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SMALL BUSINESS PENSION PLANS: HOW CAN WE INCREASE WORKER COVERAGE?

HEARING

BEFORE THE

SUBCOMMITTEE ON LONG-TERM GROWTH AND DEBT REDUCTION

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

SECOND SESSION

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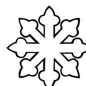

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SMALL BUSINESS PENSION PLANS: HOW CAN WE INCREASE WORKER COVERAGE?

THURSDAY, JUNE 29, 2006

U.S. SENATE,
SUBCOMMITTEE ON LONG-TERM GROWTH
AND DEBT REDUCTION,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 2:35 p.m., in room SD–215, Dirksen Senate Office Building, Hon. Gordon Smith (chairman of the subcommittee) presiding.

Present: Senator Bingaman.

OPENING STATEMENT OF HON. GORDON SMITH, A U.S. SENATOR FROM OREGON, CHAIRMAN, SUBCOMMITTEE ON LONG-TERM GROWTH AND DEBT REDUCTION

Senator SMITH. Good afternoon, ladies and gentlemen. Welcome to the Subcommittee on Long-Term Growth and Debt Reduction hearing. Our topic today is "Small Business Pension Plans: How Can We Increase Worker Coverage?" Thank you all for being here.

Small businesses are the heart of the American economy. Small business owners are out there every day, taking risks and creating jobs. They know what it is like to sign both sides of a paycheck.

When running a small business, these is no set calendar which guarantees your vacations, or even your weekends off. You are working all the time, sometimes even Christmas. Owning a small business is work, and I certainly applaud all small business owners. They are the spark plugs of the American economy and creators of the American dream.

Over the last decade, small businesses have generated the vast majority of new jobs—60 to 80 percent of net new jobs annually.

With approximately 26 million small businesses in America, they represent over 99 percent of all employer firms in the United States.

Small businesses have also contributed measurably to America's innovation and technological advances as well. They employ roughly 40 percent of high-tech workers and produce 13 to 14 times more patents per employee than large patenting firms.

The contributions of small businesses to our economy are many and manifold; unfortunately, they tend to be under-appreciated and over-regulated in the halls of government. But small businesses are central to the progress of our country, and they are central to increasing America's retirement savings.

More than half of all private sector employees are employed by small business, yet small businesses are less likely than large employers to sponsor an employer retirement plan.

Moreover, employee participation rates are shockingly low. Businesses with fewer than 20 employees have only 15 percent of their employees enrolled in a retirement plan. Businesses with 20 to 90 employees have only 43 percent of employees covered by an employer-provided plan. Employers with 100 to 500 employees have little more than half of their employees participating in an employer-provided retirement plan.

The question then becomes: why are these rates so low? Small businesses face significant barriers to establishing a retirement plan. There is the cost factor: the cost of setting up a plan and administering it are often high.

There is also the potential for additional Federal regulation requirements and liability ramifications. Small companies with fewer than 20 employees already spend 45 percent more per employee than larger firms to comply with Federal regulations and tax compliance.

Add to this the complexity and volume of pension plan regulations, and I believe small businesses are systematically discouraged from offering their employees a retirement plan.

This is a problem that needs a solution. I have heard from many small business owners in Oregon who say they want to offer retirement plans, but the cost, complexity, and liability outweighs their benefits, benefits such as recruiting and retaining key employees, as well as increasing employee satisfaction and loyalty.

These benefits are all very important to small business owners, because without good, hardworking employees, their future economic success is limited.

If we are serious about increasing Americans' savings in order to be financially secure in retirement, we need to assist small businesses in the retirement plan area. They are integral to any national savings solution.

Today we are here to focus on small employer coverage and employee participation to begin what will be a fruitful conversation on what we in Congress can do to help small businesses and Americans save for retirement.

I am very pleased to have my colleague from New Mexico, Senator Bingaman with us, and for your opening statement.

OPENING STATEMENT OF HON. JEFF BINGAMAN, A U.S. SENATOR FROM NEW MEXICO

Senator BINGAMAN. Thank you very much, Senator Smith, for having this hearing and chairing it, and your leadership in this area.

This is a very serious issue, particularly in a State like mine, where most people work for small businesses. Most employees are employed in small businesses. I think I have seen some statistics—not recently; maybe some of you have it in your testimony—some sort of a State-by-State analysis of the percentage of private sector employee participation in some type of pension plan, and I think New Mexico is about the bottom of that list.

I believe we are sort of the bottom of that list because we probably have the largest number of reasonably small employers relative to the rest of the workforce. We have very few large employers, I guess is another way to say it. So this is an extremely important issue.

I do think the statistics I have seen indicate that the trends are going in the wrong direction. Companies are bailing out of defined benefit plans, of course, but in addition to that, just the number of employees who have any type of pension coverage is declining rather than increasing, which is obviously the wrong direction.

Particularly, I want to thank Mr. Iwry and Mr. John for their proposal on automatic IRAs. I think that is very useful. Years ago I introduced some legislation that had some of the same characteristics, but we were not able to get a lot of folks interested at that time.

I know Senator Smith is very focused on this and interested in trying to move ahead with something of this type, which I think is terrific, and perhaps, working with Heritage and with Brookings, we can build enough momentum to actually pass something.

So I look forward to working with Senator Smith to see what we can do in that area, and I look forward to the testimony. Thank you all for being here.

Senator SMITH. Thank you, Senator Bingaman.

Senator Conrad and I, in fact, have an automatic enrollment for those companies that have pension plans or 401(k)s, but the problem is, not enough of them have 401(k)s to automatically enroll people in.

But it is just such a pressing national problem, because we literally have a negative savings rate in our country now. There just has to be some streamlining, some additional incentive to help people to prepare for the demographic bulge that we are simply unprepared to receive when it comes to our retirement years.

Let me give, for the record, a brief introduction of each of you.

Our first witness is Dr. Craig Copeland. He is a senior research associate at the Employee Benefit Research Institute. Dr. Copeland researches participation in employer-based retirement plans, contribution behavior in defined benefit contribution plans, and adequacy of savings for retirement.

Then I want to introduce my neighbor, Steve Bjerke. He is from my hometown of Pendleton, OR. He is an Edward Jones investment representative and has been doing this work for over 20 years. Thank you for coming here, Steve.

Mr. Daniel Hall is also from Oregon. He is a regional pension manager for Standard Insurance, based in Portland. His responsibilities include sales of new retirement plans, communication of retirement plans to employees, and overseeing businesses in the Pacific Northwest region.

Then we have Ms. Paula Calimafde. Paula is the chair of the Small Business Council of America and a practicing tax attorney for over 20 years, specializing in qualified retirement plans.

Mr. David John is a senior research fellow at The Heritage Foundation. Mr. John serves as Heritage's lead analyst on issues relating to pensions, financial institutions, asset building, and Social Security reform.

Mr. Mark Iwry is a senior advisor for The Retirement Security Project and is a senior fellow at The Brookings Institution. Mr. Iwry was Benefits Tax Counsel at the Treasury Department from 1995 to 2001.

We appreciate all of you joining us. Senator Kerry, the Ranking Member of this subcommittee, may be joining us. But in the event he is not able to, we have his statement. If there is no objection, we will include his statement in the record. [No response.]

[The prepared statement of Senator Kerry appears in the appendix.]

Senator SMITH. Dr. Copeland, take it away.

STATEMENT OF DR. CRAIG COPELAND, SENIOR RESEARCH ASSOCIATE, EMPLOYEE BENEFIT RESEARCH INSTITUTE, WASHINGTON, DC

Dr. COPELAND. Thank you, Mr. Chairman and members of the committee.

My focus today is on providing statistics on the participation of employment-based retirement plans for small employers and the demographic characteristics of small employers that affect participation in these plans.

I also examined the breakdown of retirement plan participants into each type of plan, either defined contribution or defined benefit.

A small employer is defined as one with fewer than 100 employees. The main data source is the Census Bureau's March 2005 Current Population Survey. From this data, 45 percent of private sector wage and salary workers aged 21 to 64 were found to have worked for a small employer, with 18 percent for an employer with fewer than 10 employees, 12 percent with 10 to 24 employees, and 15 percent with 25 to 99 employees.

A gap in retirement plan participation between small and large employers has existed for many years, and, in 2004, 27 percent of workers working for employers with fewer than 100 employees participated in an employment-based retirement plan, compared with 56 percent who worked for an employer with 100 or more employees.

This lower level of participation among smallest-employer workers persists across earnings levels, industries, and work status of the employees. For workers at firms with fewer than 10 employees earning less than $15,000 annually, 5 percent were participants, compared with 17 percent of workers in firms with 1,000 or more employees.

For workers earning $75,000 or more annually, 36 percent participated in the smallest employers, compared with 86 percent in the largest employers. The percentage of workers participating in the personal services industry ranged from 11 percent in the smallest firms to 33 percent in the largest firms. This compares to other industries where the percentage of employees participating ranged from just under 25 percent to just over 60 percent.

Among full-time, full-year workers, the percentage participating increased from 20 percent in the smallest firms to 68 percent in the largest firms. In contrast, among part-time, part-year workers, the percentage participating ranged from 6 percent to 14 percent.

While the percentage of workers who participated in plans was lower across the various characteristics of workers or employers, important differences in the types of workers in the small versus large employers remain. In particular, small employers have a disproportionate percentage of workers with annual earnings below $15,000.

There are 31 percent at firms with fewer than 10 employees, compared with 20 percent at employers with 100 or more employees. Small employers are also more likely to be in the personal service industry and less likely to be in the manufacturing industry, the industries with the lowest and highest overall levels of participation, respectively.

Small employers have lower shares of full-time workers and higher shares of part-time workers when compared with large employers. However, when we look at other important characteristics of the workforce—age, race and education level—it did not differ markedly.

While CPS data that have been previously cited do not include the plan type of these participants, the Federal Reserve Board Survey of Consumer Finances does. Participants of employment-based retirement plans working for small employers are more likely to have a defined contribution plan as their only plan relative to participants in larger employers.

For example, 77 percent of participants with 10 to 19 employees were in a defined contribution plan only. This compares with 57 percent at firms with 500 or more employees.

While rates of having only a defined benefit plan are similar across employer sizes, participants from the largest employers are significantly more likely to have both types of plans, 21 percent for large employers, compared with 6 percent for the small employers. This higher likelihood of having a defined contribution plan for participants in smaller employers persists across all the industries.

Despite the lower likelihood of workers at small employers being in employment-based retirement plans, there is some good news for them. The probability of being in a plan has increased since 1991.

In 1991, 20 percent of workers at firms with 10 to 24 employees participated in an employment-based plan, before growing to 27 percent by 2004. In contrast, for employers with 1,000 or more employees, participation has actually declined during that time period, from 62 percent to 59 percent.

However, this increase is mitigated somewhat by the relative decline in the last couple of years of participation across the board.

Thank you. I will be happy to answer any questions you have.

Senator SMITH. Thank you.

[The prepared statement of Dr. Copeland appears in the appendix.]

Senator SMITH. Steve?

STATEMENT OF STEVE BJERKE, INVESTMENT REPRESENTATIVE, EDWARD JONES, PENDLETON, OR

Mr. BJERKE. Mr. Chairman, thank you for holding this hearing on expanding retirement coverage for workers in small businesses, and for the opportunity to testify on behalf of Edwards Jones Investments.

Edward Jones is one of the largest investment firms in the country, and a leader in the financial service industry, with over 8,500 offices throughout the country. We applaud your commitment to ensuring that Americans have adequate retirement savings.

You have championed in this area, and we are pleased that the pension bills currently in conference contain critical provisions from the Smith-Conrad bill such as automatic enrollment. We also have been following your initiative, which focuses on narrowing the retirement income gap between men and women. We certainly want to offer our assistance on that initiative.

Mr. Chairman, this is an important hearing. Edward Jones strongly supports proposals to help employees of small businesses, where retirement coverage need is the greatest. We serve over 6 million clients, of whom approximately 20 percent are small business owners.

Our small business clients are often very small, many with under 10 employees, and it is our experience that small business owners can be reluctant to adopt a retirement plan. There are many surveys as to why small businesses do not have plans. I can tell you this firsthand.

When I visit with small business owners, they tell me setting up a plan is too complicated and too expensive. Fortunately, an opportunity to address some of these issues in the current pension conference will help.

Let me highlight a few of the provisions that will help with small businesses. The House bill makes permanent the very helpful savings provisions of the 2001 Tax Act.

The 2001 Tax Act updated and increased the limits on retirement plan contributions, which makes it possible for Americans to save more in a qualified plan. That, in turn, makes it attractive for small business owners to establish a retirement plan.

The 2001 Act created the Saver's Credit, which provided a much-needed savings incentive for low- and middle-income individuals, and it eliminated a lot of the complicated procedures that required employers to set up two plans if they wanted to provide enhanced contributions for their employees. The Act also provides a tax credit for certain small businesses to help offset the costs of starting a plan.

Mr. Chairman, these pro-small business savings provisions will expire in 2010. We support making these provisions permanent as soon as possible, and this is our top priority in the pension bill.

If we wait, uncertainty regarding their possible expiration will make small business owners hesitant to set up a plan for fear that the rules will change. Sometimes we only have one chance or one opportunity to establish a plan within these small businesses. If we lose that opportunity because of uncertainty regarding the rules, the business may never have a plan.

The pending pension bills also make beneficial modifications to SIMPLE plans. SIMPLE plans have low administrative costs and are proving to be an excellent retirement savings arrangement for small businesses that would otherwise not have a plan. The Senate pension bill would make the SIMPLE plan even more attractive to small businesses by allowing portability and a more reasonable withdrawal penalty.

Both the House and Senate bills recognize that employees need access to investment advice in order to achieve their retirement goals. We support the inclusion of the advanced provisions in both bills. The House bill, in particular, would be very helpful in stimulating the delivery of the much-needed advice.

Finally, the Senate bill would remove a significant obstacle preventing many small businesses from maintaining a retirement plan by relieving the smallest businesses from filing the multi-paged 5500 reports, which are very burdensome. We hope that the conferees will include all of these beneficial provisions.

Mr. Chairman, Edward Jones is also reviewing a number of next-generation proposals that would enhance small business pension coverage. We understand you are considering several measures, such as tax credits for contributions to new plans, equalization of treatment of retirement plan contributions of the self-employed, and allowing sponsors of SIMPLE plans to make additional employer contributions.

I talked to several people this week, and they were really excited if something like that would happen; not that they would put it in, but they would have the opportunity to put it in. We believe these, along with several suggested by Senator Max Baucus, will be very helpful.

Mr. Chairman, the retirement savings crisis is real, and we applaud your recognition that small businesses have unique challenges in trying to help their workers save more for retirement. We look forward to working with you to ensure that all Americans are prepared for retirement.

Thank you.

Senator SMITH. Steve, after the 2001 Act, with those beneficial provisions that it contained, did you see an increase in enrollment or creation of pension plans?

Mr. BJERKE. In the next year, I saw a 20- to 25-percent increase in small businesses jumping in to do something. They were just really excited that they knew what was going on.

Senator SMITH. Does that go away if we do not make them permanent?

Mr. BJERKE. Absolutely.

Senator SMITH. And if we do make them permanent, will even more get involved in it?

Mr. BJERKE. Yes. And even right now, when I am talking to people, there is a real hesitation, to say, I do not know what is going to happen in a couple of years, let us wait and see. For those who wait to see, most likely it does not happen. Running a small business is a big enough challenge. Any uncertainty that you can take away is good.

You start out facing that payroll, not knowing if you can hire enough employees and keep your business going. It is just one more uncertainty that makes it really tough on small businesses. And absolutely, that would be the number-one priority, in my mind.

[The prepared statement of Mr. Bjerke appears in the appendix.]

Senator SMITH. We will, next, go to Daniel Hall. Senator Bingaman, if you have any questions as we go along, we will just be real informal. Just ask them as they come up.

Senator BINGAMAN. All right. I will try to hold off.
Senator SMITH. All right.
Senator BINGAMAN. But if it occurs to me, I may ask.
Go ahead.

STATEMENT OF DANIEL HALL, REGIONAL PENSION MANAGER, THE STANDARD, STANCORP EQUITIES, INC., PORTLAND, OR

Mr. HALL. Thank you, Mr. Chairman and Senator Bingaman.

My name is Dan Hall, and I am a Regional Pension Manager for Standard Insurance Company. The Standard is a financial services provider in Portland, OR, which provides employee benefits, investment advice, annuities, and retirement plan products and services to more than 7 million customers nationwide.

The Standard has been in the retirement planning business since 1939, and we introduced our first 401(k) product in 1982. Our expertise is in the small plans market. We have been consistently rated a top provider by our customers and independent third parties.

I have been in the retirement planning business for 23 years, and I thank you for the opportunity to share my perspective today on barriers to small business pension coverage.

I would also like to take this opportunity to address some issues that inhibit employee participation in retirement plans. I have submitted copies of my full testimony, and I will be summarizing my written testimony.

It is imperative for the financial health of our citizens and our Nation that employers and government continue to work together to provide improved coverage and encourage individual participation in plans.

There are perceptual and real barriers to implementing retirement plans. The first perceptual barrier is that the current generation of business owners and employees has not adjusted investment habits to mirror the movement from company-provided pensions to 401(k)-type plans.

The second perception of the small business owner is that his or her company is the retirement plan, therefore, money spent on infrastructure has priority over putting money into retirement.

The final perception among small business owners is that retirement plans are complicated, over-regulated, and expensive.

Three real barriers encountered by small businesses in implementing a plan are: one, competing priorities with other employee benefits, primarily health care. The most immediate needs today often take precedence: health care is today; retirement is tomorrow. Second, compliance testing and top-heavy rules which can limit the business owner's participation in the plan are often redundant, and the top-heavy rule is outdated. Finally, the current rule requiring a third party audit if a plan has more than 100 employees represents a significant cost and burden to the small business. Recent legislation allowing plans to offer the Safe Harbor solution is a major step in the right direction, a win-win for both employer and participant.

Other solutions that would encourage small businesses to provide coverage are: (1) to offer a tax credit to small businesses to offset employer contributions or administrative costs; (2) as mentioned

earlier, to eliminate or modify top-heavy rules and simplify discrimination testing to ease the administrative burden for owners, as well as to allow providers to lower their fees; and (3) to consider changing the 100-employee audit rule, as expensive external audits offer only limited returns for such plans.

Solutions that would help increase employee participation include: (1) implementing Federal regulations that make automatic enrollment rules consistent nationwide; (2) allowing plan providers to offer unbiased and revenue-neutral investment advice from an investment advisor—a significant barrier to individual participation is the lack of knowledge about funds and investment strategies; (3) encouraging automatic deferral increase programs; (4) considering lowering the current catch-up age of 50 to age 45; (5) considering implementing a minimum loan amount, say $5,000 per loan, from a retirement account or requiring loans for hardship reasons only; (6) revising roll-over rules even further to discourage cash-outs; and (7) allowing favorable taxation on distributions that are annuitized at retirement.

It is wise public policy of this Congress to promote personal retirement savings. The key to increasing both employee and employee participation is simplicity and incentives.

Simplicity in the 401(k) arena can be achieved through eliminating unnecessary administrative requirements for small employers. The right incentives will promote employer sponsorship of retirement plans and employee participation in those plans.

Thank you for allowing my testimony. I would be happy to answer any questions members of the committee may have.

Senator SMITH. Dan, those suggestions you made for adjustments, are any of those related to ERISA? Obviously, ERISA was put into place to get rid of a lot of abuses that were occurring in some pension plans.

Mr. HALL. I believe that the one that is most directly related to ERISA is top-heavy. All of the ones that followed that are much later than ERISA. ERISA has become so much the doctrine that we follow, but I think top-heavy was the first one that was a direct result of ERISA.

Senator SMITH. And from your experience, is there some streamlining that we could do with ERISA without compromising safety for employees? Is it just so cumbersome that it simply is too great a financial impediment?

Mr. HALL. I am not sure how to answer that. ERISA, in our world, is kind of big news. We have all followed it. There are always streamlines. Top-heavy is a well-intended rule that newer tests, like anti-discrimination testing, have trumped, so that makes top-heavy not such an issue.

So when plans become top heavy, it is a little bit of a nuisance, as opposed to really preventing abuses within the plan. It discourages people. If an employer has sponsored a plan where they have had testing issues, he may say, you know, I am not going to set up another plan again. I remember 10 years ago where I did not benefit from that. So, I think there are some things you can do.

Senator SMITH. All right.

[The prepared statement of Mr. Hall appears in the appendix.]

STATEMENT OF PAULA CALIMAFDE, CHAIR, SMALL BUSINESS COUNCIL OF AMERICA, BETHESDA, MD

Ms. CALIMAFDE. Mr. Chairman, Senator Bingaman, thank you very much for holding these hearings on this vital topic.

The Small Business Council of America is a nonprofit national organization that represents small businesses only in the tax, employee benefits, and health care areas.

My message is a little different, I think, from everyone else on the panel. I consider, and the SBCA considers, the small business retirement plan system to be a major success. It covers 19 million employees, and that is a lot of employees; keep in mind, this is a voluntary system.

Many of these small business plans provide significant contributions to these employees. Now you might ask, why would a small business plan provide significant contributions? It is because, in many cases, that is the owner's best way to save for retirement. Because of the discrimination tax laws in the tax code, the owner must provide significant contributions for everyone else in the plan.

By and large, these plans are properly funded and carefully invested. Again, why? Because the owner's money is in the plan, so the owner wants to make sure that the money is safe and the money is in there. In addition to a significant employer contribution, these plans very often provide employee saving through payroll deduction. That is your 401(k) plan and your SIMPLE.

The importance of payroll deduction cannot be over-emphasized. There are data that show that when employees have the ability to save through payroll deduction, they are 11 times more likely to save than they would if they had to put the money in by themselves outside of payroll deduction.

An easy way of thinking about this, of course, is if you give me the money, I will find a way to spend it. If you take it out of my paycheck before I get it, I forget I even saved it.

Another corollary to this rule is, if I put money in an IRA and I can easily take it out, chances are I probably will. If I put money in a retirement plan that locks it down, chances are I will not access it.

Now, the coverage numbers that everyone is talking about that make small business coverage look relatively low do not take into account two factors. One factor is that most of these numbers only look at all workers, they do not look at workers who work more than 20 hours a week. In most small business retirement plans, coverage is for people who work 20 hours a week.

The other factor which is critically important is that one-third of all start-ups fail within 2 years, and more than 50 percent of those start-ups will fail within 4 years.

So when you put this shifting bottom of small businesses going in and out, they are not contributing to retirement plans because they are fighting for their lives. In fact, as we know, many of them do not make it.

I agree with—I think it was—Mr. Bjerke that the single most important thing that can be done to increase coverage right now in the small business area is to make the pension provisions in the tax bill of 2001—which we refer to as EGTRRA—make those provisions permanent.

They are incredibly important provisions to small business. This is the time to make them permanent. They sunset in 2010. The closer we get to 2010, the more uncertainty there will be whether we can count on those proposals. As Mr. Hall mentioned, certainty is incredibly important to small business owners.

Because time is so limited, I want to go over a few major items.

Senator SMITH. Paula, could you elaborate on which of those, the Saver's Credit, the capital gains dividend, which ones to make permanent or are so important?

Ms. CALIMAFDE. Well, the capital gains, unfortunately, almost works against the pension provisions. If you make capital gains rates go down too low, there is a disincentive for owners and other people to contribute to the retirement plans. Because keep in mind, when the money comes out of the retirement plan it comes out as ordinary income.

But, yes. I was referring to, actually, the items—I think Mr. Bjerke mentioned them—like increased contributions. Those provisions allowed a company that had to sponsor two plans to be able to only sponsor one plan and get the same level of contribution. So for small businesses, that was a major savings.

The 401(k) Roth contribution came in under EGTRRA. The EGTRRA provisions were really well-vetted. They were discussed for about 6 years by you all and you took into account what big business had to say, small business had to say, nonprofits, governmental entities, governmental employees, union employees, employee groups, so what you put together was a really well-crafted bill.

Senator SMITH. Thank you very much. [Laughter.]

Ms. CALIMAFDE. No. The small business community thanks you, by the way. You have, literally, helped millions of employees with that bill.

But because time is limited, I want to just go through a couple of major things that I think are important. The pension bill in conference right now—that is where you are able to make those EGTRRA pension provisions permanent—also has an automatic enrollment feature for 401(k) Safe Harbor plans, an automatic enrollment/Safe Harbor feature.

First off, Safe Harbors only apply to small businesses. They are the only ones who care about them. The automatic enrollment is an incredibly important device, which I believe, actually, Mark Iwry brought to the attention of most folks. The statistics are startling.

If an employee is automatically enrolled, by and large something like 70 percent of them forget they are being enrolled and they just stay enrolled. It is sort of inertia, but they get there and they keep putting money into the plan.

Those same people who stay enrolled stay with the default investment as well. So you can imagine this kind of passive group of people who just stay in, but once they are in, they are saving for retirement.

The House version in the pension bill that is in conference is almost right on the automatic enrollment Safe Harbor. However, it has one huge flaw: it provides enough of an incentive for small business to do automatic enrollment—because, keep in mind, this

is an extra burden that small business has to do, and they are not going to do it just because they are nice, they are going to do it because there is some reason to do it.

These folks are running a business and, as you know, most of these businesses run very close to the margin. So there is a reason to do the automatic enrollment in this Safe Harbor that the House version put out, but then they added a requirement—the Safe Harbor will only work if 70 percent of the employees who are automatically enrolled stay automatically enrolled. Well, business owners have no ability to tell their employees, you must stay enrolled.

A business owner meeting with Mr. Hall, Mr. Bjerke, or myself, if we say to them, you should amend your plan for the Safe Harbor, you will need to amend your summary plan description, you will have to explain this to your employees, you will have to tell your administrator about this, and by the way, if the folks you enroll do not stay in, it doesn't work, you have wasted your money, I can tell you right now, they are just going to say, thanks very much, forget it.

So you need to get rid of that 70-percent requirement. If you do that, you have, I think, a really good automatic enrollment Safe Harbor there.

Cash balance plans. Some people have this image that cash balance plans are bad. Cash balance plans, in the small business area, are the Cadillac plan. The reason why is because individuals have their own account balance, so they know what they have in the plan, and the investment returns are guaranteed. You cannot get much better if you are an employee.

We need the certainty from you all to say that these plans are not inherently age-discriminatory. I know there are all sorts of issues in the cash balance world that are not easy that you are dealing with, and those are the conversion issues.

But the small business world does not deal with conversion issues, because they did not go from a defined benefit to a cash balance. These are new start-up cash balances.

So the small business world needs that certainty, that if they put in the plan it will not be deemed to be age-discriminatory. Again, going back to what other members have said on the panel here, if they do not have the certainty, they are not going to put money in the plan.

Finally, funding. People talk about a problem with funding: why are businesses not funding their defined benefit plans properly? I would say this is where we have the elephant in the room, and the elephant is called the reversion tax.

Before the reversion tax, companies did not care if they overfunded, because when the plan terminated, if there was extra money in the plan, they would get it back. Today, if they terminate the plan and there is over-funding, the government takes 50 percent.

So you are now in a situation of, if you did not fund the plan properly, the company has to provide the benefits for the employees. They are guaranteeing the investment results. But if they do too well, the government takes 50 percent.

So we are almost in a heads-I-win/tails-you-lose situation, and I think if you start tinkering with that reversion tax you may end

up seeing companies going closer to the proper funding levels voluntarily.

Two other items I want to bring up, quickly. One is that, even though I have spent my time today on these issues, the Small Business Council of America endorses the testimony prepared by ASPPA, the written testimony. It goes into a number of specific issues that I understand, I think, Mr. Smith, you are working on. Every single one of those are good ideas and they will work very well, in my opinion, to increase coverage.

Finally, we also endorse the IRA proposal which has been developed, I believe by Mark Iwry and David John. I know they will be discussing it today.

Thank you.

Senator SMITH. Thank you very much, Paula. I want to point out, I think your clarification on sort of the numbers I was giving about small businesses and the availability of pensions is absolutely right. You were right in clarifying that.

The dilemma we have is, how do we reach those people who are working but who are not planning for retirement? So, we are just looking for more vehicles, because I do agree, when a small business starts, it is saving for its life, not saving for retirement.

Ms. CALIMAFDE. Right. Well, we know education is critical.

Senator SMITH. Yes.

Ms. CALIMAFDE. Because if you can get to those younger employees and get them saving in a tax-free environment, the results are amazing. So we know education is a key in this whole thing.

[The prepared statement of Ms. Calimafde appears in the appendix.]

Senator SMITH. Mr. John?

STATEMENT OF DAVID C. JOHN, SENIOR RESEARCH FELLOW, THE HERITAGE FOUNDATION, WASHINGTON, DC

Mr. JOHN. Thank you, Mr. Chairman, and thank you, Senator Bingaman, for putting on this hearing on this rather crucial area.

Mark Iwry and I are presenting joint testimony, and we are living proof that left and right can go beyond the restrictions of ideology into common ground on occasion.

Senator SMITH. Senator Bingaman and I are working on that, too, actually. [Laughter.] But, congratulations.

Mr. JOHN. Thanks.

Well, my interest in pensions comes from my daughter, my older daughter Meredith, who is 20 and in her second year of nursing school.

Now, when Meredith graduates—and the good news, being a nurse, she will always have a job—she is going to go to work for one of the big hospitals and she will have a 401(k) plan.

Meredith and I have discussed this over the years, and we have finally gone beyond the, "Oh, Daddy, not that again, that is boring," to the, "Oh, yes, that really is important" phase of the discussion.

But Meredith is not going to stay at a big hospital. She has plans to move to small practices, perhaps a public health agency, something along that line. The simple fact is, for Meredith's retirement and for kids her age's retirement, first off, we cannot assume that

Social Security's benefits are going to get any larger than they are right now. Anyone who is planning on retiring on just Social Security is going to have a very hard time of it.

Second, we cannot make the assumption that defined benefit pension plans are going to expand either. The fact is, there are probably going to be far fewer of them in the future than there are now.

If that is the case, Meredith, and people her age, have to start to participate in a defined contribution pension plan from the day they go to work, and they have to continue participating until the day they retire. It is the only way they are going to come up with a decent retirement income.

But the simple fact is that, in 2004, out of 153 million American workers, 71 million of those worked for a company that did not offer any sort of a pension plan. Now, we can say that an IRA is an option, but the simple fact is that it is not, in most cases.

The most optimistic study that I have seen on IRA coverage is about 17 percent or so, and realistically probably not more than 5 to 10 percent of the people who are eligible for IRAs (because they do not have any other pension plan) participate on a regular basis in those.

In many cases it is because they simply do not have outlets. If you are in the central city, you do not have banks and you certainly do not have stock brokerages on every corner.

If you live in the eastern panhandle of West Virginia, as I do, in most of the small towns, the financial center is the ATM at the 7–11, and they have not gotten to the point where they are selling IRAs yet, although one of the owners did tell me she was working on that.

So we have come up, Mark and I, with a proposal we call Auto IRA. Auto IRA would be for employers that have 10 or more employees and have been in business for 2 years or more and do not offer any other sort of pension plan.

These employers would be encouraged to give their employees—as a matter of fact, they would be required to give their employees—the opportunity to make regular payroll deductions to an IRA. All the employer would have to do is to get a simple "yes" or "no."

Employers with less than 10 employees could participate if they wanted to; it would be a voluntary way. We also have a method that we believe, on a voluntary basis, would get independent contractors and people who are working, say, professionals in private practice, or something along that line.

Our plan uses the existing IRA. It is not an ERISA plan. It is simple and it is cheap. It is not intended to compete with any of the existing employer-offered pension plans.

It does not require—in fact, it does not allow—employer contributions at this level. We have no incentive—we hope—in our plan, that if you are offering a 401(k) now, that you would want to move down to an Auto IRA. This is the first step.

Heritage's Center for Data Analysis, in some rough numbers that they prepared for us—and they are working on better numbers at the moment—says that Auto IRA would affect about 40 million of the 71 million people who currently work for a company that does

not offer a pension. These are workers who are employed by about 675,000 businesses at this point.

It appears that about 60 percent of those 40 million actually have no Federal income tax liability or they receive a refundable tax credit equal to their Federal tax liability.

The median income of these workers is about $17,000 a year, although the household income may be higher because some of these workers have more than one job. Again, this is a rough estimate.

We would urge employers to select an IRA from one of three sources. Source number one would be that, if the employer so chooses, he or she could simply say to the employees, if you have an IRA, we will put money in your IRA.

Second, if the employer has a relationship with a particular financial institution, the employer may choose to have all the employees send their money to this one particular financial institution.

Third, there would be a default national platform, which is very similar in nature to the TSP plan that is offered to Federal employees and uniformed military personnel now. It is a simple, low-cost alternative. Investment would be in a lifestyle fund—that would be the choice—unless the employee chooses to invest their money in something else.

This is similar to what has been said by some of the earlier witnesses here: we are basically depending on inertia. We are going to have it so that people will have the right decision made for them, unless they choose something else.

Now, the national platform is actually very similar to something that is being discussed right now in the United Kingdom and is actually being implemented in New Zealand at the moment. Sweden actually has a slight variation of this as part of their Social Security system. Let me stress, what we are talking about is not part of Social Security.

It could be structured as a TSP, which is basically government-sponsored, where the actual investment in other activities is contracted out to private professionals. It could be structured as a nonprofit or a consortium of nonprofits, it could be done on a regional basis, it could be on a national basis.

Senator SMITH. Is this a payroll deduction?

Mr. JOHN. Yes. Yes. In all cases, this would be a payroll deduction. Payroll deduction is the most important thing here.

And last, but not least, it could be done by a consortium of financial companies. Younger workers need to have something like Auto IRA. Meredith needs to participate in a defined contribution system, again, from the day she first goes to work until the day she retires.

It does not matter how large her employer is, where the employer is located, or even if she is working for herself. She has to participate, and she has to participate, inasmuch as possible, seamlessly. Otherwise, she is going to reach age 64, 65, and she is going to look back at us and say, well, how come you set me on this path to failure?

Thank you.

Senator SMITH. That is a fascinating idea. While I was not a backer of the President's idea on private accounts, I was in a way.

The way I was proposing to do them was that those young people, not 55 and below, but those young people, under current law, who are guaranteed to suffer a 25-percent cut in Social Security benefits, just through the operation of existing law, that we should set up for them that kind of an account.

The government can be the matcher, and it would cost something, but it would give them the opportunity to make up what they are guaranteed to lose. To me, that still makes the most sense.

I am sure you will want to sign onto it, Senator Bingaman. [Laughter.] It does not touch the Social Security trust fund, but it does create this new generation of investors and increases, frankly, financial literacy in our country, which is somewhat lacking.

[The prepared statement of Mr. John appears in the appendix.]

Senator SMITH. Mr. Iwry?

STATEMENT OF J. MARK IWRY, SENIOR ADVISOR, THE RETIREMENT SECURITY PROJECT, WASHINGTON, DC, AND NONRESIDENT SENIOR FELLOW, THE BROOKINGS INSTITUTION, WASHINGTON, DC

Mr. IWRY. Thank you. I will pick up where my colleague, David John, left off.

The payroll deduction is the driver of this concept. As Paula Calimafde said, people are far more likely to save when they have the automatic payroll deduction mechanism going for them. We all know that.

This is a "set it and forget it" kind of arrangement. Once it starts, that money keeps coming out of the person's paycheck until they do something to stop it or to change it.

What we would add to that is encouragement to make the setting of it automatic as well—that is, picking up on your legislation, Mr. Chairman, and the success of the automatic enrollment, automatic 401(k).

We would promote as much of that automatic enrollment—and Senator Bingaman, your legislation of a similar nature—as possible in these payroll deduction or payroll deposit IRAs so that the employer, if it was willing to, would be automatically enrolling people in them. If the employer did not want to do that, we would not make it do that.

They know their own workforce, they know their institutional culture. It is a small business. We would let them make the decision, but we would make it easy for small business to use automatic enrollment. We would have a uniform website with standard forms that an employer could use to sign people up.

The success of automatic enrollment in bringing 401(k) participation up from something like an average of 3 out of 4 to more than 9 out of 10, 90 or 95 percent, is what we would hope to build on here. We think this could make a huge difference in small business coverage.

Now, I want to emphasize, as David John did, our first priority is employer plans. If we can get an employer, small business, to adopt a 401(k), to adopt a defined benefit, profit-sharing, a SIMPLE, that is the best path to go down. But so many of them have not been willing to do that. Inevitably, there will be many who will

not. We would like to give their employees the benefit of the power of payroll deduction.

Senator SMITH. And would this be for employees of any sized company? In other words, if you have a job in America, one of the deductions is going to be for this Saver's?

Mr. IWRY. We would let the employer that already has a plan——

Senator SMITH. It would be exempted from it?

Mr. IWRY. It would be exempted from it. Obviously, if they wanted to add this kind of thing on for some of their employees who might not be in the plan, that would be great. It would be easy for them to do because this infrastructure would be all set up.

Senator SMITH. Would there be an employer match?

Mr. IWRY. No.

Senator SMITH. It is just a deduction from the employee.

Mr. IWRY. That is right. This is all funded out of the employee's own wages, so the employer is not looking at cost burden. By hypothesis, we are talking about employers not willing to offer a plan.

If we can persuade them to buy a plan, that is where we ought to be. But these are the ones that we have not been able to sell to. We would like their employees to at least get the benefit of that payroll deduction without putting any costs on the employer. It looks like we have really got that opportunity, a kind of unused capacity in the form of payroll-deposit saving.

It does not really cost the small business, because it is doing it anyway. It is taking people's FICA and HI tax, FUTA, income tax withholding, and it is deducting it and sending it on to the Federal tax depositary.

