus on the debt ceiling, budget cuts and other fiscal issues. An Auto-IRA bill was recently introduced in the Senate by Senator Jeff Bingaman (D-NM), but without a GOP co-sponsor.⁴ President Obama has at least temporarily dropped the Savers Credit expansion from his budget – and presumably from his agenda. The Administration first reduced the scope of its proposed Savers Credit expansion in its fiscal 2011 budget; and this year it eliminated any reference to a more generous and refundable Savers Credit in the fiscal 2012 budget.⁵

As this paper will show, despite the current political climate and fiscal squeeze, now is precisely the wrong time to back away from proposals to make our retirement saving system dramatically more inclusive and effective at stimulating substantial new saving. While it may well be pragmatic to presume that the current Congress will not enact legislation that re-targets tax subsidies to encourage more saving by low- and middle-income earners, there are two broader debates on the fiscal agenda that could prove to be an opportunity to add a universal and progressive saving initiative for individual workers.

One ongoing fiscal debate concerns Social Security reform. To the extent that there is a serious effort to revisit the relationship between program funding and benefits, discussion can be focused on impacts to the bottom 60 percent of earners (who depend on Social Security for the vast majority of their retirement income). Not only should consideration be given to raising the minimum benefit, but adopting in tandem a more ambitious version of the Auto-IRA can significantly help those with modest incomes accumulate greater and more secure retirement savings.

A greater opportunity is likely to be tax reform—and particularly a restructuring of current tax expenditure

¹ In testimony to the House Education and Labor Committee in September, 2000, the author proposed requiring firms with more than 25 employees to offer “payroll deduction IRAs” to all “employees at firms without pension coverage who only have recourse to IRAs, ” as well as to require “automatic plan enrollment” in 401(k)-type plans. The Automatic IRA that is the focus of this paper, with an emphasis on default features such as automatic enrollment and investment, was developed by Mark Iwry, a former Brookings Institution scholar (currently at Treasury Department) and David John of the Heritage Foundation.

² Bipartisan legislation based on the Iwry/John proposal – The Automatic IRA Act of 2007 – was introduced in the Senate (S. 1141) by Sens. Jeff Bingaman and Gordon Smith, and in the House (H.R. 2167) by Reps. Richard Neal and Phil English. The most recent Senate version of the bill was introduced in September 2011 by Senator Bingaman (D-NM) without a GOP co-sponsor.

³ “Barack Obama’s Plan to Strengthen Retirement Security,” Obama for America, 2008 campaign fact sheet.

⁴ Senator Jeff Bingaman (D-NM) introduced S. 1557, the Automatic IRA Act of 2011, on September 14, 2011.

⁵ Keightley, M. *et al.*, 2011.

subsidies to promote saving. One of the striking commonalities among the various high-profile fiscal commissions over the past year (e.g., those led by Simpson/Bowles, Domenici/Rivlin and the Senate “Gang of Six”) has been a consensus that the annual cost of tax deductions and credits need to be reduced or capped, at least for the high-income taxpayers who receive the vast majority of these subsidies.

The three most costly tax deductions—for retirement saving, employer-provided health care benefits and mortgage interest—reduce federal revenue each year by more than \$400 billion.⁶ The tax incentive for retirement saving is upside down and inefficient. It offers windfalls for top-bracket earners who would save regardless while offering little or no subsidy to low-income households who find it hardest to save.

Whether or not high-income earners retain a disproportionate tax break, comprehensive reform is an opportunity to redesign and re-target incentives to promote meaningful net savings. This should involve access to an expanded and refundable Savers Credit for at least lower- and middle-income families who contribute to qualified retirement accounts, or matching deposits, such as the proposed Saver’s Bonus, which would flow directly into targeted savings accounts.⁷

In the context of each of these coming debates—as well as for stand-alone legislation—the Auto-IRA as currently put forward by the Administration and Congressional sponsors comes up short. Even assuming that only a fundamentally voluntary personal saving system could pass Congress, the Auto-IRA needs to be substantially more inclusive, more portable, and more likely to generate greater participation

and asset building among lower-wage workers. It needs to incorporate additional elements of traditional defined-benefit pensions. In short, to meaningfully address our retirement security crisis, the Auto-IRA should be implemented as a more truly Universal 401(k) system, with full access, robust incentives, a workable infrastructure, employer contributions, and an effective set of default features capable of maximizing savings behavior.

Five policy design features can be identified that would effectively transform the Auto-IRA. These include:

- ***A refundable Savers Credit*** as a matching contribution deposited directly into the worker’s account. The match rate should be higher for low earners less likely and able to save—and apply to at least the first \$2,000 of savings each year.
- ***Every worker not currently eligible to save in a qualified plan should be included*** for automatic enrollment and mandatory payroll deduction by employers, or assisted in making deposits directly in the case of the self-employed and others without access to payroll withholding.
- ***A low-cost clearinghouse enabling continuous savings and career-long portability*** should be the default option available to every participant—and include special arrangements for the self-employed and others not eligible at work. Individuals should be able to choose to use a particular IRA provider, or to roll out balances later, but not the employer on their behalf.
- ***Employers should be able to contribute*** on a non-discriminatory basis (flat dollar or flat percentage amount for every eligible worker). Contribution limits should be higher than IRA limits, which are too low for middle-income earners to achieve an adequate replacement of pre-retirement earnings.
- ***Five default features—enrollment, escalation, investment, rollovers, annuitization – need to be required and robust***, not left to the discretion of employers or financial providers.

These features could make the difference between a truly universal 401(k)-style system and a marginal increase in retirement security among the lower-earning half of households. Half the workforce without a workplace

⁶ Cramer, R. and R. Black, 2011. p. 4. A broader definition of tax expenditures that includes not only qualified retirement saving, employer-provided health benefits and mortgage interest, but also the lower rate on capital gains, charitable deductions and a range of other preferences, reduced federal revenue by an estimated \$700 billion in 2007.

Burman, L., Toder, E. and C. Geissler, 2008.

Mandel, D. 2011 (forthcoming).

⁷ Cramer, R and R. Black, 2011

pension could be effectively excluded from Auto-IRA saving at any particular time unless *every* worker is eligible to participate and special arrangements are promoted for the 25 to 30 percent of the workforce that is self-employed or in part-time or nonstandard work arrangements. Without a refundable and more potent version of the Savers Credit, an Auto-IRA will continue to shower more than 70 percent of federal subsidies for saving on the highest-income quintile who least need incentives to save. Without the seamless eligibility and career-long portability made possible through a clearinghouse, saving gaps, lost accounts and unnecessarily high fees will undermine asset accumulations. And without required and very robust default features—including contribution escalation, rollover and annuitization—the typical worker will not end up with a retirement income as large and secure as it could be.

America's Retirement Saving Crisis

Limitations of the Current Employer-Based System

With over \$12 trillion in assets, traditional pension trusts and 401(k)-style saving plans account for the vast majority of financial assets accumulated by households. Employer-sponsored retirement plans are generally classified as either a defined benefit (DB) pension plan or a voluntary defined contribution (DC) saving plan, which are most commonly 401(k) plans. DB plans are traditional pensions that provide a fixed monthly annuity payment for life; workers are enrolled automatically, employers make all contributions and shoulder the investment burden and risk. In a typical 401(k) plan, employers match a portion of an individual worker's voluntary saving, workers make investment choices, bear investment risk, and retire with a lump sum that they continue to invest and decide how to draw down during their retirement years.

For workers with access to either a DB or DC plan, America's employer-based private pension system provides powerful saving incentives—both tax breaks and employer contributions—as well as the convenience and discipline of automatic payroll deduction. Unfortunately, more than 75 million American workers do not participate in any tax-

subsidized, payroll deduction saving plan—and therefore they tend to save very little for retirement.

Roughly one-third of all households accumulate no workplace retirement plan saving during their entire work life and end up relying almost exclusively on Social Security.

Only 43.2 percent of all private-sector workers age 25-to-64 participated in an employer-sponsored retirement plan in 2008; this was a striking decline from the 50.3 percent participation rate in 2000.⁸ Only 55.4 percent of workers in their prime saving years (age 45 to 64) participate in a retirement plan. The percentage of private sector workers whose employer even sponsors a plan (whether or not they are eligible or participate) fell to 53.2 percent in 2008. One result is that roughly one-third of all households accumulate no workplace retirement plan saving during their entire work life and end up relying almost exclusively on Social Security.⁹

While participation is somewhat higher among full-time workers (51 percent), participation rates are also strikingly lower among workers who are low-income, young, work part-time, or work at small firms. Approximately 85 percent of Americans without a pension benefit at work shared one or more of these four characteristics, according to a General Accounting Office study. Minorities also participate at substantially lower rates, primarily because they are less likely to work at a firm that sponsors a pension or 401(k)-type plan.¹⁰ While 56.6 percent of whites

⁸ Purcell, P. 2009. CRS estimates are based on the U.S. Census Bureau's *Current Population Survey* (CPS). The 2008 levels are also substantially lower than the late 1970s peak in private sector pension coverage; in 1979, 51 percent of wage and salary workers age 25-64 participated.

