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THE ROLE OF EMPLOYER-SPONSORED RETIREMENT PLANS IN INCREASING NATIONAL SAVINGS

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TUESDAY, APRIL 12, 2005

U.S. SENATE,
SPECIAL COMMITTEE ON AGING,
Washington, DC.

The committee met, pursuant to notice, at 2:35 p.m., in room SD–106, Dirksen Senate Office Building, Hon. Gordon H. Smith (chairman of the committee) presiding.

Present: Senators Smith, DeMint, Kohl, and Carper.

OPENING STATEMENT OF SENATOR GORDON H. SMITH, CHAIRMAN

The CHAIRMAN. Ladies and gentlemen, if we can come to order, we will commence this hearing of the Senate Special Committee on Aging.

Today's hearing will focus on a very important topic: the role of employer-sponsored retirement plans in increasing national savings. We are going to hear from two distinguished panels of witnesses who will provide us with their insights on whether the current employer-sponsored retirement plan system effectively increases national savings and how we can improve that system.

The average life expectancy of Americans has steadily increased. For example, the average life expectancy of Americans born in 1960 was about 70 years. Yet in 2003, life expectancy was about 77 years. Although Americans are living longer than ever before, most Americans continue to retire before age 65.

At the same time, the personal savings rate in the United States has declined dramatically over the last two decades, reaching about one percent of personal income in 2004. The decline in our savings rate is a disturbing trend because, as the length of retirement grows, Americans must save more, not less, to ensure a financially secure retirement.

The need to increase our savings was also emphasized by Chairman Alan Greenspan of the Board of Governors of the Federal Reserve System during his testimony before this committee last month on the economics of retirement. Many refer to retirement income as a three-legged stool: Social Security, employer-sponsored retirement plans, and personal savings. Although there has been a tremendous amount of focus on Social Security lately, we all know that it takes all three legs of the stool to keep the whole thing balanced.

Therefore, as pensions are the second largest sources of income among the elderly, the goal of this hearing is to focus on ways to increase savings in employer-sponsored retirement plans and thus improve the stability of America's retirement system.

Currently, savings and participation rates in employer-sponsored retirement plans are low. In 2001, only about 58 percent of households with an employed head of the household under the age of 64 included at least one worker who participated in an employer-sponsored plan. In addition, about 37 percent, or 28 million, of such households did not own a retirement savings account of any kind. With respect to the amount of retirement savings Americans have accumulated among the 47.8 million households that owned a retirement savings account of any kind in 2001, the median value of such accounts was only $27,000.

Besides low savings and participation rates, another important trend with respect to employer-sponsored retirement plans is the shift from defined benefit plans to defined contribution plans, including 401(k) plans. Over the last several years, the number of defined benefit plans has dropped dramatically, while at the same time the number of defined contribution plans has increased. In the context of savings, this shift is significant because coverage under a defined contribution plan generally requires employers to take a more active role in preparing for retirement.

For example, in general, employees must decide whether to participate in the retirement plan, how much to contribute to the plan, and how their contributions should be invested.

In response to these trends, I plan to introduce legislation shortly that is aimed at increasing savings and participation rates in employer-sponsored retirement plans. For example, the bill will include a provision intended to encourage sponsors of 401(k) plans to adopt automatic enrollment in which a percentage of each employee's salary is placed in an individual account without requiring the employee to take any action. Therefore, instead of requiring employees to actively enroll in a 401(k) plan in order to participate, under automatic enrollment employees will be automatically enrolled unless they elect to opt out, as is generally done under defined benefit plans. Automatic enrollment has been shown to increase participation rates in 401(k) plans significantly, especially among low- and middle-income individuals.

In addition, with increased life expectancies, it is also important for individuals to preserve their income throughout their retirement years and not outlive their savings. Therefore, my bill also will provide incentives to ensure income preservation throughout one's retirement by encouraging employers to offer and employees to select distributions from defined contribution plans and IRAs in the form of lifetime annuities.

I want to thank all of our witnesses for coming today, and I look forward to hearing your testimony. I would note that there is a 3:30 vote scheduled. Perhaps we can hear from everyone and get all the questions asked in that amount of time.

I now turn to my colleague, Senator Kohl, for his comments.

OPENING STATEMENT OF SENATOR HERB H. KOHL

Senator KOHL. Thank you, Mr. Chairman.

Mr. Chairman, we have all seen the statistics and the studies on the amount of money Americans are saving for retirement, and it is striking that so few are prepared for their nonworking years. Retirement income has often been compared to a three-legged stool—as you pointed out—which includes Social Security, employer-sponsored pensions, and personal savings. Increasingly, a fourth leg will be wages, as many older Americans work past traditional retirement age.

Financial planners recommend a retirement income that replaces 70 percent of pre-retirement earnings. With Social Security's overall replacement rate of about 45 percent, clearly other sources of retirement income are critical.

As we continue the Social Security debate, we cannot ignore the other legs of the stool. Clearly, the pension system needs improvement. Most workers are not covered by a plan, and only about half participate in a pension at all. Participation rates are poor for lower-income workers and small businesses. Contributions are also low across the board, and too many workers withdraw money before retirement. The typical balance for a 401(k) for workers near retirement is only $43,000, and for workers earning less than $25,000 a year, the typical balance is only $2,200.

So it is clear that more needs to be done to encourage saving, but we need to do it right. As we will hear today, the government now spends more on tax incentives for retirement saving than Americans actually save. Almost all of these incentives are worth the most to higher-income workers, who probably would have saved even without the extra inducement from the government. Some proposals by the administration, such as Retirement Savings Accounts and Lifetime Savings Accounts, instead of reversing this backwards incentive structure, would go even further in the wrong direction.

Obviously, we need to reorient government policy to encourage saving and improve retirement security among the population that most needs to save; our lowest-income workers. Several policies have the potential to do just that: encouraging automatic enrollment in 401(k)s; extending and expanding the saver's credit, which is a matching tax credit for contributions targeted toward lower-income workers; improving financial education and investment choice; and allowing taxpayers to split off a portion of their tax refund and put it directly into a savings account.

These are promising ideas with the potential to receive bipartisan support. The time to act is now; the retirement security of millions of Americans depends on it.

I thank you, Mr. Chairman, and we welcome you all to the panel.

The CHAIRMAN. Thank you, Senator Kohl.

Our only witness on our first panel is Mark J. Warshawsky, and, Mr. Secretary, we welcome you. He is the assistant secretary for Economic Policy, Department of the Treasury, and the microphone is yours.

STATEMENT OF MARK J. WARSHAWSKY, ASSISTANT SECRETARY FOR ECONOMIC POLICY, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. WARSHAWSKY. Thank you. Good afternoon, Chairman Smith, Ranking Member Kohl, and members of the committee. I appreciate the opportunity to discuss the administration's proposal to reform and strengthen the single-employer defined benefit pension system against the backdrop of the larger issue of promoting national saving.

As far back as 1776, Adam Smith identified capital accumulation as the key force in promoting growth in the wealth of nations. Smith also identified the key force in capital accumulation: increasing national savings. Since Smith's time, almost all economists have come to understand the vital nature of national saving, and increasing saving has become a standard policy prescription for enhancing economic growth and raising living standards.

We know the U.S. faces a challenge as the economy works through the implications of the retirement of the baby-boom generation. With the growth in the workforce set to slow and the average age of the population rising, maintaining steady growth in the standard of living will become more difficult. The Smith prescription shows the way out. Increase our savings, which will increase our accumulated capital, which will give each worker more and better tools to work with, which will raise productivity and secure a growing standard of living.

Despite the fact that this prescription is well known, the evidence suggests it is exceptionally hard to follow. Net private saving—which we define as gross private saving less depreciation on plant, equipment, and housing stock—as a share of national income averaged about 11 percent from 1955 through 1985, but since then has trended steadily down. Over the past 10 years, it has averaged about 5.5 percent of GDP, or about 5 percentage points below where it was during the decades of the 1950's, 1960's, 1970's, and most of the 1980's.

One reason the saving prescription is difficult to follow is that incentives work against it. Our tax system, for example, has for a long time encouraged Americans to spend first and save second. To reverse this, the Administration has worked hard to set in place the incentives that encourage saving. EGTRRA cut the top tax rates which raised the after-tax rate of return on capital income—encouraging savings. The Jobs and Growth Tax Relief Reconciliation Act of 2003 cut taxes specifically on capital income.

But even with these positive changes, the Federal income tax code still discourages saving. To combat this, the President has proposed retirement savings accounts, which would replace the complex array of retirement saving incentives currently in the tax code, such as IRAs, Roth IRAs, and similar saving vehicles. The President has also proposed employer retirement savings accounts, ERSAs, to simplify the saving opportunities individuals have through their employers. The President's lifetime savings accounts would, for the first time, allow individuals to save on a tax-preferred basis for any purpose. This can be especially important to low-income individuals and families who need to save but cannot afford to lock up funds for retirement that may be needed for an emergency in the near term. The President has also proposed individual development accounts which would give extra financial incentive to certain low-income families to set aside funds for major purchases, such as a first home.

Pensions, of course, play a critical role in savings as well. Accumulating financial assets for future retirement is indeed one of the main reasons households save any way. If individuals and households believe they will receive a pension in retirement, that clearly influences their saving and asset accumulation behavior. But if, in fact, those promised benefits are not available because of pension underfunding, then the household's savings and, when you add up households, the aggregate national savings is less than it otherwise would have been had their pension been adequately funded.

Unfortunately, the single-employer pension system's current serious financial trouble is likely to lead to just such undersaving and participant benefit losses. Many plans are badly underfunded, jeopardizing the pensions of millions of American workers, and the insurance system which protects those workers in the event that their own plans fail has a substantial deficit.

The primary goal of any pension reform effort should be to ensure that retirees and workers receive the pension benefits they have earned. Clearly, the current funding rules have failed to meet this goal. As part of its reform proposal, the administration has designed a new set of funding rules that we think will ensure that participants receive the benefits they have earned from their pension plans.

Today I will briefly discuss a few critical issues pertaining to the funding elements of the proposal and their likely effects on the economy and national savings. My written testimony provides a more comprehensive discussion of the entirety of the proposal.

For any set of funding rules to function well, assets and liabilities must be measured accurately. The system of smoothing embodied in current law serves only to mask the true financial condition of pension plans. Under our proposal, assets will be marked to market. Liabilities will be measured using a current spot yield curve that takes into account the timing of future benefit payments summed across all plan participants. Discounting future benefit cash-flows using the rates from the spot yield curve is the most accurate way to measure a plan's liability. Liabilities computed using the yield curve match the timing of obligations with discount rates of appropriate maturities. Proper matching of discount rates and obligations is, in fact, the most accurate way to measure today's cost of meeting pension obligations.

The Administration recognizes that the current minimum funding rules have added to contribution volatility. Particular problem areas are the so-called deficit reduction contribution mechanism and the limits on tax deductibility of contributions. Our proposal is designed to remedy those issues by giving plans the tools needed to smooth contributions over the business cycle. These tools include increasing the deductible contribution limit, and this will give plan contributions an additional ability to fund up during good times. We also increase the amortization period for funding deficits to 7 years compared to a period as short as 4 years under current law. Finally, there is the continued freedom that plan sponsors already have to choose prudent pension fund investments. Using all these tools, plan sponsors can limit volatility and maintain a conservative funding level so that financial market changes will not result in large increases in minimum contributions.

We believe these are the appropriate methods for dealing with risk. We believe it is inappropriate to limit contribution volatility by permitting plan underfunding that transfers risk to plan participants and the PBGC.

Under our proposal, plan funding targets for healthy plan sponsors will be established at a level that reflects the full value of benefits earned to date under the assumption that plan participant behavior remains largely consistent with the past history of an ongoing concern.

Plans sponsored by firms with below investment grade credit will be required to fund to a higher standard that reflects the increased risk that these plans will terminate. Pension plans sponsored by firms with poor credit ratings pose the greatest risk of default. It is only natural that pension plans with sponsors that fall into this readily observable, high-risk category should have more stringent funding standards. Credit ratings are used throughout the economy and, in fact, in many Government regulations to measure the risk that a firm will default on its financial obligations. A prudent system of pension regulation in insurance would be lacking if we did not use this information.

Credit balances under current law are created when a plan makes a contribution that is greater than the required minimum. Under current law, this credit balance plus an assumed rate of return can be used to offset future contributions. We see two significant problems with this system. First, the assets that underlie the credit balances may lose rather than gain value. Second, and far more important, credit balances allow plans that are seriously underfunded to take funding holidays. In our view, every underfunded plan should make minimum annual contributions.

So under our proposal, credit balances, as defined under current law, will be eliminated. Contributions in excess of the minimum, however, still reduce future minimum contributions. The value of these contributions is added to the plan's assets and, all other things equal, reduces the amount of time that the sponsor must make minimum contributions to the plan. In combination with the other elements of our proposal, there is more than adequate incentive for plan sponsors to fund above the minimum. In fact, we believe there are four other reasons that employers might choose to contribute more than the minimum: (1) there is the increased deductibility provisions that allow sponsors to accumulate on a tax-free basis; (2) disclosure of funded status to workers will encourage better funding; (3) a better funded status results in lower PBGC premiums under our proposal; and, (4) a better funded status makes benefit restrictions less likely.

Now, as I have described, the current rules often fail to ensure adequate plan funding, and recent history has made this very obvious. Formally, and speaking as an economist, we might say that the current set of rules has created a partially pay-as-you-go private pension system by allowing some accrued liabilities to be unfunded. That is, in general, when plans are not funded fully, the system basically operates by transferring contributions associated with younger workers to current retired workers.

The funding rules proposed by the administration, whereby sponsors that fall below the accurately measured minimum funding levels are required to fund up toward their contribution in a timely manner, and this moved the system in the direction of being fully funded. In a fully funded system, the contributions associated with each generation of workers are invested and fund their own retirements. A basic result in macroeconomics is that a pay-as-you-go system results in less savings, a slower rate of capital accumulation, and a lower steady state capital stock. Therefore, the Administration's proposal, through the move toward more fully funded private defined benefit pensions, is consistent and in support of the administration goal of increases saving and greater capital accumulation.

Now, let me comment that some analysts recently have expressed concern that the administration's proposal could have negative macroeconomic effects. They suggest these effects will come through depressed business investment by underfunded plan sponsors, some of whom will, in fact, face higher contributions under the administration's proposal.

In my opinion, sound economic analysis strong suggests that there are no short- or long-term macroeconomic risks associated with reforming pension funding rules. Quite the contrary, the proposal's long-term economic effects will be positive and in the direction that we have just described.

Well-functioning capital markets allow companies to finance attractive investments even if they face short-term demands on their current cash-flows. For that reason, many economists believe that there is little link between a company's cash-flows—including its pension funding requirements—and its investment decisions. This suggests that as a general matter, pension contributions are unlikely to cause a reduction in the plan sponsor's investment pattern.

But even more importantly, it is critical to recognize that pension contributions finance investment throughout the economy. They do not just disappear. The monies directed into pension accounts are invested in stocks and bonds, thereby deploying these resources throughout the economy. Failure to recognize this may have led some analysts to mistakenly attribute negative macroeconomic effects to the Administration's proposal.

In conclusion, let me say that defined benefit plans are a vital source of retirement income for millions of Americans. The Administration is committed to ensuring that these plans remain a viable retirement option for those firms that wish to offer them to their employees. The long-run viability of the system, however, depends on ensuring that it is financially sound. The Administration's proposal is designed to put the system on secure financial footing in order to safeguard the benefits that plan participants have earned and will earn in the future. We are committed to working with the Members of Congress to ensure that effective defined benefit pension reforms that protect workers' pensions are enacted into law.

It has been my pleasure to discuss the proposal, and I look forward to answering any questions you may have.

The CHAIRMAN. Thank you.

We have been joined by two colleagues, Senator DeMint of South Carolina and Senator Carper of Delaware. If either of you have an opening statement, we would be happy to take those now.

OPENING STATEMENT OF SENATOR JAMES DEMINT

Senator DEMint. Thank you, Mr. Chairman. I will just make a couple of comments and maybe ask a question, if we could just get that started.

Thank you very much for your testimony today. It is a subject near and dear to my heart. As an employer for many years, trying to get folks to save was a real challenge. I have found over the years even matching or putting savings into some form of pension is very difficult for a small employer with unpredictable profits. The regulations that require consistent contributions make it very difficult for a small employer to participate since year to year we are not sure if we can make a contribution.

The other frustrating aspect of it was we may have actually contributed 100 percent of some form of pension or savings, and only to find that an employee might pull it out with a large penalty to spend on immediate need.

I think what it comes down to pragmatically is the average-income American is going to find it very difficult to find any additional discretionary money to save. That is why I appreciate the President's recognition that when you take over 12.5 percent of what the average American makes, it is going to be very difficult for them to find additional money to save. That is why I believe it is so important that we as a Government figure out how we can start saving part of that 12.5 percent that people are already putting into their Social Security plan.

The average American family now contributes over $5,000 a year in Social Security taxes, if you include the employer's side of that. That makes it very difficult for an employee to add to. So as we look at total savings, we do see that is a key problem in America because, as you know, when there is not savings from a large percent of the population, the wealth gap continues to grow. We have half of Americans who own something and the other half who don't, half who benefit from the growth in the economy and nearly another half that don't.

So I appreciate the President's proposal. I would be very supportive of expanding particularly the idea of IDAs, which at least somewhat control how the money could be spent, expanding those in some ways. But I think I would just like your comments on realistically can we expect the Americans who need to save the most to actually come up with additional funds as well as the employers who have the most difficult time of creating these plans coming up with plans under new regulations that might make it more difficult for them to be consistent with them, if you could just make a few comments, I would appreciate it.

Mr. WARSHAWSKY. One reason to particularly focus on defined benefit plans is that under current law the rules have become extraordinarily complex. I am sure that is a strong disincentive, particularly for small employers, for sponsoring defined benefit plans. Defined benefit plans do have certain advantages for employees and employers, and in particular they are, if you will, a forced saving vehicle. Everyone participates and the money is put in by the employer, and sometimes by employees as well.

Under our proposal, we basically have a significant simplification of the rules; this is hard to appreciate without knowing how complicated the current rules are. But I think it is fair to say that we have a much simpler system, and that perhaps could have the impact down the road of encouraging smaller plan sponsors to enter the system.

Another aspect of our proposal is that by allowing companies to fund during good times, that enables them to manage their cashflow better than under current law, which is very restrictive of additional contributions because of the full funding limitations.

Senator DEMint. Thank you.

The CHAIRMAN. Senator Carper.

OPENING STATEMENT OF SENATOR THOMAS CARPER

Senator CARPER. I have got a couple of questions I want to ask our witness. I am going to wait until just a little bit later. But this is certainly a timely hearing and a timely issue, and we appreciate your input, and I look forward to asking a couple of questions.

Thank you.

The CHAIRMAN. Did I detect in your statement an expression that defined contribution or defined benefit plans do more to add to national saving, one versus the other?

Mr. WARSHAWSKY. Not necessarily. I think the import of my statement is that underfunded defined benefit plans do detract from national savings because employees think they are going to get the benefits that are promised to them and, therefore, they save less. But in point of fact, the realization may be other than what they are promised because the plan is poorly funded. So, therefore, one way of increasing national savings in the context of defined benefit pensions is to be sure that these plans are adequately funded. That is really what I was getting at in my testimony.

The CHAIRMAN. Many defined contribution plans occurs essentially through a payroll deduction, and then it is there and they own it and they watch it grow, they participate, their knowledge increases, I assume, in what they have.

Mr. WARSHAWSKY. I think that is an aspect of a defined contribution plan. That is right.

The CHAIRMAN. How much simpler are 401(k) plans versus defined benefit plans in terms of—you spoke to Senator DeMint about the complexity being a significant deterrent to small companies offering defined benefit plans. How much simpler are defined contribution?

Mr. WARSHAWSKY. There have been studies in the past that actually try to quantify the administrative costs of defined benefit versus defined contribution plans, and depending on the size of the plan sponsor, because there are economies of scale, defined contribution plans are easier and less costly to administer. Therefore, because defined benefit plans have had layer upon layer upon layer of regulation and rules that have been established for them, particularly in the funding area, one point of our proposal is to simplify that system.

The CHAIRMAN. How about the administrative cost? Is one more costly to administer versus another?

Mr. WARSHAWSKY. I believe for many employers, defined benefit plans are more costly to administer.

The CHAIRMAN. How often is it that there is malfeasance on the part of the corporation or the pension fund manager where workers are utterly cheated out of their retirement? I ask that because of a terrible case that occurred in my State whereby not only were some pensions underfunded, but then they were appropriated to the extent of over $100 million. You have people who have worked all of their lives now with no recourse and only a few people in jail. How common is that?

Mr. WARSHAWSKY. My impression is that it is fortunately not very common. That is something that is subject to Department of Labor and Internal Revenue Service oversight. Perhaps I could share my own research on this point.

In a prior position, many years ago, I used to work at the Internal Revenue Service in the Employee Plans area. We conducted an examination of about 400 large underfunded defined benefit plans. We were looking to see whether there was compliance with the current law of funding requirements, to see whether that was a reason for why the plans were underfunded.

While we discovered some small problems, by and large plan sponsors followed the rules. The reason why they were underfunded was not because they were not following the rules. They were following the rules. The problem was the rules themselves.

The CHAIRMAN. Senator Kohl.

Senator KOHL. Thank you, Mr. Chairman.

Mr. Warshawsky, in their submitted statements three of the next panel's witnesses advocate not only extending the saver's credit, but also expanding it. One study estimated that about 75 percent of the benefits of all the 2001 pension provisions go to the top 20 percent of taxpayers. In contrast, over 45 percent of the benefits of the saver's credit go to taxpayers with income below $30,000, who most need to save.

While the administration proposes to extend a variety of pension provisions, the saver's credit is on the chopping block. A New York Times article reports that the Treasury Department's explanation is that the administration is waiting for the recommendations of its tax reform panel.

Why must the saver's credit wait, but not the other pension provisions?

Mr. WARSHAWSKY. Senator, it is my understanding that one significant problem is that provisions in the code are designed for particular groups, and they therefore become very difficult for financial companies to market, because generally marketing campaigns have to be done on a mass basis. They are also very confusing because people do not know whether they are eligible or whether they are not eligible, whether they are phased out, and it introduces an enormous amount of complexity in the system and precisely for individuals, lower-income individuals, who are ill-equipped to deal with tax code complexity. Therefore, the administration, for example, has put forward the LSA proposal, the lifetime savings account proposal, which is intended to be particularly appealing to low-income folks because of the removal of various special requirements and so on and so forth, and also to enable them to be effectively marketed.

Senator KOHL. So you are saying the saver's credit is too complicated?

Mr. WARSHAWSKY. Well, I am saying that I think we need to be very mindful of the complexity in the code, and, therefore, that sometimes works at cross-purposes with the intent of very specifically, carefully targeted incentives.

Senator KOHL. Here is a tax incentive which, as I pointed out, provides benefits that lower-income families generally take advantage of; 45 percent of the saver's credit goes to taxpayers with incomes below $30,000. So it would seem that it would be something that would deserve all kinds of attention because it does exactly what we want. Yet the administration has apparently decided that it should expire completely. While 75 percent of the benefits of all the 2001 provisions go to the top 20 percent of taxpayers, 45 percent of the benefits of this credit go to people with incomes less than $30,000. So why wouldn't you say, maybe we have to simplify it or make it a little bit easier to understand, but we should really promote it because it does what we want it to do?

Mr. WARSHAWSKY. Senator, I am sure that it will be something that will be carefully studied by the tax panel, among many of the other features of the tax code in the saving incentive area.

Senator KOHL. Well, I hope so.

The administration has proposed split tax refunds in its last two budgets. A recent letter from the IRS Commissioner to Members of Congress said that split refunds cannot be implemented until 2007 because a committee needs time to do things like program computers and add a new schedule to the tax forms. It is unclear why it should take two years to resolve such minor administrative issues.

Can you assure us that everything that can be done is being done with maximum speed? Would congressional action such as providing more funding help speed things up?

Mr. WARSHAWSKY. Senator, I regret to say I am not familiar with that issue. It is more a matter of tax administration. But we would be glad to get back to you on that question.

Senator KOHL. OK. Finally, I was struck by the fact that you have devoted the bulk of your testimony to the administration's proposed PBGC funding reforms. You make almost no mention of whether current tax incentives for retirement saving actually increase private and national saving. As I mentioned in my statement, the government now spends more on these incentives than Americans save. So how can you explain this?

Mr. WARSHAWSKY. We feel it is very important that the benefits that are promised to workers be assured that they get them. It is really a matter of simple fairness and equity, Senator.

Senator KOHL. Alright. Mr. Chairman, thank you.

The CHAIRMAN. Thank you, Senator Kohl.

Senator Carper, your questions.

Senator CARPER. Do you pronounce your name "Warshawsky"?

Mr. WARSHAWSKY. That is correct.

Senator CARPER. OK. Secretary Warshawsky, just for my purposes would you—I came in about halfway through your testimony. Just distill for me just into a couple of small nuggets the problem we are trying to address here.

Mr. WARSHAWSKY. The main problem we have, Senator, in the defined benefit system is that many plans—in fact, currently most plans—are significantly underfunded. Therefore, this poses a risk both to the Government through the Pension Benefit Guaranty Corporation and even more importantly to the plan participants of not getting the benefits that they are promised.

That is the problem in a nutshell from the perspective of individuals and the Government, but there is also a macroeconomic problem, and that is, underfunded pension plans tend to decrease national savings, which is one of the points that we were talking here about as well. So it is actually a broader issue as well.

Senator CARPER. If we go back a decade or so, did we face the same problem? Were we facing the same problem in the 1990's with underfunding of these pension funds?

Mr. WARSHAWSKY. Yes. In fact, as I described my own job at the Internal Revenue Service, I was hired actually to lead a research program on underfunded defined benefit plans because there were so many and the underfunding was so significant. In fact, it seems as if each business cycle we have a cycle of underfunding and then adequate funding, and then each cycle it seems to get worse and worse. So back then in the early 1990's, there were significant problems with underfunded plans as well.

Senator CARPER. I seem to recall in the 1990's there was a time when a number of employees thought their funds were overfunded, and they sought to take money out of their fund.

Mr. WARSHAWSKY. In the late 1990's, as interest rates went up and stock prices went up, there was an apparent overfunding. But, of course, that was also related to how the liabilities were defined. If liabilities are correctly measured, we seem to find more underfunding than current law measurement of pension liabilities.

Senator CARPER. So what you are saying is this is a recurring problem.

Mr. WARSHAWSKY. Correct.

Senator CARPER. As we go through each business cycle, a cycle of the stock market going up and down, the problem gets worse over time.

Again, just lay out for me again just briefly the cure, as prescribed by the administration.

Mr. WARSHAWSKY. The cure is several-fold. One aspect, which I emphasized in my testimony, is a simple but stronger set of funding rules whereby, No. 1, assets and liabilities are marked to market, measured accurately, and the difference between assets and liabilities, if the plan is underfunded, has to be made up within seven years.

Senator CARPER. Say that last part again?

Mr. WARSHAWSKY. In other words, if the plan is underfunded, if liabilities exceed assets, that difference has to be made up within seven years, which we feel is prudent—in other words, not too fast, not too slow, it is key that it be done off of an accurate measurement of the liability.

In addition, we also propose a new method of calculating PBGC premiums for that insurance program that will also reflect the risk that plans represent, so that if plans are underfunded but are sponsored by poor credit risks, they will have to pay a higher premium, and also they have to pay more in funding for the plan because they represent a larger risk to the PBGC as well as to the plan participants.

We also have a proposal to increase disclosure. We feel it is very important that plan participants know how well funded their plans are, those are the main elements of the proposal.

Senator CARPER. What would you have us do?

Mr. WARSHAWSKY. We have the proposal, and as I understand it, it is being considered by the various committees—the Finance Committee, the House Ways and Means Committee, and the other relevant committees. We feel very strongly that this proposal would, in fact, cure the ills of the defined benefit system.

Senator CARPER. Are hearings taking place in the House and the Senate for the legislative committees?

Mr. WARSHAWSKY. We had hearings at the beginning of March, yes.

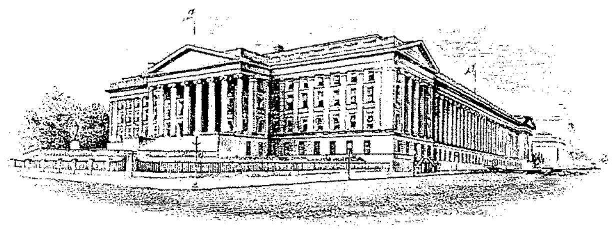
Senator CARPER. What is the prognosis?

Mr. WARSHAWSKY. I believe there is a good recognition of the problem, and I think there is an appreciation that the administration has come forward with a comprehensive package, and I think there is great interest in it.

Senator CARPER. All right. Thanks very much.

Senator KOHL [presiding.] Thank you very much, Senator Carper, and, Mr. Warshawsky, we appreciate your being here today.

[The prepared statement of Mr. Warshawsky follows:]



DEPARTMENT OF THE TREASURY

OFFICE OF PUBLIC AFFAIRS

12 April 2005 **Contact Brookly McLaughlin at 202-622-2960.**
Embargoed until 2:30PM.

Testimony of Assistant Secretary of Treasury Mark J. Warshawsky before the United States Senate Special Committee on Aging

Introduction

Good afternoon Chairman Smith, Ranking Member Kohl and members of the Committee. I appreciate the opportunity to discuss the Administration's proposal to reform and strengthen the single-employer defined benefit pension system against the background of the larger issue of promoting national saving.

As far back as 1776, Adam Smith identified capital accumulation as the key force in promoting growth in the wealth of nations. Smith also identified the key force in capital accumulation: increasing national savings. Since Smith's time, almost all economists have come to understand the vital nature of national saving, and increasing saving has become a standard policy prescription for enhancing economic growth and raising living standards.

We know the U.S. faces a challenge as the economy works through the implications of the retirement of the Baby Boom generation. With the growth in the workforce set to slow and the average age of the population rising, maintaining steady growth in the standard of living will become more difficult. The Smith prescription shows the way out. Increase our savings, which will increase our accumulated capital, which will give each worker more and better tools to work with, which will raise productivity and secure a growing standard of living.

Despite the fact that this prescription is well-known, the evidence suggests it is exceptionally hard to follow. Net private saving (gross private saving less depreciation on plant, equipment, and housing stock) as a share of national income averaged about 11 percent from 1955 through 1985, but since then has trended steadily down. Over the past ten years, it has averaged about 5-1/2 percent of GDP, or about 5 percentage points below where it was during the decades of the 1950s, 60s, 70s, and most of the 80s.

One reason the saving prescription is difficult to follow is that incentives work against it. Our tax system, for example, has, for a long time, encouraged Americans to spend first and save second. To reverse, this, the Administration has worked hard to set in place the incentives that encourage saving. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) cut the top tax rates which raised the after-tax rate of return on capital income – encouraging savings. The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) cut taxes on capital income.

But even with these positive changes, the Federal income tax code still discourages saving. To combat this, the President has proposed Retirement Savings Accounts, which would replace the complex array of retirement saving incentives currently in the tax code, such as IRAs, Roth IRAs, and similar saving vehicles. The President has also proposed Employer Retirement Savings Accounts to simplify the saving opportunities individuals have through their employers. The President's Lifetime Savings Accounts would, for the first time, allow individuals to save on a tax-preferred basis for any purpose. This can be especially important to low-income individuals and families who need to save, but cannot afford to lock up funds for retirement that may be needed for an emergency in the near-term. The President also proposed Individual Development Accounts that would give extra financial incentive to certain low-income families to set aside funds for major purchases, such as a first home.

Pensions also play a critical role in saving. Accumulating financial assets for future retirement is one of the main reasons households save at all. If individuals and households believe they will receive a pension in retirement, that influences their saving and asset accumulation behavior. If, in fact, those promised benefits not available because of pension underfunding, then the household's saving, and aggregate national saving, is less than it otherwise would have been had their pension been adequately funded.

I am pleased to have this opportunity to address you here today to discuss the Administration's pension reform proposal for single-employer defined benefit plans. Today I'll provide an overview of the pension reform proposal and describe how it fits into an agenda for enhancing national saving. I'll also address some recent criticism and discuss how, contrary to that criticism, the proposal is unlikely to have any negative short-term macroeconomic consequences.

The Administration's proposal

The single-employer defined benefit pension system is in serious financial trouble. Many plans are badly underfunded, jeopardizing the pensions of millions of American workers. The insurance system protecting these workers in the event that their own pension plans fail has a substantial deficit. Such a deficit means that although the PBGC has sufficient cash to make payments in the near-term, without corrective action the insurance system ultimately will have inadequate resources to pay all future benefits owed to participants of failed plans. Currently, the PBGC is responsible for making benefit payments to more than one million participants of such plans.

The Administration believes that current problems in the system are not transitory, nor can they be dismissed as simply the result of restructuring in a few industries. These problems have been caused by the regulatory structure of the defined benefit system itself. Correcting these problems and securing the retirement benefits of workers and retirees requires that the system be restructured. If we want to retain defined benefit plans as a viable option for employers and employees, fundamental changes must be made to the system's regulatory structure to make it financially sound. Minor tinkering with existing rules will not be sufficient.

A defined benefit pension plan is a trusteed arrangement under which an employer makes a financial commitment to provide a reliable stream of pension payments to employees in exchange for their service to the firm. One cannot expect that such obligations will be honored consistently if they are allowed to remain chronically underfunded as they are under current law. The incentives for financially sound plan funding must be improved or we will continue to see pension plans terminating with massive amounts of unfunded benefits.

When pension plans default on their obligations participants often suffer lost benefits. For many retirees and near retirees these losses come at a time when they are unable to make up the shortfall through other means. In all cases, this Administration is committed to ensuring that pension promises made are pension promises kept. The goal of the Administration's proposed defined benefit pension reform is to enhance retirement security. The reforms are designed to ensure that plans have sufficient funds to meet accurately and meaningfully measured accrued obligations to participants and to ensure the financial solvency of the PBGC.

The current defined benefit pension funding rules – which focus on micromanaging annual cash flows to the pension fund -- are in need of a complete overhaul. These rules are needlessly complex and fail to ensure that many pension plans remain prudently funded. The current rules:

- Measure plan assets and liabilities inaccurately.
- Fail to ensure adequate plan funding.
- Fail to allow sufficient contributions by plans in good economic times, making minimum required contributions rise sharply in bad economic times.
- Permit excessive risk of loss to workers.
- Are burdensome and unnecessarily opaque and complex.
- Do not provide participants or investors with timely, meaningful information on funding levels.
- Do not generate sufficient premium revenues to sustain the PBGC.
- Create a moral hazard by permitting financially troubled companies with underfunded plans to make benefit promises they cannot keep.

The President's solution to these issues is to fundamentally reform the rules governing pension plan funding, disclosure and PBGC premiums, based on the following three simple principles:

- Funding rules should ensure pension promises are kept by improving incentives to fund plans adequately.
- Workers, investors and pension regulators should be fully aware of pension plan funding status.
- Premiums should reflect a plan's risk and ensure the pension insurance system's financial solvency.

Such changes will increase the likelihood that workers and retirees actually receive the benefits that they have earned and will moderate future insurance costs borne by sound plan sponsors. Today I am going to discuss how the Administration's initiative improves incentives for adequate plan funding.

Meaningful and Accurate Measures of Assets and Liabilities

Some argue that the best way to enhance retirement security is to create the appearance of well funded pension plans through the use of asset and liability smoothing and increased amortization periods for actuarial losses.

Our view is there are significant risks associated with masking the underlying financial and economic reality of underfunded pension plans. Failure to recognize risk because of the use of smoothing mechanisms results in transfers of risk among parties, in particular from plan sponsors to plan participants and the PBGC. One need only look at the losses incurred by many steel and airline plan participants and PBGC's net position to see this is so.

The first step in improving funding incentives, therefore, is to measure plan assets and liabilities accurately. We propose measuring liabilities on an accrual basis using a single standard liability measurement concept with minimal smoothing. The measure of accrued liability reflects whether plans are likely to remain ongoing or pose a risk of termination.

Ongoing liability is defined as the present value on the valuation date of all benefits that the sponsor is obligated to pay. Salary *projections* would not be used in determining the level of accrued benefits. Expected benefit payments would be discounted using the corporate bond spot yield curve that will be published by the Treasury Department based on market bond rates. Retirement assumptions will be developed using reasonable methodologies, based on the plan's or other relevant recent historical experience. Finally, unlike the *current liability* measure under current law, plans would be required to recognize expected lump sum payments in computing their liabilities.

At-risk liability measures liabilities that would accrue as a plan heads towards termination. At-risk liability would include accrued benefits for an ongoing plan, plus additional costs that arise when a plan terminates. These costs include acceleration in early retirements, increases in lump sum elections when available and the administrative costs associated with terminating the plan.

The following table provides a summary overview of the critical differences between the ongoing and at-risk liability assumptions.

	Ongoing Liability	At-Risk Liability
Discount Rate	------------- Yield Curve -------------	
Mortality Assumptions	------------- Set by Law -------------	
Retirement Assumptions	Developed using relevant recent historical experience.	Acceleration in retirement rates – individuals retire at the earliest early retirement opportunity.
Lump Sum Payments	Developed using relevant recent historical experience.	Acceleration in lump-sum election.
Transaction Costs	Not included	Included. Calculated by formula.

Under our proposal, asset values used in determining minimum required and maximum allowable contributions will be based on market prices on the valuation date. No smoothed actuarial values of assets will be used as they mask the true financial status of the pension plan.

One aspect of our liability measurement approach that has received a fair amount of attention is the use of the yield curve to discount pension plan liabilities. Accuracy requires that the discount rates used in calculating the present value of a plan's benefit obligations satisfy two criteria: they must reflect the timing of the future payments, and they should be based on current market-determined interest rates for similar obligations. The Administration proposes to replace the current law method with a schedule of rates drawn from a spot yield curve of high grade (AA) corporate bonds averaged over 90 business days. Discounting future benefit cash flows using the rates from the spot yield curve is the most accurate way to measure a plan's liability because, by matching the maturity of the discount rate with the timing of the obligation, it properly computes today's cost of meeting that obligation. Use of a yield curve is a prudent and common practice; yield curves are regularly used in valuing other financial instruments including mortgages, certificates of deposit, etc.

The Treasury Department has developed a corporate bond yield curve that is appropriate for this purpose. Our methodology allows spot yield curves to be estimated directly from data on corporate AA bonds. The process incorporates statistically unbiased adjustments for bonds with embedded call options, and allows for statistically unbiased projections of yields beyond a 30-year maturity. We recently published a white paper detailing our methodology (Creating a Corporate Bond Spot Yield Curve for Pension Discounting Department of The Treasury, Office of Economic Policy, White Paper, February 7, 2005) that is available on the Treasury Department web site.

Our budget proposal to reform the calculation of lump-sum benefits also uses the yield curve for calculating the minimum lump sums. We propose to replace the 30-year Treasury rates used in determining lump sum settlements under qualified plans. Using the yield curve to compute lumps sums and the funding required for an annuity eliminates any distortions that would bias the participant's payout decision. Under our proposal, lump sum settlements would be calculated using the same interest rates that are used in discounting pension liabilities: interest rates that are drawn from a zero-coupon corporate bond yield curve based on the interest rates for high quality corporate bonds. This reform includes a transition period, so that employees who are expecting to retire in the near future are not subject to an abrupt change in the amount of their lump sums as a result of changes in law. The new basis would not apply to distributions in 2005 and 2006 and would be phased in for distributions in 2007 and 2008, with full implementation beginning only in 2009.[1]

Funding Targets

Under the Administration's proposal, the appropriately measured accrued liability serves as a plan's funding target. A plan's target funding level for minimum required contributions will depend on the financial health of the plan sponsor. Plans sponsored by financially healthy firms (investment grade rated) will have a funding target of 100 percent of ongoing liability. Less healthy plan sponsors (below investment grade rated) will have a funding target of 100 percent of at-risk liability.

A sponsor is considered financially weak if the plan sponsor OR any significant member of the sponsor's ~~controlled group has NO senior unsecured debt that is classified as~~ investment grade by at least one of the nationally recognized rating agencies.

Because at risk funding targets are likely to be significantly higher than ongoing targets, we provide a five year phase in period to the higher target for any plan whose sponsor becomes financially weak. The funding target during the phase-in period will be a weighted average of the ongoing and at-risk targets.[2]

Accrued Benefits Funded

Under the proposal, sponsors that fall below minimum funding levels would be required to fund up towards their appropriate target in a timely manner. If the market value of plan assets is less than the funding target for the year, the minimum required contribution for the year would be equal to the sum of the applicable normal cost for the year and the amortization payments for the shortfall. Amortization payments would be required in amounts that amortize the funding shortfall over a 7-year period. The initial amortization base is established as of the valuation date for the first plan year and is equal to the excess, if any, of the funding target over the market value of assets as of the valuation date. The shortfall is amortized in 7 annual level payments. For each subsequent plan year, if the sum of the market value of assets and the present value of future amortization payments is less than the funding target, that shortfall is amortized over the following 7

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[1] This is a different yield curve phase-in schedule than proposed for the use of the yield curve in discounting pension liabilities for minimum funding purposes.

[2] The proposal includes a detailed description of the transition rules that govern the phase-in of the higher funding target when a plan changes status from ongoing to at-risk. See the Treasury Blue Book for more information at http://www.treas.gov/offices/tax-policy/library/bluebk05.pdf.

years. If the sum of the market value of assets and the present value of future amortization payments exceeds the funding target, no new amortization base would be established for that year and the total amortization payments for the next year would be the same as in the prior year. When, on a valuation date, the market value of the plan's assets equals or exceeds the funding target, then the amortization charges would cease and all existing amortization bases would be eliminated.[3]

Benefit Limitations

The reform proposal will include benefit limitations for seriously and severely underfunded plans. Benefit restrictions serve three critical purposes. First, they will limit liability growth as a plan becomes progressively underfunded relative to its funding target. It is important to arrest the growth of unfunded liabilities in order to ensure that plan participants will collect benefits that they accrue. Under current law, sponsors of all but the most severely underfunded plans can allow additional benefits to accrue and in many situations, even make benefit improvements. Plan sponsors in financial trouble have an incentive to provide generous pension benefits, rather than increase current wages, and employees may go along because of the PBGC guarantee. This increases the likely losses faced by participants and large claims to the PBGC. The second purpose of benefit restrictions is to guard against this type of moral hazard. Third, but certainly not ~~least importantly, I believe benefit restrictions will serve as a very powerful incentive for~~ plan sponsors to maintain well funded plans.

Plans with financially weak sponsors that are funded at a level of between 60 and 80 percent of their targets will be prohibited from offering lump sums or increasing benefits. If funding falls below 60 percent of target liabilities accruals will also stop and there will be no preferential funding of executive compensation. Plans with healthy sponsors will be prohibited from increasing benefits or providing lump sum payments if they are funded at less than 60 percent of their target. Underfunded plans with sponsors in bankruptcy will also be subject to benefit limits.

Increased Deductibility

The Administration proposed reforms provide real and meaningful incentives for plans to adequately fund their accrued pension obligations. The Administration plan matches these new funding responsibilities with new opportunities – an enhanced ability to pre-fund obligations on a tax-preferred basis. Under the Administration's proposal, plans will be able to build two separate funding cushions. The first is equal to 30 percent of ongoing liability and the second allows for prefunding of some expected salary increases for final pay plans, and expected future plan amendments, based on the amendment experience of the last six years, for flat dollar plans. In addition, plans will always be able to deduct contributions that bring a plan's funding level up to at-risk liability.

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[3] This description draws on the description in the Treasury Blue Book.

Higher limits for deductible contributions, along with existing authority to allocate plan assets and hedge investment and interest rate risk, will provide sponsors with the tools they need to smooth contributions over time. We believe that providing sponsors these tools will not only allow for more effective contribution smoothing than is accomplished using the mechanisms embodied in current law, but it will also allow sponsors to optimally balance contribution smoothing with other investment objectives.

Disclosure

The financial health of defined benefit plans must be transparent and fully disclosed to the participants and their families who rely on the promised benefits. While ERISA includes a number of reporting and disclosure requirements that provide workers with information about their employee benefits, the timeliness and usefulness of that information must be improved.

The President's proposal would change the disclosures required on the annual report filed with the government, Form 5500 and the Summary Annual Report provided to participants (SAR). On the Form 5500, plans would be required to disclose the plan's ongoing liability and at-risk liability whether or not the plan sponsor is financially weak. The Schedule B actuarial statement would show the market value of the plan's assets, its ongoing liability and its at-risk liability.

Information provided in the SAR to workers and retirees would be more meaningful and timely. It would include a presentation of the funding status of the plan for each of the last three years. The funding status would be shown as a percentage based on the ratio of the value of the plan's assets to its funding target. In addition, the SAR would include information on the company's financial health and on the PBGC guarantee. The due date for furnishing the SAR for all plans would be accelerated to 15 days after the filing date for the Form 5500.

The proposal also would provide for more timely disclosure of Schedule B information for plans that cover more than 100 participants and that are subject to the requirement to make quarterly contributions for a plan year (i.e., a plan that had assets less than the funding target as of the prior valuation date). The deadline for the Schedule B report of the actuarial statement would be shortened for those plans to the 15th day of the second month following the close of the plan year, or February 15 for a calendar year plan. If any contribution is subsequently made for the plan year, the additional contribution would be reflected in an amended Schedule B that would be filed with the Form 5500.

Another important aspect of the proposal is allowing broader access to data submitted to PBGC. Under our proposal, the Section 4010 information filed with the PBGC would be made public, except for the information subject to Freedom of Information Act protections for corporate financial information, which includes confidential "trade secrets and commercial or financial information."

PBGC Premiums

The pension insurance premium structure also is in need of reform. Our plan increases incentives for plan funding and provides the pension insurance system with adequate revenues to eventually restore it to financial health. The flat rate premium will be immediately increased from $19 to $30 per participant to reflect wage growth since 1991 when the $19 rate was set. In the future, the flat premium rate will be updated annually using the same index that is used to update PBGC's maximum guarantee limits. This provision will allow the price and level of insurance coverage to grow at the same rate in the future.

The proposal will also introduce a more robust system of risk-based premiums. Risk based premiums will be charges levied on unfunded target liabilities for all plans. Two key differences distinguish risk-based premiums under the proposal from the variable rate premiums of current law. First, the liability on which underfunding is measured for premium purposes is the same liability measure used for the plan's funding target. Second, all plans with unfunded liabilities will pay risk-based premiums. This feature of risk-based premiums should provide a much stronger incentive to maintain adequately funded plans.

Credit Balances

I'd like to say a few words about credit balances. Credit balances are created when a plan makes a contribution that is greater than the required minimum. Under current law, the credit balance, plus an assumed rate of return, can be drawn down to satisfy future minimum contribution requirements. Credit balances that allow underfunded plans are undesirable and dangerous because they create funding holidays as plans become increasingly underfunded and prolong the amount of time that such plans can remain below their funding targets, leaving participants at greater risk. One need only consider the case of Bethlehem Steel to see how significant an issue this is. Just marking credit balances to market is not sufficient to solve the problem if underfunded plans are still able to take funding holidays.

It is critical to note that while our proposal does away with "credit balances" as currently construed, it does not reduce the incentives for plan sponsors to contribute above the minimum. In the Administration's proposal, the focus of the reformed funding rules on assets and accrued liabilities means that pre-funding pays off in a reduction in future required minimum payments. Plans that have made higher than minimum contributions in past years do not lose the value of such contributions. These contributions increase the value of plans assets relative to liabilities and, other things equal, reduce plan underfunding and decreases future amortization payments. In combination with the rest of the proposal, there is more than adequate incentive for plan sponsors to fund above the minimum. In fact here are four other reasons that employers might choose to contribute more than the minimum: (1) The increased deductibility provisions allow sponsors to accumulate on a pre-tax basis; (2) Disclosure of funded status to workers will encourage better funding; (3) A better funded status results in lower PBGC premiums, and (4) A better funded status make benefit restrictions less likely.

Saving and Macroeconomic Effects

National Saving

As I have described, one important goal of the Administration's proposal is to ensure that plans have sufficient funds on hand to meet accurately and meaningfully measured accrued obligations to participants.

The current rules often fail to ensure adequate plan funding – recent history has made this obvious. Formally we might say that the current set of rules has created a partially *pay-as-you* go private pension system by allowing some accrued liabilities to be unfunded. That is, in general, because when plans are not fully funded, the system basically operates by transferring contributions associated with younger workers to the current retired workers.

The funding rules proposed by the Administration, whereby sponsors that fall below the accurately measured minimum funding levels are required to fund up towards their target in a timely manner, move the system in the direction of being *fully-funded.* In a fully-funded system the contributions associated with each generation of workers are invested and fund their own retirements. A basic result in macroeconomics is that a pay-as-you-go system results ~~in less saving, a slower rate of capital accumulation, and a lower steady~~ state capital stock. Therefore the Administration's proposal – through the move towards more fully funded private defined benefit pensions – is consistent with the Administration goal of increasing saving and greater capital accumulation.

Macroeconomic Effects

Recently some analysts have expressed concern that the Administration pension funding proposal could have negative macroeconomic effects. They suggest these effects will come through depressed business investment by underfunded plan sponsors, some of whom will face higher contributions under the Administration's proposal.

I understand that these concerns may be widely held – and are likely to be repeated by the proposals detractors. In fact, in my opinion, sound economic analysis strongly suggests that there are no short- or long-term macroeconomic risks associated with reforming pension funding rules. Quite the contrary, the proposal's long-term economic effects will be positive.

Well-functioning capital markets allow companies to finance attractive investments even if they face short-term demands on their current cash flows. For that reason, many economists believe that there is little link between a company's cash flows – including its pension funding requirements – and its investment decisions. This suggests that as a general matter, pension contributions are unlikely to cause a reduction in the plan sponsor's investment pattern.

There is a strand of economic literature that suggests there is a link between short-term cash flow demands and investment decisions. However, I believe that some of the analysts who have referenced this literature in analyzing a highly stylized and in many respects inaccurate version of the Administration's proposal have misused the literature's results and overstated the effects – if any – of the proposal on plan sponsor investment behavior.

More importantly, it is critical to recognize that pension contributions finance investment throughout the economy. The monies directed into pension accounts are invested in stocks and bonds, thereby deploying these resources throughout the economy. I believe some analysts who have expressed concern about the macroeconomic effects of the Administration's proposal are mistakenly considering only investment by affected plan sponsors, and thus fail capture this additional investment. This may lead them to mistakenly attribute negative macroeconomic effects to the Administration's proposal.

As I have described, I believe there will be no negative short-term macroeconomic effects of the Administration's pension proposal. If there were effects, I am confident that these *de minimus* short-term effects of the proposal would be outweighed by its long-term beneficial effects of increasing saving and capital accumulation.

Conclusion

Defined benefit plans are a vital source of retirement income for millions of Americans. The Administration is committed to ensuring that these plans remain a viable retirement option for those firms that wish to offer them to their employees. The long run viability of the system, however, depends on ensuring that it is financially sound. The Administration's proposal is designed to put the system on secure financial footing in order to safeguard the benefits that plan participants have earned and will earn in the future. We are committed to working with Congress to ensure that effective defined benefit pension reforms that protect worker's pensions are enacted into law.

It has been my pleasure to provide this discussion of the proposal. I look forward to discussing the proposal and the motivations for the proposal further and answering any additional questions you may have.

Senator KOHL. On the second panel, if you would like to step up, we have J. Mark Iwry, who is a nonresident senior fellow of economic studies at the Brookings Institution in Washington, DC; Eugene Steuerle, senior fellow, the Urban Institute, here in DC; James Klein, president, American Benefits Council, Washington, DC; and John Kimpel, Fidelity Investments, senior vice president and deputy general counsel, here in Washington, DC.

So maybe we will start on my left with Mr. Iwry and give you each brief opportunity to make your opening statements so we will have some time to ask a question or two. Mr. Iwry.

STATEMENT OF J. MARK IWRY, NONRESIDENT SENIOR FELLOW, ECONOMIC STUDIES, THE BROOKINGS INSTITUTION, WASHINGTON, DC

Mr. IWRY. Mr. Chairman, thank you. I am Mark Iwry. I am happy to be here with you. I commend you for holding this hearing. I would like to start out by noting that our private pension system has put together what is probably the largest pool of investment capital in the world, over $5 trillion in defined benefit, defined contribution plans, and IRAs, most of it rolled over from employer plans. It covers about two-thirds of the workforce at some point in people's lives, and at any given moment about half the workforce is in an employer plan of one kind or another. It has done a great job of delivering meaningful benefits to millions of working families.

At the same time, we can do much more to make the system effective in encouraging saving. We spend about $175 billion—that is Treasury's estimate—on tax incentives for employer plans and IRAs. Much of it is skewed, as, Senator Kohl, you said, toward the people at the top, more skewed than it ought to be. One reason is that the tax preference is based on tax deductions. In other words, its value is proportional to your tax bracket. If you are in the 35-percent bracket and you have $1 that you contribute to a tax-preferred plan, you get 35 cents' worth of tax savings. So the dollar costs you a dollar minus 35, or 65 cents to save. If you are in the 10-percent bracket, you get a dime's worth of tax savings so that it costs you 90 cents to save. This is essentially an upside down system. We are giving the most incentive to the people who need it the least, who have the most wherewithal already. We are giving the least incentive to the people who need it the most for whom retirement savings actually would represent security and not just increased affluence.

It follows that we need to target our efforts more toward the three out of four Americans who are in the 15-percent bracket, the 10-percent bracket, or, in fact, the 0-percent income tax bracket, people who pay their payroll taxes but do not owe any income tax, and to level the playing field. As you said, Senator Kohl, the saver's credit does that. It is the most significant and probably the only major Federal legislation that is directly targeted toward promoting retirement saving for the majority of the working population.

Contrary to what Mr. Warshawsky said, who I very much respect personally, it is not complex. It could hardly be simpler. You contribute to a 401(k) or an IRA and you get a 50-percent tax credit, or a tax credit at a lower percentage. Instead of the amount you get for saving being dependent on how well off you are, it is dependent on how much you save. It makes a lot more sense than the deduction-based tax incentives. Even though many people have not heard of the saver's credit, 5.3 million people took advantage of it in its first year, 2002, and again in 2003.

Mr. Warshawsky, I respectfully suggest, is dead wrong when he says it is hard to market. It is not even a product. People do not market the saver's credit by itself. You market 401(k)s. You market IRAs. You market savings. The saver's credit is one of the tools that helps you market those because it is an additional benefit that people get when they do contribute to a 401(k) or another employer plan or an IRA, and something that H&R Block can attest is actually very easy to get. They helped a million people last year get a saver's credit in connection with their contributions. It costs less than 1 percent of the entire tax incentive package that we give employer plans and IRAs. Less than one percent of that tax expenditure is the cost of the saver's credit, but, unfortunately, it is about to expire at the end of next year. It is not refundable so over 50 million people intended to get it do not get it. It does not reach high enough into the lower-middle-income and middle-middle-income groups. We need to make those three changes to further improve it.

The other thing I would like to talk about very briefly is something that, Mr. Chairman, you described at the beginning of your remarks—automatic enrollment. The impact and the power of telling people that they are in a 401(k) unless they want to opt out, giving them advance notice and giving them a chance to opt out at any time, is huge. One study showed that in a particular company the 401(k) participation by low-income people was 13 percent when they had the traditional method of enrollment, you have to sign up. They switched to automatic enrollment, so you are automatically in unless you sign out of the plan. It went from 13 to 80 percent. These are people earning less than $20,000 a year. Similarly, for Hispanic Americans, a similarly dramatic increase in participation, from less than half to way more than half.

The other things I would suggest that you consider, Mr. Chairman and the other members of the committee, in thinking about promoting automatic enrollment are the related escalation of contributions, making it easier for employers to say, you know, we will not only put everybody in the plan at three percent of pay at the beginning or four percent of pay, whatever the employer is comfortable with, but over time we will make it easier for you to step up. Maybe next year it will be five percent, and a couple years later it will be six percent. But you can always step off the escalator. Anyone can opt out or say, "I want to stay at three percent. That is all I want to do."

The CHAIRMAN [presiding.] Can you speak to Senator DeMint's comment earlier that low-income people do not really have a lot of discretionary money, but where it is automatic and they do not opt out, is there any study in terms of satisfaction level with such a thing?

Mr. IWRY. There are studies that suggest that lower-income people, contrary to what we might think, actually want to save and do respond to saving incentives. When you give them a chance to save, especially if you give them a match, offer them a matching contribution, whether it is a tax credit or money deposited in an account, they do tend to step up and save.

I was at a focus group a few days ago, apropos of your question, Senator, where we had nine moderate- to lower-income people around the table who are eligible for a (k) plan and none of them were in it. They were asked why. You know, what is keeping you out? Why aren't you saving? Then they were introduced to this automatic enrollment concept and asked: What do you think of this? Does this bother you? Is it a good thing?

One woman there, about 39 years old, says, "I have been working since I was 16. I haven't saved a penny." Once she understood what automatic enrollment was about, she said, "You know, my company has a 401(k). I didn't even know it existed. I found out about it by accident the other day after several years of being with the company. If I had been put in automatic enrollment back when I was 16, it would have been"—in her words—"a beautiful thing. I would have just gone ahead, I would have seen the money accumulate, and I would have a real nest egg now."

My suggestion is that these techniques that are focused on lower-income people not only work in the sense that people really respond—I mean, 5.3 million people are doing this right now, and they are all folks—most of them are—they are all below $50,000 in income, and it is something people have barely even heard of.

My suggestion would be also that when you do focus on lower-income people with savings incentives, it increases saving. That, after all, is the topic, the focus of your hearing today. What is the impact on saving? Give savings incentives to people of moderate income, they tend to actually save more. Give savings incentives to people who are very affluent, it is a mixed bag. There is a lot of shifting. A lot of us will take money that has been in a different account that is not tax-favored, and we will just move it over to the tax-favored account. No net increase in personal saving, no net increase in national saving. Net decrease in national saving because we just spent some tax expenditure, the Government just gave a tax break to an individual who did not actually increase his or her saving, but just shifted it around. So I think it makes eminent good sense to focus on the moderate- and lower-income.

[The prepared statement of Mr. Iwry follows:]

Testimony of J. Mark Iwry[1]

Before the Special Committee on Aging
United States Senate

April 12, 2005

Chairman Smith, Ranking Member Kohl, and Members of the Committee, I appreciate the opportunity to appear before you to discuss the role of employer-sponsored retirement plans in increasing national savings.[2]

This written statement is organized as follows: Section I briefly assesses the private pension system in the context of national savings and considers several general aspects of the system that need improvement. Sections II through V present four different strategies for reform, each addressing a key area in which the private pension system needs improvement. Section II makes the case for expanding the "saver's credit" for moderate- and lower-income savers. Section III discusses automatic enrollment and related strategies for expanding coverage in the 401(k) universe. Section IV presents a related automatic investment strategy designed to improve investment performance by shifting the system from employee self-direction to increased reliance on professional investment strategies and management. Section V turns to the defined benefit part of the employer plan system and explores a possible legislative framework for resolving the controversy and uncertainty affecting cash balance pension plans.

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[1] The witness is a lawyer, Senior Adviser to the Retirement Security Project, Nonresident Senior Fellow of the Brookings Institution, and a Research Professor in Public Policy at Georgetown University. He served as the Benefits Tax Counsel of the U.S. Department of the Treasury from 1995 through 2001. Further biographical information is attached, as requested by the Committee.

The views expressed in this testimony are those of the witness alone. They should not be attributed to the staff, officers, or trustees of the Brookings Institution, to Georgetown University, to The Pew Charitable Trusts, to The Retirement Security Project, or to any other institution or organization.

[2] Because I have been asked to address some of the same issues in previous congressional testimony before other committees of the Senate and the House of Representatives, this written statement draws heavily on previous written statements that I have submitted as testimony before other committees as well as on articles or policy briefs that I have authored or co-authored on these topics (including substantial passages drawn verbatim from the previous testimony and articles or policy briefs). The previous testimony and writings include the following: Testimony of J. Mark Iwry Before the Committee on Education and the Workforce, Subcommittee on Employer-Employee Relations, U.S. House of Representatives (April 29, 2004); 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); William G. Gale, J. Mark Iwry and Peter R. Orszag, "The Saver's Credit" (Retirement Security Project, February 2005); William G. Gale, J. Mark Iwry and Peter R. Orszag, "The Automatic 401(k): A Simple Way to Strengthen Retirement Savings" (Retirement Security Project, March 2005); William G. Gale, J. Mark Iwry, "Automatic Investment: Improving 401(k) Portfolio Investment Choices" (Retirement Security Project, April 2005).

The three listed policy briefs were written under the auspices of the Retirement Security Project and are available at www.retirementsecurityproject.org. The Retirement Security Project is supported by The Pew Charitable Trusts in partnership with Georgetown University's Public Policy Institute and the Brookings Institution.