We could use that same channel, that same schedule, the same envelope that they use to make those deposits, or the same click of the mouse they use to do that electronically, if that is how they do it, to send this saving deposit to an IRA.

Senator SMITH. What percentage would it be?

Mr. IWRY. It would be, first of all, whatever the employee decides. If the employee feels they do not want to save, they do not save, and it would be zero. If the employee wants to save a fair amount, they could save that amount up to the IRA limits.

Senator SMITH. Would there be tax deferral on the earnings?

Mr. IWRY. Absolutely. It would be a regular IRA contribution, so they would get a deduction up front if it is a traditional IRA, or they would get the Roth treatment if it is a Roth, and the tax-free build-up.

The employer would not have to worry about compliance. The employer would not be responsible for making sure that the contributions are within the IRA limits, any more than an employer is today when an individual writes a check to their IRA. The individuals are responsible for making sure that the check does not go over the dollar amount, and the same would apply here.

In fact, small business really would not be doing anything other than enrolling people, telling people that this opportunity exists, which they could do by just downloading the standard form and giving it to people, taking note of who wanted to participate and who did not, and then, really, make the contribution in the way they send people's paychecks by direct deposit to a bank account. Most people have that done—your employer will, instead of hand-

ing you a paycheck, send it to a bank account or some other account. It is the same thing for the employer in this case. They are just sending saving money to an IRA account rather than a paycheck to a bank account.

Senator SMITH. That is a great idea.

Mr. IWRY. We would very much hope that this encourages more employer plans. Mr. Chairman, our thought is that——

Senator SMITH. Is there an incentive that it would not?

Mr. IWRY. We do not think so. The reason we do not think so is that the contributions you can make to an IRA are $4,000 a year, as you know. Contributions you can make to a 401(k) are $15,000 a year, a SIMPLE IRA, $10,000; of course, a little more if you are 50 or older.

The difference in incentive is very dramatic. If an employer or the employees have a lot of demand or appetite for tax-favored saving, they will go with that 401(k), or at least they will go with the SIMPLE employer-sponsored plan that has employer contributions, matching or non-matching.

Senator SMITH. The only obligation of the employer is, if you hire someone, as an American employer, you have to make known to the employee this opportunity?

Mr. IWRY. Right. If you do not sponsor a plan.

Senator SMITH. If you do not.

Mr. IWRY. And if you have been around for more than 2 years and if you have more than 10 employees. You get a tax credit for providing this facility. That is, even though we do not think it is really going to cost employers any meaningful amount, there are no out-of-pocket costs.

They have to pay attention. And small business owners are always short on time and attention, so we appreciate that. We value the fact that they are making their business run and they are not there to be a plan administrator, so we have tried to cut out all of those tasks, all that compliance.

All they have to do is tell employees this exists, and honor the employees' election. That should really not cost anything. But, as a gesture of good faith, we have suggested that Congress give a small tax credit for employers, whether they are doing it per the requirement because they have more than 10 people and they have been there for more than 2 years and they do not sponsor a plan, or voluntarily.

So if they are a little smaller, or Paula had suggested the idea of exempting the short-term employers, the ones that have not been in business for more than two years, because so many of them go out of business, they are just struggling to survive, we have taken that suggestion.

But let us say that they have only been around for one year, but they are ready to do this. They say, it does not cost me anything. I am happy to send people's paycheck to their account, so I will send something to their IRA. If they want to contribute their own money to an IRA as well, they would get a tax credit for the voluntary——

Senator SMITH. So the individual and the company.

Mr. IWRY. The company would get a tax credit. The individual, under current law, if their income is below $50,000, they would get a Saver's Credit.

Senator SMITH. So the amount of the credit is the Saver's Credit.

Mr. IWRY. For the individual, it is the Saver's Credit. For the company, we would have a special employer tax credit that would be similar to, but smaller than, the tax credit that a small business now gets for setting up a new plan.

So we would make sure, if you set up a plan, you would get twice the reward, compared to setting up a payroll deduction IRA. But setting up a payroll deduction IRA is a lot better than what we have today with a majority of our small businesses.

Senator SMITH. That is great stuff.

[The prepared statement of Mr. Iwry appears in the appendix.]

Senator SMITH. Senator Bingaman? The vote has just started, but there is plenty of time.

Senator BINGAMAN. Well, let me just ask a question or two. One of the criticisms of the IRA is that it is too easy to take money out of IRAs. If our whole idea is that we want people to get to age 65, or whatever age they retire, with a nest egg of money that they can use in retirement, should we also be trying to fix that problem?

Mr. IWRY. Senator, I think that that is a judgment call. We would resolve it in the negative, for the following reason. Although—and David John may have a different sort of rationale for this, but we are coming up with the same answer—I think the IRA is pretty leaky, as you are suggesting, it seems to be, as a practical matter, fairly sticky, that you can take the money out any time with a 10-percent penalty, in most cases, but people do not seem to do it all that often. Once it is in there, again, it is inertia.

People tend to leave it there and think of it as their retirement funds. So, it seems like the fact that it is leakier than one might ideally want it to be may not be as big a practical problem as one might expect.

If we were writing on a clean slate, I think there would be a lot to be said for locking up the money more tightly. But we are trying to be as practical as possible. We have gone 32 years since ERISA was enacted with this same small business coverage problem, with the same half of the workforce that is not able to have an employer plan.

We would love to see you and your colleagues finally make a major dent in that. So, we would advise that you take the IRA as it is, not try to design a whole new individual account, much as I think all of us would enjoy that process of creating the ideal individual account.

We would take the IRA as something that is in existence, practical, and that would enable you, if you persuaded your colleagues, to enact something in 2007 and get something going in our lifetime.

Senator BINGAMAN. Let me ask, also on this default national platform which you talk about, would it not make sense to go the next step and say anybody who has an IRA, whether they get it through this device, if this is enacted, or they set it up themselves, ought to be able to do it through this default national platform so that they then could, wherever they go to work, if the employer is

doing a payroll deduction, fine, they can ask the employer to do a payroll deduction into that?

If the employer is not doing a payroll deduction, they themselves can send money to this default national platform, but they would know that no matter what job they had, they would continue to see money contributed, either they themselves would do it or their employer would do it through a payroll deduction each year.

Mr. JOHN. It would make sense to do that, to a large extent. The one thing that you do not want to do, necessarily, is to compete too directly with the private financial services market.

So ideally, if it could be set up where an individual has the choice, that they could put it in the national default, or perhaps once they reach a certain size, if they choose, if they want to have it managed by somebody else, they could make that decision also. So, essentially it could move from provider to provider.

Senator BINGAMAN. Well, they have the choice of doing it through the private providers now. The only question is, if you set up a default national platform similar to a TSP, would you limit participation in that to the people who had their IRA contributions deducted from their payroll pursuant to this automatic one?

Mr. IWRY. We would not limit participation in that way. We would very much be building on your legislation, Senator Bingaman, from several years ago. Self-employed individuals, independent contractors, even unemployed people, to the extent they are able to save anything, would be hooked up to the national platform to the fullest extent that we could arrange.

We would encourage the same automatic mechanism that makes the payroll deduction/payroll deposit work so well and the automatic 401(k) work so well. We would encourage that in IRAs through automatic debit.

So if a person has no connection to a payroll, they could do what many of us are increasingly doing to pay our bills, that is, have the recipient of the funds automatically debit our financial account, take the agreed upon payments out on a regular basis so that it continues without our having to take the initiative every month to make that payment. People can do that to save, as well as to pay their bills, of course.

What we would do is to encourage voluntary associations, trade groups, professional associations and so forth to get their members hooked up to an automatic debit arrangement, if the members want. It is on a purely voluntary basis all around, but to make it easy for people to have an IRA.

David uses the example of the American Nurses Association, because his wife is a nurse. They could have an IRA, a single IRA, a sort of prototype for all their members, and automatic debit available for all their members who want to use those, and that would be part of the national default platform, unless the association wanted to use a private financial institution that they were working with.

Senator BINGAMAN. Thank you very much. I think it is a very useful suggestion. Thank you all. I appreciate the testimony.

Senator SMITH. Do any of our other witnesses have any comment, as it affects the worlds you are in, on what these gentlemen have presented in terms of this deduction?

Ms. CALIMAFDE. I have one comment, which is, I think it is important to understand, when Mark says this is sort of your last best plan or least best plan, this is sort of the safety net, is what he is describing. So it is important that the incentives in the tax code stay so that the 401(k) plan is your first-choice plan, because that does lock down the money.

Second is your SIMPLE, because there the employer is making a match or making a contribution, but it is not as good as your 401(k) because it is not a trustee plan, you do not have investment choices selected for you, and you can make higher contributions to the 401(k) than the SIMPLE.

This would be, the way I look at it, a safety net plan. As long as it is understood that you do not ever want an employee to go, oh, boy, I have my automatic payroll, versus, oh, boy, I have my automatic enrollment in the 401(k) plan. That is where you want them to be.

Mr. IWRY. We see it as a stepping stone, exactly, as Paula says, a stepping stone that would help people like Dan and Steve and their colleagues sell more real plans to employers, get their foot in the door, get the employer used to the idea that it is helping employees and get appropriate appreciation from the employees for the saving that it is encouraging, and getting the employer to step up to a plan after an appropriate time, and maybe from the get-go.

Senator SMITH. But it really is a new strand in the savings safety net.

Mr. IWRY. Yes.

Senator SMITH. And it is fully convertible to their products later. Exactly.

Mr. JOHN. This is the training wheels.

Senator SMITH. Well, it is a great idea. I suggest we make it law, soon.

Senator BINGAMAN. Good idea.

Senator SMITH. I will work with Senator Bingaman.

Senator BINGAMAN. Good.

Senator SMITH. I apologize, but there is a vote. The clock is running out on it. But this has been a most instructive and interesting hour, hour and a half you have spent with us. We thank you for it, and we will do something with it.

Ms. CALIMAFDE. Thank you very much.

Senator SMITH. We are adjourned.

[Whereupon, at 3:42 p.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

SMALL BUSINESS PENSION PLANS:
HOW CAN WE INCREASE WORKER COVERAGE?

TESTIMONY OF STEVEN P. BJERKE
INVESTMENT REPRESENTATIVE
EDWARD JONES INVESTMENTS

SUBCOMMITTEE ON LONG-TERM GROWTH AND DEBT REDUCTION OF
THE COMMITTEE ON FINANCE
UNITED STATES SENATE

JUNE 29, 2006

Mr. Chairman and members of the Subcommittee, thank you for holding this hearing on expanding retirement coverage for small businesses, and for the opportunity to testify on behalf of Edward Jones Investments. Edward Jones is one of the largest investment firms in the country and a leader in the financial services industry. We have over 8,500 offices throughout the country, more than any other investment firm in America.

We applaud the commitment you have made to promote legislation that will help ensure that Americans have adequate retirement savings. You have been a champion in this area, and we are pleased the pension bills currently in conference contain critical provisions from the Smith-Conrad bill (S. 1359). We make particular note of the inclusion of your automatic enrollment proposals. We believe these measures will in part provide more coverage and boost savings for many workers – particularly low and moderate income workers. We also have been following your most recent legislative initiative which focuses on narrowing the retirement income gap between men and women. We understand you are developing legislation and we certainly want to offer our assistance in any way that would be helpful.

Mr. Chairman, this is an important hearing. Edward Jones strongly supports Congressional proposals designed to help employees of small businesses, where the retirement coverage need is the greatest. We serve over 6 million clients, of whom approximately twenty percent are small business owners. Our small business clients often are very small -- many with under 10 employees, and it is our experience that small business owners can be reluctant to adopt a retirement plan. The statistics are not encouraging, and we at Edward Jones share the concern about the alarmingly low number of small businesses that provide a retirement plan for their employees.

There have been many surveys and much discussion about why small businesses don't have plans. I don't need a survey, I can tell you first hand. When I visit with small business owners, they tell me setting up a plan is too complicated and too expensive. Fortunately, there is an opportunity to address some of these issues in the conference committee now meeting to work out the differences in the pension bills passed by the House and Senate.

While the conference committee has concentrated much of its attention on working out the funding issues associated with defined benefit plans, there are some key provisions at stake that are critically important to the retirement security of employees of small businesses. We strongly support passage of a pension bill that includes those provisions. In particular, we support:

Permanence of the 2001 Tax Act.

The 2001 Tax Act contained a very comprehensive retirement savings title that made many improvements to the retirement plan rules. In that title, attention was focused on the issue of how to encourage small businesses to enter and remain in the employer retirement system.

- Most importantly, the Act increased and updated the limits on retirement plan contributions. These increases make it possible for Americans to save more in a qualified plan, which in turn makes it attractive for small business owners to create a plan.
- The 2001 Act permitted individuals who have attained age 50 to make additional "catch-up" contributions as they near retirement.
- The 2001 Act also established the "saver's credit", which provides a much-needed savings incentive for low and middle-income individuals.
- The 2001 Act eliminated IRS user fees for small businesses that adopt or amend a retirement plan with respect to the first five years the plan is in existence.
- The 2001 Act eliminated a complicated procedure that required businesses to set up two plans if they wanted to provide enhanced contributions for their employees.
- The 2001 Act recognized that start-up expenses often prevent employers from establishing a plan. The Act provided a tax credit to certain small businesses for start-up costs.

Mr. Chairman, these pro-small business savings provisions will expire after 2010. The House pension bill would make these provisions permanent. We support making these provisions permanent as soon as possible. If we wait, the uncertainty regarding the possible expiration of certain provisions will make small business owners hesitant to set up a plan for fear that the rules will change. Sometimes we have one opportunity to establish a plan for a small business; if we lose that opportunity because of uncertainty regarding the rules, that business may never have a plan.

Permanence of the 2001 Act's retirement provisions is our highest priority among the retirement plan issues pending in the pension conference.

SIMPLE Plan Reform.

The pending pension bills also make beneficial modifications to SIMPLE plans. SIMPLE plans have low administrative costs and are proving to be an excellent retirement savings arrangement for small businesses that would otherwise not have a plan. The SIMPLE plan has been a success story. The Investment Company Institute recently surveyed its members to track developments in the SIMPLE IRA market. Survey respondents indicated that between June 30, 2005 and December 31, 2005, the number of SIMPLE IRA plans increased 4 percent, the number of participants rose 5 percent, and the SIMPLE assets invested in mutual funds were up 15 percent.

The Senate pension bill would make the SIMPLE plan even more attractive to small businesses. It allows portability to and from SIMPLE plans, and the bill reduces an excessive penalty on certain SIMPLE plan withdrawals so that it conforms to the generally applicable penalty on early withdrawals.

Reducing Red-tape for Small Businesses.

The Senate bill would remove a significant obstacle preventing many small businesses from maintaining a retirement plan. Under current law, retirement plans generally must file a Form 5500 with the government every year. This multi-page reporting obligation can be very burdensome for a small business. The Senate bill would exempt the very smallest businesses from this burden and would direct the Labor Department and IRS to simplify the Form 5500 for other small businesses.

Investment Advice.

Both the House and Senate bills recognize that retirement plan participants need access to investment advice in order to achieve their retirement goals. We support inclusion of the investment advice provisions from both bills; the House bill in particular will be very helpful in stimulating the delivery of much needed advice. Without effective access to that advice, we fear that many Americans will retire with insufficient savings. Edward Jones fully supports carefully designed safeguards that ensure that participants can make informed decisions.

Mr. Chairman, these provisions should be part of the final conference agreement on the pension reform bill.

Next Generation Proposals.

Edward Jones also is reviewing a number of next generation proposals that have been designed to enhance small business pension coverage. We understand as part of your new legislative initiative, Mr. Chairman, you are considering several measures to encourage small businesses to enter and remain in the employer retirement plan system. We understand you are looking at a tax credit for small employers for contributions to new plans, equalization of tax treatment of retirement plan contributions of the self-employed, and a proposal to allow sponsors of SIMPLE plans to make additional employer contributions of up to 10 percent of compensation to the SIMPLE plan. We believe those would be very beneficial.

We also are reviewing legislation introduced by Senator Max Baucus (S. 2431) which contains a number of important provisions that would help increase small business coverage.

Mr. Chairman, Edward Jones applauds you for having this hearing. The retirement savings crisis facing America is real, and we applaud your recognition that small businesses have unique challenges in trying to help their workers save more for their retirement. We look forward to working with you and this Subcommittee to ensure that Americans are prepared for retirement.

Thank you. I would be pleased to answer any questions you may have.

STATEMENT OF PAULA A. CALIMAFDE ON BEHALF OF THE SMALL BUSINESS COUNCIL OF AMERICA

BEFORE THE COMMITTEE ON FINANCE OF THE UNITED STATES SENATE SUBCOMMITTEE ON LONG-TERM GROWTH AND DEBT REDUCTION

"SMALL BUSINESS PENSION PLANS: HOW CAN WE INCREASE WORKER COVERAGE?"

June 29, 2006

The Small Business Council of America (SBCA) is a national nonprofit organization which represents the interests of privately-held and family-owned businesses on federal tax, health care and employee benefit matters. The SBCA, through its members, represents well over 20,000 enterprises in retail, manufacturing and service industries, virtually all of which sponsor retirement plans or advise small businesses which sponsor private retirement plans. These enterprises represent or sponsor well over two hundred thousand qualified retirement plans and welfare plans.

Mr. Chairman and Members of the Committee, I am Paula Calimafde, Chair of the Small Business Council of America (SBCA). I am also a practicing attorney who specializes in retirement plan and employee benefits law. As Chair of the SBCA, I am here to present our view as to how worker coverage can be increased in the small business arena. At the outset, we would like to thank Chairman Gordon Smith and Ranking member John Kerry of the Senate Committee on Finance, Subcommittee on Long-Term Growth and Debt Reduction for examining these important issues.

VOLUNTARY QUALIFIED RETIREMENT PLAN SYSTEM – A MAJOR SUCCESS

More than *19 million* American workers are covered by the small business retirement plan system.[1] Most of these small business employees enjoy generous annual retirement plan contributions from their employers, often in the range of three to ten percent of compensation. The small business qualified retirement plan system is successful in delivering meaningful retirement benefits for its employees.

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[1] Patrick J. Purcell, Congressional Research Service (CRS) Report for Congress, Social Security Individual Accounts and Employer-Sponsored Pensions, February 3, 2005, Table 2. Employee Characteristics by Employer Retirement Plan Sponsorship, 2003 at CRS-5. This Table shows that there are approximately 5.4 million employees who work for businesses that sponsor a retirement plan and employ fewer than 10 employees, approximately 4.8 million employees who work for businesses that sponsor a retirement plan and employ between 10 and 24 employees, approximately 9.6 million employees who work for businesses that sponsor a retirement plan and employ between 25 and 99 employees and approximately 12.6 million employees who work for businesses that sponsor a retirement plan and employ between 100 and 499 employees. Small business retirement plans are sometimes considered as those with fewer than 500 participants while others use a cut off number of 250 or 100. Obviously, if the cut off number is higher than 100 participants, then the small business retirement plan system covers more than 19 million employees. The actual participation rates in these plans is somewhat lower since not all employees are eligible to participate. Many plans require employees to work a year before becoming eligible and many require employees to work at least 1000 hours a year to be eligible to receive contributions. These numbers are different from those presented in an earlier CRS report. See Patrick J. Purcell, Congressional Research Service (CRS) Report for Congress, Pension Sponsorship and Participation: Summary of Recent Trends, September 10, 2004, Table 4. Participation in Retirement Plans by Size of Firm at CRS-10. This Table shows that there are approximately 5.8 million employees who work for businesses that sponsor a retirement plan and employ fewer than 25 employees and approximately 6.1 million employees who work for businesses that sponsor a retirement plan and employ between 25 and 99 employees. There are approximately 31.5 million employees in companies that sponsor a retirement plan and employ more than 100 workers.

This was not always the case. Due to a constant onslaught of legislation and regulation throughout the '80s which cut benefits for owners while simultaneously imposing additional costs and burdens to the company, the small business retirement plan system was stagnant at best. Terminations were up and new plan formation was down. By the beginning of the '90s, it became evident to Congress that if retirement plan coverage was to be increased, it was imperative to return stability and clarity to the voluntary qualified retirement plan system. Costs for administration had to once again become reasonable. Once again companies would have to be able to rely on the assurances of their advisors so that they could take actions knowing what the results would be. Due to a series of laws passed throughout the '90s and continuing through the major tax bill in 2001 which included significant reforms for small business, Congress was able to put the system back into balance and small business formation has been increasing significantly. It is not an exaggeration to say that Congressional action in the retirement plan area over the last 15 years has saved the small business retirement system which in turn has provided retirement security for millions of small business employees.

IMPORTANCE OF TAX INCENTIVES IN THE SMALL BUSINESS RETIREMENT PLAN SYSTEM

The sine qua non of small businesses is private ownership with any year end surplus revenues (i.e., profits) flowing to the owners of the business. Each year, the owners can choose to reduce the profits by paying themselves additional taxable compensation and/or they can retain the profits inside the company and "grow" the business and/or they can contribute all or a portion of the profits to a retirement plan sponsored by the business. It is typical for the owners to weigh the tax consequences of these various options when deciding what to do with any excess revenues.

The viability of the small business retirement system is almost uniquely dependent upon the availability of sufficient tax incentives to the owners in order to offset the administrative costs of sponsoring a plan, the mandatory contributions for the non-owner employees required under the top-heavy and anti-discrimination rules set forth in the Internal Revenue Code and the fiduciary responsibility that comes with the plan. Thus, unless the owners come out ahead by making contributions to the retirement plan (taking into account the initial deduction for contributions made to the plan, the tax free growth, the eventual distributions being subject to regular income tax rates, the costs of running the plan and the costs of making the contributions necessary for staff employees) as compared to distributing the profit to the owners as taxable income and investing the net after tax compensation as they choose (with eventual favorable capital gains and/or dividend rates), small business owners will forgo the retirement plan option.

SMALL BUSINESS PLANS ALSO ALLOW EMPLOYEES TO SAVE VIA PAYROLL DEDUCTION

Not only do many small business retirement plans have a generous employer contribution (generally a profit sharing contribution) and/or an employer matching contribution, but they also often provide an attractive way for all employees to save for their retirement. 401(k) plans and SIMPLEs are so effective because employees are able to save for their retirement by having

automatic deductions taken from their paychecks which reduces the amount of their taxable income. The money saved by the employees inside the plan grows tax free and the 401(k) plan prevents easy access to the money by the employees so that the funds are able to grow and accumulate for retirement (not true for the SIMPLE see below). Intuitively, one anticipates that if an employee can reduce his or her paycheck by the amount of desired savings prior to receiving the cash in hand, the odds are the money will, in fact, be saved rather than spent. The SBCA has heard countless small business employees state how much easier it is to save by payroll deduction than by any other method.

Employer sponsored retirement plans are the most effective method for encouraging savings by low to moderate income workers. According to data collected by the Employee Benefits Research Institute (EBRI), 77.9 percent of workers earning between $30,000 to $50,000 who were covered by an employer sponsored 401(k) type plan actually participated in the plan, while only 7.1 percent of "non-covered" workers in the same income level, saved in an individual retirement account. In other words, low to moderate income workers are almost 11 times more likely to save when covered by a workplace retirement plan.[2] Reasons for this striking disparity include the convenience of payroll deductions since it is much easier to save money that one has never had in hand, the convenience of having investments preselected, the culture of savings fostered in the workplace and the incentive of the matching contributions provided by the employer. Unlike the success of the 401(k) plan and other employer-sponsored retirement plans, the rate of personal savings in this country outside of the retirement plan area (and outside IRAs) is quite low – less than two percent.

IMPORTANCE OF AUTOMATIC ENROLLMENT – LET'S NOT MISS THE OPPORTUNITY

In a number of studies, behavioral economists have found that the easier it is for an employee to save, the more likely it is for that employee to do so. While this seems to be axiomatic, it is surprising the extent to which employees do whatever is easiest. For instance, an analysis conducted in 2000 found that workers, particularly low income workers, were far more likely to participate in a 401(k) plan if they were automatically enrolled than when they had to sign up for the plan. The numbers are rather startling: when enrollment was not automatic, 37.4% of all workers overall would sign up for the 401(k) plan, but when enrollment was automatic, the number jumped up to 85.9%. This trend was even more pronounced in workers making less than $20,000 a year. Without automatic enrollment, 12.5% opted to join the plan, with automatic enrollment, 79.5% chose to participate in the plan.[3] This makes it clear that the way to encourage and increase savings, particularly for the low and mid-income worker, is to have an employer-sponsored plan, preferably with automatic enrollment and a preselected

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[2] ASPPA, based on the EBRI data, developed a chart setting this statistic out in graph format which demonstrates far more ably than words how effective the employer-sponsored retirement plan is at promoting savings for all workers.

[3] Washington Post, April 18, 2005, Private Accounts Make for Hard Sell at A8.

investment feature.[4] Interestingly, when these factors are present, employees are willing to save in these plans which effectively "lock up" the funds for long term growth since they are designed to have contributions accumulate and grow tax free until retirement. [As an aside, it is important to note that the funding problems seen in some of the very large defined benefit plans are highly unusual in the small business retirement plan system – this is likely due to the fact that the owners' retirement savings are also inside the plan so that the funding is adequate and the assets are carefully invested. Thus, not only are the plans highly effective as savings vehicles for the employees and for providing significant employer contributions for the employees, they are also by and large properly funded with the assets prudently invested.]

WORKABLE AUTOMATIC ENROLLMENT 401(K) SAFE HARBOR NEEDED

In the House version of the Pension Bill currently in conference, there is an automatic enrollment 401(k) safe harbor provision which, with one major change, could work in the small business retirement plan context. It offers an incentive to the small business to take on the extra administration inherent in automatic enrollment by reducing slightly the costs of the current 401(k) safe harbors – not by much, but in the SBCA's opinion, enough so that a small business would be willing to consider adopting it. Unfortunately, the proposed safe harbor is totally destroyed by a requirement that the safe harbor will only be operative if 70% of the employees who were automatically enrolled actually stay enrolled. This type of provision is what we refer to as an "ivory tower" provision – it sounds good but simply will not work in actual practice. Why? Because small business owners will simply not spend the money to amend the retirement plan and the summary plan description, provide written communication material explaining the new procedure, add an extra burden to their internal payroll system and add to the external administrative costs of running the plan if they are not assured that it will work. Because small business owners cannot force their employees to stay enrolled, they will not take on all of this extra expense when not assured of the outcome particularly because it is totally out of their control. The House version of the automatic enrollment 401(k) safe harbor should be adopted in the final compromise but without this provision which renders the entire safe harbor meaningless. If there is no incentive for the small business to adopt the automatic enrollment they will stay away from it because of the considerable additional administrative burden and expense imposed.

HOW MUCH IS COVERAGE LAGGING IN THE SMALL BUSINESS WORLD?

Many small businesses would like to provide retirement plans for their employees and believe that retirement plans aid in attracting and retaining top employees. As we know, however, the retirement plan coverage rate for small businesses lags behind the retirement plan coverage rate of their larger counterparts.

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[4] Id., This article also states that in the same analysis conducted in 2000 that overall 71.2% of all workers kept the default investment option offered by the plan and that 24.8% switched to their own choice. Among workers who made below $20,000 a year, 89.3% stayed with the default investment option and 8.5% chose to select their own choice.

The actual retirement plan coverage picture may not be as bleak as reported, since qualified retirement plans are not required to cover part-time employees, employees under age 21 or transient employees. The statistics cited for the low retirement plan coverage, however, most often include the entire workforce and do not differentiate between the entire workforce and that percentage of the workforce that is actually eligible to participate in a retirement plan. When these ineligible employees are excluded, the coverage numbers improve. Further, these numbers do not distinguish between start up small businesses and those that are established. Data shows that *one third* of all new small businesses fail within the first two years and *fewer than half* survive more than the first four years.[5] This is a significant number of businesses which in all likelihood do not offer any retirement plan coverage (because they are struggling merely to exist) and yet are included in the statistics on low small business plan coverage. Once again, this high death rate of small businesses is a factor that could skew the data dramatically.

Interestingly, unlike coverage, participation in a retirement plan is fairly constant regardless of the size of the employer. In 1997, 88.2% of employees who worked for companies that employed 100 or more employees and sponsored a pension or retirement savings plan actually participated in the plan. 85.5% of employees in companies with 25 to 99 employees which sponsored such a plan participated and 84.8% of employees in firms with fewer than 25 employees participated. [6] These data illustrate that when a small business sponsors a retirement plan, the employees participate at close to the same levels as in larger companies. Thus, once a small business has chosen to sponsor a retirement plan, meaningful participation results. To achieve greater coverage, therefore, the system must be made attractive to small business.

TAX CODE REQUIRES MEANINGFUL BENEFITS FOR ALL SMALL BUSINESS EMPLOYEES

As mentioned above, once a small business sponsors a qualified retirement plan, employees frequently receive excellent benefits. In fact, employer contribution levels in small business plans are often higher than those offered by larger entities. For instance, small business plans typically provide contributions for staff employees at levels of three, five, six, seven or even higher percentages of compensation. These high levels of contributions are driven by the desire of the business owners and key employees to receive sufficient contributions for their own retirement benefits. Present laws require that significant contributions be given to the non-key employees in order for the key employees to benefit to any meaningful degree.[7] These significant

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[5] The Kiplinger Letter, January 20, 2006, Volume 83, No. 3

[6] Patrick J. Purcell, Congressional Research Service (CRS) Report for Congress, Social Security Individual Accounts and Employer-Sponsored Pensions, February 3, 2005, Table 3, Panel B, entitled "Percentage of Employees in Firms that Sponsored a Plan who Participated in the Plan" at 13.

[7] The terms "key" and "non-key" as used here are not referring to the definition set forth in the top-heavy rules in I.R.C. § 416(i). Rather we are referring to "key" employees as those employees that the owners of a small business would deem key to running the business and "non-key" employees as those not essential to the operation of the business. As in all other businesses, the small business owners want to provide sufficient benefits and incentives to keep the key employees satisfied with their current employment so they will not move elsewhere. This problem is particularly acute in that small businesses

contributions for the staff employees result from the anti-discrimination rules under I.R.C. § 401 and not the top-heavy rules found under I.R.C. § 416. The top-heavy rules today are largely duplicative of the existing non-discrimination rules governing the qualified retirement plan system.

SINGLE MOST ACTION NEEDED NOW – MAKE EGTRRA PENSION PROVISIONS PERMANENT

The 2001 Economic Growth and Tax Relief Reconciliation Act (referred to as EGTRRA) made many significant improvements to the small business retirement plan system. Among many other important changes, it increased and updated the limits on retirement plan contributions to levels which make sense for today's critical need to save for retirement. It allowed individuals who have attained age 50 to make additional "catch-up" contributions as they near retirement. It established the "saver's credit," which provides a savings incentive for low and middle-income individuals. It eliminated IRS user fees for small businesses that adopt or amend a retirement plan with respect to the first five years the plan is in existence. By increasing the deduction limit available to profit sharing plans, as well as not including employees' 401(k) contributions in the deduction limit, it allowed small businesses to set up one plan instead of two in order to provide desired contributions for their employees.

All of these changes have worked together to increase small business retirement plan coverage. This is not surprising inasmuch as they were the culmination of work done by Congress over a number of years in which the ideas and opinions of virtually all affected – employers, large, small, governmental, and non-profit, unions and employee groups – were requested and taken into account in putting the law together. This is why the EGTRRA pension provisions met with approval by almost all groups affected. [As an aside, this process did not take place with many of the provisions in the Pension Bill currently in conference. For instance, one of the provisions in this bill is to use a yield curve for defined benefit plans rather than to designate a single interest rate. Aside from some ivory tower thinkers who are intent on showing that perfection can be the enemy of the good, almost every ERISA pension practitioner, whether lawyer, actuary, plan administrator, in-house pension expert or accountant, believes that this will unnecessarily complicate an already complicated system for virtually no gain to anyone in the system, including and most importantly the plan participants. If the advice of the experts had been obtained first, we would have a single interest rate rather than this complicated structure which achieves little if anything and which cannot be justified in terms of increased burdens and costs.]

Unfortunately, all of these important EGTRRA pension provisions which have strengthened the small business retirement plan system expire after 2010. The House version of the Pension Bill in conference would make these provisions permanent. *We believe it is critical to make the EGTRRA pension provisions permanent now.*

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often serve as the training ground for employees who move on to jobs with larger business entities where they perceive there is greater job security and better benefits.

We know that uncertainty in the retirement plan area is one of the leading reasons for plan terminations and lower new plan formation. Small business owners are not willing to expend their own hard earned dollars in the employee benefits area when they are not assured of the outcome. The nightmare situation would be to have these important provisions subject to a continuous state of short term extensions, perhaps even effective retroactively to cover a lapsed period. Without certainty in the system, small business owners would be unlikely to establish retirement plans when it is perceived that the pension rules cannot be relied upon from year to year. *We believe that this is perhaps the single most important issue with respect to small business coverage today.*

POLICY CHALLENGE – EASE OF ADMINISTRATION VERSUS RETENTION OF RETIREMENT PLAN MONEY

Small business has made it clear to Congress time and time again that it cannot easily accommodate additional administrative burdens. Unfortunately, qualified retirement plans impose additional burdens by way of required forms and governmental regulations. To deal with this problem, Congress has, over the last several years, developed an IRA based "retirement" plan known as the SIMPLE. Unfortunately, the very structure which makes the SIMPLE desirable from the viewpoint of the small business owners also makes it a "lesser" plan from the viewpoint of ensuring retirement income security for retired small business employees.

Congress understands the tension between the simplicity of the SEP or SIMPLE (both of which are IRA based plans) and the advantages afforded by a qualified retirement plan (a trust based plan). Small businesses operate lean and mean. They do not accept additional administrative burdens easily. The IRA based plans are almost maintenance-free. The small business simply goes to a bank or a brokerage house and sets up separate IRAs for each eligible employee. The company makes the correct contribution into each separate IRA and then walks away from the accounts. Unfortunately, this low administrative burden comes at a price.

The forced savings feature of a "regular" qualified retirement plan, such as the 401(k) plan, should not be underestimated and must be safeguarded. When a person participates in a 401(k) plan, he or she cannot remove the money on a whim. Retirement plan money can be removed by written plan loan which cannot exceed the lesser of 50% of the account balance or $50,000. Retirement plan money can also be removed by a hardship distribution, but this is a tough standard to meet. The distribution must be used to assist with a statutorily defined hardship such as keeping a house or dealing with a medical emergency.

This is in contrast to funds inside an IRA, a SIMPLE or a SEP (both of which are employer sponsored IRA programs) where the funds can be accessed at any time for any reason. True, funds removed will be subject to a 10% penalty if the employee has not reached age 59½ (which is also the case for a hardship distribution from a 401(k) plan), but unfortunately it does not appear that the 10% penalty represents a significant barrier. This is why the SIMPLE IRA starts off with a 25% penalty for the first two years an individual participates in hopes that if a participant can accumulate a little bit he or she will be tempted to leave it alone and watch it

grow. There is a distinct difference between complying with the statutory requirements for a loan or hardship distribution, including the need expressly to ask the employer for the loan or distribution, and having the power, independent of others, to remove money at whim from one's own IRA.

Thus, from a national policy viewpoint of preserving retirement assets for retirement, the SIMPLE plan should only be viewed as a starter plan. It is important, therefore, that all businesses, including the very small, be given incentives to enter the qualified retirement plan system as quickly as possible. The SIMPLE is an IRA program, as is the old SEP plan, and in the long run true retirement security for employees is better served by strengthening qualified retirement plans system rather than SIMPLEs and SEPs. This is simply because as mentioned above, employees have a far greater opportunity to remove the money from IRAs and SEPs and spend it – the forced savings feature of a qualified retirement plan is not present. It is also because the employees have no investment guidance or preselection of investment vehicles that have been determined to be prudent. Certainly, for start-up companies or micro businesses, a SIMPLE is the best first step into the retirement plan system. Thus, we believe that the "gap" between the 401(k) limit and the SIMPLE limit should be carefully preserved so that the system does not tilt in the wrong direction.

We are aware that many small business groups are asking Congress to change the law so that the IRA based plans mirror the higher contribution limits available in the 401(k) plan arena. We understand that they are hearing the complaints of small business owners who want to make everything as easy as possible. However, we believe that Congress has gotten this right and that if the SIMPLE is made stronger (by increasing the retirement plan contributions allowed to the IRA) that it will be detrimental to new small business 401(k) plan formation. This would be harmful to small business employees because they will lose the ERISA protections inherent in the 401(k) plan, the preselection of investment vehicles and most of all, they will gain the ability to have easy access to the money.

Over the years the data has consistently shown two things – give the money to an employee and they won't save it – give the money to an employee with easy access and they'll get to it and spend it. Because the goal is to encourage long-term retirement savings, Congress needs to ensure that the 401(k) continues to be the more attractive plan to employers. Thus, it is critical that Congress maintains the existing proportionate differential between contributions allowed to the SIMPLE and those allowed to a 401(k) plan. *The SBCA is opposed to changes in the law which would make the SIMPLE more attractive to a small business as compared to a 401(k).*

Under current law, a company is not allowed to make contributions to a SIMPLE IRA and contribute to any qualified retirement plan in the same calendar year. This provision is unduly restrictive and hampers the ability of small business to switch from a SIMPLE IRA to a trust-based qualified retirement plan such as a safe-harbor 401(k) plan. Taken literally, this provision would invalidate the SIMPLE IRA for the entire calendar year if the employer, at any time during that calendar year, maintained a qualified retirement plan to which contributions

were made (by the employee or employer) or benefits accrued for service in the same calendar year. There does not appear to be a good reason why a SIMPLE plan should be invalidated for the entire year if a small business chooses to switch to a qualified retirement plan (which is therefore a stronger plan for the employee) during the year, as long as the same compensation is not taken into account under both plans.