Munnell, A. and Quinby, L. 2009.

⁹ Munnell, A. and Quinby, L. 2009.

¹⁰ Munnell, A. and Sullivan, C. 2009.

employed full-time and year-round participated in employer-sponsored plans in 2008, black and Hispanic workers participated at rates 10 and 26 percentage points lower, respectively.¹¹

Not surprisingly, pension coverage is lowest among workers whose savings would truly *add to* net national saving: workers who earn less than the median wage. Even if a lower-wage worker is inclined to save, fewer than 40 percent of private sector workers in the bottom income quartile work for a firm that sponsors a retirement plan, while 72 percent of top quartile earners work at firms offering qualified plan coverage, typically a 401(k) with employer matching contributions.¹²

We might at least expect the workers lucky enough to participate in 401(k)-type plans to be accumulating significant savings. Among the subset of high-tax-bracket earners with steady access to a 401(k), this is the case. But participation and accumulation rates in the bottom two quintiles of the earning distribution are far lower. Even among longer-tenured 401(k) participants in their 50s and 60s who are earning between \$40,000 and \$60,000 the median account balance was just over \$81,000 in 2009, according to the EBRI/ICI 401(k) database.¹³

One reason for the low participation rates and accumulations is that even if a worker has coverage today, he or she may not have access to a plan next year in a new job. And even if the worker's new employer sponsors a plan, new hires are not eligible to participate for at least one year. The result is gaps in coverage. And although a long-tenured worker in a traditional pension plan will vest in monthly income for life (or a lump sum), those who terminate in less than five years may end up with no retirement accumulation at all for that period.

¹¹ Munnell, A. and Sullivan, C. 2009. p. 11.

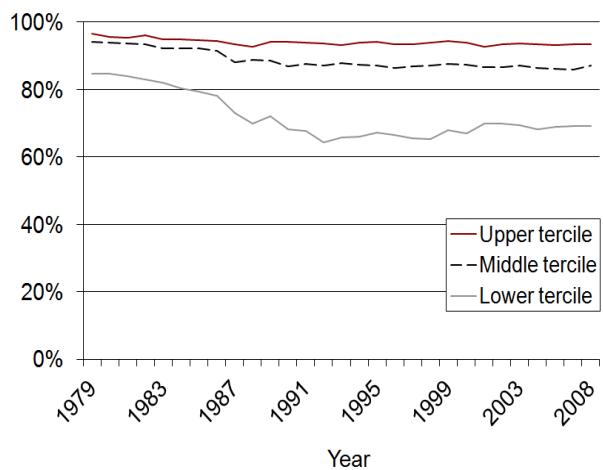
¹² Munnell, A. and Sullivan, C. 2009. p. 13. CPS data show that 73 percent of private sector workers in the highest earning quartile worked for an employer sponsoring a qualified plan, compared to only 59 percent among third quartile earners and 38 percent among workers in the lowest earning quartile.

¹³ VanDerhei, J., Holden, S., Alonso, L. 2010.

Another reason that participation rates have declined, particularly among lower-income earners, is the simple fact that 401(k) plans are voluntary and typically require workers to make investment decisions they may feel unprepared to make. Unlike traditional DB pensions, with 401(k)-type plans individuals must *choose* to save. Unfortunately, the incentives are often not nearly compelling enough, particularly for low-income workers who, unlike high-income earners, receive little if any tax subsidy for saving. As a result, the shift from DB pensions – which automatically enroll and contribute on behalf of all workers – to 401(k)-type plans coincided with a sharp decline in pension participation among the lower-income workers and lower future accumulations. One recent study showed that although access to an employer plan has remained roughly the same since 1979, the participation rate among the lowest-earning third of workers has declined far more than among middle- or upper-income earners. (See chart)

Pension Participation Rate for Private Sector Male Workers Age 25-64 at Employers with Pensions, by Earnings Tercile, 1979-2008

Source: Karamcheva and Sanzenbacher, calculations from 1980-



2008 CPS

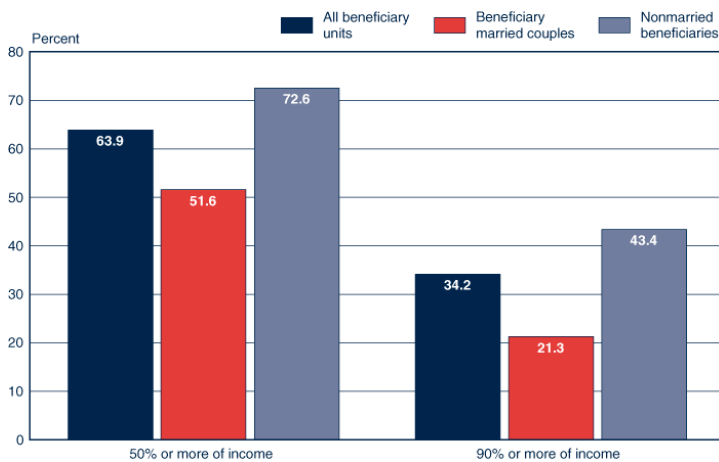
The trend toward automatic enrollment and default investment options in 401(k) plans, encouraged by the Pension Protection Act of 2006, is already showing progress in reversing this trend, especially among the

middle-third of workers as ranked by income. However, even if middle- to lower-income workers who are currently eligible for a 401(k) in their current job participate, they are far less likely than high earners to have the consistent, career-long access to a good pension or 401(k).

The Household Saving Deficit

The result of excluding half the nation from an automatic, managed and subsidized private saving plan is that too many individuals are heading toward retirement age with little more than Social Security’s safety net.

Percentage of Beneficiaries Receiving Social Security Benefits by Relative Importance of Benefits to Total Income (2008)



Source: Social Security Administration, *Income of the Aged Chartbook, 2008* (released April, 2010).

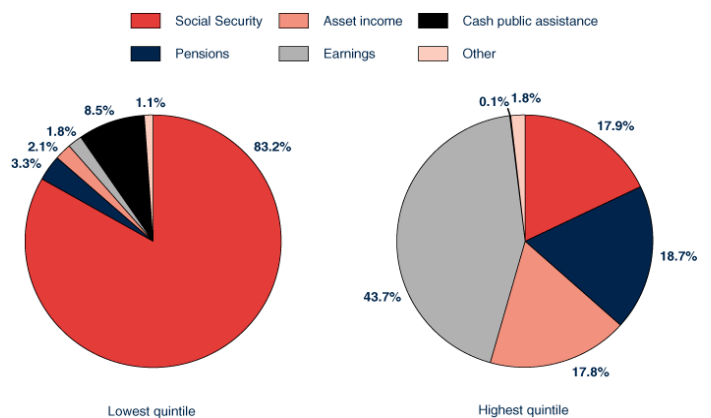
Today nearly two-thirds of beneficiaries rely on Social Security for a majority of their income. More troubling is that roughly one-third of beneficiaries rely on Social Security for 90 percent or more of their income—a dependency ratio that is even greater for widows.¹⁴ This reliance on Social Security is likely to increase as fewer and fewer retirees receive traditional pension income. The Center for Retirement Research estimates that the

¹⁴ Social Security Administration, 2008. Social Security Administration, *Income of the Aged Chartbook, 2008* (released April, 2010).

replacement rate of pre-retirement income levels is between 20 and 30 percent lower, respectively, among retired couples and single people who do not have pension income.¹⁵

Elderly in the lowest income quintile receive on average only about 5 percent of their income from either pension or asset income. And because retirees with low career earnings, or substantial time out of the work force, receive minimal Social Security benefits, the Urban Institute estimates that about 36 percent of the elderly received benefits in 2009 that fell below the individual poverty line.¹⁶

Shares of income by source for the lowest and highest income quintiles, 2008



Source: Social Security Administration, *Income of the Aged Chartbook, 2008* (released April, 2010).