No attempt is made here to be comprehensive or to touch on all of the major pension issues. Private pension issues and potential reforms are numerous and complex. One of the major areas not treated here, for example, is the set of problems and potential solutions relating to defined benefit pension funding and the role of the Pension Benefit Guaranty Corporation (PBGC). (However, as noted, the testimony does address what is perhaps the other most significant issue affecting the defined benefit universe: the fate of hybrid pension plans (such as cash balance plans) that combine defined benefit and defined contribution characteristics.)

Among the other topics not addressed in this testimony are several that are beyond the scope of this hearing, including issues relating to stand-alone individual accounts as opposed to employer-sponsored plans: these would include the possible role of universally available progressive government matching contributions to individual savings accounts; the potential for increased saving through direct deposit to IRAs or other savings accounts of bifurcated income tax refunds; and various other issues relating to IRAs (including the administration's proposed "lifetime savings accounts" and "retirement savings accounts").

I. Where Does Our Current Private Pension System Fall Short?

A. Taxpayers' Current Investment in Private Pensions

For decades, the US tax code has provided preferential tax treatment to employer-provided pensions, 401(k) plans, and individual retirement accounts (IRAs) relative to other forms of saving. These tax preferences represent a significant investment by the taxpayers, who effectively are partially subsidizing the private pension system. The Treasury Department has estimated the cost of the tax-favored treatment for pensions and retirement savings – the amount by which the pension tax advantages reduce federal tax revenues – as having a present value in the neighborhood of $174 billion. This present-value estimate is designed to take into account not only the deferral of tax on current contributions and on earnings on those contributions but also the tax collected when the contributions and earnings are distributed in the future, whether within or beyond the "budget window" period.[3]

Of this total, nearly half is attributable to section 401(k) plans (as opposed to other employer and self-employed plans and IRAs).[4] Because large portions of the employer-sponsored defined benefit plan universe are in each of the private sector and the public (mainly state and local government) sector, a significant percentage of the tax expenditure for non401(k) pensions is attributable to the plans in each of those sectors.

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[3] Budget of the U.S. Government, Fiscal Year 2006, Analytical Perspectives ("FY 2006 Analytical Perspectives")
[4] FY 2006 Analytical Perspectives. The budget documents also contain other tax expenditure estimates that are based on alternative methods.

B. Effectiveness of Pension Tax Subsidies in Promoting Security and Savings

The effectiveness of this system of subsidies remains a subject of controversy. One can readily conclude, in assessing our nation's private pension system, that the glass is half full or that the glass is half empty.

The system has been quite successful in important respects. It has provided meaningful retirement benefits to millions of workers and their families, and has amassed a pool of investment capital exceeding $11 trillion (including IRAs and retirement plans maintained by federal, state and local governments) that has been instrumental in promoting the growth of our economy[5]. Some two thirds of families will retire with at least some private pension benefits, and at any given time, employer-sponsored retirement plans cover about half of the U.S. work force.[6]

However, the benefits earned by many are quite small relative to retirement security needs. Despite the accumulation of vast amounts of wealth in pension accounts, concerns persist about the ability of the pension system to raise private and national saving, and in particular to improve saving among those households most in danger of inadequately preparing for retirement. Those moderate- and lower-income households are disproportionately represented among the roughly 75 million workers and spouses who are excluded from the system. They are far less likely to be covered by a retirement plan.[7] When they are covered, they are likely to have disproportionately small benefits and, when eligible to contribute to a 401(k) plan, are less likely to do so. (Fewer still contribute to IRAs.) Accordingly, the distribution of benefits – retirement benefits and associated tax benefits – among households by income is tilted upwards.

Yet providing retirement security for moderate- and lower-income workers – in other words, for those who need it most -- should be the first policy priority of our tax-qualified pension system. This is the case not only because public tax dollars should be devoted to enhancing retirement security as opposed to retirement

[5] Board of Governors, United States Federal Reserve System, Statistical Release Z.1, Flow of Funds Accounts of the United States (March 10, 2005), tables L.119, 120, 121, 225. This rough figure is as of the end of 2004. It is unclear how much of these accumulated assets in retirement plans represent net national saving (private saving plus public saving), because this dollar amount has not been adjusted to reflect the public dissaving attributable to government tax expenditures for pensions or to reflect any household debt or reduction in other private saving attributable to these balances. See Eric Engen and William Gale, "The Effects of 401(k) Plans on Household Wealth: Differences Across Earnings Groups." NBER Working Paper No. 8032 (Cambridge, Mass.: National Bureau of Economic Research, December 2000).

[6] Testimony of J. Mark Iwry, Benefits Tax Counsel, Office of Tax Policy, Department of the Treasury, before the Committee on Health, Education, Labor and Pensions, United States Senate (Sept. 21, 1999) ("Sept. 21, 1999 Testimony").

[7] It has been estimated that over 80% of individuals with earnings over $50,000 a year are covered by an employer retirement plan, while fewer than 40% of individuals with incomes under $25,000 a year are covered by an employer retirement plan. See Testimony of Donald C. Lubick, Assistant Secretary (Tax Policy), U.S. Department of the Treasury, before the House Committee on Ways and Means, Subcommittee on Oversight, page 6 (March 23, 1999) ("Treasury 1999 Testimony").

affluence – minimizing the risk of poverty or near-poverty in old age, reducing retirees' need for public assistance and potentially reducing pressure on the nation's Social Security system.[8] It is also because targeting saving incentives to ordinary workers tends to be a more effective means of promoting the other major policy goal of our pension system: increasing national saving.

Pensions can be viewed as increasing national saving to the extent that the saving attributable to pensions (net of any associated borrowing or other reductions in other private-sector saving) exceeds the public dissaving attributable to the tax preferences for pensions. Accordingly, the issue can be framed in terms of the efficiency of tax expenditures in promoting saving: how much "bang for the buck" do particular incentives provide in terms of added saving? To what extent do particular types of tax preferences give taxpayers good money's worth on the tax dollars they have invested in those preferences?

Tax expenditures that are of use mainly to the affluent tend to be inefficient to the extent that they induce higher-income people simply to shift their other savings to tax-favored accounts, direct to tax-favored accounts current income that would otherwise be saved in nontax-favored vehicles, or offset additional contributions with increased borrowing. To the extent such shifting occurs, the net result is that the pensions serve to shelter income from tax, rather than as a vehicle to increase saving, and the loss of government revenue does not correspond to an increase in private saving.

In contrast, contributions and saving incentives targeted to moderate- and lower-income workers – households likely to have little if any other savings or assets that could be shifted into tax-preferred accounts -- tend to increase net long-term saving rather than merely shifting assets.[9] This enhances retirement security for those most in need and advances the goals of our tax-favored pension system in a responsible, cost-effective manner.

These goals have been articulated by the Department of the Treasury in congressional testimony as follows:

> "First, tax preferences should create incentives for expanded coverage and new saving, rather than merely encouraging individuals to reduce taxable savings or increase borrowing to finance saving in tax-preferred form. Targeting incentives at getting benefits to moderate- and lower-income people is likely to be more effective at generating new saving....
>
> "Second, any new incentive should be progressive, i.e., it should be targeted toward helping the millions of hardworking moderate- and lower-income Americans for whom saving is most difficult and for whom pension

[8] Treasury 1999 Testimony, page 3.

[9] See Engen and Gale (2000) and Daniel Benjamin, "Does 401(k) Eligibility Increase Saving? Evidence from Propensity Score Subclassification," *Journal of Public Eonomics* 87, no. 5-6 (2003): 1259-90.

coverage is currently most lacking. Incentives that are targeted toward helping moderate- and lower-income people are consistent with the intent of the pension tax preference and serve the goal of fundamental fairness in the allocation of public funds. The aim of national policy in this area should not be the simple pursuit of more plans, without regard to the resulting distribution of pension and tax benefits and their contribution to retirement security....

"Third, pension tax policy must take into account the quality of coverage: Which employees benefit and to what extent? Will retirement benefits actually be delivered to all eligible workers, whether or not they individually choose to save by reducing their take-home pay?"[10]

C. Why the System Does Not Do More to Benefit Moderate- and Lower-Income Households

There are a number of reasons why the system is not doing more to address the needs of moderate- and lower-income workers.

First, tax incentives – the "juice" in our private pension system – have traditionally been structured in such a way that they prove to be of little if any value to lower-income households. This is because these tax incentives, though intended to encourage participation in employer-based retirement plans and IRAs, consist primarily of exclusions and deductions from federal income tax. Pension contributions and earnings on those contributions are treated more favorably for tax purposes than other compensation: they are excludible (or deductible) from income until distributed from the plan, which typically occurs years if not decades after the contribution is made. However, the value of this favorable tax treatment depends on the taxpayer's marginal tax rate: the subsidies are worth more to households with higher marginal tax rates, and less to households with lower marginal rates.

Workers who pay payroll taxes but no income taxes or income taxes at a low marginal rate derive little or no value from an exclusion from income (or tax deduction) for contributions to a plan, earnings on those contributions, or distributions of the contributions and earnings. Roughly three out of four American households are in the 15 percent, 10 percent or zero income tax brackets. Thus, for example, a taxpaying couple with $6,000 in deductible IRA contributions saves $2,100 in tax if they are in the 35 percent marginal tax bracket, but only $600 if they are in the 10 percent bracket.[11]

The income tax incentive approach, as currently structured, thus reflects a mismatch between subsidy and need. The tax preferences tend to encourage

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[10] Treasury 1999 Testimony, pages 3-4.
[11] Some of this difference may be recouped when the contributions are withdrawn and taxed, if families who are in lower tax brackets during their working years are also in lower tax brackets in retirement.

saving least for those who most need to save more to provide for basic needs in retirement, and most for those who need to increase their saving least (who are least likely to need additional saving to achieve an adequate living standard in retirement).[12] As discussed in the next section of this testimony, below, tax credits – even nonrefundable tax credits such as the saver's credit for 401(k) and IRA contributions under section 25B of the Internal Revenue Code -- would help address this problem.

Second, and more obviously, after spending a higher proportion of their income on immediate necessities such as food and shelter, lower-income families often have little if anything left over to save.

Third, lower-income families have less access to financial markets and credit and tend to have little if any experience with tax-advantaged financial products, investing and private financial institutions.

Fourth, the qualified plan rules permit many moderate- and lower-income workers to be excluded from coverage. The rules provide considerable leeway with respect to proportional coverage of moderate- and lower-income employees, and do not require any coverage of millions of workers whose work arrangements are part-time, based on independent contractor status, contingent, or otherwise irregular.

Reflecting these structural deficiencies, the nation's pension system betrays several serious shortcomings. First, only half of workers are covered by an employer-based pension plan in any given year, and participation rates in IRAs are substantially lower. Second, even workers who participate in tax-preferred retirement saving plans rarely make the maximum allowable contributions. Only 5 percent of 401(k) participants make the maximum contribution allowed by law, and only 5 percent of those eligible for IRAs make the maximum allowable contribution.[13] Third, despite the shift from defined benefit to defined contribution plans, many households approach retirement with meager defined contribution

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[12] See, for example, Eric M. Engen, William G. Gale, and Cori E. Uccello, "The Adequacy of Household Saving," *Brookings Papers on Economic Activity*, no. 2 (1999): pp. 65-165.

[13] For example, an unpublished study by a Treasury economist found that only 4 percent of taxpayers eligible for conventional IRAs in 1995 made the maximum allowable $2,000 contribution. Robert Carroll, "IRAs and the Tax Reform Act of 1997," Office of Tax Analysis, Department of the Treasury, January 2000. For IRA contributors at the limit, see also Craig Copeland, "IRA Assets and Characteristics of IRA Owners," *EBRI Notes*, December 2002. Other studies have found only a small percentage of 401(k) contributors to be constrained by the statutory dollar maximum. For example, the General Accounting Office (now the Government Accountability Office) found that an increase in the statutory contribution limit for 401(k)s would directly benefit fewer than 3 percent of participants (General Accounting Office, "Private Pensions: Issues of Coverage and Increasing Contribution Limits for Defined Contribution Plans," GAO-01-846, September 2001). Data from the Congressional Budget Office suggest that only 6 percent of all 401(k) participants made the maximum contribution allowed by law in 1997. (Calculations based on Congressional Budget Office, "Utilization of Tax Incentives for Retirement Saving," August 2003, table 27.) See also David Joulfaian and David Richardson, "Who Takes Advantage of Tax-Deferred Saving Programs? Evidence from Federal Income Tax Data," Office of Tax Analysis, U.S. Department of the Treasury, 2001.

balances.[14] The median 401(k) and other defined contribution (including IRA) balance among all households ages 55 to 59 was only $10,000 in 2001. Excluding the 36 percent of households who had no IRA or defined contribution plan account, the median balance for this age group was still only $50,000.

D. Targeting Incentives More Effectively to Promote Savings and Security

Given this reality, focusing incentives for retirement saving on lower- and moderate-income households makes sense for two reasons. First, such incentives are more likely to bolster long-term economic security and reduce elderly poverty, since higher-income households already tend to have substantial assets and to be better prepared to provide for their needs in retirement than other households. For some low-income families, income may be so modest that it is impossible to save after paying for necessities. Yet 60 percent of households at or below the poverty line indicate that they save at least something.[15] Experience with a program that provides tax incentives and matching funds to encourage saving among low-income families suggests that they will participate in savings programs if presented with incentives to do so.[16] The evidence on the efficacy of automatic enrollment also suggests that low-income workers will save if presented with incentives and a sound structure within which to do so.

The second reason for focusing incentives on lower- and middle-income households is the potential impact on national saving. National saving is the sum of public saving and private saving. All else equal, every dollar of forgone revenue reduces public saving by one dollar. Consequently, for national saving to increase, private saving must increase by more than one dollar in response to each dollar in lost revenue. To raise private saving, the incentives must not simply cause individuals to shift assets into the tax-preferred pensions but instead must generate *additional* contributions.

Since those with modest or low incomes are less likely to have other assets to shift into tax-preferred pensions, focusing pension tax preferences on moderate- and lower-income workers increases the likelihood that lost tax revenue will reflect additional contributions rather than shifts in assets.[17] The empirical

[14]For a discussion of this shift from defined benefit to defined contribution plans, see Iwry, Testimony before the House Committee on Education and the Workforce, Subcommittee on Employer-Employee Relations, June 4, 2003.

[15]Jeanne M. Hogarth and Chris E. Anguelov, "Can the Poor Save?" *Proceedings of Association for Financial Counseling and Planning Education* (2001).

[16]Michael Sherraden, "Asset Building Policy and Programs for the Poor," in *Assets for the Poor: The Benefits of Spreading Asset Ownership,* edited by Thomas Shapiro and Edward Wolff (New York: Russell Sage Foundation, 2001). Also, homeownership rates rose in a demonstration program that gave strong incentives for low-income families to purchase housing. See Gregory Mills and others, "Evaluation of the American Dream Demonstration: Final Evaluation Report" (Cambridge, Mass.: Abt Associates, August 2004).

[17]Economists continue to debate the impact on private saving from existing pension incentives. Most agree, however, that, whatever the overall effect, focusing incentives on those with fewer opportunities to shift assets from taxable to nontaxable forms is likely to produce a larger increase in private saving for any given reduction in government revenue.

evidence suggests that tax-preferred retirement saving undertaken by lower- and middle-income workers is much more likely to represent new saving than tax-preferred retirement saving undertaken by higher-income workers.[18]

Moderate- and lower-income households save very little, but not because they lack the option to save: most workers have accounts available to them in which they could save money on a tax-preferred basis for retirement, and any household lacking such an option could always contribute to an IRA. For those who have at least some income available after paying for necessities, the reasons they do not save lie elsewhere and are essentially twofold.

The first problem, as discussed above, is the upward-tilted structure of the current deduction-based pension tax incentives. The second problem has to do with the shift from pensions (such as defined benefit or money purchase pension plans or employer-funded profit-sharing plans) to retirement savings arrangements.

E. Dealing With the Shift from Pensions to 401(k)s

Over the past quarter century, private pension plans in the United States have trended toward a do-it-yourself approach, in which covered workers bear more investment risk and make more of their own decisions about their retirement savings. In the early 1980s, most Americans who had private retirement plan coverage obtained it chiefly from employer-sponsored, defined benefit pension plans, and to a lesser extent from defined contribution plans such as employer-funded profit-sharing and money purchase plans. Since then, pension coverage has shifted away from these programs and toward new types of defined contribution plans, especially 401(k)s. In 1981 nearly 60 percent of workers with pension coverage had only a defined benefit plan, while just under 20 percent had only a 401(k) or other defined contribution plan. By 2001, however, the share having a defined benefit plan as their only plan had dropped to slightly over 10 percent, while the share having only a 401(k) or other defined contribution plan had risen to nearly 60 percent.

Conventional analyses tend to describe this solely as a trend away from defined benefit plans and toward defined contribution plans. Such a characterization tends to focus attention on the increased portability of pensions from one job to another and the shifting of investment risk from employer to employee. But perhaps an even more fundamental development is the extent to which the accumulation of retirement benefits under the plan has come to depend on active and informed worker self-management and initiative. Traditional defined benefit

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[18]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, December 2000), and Daniel Benjamin, "Does 401(k) Eligibility Increase Saving? Evidence from Propensity Score Subclassification," *Journal of Public Economics* 87, no. 5-6 (2003): 1259-90.

and profit-sharing plans require the covered workers to make almost no important financial choices for themselves before retirement.[19] The firm enrolls all eligible workers within a defined classification, makes contributions on their behalf, and decides how to invest those contributions (or retains professional investment managers to do so). A worker's only real choices are when and in what form to collect benefits. In 401(k)-type plans, in contrast, the burden of all these decisions rests with the employee.

When 401(k) plans began their rapid spread in the early 1980s, they were viewed mainly as supplements to these traditional employer-funded plans. Since 401(k) participants were presumed to have their basic retirement income security needs covered by a traditional employer-funded plan and Social Security, they were given substantial discretion over their 401(k) choices, including whether to participate, how much to contribute, how to invest, and when and in what form to withdrawal the funds.

Over the past 25 years, however, the pension landscape has changed dramatically. The 401(k) plan has come to play a far more central and critical role in the private pension system than was envisioned 25 years ago. Many workers covered by an employer plan now have a 401(k) as their primary or only plan. Yet 401(k)s have made few changes in their basic structure, and still operate in much the same way as in the early 1980s. Workers still must, for the most part, decide for themselves whether and how much to contribute, how to invest, and how and when to withdrawal the funds. Imposing on workers the responsibility to make these choices may have been relatively harmless when 401(k)s were smaller, supplemental plans with limited coverage. The risk of workers making poor enrollment, investment and distribution choices looms much larger as 401(k)s have become the primary pension vehicle.

The trend away from the traditional, employer-managed plans and toward savings arrangements directed and managed largely by the employees themselves, such as the 401(k), is in many ways a good thing. Workers enjoy more freedom of choice and more control over their own retirement planning. Disciplined, sophisticated savers can benefit enormously from participating in a 401(k). By persistently contributing a sizable share of their earnings to a 401(k), and investing in a well-diversified portfolio of assets, employees can generate a substantial retirement income without bearing unnecessary risk. Considerable numbers of workers have thrived under this more individualized approach, amassing sizable balances in 401(k)s and similar plans, which will assure them a comfortable and relatively secure retirement income.

[19] In this sense, traditional private pensions may be characterized less by their defined benefit structure –in fact, many were defined contribution profit-sharing and money purchase plans—than by the fact that employers took the initiative to fund and manage the plans, bearing most of the risk and making most of the decisions for their employees. For a discussion of these developments, including the shift from defined benefit to defined contribution plans, see J. Mark Iwry, "Defined Benefit Pension Plans," Testimony before the House Committee on Education and the Workforce, Subcommittee on Employer-Employee Relations, June 4, 2003.

For many if not most workers, however, the 401(k) revolution has fallen short of its potential.[20] Most workers are not covered by a 401(k) plan at all. Among those covered, many do not participate. Among those who participate, many contribute little to their accounts, and others take the money out before reaching retirement age. As a result, most households have few 401(k) assets. As noted earlier, 36 percent of households aged 55 to 59 had neither a 401(k) (or other defined contribution plan) nor an IRA in 2001, and, among those who did, the median balance in such plans was only about $50,000.

Work, family, and other more immediate demands often distract workers from the need to save and invest for the future. Those who do take the time to consider their choices find the decisions quite complex: individual financial planning is seldom a simple task. For many workers, the result is poor decision making at each stage of the retirement savings process, putting both the level and the security of their retirement income at risk. Even worse, in the face of such difficult choices, many people simply procrastinate and thereby avoid dealing with the issues altogether, which dramatically raises the likelihood that they will not save enough for retirement. Thus, this increasingly 401(k)-dominated system—both the process it has evolved into and the results it is producing—leaves much room for improvement. The complications involved in investing in a 401(k) place substantial burdens on workers to understand their financial choices and assume a certain degree of confidence in making such choices. As a result, many workers shy away from these burdensome decisions and simply do not choose, while those who do choose often make poor choices. Section III of this testimony outlines an approach for making saving easier.

The next three sections of this testimony outline approaches designed to address each of these major shortcomings: the upward-tilted structure of our tax incentives (Section II, relating to expansion of the Saver's Credit) and the practical impediments to saving in a 401(k)-dominated system (Sections III and IV, relating to automatic enrollment and automatic investment).

II. Expanding the Saver's Credit: A Solution to the "Upside Down" Structure of Tax Incentives

A. In General

In 2001, Congress took a first step toward addressing the first structural problem described above -- the upward-tilted structure of the current deduction-based pension tax incentives – by enacting the Saver's Credit. The Saver's Credit in effect provides a government matching contribution, in the form of a nonrefundable tax credit, for voluntary individual contributions to 401(k) plans, IRAs, and similar retirement savings arrangements. Like traditional pension

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[20] For an excellent discussion of these shortcomings, see Alicia H. Munnell and Annika Sundén, Coming Up Short: The Challenge of 401(k) Plans (Brookings, 2004).

subsidies, the Saver's Credit currently provides no benefit for households that owe no federal income tax. However, for households that owe income tax, the effective match rate in the Saver's Credit is higher for those with lower income, the opposite of the incentive structure created by traditional pension tax preferences.

The Saver's Credit is the first and so far only major federal legislation directly targeted toward promoting tax-qualified retirement saving for moderate- and lower-income workers.[21] Although this is a historic accomplishment, the credit as enacted suffers from key design problems, not the least of which is the credit's scheduled expiration at the end of 2006.

B. Basic Design and Evolution

The Saver's Credit was enacted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA).[22] In principle, the credit can be claimed by moderate- or lower-income households who make voluntary retirement saving contributions to 401(k) plans, other employer-sponsored plans (including SIMPLE plans), or IRAs. In practice, however, the nonrefundability of the credit means it offers no incentive to save to the millions of moderate- and lower-income households with no income tax liability.

The design of the Saver's Credit reflects two key objectives. First, the credit represents an initial step toward addressing the "upside-down" structure of other tax incentives for saving— leveling the playing field for moderate- and lower-income workers by, in effect, matching contributions at higher rates for savers with lower incomes. Second, the credit was designed to coordinate with and support the employer-based pension system.

C. Higher Matching Rates for Lower-Income Savers

The matching rates under the Saver's Credit reflect a progressive structure — that is, the rate of government contributions per dollar of private contributions falls as household income rises. This pattern stands in stark contrast to the way

[21]Retirement saving for these workers is promoted – or designed to be promoted — indirectly by nondiscrimination and certain other provisions of the Internal Revenue Code of 1986 (IRC) and the Employee Retirement Income Security Act of 1974 (ERISA). Those provisions, which are subject to extensive exceptions, are intended to impose some constraint on the degree to which tax-favored benefits accrue to a limited number of owners and executives rather than the large majority of workers. The IRC and ERISA also protect and regulate the accumulation and preservation of retirement benefits. For additional discussion of these issues by the Treasury Department, see Donald C. Lubick, Assistant Secretary (Tax Policy), U.S. Department of the Treasury, Testimony before the House Committee on Ways and Means, Subcommittee on Oversight, March 23, 1999.

[22]Section 25B of the IRC of 1986 was added by section 618 of EGTRRA, Public Law 107-16, 115 Stat. 38. See also IRS Announcement 2001-106, 2001-44 I.R.B. (October 29, 2001), and IRS News Release IR 2001-107, 2001-44 I.R.B. (November 7, 2001). The credit was officially titled "Elective Deferrals and IRA Contributions By Certain Individuals." Although now generally referred to as the "Saver's Credit," that term actually appears nowhere in the law. "Saver's credit" was first used in IRS/Treasury administrative guidance at the suggestion of the witness in mid-2001 with a view to facilitating the "public marketing" of the provision, as discussed below. See IRS Announcement 2001-106, 2001-44 I.R.B. (October 29, 2001); IRS News Release IR 2001-107, 2001-44 I.R.B. (November 7, 2001).

tax deductions and the rest of the pension system subsidize saving. The Saver's Credit is currently a small exception to this general pattern: as noted, the Treasury Department estimates that the tax expenditures associated with retirement saving preferences in 2005 will total roughly $150 billion, of which only $1 billion is attributable to the Saver's Credit.[23]

The Saver's Credit applies to contributions of up to $2,000 per year per individual.[24] As table 1 shows, the credit rate is 50 percent for married taxpayers filing jointly with adjusted gross income (AGI) up to $30,000, 20 percent for joint filers with AGI between $30,001 and $32,500, and 10 percent for joint filers with AGI between $32,501 and $50,000. The same credit rates apply for other filing statuses, but at lower income levels: the AGI thresholds are 50 percent lower for single filers and 25 percent lower for heads of households.[25] Of course, the figures in table 1 assume that the couple has sufficient income tax liability to benefit from the nonrefundable income tax credit shown.

The credit's effect is to correct the inherent bias of tax deductions or exclusions in favor of high-marginal-rate taxpayers. A $100 contribution to a 401(k) by a taxpayer in the 35 percent marginal federal income tax bracket generates a $35 exclusion from income, resulting in a $65 after-tax cost to the taxpayer. In contrast, without the Saver's Credit, a taxpayer in the 15 percent marginal bracket making the same $100 contribution to a 401(k) gets only a $15 exclusion from income, resulting in an $85 after-tax cost. The tax deduction is thus worth more to the higher-income household.[26] However, if the lower-income taxpayer qualifies for a 20 percent Saver's Credit, the net after-tax cost is $65 ($100 minus the $15 effect of exclusion minus the $20 Saver's Credit). Thus, the Saver's Credit works to level the playing field by increasing the tax advantage of saving for moderate- and lower-income households.

The credit represents an implicit government matching contribution for eligible retirement savings contributions. The implicit matching rate generated by the credit, though, is significantly higher than the credit rate itself. The 50 percent *credit* rate for gross contributions, for example, is equivalent to having the

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[23]Office of Management and Budget, *Fiscal Year 2005 Analytical Perspectives*, table 18-2.

[24]Both spouses in a married couple may receive the credit. For example, if each spouse contributes $2,000 to his or her IRA, and they file jointly with adjusted gross income not exceeding $30,000, the couple will receive a nonrefundable tax credit of $2,000 ($1,000 each) if they have sufficient federal income tax liability to use the credit. As discussed later, however, because of the nonrefundable nature of the credit, very few taxpayers actually qualify for the 50 percent match.

[25]To prevent "churning" of contributions to generate credits, the level of contributions eligible for the credit is reduced by the amount of distributions from any retirement saving plan or IRA by the participant or the participant's spouse during the year for which the credit is claimed, the two preceding years, or the portion of the following year that precedes the tax return due date.

[26]As discussed in note 2, the entire subsidy associated with saving incentives depends not only on the tax rate at which the contribution is deducted, but also on the tax rate that applies to withdrawals, the length of time the funds are held in the account, the tax rate that would have applied to taxable funds while the funds are held in the tax-preferred account, and the rate of interest. Controlling for the latter factors, taxpayers who can deduct the contribution at a higher rate will generate larger tax savings.

government *match* after-tax contributions on a 100 percent basis. Consider a couple earning $30,000 who contribute $2,000 to a 401(k) plan or IRA. The Saver's Credit reduces that couple's federal income tax liability by $1,000 (50 percent of $2,000). The net result is a $2,000 account balance that cost the couple only $1,000 after taxes (the $2,000 contribution minus the $1,000 tax credit). This is the same result that would occur if the net after-tax contribution of $1,000 were matched at a 100 percent rate: the couple and the government each effectively contribute $1,000 to the account. Similarly, the 20 percent and 10 percent credit rates are equivalent to a 25 percent and an 11 percent match, respectively (table 1).

D. Enhancement of Employer-Sponsored Plans

The Saver's Credit was very deliberately designed to support, rather than undermine, employer pension plans. Employer-sponsored plans encourage participation through employer contributions, nondiscrimination rules designed to require cross-subsidies from eager to reluctant savers, the automatic character of payroll deduction, peer group encouragement, and, often, professional assistance with investments (for example, through employer selection of investment options or provision of investment management). To support these benefits of employer-sponsored plans, the Saver's Credit matches contributions to 401(k) and other plans by moderate- and lower-income employees.[27]

Moreover, the Saver's Credit applies in addition to any employer matching contributions. It can thus raise the return on 401(k) contributions: eligible taxpayers can obtain higher effective matching rates when the Saver's Credit is combined with employer matching contributions to a 401(k). For households who receive a 20 percent Saver's Credit, for example, a 50 percent employer match of the employee's 401(k) contributions implies that the total (employer plus government) effective match rate on after-tax contributions is 87.5 percent. That is, for every $100 in net contributions the taxpayer puts in, up to the appropriate match limits, the account will generate $187.50 in value.

In evaluating these high effective matching rates, it is important to emphasize that they apply only to the first $2,000 of an individual's contributions. Moreover, they apply only to moderate- and lower-income households, who tend to be more reluctant savers than higher-income households because, among other reasons, they tend to have less disposable income after providing for basic necessities. A higher effective matching rate focused on the first dollars of saving may help to "jump start" voluntary contributions by moderate- and lower-income households, many of whom currently do not save at all.

[27]See J. Mark Iwry, "Expanding the Saver's Credit," Testimony before the House Committee on Education and the Workforce, Subcommittee on Employer-Employee Relations, July 1, 2003, pp. 2-3. In particular, the Saver's Credit applies to both before-tax and after-tax contributions by eligible individuals. In addition, although this is not widely recognized, the credit can be claimed for voluntary employee contributions to an employer-sponsored defined benefit plan, although typically it applies to employee contributions to a defined contribution plan such as a 401(k).

Employee 401(k) contributions that qualify for the Saver's Credit also count toward meeting the employer's 401(k) nondiscrimination tests. Accordingly, to the extent the Saver's Credit encourages increased participation among lower earners, higher earners may also benefit, since their ability to contribute on a tax-favored basis depends on the level of contributions by less highly paid employees.[28]

Recognizing the potential benefits of the Saver's Credit for plan sponsors, the Internal Revenue Service (IRS) has provided employers a model notice to inform employees of the credit.[29] Moreover, some employers that have refrained from adopting a 401(k) plan because of expected difficulty in meeting the nondiscrimination test may be encouraged by the Saver's Credit to set up a plan. The credit not only makes it easier for the employer to pass the nondiscrimination test but also gives eligible employees a greater incentive to demand a 401(k) plan.

The Saver's Credit is also designed to complement employer plans through its interaction with automatic enrollment. As discussed elsewhere in this testimony, automatic enrollment makes it easier for employees to save in a 401(k) (or 403(b) or 457) plan by enrolling employees to participate automatically without being required to complete and sign an election form. Automatic enrollment makes the Saver's Credit available to more employees who otherwise would not receive it because they did not contribute to a 401(k). By the same token, the Saver's Credit may encourage wider use of automatic enrollment because the credit makes automatic enrollment more valuable, and hence more acceptable, to employees who are entitled to the credit (without requiring the employer to make any additional matching contributions).

E. Effects of the Saver's Credit

Although it is too soon to obtain a definitive reading of the impact of the Saver's Credit, preliminary estimates and evidence can be useful in identifying some basic themes.

1. Eligibility.

The nonrefundability of the credit substantially reduces the number of people eligible for it. Further, the low match rates for moderate-income households substantially reduce the number of people eligible to receive a significant incentive. Nonrefundability results in a credit that provides no incentives to tens of millions of low-income filers who qualify on paper for the 50 percent credit rate, but who have no income tax liability against which to apply the credit.

[28]See IRS Announcement 2001-106, A-10.

[29]IRS Announcement 2001-106.

Table 4 shows that 59 million tax filers in 2005 will have incomes low enough to qualify for the 50 percent credit.[30] Since the credit is nonrefundable, however, only about one-seventh of them actually would benefit from the credit *at all* by contributing to an IRA or 401(k). Furthermore, only 43,000 — or fewer than one out of every 1,000 — of filers who qualify based on income could receive the maximum credit ($1,000 per person) if they made the maximum contribution. These are the households who have sufficient tax liability to benefit in full from the Saver's Credit but sufficiently low income to qualify for the highest match rate.

For families with somewhat higher incomes, the nonrefundability of the credit poses much less of a problem, since more of these families have positive income tax liabilities. For these families, however, the credit provides only a modest incentive for saving. For example, a married couple earning $45,000 a year receives only a $200 tax credit for depositing $2,000 into a retirement account.

2. Usage

IRS data indicate that about 5.3 million tax filers claimed the Saver's Credit in each of 2002 and 2003, the first two years it was in effect. This figure likely understates the true number of qualifying individual savers, however, because a significant portion of these returns are from married couples filing jointly, where each of the spouses may have made a separate qualifying contribution.

3. Effects on Private Saving

A full assessment of the effects of the credit on private saving would require more information than is currently available, but some possibilities suggest themselves. A necessary, but not sufficient, condition for the credit to raise private saving is that there be an increase in 401(k) and IRA contributions among the eligible population. In one survey of 401(k) plan sponsors in 2002, representatives of 71 percent of the plans indicated that they believed the Saver's Credit had already increased participation in their 401(k) plan, and 18 percent believed the Saver's Credit had caused a "major increase" in participation.[31] The tax preparer H&R Block has said that it claimed the credit in 2002 on behalf of more than a million clients, who saved an average $175 on their tax bills. An H&R Block representative has been quoted as saying that many of these clients were first-time contributors to a retirement savings plan.[32]

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[30] The estimates presented in the tables attached to this testimony are generated by my colleagues using the Urban-Brookings Tax Policy Center microsimulation model. For more detail about the model, see www.taxpolicycenter.org.

[31] See the website of *Plan Sponsor* magazine (www.plansponsor.com), July 23, 2002.

[32] B. Tumulty and C. Burnett, "Bush Shuns Retirement Tax Credit," Gannett News Service, March 1, 2004; B. Tumulty, "White House Drops Saver Credit," *Green Bay Press-Gazette*, February 21, 2004.

F. Options for Expansion

Several significant changes could be made to improve the Saver's Credit: making the credit permanent, making it refundable, expanding it to provide stronger incentives for middle-income households, changing the rate at which it phases out, and indexing it to inflation.

1. Eliminating the 2006 Sunset

In order to reduce the apparent revenue cost, Congress stipulated that the Saver's Credit would sunset at the end of 2006. It would cost between $1 billion and $2 billion a year to make the Saver's Credit permanent.

2. Making the Credit Refundable

As noted above, tens of millions of low-income workers are unable to benefit from the credit because it is nonrefundable. To extend the intended saving incentive to most lower-income working families would require making the Saver's Credit refundable.[33]

Some Members of Congress and others have long had reservations about making tax credits refundable. Their concern is often based on a sense that refundability converts a tax credit into a form of "welfare," which is viewed as undesirable, and that refundable credits tend to pose an unacceptable risk of fraud or other noncompliance. It is not clear, however, that the concerns typically raised about refundable credits are applicable to making the Saver's Credit refundable. First, the Saver's Credit is not based on status, but requires positive action: in order to qualify for the Saver's Credit, an individual must make a contribution to a tax-preferred account. Second, the contribution is verified by third-party reporting (by the IRA trustee or plan administrator). In addition, to limit potential abuses, policymakers could require tax filers to have at least $5,000 in earnings per person in order to claim the refundable credit.

Making the credit refundable would help equalize the tax benefits of saving for higher- and lower-income households, leveling the playing field between income tax payers and workers who pay payroll tax but have no income tax liability. Short of direct income tax refundability, other variations and alternatives are possible. For example, a bill introduced by Senator Jeff Bingaman (D-NM) in 2002 would in effect make the Saver's Credit refundable, but only by matching qualifying contributions of individuals with no income tax liability who purchase an inflation-indexed U.S. savings bond that they cannot redeem until retirement age.[34] Another possibility would involve providing a tax credit to financial

[33]This change was proposed in a bill introduced by then-House minority leader Richard Gephardt in 2002 (H.R. 4482, 107th Cong., 2d Sess.). It was also proposed in a bill introduced by then-Senator John Edwards (D-NC) in 2004 (S. 2303, 108th Cong., 2d Sess.).

[34]See S. 2733 (107th Cong., 2d Sess.).

institutions for contributions that they make to their clients' savings accounts, as was proposed in the Treasury Department's February 2000 Retirement Savings Accounts approach.[35] The effect would be similar to that of a refundable tax credit at the individual level. A final possibility would be to deposit the refund directly into the saving account or 401(k), which would raise significant technical issues.[36]

3. Expanding Eligibility to More Middle-Income Households

Another set of possible expansions to the Saver's Credit would extend eligibility to additional middle-income households. The credit could be expanded in this way along three dimensions: changes to the credit rate, the income limit, and the manner in which the credit is phased out.

First, the 20 percent and 10 percent credit rates available to eligible joint filers with AGI between $32,500 and $50,000 could be raised to 50 percent.[37] This would make the 50 percent credit available to tens of millions of additional households who, for the most part, confront zero, 10 percent, or 15 percent marginal income tax rates and therefore have relatively little to gain from the traditional income tax incentive structure.

Second, the 50 percent credit rate could be expanded to working households with AGI up to $60,000 or $70,000 (for joint filers).[38] Some of these households — about 5 percent under the option that increases eligibility for the 50 percent credit to $70,000 for joint filers — are in the 25 percent marginal tax bracket and therefore already receive a somewhat larger incentive to save under the traditional system of tax subsidies. The vast majority, however, are in the 15 percent bracket, and many of these households have somewhat more disposable or discretionary income remaining after meeting essential short-term needs than do lower-income families in the same tax bracket. These households may thus

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[35]See U.S. Department of the Treasury, "General Explanations of the Administration's Fiscal Year 2001 Revenue Proposals" (February 2000), pp. 49-52.

[36]One apparent problem is the lack of easily accessible bank routing numbers for many IRAs and 401(k)s. Other complications include the need for plan sponsors to administer the account balances resulting from such deposits, including the possible need for additional "buckets" in plan data systems to keep separate track of different kinds of funds. This would be a particularly challenging problem if the balance attributable to the Saver's Credit were taxable when withdrawn from a Roth IRA, even after retirement. On the other hand, if the Saver's Credit balance were not taxable when withdrawn from a Roth IRA, it would escape tax permanently. In addition, consideration reportedly has been given to the possibility of treating the government's deposit as satisfying some of the employer's contribution obligations under the nondiscrimination standards, as if the government deposit were an employer contribution. This would in effect shift part of the employers' responsibility for funding retirement benefits for lower-income employees from employers to the government. As noted, the Saver's Credit already helps plans pass the nondiscrimination tests insofar as it induces additional contributions by moderate-income workers.

[37]See Iwry, "Expanding the Saver's Credit," Testimony before the Subcommittee on Employer-Employee Relations of the House Committee on Education and the Workforce, July 1, 2003, p. 4.

[38]Income eligibility levels would be increased to various degrees by the Bingaman and Gephardt bills (S. 2733 and H.R. 4482) and slightly by the Portman-Cardin bill (H.R. 1776, section 401).

be more likely than lower-income households to respond to the incentive, and more likely than higher-income households to respond by increasing their net saving rather than merely shifting assets.

Finally, whatever the level of AGI at which eligibility for the 50 percent credit rate stops, the credit rate could be made to phase down ratably from 50 percent to zero over a specified range of AGI, such as $10,000. Such a smooth phase-down would remove the "cliffs" in the current credit structure, which involves steep declines in the credit rate as income rises, resulting in very high effective marginal tax rates for many savers who use the credit.

Expanding the Saver's Credit would provide more powerful incentives for moderate- and lower-income households to save for retirement, and would likely reduce economic insecurity and poverty rates among the elderly and raise national saving. Estimates of the revenue cost of these expansions are provided in the attached tables and paper.

III. Automatic Enrollment and Escalation of Contributions

A. Factors That Discourage 401(k) Participation

As discussed, the shift from employer-funded pensions to 401(k)-type retirement savings plans has meant that, increasingly, it is left up to the employee to choose whether to participate, how much to contribute, which of the investment vehicles offered by the employer to invest in, and when to pull the funds out of the plan and in what form (in a lump sum or a series of payments). Workers are thus confronted with a series of financial decisions, each of which involves risk and a certain degree of financial expertise.

To enroll in a 401(k), an eligible employee usually must complete and sign an enrollment form, designate a level of contribution (typically a percentage of pay to be deducted from the employee's paycheck), and specify how those contributions will be allocated among an array of investment options. Often the employee must choose from among 15, 20 or more different investment funds. An employee who is uncomfortable making all of these decisions may well end up without any plan, because the default arrangement—that which applies when the employee fails to complete, sign, and turn in the form—is nonparticipation.

For those employees who do choose to participate, payroll deductions and associated contributions are made automatically each pay period, typically continuing year after year, unless the employee elects to make a change. Although the contributions continue over time, the traditional 401(k) arrangement does nothing to encourage participants to increase their contribution rates over time, or to diversify or rebalance their portfolios as their account balances grow. In other words, employees in a 401(k) not only must take the initiative to participate, they must further take the initiative to invest wisely and to increase their contribution rates over time.

As a result, about 1 in 4 employees who is eligible to participate in a 401(k) or similar plan fails to participate, and 401(k) balances for most employees are small relative to their needs.

B. Automatic Enrollment and Related Approaches to 401(k) Decisions

Fortunately, a disarmingly simple concept – automatic enrollment (and a similar approach to other 401(k) decisions) -- has the potential to change this pattern. A growing body of evidence suggests that the judicious use of default arrangements—arrangements that apply when employees do not make an explicit choice on their own—holds substantial promise for expanding retirement savings. The effects appear to be particularly promising for middle- and lower-income households, who have the greatest need to increase their savings. Retooling America's voluntary, tax-subsidized 401(k) plans to make sound saving and investment decisions more automatic, while protecting freedom of choice for those participating, would require only a relatively modest set of policy changes—and the steps taken thus far are already producing good results.

In a nutshell, this approach consists of changing the default option at each phase of the 401(k) savings cycle to make sound saving and investment decisions the norm, even when the worker never gets around to making a choice in the first place. Given the current structure of most 401(k) plans, workers do not participate unless they actively choose to. In contrast, under automatic enrollment, they would participate unless they actively choose not to—and similarly for each major decision thereafter. Contributions would be made, increased gradually over time, invested prudently, and preserved for retirement, all without putting the onus on workers to take the initiative for any of these steps. At the same time, however, workers would remain free to override the default options—to choose whether or not to save, and to control how their savings are invested—but those who fail to exercise the initiative would not be left behind.

A growing body of empirical evidence suggests that this may be the most promising approach to bolstering retirement security for millions of American families. A number of economists have undertaken important research and contributed practical suggestions concerning the actual and potential uses of automatic enrollment and related default arrangements in 401(k) plans.

The core concept behind this approach is quite simple: design a 401(k) to recognize the power of inertia in human behavior and enlist it to promote rather than hinder saving. Under this approach, each of the key events in the process would be programmed to make contributing and investing easier and more effective.

- Automatic enrollment: Employees who fail to sign up for the plan—whether because of simple inertia or procrastination, or perhaps because they are not sufficiently well organized or are daunted by the choices confronting them—would become participants automatically.

- Automatic escalation: Employee contributions would automatically increase in a prescribed manner over time, raising the contribution rate as a share of earnings.

- Automatic investment: Funds would be automatically invested in balanced, prudently diversified, and low-cost vehicles, whether broad index funds or professionally managed funds, unless the employee makes other choices. This aspect is discussed in Section IV of this testimony, below.

- Automatic rollover: When an employee switches jobs, the funds in his or her account would be automatically rolled over into an IRA, 401(k) or other plan offered by the new employer. Traditionally, many employees receive their accumulated balances as a cash payment upon leaving an employer, and many of them have spent part or all of it. Automatic rollovers would reduce such leakage from the tax-preferred retirement savings system. At this stage, too, the employee would retain the right to override the default option and place the funds elsewhere or take the cash payment. Automatic rollover is actually being implemented this year with respect to the smallest qualified plan distributions (not exceeding $5,000).

In each case – automatic enrollment, escalation, investment, and rollover – workers can always choose to override the defaults and opt out of the automatic design. The integrated strategy of using default arrangements to promote saving without sacrificing individual choice was first formulated – and began to be implemented – between 1998 and 2000 by the U.S. Treasury. The Treasury and the Internal Revenue Service (IRS) approved automatic enrollment for 401(k) plans in 1998 and first permitted automatic rollover in 2000. In 2001 Congress enacted legislation making automatic rollover mandatory for small lump-sum distributions, to take effect this year. Both automatic enrollment and automatic rollover were designed also to lay the groundwork for automatic investment: both generally, by establishing the principle that pro-saving defaults should apply to major retirement decisions, and specifically, by requiring plans to prescribe default investments to be used in conjunction with automatic enrollment and automatic rollover.

It is worth stressing that none of these automatic or default arrangements are coercive. Workers would remain free to opt out at any point, but automatic enrollment points workers in a pro-saving direction when they decline to make explicit choices of their own. The Treasury rulings authorizing automatic enrollment include provisions to ensure that employees retain control of enrollment and investment decisions. The plan must provide employees advance notice and an adequate opportunity to make their own, alternative choices before proceeding with the default arrangement. Similarly, under automatic rollover, employees have a variety of choices and must be given advance notice of those choices before the automatic arrangement takes effect.

C. Automatic Enrollment

Under a plan that uses automatic enrollment, unless an employee affirmatively expresses a different preference, the default mode is that the employee participates at a stated percentage of compensation.[39] This, as a practical matter, is particularly geared toward encouraging participation by moderate- and lower-income employees, who are least likely to participate without it. Studies suggest that autoenrollment can boost the rate of 401(k) plan participation from a national average of about 75 percent of eligible employees to between 85 and 95 percent. Particularly dramatic increases are seen among those subgroups of workers with the lowest participation rates. For example, one study found that, among employees with between 3 and 15 months, automatic enrollment increased participation from 13 percent to 80 percent for workers with annual earnings of less than $20,000, and from 19 percent to 75 percent for Hispanics.[40] (Automatic enrollment, like the Saver's Credit, also enables higher-paid employees to contribute more by making it easier to obtain favorable results under the 401(k) nondiscrimination test.)

Interesting administrative variants exist that can accomplish much of what automatic enrollment does. One alternative would require that all employees make an explicit election to participate or not, rather than enroll them automatically if they make no election. In at least some cases this approach has produced participation rates in the same high range as automatic enrollment. In addition, firms could require that employees who opt out sign a statement acknowledging that they have read the plan's disclosures regarding the advantages of contributing.

Despite its demonstrated effectiveness in boosting participation, autoenrollment is used today by only a small minority of 401(k) plans. According to a recent survey, 8 percent of 401(k) plans (and 24 percent of plans with at least 5,000 participants) have switched from the traditional "opt-in" to an "opt-out" arrangement. As already noted, automatic enrollment is a recent development, and therefore it may yet become more widely adopted over time, even with no further policy changes. But policymakers could accelerate its adoption through several measures. Some of these policy measures would be appropriate only if

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[39]Automatic enrollment was approved in IRS Revenue Ruling 2000-8. The IRS has recently 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.

[40]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.

automatic enrollment were adopted in conjunction with other features of the automatic 401(k), especially automatic escalation.

First, the law governing automatic enrollment could be better clarified. In some states, some employers see their state labor laws as potentially restricting their ability to adopt automatic enrollment. Although many experts believe that federal pension law preempts such state laws as they relate to 401(k) plans, additional federal legislation to explicitly confirm this would be helpful. Any such explicit preemption should be undertaken only to the extent necessary to protect employers' ability to adopt automatic enrollment.

Second, some plan administrators have expressed the concern that some new, automatically enrolled participants might demand a refund of their contributions, claiming that they never read or did not understand the automatic enrollment notice. This could prove costly, because restrictions on 401(k) withdrawals typically require demonstration of financial hardship, and even then the withdrawals are normally subject to a 10 percent early withdrawal tax. One solution would be to pass legislation permitting plans to "unwind" an employee's automatic enrollment without paying the early withdrawal tax if the account balance is very small and has been accumulating for only a short period of time.

Third, Congress could give automatic enrollment plan sponsors a measure of protection from fiduciary liability (as discussed in Section IV, below).

Fourth, broader adoption of automatic enrollment and the other key pieces of the automatic 401(k) could be encouraged by reforming an exception to the rules governing nondiscrimination in 401(k) plans (as described below). Many firms are attracted to automatic enrollment because they care for their employees and want them to have a secure retirement, but others may be motivated more by the associated financial incentives, which stem in large part from the 401(k) nondiscrimination standards. These standards were designed to condition the amount of tax-favored contributions permitted to executives and other higher-paid employees on the level of contributions made by other employees. They thus gave plan sponsors an incentive to increase participation among their less highly paid employees. Automatic enrollment is one way for them to do this.

In recent years, however, employers have had the option to satisfy the nondiscrimination standards merely by adopting a 401(k) "matching safe harbor" design. The matching safe harbor provision exempts an employer from the nondiscrimination standards that would otherwise apply as long as the firm merely offers a specified employer matching contribution. It does not matter whether employees actually take up the match offer—all that matters is that the offer was made. Indeed, the more employees contribute, the greater the employer's cost to match those contributions, without any compensating improvement in nondiscrimination results. By thus attenuating employers' interest in widespread employee participation in 401(k)s, the matching safe harbor provision presents an important obstacle to wider adoption of automatic enrollment.

To restore the attractiveness of automatic enrollment to employers, policymakers could change the rules to allow the matching safe harbor only for plans that feature automatic enrollment and the other key parts of the automatic 401(k) (especially the automatic escalation feature described below). Plan sponsors currently using the matching safe harbor could be given a transition period to meet the new requirements.

D. Automatic Escalation

One potential drawback of automatic enrollment, highlighted by recent research, is that it can induce some employees to passively maintain the default contribution rate over time, when they might otherwise have elected to contribute at a higher rate. This adverse effect can be mitigated through automatic escalation, whereby contributions rise gradually and automatically over time (for example, from 4 percent of the worker's pay in the first year to 5 percent in the second, 6 percent in the third, and so on). For example, in the "Save More Tomorrow" program proposed by Richard Thaler and Shlomo Benartzi, workers would agree (or not) at the outset that future pay increases will generate additional contributions. In one trial, "Save More Tomorrow" was shown to lead to a substantial increase in contribution rates over time for those who participated, relative to other 401(k) participants at the same company. Alternatively, workers could agree to future contribution increases even in the absence of pay raises. Automatic escalation plans have been explicitly approved by the IRS in a general information letter obtained by the witness.[41]

E. Automatic Investment

A third and related approach is automatic 401(k) investment, which is discussed in the following section of this testimony.[42]

F. Automatic Rollover

A similar automatic or default-based approach has already been applied to plan payouts before retirement, to limit leakage of assets from the retirement system. Currently, most people who receive distributions from 401(k) and similar plans take one-time cash payments. In general, the smaller this lump-sum distribution, the less likely it is to be saved by being transferred ("rolled over") to another employer plan or to an IRA. In fact, data suggest that, as of 1996, the median lump-sum distribution was $5,000, and a sizable majority of defined contribution

[41] General information letter from Internal Revenue Service to J. Mark Iwry, March 17, 2004.

[42] Many of the approaches outlined in this and the following section of this testimony are contained in H.R. 1508, the "401(k) Automatic Enrollment Act of 2005," introduced last week by Representative Rahm Emanuel (D-IL).

plan participants who receive a lump-sum distribution of $5,000 or less do not roll it over to a qualified plan or IRA.16

For years, account balances of up to $5,000 could be involuntarily "cashed out," that is, paid to departing employees without their consent, and these payments were the least likely to be preserved for retirement. In 2000, however, a Treasury-IRS ruling permitted retirement plan sponsors to transfer such amounts to an IRA established for a departing employee who did not affirmatively elect any other disposition of the funds. A year later Congress mandated such automatic rollover for distributions between $1,000 and $5,000. Under this legislation, scheduled to take effect in March 2005, plan sponsors may no longer force cash-out distributions of more than $1,000 on departing employees. Instead they are required to follow the employee's instructions either to transfer the funds to another plan or an IRA, pay the funds directly to the employee, or keep the funds in the plan if the plan permits that option. The individual thus has the choice to preserve or consume the retirement savings, but, if the individual makes no other choice, the default is preservation—either in the employer's plan, if the employer so chooses, or in an IRA that the employer opens for the employee. The employee must also be notified that, if the payout is automatically rolled over to an IRA, he or she may then roll it over to another IRA of his or her choice.

Automatic rollover was designed to have a potentially valuable byproduct, namely, the broader utilization of IRAs. Currently, fewer than 10 percent of those eligible to open and contribute to an IRA on a tax-preferred basis actually do so. Like enrolling in a 401(k), opening an IRA requires individuals to overcome inertia and to navigate their way through a number of decisions (in this case, choosing among a vast number of financial institutions and investments). Automatic rollover instead calls upon the employer to take the initiative to set up an IRA and choose investments on the employee's behalf, again unless the employee chooses to do so. The intended result is not only to preserve the assets within the tax-favored retirement plan universe, but also to create an expanding infrastructure of portable, low-cost individual accounts for the millions of workers who have no IRAs but who are covered at some point by an employer-sponsored retirement plan. Automatic rollover thus has the potential to help achieve a far broader expansion of retirement plan coverage for middle- and lower-income households. Indeed, this broader agenda is explicitly reflected in the automatic rollover legislation, which directs the Treasury and Labor Departments to consider providing special relief for the use of low-cost IRAs.

Eventually, leakage might be further limited by expanding automatic rollover to a wider array of distributions. However, for various reasons, any such expansion would need to be examined carefully. For one thing, in most cases, benefits in excess of $5,000 currently remain in the employer plan as the default arrangement that applies if the employee makes no explicit election regarding disposition of the funds.

G. Other Potential Automatic Arrangements

Alternative default options could also be considered for other aspects of retirement savings, including the form in which distributions are made at retirement. Current law reflects some preference for encouraging payouts to take the form of a lifetime annuity, which guarantees periodic payments for life (as opposed to a single cash payment, for example). Lifetime annuities are a sensible way to reduce the risk of retirees (other than those with very short life expectancies) outliving their assets, yet few people purchase them. In defined benefit and money purchase pension plans, a lifetime annuity is generally the default mode of distribution. In contrast, 401(k) and most other defined contribution plans have been able for the most part to exempt themselves from such default requirements. (Proposals have been advanced to extend to 401(k) plans default arrangements (including spousal protection) based on those that apply to defined benefit and money purchase plans.)

IV. Automatic Investment

Even those workers who successfully navigate the problems of coverage, participation, level of contribution, and retention of the funds must still deal with the challenge of sound investment. In the accumulation phase of 401(k) retirement savings, too many employees find themselves confronted by a confusing array of investment options, and lack the expertise, time, or interest to become expert investors. As a result, it appears that millions of 401(k)-type accounts fail basic standards of diversification and sound asset allocation. Rather than maintain a balanced portfolio, many hold either no equities (and are overinvested in safe but low-yielding money market funds) or almost nothing but equities. Many also apparently fail to systematically rebalance their portfolio or adjust its asset allocation over time, and some underperform because of unsuccessful attempts at market timing.

In addition, millions of workers are overconcentrated in their employer's stock.[43] This can prove especially costly: if the employer falls upon hard times, workers stand to lose not only their jobs but their retirement savings. But even when the plan sponsor does not collapse, poor investment choices impose unnecessary risk on workers, threaten the level and security of their retirement income, and reduce the public policy benefits from 401(k) tax preferences.

The risks of inadequate diversification are widely recognized. In fact, pension law generally requires plan trustees, who make investment choices in plans without employee self-direction, to diversify plan portfolios to reduce the risk of large losses. Virtually all investment professionals scrupulously avoid investing more

[43] Jack VanDerhei has found that, in plans that allow employer stock as an investment option, 46 percent of participants (some 11 million employees) hold more than 20 percent of their account balance in employer stock, and one-sixth hold more than 80 percent.

than a minuscule fraction of assets under their management in any single company. Economic theory suggests that undiversified portfolios create significant risk without providing additional expected returns. Moreover, when the undiversified stock is that of the investor's employer, the risk is compounded, as noted above.

A. Sources of the Problem

Congress has enacted two important provisions that actually encourage both self-directed investment and overinvestment in company stock while doing little to help workers manage the responsibilities arising from the dramatic shift toward 401(k)s. First, ERISA relieved employers of most fiduciary responsibility for investment losses if they allowed employees to direct their own investments—which likely was one factor encouraging the shift to 401(k)s. Yet self-direction of investments is not working as well as it should. Second, the main exception to the pervasive use of employee-directed investment in 401(k)s has been plan sponsors' frequent decision to make their contributions to these accounts in the form of employer stock. Although this tendency undermines diversification and might normally be considered a conflict of interest, Congress actually granted special exceptions from the normal fiduciary standards to allow employer (and employee) contributions to be heavily invested in employer stock.

With the expansion of 401(k)s, employer stock has moved from a supplemental to a far more central place in the pension landscape. Meanwhile, one of the main policy rationales originally articulated for providing special exceptions for employer stock—encouraging worker ownership of equities—has already been addressed by, among other things, the ready availability of diversified equity investments through 401(k)s. There are two other potential rationales for investing in employer stock: seeking to encourage higher productivity through increased worker ownership, and encouraging employers to contribute to retirement plans. But both these rationales fall short of justifying the extent to which employer stock has come to dominate so many workers' 401(k) portfolios.

In addition, Professor Richard Thaler and his coauthors have explored the causes of overconcentration in employer stock. They find that most 401(k) participants are unaware that investing in a single stock is riskier than holding a diversified portfolio. For various reasons (several possibilities are suggested below), workers do not appear to make the connection between what happened at Enron (or at other failed or distressed companies) and the risks of investing in their own company's stock.

B. Current Policy Responses

The leading 401(k) legislative proposals under consideration, which were developed in the wake of recent corporate scandals, fail to respond to either the specific problem of overinvestment in employer stock or the more general problem of less than optimal allocation of 401(k) assets. The proposals would limit plan sponsors' ability to explicitly require participating employees to invest in employer stock (with broad exceptions for the special plans known as employee stock ownership plans, or ESOPs). However, the proposals would allow employees—possibly with the effective encouragement of corporate management—to continue to overinvest their retirement funds in employer stock. As a result, such legislation would not prevent future 401(k) debacles because most 401(k) overinvestment in employer stock does not result from employers explicitly requiring such investment. It seems to result instead from a combination of factors: workers may view their own company as a more comfortable investment because it is familiar to them; they may also be influenced by management's strongly positive view of the company's prospects or by a concern about not appearing sufficiently loyal to the company. These factors may be buttressed by peer group reinforcement and by simple inertia.

One current legislative proposal would require 401(k) sponsors to give participants notice regarding the virtues of diversification. This, however, could prove ineffectual in many cases. For example, a company that still seeks to maximize plan investment in company stock may be able to make the notice inconspicuous or otherwise counteract its effects.

Another proposal would relax current fiduciary standards to allow 401(k) investment fund providers to advise workers on investing in the providers' own funds and those of their competitors. This has raised concerns and controversy about new conflicts of interest arising on the part of the providers (concerns that are avoided when the adviser is independent and is not providing advice on its own funds). In addition, evidence suggests that only a small share of 401(k) participants respond to offers of investment advice. For example, at a June 2004 Brookings Institution conference on this topic, Michael Henkel, president of Ibbotson Associates, noted that, in his firm's experience, only about 5 percent of 401(k) participants follow investment advice provided on the Internet.

Finally, despite assertions that the proposed investment advice legislation would prevent future 401(k) fiascos, the legislation as currently drafted actually stops short of requiring that investment advice extend to employer stock. It thus ignores precisely the area where employees have the most serious need for independent professional advice.

C. A General Strategy

A more promising approach would offer employers relief from selected fiduciary liabilities if they offer participants alternatives to mandatory self-direction, through either standardized investments or professionally managed accounts. Such alternatives could be the default investment option. This strategy would improve 401(k) asset allocation and investment choices while protecting employers and preserving employees' right to direct their accounts themselves if they so choose.