For example, assume that an employer offers a SIMPLE for calendar year 2006 and notifies employees that it will make 100% matching contributions up to 3% of compensation. Assume that the employer decides to terminate the SIMPLE as of June 30, 2006, and institute a safe harbor 401(k) plan as of July 1, 2006. The employee will receive at least the same contribution by the employer (if not more) than under the SIMPLE. Moreover, under the 401(k) safe harbor plan, the employee generally has the opportunity to defer more compensation and receive more contributions than under the SIMPLE. Thus, the employee is not harmed and may well be significantly benefitted. *This rule needs to be eliminated.*

IRA PAYROLL DEDUCTION

The goal, of course, is to encourage more small businesses to offer retirement plans. A very small company that cannot absorb additional administrative burdens should be encouraged to join the system via the SIMPLE. But the laws should encourage the company to join the "real" qualified retirement system, probably through the 401(k) safe harbor plan, as soon as possible. In other words, even though a small business will probably begin with the SIMPLE as a start up plan, it should be encouraged, primarily by larger contribution limits, to "graduate" to the 401(k) plan as soon as possible. But what about the company that is too small or too unstable to even sponsor a SIMPLE? The SBCA believes that it is possible for an IRA payroll deduction system to be constructed that would not trigger any employer fiduciary liability which might prove helpful in allowing the employees to save by payroll deduction. Of course, the details of such a proposal would be critical so that such a rule should not apply to new start ups or to micro businesses.

THE 401(K) PLAN – MAJOR SUCCESS STORY

The 401(k) plan is a tremendous success story. The excitement generated by this plan in the small business arena is amazing. Prospective employees ask potential employers if they have a 401(k) plan and if so, what the investment options are and how much the employer contributes. Employees meet with investment advisors to be guided as to which investments to select and have toll-free numbers to call to see how their investments are doing and to determine whether they want to change them. Employees discuss among themselves which investment vehicles they like and how much they are putting into the plan and how large their account balances have grown. There is no question that this is the most well-known and well-liked retirement plan design today.

401(K) SAFE HARBORS

Safe harbor provisions were added by Congress to the 401(k) plan specifically to make the plan more attractive to small business.[8] Prior to 1999, all 401(k) plans were subject to complicated discrimination plans which tied contributions that highly compensated employees could make to the contributions made by non-highly compensated employees. These tests are expensive to administer. Additionally, if non-highly compensated employees did not optimize their participation, then highly compensated employees could not contribute as much as they wished.

It is now possible for 401(k) plans to eliminate the discrimination tests and allow every employee (including highly compensated employees) to contribute up to the maximum. Under current law, a 401(k) plan will be treated as meeting the discrimination tests if the employer: (i) makes a contribution for every eligible non-highly compensation employee equal to at least three percent of that employee's compensation (referred to as the 3% non-elective contribution); or (ii) makes a required matching contribution set forth in the tax code. These contributions must be 100% vested and made to every employee even if he/she does not meet the 1,000 hour requirement or is not employed on the last day of the plan year. In addition the employer must provide written notice to employees apprising the employees of their rights and obligations under the plan. This notice must be comprehensive and be written in "plain" English.

There appears to be no rationale for such advanced notice in the context of the non-elective three percent contribution – no employee is going to change any behavior with respect to making 401 (k) contributions merely because a contribution will be made for them at the end of the year.[9] If anything, it could depress employee contributions since the employee might be satisfied with the employer's contributions alone. The notice requirement, however, may have an inadvertent chilling effect on a company's ability to use the safe harbor. Unless an outside advisor informs a small business that it must give a fairly extensive written notice to employees about the safe harbor by a certain date and the company complies with the notice requirement, the company may not be able to take advantage of the safe harbor for an entire year.[10] Treasury and IRS have worked around this requirement as much as possible.[11] However, the notice requirement is a statutory requirement. Thus, Treasury and IRS are not capable of removing it. The notice requirement serves no purpose with respect to the 3% non-elective safe harbor. It is at best a nuisance and at worst a trap for the unwary. *The SBCA suggests that the notice*

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8 I.R.C. § 401(k)(12) as amended by Small Business Job Protection Act of 1996.

9 The rationale for advance notice in the context of the match safe harbor is self evident. An employee may very well change his or her behavior and contribute more knowing that a match is going to be made.

10 I.R.S. Notice 98-52, 1998-46 I.R.B. 16 at V.C.

11 I.R.S. Notice 2000-3, 2000-4 I.R.B. 413, at Q&A #1.

requirement for the 3% non-elective safe harbor requirement be eliminated. It serves no purpose.

TOP-HEAVY ISSUES IN THE 401(K) CONTEXT

The top-heavy rules discourage small businesses from allowing employees to become immediately eligible to participate in a top-heavy 401(k) plan in which the company is making plan contributions. In the normal retirement plan world (that is outside the top-heavy rules[12]), merely allowing a new employee to become eligible to participate in the 401(k) portion of a plan immediately upon employment would not, by itself, trigger any additional company contributions. In a top-heavy plan, in contrast, a non-key employee who is merely eligible to participate in the 401(k) portion of the plan must receive the 3% top-heavy minimum contribution even if he or she is not eligible to receive any other employer contribution (i.e, a profit sharing contribution or a match contribution).[13] For example, if a small business sponsored a top-heavy profit sharing/401(k) combination plan which had a one year wait for eligibility for the profit sharing portion and immediate eligibility for the 401(k) portion, most practitioners believe that every non-key employee would be entitled to receive the 3% top-heavy contribution regardless of whether the employee chose to make 401(k) contributions. Unfortunately, as is the case with many of the obscure top-heavy rules, there are many advisors who are not even aware of this issue. Because of this requirement, knowledgeable small business retirement plan advisors tell their clients to have a one year wait for both the 401(k) portion and profit sharing and/or match portion of the plan. This hurts the first year employees by keeping them out of the 401(k) portion of the plan for the first year, thereby delaying their chance to save in a tax free environment. If they were employed by a larger entity, they likely would not encounter this problem because the top-heavy rules would not apply. *This rule should be changed so that any employee entering the 401(k) portion of the plan before meeting the one year eligibility requirement for the profit sharing portion of the plan is not entitled to the top-heavy contribution (nor to any profit sharing or gateway contribution).*

Perhaps the most unfair rule in the context of top-heavy 401(k) plans was imposed on small business through the regulations on employee pay-all plans.[14] This rule converts 401(k) contributions made by key employees into employer (profit sharing) contributions, thus triggering the top-heavy minimum contributions. In practical effect, the key employees are precluded from making 401(k) contributions to an employee pay-all plan even if these employees would have been allowed to do so under the ADP rules. Because this rule only applies to top-

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[12] The top-heavy rules, because of the make up of most small businesses, basically apply to almost all small business plans and thus, small business plans counter intuitively are actually subject to increased burdens.

[13] Treas. Reg. § 1.416-1, Q & A M-7 and M-10 (as amended in 1992); 29 U.S.C. § 1002(7) (1999) (ERISA § 3(7)).

[14] Treas. Reg. § 1.416-1, Q & A M-20 (as amended in 1992).

heavy plans, it primarily affects small business.[15] This is simply unfair to small business. If a larger entity (that is, one which is essentially exempt from the top-heavy rules) sponsors an employee pay-all plan, all employees (highly compensated, keys or otherwise) can make 401(k) contributions allowed by the ADP tests without triggering any profit sharing contribution. The very same plan, in the small business context, triggers a 3% top-heavy contribution for the non-key employees, if the plan is top-heavy.[16] *The SBCA strongly supports your proposal to change this unfair rule which will act to increase coverage.*

Because of this rule, most small businesses simply do not offer employee pay-all 401(k) plans. This represents a real lost opportunity to encourage small businesses to offer qualified retirement plans. These plans would allow small business employees to defer up to $15,000 (or even higher if they are 50 or older) if allowed under the anti-discrimination tests (ADP tests). Small business owners likely would sponsor employee pay-all 401(k) plans, notwithstanding the administrative burdens and expenses, if they knew they could participate in the plan like other employees.

CASH BALANCE PLANS

Cash balance plans are not inherently "bad" plans. In fact, in the small business world, they are the "Cadillac" plan. Due to legislative changes in the 1980s, small business by and large has no interest in the defined benefit plan. For this reason, small businesses are not confronting the same conversion issues as are large companies. Some small businesses, however, do sponsor cash balance plans. Often, this is the plan of choice as it blends the best of the defined contribution and defined benefit worlds.

The cash balance plan looks like a defined contribution plan built upon a defined benefit chassis. The plan is essentially a defined benefit plan, but unlike a defined benefit plan it provides separate account balances for each plan participant. By providing individual account balances, cash balance plans give employees a "proprietary" interest in the plan. At the same time, the cash balance plan offers many of the safeguards of a defined benefit plan. Of greatest importance, the investment risk is assumed by the employer rather than the employee. *It is essential that Congress makes it clear that cash balance plans are not inherently age discriminatory so that this valuable plan will be sponsored by small businesses. Congress should also make it clear that the benefit of the plan can be measured by the lump sum value of the participant's account and not require that the account be changed to an annuity and then*

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15 The SBCA has never been able to come up with an acceptable rationale for this rule.

16 The top-heavy rules rankle small business owners. The top-heavy rules are one of the primary reasons why small business owners maintain that the qualified retirement plan system discriminates against them and small businesses. As mentioned above, the vast majority of small business plans are top-heavy because of the mechanical mathematical tests utilized to determine top-heavy status which largely depend upon the number of key employees, as defined under I.R.C. § 416, employed by the company compared to the number of non-key employees.

changed back to a lump sum value which can give rise to a lump sum distribution different than the participant's account balance which of course makes no sense to the plan participant.

REQUIRED BEGINNING DATE

Employees, other than 5% owners, may delay distributions from qualified retirement plans until actual retirement if that date is later than the date that otherwise would be the employee's required beginning date. *This rule should be extended to 5% owners.* By and large a 5% owner is a small business owner. If the small business owner is still working, this rule in effect requires the small business owner to remove retirement funds sooner than he or she would need them. There is no apparent policy rationale for this result. First, this approach is financially wasteful since the account owner is forced to withdraw retirement assets prior to retirement. When the business owner actually does retire, he or she will have fewer assets in the plan. Since the withdrawn assets are reduced by income taxes, only the after-tax dollars are available for re-investment and the appreciation on these investments is subject to additional tax as interest, dividends or capital gains are realized. This deleterious impact is compounded by the fact that small businesses seldom provide retirement income streams other than by means of the retirement plan.

SIMPLIFICATION SHOULD BE OPTIONAL

Many changes which are intended to simplify the qualified retirement plan system should be optional. The 401(k) safe harbors are an excellent example of an optional simplification. Although these safe harbors create an alternative to the cumbersome ADP and ACP tests, companies are free not to utilize these alternatives. Indeed, many companies choose not to use the safe harbor because they consider a 3% employer contribution or required match contribution too high a price to pay for the reduced administrative burdens. Many companies expend significant time and money on their retirement plan software and/on employee communications. For these companies the cost of new software and written communication materials for employees may exceed the prospective administrative savings offered by the safe harbor. Thus, what may look like simplification to Congress may end up costing companies countless dollars and time. By making these intended simplifications optional, companies retain the flexibility to decline the "savings" of the perceived "simplification." In this vein, a proposal, such as the ERSA proposal, which provided an easier anti-discrimination testing, should be adopted by Congress, but made *optional.* Some companies will prefer to move to that new model of testing and others will find it easier to leave their plans, SPDs, testing software, etc. intact and forgo a slightly easier test because it actually costs more to move over to another plan design.

NEW USES FOR 401(K) PLANS

The 401(k) plan could be utilized to allow employees to make pretax contributions to a retiree health care account. This would enable employees to afford supplemental health insurance after retirement. The 401(k) feature could be expanded to include a second account into which the employee could make contributions for his or her retiree health care. This could

operate essentially as a HSA. Funds accumulated in the retiree health care account would, as with the 401(k) account, grow tax deferred, and qualified contributions by the employees would be exempt from income tax. Upon the employee's retirement, disability or termination of employment, the employee would be allowed to roll over the retiree health care account to an HSA. Money in the retiree's health care accounts could be used to purchase supplemental health insurance, to defray major medical expenses that are not covered by insurance (possibly even if needed prior to retirement) or perhaps for long term care costs.

The permissible maximum annual contribution to a retiree health care account would, of course, need to be determined by Congress after taking into account projections of the costs that the nation would have to absorb in the next two or three decades if retirees cannot provide for those long term care or medical expenses not covered by the Government. The lost tax revenues resulting from incremental contributions to long term health care and retiree health care accounts (in addition to the § 415 limits which apply to profit sharing and 401(k) contributions) may be smaller than the increased governmental expenditures needed in the next few decades to provide long term care and retiree medical care to retirees who lack adequate savings to provide for this care themselves.

FORM 5500

The Form 5500 is administratively burdensome and might well prove a deterrent to small businesses considering switching from a SIMPLE to a 401(k) safe harbor. With the SIMPLE the annual reporting requirements are imposed primarily on the IRA trustee or custodian, with a 401(k) plan, significant reporting requirements are imposed on the employer. These reporting requirements are so daunting that many small businesses simply may not be able to handle these forms internally. They will need to engage outside benefits advisors, at considerable cost, to ensure compliance. This form should be simplified significantly for small businesses, particularly for plans with fewer than twenty-five employees. The objective would be to devise a form that provides the IRS and Department of Labor with sufficient information to monitor compliance matters but that can be readily completed by the owners or the company's accountant without relying upon a retirement plan expert.

404(C) SAFE HARBORS

To encourage businesses to offer qualified retirement plans, the DOL should provide voluntary ERISA §404(c) safe harbors for businesses. Satisfying the safe harbor would ensure that the business has met the fiduciary standards of § 404(c). Many small businesses are concerned about the fiduciary liability inherent in establishing a trusteed plan such as a 401(k). Section 404(c) was originally established to alleviate trustees' and plan sponsors' fear of liability with respect to plan investment. Unfortunately, because of the way this section has been implemented, many advisors consider it impossible to determine whether a company has met the § 404(c) requirements.

A clear, voluntary safe harbor could eliminate these fiduciary risks. Such a safe harbor could, for instance, require the plan to provide at least eight investment choices, for example, at least one money market fund, one stock index fund, a balanced stock fund, a balanced bond fund and a large cap value fund. The plan would be free to offer different investment options in addition, but at least a minimum variety of selections would be required. The safe harbor could require that all investments be offered by one or more financial institutions which had more than a stated minimum amount of dollars under management. There could be additional objective standards regarding stated loans or commissions. Perhaps a second voluntary safe harbor could be designed to allow the plan to offer a choice of a few different life style funds.

To be effective, any safe harbors would have to set forth clear guidelines and should not rest upon a facts and circumstances standard. This type of standard affords small business no meaningful assistance. Only voluntary safe harbors with clear cut rules can afford small business the necessary comfort regarding liability while still offering employees investment choices.

TAX REVENUE LOSS FROM IMPROVING RETIREMENT PLAN COVERAGE

SBCA suggests that a sea change is needed in how we view our loss of tax revenue due to increased retirement contributions by employees and employers. This revenue is not "lost," it is merely deferred. Further, the short term loss of those tax dollars may do more for the income security for our taxpayers in their retirement than almost any other change in the tax code. For example, reducing the marriage penalty may provide extra dollars to raise living standards for families in the short term. But these families are not likely to use a significant portion of those dollars to save for retirement, medical disasters or long term care. Instead they will rely on Social Security and a company sponsored retirement plan. The relatively few dollars that would be required to make these suggested changes would return far higher dividends to the country's well-being than almost any other tax expenditure.

Because qualified retirement plans are subject to a myriad of technical, micro-focused rules, relatively small changes ("micro" changes) in the qualified retirement plan system can bring about a substantial or "macro" result. A change in a single technical rule can have a dramatic impact.

The qualified private retirement plan system is remarkably successful. By making the EGTRRA pension provisions permanent as well as making improving the system as discussed above, (which are by no means intended to be exhaustive), small businesses will continue to embrace qualified private retirement plans so that small business employees will receive the significant benefits of retirement plan coverage.

Written Statement
for the

Subcommittee on Long-Term Growth
and Debt Reduction

Senate Committee on Finance

Hearing on:
"Small Business Pension Plans: How Can We Increase Worker Coverage?"

Thursday, June 29, 2006

By

Craig Copeland

Senior Research Associate

EBRI

"Participation by Employees of Small Employers
in Employment-Based Retirement Plans"

Mr. Chairman and members of the committee, my name is Craig Copeland of the Employee Benefit Research Institute (EBRI), where I am a Senior Research Associate and Project Director of the Social Security Reform Evaluation Program.

My focus today is the participation in employment-based retirement plans by small employers, and the demographic characteristics of small employers that affect the participation in these plans. I'll also examine the breakdown of retirement plan participants in each type of plan: defined contribution or 401(k)-type plan and defined benefit pension plan.

The definition of a small employer used in this research is one with fewer than 100 employees. The data used to analyze this group's participation in employment-based retirement plans come from the Census Bureau's March 2005 Current Population Survey (CPS). According to these data, 44.7 percent of private-sector wage and salary workers age 21–64 worked for a small employer, 18.2 percent for an employer with fewer than 10 employees, 11.6 percent for an employer with 10–24 employees, and 14.8 percent for one with 25–99 employees (Figure 1).

A gap in retirement plan participation between small and large employers has existed for many years, and in 2004 small-firm workers had a participation level half that of large employers:

- Specifically, 26.7 percent of workers working for employers with fewer than 100 employees participated in an employment-based retirement plan (Figure 2). This breaks down into 16.0 percent at employers with fewer than 10 employees, 27.2 percent at employers with 10 to 24 employees, and 39.6 percent at employers with 25 to 99 employees.
- This compares with 56.2 percent who worked for an employer with 100 or more employees.

The reasons for these differences have been explored in EBRI's Small Employer Retirement Survey, where small employers primarily cited either uncertain profits or lack of employee demand as the key reasons for why they tend to not offer retirement benefits.

This lower level of participation among small-employer workers persists across earnings levels, industries, and work status of the employees:

- For workers at firms with fewer than 10 employees earning less than $15,000 annually, 5 percent were participants, compared with 17 percent in firms with 1,000 or more employees (Figure 3).
- For workers earning $75,000 or more annually, 36 percent participated in the smallest employers compared with to 86 percent in the largest employers.
- For three industries (agriculture, mining, and construction; manufacturing; and wholesale and retail trade), the percentage of employees participating in a retirement plan increases from less than 25 percent for employers with fewer than 10 employees to just over 60 percent for employers with 1,000 or more employees (Figure 4). However, the percentage of workers participating in personal services ranges only from 11 percent to 33 percent.
- Among full-time, full-year workers, the percentage of workers participating increases from 20 percent for the smallest firms to 68 percent for the largest firms (Figure 5). In contrast, among part-time, part-year workers, the percentage participating ranged from 6 percent to 14 percent.

While the percentage of workers who participated in a plan was lower across various characteristics of workers or employers, important differences in the types of workers in small versus large employers remain.

- Small employers have a disproportionate percentage of workers with annual earnings below $15,000: 31 percent at firms with fewer than 10 employees, compared with 20 percent at employers with 100 or more employees (Figure 6).
- Small employers are more likely to be in the personal service industry and less likely to be in the manufacturing industry, the industries with lowest and highest overall levels of participation, respectively (Figure 7).
- Small employers have lower shares of full-time workers and higher shares of part-time workers, when compared with larger employers (Figure 8). It is of note that when examining some important worker characteristics—such as age, gender, and race/ethnicity—no significant differences emerged between the small employer and large employer work forces (Figure 9).

The CPS does not include plan type, but the Federal Reserve Board's Survey of Consumer Finances (SCF) does provide this information.[1]

- Participants of employment-based retirement plans working for small employers are more likely to have a defined contribution (401(k)-type) plan as their only plan, relative to participants in larger employers. For example, 77 percent of the participants at firms with 10–19 employees were in a defined contribution plan only, compared with 57 percent at firms with 500 or more employers (Figure 10).
- While the rates of having only a defined benefit plan (traditional pension) are similar across employer sizes, participants from the largest employers are significantly more likely to have both types of plans (21 percent compared with 6 percent). Smaller employers' higher likelihood of having only a defined contribution plan for participants persists across each industry (Figure 11).

Despite the lower likelihood of workers at small employers being in an employment-based retirement plan, there is some good news: Their probability of being in a plan has increased since 1991. In 1991, 19.8 percent of workers at firms with 10–24 employees participated in an employment-based retirement plan before rowing to 27.2 percent by 2004 (Figure 12). In contrast, for employers with 1,000 or more employees, participation declined from 61.9 percent in 1991 to 59.2 percent in 2004.

Thank you and I will be happy to answer any questions you may have.

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[1] The Survey of Consumer Finances (SCF) has similar breakdowns for employer size and industry but not exactly corresponding to the March Current Population Survey (CPS). CPS has employer sizes of fewer than 10, 10–24, 25–99, 100–999, and 1,000 or more, while the SCF has fewer than 10, 10–19, 20–99, 100–499, and 500 or more. The industry categories in CPS are agriculture, mining, and construction (which are separated in SCF), manufacturing (same in SCF), wholesale and retail trade (which has some industries that are separated in SCF from the finance, insurance, real estate, and business and repair services and the transportation, communications, public utilities, and personal and professional service industries), and personal services (which is part of the transportation, communications, public utilities, and personal and professional service industry in SCF).

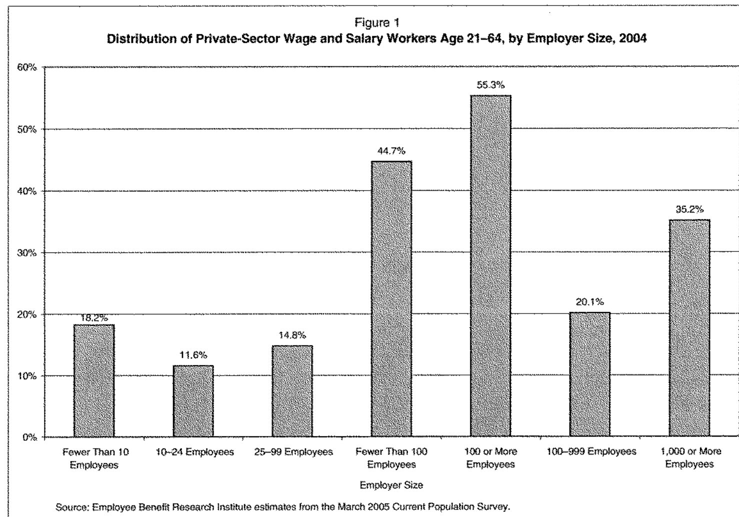


Figure 1
Distribution of Private-Sector Wage and Salary Workers Age 21–64, by Employer Size, 2004
60%
50%
40%
30%
20%
10%
0%
18.2%
11.6%
14.8%
44.7%
55.3%
20.1%
35.2%
Fewer Than 10 Employees
10–24 Employees
25–99 Employees
Fewer Than 100 Employees
100 or More Employees
100–999 Employees
1,000 or More Employees
Employer Size
Source: Employee Benefit Research Institute estimates from the March 2005 Current Population Survey.

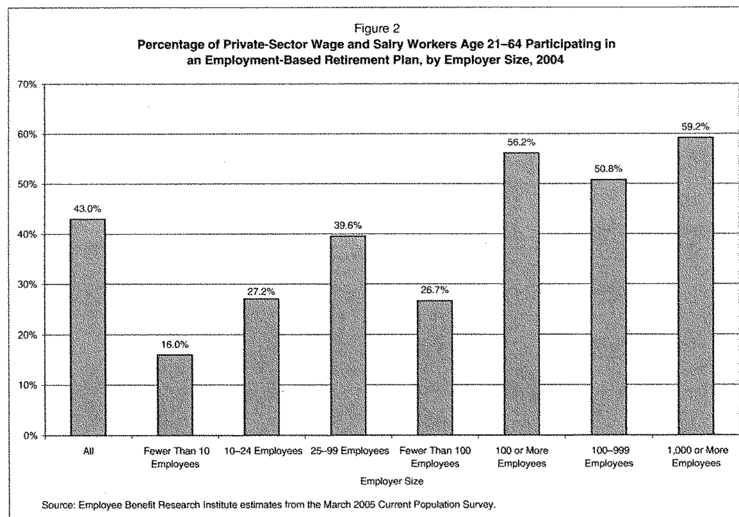


Figure 2
Percentage of Private-Sector Wage and Salry Workers Age 21–64 Participating in an Employment-Based Retirement Plan, by Employer Size, 2004
70%
60%
50%
40%
30%
20%
10%
0%
43.0%
16.0%
27.2%
39.6%
26.7%
56.2%
50.8%
59.2%
All
Fewer Than 10 Employees
10–24 Employees
25–99 Employees
Fewer Than 100 Employees
100 or More Employees
100–999 Employees
1,000 or More Employees
Employer Size
Source: Employee Benefit Research Institute estimates from the March 2005 Current Population Survey.

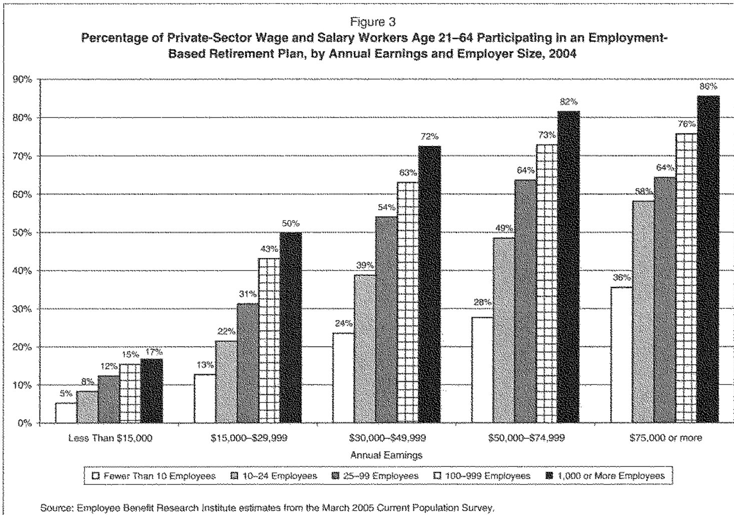


Figure 3
Percentage of Private-Sector Wage and Salary Workers Age 21–64 Participating in an Employment-Based Retirement Plan, by Annual Earnings and Employer Size, 2004

Source: Employee Benefit Research Institute estimates from the March 2005 Current Population Survey.

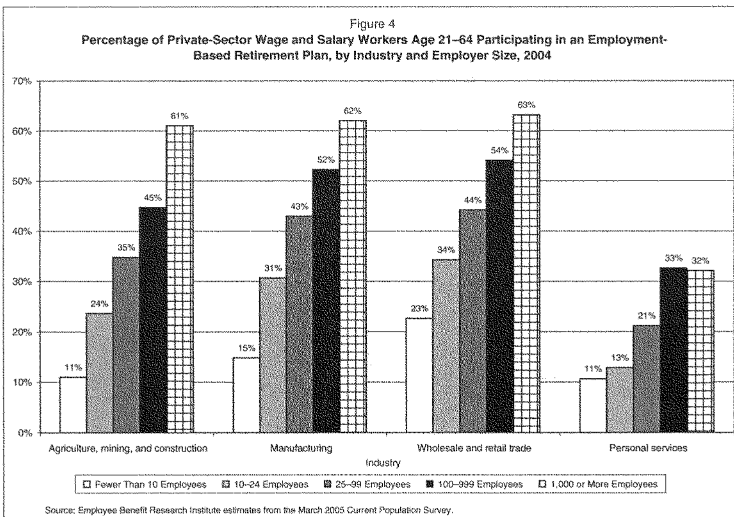


Figure 4
Percentage of Private-Sector Wage and Salary Workers Age 21–64 Participating in an Employment-Based Retirement Plan, by Industry and Employer Size, 2004

Source: Employee Benefit Research Institute estimates from the March 2005 Current Population Survey.

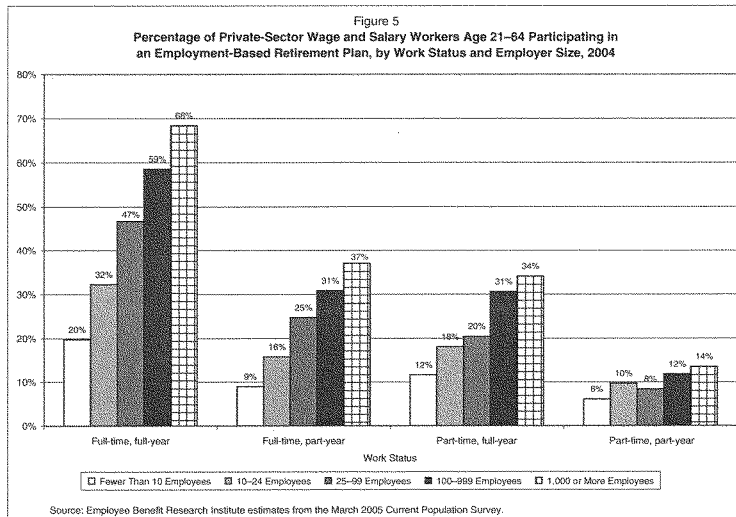


Figure 5
Percentage of Private-Sector Wage and Salary Workers Age 21–64 Participating in an Employment-Based Retirement Plan, by Work Status and Employer Size, 2004
80%
70%
60%
50%
40%
30%
20%
10%
0%
20%
32%
47%
59%
68%
9%
16%
25%
31%
37%
12%
18%
20%
31%
34%
6%
10%
8%
12%
14%
Full-time, full-year
Full-time, part-year
Part-time, full-year
Part-time, part-year
Work Status
Fewer Than 10 Employees
10–24 Employees
25–99 Employees
100–999 Employees
1,000 or More Employees
Source: Employee Benefit Research Institute estimates from the March 2005 Current Population Survey.

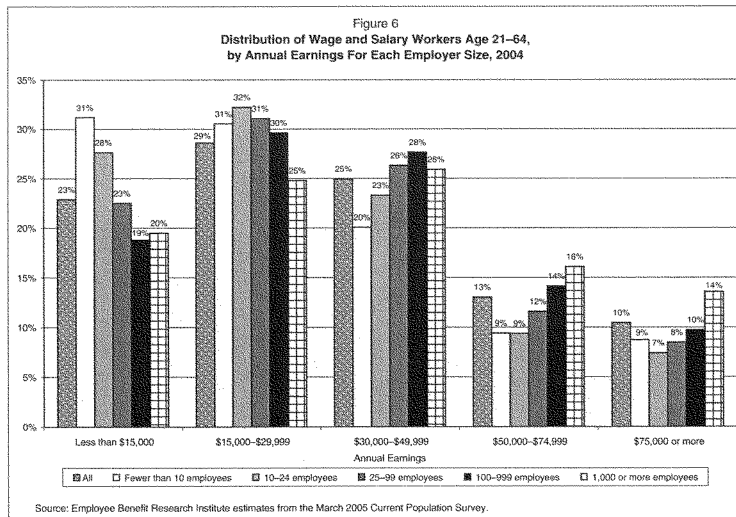


Figure 6
Distribution of Wage and Salary Workers Age 21–64, by Annual Earnings For Each Employer Size, 2004
35%
30%
25%
20%
15%
10%
5%
0%
23%
31%
28%
23%
19%
20%
29%
31%
32%
31%
30%
25%
25%
20%
23%
26%
28%
26%
13%
9%
9%
12%
14%
16%
10%
9%
7%
8%
10%
14%
Less than $15,000
$15,000–$29,999
$30,000–$49,999
$50,000–$74,999
$75,000 or more
Annual Earnings
All
Fewer than 10 employees
10–24 employees
25–99 employees
100–999 employees
1,000 or more employees
Source: Employee Benefit Research Institute estimates from the March 2005 Current Population Survey.

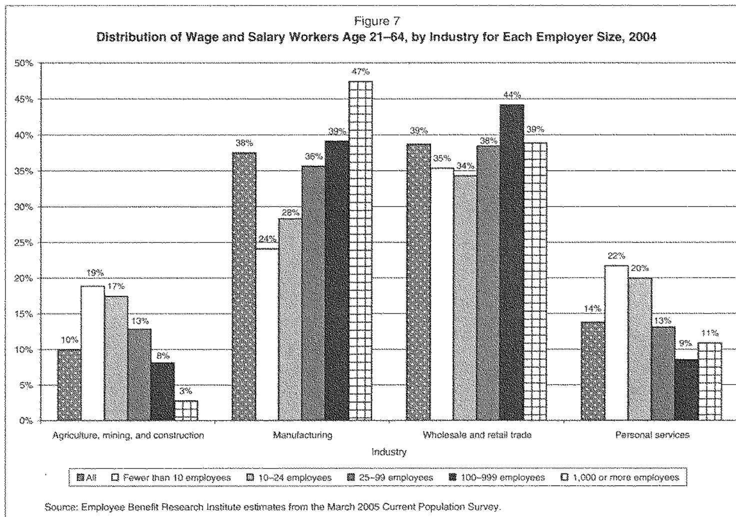


Figure 7
Distribution of Wage and Salary Workers Age 21–64, by Industry for Each Employer Size, 2004
Agriculture, mining, and construction
Manufacturing
Wholesale and retail trade
Personal services
Industry
All
Fewer than 10 employees
10–24 employees
25–99 employees
100–999 employees
1,000 or more employees
Source: Employee Benefit Research Institute estimates from the March 2005 Current Population Survey.

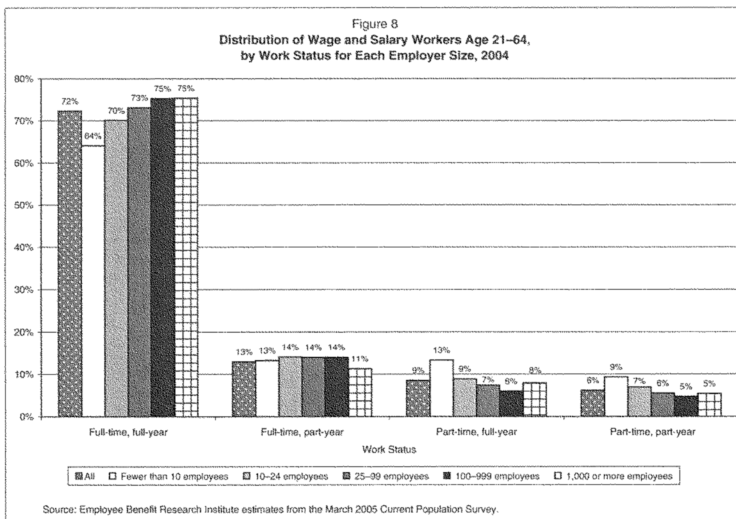


Figure 8
Distribution of Wage and Salary Workers Age 21–64, by Work Status for Each Employer Size, 2004
Full-time, full-year
Full-time, part-year
Part-time, full-year
Part-time, part-year
Work Status
All
Fewer than 10 employees
10–24 employees
25–99 employees
100–999 employees
1,000 or more employees
Source: Employee Benefit Research Institute estimates from the March 2005 Current Population Survey.

Figure 9
Distribution of Private Sector Wage and Salary Workers 21–64, by Various Characteristics and Employer Size, 2004

	Number of Employees					
	All	Fewer Than 10	10–24	25–99	100–999	1,000 or More
All	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Age						
21–24	10.6	9.6	12.2	10.0	9.3	11.5
25–34	25.5	23.0	27.5	26.6	25.9	25.4
35–44	26.8	27.6	26.8	26.9	26.4	26.6
45–54	24.1	25.5	22.0	24.1	24.8	23.7
55–64	13.0	14 3	11.5	12.4	13.5	12.8
Gender						
Male	54.2	56.0	56.7	57.0	53.7	51.5
Female	45.8	44.0	43.3	43.0	46.3	48.5
Race/Ethnicity						
White	68.6	70.5	67.6	68.9	67.5	68.5
Black	10.7	6.8	8.1	9.3	12.1	13.5
Hispanic	14.3	16.0	18.0	16.5	14.4	11.3
Other	6.3	6.8	6.3	5.4	6.0	6.7
Annual Earnings						
Less than $15,000	22.9	31.2	27.7	22.5	18.8	19.5
$15,000–$29,999	28.6	30.6	32.2	31.1	29.6	24.8
$30,000–$49,999	25.0	20.1	23.3	26.3	27.7	25.9
$50,000–$74,999	13.0	9.4	9.4	11.6	14.1	16.1
$75,000 or more	10.5	8.8	7.4	8.5	9.7	13.6
Work Status						
Full-time, full-year	72.3	64.1	70.1	73.1	75.3	75.4
Full-time, part-year	12.9	13.3	14.1	14.0	14.0	11.3
Part-time, full-year	8.5	13 3	8.9	7.4	6.0	7.9
Part-time, part-year	6.2	9.3	6.9	5.5	4.7	5.4
Industry						
Agriculture, mining, and construction	10.0	18 9	17 5	12.8	8.1	2.8
Manufacturing	37.5	24.1	28.3	35.6	39.1	47.4
Wholesale and retail trade	38.7	35.4	34.3	38.4	44.2	38.9
Personal services	13.8	21.7	20.0	13.1	8.6	10.9

Source: Employee Benefit Research Institute estimates from the March 2005 Current Population Survey.