Today’s baby boomer and younger cohorts are likely to end up even more dependent on Social Security based on current trends in saving and asset accumulation. The National Retirement Risk Index indicates that a majority (51 percent) of working-age households are “at risk” of not having enough retirement income to maintain their standard of living in retirement. Based on the Federal Reserve’s triennial Survey of Consumer Finances, the NRRRI suggests a worsening trend, with 41 percent of Early

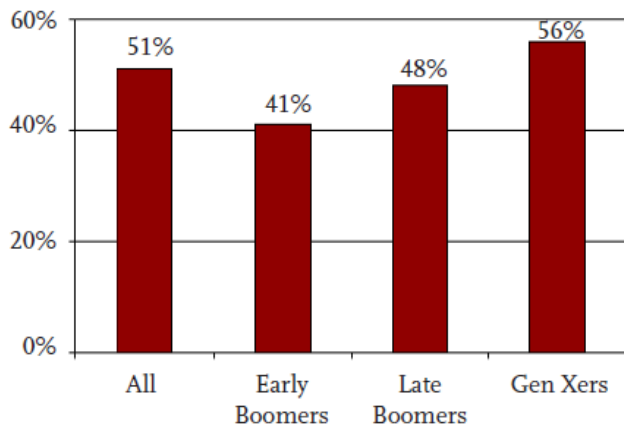
¹⁵ Munnell, A. and Soto, M. 2005.

¹⁶ Favreault, M. 2010 a.

Favreault, M. 2010 b.

Boomers, 48 percent of Late Boomers, and 56 percent of Gen Xers “at risk.”¹⁷ These “at risk” estimates rise if health care cost inflation is factored in. These shortfalls represent a cumulative \$6.6 trillion “retirement income deficit” according to the Center for Retirement Research, which created the NRRI.¹⁸

Percentage of Working-Age Households “At Risk” by Cohort



Source: Center for Retirement Research, Munnell, et al. (2009)

The Retirement Readiness Rating, calculated by the Employee Benefit Research Institute, similarly estimates that nearly one-half of Early Boomers (47.2 percent) and 44.5 percent of Gen Xers are on track to retire without sufficient income to pay for both “basic” cost of living expenses and uninsured health care costs.¹⁹ While there is a range of views about what income replacement rates are “adequate” and how precisely to measure the nation’s retirement saving gap, there is no question that tens of millions more working-age adults need access to easy, automatic and incentivized saving plans.

Key Features and Advantages of the Automatic IRA

The Auto-IRA proposal aims to give workers at firms not sponsoring a qualified retirement plan many of the

advantages of a well-designed 401(k). The goal is to make it easy and automatic to save.²⁰

The program accomplishes this by requiring employers with more than ten employees (and in business more than two years) that do not sponsor a qualified retirement plan to offer eligible workers the option to participate in an automatic payroll deduction IRA. Most workers would be automatically enrolled, at least initially, at a contribution rate of three percent of pay.²¹ Every employee is given the option to opt out entirely, or change their level of contribution, at any time. Automatic escalation of the default contribution rate may be determined by regulation, up to eight percent or higher in some proposals, although this is not a required element.

In return for facilitating automatic enrollment and forwarding payroll-deductions, participating firms receive a temporary tax credit, which would be \$250 for up to two years under the President’s latest proposal.²² All of the leading proposals also allow the employer to designate the financial institution that will manage the accounts for all of its workers (although an individual can choose later to roll his or her balance to a qualified IRA of their choice). While the employer can set up accounts for its workforce at a single IRA provider, employers would have other options as well. Employers would have the option to permit employees to designate their own IRA provider (as they do a bank or credit union for automatic paycheck deposit). The employer would also have the option to use a “default

²⁰ The brief summary here contains elements most common to President Obama’s budget proposals and the several “Automatic IRA Acts” that have been introduced in Congress since 2007.

²¹ President Obama’s FY 2012 budget proposes requiring employers (except those with fewer than 10 employees or in business less than 2 years) that do not offer a qualified retirement plan to offer automatic enrollment in a payroll-deduction IRA at a contribution rate of 3 percent of wage compensation. Keightley, M. 2011 p. 2.

²²Keightley, M. 2011 p. 2. The President’s FY 2012 budget proposes a temporary tax credit for up to two years equal to \$25 per employee enrolled up to \$250 per year total. It proposes a tax credit of \$500 for up to three years for small employers (less than 100 employees) that instead sponsor a qualified 401(k) or SIMPLE plan.

¹⁷ Munnell, A., Webb, A., Golub-Sass, F. 2009.

¹⁸ “The Retirement Income Deficit,” Retirement USA.

¹⁹ VanDerhei, J. 2011.

provider” selected on the employee’s behalf from a list of financial institutions maintained on a government website.

The Automatic IRA Act introduced by Senators Jeff Bingaman and Gordon Smith in 2007 would have given employers the additional option of simply including each workers’ payroll-deducted savings with its regular remittance to the Treasury of payroll and income tax withholding. Under this option, a clearinghouse for deposits would be created within the federal Thrift Savings Plan (which manages 401(k)-style plans for federal employees) and simple, low-cost accounts would be managed for every participant. Although the clearinghouse would be centralized, under the Bingaman-Smith approach the investment management, record-keeping and other administrative services would be contracted out to the private sector to the “maximum extent practicable.” Individuals would be permitted to roll their balances out to a qualified private financial institution at any time, but only after their balance exceeded \$15,000.

Most workers would be automatically enrolled, at least initially, at a contribution rate of 3 percent of pay. Every employee is given the option to opt out entirely, or change their level of contribution, at any time.

Another common feature of Auto-IRA proposals is default investment in a balanced fund, or life-cycle fund, that automatically allocates the worker’s assets into an age-appropriate blend of equities (stocks) and fixed-income investments. Proposals typically allow regulation to limit the choice of funds in the IRA with the goal of keeping the accounts simple and relatively low cost.

The limits and restrictions on contributions is perhaps the biggest difference between Auto-IRAs and 401(k)s. Employers would be prohibited from matching employee contributions, or contributing any amount on behalf of

their workforce. This is true even if the employer is willing to contribute a flat dollar amount (or an equal percentage of pay) for all participants. Employees can contribute only up to the current IRA limit, which is \$5,000 (or \$6,000 for individuals over 50), a dramatically lower limit than the combined \$49,000 limit on employee plus employer contributions to a 401(k)-type plan.²³

While the existing, non-refundable Savers Credit would apply to Auto-IRA contributions, just as it does today to IRA and 401(k) contributions by low-income savers, none of the leading proposals incorporate an expansion of the Savers Credit into a matching deposit (although most Auto-IRA advocates separately support a more generous Savers Credit). By default an Auto-IRA would be treated as a Roth IRA for tax purposes, with contributions taxed as current income and all future withdrawals tax free, although some proposals permit individuals to opt for regular IRA tax status (with contributions deductible from current taxable income, but all future withdrawals taxable as regular income).

Five Ways to Improve Automatic IRAs

The transformation of the American private pension system over the past 25 years from inclusive, employer-paid defined benefit plans to predominantly voluntary, contributory plans has widened the nation’s retirement saving deficit. As we’ve turned into more of a do-it-yourself 401(k) nation, several flaws in the employer-based system have been exacerbated. One significant flaw in this system is that of inclusion. As detailed above, employer-sponsored plans cover fewer than half of all private sector workers, leaving more than 75 million workers—including a disproportionate share of low-income, part-time, small business and minority employees, as well as the self-employed—without an easy, automatic, incentivized and professionally-managed infrastructure to facilitate saving throughout a career.

²³ Note limit on SIMPLE – lower than 401(k) but much higher than IRA.

A second, related problem is the lack of pension portability. Labor market mobility is increasing and job tenure is steadily decreasing. The typical worker will change jobs seven or more times after age 25 and, even if they are fortunate enough to have pension coverage in every job, will face eight or more years of ineligibility for automatic saving and the incentive of matching deposits. Meanwhile, at least one in four U.S. workers are in non-standard work arrangements (part-time, temporary and contract workers) that rarely include pension coverage. While a “free agent” workforce may be good for productivity, it makes the current job-based pension system increasingly inadequate.

While a “free agent” workforce may be good for productivity, it makes the current job-based pension system increasingly inadequate.

A third fundamental flaw in the current system is tax incentives that are not targeted on the public policy goal of promoting retirement saving at the margin – and among middle-to-low-income earners who have the greatest difficulty sacrificing current income for saving. A tax deduction for saving will typically contribute \$35 in federal expense for every \$100 saved by a top-bracket earner – and no subsidy at all for most of the lowest-earning 40 percent who would be more powerfully motivated by a matching tax credit deposited directly into their account (which would also serve to build their asset accumulation and not simply reduce their tax bill). While the affluent can respond to tax incentives for saving by shifting rather than actually increasing their net saving effort, households that would not otherwise save generate net new national saving.

A final set of challenges relate to income adequacy and longevity. Even among those workers who are currently participating in a 401(k) or other defined contribution plans, saving is not continuous enough, accumulations are

not large enough, and lump-sum withdrawals in retirement are often depleted too quickly, exacerbating the risk of outliving assets. Even an essentially voluntary saving system like the Auto-IRA needs to design in a set of “nudges” strong enough to push the typical middle- to lower-income worker toward a higher contribution rate (6 to 12 percent or more), reinforced by the incentive of additional matching contributions (from both tax credits and employer contributions), and converted as a default into a secure stream of income for life. The supposedly pragmatic urge to make the Auto-IRA politically innocuous also threatens to make it only marginally efficacious in practice.