1. Standard Investments

Congress could designate certain standardized, broadly described types of investments as qualifying for a measure of fiduciary safe harbor treatment. In other words, plan sponsors would enjoy a degree of protection from certain challenges for imprudence or lack of diversification under ERISA if they made such standard investments the plan's default investment and participants did not opt out of the default (or if participants affirmatively selected such investments from among an array of options). In addition to stable-value investments such as bond and money market funds, standard investments would include balanced, prudently diversified, low-cost funds (such as low-cost index funds) with a range of permissible allocations between equities and bonds. Plan sponsors would not be required to offer such investments but would be permitted to impose them on all participants, include them among participants' investment options, or make them the plan's default option. Standards could be drawn broadly enough so that market competition would continue on price, service, and, to some extent, product.

Plan sponsors would have an incentive to use standard investments to the extent that doing so would help protect them against charges of imprudent asset allocation or lack of diversification. Employers would not be given a blanket exemption from all fiduciary responsibility: plan fiduciaries would retain appropriate responsibility for avoiding conflicts of interest, excessive fees, lack of diversification, and imprudent investment choices. However, employers would receive meaningful protection under ERISA, thus encouraging more employers to consider automatic enrollment. Indeed, the market might come to view the types of investment that receive such favorable treatment as in effect enjoying a presumption of prudence. Use of "presumptively prudent" balanced or life-cycle funds as the default investment in lieu of stable-value funds or employer stock seems likely, in turn, to improve investment returns for participants.

The law could provide explicit approval for short-term default investment in stable-value funds, which then switch to balanced or life-cycle funds thereafter. This option could be especially useful for firms that include automatic enrollment as part of their 401(k) plan. The purpose would be to ensure that workers who quickly changed their minds and wanted to opt out of the 401(k), perhaps because they had not realized that they would be included as a result of automatic enrollment, would not experience capital losses.[44]

2. Managed Accounts

[44] As discussed earlier, Congress could encourage automatic enrollment by providing a short "unwind" period during which workers who decided to opt out of the 401(k) could withdraw their contributions and could avoid early withdrawal penalties. Accordingly, the default investment could be a stable-value fund for the duration of this unwind period.

Congress could also make it clear that plan sponsors seeking protection from fiduciary liability could designate an independent professional investment manager to invest participants' accounts. This would free participants from having to manage their own accounts, although they could retain the option to do so. The plan sponsor and trustee would be protected from fiduciary responsibility for investments appropriately delegated to an independent investment manager (except for the continuing responsibility to prudently select and monitor the manager).

The law may be sufficiently clear in this area that no statutory change is required. However, Congress could clarify how a managed account approach can fit into an otherwise self-directed 401(k) plan, which might accelerate the expansion of professional account management services, already an emerging trend. Like standard investments, managed accounts generally would ensure reasonable asset allocation and adequate diversification. (In practice, the two approaches would likely converge.) Accordingly, an important by-product would likely be the divestiture of excessive amounts of employer stock in the interest of diversification. And Congress could give managers a fiduciary safe harbor or exemption for investing some fraction (say, up to 5 or 10 percent) of each account balance in employer stock, if desired.

D. Policy Strategies Targeted More Specifically to Employer Stock

Specific policy changes relating to company stock are also warranted. The goal is not to eliminate company stock investments, but rather to reduce the overconcentration that exposes so many participants to unnecessary risk. David Wray, President of the Profit-Sharing 401(k) Council of America, has noted that sometimes the choice is effectively between employer contribution of company stock and no contribution at all—especially during economically difficult times and for privately held companies.

1. "Crowdout" of Employer Stock

A minimalist strategy for diversifying away from employer stock, in the context of the above proposals, would be to do nothing specifically about it, on the ground that exposing employees' 401(k) accounts to professional investment management (or standardized default investments) is itself likely to reduce the concentration in employer stock over time. The gospel of sound asset allocation and diversification will become more pervasive, and professional expertise will permeate the system far more readily, once employees are no longer the only or primary managers of their plan portfolios. Accordingly, as professional management and standard investments increasingly replace employee self-direction, the practice of overconcentration in employer stock and poorly balanced portfolios would eventually give way to diversification and sound asset allocation.

2. Diversification Safe Harbor for Plan Sponsors

Congress could also give a fiduciary safe harbor to plan fiduciaries that follow a systematic employer stock divestiture program. This would facilitate divestiture by plan sponsors that recognize they might have gotten in too deep but are still hesitant to divest themselves of the company stock. Employers fear litigation for fiduciary breach if their plans sell company stock or sell it too quickly (in the event the stock value subsequently rises) or too slowly (in the event the stock value falls). A safe harbor "glide path" for systematic, gradual diversification would also help address employers' other legitimate concerns that large sales of company stock from the plan might depress the market for the stock or, more commonly, might be perceived by the market or by employees as a signal that management lacks confidence in the company's future.

3. "Sell More Tomorrow"

Richard Thaler and Shlomo Benartzi suggest that plan sponsors offer employees the option of participating in a systematic program of gradual employer stock divestiture over a period of years.[45] Consistent with the employer-level safe harbor "glide path" approach suggested above, Thaler and Benartzi advocate this creative, employee-level approach (which they call "Sell More Tomorrow") as a way to encourage employees to take a possibly difficult step by arranging to do most of it in the future. By spreading out the sale of the shares over time, this approach also avoids potentially depressing the market for the stock and mitigates any risk of remorse on the part of employees for having sold at the wrong time.

4. Threshold Approach

Another possible approach to reducing overconcentration in employer stock would permit employees to invest employee contributions in employer stock only to the extent that the contributions in a given year exceed some threshold. Such a threshold could be set, for example, at 7 percent of pay—a level slightly above the actual average 401(k) contribution rate.

E. Autoinvestment in General

The automatic investment approaches described here—particularly the use of managed accounts or sound standard investments not only as an investment option but also as the default investment mode—would improve 401(k) asset allocation and investment performance generally while working in concert with other methods described here to reduce overconcentration in company stock. Approaches such as these would save employees from having to be financial experts while continuing to allow self-direction for those employees who want it.

[45] Shlomo Benartzi and Richard H. Thaler, "Sell More Tomorrow: Using Behavioral Economics to Improve Diversification in 401(k) Plans: Solving the Company Stock Problem," University of California, Los Angeles, 2002.

And by improving investment performance, such a strategy should increase retirement savings.

V. Cash Balance Pension Conversions: A Legislative Framework for Resolution

The regulation of cash balance and other hybrid plans has potentially far-reaching consequences for the health of the defined benefit pension system and for workers' retirement security. The system as a whole would benefit from a resolution of the cash balance controversy that would settle the law governing those plans in a reasonable way. I believe that Congress can resolve the cash balance issue in a manner that provides substantial protection to older workers from the adverse effects of a conversion while allowing employers reasonable flexibility to change their plans and reasonable certainty regarding the applicable rules.

Hybrid plans, such as cash balance pension plans, are plans of one type – defined benefit (DB) or defined contribution (DC) – that share certain characteristics of the other type. Currently, a major portion of the defined benefit universe takes the form of cash balance or other hybrid plans, as hundreds of sponsors of traditional defined benefit plans have converted those plans to cash balance formats in recent years. However, the precise application of the governing statutes to such hybrid plans has been the subject of uncertainty, litigation and controversy.

The following portion of this testimony illustrates a possible legislative framework for resolution of the cash balance pension issue. Of course, no resolution of this highly contentious issue would leave all parties fully satisfied. There is ultimately a sharp tradeoff between protecting older workers from certain changes in plans and preserving employers' flexibility to make changes in a private pension system where they are not required to adopt or continue plans. However, the approach outlined here seeks to illustrate how Congress might find common ground – or at least middle ground – by allowing cash balance plans and conversions, resuming the IRS review and approval process, and giving plan sponsors reasonable flexibility to choose how – but not whether – to protect older workers. In a sense, plan sponsors have already pointed the way: corporate 'best practices" in a number of instances have sought to combine reasonable protection for employees with reasonable flexibility for the employer.

The material provided in this statement is illustrative, not prescriptive; it is intended to illustrate that Congress has realistic options for providing cash balance conversion relief with reasonable employer flexibility, rather than to make specific recommendations.

A. Preliminary Matters

The cash balance pension issue has been the subject of sharply differing views, reflected in proposed legislation, legislative and policy debate, litigation, comments on regulations, academic writing, editorials, etc. In addition, the issues relating to cash balance plans and conversions of traditional defined benefit (DB) pension plans to cash balance plans and other hybrid pension programs are relatively involved.[46]

This statement is intended only to sketch out a "broad-brush" response. It does not rehearse the legal or policy issues presented by cash balance plans and conversions; it does not go into detail regarding the specifics of the approaches outlined here; it certainly does not purport to illustrate how all of the important related issues and major questions in this area might be resolved; and, as noted, it is illustrative or descriptive rather than prescriptive. Should the Committee wish to have further information, I would be glad to respond.

B. Cash Balance Conversion Relief and Employer Flexibility

A central policy concern raised by cash balance plans[47] is whether and how conversions from traditional defined benefit to cash balance plans can be carried out in a manner that sufficiently protects older and long-tenured employees who would otherwise be adversely affected -- without unduly limiting employer flexibility to change their plans and without stifling innovation and creativity in the market and in pension design.[48] In fact, among the significant legal issues that have been raised regarding cash balance plans are whether the plans are inherently age discriminatory and whether conversions are age discriminatory -- particularly whether the plans or conversions violate the age-related proscriptions of section 411(b)(1)(H) of the Internal Revenue Code (IRC) and its counterpart provisions under ERISA and the Age Discrimination in Employment Act (ADEA).

Plan sponsors undertaking cash balance conversions have adopted a range of provisions intended to provide varying degrees of transition protection to current employees.[49] Some of these protective provisions might be described as corporate "best practices" that are generally similar to the "choice" requirements

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[46] In some respects, cash balance plans resemble DC plans. They are presented to employees using DC plan concepts, with an account that increases over time as a result of interest and compensation credit. In addition, the pattern of economic accrual under a cash balance plan (i.e., each employee is credited with a hypothetical allocation which is a percentage of that employee's compensation for that year) is closer to the economic accrual under a traditional DC plan than under a traditional DB plan design. However, a cash balance plan is not a DC plan because an individual's benefits under a cash balance plan are not solely derived from the individual's allocated contributions plus attributable investment return. Therefore, cash balance plans are DB plans.

The material in this footnote is quoted essentially verbatim from prior testimony of the witness (while serving in the Treasury Department):Testimony of J. Mark Iwry, Benefits Tax Counsel, Office of Tax Policy, U. S. Department of the Treasury, before the Committee on Health, Education, Labor and Pensions, United States Senate, page 4. That testimony contains further discussion of cash balance plans and conversions.

[47] In the interest of avoiding further complexity, this testimony refers to "cash balance plans" rather than attempting to address the issues raised by other forms of hybrid plans such as pension equity plans.

[48] The material in this paragraph is drawn largely from my June 4, 2003 testimony, pages 5-6, 18-19.

[49] U. S. General Accounting Office, Cash Balance Plans: Implications for Retirement Income, pages 34-36 (2000).

that would be imposed by H. R. 1677, the Pension Benefits Protection Act, introduced by Congressman Bernie Sanders and this Committee's Ranking Member, Congressman George Miller, and co-sponsored by other Members. The bill requires companies that convert to cash balance plans to allow workers who are either at least 40 years old or have at least 10 years of service the choice to remain in the traditional defined benefit plan.

Other converting employers have provided protection that would not meet the standard established in H.R. 1677, but that some would describe as "good practices" that substantially exceed the requirements that would have been imposed, for example, by the regulations proposed by the Treasury Department in December 2002.[50]

C. Possible Framework for a Legislative Solution

As noted, a possible legislative resolution of the cash balance issue could allow cash balance plans and conversions, resume the IRS review and approval process, and give plan sponsors reasonable flexibility to choose how – but not whether – to protect older workers. Thus, at the core of the legislative package would be an essential quid pro quo: a clean bill of health for hybrid plans that meet certain standards in exchange for reasonable protection of older/longer serving participants affected by conversions.

It must be recognized that this would break new ground, taking ERISA and the plan qualification rules to a place where they generally have not been before. If Congress is to give effect to a policy rooted in age discrimination concerns raised by conversions to hybrid plans, care must also be taken to minimize collateral damage to employers' willingness to sponsor defined benefit or qualified plans generally. Because of the overall state of the defined benefit system and plan sponsor fears that this type of legislation might portend further legislative restrictions on employers' flexibility to amend plans, some believe such legislation would contribute to widespread defined benefit plan freezes or terminations. However, others are concerned that the current uncertainty is likely to be more damaging, and that clear rules are needed for hybrids and conversions.

Minimizing spillover effects of the legislation would involve, among other things, distinguishing conversions to hybrid plans from other types of amendments, in order to make clear that newly-enacted participant protection requirements would apply to conversions but not to other types of amendments (or to plan terminations or freezes). Presumably, for example, the new legislation would not apply to an amendment of a traditional defined benefit plan to move from final to

[50] See id. Of course Congress should not view the proposed regulations as a source of potential guidance concerning the appropriate policy balance here. When it developed those regulations, Treasury was operating under a major constraint:: it was required to work within its interpretation of the current statute. As discussed below, Treasury's subsequent legislative proposal goes well beyond the scope of the proposed regulations.

career average pay and/or to eliminate an early retirement subsidy in compliance with current anti-cutback requirements – unless the amendment also involves conversion to hybrid format. Legislators, regulators, or the courts would then need to consider how to deal with step transactions that involve sequential conversions and other amendments.

For these purposes, the legislation would need to define hybrid plans (perhaps in terms that refer, for example, to defined benefit plans that state the accrued benefit as an account balance) and conversions (e.g., amendment of a defined benefit plan that does not, to one that does, state the accrued benefit in terms of an account balance).

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Explicitly or implicitly, the legislation would address hybrid plans in steady state and conversions, at least those that take place after a specified effective date. Explicitly or implicitly, it would also have to deal with past years – steady state and conversions -- or at least be drafted with care to take into account its possible implications for past years and for existing litigation.

By way of illustration, legislation could include the following 12 basic elements:

1. Provide that cash balance plans will not be treated as inherently age discriminatory, i.e., that new or steady-state cash balance plans do not per se violate the age discrimination laws if they would satisfy the defined contribution age discrimination standard of IRC section 411(b)(2).

2. As a condition of treating a conversion as lawful, require the plan to protect a specified class of older and longer-service workers from wearaway of their normal and early retirement benefits.

3. As a further condition, require the plan to give that protected class of older and longer-service participants a reasonable level of additional protection from the adverse effects of the conversion.

4. Prescribe the minimum level of protection in a manner that maximizes employers' flexibility to choose among a specified array of "safe harbor" alternatives for designing their protective arrangements (discussed below).

5. Give employers further flexibility by providing a "safety valve", allowing individual plan sponsors to demonstrate to the IRS that their conversion provisions are substantially as protective of older participants as at least one of the safe harbors. This could include a "facts and circumstances" demonstration.

6. Give IRS specified additional FTE and budgetary resources to help it address the cash balance backlog, provided Treasury and IRS concur. A conversion that is the subject of such a safety valve application (see #5, above) could not be implemented before IRS had received such additional FTEs and funds or without an IRS determination letter. IRS would be authorized to prescribe reasonable conditions to limit the volume of such case-by-case applications.

7. Direct Treasury to propose, after consultation with EEOC and DOL, regulations implementing the safe harbors and related legislation (replacing the December 2002 proposed regulations) and to resume the IRS determination letter review process for cash balance conversions.

8. Possibly authorize Treasury to publish additional safe harbors that are not less protective of older or longer-service participants than the statutorily described safe harbors and that would not go into effect until after a longer than usual period following their submission to Congress in proposed form.

9. Allow cash balance plans to pay lump-sum distributions of the participant's account balance, subject to possible limitations of interest crediting rates so as not to exceed market rates of return (sometimes referred to as the "whipsaw" issue).

10. To the extent practical, take steps to clarify the application of other related plan qualification provisions to hybrid plans and direct Treasury to fine tune the safe harbors to the extent necessary to coordinate conversion protections for older workers with other plan qualification rules, including the prohibitions on discrimination in favor of highly compensated employees and restrictions on "backloading" of benefits.

11. Provide that the legislation is intended to have no effect on the application or interpretation of the age discrimination laws beyond the limited sphere of hybrid pension plans and conversions.

12. Congress must determine the effective date of the provisions referred to in ## 2-4, above, and whether a reasonable "safe harbor" (involving a lower level of participant protection) should apply to past conversions (including those for which an application for IRS determination letter has been pending) and whether plan sponsors that wish to "top up" their past conversions to meet such a standard should be given specific methods of doing so.

D. Building Blocks for Constructing Conversion Safe Harbors

1. In General

In considering how to design options employers can use to protect current employees affected by a conversion, it is important to bear in mind that employer flexibility to choose among a menu of alternatives means that, in many instances, the protection will be only as strong as the weakest alternative. In accordance with the character of this discussion as descriptive rather than prescriptive, this testimony is not intended to advocate or recommend a particular approach regarding the degree or specific nature of the conversion protection Congress should require. Determining how much protection to require for current employees from the potential adverse effects of a conversion depends on how the nature and gravity of those effects are viewed and on how employees' interests in protecting their benefits are balanced against plan sponsors' need for flexibility and the potential impact on their willingness to maintain plans.[51]

2. Full Protection of Benefit "Expectations"

According to one view, the law should protect older workers' expectations of future higher benefits under a traditional DB plan from the effects of a conversion – as some employers have done – because older workers affected by the

[51] The discussion in this part does not address concerns that have been raised to the effect that the basic structure of the cash balance plan formula generally fails to comply with the existing provisions of IRC section 411(b)(1)(H) and similar ADEA and ERISA prohibitions on reduction in the rate of benefit accrual because of the attainment of any age. To the extent that concerns such as these are viewed as more in the nature of legal concerns under the current statutory provisions than policy concerns, they could be addressed as part of a legislative package, such as that outlined here, that would protect older workers from the adverse effects of cash balance conversions. At the same time, such concerns can also reflect an underlying policy concern about the effects of cash balance plans and of legislation that might encourage them. This testimony does not attempt to address the debate regarding the policy merits and drawbacks of hybrid plans.

conversion have given up current wages (whether implicitly or explicitly) in exchange for a traditional pension formula that provides only modest benefits in the employee's earlier years on the understanding that longer-serving employees will be more richly rewarded late in their career. In addition, under a related view, conversions often discriminate against older workers, treating them less favorably than younger employees. These concerns might suggest requiring older or longer-service employees to be grandfathered in the old formula benefit, giving them the greater of the old and new formula benefit, or giving them a choice between the two formulas at retirement.[52] See, for example, H.R. 1677.

Some employers have extended such grandfathering, "greater of" treatment, or choice to a specified class of individuals who participated in the traditional DB plan at conversion (e.g., those who have reached a certain age and/or have completed a certain period of service as of the conversion). Variations of this view – reflected in various other corporate practices and in Treasury's legislative proposal, discussed below -- would require such protection to last only for a limited period of years.

Under these approaches, it is assumed that where the conversion is intended to reduce pension costs for the plan sponsor or to spread the benefits of the DB plan more broadly among the work force, the temporary transition relief for current employees will not prevent the sponsor from realizing those benefits in the long run, as the number of nongrandfathered employees grows while the number of grandfathered employees diminishes.

3. Preventing the Worst of Both Worlds

A different view is driven more by a recognition of the employer's ability to freeze or terminate a DB plan, even a traditional one with a "backloaded" pattern of benefits, and by a concern about the impact on the private employer-sponsored pension system of beginning to require qualified plan sponsors to protect employee expectations of future benefit accruals. For some, however, this concern is tempered by a recognition that a conversion can result in a smaller total benefit for an employee than if he or she had been covered by the cash balance plan for the employee's entire career. This can occur because, during the early years of one's career, the traditional DB might provide smaller benefits than the cash balance plan. (This is sometimes referred to as the "bow tie" effect, reflecting of the shape of the graph depicting it.)

[52] Some contend that employee choice regarding such technical matters is less appropriate than grandfathering employees in the old formula to the extent it would provide a greater benefit at retirement. Under this view, permitting employees a choice at retirement amounts to little more than offering a choice between more money and less – an exercise that is either wasted motion or, in a few cases, unnecessarily risky. And offering employees a choice at the time of conversion presents an undue risk of unwise or uninformed choices, which can ultimately result in remorse and litigation to the detriment of both employees and employers. In view of the risk of eventual litigation, the concern has been expressed that choice at conversion puts excessive pressure on the accuracy, comprehensiveness, and usefulness of the plan sponsor's disclosures and any related assistance to employees. Choice also raises issues relating to the handling of plan amendments that take effect between conversion and retirement.

Thus, some would hold that even if it were impractical for the system to require converting employers to guarantee their workers the best of both worlds (the greater of the old and new formulas or a choice between them), it should at least require employers to protect their employees from the worst of both worlds. One method of preventing the "bow tie" effect is to establish an opening account balance equal to the present value of a hypothetically "reconstructed" cash balance benefit. This would be the benefit the employee would have earned before the conversion date had the cash balance formula covered the employee since he or she began work with the employer (assuming that amount exceeds the present value of the employee's actual pre-conversion accrued benefit under the traditional DB plan). Alternatively, if the "sum-of" (A+B) method (discussed below) is used, and if the present value of the A piece (the frozen old-formula benefit) is less than the hypothetically reconstructed preconversion cash balance benefit, then the present value of the A element might be increased to equal that reconstructed benefit.

4. Preventing Wearaway

"Greater-of" Approach. A related adverse effect of a conversion on employees is the extended suspension of new benefit accruals that can occur after a conversion when employees are promised the greater of an old-formula benefit that is frozen (because additional service is not earning employees additional benefits under that formula) and a new-formula benefit that is less generous but that does continue to grow with additional service. This so-called "wearaway" of the frozen old-formula benefit – whereby no new net benefits are being earned so long as the frozen old-formula benefit continues to exceed the growing new-formula benefit – can apply to the normal retirement benefit (typically the benefit payable at age 65) and to the early retirement benefit. In many cases, where the early retirement benefit is "subsidized" and hence is actuarially more valuable than the normal retirement benefit, the wearaway of the early retirement benefit will be potentially more costly to the employee than the wearaway of the normal retirement benefit.

Some would advocate requiring protection only to the extent necessary to prevent or to simply mitigate the wearaway – of either the normal and early retirement benefits or only the normal retirement benefit. (The December 2002 proposed Treasury regulations would require converting plan sponsors to take steps to mitigate the wearaway of the normal retirement benefit, but the Treasury's later legislative proposal would prohibit wearaway of the early retirement benefit as well.)

"Sum-of" or "A+B" Approach. This approach would formulate protections based generally on a policy that employers should continue to be free in the future to stop one plan formula and start another, but without offsetting the old benefits against the new – at least not in a way that particularly disadvantages older workers. Thus, the employer could be required to mimic the result that would obtain if it froze the traditional DB plan and adopted a new cash balance plan that provided benefits wholly unrelated to the old frozen plan benefits.

This would suggest a 'sum-of' or "A+B" approach whereby employees' normal and early retirement benefits after the conversion are equal to the sum of the normal or early retirement benefits they earned before the conversion under the old plan formula (the "A" element) and the cash balance benefits they earn after the conversion (the "B" element). (This "sum-of" approach is contrasted with the "greater-of" approach described above, which promises employees the greater of an old-formula frozen benefit and a growing new-formula cash balance benefit.)

Recognizing Post-Conversion Compensation Increases. A variation would require the employer to increase the "A" element – the benefit earned under the old formula before conversion – to reflect post-conversion increases in compensation (though not post-conversion service). The rationale would be that, even if the employee is not grandfathered in the entire old formula such that it would continue to apply to service after the conversion, the final average pay feature of the old formula was a particularly key element of the employee's expectations that should be honored after the conversion. In addition, essentially indexing the pre-conversion benefit for inflation in this manner can help address the concern of those who believe that merely preventing post-conversion wearaway does too little to offset the harm to older employees.

Immediate Vesting. Another possible element would be to require full and immediate vesting of benefits (to the extent funded) upon the conversion. The rationale for this would be that the conversion, if likened to a freeze of one plan and establishment of another, has an effect similar to a partial termination of a plan that would require immediate vesting.[53]

Establishing Opening Account Balance to Prevent Wearaway of Normal Benefit. A variation on the "sum-of" approach would allow the employer, as an alternative, to establish an opening account balance under the cash balance formula that includes the full present value of the normal retirement benefit the employee had earned under the traditional plan formula before the conversion, and that grows as the employee earns cash balance pay and interest credits. Congress could require the present value to be calculated using actuarial assumptions that include the statutorily prescribed interest rate for determining present values of pension benefits. The advantage of this alternative to the "sum-of" is presentational simplicity: it presents the full normal retirement benefit, pre- and post-conversion, in a single format, as an account balance.

A major drawback, however, is that the opening account balance approach does not readily lend itself to preventing wearaway of early retirement benefits. (It also does not readily lend itself to recognizing the effect of post-conversion

[53] Some have argued that conversions should be treated as plan terminations, triggering not only immediate vesting but also annuitization and excise and income tax on any surplus assets.

compensation increases on the traditional old-formula benefit.) Early retirement benefits under a traditional DB plan can be particularly valuable because they often are "subsidized" relative to the normal retirement benefit (i.e, the monthly or annual payment under the early retirement annuity is not reduced – or not reduced sufficiently -- to reflect the fact that it begins earlier and therefore is expected to make more payments than the age-65 annuity). Consequently, the opening account balance method needs to be supplemented by a contingent early retirement subsidy (the "pop-up" benefit described below).

"Pop-Up" Early Retirement Subsidy. An early retirement subsidy is a contingent benefit. Its value depends on whether and when the employee retires. An employee does not realize any early retirement subsidy if he or she terminates employment either before becoming eligible for it or after reaching normal retirement age. Consequently, the value of the subsidy is not readily captured in a post-conversion opening account balance. Attempts to do so, depending on how they are designed, tend to result in age discrimination, partial loss of benefits, and windfalls.

However, early retirement subsidies can be preserved on a contingent, "springing" basis. The plan keeps track of the subsidy under the old formula and prevents wearaway of the subsidy by adding it to the employee's total retirement benefit (under the old and new formulas) if and when the employee retires early and qualifies for it. This "pop-up" protection can be quite important to employees, although employers note that it comes at a cost in terms of presentational simplicity. It can also be combined with the use of an opening account balance that reflects the present value of the normal retirement benefit earned before the conversion.

5. Greater of "Sum-of" and "Greater-of"

Another variation would provide a normal retirement benefit equal to the greater of the benefit produced by the "sum-of" A+B method and the "greater-of" (opening account balance) method. As noted,

- the "sum-of" method provides a total benefit equal to the sum of the frozen old formula pre-conversion benefit in the form expressed under the traditional plan ("A") and the new formula account balance resulting from annual post-conversion cash balance pay and interest credits ("B");

- the "greater-of" method provides a total benefit equal to the greater of the old formula frozen benefit and the new formula account balance, which in turn consists of an opening account balance equal to the present value of the pre-conversion benefit plus annual post-conversion cash balance pay and interest credits.

This approach would prevent wearaway without the associated risk, under some circumstances, that the final benefit will be less than it would be under a "greater-of" approach.

6. "Straight-lining": Preventing Reduction of the Pre-Conversion Accrual Rate

Another view would stop short of requiring protection of employees' expectations of steadily increasing accrual rates under the traditional defined benefit plan, but would interpret the section 411(b)(1)(H) prohibition on reducing the rate of benefit accrual because of age as requiring a comparison of older and younger employees' rates of benefit accrual before and after the conversion. Instead of comparing a conversion to a freeze of one plan and fresh-start adoption of another, this approach would take the view that because the conversion is a plan amendment and the plan retains its defined benefit character, the conversion should be analyzed as a plan amendment under IRC section 411(b)(1)(H) to determine whether it reduces the rate of benefit accrual because of age.

To permit an "apples to apples" comparison for this purpose, one could take the present value of the traditional DB plan's pre-conversion rate of accrual and express it as an equivalent allocation rate (i.e., an equivalent DC plan contribution) or cash balance pay credit.

- For example, a conversion might provide a 5%-of-pay hypothetical cash balance contribution or pay credit to all employees, including an older employee who had an accrual rate under the traditional DB plan equivalent to a 12%-of-pay contribution and a younger employee who had an accrual rate under the traditional plan equivalent to a 4%-of-pay contribution.

Under one view, the conversion would have impermissibly reduced the rate of benefit accrual on account of age. Under such an interpretation, preventing age discrimination would not require grandfathering an older employee in his or her traditional DB benefit formula, including expected future increases in the rate of benefit accrual, but only in a pay credit equivalent to the employee's pre-conversion rate of benefit accrual. Literal adoption of such an approach would give rise to a host of issues, such as the practical complexity of maintaining many different age-sensitive pay credit rates and coordination with qualified plan standards designed to prevent discrimination in favor of highly paid employees. One alternative, however, would be to view this concept not as an application of current law but rather as an underlying theory that might serve as a basis for designing a safe harbor, available for future conversions, that would involve age- or service-weighted pay credits (as described in the following section).

7. Age- or Service-Weighted Pay Credits or Opening Balances

A practice not uncommon among converting employers has been to provide for a tiered pay credit rate under the cash balance plan – a higher pay credit percentage for older (or longer service) employees than for younger (or shorter service) employees – though not necessarily as high as would be needed to equal the older worker's pre-conversion rate of accrual (see 6, above).

Congress could, if it wished, borrow a leaf from these employers. A conversion could be treated as not age discriminatory if older employees receive sufficiently high and durable cash balance pay credits – defined by reference to the pre-conversion rate of accrual, younger employees' pay credits, or an absolute percentage of pay. Like other ameliorative measures, such an approach would need to be carefully crafted to avoid doing violence to age discrimination law generally. It also would need to be coordinated with qualified plan nondiscrimination policy and standards.

Additional amounts credited to older employees' opening account balances might be designated as another permissible means of offsetting the adverse effects of the conversion, if meaningful equivalencies can be determined. It is difficult, however, to preserve the benefits of an early retirement subsidy solely through higher pay credits or an additional opening account balance, as opposed to an additional benefit that becomes payable if and when a participant becomes eligible for the early retirement subsidy after retiring (the "pop-up" approach).

E. Conversion Safe Harbors

As noted earlier, Congress could prescribe minimum standards for protecting employees from the adverse effects of cash balance conversions by giving employers flexibility to choose among a specified array of "safe harbor" alternatives for designing protective arrangements.

In addition to defining safe harbors (which could be fleshed out through regulations once they were sufficiently described in the statute), Congress would need to determine how non-safe-harbor conversions would be treated. For example, one possible approach would be to provide that a conversion that does not satisfy any safe harbor is vulnerable to challenge as age discriminatory (i.e., it reduces the rate of benefit accrual on account of age in violation of the statutory provisions) and is not entitled to an IRS determination letter covering the age discrimination issue, unless the specific facts demonstrate otherwise. Another approach would be to provide that such a conversion is subject to a rebuttable presumption that it reduces the rate of benefit accrual because of age.

As noted, this testimony is not intended to suggest where Congress should set the bar, i.e., it does not advocate or recommend a particular approach regarding the amount or type of conversion protection Congress should require.

Conversion safe harbors could be constructed from the methods or "building blocks" described above. By way of illustration, possible safe harbors might include provisions along the lines of the following:

1. Full Protection of "Expected" Benefits

One safe harbor could require protection of older or longer-service employees' old-formula benefit expectations, including expectations regarding future increases in the rate of benefit accrual. This protection could take the form of being (a) grandfathered in the old formula benefit, (b) given the greater of the old and new formula benefit at retirement, or (c) given a choice between the two formulas at retirement. See D.2, above.

- In addition to limiting the required protection to a particular class of employees by age and service, Congress could, if it thought it appropriate, limit the duration of the required protection.

2. Preservation of Pre-Conversion Rate of Accrual

A second safe harbor might treat a conversion as not reducing the rate of benefit accrual because of age if the plan provided age-weighted (or age- and service-weighted) pay credits based on the pay credit equivalents of employees' pre-conversion rates of benefit accrual. See D.7, above.

- If Congress thought it appropriate, it could set the bar for age-weighted pay credits somewhat lower than – but taking into account -- the level required to make employees whole relative to their pre-conversion accrual rates. The legislation could, for example, define the level of credits required for older employees by reference to the pre-conversion rate of accrual, younger employees' pay credits, or an absolute percentage of pay. Congress might also allow other types of credits – such as one-time transition credits added to the opening account balance -- to substitute for some or all of the higher pay credits, although the determination of rough equivalencies would not be straightforward. See D.7, above.

3. "Sum-of" (A+B) Plus Early Retirement Subsidy Pop-Up and Compensation Updates to Old-Formula Benefit

A third safe harbor might be constructed by building on the anti-wearaway protections described in D.4, above. Just as Congress, if it decided to seek a middle ground between competing interests, would have to determine how much to limit or subtract from the basic structure of the first two safe harbors (full grandfathering), it would similarly have to decide how much to build up or add to the basic structure of this third safe harbor (the "sum-of" approach to preventing wearaway).

Often, the two aspects of the traditional DB benefit formula that contribute most to the "backloaded" character of the plan are early retirement subsidies and the final average pay feature. If it wished to, Congress could partially offset the loss of these features by, for example, designing a safe harbor that begins with the "sum-of" (A+B) method and adds both an early retirement subsidy pop-up and recognition of post-conversion compensation increases in determining the value of the "A" element (the frozen old-formula benefit). See D.4, above.

4. Enhanced Opening Account Balance Plus Early Retirement Subsidy Pop-Up

As an alternative to the "sum-of" approach, which starts with a zero account balance after the conversion, another safe harbor could permit use of the opening account balance method outlined in D.4, above. Under that method, the cash balance account begins by including the full present value (determined using the statutory interest rate) of the employee's pre-conversion normal retirement benefit, and grows as the employee earns cash balance pay and interest credits.

As in the previous safe harbor, early retirement subsidies under the traditional plan would be preserved via an early retirement subsidy pop-up. However, since this single account balance (opening account balance) method does not readily accommodate recognition of post-conversion compensation increases in determining benefits, the employer might be required to increase the opening account balance by a specified percentage as a rough-justice substitute.

5. Safety Valve Facts and Circumstances Determination

As an alternative to using a safe harbor method, employers might be given further flexibility through a "safety valve" procedure allowing individual employers to make a "facts and circumstances" demonstration to the IRS that their conversion provisions are substantially as protective of older participants as at least one of the safe harbors or that, in any event, their conversion does not reduce the rate of benefit accrual because of age in violation of IRC section 411(b)(1)(H).

Any such safety valve option would likely impose heavy demands on IRS resources. Processing such an application would be a labor-intensive procedure requiring highly trained technical personnel, who are in short supply. Accordingly, access to such a determination would need to be, in effect, rationed. This could be done by appropriately limiting the eligibility conditions. In addition, a natural rationing process might occur as plan sponsors seeking such special determinations instead of complying with one of the safe harbors would be forced to wait in the queue and probably endure substantial delays. Of course such rationing would be justifiable only if the safe harbors were reasonable.

* * * * *

As an additional cross-cutting requirement, converting employers, regardless of which safe harbor they are relying on, might be required to protect employees from the "worst of both worlds" situation described in D.3, above, using the "reconstructed account balance" described there or an alternative method.

* * * * *

F. Treasury's Legislative Proposal

In response to a congressional directive, the Treasury Department suspended its cash balance regulations project and, in February 2004, issued a legislative proposal regarding cash balance conversions (reiterated in substantially similar form in February 2005 in connection with the administration's budget). Substantial elements of the Treasury proposal are similar to elements outlined above (and in testimony I submitted to the House on July 1, 2003).

In my view, the Treasury proposal represents a serious and constructive first step toward a solution. Congress should carefully consider a number of the elements in Treasury's proposal when it crafts legislation. However, the Treasury proposal as a whole should not be viewed as meeting the requirements of an adequate solution, for reasons suggested below.

1. Basic Elements

Treasury's proposal would provide that cash balance and other hybrid plans do not violate the age discrimination rules if they satisfy the defined contribution standard for avoiding age discrimination (similar to item 1 in the list of 12 basic elements above). The so-called "whipsaw" restrictions would be eliminated, so that cash balance plans would be permitted to distribute a participant's account balance as a lump sum distribution provided that interest was not credited in excess of a market rate of return (similar to item 9 in the list of basic elements above).

The conversion protections – which would apply only to future conversions -- would take two forms. First, wearaway of the normal or early retirement benefit would be prohibited for all participants (see item 2 above). Second, a "hold harmless" period would apply for the first five years after a future conversion: benefits earned by any employee under the cash balance plan would be required to be at least as valuable as the benefits the employee would have earned under the traditional plan absent the conversion (compare to items 3 and 4, above). A plan sponsor would also satisfy that requirement if it grandfathered current participants under the traditional benefit formula or gave them a choice between the traditional formula and the cash balance formula.

The conversion transition protections would not be plan qualification requirements or, apparently, requirements under Title I of ERISA. Instead, a 100 percent excise tax would be imposed on the plan sponsor equal to any shortfall between the benefits actually provided by the cash balance plan and the benefits required. However, to provide relief to companies "experiencing adverse business conditions," the excise tax would be limited to the greater of the surplus assets of the plan upon conversion or the sponsor's taxable income. The proposal would be effective prospectively, with legislative history stating the intent that no inference be drawn as to the status of cash balance plans or conversions under current law.

2. Comments

A number of elements in the Treasury proposal invite particular scrutiny. For example --

- While some would regard any required "hold harmless," grandfathering, or choice as excessive, many would view the five-year limitation on that protection in the Treasury proposal as unduly brief. A long-service participant in his or her fifties or late forties, for example, might well be exposed to a significant reduction for an extended period of employment after the five years have elapsed.

- The conversion protections under the Treasury proposal are not limited to a specified protected class of older and longer-service participants. This gives the proposal the appearance of applying more broadly than many actual or proposed transition provisions that limit the required protection to those participants who have reached a specified age or years of service or both (such as a specified number of age and service "points"). Treasury's decision not to limit the class of participants required to be protected may well reflect a concern about very substantial discrepancies between the treatment of participants who are on different sides of the eligibility line. The benefits realized by a protected participant from a hold harmless transition provision could be quite significant, and would contrast starkly with the lack of any such benefits for a participant with only a few months less service or age. Others would argue, however, that some element of arbitrary line-drawing is inevitable in this type of undertaking, and that the amount of transition benefit for those who barely qualify for the protected class might be sized appropriately without falling into excessive complexity.

- While the duration of the protective provisions is limited under the proposal, it appears that plan sponsors would not have the flexibility to provide less than the full amount of benefits that participants would have earned under the traditional formula. Some would favor this approach, but others might advocate for allowing employers the flexibility to give something less than full protection during any transition period, i.e., partial continuation or preservation – sufficient to meet a specified standard -- of the benefits that would have been earned under the traditional formula. The Treasury approach would not necessarily accommodate techniques such as age- and service-weighted pay credits that might provide substantial transition relief but less than the full benefit participants would have earned under the traditional formula.

- The apparent decision to omit the protections from the plan qualification rules and Title I of ERISA raises questions regarding enforcement and remedies. An indirect Title I right might arise in certain cases, specifically where the plan provisions reflect the transition protection requirements but the employer fails to comply.

- With respect to the exception for employers with no taxable income, there is a threshold question whether a company in financial distress should be allowed to undertake a conversion without protecting older participants. Some would argue that when plan sponsors need to save money as a matter of survival, it is not important or necessarily desirable as a matter of policy to ensure that they have the option of realizing savings through a cash balance conversion that does not adequately protect older employees (as opposed to other means of saving money, perhaps including more direct reductions in benefits). Others would be swayed by the concern that a likely alternative in such circumstances might be an outright plan termination or freeze, but may nonetheless view the scope of the Treasury exception as unduly broad. As currently described in the Treasury documents, the exception to the excise tax appears to allow avoidance of the protective requirements by plan sponsors that are not in extremis but that have arranged their affairs so as to report little or no taxable income in a given year.

- Many would view the purely prospective nature of the Treasury proposal as desirable (e.g., on the basis that plan sponsors should not be required to have predicted the protective requirements before they were enacted). Others would prefer past conversions to be addressed by legislation in some fashion. Some would contend that at least the plan sponsors that converted after the IRS declared its moratorium on conversion-related determination letters (September 15, 1999) -- and after the public notice shortly thereafter stating that the Treasury and IRS were reconsidering the application of the plan qualification rules to conversions – should be deemed to have been on notice and to have assumed the risk. Others would argue more broadly that participants affected by past conversions undertaken with little or not transition protection should be protected now at least to some practicable extent. Still others would have an interest in a provision making clear that many past conversions – those that met a reasonable and flexible standard specified in legislation – were valid and will be protected from challenge. These issues are discussed above.

G. Dealing With Past Conversions

As noted, the process of crafting such legislation also requires dealing – explicitly or implicitly – with past years, including conversions that occurred in the past. Any bill would need to be drafted with care to take into account its possible implications for past years and for existing litigation. A number of alternative approaches are possible, including --

1. Statutory silence regarding past conversions with no inference language in the legislative history.

2. Required protections for past conversions (significantly lower than those required for future conversions) as a condition of obtaining comfort regarding past steady state hybrids or a safe harbor for past conversions that does not impose an explicit requirement.

3. Some kind of process for obtaining comfort and resolving disputes regarding past conversions.

Plan sponsors that undertook conversions in the past would ideally wish for an explicit clean bill of health for past conversions. But if this is not feasible, then, according to one point of view, legislation should establish a prospective effective date for conversion requirements and "no inference" language regarding past conversions.[54] According to this view, plan sponsors are better off without any statutory provisions seeking to provide "comfort" for past years: a safe harbor for past conversions arguably invites plaintiffs to challenge all conversions failing to meet the safe harbor. The variety of transition provisions in past conversions means many might not satisfy any single or simple safe harbor.

Under a second and different view, at least some cash balance plan sponsors would welcome the certainty of being able to obtain comfort that their past conversions will not be challenged in court and that their hybrid plan will not be treated as age discriminatory in its steady state for past as well as future years. Under this approach, a statute that prescribes specific requirements for future conversions but provides only a reasonable and significantly lower safe harbor standard for past conversions would not mean that past conversions failing to meet the safe harbor are necessarily age discriminatory or otherwise violate the

[54] Many argue that, when converting in the past, employers had no way of knowing that any particular standard would apply; that they read signals from the government (e.g., section 401(a)(4) regulation safe harbor provision and preamble sentence, Notice 96-8 and, arguably, section 204(h) notice advance disclosure legislation) stating, suggesting or implying, as the case may be, that steady state cash balance plans were not age discriminatory, and numerous cash balance plans received IRS determination letters following conversion. Others respond that cash balance plans by their nature violated the literal terms of the three statutes; that conversions that failed to protect older participants were age discriminatory, and that at least some employers and their advisers were aware, while others arguably should have been aware, of this possibility.

plan qualification requirements. (The safe harbor would prescribe one method -- but not the only method[55] -- of demonstrating that the conversion was not age discriminatory.) But such legislation would give comfort to employers whose past conversions met the safe harbor and would give a choice to employers that want protection to top up and meet the safe harbor retroactively

Finally, others would argue that, just as the price of an explicit statutory blessing of future steady state hybrid plans might be adequate protection of older participants in future conversions, the price of any statutory protection of employers from litigation over steady state hybrids in past years should be at least some protection of older workers in past conversions. Plan sponsors whose past conversions failed to meet this lower bar (presumably in the form of a safe harbor) would be able to "top up" after the fact, at least with respect to affected older employees who are still active, and would have guidance on how much top up is necessary on a safe harbor basis. According to this view, the employees who are most aggrieved are those adversely affected by the many past conversions – at least those that did not provide adequate transition relief – and because many of these employees have yet to retire, their benefits have not yet been definitively calculated.

*   *   *

A number of the potential arrangements described here can be viewed as means of giving employees "half a loaf" – although the exact fraction that is or should be provided is the subject of vigorous debate. If Congress wished to find middle ground on this issue that strikes a balance between the legitimate competing interests, these are tools it can use (in addition to other techniques not described here). As noted, however, it is not the purpose of this discussion to suggest where Congress should strike any such balance along the spectrum of possible requirements from fuller protection (as in H.R. 1677) to far more limited protection.

In addition, this discussion does not attempt to be comprehensive. It does not address many of the other issues implicated by or relevant to a legislative approach to conversions (other rules governing cash balance plans, application of a legislative approach to other hybrid plans, coordination with rules prohibiting discrimination in favor of highly compensated employees and restricting backloading, sanctions, financial accounting issues, etc.[56]).

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[55] A possible alternative approach might: allow controversies over past conversions to be resolved through a process established by legislation. The process might involve alternative dispute resolution without a government role or, alternatively, it might be a governmental process such as the opportunity to apply for an IRS determination that a past conversion (with or without top-up) satisfied a standard designed to prohibit age discrimination.

[56] Some have argued, for example, that future legislation should not permit conversions to cash balance plans that are "integrated" with Social Security (i.e., that use a formula that takes advantage of "permitted disparity" referred to in IRC section 401(l) to provide a higher pay credit for compensation above than for compensation below a specified level) on the theory that this plan design is inconsistent with the rationale for hybrid plans to the effect that they are easy for participants to understand.

*   *   *   *   *

As noted, this testimony does not attempt to provide a comprehensive outline of reforms to the employer system but instead focuses on several strategies for promoting retirement security and saving that, in my view, are particularly promising.

Mr. Chairman and Ranking Member Kohl, I would be pleased to respond to any questions you and the Members of the Committee might have.

Table 1

Saver's Credit Rates and Effective Matching Rates by Income[1]

Dollars except where stated otherwise

Adjusted gross income					
Married filing jointly	Singles and married filing separately	Credit rate (percent)	Tax credit for $2,000 contribution	After-tax cost of $2,000 contribution	Effective after-tax match rate (percent)
0-30,000	0-15,000	50	1,000	1,000	100
30,001-32,500	15,001-16,250	20	400	1,600	25
32,501-50,000	16,251-25,000	10	200	1,800	11

Source: Authors' calculations.

(1) Calculations assume that the taxpayer has sufficient income tax liability to benefit from the nonrefundable credit shown, and exclude the effects of any tax deductions or exclusions associated with the contributions or with any employer matching contributions.

Table 4
Eligibility for 50 Percent Credit Rate

	Returns by Filing Status (thousands)[1]				
	Single	Married Filing Jointly	Head of Household	Other	Total
(A) Total Returns	59,235	61,658	21,915	2,513	145,321
(B) Returns Eligible for 50 Percent Credit Based on Income[2]	25,679	20,105	12,916	511	59,211
(C) Returns That Would Receive Any Benefit from 50 Percent Credit[3]	5,195	2,327	743	183	8,448
As a share of those eligible based on income (=C/B)	20.2%	11.6%	5.8%	35.8%	14.3%
(D) Returns That Would Benefit in Full for Maximum Allowed Contribution[4]	1	3	39	0	43
As a share of those eligible based on income (=D/B)	0.0%	0.0%	0.3%	0.0%	0.1%

Source: Urban-Brookings Tax Policy Center Microsimulation Model.

(1) Both filing and nonfiling units are included. Filers who can be claimed as dependents by other filers are excluded.

(2) Eligible returns exclude filing units above the relevant AGI threshold and those claimed as dependents on other tax returns.

(3) Returns that would receive any benefit form the saver's credit are eligible and would see some reduction in taxes as a result of the credit if a contribution were made to an approved retirement account.

(4) Returns that would benefit in full from the 50 percent saver's credit for the maximum alowable contribution are both eligible and would see a reduction in taxes equal to the size of the credit if the maximum contribution were made to an approved retirement account.

The CHAIRMAN. Thank you very much. Just for your notice, we probably have a vote coming up fairly soon.

We do not have timing lights apparently operating in this room right now, so one of our assistants is going to notify you as to a reasonable amount of time so we can make sure we hear all of you.

I am sorry. Pronounce your name for me.

Mr. STEUERLE. "Steuerle."

The CHAIRMAN. Steuerle, OK.

STATEMENT OF EUGENE STEUERLE, SENIOR FELLOW, THE URBAN INSTITUTE, WASHINGTON, DC

Mr. STEUERLE. Thank you, Mr. Chairman and Senator Kohl. As I mentioned to Senator Smith before the formal hearing began it is a privilege to testify before this committee, in part because I think it is one of the true bipartisan committees on either side of the Congress. I always enjoy working with the committee because it really does try to seek answers to questions.

As Mark has mentioned, on the positive side the United States is in a select group of developed countries with a very significant share of assets in pension and retirement accounts, and they are largely employer-sponsored. I would like to add that the involvement of employers appears to be very crucial in increasing retirement assets, whether the employer directly funds these accounts or merely makes them available to employees.

Nonetheless, the evidence that retirement and pension incentives have done much recently for national saving is very weak. As you mentioned, Senator Kohl, citing some statistics, I believe, that a colleague and I came out with a few weeks ago, total personal saving in the United States is now below just the revenue spent on supporting retirement and pension plans. That does not even count the revenue spent on other so-called saving incentives that Congress has adopted. Even that comparison further does not count other accounts in areas like health that have a saving component.

Even if net saving were not an issue, the distribution of retirement saving is very highly skewed, and the current system fails to provide much in the way of retirement saving—but not just for low-income taxpayers, whom we have been talking about, but for middle-income taxpayers, as well. Most middle-income taxpayers, not just low-income taxpayers, go into retirement with very little in the way of saving. I make that comment very strongly because among the issues we discussed, such as automatic enrollment, it is not just an issue for low-income people. It is even for the middle-income people who are not saving.

I will give you one quick statistic. For two-thirds of the population in the United States, the value of their Social Security and Medicare benefits alone is in excess of all their saving from every other source—their own homes, their retirement assets, their savings accounts, every other source. So two-thirds of the population have more in Government benefits coming to them than from their entire saving when they go into retirement. So it is far more than a low-income issue.

Now, one major reason is that all of these Government subsidies that we have are not for saving. They are for deposits. There is a big difference. A taxpayer can borrow, for instance, and put money in a saving account or a subsidized saving account, and he would be taking interest deductions on the other side without saving a dime.

A second reason—and it has been mentioned by Secretary Warshawsky—is that the extraordinary complexity of the laws discourages saving. It discourages saving both by employees and it discourages the offering of saving accounts or pension plans by employers.

I would like to also add that some pension designs and laws also present an assortment of problems that probably discourage saving, such as easy withdrawals of deposits before old age and design of traditional defined benefit plans that often discriminate against older-age employees. In fact, I can show you a number of cases where older employees accrue negative pension benefits by working longer.

Yet another negative influence on saving is that most people retire in middle age. We have a system of retirement now, both public and private, that basically has people retiring for about one-third of their adult lives. That is, they are retiring in years when traditionally they have been savers. It would be as if about 50 or 60 years ago we had people retiring in their early 50's and then not saving for years beyond that early retirement age.

Finally, the incentives, as has been mentioned several times, for low- and moderate-income, even middle-income taxpayers, are often small and sometimes nonexistent. Let me quickly mention some ways of dealing with these issues.

One is to limit the tax breaks for those who are arbitraging the tax system by applying limitations on their interest deductions when, on the one hand, they are getting preferences for so-called savings but really deposits and, on the other hand, taking deductions—it might be mortgage interest deductions, it might be investment interest deductions—without actually saving at all. They are not counting their interest receipts when taking these interest deductions. Tightening up on withdrawals from retirement plans before old age could enhance saving. Yet another approach is to simplify, even though one has to admit simplification means that some people somewhere in the system are going to lose. Mind you that simplification is not just offering of a new simple plan. It is reducing the extraordinary array of plans that people have to choose from. If you look in the back of my testimony, I show a scheme for the plans that Congress now offers that makes the Clinton health plan, if you may remember the design of that, look simple by comparison. The pension laws are extraordinary complex and expensive.

Strong consideration also needs to be given to providing safe harbors for employers in designing new retirement plans for older workers so these older workers can save, at the same time making it easier for them to have bridge jobs, while removing the threat of suits that employers face from tax laws, labor laws, and old-age discrimination laws.

Another promising approach is to provide defaults for deposits which employers can opt out rather than opt in, as we have talked about. Another strong possibility is to increase the subsidy for lower- and moderate-income taxpayers.

Both of you, Senators Smith and Kohl, have asked about the saver's credit. I would like to offer my support for expanding the saver's credit, but also to mention three major limitations. It does not apply to most low- and moderate-income taxpayers. It does not cover employer deposits. The subsidy itself does not go directly into retirement accounts. So I think we need to work with the saver's credit, not merely just continue or increase it.

Another promising approach is to provide a clearinghouse to handle rollovers out of employer plans and a simplified saving system, especially when small amounts are involved. Finally, mandates that employees save for retirement, including in employer-sponsored plans, should be considered as one leg of a broader retirement stool. That issue of mandates for employee deposits is on the table right now, but very indirectly, as part of the Social Security debate. I think it needs to be brought into the broader private retirement system debate as well.

Thank you.

[The prepared statement of Mr. Steuerle follows:]

THE ROLE OF EMPLOYER-SPONSORED RETIREMENT PLANS AND NATIONAL SAVING

Testimony before the
Special Committee on Aging
United States Senate

April 12, 2005

*Eugene Steuerle**
Senior Fellow
The Urban Institute

*Eugene Steuerle is a Senior Fellow at the Urban Institute and a former Deputy Assistant Secretary of the Treasury. He also serves currently on the Advisory Board for the Retirement Security Project sponsored by the Pew Charitable Trusts, as well as an advisor to the Conversation on Coverage, convened by the Pension Rights Center, co-sponsored by a host of other organizations, including the Urban Institute, and supported in part by the Ford Foundation and the W.K. Kellogg Foundation. Part of his testimony is taken from research with Elizabeth Bell, Adam Carasso, and Richard Johnson and as part of a broader project on Opportunity and Ownership and supported in part by the Annie E. Casey Foundation. All views expressed in this testimony are his and do not necessarily reflect those of the Urban Institute, its board, its trustees, or any of the individuals in the organizations above.

Mr. Chairman and Members of the Committee:

It is a privilege to join you again today and to discuss the role of employer-sponsored retirement plans in national saving. On the positive side, the United States is in a select group of developed nations with a significant share of its assets in pension and retirement accounts, largely employer sponsored. The involvement of employers appears to be crucial to increasing retirement assets, whether the employer directly funds these accounts or merely makes them available to employees.

The evidence that retirement and pension incentives have done much recently for national saving, however, is weak. Total personal saving in the United States is now below the annual revenues spent in supporting retirement and pension plans. Even that comparison does not even count the revenues used to support other saving incentives, such as for education or health. Even if net saving were not an issue, the distribution of retirement saving is highly skewed, and the current system fails to provide much in the way of retirement saving not just for those with low-income, but for a substantial majority of the population.

One major reason is that all of these government subsidies are for *deposits* (whether by employees or employers), not saving, and there is a big difference. A second is that the extraordinary complexity of the laws surrounding employee benefits discourages some employers from participating, and the related costs absorb a significant share of the returns to saving. Some pension designs and laws also present an assortment of problems that probably also reduce saving: easy withdrawal before very old age, traditional defined benefit plan designs that often discriminate against older workers, and a threat of lawsuits (from tax, labor, and age discrimination statutes) that raise employer costs for providing retirement benefits. Yet another negative influence on saving is that most people now retire in late middle-age with one-third of their adult lives remaining before them—moving into spend-down patterns in years where traditionally saving rates tend to be high. Finally, the incentives provided to low- and moderate-income households often are also fairly small and sometimes non-existent.

There are various ways to try to deal with these issues. One is limiting tax breaks for those who are "arbitraging" the tax system by applying limitations on their interest deductions when they are receiving tax-deferred interest or other capital income in retirement accounts. Tightening up on withdrawals from retirement plans before old age could also enhance saving. Another approach is to simplify, even at the cost of removing some preferences for some people. Strong consideration should be given to creating "safe harbors" for employers in designing retirement plans for older workers, including those seeking bridge jobs rather than full retirement. Another promising approach is to promote policies that allow employers to set defaults for employee deposits from which employees can opt out, rather than using defaults of zero deposits to which they must opt in. Another strong possibility is to increase the subsidy for lower- and moderate-income taxpayers. The savers credit serves as an example, although it has three major limitations: it is small or does not apply for most low- and moderate-income households; it does not cover employer deposits; and the tax subsidy itself does not go into retirement accounts. A clearinghouse may be necessary to handle rollovers out of employer plans and a simplified saving system, especially when small amounts are involved. Finally, mandates that employees save for retirement, including through employer-sponsored plans, should be considered as one leg of a broader retirement stool.

The rest of my testimony elaborates on these points.

Aggregate Level of Retirement Assets

Households in the United States hold close to one-fourth of their net worth in retirement assets of one type or another—largely employer-sponsored retirement accounts. According to data compiled by the Federal Reserve Board, over $11 trillion are now held in pensions and retirement accounts. The United States is among an elite group of industrial nations in terms of its level of funding of pension plans. Some countries have relied more upon unfunded private pension plans, and this has become a grave concern as their populations age. Imagine, if you will, our own very serious Pension Benefit Guarantee Corporation problem multiplied several-fold, and you get some idea of the problems facing some other nations.

The employer plays a crucial role in encouraging retirement saving. Perhaps the strongest proof comes from comparing participation rates in employer-sponsored plans with participation rates in Individual Retirement Accounts (IRAs). Each year significantly less than 10 percent of the eligible population voluntarily puts money into IRAs, but participation in employer-sponsored plans is often 50 percent or higher—even when the employee is responsible for making the contribution. The simplicity of automatic payroll deductions and the involvement of employers as intermediaries in explaining and encouraging plan participation are clearly important factors in savings rates.

Lack of Net Saving

Still, net saving by households is quite small. In fact, total personal saving by households is now below the annual revenue cost of subsidizing retirement and pension plans (see Figure 1). Although both measures—retirement saving incentives and personal saving—have limitations (e.g. personal saving does not count investment in owner-occupied housing), the comparison reveals how little net saving these incentives are creating. It appears that efforts over the past few decades to stimulate private saving by providing numerous tax incentives for contributions to pension plans and retirement accounts have limited success in raising overall private saving. Given the revenue costs involved, these efforts have been even less successful in raising national saving, or the sum of private and public saving.

Trends in Pension Savings: Participation and Accumulation

For most households, pension saving covers only a modest portion of total retirement needs. For almost two-thirds of households approaching retirement, the lifetime value of their future Social Security and Medicare benefits (that is, the lump sum value as if in a 401(k) plan near to time of retirement) is greater than the sum of all their private assets: retirement plans, housing, and other private saving combined (Figure 2). Even excluding Medicare, Social Security by itself comprises over one-half of retirement wealth for most households.

When examined in terms of cash income (which excludes Medicare and rent saving from homeownership), Social Security benefits are the largest source, providing 50 percent or more of retirement income for 65 percent of beneficiaries.[1] While the vast majority of workers are

[1] Income of the Aged Chart Book, 2001, Washington, DC: The Social Security Administration.

covered by Social Security (91 percent), almost half of all full-time workers do not currently participate in a pension plan and, more crucially, 12 percent who do not participate are 55 to 64 years old.

Figure 3 shows the aggregate shares of different sources of retirement income that go to the 65 and over population, for the poorest (first), third, and richest (fifth) income quintiles. Social Security is clearly the mainstay of retirement for low-income families with the next largest contribution coming from public assistance. Only those in the top quintile rely substantially upon pension and retirement plans; they enjoy a much more balanced distribution of income sources in retirement, with earnings from employment supplying 35.2 percent, and then roughly similar shares (18-25 percent each) of income supplied by private and government pensions, other assets, and Social Security. Even the middle-income quintile of retirees receives only about 16 percent of income from pensions.

Table 1 characterizes full-time and part-time employees with no employer-sponsored retirement plan in 2003. Among full-time workers who had access to an employer plan, nearly 72 percent of the bottom income quartile failed to participate, compared to 28 percent in the top quartile. Along with income, firm size is another predictor of employee participation, with much higher percentages of workers at smaller firms (73 percent) failing to participate than at larger firms (32 percent).

Not unexpectedly, research shows markedly different retirement savings outcomes based on worker demographic characteristics, such as race, education, and marriage. For instance,

- A higher level of educational attainment leads to a higher likelihood of having an employer-sponsored pension plan; having a high school diploma or its equivalent raises this likelihood by nearly twenty percentage points;
- Married workers enjoy a higher percentage of pension participation than unmarried individuals;
- A very high percentage of Hispanics do not have pension plans;
- Smaller firms are often reluctant or unable to accept the fiduciary responsibility and administrative costs that accompany employer-sponsored plans, while low-income workers are both more likely to work for such firms and to have a high turnover rate.
- Part-time workers have much lower participation rates. Individuals in the bottom earnings quartile are among those most likely to be employed at smaller firms, and such firms have a drastically lower share of employees participating.