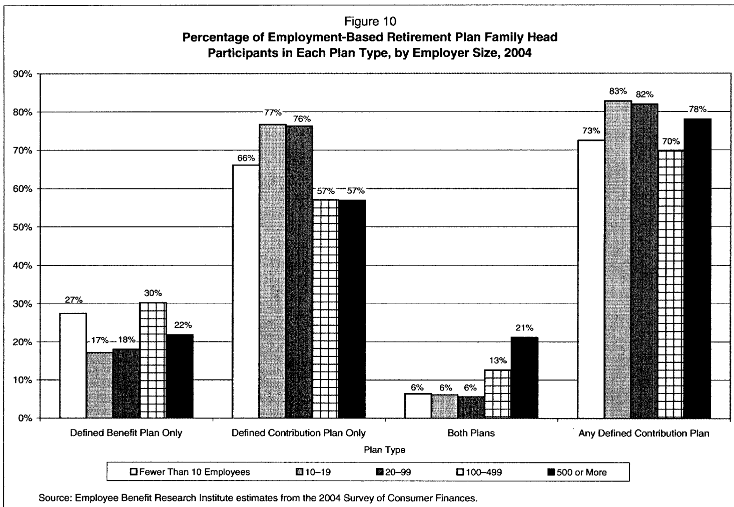


Figure 10
Percentage of Employment-Based Retirement Plan Family Head
Participants in Each Plan Type, by Employer Size, 2004
Defined Benefit Plan Only
Defined Contribution Plan Only
Both Plans
Any Defined Contribution Plan
Plan Type
Fewer Than 10 Employees
10–19
20–99
100–499
500 or More
Source: Employee Benefit Research Institute estimates from the 2004 Survey of Consumer Finances.

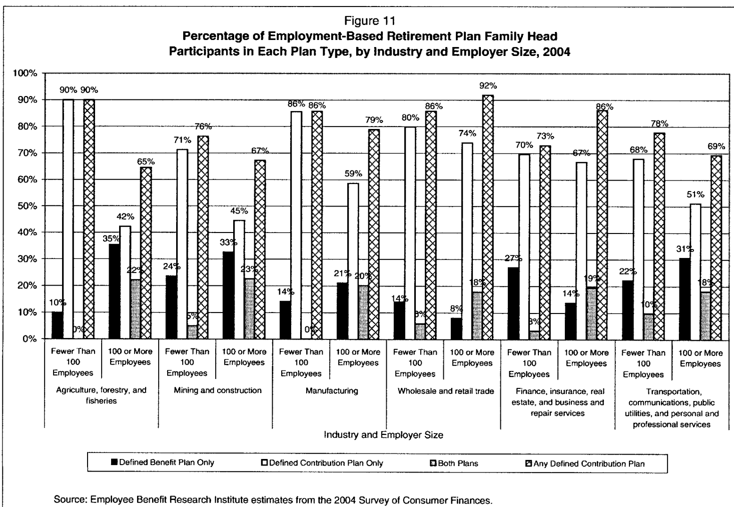
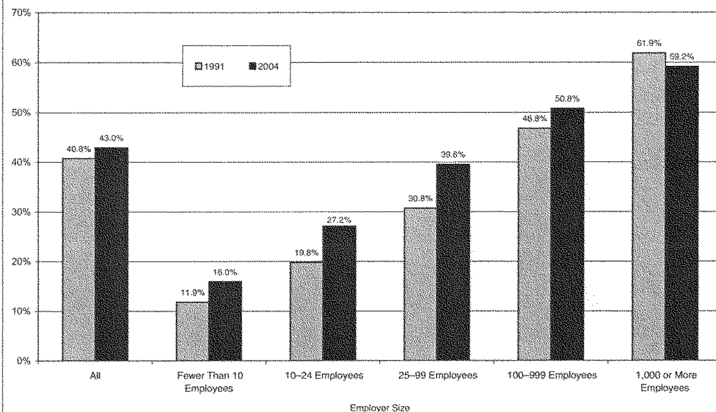


Figure 11
Percentage of Employment-Based Retirement Plan Family Head
Participants in Each Plan Type, by Industry and Employer Size, 2004
Fewer Than 100 Employees
100 or More Employees
Agriculture, forestry, and fisheries
Mining and construction
Manufacturing
Wholesale and retail trade
Finance, insurance, real estate, and business and repair services
Transportation, communications, public utilities, and personal and professional services
Industry and Employer Size
Defined Benefit Plan Only
Defined Contribution Plan Only
Both Plans
Any Defined Contribution Plan
Source: Employee Benefit Research Institute estimates from the 2004 Survey of Consumer Finances.

Figure 12

Percentage of Wage and Salary Workers Age 21–64 Participating in an Employment-Based Retirement Plan, by Employer Size, 1991 and 2004



Source: Employee Benefit Research Institute estimates from the March 2005 Current Population Survey.

Testimony of
Daniel W. Hall
Regional Pension Manager
Standard Insurance Company

Submitted June 27, 2006

to

Subcommittee on Long-Term Growth and Debt Reduction,
Senate Finance Committee
"Small Business Pension Plans: How Can We Increase Worker Coverage?" – Hearing. June 29, 2006

Mr. Chairman, members of the committee, my name is Dan Hall. I am a regional pension manager for Standard Insurance Company. The Standard is a financial services company headquartered in Portland, Oregon, and provides employee benefits, investment advice, annuities and retirement plan products and services to more than seven million customers nationwide.

We are committed to helping people achieve financial security. The Standard has been in the retirement plans business since 1939 and we introduced our first 401(k) product in 1982. Our particular expertise is micro and small plans. We are consistently rated as a top provider of such plans by our customers and independent third parties. Micro plans serve businesses with up to 100 employees and small plans serve employers with 100 – 500 employees. I have been in the retirement planning business for 23 years.

Thank you for the opportunity to share my perspective on the barriers to small business pension coverage. I would also like to take this opportunity to address some issues that inhibit employee participation in pension plans.

The existence of employer–provided retirement plans when used by a large number of employees helps alleviate pressure on state and federal social welfare programs, creating

significant taxpayer savings. Employer-provided plans also provide a critical safety net to individuals. It is imperative for the financial health of our citizens and our nation that employers and government continue to work together to provide improved pension coverage and encourage individual participation.

In my daily discussions with employers about implementing pension plans, I encounter two types of barriers:

1. Barriers due to perceptions that small business owners hold about pension plans.
2. Barriers created by the realities of implementing a pension plan.

Prior to the advent of the 401(k), many employers provided retirement income through defined benefit pension plans. Originally, 401(k) plans were intended to supplement Social Security and the company pension rather than becoming the primary retirement income vehicle. Many small business owners today grew up in households with parents whose retirement income was provided by the company's pension plan. My experience is that the current generation of business owners and employees has not adjusted savings habits to reflect the movement from company-provided pensions to 401(k) plans, which require employees to exercise discretion and take responsibility for their own retirement security.

Another perception creating barriers to small business employers providing pension plans is that many view their business as their retirement. Consequently, when choices are made between investing in infrastructure to improve the business and investing money for a retirement plan for themselves and their employees, infrastructure usually takes priority.

Small business owners also have a general perception that retirement plans are complicated, over-regulated and expensive. They often fear that they do not have the skills or resources to manage the compliance issues and mandatory plan testing. The question becomes, "If I do this, what part of my business suffers?" or "Will I need to hire staff just to administer this plan?"

Although these perceptions present barriers to small businesses providing pension coverage, they can typically be overcome with education and information. Beyond perception issues, however, are some real barriers for small businesses seeking to provide pension coverage for their employees.

Competing priorities regarding employee benefits are a constant reality for small business owners: medical, dental, life and vision insurance, disability coverage, long term care, childcare assistance – the list goes on. The most pressing needs require more immediate attention and take precedence in a small business. Health care is a basic, immediate need and both the employer and the employee can see tangible results from medical coverage. Retirement planning for many is abstract until retirement approaches. By the time retirement planning becomes a priority it is often too late.

One method to promote the provision of retirement plans by small business is to offer a tax credit to help offset either the employer contribution or the expense of implementing plans. Typically, small employers are required to pay an annual administrative fee to cover some of the costs of servicing a plan. The fee can be several thousand dollars. A tax credit on employer contributions or an annual tax credit equal to all or part of the annual administrative fee would encourage the formation of these plans.

A second barrier is compliance testing. Although well intended, it works against the small business owner. Top-heavy and non-discriminatory compliance testing ensures that a plan does not discriminate in favor of highly compensated employees.

However, non-discriminatory compliance testing eliminates top-heavy issues, making the top-heavy rule outdated and redundant. Eliminating the top-heavy rule would allow providers to lower fees, reducing the costs of pension plans.

Most experts agree that the majority of employees are not saving enough in their retirement accounts. In addition, many eligible participants have not made the decision to participate in their employers' plan. So it is important to increase employee participation and the level of their contribution to the employer plan.

Two ways to increase employee participation are through automatic enrollment features and promotion of automatic deferral increases.

Automatic enrollment, requiring employees to opt out of the plan rather than in, would help increase participation. Implementing federal regulations that make automatic enrollment rules consistent nationally would encourage plan providers to offer automatic enrollment and multi-state employers to implement it.

Although plan sponsors are able to implement automatic deferral increases, this tool is underutilized. Automatic deferral increase options allow participants to set up a schedule of future increases to their salary deferral rates at enrollment. Typically, these increases are timed to coincide with salary increases so an employee's take-home pay is not reduced. Educating and encouraging small business owners to implement automatic deferral increases will increase participation and help ensure that employees, including the small business owner, are participating at the appropriate level.

The third barrier for small businesses is the federal law requiring employee benefit plans with 100 or more eligible participants to have an audit performed by a third party. Audits can cost several thousand dollars annually. My clients' experience has been that audits rarely uncover anything. Often rapidly growing companies are surprised by the 100-employee audit rule. Raising the audit minimum – perhaps to 200 employees – would reduce the scope of this issue.

"Safe harbor" regulations introduced in 2006 have addressed many of the above issues. However, a serious barrier remains for small businesses. Payroll, equipment outlays, advertising, sales costs and the rising costs of health care place immediate demands on the capital of a small business. It is often difficult for businesses to provide matching funds and their plans are, therefore, not eligible for "safe harbor" treatment.

In summary, the two barriers to increasing pension coverage for small business employees are:

Perceptional

1. The 401(k) requires new investment habits for baby boomers.
2. Small business owners view their business as their nest egg and have little financial incentive to offer a plan for employees that unduly caps the participation of the owner.
3. Retirement plans are complicated, highly regulated and expensive, three traits a small business is not eager to tackle.

Actual

1. Competing benefit priorities – health care, dental and other employee benefits may provide more immediate returns versus a retirement plan.
2. Compliance testing to ensure that pension plans do not discriminate in favor of highly compensated employees.
3. The 100-employee audit rule.

On a daily basis, my staff and I have the opportunity to correct misperceptions that small business owners have about pension plans. However, the actual barriers created by the reality of running a small business and the administration required for pension plans are more difficult to overcome.

Some solutions with incentives for both parties to the transaction – the employer and the employee – should be considered to help small businesses provide pension coverage:

1. Offering a tax credit, rather than a deduction, to small business employers who implement plans.
2. Implementing federal regulations that make automatic enrollment rules consistent nationally for multi-state employers and plan providers.
3. Eliminating top-heavy rules to allow plan providers to lower fees. Non-discriminatory testing already addresses top-heavy issues.
4. Raising the 100-employee audit rule to 200.

Participation is often low even when voluntary retirement plans are offered. In addition to the benefit to employees, increased employee participation provides more benefit to the small business owner as it raises the allowable participation by the owner in the plan.

Some solutions that may help increase employee participation:

1. Automatic enrollment whereby employees opt out of plan participation rather than in. Even the simple act of enrollment is an impediment for many employees.
2. Automatic deferral increases.

Some additional solutions that have not previously been discussed, but may help participation rates are:

3. Encourage plan providers to offer unbiased and revenue neutral advice. A significant barrier to individual participation is the lack of knowledge about investment options and strategies.

4. Revisit the age 50 catch-up provision – lower the age or allow catch-up based on a percentage of income. Currently, catch-up contributions are exempt from non-discriminatory testing. This would allow small business owners more time to realize benefit from a group pension plan.

5. Consider limiting the available loan amount to $5,000 and tighten the rules to allow loans for hardship only. 401(k) loans are often abused. We currently have a plan with 120 participants with 70 loans on the plan.

6. Revise rollover rules so that it is more beneficial and easier to rollover a 401(k) than to cash out. In today's work environment individuals change companies frequently. Providing incentives to keep money invested during job changes may decrease the number of cash outs.

7. Allow favorable tax treatment on benefits that are annuitized. Currently, annuitized benefits are taxed at normal income tax rates at the time of distribution.

The keys to increasing both employer and employee participation in pension plans are simplicity, education, decreasing the administrative burden and offering incentives for business owners to provide plans and employees to participate.

The private sector can then handle the educational component. Financial knowledge and expertise is often a barrier to small businesses providing plans and it is almost always a barrier to employees participating. The more we can educate and provide financial advice and direction the more we will increase participation.

Joint Written Statement of David C. John and J. Mark Iwry
Before the
Subcommittee on Long-Term Growth and Debt Reduction
Committee on Finance
United States Senate

June 29, 2006

Pursuing Universal Retirement Security Through Automatic IRAs

Chairman Smith, Ranking Member Kerry, and Senator Grassley, we appreciate the opportunity to testify before you.[1] We are submitting our testimony as a single joint statement because we believe strongly in the need for a common strategy to expand retirement savings, and in the importance of approaching these issues in a manner that transcends ideological and partisan differences.

At the request of Committee staff, this written statement focuses on our proposal to expand retirement savings for small business workers – the automatic IRA. We are pleased by the positive reaction the proposal has received and are grateful to our colleagues, including those in government and in various stakeholder organizations, who have contributed to these ideas.[2]

With the looming retirement security crisis facing our country, policy-makers from both parties are focused on ways to strengthen pensions and increase savings. Our proposal for automatic IRAs would provide a relatively simple, cost-effective way to increase retirement security for the estimated 71 million workers whose employers (usually smaller businesses) do not sponsor plans. It would enable these employees to save for retirement by allowing them to have their employers regularly transfer amounts from their paycheck to an IRA.

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The views expressed in this testimony are those of the two witnesses alone and should not be attributed to The Heritage Foundation, the Brookings Institution, Georgetown University's Public Policy Institute, or The Pew Charitable Trusts.

2 "Think Tanks: Allow automatic IRA payroll deductions" USA Today, February 23, 2006; Crenshaw, Albert., "Automatic IRAs – a Quick Fix for Workers Without Pensions?" Washington Post, February 19, 2006; "The Way to Save" Editorial, New York Times, February 20, 2006; Bernard, Tara, "Groups Propose Payroll Deductions for IRAs" The Wall Street Journal, February 16, 2006; Iwry, J. Mark and David John, "The Other 71 Million" The Washington Times, March 24, 2006; Editorial, Newsday, Feb. 22, 2006; Marketwatch.com (Feb. 16, 2006). The automatic IRA proposal emerged as one of the leading recommendations of the 2006 National Summit on Retirement Savings (Saver Summit).

We are by no means suggesting that the automatic IRA proposal is the only step that should be taken to expand retirement savings for small business workers. In fact, we have long believed in the primacy of employer-sponsored retirement plans as vehicles for pension coverage.[3] Additionally, we continue to advocate strongly for the expansion of pension coverage through automatic features in 401(k) and similar retirement savings plans.[4]

The automatic 401(k) approach makes intelligent use of defaults – the outcomes that occur when individuals are unable or unwilling to make an affirmative choice or otherwise fail to act – to enlist the power of inertia to promote saving. Automating enrollment, escalation of contributions, investment, and rollovers expands coverage in several ways. Enrolling employees in a plan unless they opt out increases significantly the number of eligible employees who participate in the plan. Escalating the amount of the default contribution tends to increase the amount people save over time. Providing for a default investment (which participants can reject in favor of other alternatives) reflecting consensus investment principles such as diversification and asset allocation tends to raise the expected investment return on contributions. Finally, making retention or rollover of benefits rather than consumption the default when an employee leaves a job furthers the long-term preservation of retirement savings for their intended purposes. By helping improve performance under the nondiscrimination standards and generally making plans more effective in providing retirement benefits, the automatic 401(k) can also encourage more employers to sponsor or continue sponsoring plans.

The automatic IRA builds on the success of the automatic 401(k). Moreover, as explained below, we would intend and expect the introduction of automatic IRAs to expand the number of employers that choose to sponsor 401(k) or SIMPLE plans instead of offering only automatic IRAs. But for millions of workers who continue to have no employer plan, the automatic IRA would provide a valuable retirement savings opportunity.

The automatic IRA proposal is set out in the remainder of this written statement.

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3 We have previously written and testified before Congress on various aspects of employer-sponsored retirement plans. David John has written and testified about the funding problems faced by defined benefit pension plans and about the United Kingdom's pension situation. Mark Iwry led the Executive Branch efforts in the 1990s to develop the SIMPLE plan for small business, the startup tax credit for small employers that adopt new plans, and the saver's credit for moderate- and lower-income workers, as well as the Executive Branch initiatives to define, approve and promote 401(k) automatic enrollment, automatic rollover to restrict pension leakage, and automatic 401(k) features generally. See also William G. Gale, J. Mark Iwry and Peter R. Orszag, "The Saver's Credit" (The Retirement Security Project, Policy Brief No. 2005-2; available at www.retirementsecurityproject.org).

4 William G. Gale, J. Mark Iwry and Peter R. Orszag, "The Automatic 401(k): A Simple Way to Strengthen Retirement Savings," (The Retirement Security Project, Policy Brief No. 2005-1; available at www.retirementsecurityproject.org); William G. Gale and J. Mark Iwry, "Automatic Investment: Improving 401(k) Portfolio Investment Choices" (The Retirement Security Project, Policy Brief No. 2005-4; available at www.retirementsecurityproject.org).

PURSUING UNIVERSAL RETIREMENT SECURITY THROUGH AUTOMATIC IRAS[1]

J. Mark Iwry and David C. John

Executive Summary of Proposal

This testimony proposes an ambitious but practical set of initiatives to expand dramatically retirement savings in the United States—especially to those not currently offered an employer-provided retirement plan.[2] The essential strategy here, as in the case of the automatic 401(k) described above, is to make saving more automatic—and hence easier, more convenient, and more likely to occur. As noted, making saving easier by making it automatic has been shown to be remarkably effective at boosting participation in 401(k) plans, but roughly half of U.S. workers are not offered a 401(k) or any other type of employer-sponsored plan. Among the 153 million working Americans in 2004, over 71 million worked for an employer that did not sponsor a retirement plan of any kind, and another 17 million did not participate in their employer's plan.[3] This testimony explores a new and, we believe, promising approach to expanding the benefits of automatic saving to a wider array of the population: the "automatic IRA."

The automatic IRA would feature direct payroll deposits to a low-cost, diversified individual retirement account. Most American employees not covered by an employer-sponsored retirement plan would be offered the opportunity to save through the powerful mechanism of regular payroll deposits that continue automatically (an opportunity now limited mostly to 401(k)-eligible workers).

Employers above a certain size (e.g., 10 employees) that have been in business for at least two years but that still do not sponsor any plan for their employees would be called upon to offer employees this payroll-deduction saving option. These employers would receive a temporary tax credit for simply serving as a conduit for saving, by making regular payroll deposit available to their employees. Employers would receive a small additional tax credit for each employee who participates. Other employers that do not sponsor a plan also would receive the tax credit if they offered payroll deduction saving.

Firms would be provided a standard notice to inform employees of the automatic IRA (payroll-deduction saving) option, and a standard form to elicit from each employee a decision either to participate or to opt out. For most employees, the payroll deductions would be made by direct deposit similar to the very common direct deposit of paychecks to employees' accounts at their financial institutions.

To maximize participation, employers would be provided a standard enrollment module reflecting current best practices in enrollment procedures.

The use of automatic enrollment (whereby employees automatically participate at a statutorily specified rate of contribution unless they opt out) would be encouraged in two ways. First, the standard materials provided to employers would be framed so as to present auto enrollment as the presumptive enrollment method, although employer would be able to opt for the alternative of obtaining responses from all employees. Second, employers using auto enrollment to promote participation would not need to obtain responses from unresponsive employees. As discussed earlier, evidence from the 401(k) universe strongly suggests that high levels of participation tend to result not only from auto enrollment but also from the practice of eliciting from each eligible individual an explicit decision to participate or to opt out.

Employers making direct deposit or payroll deduction available would be protected from potential fiduciary liability and from having to choose or arrange default investments. Instead, diversified default investments and a handful of standard, low-cost investment alternatives would be specified by statute and regulation. Payroll deduction contributions would be transferred, at the employer's option, to a central repository, which would remit them to IRAs designated by employees or, absent employee designation, to a default collective retirement account.

Investment management as well as record keeping and other administrative functions would be contracted to private sector financial institutions to the fullest extent practicable. Costs would be minimized through a no-frills design relying on index funds, economies of scale, and maximum use of electronic technologies, and modeled to some degree on the Thrift Savings Plan for federal government employees. Once accounts reached a predetermined balance (e.g., $15,000) sufficient to make them sufficiently profitable to attract the interest of the full range of IRA providers, account owners would have the option to transfer them to IRAs of their choosing.

This approach involves no employer contributions, no employer compliance with qualified plan or ERISA requirements, and, as noted, no employer liability or responsibility for selecting investments, for selecting an IRA provider, or for opening IRAs for employees. It also steers clear of any adverse impact on employer-sponsored plans or on the incentives designed to encourage firms to adopt new plans. In fact, the indirect intended effect of the proposal would be to draw small employers into the private pension system.

Our proposed approach would seek to capitalize on the rapid trend toward automated or electronic fund transfers. With the spread of new, low-cost technologies, employers are increasingly using automated or electronic systems to manage payroll, including withholding and federal tax deposits, and for other transfers of funds. Many employers use an outside payroll service provider, an on-line payroll service, or software to perform these functions, including direct deposit of paychecks to accounts designated by employees.

For firms already offering direct deposit, including many that use outside payroll providers, direct deposit to an IRA would entail no additional cost, insofar as these systems have unused fields that could be used for the additional direct deposit destination. Other small businesses still write paychecks by hand, complete the federal tax deposit forms and Forms W-2 by hand, and deliver them to employees and to the local depositary institution. Our proposal would not require these employers to make the transition to automatic payroll processing or use of on-line systems (although it might have the effect of encouraging such transitions).

At the same time, we would not be inclined to deny payroll deduction savings to all employees of employers that do not yet use automatic payroll processing (and we would not want to give small employers an incentive to drop automatic payroll processing). These employees would benefit from the ability to save through regular payroll deposits at the workplace whether the deposits are made electronically or by hand. Employees would still have the advantages of a method of saving that, once begun, continues automatically, that is more likely to begin because of workplace enrollment arrangements and peer group reinforcement, and that often will not reduce take-home pay. To that end, we outline below a strategy to address these situations efficiently and with minimal cost.

For the self-employed and others who have no employer, regular contributions to IRAs would be facilitated in three principal ways: (1) extending the payroll deposit option to many independent contractors who work for employers (other than the very smallest businesses); (2) enabling taxpayers to direct the IRS to make direct deposit of a portion of their income tax refunds; and (3) expanding access to automatic debit arrangements, including on-line and traditional means of access through professional and trade associations that could help arrange for automatic debit and direct deposit to IRAs. Automatic debit essentially replicates the power of payroll deduction insofar as it continues automatically once the individual has chosen to initiate it.

In addition, a powerful financial incentive to contribute might be provided by means of matching deposits to the IRAs. Private financial institutions that maintain the accounts could deliver matching contributions and be reimbursed through tax credits.

The Basic Problem and Proposed Solution

In general, the households that tend to be in the best financial position to confront retirement are the 42 percent of the workforce that participate in an employer-sponsored retirement plan.[4] For reasons we have discussed earlier, traditionally, the takeup rate for IRAs (those who contribute as a percentage of

those who are eligible) is less than 1 in 10, but the takeup rate for employer-sponsored 401(k) plans tends to be on the order of 7 in 10.

Moreover, as discussed, an increasing share of 401(k) plans are including automatic features that make saving easier and bolster participation. When firms are not willing to sponsor 401(k)-type plans, the automatic IRA proposed here would apply many of the lessons learned from 401(k) plans[5] so that more workers could enjoy automated saving to build assets—but without imposing any significant burden on employers. Employers that do not sponsor plans for their employees could facilitate saving by employees—without sponsoring a plan, without making employer matching contributions, and without complying with plan qualification or fiduciary standards. Employers can help employees save simply by offering to remit a portion of their pay to an IRA, preferably by direct deposit, at little or no cost to the employer.

Such direct deposit savings using IRAs would not and should not replace retirement plans, such as pension, profit sharing, 401(k), or SIMPLE-IRA plans. Indeed, the automatic IRA would be carefully designed so as to avoid any adverse effect on employer sponsorship of "real" plans, which must adhere to standards requiring reasonably broad or proportionate coverage of moderate- and lower-income workers and various safeguards for employees, and which often involve employer contributions. Instead, payroll-deduction direct deposit savings, as envisioned here, would promote wealth accumulation for retirement by filling in the coverage gaps around employer-sponsored retirement plans. Moreover, as described below, the arrangements we propose are designed to set the stage for small employers to "graduate" from offering payroll deduction to sponsoring an actual retirement plan.

Employee Access to Payroll Deposit Saving

The automatic IRA is a means of facilitating direct deposits to a retirement account, giving employees access to the power of direct deposit saving. In much the same way that millions of employees have their pay directly deposited to their account at a bank or other financial institution, and millions more elect to contribute to 401(k) plans by payroll deduction, employees would have the choice to instruct the employer to send an amount they select directly from their paychecks to an IRA. Employers generally would be required to offer their employees the opportunity to save through such direct deposit or payroll-deduction IRAs.

Direct deposit to IRAs is not new. In 1997, Congress encouraged employers not ready or willing to sponsor a retirement plan to at least offer their employees the opportunity to contribute to IRAs through payroll deduction.[6] Both the IRS and the Department of Labor have issued administrative guidance to publicize the payroll deduction or direct deposit IRA option for employers and to "facilitate the establishment of payroll deduction IRAs."[7] This guidance has made

clear that employers can offer direct deposit IRAs without the arrangement being treated as employer sponsorship of a retirement plan that is subject to ERISA or qualified plan requirements.[8] However, it appears that few employers actually have direct deposit or payroll-deduction IRAs—at least in a way that actively encourages employees to take advantage of the arrangement. After some years of encouragement by the government, direct deposit IRAs have simply not caught on widely among employers and, consequently, offer little opportunity for employees to save.

With this experience in mind, we propose a new strategy designed to induce employers to offer, and employees to take up, direct deposit or payroll deposit saving.

Tax Credit for Employers That Serve as Conduit for Employee Contributions

Under our proposal, firms that do not provide employees a qualified retirement plan, such as a pension, profit-sharing, or 401(k) plan, would be given an incentive (a temporary tax credit) to offer those employees the opportunity to make their own payroll deduction contributions to IRAs using the employers' payroll systems as a conduit. The tax credit would be available to a firm for the first two years in which it offered payroll deposit saving to an IRA, in order to help the firm adjust to any modest administrative costs associated with the "automatic IRA." This automatic IRA credit would be designed to avoid competing with the tax credit available under current law to small businesses that adopt a new employer-sponsored retirement plan.

Small Business New Plan Startup Credit

Under current law, an employer with 100 or fewer employees that starts a new retirement plan for the first time can generally claim a tax credit for a portion of its startup costs. The credit equals 50 percent of the cost of establishing and administering the plan (including educating employees about the plan) up to $500 per year. The employer can claim the credit of up to $500 for each of the first three years of the plan.

Accordingly, the automatic IRA tax credit could be set, for example, at $50 plus $10 per employee enrolled. It would be capped at, say, $250 or $300 in the aggregate – low enough to make the credit meaningful only for very small businesses, and lower than the $500 three-year credit available under current law for establishing a new employer plan. Employers would be precluded from claiming both the new plan startup credit and the proposed automatic IRA credit; otherwise, somewhat larger employers might have a financial incentive to limit a new plan to fewer than all of their employees in order to earn an additional credit for providing payroll deposit saving to other employees. As in the case of the current new plan startup credit, employers also would be ineligible for the credit if

they had sponsored a retirement plan during the preceding three years for substantially the same group of employees covered by the automatic IRA.

Example: Joe employs four people in his auto body shop, and currently does not sponsor a retirement plan for his employees. If Joe chooses to adopt a 401(k) or SIMPLE-IRA plan, he and each of his employees generally can contribute up to $15,000 (401(k)) or $10,000 (SIMPLE) a year, and the business might be required to make employer contributions. Under this scenario, Joe can claim the startup tax credit for 50 percent of his costs over three years up to $500 per year.

Alternatively, if Joe decides only to offer his employees payroll deposit to an IRA, the business will not make employer contributions, and Joe can claim a tax credit for each of the next two years of $50 plus $10 for each employee who signs up to contribute out of his own salary.

Employers with more than 10 employees that have been in business for at least two years and that still do not sponsor any plan for their employees would be called upon to offer employees this opportunity to save a portion of their own wages using payroll deposit. If the employer sponsored a plan designed to cover only a subset of its employees (such as a particular subsidiary, division or other business unit), it would have to offer the payroll deposit facility to the rest of its workforce (i.e., employees not in that business unit) other than employees excluded from consideration under the qualified plan coverage standards (union-represented employees or nonresident aliens) and those in the permissible qualified plan eligibility waiting period. The arrangement would be structured so as to avoid, to the fullest extent possible, employer costs or responsibilities. The tax credit would be available both to those firms that are required to offer payroll deposit to all of their employees and to the small or new firms that are not required to offer the automatic IRA, but do so voluntarily. The intent would be to encourage, without requiring, the smallest employers to participate.

Acting as Conduit Entails Little or No Cost to Employers

For many if not most employers, offering direct deposit or payroll deduction IRAs would involve little or no cost. Unlike a 401(k) or other employer-sponsored retirement plan, the employer would not be maintaining a plan. First, there would be no employer contributions: employer contributions to direct deposit IRAs would not be required or permitted. Employers willing to make retirement contributions for their employees would continue to do so in accordance with the safeguards and standards governing employer-sponsored retirement plans, such as SIMPLE-IRAs, 401(k)s, and traditional pensions. (The SIMPLE-IRA is essentially a payroll deposit IRA with an employee contribution limit that is in between the IRA and 401(k) limits and with employer contributions, but without the annual reports, plan documents, and most of the other administrative requirements applicable to other employer plans.)

Employer-sponsored retirement plans are the saving vehicles of choice and should be encouraged; the direct deposit IRA is a fallback designed to apply to employees who are not fortunate enough to be covered under an actual employer retirement plan. (As discussed below, it is also intended to encourage more employers to make the decision sooner or later to "graduate" to sponsorship of an employer plan.)

Direct deposit or payroll deduction IRAs also would minimize employer responsibilities. Firms would not be required to

- comply with plan qualification or ERISA rules,
- establish or maintain a trust to hold assets (since IRAs would receive the contributions),
- determine whether employees are actually eligible to contribute to an IRA,
- select investments for employee contributions,
- select among IRA providers, or
- set up IRAs for employees.

Employers would be required simply to let employees elect to make a payroll- deduction deposit to an IRA (in the manner described below, with a standard notice informing employees of the automatic IRA (payroll-deposit saving) option, and a standard form eliciting the employee's decision to participate or to opt out. Employer then would implement deposits elected by employees. Employers would not be required to remit the direct deposits to the IRA provider(s) any faster than the timing of the federal payroll deposits they are required to make. (Those deposits generally are required to be made on a standard schedule, either monthly or twice a week.) Nor would employers be required to remit direct deposits to a variety of different IRAs specified by their employees (as explained below).

A requirement to offer payroll-deduction to an IRA would by no means be onerous. It would dovetail neatly with what employers already do. Employers of course are already required to withhold federal income tax and payroll tax from employees' pay and remit those amounts to the federal tax deposit system. While this withholding does not require the employer to administer an employee election of the sort associated with direct deposit to an IRA, the tax withholding amounts do vary from employee to employee and depend on the way each employee completes IRS Form W-4 (which employers ordinarily obtain from new hires to help the employer comply with income tax withholding). The employee's

payroll deposit IRA election might be made on an attachment or addendum to the Form W-4. Because employees' salary reduction contributions to IRAs would ordinarily receive tax-favored treatment, the employer would report on Form W-2 the reduced amount of the employee's taxable wages together with the amount of the employee's contribution.

Direct Deposit; Automated Fund Transfers

Our proposed approach would seek to capitalize on the rapid trend toward automated or electronic fund transfers. With the spread of new, low-cost technologies, employers are increasingly using automated or electronic systems to manage payroll, including withholding and federal tax deposits, and for other transfers of funds. It is common for employers to retain an outside payroll service provider to perform these functions, including direct deposit of paychecks to accounts designated by employees or contractors. Other employers use an on-line payroll service that offers direct deposit and check printing (or that allows employers to write checks by hand). Still others do not outsource their payroll tax and related functions to a third-party payroll provider but do use readily available software or largely paperless on-line methods to make their federal tax deposits and perhaps other fund transfers, just as increasing numbers of households pay bills and manage other financial transactions on line. (The IRS encourages employers to use its free Electronic Federal Tax Payment System for making federal tax deposits.)

For the many firms that already offer their workers direct deposit, including many that use outside payroll providers, direct deposit to an IRA would entail no additional cost, even in the short term, insofar as the employer's system has unused fields that could be used for the additional direct deposit destination. Other small businesses still write their own paychecks by hand, complete the federal tax deposit forms and Forms W-2 by hand, and deliver them to employees and to the local bank or other depositary institution. Our proposal would not require these employers to make the transition to automatic payroll processing or use of on-line systems (although it might have the beneficial effect of encouraging such transitions).

At the same time, we would not be inclined to deny the benefits of payroll deduction savings to all employees of employers that do not yet use automatic payroll processing (and we would not want to give small employers an incentive to drop automatic payroll processing). These employees would benefit from the ability to save through regular payroll deposits at the workplace whether the deposits are made electronically or by hand. Employees would still have the advantages of tax-favored saving that, once begun, continues automatically, that is more likely to begin because of workplace enrollment arrangements and peer group reinforcement, and need not cause a visible reduction in take-home pay if begun promptly when employees are hired.

Accordingly, we would suggest a three-pronged strategy with respect to employers that do not use automatic payroll processing.

First, a large proportion of the employers that still process their payroll by hand would be exempted under the exception for very small employers described below. As a result, this proposal would focus chiefly on those employers that already offer their employees direct deposit of paychecks but have not used the same technology to provide employees a convenient retirement saving opportunity.

Second, employers would have the ease of “piggybacking” the payroll deposits to IRAs onto the federal tax deposits they currently make. The process, including timing and logistics, for both sets of deposits would be the same. Accompanying or appended to the existing federal tax deposit forms would be a similar payroll deposit savings form enabling the employer to send all payroll deposit savings to a single destination. The small employer who mails or delivers its federal tax deposit check and form to the local bank (or whose accountant or financial provider assists with this) would add another check and form to the same mailing or delivery.

Third, as noted, the existing convenient, low-cost on-line system for federal tax deposits would be expanded to accommodate a parallel stream of payroll deduction savings payments.

Since employers making payroll deduction savings available to their employees would not be required to make contributions or to comply with plan qualification or ERISA requirements with respect to these arrangements, the cost to employers would be minimal. They would administer and implement employee elections to participate or to opt out through their payroll systems. On occasion, employers might need to address mistakes or misunderstandings regarding employee payroll deductions and deposit directions. The time and attention required of the employer could generally be expected to be minimized through orderly communications, written or electronic, between employees and employers, facilitated by the use of standard forms that “piggyback” on the existing IRS forms such as the W-4 used by individuals to elect levels of income tax withholding.

Exemption for Small and New Employers

As discussed, the requirement to offer payroll deposit to IRAs as a substitute for sponsoring a retirement plan would not apply to the smallest firms (those with up to 10 employees) or to firms that have not been in business for at least two years. However, even small or new firms that are exempted would be encouraged to offer payroll deposit through the tax credit described earlier. (In addition, a possible approach to implementation of this program would be to require payroll deposit for the first year or two only by non-plan sponsors that are

above a slightly larger size. This would try out the new system and could identify any "bugs" or potential improvements before broader implementation.)

Employees of small employers that are exempted—like other individuals who do not work for an employer that is part of the payroll deposit system outlined here—would be able to use other mechanisms to facilitate saving. These include the ability to contribute by instructing the IRS to make a direct deposit of a portion of an income tax refund, by setting up an automatic debit arrangement for IRA contributions (perhaps with the help of a professional or trade association), and by other means discussed below.

Employee Participation

Like a 401(k) contribution, the amount elected by the employee as a salary reduction contribution generally would be tax-favored. It either would be a "pre-tax" contribution to a traditional, tax-deductible IRA—deducted or excluded from the employee's gross income for tax purposes—or a contribution to a Roth IRA, which instead receives tax-favored treatment upon distribution. An employee who did not qualify to make a deductible IRA contribution or a Roth IRA contribution (for example, because of income that exceeds the applicable income eligibility thresholds), would be responsible for making the appropriate adjustment on the employee's tax return. The statute would specify which type of IRA is the default, and the firm would have no responsibility for ensuring that employees satisfied the applicable IRA requirements.

It is often argued that a Roth IRA is the preferred alternative for lower-income individuals on the theory that their marginal income tax rates are likely to increase as they become more successful economically. The argument is often made also that a Roth is preferable for many others on the assumption that federal budget deficits will cause income tax rates to rise in the future. On either of those assumptions, all other things being equal, the Roth's tax advantage for payouts would likely be more valuable than the traditional IRA's tax deduction for contributions. In addition, the Roth, by producing less taxable income in retirement years, could avoid exposing the individual to a higher rate of income-related tax on social security benefits in retirement.