While the combination of a very robust version of the Automatic IRA and an expanded, refundable version of the Savers Credit could address each of these flaws to a considerable degree, current Auto-IRA proposals alone are likely to have a limited impact.

A weak version of the Auto-IRA could effectively exclude nearly more than a third of the workforce from the benefits of consistent and automatic saving.

What follows is a description of five improvements that could turn the Auto-IRA into a more universal and progressive version of today’s 401(k).

Inclusion: Ensuring Every Worker has Consistent Access to Automatic Saving

Nearly every critique of America’s broken retirement saving system leads off with the observation that fewer than half of all workers participate in pension or saving plans at work.

While automatic enrollment in Auto-IRAs at firms not sponsoring a qualified plan will surely increase participation among those excluded today, a weak version of the Auto-IRA could effectively exclude nearly more than a

third of the workforce from the benefits of consistent and automatic saving.

The major categories of private sector workers that could potentially be excluded (and their percentage of the total private workforce) include:

- Workers at firms with fewer than 10 employees or which have not been in business at least two years (~25% workforce).
- Workers at firms that sponsor a qualified plan, but who are not eligible to participate because they haven't satisfied the 1-year service requirement (~10% workforce).
- Workers at firms with a qualified plan who are not eligible to participate because they are part-time (less than 1,000 hours/year ERISA qualification), classified as contractors, temporary or otherwise contingent (~8%).
- Workers at firms without a qualified plan who may still not be eligible because they are part-time (less than 1,000 hours/year), contractors, temporary or contingent (~8%).
- Self-employed individuals, including those who incorporated and those (two-thirds of the total) who have not (~11%).

While these categories overlap, together they comprise a majority of the private sector workforce that is not currently participating in a qualified retirement plan. Auto-IRA proposals generally exempt the smallest employers (10 or fewer), which by itself leaves more than 18 million workers without an automatic savings vehicle, since few firms that size sponsor retirement plans. More than 25 percent of all U.S. workers are self-employed or work in part-time, temporary, on-call or contract arrangements that typically exclude them from pension coverage.

The two largest categories are part-time workers (26 million) and the self-employed (16.5 million in 2009). While the self-employed simply do not have an employer to administer payroll-deducted saving – and will need to be accommodated through a clearinghouse or other strategies (see below) – under current Auto-IRA proposals millions of

part-time, contract and contingent workers would be excluded simply because they work for an employer that sponsors a qualified plan for which they are not eligible. In addition, millions of new hires at these same firms would be ineligible for both their employer's plan and the Auto-IRA during the one-year waiting period for plan eligibility.

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One-Year Waiting Period and Vesting Exclusions

The leading Auto-IRA proposals generally exempt employers that maintain a qualified pension or saving plan for most of their workers.²⁴ A majority of workers in the private sector work at firms that sponsor a plan. Although many who are eligible for 401(k)-type plans choose not to participate, at any given time millions of other employees at firms sponsoring plans are not eligible to participate. The most common reason is the one-year waiting period that the vast majority of plans impose on new hires. Since median job tenure is 4.4 years,²⁵ the typical plan sponsor could easily have 15 percent or more of its covered workforce at least temporarily ineligible to contribute (or to participate in a defined-benefit plan).

From the individual worker's perspective, these one-year "time outs" from a payroll-deduction saving plan (whether the employer's or the Auto-IRA) disrupt the sort of consistent saving that leads to an adequate nest egg. This "time out" from asset accumulation can be considerably

²⁴ In some proposals, employees in a separate subsidiary or business unit not covered by a plan could be eligible for the AutoIRA. See Senate bill 3760, "Automatic IRA Act of 2010" (sponsored by Sens. Bingaman and Kerry), at p. 4.

²⁵ Bureau of Labor Statistics, "Employee Tenure in 2010," News Release (Sept. 14, 2010).

longer for a worker with only a defined-benefit pension plan, since short-tenured workers are typically denied any benefit at all when they terminate before vesting. Even after a covered employee is eligible to participate, it can be as long as five years before the worker *vests* in any benefit.²⁶ Ironically, since the typical worker changes jobs eight or more times during the course of a career, workers lucky enough to move between employers that sponsor a plan of any type could end up without access to an automatic payroll saving plan (or defined benefit accrual) for a substantial number of working years.

Trends in job tenure exacerbate these saving gaps. Although saving early in one's career has the biggest impact on adequacy (because of compounding investment returns over time), workers under 45 change jobs far more often than older workers. A longitudinal study by the Bureau of Labor Statistics found that the youngest baby boomers changed jobs 11 times on average between age 18 and 44.²⁷ And although most of these job changes occurred by age 27, the typical worker had only an average 4-year tenure in jobs between age 28 and 44. BLS concluded that although the length of employment increases with age, "these baby boomers continued to have large numbers of short-duration jobs even at middle age. Among jobs started by 39- to 44-year-olds, 33 percent ended in less than a year, and 68 percent ended in fewer than 5 years."²⁸

²⁶ ERISA allows employers sponsoring DB plans to deny short-tenured employees any benefit accrual at all by choosing between "cliff" vesting and "graded" vesting. Under cliff vesting the participant must become 100% vested in their benefit earned to date after no more than five years. Under graded vesting after two years of service a participant must become vested in 20% of benefits earned to date for each additional year (e.g., 20% after three years, 40% after four years) until reaching 100% after seven years.

²⁷ Bureau of Labor Statistics, "Number of Jobs Held, Labor Market Activity, And Earnings Growth Among the Youngest Baby Boomers: Results from a Longitudinal Survey," News Release (Sept. 10, 2010). *See also* "Employee Tenure in 2008," U.S. Bureau of Labor Statistics, News Release, USDL 08-11344, Sept. 26, 2008 (suggesting a typical 25-year-old will work for seven or more employers by age 65).

²⁸ Bureau of Labor Statistics, 2008.

Since 1980, the largest drop in median job tenure has been among males in their prime saving years. According to Bureau of Labor Statistics data compiled by EBRI, median tenure for males 55 to 64 years old dropped from just over 15.3 years in 1983 to 10.4 years last year. The second largest shortening in median job tenure was among males age 45 to 54 (from 12.8 to 8.5 years over the same period).²⁹ An Auto-IRA could promote continuous, career-long saving if it is designed to both allow and encourage participation by everyone not currently able to save in a comparable or better qualified plan.

Excluded part-time, contract, and contingent workers

A second large group of workers excluded from current Auto-IRA proposals are millions of part-time, temporary, on-call workers, self-employed contractors, and other contingent workers at firms sponsoring a qualified plan and who are not required to be covered under ERISA. There are currently more than 26 million part-time employees; and while some are covered by today's qualified plans because they have averaged more than 1,000 hours (roughly 20 hours per week) for more than one year, the majority are typically excluded. Indeed, many companies hire large numbers of part-time and contingent workers in part to reduce the cost of benefit compensation. And while the leading Auto-IRA proposals appear to include part-time and contingent workers at firms that do not sponsor a qualified plan, they exclude an equally large number of part-time and nonstandard workers at firms that maintain a plan for most of their employees.

One in Nine Workers is Self-Employed

More than one in nine workers was self-employed in 2009. There are more than 16.5 million self-employed and independent contract workers (nearly 12 percent of the workforce) who must set up and handle contributions to

²⁹ Copeland, C. 2010. p. 3. EBRI's longitudinal study of a large sample of 401(k) plan participants has also shown that consistent participation in a plan yields far larger average account balances than the norm.

VanDerhei, J. 2009.

their own retirement saving account.³⁰ This type of “free agent” workforce may be flexible and productive, but is not well served by the current employer-based pension system.

The Automatic IRA Act introduced in the House and Senate in 2007 anticipated this challenge by providing for a public information campaign to encourage the use of automatic debits from checking accounts, efforts by voluntary associations, and direct deposits of federal and state income tax refunds into IRAs. The legislation did not explicitly provide for a mechanism to enroll the self-employed or the categories of workers not eligible for an Auto-IRA through their employer. However, the bills did provide for the creation of a central clearinghouse, overseen by the Federal Thrift Savings Plan, which could readily be harnessed for this purpose. (The importance of a clearinghouse is discussed further below.)