Figure 4 shows the accumulation of retirement savings, other than defined benefit pension plans, by age for persons at the 50th (median), 70th and 90th percentiles of income. The chart plots a trendline through data points at each age, expressing the amount of savings in multiples of the Social Security average wage, which was about $35,000 in 2004. At the 50th percentile and at the peak ages of asset accumulation (between ages 50 and 60), the balance of retirement accounts never reaches more than three-quarters of the average wage--or about $27,000 in 2004. Even at the 70th percentile, the accumulation peaks at about two times the average wage--or about $70,000. Only the top 10 percent of households have retirement saving equivalent to about eight times the average wage. Clearly, only the highest income groups have much in the way of retirement saving to tap into at retirement.

Some Explanations for the Low Saving Rate

5. ***Subsidies for Deposits, not for Saving***

Although an argument can be made that today individuals save less than their parents, in point of fact they (or at least the richer among today's workers) are making substantial *deposits* to retirement and pension plans. Therefore, we must dig a little deeper. The main distinction with the past is that households are borrowing at much higher level to finance consumption. When deposits are borrowed for consumption, there is no increase in saving or investment in the economy.

Now think about so-called retirement saving incentives. Part of the problem is that these incentives do not really subsidize saving, which requires a reduction in consumption spending and current living standards to finance investment. Instead, they merely subsidize deposits or contributions, whether by employer or employee, into a pension plan or retirement account. These contributions can be made in many "painless" ways that do not involve reducing one's standard of living. High-income, high-wealth households are best able to make such painless contributions, drawing from income they would have saved anyway, assets they have already saved, or borrowed money. Note that depositors don't have to think about this process. They may one day deposit more money to a 401(k) plan or accept lower wages because their employer makes such a contribution. The next year they may take out a second mortgage, without making any connection between the two events. Many other pension deposits increase the funds lent to other individuals on their credit cards.

2. ***Complexity of Plans***

I have been working in this policy arena since the mid-1970s, and not a year has gone by when some new saving proposal has not been proposed in Congress. A very large number have been enacted. Today, the array of retirement plan options (not to mention other saving incentives) is extraordinary in number (see Figure 5). Each has rules, often different, with regard to deposits, withdrawals, loans, penalties, income taxability, Social Security taxability, age restrictions, vesting, and a whole range of other issues. I have yet to meet any pension lawyer, much less employee benefit expert, who understands them all.

All of this costs money. Many employers no longer want to absorb these costs. In the end, most are borne by employees. These costs not only reduce employer offerings, but they likely reduce the net return available to employees even when plans are offered. Moreover, many firms producing particular goods or services do not want to be responsible for assets of employees who have long left the firm, or to handle issues of divorce, separation, and other household rearrangements that may affect ownership rights to those assets. Many employers simply do not want that level of fiduciary responsibility, even though many are quite content to make deposits on behalf of employees.

3. ***Pension and Retirement Plan Design***

A number of issues arise in the ways that retirement plans are now constructed. Defined contribution plans like 401 (k) plans can be spent down quickly at retirement since few individuals take those benefits in the form of an annuity. When employees change jobs, they are likely to withdraw money from both defined contribution and defined benefit plans, which often provide lump sum values at time of transition. Traditional defined benefit plans typically discriminate against both old and young workers by giving them little in the way of benefits relative to middle-age workers. For some older workers, the pension benefit—defined as economic accrual—is actually negative, encouraging them to retire and draw down assets rather than to continue to work and save (see Figure 6). By the way, the government's own Federal Employees Retirement System (FERS) has these same negative features for older workers. Meanwhile, employers hiring or retaining older workers, if they are not careful, run the risk of getting sued under ERISA labor law, tax law, and laws on age discrimination. Thus, employers have difficulty constructing reasonable retirement plan options for workers in their 60s and 70s—an age group quickly becoming the largest underutilized pool of human resources in the economy.

4. ***Retirement in Prime Saving Years***

People now retire in middle age. In 1940, the average worker retired at age 68 with about 11 years of life expectancy. Today, if the typical worker were to retire for the same number of expected years of life, he or she would be retiring at about age 74. By about 2065, he or she would retire at about age 78. Instead, the typical worker retires today at age 63, and employer plans—partly following the law—provide benefits to people when they are still in middle age, at least as defined by life expectancy. At first you may think this is a labor force, not a saving, issue. But, in fact, people are retiring in years when traditionally they were very likely to be significant savers. Instead of being net savers, they turn into dis-savers, drawing down instead of building up assets. This adds to the decline in national saving both because there is less output from the smaller labor force and because a larger proportion of output is being consumed.

5. ***Limited Subsidies for Low- and Moderate-Income Households***

Our system of government subsidies for retirement contains limited support for low- and moderate-income households. A person in a low- or zero-tax bracket has little tax incentive to save. The savers credit in the current law contains maximum amounts for which almost no one is eligible because it is nonrefundable and is already phasing down as income increases to the point that taxpayers start paying enough taxes to be eligible for a refund.

Policy Options

There are a variety of retirement options associated with employer-sponsored plans that Congress ought to consider trying to increase the saving rate in the economy. A related goal—one that is prudential even if net saving does not increase—is to try to increase the level of retirement saving for most low- and middle-income Americans. Here are some possibilities.

First, there need to be greater restrictions on subsidies for deposits that aren't leading to net saving and on early withdrawals of deposits that aren't saved to cover needs in old age. Among the tougher standards here would be limits on interest deductions to the extent that retirement income is excluded from tax (this would require current information reporting from retirement plans). Congress should also consider tighter limits on withdrawals from retirement plans, whether on the job, at time of transition to a new job, or even early in retirement years. As noted, these withdrawals increase the likelihood that households will have few assets available if they live to a ripe old age.

Second, simplification is long overdue. The transition from a world of dozens of choices is not easy, but required.

Third, pensions and retirement plans need to be designed around the needs of workers and employers today, not those of the 1950s. Simple safe harbors in retirement plan design are necessary for employers hiring or retaining older workers. I expect their numbers to increase substantially in the future, and we need laws to accommodate these changes. The constant threat of lawsuits needs to be greatly reduced.[2] The age limits specified in the laws are outdated. People are living much longer, for instance, so various age requirements—such as required withdrawals beginning close to age 70—need to be adjusted upward.

Fourth, there is strong evidence that participation rates in employer plans would increase significantly if more employers would automatically enroll employees unless they chose to opt out. A closely related opportunity is to automatically increase the contribution rate of employees as they get raises—again, unless they opt out. A Retirement Security Project has these items very high on their list of issues to pursue, and many conservatives and liberals both seem to be in agreement as to the potential gains. Although such options are probably legal now, clarification by Congress could help prevent the threat of future lawsuits.

Fifth, we need to figure out better ways of providing incentives to low-, moderate-, and even middle-income taxpayers. Expanding the savers credit and making it permanent is one option, but, as noted, it has three major limitations. Strong consideration should be given to figuring out how to deal with making the credit refundable, applying the credit to employer deposits, and keeping the subsidies in retirement accounts.

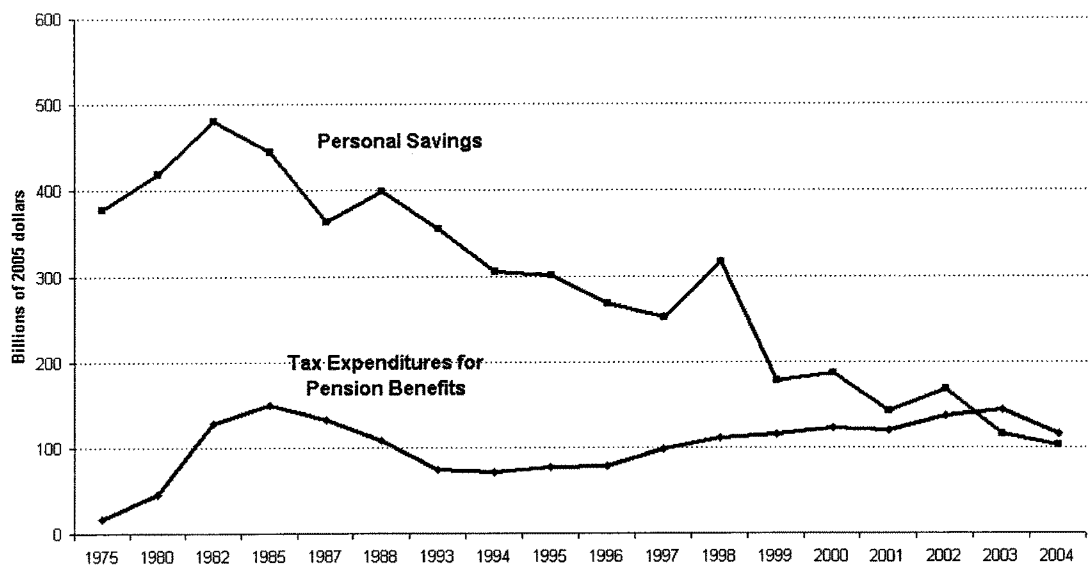
A sixth area of investigation is to attenuate employer worries over the costs and fiduciary responsibilities of retirement plans—especially for departed employees and for small amounts—by providing a clearinghouse that could help with the collection of rollover amounts, default rules for the management of investments, and the disbursement of benefit payments over time rather than all at once.

Finally, mandated saving by employees is on the table as a Social Security issue, but it needs separately to be brought into the debate over employer-provided pensions and other private retirement arrangements.

[2] As a technical matter, the law also needs to make clear that for almost all purposes (often related to measuring discimination), accrual means economic accrual, not the attainment of a higher annual benefit even when the present value of benefits is reduced.

FIGURE 1

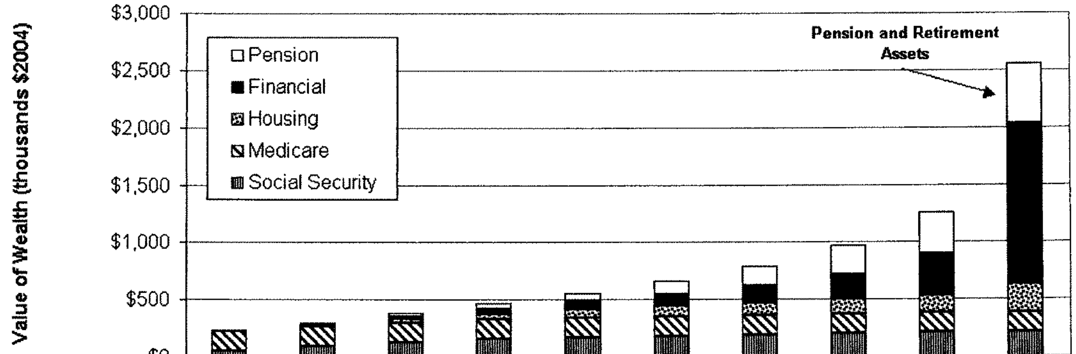
Retirement Savings Incentives Versus Personal Savings, 1975-2004



Note: Tax expenditures are not strictly additive. The cash flow measures above do not reflect the present value of pension subsidies.
Source: The Urban Institute, 2005. Based on data from the Office of Management and Budget, Analytical Perspectives (prior to 1990, Special Analyses), Budget of the United States Government, various years. Personal savings data from the Board of Governors of the Federal Reserve, 2005.

FIGURE 2

Mean Value and Composition of Household Wealth, Ages 51-61, by Wealth Decile



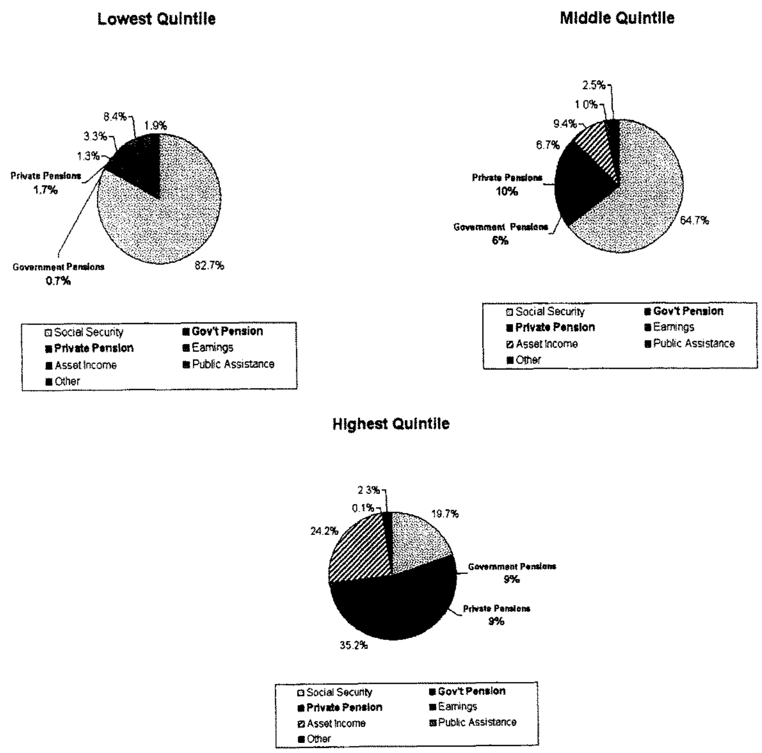
thousands of dollars	First	Second	Third	Fourth	Fifth	Sixth	Seventh	Eighth	Ninth	Tenth
Pension	2	9	26	47	68	114	169	251	361	526
Financial	2	14	25	44	74	102	148	214	359	1,391
Housing	-8	15	34	50	73	93	110	129	151	244
Medicare	171	171	171	171	171	171	171	171	171	171
Social Security	57	93	127	155	173	183	193	201	214	218

Wealth Decile

Note: Private pension, Social Security, other financial, and housing wealth data come from Moore and Mitchell (2000), based on a sample of households from the Health and Retirement Survey in which at least one member was aged 51-61 in 1992. Medicare wealth is from Steuerle and Carasso (2004).
Source: Moore, James F., and Olivia S. Mitchell. 2000. "Projected Retirement Wealth and Savings Adequacy." In *Forecasting Retirement Needs and Retirement Wealth*, edited by O.S. Mitchell, P.B. Hammond, and A.M. Rappaport. Philadelphia: Univ. of Pennsylvania Press; C. Eugune Steuerle, and Adam Carasso. 2004. "The USA Today Lifetime Social Security and Medicare Benefits Calculator: Assumptions and Methods." Washington, DC: The Urban Institute.

FIGURE 3

Composition of Income in Retirement for Aged Units 65 and Over



Note: Quintile limits are as follows for all units: First quintile: \$0-\$9,295; Second quintile: \$2,296-\$14,980; Third quintile: \$14,981-\$23,631; Fourth quintile: \$23,632-\$39,719; Fifth quintile: >\$39,719. Social Security includes Railroad Retirement.

Source: The Urban Institute, 2004. Based on data from the Income of the Aged Chartbook, 2001, Washington, DC: Social Security Administration, February, 2002, Table 7.5.

TABLE 1

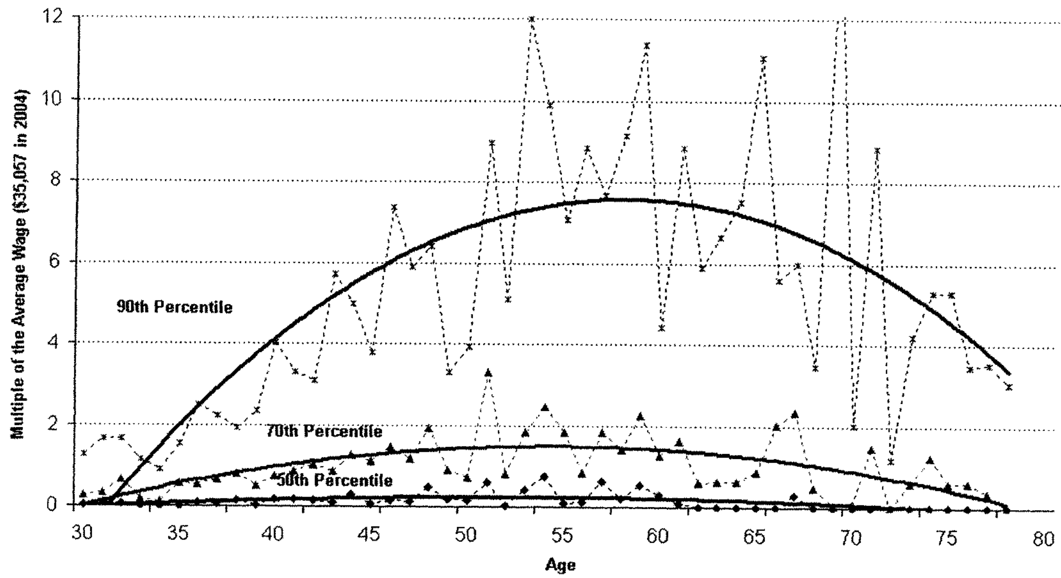
Characteristics of Workers without Pension Plans, 2003
Private-sector wage and salary workers, ages 25 to 64

Characteristic	Full-time only Percent	Full- and Part-time Percent
Total Individual Income		
Top Quartile	27.5%	28.3%
Second Quartile	36.4%	45.0%
Third Quartile	48.3%	72.4%
Bottom Quartile	71.6%	90.4%
Race		
White, non-Hispanic	40.7%	45.6%
Black, non-Hispanic	50.9%	55.0%
Hispanic	67.4%	72.0%
Other	50.9%	53.5%
Marital Status		
Married	42.8%	46.8%
Single	56.1%	59.5%
Education		
Some high school	74.2%	76.6%
High School graduate	52.1%	55.7%
Some College	47.0%	51.8%
College graduate	36.4%	40.0%
Firm size		
Fewer than 25 employees	72.8%	82.7%
25-99 employees	50.2%	56.5%
100 or more employees	32.4%	37.8%
Age in years		
25-34	54.3%	59.8%
35-44	45.6%	48.9%
45-54	40.1%	43.3%
55-64	41.8%	46.8%
All workers	**45.9%**	**74.7%**

Source: The Urban Institute, 2004. Based on data from Patrick J. Purcell, "Pension Sponsorship and Participation: Summary of Recent Trends." CRS Report for Congress, September 2004; and original data from the Current Population Survey, various years.

FIGURE 4

Ratio of Retirement Account Balances to Average Earnings by Age and Income Percentile
(Median Income is the 50th Percentile)



Notes: Average earnings as reported by the Social Security Administration; present value of defined benefit accounts are not included in the retirement account balances. Source: Urban Institute cross-sectional tabulations of the 2001 Survey of Consumer Finances.

FIGURE 5

Types of Pension Plans Under Current Law

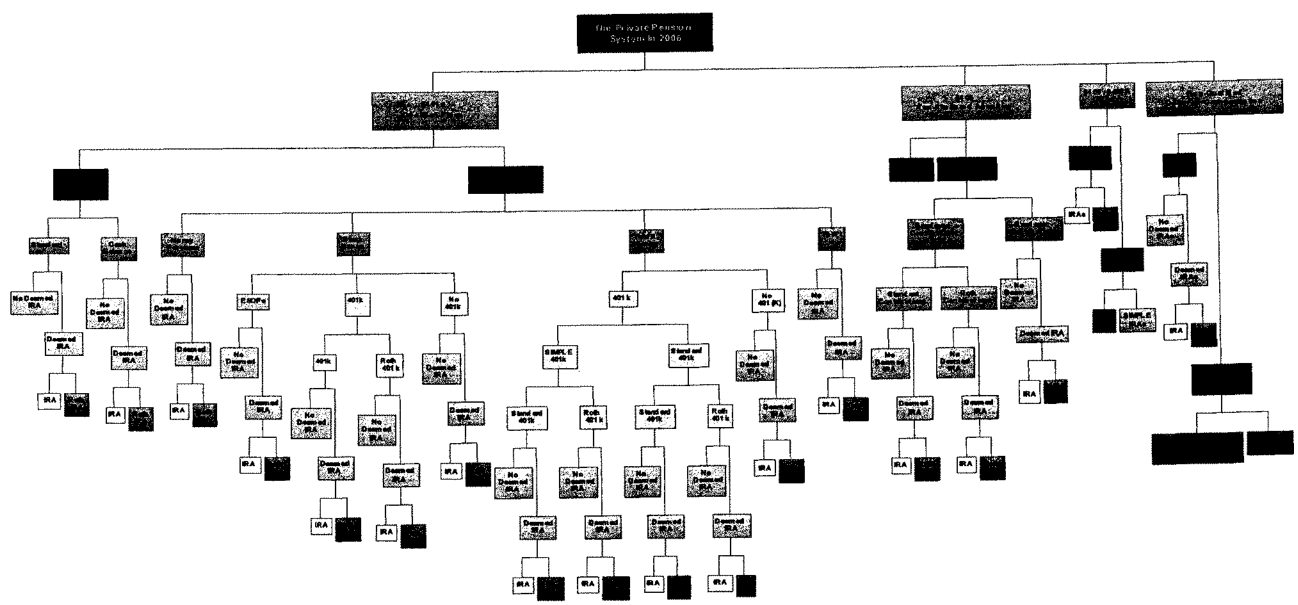
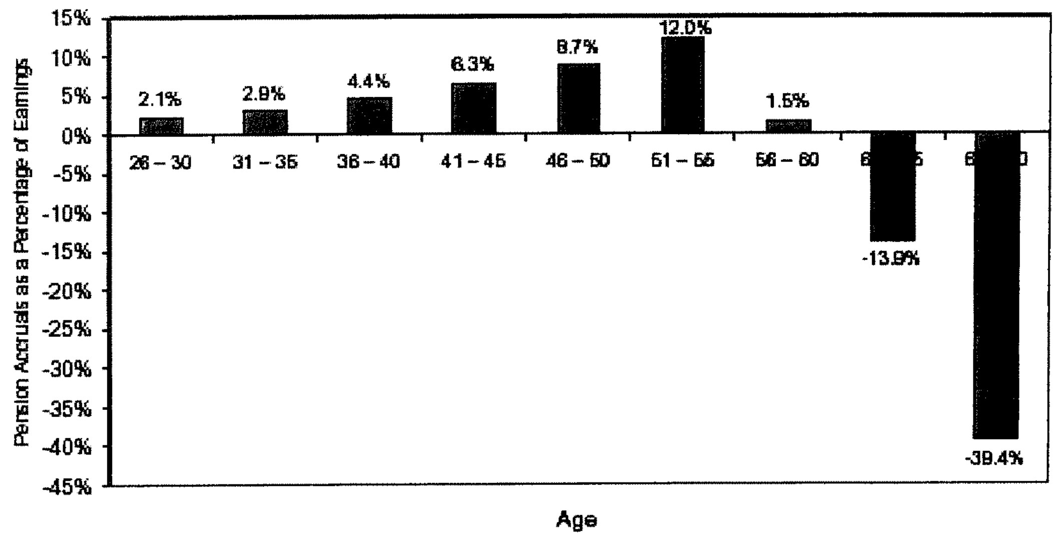


FIGURE 6

Average Accruals in Private Defined Benefit Plans, 2002
(For Workers Starting at Age 25)



Note: The analysis is based on a sample of 340 salary-based defined benefit plans in the private sector. Accrual estimates assume that workers join the firm at age 25 and leave at the age that maximizes the present discounted value of pension benefits (or age 70). The analysis assumes that inflation is 3.3% and that real interest is always 3% above inflation. Estimates are weighted by firm size.

Source: From Rudy Penner, Pamela Perun and C. Eugene Steuerle. "Legal and Institutional Impediments to Partial Retirement and Part-time work by Older Workers." Washington DC: The Urban Institute, November 20, 2002. Available at http://www.urban.org/url.cfm?ID=410587.

Additional submission for the record to clarify different numbers used by those testifying on the amount of assets in pension and retirement accounts:

Total Financial Assets in Public and Private Retirement Plans, 2004
(billions of dollars)

Type of Plan/Account	
Private Plans:	
Defined Benefit	1,810.6
Defined Contribution	2,633.9
IRAs*	3,698.1
Subtotal	*8,142.6*
Public Plans:	
Federal	1,024.0
State and Local	2,072.4
Subtotal	*3,096.4*
TOTAL	**11,239.0**

*Data for IRAs are not yet available for 2004. This approximate estimate is produced by using 2002-2003 growth rate for IRA assets. Using the average growth rate over the 1992-2003 period yields approximately $3,400 billion in IRA assets and a total of $10,940.9.

Source: The Urban Institute, 2005. Based on data from the fourth quarter 2004 Flow of Funds Accounts, released by the Federal Reserve Board on March 10, 2005 and available online at <http://www.federalreserve.gov/releases/z1/current/z1.pdf>, tables L.119.b (Defined Benefit), L.119.c (Defined Contribution), L.120 (State and Local), L.121 (Federal), and L.225.i (IRAs).

Senator KOHL [presiding.] Thank you very much, Mr. Steuerle. Mr. Klein.

STATEMENT OF JAMES A. KLEIN, PRESIDENT, AMERICAN BENEFITS COUNCIL, WASHINGTON, DC

Mr. KLEIN. Thank you, Senator Kohl. I appreciate the opportunity to be here. I am the president of the American Benefits Council. Our organization represents companies that either directly sponsor or provide services to retirement and health plans that cover more than 100 million Americans.

My written testimony, which is being submitted for the record, provides a lot of data and statistics as well as a number of specific recommendations for improvements to the private employer-sponsored retirement system, and I would be delighted to chat about that if there is a question-and-answer period. But I thought that I would use my few moments during the oral remarks to just make some observations that are not fully developed in the written statement.

To start out, I would like to just call your attention to three charts that I have brought with me. The first chart here shows the growth in private pension fund assets from 1945 until 2004, and that is both defined benefit and defined contribution assets. As you can see—or it may be a little bit hard to see from where you are sitting—the growth in the assets really took off in the late 1970's, early 1980's, corresponding roughly with the advent of the 401(k) plan that provided opportunities for both employers as well as individuals to make additional retirement savings.

We have talked a lot about the abysmally low savings rate in this country, and it is absolutely appropriate to do so. You pointed out, in fact, in your introductory remarks that the actual average amount in individuals' accounts is nowhere near what is needed.

I would point out, though, that at least retirement savings is the one bright light in an otherwise very dismal picture on overall savings rates, and we have commissioned research in the past that showed that but for retirement savings, we would have had net negative savings in this country. So it at least contributes to the fact that we have some modest savings.

The other notable thing I think about this chart is the substantial dip that you see in the line from the year 2000 to 2002, and obviously that corresponds with the downturn in the economy. But I think that that really underscores a separate point that relates back to Secretary Warshawsky's earlier testimony, and that it underscores, in our view, the importance of preserving the defined benefit system, because unlike defined contribution plans, in the defined benefit system, of course, the employer bears the risk of ensuring that a payment will be made. So notwithstanding the downturn in the assets, defined benefit plans help provide some very important protections there.

The next chart shows employer contributions to plans, and as you can see, those have steadily risen. I think what is significant about this chart is that it does not show the same dip that the prior one did. Notwithstanding periods of market downturn, employers continue to make contributions to plans, and, in fact, notably, with respect to defined benefit plans, the employer is on the hook to make up additional contributions to those plans during periods of time when the plan becomes less well funded.

If the first two charts were in large part the good news, then this final chart is the bad news because this is a chart showing the decline of defined benefit plans insured by the Pension Benefit Guaranty Corporation. The height of defined benefit plan existence, if you will, was in 1985 when there were about 112,000 plans. Following the passage of the Tax Reform Act of 1986, there started a decline in the number of those plans, in large part, not entirely but in large part due to a number of changes that were made in that law. Very substantially, and I think what should be very worrisome to all of us, is that in the last decade alone, from 1994 to 2004, we lost half—half—of the defined benefit pension plans in this country, from about 57,000 plans down to about 29,000 plans.

So while it is good news that through defined contribution plans we are absolutely increasing a tremendous amount of wealth accumulation—and I am sure Mr. Kimpel will discuss that in greater detail—there are challenges here, both with respect to defined contribution plans and certainly on the defined benefit side.

The sum total, I think, of these charts says, to me at least, two messages. First, that is really imperative for Congress to deal this year with the issue of funding reforms. While we at the American Benefits Council embrace a lot of the goals that the administration has laid out, we have tremendous concerns that the specifics of many of the proposals that they have put forward will, in fact, very much unintentionally, undermine the defined benefit system and will cause a lot of companies to exit the system. At the end of the day, what should probably keep us awake at night is not the notion that a few more seriously underfunded plans will terminate and impose those liabilities on the PBGC. That is a concern that we have, and, in fact, we have a very extensive report which enumerates many proposals that we have for how to shore up the pension system. Obviously, as premium payers, the sponsors of well-funded plans are very much concerned when poorly funded plans dump their liabilities on the PBGC. But really the bigger issue and the bigger backdrop against which all of this needs to be considered is not that a handful of underfunded plans will terminate, but that tens of thousands of very well-funded plans are exiting the system and their exit from the system may be exacerbated if we—that is, Congress—make the wrong decisions with respect to funding reforms.

The second related issue to defined benefit plans concerns the one bright light in the defined benefit system, and that is the creation over the past several years of so-called hybrid plans, cash balance plans, and other types of varieties. The legal status of these plans is very much in doubt, both in Congress and certainly in the courts, and we urge the Congress to act sooner rather than later, very quickly to try to establish that these are legal, legitimate plans. Arriving at that conclusion is inextricably linked with the fiscal health of the Pension Benefit Guaranty Corporation because there are roughly 1,200 so-called cash balance or hybrid pension plans in this country. They cover over 7 million Americans, and they are predominantly very well-funded plans, by the way, and they represent fully 20 percent of the premium revenue that goes to the PBGC. So not dealing with the issue of the legal status of hybrid plans can have a very deleterious impact on the health of the overall defined benefit system and the health of the PBGC.

In conclusion, I just want to hit four very quick points for your attention, and then if I may, either at the end or as part of the question-and-answer period, address this whole question about whether or not we are getting adequate value for the tax expenditure, which has come up a number of times.

The first point that I would make is that clearly this is not a hearing about Social Security, but I think that there can be and should be bipartisan agreement that the private retirement system needs to be strong, and that to the extent that it is not, the financial pressure on Social Security to do more will be made even larger. So we would very strongly urge two things: first of all, as Congress proceeds in whatever it chooses to proceed on the issue of Social Security reform, that it take into account the implications for employer-sponsored plans; and, second, that Congress should really not consider Social Security reform without also addressing a variety of things that need to be done to help improve the defined benefit and defined contribution private system.

The second very quick point is that one of the greatest threats to retirement security in this country is what is happening on health care costs, and it is very important not to lose sight of the fact that health care costs are absorbing the available resources that would otherwise be put into what we think of as more retirement income plans. These two issues must be considered together.

The third point is that the retirement system not only is obviously crucial for providing retirement income security, but also is the source of most of the investment capital in this country, and I see you perhaps want to——

Senator KOHL. The time for the vote is just about out, and Senator Smith will be back in just a minute and will resume the hearing. But I need to recess so I can get over.

Mr. KLEIN. Absolutely.

Senator KOHL. So he will be back in just a minute. I thank you.

Mr. KLEIN. Thank you.

Senator KOHL. We will be in a short recess. [Recess.]

The CHAIRMAN [presiding.] We will reconvene this hearing. Regrettably, the Majority Leader does not run the Senate schedule around the Aging Committee's schedule. We mean no disrespect, and we truly appreciate your participation.

Mr. Klein, I believe you are finishing, and please proceed.

Mr. KLEIN. Gosh, I was hoping I would be able to start from the top again. [Laughter.]

The CHAIRMAN. Anything you want to recapitulate for me, I would appreciate it.

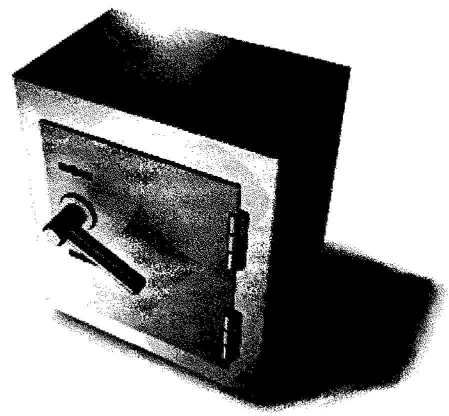
Mr. KLEIN. Well, I would be delighted to, either now or in part of the question-and-answer period.

I guess the two last points that I would make is that we need to think both short term, which is what I have addressed thus far, as well as long term. In that regard—and I will not take the time now as part of these oral remarks, but in that regard, we have developed a very extensive report called "Safe and Sound," which is a long-term strategic plan about what both the health and the retirement system might look like 10 years from now. In that report, we establish three retirement policy goals. They are very specific, measurable goals relating to financial literacy, increasing coverage in employer-sponsored plans, and also boosting overall retirement savings. Then, not surprisingly, we followed up with a substantial number of very specific initial policy recommendations to help us achieve those goals, and with your permission, I would like to submit that report as part of the formal hearing record.

The CHAIRMAN. We will include that.

[The report follows:]

Safe and Sound



A Ten-Year Plan for Promoting Personal Financial Security

An Employer Perspective

POLICY RECOMMENDATIONS

June 2004

American Benefits Council

A New Architecture for the Employee Benefits System

The purpose of this long-term strategic plan is to present the American Benefit Council's visions, goals, and recommendations for building a new, more effective and sustainable employee benefits system over the next decade that achieve the following broad objectives:

1. Retirement systems should have incentives that encourage employers and employees to contribute adequate amounts to retirement income and savings programs, and encourage employees to manage their assets to last throughout retirement;

2. Active employee health care systems should promote broad coverage and empower purchasers to be effective health care consumers.

3. Retiree health and long-term care systems should help ensure adequate health care security in retirement while still allowing retirees to continue to have the level of income they have come to enjoy.

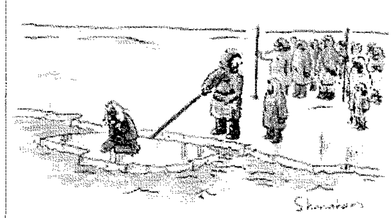
4. Stock plan ownership arrangements should advance personal financial security through accumulation of capital.

This long-term strategic plan should be viewed as a living document. For each of the benefit systems addressed in this plan the Council adopted a *vision statement*, followed by *goals* and *recommendations*.

Each of these parts of the overall plan are subject to periodic reevaluation and adjustment as the Council reviews progress in addressing the challenges outlined in this paper and as other changes may reorder priorities.

The *recommendations* below may not represent all the initiatives that are likely to be required to achieve the stated goals. In that sense, they should be viewed as initial or illustrative recommendations with the expectation that further recommendations may be forthcoming to help achieve the goals enumerated. Some goals will likely be achieved before 2014. Others may take longer. As a benchmark of our progress, the goals will be regularly reassessed. When they are found to be either too modest or overly ambitious, they can be adjusted accordingly. In some cases individual recommendations support more than one goal.

The Council has not calculated the cost attached to each of the recommendations in this plan, but acknowledges that the expense of financing the recommendations will be a crucial element of any policy decision.



"Remember, son, it's never too early to start saving for retirement."

FUTURE RETIREMENT SYSTEMS

Vision Statement

As *individuals* assume primary responsibility for their own personal financial security, it is essential they be equipped with the tools needed to achieve this goal. In our vision, *individuals* are empowered through education, technology and incentives to determine the retirement income they need; to understand the available sources of retirement income; to save the amounts they need; and to manage their retirement savings to produce a sustained retirement income throughout their lifetime.

In this vision, *employers* assist their employees in accumulating the assets needed to produce an adequate retirement income by continuing to develop, sponsor, and fund (to the extent economically feasible) efficient and tax effective retirement income and savings plans.

In this vision, *government* continues to provide a foundation for retirement income through the Social Security system, on which individuals and employers can build income from additional sources.

Government also provides tax incentives and a streamlined regulatory regime to promote retirement benefits programs — especially employer-sponsored plans of all types from traditional defined benefit plans through hybrid plans to defined contribution plans. *Government* also encourages the development of innovative plan designs that help individuals attain personal financial security.

Despite the best collective efforts to promote retirement income security, it must be recognized that many individuals are not able to maintain an adequate standard of living in retirement without *government* assistance.

In this vision, the *other stakeholders* expend intellectual capital, provide data and research, and use advanced technology to support the actions and efforts of individuals, employers and government. They can do this by developing innovative plans, products, programs and educational materials that promote retirement income and saving systems. These plans and programs should work to expand coverage, increase quality and improve cost effectiveness.

Goals

Goal 1: Raise Financial Literacy

By 2014, virtually all households will have access to some form of investment education and advice and 75 percent of households will have calculated the amount of retirement savings needed to maintain their standard of living throughout retirement, as well as the savings rate necessary to achieve this target.

Context

The number of people who have access to investment advice is very small. Estimates suggest that only 16 percent of 401(k) participants have an investment advisory service available to them.[81] When advice is offered, participants do not always seek it out. One report indicates that only 24 percent of those who are registered to receive advice actually take steps to obtain the service.[82]

However, if public policies are adopted that facilitate investment advice, employers and providers can be expected to develop ways to provide access to investment education and advice to virtually all households.

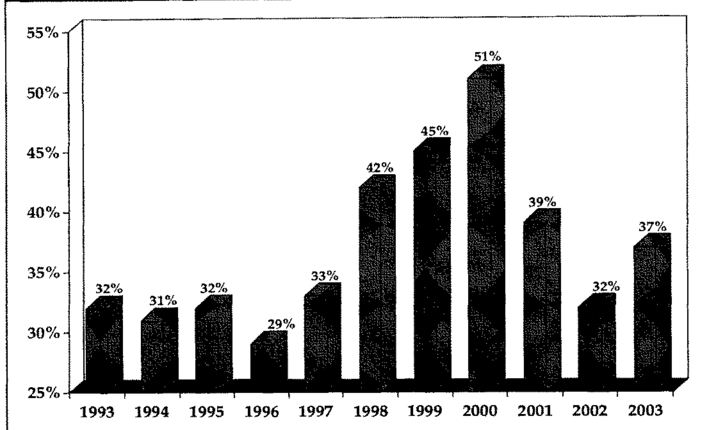
One of the first steps toward building an adequate retirement income is to calculate how much one needs to save to reach one's retirement goals. In 2004, 42 percent of U.S. workers reported that sometime in the last three years they or their spouses have calculated how much money they will need to save in order to live comfortably in retirement, according to the Retirement Confidence Survey.[83] Over the past decade the proportion of workers who have engaged in this key retirement planning activity in the annual retirement confidence survey has varied from a low of 31 percent in 1994 to a high of 53 percent in 2000.

The goal of 75 percent was chosen because it represents a significant increase from the peak level reported in the 2000 Retirement Confidence Survey. The amount-needed-to-save calculation was chosen as a goal because it indicates that a worker has achieved enough financial literacy to begin retirement planning and is prepared to take steps to act on what has been learned.

Estimates suggest that only 16 percent of 401(k) participants have an investment advisory service available to them.

Workers, however, may be underestimating how much they need or may not be able to make a determination at all.[84] Thirty-eight percent of those surveyed in 2004, for example, expected they will need an income of less than 70 percent of their pre-retirement earnings. By contrast, most retirement advisers suggest that a retirement income of

Percent of Individuals Who Have Calculated How Much They Will Need for Retirement, 1993-2003



SOURCE: *Employee Benefit Research Institute, "2003 Retirement Confidence Survey."*

at least 70 percent or more of pre-retirement earnings is needed to maintain an individual's pre-retirement lifestyle. (Some advisers suggest 100 percent of pre-retirement income.) Respondents in the survey did not determine what savings rate they needed to adopt in order to meet their retirement goal.

Initial Policy Recommendations:

- Provide public sector and private foundation funding to develop educational tools that can be used by employers, government and other stakeholders in educating workers about saving, investment and income management principles. Education efforts also include information about longer life spans people are expected to have in the future, and how workers can financially prepare for longevity risk.

- Establish financial education as a high school and college graduation requirement.

- Enact legislation to allow employees to receive financial education and advice through their workplace and/or from a retirement plan administrator. If provided through the employer, qualified advisers affiliated with plan investment offerings may participate (with certain worker protections provided) and employers should be protected from fiduciary liability for the specific advice provided to individual participants.

- Include in the Social Security Administration annual statement mailed to workers information on how to calculate a rough estimate of the amount one needs to save that, when combined with one's projected Social Security benefit, will provide a replacement level income of 70 percent of one's pre-retirement earnings.

Goal 2: Increase the Share of Workers in Workplace Retirement Plans

By 2014, 96 million (74 percent) of full-time and part-time private sector employees will participate in workplace retirement plans.

Context

According to the most recent federal data from a survey of employers,[85] approximately 49 percent of 103 million — or about 50 million full-time and part-time private sector workers[86] — in 2003 participated[87] in a workplace retirement plan.[88] An increase to 96 million would raise participation rates to 74 percent in 2014 when the size of the private sector salaried and wage workforce[89] is projected to be about 130.3 million.[90] This represents a 50 percent improvement over current participation rates.

About 50 million full-time and part-time private sector workers in 2003 participated in a workplace retirement plan.

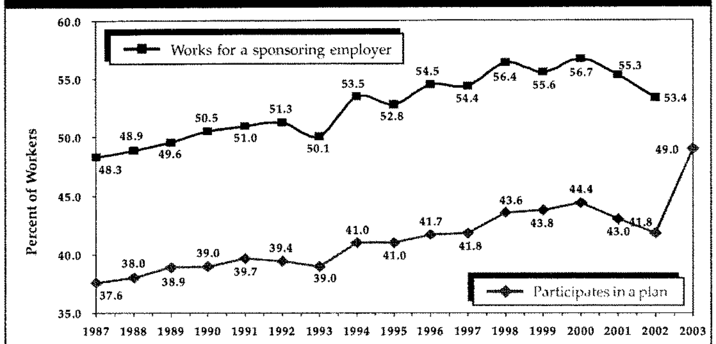
Looking at the increase from the perspective of 2003, and the most recent survey data, such a proportional gain would have increased by half the number of private sector salary and wage workers who participate in a workplace retirement plan, adding 25 million full-time and part-time workers and raising the number of participants from 50 million to 75 million.

Different segments of the workplace population have widely differing participation rates. In 2003, for example, medium and large businesses (100 employees or more) had a participation rate of 65 percent, while small businesses (99 or fewer workers) had a participation rate of 35 percent.[91] Further, the participation rate for full-time workers of all private sector businesses was 58 percent, significantly higher than the 18 percent for part-time workers.[92] And, there was an even higher participation rate for full-time workers at medium and large businesses, which had an 80 percent participation rate, while full-time workers at small businesses had a 42 percent participation rate.[93]

One can see from recent historic experience that employers have been able to increase the level of participation significantly. From 1987 to 2000, the participation rate for private sector wage and salary workers rose 7 percentage points from 40 percent to 47 percent, according to an analysis[94] of the data sets in the U.S. Census Bureau's Current Population Surveys by the Employee Benefit Research Institute.

A significant increase in participation rates over the next decade can occur mostly from increases in participation rates at small businesses, as occurred between 1987 and 2000. There is also room for improvement at medium and large business, as well as among part-time employees at all businesses.

Workplace Retirement Plan Participation Rates, 1987-2003



SOURCE: Employee Benefit Research Institute Issue Brief No. 256, "Employment-Based Retirement and Pension Plan Participation: Geographic Differences and Trends" (2003).

If participation is to increase, more employers will have to offer retirement plans. This outcome, in turn, depends on devising innovative and flexible plans that are attractive to employers, especially small- and mid-sized businesses.

Expanding participation in workplace plans is important for other reasons. It appears to be the best way to increase retirement saving. If one looks at federal income tax return data, the proportion of filers who claim an IRA or Keogh deduction has been both fairly modest and steadily declining over time. From a peak of 16.2 percent in 1986, it fell to 3.5 percent in 2000 and 2001.[95] In contrast, the participation rate in workplace plans is 66.2 percent of those eligible for 401(k) plans (a population of workers that represents 32.6 percent of the private sector workforce).[96]

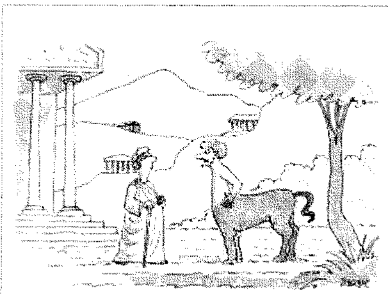
A different challenge faces defined benefit plans. Such plans, which provide a guaranteed income in retirement, now cover 19 percent of full-time and part-time workers[97] in the private sector.[98] The number of plans insured by the Pension Benefit Guaranty Corporation declined dramatically from approximately 114,000 in 1985 to about 32,000 plans in 2002.[99] In 1998, defined benefit plans in the private sector paid out an extraordinary $107.8 billion in direct benefits and an additional $3.4 billion to insurance companies for the purchase of annuities for beneficiaries.[100]

Funding rules, market declines, and low interest rates used for a variety of pension calculations, including determining plan liabilities, caused some employers to freeze their defined benefit plans. These developments have also deterred other employers from starting new defined benefit plans including hybrids, such as cash balance plans. Concerns about the volatility of the funding liability have complicated the task of preserving these plans and devising policies to get more companies interested in traditional defined benefit and hybrid defined benefit plans.

All types of defined benefit plans, including hybrid plans, can play a role in increasing participation rates in workplace retirement plans. To the extent that further erosion of the defined benefit system can be halted, the task of expanding coverage through other types of plans becomes less daunting.

Also, to the extent that new, innovative hybrid designs can attract more employers to offer defined benefit plans, it can help increase participation rates in retirement plans. Further, enrolling more employees in defined benefit plans potentially can provide more workers a guaranteed income in retirement.

Efforts are under way to develop new types of plans, such as a combination of a 401(k) plan and a guaranteed benefit from defined benefit plan or hybrid into a single plan, or DB(k).



"Being a hybrid, I get to have my way with a variety of species, and at the same time I enjoy a healthy tax credit."

New types of simplified guaranteed annuity plans could also be offered in combination with a 401(k) plan. Efforts are also underway to devise new funding rules to reduce the volatility in funding liabilities for employers who sponsor defined benefit plans. To the extent such policies can be established, they could help preserve and/or expand participation in defined benefit and hybrid plans.

Initial Policy Recommendations:

- New policies should ensure that employers have a range of plan designs available so they can select the retirement plan design that best suits their workforce needs. This would include enhancing all existing plan design types and encouraging new simplified plan designs that offer employer tax incentives, reduce administrative requirements, and provide for worker education on saving for retirement.

- Authorize the creation of a "clearing-house" model plan through federal legislation so workers who change jobs frequently can contribute to one retirement plan. This plan would be modeled on a multi-employer plan model that could provide individuals with one account that would stay with them when they change jobs. Employer contributions to the plan would be voluntary and no financial or administrative requirements would be imposed on employers (other than transferring worker contributions to the plan). This model plan would accept differing levels of employee contributions and employer contributions, and would be able to accommodate different investment vehicles. Any financial services firm meeting certain qualification criteria would be able to offer the "clearinghouse" model plan.

- Enhance default mechanisms (e.g., automatic enrollment, lifestyle funds, retirement target funds) to be sure that individuals who decline to make a choice are more likely to be enrolled in a plan (and be savers) and to invest their assets appropriately for their age and for the best risk-adjusted return.

- Eliminate rules that restrict workers and employers from creating flexible working relationships and benefits arrangements such as phased retirement programs.

- Maintain support for the voluntary use of company stock in retirement plans through employer contributions or by making company stock available to employees as an investment alternative in the retirement plan. Employees should be educated about the special risks of company stock ownership in retirement plans.

- Support plan funding reforms that reduce the volatility of the funding obligation in defined benefit plans. Support policies that provide for new types of defined benefit plans that can offer guaranteed levels of retirement income. Such guaranteed annuity plans could be offered alone or in conjunction with a 401(k) or other defined contribution plan.

"Won't all these new rules impact adversely on the viability of small businesses with fewer than fifty employees?"

Goal 3: Raise Retirement Savings
By 2014, the gross personal savings rate, which covers saving for all purposes, will reach 15 percent of disposable income. In addition, many, if not most individual workers across the income spectrum will be saving at a rate between 7 and 15 percent of earnings specifically to provide a retirement income that is at least 70 percent of pre-retirement earnings.

Context
The choice of a 15 percent household savings rate was based on the need to raise saving levels to a level closer to that of other developed nations and to make it high enough to cover both retirement saving and other household saving needs. The Organization for Economic Cooperation and Development (OECD) reports, for example, that in 2001 the U.S. savings rate was

4.7 percent, while the other six members of the seven largest developed nations averaged a 10.3 percent gross personal savings rate.[101] Using the OECD methodology, the U.S. savings rate averaged 6.4 percent for the six years from 1998 to 2003. That was much lower than levels during the decade from 1983 to 1992, when the U.S. gross personal savings rate averaged 13 percent. The rate averaged 10.4 percent from 1993 to 1997. The gross household savings rate is, of course, not a proxy for how much households are saving for retirement. However, it does reflect partly, and perhaps largely, the level of saving for retirement.

The U.S. savings rate averaged 6.4 percent for the six years from 1998 to 2003, much lower than levels during the period from 1983 to 1997.

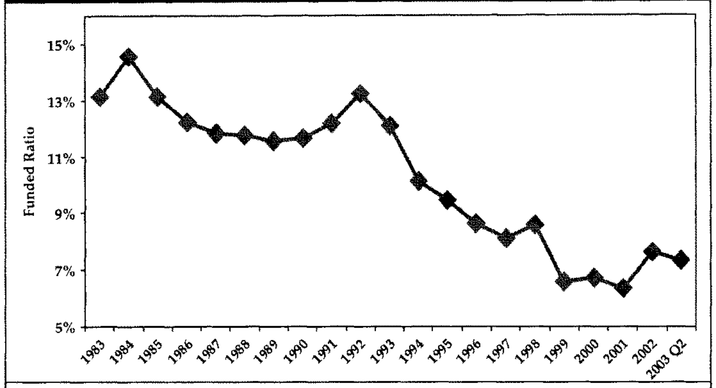
If one assumes that most workers begin to save between 21 and 35 years of age, then an overall household savings rate of 15 percent would likely be high enough to encompass what households need to save for retirement and still leave room for other forms of saving, such as saving to buy a home, for emergencies, for college education, and medical care. To the extent workers delay too long past age 30 to begin saving for retirement, however, a 15 percent household savings rate would not be adequate to assure a 70 percent replacement rate in retirement for most workers.

The calculation of how much one needs to save for retirement must be made on an individual basis. That amount most importantly depends on how early in one's working life a person begins to save. The earlier a worker starts, the lower the savings rate required to reach an income level after retirement close what the worker earned before retirement. The amount one needs to save also depends on assumptions about a number of other factors, including the rate of return on retirement savings, the rate of future wage and salary growth, and how many years one expects to live after age 65.

If one begins to save at 21, one could accumulate a 70 percent replacement rate (not counting Social Security) by saving 3.5 percent of one's income, provided it is invested in a portfolio allocated 60 percent to stocks, 40 percent to bonds.[102] Few people start saving for retirement at age 21, however. If a person earning $35,000 waits until age 35, for example, he would have to save 12.6 percent of his income to retire at age 65 with a 70 percent replacement, including Social Security.[103] The rate rises to 15.2 percent for a worker making $55,000 a year. It is higher because Social Security replaces less of one's income as income rises. If one wants to also save for other needs, such as Medicare supplemental policies and out-of-pocket health expenses, one would have to save at an even higher rate. If one wants to be sure that one does not outlive their assets, one will also have to save at an even higher rate.

A study[104] by the Employee Benefit Research Institute in collaboration with the Millbank Memorial Fund calculates that Americans will need an additional $400 billion more than they will have saved to cover basic expenditures in retirement and any expense associated with an episode of care in a

Gross Personal Saving Rate, 1983-2003



SOURCE: Organization for Economic Cooperation and Development, Main Economic Indicators (Paris: OECD, January 2004).

nursing home or from a home health care provider for the decade between 2020 and 2030. The study simulates retirement income from Social Security projections and savings from current patterns of saving in tax-preferred retirement savings vehicles, including defined benefit plans, defined contribution plans, and IRAs of all types.[105] It also simulates retirement expenditures on living, health care and long-term care. It calculates the shortfall between retirement savings and expenses by age and income cohorts from 1936 to 1965.

The study finds that most couples in the top two quartiles of income born after 1945 can close the gap by increasing their savings rate by just 5 percentage points.[106] However, most couples in the lower two income quartiles born after 1945 would need to save an additional 10 to 17 percent in order to close the gap.[107] Those born in 1945 and earlier will need to save more to meet their needs while those born in later years can meet their needs with less of an increase in savings.[108] Single men and women need to save more than couples to close the gap. However, single women in the lowest quartile face an impossible task of saving more than an additional 25 percent of savings on very modest incomes.

The study does not, however, translate the additional retirement savings needed to meet retirement needs for the various cohorts in the study into an explicit aggregate savings rate for the entire economy. Its findings do, however, generally support the goal of raising overall savings for the economy to 15 percent from recent levels of 6.4 percent. That would be enough to close to retirement savings gap for the great majority of Americans born after 1945 provided the savings were spread relatively evenly across the population.

Initial Policy Recommendations:

- Provide an enhanced saver's tax credit for low-income individuals above and beyond current law, which provides a partial tax credit for employee contributions made to defined contribution plans and Individual Retirement Accounts.

- Provide new tax credits to employers to finance contributions that represent for each employee a uniform percentage of wages and salaries and/or to finance supplemental contributions for low-income workers.

- Provide increased tax incentives to all individuals to encourage them to maximize retirement savings and to ensure that their savings last throughout retirement.

- Simplify onerous plan administration and compliance requirements (e.g., nondiscrimination testing) in order to maximize individual savings and encourage employers to start up and/or maintain qualified retirement plans.

Future Health Care System for Active Workers

Vision Statement

The current health care system is in crisis and is unsustainable unless significant changes occur soon. In our vision, a major overhaul of our health care delivery system is imperative in order to make it less burdensome, less litigious and more focused on achieving high-quality and consistent results. We assert, however, that past attempts at one-time comprehensive solutions have failed and have actually impeded innovation and reform.

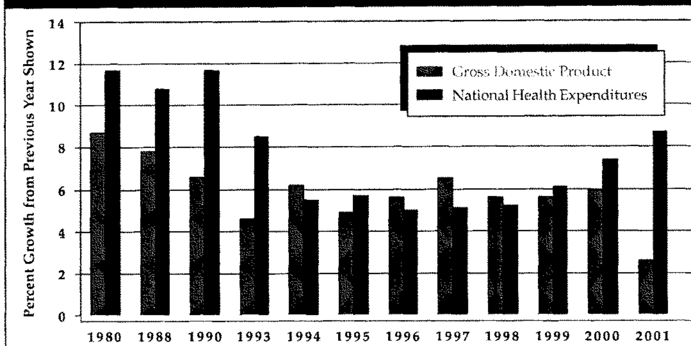
Our vision does not embrace extreme "solutions" that rely exclusively on either individuals or the government to take control of the health care system. In our vision, the successful reform of the health care system can be achieved through practical and meaningful steps that actually have the possibility — both substantively and politically — to be implemented. These measures can only succeed if all stakeholders commit to the sustained effort that will be required.

In this vision, the reformed health care system empowers *individuals* through education, technology, and incentives to be actively engaged in the choices that lead to healthier lives and to be able to make well informed decisions about the appropriate use of health care services.

Employers continue to play a leading role in providing access to vital health care services, in driving improvements in the health care system and in sharing the cost of health care services with their employees.

Government provides tax incentives and a streamlined regulatory regime that support a health care system characterized by healthy individual lifestyle choices, expanded coverage, broad flexibility in health plan design and high quality, cost effective health care services, and protection of health care system stakeholders from unwarranted liability.

National Health Expenditures and Gross Domestic Product, Selected Years 1980-2001



SOURCE: Centers for Medicare and Medicaid Services, Office of the Actuary: National Health Statistics Group; U.S. Department of Commerce, Bureau of Economic Analysis; and U.S. Census Bureau.

In this vision, the *other stakeholders* expend intellectual capital, provide data and research, and use advanced technology to develop innovative plans, products, programs, educational materials and delivery systems to support the actions and efforts of individuals, employers and the government.

In addition, information on quality, efficiency, and patient satisfaction with hospitals, physicians, treatment protocols and health plans is made available to consumers so that health decisions are made on an informed basis. These efforts are structured and designed to promote a cost-effective and affordable health care system with expanded coverage, increased quality, and evidence-based individual health care decision-making. Other stakeholders also work closely with the primary stakeholders to develop and implement innovative strategies to contain the rapidly escalating costs of health care services that are undermining the health care security of all.

The goals set forth are bold. By contrast, some of the recommendations represent measured steps toward improving the system. This approach has been taken because in the past, when comprehensive reforms were tried, they utterly failed. For this reason, the paper is focused on bold but achievable goals and pragmatic recommendations that can incrementally improve the system.

Goal 4: Make Health Coverage More Affordable

By 2014, health care costs will return to a more sustainable annual rate of increase in the single digit range that more closely tracks the overall increase in the gross domestic product (GDP).

Context

The Centers for Medicare and Medicaid Services track total health care spending in the United States. Their latest data show that total health care spending at all levels – private and public – rose 9.3 percent in

2002.[109] At the same time the Gross Domestic Product (GDP) grew at only 3.6 percent. Thus, in 2002 the pace of gains in health care spending were nearly three times the rate of growth for the economy, clearly an unsustainable situation.

In the past the United States has been able to bring health care spending into line with economic growth, but only for a short period of time.[110] For example, after a big spurt in health care spending in the late 1980s and early 1990s, GDP growth outpaced gains in health care spending in 1994, 1996, 1997 and 1998. Since 1999 health care spending has increasingly outpaced gains in the GDP.

In 2002, the pace of gains in health care spending were nearly three times the rate of growth for the economy, clearly an unsustainable situation.

Taking a longer term view, health care spending has, on average, risen faster than the GDP, but not at the very high rates seen in recent years. During the four decades from 1960 to 2001, health care spending averaged 2.5 percentage points higher than the growth of GDP.[111] Between 1990 to 2001, health care spending averaged 1.5 percentage points higher than the GDP. If the United States could bring health care spending growth rates closer to a level 1 to 1.5 percentage points above GDP, it would go a long way toward moderating the scope of spending in the future.

A goal of bringing total health care spending closer to GDP growth rates assures that the portion of the economy allocated to health care spending — already quite high — does not sharply increase its relative share, although the United States may not be likely to prevent health care spending from taking a larger share of GDP. For businesses, keeping health care spending closer to GDP growth rates can help assure that the cost of providing health care to employees can be relatively stable and sustainable.

Addressing the issues surrounding medical errors can enhance the quality and affordability of the system. According to a report by the Institute of Medicine, at least 44,000 people, and perhaps as many as 98,000, die in hospitals yearly as a result of medical errors that could have been prevented.[112] The cost of medical errors in hospitals, including the expense of additional care made necessary by the errors, lost income and household productivity, and disability, is between $17 billion and $29 billion a year.

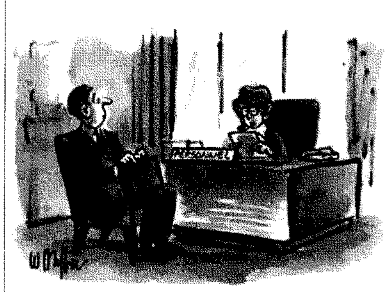
The Institute of Medicine's study prompted the formation of The Leapfrog Group for Patient Safety, a consortium of larger employers working to get hospitals to implement measures to improve patient safety and the quality of care. However, there is concern that aggressive medical malpractice attorneys could transform the Leapfrog standards into performance expectations. For example, some worry that if hospitals violate the Leapfrog standards, it could lead to more medical malpractice lawsuits that would drive up malpractice premiums and raise the overall costs of medical care. The General Accounting Office, in a recent report,[113] cites rising malpractice claims as the "primary driver" of higher medical malpractice insurance premiums.

These developments illustrate that efforts to reduce medical errors alone will not necessarily reduce costs, but must be accompanied by tort reform affecting medical malpractice.

Some of the initial policy recommendations to restrain the growth in health care spending and inflation include, but are not limited to the following: (1) the adoption of reforms that empower consumers to make better informed health care decisions, (2) a reduction in medical errors and excessive liability, (3) greater flexibility in health plan design, and (4) the education of individuals to be more effective consumers of health care.

Initial Policy Recommendations

- Improve the quality and performance of the health care system by developing, through private and public sector initiatives, consistent, evidence-based measures. In addition, increase funding for outcomes-based research for health care services supplied by hospitals, physician specialists, clinical laboratories and other health care providers that can be used by purchasers and individuals to identify the "best performers" in the health care system.



There are no medical or pension benefits, but the employees' lounge has excellent free coffee."

- Increase the incentives for individuals to lead healthier, more active lifestyles that would reduce the incidence of obesity and other avoidable diseases. In addition, expand the availability of workplace wellness programs and health plan designs that promote wellness and cover cost-effective preventive services.