This point of view, however, may well overstate the probability that our tax system, including the federal income tax, social security taxes, and the tax treatment of the Roth IRA, will continue essentially as it is. If, instead of increasing marginal tax rates, we moved to a consumption or value added tax or another system that exempts savings or retirement savings from tax – or if a future Congress eliminated or limited the Roth income tax (and social security benefits tax) advantages -- the choice of a Roth over a deductible IRA would entail giving up the proverbial bird in the hand for two in the bush.

Because the automatic IRA proposal would encourage but not require individuals to save, the associated incentives for saving are important. The instant gratification taxpayers can obtain from a deductible IRA might do more to motivate many households than the government's long-term promise of an uncertain tax benefit in an uncertain future. (In addition, by shifting the loss of tax revenues beyond the congressional budget "window" period, the Roth also presents a special challenge to a policy of fiscal responsibility.) Accordingly, we are inclined to make the traditional IRA the default but to allow individuals to elect payroll deposits to a Roth.

Employees Covered

Employees eligible for payroll deposit savings might be, for example, employees who have worked for the employer on a regular basis (including part-time) for a specified period of time and whose employment there is expected to continue. Employers would not be required, however, to offer direct deposit savings to employees they already cover under a retirement plan, including employees eligible to contribute (whether or not they actually do so) to a 401(k)-type salary-reduction arrangement. Accordingly, as discussed, an employer that limits retirement plan coverage to a portion of its workforce generally would be required to offer direct deposit or other payroll deduction saving to the rest of the workforce.

The Automatic IRA

Obstacles to Participation

Even if employers were required to offer direct deposit to IRAs, various impediments would prevent many eligible employees from taking advantage of the opportunity. To save in an IRA, individuals must make a variety of decisions and must overcome inertia. At least five key questions are involved in the process for employees:

a) whether to participate at all;

b) where (with which financial institution) to open an IRA (or, if they have an IRA already, whether to use it or open a new one);

c) whether the IRA should be a traditional or Roth IRA;

d) how much to contribute to the IRA; and

e) how to invest the IRA.

Once these decisions have been made, the individual must still take the initiative to fill out the requisite paperwork (whether on paper or electronically) to

participate. Even in 401(k) plans, where decisions (b) and, unless the plan offers a Roth 401(k) option, (c) are not required, millions of employees are deterred from participating because of the other three decisions or because they simply do not get around to enrolling in the plan.

Overcoming the Obstacles to Participation: Encouraging Automatic Enrollment

These obstacles can be overcome by making participation easier and more automatic, in much the same way as is being done increasingly in the 401(k) universe. An employee eligible to participate in a 401(k) plan automatically has a savings vehicle ready to receive the employee's contributions (the plan sponsor sets up an account in the plan for each participating employee) and benefits from a powerful automatic savings mechanism in the form of regular payroll deduction. With payroll deduction as the method of saving, deposits continue to occur automatically and regularly—without the need for any action by the employee—once the employee has elected to participate. And finally, to jump-start that initial election to participate, an increasing percentage of 401(k) plan sponsors are using "automatic enrollment."[9]

Auto enrollment tends to work most effectively when it is followed by gradual escalation of the initial contribution rate. The automatic contribution rate can increase either on a regular, scheduled basis, such as 4 percent in the first year, 5 percent in the second year, etc., or in coordination with future pay raises.[10] But if the default mode is participation in the plan (as it is under auto enrollment), employees no longer need to overcome inertia and take the initiative in order to save; saving happens automatically, even if employees take no action.

Employers offering payroll deposit saving to an IRA should be explicitly permitted to arrange for appropriate automatic increases in the automatic IRA contribution rate. However, an employer facilitating saving in an automatic IRA has far less of an incentive to use automatic escalation (or to set the initial automatic contribution rate as high as it thinks employees will accept) than an employer sponsoring a 401(k) plan. The 401(k) sponsor generally has a financial incentive to encourage nonhighly compensated employees to contribute as much as possible, because their average contribution level determines how much highly compensated employees can contribute under the 401(k) nondiscrimination standards. Because no nondiscrimination standards apply to IRAs, employers have no comparable incentive to maximize participation and contributions to IRAs.

Automatic enrollment, which has typically been applied to newly hired employees (as opposed to both new hires and employees who have been with the employer for some years), has produced dramatic increases in 401(k) participation.[11] This is especially true in the case of lower-income and minority employees. In view of the basic similarities between employee payroll-deduction

saving in a 401(k) and under a direct deposit IRA arrangement, the law should, at a minimum, permit employers to automatically enroll employees in direct deposit IRAs.[12]

The conditions imposed by the Treasury Department on 401(k) auto enrollment would apply to direct or payroll deposit IRA auto enrollment as well: all potentially auto enrolled employees must receive advance written notice (and annual notice) regarding the terms and conditions of the saving opportunity and the auto enrollment, including the procedure for opting out, and all employees must be able to opt out at any time.

It is not at all clear, however, whether simply *allowing* employers to use auto enrollment with direct deposit IRAs will prove to be effective. A key motivation for using auto enrollment in 401(k) plans is to improve the plan's score under the 401(k) nondiscrimination test by encouraging more moderate- and lower-paid ("nonhighly compensated") employees to participate, which in turn increases the permissible level of tax-preferred contributions for highly compensated employees. This motivation is absent when the employer is merely providing direct deposit IRAs, rather than sponsoring a qualified plan such as a 401(k), because no nondiscrimination standards apply unless there is a plan.

A second major motivation for using 401(k) auto enrollment in many companies is management's sense of responsibility or concern for employees and their retirement security. Many executives involved in managing employee plans and benefits have opted for auto enrollment because they believe far too many employees are saving too little and investing unwisely and need a strong push to "do the right thing" and take advantage of the 401(k) plan. This motivation—by no means present in all employers—is especially unlikely to be driving an employer that merely permits payroll deposit to IRAs without sponsoring a retirement plan.

Third, employers might have greater concern about potential employee reaction to auto enrollment in the absence of an employer matching contribution. The high return on employees' investment delivered by the typical 401(k) match helps give confidence to 401(k) sponsors using auto enrollment that they are doing right by their employees and need not worry unduly about potential complaints from workers who failed to read the notice.

Finally, an employer concern that has made some plan sponsors hesitate to use auto enrollment with 401(k) plans might loom larger in the case of auto enrollment with direct deposit IRAs. This is the concern about avoiding a possible violation of state laws that prohibit deductions from employee paychecks without the employee's advance written authorization. Assuming most direct deposit IRA arrangements are not employer plans governed by ERISA, such state laws, as they apply to automatic IRAs, may not be preempted by ERISA because they do not "relate to any employee benefit plan." For reasons such as these, without a

meaningful change in the law, most employers that are unwilling to offer a qualified plan today are unlikely to take the initiative to automatically enroll employees in direct deposit IRAs.[13]

Not Requiring Employers to Use Automatic Enrollment

One possible response would be to require employers to use automatic enrollment in conjunction with the direct deposit IRAs (while giving the employers a tax credit and legal protections). The argument for such a requirement would be that it would likely increase participation dramatically while preserving employee choice (workers could always opt out), and that, for the reasons summarized above, employers that do not provide a qualified plan (or a match) are unlikely to use auto enrollment voluntarily. The arguments against such a requirement include the concern that a workforce that presumably has not shown sufficient demand for a qualified retirement plan to induce the employer to offer one might react unfavorably to being automatically enrolled in direct deposit savings without a matching contribution. (In addition, some small business owners who have only a few employees and work with all of them on a daily basis might take the view that automatic enrollment is unnecessary because of the constant flow of communication between the owner and each employee.)

It is noteworthy, however, that recent public opinion polling shows strong support among registered voters for making saving easier by making it automatic, with 71 percent of respondents favoring a fully automatic 401(k), including automatic enrollment, automatic investment, and automatic contribution increases over time, with the opportunity to opt out at any stage.[14] A vast majority (85 percent) of voters said that if they were automatically enrolled in a 401(k), they would not opt out, even when given the opportunity to do so. In addition, given the choice, 59 percent of respondents preferred a workplace IRA with automatic enrollment to one without.

Requiring Explicit "Up or Down" Employee Elections While Encouraging Auto Enrollment

An alternative approach that has been used in 401(k) plans and might be particularly well suited to payroll deposit savings is to require all eligible employees to submit an election that explicitly either accepts or declines direct deposit to an IRA. Instead of treating employees who fail to respond as either excluded or included, this "up or down" election approach has no default. There is evidence suggesting that requiring employees to elect one way or the other can raise 401(k) participation nearly as much as auto enrollment does. Requiring an explicit election picks up many who would otherwise fail to participate because they do not complete and return the enrollment form due to procrastination, inertia, inability to decide on investments or level of contribution, and the like.[15]

Accordingly, a possible strategy for increasing participation in payroll deposit IRAs would be to require employers to obtain a written (including electronic) "up or down" election from each eligible employee either accepting or declining the direct deposit to an IRA. Under this strategy, employers that voluntarily auto enroll their employees in the direct deposit IRAs would be excused from the requirement that they obtain an explicit election from each employee because all employees who fail to elect would be participating. This exemption—treating an employer's use of auto enrollment as an alternative means of satisfying its required-election obligation—would add an incentive for employers to use auto enrollment without requiring them to use it. Any firms that prefer not to use auto enrollment would simply obtain a completed election from each employee, either electronically or on a paper form. And either way—whether the employer chose to use auto enrollment or the required-election approach—participation would likely increase significantly, perhaps even approaching the level that might be achieved if auto enrollment were required for all payroll deposit IRAs.

This combined strategy for promoting payroll deposit IRA participation could be applied separately to new hires and existing employees: thus, an employer auto enrolling new hires would be exempted from obtaining completed elections from all new hires (but not from existing employees), while an employer auto enrolling both new hires and existing employees would be excused from having to obtain elections from both new hires and existing employees.

The required election would not obligate employers to obtain a new election from each employee every year. Once an employee submitted an election form, that employee would not be required to make another election: as in most 401(k) plans, the initial election would continue throughout the year and from year to year unless and until the employee chose to change it. Similarly, an employee who failed to submit an election form and was auto enrolled by default in the payroll deposit IRA would continue to be auto enrolled unless and until the employee took action to make an explicit election.

To maximize participation, employers would receive a standard enrollment module reflecting current best practices in enrollment procedures. A nationwide website with standard forms would serve as a repository of state-of-the-art best practices in and savings education. The use of automatic enrollment (whereby employees automatically are enrolled at a statutorily specified rate of contribution – such as 3% of pay -- unless they opt out) would be encouraged in two ways. First, the standard materials provided to employers would be framed so as to present auto enrollment as the presumptive or perhaps even the default enrollment method, although employers would be easily able to opt out in favor of simply obtaining an "up or down" response from all employees. In effect, such a "double default" approach would use the same principle at both the employer and employee level by auto enrolling employers into auto enrolling employees.

Second, as noted, employers using auto enrollment to promote participation would not need to obtain responses from unresponsive employees.

Compliance and Enforcement

Employers' use of the required-election approach would also help solve an additional problem—enforcing compliance with a requirement that employers offer direct deposit savings. As a practical matter, many employers might question whether the IRS would ever really be able to monitor and enforce such a requirement. Employers may believe that, if the IRS asked an employer why none of its employees used direct deposit IRAs, the employer could respond that it told its employees about this option and they simply were not interested. However, if employers that were required to offer direct deposit savings had to obtain a signed election from each eligible employee who declined the payroll deposit option, employers would know that the IRS could audit their files for each employee's election. This by itself would likely improve compliance.

In fact, a single paper or e-mail notice could advise the employee of the opportunity to engage in payroll deduction savings and elicit the employee's response. The notice and the employee's election might be added or attached to IRS Form W-4. (As noted, the W-4 is the form an employer ordinarily obtains from new hires and often from other employees to help the employer comply with its income tax–withholding obligations.) If the employer chose to use auto enrollment, the notice would also inform employees of that feature (including the default contribution level and investment and the procedure for opting out), and the employer's records would need to show that employees who failed to submit an election were in fact participating in the payroll deduction savings.

Employers would be required to certify annually to the IRS that they were in compliance with the payroll deposit savings requirements. This might be done in conjunction with the existing IRS Form W-3 that employers file annually to transmit Forms W-2 to the government. Failure to offer payroll deposit savings would ultimately need to be backed up by an appropriate sanction, such as the threat of civil monetary penalties or an excise tax.

Portability of Savings

IRAs are inherently portable. Unlike a 401(k) or other employer plan, an IRA survives and functions independently of the individual saver's employment status. Thus the IRA owner is not at risk of forfeiting or losing the account or suffering an interruption in the ability to contribute when changing or losing employment. As a broad generalization, the automatic IRAs outlined here presumably would be freely transferable to and with other IRAs and qualified plans that permit such transfers. (However, as discussed below, the investment limitations and other cost-containment features of these IRAs raise the issue of

whether transferability to other types of vehicles should be subject to restrictions.)

Making a Savings Vehicle Available

Most current direct deposit arrangements use a payroll-deduction savings mechanism similar to the 401(k), but, unlike the 401(k), do not give the employee a ready-made vehicle or account to receive deposits. The employee must open a recipient account and must identify the account to the employer. However, where the purpose of the direct deposit is saving, it would be useful to many individuals who would rather not choose a specific IRA to have a ready-made fallback or default account available for the deposits.

Under this approach, modeled after the SIMPLE-IRA, which currently covers an estimated 2 million employees, individuals who wish to direct their contributions to a specific IRA would do so. The employer would follow these directions as employers ordinarily do when they make direct deposits of paychecks to accounts specified by employees. At the same time, the employer would also have the option of simplifying its task by remitting all employee contributions in the first instance to IRAs at a single private financial institution that the employer designates.[16] However, even in this case, employees would be able to transfer the contributions, without cost, from the employer's designated financial institution to an IRA provider chosen by the employee.

By designating a single IRA provider to receive all contributions, the employer could avoid the potential administrative hassles of directing deposits to a multitude of different IRAs for different employees, while employees would be free to transfer their contributions from the employer's designated institution to an IRA provider of their own choosing. Even this approach, though, still places a burden on either the employer or the employee to choose an IRA. For many small businesses, the choice might not be obvious or simple. In addition, the market may not be very robust because at least some of the major financial institutions that provide IRAs may well not be interested in selling new accounts that seem unlikely to grow enough to be profitable within a reasonable time. Some of the major financial firms appear to be motivated at least as much by a desire to maximize the average account balance as by the goal of maximizing aggregate assets under management. They therefore may shun small accounts that seem to lack much potential for rapid growth.

The current experience with automatic rollover IRAs is a case in point. Firms are required to establish these IRAs as a default vehicle for qualified plan participants whose employment terminates with an account balance of not more than $5,000 and who fail to provide any direction regarding rollover or other payout. The objective is to reduce leakage of benefits from the tax-favored retirement system by stopping involuntary cashouts of account balances between $1,000 and $5,000. (Plan sponsors continue to have the option to cash out

balances of up to $1,000 and to retain in the plan account balances between $1,000 and $5,000 instead of rolling them over to an IRA.) Because plan sponsors are required to set up IRAs only for "unresponsive" participants—those who fail to give instructions as to the disposition of their benefits—these IRAs are presumed to be less likely than other IRAs are to attract additional contributions. Accordingly, significant segments of the IRA provider industry have not been eager to cater to this segment of the market. As a result, plan sponsors have tended to reduce their cashout level from $5,000 to $1,000 so that new IRAs would not have to be established.

For somewhat similar reasons, IRA providers might expect payroll deposit IRAs to be less profitable than other products. As a result, employers and employees might well find that providers are not marketing to them aggressively and that the array of payroll deposit IRA choices is comparatively limited.

The prospect of tens of millions of personal retirement accounts with relatively small balances likely to grow relatively slowly suggests that the market may need to be encouraged to develop widely available low-cost personal accounts or IRAs. Otherwise, for "small savers," fixed-cost investment management and administrative fees may consume too much of the earnings on the account and potentially even erode principal.[17]

A Standard Default Account

Accordingly, to facilitate saving and minimize costs, we believe that a strong case can be made for a default IRA that would be automatically available to receive direct deposit contributions without requiring either the employee or employer to choose among IRA providers and without requiring the employee to take the initiative to open an IRA. Under this approach, for the convenience of both employees and employers, those who wish to save but have no time or taste for the process of locating and choosing an IRA would be able to use a standard default, or automatic, account. If neither the employer nor the employee designated a specific IRA provider, the contributions would go to a personal retirement account within a plan that would in some respects resemble the federal Thrift Savings Plan (the 401(k)-type retirement savings plan that covers federal government employees).

These standard default accounts would be maintained and operated by private financial institutions under contract with the federal government. To the fullest extent practicable, the private sector would provide the investment funds, investment management, record keeping, and related administrative services. To serve as a default account for direct deposits that have not been directed elsewhere by employers or employees, an account need not be maintained by a governmental entity. Given sufficient quality control and adherence to reasonably uniform standards, various private financial institutions could contract to provide the default accounts, on a collective or individual institution basis, more or less

interchangeably—perhaps allocating customers on a geographic basis or in accordance with other arrangements based on providers' capacity. These fund managers could be selected through competitive bidding. Once individual default accounts reached a predetermined balance (e.g., $15,000) sufficient to make them potentially profitable for many private IRA providers, account owners would have the option to transfer them to IRAs of their choosing.

Cost Containment

Both the direct deposit IRAs expressly selected by employees and employers and the standardized direct deposit IRAs that serve as default vehicles would be designed to minimize the costs of investment management and account administration. It should be feasible to realize substantial cost savings through index funds, economies of scale in asset management and administration, uniformity, and electronic technologies.

In accordance with statutory guidelines for all direct deposit IRAs, government contract specifications would call for a no-frills approach to participant services in the interest of minimizing costs. By contrast to the wide-open investment options provided in most current IRAs and the high (and costlier) level of customer service provided in many 401(k) plans, the standard account would provide only a few investment options (patterned after the Thrift Savings Plan, if not more limited), would permit individuals to change their investments only once or twice a year, and would emphasize transparency of investment and other fees and other expenses.[18]

Specifically, costs of direct deposit IRAs might be reduced by federal standards that, to the extent possible,

- Exclude brokerage services and retail equity funds from the investment options available under the IRA.
- Limit the number of investment options under the IRA.
- Allow individuals to change their investments only once or twice per year.
- Specify a low-cost default investment option and provide that, if any of an individual's account balance is invested in the default option, all of it must be.
- Prohibit loans (IRAs do not allow them in any event) and perhaps limit pre-retirement withdrawals.
- Limit access to customer service call centers.
- Preclude commissions.

- Make compliance testing unnecessary.

- Give account owners only a single account statement per year (especially if daily valuation is built into the system and is available to account owners).

- Encourage the use of electronic and other new technologies (including enrollment on a web site) for fund transfers, record keeping, and communications among IRA providers, participating employees, and employers to reduce paperwork and cost. Electronic administration has considerable potential to cut costs.

The availability to savers of a major low-cost personal account alternative in the form of the standard account may even help, through market competition, to drive down the costs and fees of IRAs offered separately by private financial institutions. Through efficiencies associated with collective investment and greater uniformity, the standard account should help move the system away from the retail-type cost structure characteristic of current IRAs. It should also help create a broad infrastructure of individual savings accounts that would cover most of the working population.[19]

In conjunction with these steps, Congress and the regulators may be able to do more to require simplified, uniform disclosure and description of IRA investment and administrative fees and charges (building on previous work by the Department of Labor relating to 401(k) fees). Such disclosure should help consumers compare costs and thereby promote healthy price competition.

Another approach would begin by recognizing the trade-off between asset management costs and investment types. As a broad generalization, asset management charges tend to be low for money market funds, certificates of deposit, and certain other relatively low-risk, lower-return investments that generally do not require active management. However, it appears that limiting individual accounts to these types of investments would be unnecessarily restrictive. As discussed below (under "Default Investment Fund"), passively-managed index funds, such as those used in the Thrift Savings Plan, are also relatively inexpensive.[20]

A very different approach to cost containment would be to impose a statutory or regulatory limitation on investment management and administrative fees that providers could charge. One example is the United Kingdom's limit on permissible charges for management of "stakeholder pension" accounts—an annual 150 basis point fee cap for five years that is scheduled to drop to 100 basis points thereafter. [21] As another and more limited example, the U.S. Department of Labor has imposed a kind of limitation on fees charged by providers of automatic rollover IRAs established by employers for terminating

employees who fail to provide any direction regarding the disposition of account balances of up to $5,000. Labor regulations provide a fiduciary safe harbor for auto rollover IRAs that preserve principal and that do not charge fees greater than those charged by the IRA provider for other IRAs it provides.

Presumably, a mandatory limit would give rise to potential cross-subsidies from products that are free of any limit on fees to the IRAs that are subject to the fee limit -- a result that could be viewed either as an inappropriate distortion or as a necessary and appropriate allocation of resources. We would view a mandatory limit as a last resort, preferring the market-based strategies outlined above.

Default Investment Fund

Both the IRAs offered independently by private financial institutions and explicitly selected by employees or employers and the default IRAs would serve the important purpose of providing low-cost professional asset management to millions of individual savers, presumably improving their aggregate investment results. To that end, all of these accounts would offer a similar, limited set of investment options, including a default investment fund in which deposits would automatically be invested unless the individual chose otherwise. This default investment would be a highly diversified "target asset allocation" or "life-cycle" fund comprised of a mix of equities and fixed income or stable value investments, and probably relying heavily on index funds. (The life-cycle funds recently introduced into the federal Thrift Savings Plan are one possible model.) A portion or all of the fixed income component could be comprised of Treasury inflation protected securities ("TIPS") to protect against the risk of inflation.

The mix of equities and fixed income would be intended to reflect the consensus of most personal investment advisers, which emphasizes sound asset allocation and diversification of investments—including exposure to equities (and perhaps other assets that have higher-risk and higher-return characteristics), at least given the foundation of retirement income already delivered through Social Security and assuming the funds will not shortly be needed for expenses. The use of index funds would avoid the costs of active investment management while promoting wide diversification.[22]

This default investment would actually consist of several different funds, depending on the individual's age, with the more conservative investments (such as those relying more heavily on TIPS) applicable to older individuals who are closer to the time when they might need to use the funds. Individuals who selected the default fund or were defaulted into it would have their account balances entirely invested in that fund. However, they would be free to exit the fund at specified times and opt for a different investment option among those offered within the IRA.

The standard automatic (default) investment would also serve two other key purposes. It would encourage employee participation in direct deposit savings by enabling employees who are satisfied with the default to simplify what may be the most difficult decision they would otherwise be required to make as a condition of participation (i.e., how to invest). Finally, the standard default investment should encourage more employers to use automatic enrollment (thereby boosting employee participation) by saving them from having to choose a default investment. This, in turn, would make it easier to protect employers from responsibility for IRA investments, especially employers using automatic enrollment (as discussed below).

We would not fully specify the default investment by statute. It is desirable to maintain a degree of flexibility in order to reflect a consensus of expert financial advice over time. Accordingly, general statutory guidelines would be fleshed out at the administrative level after regular comment by and consultation with private-sector investment experts.

An additional and major design issue is whether the standard, limited set of investment options for payroll deposit IRAs should be only a minimum set of options in each IRA, so that the IRA provider would be permitted to provide any additional options it wished. Limiting the IRAs to these specified options would best serve the purposes of containing costs, improving investment results for IRA owners in the aggregate, and simplifying individuals' investment choices. At the same time, such restrictions would constrain the market, potentially limit innovation, and limit choice for individuals who prefer other alternatives.

One of the ways to resolve this tradeoff would be to limit direct deposit IRAs to the prescribed array of investment options without imposing any comparable limits on other IRAs, and to allow owners of direct deposit IRAs (including default IRAs) to transfer or roll over their account balances between the two classes of accounts. Under this approach, the owner of a direct deposit IRA could transfer the account balance to other (unrestricted) IRAs that are willing to accept such transfers (but perhaps only after the account balance reaches a specified amount that would no longer be unprofitable to most IRA providers). While such a transfer to an unrestricted IRA would deprive the owner of the cost-saving advantages of the no-frills, limited-choice model, such a system would still enable individuals to retain the efficiencies and cost protection associated with the standard low-cost model if they so choose.[23]

Employers Protected from any Risk of Fiduciary Liability

Employers traditionally have been particularly concerned about the risk of fiduciary liability associated with their selection of retirement plan investments. This concern extends to the employer's designation of default investments that employees are free to decline in favor of alternative investments. In the IRA universe, employers transferring funds to automatic rollover IRAs and employer-

sponsored SIMPLE-IRAs retain a measure of fiduciary responsibility for initial investments.

By contrast, under our proposal, employers making direct deposits would be insulated from such potential liability. These employers would have no liability or fiduciary responsibility with respect to the manner in which direct deposits are invested in default IRAs or in nondefault IRAs (whether selected by the employer or the employee), nor would employers be exposed to potential liability with respect to any employee's choice of IRA provider or type of IRA. This protection of employers is facilitated by statutory designation of standard investment types that reduces the need for continuous professional investment advice. To protect workers against inappropriate IRA providers or inappropriate employer selection of IRA providers while continuing to insulate employers from fiduciary responsibility, employers could be precluded from imposing a particular IRA provider on its employees other than the government-contracted default IRA or could be constrained to choose among an approved list of providers based on capital adequacy, soundness, and other criteria.

Public Opinion Polling

Recent public opinion polling has shown overwhelming support for payroll-deduction direct deposit saving. Among registered voters surveyed, 83 percent of respondents said they would be agreeable to having their employer offer to sign them up for an IRA and allow them to contribute to it through direct deposit of a small amount from their paycheck to help them save for retirement. Similarly, 79 percent of registered voters expressed support (and 54 percent expressed "strong" support) for giving taxpayers the option to have part of their income tax refund deposited into a retirement savings account such as an IRA by just checking a box on their tax return.

In addition, the polling shows very strong support for a requirement that goes far beyond our proposal, that every company offer its employees some kind of retirement plan—such as a pension or 401(k), or at least an IRA to which employees could contribute. Among registered voters surveyed in August 2005, 77 percent supported such a requirement (and 59 percent responded that they were "strongly" in support).[24] As discussed, the approach described in this paper would not require employers to offer their employees retirement plans, but would give firms a financial incentive to offer their employees access to payroll deduction as a convenient and easy means of saving, and would require firms above a certain size and maturity to extend this offer to their employees.

The Importance of Protecting Employer Plans

Employer-sponsored pension, profit-sharing, 401(k), and other plans can be particularly effective – more so than IRAs -- in accumulating benefits for employees. As noted earlier, the participation rate in 401(k)s, for example, tends

to range from two thirds to three quarters of eligible employees, in contrast to IRAs, in which fewer than 1 in 10 eligible individuals participates. Employer plans tend to be far more effective than IRAs at providing coverage because of a number of attributes: for one thing, pension and profit-sharing plans, for example, are funded by employer contributions that automatically are made for the benefit of eligible employees without requiring the employee to take any initiative in order to participate. Second, essentially all tax-qualified employer plans must abide by standards that either seek to require reasonably proportionate coverage of rank-and-file workers or give the employer a distinct incentive to encourage widespread participation by employees. This encouragement typically takes the form of both employer-provided retirement savings education efforts and employer matching contributions. The result is that the naturally eager savers, who tend to be in the higher tax brackets, tend to subsidize or bring along the naturally reluctant savers, who often are in the lowest (including zero) tax brackets.

Employer-sponsored retirement plans also have other features that tend to make them effective in providing or promoting coverage. As noted, the proposal outlined here seeks to transplant some of these features to the IRA universe. These include the automatic availability of a saving vehicle, the use of payroll deduction (which continues automatically once initiated), matching contributions (further discussed below), professional investment management, and peer group reinforcement of saving behavior.

The automatic IRA must thus be designed carefully to avoid competing with or crowding out employer plans and to avoid encouraging firms to drop or reduce the employer contributions that many make to plan participants. Owners and others who control the decision whether to adopt or continue maintaining a retirement plan for employees should continue to have incentives to sponsor such plans. The ability to offer employees direct deposit to IRAs should be designed so that it will not prompt employers to drop, curtail, or refrain from adopting retirement plans.

Probably the single most important protection for employer plans is to set maximum permitted contribution levels to the automatic IRA so that they will be sufficient to meet the demand for savings by most households but not high enough to satisfy the appetite for tax-favored saving of business owners or decision-makers. The average annual contribution to a 401(k) plan by a nonhighly compensated employee is somewhat greater than $2,000, and average annual 401(k) contributions by employees generally tend to be on the order of 7 percent of pay.[25] A $3,000 contribution is 7.5 percent of pay for a family earning $40,000, and 6 percent of pay for a family earning $50,000.

Yet IRA contribution limits are already higher than these contribution levels. IRAs currently allow a married couple to contribute up to $8,000 ($4,000 each) on a tax-favored basis, and an additional $1,000 ($500 each) if they are

age 50 or older. By 2008, these figures are scheduled to rise to $10,000 plus $2,000 ($1,000 each) for those age 50 or older. These amounts—the current $9,000 a year for those age 50 and over ($8,000 for others) and the post-2007 $12,000 annual amount for those age 50 and over ($10,000 for others)—may well be enough to satisfy the desire of many small-business owners for tax-favored retirement savings. Even some small-business owners that might consider saving somewhat more than $10,000 or $12,000 per year might well conclude that they are better off not incurring the cost of making contributions and providing a plan for their employees because the net benefit to them of having a plan for employees is not greater than the net benefit of simply saving through IRAs and giving their employees access to IRAs.

Accordingly, at the most, payroll deposit IRAs should not permit contributions above the current IRA dollar limits, and could be limited to a lower amount such as $3,000. (A 3% of pay contribution would remain below $3,000 for employees whose compensation did not exceed $100,000.) Imposing a lower limit on the payroll deduction IRA would reduce to some degree the risk that employees will exceed the maximum IRA dollar contribution limit because of auto enrollment, combined with possible other contributions to an IRA.[26] That is already a risk under current law, but the automatic nature of auto enrollment increases the risk, especially if auto escalation is implemented. There is a tradeoff between the desirability of limiting the contribution amount (to mitigate both this risk and the risk of competing with employer plans) and the simplicity of using an existing vehicle (the IRA) "as is".

In any event, the employee – not the employer – would be responsible for monitoring any of all of their IRA contributions to comply with the maximum limit (in part because employees can contribute on their own and through multiple employers). The ultimate reconciliation would be made by the individual when filing the federal income tax return.

In addition, the automatic IRA should be designed to avoid reducing ordinary employees' incentives to contribute to employer-sponsored plans such as 401(k)s. If workers perceive a program such as direct deposit savings to IRAs as a more attractive destination for their contributions than an employer-sponsored plan (for example, because of better matching, tax treatment, investment options, or liquidity), it could unfortunately divert employee contributions from employer plans. This in turn could have a destabilizing effect by making it difficult for employers to meet the nondiscrimination standards applicable to 401(k)s and other plans and therefore potentially discouraging employers from continuing the plans or their contributions. While a detailed discussion of these points is beyond the scope of this paper, it is important to maintain a relationship between IRAs and employer-sponsored retirement plans that preserves and protects the employer plans.

Automatic Payroll Deduction Can Promote Marketing and Adoption of Employer Plans

Our approach is designed not only to avoid causing any reduction or contraction of employer plans, but actually to promote expansion of employer plans. Consultants, third-party administrators, financial institutions, and other plan providers could be expected to view this proposal as providing a valuable new opportunity to market 401(k)s, SIMPLE-IRAs and other tax-favored retirement plans to employers. Firms that, under this proposal, were about to begin offering their employees payroll deduction saving or had been offering their employees payroll deduction saving for a year or two could be encouraged to "trade up" to an actual plan such as a 401(k) or SIMPLE-IRA.

Especially because these plans can now be purchased at very low cost, it would seem natural for many small businesses to graduate from payroll deduction savings and complete the journey to a qualified plan in order to obtain the added benefits in terms of recruitment, employee relations, and larger tax-favored saving opportunities for owners and managers.

The following compares the maximum annual tax-favored contribution levels for IRAs, SIMPLE-IRA plans and 401(k) plans in effect for 2006:

	IRA	SIMPLE-IRA	401(k)
Under age 50	$4,000 per spouse ($5,000 after 2007)	$10,000	$15,000
Age 50 and above	$4,500 per spouse ($6,000 after 2007)	$12,000	$20,000

In addition, as noted, small employers that adopt a new plan for the first time are entitled to a tax credit of up to $500 each year for three years. As discussed, the proposed tax credit for offering payroll deposit would be smaller, so as to maintain the incentive for employers to go beyond the payroll deduction or direct deposit IRA and adopt an actual plan such as a SIMPLE, 401(k), or other employer plan.

Encouraging Contributions by Nonemployees

The payroll deposit system outlined thus far would not automatically cover self-employed individuals, employees of the smallest or newest businesses that are exempt from any payroll deposit obligation, or certain unemployed individuals who can save. A strategy centered on automatic arrangements can also make it easier for these people to contribute to IRAs.

Encouraging Automatic Debit Arrangements

For individuals who are not employees or who otherwise lack access to payroll deduction, automatic debit arrangements can serve as a counterpart to automatic payroll deduction. Automatic debit enables individuals to spread payments out over time and to make payments on a regular and timely basis by having them automatically charged to and deducted from an account—such as a checking or savings account or credit card—at regular intervals on a set schedule. The individual generally gives advance authorization to the payer that manages the account or the recipient of the payment, or both. The key is that, as in the case of payroll deduction, once the initial authorization has been given, regular payments continue without requiring further initiative on the part of the individual. For many consumers, automatic debit is a convenient way to pay bills or make payments on mortgages or other loans without having to remember to make each payment when due and without having to write and mail checks.

Similarly, as an element of an automatic IRA strategy, automatic debit can facilitate saving while reducing paperwork and cutting costs. For example, households can be encouraged to sign up on-line for regular automatic debits to a checking account or credit card that are directed to an IRA or other saving vehicle. With on-line sign-up and monitoring, steps can be taken to familiarize more households with automatic debit arrangements and, via Internet websites and otherwise, to make those arrangements easier to set up and use as a mechanism for saving in IRAs.

Facilitating Automatic Debit IRAs Through Professional or Trade Associations

Professional and trade associations could facilitate the establishment of IRAs and the use of automatic debit and direct deposit to the IRAs. Independent contractors and other individuals who do not have an employer often belong to such an association. The association, for example, might be able to make saving easier for those members who wish to save by making available convenient arrangements for automatic debit of members' accounts. Association websites can make it easy for members to sign up on line, monitor the automatic debit savings, and make changes promptly when they wish to. Although such associations generally lack the payroll-deduction mechanism that is available to employers, they can help their members set up a pipeline involving regular automatic deposits (online or by traditional means) from their personal bank or other financial accounts to an IRA established for them.

Facilitating Direct Deposit of Income Tax Refunds to IRAs

Another major element of a strategy to encourage contributions outside of employment would be to allow taxpayers to deposit a portion of their income tax refunds directly into an IRA by simply checking a box on their tax returns.[27]

Currently, the IRS allows direct deposits of refunds to be made to only one account. This all-or-nothing approach discourages many households from saving any of the refund because at least a portion of the refund is often needed for immediate expenses. Allowing households instead to split their refunds to deposit a portion directly into an IRA could make saving simpler and, thus, more likely.

The Bush administration has supported divisible refunds in its last three budget documents; however, the necessary administrative changes have yet to be implemented. Since federal income tax refunds total nearly $230 billion a year (more than twice the estimated annual aggregate amount of net personal savings in the United States), even a modest increase in the proportion of refunds saved every year could bring about a significant increase in savings.

Extending Direct Deposit to Independent Contractors

Millions of Americans are self-employed as independent contractors. Many of these workers receive regular payments from firms, but because they are not employees, they are not subject to income tax or payroll tax withholding. These individuals might be included in the direct deposit system by giving them the right to request that the firm receiving their services direct deposit into an IRA a specified portion from the compensation that would otherwise be paid to them.

Compared to writing a large check to an IRA once a year, this approach has several potential advantages to independent contractors, which might well encourage them to save. These include the ability to commit themselves to save a portion of their compensation before they receive it (which, for some people, makes the decision to defer consumption easier); the ability to avoid having to make an affirmative choice among various IRA providers; remittance of the funds by the firm by direct deposit to the IRA; and, where payments are made to the independent contractor on a regular basis, an arrangement that, like regular payroll withholdings for employees, automatically continues the pattern of saving through repeated automatic payroll deductions unless and until the individual elects to change.

In many cases, the independent service provider will not have a sufficient connection to a firm that receives the services, or both the independent contractor and the firm will be unwilling to enter into a payroll deposit type of arrangement. In such instances, the independent contractor could contribute to an IRA using automatic debit (as discussed above) or by sending together with the estimated taxes that generally are due four times a year.

Matching Deposits as a Financial Incentive

A powerful financial incentive for direct deposit saving by those who are not in the higher tax brackets (and who therefore derive little benefit from a tax deduction or exclusion) would be a matching deposit to their direct deposit IRA.