A federal clearinghouse would facilitate a one-step checkbox on annual income tax returns that make it easy for an individual to direct a tax refund (or portion of a split refund) – or a contribution amount on the quarterly advance tax filing by the self-employed – into an Auto-IRA account. Since the tax form already has the individual’s Social Security number and updated contact information, a new account can be established, or an existing account located, without additional paperwork. Just as the existing and mandatory W-4 form is the most efficient means to implement Auto-IRA enrollment and the specification of a contribution level in the workplace, the tax forms routinely filed by individuals unable to enroll at work should include the same option for voluntary enrollment. This could include not only one-off contributions (e.g., from income tax refunds), but the option to set up an automatic monthly checking or saving account debit that replicates the benefit of automatic payroll deduction at work.

³⁰ This estimate combines the 15.3 million individuals reported as self-employed in 2009 by BLS with the 13% of contractors who were identified in a separate survey by BLS as wage and salary workers (87% of contractors number among the self-employed). Hipple, S. 2010.; Bureau of Labor Statistics, 2005.

Incentives: Matching Contributions with a Refundable Savers Credit

Even if lower-wage workers gain consistent access to an Automatic IRA, the current tax system gives them little if any financial incentive to save when compared to middle- and upper-income earners.

A tax deduction is neither an effective nor an equitable means to encourage pension saving among lower-income workers whether or not they participate in an employer plan. And although the current Savers Credit provides (most commonly) a 10 percent tax credit for retirement saving by low-income taxpayers, the lack of refundability means that millions of workers—who have payroll tax liability, but no current income tax liability to offset—receive no credit at all. As Morgan Stanley’s Stephen Roach wrote in a recent report recommending policies to put the U.S. economy back on track long-term, “[m]aking the existing Saver’s Credit, enacted in 2001, refundable for some 45 million low- and middle-income tax filers who do not have any federal tax liability would be an important step in repairing that hole in America’s social safety net.”³¹

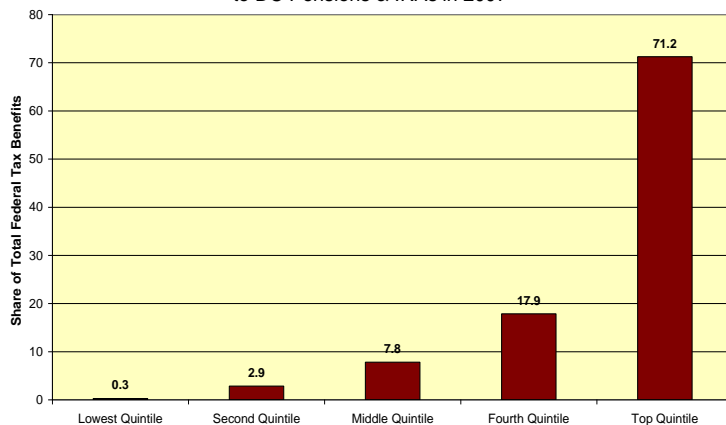
A tax deduction is neither an effective nor an equitable means to encourage pension saving among lower-income workers.

The tax break for retirement saving is one of Washington’s most expensive programs, costing a projected \$123 billion in uncollected federal tax revenue in fiscal 2011 alone, according to Joint Tax Committee estimates.³² Cost aside, the primary problem is that tax incentives for saving are not actually targeted to stimulate net new saving by the lower half of the income distribution who save far too little. More than 70

³¹ Roach, St. 2011. p. 2.

³² Joint Committee on Taxation, “Estimates Of Federal Tax Expenditures For Fiscal Years 2010-2014,” JCS-3-10 (Dec. 20, 2010), Table 1, p. 49. This total estimate includes Keogh plans used by certain sole proprietors and partnerships (\$15.7 billion) and both traditional and Roth IRAs (\$12.3 and \$4.0 billion, respectively).

Share of Current Law Tax Benefits for Contributions to DC Pensions & IRAs in 2007



Source: Adam Carasso and Jon Forman, using the Urban-Brookings Tax Policy Center Microsimulation Model (version 0305-3a).

percent of the tax subsidies for retirement saving flow to the most affluent 20 percent of taxpayers— with 40 percent of the subsidies to the top 5 percent of earners – but virtually none (3 percent) goes to encourage saving by the lowest-earning 40 percent.³³ The reason is simple but too often overlooked even by liberal policymakers: a program subsidized by tax deductions, as opposed to refundable tax credits, is highly regressive.

Under current law qualified retirement saving reduces taxable income, a deduction that reduces the tax liability of a top-bracket taxpayer by 35 cents for each dollar saved. In contrast, a tax deduction for saving is worth *zero* to the more than 40 million low-earning taxpayers who have payroll tax liability but who don't have any income tax liability to offset. Even median-income families in the 10 and 15 percent income tax brackets receive a weak subsidy compared to the 33 or 35 percent subsidy rate that applies to those earning over \$200,000 a year. In contrast, the effect on higher-income workers – who would likely save anyway – is primarily a shifting of assets from taxable to tax-deferred accounts.

The lack of a substantial tax benefit for middle- to low-income earners also impacts the inclination of firms to sponsor a plan. Despite the “carrot” of tax subsidies for pension benefits, a majority of firms with fewer than 500 employees choose not to shoulder the administrative burden and financial risk of sponsoring a pension plan. But even very large companies with a predominantly low-wage workforce—the Walmarts and McDonalds among employers—have little incentive to sponsor a plan for workers who (a) receive little or no financial benefit from a tax deduction, and (b) without a strong incentive would prefer a higher wage now to an

employer contribution for retirement. In contrast, large high-wage employers use retirement plans to steer tens of billions of dollars in pension tax subsidies to their employees every year. If, instead, contributions by both workers and firms were matched by a refundable matching tax credit, then—as with the EITC—the after-tax value of benefits paid to low-wage workers would be far greater, rather than less so.

Although automatic enrollment will boost participation among many low earners, overall rates of participation, contribution and accumulation are not likely to come close to reducing the retirement saving gap without the incentive of matching contributions that also are deposited into the account (and not refunded, as the current Savers Credit is). A refundable credit would operate just like an employer match in a company 401(k) plan. Just as most employers match contributions to 401(k) accounts, the government should match voluntary saving by providing a refundable tax credit that would be deposited directly into the worker's account. Studies show that workers are far more likely to save if given generous matching credits—and once they develop the habit of saving by payroll deduction, most continue even when the match rate is reduced. For example, Census data indicates that 60 percent of eligible low-income workers choose to participate in their employer's 401(k) plan.³⁴ Although these workers receive little if any tax subsidy from an income tax deduction, the employer's matching deposit itself is a powerful inducement since they would be forfeiting compensation by not participating.

³³ Carasso, A., Forman, J. 2007. A more recent estimate of the distributional effects of ending tax incentives for retirement saving concluded that the highest-earning quintile receives 79.6 percent of the total net benefit and that the overall revenue saved could fund a refundable tax credit for equal to \$781 for every taxpaying adult and \$391 for every dependent child under age 17.

Toder, E., Harris, B., and Lim, K. 2010.

Burman, L., Gale, W., Hall, M., Orszag, P. 2004. shows that the average cash savings from tax preferences for defined-contribution retirement plans averaged \$1,838 for the top income quintile, but only \$77 and \$6 for the second and first income quintiles, respectively.

³⁴ Karamcheva, N., Sanzenbacher, G. 2010.

The critical importance of coupling a strong matching credit for lower-income earners as part of an Auto-IRA suggests that tax reform may very well be the relevant context for enacting the two together. An example of an alternative tax incentive for retirement saving focused on the eligibility of individual workers could be structured as follows:³⁵

Income Range (AGI)	Match Ratio	Matched Limit	Maximum Credit	Credit Rate	Tax Treatment
\$5,000-\$30,000	1:1	\$2,000	\$2,000	100%	Roth IRA
\$30,001-\$60,000	1:2	\$4,000	\$2,000	50%	Roth IRA
\$60,001+	1:4	\$8,000	\$2,000	25%	Roth IRA

Unlike the current system, a sliding-scale tax credit of this type targets a stronger saving incentive at those less likely and less able to save. For example, an individual earning less than \$30,000 could receive a \$1 per \$1 (1:1) matching credit on his or her first \$2,000 in savings; whereas workers in families earning above that level (up to \$60,000) could receive a \$0.50 per \$1 (1:2) matching credit on their first \$4,000 in savings; while taxpayers with higher incomes could receive a \$0.25 per \$1 credit (1:4). This approach is also equitable since it gives every taxpayer an opportunity to receive the maximum credit (\$2,000 in this example), while at the same time requiring households with higher discretionary income to save more in total to receive the full subsidy.