- Significantly reduce the current unacceptably high levels of medical errors, inappropriate care and the provision of health care services that result in patient harm or death. Medical errors can be reduced by adopting national goals directed at achieving measurable annual improvements in health care quality, consistency and positive patient outcomes.

- Curb excessive liability and unsustainable cost increases caused by "defensive medicine" by enacting federal medical liability reform legislation with firm, reasonable limits on damages and other sensible tort reforms.

- Allow greater flexibility in the design of health plans by strengthening ERISA preemption and eliminating specific benefit mandates or conditions on health coverage at either the state or federal level that interfere with the ability of either insured or self-insured health plans to offer more affordable health plans.

Goal 5: Increase the Quality of Health Care Services

By 2014, at least 50 percent of Americans with health care coverage will be enrolled in a health plan design that provides user-friendly, comparative information on the quality and performance of health care providers and services and the majority of all others with coverage will have the option to choose to enroll in such a plan.

Only about 1 percent of Americans are now enrolled in some type of consumer-driven health plan.

Context

Currently, only about 1 percent of Americans are enrolled in some type of consumer-driven health plan.[114] One form of these plans currently available typically transfers the liability for costs for the first several thousand dollars of claims to the employee. The plan includes an employer-funded account that workers can use for a variety of medical expenses, including premiums. The plan provides workers with catastrophic health care coverage for expenses above the high deductible, although some plans have first dollar provisions that cover initial expenses up to a modest limit. This example is one of potentially many plan models we can expect to emerge to help consumers be more cost conscious and to assist them in making better quality choices.

Employers, especially those that currently sponsor Preferred Provider Organization (PPO) health plans,[115] are expected to offer CDHP-type plans over the next few years. As many as 40 percent of the people currently in PPO plans are expected to move to some type of consumer-driven health plan, with a big boost coming between 2006 and 2007, according to a study by Forrester Research.[116]

The type of CDHP plan available today may not necessarily be the preferred choice in the future. Employers may consider other types of plans that shift less of the risk to the employee, for example. Employers will be looking for plans that help make consumers more cost and quality conscious. Such plans might, for example, rate or rank health care providers. Some employers might also adapt existing PPO and Health Maintenance Organization (HMO) plans to incorporate changes that make consumers more cost and quality conscious about the health care services available to them. They may wish, for example, to group health care providers into different quality tiers, each of which would be available to the plan's enrollees, but with a different out-of-pocket cost.

Plans designed to make consumers more quality and cost conscious are expected to affect the health care market place when the number of people enrolled in the plans reaches about one-fourth of the market. Forrester calculates this will happen by 2010. At this level of market penetration, such plans are expected to begin to encourage more transparency and responsiveness by health care providers to cost-conscious and cautious consumers.

As plans that provide better information to consumers compete for more enrollees, consumer-driven plans are expected to lead health care providers to respond more openly and effectively to improve quality within the system and make an effort to provide the kind of customer satisfaction that will attract and keep health care customers. By expanding the market share of consumer-driven plans further to 50 percent by 2014, it will strengthen the benefits of the consumer-driven approach to health care.

The benefits expected from consumer-driven plans will, of necessity, require an increase in consumer access to information on health care and providers.[117] In that regard, the Institute of Medicine's Committee on Quality of Health Care in America recommends a high-level national effort to improve the use of information technology in the field of medicine. It recommends that Congress, the executive branch and leaders of health care organizations, public and private purchasers, and health informatics associations and vendors should make a renewed national commitment to building an information infrastructure to support health care delivery, consumer health, quality measurement and improvement, public accountability, clinical and health services research, and clinical education.[118] This challenge is daunting, the committee states, and in the absence of a national commitment and financial support, progress will be "painfully slow."[119]

> **The benefits expected from consumer-driven plans will require an increase in consumer access to information on health care and providers.**

Finally, the points made in the context section for Goal 4 regarding medical errors and medical malpractice are equally applicable here to quality in medical care.

Initial Policy Recommendations:

- Develop clear, publicly-disclosed information that individual consumers can easily understand and use to compare health care providers and services on the basis of standardized measures of their quality, safety, patient satisfaction and efficiency.

- Significantly expand the availability of different forms of health plans that support and reward individuals who become more actively engaged in making well-informed decisions about the appropriate use of quality health care services.

- Encourage much greater use of advanced information technology to support employers and employees in evaluating and choosing the health care services and providers best suited to their needs.

- Expand the availability of public and privately-funded educational tools to assist individuals with their increased decision-making responsibilities in the health care system and assist them as participants in consumer-directed health plans.

Goal 6: Increase the Number of People with Health Insurance Coverage

By 2014, 243 million or 91 percent of non-elderly Americans will have some form of health insurance. This will represent a reduction by half the proportion of the nonelderly population that is uninsured today.

Context

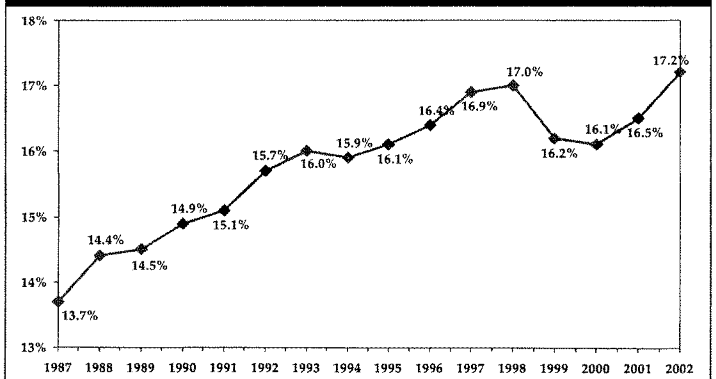
In 2002 82.7 percent or 208.4 million of the U.S. non-elderly population of 251.7 million was covered by some type of health insurance, while 43.3 million or 17.2 percent were uninsured.[120] A year earlier, 83.5 percent or 206.6 million of the U.S. non-elderly population of 247.5 million was covered while 16.5 percent or 40.9 million were not.

An analysis of the 2001 data reveals that within the insured population, 162.3 million or 79 percent were covered by an employer-based plan. Almost half of those were dependents.[121] In addition, 16.4 million were covered by individual policies, and 37.9 million were covered by public programs, including Medicare (5.6 million), Medicaid (28.3 million) and Tricare/ CHAMPVA[122] (6.6 million).

An increase from 82.7 percent to 91.4 percent would have been equivalent to adding 21.65 million nonelderly to the ranks of the insured in 2001 and would have increased the insured population from 208.40 million to 230.05 million. Such a gain also would have *cut in half* the number of uninsured nonelderly from 43.3 million to 21.65 million.

In 2014, the nonelderly population will be 265.2 million, according to projections by the U.S. Census Bureau.[123] An increase from 82.7 percent (219.3 million) to 91.4 percent (243.2) will represent an additional 23.9 million insured nonelderly Americans.

Percentage of Non-Elderly Americans Without Health Insurance, 1987-2002



SOURCE: *Employee Benefit Research Institute estimates of the March Current Population Survey, 1988-2002 Supplements.*

Both employment-based and public health insurance can contribute to an expansion of coverage and a reduction of the uninsured population. In each of these two sectors, periodic trends of reduced coverage have emerged since 1987, according to an analysis of changing patterns of coverage by the Employee Benefit Research Institute.[124]

Between 1987 and 1993 the number of uninsured increased from 13.7 percent to 16.0 percent due to an erosion of employment-based health benefits. The decline in workplace benefits was greater than growth in coverage by public programs.

Between 1993 and 1999, however, the portion of the population covered by employer-based health benefits rose while the portion covered by public programs slipped.[125] The net result was the proportion of uninsured was only modestly higher by 1999 at 16.2 percent.

Medicaid coverage declined during the 1990s because welfare reform and a strong economy lifted more people out of welfare and into the employment sector – but into jobs without health benefits. At the same time continued downsizing of the military during the 1990s reduced the number of people covered by Tricare or CHAMPVA.[126]

Between 1998 and 2001 the number of children covered by Medicaid or State Children's Health Insurance Programs (S-CHIP) increased from 20 to 23 percent. However, despite declines in the portion of children covered by employment-based health benefits in 2000 and 2001, the percentage of children without health insurance fell from 14 percent to 12 percent between 1998 and 2001.

To the extent coverage can be expanded in both the employment sector and the public

"The challenge now before the Administration, the Congress and the industry is to strengthen businesses' ability to deliver the retirement income and security that workers deserve and depend upon, but to do it in such a way that we don't discourage employers from offering and maintaining plans for their workers."

— Assistant Secretary of Labor, Employee Benefits Security Administration, Ann Combs

Conclusion

A broad array of demographic, workplace and economic changes in the decade ahead provide challenges to personal financial security and threaten a crisis for the employee benefits system in its current form. These challenges include the aging of America, changes in composition of the workforce, evolving changes in social structure and families, and continuously rising health care costs.

Population aging and rising health care costs will increase the burden of Social Security, Medicare, and Medicaid for taxpayers, and may increase pressure to reduce benefits. This makes it all the more important that the employee benefits system is preserved and adapted to changing times in order to better meet the needs of a changing workforce and to help individuals and households better prepare themselves for the challenges ahead.

The burden of saving adequately, investing retirement savings, and making good and cost-effective health care decisions will fall increasingly on the individual. Employers can continue to see that the employee benefit system can help individuals in their efforts to build and maintain their personal financial security. The government will also play a key role in setting the regulatory framework that can sustain and enhance the employee benefits system. Government leaders can also reform Social Security and Medicare in ways that make the programs sustainable over the long term.

This strategic plan has laid out a vision for how the employee benefits system can continue to be a vital part of the personal financial security of Americans. If the employee benefits system is to remain vital, plans will need to be increasingly flexible and adjustable to the challenges that lie ahead. The plan addresses four benefit areas: workplace retirement plans, active worker health care, retiree health care and long-term care, and, finally, stock plans.

The plan establishes nine key goals. In the area of retirement they are to (1) raise financial literacy, (2) increase the share of workers in workplace retirement plans and (3) raise retirement savings.

In active worker health care, this plan sets the following goals: (4) make health coverage more affordable, (5) increase the quality of health care services, and (6) increase the number of people with health insurance coverage.

In retiree benefits, this plan establishes two goals: (7) make retiree health and long-term care accessible and affordable and (8) modernize Medicare. Finally, in stock ownership, this plan has a single goal: boost broad-based opportunities for employees to own stock.

The plan offers an array of initial policy recommendations to achieve the goals it sets forth. The American Benefit Council will review its goals and recommendations and adjust and modify them as necessary. If these initial policy recommendations are followed and all stakeholders work together and fulfill their respective responsibilities, it will advance the United States toward the broad goal of keeping the employee benefits system a strong and vibrant part of the total compensation of employees. It will also help ensure that Americans will be better able to build and maintain a high level of personal financial security. It will also help prepare workers to provide the income, health care and custodial care they will need for longer, better lives in retirement.

Mr. KLEIN. The last point I would like to just pick up on is something I was not necessarily planning on discussing, but in light of the fact that it has been discussed so extensively already, I just want to comment on it. That is the issue about whether or not we are really getting our money's worth with respect to the tax expenditure for employer-sponsored retirement, which is one of the largest tax expenditures in the budget. I agree with some of what has been said, but also would point out the following:

First of all, in terms of whether or not an adequate portion of the tax expenditure is going to lower-income individuals, as my testimony indicates, we very strongly support both extension and, frankly, the expansion of the low-income saver's credit. We think that it is extremely important to do more to help low-wage workers save more effectively. So I am in complete agreement on that point.

But there is a very comprehensive, many would say extraordinarily onerous set of nondiscrimination rules that govern the employer-sponsored retirement system that are designed to ensure that a disproportionate amount of the value of the tax expenditure not go just to the very highly paid. So it is not like Congress has somehow ignored this issue and not tried to design the system in order to ensure that workers across the income spectrum are benefiting from this system.

Moreover, there are at least two reasons for what would appear to be a disconnect between the amount of the tax expenditure and also the amount of taxes that are being paid out on the benefits. That, of course, relates to simply the present value that workers now today are getting as an exclusion for money that is being put into a plan. In the case of their 401(k) plans, companies get a deduction, individuals get an exclusion for the amount that they put in, as well as the amount that their company puts in on their behalf. But, of course, those benefits will then be paid out later on when those individuals retire, including, of course, those high-income people for whom these large deductions and exclusions presumably are taking place. So I think that one has to keep in mind, uppermost in mind, the timing issue.

The other point, of course, is that we are dealing right now demographically with a situation whereby there is a larger group of baby boomers who are in the working population for whom these deductions and exclusions are being taken and being made and a comparatively smaller group of retirees. But once we baby boomers retire, we are going to be in the population that will be paying taxes on the benefits that are paying out.

So I think that these are very crucial points to keep in mind in answer to Senator Kohl's earlier questions around this point.

With that, I would conclude and be delighted to answer questions later.

[The prepared statement of Mr. Klein follows:]

AMERICAN BENEFITS COUNCIL

TESTIMONY OF
JAMES A. KLEIN

PRESIDENT OF THE
AMERICAN BENEFITS COUNCIL

BEFORE A HEARING OF
THE SENATE SPECIAL COMMITTEE ON AGING

ON THE ROLE OF
EMPLOYER-SPONSORED RETIREMENT PLANS
IN INCREASING NATIONAL SAVINGS

Washington DC
April 12, 2005

Shaping the World of Corporate Benefits Policy

1212 New York Avenue, NW Suite 1250 Washington, DC 20005 202-289-6700 Facsimile 202-289-4582 www.americanbenefitscouncil.org

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Chairman Smith, Ranking Member Kohl, and Members of the Committee, thank you for the opportunity to appear before this Committee. My name is James A. Klein, President of the American Benefits Council. The Council is a public policy organization representing principally large companies and other organizations that assist employers of all sizes in providing benefits to employees. Our members either sponsor directly or provide services to retirement and health plans covering more than 100 million Americans.

Mr. Chairman, I commend you and the other Members of the Committee for shining the spotlight on the vital role our nation's employment-based retirement system plays in overall savings. Your leadership is critical to strengthening our nation's retirement system, and we urge you to continue to be active in fostering policies that encourage American employers to offer retirement programs to their employees.

The voluntary employer-sponsored retirement system is a bright spot on the savings landscape. As of 2003 (the most recent year for which data is available), American families had accumulated nearly $10 trillion in U.S. retirement arrangements -- the vast bulk of which is attributable to workplace plans. This tremendous pool of capital is an essential source of retirement income security for millions of Americans and a major driver of the U.S. economy.

While individuals can save on their own without an employer-sponsored plan, savings rates are much higher when employees have the opportunity to save through an employer plan. Moreover, employer-sponsored plans increase *retirement* savings, arguably the type of savings that American workers need most.

Despite the success of the employment-based retirement system, Americans today are saving less overall than at almost any time since World War II, and we are saving far less than all of our major international competitors. In just a few short years, the first of the Baby Boom generation will become eligible for retirement benefits, and numerous studies have shown that far too many of them are not saving enough for a secure retirement.

The nation's private sector defined benefit pension system is in distress, providing coverage to only 20 percent of working Americans. The defined contribution plan system has expanded over the last 20 years, with trillions of dollars being saved in 401(k) and similar arrangements. However, millions of Americans have no savings at all and millions more are not saving enough.

Reforms are needed to enhance financial literacy, increase the share of workers in workplace retirement plans, and raise retirement savings. We have a number of policy recommendations for attaining these ends. For example, we strongly support reforms that (1) promote automatic enrollment and automatic increase designs for voluntary savings plans, (2) create a stable and sustainable defined benefit system, (3) affirm the legality of cash balance and other hybrid plans, (4) eliminate barriers to investment advice, (5) encourage lifetime payouts of retirement savings so American families do not outlive their savings, and (6) expand the Saver's Credit to enhance savings among moderate- and lower-income workers. With decisive action in these areas, our nation's retirement system will continue to be an engine for increased savings and retirement security.

Last year, the Council released a long-term public policy strategic plan, *Safe and Sound: A Ten-Year Plan for Promoting Personal Financial Security*, which is attached to this testimony. It assembles in one document a comprehensive analysis of the dimensions of the health, retirement and demographic challenges facing our nation. The report sets forth very specific measurable goals for the retirement (and health benefits) system to be achieved by the year 2014. Drawing on *Safe and Sound*, the remainder of this testimony discusses the role the employment-based retirement system plays in increasing savings and makes a number of policy recommendations for strengthening the system and helping us achieve the goals.

EMPLOYMENT-BASED RETIREMENT PLANS INCREASE SAVINGS

The employment-based retirement system is a proven and effective means of increasing savings. Data suggests that savings rates are much higher when employees have the opportunity to save through an employer-provided plan. If one looks at federal income tax return data, the proportion of filers who claim an IRA or Keogh deduction is fairly modest. In contrast, the participation rate in workplace plans is 66 percent of those eligible for 401(k) plans. Even when no employer match or contribution is offered in a 401(k) plan, contribution rates are high. Analysis shows that employees contribute an average of 7.4 percent of their salary even when there is no employer contribution.

The success of the system at increasing savings, even when it is not provided through employer contributions or other employer-funded benefits, is largely attributable to the characteristics of the employment setting. For example, savings is greatly enhanced by the opportunity for payroll deduction. If workers can elect to have a portion of their pay regularly set aside for savings, rather than having to affirmatively make a decision to set aside funds, it is clear that more is saved. Further, pooling money in employer-sponsored retirement savings vehicles enables individual participants to benefit from economies of scale and to lower their transaction costs, thereby increasing asset accumulation and wealth.

That the system has been a success at saving is nearly indisputable. Of the $10 trillion in the U.S. retirement system in 2003, more than $4.5 trillion had been put aside through the use of private employer-sponsored retirement plans, including defined benefit and defined contribution plans. An additional $2.1 trillion has been collected through the use of state and local government plans and individuals have accumulated more than $3 trillion in IRAs -- amounts which are largely attributable to rollovers from employment-based plans.

While some of these funds undoubtedly would otherwise have been contributed to other types of accounts, it seems apparent that much of the savings in the U.S. retirement system is new savings. The current voluntary employer-sponsored retirement system involves a careful balancing of interests designed to encourage employers to maintain plans while ensuring that retirement savings are accumulated for the benefit of workers at all income levels. For many workers who are living from paycheck to paycheck, the savings created by employer contributions and other employer-funded benefits is their only savings. For others, matching contributions offer an important incentive to save more. Even for active savers, the convenience of payroll deduction encourages greater savings.

In one recent study conducted on behalf of the National Bureau of Economic Research (NBER), economists found that in addition to increasing retirement savings, employer-sponsored retirement plans significantly increase overall savings. The study even suggests that having a retirement plan may "induce an increase in the holding of other assets," thereby resulting in a further increase in total savings.

It is also critical to recognize that savings that could be considered shifted into the U.S. retirement system from other accounts represents amounts that are set aside for retirement purposes. Without dedicated retirement savings, it is doubtful that many workers will accumulate enough savings in other sources to maintain their pre-retirement standard of living.

In this regard, the employment-based retirement system serves two essential public policy goals. It increases overall capital accumulation and wealth, and it enhances retirement security of American families. In both respects, the U.S. retirement system has been an enormous success.

REFORMS ARE NEEDED TO REVITALIZE AND STRENGTHEN THE EMPLOYMENT-BASED RETIREMENT SYSTEM

Changing workforce patterns, shorter job tenures, changes in employee benefit preferences, regulatory burdens, funding requirements, and accounting rule changes have led more employers, especially small businesses, to switch from defined benefit plans to defined contribution plans. As a result, far fewer workers are likely to receive a pension annuity when they retire today than was the case a generation ago.

Defined contribution plans have demonstrated their ability to provide a vehicle for retirement savings for more and more of the workforce. For nearly 25 years, the 401(k) plan (and other similar arrangements) has enabled millions of Americans to save for their retirement future. Today, there are 465,000 401(k) plans covering more than 54 million working Americans. As of the end of 2003, 401(k) plans held nearly $2 trillion in assets, making the 401(k) plan one of the most effective wealth-building tools ever conceived.

However, there are still too many businesses that do not offer any retirement plan. Small employers are focused on covering their payroll, managing labor, and providing health insurance access. Retirement plans are perceived by many small employers as an additional administrative burden. This leaves countless individuals without access to a retirement plan.

Further, voluntary savings plans mean that employees need to choose to participate and, even where plans are offered, participation rates are not as high as they could be. The lowest participation rates are found among lower- and moderate-income workers who can least afford to forego preparing for retirement.

The shift to defined contribution plans and the increasing prevalence of retirees opting to take lump sums from their defined benefit plans has also meant that workers and retirees are increasingly responsible for managing their retirement assets. Not enough plans, however, offer the type of personal guidance that participants want because pension rules place unnecessary burdens on providing investment advice. More than half of workers with access to 401(k) plans have indicated a need for assistance in deciding how to invest their plan assets and more than 20 percent of 401(k) participants have accounts invested entirely in a single non-blended investment option, lacking any diversification.

Whatever the mix of types of benefit plans in the future – be it defined benefit, defined contribution or hybrid plans – it is critical that sufficient incentives be in place to ensure adequate savings for, and income in, retirement. Since more of the responsibility for saving for retirement will undoubtedly be borne by workers given current trends, it is important they save adequately for retirement.

Raise Financial Literacy

Safe and Sound's first goal is to raise financial literacy. It states, "by 2014, virtually all households will have access to some form of investment education and advice and nearly 75 percent of households will have calculated the amount of retirement savings needed to maintain their standard of living throughout retirement, as well as the savings rate necessary to achieve this target."

One of the most basic elements of savings is understanding the need to save. Yet financial literacy is deficient across all generations and socio-economic levels. The National Council for Economic Education Studies (NCEE) reports that nearly two-thirds of American adults and students do not understand basic economic principles such as "inflation."

One aspect of financial literacy is understanding how much one needs to save to reach one's retirement goals. However, according to the 2004 Retirement Confidence Survey by the Employee Benefit Research Institute (EBRI), the majority of Americans -- 58% -- have not calculated how much money they will need to save in order to live comfortably in retirement. Of those individuals that have considered retirement, data from the survey suggests that many of these individuals may be underestimating how much savings they will need for a secure retirement.

Another aspect of financial literacy is managing the investment of retirement assets. Yet many lack the knowledge necessary to make prudent investment decisions. Even participants who are relatively knowledgeable may lack the time to make and update investment decisions in a consistent and well-informed manner. Moreover, many participants are uncomfortable making investment decisions without assistance and there is an enormous demand for investment advice.

Findings from the 2004 Retirement Confidence Survey make clear that Americans both want and need to be more financially literate. Just one third of workers surveyed reported receiving retirement education materials or seminars from an employer or work-related retirement plan provider in the ten months prior to the survey being conducted. For the 21 percent of workers who did report receiving education materials or seminars from their employer, 67 percent of the workers reported implementing some of the recommendations provided in the education materials or seminars.

Further, it is clear that savings would be materially enhanced if Americans across all socio-economic classes were more financially literate. Listed below are policy recommendations drawn from *Safe and Sound* for achieving the goal of raising financial literacy.

Policy Recommendations:

- **Eliminate barriers to investment advice.** Enact legislation to allow employees to receive financial education and advice through their workplace and/or from a retirement plan administrator. If provided through the employer, qualified advisers affiliated with plan investment offerings should be permitted to participate (with certain worker protections provided) and employers should be protected from fiduciary liability for the specific advice provided to individual participants.

- **Support efforts to expand financial education.** Provide public sector and private foundation funding to develop educational tools that can be used by employers, government and other stakeholders in educating workers about saving, investment and income management principles. Education efforts should also include information about the longer life spans people are expected to have in the future, and how workers can financially prepare for longevity risk.

- **Establish financial literacy requirements.** Financial education should be a high school and college graduation requirement. More states need to be encouraged to adopt financial literacy requirements.

- **Promote a focus on retirement planning.** Include in the Social Security Administration annual statement mailed to workers information on how to calculate a rough estimate of the amount one needs to save that, when combined with one's projected Social Security benefit, will provide a replacement income of 70 percent of one's pre-retirement earnings.

Increase the Share of Workers in Workplace Retirement Plans

Safe and Sound's second goal is to increase the share employer-sponsored retirement plan coverage and participation. Specifically the goal states that: "by 2014, 96 million (74 percent) of full-time and part-time private sector employees will participate in workplace retirement plans."

According to the most recent federal data from a survey of employers, about 50 million full-time and part-time private sector workers in 2003 -- approximately 49 percent of 103 million workers—were covered by a workplace retirement plan. Projecting increases in the size of the workforce, this goal represents a 50 percent increase in retirement plan participation.

If participation is to increase, more employers will have to offer retirement plans. This outcome, in turn, depends on devising innovative and flexible plans that are attractive to employers, especially small- and mid-sized businesses.

A different challenge faces defined benefit plans. Such plans, which provide a guaranteed income in retirement, now cover only 20 percent of full-time and part-time workers in the private sector. The number of single-employer plans insured by the Pension Benefit Guaranty Corporation declined dramatically from approximately 112,000 in 1985 to about 30,000 plans in 2003. Half of the nation's roughly 57,000 defined benefit plans in existence in 1994 had been terminated a decade later in 2004. However, defined benefit plans remain a critical part of how most large and many mid-size employers provide retirement security to their workers. In this regard, single-employer defined benefit plans paid benefits in excess of $120 billion during 1999 (the most recent year for which official Department of Labor statistics have been published).

Funding rules, market declines, and low interest rates used for a variety of pension calculations, including determining plan liabilities, caused some employers to freeze their defined benefit plans whereby the plans are closed to employees who are hired after a certain date and/or current participants do not earn any further benefit accruals for their working years after an established date. These developments have also deterred other employers from starting new defined benefit plans including hybrids, such as cash balance plans. Concerns about the volatility of the funding liability have complicated the task of preserving these plans and devising policies to get more companies interested in traditional defined benefit and hybrid defined benefit plans.

All types of defined benefit plans, including hybrid plans, can play a role in increasing participation rates in workplace retirement plans. To the extent that further erosion of the defined benefit system can be halted, or slowed down, the task of expanding coverage through other types of plans becomes less daunting.

Also, to the extent that new, innovative hybrid designs can attract more employers to offer defined benefit plans, it can help increase participation rates in retirement plans. Enrolling more employees in defined benefit plans of various designs, potentially can provide more workers a guaranteed income in retirement.

Efforts are under way to develop additional ways to strengthen savings through defined contribution plans such as new types of simplified guaranteed annuity arrangements to be offered in combination with a 401(k) plan.

The current debate over devising new funding rules for single-employer defined benefit plans also has the potential to strengthen the system. We believe the system can be reformed without tearing down something that is a core part of how employers provide, and millions of Americans receive, retirement income security. To the extent new policies are established, they should help preserve and/or expand participation in defined benefit and hybrid plans. Listed below are policy recommendations drawn from *Safe and Sound* for achieving the goal of increasing the number of workers in employer-sponsored retirement plans.

Policy Recommendations:

- **Promote automatic enrollment and automatic increase designs.** Enhance default mechanisms (e.g., automatic enrollment, lifestyle funds, retirement target funds) to ensure that individuals who decline to make a choice are more likely to be enrolled in a plan (and be savers) and to invest their assets appropriately for their age and for the best risk-adjusted return. Auto enrollment is a proven tool for increasing participation dramatically, particularly among low and moderate-income workers, typically raising participation rates from the 60-65% range to the 85% plus range.

- **Encourage and protect defined benefit plans.** Support plan funding reforms that reduce the volatility of the funding obligation in defined benefit plans. Support policies that provide for new types of defined benefit plans that can offer guaranteed levels of retirement income. Such guaranteed annuity plans could be offered alone or in conjunction with a 401(k) or other defined contribution plan.

- **Confirm the legality of alternative plan designs.** New policies should ensure that employers have a range of plan designs available, including cash balance and other hybrid designs, so employers can select the retirement plan design that best suits their workforce needs. This would include enhancing all existing plan design types and encouraging new simplified plan designs that offer employer tax incentives, reduced administrative requirements, and provide for worker education on saving for retirement.

- **Make the 2001 improvements permanent.** Make today's retirement savings opportunities permanent. The retirement savings and pension reforms contained in the 2001 tax relief act -- from catch-up contributions to small business pension incentives to expanded IRAs and 401(k)s -- have proven extremely successful. Unfortunately, the retirement savings reforms of the 2001 act are scheduled to sunset at the end of 2010, frustrating the long-term planning that is critical for both individual savers and employer sponsors of retirement plans.

- **Provide a "clearinghouse" plan.** Authorize the creation of a "clearinghouse" model plan through federal legislation so workers who change jobs frequently can contribute to one retirement plan. This plan would be modeled on a multi-employer plan model that could provide individuals with one account that would stay with them when they change jobs. Employer contributions to the plan would be voluntary and no financial or administrative requirements would be imposed on employers (other than transferring worker contributions to the plan). This model plan would accept differing levels of employee contributions and employer contributions, and would be able to accommodate different investment vehicles. Any financial services firm meeting certain qualification criteria would be able to offer the "clearinghouse" model plan.

- **Facilitate new models for retirement.** Eliminate rules that restrict workers and employers from creating flexible working relationships and benefits arrangements such as phased retirement programs.

- **Maintain support for company stock in retirement plans.** Maintain support for the voluntary use of company stock in retirement plans through employer contributions or by making company stock available to employees as an investment alternative in the retirement plan. Employees should be educated about the special risks of company stock ownership in retirement plans.

Raise Retirement Savings

Safe and Sound's third goal relates to raising retirement savings. Specifically it states: "by 2014, the gross personal savings rate, which covers saving for all purposes, will reach 15 percent of disposable income. In addition, many, if not most individual workers across the income spectrum will be saving at a rate between 7 and 15 percent of earnings specifically to provide a retirement income that is at least 70 percent of pre-retirement earnings."

The context for this goal is to raise our savings rate to a comparable level of our principal global competitors among the Organization for Economic Cooperation and Development nations and to provide 70 percent of pre-retirement earnings which is commonly suggested by many experts as the necessary income replacement rate to maintain one's standard of living in retirement. (This is a conservative target inasmuch as in recent years the suggested figure has been raised by many other experts.) If one assumes that most workers begin to save between 21 and 35 years of age, then an overall household savings rate of 15 percent would likely be high enough to encompass what households need to save for retirement and still leave room for other forms of saving, such as saving to buy a home, for emergencies, for college education, and medical care. To the extent workers delay too long past age 30 to begin saving for retirement, however, a 15 percent household savings rate (already a challenge to achieve) would not be adequate to assure a 70 percent replacement rate in retirement for most workers.

The calculation of how much one needs to save for retirement must be made on an individual basis. That amount most importantly depends on how early in one's working life a person begins to save. The earlier a worker starts, the lower the savings rate required to reach an income level after retirement close to what the worker earned before retirement. The amount one needs to save also depends on assumptions about a number of other factors, including the rate of return on retirement savings, the rate of future wage and salary growth, and how many years one expects to live after age 65.

A study by the Employee Benefit Research Institute in collaboration with the Millbank Memorial Fund calculates that Americans will need an additional $400 billion more than they will have saved to cover basic expenditures in retirement and any expense associated with an episode of care in a nursing home or from a home health care provider. The study simulates retirement income from Social Security projections and savings from current patterns of saving in tax-preferred retirement savings vehicles, including defined benefit plans, defined contribution plans, and IRAs of all types. It also simulates retirement expenditures on basic living, health care and long-term care. It calculates the shortfall between retirement savings and expenses by age and income cohorts from 1936 to 1965.

The study finds that most couples in the top two quartiles of income born after 1945 can close the gap by increasing their savings rate by just 5 percentage points. However, most couples in the lower two income quartiles born after 1945 would need to save an additional 10 to 17 percent in order to close the gap. Those born in 1945 and earlier will need to save more to meet their needs. Single men and women need to save more than couples to close the gap.

The study does not, however, translate the additional retirement savings needed to meet retirement needs for the various cohorts in the study into an explicit aggregate savings rate for the entire economy. Its findings do, however, generally support the goal of raising overall savings to 15 percent from recent levels of 6.4 percent. That would be enough to close the retirement savings gap for the great majority of Americans born after 1945 provided the savings were spread relatively evenly across the population. To that end, a number of legislative solutions are appropriate to help achieve the goal of raising retirement savings.

Policy Recommendations:

- **Create tax incentives for lifetime payments.** More Americans are retiring with lump sum payments from their retirement plans and many face the prospect of having no defined benefit pension. These retirees confront the difficult task of making their savings last throughout their lives, a task that is only becoming more daunting as life expectancies continue to increase. Annuitizing some retirement savings is an effective way to protect against outliving one's assets. Congress should enact modest tax exclusions to encourage lifetime payouts.

- **Enhance the Saver's Tax Credit.** Provide an enhanced saver's tax credit for low-income individuals above and beyond current law, which provides a partial tax credit for employee contributions made to defined contribution plans and Individual Retirement Accounts. The Saver's Credit has proven quite successful. According to official IRS data, more than 5.4 million households claimed the Saver's Credit in 2003. Yet the Saver's Credit is scheduled to expire at the end of 2006. Given its track record of success, Congress should make the Saver's Credit a permanent part of the retirement savings tax incentives offered to the American people.

- **Increase tax incentives for savings.** Provide increased tax incentives to all individuals to encourage them to maximize retirement savings and to ensure that their savings last throughout retirement.

- **Remove complex and superfluous rules.** Retirement plan rules are often complex and arbitrary. As a result, employers, especially small employers, are unwilling to voluntarily sponsor retirement plans for their employees. Simplifying onerous plan administration and compliance requirements (e.g., nondiscrimination testing) will help maximize individual savings and encourage employers to start up and/or maintain qualified retirement plans.

CONCLUSION

The current voluntary employer-sponsored retirement system has been an enormous success. While individuals can save on their own without an employer-sponsored plan, savings rates are much higher when employees have the opportunity to save through an employer-provided plan.

However, the nation's retirement system faces enormous obstacles and there are a number of trends on the horizon that will test the system. A broad array of demographic, workplace and economic changes in the decade ahead will provide challenges to personal financial security and the employment-based retirement system. These challenges include the aging of America, changes in the composition of the workforce, evolving changes in social structure and families, and continuously rising health care costs.

Reforms are needed now to address these issues and allow the retirement system to grow and retain its vigor. With decisive action, our nation's retirement systems will continue to be an engine for increased savings and retirement security.

Chart 1: U.S. Private Pension Fund Assets (1945 – 2004)

In Billions of U.S. dollars; Source: U.S. Federal Reserve, Flow of Funds Accounts of the United States

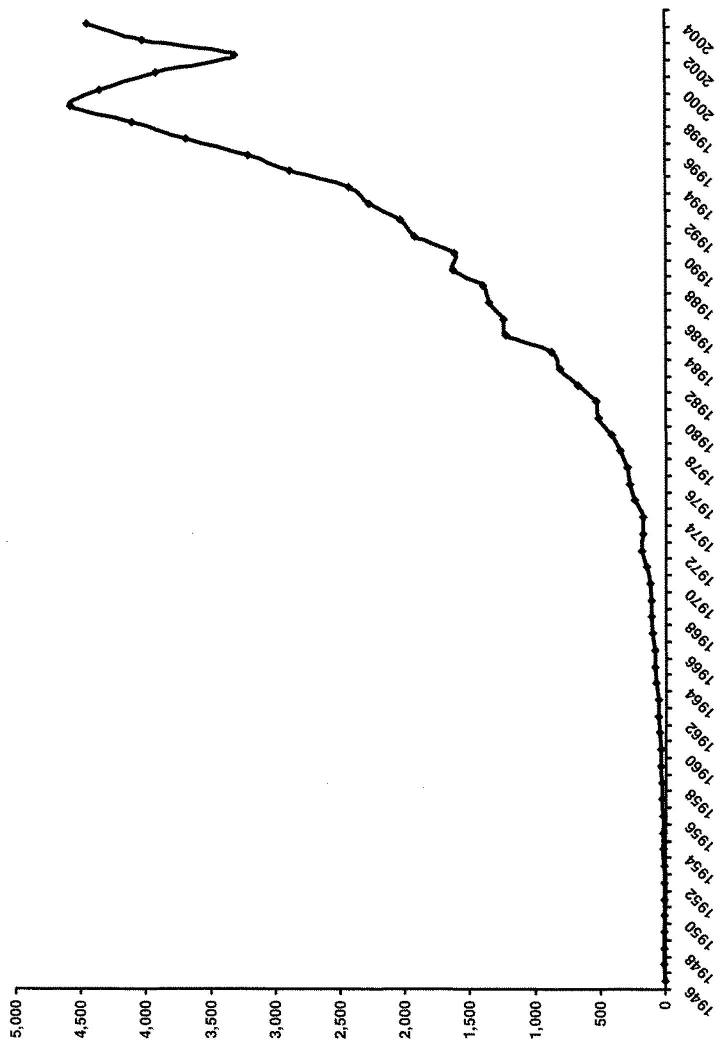


Chart 2: U.S. Private Employer Pension Contributions (1948 – 2003)

In Billions of U.S. dollars; Source: U.S. Department of Commerce, Bureau of Economic Analysis, National Income and Product Accounts Tables

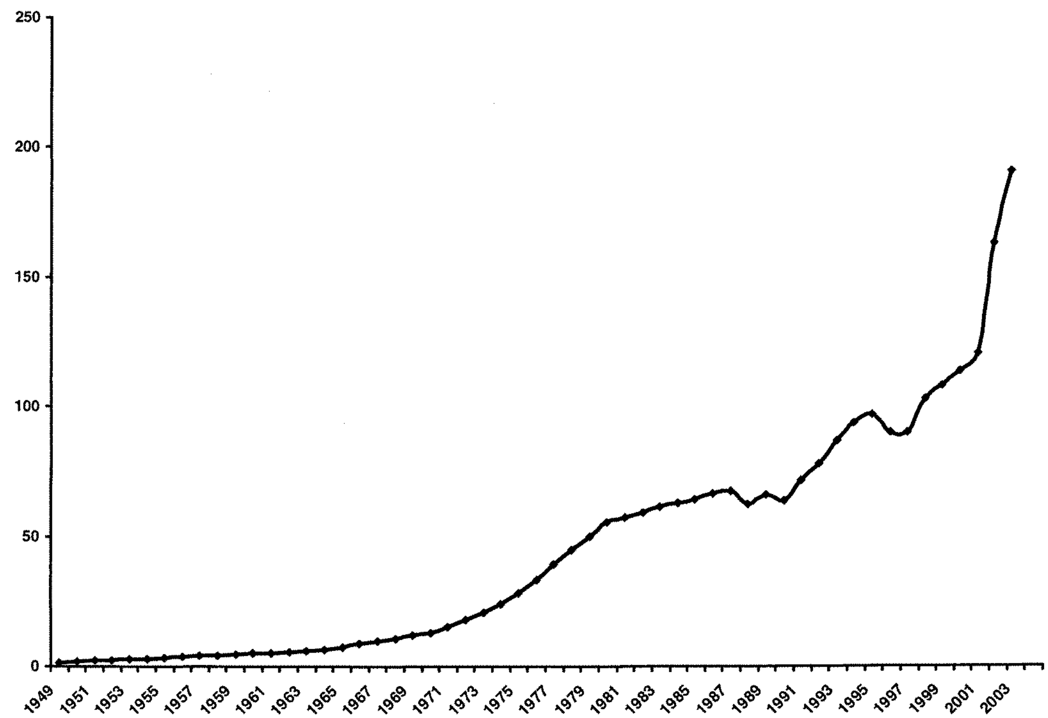
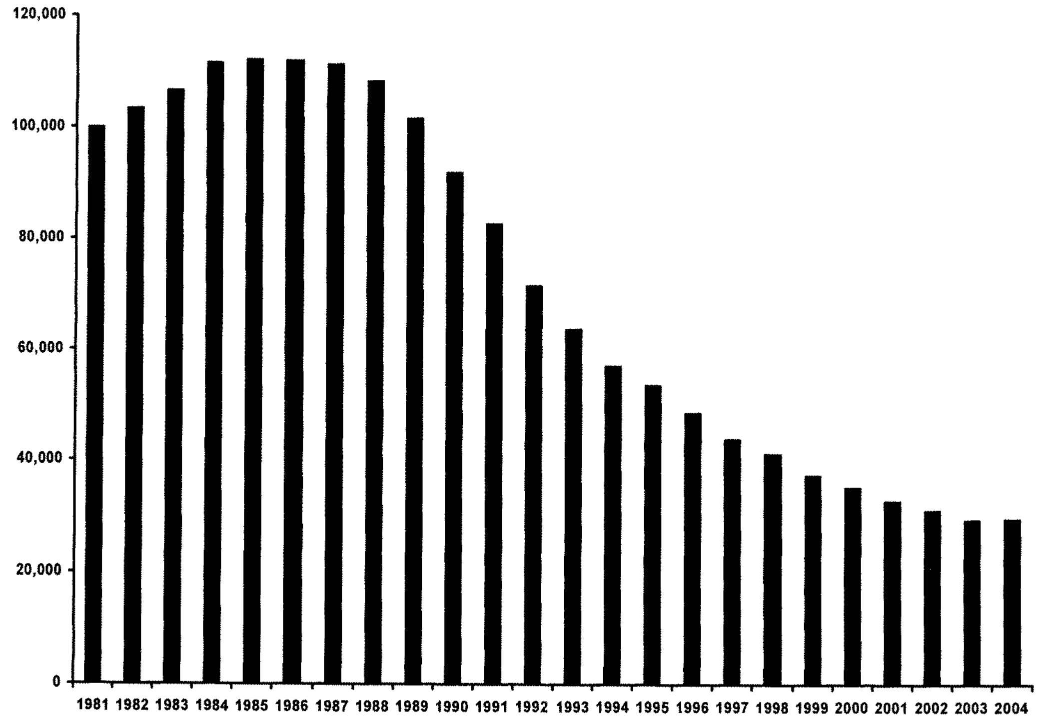


Chart 3: PBGC-Insured Single-Employer Plans (1980-2004)

Source: PBGC Pension Insurance Data Book 2003 and 2004 Annual Report



The CHAIRMAN. Thank you very much.
Mr. Kimpel.

STATEMENT OF JOHN M. KIMPEL, SENIOR VICE PRESIDENT AND DEPUTY GENERAL COUNSEL, FIDELITY INVESTMENTS, BOSTON, MA

Mr. KIMPEL. Thank you, Mr. Chairman.

Fidelity is the largest mutual fund manager in the country. In addition to that, we are the largest provider of employer-sponsored plan services. The main part of that business is in providing investment management and recordkeeping services to defined contribution plans. All of you have received a copy of a report that we have done now for 5 years drawing on the data that we have as the largest defined contribution recordkeeper. We currently record-keep over 10,000 plans covering over 8 million employees with assets approaching $500 billion. The report is all based on data at the end of 2003. We are in the process of gathering the data and putting together a report for 2004.

With that, I just want to focus on three or four points.

The first, in looking through this and trying to get a capsule of who is the average defined contribution or 401(k) participant, who is it, and what we see from our database is it is a person 44 years old, who earns about $53,000; who is contributing 7 percent of his or her compensation a year, that works out to slightly more than $3,500 a year; and who has an average account balance—and I am jumping ahead because I just received the numbers for the end of 2004—of a little over $61,000 in that account balance.

Now, the good news there is that average participant still has approximately 20 years to grow that number into a significant retirement nest egg.

As the presentation I provided and the report also shows, all of the important things we care about—participation rates, deferral rates, and account balances—increase as the participant's income goes up, as the participant ages, and, importantly, as the participant's job tenure with the employer increases.

Now, the opposite of that is also true, as we have all talked about as well, that a lower-paid, short-tenured, low-compensation participation will have less. But if you make some reasonable assumptions about where that person will ultimately be, you can see that those account balances will grow, participation rates will grow, and deferral rates will grow.

So the issue that I would like to focus on in particular is trying to put these numbers in the appropriate context, and what I would like to do is focus on the importance that the employer plays in all of this. In addition, as you know, Fidelity is a very large IRA provider. We have some experience in that market as well. But what is significant to us—and if you look at one of the pages in the presentation, if you look at participation rates comparing employer-sponsored DC plan to IRA, if you look at deferral rates or contribution rates, and if you look at account balances, what you see is significantly, wildly larger numbers under the employer-sponsored plan. The most important of those is the participation rate. Sixty-six percent of people who are offered the opportunity to participate in a 401(k) plan do so. We sometimes complain that is not high enough, that it should be higher, that it should be 100 percent, and God knows we all wish it were 100 percent. But the figure for employees who do not participate in an employer-provided plan, the contribution rate or the participation rate for them in IRAs—and all of them have the ability to participate in an IRA—is only 5.5 percent. So the power of the workforce, the power of the employer providing a plan is very significant.

The CHAIRMAN. Sixty percent versus 5?

Mr. KIMPEL. It is 5.5 for IRAs.

Now, then we get to the question of what to do. People have talked about automatic enrollment. We think automatic enrollment is terrific. We are doing it with a lot of plans. Treasury regulations allow it today. Anything to encourage greater use of automatic enrollment is terrific. To make it unanimous, we, like the other panelists, are in favor of the continuation and possible expansion of the saver's credit.

But there is one other thing I would like to bring up that nobody else has talked about, and that is, when you have automatic enrollment, where does the money go? How is it invested? Another thing that we think is important to put on the legislation table is having the default fund be a life cycle fund or some kind of a balanced fund, because what everybody does now is the money goes into a money market fund. Again, looking at our data base, fewer than 5 percent of the participants are defaulted into a life cycle fund. A life cycle fund is one that invests in different asset classes, that change as the participant ages, so it is appropriate for that age, so it is a higher—it would be a higher investment in equities, and then as the participant ages, it will go increasingly away from equities into money market.

The CHAIRMAN. So is that something that exists or something you want us to create?

Mr. KIMPEL. It exists, Senator. The problem is the fiduciary rules under ERISA and Section 44(c) in particular. They do not provide any relief from liability to an employer who identifies the life cycle fund as the default fund because participants are not deemed to exercise control over the default fund. So what employers all do, therefore, is default to a money market fund. That, coupled with automatic enrollment, would be a huge benefit under the current system.

The CHAIRMAN. What percent of, say, their 7 percent, their personal and their employer contributions, what percent would it take to do the default fund?

Mr. KIMPEL. Well, I am not sure——

The CHAIRMAN. Is this something separate that you created?

Mr. KIMPEL. No, no.

The CHAIRMAN. An extra percent or something?

Mr. KIMPEL. No. The question is what happens to a participant who does not identify where his or her account should—what investment should be allocated to. So when you think of automatic enrollment——

The CHAIRMAN. Oh, I understand now. OK. You are not talking about somebody whose investments tank.

Mr. KIMPEL. No, no. No, I am just talking about someone who was automatically enrolled into a plan——

The CHAIRMAN. But they do not designate where——

Mr. KIMPEL. They do not designate an investment fund.

The CHAIRMAN. Of those who enroll with Fidelity, what kind of a program do you offer them? High risk? Medium risk? Low risk? What does the average participant do? Do they spread it?

Mr. KIMPEL. The average participant—well, let's go back to the default issue. Approximately, I believe, 20 percent of participants end up being in one fund, and typically that one fund will be the default fund, which is why that issue is so important. Beyond that, what we——

The CHAIRMAN. What does a default fund earn?

Mr. KIMPEL. Money market rates.

The CHAIRMAN. Just the same money market rate.

Mr. KIMPEL. Yes, typically. If the money market fund is the default fund. If you look at this across different age spectrums, what we see is that there is some level of appropriate—of reasonably appropriate—at least on average, of appropriate allocation among participants, among equity, fixed income, and money market. In other words, you see significantly higher concentrations of equity funds in participants' accounts when they are younger, and that percentage declines over age.

I think the typical holding, number of funds held, it will again depend on the particular plan because it is the plan sponsor who designs the plan, decides what investment options to provide and how many of them. So you will get variations depending on how many plan options are available.

The CHAIRMAN. The 20 percent who go into the default fund, why don't they choose? What is their excuse? They are not educated? They are not told? They are not given an option?

Mr. KIMPEL. Well, the why, I am not sure we know the answer to.

The CHAIRMAN. I mean, you know, they have to sign up for it.

Mr. KIMPEL. Correct. They have signed up. I think it is because they simply—I think, and this is just opinion, I think they don't have confidence in terms of what it should be, what they should be doing.

Now, going back to the life cycle funds, we do see more and more employers offering them as an option, and we see more and more people going into them of their own volition. But we also have not been able—and this is one of the things we are trying to do in the data point, is track what people do. In other words, if they go into a default fund, do they stay there? We think most of them, unfortunately, do.

The CHAIRMAN. Does Fidelity handle any defined benefit plans?

Mr. KIMPEL. Yes, we administer defined benefit plans as well, and we also manage defined benefit plan assets.

The CHAIRMAN. Can you share with me the pros and cons? I am looking for an answer why is—beyond the complexity of defined benefit plans and the cost—why is one declining and the other going up?

Mr. KIMPEL. Well, I think the simple reason that defined benefit plans are declining is not so much the cost but the uncertainty of the cost. If you are a corporation, what you do know with defined contribution plans, if you are contributing 5 percent or 7 percent, or whatever that number is, no matter what happens fiscally to your company, that is the rate you will have to contribute each year. But in a defined benefit plan, you don't know from year to year what that contribution is going to be because it will be in part determined by your workforce and your compensation, which you have some control over, but it is also going to be determined by how well your investments do. That uncertainty, in our experience, drives corporate treasurers crazy.

The CHAIRMAN. The mobility of our society today, I assume a lot of employees, as they become educated with respect to in 401(k) plans, they are asking for that instead of defined benefit plans.

Mr. KIMPEL. I think that is true, too.

The CHAIRMAN. Because it goes with them. There is no red tape. It is theirs, they own it, they grow it, they manage it.

[The prepared statement of Mr. Kimpel follows:]

Fidelity INVESTMENTS

TESTIMONY
Before
Senate Special Committee on Aging
Regarding Role of Employer-Sponsored Retirement Plans
April 12, 2005

John M. Kimpel
Senior Vice President and Deputy General Counsel
Fidelity Investments
82 Devonshire Street, F7A
Boston, MA 02109
Phone: 617/563-7924
Fax: 617/476-7217
E-Mail: john.kimpel@fmr.com

Fidelity INVESTMENTS

Agenda

- Overview
- Participation Rates
- Deferral Rates
- Account Balances
- Conclusions

Fidelity Investments

Fidelity Generally

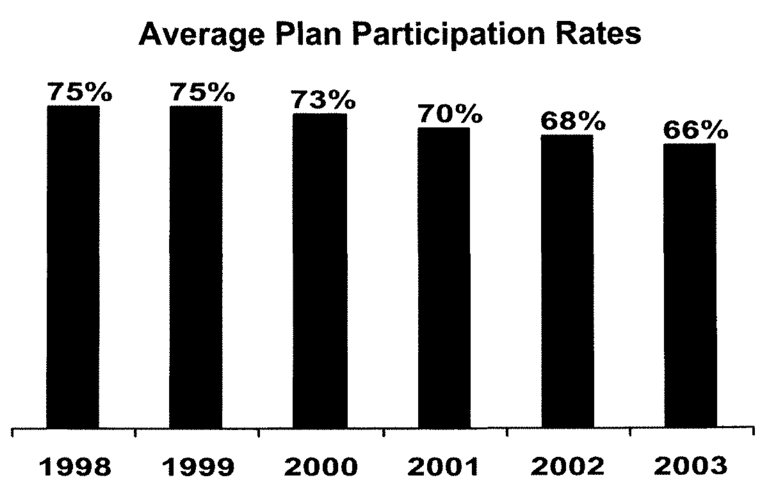
- $2.1T custodial assets
- $1.1T managed assets
- 19M individual customers
- Largest workplace retirement services provider

Corporate DC Overview

- Year-end 2003 data
- 10,316 recordkept plans
- 8.2 million participants
- $453 billion in assets

Fidelity INVESTMENTS

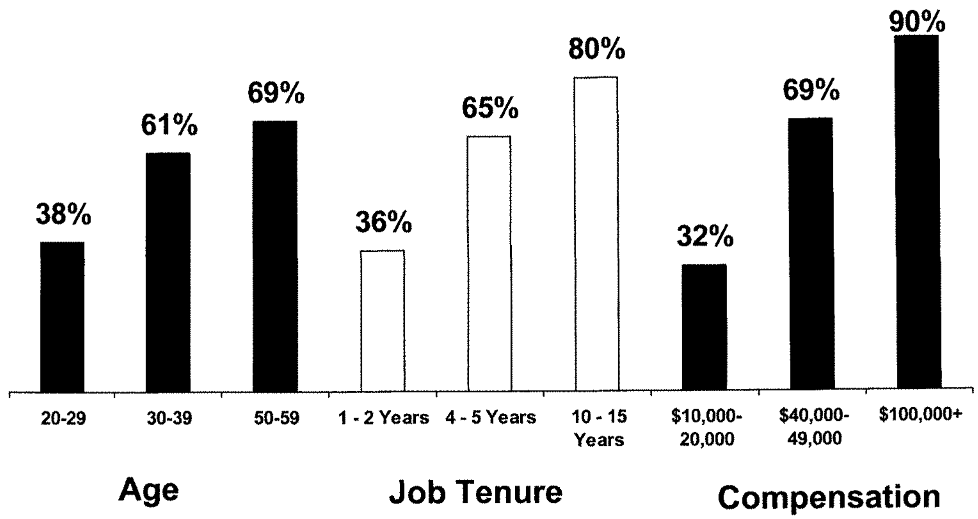
Participation Rates Have Declined



Source: Building Futures Volume V,
Fidelity Investments, 2004

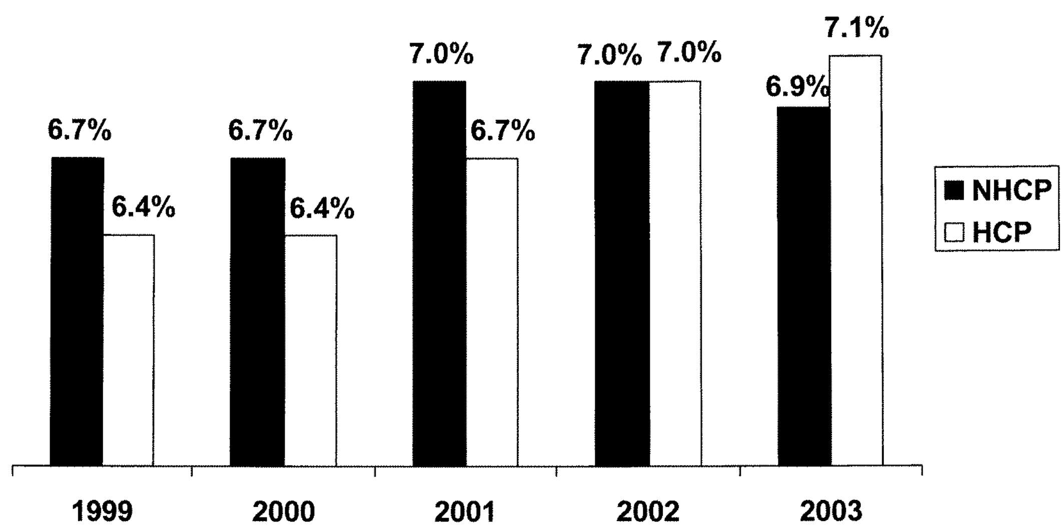
Fidelity INVESTMENTS

Participation Rates Grow with Age, Job Tenure and Compensation



Source: Building Futures Volume V,
Fidelity Investments, 2004

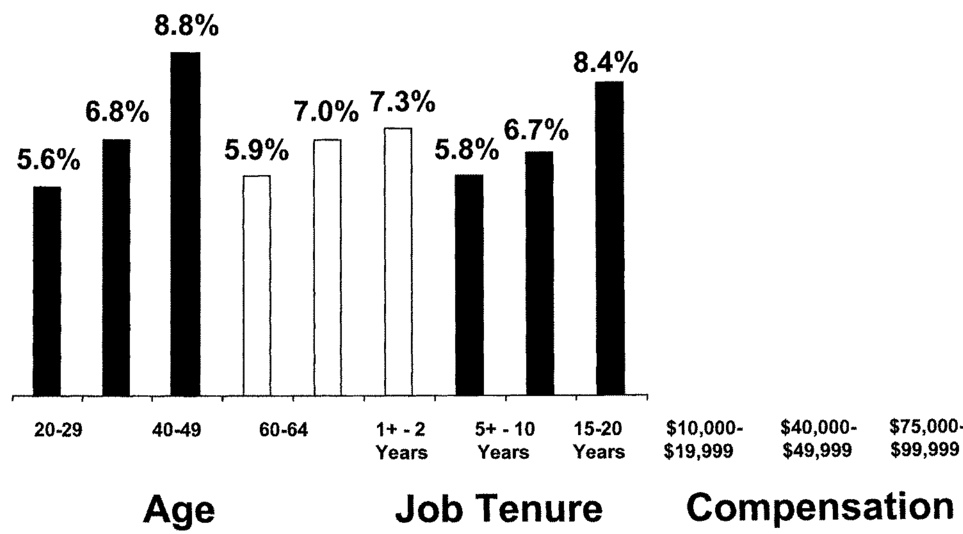
Deferral Rates Remain Steady



Source: Building Futures Volume V,
Fidelity Investments, 2004

Fidelity Investments

Deferral Rates Grow with Age, Job Tenure and Compensation

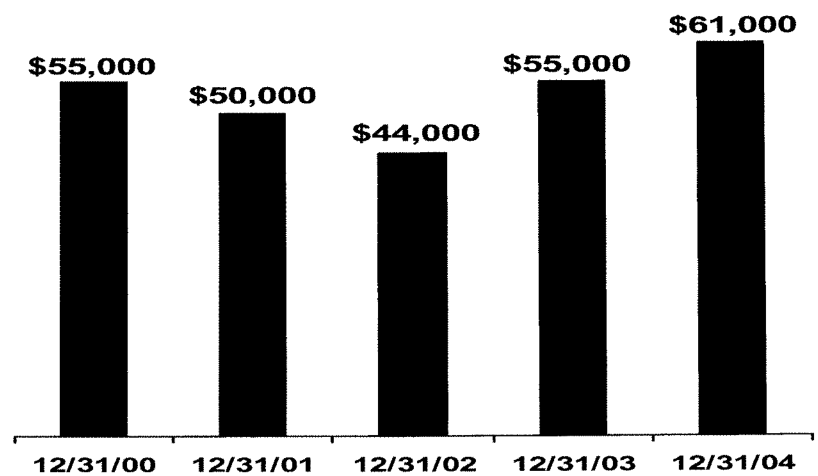


Source: Building Futures Volume V, Fidelity Investments, 2004

Fidelity Investments

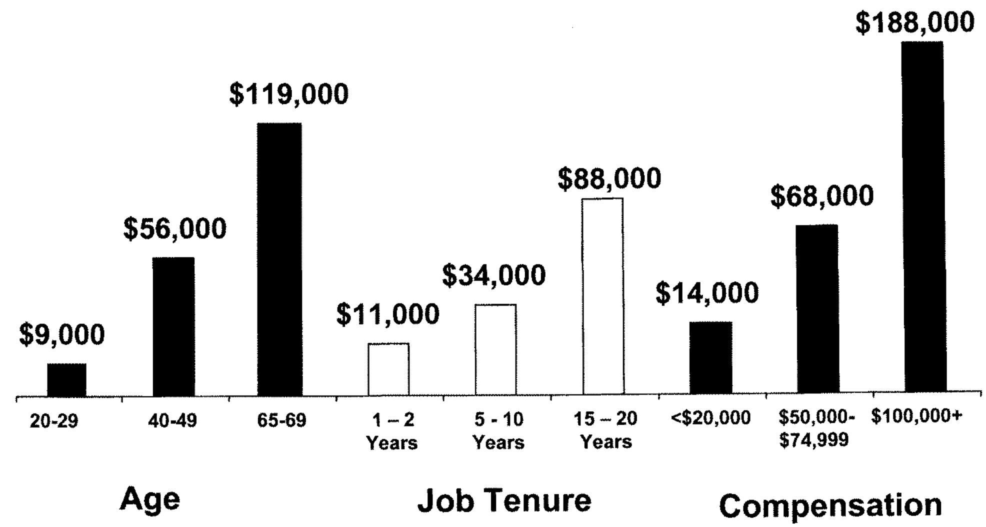
Account Balances Have Increased

Average Account Balance



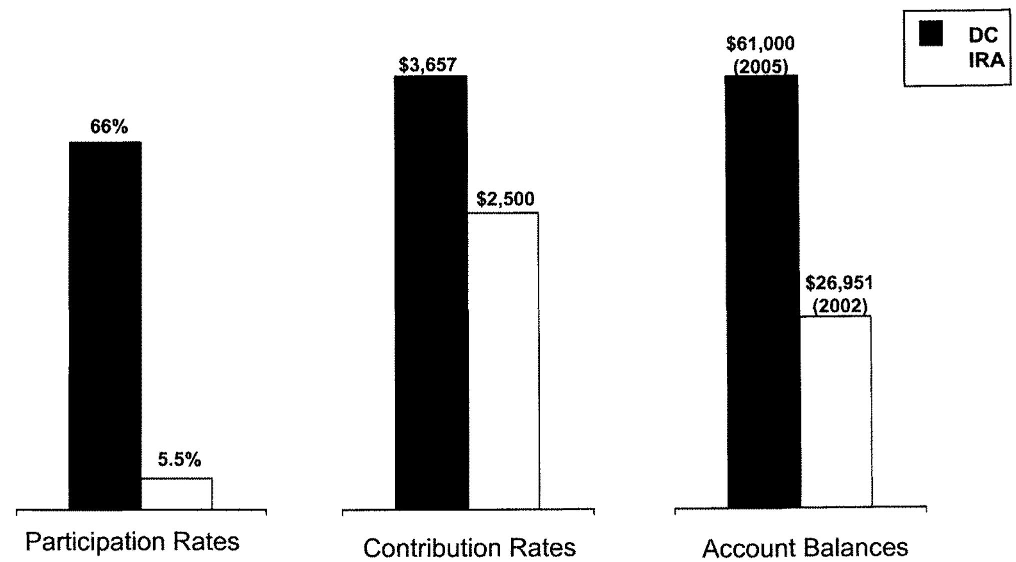
Source: For 2000-2003 Building Futures Volume V, Fidelity Investments, 2004
For 2004, unpublished data, Fidelity Investments, 2005

Account Balances Grow with Age, Job Tenure and Compensation



Source: For Age and Job Tenure, Building Futures Volume V, Fidelity Investments, 2004
For Compensation, Building Futures Volume II, Fidelity Investments, 2001

Employer DC Plans Compared to IRAs



Sources: Fidelity Investments, Employee Benefits Research Institute, Investment Company Institute, 2004-2005

Fidelity INVESTMENTS

Conclusions

- Employer-sponsored defined contribution plans continue to meet their intended goal of helping provide adequate retirement income
- Employer-sponsored defined contribution plans contribute to retirement savings and, therefore, national savings

Mr. STEUERLE. Senator, could I speak to that?