One means of delivering such a matching deposit would be via the bank, mutual fund, insurance carrier, brokerage firm, or other financial institution that provides the direct deposit IRA. For example, the first $500 contributed to an IRA by an individual who is eligible to make deductible contributions to an IRA might be matched by the private IRA provider on a dollar-for-dollar basis, and the next $1,000 of contributions might be matched at the rate of 50 cents on the dollar. The financial provider would be reimbursed for its matching contributions through federal income tax credits.[28]

Recent evidence from a randomized experiment involving matched contributions to IRAs suggests that a simple matching deposit to an IRA can make individuals significantly more likely to contribute and more likely to contribute larger amounts.[29]

Matching contributions—similar to those provided by most 401(k) plan sponsors—not only would help induce individuals to contribute directly from their own pay, but also, if the match were automatically deposited in the IRA, would add to the amount saved in the IRA. The use of matching deposits, however, would make it necessary to implement procedures designed to prevent gaming—contributing to induce the matching deposit, then quickly withdrawing those contributions to retain the use of those funds. Among the possible approaches would be to place matching deposits in a separate subaccount subject to tight withdrawal rules and to impose a financial penalty on early withdrawals of matched contributions.[30]

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American households have a compelling need to increase their personal saving, especially for long-term needs such as retirement. This paper proposes a strategy that would seek to make saving more automatic—hence easier, more convenient, and more likely to occur—largely by adapting to the IRA universe practices and arrangements that have proven successful in promoting 401(k) participation. In our view, the automatic IRA approach outlined here holds considerable promise of expanding retirement savings for millions of workers.

Notes

1. This testimony does not address any issues relating to Social Security reform. The proposal is intended to have no implications, one way or the other, regarding proposals to finance individual accounts using Social Security taxes or to offset Social Security benefits by individual accounts. Also outside the scope of this testimony are potential reforms to the private pension system (including employer-sponsored defined contribution and defined benefit plans).

2. This testimony is intended only to outline the proposal, not to resolve all of the specific but significant design and implementation issues that cannot readily be addressed within the limited scope of this testimony.

3. Craig Copeland, "Employer-Based Retirement Plan Participation: Geographic Differences and Trends: Employee Benefit Research Institute Issue Brief No. 286," October 2005 (referred to below as "Copeland, EBRI Issue Brief No. 286"), Figure 1, p. 7. The nonparticipants include those who are not eligible for their employer's plan as well as those who are eligible but who fail to participate. Among the subset of approximately 92 million full-time, full-year wage and salary workers between the ages of 21 and 64, 65 percent work for an employer that sponsors a plan, and 57 percent participate in an employer-sponsored plan. Id.

4. Copeland, EBRI Issue Brief No. 286, Figure 1, p. 7.

5. See, for example, Alicia H. Munnell and Annika Sunden, *Coming Up Short: The Challenge of 401(k) Plans* (Brookings Institution Press, 2004).

6. In the Conference Report to the Tax Reform Act of 1997, Congress stated that "employers that choose not to sponsor a retirement plan should be encouraged to set up a payroll deduction [IRA] system to help employees save for retirement by making payroll-deduction contributions to their IRAs" and encouraged the Secretary of the Treasury to "continue his efforts to publicize the availability of these payroll deduction IRAs" (H.R. Rep. No. 220, 105th Cong., 1st Sess. 775 [1997]).

7. Department of Labor Interpretive Bulletin 99-1 (June 18, 1999), 29 C.F.R. 2509.99-1(b); IRS Announcement 99-2.

8. Neither the IRS nor the Department of Labor guidance addressed the possible use of automatic enrollment in conjunction with direct deposit IRAs (discussed at length below).

9. William G. Gale, J. Mark Iwry, and Peter R. Orszag, "The Automatic 401(k): A Simple Way to Strengthen Retirement Savings," (The Retirement Security Project, Policy Brief No. 2005-1; available at www.retirementsecurityproject.org);

10. In 2004, the IRS affirmed that plans are permitted to increase the automatic contribution rate over time in accordance with a specified schedule or in connection with salary increases or bonuses. See letter dated March 17, 2004, from the Internal Revenue Service to J. Mark Iwry. The idea of coordinating automatic contribution increases with pay increases was developed by Richard Thaler and Shlomo Benartzi. See Thaler and Benartzi, "Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving," *Journal of Political Economy* 112, no. 1, pt.2, pp. S164-87.

11. Brigitte Madrian and Dennis Shea, "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior," *Quarterly Journal of Economics* 116, no. 4 (November 2001): 1149–87; and James Choi and others, "Defined Contribution Pensions: Plan Rules, Participant Decisions, and the Path of Least Resistance," in *Tax Policy and the Economy,* vol. 16, edited by James Poterba (Cambridge, Mass.: MIT Press, 2002), pp. 67–113. See also Sarah Holden and Jack

VanDerhei, "The Influence of Automatic Enrollment, Catch-Up, and IRA Contributions on 401(k) Accumulations at Retirement," Employee Benefit Research Institute Issue Brief No. 283 (July 2005).

12. Any such statutory provision could usefully make clear that automatic enrollment in direct deposit IRAs is permitted irrespective of any state payroll laws that prohibit deductions from employee paychecks without the employee's advance written approval. Assuming that most direct deposit IRA arrangements are not employer plans governed by ERISA, such state laws, as they apply to automatic IRAs, may not be preempted by ERISA because they do not "relate to any employee benefit plan."

13. The absence of an employer match might make some employers more willing to offer auto enrollment on direct deposit IRAs because increased participation would not come at the cost of increased employer matching contributions. On the other hand, the absence of the match tends to make participation in the plan less attractive to workers, which could exacerbate employee concerns or complaints about having been enrolled in a program that reduces their take-home pay without their explicit prior written authorization. As a result, the absence of a match might also make employers more apprehensive about possible complaints from employees who failed to read the auto enrollment notice.

14. Between August 28 and 31, 2005, in a survey commissioned by The Retirement Security Project, The Tarrance Group, in conjunction with Lake, Snell, Mermin/Decision Research, interviewed 1,000 registered voters nationwide about retirement security issues. A full report of the survey findings can be found at www.retirementsecurityproject.org.

15. James Choi, David Laibson, Brigitte Madrian, and Andrew Metrick, "Active Decisions" NBER Working Paper No. 11074 (January 2005).

16. Employers that sponsor a SIMPLE-IRA plan may deposit all employee contributions in IRAs at a single designated financial institution selected by the employer (IRS Notice 98-4, 1998-2 I.R.B. 25).

17. Considerable challenges are involved in building and implementing a workable universal saving system based on employer direct deposits of contributions to IRAs. These challenges include dealing with the contingent workforce, with employees who have multiple jobs, who work part-time, and often who earn relatively low wages, and with small employers. A somewhat different and thoughtful approach to designing such a system can be found in the evolving work of the Conversation on Coverage, a collaborative effort among individuals (including one of the authors) drawn from a diverse range of stakeholder organizations. See Conversation on Coverage, "Covering the Uncovered," Report of Working Group II (2005). For a recently published analysis by a non-partisan expert panel (including one of the authors) of the issues involved in designing arrangements for distributions from individual accounts, see National Academy of Social Insurance, *Uncharted Waters: Paying Benefits from Individual Accounts in Federal Retirement Policy* (2005). There have been various other efforts to design such systems or programs, which this testimony does not attempt to catalogue.

18. Until recently the federal Thrift Savings Plan had five investment funds: three stock index funds (S&P 500, small and midcapitalization U.S. stocks, and mostly large-capitalization foreign stocks), a bond index fund consisting of a mix of government and corporate bonds, and a fund consisting of short-term, nonmarketable U.S. Treasury securities. Effective August 1, 2005, the Plan added a set of life-cycle funds, each one of which is composed of a mix of the other five investment funds.

19. This was part of the impetus behind the 2001 statutory provision to the effect that the Secretaries of Labor and Treasury may provide, and shall give consideration to providing, special

relief with respect to the use of low-cost individual retirement plans for purposes of automatic rollovers and for other uses that promote the preservation of assets for retirement income (Economic Growth and Tax Relief Reconciliation Act of 2001, Public Law 107-16, 115 Stat. 38, Section 657[c][2][B]).

In a similar vein, one of the co-authors has proposed a strategy for States to act as a catalyst in expanding coverage under standardized, low-cost payroll-deposit IRAs, SIMPLE-IRA plans, and 401(k) plans by facilitating the pooling of small businesses to offer these vehicles. The proposal has been outlined in "Expanding Retirement Savings at the State Level," Written Statement of J. Mark Iwry to the Legislature of the State of Washington (April 2003), and is more fully described in a separate written statement by Iwry, separately submitted for the record, and scheduled to be published in the NYU Review of Employee Benefits and Executive Compensation 2006 and the BNA Tax Management Compensation Planning Journal.

20. The difference in expense between passively managed index funds and actively managed mutual funds has been estimated to be—as a broad generalization—roughly 100 basis points (1 percent) a year (William F. Sharpe, "Indexed Investing: A Prosaic Way to Beat the Average Investor" presented at the Spring President's Forum, Monterey Institute of International Studies (May 2002).

21. One of the authors has testified before Congress regarding the British retirement plan system and has been critical of the UK's attempt to impose a limit on charges. See David C. John, testimony before the Subcommittee on Social Security of the Committee on Ways and Means, U.S. House of Representatives (June 16, 2005); David C. John, "What the United States Can Learn from the UK's Pensions Commission Report" (forthcoming).

22. As noted, the federal Thrift Savings Plan consists mainly of index funds, which are the building blocks for the recently added life-cycle funds. The Thrift Savings Plan informational materials state that the life-cycle funds "provide a way to diversify your account optimally, based on professionally determined asset allocations. This provides you with the opportunity to achieve a maximum amount of return over a given period of time with a minimum amount of risk. . ." (Federal Thrift Savings Plan website, www.tsp.gov). To the extent that a professionally run "managed account" could achieve similar results at no greater cost, that might be another attractive option, and managed accounts are growing in popularity as an option in 401(k) plans. A question may be raised as to whether, managed accounts are a better fit for 401(k) plans than for automatic IRAs, because 401(k)s tend to have more substantial account balances and greater flexibility to accommodate individual preferences while allocating costs to individuals who opt for costlier alternatives.

23. The question of how best to fit the direct deposit IRAs, with their improved and simplified investment structure, into the larger IRA universe is related to a broader issue: the potential simplification of IRAs. We favor simplification and revision of the current array of IRA options. However, the specifics of any such proposals are beyond the scope of this testimony.

24. The retirement security poll referred to in note 14, above, had a margin of error of 3.1 percent. The question that elicited these results was as follows: "Would you support or oppose a requirement that every company offer their employees some sort of retirement plan—either a traditional pension, a 401(k) or an IRA that the employer sets up but does not contribute to. The company would choose which one they wanted to offer employees. Would you support or oppose requiring every employer to give employees at least one of these options?" A full report of the survey findings can be found at www.retirementsecurityproject.org.

25. See Craig Copeland, "Retirement Plan Participation and Retirees' Perception of Their Standard of Living," Employee Benefit Research Institute Issue Brief No. 289 (January, 2006), pp. 1-6, Figure A4.

26. It is conceivable that the risk of exceeding the IRA dollar limit could be mitigated to some degree through enrollment procedures that cap automatic enrollment at, say, $250 a month (for an annual total of $3,000) or $300 a month. However, because automatic enrollment would be administered at the employer level and might be based on paychecks provided weekly or every two weeks, the maximum dollar amount would need to be adjusted accordingly (e.g., $60 if weekly, $120 if every two weeks, or $250 if monthly).

27. J. Mark Iwry, "Using Tax Refunds to Increase Savings and Retirement Security" (Retirement Security Project, Policy Brief No. 2006-1, Jan. 2006; available at www.retirementsecurityproject.org).

28. Among the issues such an approach would need to address is the means of reimbursing those private financial institutions that have no federal income tax liability to offset because they are tax exempt or in a loss position.

An alternative mechanism would modify the existing saver's credit (a federal income tax credit to households with income below $50,000 for contributing to an IRA or employer plan) to convert it to a direct matching deposit to an IRA or other savings account. (As currently structured, the saver's credit reduces the household's federal income tax liability and is nonrefundable; thus, it is not automatically saved.) A variation would be to have such a direct matching deposit delivered by the financial institution that sponsors the IRAs or serves as financial provider to the 401(k) plan to which the individual contributes. One of the authors was involved in developing the Saver's Credit and, in congressional testimony and writings, has advocated its extension and expansion. See, e.g., William G. Gale, J. Mark Iwry, and Peter R. Orszag, "The Saver's Credit: Expanding Retirement Savings for Middle- and Lower-Income Americans" (Retirement Security Project Policy Brief No. 2005-2, March 2005; available at www.retirementsecurityproject.org). However, issues relating to the Saver's Credit and its potential expansion are beyond the scope of this testimony. Another significant asset-building approach targeted to lower- and moderate-income households is reflected in the Individual Development Accounts (IDAs). See, e.g., Michael Sherraden, *Assets and the Poor: A New American Welfare Policy* (M. E. Shapre, 1992), and Ray Boshara, "Individual Development Accounts: Policies to Build Savings and Assets for the Poor" (Brookings, Policy Brief, March 2005).

29. Esther Duflo, William Gale, Jeffrey Liebman, Peter Orszag, and Emmanuel Saez, "Saving Incentives for Low- and Middle-Income Families: Evidence from a Field Experiment with H&R Block" (Retirement Security Project, May 2005; available at www.retirementsecurityproject.org).

30. A detailed treatment of the matching deposit option is beyond the scope of this testimony.

The views expressed in this testimony are those of the authors alone and should not be attributed to the Heritage Foundation, the Brookings Institution, Georgetown University's Public Policy Institute, or the Pew Charitable Trusts.

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State-K: A Strategy for Using State-Assisted Saving to Expand Private Pension Coverage

Supplemental Written Testimony of J. Mark Iwry

Before the Subcommittee on Long-Term Growth and Debt Reduction Of the Committee on Finance United States Senate

June 29, 2006

Mr. Chairman, Senator Kerry, and Chairman Grassley, I appreciate the opportunity to appear before you to discuss strategies for increasing pension coverage for small business employees. This written statement addresses the potential for States to play a constructive role in promoting pension coverage and retirement savings for small business employees. The statement is being submitted at the request of Committee staff who, in view of recent press

The witness is a Nonresident Senior Fellow at The Brookings Institution; Senior Adviser, The Retirement Security Project; Research Professor, Georgetown University; a practicing lawyer; former Benefits Tax Counsel, U.S. Department of the Treasury (1995-2001), and former chair, Employee Benefits Committee, D.C. Bar Section of Taxation. Of relevance to the subject of today's hearing, the witness directed the Executive Branch efforts in the 1990s to develop the SIMPLE plan for small business, the startup tax credit for small plan sponsors, and the saver's credit, as well as the Executive Branch initiatives to define, approve and promote 401(k) automatic enrollment, automatic rollover, and automatic 401(k) features generally. He also was centrally involved in developing the Universal Savings Accounts and payroll deduction IRA proposals.

The views expressed in this statement are those of the witness alone and should not be attributed to the Brookings Institution, The Retirement Security Project, Georgetown University, The Pew Charitable Trusts, any other organization, or any of the individuals acknowledged below. Nothing herein constitutes legal or tax advice and nothing herein should be construed or relied upon as such.

The material in this statement is scheduled to be published in the Tax Management Compensation Planning Journal (BNA) in July 2006 and in the NYU Review of Employee Benefits and Executive Compensation 2006 in August 2006 and is derived from the witness's address to the National Association of State Treasurers Annual Issues Conference in New York City on November 18, 2005, remarks at the Annual Meeting of the National Council of State Legislators in Chicago on December 7, 2005, statements before the Finance Committee of the Michigan State Senate on February 8, 2006 and Appropriations Committee of the Maryland House of Delegates on March 16, 2006, and statement dated April 2003 submitted to the Legislature of the State of Washington.

The witness thanks Al Lurie for valuable comments on an earlier draft of this proposal; John Barry, Bill Bortz, David Levine, Al Lurie and Stuart Lewis for valuable discussions in 2006 raising issues and suggesting improvements; and BNA Tax Management for inviting the witness to present an earlier draft to its advisory board and other invited practitioners in May 2006. Of course any shortcomings or errors would be the sole responsibility of the witness. © 2006 J. Mark Iwry, all rights reserved.

coverage (see the item appended to this statement), have asked that testimony describe the pension proposal that I have been discussing with State legislators.[1]

1.01 INTRODUCTION

The core concept is simple: the private market, with the aid of more than $100 billion in annual federal tax subsidies, has provided employer-sponsored retirement plans to about half of the U.S. work force. However, the market – under current arrangements – has not succeeded sufficiently in meeting our nation's need for greater and more widely distributed retirement security and saving.

One approach not tried to date is to enlist the efforts of State governments, working with and through the private sector, to promote expansion of the private pension system. States could play an important but carefully limited role in helping to expand coverage, especially for small business and moderate- and lower-income workers. States could help small business employees and owners and the self-employed achieve economies of scale and reduce transaction costs by assisting them to pool their efforts in the market for retirement plans and investments. To that end, States might leverage their experience, bargaining power, and possibly the systems and the financial and administrative economies of scale associated with State sponsorship of retirement plans holding billions of dollars for millions of State and local government employees.

This proposal would not and could not introduce State regulation in a system already heavily regulated at the federal level; in general, State regulation presumably would be preempted by ERISA.[2] Moreover, the State would not be acting as plan sponsor but rather as facilitator. Rather than maintaining, managing or operating a plan, States would partner with providers to help make it cheaper and easier for small employers and self-employed individuals to do so. Thus, the intent would be to leverage State government resources in order that States might act as catalysts – pooling or aggregating rather than regulating -- to encourage the market to expand private pension coverage.

The remainder of this written statement seeks to demonstrate why and how States can help. Section 1.02 briefly describes the need for additional saving and private pension coverage and for improvement in our existing system. Section 1.03 outlines a framework for potential State government involvement in

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[1] The principal testimony the witness is submitting to the Subcommittee today is the joint written statement with David C. John of the Heritage Foundation that describes the "automatic IRA" proposal. That proposal would involve federal legislation. By contrast, it is contemplated that the State-assisted saving proposal outlined in this supplemental written statement would require State, not federal, legislation. Interested States presumably could pursue the State-assisted saving approach as an adjunct to and in coordination with the automatic IRA.

[2] The Employee Retirement Income Security Act of 1974, as amended, is referred to in this statement as "ERISA". In general, references in this statement to ERISA refer to Title I of ERISA.

promoting more and better coverage. Section 1.04 gives brief attention to a number of the key issues raised by this proposal. Section 1.05 describes some of the initial efforts to implement the proposal in several States.

1.02 THE PROBLEM

[1] The Need for Additional Saving and Private Pension Coverage

For most American households, Social Security will not be adequate to maintain a reasonable standard of living after retirement. Accordingly, a basic function of our private pension system is to supplement Social Security in helping families manage the financial risks associated with retirement. These include the risks of a drastic drop in one's standard of living on account of inadequate income replacement and savings after retirement, outliving the assets one has accumulated, high medical and long-term care costs, investment losses, inflation, and illness or disability interfering with continued ability to earn.

Yet most have not saved enough through private pensions or individual saving. Defined benefit pensions are covering a shrinking portion of the workforce, especially newly hired employees. Defined contribution (largely Section 401(k)[3]) plans, and individual saving have not done enough to fill the gap for most Americans. In 2001 half of all households headed by adults aged 55 to 59 had no more than $10,000 in a 401(k) type account or IRA. Their median balance, even excluding those who had no such account at all, was only about $50,000.[4]

At present, less than half of the workforce in the United States is covered by an employer-sponsored retirement plan. Some 71 million workers have no access to a retirement plan at the workplace. Moreover, a disproportionate share of this uncovered population comprises lower- and moderate-income workers – many of whom are more in need of additional retirement security than many of those who are covered – as well as employees of small businesses.

In addition to promoting financial security for working households, the private pension system performs a second important function: it promotes national saving, which ultimately contributes to increased national productivity and higher standards of living. Here too, the glass is at least half empty. While the pension system contributes importantly to private-sector saving, overall net personal saving as a percentage of disposable income has dropped from a rate of over 10

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[3] Unless otherwise specified, references in this statement to sections refer to sections of the Internal Revenue Code of 1986, as amended (the "Code").

[4] William G. Gale, J. Mark Iwry, Peter R. Orszag, "The Automatic 401(k): A Simple Way to Strengthen Retirement Savings" (Retirement Security Project Policy Brief No. 2005-1), page 2 (available at www.retirementsecurityproject.org).

percent in the early 1980s to 1 to 2 percent in recent years and, in 2005, a rate less than zero.[5]

Moreover, in determining national saving, personal saving must be combined with public saving. Federal spending and budget deficits represent "dissaving,"[6] and the savings attributed to pension balances accumulating in a tax-favored system are offset by the public cost of providing the tax preferences. That cost – mainly the estimated federal tax expenditure for pensions and retirement savings -- exceeds $100 billion a year.

In addition, pension contributions and the resulting balances do not represent additional saving to the extent that they are derived from other assets that were previously saved. The mere shifting of assets from a taxable account to a tax-favored account does not add to national saving; nor does an accumulation of assets offset by an accumulation of personal debt. The evidence suggests that, in general, incentives to contribute to savings vehicles tend to induce more shifting in higher-income, wealthier households and more new saving in moderate- or lower-income households that have fewer existing financial assets.[7] This in turn suggests that expanding pension coverage to promote more retirement saving among the majority of the population – the moderate- and lower-income households – is particularly important not only because they have the greatest vulnerability to financial risk in the long term but because it is a strategy calculated to increase national saving.

[2] Tax-Favored Vehicles for Saving Are Available

To begin with, it appears that the vehicles for saving are available. Existing tax-favored pension and retirement saving vehicles for employees include qualified defined benefit pension plans (traditional and hybrid forms), money purchase pension plans, profit sharing plans, cash or deferred arrangements (401(k) plans), SIMPLE (savings incentive match plans for employees) plans, SEPs (simplified employee pensions), and individual retirement accounts (IRAs).[8] In

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[5] See US Department of Commerce, Bureau of Economic Analysis, National Income and Product Accounts, Table 5.1.

[6] "National savings is the sum of public savings and private savings. All else equal, every dollar of forgone tax revenue reduces public savings by one dollar. Consequently, for national savings to increase, private savings must increase by more than one dollar in response to each dollar in lost revenue. To raise private savings, the incentives must not simply cause individuals to shift assets into the tax-preferred pensions but instead must generate *additional* contributions." William G. Gale, J. Mark Iwry, Peter R. Orszag, "The Saver's Credit: Expanding Retirement Savings for Middle- and Lower-Income Americans" (Retirement Security Project, No. 2005-2), March 2005, page 8.

[7] See, for example, Eric M. Engen and William G. Gale, "The Effects of 401(k) Plans on Household Wealth: Differences Across Earnings Groups," Working Paper 8032 (Cambridge, Mass.: National Bureau of Economic Research, Dec. 2000.

[8] Section 403(b) tax-sheltered annuities and Section 457 deferred compensation plans present additional alternatives for employees of nonprofit organizations and State and local governments. See Code Sections 403(b), 457.

the small business sector, where plan coverage is particularly sparse, the plans that commonly have had the most appeal to employers and employees are 401(k) plans (often with employer matching contributions and sometimes including employer profit sharing contributions) and SIMPLEs.

This array of tax-favored vehicles can be conceived of as reflecting at least an attempt at "intelligent design," i.e., not as a random collection of options, but as a laddered hierarchy of plan forms designed to encourage coverage through a functional relationship between incentives and regulation. As a broad generalization, rewards or incentives for each plan design are calibrated to the effort it involves on behalf of workers and to its public policy benefits: more generous tax incentives are generally associated with better quality coverage.[9]

Beginning at the top of the ladder, the defined benefit pension allows the greatest amount of income to be sheltered from taxation (older, higher-income individuals can often contribute well over $100,000 per year to defined benefit plans), assumes the greatest financial risk, and, given the stakes, is subject to the most extensive regulation. The next option, the money purchase pension, traditionally has been the "highest form" of defined contribution plan. Compared to the defined benefit ("DB") plan, it generally affords somewhat less opportunity for tax-favored contributions while taking on less risk, but is still a "pension" plan with funding obligations, joint and survivor protections, etc., and is subject to considerable but less regulation than the DB.

The profit sharing plan (and to some degree the stock bonus plan and employee stock ownership plan) gives workers somewhat less protection from risk but still involves an employer contribution up to a substantial amount that is not conditioned on employees taking the initiative to contribute. (Until it was changed in the 2001 EGTRRA legislation, the deduction scheme reflected an effort to give employers greater incentives to sponsor a money purchase pension than the less worker-protective profit sharing plan.)

Descending further, the 401(k) plan usually offers, but does not necessarily make, an employer contribution, as the employer matching contribution is conditioned on the employee's willingness to contribute. To make it more likely that the plan carries out its policy purpose, an employer match, like other employer and employee contributions, must meet a nondiscrimination standard. However, more than two thirds of the funds contributed to a typical 401(k) plan that has an employer match are contributed by employees, on a pre-tax basis. The 401(k) without employer match is a less powerful engine of saving, and the business owner and managers confront correspondingly lower maximum limits on their opportunity to protect current income from taxation.

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[9] See Testimony of J. Mark Iwry Before the Special Committee on Aging, United States Senate (April 12, 2005); Testimony of J. Mark Iwry Before the Committee on Education and the Workforce, Subcommittee on Employer-Employee Relations, U.S. House of Representatives (June 4, 2003).

The SIMPLE-IRA plan was designed to occupy the space between the 401(k) and the IRA, offering small employers an option that minimizes regulation and paperwork (no nondiscrimination testing, plan documents, IRS approval process, etc.) in exchange for lower contribution limits. In lieu of nondiscrimination testing, the SIMPLE requires a specified level of employer contributions (either matching or nonmatching).[10]

Finally, the IRA requires the sponsor to make no effort to "spread the wealth" or to cover others, requires no employer contributions, and is subject to minimal regulation, but also imposes the lowest limits on tax-favored contributions. In addition, during the 1990s, the Treasury Department sought to encourage coverage by mapping out the middle ground between the IRA and the SIMPLE plan. The payroll deduction IRA or direct deposit IRA involves the employer solely as conduit for employee contributions to IRAs, not as sponsor of a qualified or ERISA-governed plan. The employer informs employees that it is willing to offer its payroll system to enable employees to contribute to IRAs using the powerful mechanism of regular payroll deduction -- in much the same way that many employers offer direct deposit of paychecks to accounts designated by employees. The employer makes no contributions of its own and is not responsible for opening IRAs, choosing investments, monitoring contribution limits, etc.[11]

Payroll deduction IRAs have not been widely adopted to date, but the witness, in a separate proposal (the "automatic IRA") advanced jointly with co-author David John, has proposed that they play a much larger role in expanding coverage for employees of small employers.[12] As discussed below, payroll deduction IRAs could also be an important element of a State-related coverage strategy.

In sum, an array of saving vehicles is available. A number of them are relatively simple and not costly (although the array of options in the aggregate can at least

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[10] See Code Section 408(p); ERISA Sections 101(h), 403(b)(3)(B), 404(c)(2); IRS Notice 98-4 (I.R.B. 1998-2); 29 C.F.F. section 2510.3-102(b)(2).

[11] See IRS Announcement 99-2; Department of Labor Interpretive Bulletin 99-1 (June 18, 1999), 29 C.F.R. 2509.99-1(b). In the Conference Report to the Tax Reform Act of 1997, Congress stated that "employers that choose not to sponsor a retirement plan should be encouraged to set up a payroll deduction [IRA] system to help employees save for retirement by making payroll-deduction contributions to their IRAs" and encouraged the Secretary of the Treasury to "continue his efforts to publicize the availability of these payroll deduction IRAs." H.R. Rep. No. 220, 105th Cong., 1st Sess. 775 (1997).

[12] As noted, the automatic IRA proposal is described in the joint written statement that the witness and co-author David John are submitting to the Subcommittee as testimony for this hearing. See also J. Mark Iwry and David C. John, "Pursuing Universal Retirement Security Through Automatic IRAs" (Retirement Security Project working paper, draft, Feb. 2006) (available at www.retirementsecurityproject.org and at www.heritage.org). See The New York Times, February 20, 2006 (editorial) page A18; The New York Times, March 18, 2006 (editorial) page A18; Albert Crenshaw, "Automatic IRAs—A Quick Fix for Workers Without Pensions?", The Washington Post (Feb. 19, 2006), pp. F-1, F-8; Iwry and John, "The Other 71 Million" (op-ed), The Washington Times (March 24, 2006).

create the impression of complexity). The discussion below considers the reasons why the available vehicles are not more widely used by small employers and individuals.

[3] Why Are Coverage and Savings Inadequate?

Is there some reason why the operation of the market in this area may not be sufficient, and why further government intervention (beyond the existing tax preferences and associated regulation) may therefore be justified? It is submitted that the market by itself has been unable to achieve the public policy goals of near universal financial preparedness for retirement and adequate savings, and that there is a legitimate need for some further action, including a catalyst role for State governments. Indeed, the major federal (and corresponding State-level) tax expenditures for pensions and retirement saving reflect a recognition that there is a shortfall between the outcomes that the market would produce without government involvement and the needs and goals of public policy relating to retirement savings. These tax expenditures that subsidize retirement plan contributions through special tax preferences, as well as the extensive federal regulation under the Code and ERISA, already constitute a substantial government role in the market.

[a] Many Households Are Not Well Equipped or Inclined to Engage in the Requisite Analysis and Planning

The extensive tax subsidies for retirement saving reflect a recognition, supported by behavioral evidence, that many individuals need help saving for retirement and other long-term goals and providing for the management of long-term economic risks.[13] The underlying premise (with which the witness agrees) is that much of the population is "myopic" when it comes to saving and risk management and therefore tends to exhibit something less than "rational" behavior in these areas. The analyses required for households to plan and provide adequately for the management of the major short- and long-term risks that confront them – mortality, longevity, disability, morbidity, unemployment, credit, market performance, interest rates, inflation, and others – do not come naturally to many individuals. For various reasons, many are unable or unwilling to confront risks that are frightening or unpleasant, to think probabilistically, to translate between present values and appropriately discounted streams of future income, or to perform financial analyses under conditions of uncertainty.

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[13] See, e.g., Brigitte Madrian and Dennis Shea, "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior," *Quarterly Journal of Economics* 116, no. 4 (Nov. 2001), pp. 1149-87; Richard Thaler and Shlomo Benartzi, "Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving," *Journal of Political Economy* 112, no. 1, pt. 2, pp. S164-87; James Choi, David Laibson, Brigitte Madrian and Andrew Metrick, "For Better or Worse: Default Effects and 401k) Savings Behavior," in *Perspectives in the Economics of Aging*, edited by D. Wise (University of Chicago Press, 2003), pp. 81-121; Cass R. Sunstein and Richard H. Thaler, "Libertarian Paternalism is Not an Oxymoron," *University of Chicago Law Review* 70, no. 4 (2003), pp. 1159-1202; Alicia Munnell and Annika Sunden, *Coming Up Short: The Challenge of 401(k) Plans* (Brookings, 2004).

(Arguably, these complications and stakes are greater than those entailed by most other consumer decisions.) Lack of transparency and imperfect information on the costs and benefits of alternative investments and financial products in the market also tend to hamper efforts by households to make apples-to-apples comparisons.

Most households do not appear to have overcome these handicaps by obtaining sufficient education and information regarding savings and investment or by obtaining professional advice and assistance. In addition, systematic risk management and saving requires not only some reasonable level of information, understanding and analysis, but also behavioral discipline, such as the discipline involved in deferring consumption, saving systematically, and rebalancing investment portfolios in the face of temptation to "ride" or "time" the market.[14]

[b] Saving Requires Making Decisions, Overcoming Inertia and Exercising Discipline

Much of the shortfall in saving and rational risk management appears to be attributable to the fact that most available institutional arrangements have not made it sufficiently easy for households to save. In theory, IRAs fill the gaps in employer plan coverage so that tax-favored retirement savings is almost universally available. In practice, however, millions of households that could save through IRAs and 401(k)s fail to do so, in part because we have not made saving through these vehicles easy enough. Those who consider saving in an IRA need to take the initiative in a number of ways: they need to decide which financial institution to select as the IRA trustee or custodian, may need (or think they need) to go to the institution and stand in line to fill out forms, need to decide how much to contribute, and need to decide how to invest. Many are daunted by the decisions; many others are affected by simple inertia and procrastination. As a result, in most years only roughly 1 in 10 eligible individuals actually contributes to an IRA, compared to the 401(k) participation rate of about 3 in 4.

One reason for the difference is the power of automatic payroll deduction. Once an employee elects to save, saving through the payroll system continues automatically. In addition, the pattern of contributions through payroll deduction consists of regular small amounts, which enables households to avoid having to come up with several thousand dollars all at once in order to contribute. Another reason for the relative effectiveness of employer-sponsored plans is that, unlike IRAs, employer plans have nondiscrimination standards designed to give business owners and managers an incentive to encourage participation among the majority of their employees. Largely as a result, a majority of 401(k) plans have an employer matching contribution, and many employers are motivated to educate employees about saving and to encourage participation in the plan. This

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[14] See, e.g., J. Mark Iwry, "Promoting 401(k) Security" (Tax Policy Issues and Options No. 7, Urban-Brookings Tax Policy Center, September 2003).

in turn promotes the "water cooler effect" whereby employees may encourage one another to participate through peer group reinforcement.[15]

Here too, however, employees eligible for a 401(k) or similar retirement savings plan must usually take the initiative to participate (unless the plan uses automatic enrollment), and must not only choose whether to participate but, if so, how much to contribute, how to invest, and, ultimately, when and how to draw their benefits. As a result, millions who are eligible for 401(k)s "leave money on the table" by not contributing, even in the face of an employer match.

In addition, the benefits of 401(k) coverage are less than they should be. Investment returns in 401(k) plans lag behind those in defined benefit pensions or other professionally managed funds. A key reason is that employees self-direct their 401(k) investments. Yet self-directed investments are neither a legally required nor otherwise an integral element of a 401(k) plan. These plans were not originally designed and do not currently operate in a way that makes it necessary for every participating employee to act as his or her own investment manager.

Indeed, the case can be made that 401(k) investment self-direction has expanded far beyond the degree of choice that is necessary or appropriate. While choice generally is desirable, employees suffer to the extent that they are effectively forced to manage their own investments. As amateurs, employees predictably underperform the professionals who traditionally manage employer-sponsored pension investments such as defined benefit plan assets or (largely in a bygone era) employer-sponsored profit sharing investments. It is not realistic to expect investment education or advice to overcome this disadvantage. Successful investing depends not only on knowledge but on experience, regular attention, and discipline, such as the discipline involved in regular rebalancing. Even the minority of employees who are relatively sophisticated financially often lack the time or interest to run their own 401(k) investments, and often lack the discipline and professional detachment needed to do so effectively. .

Accordingly, policymakers and the market are moving toward automatic 401(k)s: automatic enrollment to maximize participation and automatic investment to maximize investment performance.[16] The latter takes the form of asset-allocated and diversified default investments that permit employees to avoid having to

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[15] See, e.g., "Using the Private Pension System and IRAs to Promote Asset Accumulation for Lower-Income Families," Testimony of J. Mark Iwry Before the Subcommittee on Social Security and Family Policy of the Committee on Finance, United States Senate (April 28, 2005).

[16] The Treasury Department and Internal Revenue Service began to promote automatic enrollment in 1998. See Revenue Rulings 98-30 (1998-2 I.R.B. 8); 2000-8 (2000-1 C.B. 617); 2000-35 (2000-2 C.B. 138); 2000-33 (2000-1 C.B.142); IRS General Information Letter to J. Mark Iwry (March 17, 2004)(available at www.retirementsecurityproject.org). See also Gale, Iwry and Orszag, "The Automatic 401(k)," n.4 above.

make an affirmative choice, or managed accounts that give employees the benefit of professional asset management.[17]

As will be described below, States can help by making it easier to save in employer-sponsored plans by promoting standardized vehicles that will be attractive for employers to adopt and that reflect best practices such as automatic enrollment and investment.

[c] Most of Our Pension Tax Incentives Are Not Well Designed for the Majority of the Population

One reason small employers cite for not sponsoring plans is inadequate demand on the part of employees, who often express a preference for cash wages over retirement benefits. One of the reasons, in turn, why moderate- and lower-income people do not more often demand or contribute to retirement plans has to do with the structure of the pension tax preference. Whether an individual saves through a 401(k) or similar retirement savings plan or through an IRA, the federal income tax advantages generally are comparable. Contributions generally are excluded from income for tax purposes or, in a traditional IRA, generally are tax-deductible; earnings in the account accumulate on a tax-deferred basis; and distributions can be transferred tax-free to other tax-preferred vehicles (plans or IRAs). (In Roth IRAs and Roth 401(k) accounts, contributions are not tax-deductible, but the earnings accumulate on a tax-deferred basis, and the ultimate payment of contributions and earnings from the plan generally is excludible from income.)

However, the value of these tax incentives is proportional to the taxpayer's bracket or marginal income tax rate. A dollar of pension contribution is initially worth 35 cents to someone in the 35% bracket, and only 10 cents to someone in the 10% bracket. By using deductions and exclusions from income to deliver the tax subsidy, our system is effectively "encourag[ing] saving least for those who need to increase their saving most, and most for those who need to increase their saving least."[18] This (in addition to the basic liquidity constraints confronting lower-income households) is a reason retirement saving is lower among the lower-income population.

A first step toward a solution is the "saver's credit." Starting in 2002, eligible moderate- and lower-income individuals can claim a federal income tax credit for their voluntary contributions to a plan or IRA (the "saver's credit").[19] While the

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[17] William G. Gale and J. Mark Iwry, "Automatic Investment: Improving 401(k) Portfolio Investment Choices" (Retirement Security Project, No. 2005-4)(April 2005)(available at www.retirementsecurityproject.org).

[18] Id. at 3.