Any tax preference for retirement saving in excess of the matching credit limit (e.g., above \$8,000 for upper-middle and high-income earners) would ideally be credited at the same flat 25 percent rate, rather than today's upside-down incentive that provides the equivalent of a 35 percent credit to the top-bracket earners. A proposal from the Brookings

Institution takes this approach, suggesting a flat 30 percent refundable credit for qualified retirement saving up to a \$20,000 limit for 401(k) plans (and up to a \$5,000 limit for IRAs).³⁶ Although a 30 percent flat-rate credit is simpler, it also denies lower-income families a more generous incentive for the considerably smaller sums they are able to save.

Infrastructure: Career-Long Portability Using a Low-Cost Clearinghouse

A great benefit of the Auto-IRA concept is that, like a 401(k) plan, it would give workers access to the convenience, discipline and protections provided by automatic payroll deduction and professional asset management in an account tied to their current job. However, Auto-IRAs could do more to promote continuous saving and career-long portability for all workers (regardless of employment status), as well as to reduce leakage from pre-retirement cash-outs and the administrative burden on employers. A critical piece of the “plumbing” needed to achieve these broader goals is a Clearinghouse comparable to the Federal Thrift Savings Plan (TSP), which manages very low-cost 401(k)-style saving accounts for three million federal military and civilian personnel. A clearinghouse can receive deposits directly from individuals not able to participate through an employer and be the default administrator for small, unprofitable accounts.

Record keeping would be centralized, but the investment management and most functions could be contracted out to private investment firms, as TSP does today. The clearinghouse would strive to keep costs and complexity to a minimum. Although payroll-deducted savings and matching tax credits would flow through the clearinghouse, the assets could be fully portable and transferable at any time at the worker's request to another qualified financial institution, or to a future employer's 401(k) or other qualified plan.

³⁵ The author initially made this proposal in testimony to the House Committee on Education and the Workforce. Calabrese, M. 2000. p. 6. There would likely be a phase-out range at each income level.

³⁶ Gale, W. 2011
Gale, W., Gruber, J., and Orszag, P. 2006.

Indeed, because the primary function (in addition to record keeping) is to manage relatively small accounts that would be unprofitable to a private money manager, we would expect that as account accumulations grow over time, most participants will eventually roll over to a more full-service IRA provider. At the same time, individuals could maintain the account throughout their careers, since it would remain open as they moved from job to job. It can be the receptacle for automatic rollovers as workers leave jobs without designating an alternative. It would also be easy to notify holders of inactive accounts by appending an account summary to the annual benefit projection notice sent annually to almost every adult by the Social Security Administration.

The bipartisan Automatic IRA Acts introduced in the House and Senate in 2007 included a provision establishing a procedure whereby employers could choose to either maintain IRA accounts at a financial institution of their choice, or instead send their employees' payroll deduction savings along with the firm's regular remittance of payroll tax and income tax withholding to the Treasury. This alternative account system would be overseen by a "TSP II Board," which would in turn contract out investment management and administrative services to the private sector as appropriate. The primary architects of the Auto-IRA, Mark Iwry and David John, also propose "a platform maintained and operated by private financial institutions under contract with the federal government" as a sort of last resort where "it proved impossible to find IRA providers interested in serving all small employers that are required to offer Automatic IRAs to their employees."³⁷

It may be politically more acceptable to limit the federal clearinghouse to a fall-back role that is optional to employers and fully privatized, but there are a number of compelling policy reasons to maintain a central clearinghouse for record-keeping and low-cost account management. The most important reason is to facilitate and promote universal inclusion and continuous, career-

long saving. As described above, a substantial share of workers not currently able to participate in a 401(k) or other employer-sponsored plan will also not be eligible for a payroll-deduction Auto-IRA.

Even if firms not maintaining a qualified plan are required to enroll every worker, the 18 million workers at firms with 10 or fewer employees would need access to a saving plan, as would the nation's 16.5 million self-employed and independent contract workers, and the more than 15 million part-time, contingent and new hires at companies exempt from the Auto-IRA because they sponsor a qualified plan. While some of these workers may be saving regularly in an IRA, the data suggests that they also need a more easy, automatic and continuous way to save. During periods that workers lack access to automatic payroll deduction, a clearinghouse and "career account" can facilitate and simplify saving.

A clearinghouse can receive deposits directly from individuals not able to participate through an employer and be the default administrator for small, unprofitable accounts.

The most obvious channel to facilitate saving is the federal tax return. Without any significant increase in cost or complexity, the Form 1040 can ask taxpayers if they would like to save more regularly by designating a bank account for an automatic monthly debit. The return can also automate the deposit of a full or partial (split) income tax refund into retirement saving without the need to first establish an IRA at a financial institution. In 2010 more than 109 million Americans (77 percent of all taxpayers) received tax refunds totaling over \$325 billion, suggesting that making it simple and automatic to direct at least a portion of a tax refund into saving – and receive a matching

³⁷ Iwry, M., John, D. 2009. p. 67.

credit in addition – would yield a considerable increase in saving across the income spectrum.³⁸

During periods that workers lack access to automatic payroll deduction, a clearinghouse and “career account” can facilitate and simplify saving.

Another set of reasons for a clearinghouse involve continuity, leakage and lost accounts. The leading Automatic IRA proposals all envision the employer establishing an account for each new employee at a financial institution of the *employer’s* choice. While this is familiar as the way firms administer 401(k) plans, it creates a number of long-term problems as employees change jobs multiple times. Median job tenure has varied between 4.1 and 4.4 years in recent years. And even among older workers, average job tenure is nearly 50 percent less than it was before 1990 (8.5 years among workers 45 to 54, and 10.4 years for age 55 to 64).³⁹

One casualty of increasingly shorter job tenures is continuity. When a worker leaves a firm – and payroll deposit ends – they may “own” the account but have no real connection to the financial institution chosen by the employer. The typical worker will end up with multiple accounts – and with nobody tracking or consolidating these accounts on their behalf. This is likely to lead to a massive number of lost or abandoned accounts, particularly among workers who change jobs often, who are more itinerant, or who are less financially literate. The American labor force is increasingly mobile geographically, with younger workers in particular experiencing periods of employment in different states. Although some churn and complexity is unavoidable, the typical worker will benefit most if the default option for an Auto-IRA is a career account.

³⁸ Roach, S. p. 2.

³⁹ Employee Benefit Research Institute, “Employee Tenure Trend Lines, 1983-2010,” Notes, Dec. 2010, at p. 3.

A case in point is Australia’s Superannuation Guarantee (SG) retirement saving system, initiated in 1986, which operates like a mandatory 401(k). Employers are required to deposit 9 percent (increasing to 12 percent) of an employee’s wages into an individual retirement account, with workers making voluntary contributions above that level. Australia moved this year toward a central clearinghouse precisely because of the proven inefficiencies, high fees and millions of lost accounts that resulted from tying accounts to jobs and employer choice rather than giving workers a “career account” based on individual choice. While SG is generally considered a great success, accumulating \$1.2 trillion in assets, the government initiated a review and reforms in 2010 aimed at making the superannuation system more efficient and fair for average workers. One of the biggest problems is that the system’s 12 million participants had 33 million accounts – nearly three for each worker – and more than one lost account for every two workers.⁴⁰ By 2008 there were 6.4 million lost or abandoned accounts with nearly \$13 billion held by financial institutions.⁴¹ As workers changed jobs and moved, whether around Australia or abroad, far too many simply could not keep track of their accounts or navigate the system to consolidate them.

Nick Sherry, the former Minister for Superannuation, kicked off a campaign to encourage workers to locate and consolidate their accounts because “[h]aving money sitting in three, four or more places means your retirement income gets eaten away by multiple, often high, fees and charges, and that’s not in your interest.”⁴² On July 1 Australia implemented a reform to streamline account reporting through a central clearinghouse that will track

⁴⁰ Nick Sherry, former Australian Minister of Superannuation and Corporate Law, conversation with author (Jan. 20, 2011).

⁴¹ “Superannuation Clearing House and the Lost Members Framework, Part B,” Minister of Superannuation and Corporate Law, media release and discussion paper (released Nov. 14, 2008), available www.treasurer.gov.au.

⁴² Sherry, N. 2007.

each worker's accounts by Tax File Number (equivalent to a U.S. Social Security number).⁴³

A related problem is leakage. When an employee terminates, he or she can take steps to roll the balance to another qualified account or IRA. But if 401(k)s are any indication, a large share of these assets will be withdrawn for spending. One recent study found that among workers who left their job between 2006 and 2010, 42 percent took a cash distribution despite the tax penalty.⁴⁴ Leakage is particularly great among younger participants (who also change jobs more often) and those with low account balances. Assets that accumulate automatically from one job to another through a clearinghouse mechanism would be less susceptible to leakage. A central clearinghouse could also better facilitate options to continue saving through tax withholding or automatic debit into a "career account" maintained in a well-known and trusted repository.