The CHAIRMAN. Yes, please.

Mr. STEUERLE. We have done some studies at the Urban Institute speaking exactly to your point. The traditional defined benefit plan over time only favored a small segment of the employee population, mainly——

The CHAIRMAN. It is usually the high-income.

Mr. STEUERLE. The higher-income, but also those who are long-term employees with the same firm, not the more mobile population. If you look at the distribution of benefits by age and time with the firm, it is a hill-shaped. The very young get almost nothing because if they leave the plan at age 30 or 40, the plan is not indexed for inflation. The benefits are often almost worthless. The middle-aged people on the other hand start getting a huge buildup of assets, but that works badly for retaining employees. If you are an employer, all of a sudden you have some middle-aged employees say in a firm in Detroit who become very expensive. It is sometimes cheaper to close down the plant and move to Kentucky. Whereas, if you are on the other side of the hill, if you are on the down side, as I mentioned earlier in my testimony, sometimes the benefits go negative for older employees.

Are employers looking for older employees? I think they are a major demand in the future as these people who are now retiring 55 to 75 and are the largest underutilized pool of human resources in our economy. The traditional defined benefit plan has not adjusted to figuring out how to provide them with a modicum of benefits.

One thing all four of us have spoken to at one level or the other is how important it is to provide employers with some simple default options that they can use for a variety of pension reform issues so they are not threatened with suits under the labor laws, the tax laws, and the age discrimination laws. They know they can set it up. In many cases they don't want broad fiduciary responsibilities. They don't mind making deposits on behalf of employees, but they generally don't want long-term fiduciary responsibilities that threaten them with lawsuits. I think we spoke of this challenge for cash balance plans, automatic enrollment and automatic escalation plans and allowing life cycle plans. The notion that in the law or at least in the regulations there are safe harbors that reduces the threat of lawsuits, I think, is a very important advance, which I think all four of us would support.

The CHAIRMAN. Can I ask you a question? I don't know the answer to it. I am looking for education for myself. Where you have a company like United Airlines who—I believe one of their problems is the whole defined benefit plan liability. A new airline is set up called Ted. What does Ted offer to their employees? Is it a 401(k) or is it a defined benefit plan?

Mr. KLEIN. Well, I don't specifically know what is offered to that airline——

The CHAIRMAN. I mean, there are lots of examples like that.

Mr. KLEIN. I assume that they do not provide the same level of benefits, retirement or otherwise, but it is clear that in that industry they are facing pressure. Some of the companies, the legacy carriers, are facing pressure not only from those who have terminated their plans, like the Uniteds and U.S. Airways, but also some of the newer low-fare air carriers that clearly do not have a defined benefit pension.

The CHAIRMAN. Would JetBlue have a 401(k)?

Mr. KLEIN. I would think they do.

Mr. IWRY. Mr. Chairman, I agree——

Mr. KLEIN. I also—go ahead, Mark.

Mr. IWRY. I am sorry. I was just going to add to what Jim Klein is saying, that the newer carriers and in general the newer industries in our country have gone much more toward the 401(k) model, and this answers both of your questions in part, in addition to the factors my colleagues have mentioned. The defined benefit has been associated traditionally with manufacturing and with unionized industries particularly. As the share of the workforce represented by unions has declined and as the share of the workforce in this country involved in manufacturing has declined in favor of service industries, we have seen that mix of——

The CHAIRMAN. That accounts for part of the decline of one and the rise of the other. But are there any union pension funds that are or were defined benefit, are any of them transferring to 401(k)?

Mr. IWRY. Yes, or they have added 401(k)s.

The CHAIRMAN. They have added it.

Mr. KLEIN. Mr. Chairman, if I might also further embellish upon the answer to your question about the reasons for the decline, which are many, and kind of refer back to the chart that I showed during my comments. You know, at its peak in 1985, we had 112,000 of these defined benefit plans insured by the Pension Benefit Guaranty Corporation. In 1986, the Tax Reform Act was enacted. Now, admittedly it did, through some of its changes, get rid of a number of very, very small defined benefit plans that maybe were only covering one or two people in a professional organization. But once you clear those out of there I want to debunk the notion that employers do not really necessarily want a defined benefit plan. I think that a lot of the provisions and the regulations that have followed on top of the provisions from the Tax Reform Act of 1986 and its progeny have made it very difficult for companies to have defined benefit plans.

I completely agree with John Kimpel's comment that it is not so much the actual cost as it is the uncertainty about the cost. I hear that time and again from our Fortune 500 company members who are saying they find it very, very difficult to make the case to their boards of directors and their shareholders that it is worthwhile having a defined benefit plan given the unpredictability. That is why we are so tremendously concerned about certain features of the administration's proposals on funding.

The last point is the notion that people have obviously experienced, notwithstanding the dip during the market downturn, an enormous amount of wealth accumulation in 401(k) and other types of defined contribution plans. So from an employee relations point of view, there is a tremendous amount of interest in those kinds of plans, which brings us back to the beauty, I think, of the cash balance and other kinds of hybrid plans that combine the best features of both. It is a defined benefit plan. Its benefits are guaranteed by the Pension Benefit Guaranty Corporation. The employer funds it, but it is more transparent and individuals have a better sense of the value that they have.

I will just leave you with one fascinating anecdote. A member company of ours did a survey of its workers about the extent to which those workers value different kinds of benefits, and they found that they placed a far superior value on the company-run gymnasium than they did on the defined benefit pension plan, notwithstanding that the company was obviously spending vastly more resources on the defined benefit plan. That speaks to the issue of communications and why it is important to engage people in the value of their defined benefit plan since it is not as evident to them as the defined contribution plan.

But I think also that survey was done prior to the market downturn, and I think a lot of people began to realize the value of that security of the defined benefit plan. Most large companies obviously sponsor both or try to sponsor both.

The CHAIRMAN. I have to apologize. There is another vote. We have only a few minutes left.

Do any of you have any concluding comments that you can say briefly that would add to our record? Yes, Mr. Iwry.

Mr. IWRY. Mr. Chairman, I would like to reinforce and expand upon something that Mr. Kimpel called attention to. 401(k)s can be made easier and more effective in a number of different ways, really in all three phases: contributing to the plan, accumulating through sound investment, and then paying out.

Mr. Kimpel is absolutely right that the accumulation phase needs some legislative comfort, and Gene Steuerle said this as well. We can use some more fiduciary reassurance for employers that if they default people into a life cycle fund instead of a money market fund or into a managed account where there is a professionally managed individual account for employees, if they want to let a professional manage it the way we run our defined benefit plans, with professional management, we will have made a great step forward and moved the system away from the excessive dependence now on self-direction. Every employee having to become their own investment expert, their own investment manager, it is too great a demand on people.

Again, if I can refer to these focus groups that the Retirement Security Project has arranged, we saw people essentially begging for help with the investments. They do not know exactly how they ought to be investing their money. They want some professional help.

You can have the right to opt out and have the right to continue to choose your own investments, the way we do today in 401(k)s, but let the employer have a default that represents a diversified and balanced fund or managed account.

Mr. KLEIN. Mr. Chairman, my only final comment would be to echo what is in our written statement commending you for the efforts that you articulated earlier with respect to automatic enrollment and associate myself with the comments of the others on the panel.

The CHAIRMAN. Thank you.

Yes?

Mr. STEUERLE. Senator, the one comment I would add is that for some of the options we have been talking about at the end—the automatic enrollment, the clear statements as to fiduciary responsibilities and the removal of possibilities of a lawsuit—I think there is fairly uniform agreement. I really do hope that Congress moves ahead in those areas. But in some ways, those are the easier decisions. Especially at this time of budget stringency, we have to admit that some aspects of our current system are not working well, and I do not want to leave you with the notion that some harder decisions do not have to be made.

I would mentioned one, for instance. We have a system now where people can borrow on the one side, take interest deductions, put money into accounts that get interest receipts, not save a dime, not make a dollar of interest income on net, and yet get substantial amounts of tax savings—tax savings, by the way, that can be as great or greater than these given to the people that actually do save. I have given other instances in my testimony.

Consider early withdrawal options that are so easy for employees that sometimes they take money out of saving that the Government has subsidized, and leave nothing by the time of retirement age. The people then are more likely to turn to the Government for help in old age. Maybe it is nursing home help. Maybe it is retirement help.

There are some tough decisions to be made here to encourage more people to keep money in a retirement solution. If the Government is going to be subsidizing people, and especially subsidizing additions to the saver's credit, which most of us favor, we have to take a hard look in making sure that this money is adding to net saving and actually does stay in a retirement solution.

The CHAIRMAN. Gentlemen, thank you all so very much. I know you have given me some ideas of things to add to my bill, and I invite and encourage and ask for your continued engagement with my office and other Senators, because we have got to start working on this soon because we have got a real economic or retirement tsunami ahead of us if we do not get ahead of this.

So thank you all so much. It has been a very enlightening hearing, and you have added to the public record in a measurable way.

With that, we thank you and we are adjourned.

[Whereupon, at 4:16 p.m., the committee was adjourned.]

APPENDIX

WRITTEN TESTIMONY OF

PATRICIA COX,
CHIEF OPERATING OFFICER
SCHWAB RETIREMENT PLAN SERVICES, INC.
THE CHARLES SCHWAB CORPORATION

SUBMITTED TO THE

U.S. SENATE SPECIAL COMMITTEE ON AGING

FOR ITS HEARING ON

"THE ROLE OF EMPLOYER-SPONSORED RETIREMENT PLANS IN INCREASING NATIONAL SAVINGS"

APRIL 12, 2005

Mr. Chairman, thank you for allowing me to submit a written statement for the record of the U.S. Senate Special Committee on Aging hearing, "The Role of Employer-Sponsored Retirement Plans in Increasing National Savings." I am the Chief Operating Officer of Schwab Retirement Plan Services, Inc., part of Schwab Corporate Services, which provides services to retirement plan sponsors and participants. At the end of 2004, total client assets in employer-sponsored retirement plans at Schwab equaled $131 billion. Overall, the Charles Schwab Corporation is one of the largest financial services firms in the nation, with more than 7 million individual investor accounts and more than $1 trillion in client assets. I am pleased to be able to offer Schwab's perspective on this very important issue.

At Charles Schwab, we believe strongly that employer-sponsored plans play a critical role in ensuring a secure retirement and in increasing savings in general. They are the primary savings vehicle for tens of millions of American workers. But we share the Committee's frustration that these plans are not available to all workers, and that far too many workers do not take advantage of these savings opportunities even when their employer does offer a retirement plan. We strongly support the goal of finding ways to make it easier for plan administrators to provide plans, incent employers to offer them, and to increase employee participation in them.

Undoubtedly, the Committee has been barraged with a number of statistics about the participation rates in employer-sponsored retirement plans and the number of businesses that offer plans. While offering a few statistics of my own, I would like to focus my comments on recommendations for improving the numbers in both of these areas. In particular, I would like to discuss what we at Schwab believe to be the most important factors in increasing participation in retirement plans today: the availability of quality investment advice and ongoing account management for participants, and permitting automatic enrollment in an employer's plan.

Let me begin by offering some historical perspective by looking at the evolution of defined contribution plans over the last 25 years. In the early 1980s, the first defined contribution plans were really nothing more than glorified profit-sharing plans. There was nothing required on the employee's part – no investment decisions or other choices to make. By the middle of the 1980s, though, employees were more and more frequently allowed to contribute portions of their own salary to the plan, and often had a very limited group of investment choices. Mutual funds began to dominate employer-sponsored retirement plans, so a participant might have three or four funds from which to choose: a bond fund, a balanced fund, perhaps a relatively low-risk equity fund.

In the late 1980s and the beginning of the 1990s, a kind of "space race" developed in the retirement plan world, and participants saw incrementally increasing investment options. Competition in the marketplace led providers to offer more and more features, and more and more investment options. But with increased choice came the need for increased education. By the mid to late 1990s, at the height of the market boom, many participants were provided with a wide array investment options, but without receiving adequate investment education, including the need for diversification. Many tried to catch the wave, making riskier and riskier investment choices at a time when it seemed like just about anything would produce staggering returns. And then the bubble burst, and suddenly retirement plan investors were front-page news, with heart-wrenching stories of seeing their retirement savings wiped out when companies collapsed and stock prices plummeted.

The first two decades in the life of defined contribution plans were marked by an unprecedented 20-year bull market. But the last five years have been a very different story. Today, we see investors much more interested in stability within their retirement plan. They prefer things like target funds or life-cycle funds that automatically adjust risk as the participant nears retirement age. But perhaps most significantly, the last five years have taught retirement plan participants – painfully, in too many cases -- that they are not as savvy as they thought they were in the 1990s, that managing one's own investments takes time, energy, education and effort. In the middle of their busy and hectic lives, many participants simply don't have the time, inclination or interest to learn the dynamics of investing and to pay attention day after day, year after year, to their retirement portfolio. They need help and they are asking for help. I believe that we will continue to struggle to increase the savings rate until every retirement plan participant has the opportunity to get investment education and advice within the context of their plan.

The Importance of Advice in Retirement Plans

In a 2001 Advisory Opinion issued to Sun America, the Department of Labor concluded that a plan trustee providing recordkeeping and other plan services would not violate ERISA's prohibited transaction rules by offering asset allocation advice services to defined contribution plan participants where the investment recommendations were those of an independent financial expert. At that time, Assistant Secretary of Labor Ann Combs issued a public statement in conjunction with the opinion, observing that the guidance allowed "much-needed asset allocation advice to plan participants." She also urged the passage of legislation that would permit an even wider array of advice services to be offered to participants. The Department of Labor clearly recognizes that employer-sponsored retirement plans are at the very heart of savings for many Americans, but is also cognizant that plan participants need some help understanding their choices and then making investment decisions that are best for their particular situation.

A little more than a year ago, Schwab began offering personalized advice – at no additional cost to the plan participant or the plan itself – through an independent third party, GuidedChoice, Inc., an innovator in the development and delivery of investment advice.

Participants have access to personalized advice either online, by phone or in person, including recommendations specific to the core investment fund choices available in their particular plan, as well as recommendations about how much the individual should save based on their current income and life situation. We believe a critically important element of this offering is that we make advice available through a variety of channels. Many plan participants want to talk to a real person about their choices. Online tools and models have an important function in helping participants understand the performance of the investment options within their plan and the proper allocation of assets. But to be really effective, a more personal relationship is necessary. Our experience shows that when advice is offered online, 20% adopt advice. When advice is offered as an in-person phone session, the adoption rate goes up to 42%. And when a face-to-face session is offered, 54% of participants take advantage of the advice. Clearly, the personal contact is vitally important. The other element of our offering that we believe is critical to its effectiveness is that it is offered at no additional cost to the participant or the plan.

The advice offering focuses on what we believe to be the three central questions that employees have about how to save for retirement. First, how much should I save? Employees of all ages underestimate how much money they will need for retirement. Our advice helps employees determine how much they will need for retirement, then calculates and re-calculates how much they need to save in order to achieve that goal, taking into consideration their life situation, salary and other factors. Second, employees want to know where they should save, given the choices offered in their plan. Our advice offering helps employees properly allocate their assets among the investment options in their plan. And third, employees want to know how they are progressing – how much will they have to live on in retirement. Through GuidedChoice, employees are able to see how their current savings translates, in today's dollars, into per-month retirement income, much as annual Social Security statements do today.

The results have been extremely promising. In the first year, individuals using the services more than doubled their average savings rate to from 4.57 to 9.57 percent of eligible income – undoubtedly because the advice offering made them realize that they were not saving enough to have the kind of retirement lifestyle they would like. Nearly 85 percent of these individuals enrolled in managed accounts – again, at no additional cost – that provide ongoing account monitoring for proper asset allocation, as well as automatic rebalancing, ensuring that the participant's assets are properly allocated and are adjusted over time without the employee having to worry about it. Perhaps most importantly, participants appear to be taking advantage of this service relatively early in their careers. A third of those participants using the advice are 35 and under, and another 28 percent are between 36 and 45 years old. Forty-three percent have account balances of under $25,000. And 55 percent have salaries under $60,000. By establishing a pattern of saving early in their careers, these employees exponentially increase their chances of having the money to support the kind of retirement lifestyle they desire. But while we are particularly pleased that newer employees are signing up for the advice, we have found that employees across the board are taking advantage of the offering – regardless of how old they are, what their salary is, or how much they have saved. By reducing barriers to access, we have begun to democratize advice.

The reality is that many employees lack an understanding about their future financial needs. Many have never calculated how much they need to save for retirement, and when they do, they find they are woefully behind. Many employees are also uninformed about investments and the financial markets. They are intimidated by these areas and that leads to inaction. Advice and managed account services, as a standard part of every defined contribution plan can help break down these barriers, which can have nothing but a positive effect on savings.

We also believe there are important steps that can and must be taken in order to increase the use of advice in employer-sponsored plans. Roughly half of plans today offer some sort of advice or managed solution, but the half that does not is concerned about the consequences of bad advice or investment losses. We need to ensure that the fiduciary liability does not extend to the employer in cases where a completely independent third party is providing the advice or where the advice is free from conflicts. We also believe that ultimately advice and managed accounts should be standard in every plan. And we would recommend expanding the advice available through the employer to extend to all of an employee's financial assets, not just those within the retirement plan itself. If our goal is to make a more educated saving public, we need to explore ways to allow an individual who has become comfortable with the advice provided to him or her within a retirement plan to leverage that relationship into something that will be of benefit outside the plan.

We believe that no single development in the employer-sponsored plan world is more important to increasing savings than making quality advice available to all participants. It gives employees a confidence level to participate in the plan in the first place, to become more involved in understanding the choices within their plan, and to stay actively engaged in monitoring their savings. The confidence that comes from knowing that they have a support system in place to ask questions is absolutely critical to ensuring that employees take advantage of the opportunity available to them through their employer's retirement plan.

Increasing Availability of and Participation in Plans

The other critical pieces of a campaign toward making employer-sponsored plans even more successful are to make it easier for employees to participate and to increase the incentives for employers to offer a plan in the first place. Schwab supports automatic enrollment as the most important way to increase employee participation. Unfortunately, despite the increasing use of automatic enrollment among plan sponsors, many employers are reluctant to implement such a provision for fear that 1) they may incur liability in the event a participant relies only on the default savings rate established by the employer and fails to achieve their retirement goals; and 2) that by selecting a default investment option for participants automatically enrolled in the plan, they increase their fiduciary liability in a way not easily measured or controlled. Under current law, unless a participant makes "affirmative" elections with respect to the investment allocation of their contributions to a plan, the employer cannot avail itself of the protections provided under ERISA Section 404(c) (relieving the employer of some fiduciary liability associated with participant investment elections) and retains full fiduciary responsibility for the management of plan assets. This added responsibility (and liability) could also require employers to provide on-going monitoring of the participant's investments, and make adjustments as would be prudent from time to time. Few employer have the resources or desire to become so actively involved in participant accounts.

Employers should be permitted to deduct a minimum amount from a new employee's paycheck and invest those deferrals in the plan's default investment, with a "safe harbor" amount and default investment option that, if followed, will not create any additional fiduciary responsibility or monitoring for the employer. An opt-out should be allowed for employees who, for whatever reason, do not want to enroll. But the emphasis should be placed on making employees take action if they *do not* want to enroll, rather than forcing employees to negotiate the cumbersome rules that exist at most plans today in order to enroll. Many plans have waiting periods before an employee becomes eligible. Once the waiting period is over, notices are sent to the employee, but he or she must take the initiative to enroll – and we all know that procrastination, lack of understanding, fear of not knowing where to invest, and countless other excuses mean that millions of employees are missing out on the opportunity. Evidence has shown that automatic enrollment is often the nudge the employee needs to get involved, begin educating themselves, and create a savings strategy. Congress should also create a national standard around automatic enrollment, thus eliminating conflicts with some states that currently require written consent from the employee before that employee can be automatically enrolled.

In addition to automatic enrollment, employers should be allowed to increase automatically the amount of savings deducted from the employee's paycheck as his or her salary increases, with some certainty as to their fiduciary liability in doing so. Again, this change will help employees save more without having to be responsible for performing an annual calculation themselves of how much they should put into their retirement savings plan.

We recognize that the cost to the employer – both in matching dollars if a company provides a match and in administrative costs – will be significantly increased if automatic enrollment, a wider pool of default investment choices, and automatic savings increases are permitted. So a balance needs to be struck of offering employers relief and certainty if they are going to be willing to offer these enhancements.

One outcome we do not want to emerge from these recommendations is for fewer – not more – employers to offer plans to their employees. So in addition to considering things like providing fiduciary clarity around advice and automatic enrollment, the federal government also needs to provide incentives for employers to offer plans in the first place. Only about half of employers today sponsor a plan. Too many employers do not offer plans because starting one is too complicated or too expensive. We urge the Committee to explore ways to reduce the barriers to offering employees a retirement savings plan at all.

Finally, from the tax perspective, we support extending or making permanent the increased contribution limits for employer-sponsored plans that were implemented as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). Under that law, increases in contribution limits are being phased in, reaching $15,000 next year, with subsequent increases tied to inflation (though capped at no more than $500 per year). Even more importantly, "catch-up" contributions of up to an additional $5,000 (beginning in 2006) are permitted for individuals age 50 and over, to help them reach their retirement goals. Without intervening action by Congress, however, those limits will revert to their pre-2001 levels in 2011. While we do not believe it is critical for Congress to make these particular provisions permanent this year, we do believe that Congress should not wait until the last minute to extend these enhanced contribution limits. Uncertainty about how much an individual can contribute and concern that the limit may be lowered will have an extremely negative effect on savings.

Conclusion

Charles Schwab founded the company that bears his name more than three decades ago because he believed that everyone could become an investor. The key was education – demystifying the markets so that ordinary investors could understand their choices and make wise decisions. That is the philosophy we live by today, and that is particularly true within Schwab Corporate Services. Retirement plans are the primary way of entering the markets for millions of investors. But without education that explains options, minimizes risk, quells fears, and generally raises the comfort level of the plan participant, many individuals are going to be reluctant to participate or, if they do participate, they may end up with a portfolio that does not suit their particular needs. Advice is proving to be the answer, and we strongly encourage Congress to make advice easier for the plan administrator to provide, for the employer to offer and for the employee to access. Advice should not be another choice for employers and employees to consider; rather, it should be automatic. With increased certainty around the obligations of both the employer and the service provider, we can make that happen. Finally, encouraging automatic enrollment in employer-sponsored plans can be the mechanism for jump-starting a lifelong educational effort that will produce generations of wiser, more financially literate savers.

We look forward to working with members of the Senate Special Committee on Aging on this important issue, and we thank you for the opportunity to participate in this dialogue.

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Statement of

The Principal Financial Group ®

To

United States Senate
Special Aging Committee

On

The Role of Employer-Sponsored Retirement Plans in Increasing National Savings

Tuesday, April 12, 2005

The Principal Financial Group® (The Principal®) is a diversified family of financial service companies with total assets under management of $168.7 billion. More employers choose The Principal for their 401(k) plans than any other bank, mutual fund or insurance company in the United States. A member of the Fortune 500, The Principal serves 614,000 individual policyholders, 75,000 group employer clients, and 47,000 pension customers (employers). Princor Financial Services Corporation services approximately 890,000 mutual fund shareholder accounts and Delaware Charter Guarantee Trust Company, conducting business as Trustar® Retirement Services, serves as directed trustee to more than 200,000 retirement and savings accounts. In all, 15 million customers (businesses, individuals and their dependents) worldwide rely on the member companies of the Principal Financial Group for their financial services needs. Principal Financial Group Inc. is traded on the New York Stock Exchange under the ticker symbol PFG.

The Principal® appreciates the opportunity to provide comments regarding retirement savings. Today, there is a growing concern that many people will outlive their retirement savings due to inadequate personal savings, spending too much in the early years of retirement, poor investment performance, failure to plan for the effects of inflation, and living longer than expected. Since workers are not saving on their own for their retirement, employer-sponsored retirement plans must help provide the income security workers need at retirement. Basically, workers need qualified employer-sponsored retirement plans since:

- Social Security does not provide adequate retirement income.
- The age that full Social Security benefits are paid is increasing.
- On their own, workers do not adequately save for retirement.
- Individuals that are retiring today are expected to live longer than in the past which results in more years of retirement.

Redefining Retirement

Current Effectiveness of National Savings
Employer-sponsored plans are one of the most cost-effective methods for U.S. workers to save for retirement. However, small employers sponsor plans less frequently than large employers. According to the March 2004 U.S. Census Bureau Current Population Study[1], 76 percent of private-sector employers with over 1000 employees sponsor a plan, and 60 percent of full-time private sector employees participate in a plan. This compares to only 27 percent of small employers with less than 25 employees sponsoring a plan and only 21 percent of employees of small employers participating.

Personal savings as a percentage of disposable income remained high in the 1970's, topped out at 11.2 percent in 1982, then dropped sharply and remains at low levels today. The personal savings rate for 2004 hit an all-time low of 1.2 percent. [2]

Reasons Small Employers Do Not Sponsor a Retirement Plan
Small employers give many reasons for not sponsoring a retirement plan. One of the greatest challenges small business owners face is to agree to sponsor a plan when business revenue is low and uncertain. Small employers also report that they do not sponsor a plan for the following reasons:

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[1] U.S. Census Bureau, Current Population Study, March 2004
[2] U.S. Department of Commerce, Bureau of Economic Analysis

- Administration of a plan is too complex.
- Lack of interest from employees.
- Contributions are too expensive.
- Cost of plan sponsorship is too high.

Another obstacle to plan sponsorship is the lack of familiarity of different plan types. A large percentage of small business owners (73 percent) have never heard of or are not too familiar with a Simplified Employee Plan (SEP). Over half (52 percent) have never heard of or are not too familiar with the Savings Incentive Match Plan for Employees (SIMPLE) plan.[3] Congress created SIMPLE plans specifically for small employers.

Ways to Encourage Plan Sponsorship
The Principal believes more can and should be done to make retirement plans attractive for small employers. Ways must be found to make it easier and less costly for employers to provide plans for their employees and to give small employers both financial and practical incentives for establishing retirement plans. We offer the following suggestions to increase plan sponsorship:

Inform Employers
Employers need to be informed about the types of qualified plans available and the costs associated with each type of plan. Many employers are misinformed about the contributions required under a plan. 401(k) plans, in particular, can be designed to meet a small employer's need for flexibility in contribution amounts (e.g., a discretionary employer match or profit sharing contribution) and to allow employees to share in plan costs.

Permanent Tax Credits For Plan Start-Up Costs
Many employers feel the costs associated with running a retirement plan prohibits them from establishing one. This is especially true for small employers whose decision to sponsor a plan is impacted by the cost of the plan. As a result, a tax credit to help offset the cost of establishing a retirement plan is helpful to small employers. EGTRRA '01 provides for a temporary tax credit for small employers establishing a new plan. According to the EBRI Small Employers Survey, two of ten non-sponsors indicated that the EGTRRA '01 tax credit makes offering a retirement plan more attractive for their business. To encourage small employers to establish a retirement plan, this tax credit should become permanent.

Simplify Defined Benefit Plan Rules
We believe more should be done to encourage employers to establish and maintain defined benefit plans. We support creating a simplified defined benefit plan for small employers and to reduce existing administrative costs and hassles that make defined benefit plans unattractive to many employers. We offer the following additional suggestions:

- Create a simplified defined benefit plan that will encourage more plan sponsors to adopt defined benefit plans.
- Reduce the amount of Pension Benefit Guaranty Corporation defined benefit pension premiums to reduce the cost of maintaining a defined benefit plan.
- Create a new type of plan that combines defined benefit and 401(k) features. This would allow employers to offer two plans while paying the cost for one.
- Encourage creative and flexible hybrid plan designs such as cash balance plans.

[3] 2003 Small Employer Retirement Survey

Reduce Administrative Costs and Burdens
Administrative costs and burdens, which have a disproportionate impact on small employers, must be reduced. We suggest the following actions be taken:

- Simplify the annual reporting requirements.
- Simplify the general nondiscrimination and coverage testing rules.
- Extend the time period for making a corrective distribution of excess contributions.
- Reduce the excise tax for failure to make minimum required contributions timely.

Coverage Rates Today in Employer-Sponsored Retirement Plans
In an annual study, The Principal collects data and provides its plan sponsors a comprehensive report of changes in retirement savings. The study, *Beyond the Numbers 2004: Review of 401(k) Plan Trends & Analysis,* took an in-depth look at trends among nearly 26,000 401(k) plan sponsors and over 2 million 401(k) plan participants at The Principal. Here are some participant behavior findings:

- Overall, average deferral rates remained fairly flat with a slight increase from 6.5 percent in 2002 to 6.7 percent. Older employees (55-64 age group) who see their retirement on the horizon are saving more. Deferral rates average nearly 7 percent for this age group.
- The lowest participation and savings rates are among younger workers. Forty-two percent of eligible employees under age 35 do not participate in their 401(k) plan, thereby missing out on the powerful effect of compounding over time. When they do participate, it is often at a low deferral rate.
- Employees with income in the $30,000 - $50,000 range continue to have the highest participation and deferral rates.
- The overall average account balance for 401(k) plans with a defined benefit plan was 13 percent higher than stand-alone 401(k) plans. The average account balance in a 401(k) plan with a defined benefit plan was $38,899. The average account balance in a stand-alone 401(k) plan is $34,344.
- The highest deferral rates are seen in the mining, finance, insurance, real estate, and service industries which ranged between 7.2 – 7.4 percent. The lowest deferral rates are seen in the retail trade and agriculture, forestry, and fishing industries, which averaged 6.3 percent.

Ways to Increase Savings in Employer-Sponsored Retirement Plans
Reasons that employees give for not savings for retirement in their employer-sponsored plan include:

- They think they can work past normal retirement.
- They underestimate how much they will need to live in retirement.
- They are unwilling to cut back on current spending.
- They procrastinate saving until it is too late to save enough.

The Principal believes more can and should be done to encourage employees to participate in a retirement plan. Steps must be taken to educate employees about the need for retirement savings, offer incentives to participate in an employer-sponsored plan, and make participation easier to do. We offer the following suggestions to increase plan participation:

Match Elective Deferrals
One incentive to encourage employees to save is for the employer to match elective deferral contributions in a 401(k) plan. The Retirement Confidence Survey found that 72% of workers are more likely to contribute to a 401(k) plan if the employer provides a generous match of up to 5% of salary.[4] We support incentives for an employer to match that includes exempting the plan from nondiscrimination and top heavy testing.

Provide Easy/Automatic Investment Options
During the past ten years there has been an explosive growth of investment options available to plan participants that has created a critical need for investment education and advice. In addition, the market downturn in the past few years caused participants to feel uncomfortable with their knowledge in making investment decisions.

The Retirement Confidence Survey reports that 65 percent of workers are more likely to contribute to a 401(k) plan if their salary deferrals could be invested in a lifecycle fund option that is designed based on age and income level and automatically becomes more conservative as retirement date nears. We encourage giving employees the education and advice they need and an easier approach to choosing appropriate investment options.

Employers should be given fiduciary protection in choosing a default investment as long as certain specified "safe harbors" are met. This includes giving participants acceptable notice and disclosure, and allowing participants to select an alternative investment option.

Provide Automatic Enrollment
The plan sponsor community is promoting a legislative proposal to encourage the creation of an "Automatic 401(k)." The Principal supports this concept. Many employees fail to sign up to participate in their employer's 401(k) plan out of inertia rather than a specific desire not to participate. Making the process automatic not only simplifies the process for employers but also helps further the savings for many Americans. By further increasing the savings percentage automatically on a yearly basis helps move people toward having a more secure retirement and avoids the natural instinct to procrastinate. The increase in participant contributions will be less "painful" for employees who might otherwise think they cannot afford to increase deferrals if the increase would take affect on an annual basis coinciding with other changes such as merit increases.

The "Automatic 401(k)" would include safe harbors for nondiscrimination testing. This is an attractive addition to the proposal that would simplify plan administration thus encourage employer sponsorship.

Effectiveness of Tax Incentives to Increase Savings
The Principal believes tax incentives propel personal retirement savings. Looking in the past, the combination of tax-deferred elective salary contributions for participants and contribution tax deductions for employers fueled the success of 401(k) plans. Here are further ideas for tax incentives:

Lower the Age for Catch-up Elective Deferrals
Workers experience life stages at varying ages; for example, some women re-enter the workforce on a full-time basis at age 40 when their children are in high school or college.

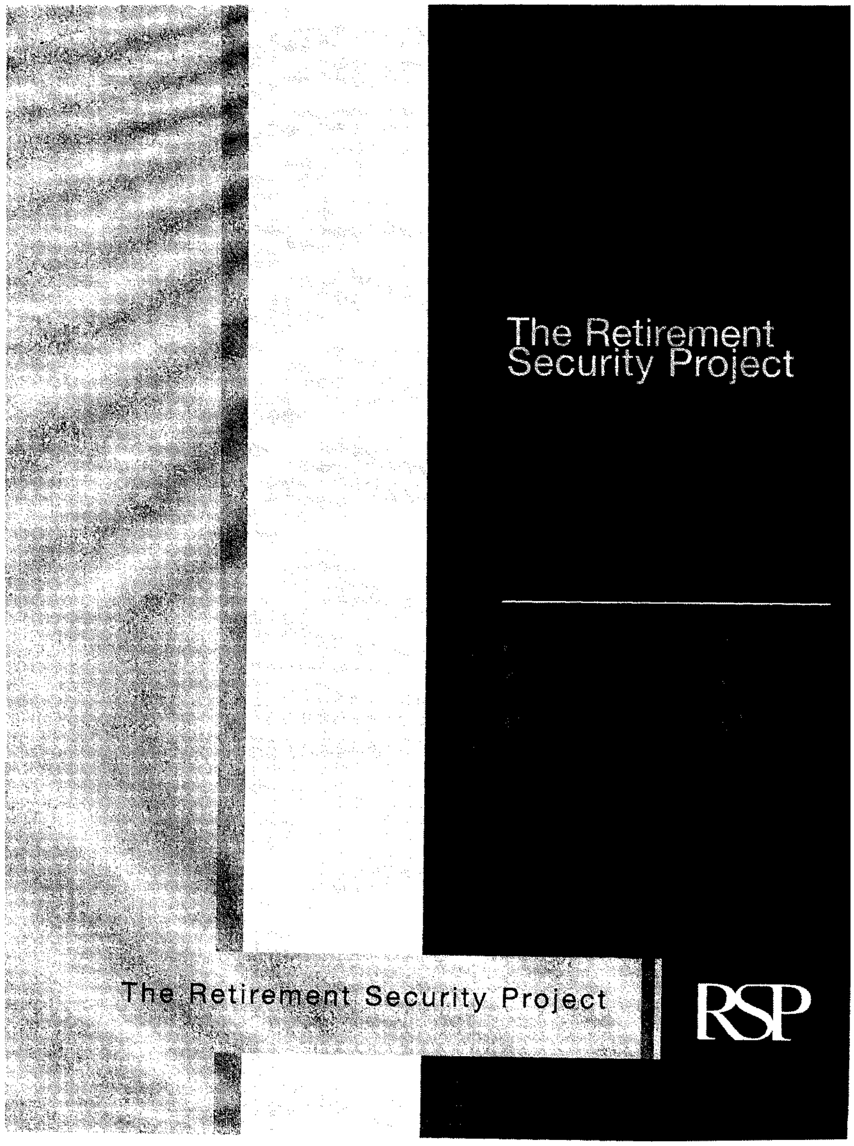
[4] EBRI 2005 Retirement Confidence Survey

Should these women be in a position make to catch-up elective deferral contributions, they should be allowed to put aside additional savings beginning at age 40 achieving more years of investment earnings, instead of waiting until age 50.

Expanded Saver's Credits with Enhanced Match for Lower-Income Earners
Give an enhanced tax deduction for employers that provide a tiered matching formula for lower-income workers of 100 percent match for the first 3 percent of deferrals and 50 percent match for the next 3 percent of deferrals. The tiered match along with an expanded, refundable saver's credit and auto enrollment would provide lower income workers more than a dollar for dollar incentive to begin and remain saving in an employer sponsored plan.

Niche Savings Incentives
Factors such as salary, family income, martial status, number of dependents, and number of hours worked all play a part in the decision of how much a worker can set aside each paycheck for retirement. Because of the wide variances effecting workers, no single tax incentive is meaningful to all workers. Roth 401(k) contributions, effective in 2006, and will be attractive tax strategy to some workers who seek 401(k) plan retirement distributions that are a mixture of tax deferred and after-tax status. New tax incentives that may appeal to some workers, niche incentives, are needed to encourage new, additional savings.

In Summary
We believe that the employer-sponsored retirement plan is an effective way to help workers save for retirement. Steps must be taken to encourage small employers to sponsor a plan by better informing them about the types of plans that are available, providing incentives to establish a plan, such as a tax credit to help pay start-up costs, and make plan administration less costly and time consuming. In addition, employees must be encouraged to participate by giving employers an incentive to do so and offer easier solutions to investment choices they must make.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The Automatic 401(k):

A Simple Way to Strengthen Retirement Savings

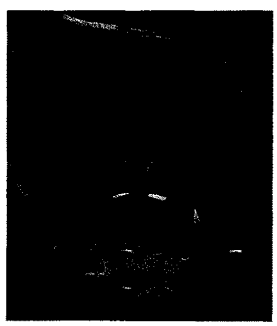
William G. Gale, J. Mark Iwry, and Peter R. Orszag

Over the past quarter century, private pension plans in the United States have trended toward a do-it-yourself approach, in which covered workers bear more investment risk and make more of their own decisions about their retirement savings. Some workers have thrived under this more individualized approach, amassing sizable balances in 401(k)s and similar plans, which will assure them a comfortable and relatively secure retirement income.

For others, however, the 401(k) revolution has fallen short of its potential. Work, family, and other more immediate demands often distract workers from the need to save and invest for the future. Those who do take the time to consider their choices find the decisions quite complex: individual financial planning is seldom a simple task. For many workers, the result is poor decision making at each stage of the retirement savings process, putting both the level and the security of their retirement income at risk. Even worse, in the face of such difficult choices, many people simply procrastinate and thereby avoid dealing with the issues altogether, which dramatically raises the likelihood that they will not save enough for retirement.

A disarmingly simple concept—what we call the "automatic 401(k)"—has the potential to cut through this Gordian knot and improve retirement security for millions of workers through a set of common sense reforms. In a nutshell, the automatic 401(k) consists of changing the default option at each phase of the 401(k) savings cycle to make sound saving and investment decisions the norm, even when the worker never gets around to making a choice in the first place. Given the current structure of most 401(k) plans, workers do not participate unless they actively choose to. In contrast, under an automatic 401(k) they *would* participate unless they actively choose *not* to—and similarly for each major decision thereafter. Contributions would be made, increased gradually over time, invested prudently, and preserved for retirement, all without putting the onus on workers to take the initiative for any of these steps. At the same time, however, workers would remain free to override the default options—to choose whether or not to save, and to control how their savings are invested—but those who fail to exercise the initiative would not be left behind.

The steps involved in building an automatic 401(k) are not complicated, and the benefits could be substantial; indeed, a growing body of empirical evidence suggests that the automatic 401(k) may be the most promising approach to bolstering retirement security for millions of American families. A number of economists have undertaken important research and contributed practical suggestions concerning the actual and potential uses of automatic enrollment and related default arrangements in 401(k) plans.[1] Drawing on their contributions, this policy brief describes the motivation for, the features of, and the potential benefits of the automatic 401(k).



In most 401(k) plans, workers do not participate unless they actively choose to. Under an automatic 401(k), they *would* participate unless they actively choose *not* to.

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The Historical Context

In the early 1980s, most Americans who had private retirement plan coverage obtained it chiefly from employer-sponsored, defined benefit pension plans, and to a lesser extent from defined contribution plans such as profit-sharing and money purchase plans. Since then, pension coverage has shifted away from these programs and toward new types of defined contribution plans, especially 401(k)s. In 1981 nearly 60 percent of workers with pension coverage had only a defined benefit plan, while just under 20 percent had only a 401(k) or other defined contribution plan. By 2001, however, the share having a defined benefit plan as their only plan had dropped to slightly over 10 percent, while the share having only a 401(k) or other defined contribution plan had risen to nearly 60 percent.

Conventional analyses tend to describe this solely as a trend away from defined benefit plans and toward defined contribution plans. Such a characterization tends to focus attention on the increased portability of pensions from one job to another and the shifting of investment risk from employer to employee. But perhaps an even more fundamental development is the extent to which the accumulation of retirement benefits under the plan has come to depend on active and informed worker self-management and initiative. Traditional defined benefit and profit-sharing plans require the covered workers to make almost no important financial choices for themselves before retirement.[2] The firm enrolls all eligible workers within a defined classification, makes contributions on their behalf, and decides how to invest those contributions (or retains professional investment managers to do so). A worker's only real choices are when and in what form to collect benefits. In 401(k)-type plans, in contrast, the burden of all these decisions rests with the employee.

The trend away from the traditional, employer-managed plans and toward savings arrangements directed and managed largely by the employees themselves, such as the 401(k), is in many ways a good thing. Workers enjoy more freedom of choice and more control over their own retirement planning. In some ways, however, this increasingly 401(k)-dominated system—both the process it has evolved into and the results it is producing—leaves much room for improvement.

Two Problems with Today's System

The most vivid manifestation of the shortcomings of today's private arrangements is the simple fact that many families approaching retirement age have meager retirement savings, if any.[3] In 2001 half of all households headed by adults aged 55 to 59 had $10,000 or less in an employer-based 401(k)-type plan or tax-preferred savings plan account. If the 36 percent of households who had no 401(k) or Individual Retirement Account (IRA) are excluded, the median balance for this age group was still only $50,000.

These households clearly have the option to save: most workers have accounts available to them in which they could save money on a tax-preferred basis for retirement, and any household lacking such an option could always contribute to an IRA. The problems lie elsewhere and are essentially twofold.

The first problem is that the tax incentives intended to encourage participation in employer-based retirement plans and IRAs consist primarily of deductions and exclusions from federal income tax. The immediate value of any tax deduction or exclusion depends directly on one's income tax bracket. For example, a taxpaying couple with $6,000 in deductible IRA contributions saves $1,500 in tax if they are in the 25 percent marginal tax bracket, but only $600 if they are in the 10 percent bracket.[4] The income tax incentive approach thus tends to encourage saving least for those who need to increase their saving most, and most for those who need to increase their saving least. In contrast, the Saver's Credit, enacted in 2001, provides a progressive government match for retirement savings by middle-income households. Other Retirement Security Project analyses examine ways to address the "upside-down" nature of existing tax incentives for saving, including through strengthening the Saver's Credit.[5]

The second problem, and the one addressed in this policy brief, is the set of complications involved in investing in a 401(k). Most 401(k)s place substantial burdens on workers to understand their financial choices and assume a certain degree of confidence in making such choices. Many workers shy away from these burdensome decisions and simply do not choose. Those who do choose often make poor choices.

The Complications of Participating in a 401(k)

A 401(k)-type plan typically leaves it up to the employee to choose whether to participate, how much to contribute, which of the investment vehicles offered by the employer to invest in, and when to pull the funds out of the plan and in what form (in a lump sum or a series of payments). Workers are thus confronted with a series of financial decisions, each of which involves risk and a certain degree of financial expertise.
To enroll in a 401(k), an eligible employee usually must complete and sign an enrollment form, designate a level of contribution (typically a percentage of pay to be deducted from the employee's paycheck), and specify how those contributions will be allocated among an array of investment options. Often the employee must choose from among 20 or more different investment funds. An employee who is uncomfortable making all of these decisions may well end up without any plan, because the default arrangement—that which applies when the employee fails to complete, sign, and turn in the form—is nonparticipation.

For those employees who do choose to participate, payroll deductions and associated contributions are made automatically each pay period, typically continuing year after year, unless the employee elects to make a change. Although the contributions continue over time, the traditional 401(k) arrangement does nothing to encourage participants to increase their contribution rates over time, or to diversify or rebalance their portfolios as their account balances grow. In other words, employees in a 401(k) not only must take the initiative to participate, they must further take the initiative to invest wisely and to increase their contribution rates over time.

Heavy reliance on self-direction in 401(k) plans made more sense when 401(k) plans were first developed in the early 1980s. At that time, they were mainly supplements to employer-funded defined benefit pension and profit-sharing plans, rather than the worker's primary retirement plan. Since participants were presumed to have their basic needs for secure

retirement income met by an employer-funded plan and by Social Security, they were given substantial discretion over their 401(k) choices. Today, despite their increasingly central role in retirement planning, 401(k)s still operate under essentially the same rules and procedures, based on those now-outmoded presumptions. Yet the risks of workers making poor investment choices loom much larger now that 401(k)s have become the primary retirement savings vehicle.

The Automatic 401(k): Key Features

The core concept behind the automatic 401(k) is quite simple: design a 401(k) to recognize the power of inertia in human behavior and enlist it to promote rather than hinder saving. Under an automatic 401(k), each of the key events in the process would be programmed to make contributing and investing easier and more effective.

- *Automatic enrollment:* Employees who fail to sign up for the plan—whether because of simple inertia or procrastination, or perhaps because they are not sufficiently well organized or are daunted by the choices confronting them—would become participants automatically.
- *Automatic escalation:* Employee contributions would automatically increase in a prescribed manner over time, raising the contribution rate as a share of earnings.
- *Automatic investment:* Funds would be automatically invested in balanced, prudently diversified, and low-cost vehicles, whether broad index funds or professionally managed funds, unless the employee makes other choices. Such a strategy would improve asset allocation and investment choices while protecting employers from potential fiduciary liabilities associated with these default choices.

Would automatic 401(k)s boost net worth?

Automatic enrollment has been shown to increase participation rates in 401(k) plans, and automatic escalation has been shown to raise contribution rates and accumulations within 401(k)s over time. A promising topic for future research is the extent to which the added contributions due to these automatic features represent net additions to households' overall net worth and national savings. It could be that participants respond to automatic enrollment by decreasing their savings or increasing their borrowing outside of the plan.

It is plausible, however, that the net effects on both household wealth and national savings would be positive. Workers who become contributors through automatic enrollment tend to be younger and have lower incomes and less education than other participants. Evidence from the pension and 401(k) literature suggests that a significant portion of contributions by households with these characteristics is a net addition to household wealth and national savings.

- *Automatic rollover:* When an employee switches jobs, the funds in his or her account would be automatically rolled over into an IRA, 401(k) or other plan offered by the new employer. At present, many employees receive their accumulated balances as a cash payment upon leaving an employer, and many of them spend part or all of it. Automatic rollovers would reduce such leakage from the tax-preferred retirement savings system. At this stage, too, the employee would retain the right to override the default option and place the funds elsewhere or take the cash payment.

In each case – automatic enrollment, escalation, investment, and rollover – workers can always choose to override the defaults and opt out of the automatic design.[6]

The integrated strategy of using default arrangements to promote saving without sacrificing individual choice was first formulated by the U.S. Treasury in the late 1990s. The Treasury and the Internal Revenue Service (IRS) approved automatic enrollment for 401(k) plans in 1998 and first permitted automatic rollover in 2000. In 2001 Congress made automatic rollover mandatory for small lump-sum distributions, to take effect in March 2005. Both automatic enrollment and automatic rollover were designed also to lay the groundwork for automatic investment: both generally, by establishing the principle that pro-saving defaults should apply to major retirement decisions, and specifically, by requiring plans to prescribe default investments to be used in conjunction with automatic enrollment and automatic rollover.

It is worth stressing that none of these automatic or default arrangements are coercive. Workers would remain free to opt out at any point. More fundamentally, automatic 401(k)s do not dictate choices any more than does the current set of default options, which exclude workers from the plan unless they opt to participate. Instead, automatic 401(k)s merely point workers in a pro-saving direction when they decline to make explicit choices of their own.[7] For example, the Treasury rulings authorizing automatic enrollment include provisions to ensure that employees retain control of enrollment and investment decisions. The plan must provide employees advance notice and an adequate opportunity to make their own, alternative choices before proceeding with the default arrangement. Similarly, under automatic rollover, employees have a variety of choices and must be given advance notice of those choices before the automatic arrangement takes effect.

Automatic Enrollment

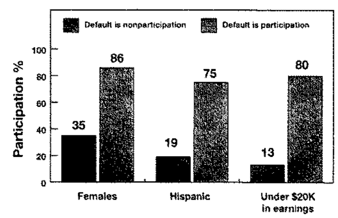
Automatic enrollment has been shown to be remarkably effective in raising participation rates among eligible workers. Studies indicate that it boosts the rate of plan participation from a national average of about 75 percent of eligible employees to between 85 and 95 percent.[8] Particularly dramatic increases are seen among those subgroups of workers with the lowest participation rates. For example, one study found that, among employees with between 3 and 15 months, automatic enrollment increased participation from 13 percent

Automatic enrollment has been shown to be remarkably effective in raising participation rates among eligible workers.

to 80 percent for workers with annual earnings of less than $20,000, and from 19 percent to 75 percent for Hispanics.[9]

Automatic enrollment can boost the rate of 401(k) plan participation to between 85 and 95 percent, with particularly dramatic increases among workers with the lowest participation rates.

Impact of 401(k) Auto Enrollment



Actual results from employees with between 3 and 15 months of tenure. Study by Brigitte Madrian, University of Pennsylvania's Wharton School, and Dennis Shea, UnitedHealth Group.

Interesting administrative variants exist that can accomplish much of what automatic enrollment does. One alternative would require that all employees make an explicit election to participate or not, rather than enroll them automatically if they make no election. In at least some cases this approach has produced participation rates in the same high range as for automatic enrollment.[10] In addition, firms could require that employees who opt out sign a statement acknowledging that they have read the plan's disclosures regarding the advantages of contributing.

Despite its demonstrated effectiveness in boosting participation, only a small minority of 401(k) plans today have automatic enrollment. According to a recent survey, 8 percent of 401(k) plans (and 24 percent of plans with at least 5,000 participants) have switched from the traditional "opt-in" to an "opt-out" arrangement.[11] As already noted, automatic enrollment is a recent development, and therefore it may yet become more widely adopted over time, even with no further policy changes. But policymakers could accelerate its adoption through several measures.[12] Some of these policy measures would be appropriate only if automatic enrollment were adopted in conjunction with other features of the automatic 401(k), especially automatic escalation, which are discussed further on page 8.

First, the law governing automatic enrollment could be better clarified. In some states, some employers see their state labor laws as potentially restricting their ability to adopt automatic enrollment. Although many experts believe that federal pension law preempts such state laws as they relate to 401(k) plans, additional federal legislation to explicitly confirm this would be helpful. Any such explicit preemption should be undertaken only to the extent necessary to protect employers' ability to adopt automatic enrollment.

Second, some plan administrators have expressed the concern that some new, automatically enrolled participants might demand a refund of their contributions, claiming that they never read or did not understand the automatic enrollment notice. This could prove costly, because restrictions on 401(k) withdrawals typically require demonstration of financial hardship, and even then the withdrawals are normally subject to a 10 percent early withdrawal tax. One solution would be to pass legislation permitting plans to "unwind" an employee's automatic enrollment without paying the early withdrawal tax if the account balance is very small and has been accumulating for a short period of time.

Third, Congress could give automatic enrollment plan sponsors a measure of protection from fiduciary liability if the default investment they have prescribed is an appropriate one, such as a "balanced" mutual fund that invests in both diversified equities and bonds or other stable-value instruments. The exemption from fiduciary responsibility would not be total: plan fiduciaries would retain appropriate responsibility for avoiding conflicts of interest, excessive fees, lack of diversification, and imprudent investment choices. However, it would provide meaningful protection under ERISA (the Employee Retirement Income Security Act of 1974, the principal legislation governing employer pension plans), thus encouraging more employers to consider automatic enrollment.

Fourth, Congress could establish the federal government as a standard-setter in this arena by incorporating automatic enrollment into the Thrift Savings Plan, the defined contribution retirement savings plan covering federal employees. The Thrift Savings Plan already has a high participation rate, but if automatic enrollment increased participation by even a few percentage points, that would draw in tens of thousands of eligible employees who are not currently contributing. Moreover, the Thrift Savings Plan's adoption of automatic enrollment, along with other elements of the automatic 401(k), would serve as an example and model for other employers.

Finally, broader adoption of automatic enrollment and the other key pieces of the automatic 401(k) could be encouraged by reforming an exception to the rules governing nondiscrimination in 401(k) plans (as described below). Many firms are attracted to automatic enrollment because they care for their employees and want them to have a secure retirement, but others may be motivated more by the associated financial incentives, which stem in large part from the 401(k) nondiscrimination standards. These standards were designed to condition the amount of tax-favored contributions permitted to executives and other higher-paid employees on the level of contributions made by other employees. They thus gave plan sponsors an incentive to increase participation among their less highly paid employees. Automatic enrollment is one way for them to do this. In recent years, however, employers have had the option to satisfy the nondiscrimination standards merely by adopting a 401(k) "matching safe harbor" design. The matching safe harbor provision exempts an employer from the nondiscrimination standards that would otherwise apply as long as the firm merely *offers* a specified employer matching contribution. It does not matter whether employees actually take up the match offer—all that matters is that the offer was made. Indeed, the more employees contribute, the greater the employer's cost to match those contributions, without any compensating improvement in nondiscrimination results. By thus attenuating employers' interest in widespread employee participation in 401(k)s, the matching safe harbor provision presents an important obstacle to wider adoption of automatic enrollment.

To restore the attractiveness of automatic enrollment to employers, policymakers could change the rules to allow the matching safe harbor only for plans that feature automatic enrollment and the other key parts of the automatic 401(k) (especially the automatic escalation features discussed on page 8). Plan sponsors currently using the matching safe harbor could be given a transition period to meet the new requirements.

Automatic Escalation

One potential problem with automatic enrollment, highlighted by recent research, is that it can induce some employees to passively maintain the default contribution rate over time, when they might otherwise have elected to contribute at a higher rate.[13] This adverse effect can be mitigated through automatic escalation, whereby contributions rise gradually and automatically over time (for example, from 4 percent of the worker's pay in the first year to 5 percent in the second, 6 percent in the third, and so on). For example, in the "Save More Tomorrow" program proposed by Richard Thaler and Shlomo Benartzi, workers would agree (or not) at the outset that future pay increases will generate additional contributions.[14] In one trial, "Save More Tomorrow" was shown to lead to a substantial increase in contribution rates over time for those who participated, relative to other 401(k) participants at the same company. Alternatively, workers could agree to future contribution increases even in the absence of pay raises. Automatic escalation plans have been explicitly approved by the IRS in a general information letter obtained by one of the authors.[15]

Automatic Investment

A third key feature of the automatic 401(k) is automatic investment. In the accumulation phase of 401(k) retirement savings, too many employees find themselves confronted by a confusing array of investment options and lack the expertise, time, or interest to become expert investors. As a result, many 401(k)-type accounts fail basic standards of diversification and sound asset allocation: millions of workers are overconcentrated in their employer's stock or overinvested in safe but low-yielding money market funds.

Policies that encourage employers to provide sound default investments should increase retirement savings by improving investment performance. A key step to improving asset allocation choices would be to grant employers relief from selected fiduciary liabilities if they offer employees alternatives to mandatory self-direction, through either standardized investments, such as low-cost diversified balanced funds, or professionally managed accounts. Such a strategy would improve asset allocation and investment choices in 401(k) plans while protecting employers and preserving employees' rights to self-direct their accounts if they so choose.

Asset allocation choices could be improved by granting employers relief from selected fiduciary liabilities if they offer alternatives to mandatory self-direction, through either standardized investments or professionally managed accounts.

Two changes in legislation would greatly encourage automatic investment. First, Congress could designate certain standardized types of investments, the inclusion of which in a 401(k) would assure the employer a measure of fiduciary safe harbor treatment. That is, the employer would be immune from certain challenges for imprudence or lack of diversification to which they might otherwise be subject under ERISA. The definition of qualifying investments would remain broad: in addition to certain recognized stable-value investments, they would include balanced, prudently diversified, low-cost funds with a range of permissible allocations between equities and bonds. Plan sponsors would not be required to offer such investments, but they would be permitted to impose standard investments on all participants who make no other choice, or to include standard investments among participants' investment options.

Employers would have an incentive to use standard investments to the extent that doing so would provide fiduciary safe harbor protection. Indeed, the market might come to view investments that receive such favorable treatment as, in effect, enjoying a presumption of prudence. Use of presumptively prudent balanced or life-cycle funds as the default investment, in lieu of money market or stable-value funds or employer stock, seems likely, in turn, to improve investment returns for participants.

Second, Congress could make it clear that plan sponsors seeking protection from fiduciary liability may designate an independent professional investment manager to invest participants' accounts. This would free participants from having to manage their own accounts, although they could retain the option to do so. The plan sponsor and trustee would be exempt from fiduciary responsibility for investments appropriately delegated to an independent investment manager, except for the continuing responsibility to prudently select and monitor the manager (for example, to ensure reasonable fees). Such guidance from policymakers would likely accelerate the expansion of professional account management services, already an emerging trend. Like standard investments, professionally managed accounts would tend to ensure reasonable asset allocation and adequate diversification (including reduced exposure to employer stock), two key factors in raising expected returns and reducing risks.

Automatic Rollover

A similar automatic or default-based approach has already been applied to plan payouts before retirement, to limit leakage of assets from the retirement system. Currently, most people who receive distributions from 401(k) and similar plans take one-time cash payments. In general, the smaller this lump-sum distribution, the less likely it is to be saved by being transferred ("rolled over") to another employer plan or to an IRA. In fact, data suggest that, as of 1996, the median lump-sum distribution was $5,000, and a sizable majority of defined contribution plan participants who receive a lump-sum distribution of $5,000 or less do not roll it over to a qualified plan or IRA.[16]

For years, account balances of up to $5,000 could be involuntarily "cashed out," that is, paid to departing employees without their consent, and these payments were the least likely to be preserved for retirement. In 2000, however, a Treasury-IRS ruling permitted retirement plan sponsors to transfer such

Most defined contribution plan participants who receive a lump-sum distribution of $5,000 or less fail to roll it over to a qualified plan or IRA. Automatic rollover would ensure that more of those funds are saved.

amounts to an IRA established for a departing employee who did not affirmatively elect any other disposition of the funds. A year later Congress mandated such automatic rollover for distributions between $1,000 and $5,000. Under this legislation, scheduled to take effect in March 2005, plan sponsors may no longer force cash-out distributions of more than $1,000 on departing employees. Instead they are required to follow the employee's instructions either to transfer the funds to another plan or an IRA, pay the funds directly to the employee, or keep the funds in the plan if the plan permits that option. The individual thus has the choice to preserve or consume the retirement savings, but, if the individual makes no other choice, the default is preservation—either in the employer's plan, if the employer so chooses, or in an IRA that the employer opens for the employee. The employee must also be notified that, if the payout is automatically rolled over to an IRA, he or she may then roll it over to another IRA of his or her choice.