[19] Section 25B of the Code. The saver's credit is available to households filing jointly with adjusted gross income (AGI) of up to $50,000 and singles with AGI of up to $25,000. The saver's credit is scheduled to expire at the end of 2006, but legislation is pending to extend it or make it permanent.

proposed credit was severely truncated in the 2001 legislative process, the saver's credit as enacted still makes the reward for saving proportional to the amount saved, not to the level of the saver's income. This is because it takes the form of a tax credit instead of a deduction or exclusion from income. The saver's credit has been claimed by some 5.4 million tax filers each year it has been in effect (based on data for 2002 and 2003), but this is far fewer than those who are eligible.[20]

[d] Per Capita Cost is an Obstacle

A key factor that helps explain why employees of small employers are far less likely to be covered by an employer-sponsored plan than other employees is per capita cost. The cost of sponsoring a retirement plan is greater on a per capita or per account basis for a small employer than a large one. There are at least three reasons for this difference.

First, larger employers can realize economies of scale by spreading fixed costs of plan administration and investment management over a larger number of accounts.

Second, small employers often have fewer managerial resources to gather and process the information necessary to choose a provider, type of plan, specific plan design, and investments, and to operate the plan, including compliance with legal requirements.

Third, larger employers' greater bargaining power helps them negotiate lower investment and plan administrative fees with financial services, consulting and third party administrator firms. By contrast, like individuals purchasing a retirement savings product on their own, small employers purchasing on behalf of a few employees have little bargaining power. They deal with the financial services industry and the pension industry on a retail rather than wholesale basis, and accordingly pay retail prices. What is said here about small employers is in most cases even more true of self-employed individuals.

[e] The Financial Services Industry Has Less Profit Interest in Small Accounts

Some financial providers are interested in selling IRAs, 401(k)s and SIMPLE plans to small employers and to individuals who are not in a position to contribute substantial amounts. However, major sectors of the financial services industry point out that very small accounts (that do not rapidly grow) tend to be unprofitable (or less profitable). Unless these small accounts are in the same

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[20] William G. Gale, J. Mark Iwry, Peter R. Orszag, "The Saver's Credit: Expanding Retirement Savings for Middle- and Lower-Income Americans" (Retirement Security Project Policy Brief No. 2005-2)(March 2005)(available at www.retirementsecurityproject.org).

plan as a sufficient number of larger accounts (which can cross-subsidize the smaller accounts), their modest investment returns may not exceed or even cover the costs of establishing, administering and ultimately closing the small accounts. Average account balance – as opposed to total assets under management – appears to be a key driver for many sectors of the industry. The prospect of a smaller employer with a less affluent work force generating low average account balances holds little appeal for many providers. Much of the financial services industry would be interested in taking the accounts once they have grown to a profitable size, but would just as soon have the government bear or subsidize the cost of slow-growing accounts during their "incubation" phase.

The industry does not seem to be homogeneous in this regard. Significant differences among providers' cost structures, systems, distribution networks, levels of service, marketing strategies and compensation schemes may explain why some are less interested in selling small accounts than others. Yet the tens of millions of moderate- and lower-income families that need to save more, especially through employer provided coverage, will tend to have relatively small accounts, and much of the industry appears to lack the incentive to expend the effort necessary to sell small dollar-amount savings products. Accordingly, the market currently seems imperfectly situated to promote the public policy goal of promoting retirement security and saving for this population, which comprises the majority of the U.S. workforce.

[f] Fees and Expenses May Be High and Not Sufficiently Transparent

One aspect of the "market failure" has to do with imperfect information. It is hard for consumers – individuals and small business owners – to engage in efficient comparison shopping among competing retirement plan providers. Fees and expenses are packaged and presented in ways that make "apples to apples" comparison difficult. As a result, there is at least anecdotal evidence that market competition may not be efficiently driving down the prices of these savings products, especially in the retail setting in which individuals and small businesses relate to the financial services and pension industry.

Concern about being charged excessive fees and the burden of gathering and analyzing cost and other information in order to make a competent comparison are among the factors that discourage consumers from purchasing retirement saving products. In recent years, revelations of improper practices by some financial providers probably have eroded consumer trust and made many even more cautious, further complicating the purchase decision.

1.03 <u>A POTENTIAL ROLE FOR THE STATES</u>

In general, for the reasons described, households' demand for retirement saving and their use of the existing opportunities for saving fall short of public policy

needs and objectives, as does the supply of retirement savings by employers and financial providers. As noted, this is especially true in the case of moderate- and lower-income households, which comprise the majority of the U. S. population, as well as employees of small employers.

A number or promising strategies for addressing this shortfall have been proposed. These include expanding the automatic 401(k) (notably automatic enrollment, escalation, and investment), establishing and promoting the automatic IRA, expanding and improving the saver's credit, offering taxpayers the ability to have the IRS make direct deposit of a portion of their income tax refunds to IRAs, and exempting IRA and defined contribution retirement savings from asset tests for eligibility for public assistance programs.[21] Most of these initiatives involve some further action by the federal government to make more efficient use of the existing tax subsidies for retirement saving by encouraging the market to expand coverage and by removing barriers to increased saving.

In addition, State governments have the potential to contribute to the expansion of private-sector pension coverage in a carefully limited but effective way. One reason this possibility traditionally has received virtually no attention is that the legal framework governing tax-favored pensions generally provides that federal law relating to benefit plans for private-sector employees supersedes State law, while carving out a niche for State and local governments to provide pension coverage for their employees largely free of federal regulation. See section 1.04[1][a], below. Yet it is submitted that the States, in part because they furnish pensions to their own employees on a very large scale, could contribute importantly to the expansion of private pension coverage, and that this potential is well worth exploring.

[1] What Assets and Resources Do States Bring to the Table?

States and local government authorities generally sponsor tax-qualified retirement plans for State and local government employees. These plans account for a large portion of the entire qualified plan universe and a large portion of the associated federal tax expenditure. State and local government plans include defined benefit pensions as well as defined contribution retirement savings programs such as grandfathered 401(k) plans, 403(b) tax-sheltered annuities, and deferred compensation plans under Code section 457. Many of the State-sponsored plans cover hundreds of thousands or even millions of workers and hold assets worth billions of dollars. In general, State and local government plans are exempt from most of the provisions of ERISA, but are subject to a version of the Code's plan qualification requirements.

As a result, State governments have valuable resources that might be leveraged to promote private-sector retirement coverage in the small business sector (as well as among the self-employed), where pension coverage is particularly

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[21] For descriptions of these initiatives, see generally the publications at www.retirementsecurityproject.org.

sparse. (In fact, States could limit their efforts to employers below a specified size and to individuals.) These State resources include extensive experience and expertise in designing, managing and administering retirement programs, managing investments, communicating with participants, partnering with private financial institutions, and potentially making available economies of scale associated with their large accumulations of assets and large plan populations.

In addition, a State government, unlike private-sector employers or providers, can be expected to continue in existence on a permanent basis. This might provide greater assurance to some small employers, their employees, and self-employed individuals. It also could ultimately translate to greater portability of pensions, as a State-affiliated program might be more impervious to the effects on the participant of job losses or changes.

[2] Potential State Role

States could help in two broad ways. First, by offering a low-cost, off-the-shelf, turnkey plan that simplifies employers' and individuals' purchase decisions, and through the State's capacity for outreach, States could facilitate employer adoption of tax-favored retirement plans for their employees. Acting as aggregators rather than regulators, States could assist small businesses to pool their efforts in purchasing low-cost retirement plans. Second, for employees whose employers are not yet ready to adopt a retirement plan, States could help arrange for easier access to payroll deposit IRAs (and potentially other IRAs).

Accordingly, State involvement in promoting low-cost, portable retirement savings could potentially be structured in two tiers. Tier I involves universal payroll deposit IRAs for employees, and stand-alone IRAs for self-employed people, who choose to participate. Tier II involves employer plans, in particular the 401(k) and the SIMPLE-IRA.

[a] Tier I: Promoting an Improved IRA Saving Opportunity for Employees and the Self-Employed

As discussed earlier, it is common practice for employers to offer employees the convenience of direct deposit of paychecks to bank accounts or other financial institutions. Employees sometimes direct their employer to have a portion of their salary or wages directly deposited to make regular payments on a mortgage or automobile loan, and tens of millions of employees use the powerful direct deposit or "payroll deduction" method to save in 401(k) or similar retirement savings plans. As noted, a potential alternative for employees of employers that are not ready (for whatever reason) to sponsor a retirement plan is the payroll deduction IRA. However, the availability of this simple and virtually costless option -- requiring no employer contributions -- is not well known. Moreover, as discussed, many providers who sell retirement plans have relatively little interest in this option because account balances will tend to be small.

States could step into the breach by informing in-State employers that are not plan sponsors that they can at least offer to transmit electing employees' salary reduction contributions to IRAs.[22] States could also encourage employers to consider this option by making it easy and inexpensive. In particular, this payroll deduction IRA arrangement could readily be limited so as not to constitute an employer-sponsored plan. This generally means there would be no ERISA requirements and no qualified plan requirements.

Employers that wished to do so would merely offer their payroll system as a conduit for employees interested in saving a portion of their own salary or wages. The employer would neither be required nor permitted to make its own contributions, matching or otherwise. (Employers wishing to contribute could sponsor a SIMPLE or a qualified plan. See Tier II, below.) Employers also would not be responsible for opening or designating an IRA or IRA investments, and would have no fiduciary responsibility. Using State-provided forms, employers could inform employees of the opportunity to contribute to an IRA by payroll deduction. (Employers could also be given the option of enrolling employees using automatic enrollment, although this might well require the employer to ensure that the arrangement complies with ERISA.)

The State might contract with one or more private financial institutions to serve as IRA trustee or custodian. They would be selected, pursuant to competitive bidding or other applicable State procurement procedures, to provide a standard, low-cost IRA that would bear, in an appropriate fashion, the imprimatur of the State. (An alternative approach would accommodate multiple providers, each of which meets State standards, provided that those were not subject to preemption by federal law.) This IRA would be targeted to employees who wish to participate but do not already have an employer plan or IRA. It would have a separate account for each individual who chose to participate, and would have an asset-allocated diversified default investment or professionally managed fund with a limited array of specified alternative investments. (Of course no employee would be required to participate or to continue contributing.) The State, working with the financial provider(s) and an independent expert, could specify in its request for proposals that low-cost, highly diversified index funds and Treasury

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[22] Without any relation to a role for State governments, the author has proposed, with co-author David John, to require certain employers (excluding the smallest and newest) that do not sponsor plans to offer payroll deduction to their employees. See Iwry and John, cited at n.12, above. Most of the material in this paragraph and the following two paragraphs -- except as they refer specifically to the role of the State government -- is borrowed (verbatim or otherwise) from that written statement or working paper. In general, under the arrangements outlined here, the employer's decision whether or not to offer payroll deduction would be voluntary, unless the State decides to require a class of employers within the State that do not sponsor a retirement plan to offer their employees the opportunity to contribute wages, through payroll deduction, to an IRA.

inflation-protected securities would constitute major components of the investments.[23]

The State could maintain a central program web site for use by employers and employees. Employers would have the convenience of being able to send all of the funds to a single destination, perhaps using the same schedule and even conceivably the same process that they use for State income and payroll tax withholding and deposits.

Self-employed individuals would also be able to open and save in a standard State-approved IRA that might benefit from economies of scale associated with pooling of investments. The State could facilitate participation by offering convenient electronic automatic debit arrangements, possibly using a State-sponsored web site.

Finally, States might consider whether efficiencies, such as lower investment costs, could be realized by making use of collective investments that are permissible for use with IRAs or qualified plans or both. These pooled investment arrangements might include bank common trust funds, common investment funds, or group trusts.[24] (IRAs are prohibited from commingling their assets with other property except in a common trust fund or common investment fund.[25])

[b] Tier II: Promoting Employer-Sponsored Retirement Plans

Independently of the role just described as "Tier I," States could make it easy for small employers doing business in the State and not sponsoring a retirement plan to adopt simple, standardized, off-the-shelf, retirement savings plans for their employees. These are low-cost "turnkey" products that are available on the market today, but that most small businesses have not adopted for reasons such as those described above. The two key plan types for this purpose are the 401(k) (in the form of a "prototype" plan) and the SIMPLE-IRA.[26]

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[23] The application of federal or state securities laws to investment offerings under State-assisted plans and IRAs is beyond the scope of this statement.

[24] See Code section 584 (bank common trust funds); Revenue Ruling 81-100, 1981-1 C.B. 326 (assets of tax-qualified plans and assets of IRAs may be commingled and collectively invested in a group trust without jeopardizing the tax-favored treatment of the qualified plans, IRAs or group trust, provided that certain conditions are satisfied); Revenue Ruling 2004-67, 2004-28 I.R.B.28, (expanding the group trust treatment under Rev. Rul. 81-100 to include assets of eligible State and local government plans covering government employees under Code section 457(b)).

[25] Code section 408(a)(5).

[26] Another simple option is the SEP (simplified employee pension), but the basic SEP provides for nonmatching employer contributions without allowing employees to contribute. See Code section 408(k). The version of the SEP that does allow employees to contribute is the "SARSEP" (short for "salary reduction SEP"), but the SIMPLE-IRA is an improved and updated model that was designed essentially to replace the SARSEP. The SIMPLE-IRA also allows employer contributions (matching as well as limited nonmatching

Just as a State could choose to focus its efforts, at least initially, on either Tier I or Tier II (or could move forward on both), within Tier II a State could choose to focus on promoting adoption of the 401(k), the SIMPLE, or both.[27]

States could approve and help market to small employers a State-approved, tax-qualified "master" or "prototype" 401(k) plan using the existing IRS "master and prototype" program for qualified plans.[28] Under this program, a financial institution or other commercial entity provides a plan, obtains IRS approval of the plan document, and, acting as "sponsor", markets the plan to employers for adoption. Under the approach outlined here, the State would contract with one or more organizations that currently serve as prototype plan sponsors. The sponsor(s) would provide a prototype that meets State contractual specifications (to the extent permitted consistent with federal preemption of State law relating to benefit plans) and that is submitted for IRS approval in the usual manner. The specifications probably would be reflected in a request for proposals or contractual provisions rather than in State law.[29] To the extent consistent with federal preemption, the State might select a prototype plan that it deems worthy of receiving State government endorsement or promotion. As a condition of obtaining the State's imprimatur, the private prototype sponsor could design its plan to satisfy State preferences.

This would offer small employers an inexpensive, standardized product that they could adopt for their employees, with limited options that the employer would select. At a minimum, this standardized approach might also make it feasible to give employers centralized assistance with 401(k) plan administration, including preparation of Form 5500 annual reports, summary plan descriptions and other employee communications, nondiscrimination testing, and other tasks.

Such administrative assistance – which might be provided in part by private contractors and in part by State government personnel -- could encourage more employers to adopt plans and could also entail significant public policy benefits in

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ones) in addition to the employee contributions, though the employer contributions are limited. Employers that wish to contribute more can do so through a 401(k) plan.

[27] State activities would be designed so as to avoid preemption by federal law. See section 1.04[1], below.

[28] The IRS master and prototype (or "M&P") program is described in Revenue Procedure 2005-16, 2005-10 I.R.B. 674. A "master plan" is defined, in pertinent part, by the IRS as "a plan (including a plan covering self-employed individuals) that is made available by a sponsor...for adoption by employers and for which a single funding medium (for example, a trust or custodial account) is established, as part of the plan, for the joint use of all adopting employers...." Rev. Proc. 2005-16, 2005-10 I.R.B. 674, section 4.01. A "prototype plan" is defined by the IRS in generally similar terms except that a separate funding medium is established for each adopting employer. Rev. Proc. 2005-16, 2005-10 I.R.B. 674, section 4.02.

[29] If permitted by the IRS under its M&P program, the State government itself could conceivably consider acting as the sponsor of the master and prototype plan. However, this seems like an unlikely scenario, as the State's potential exposure to liability might be greater if it were in the position of sponsor, rather than working with an established, expert sponsor of such plans. State governments presumably have little reason to acquire internal expertise concerning ERISA or private-sector plan qualification requirements.

the form of improved small business plan compliance. This could attract favorable interest in the Employee Plans function within the TEGE (Tax Exempt and Governmental Entities) Division at the IRS, as operational compliance in the small business master and prototype sector has long been a concern. All too often, small employers have been sold a prototype plan by a broker, insurance agent, or other salesperson, without adequate followup assistance with the tasks of ongoing operational compliance.

In part because of the potential for improved compliance and efficiency, States might explore with the IRS whether it would be possible to simplify or streamline certain requirements of the current master and prototype program in this context. This might include, for example, the filing of a single annual report on Form 5500 on behalf of all participating employers, and avoidance of the need to obtain any IRS approval of plans adopted by individual employers. (Nondiscrimination testing could be avoided by adoption of a "design-based safe harbor" 401(k) format, but that would require employer contributions at a level that might discourage many small employers.)

Another possible step toward standardization and streamlining might be a uniform national prototype or model 401(k) plan document, approved in advance by the IRS and made available for endorsement by States that are interested. This approach would enable States to avoid an individual IRS approval process, while probably still leaving the investment selection to States and their private-sector partners. States using this uniform national prototype would have no flexibility in designing the detailed provisions of the plan or choosing a specific plan design, although presumably they would retain the option of shopping for IRS-approved prototype plans sponsored by private-sector providers. For employers located within a single State – as is typical of the small businesses that comprise the target audience for this proposal – State-by-State variation in State-endorsed prototypes would not matter.

In a sense, a simplified, uniform national prototype 401(k) for small business already exists. It is the SIMPLE plan, which was designed for this purpose, as a mini-401(k) for small business. The SIMPLE requires no IRS approval largely because it precludes nearly all variations among plan designs. In fact, the SIMPLE enables employers to avoid most of the administrative responsibilities associated with sponsorship of a qualified plan: it requires no annual Form 5500 reporting to the IRS, no IRS approvals, no nondiscrimination testing, and no drafting or purchase of detailed plan documents. The employer simply signs a two-page standard IRS form that states the terms of the plan. The employer may allow each participating employee to select an IRA to receive contributions (thereby avoiding employer fiduciary responsibility) or, if the employer prefers, it may designate a single financial institution to provide SIMPLE-IRAs for all participating employees (in which case the employer is choosing to take on the limited fiduciary responsibility associated with having made that decision).

State endorsement of the SIMPLE-IRA would lend itself to participation by multiple financial providers, as the plan design is nearly uniform. For both the SIMPLE and the 401(k), the State could work with providers in structuring a uniform array of low-cost investments reflecting best practices, including a default investment for employees who would rather not choose. In either case, States could consider establishing a centralized arrangement for pooled investment of plan assets, such as a single master trust or other collective investment arrangement administered by the financial institution(s) sponsoring the plan. A variation on this approach might be to mirror or "piggyback" on at least certain existing investment funds under the defined contribution plans States sponsor for their employees – without combining the private-sector ERISA-governed plans with the State employees' plans in a way that would jeopardize the State plans' exemption from ERISA. Whether it would be worth creating an actual pooled investment such as a master trust may depend on the degree to which this – as opposed to simply mirroring existing investment options (for example, in plans for public employees) -- would be necessary in order to realize economies of scale or other efficiencies in investments.

Another alternative model for Tier II would be an initiative whereby the State government organized and facilitated the establishment of a multiple employer plan (see Code Section 413(c)). Under this approach, each private sector employer choosing to participate would adopt the common plan for the benefit of that employer's employees, using a common trust fund managed by a private financial institution contracting with the State and centralized administrative assistance from the State or its contractor.

As noted earlier, a potentially significant concern affecting the multiple employer approach would be the risk that any participating employer's failure to comply with federal plan qualification requirements in administering the plan for its employees could imperil the tax qualified status of the multiple employer plan as a whole. On the other hand, the risk that the entire plan would be disqualified because of noncompliance by an isolated employer or employers is more theoretical than real. The risk might conceivably be mitigated by a special arrangement with the IRS, if the IRS were willing to consider this.

[c] Variations in Approach Among States

The framework outlined here – including the Tier I and Tier II structure -- is designed to foster diversity in the strategies States employ to take advantage of their particular strengths and opportunities. It is also intended to encourage experimentation at the State level with a view to learning what kind of State involvement might work best. Thus, a State could begin by focusing only on the basic IRA approach outlined in Tier I above without venturing into the simple employer plans described in Tier II. Alternatively, a State could begin with Tier II or could decide to implement Tiers I and II from the outset.

At the same time, it may be desirable to maintain a basic consistency among State efforts in this area insofar as they rely on established vehicles for tax-preferred saving that have been authorized by federal law. These vehicles – mainly the existing forms of IRAs and 401(k) plans, including the payroll deduction IRA and the SIMPLE-IRA plan referred to above – and the established rules and regulations governing them have been fine-tuned over the years by the market and by regulators in pursuit of effectiveness and simplicity. Use of these familiar IRA and 401(k) vehicles should also make it unnecessary to seek federal legislation, and should otherwise simplify the implementation process, including the involvement of federal regulators.

[3] How Would State Involvement Add Value?

State governments could enter into retirement savings partnerships with the private sector, leveraging their resources and expertise, as sponsors of large-scale retirement savings plans for their employees (and college savings plans), to expand private pension coverage. Such State activity could add value in a number of ways.

[a] Pooling of Small Employers and Self-Employed

One of the State government's key assets is the capacity to facilitate pooling by small employers and self-employed individuals. Pooling of employers in multiemployer plans and multiple employer plans has long been a feature of the pension landscape. Accordingly, the thought that pooling of smaller employers in arrangements similar to these might be a desirable way to encourage them to sponsor plans for their workers has been a staple of pension coverage discussions for years. Unfortunately, the development of new multiple employer arrangements -- outside of the specific collectively bargained industries where multiemployer plans are the norm – has been quite limited. By and large, pooling of small businesses to provide retirement plans has not occurred on any significant scale.

One reason is the lack of ready catalysts outside of the Taft-Hartley collective bargaining universe. To some degree, financial providers can play this role, but, given their cost structures and financial incentives, it is often unprofitable to market to and group together all willing small employers and lower-to-moderate income workers. Instead, financial providers' incentives often lead in the direction of cream-skimming and cherry-picking, with fees and expenses high enough to could deter many small employers and workers.

To some degree, a pooling function can be performed by firms that provide payroll or staff leasing services. Such firms often offer 401(k) plans on a collective basis to participating small employers. Congress and Treasury/IRS have generally limited those firms to the use of multiple employer plan arrangements. A drawback of the multiple employer plan model is the risk that a

qualification defect on the part of any participating employer will taint the entire plan, potentially imposing adverse consequences on all other participating employers and employees.[30] As noted, this risk may be more theoretical than real, but an advance administrative arrangement with the IRS – if one could be negotiated on behalf of all States -- would be desirable to provide a measure of assurance on this score before a State adopted a multiple employer plan.

State governments could serve as a catalyst or coordinator for pooling small businesses and individuals. It would be fair to ask why the government should get involved as opposed to leaving this to small business associations and other trade or professional organizations. In general, however, it appears that small business associations thus far have not in fact launched such large-scale pooling arrangements on their own. One reason may be that the associations have traditionally had other, higher organizational priorities, which do not necessarily include the public policy purpose of expanding retirement security and savings, and their members have traditionally viewed employer-provided health coverage as a higher priority than retirement savings. Moreover, their members may include brokers, insurance agents and others who might view efforts to assemble small business pooling arrangements that negotiate for lower costs as a threat to their business (but see section 1.03[e] and [f], below).

It should be possible, however, for a State government to partner with small business or other trade or professional organizations that are willing to collaborate in reaching out to members and potential members of those groups and offering a pooled retirement savings arrangement. Such public-private alliances also could conceivably help overcome distrust of government among some small business owners who might potentially sponsor a plan.

[b] Negotiating on Behalf of Small Employers and Individuals for Low Costs and Best Practices

It is common for State governments to contract with private financial institutions to provide investments and assist with the management and administration of the State-sponsored 403(b), 457, or grandfathered 401(k) plans for State and local government employees. In addition, States enter into arrangements with private financial institutions to provide prepaid tuition and college savings plans under Section 529 of the Code. Large-scale programs such as these obviously tend to be of interest to providers competing in the marketplace. The same might be true of a State-affiliated plan for private sector employees.

A State government might be expected to have considerable bargaining power with providers based on the prospect that a new program of this kind could ultimately grow to scale. That bargaining power and the prospect of large economies of scale could be used, for example through a process of competitive

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[30] Treasury Regulations section 1.413-2(a)(3)(iv)

bidding and procurement, to negotiate for plans that are low in cost and incorporate best practices in enrollment, investment, and other respects.[31]

[c] Calling Attention to Valuable Federal Tax Benefits

States could make it easier for employees and employers to take advantage of the federal tax benefits for saving through employer plans or IRAs – particularly the more recently enacted tax credits specifically designed to increase coverage, which are the saver's credit for lower- and moderate-income savers and the startup credit for small employers establishing a new plan for the first time. (The startup credit defrays 50 percent (up to $500) of the costs of starting and administering a new plan each year for up to three years.[32]) By publicizing and calling employees' and employers' attention to these benefits and by making it easier to adopt and maintain a qualified plan or to save through an IRA, States can help promote coverage and deliver valuable federal tax benefits to their citizens and to small employers within the State. States would also have the option of providing State tax credits as an additional inducement if they wished to do so.

[d] Simplifying Employers' Decision to Adopt a New Plan

State government's capacity for outreach and "public marketing" could be used to help expand coverage by encouraging employers to make the decision to adopt a new plan. The State's involvement – backing up a private-sector prototype plan sponsor -- may provide additional assurance to small business owners that adoption of a retirement plan for their employees would be a realistic, feasible alternative. Some employers perceive retirement plans to be more complex and costly than they actually are, especially as software, electronic communications, and the internet have simplified administration and reduced costs. A simple, low-cost, standardized plan that is publicized by the State and bears the State's imprimatur might raise small employers' confidence level and simplify their choice among various providers and types of plans. Employers considering adoption of a plan may also be encouraged by the prospect of convenient professional assistance with plan investments, administrative tasks and compliance – arranged or provided by a State agency. In addition, State backing of a standardized IRA might similarly encourage individuals to purchase and use that product.

[31] This statement does not explore the question whether there would be a lawful and appropriate way for States to structure their procurement or competitive bidding process to link contracts relating to State public employee plans with State contracts relating to plans for private sector employees.

[32] Code section 45E.

[e] Assisting Employers With Plan Administration and Compliance

As discussed, a standardized prototype plan backed by the State might also give employers centralized support with plan administration and compliance. Uniformity of plan design and economies of scale could make it feasible to assist employers with enrollment procedures, plan amendments, filings for IRS approvals, preparation of Form 5500 annual reports, summary plan descriptions and other employee communications and customer assistance, nondiscrimination testing, and other operational tasks. However, it would be desirable to seek special relief from the IRS (and Department of Labor, as necessary) to permit the filing of a single Form 5500 for all employers participating in a State-affiliated prototype 401(k). In addition, as noted, by having all employers adopt a prototype document with identical terms (as opposed to allowing employer-by-employer variation), it may be possible to obviate the need for individual employers to seek IRS approval (determination letters) on the prototype document.

[f] Providing a Platform for Innovations, Best Practices, and Retirement Savings Education

State activity in this area could provide a platform for the implementation of 401(k) innovations and best practices as they continue to evolve. These might include practices such as automatic enrollment, automatic escalation of contributions, asset-allocated default investments, plan design involving a limited number of investment options, development and expanded use of cost-efficient lifetime guaranteed income products as distribution options, and perhaps improvements in portability such as expanded automatic rollover of benefit distributions to other retirement savings vehicles.

The involvement of the State in a facilitating or coordinating role might also make it easier to provide and disseminate financial education to individuals regarding planning, saving and investment for retirement.

1.04 SELECTED KEY ISSUES RELATING TO STATE PRIVATE PENSION INITIATIVES

The following section gives very brief attention to a number of related issues.

[1] Application of ERISA

[a] In General

ERISA imposes a variety of requirements relating to "employee benefit plans" (as defined in ERISA),[33] and, in general, supersedes any State laws insofar as they

[33] ERISA section 4(a).

"relate to any employee benefit plan."[34] This preemption of State laws by ERISA is subject to certain exceptions, including exceptions for State laws regulating insurance, banking or securities, and generally applicable State criminal laws.[35] For this purpose, ERISA defines "State law" to include "all laws, decisions, rules, regulations, or other State action having the effect of law, of any State", and defines "State" to include "a State, any political subdivisions thereof, or any agency or instrumentality of either, which purports to regulate, directly or indirectly, the terms and conditions of employee benefit plans covered by this title."[36]

As noted, plans sponsored by State governments or local government authorities for their employees are exempt from ERISA as "governmental plans."[37] Carefully delimited activities of State governments designed to promote savings for their citizens in the private sector, as proposed in this testimony, would be separate and distinct from – and should not affect ERISA's express statutory exemption for -- States' sponsorship of plans for their own employees. Even if a State government were considered a fiduciary under ERISA in respect of its activities relative to a plan sponsored by a private-sector employer for that employer's employees that was subject to ERISA, there would be no reason why ERISA coverage of those State activities should extend to the State's activities relating to plans for State and local government employees. Moreover, as briefly discussed below, it appears that State governments should readily be able to structure their involvement in activities to promote private-sector retirement savings opportunities in a way that avoids ERISA compliance problems or complexities with respect to those activities.

[b] Avoiding ERISA Preemption

IRAs (at least ordinary "standalone" IRAs that are not sponsored by employers or unions for their employees) generally are exempt from ERISA.[38] Payroll deduction IRAs would likewise be exempt to the extent that the employer does

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[34] ERISA section 514(a).

[35] ERISA section 514(b)(2), (4).

[36] ERISA section 514(c).

[37] ERISA section 3(32), 4(b)(1).

[38] 29 C.F.R. section 2510.3-2(d). See ERISA 3(2)(A), 201(6), 403(b)(3)(B). The Department of Labor has promulgated an "IRA safe harbor" in which it takes the position that ERISA does not apply to an IRA if no contributions are made by employers or unions, participation by employees is completely voluntary, the employer's or union's sole involvement is "without endorsement to permit the sponsor [typically the financial institution that provides the IRA and serves as its trustee or custodian] to publicize the program to employees or members, to collect contributions through payroll deductions or dues checkoffs and to remit them to the sponsor," and the employer or union receives no consideration except for "reasonable compensation for services actually rendered in connection with payroll deduction or dues checkoffs." 29 C.F.R. section 2510.3-2(d)(iii), (iv). In addition to other provisions of the Code (e.g., sections 408, 408A), IRAs are subject to the prohibited transaction rules under Code section 4975.

not make contributions of its own and that its role is otherwise limited in accordance with Department of Labor interpretations (which is what is contemplated here).[39] In fact, the Department of Labor has stated that,

> "It has been the Department's long-held view that an employer who simply provides employees with the opportunity for making contributions to an IRA through payroll deductions does not thereby establish a "pension plan" within the meaning of . . . ERISA. . . . Thus, an employer may, with few constraints, provide to its employees an opportunity for saving for retirement,. . . without thereby creating a pension plan under Title I of ERISA. The guidance provided herein is intended to clarify the application of the IRA safe harbor . . . and, thereby, to facilitate the establishment of payroll deduction IRAs."[40]

Accordingly, the "Tier I" State government role (see section 1.03[2][a], above) and activities described in this statement with respect to IRAs should be largely exempt from ERISA to the extent that the IRAs are not considered "employee benefit plans" under ERISA, and therefore those State activities should not be subject to preemption by ERISA.

By contrast, ERISA would apply to the "Tier II" 401(k) plans, whether sponsored by for-profit or by not-for-profit employers in the private sector for their employees.[41] SIMPLE-IRA plans are also subject to ERISA, though only to a more limited extent, consistent with their character as a mini-401(k) with some characteristics of an IRA.[42] Therefore, if a State purported to regulate or otherwise impose legal requirements on such plans, ERISA preemption would come into play. Accordingly, States would need to frame their activities promoting such plans in a manner that takes into account the need to steer clear of preemption by ERISA.

For example, a State might offer what amounts to a "seal of approval" and outreach assistance to all prototype private-sector 401(k) plans that satisfied certain conditions relating to plan design, investments, and cost, as set forth in a State request for proposals. A good case could be made that this would not

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[39] Id.; 29 C. F. R. section 2509.99-1.

[40] 29 C. F. R. 2509.99-1(b). The Department issued a special interpretive bulletin in 1999 that details the conditions for exemption of a payroll deduction IRA from ERISA and enumerates activities an employer may undertake without converting the payroll deduction IRA program into an ERISA plan. Those activities include such things as encouraging employees to save for retirement by giving them general information on the IRA payroll deduction program (including materials that include the employer's name and logo), and answering employee questions about how the program works, provided it is clear to employees that the employer's involvement is limited to facilitating employee contributions through payroll deduction as opposed to endorsing the IRA sponsor or its investment or other financial products or giving employees any additional benefit with respect to the program. For example, an employer may, without triggering ERISA coverage, limit the number of IRA sponsors to which employees may transfer payroll deduction contributions or may designate a single IRA sponsor as the recipient of those contributions, but may not influence the investments permitted, negotiate special terms and conditions for its employees, or bear costs that the IRA sponsor would otherwise expect employees to bear (except for internal costs such as overhead or bookkeeping). 29 C.F.R. section 2509.99-1(c), (d), (e).

[41] ERISA section 3(2), (3), (5), (6).

[42] See ERISA sections 101(h), 403(b)(3)(B), 404(c)(2); 29 C.F.R. section 2510.3-102(b)(2).

amount to State law or the imposition of regulation or regulatory requirements relating to ERISA-governed employee benefit plans so as to trigger preemption by ERISA. Under this view, such State activities would only constitute support for or partnership with certain competitors in the provider market, and the State would be regarded as acting in a manner similar to a private participant in the market that was negotiating a contract. (Although it might be somewhat far-fetched, a counter argument might be made that State action relating to ERISA plans should be subject to preemption if and to the extent that it imposes requirements as a condition of conferring major, unique benefits of a kind that only a State could confer.) One possibility would be to apply for a Department of Labor advisory opinion confirming that specified State activities do not raise ERISA preemption concerns.

[2] Could There Be a Role for Sidecar or Deemed IRAs?

An interesting issue is whether private-sector employees and self-employed individuals could be allowed to keep their IRA assets in the State government's plan for its own employees without jeopardizing the State plan's exemption from ERISA. The question is whether this could be done by establishing State-affiliated "sidecar" or "deemed" IRAs, trusteed by the State or by a financial institution contracting with the State, that are effectively attached to or associated with State-sponsored retirement plans covering State government employees.[43] If such IRAs could be established for self-employed individuals and employees of small businesses that are not ready to sponsor a plan – without losing the State plan's ERISA exemption – those individuals could benefit from the economies of scale associated with the same investments that are offered by the State's plans for its employees.

In general, "sidecar IRAs" or "deemed IRAs" can have investments that mirror those of the State employees' plan because they are permitted to commingle their funds with those of the plan; and a State or other governmental entity that meets certain requirements may serve as the trustee of a sidecar IRA that it establishes as part of its employer plan.[44] The Department of Labor has ruled in an advisory opinion that the establishment of sidecar IRAs as part of a governmental plan would not subject the plan or the sidecar IRAs to Title I of

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[43] Sidecar IRAs and the qualified employer plan may share the same trust (with separate accounts for each individual's IRA) or may maintain different trusts (with the IRAs either grouped in a single trust or with a separate trust for each IRA). However, use of a single trust for both means that, if either the IRAs or the plan fails to satisfy their respective qualification requirements, the other is automatically disqualified as well. This risk can be avoided by maintaining the plan and the IRAs in separate trusts or in a common trust fund or common investment fund. See Code section 408(q). IRAs may be attached to a qualified employer plan or to an eligible State government plan under Code section 457(b) that is sponsored by a State government for its employees.

[44] See Proposed and Temporary Treasury Regulations section 1.408 -2(e)(8) & -2T(e)(8). See also Elizabeth T. Dold, "Deemed IRAs – A Welcomed New Plan Design Feature," *Pension & Benefits Week* (RIA) (November 18, 2002), pp. 7-12.

ERISA where the individuals for whom the IRAs were established were governmental, not private-sector, employees.[45] There is no assurance, however, that a governmental plan would retain its exemption from ERISA if it established sidecar IRAs for more than a de minimis number of private-sector employees. In any event, the relative importance of this question depends on whether, as a practical matter, sidecar IRAs would deliver benefits beyond those that might be realized by the more traditional methods of pooling investments.

[3] Competition With Existing Providers

As noted, many financial providers have limited or no interest in serving small employers that sponsor plans with low average account balances. However, some financial institutions, as well as some consulting or administration firms, are interested in selling plans and plan-related services in this market. These firms could be expected to consider whether State government activity of this kind – pooling employers and employees, negotiating lower fees and costs, etc. – would be a threatening form of competition.

The proposed State activity would not impede or restrict competition in the market. In fact, the State's role might have the effect of increasing competition, especially for the smallest or lowest-wage firms. Second, it is contemplated that the States would contract with private financial institutions and other providers, as they do with the plans they sponsor for their employees (and perhaps to some degree as they do with their Section 529 plans). Third, the State's involvement, if successful, might help the pension industry and related providers penetrate the small business market. This could help create thousands of new retirement savings accounts, many of which can ultimately be expected to be rolled over to IRAs maintained by private financial institutions.

In addition to those considerations, if the financial services industry is not avid in its marketing to most small employers and groups with low average account balances, then it is legitimate for government to step in and promote saving in this market segment. In the long term, the result may be to establish a saving infrastructure in which all working Americans have an IRA or similar individual account in which they are encouraged to save, invest, and own assets. Ultimately, in general, more saving for retirement and other long-term needs increases retirement security and tends to accumulate more investment capital to enhance national productivity and more assets under management for the financial services industry.