A federal clearinghouse overseen by the Treasury (and/or a TSP II Board it appoints) would also streamline the process for employers. Although firms could be allowed to select and monitor a single IRA provider, or to forward payroll-deducted contributions directly to the qualified IRA provider designated by individual employees, many employers will find the program less burdensome if they can simply add this additional withholding to the payroll and income taxes they routinely withhold and remit on behalf of each employee. The Automatic IRA Acts introduced in 2007 made this an option for employers, but it should be either required or at least the default option.

Inertia: All Five Potential Default Features Should be Robust

Central to the Auto-IRA is the concept of converting myopia into positive inertia by making participation the default option for everyone. Although the Pension Protection Act clarified that plan sponsors can choose to implement automatic enrollment, it is not required. It should be.

Studies have shown that automatic enrollment can boost 401(k) participation rates as high as 95 percent—when there is also an employer match—and to 80 percent among low-income workers. However, as we know from today's 401(k)s, even with the added incentive and accumulation that comes from an employer matching contribution, enrollment alone does not nudge participants into the savings behavior associated with achieving an adequate and guaranteed stream of retirement income that long-tenured workers receive from a quality DB pension. Because studies have shown substantial inertia among participants in 401(k) plans with respect to both contribution levels and managing their accounts,⁴⁵

It's important to get the defaults right... including a high initial contribution, automatic escalation, investment allocation, rollover and annuitization. Without required and very robust default features, the typical worker will not end up with a retirement income as large and secure as it could be.

Automatic Enrollment

There is a clear consensus that automatic enrollment in 401(k)s has greatly increased participation. Recent surveys suggest that among the 44 percent of large 401(k) plan providers that have adopted automatic enrollment, participation rates have increased by about 30 percent compared to pre-automatic enrollment levels.⁴⁶

In contrast, there is considerable disagreement concerning the initial default contribution rate. Among defined-contribution plan sponsors that have adopted automatic enrollment, more than 60 percent are using a default contribution rate of 3 percent and some even less (the Pension Protection Act cites a range of 2 to 4 percent). The President's FY 2012 budget assumes a default rate of 3 percent of employee compensation. Similarly, the Senate Automatic IRA Act of 2010 provides for a range of not less than 2 percent or more than 4 percent.

⁴³ Shorten, B. 2010.

⁴⁴ Austin, Rob, et. al. (2011).

⁴⁵ Choi, J., Laibson, D., Madrian, B., Metrick, A. 2001.

⁴⁶ Lucas, L., Hess, P., Peterson, C. 2011.

It's important to get the defaults right... including a higher initial contribution, automatic escalation, investment allocation, rollover and annuitization.

As the *Wall Street Journal* opined in a recent page one report, automatic enrollment at a 3 percent default rate is far too low to achieve even basic retirement income adequacy. The problem, according to the *Journal's* report, is that “[m]ore than two-thirds of companies set contribution rates at 3% of salary or less, unless an employee chooses otherwise.”⁴⁷ Absent automatic escalation (see below), inertia works against adequate saving rates since too many workers leave that low default rate in place indefinitely. They may even mistakenly believe that their employer is defaulting them to the “appropriate” saving rate. And even with escalation, it would take many years to push the contribution rate up to the 10 to 12 percent level that is considered minimally adequate, creating a savings deficit in the meantime.

If we intend the “default” rate to be interpreted by participants as expert advice about smart savings behavior, then a 6 percent default rate would seem minimal. Although there is a legitimate fear that new hires may opt out if they believe the default rate is too high, the extra accumulation from a 6 percent contribution rate would be worth what appears to be a very small risk for two reasons. First, 6 percent is the average self-selected contribution by a 401(k) participant even at lower income levels.⁴⁸ Second, if a participant takes affirmative action to change their default

status, they can simply reduce the contribution rate (to 3 percent or whatever they wish) rather than opt out entirely.

An additional way to boost the impact of automatic enrollment is to renew it every two years. Current proposals seem to anticipate a one-time default enrollment – and if a worker opts out it is up to them to take the initiative to sign up in future years. However, a worker who opts out when first hired may have a different perspective after being on the job for two years. At a minimum, this sends a reminder and a message that they should be saving – and ensures that they are still consciously deciding not to participate.

The same power of inertia that makes automatic enrollment effective can cause too many workers to remain at the low initial default rate for far too long.

Automatic Escalation

A closely related issue is whether and how to automatically increase the default contribution rate over time, so that barring a different choice by the individual, it reaches the 10 to 12 percent level needed to achieve income adequacy (assuming fairly continuous saving over a career). Unfortunately, the same power of inertia that makes automatic enrollment effective can cause too many workers to remain at the low initial default rate for far too long.

Currently only about one-third of 401(k) plan sponsors combine auto escalation with auto enrollment; and most of these firms cap the ultimate default rate at 6 percent of compensation.⁴⁹

However, as the *Wall Street Journal* report noted above observed, even auto enrollment at 6 percent will not accumulate adequate savings if workers remain at that rate. A 2010 study by EBRI and the Defined Contribution

⁴⁷ Tergesen, A. 2011.

⁴⁸ In large part this reflects the impact of employer matching contributions, which most commonly match 50% of the first 6% of pay contributed by the employee. In the context of an Auto-IRA, a worker earning \$33,000 would need to save 6% of pay (\$2,000) in order to receive the full benefit of a refundable Savers Credit match set at a rate of 1:1. This effort would add a total of \$4,000 (12% of pay) to the worker's account.

⁴⁹ Lucas, L., Hess, P., Peterson, C. 2011.

Institutional Investment Association found that, depending on income level, between 54% to 73% of employees would fall short of saving enough money to replace at least 80 percent of their pre-retirement income level if they enrolled in their companies' 401(k) plans at the default-contribution rate and were auto-escalated by 1% a year to a maximum of 6%.⁵⁰

The Auto-IRA bills introduced in Congress have generally authorized but not required automatic escalation. We believe it should be required as an annual 1 or 2 percent increase until the default rate reaches at least 10 percent. The EBRI analysis noted just above assessed the impact of a number of features related to automatic escalation and concluded “it is clear that the impact of increasing the limit on employee contributions is much greater than any of the other three factors.”

Automatic Investment

Auto-IRA proposals generally require that if employees do not affirmatively choose how to allocate their assets among different investment options, the default would be a balanced or life-cycle fund that diversifies among equity and fixed-income investments. Requiring this diversification as the default is important since otherwise employers tend to choose overly conservative investments with little risk of capital loss, such as money market funds and stable value funds, to avoid any potential liability or backlash from employees if the allocation they have chosen declines in value.⁵¹ Financial analysts uniformly agree that retirement assets should be invested with a long time horizon – and that money market or stable value funds that barely offset inflation sacrifice the compounding of interest and earnings on saving that is critical to achieving an adequate accumulation over the life course. Life-cycle

⁵⁰ VanDerhei, J., Lucas, L. 2010.

⁵¹ The Pension Protection Act of 2006 amended ERISA Section 404(c) to give plan sponsors that choose to adopt automatic enrollment and default investment allocation the same insulation from fiduciary liability for investment losses that generally apply to participant-directed investments in qualified DC plans. However, just as employers are not required to adopt default enrollment, they can also choose an overly conservative default investment allocation.

funds (sometimes called target-date funds) are generally best-suited for this purpose, since they automatically reallocate the assets over the years to invest more in bonds and less in stock as the participant gets closer to retirement.

Automatic Rollovers

Millions of workers who participate in employer-sponsored plans for a portion of their career retire without any pension income or assets. The reason is that roughly half of all lump-sum distributions to workers changing jobs or otherwise terminating their employment are not rolled over into an IRA or another retirement plan. Census survey data on lump sum distributions between 2000 and 2006 indicated that only 46 percent of separating employees rolled over the entire amount, accounting for 73 percent of the dollars distributed since larger accumulations were far more likely to be rolled over.

Most cash-outs represent smaller accumulations by younger workers. For example, Aon Hewitt reports that 75% of those with distributions of less than \$1,000 took a cash distribution.⁵² Nonetheless, the opportunity cost of this leakage is substantial. The Congressional Research Service estimates that due to compounding and the young age of most workers not rolling over distributions, cash-outs between 1980 and 2006 could have paid those who did not roll them over \$220 in monthly income for life by age 65 (assuming an average return equal to AAA-rated corporate bonds).⁵³ Employers can simply “cash out” a worker’s 401(k), without the employee’s consent, if the balance is less than \$1,000. Unless the employee directs otherwise, ERISA now requires employers to deposit distributions between \$1,000 and \$5,000 into an IRA on the worker’s behalf. However, the employee may have little awareness of this default IRA, triggering many of the same problems with fragmented and lost accounts noted above in the discussion of Australia’s superannuation system and clearinghouse remedy.