Automatic rollover was designed to have a potentially valuable byproduct, namely, the broader utilization of IRAs. Currently, fewer than 10 percent of those eligible to open and contribute to an IRA on a tax-preferred basis actually do so. Like enrolling in a 401(k), opening an IRA requires individuals to overcome inertia and to navigate their way through a number of decisions (in this case, choosing among a vast number of financial institutions and investments). Automatic rollover instead calls upon the employer to take the initiative to set up an IRA and choose investments on the employee's behalf, again unless the employee chooses to do so. The intended result is not only to preserve the assets within the tax-favored retirement plan universe, but also to create an expanding infrastructure of portable, low-cost individual accounts for the millions of workers who have no IRAs but who are covered at some point by an employer-sponsored retirement plan. Automatic rollover thus has the potential to help achieve a far broader expansion of retirement plan coverage for middle- and lower-income households. Indeed, this broader agenda is explicitly reflected in the automatic rollover legislation, which directs the Treasury and Labor Departments to consider providing special relief for the use of low-cost IRAs.

Eventually, leakage might be further limited by expanding automatic rollover to a wider array of distributions. However, for various reasons, any such expansion would need to be examined carefully. For one thing, in most cases, benefits in excess of $5,000 currently remain in the employer plan as the default arrangement that applies if the employee makes no explicit election regarding disposition of the funds.

Other Potential Components of the Automatic 401(k)

Alternative default options could also be considered for other aspects of retirement savings, including the form in which funds are paid out upon retirement. Current law reflects some preference for encouraging payouts to take the form of a lifetime annuity, which guarantees periodic payments for life (as opposed to a single cash payment, for example). Lifetime annuities are a sensible way to reduce the risk of retirees outliving their assets, yet few people purchase them. In defined benefit and money purchase pension plans, a lifetime annuity is generally the default mode of distribution. In contrast, 401(k) and most other defined contribution plans have been able for the most part to exempt themselves from such default requirements. Proposals to extend to 401(k) default arrangements (including spousal protection) similar to those of defined benefit and money purchase plans have been advanced and have generated lively debate.

Conclusion

A growing body of evidence suggests that the judicious use of default arrangements—arrangements that apply when employees do not make an explicit choice on their own—holds substantial promise for expanding retirement savings. The effects appear to be particularly promising for middle- and lower-income households, who have the greatest need to increase their savings. Retooling America's voluntary, tax-subsidized 401(k) plans to make sound saving and investment decisions more automatic, while protecting freedom of choice for those participating, would require only a relatively modest set of policy changes—and the steps taken thus far are already producing good results. Expanding these efforts will make it easier for millions of American workers to save, thereby promising greater retirement security for millions of American families.

About The Retirement Security Project

The Retirement Security Project is dedicated to promoting common sense solutions to improve the retirement income prospects of millions of American workers. The goal of The Retirement Security Project is to work on a nonpartisan basis to make it easier and increase incentives for middle- and lower-income Americans to save for a financially secure retirement.

The Retirement Security Project is supported by The Pew Charitable Trusts in partnership with Georgetown University's Public Policy Institute and the Brookings Institution.

Footnotes

1 Particularly notable contributions have been made by Brigitte Madrian, Dennis Shea, James Choi, David Laibson, and Andrew Metrick; by Richard Thaler and Shlomo Benartzi; and by Alicia Munnell and Annika Sundén. See the citations of their work elsewhere in this policy brief.

2 In this sense, traditional private pensions may be characterized less by their defined benefit structure—in fact, many were defined contribution profit-sharing and money purchase plans—than by the fact that employers took the initiative to fund and manage the plans, bearing most of the risk and making most of the decisions for their employees. For a discussion of these developments, including the shift from defined benefit to defined contribution plans, see J. Mark Iwry, "Defined Benefit Pension Plans," Testimony before the House Committee on Education and the Workforce, Subcommittee on Employer-Employee Relations, June 4, 2003.

3 For a broader discussion of these issues, see William G. Gale and Peter R. Orszag, "Private Pensions: Issues and Options," in *Agenda for the Nation*, edited by Henry J. Aaron, James M. Lindsay, and Pietro S. Nivola (Brookings, 2003), pp. 183-216; Peter R. Orszag, "Progressivity and Saving: Fixing the Nation's Upside-Down Incentives for Saving," Testimony before the House Committee on Education and the Workforce, February 25, 2004; and J. Mark Iwry, "Defined Benefit Pension Plans," Testimony before the House Committee on Education and the Workforce, Subcommittee on Employer-Employee Relations, June 4, 2003. These and other related publications are available on The Retirement Security Project website (www.retirementsecurityproject.org).

4 Some of this difference may be recouped when the contributions are withdrawn and taxed, if families who are in lower tax brackets during their working years are also in lower tax brackets during their retirement.

5 William G. Gale, J. Mark Iwry, and Peter R. Orszag, "The Saver's Credit" (The Retirement Security Project, March 2005; available at www.retirementsecurityproject.org).

6 See Alicia Munnell and Annika Sundén, *Coming Up Short: The Challenge of 401(k) Plans* (Brookings, 2004).

7 In other words, automatic 401(k)s are an example of what Cass Sunstein and Richard Thaler have called "libertarian paternalism." See Cass R. Sunstein and Richard H. Thaler, "Libertarian Paternalism is Not an Oxymoron," *University of Chicago Law Review* 70, no. 4 (2003): 1159-1202; and Richard H. Thaler and Cass R. Sunstein, "Libertarian Paternalism," *American Economic Review (Papers and Proceedings)* 93, no. 2 (2003): 175-79.

8 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 (MIT Press, 2002), pp. 67-113.

9 Madrian and Shea, "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior," table 5.

10 James Choi, David Laibson, Brigitte Madrian and Andrew Metrick, "Active Decisions: A Natural Experiment in Savings," Working Paper, Harvard University, August 2003.

11 Profit Sharing/401(k) Council of America, *47th Annual Survey of Profit Sharing and 401(k) Plans* (2004).

12 Although some have raised the question of whether automatic enrollment should be a *required* feature of 401(k) and similar types of plans, the pros and cons of such a proposal are beyond the scope of this brief.

13 James Choi, David Laibson, Brigitte Madrian and Andrew Metrick, "For Better or For Worse: Default Effects and 401(k) Savings Behavior," in *Perspectives in the Economics of Aging*, edited by D. Wise (University of Chicago Press, 2003), pp. 81-121.

14 Richard Thaler and Shlomo Benartzi, "Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving," *Journal of Political Economy* 112, no. 1, pt. 2 (2004), S164-S187.

15 General information letter from Internal Revenue Service to J. Mark Iwry, March 17, 2004.

16 J. Mark Iwry and Jack VanDerhei, "Lump Sum Distributions," Testimony before the House Committee on Education and the Workforce, Subcommittee on Employer-Employee Relations, July 1, 2003.

William G. Gale is Deputy Director of the Economic Studies Program at the Brookings Institution, the Arjay and Frances Fearing Miller Chair in Federal Economic Policy at Brookings, and Co-Director of the Urban-Brookings Tax Policy Center.

J. Mark Iwry is Senior Adviser to The Retirement Security Project, a Nonresident Senior Fellow at Brookings, and the former Benefits Tax Counsel at the U.S. Treasury Department, where he played a lead role in developing the Saver's Credit and automatic rollover and in approving and advancing automatic enrollment.

Peter R. Orszag is Director of The Retirement Security Project, the Joseph A. Pechman Senior Fellow in Tax and Fiscal Policy at the Brookings Institution, and Co-Director of the Urban-Brookings Tax Policy Center.

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Mission Statement

The Retirement Security Project is dedicated to promoting common sense solutions to improve the retirement income prospects of millions of American workers.

The goal of The Retirement Security Project is to work on a nonpartisan basis to make it easier and increase incentives for middle- and lower-income Americans to save for a financially secure retirement.

1755 Massachusetts Ave., NW, Suite 550
Washington, DC 20036
p: 202.483.1370 f: 202.483.1460
www.retirementsecurityproject.org

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The Retirement Security Project

The Saver's Credit:

Expanding Retirement Savings for Middle- and Lower-Income Americans

The Retirement Security Project

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Common sense reforms, real world results

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The Saver's Credit:

Expanding Retirement Savings for Middle- and Lower-Income Americans

William G. Gale, J. Mark Iwry, and Peter R. Orszag

For decades, the U.S. tax code has provided preferential tax treatment to employer-provided pensions, 401(k)-type plans, and Individual Retirement Accounts (IRAs) relative to other forms of savings. The effectiveness of this system of subsidies remains a subject of controversy. Despite the accumulation of vast amounts of wealth in pension accounts, concerns persist about the ability of the pension system to raise private and national savings, and in particular to improve savings among those households most in danger of inadequately preparing for retirement.[1]

Many of the major concerns stem, at least in part, from the traditional form of the tax preference for pensions. Pension contributions and earnings on those contributions are treated more favorably for tax purposes than other compensation: they are excludible (or deductible) from income until distributed from the plan, which typically occurs years if not decades after the contribution is made. The value of this favorable tax treatment depends on the taxpayer's marginal tax rate: the subsidies are worth more to households with higher marginal tax rates, and less to households with lower marginal rates.[2] The pension tax subsidies, therefore, are problematic in two important respects:

- First, they reflect a mismatch between subsidy and need. The tax preferences are worth the least to lower-income families, and thus provide minimal incentives to those households who most need to save more to provide for basic needs in retirement. Instead the tax preferences give the strongest incentives to higher-income households, who, research indicates, are the least likely to need additional savings to achieve an adequate living standard in retirement.[3]
- Second, as a strategy for promoting national savings, the subsidies are poorly targeted. Higher-income households are disproportionately likely to respond to the incentives by shifting existing assets from taxable to tax-preferred accounts. To the extent such shifting occurs, the net result is that the retirement savings plans serve as a tax shelter, rather than as a vehicle to increase savings, so the loss of government revenue does not correspond to an increase in private savings. In contrast, middle- and lower-income households, if they participate in retirement savings plans, are most likely to use the accounts to raise net savings.[4] Because middle-income households are much less likely to have other assets to shift into tax-preferred accounts, any deposits they make to tax-preferred accounts are more likely to represent new savings rather than asset shifting.

The Saver's Credit, enacted in 2001, was expressly designed to address these problems. The Saver's Credit in effect provides a government matching contribution, in the form of a nonrefundable tax credit, for voluntary individual contributions to 401(k)-type plans, IRAs, and similar retirement savings arrangements. Like traditional retirement savings plan subsidies, the Saver's Credit currently provides no benefit for households that owe no federal income tax. However, for households that owe income tax, the effective match rate in the Saver's Credit is higher for those with lower income, the opposite of the incentive structure created by traditional pension tax preferences.

and so far only major federal legislation directly targeted at promoting tax-qualified retirement savings for middle- and lower-income workers.

The Saver's Credit is the first and so far only major federal legislation directly targeted at promoting tax-qualified retirement savings for middle- and lower-income workers.[5] Although this is an important step, several options are available to improve the design, not the least of which is the credit's scheduled expiration at the end of 2006.

Policymakers, including Representatives Rob Portman (R-OH) and Benjamin Cardin (D-MD), are exploring possible expansions of the Saver's Credit. Rep. Portman recently emphasized his desire to "get at what I think is the biggest potential for saving in this country, and that is those who are at modest and low income levels."[6] This paper is intended to inform such efforts.

The first section of the paper provides background on the evolution and design of the Saver's Credit. The second section discusses the rationale behind the Saver's Credit and the role of such a credit in the retirement income security system as a whole. The third section examines empirical data and models of the revenue and distributional effects of the Saver's Credit. The fourth section discusses measures that would expand the scope and improve the efficacy of the Saver's Credit.

Basic Design and Evolution

The Saver's Credit was enacted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA).[7] In principle, the credit can be claimed by middle- or lower-income households who make voluntary retirement savings contributions to 401(k)-type plans, other employer-sponsored plans (including SIMPLE plans), or IRAs.[8] In practice, however, the nonrefundability of the credit means it offers no incentive to save to the millions of middle- and lower-income households with no federal income tax liability.[9]

The design of the Saver's Credit reflects two key objectives. First, the credit represents an initial step toward addressing the "upside-down" structure of other tax incentives for saving—leveling the playing field for middle- and lower-income workers by, in effect, matching contributions at higher rates for savers with lower incomes. Second, the credit was designed to coordinate with and support the employer-based retirement system.

[illegible] Matching [illegible] for Mid[illegible]

The matching rates under the Saver's Credit reflect a progressive structure — that is, the rate of government contributions per dollar of private contributions falls as household income rises. This pattern stands in stark contrast to the way tax deductions and the rest of the retirement system subsidize savings. The Saver's Credit is currently a small exception to this general pattern: the Treasury Department estimates that the tax expenditures associated with retirement savings preferences in 2005 will total roughly $150 billion, of which only $1 billion is attributable to the Saver's Credit.[10]

The Saver's Credit applies to contributions of up to $2,000 per year per individual.[11] As Table 1 shows, the credit rate is 50 percent for married taxpayers filing jointly with adjusted gross income (AGI) up to $30,000, 20 percent for joint filers with AGI between $30,001 and $32,500, and 10 percent for joint filers with AGI between $32,501 and $50,000. The same credit

Table 1. Saver's Credit Rates and Effective Matching Rates by Income[1]

Dollars except where stated otherwise

Adjusted gross income					
Married filing jointly	Singles and married filing separately	Credit rate (percent)	Tax credit for $2,000 contribution	After-tax cost of $2,000 contribution	Effective after-tax match rate (percent)
0-30,000	0-15,000	50	1,000	1,000	100
30,001-32,500	15,001-16,250	20	400	1,600	25
32,501-50,000	16,251-25,000	10	200	1,800	11

Source: Authors' calculations using the 2001 Survey of Consumer Finances.

(1) Calculations assume that the taxpayer has sufficient federal income tax liability to benefit from the nonrefundable credit shown, and exclude the effects of any tax deductions or exclusions associated with the contributions or with any employer matching contributions.

How the Saver's Credit Works for Employees and Employers

Ruth and Tom are married, file a joint return, and have $34,000 of income, all from Ruth's salary. Ruth is eligible to participate in her employer's 401(k) plan but has not done so in the past. Neither spouse has an IRA. After Ruth receives a notice about the Saver's Credit from her employer, she and Tom decide that she will contribute $2,000 to the 401(k) and he will contribute $2,000 to an IRA.

Their contributions reduce their adjusted gross income from $34,000 to $30,000, which means they qualify for the 50 percent credit rate. As a result, they receive a $2,000 tax credit (50 percent of $4,000).

The couple begins to benefit from the Saver's Credit early in the year, when Ruth reduces the federal income tax withholding from her employer to reflect the fact that she and Tom will be entitled to the credit for the year. When the time comes to file their federal income tax return for the year, they claim the credit on their return.

Ruth's contribution also affects her employer's 401(k) nondiscrimination test results. Ruth's contribution has increased from 0 percent of her pay in previous years to nearly 6 percent ($2,000 divided by $34,000), which increases the average 401(k) contribution percentage for the group of non-highly compensated employees eligible to participate in the plan. That increase, in turn, raises the permissible 401(k) contribution percentage for the highly compensated employees in the firm.

rates apply for other filing statuses, but at lower-income levels: the AGI thresholds are 50 percent lower for single filers and 25 percent lower for heads of households.[12] Of course, the figures in Table 1 assume that the couple has sufficient income tax liability to benefit from the nonrefundable income tax credit shown.

The credit's effect is to correct the inherent bias of tax deductions or exclusions in favor of high-marginal rate taxpayers. A $100 contribution to a 401(k)-type plan by a taxpayer in the 35 percent marginal federal income tax bracket generates a $35 exclusion from income, resulting in a $65 after-tax cost to the taxpayer. In contrast, a taxpayer in the 15 percent marginal bracket making the same $100 contribution to a 401(k)-type plan gets only a $15 exclusion from income, resulting in an $85 after-tax cost. The tax deduction is thus worth more to the higher-income household.[13] However, if the lower-income taxpayer qualifies for a 20 percent Saver's Credit, the net after-tax cost is $65 ($100 minus the $15 effect of exclusion minus the $20 Saver's Credit). Thus, the Saver's Credit works to level the playing field by increasing the tax advantage of saving for middle- and lower-income households.

The credit represents an implicit government matching contribution for eligible retirement savings contributions. The implicit matching rate generated by the credit, though, is significantly higher than the credit rate itself. The 50 percent *credit* rate for gross contributions, for example, is equivalent to having the government *match* after-tax contributions on a 100 percent basis. Consider a couple earning $30,000 who contributes $2,000 to a 401(k)-type plan or IRA. The Saver's Credit reduces that couple's federal income tax liability by $1,000 (50 percent of $2,000). The net result is a $2,000 account balance that costs the couple only $1,000 after taxes (the $2,000 contribution minus the $1,000 tax credit). This is the same result that would occur if the net after-tax contribution of $1,000 were matched at a 100 percent rate: the couple and the government each effectively contribute $1,000 to the account. Similarly, the 20 percent and 10 percent credit rates are equivalent to a 25 percent and an 11 percent match, respectively (table 1).[14]

Enhancement of Employer-Sponsored Plans

The Saver's Credit was designed to support, rather than undermine, employer-sponsored retirement savings plans. These plans encourage participation through employer contributions, nondiscrimination rules designed to require cross-subsidies from eager to reluctant savers, the automatic character of payroll deduction, peer group encouragement, and, often, professional assistance with investments (for example, through employer selection of investment options or provision of investment management). To support these benefits of employer-sponsored plans, the Saver's Credit matches contributions to 401(k) and other plans by middle- and lower-income employees.[15] As a result, employees need not choose between the Saver's Credit or an employer matching contribution in their 401(k)-type plan.

Since the Saver's Credit applies in addition to any employer matching contributions, it can raise the return on 401(k)-type contributions: eligible taxpayers can obtain higher effective matching rates when the Saver's Credit is combined with employer matching contributions to a 401(k)-type plan.[16] For households who receive a 20 percent Saver's Credit, for example, a 50 percent employer match of the employee's 401(k)-type plan contributions implies that the total (employer plus government) effective match rate on after-tax contributions is 87.5 percent. That is, for every $100 in net contributions the taxpayer puts in, up to the appropriate match limits, the account will generate $187.50 in value.

To see how the 87.5 percent effective match rate occurs, consider a taxpayer eligible for a 20 percent credit rate under the Saver's Credit who contributes $2,000 to a retirement account. The government gives a tax credit of $400, which means the taxpayer has invested a net amount of $1,600. This alone generates an effective match of 25 percent. At the same time, the employer matches 50 percent of the $2,000 contribution, adding $1,000 to the account. A total of $3,000 is thus deposited in the account, at a cost to the taxpayer of only $1,600 net of the tax credit. Similar calculations in Table 2 show that, for taxpayers who receive a 50 percent government matching contribution, the effective matching rate, including a 50 percent employer match, is a striking 200 percent.[17]

In evaluating these high effective matching rates, it is important to emphasize that they apply only to

Table 2. Total Effective Match Rates with Saver's Credit and a 50 Percent Employer Matching Contribution[1]

Dollars except where stated otherwise

Credit rate (percent)	Tax credit for $2,000 before-tax employee contribution	Net after-tax contribution	Total contribution after 50 percent employer match	Ratio of total contribution to employee's after-tax contribution	Effective after-tax match rate (percent)
50	1,000	1,000	3,000	3.000	200.0
20	400	1,600	3,000	1.875	87.5
10	200	1,800	3,000	1.667	66.7

Source: Authors' calculations using the 2001 Survey of Consumer Finances.

(1) Calculations assume that the taxpayer has sufficient federal income tax liability to benefit from the nonrefundable credit shown, and exclude the effects of any tax deductions or exclusions associated with the contributions.

The credit not only makes it easier for the employer to pass the nondiscrimination test but also gives eligible employees a greater incentive to demand a 401(k)-type plan.

the first $2,000 of an individual's contributions. Moreover, they apply only to middle- and lower-income households, who tend to be more reluctant savers than higher-income households because, among other reasons, they tend to have less disposable income after providing for basic necessities. A higher effective matching rate focused on the first dollars of saving may help to "jump start" voluntary contributions by middle- and lower-income households, many of whom currently do not save at all.

Employee contributions to 401(k)-type plans that qualify for the Saver's Credit also count toward meeting the employer's nondiscrimination tests. Accordingly, to the extent the Saver's Credit encourages increased participation among lower earners, higher earners may also benefit, since their ability to contribute on a tax-favored basis depends on the level of contributions by less highly paid employees.[18]

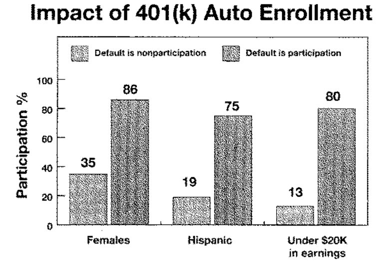
Recognizing the potential benefits of the Saver's Credit for plan sponsors, the Internal Revenue Service (IRS) has provided employers a model notice to inform employees of the credit.[19] Moreover, some employers that have refrained from adopting a 401(k)-type plan because of expected difficulty in meeting the nondiscrimination test may be encouraged by the Saver's Credit to set up a plan. The credit not only makes it easier for the employer to pass the nondiscrimination test but also gives eligible employees a greater incentive to demand a 401(k)-type plan.

The Saver's Credit is also designed to complement employer plans through its interaction with automatic enrollment. Automatic enrollment makes it easier for employees to save in a 401(k)-type plan by enrolling employees to participate automatically without being required to complete and sign an election form. Thus, unless an employee affirmatively expresses a different preference, the default mode under an automatic enrollment plan is that the employee participates at a stated percentage of compensation.[20] Automatic enrollment is a particularly effective mechanism for raising savings and is another focus of The Retirement Security Project.[21]

Automatic enrollment, as a practical matter, is particularly geared toward encouraging participation by middle- and lower-income employees, who are least likely to participate without it. For example, a recent analysis showed that, before the adoption of automatic enrollment, only 12.5 percent of workers with annual earnings under $20,000 participated in a 401(k)-type plan offered by the employer; after the adoption of automatic enrollment, 79.5 percent participated.[22] (Automatic enrollment, like the Saver's Credit, also enables higher-paid employees to contribute more by making it easier to obtain favorable results under the 401(k) nondiscrimination test.)

Automatic enrollment makes the Saver's Credit available to more employees who otherwise would not receive it because they did not contribute to a 401(k)-type plan. By the same token, the Saver's Credit may encourage wider use of automatic enrollment because the credit makes automatic enrollment more valuable, and hence more acceptable, to employees who are entitled to the credit (without requiring the employer to make any additional matching contributions).

Impact of 401(k) Auto Enrollment



Actual results from employees with between 3 and 15 months of tenure. Study by Brigitte Madrian, University of Pennsylvania's Wharton School, and Dennis Shea, UnitedHealth Group.

Table 3. Ownership of Assets in Retirement Accounts Among Households Aged 55-59, by Income, 2001[1]

Dollars except where stated otherwise

Income percentile	Percentage of households in indicated income range with assets	Median assets		Share of aggregate assets of all households (percent)
		All households in income range	Households with assets only	
Below 20	25.0	0	8,000	1.1
20-39.9	49.6	0	12,000	4.2
40-59.9	61.6	7,200	28,000	8.6
60-79.9	91.0	50,000	54,000	16.7
80-89.9	95.4	148,000	190,000	18.8
90-100	92.1	215,000	299,000	50.6
All households	63.6	10,400	50,000	100

Source: Authors' calculations using the 2001 Survey of Consumer Finances.

(1) Throughout table, "assets" refer only to assets held in defined contribution plans or Individual Retirement Accounts.

The Role of the Saver's Credit in the Pension System

As the baby boomer generation nears retirement, the shortcomings in the nation's upside-down system of incentives for retirement savings are becoming increasingly apparent.[23] As already noted, the existing structure is upside down for two reasons:

- First, the tax preferences are worth the least, and thus provide minimal incentives to save, to households who most need to save more to provide for basic needs in retirement. These preferences give the strongest incentives to higher-income households, who least need to save more to maintain an adequate retirement living standard.[24]

- Second, higher-income households, who receive the greatest benefit from the tax subsidies, are the most likely to use pensions as a tax shelter, rather than as a vehicle to increase savings. High-income households are disproportionately likely to respond to retirement savings tax incentives by shifting assets from taxable to tax-preferred accounts; the net result is a loss of government revenue with no increase in private savings.

Reflecting these upside-down incentives, the nation's broader pension system has several serious shortcomings:

- Only half of workers are covered by an employer-based pension plan in any given year, and participation rates in IRAs are substantially lower.

- Even workers who participate in tax-preferred retirement savings plans rarely make the maximum allowable contributions. Only 5 percent of 401(k)-type plan participants make the maximum contribution allowed by law, and only 5 percent of those eligible for IRAs make the maximum allowable contribution.[25]

- Despite the shift from defined benefit to defined contribution plans, many households approach retirement with meager defined contribution balances.[26] The median defined contribution balance among all households ages 55 to 59 was only $10,000 in 2001 (Table 3). Excluding the 36 percent of households who had no IRA or defined contribution plan account, the median balance for this age group was $50,000.

Given this reality, focusing incentives for retirement savings on middle- and lower-income households makes sense for two

To raise private savings, the incentives must not simply cause individuals to shift assets into tax-preferred pensions but instead must generate *additional* contributions.

reasons. First, such incentives are more likely to bolster long-term economic security and reduce elderly poverty, since higher-income households already tend to have substantial assets and to be better prepared to provide for their needs in retirement than other households. For some lower-income families, income may be so modest that it is impossible to save after paying for necessities. Yet 60 percent of households at or below the poverty line indicate that they save at least something.[27] Experience with a program that provides tax breaks and matching funds to encourage saving among lower-income families suggests that they will participate in savings programs if presented with incentives to do so.[28] The evidence cited above on the efficacy of automatic enrollment also suggests that lower-income workers will save if presented with incentives and a sound structure within which to do so.

The second reason for focusing incentives on middle- and lower-income households is the potential impact on national savings. National savings is the sum of public savings and private savings. All else equal, every dollar of foregone 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.

Since those with modest or low incomes are less likely to have other assets to shift into tax-preferred retirement savings accounts, focusing tax preferences on middle- and lower-income workers increases the likelihood that lost tax revenue will reflect additional contributions rather than shifts in assets.[29] The empirical evidence suggests that tax-preferred retirement savings undertaken by middle- and lower-income workers is much more likely to represent new savings than tax-preferred retirement savings undertaken by higher-income workers.[30]

Effects of the Saver's Credit

Although it is too soon to obtain a definitive reading of the impact of the Saver's Credit, preliminary estimates and evidence can be useful in identifying some basic themes.

Eligibility

The nonrefundability of the credit substantially reduces the number of people eligible for it. Further, the low match rates for middle-income households substantially reduce the number of people eligible to receive a significant incentive. Nonrefundability results in a credit that provides no incentive to tens of millions of lower-income filers who qualify on paper for the 50 percent credit rate, but who have no federal income tax liability against which to apply the credit.

Table 4 shows that 59 million tax filers in 2005 will have incomes low enough to qualify for the 50 percent credit.[31] Since the credit is nonrefundable, however, only about one-seventh of them actually would benefit from the credit *at all* by contributing to an IRA or 401(k)-type plan.[32] Furthermore, only 43,000 — or fewer than one out of every 1,000 — filers who qualify based on income could receive the maximum credit ($1,000 per person) if they made the maximum contribution. These are the households who have sufficient tax liability to benefit in full from the Saver's Credit but sufficiently low income to qualify for the highest match rate.

For families with somewhat higher incomes, the nonrefundability of the credit poses much less of a problem, since more of these families have positive income tax liabilities. For these families, however, the credit provides only a modest incentive to save. For example, a married couple earning $45,000 a year receives only a $200 tax credit for depositing $2,000 into a retirement account. This small credit reflects the modest matching rate at that level of income (see Tables 1 and 2), which provides less incentive to participate.

Table 4. Eligibility for 50 Percent Credit Rate, 2005

	Returns by Filing Status (thousands)[1]				
	Single	Married Filing Jointly	Head of Household	Other	Total
(A) Total returns	59,235	61,658	21,915	2,513	145,321
(B) Returns eligible for 50 percent credit based on income[2]	25,679	20,105	12,916	511	59,211
(C) Returns that would receive any benefit from 50 percent credit[3]	5,195	2,327	743	183	8,448
As a share of those eligible based on income (=C/B)	*20.2%*	*11.6%*	*5.8%*	*35.8%*	*14.3%*
(D) Returns that would benefit in full for maximum allowed contribution[4]	1	3	39	0	43
As a share of those eligible based on income (=D/B)	*0.0%*	*0.0%*	*0.3%*	*0.0%*	*0.1%*

Source: Authors' calculations using Urban-Brookings Tax Policy Center Microsimulation Model.
(1) Both filing and nonfiling units are included. Filers who can be claimed as dependents by other filers are excluded.
(2) Eligible returns exclude filing units above the relevant AGI threshold and those claimed as dependents on other tax returns.
(3) Returns that would receive any benefit from the Saver's Credit are eligible and would see some reduction in taxes as a result of the credit if a contribution were made to an approved retirement account
(4) Returns that would benefit in full from the 50 percent Saver's Credit for the maximum allowable contribution are both eligible and would see a reduction in taxes equal to the size of the credit if the maximum contribution were made to an approved retirement account.

Table 5. Distributional Effect of Saver's Credit[1]
Distribution of Income Tax Change by Cash Income Class, 2005

Cash Income Class (thousands of 2003 Dollars)[2]	Tax Units[3]			Percent Change in After-Tax Income[4]	Percent of Total Income Tax Change	Average Tax Change($)	Average Federal Tax Rate[5]	
	Number (thousands)	Percent of Total	Percent with Tax Cut				No Credit	Current Law
Less than 10	20,301	14.0	0.3	0.0	0.1	0	3.3	3.3
10-20	26,357	18.1	5.0	0.1	19.9	-15	5.5	5.4
20-30	20,537	14.1	9.9	0.1	26.3	-25	10.9	10.8
30-40	15,633	10.8	7.8	0.1	19.2	-24	15.0	14.9
40-50	11,543	7.9	10.9	0.1	16.1	-27	17.0	17.0
50-75	20,112	13.8	5.5	0.0	16.9	-17	19.0	18.9
75-100	11,773	8.1	0.3	0.0	0.6	-1	20.4	20.4
100-200	14,039	9.7	0.2	0.0	0.7	-1	22.6	22.6
200-500	3,588	2.5	0.1	0.0	0.0	0	25.6	25.6
500-1,000	593	0.4	0.0	0.0	0.0	0	27.6	27.6
More than 1,000	284	0.2	0.0	0.0	0.0	0	31.1	31.1
All	145,321	100.0	4.9	0.0	100.00	-14	20.7	20.7

Source: Authors' calculations using Urban-Brookings Tax Policy Center Microsimulation Model.
(1) Baseline is current law without the Saver's Credit.
(2) Returns with negative cash income are excluded from the lowest income class but are included in the totals.
(3) Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.
(4) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.
(5) Average federal tax (individual income tax, net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax) as a percentage of average cash income.

Usage Patterns and Distributional Effects

IRS data indicate that in each of 2002 and 2003, about 5 million tax filers claimed the Saver's Credit.[33] This figure likely understates the true number of qualifying individual savers, however, because a significant portion of these returns are from married couples filing jointly, where each of the spouses may have made a separate qualifying contribution.[34]

Table 5 shows the estimated distributional effect of the Saver's Credit. The data suggest that over 45 percent of

Table 6. Alternative Estimates of Revenue Effects of Saver's Credit[1]

Billions of dollars

Fiscal Year	Joint Tax Committee, revenue effect given 2006 sunset	Administration fiscal 2005 budget, tax expenditure estimate[1]	Revenue effect from eliminating sunset	
			Congressional Budget Office	Urban-Brookings Tax Policy Center
2002	1.0			
2003	2.1	0.9		
2004	2.0	1.0		
2005	1.9	1.1		
2006	1.8	1.2		
2007	0.9	0.7	0.6	0.6
2008	0.1		1.9	1.7
2009	0.1		1.7	1.6
2010	0.1		1.6	1.5
2011	0.1		1.4	1.6
2012			1.4	1.8
2013			1.3	1.7
2014			1.1	1.6
2015				1.5

Sources: Joint Tax Committee; Office of Management and Budget: Congressional Budget Office, authors' calculations using Urban-Brookings Tax Policy Center Microsimulation Model.

(1) Note that tax expenditure estimates do differ in certain respects from estimated revenue effects.

the benefits accrue to filers with cash income between $10,000 and $30,000. Households with income below $10,000 receive almost none of the benefits, an outcome that reflects the nonrefundability of the credit.

Effects on Private Savings

A full assessment of the effects of the credit on private savings would require more information than is currently available, but some possibilities suggest themselves. A necessary, but not sufficient, condition for the credit to raise private savings is to see an increase in IRA and 401(k)-type plan contributions among the eligible population.[35] In one survey of 401(k) plan sponsors in 2002, representatives of 71 percent of the plans indicated that they believed the Saver's Credit had already increased participation in their plans, and 18 percent believed the Saver's Credit had caused a "major increase" in participation.[36] The tax preparer H&R Block has said that it claimed the credit in 2002 on behalf of more than a million clients, who saved an average $175 on their tax bills. An H&R Block representative has been quoted as saying that many of these clients were first-time contributors to a retirement savings plan.[37]

Options for Expansion

Several significant changes should be considered that could be made to improve the Saver's Credit: making the credit permanent, making it refundable, expanding it to provide stronger incentives for middle-income households, changing the rate at which it phases out, and indexing it to inflation. Most of these options are already under active discussior among policymakers.

Eliminating the 2006 Sunset

In order to reduce the apparent revenue cost, Congress stipulated that the Saver's Credit would sunset at the end of 2006.[38] It would cost between $1 billion and $2 billion a year to make the Saver's Credit permanent. As Table 6 shows, estimates generated by the Tax Policy Center model

In one survey of 401(k) plan sponsors in 2002, representatives of 71 percent of the plans indicated that they believed the Saver's Credit had already increased participation in their plans, and 18 percent believed the Saver's Credit had caused a "major increase" in participation.

are similar to those published by the Congressional Budget Office.

Making the Credit Refundable

As noted above, tens of millions of lower-income workers are unable to benefit from the credit because it is nonrefundable. To extend the intended savings incentive to most lower-income working families would require making the Saver's Credit refundable.[39]

Some public policymakers and others have long had reservations about making tax credits refundable. Their concern is often based on a sense that refundability converts a tax credit into a form of "welfare," which is viewed as undesirable, and that refundable credits tend to pose an unacceptable risk of fraud or other noncompliance. It is not clear, however, that the concerns typically raised about refundable credits are applicable to making the Saver's Credit refundable. To qualify for the Saver's Credit, an individual must make a contribution to a tax-preferred account, which is verified by third-party reporting (by the IRA trustee or plan administrator). In addition, to limit potential abuses, policymakers could require tax filers to have at least $5,000 in earnings per person to claim the refundable credit.

Table 7 reports the revenue effects of making the Saver's Credit refundable, as estimated using the Tax Policy Center microsimulation model. The second column of the table shows that refundability would add $2 billion to $3 billion a year to the cost. Since the current cost amounts to between $1 billion and $2 billion, adding refundability would raise the cost to about $4 billion a year.[40]

Making the credit refundable would help equalize the tax benefits of saving for higher- and lower-income households, leveling the playing field between income tax payers and workers who pay payroll tax but have no federal income tax liability. Refundability would significantly benefit lower-income earners, with almost 38 percent of the tax benefit accruing to individuals and families with $20,000 or less in cash income (table 8).

Short of direct income tax refundability, other variations and alternatives are possible.[41] For example, a bill introduced by Sen. Jeff Bingaman (D-NM) in 2002 would in effect make the Saver's Credit refundable, but only by matching qualifying contributions of individuals with no federal income tax liability who purchase an inflation-indexed U.S. savings bond that they cannot redeem until retirement age.[42] Another possibility would involve providing a tax credit to (essentially through) financial institutions for contributions that they make to their clients' savings accounts, as was proposed in the Treasury Department's February 2000 Retirement Savings Accounts approach.[43] The effect would be similar to that of a refundable tax credit at the individual level. A final possibility would be to deposit the refund directly into the savings account or 401(k)-type plan, an option that is under discussion but raises significant technical issues.[44]

Indexing AGI Limits to Inflation

The AGI phase-out limits for the credit rates are currently not indexed to inflation. As a result, the credit grows less generous over time, as inflation pushes more households above the phase-out thresholds. Most features of the tax code are indexed to inflation, so that inflation by itself does not increase tax burdens. The Saver's Credit thresholds could be made to conform to this general tax treatment. As shown in Appendix Table 1, indexation would add about $9.2 billion over ten years to the cost of the refundable credit.

Table 7. Revenue Cost of Extending The Saver's Credit and Making It Refundable

Billions of dollars

Year	Extend existing credit beyond 2006	Extend and make refundable
2006	0.0	1.1
2007	0.6	3.8
2008	1.7	4.8
2009	1.6	4.7
2010	1.5	4.5
2011	1.6	4.3
2012	1.8	4.1
2013	1.7	4.0
2014	1.6	3.8
2015	1.5	3.7
Total, 2006-15	13.5	38.8

Source: Authors' calculations using Urban-Brookings Tax Policy Center Microsimulation Model.

Table 8. Distributional Effect of Making Saver's Credit Refundable[1]
Distribution of Income Tax Change by Cash Income Class, 2005

Cash Income Class (thousands of 2003 Dollars)[2]	Tax Units[3]			Percent Change in After-Tax Income[4]	Percent of Total Income Tax Change	Average Tax Change ($)	Average Federal Tax Rate[5]	
	Number (thousands)	Percent of Total	Percent with Tax Cut				Current Law	Proposal
Less than 10	20,301	14.0	3.8	0.2	8.4	-14	3.3	3.1
10-20	26,357	18.1	8.2	0.2	29.2	-36	5.4	5.1
20-30	20,537	14.1	8.1	0.2	30.6	-49	10.8	10.6
30-40	15,633	10.8	6.6	0.1	16.3	-34	14.9	14.8
40-50	11,543	7.9	4.6	0.1	7.1	-20	17.0	16.9
50-75	20,112	13.8	1.5	0.0	4.2	-7	18.9	18.9
75-100	11,773	8.1	0.3	0.0	1.0	-3	20.4	20.4
100-200	14,039	9.7	0.3	0.0	1.5	-3	22.6	22.6
200-500	3,588	2.5	0.1	0.0	0.2	-2	25.6	25.6
500-1,000	593	0.4	0.1	0.0	0.0	-1	27.6	27.6
More than 1,000	284	0.2	0.1	0.0	0.0	-2	31.1	31.1
All	145,321	100.0	4.5	0.0	100.00	-22	20.7	20.7

Source: Authors' calculations using Urban-Brookings Tax Policy Center Microsimulation Model
(1) Baseline is current law.
(2) Returns with negative cash income are excluded from the lowest income class but are included in the totals.
(3) Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.
(4) After-tax income is cash income less: individual income tax net of refundable credits, corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.
(5) Average federal tax (individual income tax, net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax) as a percentage of average cash income.

Expanding Eligibility to More Middle-Income Households

Another set of possible expansions to the Saver's Credit would extend eligibility to additional middle-income households. The credit could be expanded in this way along three dimensions: changes to the credit rate, the income limit, and the manner in which the credit is phased out.

First, the 20 percent and 10 percent credit rates available to eligible joint filers with AGI between $32,500 and $50,000 could be raised to 50 percent.[45] This would make the 50 percent credit available to tens of millions of additional households who, for the most part, confront zero, 10 percent, or 15 percent marginal income tax rates and therefore have relatively little to gain from the traditional income tax incentive structure. Estimates using the Tax Policy Center model show that 96 percent of the households who would benefit from the expanded 50 percent credit are in the 15 percent marginal tax bracket. These households typically have fewer additional assets to help meet basic needs in retirement and are among those who most need help to save for retirement. According to the model, median financial assets among those households who would benefit from the expanded 50 percent credit rate are currently about $30,000.

Second, the 50 percent credit rate could be expanded to working households with AGI up to $60,000 or $70,000 (for joint filers).[46] Some of these households — about 5 percent under the option that increases eligibility for the 50 percent credit to $70,000 for joint filers — are in the 25 percent marginal tax bracket and therefore already receive a somewhat larger incentive to save under the traditional system of tax subsidies. The vast majority, however, are in the 15 percent bracket, and many of these households have somewhat more disposable or discretionary income remaining after meeting essential short-term needs than do lower-income families in the same tax bracket. These households may thus be more likely than lower-income households to respond to the incentive, and more likely than higher-income households to respond by increasing their net savings rather than merely shifting assets. (If the 50 percent credit rate were expanded to joint filers with incomes of up to $70,000, the Tax Policy Center model suggests that the newly eligible households would have median fin- -l assets of $42,000 and mear. ir ;sets of $83,000.)

Finally, whatever the level of AGI at which eligibility for the 50 percent credit rate stops, the credit rate could be made to phase down ratably from 50 percer zero over a specified range of AGI, suc as $10,000. Such a smooth phase-down would remove the "cliffs" in the current credit structure, which involves steep declines in the credit rate as income rises, resulting in very high effective marginal tax rates for many savers who use the credit. For example, consider a married couple earning $30,000 in AGI and contributing $2,000 to an IRA. At present, if the couple's AGI increases to $30,001, the tax credit for that contribution declines from $1,000 to $400 – a $600 increase in tax liability triggered by a $1 increase in income.

We examine three potential expansions of the 50 percent credit: to joint filers with AGI of $50,000, $60,000, and $70,000. Each involves a ratable phase-down of the credit from 50 percent to zero over a $10,000 AGI range. The income cutoffs for single filers and heads of households would remain in the same proportion to the joint filer thresholds as under the current Saver's Credit. As Table 9 shows, extending the 50 percent credit rate to joint filers with AGI of $50,000 adds about $5 billion a year to the cost of the credit. Each $10,000 increment above $50,000 then adds another $3 billion to $5 billion a year in revenue cost.

Appendix Tables 2 through 7 provide more details about the effects of combining these expansions with making the credit refundable. For example, extending the Saver's Credit past its 2006 sunset, making it refundable, indexing its AGI thresholds to inflation, and expanding the 50 percent credit rate to joint filers with $50,000 of AGI is estimated to cost about $118.5 billion in tax revenue over ten years (final column of Appendix Table 2). Table 10 (reprinted as Appendix Table 3) shows the distributional effects of these combined changes. Tax filers with cash income under $40,000 would receive about half the tax benefits; the rest would mostly accrue to tax filers with cash income between $40,000 and $75,000.

Table 9. Revenue Cost of Extending Saver's Credit and Expanding Eligibility for Top Credit Rate

Billions of dollars

Year	Extend existing credit beyond 2006	Extend and expand eligibility for 50 percent credit rate to joint filers with AGI up to $50,000	$60,000	$70,000
2006	0.0	1.9	3.5	5.3
2007	0.6	6.0	10.4	15.4
2008	1.7	6.7	11.0	15.8
2009	1.6	6.3	10.4	15.1
2010	1.5	6.0	9.9	14.4
2011	1.6	6.2	9.9	14.3
2012	1.8	6.9	10.4	14.7
2013	1.7	6.6	9.9	13.9
2014	1.6	6.2	9.4	13.1
2015	1.5	5.9	8.9	12.4
Total, 2006-15	13.5	58.7	93.9	134.5

Source: Authors' calculations using Urban-Brookings Tax Policy Center Microsimulation Model.

The income cut-offs for single filers and heads of households would remain in the same proportion to the joint filer thresholds as under the current Saver's Credit.

Table 10. Distributional Effect from Extending Credit, Indexing It, Making It Refundable, and Expanding 50 Percent Credit to $50,000 for Joint Filers[1]
Distribution of Income Tax Change by Cash Income Class, 2005

Cash Income Class (thousands of 2003 Dollars)[2]	Tax Units[3]			Percent Change in After-Tax Income[4]	Percent of Total Income Tax Change	Average Tax Change ($)	Average Federal Tax Rate[5]	
	Number (thousands)	Percent of Total	Percent with Tax Cut				Current Law	Proposal
Less than 10	20,301	14.0	3.8	0.2	2.5	-14	3.3	3.1
10-20	26,357	18.1	9.8	0.3	10.6	-45	5.4	5.1
20-30	20,537	14.1	16.6	0.5	21.6	-117	10.8	10.4
30-40	15,633	10.8	16.8	0.4	16.8	-119	14.9	14.6
40-50	11,543	7.9	17.7	0.4	16.9	-163	17.0	16.6
50-75	20,112	13.8	17.8	0.3	29.1	-161	18.9	18.7
75-100	11,773	8.1	1.2	0.0	1.2	-11	20.4	20.4
100-200	14,039	9.7	0.6	0.0	0.8	-7	22.6	22.6
200-500	3,588	2.5	0.4	0.0	0.1	-3	25.6	25.6
500-1,000	593	0.4	0.2	0.0	0.0	-2	27.6	27.6
More than 1,000	284	0.2	0.1	0.0	0.0	-2	31.1	31.1
All	145,321	100.0	10.5	0.2	100.00	-76	20.7	20.6

Source: Authors' calculations using Urban-Brookings Tax Policy Center Microsimulation Model.
(1) Baseline is current law. Reform includes making the credit refundable, increasing the AGI limit for married couples filing jointly to $50,000, and phasing out the limit over $10,000.
(2) Returns with negative cash income are excluded from the lowest income class but are included in the totals.
(3) Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.
(4) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.
(5) Average federal tax (individual income tax, net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax) as a percentage of average cash income.

Conclusion

The Saver's Credit offers the potential to help correct the nation's "upside-down" tax incentives for retirement savings. The current tax system provides the weakest incentives for participation in tax-preferred saving plans to those who most need to save for retirement and who are more likely to use tax-preferred vehicles to increase net savings than to serve as a shelter from tax.

The experience thus far with the Saver's Credit has been encouraging. Several options are available, however, to improve the design of the credit: making it refundable, making it permanent, expanding it to provide more powerful incentives for middle-income households, and indexing its thresholds to inflation. These changes would further help middle- and lower-income families save for retirement, reduce economic insecurity and poverty rates among the elderly, and raise national savings.

About The Retirement Security Project

The Retirement Security Project is dedicated to promoting common sense solutions to improve the retirement income prospects of millions of American workers. The goal of The Retirement Security Project is to work on a nonpartisan basis to make it easier and increase incentives for middle- and lower-income Americans to save for a financially secure retirement.

The Retirement Security Project is supported by The Pew Charitable Trusts in partnership with Georgetown University's Public Policy Institute and the Brookings Institution.

Appendix Table 1. Revenue Cost of Comprehensive Saver's Credit Reforms

Billions of dollars

Year	Extend and make refundable	Extend, index, and make refundable	Extend, index, make refundable, and extend 50 percent credit rate up to indicated AGI (for joint filers) $50,000	$60,000	$70,000
2006	1.1	1.2	3.9	5.7	7.5
2007	3.8	4.0	11.8	16.8	22.1
2008	4.8	5.2	13.0	18.0	23.2
2009	4.7	5.3	13.0	18.0	23.2
2010	4.5	5.4	13.0	18.0	23.1
2011	4.3	5.3	12.8	17.8	22.9
2012	4.1	5.3	12.7	17.6	22.7
2013	4.0	5.4	12.7	17.4	22.5
2014	3.8	5.4	12.7	17.3	22.3
2015	3.7	5.5	12.8	17.2	22.2
Total, 2006-15	38.8	48.0	118.5	163.9	211.8

Source: Authors' calculations using Urban-Brookings Tax Policy Center Microsimulation Model.

The income cut-offs for single filers and heads of households would remain in the same proportion to the joint filer thresholds as under the current Saver's Credit

Appendix Table 2. Revenue Effect from Extending Credit, Indexing It, Making It Refundable, and Expanding 50 Percent Credit to $50,000 for Joint Filers

Billions of dollars

	Extend, Index, Make Refundable	Extend, Index, Make Refundable and Increase 50 Percent Credit Rate for Joint Filers to $50,000
2006	1.2	3.9
2007	4.0	11.8
2008	5.2	13.0
2009	5.3	13.0
2010	5.4	13.0
2011	5.3	12.8
2012	5.3	12.7
2013	5.4	12.7
2014	5.4	12.7
2015	5.5	12.8
Total, 2006-2015	48.0	118.5

Source: Authors' calculations using Urban-Brookings Tax Policy Center Microsimulation Model.

Appendix Table 3. Distributional Effect from Extending Credit, Indexing It, Making It Refundable, and Expanding 50 Percent Credit to $50,000 for Joint Filers[1]

Distribution of Income Tax Change by Cash Income Class, 2005

Cash Income Class (thousands of 2003 Dollars)[2]	Tax Units[3] Number (thousands)	Tax Units[3] Percent of Total	Tax Units[3] Percent with Tax Cut	Percent Change in After-Tax Income[4]	Percent of Total Income Tax Change	Average Tax Change ($)	Average Federal Tax Rate[5] Current Law	Average Federal Tax Rate[5] Proposal
Less than 10	20,301	14.0	3.8	0.2	2.5	-14	3.3	3.1
10-20	26,357	18.1	9.8	0.3	10.6	-45	5.4	5.1
20-30	20,537	14.1	16.6	0.5	21.6	-117	10.8	10.4
30-40	15,633	10.8	16.8	0.4	16.8	-119	14.9	14.6
40-50	11,543	7.9	17.7	0.4	16.9	-163	17.0	16.6
50-75	20,112	13.8	17.8	0.3	29.1	-161	18.9	18.7
75-100	11,773	8.1	1.2	0.0	1.2	-11	20.4	20.4
100-200	14,039	9.7	0.6	0.0	0.8	-7	22.6	22.6
200-500	3,588	2.5	0.4	0.0	0.1	-3	25.6	25.6
500-1,000	593	0.4	0.2	0.0	0.0	-2	27.6	27.6
More than 1,000	284	0.2	0.1	0.0	0.0	-2	31.1	31.1
All	145,321	100.0	10.5	0.2	100.00	-76	20.7	20.6

Source: Authors' calculations of Urban-Brookings Tax Policy Center Microsimulation Model.

(1) Baseline is current law. Reform includes making the credit refundable, increasing the AGI limit for married couples filing jointly to $50,000, and phasing out the limit over $10,000.

(2) Returns with negative cash income are excluded from the lowest income class but are included in the totals.

(3) Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.

(4) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.

(5) Average federal tax (individual income tax, net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax) as a percentage of average cash income.

Appendix Table 4. Revenue Effect from Extending Credit, Indexing It, Making It Refundable, and Expanding 50 Percent Credit to $60,000 for Joint Filers

Billions of dollars

	Extend, Index, Make Refundable	Extend, Index, Make Refundable and Increase 50 Percent Credit Rate for Joint Filers to $60,000
2006	1.2	5.7
2007	4.0	16.8
2008	5.2	18.0
2009	5.3	18.0
2010	5.4	18.0
2011	5.3	17.8
2012	5.3	17.6
2013	5.4	17.4
2014	5.4	17.3
2015	5.5	17.2
Total, 2006-2015	48.0	163.9

Source: Authors' calculations using Urban-Brookings Tax Policy Center Microsimulation Model.

Appendix Table 5. Distributional Effect from Extending Credit, Indexing It, Making It Refundable, and Expanding 50 Percent Credit to $60,000 for Joint Filers[1]
Distribution of Income Tax Change by Cash Income Class, 2005

Cash Income Class (thousands of 2003 Dollars)[2]	Tax Units[3] Number (thousands)	Percent of Total	Percent with Tax Cut	Percent Change in After-Tax Income[4]	Percent of Total Income Tax Change	Average Tax Change ($)	Average Federal Tax Rate[5] Current Law	Proposal
Less than 10	20,301	14.0	3.8	0.2	1.7	-14	3.3	3.1
10-20	26,357	18.1	9.8	0.3	7.3	-45	5.4	5.1
20-30	20,537	14.1	16.6	0.5	15.2	-120	10.8	10.3
30-40	15,633	10.8	22.9	0.6	17.5	-181	14.9	14.4
40-50	11,543	7.9	18.5	0.5	12.9	-182	17.0	16.6
50-75	20,112	13.8	27.9	0.6	40.9	-329	18.9	18.4
75-100	11,773	8.1	7.1	0.1	3.4	-46	20.4	20.4
100-200	14,039	9.7	0.9	0.0	0.8	-9	22.6	22.6
200-500	3,588	2.5	0.6	0.0	0.1	-6	25.6	25.6
500-1,000	593	0.4	0.2	0.0	0.0	-2	27.6	27.6
More than 1,000	284	0.2	0.2	0.0	0.0	-2	31.1	31.1
All	145,321	100.0	13.2	0.2	100.00	-111	20.7	20.5

Source: Authors' calculations of Urban-Brookings Tax Policy Center Microsimulation Model.
(1) Baseline is current law. Reform includes making the credit refundable, increasing the AGI limit for married couples filing jointly to $60,000, and phasing out the limit over $10,000.
(2) Returns with negative cash income are excluded from the lowest income class but are included in the totals.
(3) Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.
(4) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.
(5) Average federal tax (individual income tax, net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax) as a percentage of average cash income.

Appendix Table 6. Revenue Effect from Extending Credit, Indexing It, Making It Refundable, and Expanding 50 Percent Credit to $70,000 for Joint Filers
Billions of dollars

	Extend, Index, Make Refundable	Extend, Index, Make Refundable and Increase 50 Percent Credit Rate for Joint Filers to $70,000
2006	1.2	7.5
2007	4.0	22.1
2008	5.2	23.2
2009	5.3	23.2
2010	5.4	23.1
2011	5.3	22.9
2012	5.3	22.7
2013	5.4	22.5
2014	5.4	22.3
2015	5.5	22.2
Total, 2006-2015	48.0	211.8

Source: Authors' calculations using Urban-Brookings Tax Policy Center Microsimulation Model.

Appendix Table 7. Distributional Effect from Extending Credit, Indexing It, Making It Refundable, and Expanding 50 Percent Credit to $70,000 for Joint Filers[1]
Distribution of Income Tax Change by Cash Income Class, 2005

Cash Income Class (thousands of 2003 Dollars)[2]	Tax Units[3] Number (thousands)	Percent of Total	Percent with Tax Cut	Percent Change in After-Tax Income[4]	Percent of Total Income Tax Change	Average Tax Change ($)	Average Federal Tax Rate[5] Current Law	Proposal
Less than 10	20,301	14.0	3.8	0.2	1.3	-14	3.3	3.1
10-20	26,357	18.1	9.8	0.3	5.5	-45	5.4	5.1
20-30	20,537	14.1	16.6	0.5	11.5	-120	10.8	10.3
30-40	15,633	10.8	24.0	0.7	15.7	-216	14.9	14.3
40-50	11,543	7.9	24.7	0.6	11.4	-212	17.0	16.5
50-75	20,112	13.8	29.2	0.8	37.0	-395	18.9	18.3
75-100	11,773	8.1	26.5	0.4	16.1	-293	20.4	20.1
100-200	14,039	9.7	1.6	0.0	1.1	-17	22.6	22.6
200-500	3,588	2.5	0.7	0.0	0.1	-8	25.6	25.6
500-1,000	593	0.4	0.3	0.0	0.0	-4	27.6	27.6
More than 1,000	284	0.2	0.2	0.0	0.0	-3	31.1	31.1
All	145,321	100.0	15.6	0.3	100.00	-148	20.7	20.5

Source: Authors' calculations using Urban-Brookings Tax Policy Center Microsimulation Model.
(1) Baseline is current law. Reform includes making the credit refundable, increasing the AGI limit for married couples filing jointly to $70,000, and phasing out the limit over $10,000.
(2) Returns with negative cash income are excluded from the lowest income class but are included in the totals.
(3) Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.
(4) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.
(5) Average federal tax (individual income tax, net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax) as a percentage of average cash income.

Footnotes

1 For a broader discussion of these issues, see William G. Gale and Peter R. Orszag, "Private Pensions: Issues and Options," in *Agenda for the Nation*, edited by Henry J. Aaron, James M. Lindsay, and Pietro S. Nivola (Brookings, 2003); Peter R. Orszag, "Progressivity and Saving: Fixing the Nation's Upside-Down Incentives for Saving," Testimony before the House Committee on Education and the Workforce, February 25, 2004, and J. Mark Iwry, Testimony before the House Committee on Education and the Workforce, Subcommittee on Employer-Employee Relations, June 4, 2003. These and related publications are available on The Retirement Security Project website (www.retirementsecurityproject.org).

2 Technically, the lifetime subsidy from such accounts comes from two sources: the difference (if any) between the tax rate at the time of contribution and that at the time of withdrawal, and the tax-free accumulation of funds. See Leonard E. Burman, William G. Gale, and David Weiner, "The Taxation of Retirement Saving: Choosing between Front-Loaded and Back-Loaded Options," *National Tax Journal* 54, no. 3 (September 2001), and Eric M. Engen, John Karl Scholz, and William G. Gale, "Do Saving Incentives Work?" *Brookings Papers on Economic Activity*, no. 1 (1994), pp. 85-151. In practice, however, these items are often correlated with the tax rate at the time of the contribution, and casual evidence suggests that the up-front deductibility of most of these plans (such as 401(k)s and traditional IRAs, which provide the tax advantage at the time of contribution rather than distribution) is an important determinant of whether people make contributions.

3 See, for example, Eric M. Engen, William G. Gale, and Cori E. Uccello, "The Adequacy of Household Saving," *Brookings Papers on Economic Activity*, no. 2 (1999): pp. 65-165.

4 Ibid.

5 Retirement saving for these workers is promoted -- or designed to be promoted — indirectly by nondiscrimination and certain other provisions of the Internal Revenue Code of 1986 (IRC) and the Employee Retirement Income Security Act of 1974 (ERISA). Those provisions, which are subject to extensive exceptions, are intended to impose some constraint on the degree to which tax-favored benefits accrue to a limited number of owners and executives rather than the large majority of workers. The IRC and ERISA also protect and regulate the accumulation and preservation of retirement benefits. For additional discussion of these issues by the Treasury Department, see Donald C. Lubick, Assistant Secretary (Tax Policy), U.S. Department of the Treasury, Testimony before the House Committee on Ways and Means, Subcommittee on Oversight, March 23, 1999.

6 Michael Wyand, "Savings Effort to Continue Based on RSA Plus Savers Credit, Not LSA, Portman Says," BNA, March 16, 2004.

7 Section 25B of the IRC of 1986 was added by section 618 of EGTRRA, Public Law 107-16, 115 Stat. 38. See also IRS Announcement 2001-106, 2001-44 I.R.B. (October 29, 2001), and IRS News Release IR 2001-107, 2001-44 I.R.B. (November 7, 2001). The credit was officially titled "Elective Deferrals and IRA Contributions By Certain Individuals." Although now generally referred to as the "Saver's Credit," that term actually appears nowhere in the law. "Saver's Credit" was first used in IRS/Treasury administrative guidance at the suggestion of one of the authors in mid-2001 with a view to facilitating the "public marketing" of the provision. See IRS Announcement 2001-106, 2001-44 I.R.B. (October 29, 2001); IRS News Release IR 2001-107, 2001-44 I.R.B. (November 7, 2001).

8 The only exceptions are relatively minor: the credit may not be used by individuals who have not reached age 18 by the end of the taxable year, are full-time students, or are claimed as dependents on another return. IRC section 151(c)(4) and IRS Announcement 2001-106 elaborate on the definition of "student" for this purpose.

9 The Saver's Credit can be used to offset regular income tax liability as well as alternative minimum tax liability (IRC section 25B(g)(1)), although the latter generally is not a concern for the eligible income group.

10 Office of Management and Budget, *Fiscal Year 2005 Analytical Perspectives*, table 18-2.

[11] Both spouses in a married couple may receive the credit. For example, if each spouse contributes $2,000 to his or her IRA, and they file jointly with adjusted gross income not exceeding $30,000, the couple will receive a nonrefundable tax credit of $2,000 ($1,000 each) if they have sufficient federal income tax liability to use the credit. As discussed later, however, because of the nonrefundable nature of the credit, very few taxpayers actually qualify for the 50 percent match.