Finally, if State activity leads to more active price competition in a market where consumers often lack the information and ability to compare and shop for price, and if this in turn helps drive down fees and expenses, that may be all for the good. However, to mitigate potential competition with private-sector providers, a State could make its plan available only to employers below a specified size. As

[45] Department of Labor Advisory Opinion 2003-01A (January 24, 2003).

a variation on that approach, a State might even consider making its plan available only to small tax-exempt employers if it believes that, as a broad generalization, those entities might have somewhat lower compensation levels and that there might be less competition for their business.

[4] Cost and Potential Liability

States should have only limited costs because federal preemption would preclude them from actually regulating ERISA-governed plans, and because they would neither fund nor regulate the plans. The objective would be for States to recover their administrative costs from plan investment returns. Conceivably, private-sector contractors might help absorb start-up administrative costs.

States could design their role to minimize their potential liability in the event of a market crash or other unexpected developments. Depending on the services it provides or the functions it performs in relation to ERISA-governed plans and their investments, a State government agency might conceivably be treated as a plan fiduciary under ERISA. A State agency might either limit its activities and functions so as to avoid fiduciary status or accept the possibility or certainty of fiduciary status but structure the arrangements to limit its potential exposure as many ERISA plan sponsors do. For example, the State might contract with prototype plan sponsors or other third party pension or investment professionals to assume appropriate responsibility, and it might delegate key functions or decisions to, or obtain advice from, independent fiduciaries and experts. Whether it may also be advisable to consider enactment of statutory protection from liability, if necessary under State law, is beyond the scope of this statement.

[5] Should State Bonds Be Permitted As Potential Investments?

Could or should there be a role for State-issued bonds within such a program – either in a balanced or life cycle fund or in a conservative fixed income investment option? Such an approach could give the State a greater stake in expanding pension coverage – an additional incentive to take an interest in launching and marketing the plan – and an additional means of defraying costs of startup and administration. On the other hand, State bonds would raise diversification concerns unless limited to a very small fraction of the portfolio. Of course the safety of the bonds would depend on their ratings and the financial strength of the State at any given time. The credit history of certain municipalities and counties, for example, is not entirely reassuring, and some States' bonds might be more vulnerable than alternative fixed income investments to fluctuation of principal value as interest rates and credit ratings change. In addition, giving the State a financial interest in the investments might raise conflict of interest concerns and might generate at least some suspicion among employers and individuals regarding the State's motives for endorsing the plan.

[6] Relation to Defined Benefit Pension Plans

The assumption implicit in the foregoing discussion is that, in recent years, small employers generally have shown themselves to be more receptive to adoption of new 401(k) (and SIMPLE-IRA) plans than new defined benefit plans. The portability, relative simplicity, low cost, and "name recognition" associated with the 401(k) has made it particularly appealing to smaller employers. Accordingly, the most realistic strategies to expand coverage in the market segment where coverage is most sparse – the small business sector, as well as among moderate- and lower-income workers – might lead with these types of plans.

Such an approach, however, is by no means intended to give up on defined benefit pensions. Generally, depending on the specifics of the plan design, defined benefit plans have particular advantages. In fact, it is not inconceivable that State governments might play a role in encouraging defined benefit coverage through collective arrangements that are beyond the scope of this testimony.

The initiatives outlined here are very much intended to steer clear of the debates within some States over whether to shift from defined benefit to defined contribution plans for State and local government employees. The witness believes it is desirable to encourage and preserve well-designed defined benefit plans as well as defined contribution plans, and that it is particularly important to protect and perpetuate existing defined benefit plans that effectively cover substantial numbers of middle- and lower-income workers. A pension coverage strategy seeking to penetrate the small business market based on the perception that small businesses are more likely to consider adopting a new 401(k) than a new defined benefit pension plan should be viewed as having no intended impact on debates about the future of defined benefit plans covering hundreds of thousands or millions of State and local government employees.

1.05 FIRST STEPS TOWARD IMPLEMENTATION

[1] In general

A number of incipient efforts are under way in several States to implement the concept outlined here. As of this writing, it appears that no State has implemented the concept, but the witness has participated in designing and drafting proposed legislation reflecting this approach that has been introduced as bills in Washington and Maryland, and that appears likely to be introduced soon in Michigan and Vermont. In a number of other States as well, the witness has been in contact with legislators, Executive Branch officials and stakeholders who are beginning to explore the possibility of a limited State government role in promoting saving and private pension coverage.

Each of these legislative efforts could implement the concept of State-assisted private-sector retirement saving in a slightly different way, reflecting the views and preferences of the relevant legislative sponsors and Executive Branch officials in each of these States. The bills introduced thus far (and future bills that may be introduced in other States) can be expected to undergo changes in the course of the legislative process, and the outcome – whether they are ultimately enacted and how they are actually implemented -- is uncertain.

[2] Maryland

Early in 2006, a bill to establish the "Voluntary Employee Accounts Program" was introduced in the Maryland House of Delegates by Delegate Samuel I. ("Sandy") Rosenberg.[46] The legislation was suggested by the witness to authorize the State to promote the adoption of the programs described in Tier I and Tier II, above – voluntary IRAs, payroll deduction IRAs, and employer-sponsored SIMPLE-IRA and 401(k) plans. The proposed legislation authorizes the Board of Trustees of the Maryland Teachers and State Employees Supplemental Retirement Plans to contract with private financial institutions to help establish and administer such a program. The authority embraces master and prototype programs, collective investment and administrative arrangements, and authority to obtain federal agency approvals.

[3] Michigan

As of this writing, the introduction of a bill in Michigan appears to be imminent. Based on the witness's 2005 presentation to the National Association of State Treasurers, then State Treasurer Jay Rising suggested the concept to Governor Jennifer Granholm. The Governor, in her State of the State address on January 25, 2006, called for developing a State-assisted 401(k) plan for small businesses in Michigan that do not currently sponsor plans and that choose to adopt the new program.[47] The witness has been involved in the effort to draft legislation focusing on a Tier II approach.

[4] Vermont

Vermont State Treasurer Jeb Spaulding and a tri-partisan group of Vermont legislators – Representative Donna Sweaney, Senator Diane Snelling, Senator Susan Bartlett, and Rep. Sarah Edwards – recently announced that legislation would be introduced next year to promote the concept in Vermont. (Their news release is appended to this statement.) The Vermont Voluntary Retirement Savings Program would be based also on the witness's 2005 presentation to the National Association of State Treasurers.

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[46] The bill, HB 1414, was cosponsored by Delegate Richard S. Madaleno, Jr., and was amended in March 2006.

[47] The effort is now being spearheaded by Chris DeRose, director/CEO of Michigan's statewide retirement systems. See Amy Lane, "Fahrenheit 401(k)," *Crain's Detroit Business* (March 13, 2006), pp. 3, 29.

[5] Washington

To date, the State of Washington has made more progress than any other State in moving the proposal forward in the legislative process, owing mainly to the work of Marilyn Watkins and John Burbank of the Seattle-based Economic Opportunity Institute.[48] Legislation with bipartisan cosponsorship, revised to reflect in large part the witness's 2003 proposal, has been pending in the State legislature for several years, and has been favorably voted out of committees in both houses.[49]

As in Maryland, the legislation authorizes the State to promote the adoption of the programs described in Tier I (voluntary IRAs and payroll deduction IRAs) and Tier II (employer-sponsored SIMPLE-IRAs, and master and prototype 401(k) plans). Unlike Maryland, the sponsors of the Washington legislation chose to require small employers that do not sponsor a retirement plan to cooperate with the State Department of Retirement Systems to facilitate their employees' participation in payroll deduction IRAs. In other words, while employers would not be required to sponsor plans for their employees, small employers that do not sponsor a plan would be required to offer their employees the opportunity to save through payroll deposit to an IRA (which would be made available by the State). The State Investment Board would manage the investment of the contributions. Implementation would await necessary federal approvals and identification of funds for startup of the program. If the program were not self-supporting after six years, the Director would be required to recommend a method of terminating it.

1.06 CONCLUSION

State-assisted saving, as described here, has the potential to serve the legitimate interests of workers, employers, and the public, including the States.

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[48] In Washington, the original impetus for a State government role in expanding private pensions appears to have come from Dean Baker, Co-Director of the Center for Economic & Policy Research in Washington, D.C., working with Ms. Watkins. Dr. Baker's article, "Pensions for the 21st Century" (Century Foundation, 2000) summarizes and evaluates the federal Universal Savings Accounts proposal (which the witness participated in developing while serving in the Executive Branch in 1999-2000) and two other proposals, suggests that selected elements of each be combined in an amalgam approach, and notes that this could be administered at the federal or state level.

In 2002 or 2003, the witness recommended that Washington consider the specific two-tier framework summarized in his April 2003 written statement for the Washington legislature (and in this testimony), based on the use of four existing federally-regulated retirement savings vehicles -- the IRA, the payroll deduction IRA, the SIMPLE, and the master and prototype 401(k) – and on the hope of avoiding the need for new federal legislation to authorize such State activity.

[49]Second Substitute Senate Bill 5544 and Substitute House Bill 1570, creating the "Washington Voluntary Accounts Program".

Saving for retirement by employees and the self-employed could be facilitated through plans that are more available, simpler, cheaper, and portable. This approach could help small businesses to more effectively recruit and retain valuable workers and reduce turnover through simpler, cheaper plans for employees that create less distraction from running the business. (In addition, small employers could obtain the startup costs tax credit for establishing a new plan.)

In addition, State-assisted saving could be a wise investment for the State and the Nation. Citizens could become more financially independent and self-sufficient, therefore less likely to end up as charges upon the State. This could tend to relieve pressure on State and federal public assistance programs. Moreover, the State role outlined here would be feasible at reasonable cost to the States because they would not contribute to fund these plans, would not regulate them, and could recover administrative costs from investment returns. States would use their ability to pool small employers and their collective buying power, their accumulated expertise and experience, perhaps some of their administrative infrastructure, their capacity for outreach, and their credibility to encourage saving and expand pension coverage in the private sector.

Finally, the strategy outlined here would likely spawn differing approaches to promoting retirement security and expanding coverage in various States, to the extent consistent with federal preemption. The potential for creativity at the State level would be a key advantage, permitting States – in Justice Brandeis' classic words – to "serve as a laboratory"...and "remould, through experimentation, our economic practices and institutions to meet changing social and economic needs."[50]

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[50] New State Ice Co. v. Liebmann, 285 U.S. 262, 310-311 (1932)(Brandeis, J., dissenting).

NEWS RELEASE NEWS RELEASE NEWS RELEASE NEWS RELEASE

For immediate release:	June 13, 2006
For more information, contact:	Jeb Spaulding at 802-828-1452
	Donna Sweaney at 802-674-5175
	Diane Snelling at 802-482-4382
	Susan Bartlett at 802-888-5591
	Sarah Edwards at 802-257-4630

Tri-Partisan Effort to Boost Retirement Savings Launched in Vermont

Montpelier – Recognition that half of today's workforce is not covered by any retirement savings plan has prompted a proposal by a tri-partisan group of Vermont legislators and the State Treasurer to provide for a statewide voluntary retirement savings program. The proposal would leverage the resources and expertise of Vermont's state level retirement plans to assist small businesses in providing a 401(K)-type retirement savings plan for their employees.

Introducing the Vermont Voluntary Retirement Savings Program, State Treasurer Jeb Spaulding explained, "We know that a large percentage of Vermonters are not currently saving for retirement and that taxpayers will bear the ultimate responsibility for seniors with insufficient savings. We also know people are more likely to save if a simple retirement plan is available at work and that by providing a simple, inexpensive, high-quality, and safe retirement plan option for small employers and self-employed Vermonters, we can increase critical savings for retirement."

Legislative members of three political parties (Democrat, Republican, and Progressive) expect to sponsor enabling legislation next year and will spend the summer and fall working with citizens, legislators, and business partners to promote the concept.

According to Representative Donna Sweaney, D-Windsor, four states – Washington, Maryland, Michigan, and Vermont – are actively moving to create voluntary retirement savings programs and several others have expressed interest in the concept, which was developed and promoted by former U.S. Treasury official Mark Iwry, currently at the Brookings Institution in Washington, DC. "We will be devoting a major portion of an upcoming New England Women Legislators Symposium to this subject," Rep. Sweaney stated.

more

The Vermont proposal calls for the creation of a voluntary retirement savings program as an option for employers and employees, and self-employed Vermonters, sponsored by the state, and at no cost to the taxpayers. The program would take advantage of economies of scale by piggybacking on the State's existing retirement plans to offer businesses the option of providing a 401(K)-type retirement plan for their employees. Administrative costs will be covered in the fee for plan participants.

"This collaborative effort will bring the resources of the State Treasurer's Office, legislative leaders, and the private sector to bear on a major issue facing Vermonters – the lack of adequate savings to meet future retirement needs, especially as the baby-boomers begin to leave the work force. Many of Vermont's small businesses want to provide retirement plans for their workers, but are unable to do so because of cost and administrative barriers. This plan provides a straightforward voluntary approach to assist these businesses," said Senator Diane Snelling, R-Chittenden.

"People are living longer and not saving enough. This public/private partnership can be a win-win-win proposition: Vermonters will have more savings and a better quality of life at retirement, businesses will be able to attract and retain employees with enhanced benefits at little or no cost, and state government will avoid some future liabilities for those with inadequate retirement savings," stated Sarah Edwards, P-Brattleboro.

According to Senator Susan Bartlett, D-Lamoille, Chair of the Senate Appropriations Committee, women have distinct retirement challenges that would benefit from the Vermont Voluntary Retirement Savings Program. "An alarming number of older women face the reality of moving from the middle class to poverty when their spouse dies. Since women live longer, often interrupt their careers to raise children or care for aging parents, and are paid less than men, they often end up with inadequate retirement savings. Making it easier for them to save would be very helpful," she explained.

Iwry, who serves as Senior Adviser to the Retirement Security Project at Brookings, said of the Vermont proposal, "Leveraging their resources and bargaining power, states can assist small businesses in pooling their efforts to help employees save. Vermont can act as a powerful catalyst, partnering with the private sector to expand private pension coverage."

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Statement of Senator John Kerry
Senate Finance Subcommittee
on Long-term Growth and Debt Reduction Hearing:
"Small Business Pension Plans: How Can We Increase Worker Coverage?"
June 29, 2006

Mr. Chairman, thank you for holding this hearing today on this extremely important topic — small business pension coverage. Back in April, this Subcommittee held a hearing on our national savings rate. We heard compelling testimony from witnesses about our fiscal outlook and how we need to improve our public and private savings. An important component of this is personal savings.

Our personal savings rate is negative for the first time since the Great Depression. We need to ask ourselves if we are saving enough for retirement. Retirement savings consists of individual savings, Social Security, and pensions. Currently, Congress is working on legislation that would strengthen one aspect of our pension systems, defined benefit plans, but more must be done.

We have to ask ourselves if we are providing the right tax incentives that will help improve pension coverage. According to the Joint Committee on Taxation, we will spend over $700 billion over the next five years on tax expenditures for pension plans. From the testimony that we will hear today, we will learn that 71 million employees work for companies that do not offer pension plans. This statistic begs the question are we spending our resources appropriately. I am concerned that we might be providing too many tax benefits to those who do not need any incentives to save and that we are not doing enough for small businesses and low-income individuals.

Pension coverage needs to improve, particularly for small businesses. In 2004, only 26 percent of workers at firms with fewer than 25 employees participated in pension plans. We need to work together to improve this statistic. I look forward to learning from the witnesses ways that we can improve coverage. We need to know what works and what doesn't.

We will hear about a new proposal — automatic individual retirement accounts (IRAs). This proposal has merit because it provides a simple way for small employers to help their employees save. I look forward to learning more details about this proposal and how it will fit into our current system. If implemented properly, it could be a stepping stone for small employers to offer pension coverage. Hopefully, employers would start with an automatic IRA and then offer a plan with more benefits.

I look forward to working with Chairman Smith on legislation that will make it easier for small businesses to offer pension plans. I thank the Chairman for holding this hearing that should provide constructive information on how we should help the 36 million Americans employed by firms with less than 25 employees save for retirement.

COMMUNICATIONS

June 29, 2006

The Honorable Gordon Smith
Chairman
Subcommittee on Long-Term Growth
and Debt
Committee on Finance

Dear Senator Smith:

AARP commends you for holding today's hearing on increasing pension plan coverage in the small business community. Over the past few years, the attention of Congress has been focused on dealing with issues related to the private pension system, with little attention paid to the fact that approximately half of the U.S. workforce does not have any employer provided pension coverage or convenient employer-based way to save for retirement. We hope the hearing will serve as a catalyst to bring together Congress, the small business community, and other interested parties to address this issue and expand the opportunities for workers without employer-provided pension coverage to save for retirement.

Towards this end, AARP supports a universal payroll deduction IRA, one example of which has been proposed by the Retirement Security Project (RSP). A payroll deduction IRA is a practical, voluntary and low-cost way to provide a retirement savings option for the approximately 71 million workers without any employer-sponsored retirement plan. For example, under the RSP plan, all employers with 10 or more employees would be required to provide automatic payroll deduction IRAs to their workers unless the employer offers some other type of retirement plan. Employers, however, would not be required to make contributions, maintain the IRA, or determine how or where contributions are invested. The employer would simply act as a conduit -- transferring contributions determined by the worker to a specific IRA via a payroll deduction.

AARP believes that the implementation of the automatic IRA is an essential first step in helping the millions of workers currently without pension coverage to begin saving for retirement. Most employees prefer to save by having money withheld directly from each paycheck. A payroll deduction IRA will help encourage saving by simplifying the saving process for workers. In addition, the Saver's Tax Credit will serve as an added incentive for lower wage workers to save, and we urge that the Savers Credit be expanded and extended.

We again applaud your interest in helping the millions of workers currently without pension coverage to save for retirement. We look forward to working with the members of the Subcommittee and other interested parties to increase savings, including efforts to make an automatic payroll deduction IRA available to the millions of workers without pension coverage.

Sincerely,

David P. Sloane
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Hearing Testimony for the Record
Senate Committee on Finance
Subcommittee on Long-Term Growth and Debt Reduction

"Small Business Pension Plans: How Can We Increase Worker Coverage?"

June 29, 2006

Introduction

The American Society of Pension Professionals & Actuaries (ASPPA) appreciates the opportunity to submit our comments to the Senate Committee on Finance, Subcommittee on Long-Term Growth and Debt Reduction, June 29 hearing, "Small Business Pension Plans: How Can We Increase Coverage?" We fully support the Committee's efforts to increase retirement savings for millions of employees working for small business employers. These workers frequently do not have the opportunity to save through a workplace retirement plan.

ASPPA is a national organization of approximately 6,000 retirement plan professionals who provide consulting and administrative services for qualified retirement plans covering millions of American workers. ASPPA members are retirement professionals of all disciplines, including consultants, administrators, actuaries, accountants and attorneys. Our large and broad-based membership gives ASPPA unusual insight into current practical problems with ERISA and qualified retirement plans, with a particular focus on the issues faced by small- to medium-sized employers. ASPPA's membership is diverse but united by a common dedication to the employer-sponsored retirement plan system.

ASPPA would like to thank Chairman Gordon Smith (R-OR) and Ranking member John Kerry (D-MA) of the Senate Committee on Finance, Subcommittee on Long-Term Growth and Debt Reduction for examining these important issues. In particular, we would like to thank the efforts made by Senators Smith and Kent Conrad (D-ND) to examine the issues facing small business retirement plan coverage and the challenges faced by women in saving for retirement. ASPPA is hopeful that these efforts will ultimately produce comprehensive and valuable legislation that will bolster retirement plan coverage for millions of American workers.

ASPPA Supported Proposals

ASPPA strongly supports the following proposals and recommends the Committee incorporate these issues into possible future legislation designed to expand retirement plan coverage.

Increasing Retirement Savings through Automatic IRAs

ASPPA supports giving American workers access to an employer-based retirement savings program, specifically a payroll-deduction IRA, where they are not already covered by a qualified retirement plan is essential. Coupled with an expanded SAVER's credit, this legislative proposal will likely persuade more employers, particularly small businesses, to offer a qualified retirement plan to their workers. It should also greatly improve the retirement savings rates of lower-income workers (statistics clearly show that low- to moderate-income workers are significantly more likely to save for retirement when allowed to save at the workplace[1]).

It is important to emphasize that employers offering a qualified retirement plan should not be required to also offer a payroll-deduction IRA. Requiring such employers to offer two plans would be unnecessarily burdensome and would actually serve to discourage the formation of the qualified retirement plans that provide more generous benefits to workers.

Amending 401(k) Plan Coverage Rules for Long-Term, Part-Time Workers

Under current law, employers can generally exclude part-time employees who work less than 1,000 hours per year from coverage under a defined contribution (DC) plan. This rule can exclude long-term, part-time employees from adequately preparing for retirement. In particular, this rule penalizes women who are more likely than men to work part-time.

ASPPA supports a requirement that employers sponsoring 401(k) plans would have to allow part-time employees to participate in the plan if they work at least 500 hours of service per year for three years. Requiring employers to include long-term, part-time employees while still excluding short-term or seasonal employees is consistent with the intent of current law and provides a vehicle for retirement savings for these workers, many of whom are women, who are working part-time on a more permanent basis.

To not impose any added cost to employers, employers should be permitted to permissively disaggregate those part-time workers for non-discrimination testing. Otherwise, employers would likely face significantly greater costs due to the addition of these part-time workers to the plan.

Allowing Participants with a Non-Working Spouse to Make Additional 401(k) Contributions

Many participants in 401(k) plans have non-working spouses who are full-time homemakers. These non-working spouses do not have the ability to save through an employer-sponsored retirement plan. Under IRC §402(g), working spouses who participate in a 401(k) plan are subject to an annual maximum contribution amount.

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[1] According to the Employee Benefits Research Institute, low- to moderate-income workers are almost 20 times more likely to save when covered by a workplace retirement plan. Of workers who earned $30,000 to $50,000 and were covered by an employer-sponsored 401(k)-type plan, 77.7 percent actually saved in the plan, while only 4 percent of workers at the same level of income, but not covered by a 401(k)-type plan, saved in an individual retirement account.

ASPPA supports allowing 401(k) plan participants who have non-working spouses to contribute an additional $5,000 annually to the plan. This allowance would be accomplished by increasing the maximum annual contribution limit under IRC §402(g) by $5,000. This change would significantly increase the ability of such participants to further support both the working and non-working spouse upon retirement.

Allowing Start-up Credit for New Small Business Retirement Plan Contributions

Non-discrimination rules require contributions that are often prohibitively expensive for many small businesses. Statistically, however, once small businesses adopt a retirement plan, they typically continue maintaining the plan. Therefore, ASPPA supports a provision that would provide contribution tax credits for the first three years of a new retirement plan. This credit would contribute greatly to expanding and maintaining small business retirement plan coverage. [2]

Modifying the Top Heavy Rules for Deferral-Only 401(k) Plans

Many small employers are interested in providing a 401(k) plan. While some cannot afford to make employer contributions, they want to offer their employees the opportunity to build savings on a tax-favored basis. In a small-employer plan, the plan may be top heavy, depending on the demographics, the level of participation and the number of eligible employees. Top heavy status is measured at the end of the first year. If a key employee (business owner) has made any deferral in that first year, and the plan is determined to be top heavy, this deferral could trigger a contribution requirement of up to 3 percent of pay for all non-key employees. This requirement becomes a major disincentive for small employers to create a plan for their employees.

ASPPA supports a modification of the top heavy rules so that salary deferrals by key employees (from their own compensation) are not considered employer contributions that trigger top heavy minimum contribution requirements. Removing this top heavy obstacle would encourage previously hesitant small employers to provide a 401(k) plan.

Amending Minimum Participation Rules Applicable to Small Business Defined Benefit Plans to Increase Retirement Coverage for Small Employers

Eliminate the separate requirement to test for minimum participation rules where an employer provides a 7.5 percent minimum gateway contribution

The minimum participation rules of IRC §401(a)(26) are intended to ensure that a defined benefit (DB) plan is not used to disproportionately benefit only a few highly compensated employees (HCEs). The minimum participation rule under IRC §401(a)(26) requires that the DB plan cover at least 40 percent of employees or 50 employees, whichever is less, but no less than two employees.

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[2] The proposed credit should be available for the first three years of the plan and equal to 50 percent of the amount of employer contributions for non-highly compensated employees that would otherwise be deductible to the extent of up to 3 percent of compensation.

The concerns of IRC §401(a)(26) have, in large measure, been alleviated by the use of gateways for cross-testing now required by Treasury regulations. When there are two different plans covering employees, cross-testing is almost inevitably used to show that the plans are not discriminatory under the minimum participation rules. To use cross-testing, certain additional requirements (gateways) must be met. These gateways ensure that significant benefits are provided to all non-highly compensated employees (NHCEs). With the addition of a minimum gateway contribution requirement for non-discrimination testing, most NHCEs receive a minimum gateway contribution of between 5 and 7.5 percent of compensation. Consequently, the gateways eliminate the need for the protections of IRC §401(a)(26).

With these recent changes, the need to test under the minimum participation rules in addition to the gateway requirements is too restrictive and discourages the formation of plans covering significant numbers of NHCEs. Furthermore, it forces the employer to cover some employees under the DB plan while others are in the DC plan, which inevitably leads to issues of fairness.

ASPPA recommends a requirement that when an employer maintains a DC plan under which NHCEs receive a minimum gateway allocation of at least 7.5 percent of compensation, the employer would not be required to separately satisfy the IRC §401(a)(26) minimum participation rules for a DB plan where the DC plan is aggregated for the nondiscrimination and coverage rules of IRC §§401(a)(4) and 410(b).

Exempt DB plans of very small employers with only HCEs or employees otherwise excluded by statute from IRC §401(a)(26)

Defined benefit plans must satisfy the minimum participation rules of IRC §401(a)(26) even where an employer has only highly compensated employees (HCEs) or employees otherwise excludable by statute.[3]

The minimum participation rules under IRC §401(a)(26) were enacted to eliminate abusive and discriminatory practices—that is, a situation in which a company covered a small number of HCEs or owners in one DB plan and covered the non-highly compensated employees (NHCEs) in another plan. There are situations with very small employers, however, where these rules serve no purpose since the only employees are owners, HCEs, or employees otherwise excluded from coverage by statute.

Accordingly, the minimum participation rules currently restrict the ability of such a company to design an effective benefit program or programs. This is an unintended consequence of the implementation of IRC §401(a)(26) and should be eliminated so these employers are not prevented from adopting their retirement plan of choice.

ASPPA supports allowing an exemption from the minimum participation rules under IRC §401(a)(26) for those plans with only HCEs or employees otherwise excludable by statute. For example, an employer in which the only two employees are also partners (owners) in the

[3] IRC §§410(b)(3) and 410(b)(4) define "excludable" employees as nonresident aliens, collectively bargained employees, and people who do not meet age and/or service requirements. Furthermore, Treas. Reg. §1.410(b)-6 adds the exclusion of terminated employees with less than 500 hours of service.

business could have a defined benefit plan for one partner and a defined contribution plan for the other. Under current law, this arrangement would not be permitted even though there are no other employees besides the business owners and thus no potential for abuse.

Summary

It is vital that Congress appreciate the barriers currently faced by small employers in providing small business retirement plan coverage. Senators Smith's and Conrad's efforts to provide incentives to expand small business retirement plan coverage are important efforts in the right direction. ASPPA looks forward to working with you to make these proposals a reality.

Statement Presented to
The U.S. Senate Committee on Finance
Subcommittee on Long-Term Growth and Debt Reduction

Hearing on
Small Business Pension Plans: How Can We Increase Worker Coverage?

June 29, 2006

Transamerica Retirement Services appreciates the opportunity to provide this written Statement in connection with the U.S. Senate Committee on Finance, Subcommittee on Long-Term Growth and Debt Reduction and its hearing on the issues related to the offering of retirement benefits by small business. TRS commends Chairman Gordon Smith and Ranking Member John Kerry for focusing on the particular concerns of small business in providing retirement benefits.

Transamerica Retirement Services ("TRS"), a marketing unit of Transamerica Financial Life Insurance Company and its affiliates, designs customized retirement plan solutions to meet the unique needs of small to midsized businesses. TRS serves more than 15,000 small business clients who collectively represent nearly $12 billion in plan assets under management as of December 31, 2005. Transamerica Retirement Services is part of the AEGON Group. Headquartered in the Netherlands, AEGON is one of the largest life insurance and pension companies, and a strong provider of investment products. AEGON's businesses focus on life insurance, pension, supplemental health, savings and investment products.

Pertinent facts about small business

According to the U.S. Census Bureau, small businesses (less than 500 employees) represent 99.7% of the total firms and 50.7% of the workforce in the United States.[1] Further, according to the National Federation of Independent Business, small businesses create two-thirds of the new jobs in the United States, represent 98% of the new businesses formed and supply 40% of the U.S. gross domestic product.[2] Given the prominent role that small businesses play in the U.S. economy, it is vital to encourage small business owners to sponsor retirement plans and help the small business workforce adequately prepare for retirement.

The small business sector is highly dynamic with high start-up rates, closure rates, and merger and acquisition activity. Small businesses are represented in all industries and generate a wide range of revenue, earnings, and payroll. As such, at any given time, a small business may have unique needs and objectives for sponsoring a retirement plan. While some small business owners feel that they need to sponsor a plan to attract and

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[1] U.S. Census Bureau, 2003 County Business Patterns. For information on confidentiality protection, sampling error, nonsampling error, and definitions, see http://www.census.gov/epcd/susb/introusb.htm
[2] www.nfib.org

retain employees, others may be focused on their own personal retirement security, and all seek to do so at a cost that they can afford.

Small businesses' role in providing workplace retirement plans

It is well documented that Americans do not save adequately for their retirement and that employer sponsored retirement savings plans play a critical role in facilitating such savings. According to the Seventh Annual Transamerica Retirement Survey[3] (the "Transamerica Survey"), 74% of workers surveyed (at companies with greater than 10 employees) indicated that they participate in their company's defined contribution retirement plan – compared to the Investment Company Institute's finding that only 17% of U.S. households contributed to an IRA in 2004[4].

The role of employers in providing retirement savings plans to their workers has long been supported by public policy and the work of this and prior congresses in enacting tax incentives both for employers to sponsor retirement plans for their workers and for workers to accumulate long-term savings through those plans. The current tax system also helps to ensure that these savings will be there for retirement by placing restrictions on pre-retirement distributions and imposing tax penalties for early withdrawals.

However, it is striking that while small business accounts for 50.7% of jobs in the economy, according to the Transamerica Survey only 76.5% of small business employers with 10-499 employees reported that they provide 401(k) or other employee retirement savings plans for their workers. This is in contrast to the fact that 96.1% of large employers with over 500 employees reported that they provide 401(k) or other employee-funded retirement plans for their workers. In addition, 81.4% of employees in large businesses indicated that they participate in their employer provided retirement plans in contrast to 63.9% of small business employees. Furthermore, workers in small businesses only contribute 7% of their salary (median) to employer plans as compared to workers in large businesses who contribute 10% of their salary (median).

According to the Transamerica Survey, while 76.5% of small businesses reported providing 401(k) or similar retirement savings plans for their workers only 13.7%

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[3] A full copy of the Transamerica Survey can be found at http://www.ta-retirement.com/TheCenter/tcrs_content_viewer.aspx This is a national telephone survey of employed adults conducted by Zogby International in 2005. The target sample is 1335 interviews with approximately 61 questions asked. Samples are randomly drawn from telephone CDs of national listed sample. Zogby International surveys employ sampling strategies in which selection probabilities are proportional to population size within area codes and exchanges. As many as six calls are made to reach a sampled phone number. Cooperation rates are calculated using one of AAPOR's approved methodologies and are comparable to other professional public-opinion surveys conducted using similar sampling strategies. Weighting by *age, race, and gender* is used to adjust for non-response. Margin of error is +/- 2.7 percentage points. Margins of error are higher in sub-groups.

[4] Investment Company Institute, The Role of IRAs in Americans' Retirement Preparedness, January 2006

indicated that they provided a company funded defined benefit pension plan. Therefore, this Testimony will focus on those retirement savings/ defined contribution plans.

There are many reasons for the disparity between small and large businesses in providing retirement savings benefits for their workers. Many small businesses do not have the financial or administrative resources to provide or maintain such plans. The Transamerica Survey found that of small business employers who do not sponsor a defined contribution plan, 74.4% do not plan to do so in the future with the main reason cited being that it is too expensive / costly at 47.2%.

Not only are the absolute costs of implementing and administering a retirement plan great, but they are relatively greater than those for larger businesses on a per employee basis due to the difficulty of achieving economies of scale. Mandatory employer contributions under ERISA to meet nondiscrimination rules only increase the employer cost of maintaining the retirement plan.

Finally, the Transamerica Survey has found that only 36.2% of small business employers believe that a company's retirement savings plan is "very important" to attracting and retaining employees compared to 54.0% of larger employers that believe this.

There are also reasons for the disparity in employee participation in retirement plans provided by small versus large businesses. First, the household income of workers in small businesses is typically much lower than that of workers in large businesses, and therefore these workers generally have less disposable income to contribute to a retirement plan.

Due to the dynamic nature of the small business landscape, employee turnover tends to be higher than that of large companies. Such turnover can be involuntary such as the result of the business going under, merger and acquisition activity, or employees deciding to seek jobs with higher pay and better benefits. Employee turnover makes plans more costly for employers to sponsor from the perspective of administrative costs and, for employees, minimum vesting requirements and rollover concerns may make employer contributions to the plan less valuable if they do not plan to stay with the same employer long-term.

Recommendations

Given the increasing number of workers employed by small businesses and the particular challenges faced by small businesses in providing retirement plans for their workers, much work needs to be done to provide the regulatory relief and incentives needed to both ease the burdens of small businesses in providing retirement savings plans for their workers, and to create an incentive for these workers to participate in these plans. A number of important steps in this direction were taken in the 2001 tax bill, but more work needs to be done

First, the Pension conference on H.R. 2830 and S. 1783 (collectively, the "Pension bill" or the "Pension conference") should be completed and the final bill enacted as soon as possible. The bill contains many valuable reforms that will help increase retirement savings and Chairman Smith and the other members of this Subcommittee are to be commended in the work they have put into the Pension bill. In particular, TRS has actively supported inclusion of the following provisions in the Pension conference as critical for small business: permanence of the bi-partisan retirement savings changes contained the 2001 Tax Act, incentives and safe harbors needed to increase participation in employment-based plans through automatic enrollment, removal of impediments to employers providing both investment advice to plan participants and distribution of a participant's account in a guaranteed lifetime income stream through an annuity. The 2001 Tax Act pension savings provisions have been proven to increase retirement savings. In particular the Savers Credit, which is scheduled to expire this year, is especially important in the small business sector where income is typically lower (making eligibility implicitly higher). The 2001 Tax Act provisions increasing plan contributions and benefits and raising various plan limits, granting an employer tax credit for plan formation, creating the Roth 401(k) and simplifying a number of complex administrative requirements have also proven extremely valuable in increasing both the number of retirement plans offered by employers and the participation of workers in these plans.

In finalizing work on the automatic enrollment provisions in the Pension bill, conferees are urged to be mindful that cost and employer flexibility are paramount to small business owners and therefore should include those provisions that do not increase the cost or administrative burden of compliance. As stated previously, mandatory employer contributions under ERISA to meet nondiscrimination rules only increase the employer cost of maintaining the retirement plan.

Other reforms to be considered to encourage increased savings

In addition to the reforms included in the Pension bill, Congress should also consider further reforms directed at helping both small businesses to provide retirement plans for their employees and small business employees to increase their participation in those plans. The Saver's Credit should be made permanent and broadly promoted to encourage increased retirement savings plan participation. In addition, the Saver's Credit should be made refundable. This will help encourage lower income workers, in particular, to save.

Congress is also urged to consider additional tax incentives and guidance for small employers to establish new retirement savings plans. Tax incentives provide a valuable financial tool to small businesses that are considering establishing a retirement plan for their workers. These incentives will help to reduce the cost of establishing and administering a retirement savings plan and the relative burden this cost places on a small employer vs. a large employer.

Legal certainty and protection from fiduciary liability provide another powerful incentive to small businesses considering establishing a retirement plan. Additional guidance on safe harbors from fiduciary liability should be provided for employers whose plans meet

certain requirements with respect to investments, asset class coverage, administration and processing, disclosures, etc.

Finally, consideration should be given to enabling small businesses that do not have a retirement plan to provide the means for their employees to contribute a portion of their pre-tax earnings into a multiple employer or group plan to be provided by a financial institution. To be effective, this plan should be simple to administer and should provide safe harbors from fiduciary liability for each employer. In addition, care should be taken to protect employers from any fiduciary liability for the acts of other employers participating in the plan, provide tax incentives for employers and employees to encourage participation and provide the means to ensure reasonable compensation for financial institutions for taking on investment and administrative functions. Multiple employer plans would provide very standard plan terms, and therefore, employers that want plan design flexibility, such as by offering a more robust investment menu, would continue to offer their own plans.

Incentives to help employees manage their savings upon distribution.

The 2001 Tax Act and the Pension bill have provided many good reforms to increase savings in employer plans. However, it is equally important for employees to have the necessary tools to manage their employer plan savings upon distribution. TRS urges Congress to enact tax incentives to encourage all individuals to convert a portion of their savings into guaranteed lifetime income. Chairman Smith and Senator Conrad have taken an important leadership role in encouraging individuals to annuitize their savings by including in S. 1359 and S. 381 provisions that create a tax incentive for the purchase of a lifetime annuity.

Conclusion

TRS commends Chairman Smith and Ranking Member Kerry on their consideration of the particular challenges and needs of small businesses in providing retirement savings plans to their workers. TRS appreciates the opportunity to present its views on the particular challenges faced by small businesses and its suggestions of reforms that can help to alleviate those burdens.