⁵² Austin, Rob, *et. al.* (2011).

⁵³ Purcell, P. 2009.

With a central clearinghouse and notional “career accounts” established for every worker, the default for all non-directed distributions from an employer-sponsored plan—including those of less than \$1,000—can be deposit into the worker’s Auto-IRA account. Employers would thereby avoid the burden of opening IRAs for ex-employees; and even uninformed or disinterested workers would at some point learn that this automatic rollover is being invested on their behalf in one consolidated and consistent account.

Automatic Annuitization

Finally, at retirement age, the default payout option should be in the form of an annuity – guaranteed monthly payments – to ensure that retirees do not outlive their assets.

For example, currently a 65-year-old male will live 17 more years on average, but has a 19.3 percent chance of living to age 90. In a 401(k) nation, this longevity risk is exacerbated by the natural inclination of most people to underestimate the level of assets they must maintain to sustain their pre-retirement standard of living. There should be incentives to encourage and facilitate annuitization, which is one of the great (and disappearing) advantages of a defined-benefit plan.

Another advantage of a central clearinghouse for Auto-IRAs is that it can serve as the broker for the pooling and purchase of annuity contracts from financial industry providers. Currently very few retirees choose to purchase annuities, but that could change considerably through the combination of a default option and innovative lifetime income options. Annuity options that could be made available include partial annuities, trial annuities and longevity annuities. A longevity annuity is a type of partial annuity that begins to distribute payments only after the retiree reaches an advanced age, such as 80 or 85. Allocating a portion of accumulated assets for this form of longevity insurance is particularly useful in preparing for

potentially catastrophic long-term health care costs late in life.⁵⁴

The default payout option should be in the form of an annuity – guaranteed monthly payments – to ensure that retirees do not outlive their assets.

As a default option, the combination of a trial annuity and partial annuitization appears to be the most promising since it would give any retiree who does not opt out a familiarity with fixed monthly income payments without locking them in. For example, the Retirement Security Project at Brookings has proposed that a substantial portion of assets in 401(k)-type plans “be automatically directed (defaulted) into a two-year trial income product when retirees take distributions from their plan, unless they affirmatively choose not to participate.”⁵⁵ At the end of the trial period, retirees could choose among several options – including opting for a lump sum, or annuitization of all or just a portion of their nest egg. If they made no choice they’d default into a permanent income distribution plan. “This would put inertia to work on behalf of the income stream rather than on behalf of the lump sum,” according to the Brookings proposal.⁵⁶ A similar trial annuity could be the default option for Auto-IRA assets as well, giving individuals who did not opt out the longevity insurance traditionally associated with a DB plan.

Another role for a central clearinghouse could be to aggregate demand for purchasing lifetime income contracts. Annuity contracts could be bid out to one or several private insurers or other financial institutions, as DB plan sponsors do when they purchase a Guaranteed Investment Contracts. Since annuities purchased through state-regulated insurance companies are not government

⁵⁴ Youngkyun, P. 2011.

⁵⁵ Gale, W., Iwry, M., John, D., Walker, L. 2008.

⁵⁶ Gale, W., Iwry, M., John, D., Walker, L. 2008. p. 11.

guaranteed, benefits could also potentially be reinsured, in whole or in part, by the Pension Benefit Guarantee Corporation, the federal pension insurer that currently manages guaranteed annuity payments each month for millions of private-sector retirees who were participants in a defined benefit pension plan sponsored by a company that defaulted on its obligations, typically due to bankruptcy. The Brookings proposal suggested more generally that “[a] federal insurance agency patterned on the Federal Deposit Insurance Corporation (FDIC) could . . . establish uniform financial standards and safeguards for consumers, regardless of the state in which they purchased their contract,” with annuity providers paying an annual premium for this protection, just as DB plans pay a modest insurance premium to the PBGC.⁵⁷

Income: Boosting Adequacy with Employers Contributions and Higher Limits

One common element in Auto-IRA proposals is a prohibition on employer contributions. However, subject to certain conditions, allowing employers to contribute on behalf of their employees is a win-win for firms and employees alike.

It would grow workers’ savings more rapidly while giving employers the option to provide a pension benefit without the burden of administering a pension plan. Employers should have the flexibility to decide from year to year whether to contribute to their workers’ accounts. Some firms would choose to do so as a type of year-end, profit-sharing bonus depending on performance. Employer contributions should be taxable as income, but tax free when withdrawn at retirement age, receiving the same Roth IRA treatment as employee contributions.

The sort of nondiscrimination testing that complicate 401(k)-type plans would be unnecessary if employer contributions are limited to a flat percentage of wage income, or a flat dollar amount, and made on behalf of *all* payroll employees, including part-time workers. Without

such a requirement, employer contributions might undermine ERISA nondiscrimination rules aimed at ensuring that employers are not using the tax subsidies to favor only their higher-wage employees.

Allowing employers to contribute on behalf of their employees is a win-win for firms and employees alike.

A final design issue where Auto-IRA proposals fall short is in restricting contributions to today’s meager IRA limits (\$5,000 or \$6,000 for workers over age 50). While this may be as much as we can realistically expect low-income workers to save in a year, most middle-income workers – of whom there are tens of millions who lack access to a 401(k), SIMPLE or other employer-sponsored plan – simply cannot hope to achieve retirement adequacy with their saving restricted at this level. Moreover, while higher-income earners can contribute \$16,500 of their own wages to a 401(k) or similar DC plan – and receive up to \$5,775 in public subsidy (at the 35 percent bracket) – the bill would limit the majority of American workers to far less.

It is not primarily access to a savings account that spurs participation, but the four “I’s”—Inclusion, Incentives, Infrastructure, and Inertia.

Both the ban on employer contributions and the proposed low limits on worker savings are motivated primarily by a concern that an Auto-IRA not undermine the incentives for business owners to sponsor a SIMPLE or 401(k) plan, which would typically be a better benefit for most workers because of the employer match. One way to balance these concerns is with a contribution limit that is between today’s IRA and SIMPLE limit (which is \$10,500). An individual

⁵⁷ Gale, W., Iwry, M., John, D., Walker, L. 2008. p. 17-18.

limit in the neighborhood of \$8,000 would still leave business owners with the incentive to “graduate” up to the higher SIMPLE or 401(k) limits if they personally wish to save more.

The reality, however, is that for a variety of reasons, a very substantial number of new, small and even medium-sized employers will not sponsor a qualified plan and may welcome the ability to facilitate an adequate level of saving by their employees – and even to contribute to those accounts if it could be done at their discretion and with minimum regulation.

Designing a More Inclusive and Seamless Universal Saving System

Today’s private pension system works well for those workers who have consistent access to a plan and choose to save. Every working American needs access to both a potent tax incentive to save and the infrastructure of automatic payroll deduction into a portable, professionally-managed account *whether or not* his current employer sponsors a retirement plan. The fact that so few workers save regularly in IRAs reinforces what demonstration projects among low-income families have found: it is not primarily access to a savings account that spurs participation, but the four “I’s” —Inclusion, Incentives, Infrastructure, and Inertia.

While still fundamentally voluntary, the Auto-IRA concept could be greatly strengthened and better targeted to promote saving among middle-to-lower-income workers over the life course by incorporating these overall design principles:

- Eligibility and design criteria that emphasizes ***inclusion***, both permitting and encouraging every working adult not currently able to participate in a qualified employer-sponsored plan to contribute to

their “career account” by payroll deduction, bank debit, tax refund designation, or other means.

- A tax ***incentive*** for saving that is more inclusive—and targeted toward lower-income earners who find it most difficult to save—by expanding the Savers Credit, making it refundable and a more generous match for low-wage workers, and depositing it directly into the individual’s account.
- An account-based ***infrastructure*** that enables every worker to save by automatic payroll deduction and facilitates career-long portability through a central and low-cost default account and clearinghouse function.
- Default options that convert myopia into positive ***inertia***, through automatic enrollment and payroll deduction, automatic escalation, automatic asset allocation, automatic rollover, and automatic annuitization.

Under a universal saving plan with these key attributes, all workers not participating in an employer plan, including recent hires, part-time employees, and temporary and other contingent workers, would be automatically enrolled and contribute by payroll deduction, although an individual could opt out and choose not to save. The government would match voluntary contributions by workers and their employers with refundable tax credits deposited directly into the worker’s account. Workers participating in their employer’s 401(k) or other qualified plan would receive stronger tax incentives to save, but otherwise see no difference. Contributions for workers not participating in an employer plan would be forwarded to a federally-chartered clearinghouse, which would manage small accounts at low cost and could even convert account balances into guaranteed income for life at retirement. An Auto-IRA with the more robust features described above would make saving for retirement considerably more inclusive, automatic, adequate and equitable.

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