[12] The level of contributions eligible for the credit is reduced by the amount of distributions from any retirement savings plan or IRA by the participant or the participant's spouse during the year for which the credit is claimed, the two preceding years, or the portion of the following year that precedes the tax return due date. Distributions that are rolled over to another plan or IRA are not counted against the participant for this purpose. The IRS uses the following example to illustrate how this anti-churning provision works: "Mark's adjusted gross income for 2002 is low enough for him to be eligible for the credit that year and he defers $3,000 of his pay to his employer's 401(k) plan during 2002. During 2001, Mark took a $400 hardship withdrawal from his employer's plan and during 2002 he takes an $800 IRA withdrawal. Mark's 2002 Saver's Credit will be based on contributions of $1,800 ($3,000 – $ 400 - $800)." Some gaming is still possible despite these rules (see Leonard Burman, William G. Gale, and Peter R. Orszag, "The Administration's Saving Proposals: A Preliminary Analysis" Tax Notes, March 3, 2003). However, in the process of designing the Saver's Credit, other, more restrictive anti-churning provisions were considered and rejected in the interest of keeping the proposal simple and workable.

[13] As discussed in note 2, the entire subsidy associated with savings incentives depends not only on the tax rate at which the contribution is deducted, but also on the tax rate that applies to withdrawals, the length of time the funds are held in the account, the tax rate that would have applied to taxable funds while the funds are held in the tax-preferred account, and the rate of interest. Controlling for the latter factors, taxpayers who can deduct the contribution at a higher rate will generate larger tax savings.

[14] The true magnitude of these effective matching rates may not be evident to many taxpayers, however, because the Saver's Credit is presented as applying at a 50 percent, 20 percent, or 10 percent rate. Indeed, the prevalence of employer 401(k)-type plan matching contributions may well invite some households who are or have been eligible for a 401(k)-type plan to view the credit rate as a matching rate, even though the implicit matching rate is higher than the credit rate and the overall combined subsidy is substantially higher if there is an employer match. To the extent that taxpayers make such misleading comparisons, even the maximum Saver's Credit rate would appear to be no higher than the common 50 percent employer match. In short, the "optics" of the Saver's Credit may well reduce its incentive effect.

[15] See J. Mark Iwry, "Expanding the Saver's Credit." Testimony before the House Committee on Education and the Workforce, Subcommittee on Employer-Employee Relations, July 1, 2003. In particular, the Saver's Credit applies to both before-tax and after-tax contributions by eligible individuals. In addition, although this is not widely recognized, the credit can be claimed for voluntary employee contributions to an employer-sponsored defined benefit plan, although typically it applies to employee contributions to a defined contribution plan such as a 401(k).

[16] The exclusion of IRA and 401(k)-type plan contributions from AGI measures also will make more households eligible for the credit and for a higher credit rate. As a simplified example, consider a married couple filing jointly who have before-tax gross earnings of $34,000. If one spouse contributes $2,000 to a 401(k)-type plan and the other contributes $2,000 to a traditional IRA, AGI will be reduced to $30,000, which would increase their Saver's Credit rate to 50 percent from 10 percent (the rate that would have applied with AGI of $34,000).

[17] The upfront deductibility of 401(k)-type plan and IRA contributions combined with taxation of withdrawals further increases the net overall return to the extent that the tax rate at the time of withdrawal is lower than the tax rate at the time the contributions were made. If the two tax rates are the same, the results of the Saver's Credit and employer match are like those in tables 1 and 2, depending on whether an employer match exists. Even if the tax rates are the same, however, the value of tax deferral with respect to the earnings on the deductible portion of the contribution — in addition to the Saver's Credit and any employer match — may still encourage taxpayers to contribute to the plans.

[18] See IRS Announcement 2001-106, A-10. Under the 401(k)-type plan nondiscrimination standards, the work force eligible to contribute to the plan is divided into highly compensated employees, or HCEs (largely those earning $95,000 or more, as indexed for 2005) and non-highly compensated employees (NHCEs). The tests compare the average pretax contribution rates (as a percentage of pay) of the two groups, limiting the HCE group to a collective average that does not exceed the corresponding collective average for the NHCE group by more than a specified margin. (A parallel test applies to employees' after-tax contributions and employer matching contributions.) Eligible NHCEs who fail to contribute to the plan bring down the average for their group (and hence the allowable average for the HCE group) because they are counted as zeros in determining the NHCE average. The Saver's Credit was designed to reduce the number of zeros.

[19] IRS Announcement 2001-106. With the aim of reaching as many employees as possible, then-IRS Commissioner Charles Rossotti issued a news release shortly before the Saver's Credit took effect on January 1, 2002, encouraging employees to take advantage of the credit and enroll in 401(k)-type plans, and the IRS took the unusual step of preparing and publishing a Spanish-language version of the model employer notice to employees. See IR 2001-107, 44 I.R.B. (November 7, 2001).

[20] Automatic enrollment was approved in IRS Revenue Ruling 2000-8. The IRS has recently 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.

[21] William G. Gale, J. Mark Iwry, Peter R. Orszag, "The Automatic 401(k): A Simple Way to Strengthen Retirement Savings," *Policy Brief* No. 2005-1. These and related publications are available on The Retirement Security Project website (www.retirementsecurityproject.org).

[22] 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

[23] For a broader discussion of these issues, see William G. Gale and Peter R. Orszag, "Private Pensions: Issues and Options." For a broader discussion of the objectives of the private pension system and why more has not been done to address the needs of middle- and lower-income households, see J. Mark Iwry, Testimony before the House Committee on Education and the Workforce, Subcommittee on Employer-Employee Relations, June 4, 2003.

[24] See Engen, Gale, and Uccello, "The Adequacy of Household Saving."

[25] For example, an unpublished study by a Treasury economist found that only 4 percent of taxpayers eligible for conventional IRAs in 1995 made the maximum allowable $2,000 contribution. Robert Carroll, "IRAs and the Tax Reform Act of 1997," Office of Tax Analysis, Department of the Treasury, January 2000. For IRA contributors at the limit, see also Craig Copeland, "IRA Assets and Characteristics of IRA Owners." *EBRI Notes*, December 2002. Other studies have found a paucity of 401(k)-type plan contributors to be constrained by the statutory dollar maximum. For example, the General Accounting Office (now the Government Accountability Office) found that an increase in the statutory contribution limit for 401(k)-type plans would directly benefit fewer than 3 percent of participants (General Accounting Office, "Private Pensions: Issues of Coverage and Increasing Contribution Limits for Defined Contribution Plans," GAO-01-846, September 2001). Data from the Congressional Budget Office suggest that only 6 percent of all 401(k)-type plan participants made the maximum contribution allowed by law in 1997. (Author's calculations based on Congressional Budget Office, "Utilization of Tax Incentives for Retirement Saving," August 2003, table 2.) See also David Joulfaian and David Richardson, "Who Takes Advantage of Tax-Deferred Saving Programs? Evidence from Federal Income Tax Data," Office of Tax Analysis, U.S. Department of the Treasury, 2001.

[26] For a discussion of this shift from defined benefit to defined contribution plans, see J. Mark Iwry, Testimony before the House Committee on Education and the Workforce, Subcommittee on Employer-Employee Relations, June 4, 2003

[27] Jeanne M. Hogarth and Chris E. Anguelov, "Can the Poor Save?" *Proceedings of Association for Financial Counseling and Planning Education* (2001).

[28] Michael Sherraden, "*Asset Building Policy and Programs for the Poor,*" *in Assets for the Poor: The Benefits of Spreading Asset Ownership*, edited by Thomas Shapiro and Edward Wolff (N.Y. Russell Sage Foundation, 2001). Also, homeownership rates rose in a demonstration program that gave strong incentives for lower-income families to purchase housing. See Gregory Mills and others, "Evaluation of the American Dream Demonstration: Final Evaluation Report" (Cambridge, Mass.: Abt Associates, August 2004).

[29] Economists continue to debate the impact on private savings from existing pension incentives. Most economists agree, however, that whatever the overall effect, focusing incentives on those with fewer opportunities to shift assets from taxable to nontaxable forms is likely to produce a larger increase in private savings for any given reduction in government revenue.

[30] 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, December 2000), and Daniel Benjamin, "Does 401(k) Eligibility Increase Saving? Evidence from Propensity Score Subclassification," *Journal of Public Economics* 87, no. 5-6 (2003): 1259-90.

[31] These estimates are generated by the Urban-Brookings Tax Policy Center microsimulation model. The model is based on data from the 1999 public-use file produced by the Statistics of Income Division of the IRS. The model contains additional information on demographics and sources of income that are not reported on tax returns through a constrained statistical match of the public-use file with the March 2000 Current Population Survey of the U.S. Census Bureau. The retirement savings module also uses data from the Survey of Consumer Finances and the Survey of Income and Program Participation. For more detail about the model, see www.taxpolicycenter.org.

[32] Some households who can benefit from the Saver's Credit do not have positive income tax liability, but do have positive income tax liability before taking into account the Earned Income Tax Credit (EITC). For these households, the EITC refund is increased to the extent that the Saver's Credit reduces their pre-EITC tax liability.

[33] Individual Income Tax Returns, Preliminary Data: Selected Income and Tax Items, Tax Years 2002 and 2003 <http://www.irs.gov/pub/irs-soi/03in01fg.xls> Unpublished SOI Data. February 2005.

[34] The IRS data are based on the number of tax returns that claimed the Saver's Credit by entering an amount on line 49 of Form 1040 "retirement savings contributions credit" and filing Form 8880 "Credit for Qualified Retirement Savings Contributions". (On the 2004 tax return, the Saver's Credit is claimed by entering an amount on line 50.) The data do not show a breakdown of contributions by type of plan (employer plan versus IRA, for example) or size of contribution. However, partial data that shed some light on these issues are available from other sources, such as professional tax preparers, with whose aid a significant portion of returns claiming a Saver's Credit were filed.

[35] If 401(k)-type plan or IRA contributions were offset by reduced savings in other accounts or more borrowing, the net effect on overall savings rates could be zero even if the effect on 401(k)-type plan and IRA contributions were positive.

[36] See the website of *Plan Sponsor* magazine (www.plansponsor.com), July 23, 2002. It should be noted that the survey was targeted to compliance with the EGTRRA legislation generally; the questions regarding the Saver's Credit constituted only a small fraction of the total questions in the survey. In addition, the plan sponsors surveyed represented a small sample that appears to have been selected in an informal manner from among clients of the surveying firm, and the basis for determining the impact on participation in the 401(k) was not made clear. Nonetheless, the results, reflecting the perceptions of those who administer 401(k) plans, are striking, especially given that they were sampled only six months after the credit took effect.

[37] B. Tumulty and C. Burnett, "Bush Shuns Retirement Tax Credit," Gannett News Service, March 1, 2004; B. Tumulty, "White House Drops Saver Credit," *Green Bay Press-Gazette*, February 21, 2004.

[38] Various proposals – including bills introduced by Sen. Jeff Bingaman (D-NM) and Rep. Richard Gephardt (D-MO), S. 2733 and H.R. 4482, respectively and H.R. 1776, the Pension Preservation and Savings Expansion Act of 2003, introduced by Reps. Portman and Cardin (see section 102 of that bill) – would remove the sunset on the Saver's Credit.

[39] This change was proposed in a bill introduced by then House Minority Leader Richard Gephardt in 2002 (H.R. 4482, 107th Cong., 2d Sess.) It was also proposed in a bill introduced by then Senator John Edwards (D-NC) in 2004 (S. 2303, 108th Cong., 2d Sess.).

[40] Requiring tax filers to have at least $5,000 in earnings per person ($10,000 for joint filers) in order to claim a refundable credit would reduce the cost by about $0.5 billion to $0.7 billion a year.

[41] If the Saver's Credit remains nonrefundable, it should be coordinated better with the child tax credit. The legislation enacting the Saver's Credit provided originally that it would be taken into account after most other nonrefundable or partially refundable tax credits, notably the partially refundable child tax credit. See IRC sections 24(b)(3)(B) and 25B(g)(2) and IRS Announcement 2001-106 (sample notice). The nonrefundable component of the child tax credit "competes" with the nonrefundable Saver's Credit to reduce the same income tax liability. Accordingly, if the child tax credit completely eliminated a taxpayer's income tax liability, it would effectively crowd out the Saver's Credit, so that the latter would lose its incentive effect. (In contrast, the EITC is refundable and does not reduce the amount of the Saver's Credit.) However, since enacting the Saver's Credit, Congress has made temporary changes to the interaction of the credits that have had the effect of temporarily reversing this stacking order and taking the Saver's Credit into account before the nonrefundable portion of the child tax credit. Congress could make these changes permanent, preserving the incentive value of the Saver's Credit by amending the tax code to provide on a permanent basis that the Saver's Credit is taken into account to offset tax liability before the child tax credit. Stacking the Saver's Credit before the child tax credit, if scored as a change in law, would cost about $500 million a year. This is a distinctly second-best solution, however, compared with the far more effective step of making the Saver's Credit refundable.

[42] See S. 2733 (107th Cong., 2d Sess.)

[43] See U.S. Department of the Treasury, "General Explanations of the Administration's Fiscal Year 2001 Revenue Proposals" (February 2000), pp. 49-52

[44] One apparent problem is the lack of easily accessible bank routing numbers for many IRAs and 401(k)-type plans. Other complications include the need for plan sponsors to administer the account balances resulting from such deposits, including the possible need for additional "buckets" in plan data systems to keep separate track of different kinds of funds. This would be a particularly challenging problem if the balance attributable to the Saver's Credit were taxable when withdrawn from a Roth IRA, even after retirement. On the other hand, if the Saver's Credit balance were not taxable when withdrawn from a Roth IRA, it would escape tax permanently. In addition, consideration reportedly has been given to the possibility of treating the government's deposit as satisfying some of the employer's contribution obligations under the nondiscrimination standards, as if the government deposit were an employer contribution. This would in effect shift part of the employers' responsibility for funding retirement benefits for lower-income employees from employers to the government. As noted, the Saver's Credit already helps plans pass the nondiscrimination tests insofar as it induces additional contributions by middle-income workers.

[45] See J. Mark Iwry, "Expanding the Saver's Credit," Testimony before the Subcommittee on Employer-Employee Relations of the House Committee on Education and the Workforce, July 1, 2003, p. 4.

[46] Income eligibility levels would be increased to various degrees by the Bingaman and Gephardt bills (S. 2733 and H.R. 4482) and slightly by the Portman-Cardin bill (H.R. 1776, section 401).

William G. Gale is Deputy Director of the Economic Studies Program at the Brookings Institution, the Arjay and Frances Fearing Miller Chair in Federal Economic Policy at Brookings, and Co-Director of the Urban-Brookings Tax Policy Center.

J. Mark Iwry is Senior Adviser to The Retirement Security Project, a Nonresident Senior Fellow at Brookings, and the former Benefits Tax Counsel at the U.S. Treasury Department, where he played a lead role in developing the Saver's Credit and automatic rollover and in approving and advancing automatic enrollment.

Peter R. Orszag is Director of The Retirement Security Project, the Joseph A. Pechman Senior Fellow in Tax and Fiscal Policy at the Brookings Institution, and Co-Director of the Urban-Brookings Tax Policy Center.

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Mission Statement

The Retirement Security Project is dedicated to promoting common sense solutions to improve the retirement income prospects of millions of American workers.

The goal of The Retirement Security Project is to work on a nonpartisan basis to make it easier and increase incentives for middle- and lower-income Americans to save for a financially secure retirement.

1755 Massachusetts Ave., NW, Suite 550
Washington, DC 20036
p: 202.483.1370 f: 202.483.1460
www.retirementsecurityproject.org

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FUTURES
VOLUME V

BUILDING FUTURES | A Report on Corporate Defined Contribution Plans

It is a pleasure to provide you with *Building Futures, V*, the latest in Fidelity's series of in-depth research reports on the state of the defined contribution industry. For this report, we tracked our more than 10,000 recordkept plans and their 8.2 million participants to assess plan and asset distribution; participation, deferral, and withdrawal rates; average account balances; demographic patterns; investment options; and more.

We gain a lot by studying such information. While one year's worth of statistics and graphs certainly provides a useful snapshot in time, many years' worth of specific, measurable, comparative data help illustrate a much larger story about plan performance and participant behavior over time and across fluctuations in market conditions. And that helps all of us who care about the economic future of the U.S. workforce shape a meaningful strategy for responding to employees' retirement needs well before they retire.

For example, last year's *Building Futures IV* research found that, in the face of unpredictable markets in 2002, the system was fundamentally sound—signified by an increase in deferral rates even while account balances declined. A year later, as you will see in *Building Futures V*, we find that average account balances increased 25% during 2003. What does this tell us? The answer is important: participants are staying the course and making decisions that will help them live well in retirement. Helping them reach those goals and live comfortably for the duration of their lifetime is essentially our purpose and our privilege. I hope you'll find that *Building Futures V* sheds some light on your own pursuit toward that end.

Sincerely,

William C. Carey
President
Fidelity Institutional Retirement Services Company

BUILDING FUTURES | Table of Contents

To see an online version of the report, go to *http://buildingfutures.fidelity.com*.

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Executive Summary

Amid the shifting economic and market conditions that characterized the first four years of the 2000s, the defined contribution plan system has demonstrated reassuring stability and strength. This attribute is fully evident in this fifth edition of *Building Futures*, a report on trends and patterns among corporate defined contribution plans for which Fidelity Employer Services Company performed recordkeeping services in 2003.

Building Futures, Volume V, marks a milestone in Fidelity Investments' comprehensive reporting on the corporate defined contribution plans for which it provides recordkeeping services. With this report, *Building Futures* has now spanned a six-year period that began in the midst of a long-running bull market, continued through a significant three-year downturn, and in 2003 saw equity markets make a strong recovery. Through the lens of this market cycle, *Building Futures V* provides insight into the defined contribution system through both good times and bad, and the results are largely encouraging.

The data in this report were compiled from corporate defined contribution plans for which Fidelity Employer Services Company has performed recordkeeping services. In 2003, this Fidelity client base exceeded 8 million participants enrolled in more than 10,000 plans. These figures represent a 19% increase in plans and a 15% increase in participants since the end of 2000. While Fidelity's leading share of the corporate defined contribution marketplace is substantial, the results of the analyses in this report may not reflect exactly the trends of the industry as a whole. Nevertheless, the data set is significantly large enough to provide meaningful insights into the direction of the nation's defined contribution system.

As equity markets produced positive returns in 2003 for the first time since 1999, the impact of the rebound was felt strongly by Fidelity-recordkept participants, whose average account balance increased 25% during the year, to $55,000. In addition, 41% had balances above $30,000, while the median balance increased by a third, to $20,000. Employee pretax deferral rates remained steady to slightly higher, at about 7% for participants in "continuous" plans (plans that were present in both 2002 and 2003). Areas of ongoing concern in 2003 included a continuation of gradually decreasing participation rates, which declined to 66%, and a persistent portion of participants—about one-fourth—who continued to hold only a single investment option.

Meanwhile, the percentage of plans offering Fidelity Freedom Funds,® Fidelity's family of life-stage funds, increased from 62% in 2002 to 72% in 2003, and 19% of participants who have access to Freedom Funds have assets in them.

A new analysis performed for this report found that in 2003 approximately one in ten contributing participants reached the 402(g) maximum deferral pretax contribution limit of $12,000, suggesting that, given the opportunity, some American workers could be saving more in their defined contribution plans.

Plan overview

Plans, participants, and assets—The Fidelity-recordkept corporate defined contribution plan base exceeded 10,000 in 2003, reaching 10,136 plans with 8.2 million participants. At the same time, the administered asset base increased 26%, to $453 billion, reflecting the strong stock market performance of 2003.*

Plan and asset distribution—The 2003 data reflected a stable plan base spread across companies of all sizes in virtually all industries. Two-thirds of Fidelity-recordkept plans had fewer than 150 participants, while larger plans had the majority of assets and participants. The broadly defined Manufacturing industry represented the largest share of plans (29%), assets (52%), and participants (46%).

Plan performance

Participation rates—The average plan participation rate among plans for which Fidelity performed nondiscrimination testing decreased from 68% in 2002 to 66% in 2003, continuing a trend that has been present throughout the *Building Futures* report series.

Average account balances—The 2003 stock market rebound was the primary driver of an $11,000 increase in the weighted average account balance of participants in Fidelity-recordkept plans. It was the largest one-year change since the inception of *Building Futures*. The $55,000 weighted average balance at the end of 2003 represented a 25% increase over the average at year-end 2002. Median account balances, meanwhile, increased from $15,000 at the end of 2002 to $20,000 at the end of 2003.

Deferral rates for active participants—The overall average deferral rate for highly compensated participants (HCPs) increased by one-tenth of a percentage point, to 7.1%, in 2003, while the rate for non-highly compensated participants (NHCPs) dropped one-tenth of a percentage point, to 6.9%. However, the rate for NHCPs in continuous plans was unchanged, while the rate for HCPs in continuous plans increased by almost three-tenths of a percentage point.

Demographics and participant behavior

Demographic patterns—Nearly one-third of all participants in Fidelity-recordkept plans were in their 40s in 2003, with the overall median participant age being 44. The average participant age continued to edge higher, as illustrated by an increase in the portion of participants in their 50s (from 22.3% in 2002 to 22.9% in 2003) and a corresponding decrease in the portion in their 30s (from 27.1% in 2002 to 26.3% in 2003).

The mean compensation for active participants increased 2.8% in 2003, to almost $68,000. This increase was not across the board, however, with an increase in the percentage of active participants making less than $50,000 and more than $100,000, and a decrease in the percentage making between $50,000 and $100,000.

Although the majority of participants continued to have account balances below $30,000, the portion with balances above that mark increased to 41% in 2003 from 34% in 2002, again reflecting the strong stock market performance during the year.

Use of exchanges—Approximately 13% of participants initiated exchanges in 2003, virtually the same portion as in 2002, despite significant differences in stock market performance during those two years. Among all participants who made exchanges, the majority (58%) made them on just a single day, while only 2% of participants made exchanges on four or more days in 2003.

Use of loans—Of the 93% of active participants who were enrolled in plans that allowed them to take a loan against their accounts, only 20% had a loan outstanding in 2003, the same portion as in 2002.

Withdrawal activity—Almost 17% of participants took full or partial withdrawals in 2003, one-third of a percentage point higher than in 2002. Consistent with minimum required distribution rules, a much higher portion of participants age 70 and older (79%) took withdrawals than did younger participants.

Plan investment options and participant investment choices

Investment options—The mean number of investment options available to participants in 2003 increased to 18 from 16 in 2002, continuing a trend among recordkept plans to add an average of two options per year. However, for plans present in both 2002 and 2003 ("continuous plans"), 53% did not change the number of investment options offered, while 36% increased and 11% reduced the number of investment options they offered. Consistent with previous years, the four asset classes offered most often by Fidelity-recordkept plans were domestic equity (99% of plans), fixed income (93%), blended (91%), and international equity (89%).

Investment behavior—With 93% of participants having access to 11 or more investment options in 2003—slightly higher than in 2002—the average number of investment options held by participants also edged upward, to 3.6 from 3.5 in 2002. The asset class with the largest portion of participant assets continued to be domestic equities, which accounted for 41% of participants' assets in 2003, up from 38% in 2002. Meanwhile, the portion of participants' assets in short-term, stable value, and fixed-income investments decreased. Analyzed by age, participants' overall asset allocation decisions once again reflected age-appropriate choices on average, with the percentage of assets held in equities decreasing with age, and the percentage held in conservative investments increasing with age.

Single investment option holders—The portion of participants who held just one investment option remained unchanged at 25% in 2003. Members of this group tended to have significantly lower account balances and held more conservative investment options than the overall recordkept participant population. One pattern change that occurred in 2003 was a modest shift in the percentage of single option holders from domestic equities to blended options, which include Fidelity Freedom Funds. The percentage of single investment option holders who held blended investment options increased from 16% in 2002 to 18% in 2003.

Life-stage funds—Although the percentage of single investment option holders remained steady, a growing number of plans in 2003 offered life-stage funds that provide age-appropriate diversification within a single "fund of funds." Although there are various life-stage fund families, the analyses included in this report are limited to Fidelity Freedom Funds.* The percentage of plans offering at least one Fidelity Freedom Fund increased 10 percentage points from 2002, to 72% overall. The percentage of plans offering a family of three or more Fidelity Freedom Funds increased from 51% in 2002 to 60% in 2003. Nineteen percent of participants in plans that offered Freedom Funds had some portion of their assets in Freedom Funds.

Response to market volatility—The small percentage of participants who made exchanges in 2003 reacted to the change in market performance by exchanging into equities and out of more conservative options. Conversely, the much greater number of participants making contributions continued a three-year trend of decreasing their percentage of new contribution dollars into domestic and international equities, from 56% in 2002 to 52% in 2003.

Conclusion

The data in this report reinforce the indication that American workers recognize the important role of their defined contribution plans as long-term investment vehicles for helping to meet their financial needs during retirement. Even as stock market volatility buffeted account balances from one year to the next, participants did not react rashly, but, rather, continued the steady flow of contributions into their accounts. Shifts occurred between conservative and more equity market–driven investments, reflecting the direction of investment performance, but withdrawal and exchange activity remained steady, indicating that participants were weathering the ups and downs. In 2003, as the markets rebounded and account values increased to past levels, participants as a group exhibited characteristic calm by generally maintaining age-appropriate asset allocation behaviors.

*These plan, participant and asset figures are lower than certain other officially published Fidelity DC statistics because they exclude tax-exempt DC plans, intermediary market plans, non-assetized unfunded nonqualified plans, plans in implementation, etc.

Neither diversification nor asset allocation ensures a profit or guarantees against loss.

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SECTION 1 | Plan Overview

To see an online version of the report, go to *http://buildingfutures.fidelity.com*.

The Fidelity-recordkept plan base and number of participants grew between 1% and 2% in 2003. The increase in the value of recordkept plan assets, meanwhile, was much greater—26%—primarily reflecting investment performance during the year.

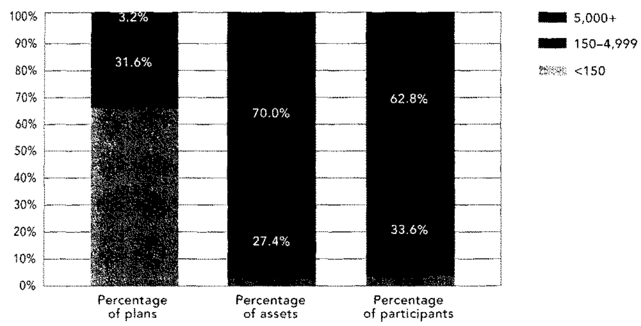
1 Fidelity corporate defined contribution plans

	2003	2002
Assets recordkept	**$453 billion**	$361 billion
Recordkept participants	**8.22 million**	8.11 million
Active participants	**5.84 million**	5.78 million
Plans recordkept	**10,136**	9,948
Clients recordkept	**8,885**	8,683

Note: Assets recordkept include all dollars in corporate DC plans for which Fidelity Employer Services Company is recordkeeper, including assets in investment options managed by Fidelity as well as by other institutions. Recordkept participants are those participants with a plan balance, whether or not they were employed by the plan sponsor as of 12/31/2003. Active participants are those participants with a plan balance who were still employed by the plan sponsor as of 12/31/2003. Plans recordkept are predominantly qualified plans; however, approximately 3% are nonqualified plans with assets set aside by the plan sponsor through segregated investment accounts or rabbi trusts. All data in the report exclude plans recordkept for Fidelity Investments' own employees. See the Methodology section for further details on definitions used in the report.

The distribution of plans, participants, and assets by plan size changed very little in 2003, reflecting the overall stability of the Fidelity client base. Plans with fewer than 150 participants continued to represent about two-thirds of the plan base, while larger plans contained the majority of assets and participants. Plans with 5,000 or more participants comprised just 3% of total plans but contained 71% of assets and 64% of participants.

2 Overview of Fidelity corporate defined contribution plans, by plan size (number of participants)



A more granular view of plans shows a similar trend as Table 2, with the smallest plans making up the largest portion of plans but the smallest portion of assets and participants.

3 Fidelity corporate defined contribution plans, by plan size (number of participan

	Plan size	Percentage of plans	Percentage of assets	Percentage of participants
<150	<25	28%	0.2%	0.4%
	25–49	14%	0.4%	1%
	50–149	23%	2%	2%
150–4,999	150–499	18%	4%	6%
	500–999	6%	4%	5%
	1,000–2,499	5%	8%	10%
	2,500–4,999	2%	10%	11%
5,000+	5,000–9,999	2%	12%	14%
	10,000–24,999	1%	22%	22%
	25,000+	0.5%	37%	28%
	Total	**100%**	**100%**	**100%**

The distribution of plans among industry sectors in 2003 was consistent with 2002. The sector with the most plans continued to be Manufacturing, with 29%, followed closely by Professional, Scientific, and Technical Services, with 25%. Manufacturing remained far ahead of other sectors in terms of total assets (52%) and total participants (46%). Meanwhile, the Information Services sector represented just 7% of all plans, but 15% of assets and participants.

4 Fidelity corporate defined contribution plans, by industry

Industry	Percentage of plans	Percentage of assets	Percentage of participants
Accommodation and Food Services	1%	0.4%	1%
Administrative Support, Waste Management, and Remediation Services	1%	0.3%	1%
Agriculture, Forestry, Fishing, and Hunting	0.5%	0.2%	0.3%
Arts, Entertainment, and Recreation	1%	0.3%	1%
Construction	3%	1%	2%
Educational Services	0.4%	0.1%	0.2%
Finance and Insurance	7%	4%	5%
Health Care and Social Assistance	4%	2%	3%
Information Services	7%	15%	15%
Management of Companies and Enterprises	1%	0.5%	1%
Manufacturing	29%	52%	46%
Mining	1%	3%	2%
Other Services (except Public Administration)	2%	0.5%	1%
Professional, Scientific, and Technical Services	25%	7%	7%
Public Administration	0.03%	0.04%	0.2%
Real Estate and Rental and Leasing	2%	1%	1%
Retail Trade	4%	3%	5%
Transportation and Warehousing	2%	4%	5%
Utilities	1%	4%	2%
Wholesale Trade	5%	2%	3%
Total	**100%**	**100%**	**100%**

Domestic and international equity markets made a strong recovery in 2003, providing positive full-year returns to investors for the first time since 1999. Returns for bonds and three-month Treasury bills remained positive in 2003, but significantly lower than in previous years. These shifting market trends contributed significantly to changes in the distribution of plan asset values among investment categories as reported in the Participant Investment Choices section of this report.

5 Rates of return, December 31, 1998, to December 31, 2003

Index	Return 2003	Return 2002	Return 2001	Return 2000	Return 1999	Source
Three-month Treasury bill	1%	2%	4%	6%	5%	Lehman Brothers
Lehman Brothers® Aggregate Bond Index	4%	10%	8%	12%	–1%	Lehman Brothers
S&P 500® Composite Stock Price Index	29%	–22%	–12%	–9%	21%	Standard & Poor's
Wilshire 5000	32%	–21%	–11%	–11%	24%	Wilshire
Morgan Stanley Europe, Australasia, Far East (EAFE®) Index	39%	–16%	–21%	–14%	27%	Morgan Stanley

Note: Past performance is no guarantee of future results. U.S. stock prices are more volatile than those of other securities. Government bonds and corporate bonds have more moderate short-term price fluctuations than stocks but provide lower potential long-term returns. U.S. Treasury bills maintain a stable value (if held to maturity), but returns are generally only slightly above the inflation rate. Foreign investments, especially those in emerging markets, involve greater risk and may offer greater potential returns than U.S. investments. This risk includes the political and economic uncertainties of foreign countries as well as the risk of currency fluctuation. An investment cannot be made in any index. For index definitions, please see the Methodology section.

A Note on Methodology:

As in previous years' reports, the tables in Building Futures V contain multiyear data when those data are useful in illustrating relevant trends, and in some instances the accompanying narrative contains references to past-year data that may not be shown in the tables. Also, there are frequent references to "continuous plan" data, which are plans that were present in both 2003 and 2002. Decisions on whether to include multiyear or continuous plan data were made based on the ability of the information to provide insight into the direction, significance, or context of a particular trend.

SECTION 2 | Plan Performance

To see an online version of the report, go to *http://buildingfutures.fidelity.com*.

After three consecutive years of stock market declines, 2003 brought strong overall returns to equity investors. The stock market rebound rewarded participants in Fidelity-recordkept defined contribution plans by helping boost the average account balance by $11,000, to $55,000 (a 25% increase). This increase—the largest year-over-year change since Fidelity began publishing *Building Futures*—brought the average balance back to the same level at which it finished in 2000.

Although investment performance was the dominant factor in shaping many of the report's findings, it was not a panacea in all areas. Participation rates, for example, continued their gradual decline that began at about the start of the decade. The 2003 participation rate decrease in the face of strong investment performance suggests that complex economic and demographic factors are underlying the trend.

PARTICIPATION RATES

Participation rates decreased from 68% in 2002 to 66% in 2003. Among continuous plans,* decreases occurred in every plan-size category. As in previous years, small plans experienced higher participation rates than large plans.

6 Participation rate, by plan size (number of eligible participants)

Plan size	2003	2002	2001
<25	74%	75%	82%
25–49	70%	71%	74%
50–149	66%	68%	71%
150–499	64%	68%	69%
500–999	62%	65%	65%
1,000–2,499	60%	61%	63%
2,500–4,999	59%	64%	63%
5,000–9,999	60%	58%	58%
10,000–24,999	53%	60%	57%
25,000+	60%	56%	55%
Unweighted Average	**66%**	**68%**	**70%**

Note: For purposes of reporting participation rates and deferral rates, plans are grouped by number of eligible nondiscrimination testing (NDT) participants. For all other data in the report where plans are grouped by participants, they are grouped by number of recordkept participants. Participation rates at the plan level are reported as unweighted averages, as are nondiscrimination testing deferral percentages. All other average data in the report, including participation rates at the participant demographic level, are reported as weighted averages. For a complete description of how participation rates are calculated and of the use of weighted and unweighted averages, see the Methodology section.

*Continuous plans are plans present in both 2002 and 2003.

Average participation rates decreased across most industry categories. The largest decrease among continuous plans was in Arts, Entertainment, and Recreation, where the rate was down 5.4%. The Mining industry, which saw a large participation rate decline overall, was comparable to other industries' declines when only continuous plans were considered. The largest participation rate increase among continuous plans, meanwhile, was in Agriculture, Forestry, Fishing, and Hunting, where the rate was 11.5% higher.

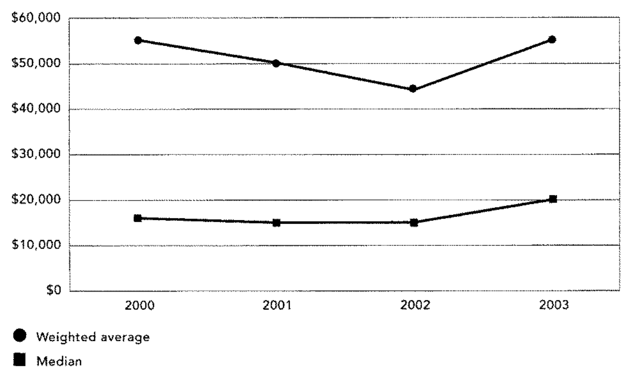
7 Participation rate, by industry category

Industry	2003	2002	2001
Accommodation and Food Services	48%	47%	54%
Administrative Support, Waste Management, and Remediation Services	56%	57%	64%
Agriculture, Forestry, Fishing, and Hunting	67%	53%	56%
Arts, Entertainment, and Recreation	53%	56%	54%
Construction	62%	67%	69%
Educational Services	66%	59%	61%
Finance and Insurance	73%	76%	78%
Health Care and Social Assistance	62%	64%	69%
Information Services	65%	67%	69%
Management of Companies and Enterprises	66%	70%	69%
Manufacturing	67%	69%	70%
Mining	69%	80%	78%
Other Services (except Public Administration)	64%	65%	70%
Professional, Scientific, and Technical Services	68%	72%	72%
Real Estate and Rental and Leasing	63%	66%	65%
Retail Trade	49%	53%	56%
Transportation and Warehousing	59%	59%	61%
Utilities	75%	79%	84%
Wholesale Trade	65%	69%	71%
Unweighted Average	**66%**	**68%**	**70%**

ACCOUNT BALANCES

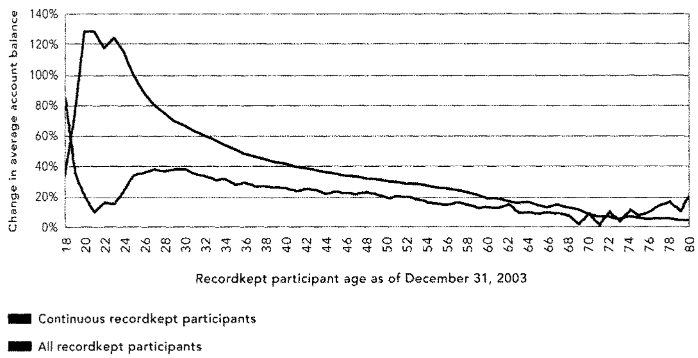
Weighted average account balances increased 25% from 2002 to 2003, from $44,000 to $55,000, driven largely by the performance of equity markets. Median balances, as in the past, continued to be considerably lower than weighted average balances, reflecting the tendency of high-balance accounts to pull up the averages. The overall median balance—the point at which half of all participants' balances were below and half were above—increased to $20,000 in 2003, an increase of 33% from $15,000 in 2002.

8 Trends in average account balances



Although the weighted average account balance for all Fidelity-recordkept participants increased by 25% in 2003, the increase was even greater—30%—for continuous participants. The graph below shows strikingly that the largest percentage increases for continuous participants occurred in the younger age groups. This results from the fact that younger participants tend to have lower balances than older ones, so new contributions, not investment performance, are the primary driver of their account value growth. Older participants' balances, on the other hand, are generally higher and therefore are affected much more significantly by investment performance. This trend, shown by the shape of the "Continuous recordkept participants" curve, has remained quite consistent over time, with the only key difference being the break-even age (i.e., the age below which continuous participants had increases in balances and above which they had decreases in balances). From 2002 to 2003, the percentage change in weighted average account balances was positive for continuous participants in all age groups. For the one-year periods ending in 2001 and 2002, however, the break-even ages were in the mid- to late-30s.

9 Percentage change in average account balance, December 31, 2002, to December 31, 2003



Note: Data in the chart should be interpreted as follows: The "All recordkept participants" curve shows the percentage difference in average account balances for all participants who were 36 years old at the end of 2002 relative to all those who were 37 years old at the end of 2003, for example. The "Continuous recordkept participants" curve, on the other hand, shows the percentage change in average account balances for those participants who had balances at the end of both 2002 and 2003, and who were 36 at the end of 2002 and 37 at the end of 2003, for example.

Weighted average account balances increased across all plan-size groupings in 2003. The increases ranged from 20% to 31% in all groups except the group with the smallest plans, which saw a 50% increase. The ratio of median to weighted average balance ranged from 32% to 42% across all plan-size groupings. On both weighted average and median balance bases, larger plans continued to have higher average balances than smaller plans. This result reflects the overall ages of plans and the amount of time participants have had to accumulate assets.

10 Participant account balance, by plan size (number of participants)

		Weighted average participant account balance			
Plan size	2003 median participant account balance	2003	2002	2001	2000
<25	$12,000	$36,000	$24,000	$27,000	$29,000
25–49	$13,000	$39,000	$31,000	$32,000	$37,000
50–149	$15,000	$42,000	$34,000	$36,000	$42,000
150–499	$15,000	$40,000	$31,000	$35,000	$39,000
500–999	$17,000	$43,000	$35,000	$39,000	$42,000
1,000–2,499	$17,000	$43,000	$35,000	$40,000	$44,000
2,500–4,999	$20,000	$50,000	$40,000	$42,000	$45,000
5,000–9,999	$19,000	$48,000	$40,000	$45,000	$50,000
10,000–24,999	$22,000	$59,000	$45,000	$51,000	$54,000
25,000+	$29,000	$70,000	$57,000	$66,000	$74,000
Overall	**$20,000**	**$55,000**	**$44,000**	**$50,000**	**$55,000**

Note: Balances represent the weighted average or median balances for all recordkept participants in plans falling within a plan-size range. Balances are net of outstanding loan amounts. All participant balance data in the report are rounded to the nearest $1,000. For a complete description of how account balances are calculated, see the Methodology section.

Year-to-year increases in weighted average account balances varied substantially across industry categories in 2003, but the sectors with the most plans—Manufacturing and Professional, Scientific, and Technical Services—were comparable at 24% and 30%, respectively. The only category to experience a decrease was Management of Companies and Enterprises, in which the average account balance was down 20%. However, when only continuous plans were considered, that industry showed an increase of 22%, consistent with the overall average account balance increase of 25%.

11 Participant account balance, by industry

Industry	2003	2002	2001	2000
Accommodation and Food Services	$23,000	$15,000	$15,000	$20,000
Administrative Support, Waste Management, and Remediation Services	$26,000	$20,000	$21,000	$22,000
Agriculture, Forestry, Fishing, and Hunting	$29,000	$26,000	$30,000	$33,000
Arts, Entertainment, and Recreation	$28,000	$22,000	$24,000	$31,000
Construction	$41,000	$33,000	$35,000	$37,000
Educational Services	$35,000	$26,000	$31,000	$36,000
Finance and Insurance	$52,000	$43,000	$48,000	$53,000
Health Care and Social Assistance	$35,000	$27,000	$31,000	$34,000
Information Services	$56,000	$50,000	$58,000	$63,000
Management of Companies and Enterprises	$43,000	$54,000	$60,000	$69,000
Manufacturing	$62,000	$50,000	$56,000	$61,000
Mining	$88,000	$79,000	$102,000	$126,000
Other Services (except Public Administration)	$48,000	$40,000	$48,000	$53,000
Professional, Scientific, and Technical Services	$52,000	$40,000	$45,000	$50,000
Public Administration	$13,000	$11,000	$11,000	$12,000
Real Estate and Rental and Leasing	$33,000	$25,000	$27,000	$31,000
Retail Trade	$29,000	$24,000	$28,000	$31,000
Transportation and Warehousing	$43,000	$31,000	$34,000	$38,000
Utilities	$91,000	$66,000	$72,000	$77,000
Wholesale Trade	$38,000	$33,000	$34,000	$35,000
Overall	**$55,000**	**$44,000**	**$50,000**	**$55,000**

Note: Balances represent the weighted average for all recordkept participants in plans falling within an industry category.

DEFERRAL RATES

Average pretax deferral rates for highly compensated participants (HCPs) increased by one-tenth of a percentage point from 2002, from 7.0% to 7.1%, while the average pretax deferral rate for non-highly compensated participants (NHCPs) was one-tenth of a percentage point lower, from 7.0% to 6.9%. The averages among continuous plans told a slightly different story, however. The average pretax deferral rate for HCPs in continuous plans was three-tenths of a percentage point higher, while the rate for NHCPs in continuous plans was essentially unchanged.

12 Average deferral rate for HCP and NHCP, by plan size (active participants)

	2003		2002	
Plan size	HCP	NHCP	HCP	NHCP
<25	6.9%	7.2%	7.0%	7.0%
25–49	6.9%	7.3%	6.6%	7.1%
50–149	7.0%	7.0%	6.8%	7.0%
150–499	6.8%	6.8%	6.7%	6.9%
500–999	6.9%	6.8%	6.9%	6.9%
1,000–2,499	6.9%	6.7%	7.1%	6.8%
2,500–4,999	6.9%	6.7%	7.0%	6.9%
5,000–9,999	7.0%	6.9%	6.6%	6.7%
10,000–24,999	7.3%	7.0%	7.0%	7.0%
25,000+	7.3%	7.0%	7.2%	7.4%
Average	**7.1%**	**6.9%**	**7.0%**	**7.0%**

Note: Active NDT participants represent participants in those plans for which Fidelity provided nondiscrimination testing who were employed by the plan sponsor and who made contributions to their plan at any time during the 2003 test year, whether or not they were present at the end of 2003.

The deferral trends among all eligible highly compensated employees (HCEs) and all eligible non-highly compensated employees (NHCEs) were similar to those for the subset of employees who were contributing to their plans in 2003. Deferral rates increased for HCEs, from 5.9% in 2002 to 6.3% in 2003, and rates decreased for NHCEs, from 4.0% in 2002 to 3.8% in 2003. The rates are lower than those in Table 12, however, because they include eligible employees whose contribution rate was zero. Among continuous plans, the average HCE deferral rate was six-tenths of a percentage point higher, from 5.7% to 6.3%, and the average NHCE rate was one-tenth of a percentage point lower than in 2002, from 4.0% to 3.8%.

13 Average deferral rate for HCE and NHCE, by plan size (eligible employees)

	2003		2002	
Plan size	HCE	NHCE	HCE	NHCE
<25	5.9%	5.0%	6.1%	4.8%
25–49	6.0%	4.8%	5.7%	4.8%
50–149	6.1%	4.4%	6.0%	4.6%
150–499	6.0%	4.2%	5.8%	4.4%
500–999	6.1%	4.0%	6.1%	4.2%
1,000–2,499	6.0%	3.8%	5.9%	4.0%
2,500–4,999	6.2%	3.7%	5.8%	4.2%
5,000–9,999	6.1%	3.8%	5.4%	3.5%
10,000–24,999	6.5%	3.5%	6.2%	3.9%
25,000+	6.5%	4.0%	5.9%	4.0%
Average	**6.3%**	**3.8%**	**5.9%**	**4.0%**

Note: "Eligible employees" represent employees in plans for which Fidelity performed nondiscrimination testing who were employed by the plan sponsor and were eligible to participate in the 2003 test year, whether or not they were actually participating in the plan or were present at the end of 2003.

The Utilities industry had the highest deferral rates for highly compensated participants (HCPs) and for non-highly compensated participants (NHCPs), while the Accommodation and Food Services industry had the lowest deferral rates among both participant populations. In year-over-year comparisons of continuous plans, Educational Services and Utilities showed the largest deferral rate increase (one percentage point), while rates for Mining and Real Estate and Rental and Leasing were both down by half a percentage point. The year-over-year changes were generally smaller for NHCPs.

14 Average deferral rate for active participants, HCP and NHCP, by industry category

Industry	HCP	NHCP
Accommodation and Food Services	5.7%	5.6%
Administrative Support, Waste Management, and Remediation Services	7.0%	7.0%
Agriculture, Forestry, Fishing, and Hunting	6.5%	6.2%
Arts, Entertainment, and Recreation	6.3%	7.5%
Construction	6.7%	6.2%
Educational Services	8.1%	7.1%
Finance and Insurance	5.8%	6.3%
Health Care and Social Assistance	6.0%	6.4%
Information Services	7.3%	7.1%
Management of Companies and Enterprises	6.4%	6.4%
Manufacturing	7.2%	7.0%
Mining	6.7%	7.6%
Other Services (except Public Administration)	6.8%	6.2%
Professional, Scientific, and Technical Services	7.1%	7.5%
Real Estate and Rental and Leasing	6.1%	6.4%
Retail Trade	6.3%	6.0%
Transportation and Warehousing	7.3%	6.5%
Utilities	8.4%	7.8%
Wholesale Trade	6.7%	6.2%

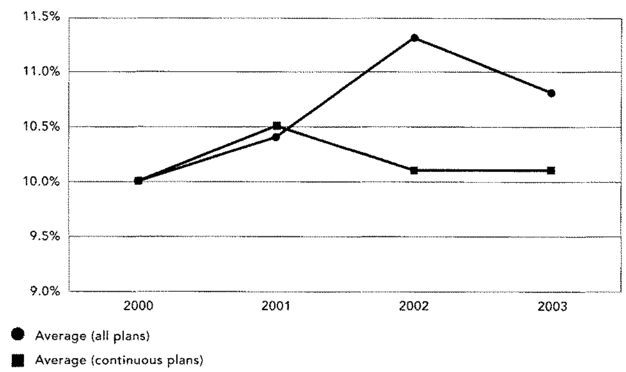
Approximately 11% of contributing participants in 2003 reached the $12,000 employee pretax contribution limit imposed under Section 402(g) of the federal tax code. Within the total population, 40% of highly compensated participants reached the limit, while less than 5% of non-highly compensated participants did so. It should be noted that the data do not reflect participants who may have reached their individual *plan limit* before reaching the 402(g) limit, but this was likely a small number in 2003, as many plans increased their limit in 2002 and 2003 as a result of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA).

15 Percentage of contributing participants who reached the 402(g) limit

Plan size	All plans	Continuous plans
<25	19.8%	17.8%
25–49	15.9%	15.0%
50–149	12.0%	11.4%
150–499	10.0%	7.7%
500–999	9.5%	7.1%
1,000–2,499	8.9%	8.4%
2,500–4,999	9.9%	9.1%
5,000–9,999	9.8%	7.9%
10,000–24,999	11.2%	13.4%
25,000+	13.9%	12.9%
Average	**10.8%**	**10.1%**

Overall, the percentage of contributing participants who reached the 402(g) limit varied from 2000 to 2003, from a low of 10% in 2000 to a high of 11.3% in 2002. The percentage of participants in continuous plans, however, remained fairly stable, between 10.0% and 10.5%.

16 Trends in contributing participants who reached the 402(g) limit



SECTION 3 Participant Demographics and Behavior

To see an online version of the report, go to *http://buildingfutures.fidelity.com*.

The average Fidelity-recordkept participant in 2003 was slightly older, earned about $1,800 more annually, and had an $11,000 higher account balance ($5,000 higher on a median basis) compared with 2002. Aside from looking a bit different demographically, however, participants exhibited little change in their overall behavior, including their moderate use of plan features. For example, just as they did during the stock markets' down years, the vast majority of participants greeted the markets' reversals of fortune with the same level of exchange activity as in previous years. Only 13% of participants made exchanges on one or more days during the year, and only 2% made exchanges on four or more days. Loan and withdrawal activity also remained stable.

Although average account balances increased significantly, a sizeable portion of the participant population age 60 and older continued to have balances below $5,000, clearly inadequate for funding a long retirement without significant income from other sources, such as previous employer-recordkept 401(k) accounts, individual retirement accounts (IRAs), and pension plans.

PARTICIPANT DEMOGRAPHICS

Age

The participant base continued its very gradual aging trend in 2003. Overall, the median participant age was 44 in 2003, up from 42 in 1996. The data also showed that the older portion of the participant base, those who were 50 or older, increased from 29.3% of participants in 2001 to 31.9% in 2003. Conversely, 20 to 49 year olds decreased from 70.7% of the participant base in 2001 to 68.1% in 2003.

17 Plan participants, by age

Age	2003	2002	2001
20–29	10.1%	10.6%	11.3%
30–39	26.3%	27.1%	28.0%
40–49	31.7%	31.7%	31.4%
50–59	22.9%	22.3%	21.7%
60–64	5.4%	5.0%	4.7%
65–69	2.2%	2.1%	1.9%
70+	1.4%	1.2%	1.1%

A look at active versus terminated participants shows that 71% of participants were actively employed by their plan sponsor and had balances at the end of 2003, while 29% were not. An analysis of active participants shows that the majority of younger participants were active, while the majority of the oldest participants were no longer working for their plan sponsor. In the 20 to 29 age group, for example, 80% of participants were active, while 20% had left the employ of their plan sponsor but maintained assets in their previous employer's Fidelity defined contribution plan. The portion of participants who were still actively employed by their plan sponsor fell with age, from 75% for 30 to 39 year olds, to 70% for 50 to 59 year olds, to 52% for 60 to 64 year olds.

18 Distribution of active and terminated participants, by age range

Age	Active participants	Terminated participants	Total
20–29	80%	20%	**100%**
30–39	75%	25%	**100%**
40–49	74%	26%	**100%**
50–59	70%	30%	**100%**
60–64	52%	48%	**100%**
65–69	30%	70%	**100%**
70+	19%	81%	**100%**
Overall	**71%**	**29%**	**100%**

19 Distribution of age ranges, by active and terminated participants

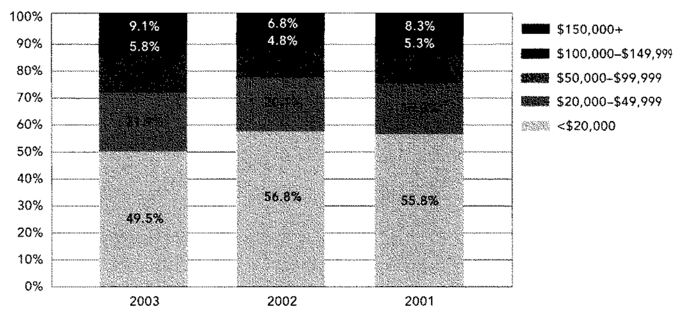
Age	Active participants	Terminated participants
20–29	11%	7%
30–39	28%	23%
40–49	33%	28%
50–59	22%	24%
60–64	4%	9%
65–69	1%	5%
70+	0.4%	4%
Total	**100%**	**100%**

Note: For Tables 18 and 19, "Active participants" represent those participants who both had an account balance and were employed by the plan sponsor as of year-end 2003 (irrespective of whether they actually made a contribution to the plan in 2003). "Terminated participants" represent those participants with an account balance as of year-end 2003 who were no longer employed by the plan sponsor.

Account balances

Average account balances were significantly higher at the end of 2003 than they were 12 months earlier, driven primarily by the strong performance of equity markets during the year. As mentioned earlier, the weighted average account balance for participants was $55,000 in 2003, up 25% from 2002. As average balances increased from 2002 to 2003, the percentage of participants with balances under $20,000 decreased to 49% in 2003, from 57% in 2002, and the percentage with balances greater than $50,000 increased from 23% to 29%.

20 Participant account balance distributions



Further analysis of the 24% of participants with balances of less than $5,000 shows that 48% had balances of less than $1,000, and 52% were single investment option holders. Of participants with balances of less than $1,000, 63% were single investment option holders.

21 Plan participants, by account balance

Account balance	2003	2002	2001
<$5,000	24%	28%	28%
$5,000–$9,999	11%	13%	12%
$10,000–$19,999	15%	16%	15%
$20,000–$29,999	10%	9%	9%
$30,000–$39,999	7%	6%	6%
$40,000–$49,999	5%	4%	4%
$50,000–$69,999	7%	6%	6%
$70,000–$99,999	7%	5%	6%
$100,000–$149,999	6%	5%	5%
$150,000+	9%	7%	8%
Total	**100%**	**100%**	**100%**

Note: The basis for determining account balance distribution in Tables 20 and 21 is recordkept participants.

The ratio of active versus terminated participants remained within a narrow range across all account balance ranges, although the terminated percentage was slightly higher among the lowest- and highest-balance participants.

22 Distribution of active and terminated participants, by account balance

Account balance	Active participants	Terminated participants	Total
<$5,000	67%	33%	**100%**
$5,000–$9,999	73%	27%	**100%**
$10,000–$19,999	71%	29%	**100%**
$20,000–$29,999	73%	27%	**100%**
$30,000–$39,999	74%	26%	**100%**
$40,000–$49,999	75%	25%	**100%**
$50,000–$69,999	74%	26%	**100%**
$70,000–$99,999	73%	27%	**100%**
$100,000–$149,999	72%	28%	**100%**
$150,000+	69%	31%	**100%**
Overall	**71%**	**29%**	**100%**

The distribution of active and terminated participants across account balance ranges was fairly comparable; however, there was a higher percentage of terminated participants with balances below $5,000.

23 Distribution of account balances, by active and terminated participants

Account balance	Active participants	Terminated participants
<$5,000	22%	27%
$5,000–$9,999	11%	10%
$10,000–$19,999	15%	15%
$20,000–$29,999	10%	9%
$30,000–$39,999	7%	6%
$40,000–$49,999	6%	5%
$50,000–$69,999	8%	6%
$70,000–$99,999	7%	6%
$100,000–$149,999	6%	6%
$150,000+	9%	10%
Total	**100%**	**100%**

Note: For Tables 22 and 23, "Active participants" represent those participants who had an account balance and were still employed by the plan sponsor as of year-end 2003 (irrespective of whether they actually made a contribution to the plan in 2003). "Terminated participants" represent those participants with an account balance as of year-end 2003 who were no longer employed by the plan sponsor.

The largest percentage increase in account balances between 2002 and 2003 was seen in the younger age groups, because younger participants tend to have lower balances than older ones, and thus contributions have a greater impact for them than does market movement.

The median account balance was significantly lower than the weighted average balance across all age ranges. The overall median account balance was $20,000, up from $15,000 in 2002. It varied by age from $4,000 for 20 to 29 year olds up to $43,000 for 65 to 69 year olds. The ratio of median to weighted average balance changed very little between 2002 and 2003: slightly above 50% for 20 to 39 year olds, mid-40% range for 40 to 59 year olds, and 35%–40% for those age 60 and older.

The median balance of participants present in both 2002 and 2003 was higher in both years than overall recordkept participants' median balances, across every age range. This finding is consistent with the findings in Table 9 in which the percentage increase in weighted average balance from one year to the next is higher for continuous participants (participants present in both 2002 and 2003) than for all recordkept participants, across all but the very oldest age groups.

24 Participants' weighted average and median account balances, by age

	Median account balance				Weighted average account balance			
Age	2003	2002	2001	2000	2003	2002	2001	2000
20–29	$4,000	$3,000	$3,000	$3,000	$9,000	$7,000	$7,000	$7,000
30–39	$15,000	$11,000	$11,000	$11,000	$27,000	$21,000	$24,000	$27,000
40–49	$27,000	$20,000	$21,000	$22,000	$56,000	$45,000	$52,000	$58,000
50–59	$37,000	$29,000	$32,000	$35,000	$86,000	$72,000	$83,000	$92,000
60–64	$41,000	$33,000	$38,000	$42,000	$105,000	$91,000	$104,000	$113,000
65–69	$43,000	$38,000	$45,000	$50,000	$119,000	$107,000	$123,000	$134,000
70+	$44,000	$39,000	$47,000	$47,000	$121,000	$111,000	$128,000	$132,000
Overall	**$20,000**	**$15,000**	**$15,000**	**$16,000**	**$55,000**	**$44,000**	**$50,000**	**$55,000**

As could be expected, account balances were highest, proportionally, among older participants, who had more time to contribute to their accounts and accumulate earnings than younger participants. Twenty to 23% of participants age 60 and older had balances of $150,000 or more, and nearly 40% had balances of $70,000 or more. At the same time, however, about 20% of participants in these older age groups had account balances below $5,000, reflecting, in part, the greater likelihood that older participants have multiple retirement accounts. The group with the highest proportion of low balances was the 20- to 29-year-olds, 53% of whom had balances below $5,000. Also consistent with expectations, increasing age correlated with increasing median account balances: $27,000 in the 40–49 age group; $37,000 in the 50–59 age group; and nearly $44,000 in the 65-plus age group, as shown in Table 24.

25 Distribution of account balances, by age range

	Age							
Account balance	20–29	30–39	40–49	50–59	60–64	65–69	70+	**Overall**
<$5,000	53%	26%	18%	16%	18%	20%	21%	**23%**
$5,000–$9,999	17%	14%	10%	8%	7%	6%	6%	**11%**
$10,000–$19,999	16%	19%	15%	12%	11%	9%	9%	**15%**
$20,000–$29,999	7%	12%	10%	9%	8%	7%	7%	**10%**
$30,000–$39,999	3%	8%	8%	7%	6%	6%	5%	**7%**
$40,000–$49,999	2%	6%	6%	6%	5%	5%	5%	**5%**
$50,000–$69,999	1%	7%	9%	9%	8%	7%	7%	**7%**
$70,000–$99,999	0.3%	5%	8%	9%	8%	8%	8%	**7%**
$100,000–$149,999	0.05%	3%	7%	9%	9%	9%	9%	**6%**
$150,000+	0.01%	1%	10%	17%	20%	22%	23%	**9%**
Total	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**

When looking at age distribution by account balance, as would be expected, a greater percentage of participants in the higher account balance ranges were older. In fact, 62% of participants with balances greater than $150,000 were age 50 or older.

26 Distribution of age ranges, by account balance

	Age							
Account balance	20–29	30–39	40–49	50–59	60–64	65–69	70+	**Total**
<$5,000	23%	29%	25%	16%	4%	2%	1%	**100%**
$5,000–$9,999	16%	33%	29%	17%	3%	1%	1%	**100%**
$10,000–$19,999	11%	33%	31%	19%	4%	1%	1%	**100%**
$20,000–$29,999	7%	32%	33%	21%	4%	2%	1%	**100%**
$30,000–$39,999	5%	30%	35%	23%	5%	2%	1%	**100%**
$40,000–$49,999	3%	28%	36%	25%	5%	2%	1%	**100%**
$50,000–$69,999	2%	25%	37%	27%	6%	2%	1%	**100%**
$70,000–$99,999	0.5%	19%	39%	30%	7%	3%	2%	**100%**
$100,000–$149,999	0.1%	13%	39%	34%	8%	3%	2%	**100%**
$150,000+	0.01%	4%	33%	42%	12%	5%	3%	**100%**
Overall	**10%**	**26%**	**32%**	**23%**	**5%**	**2%**	**1%**	**100%**

Compensation

The simple average (mean) compensation for active participants was up 2.8% from 2002 to 2003 (from $66,000 to $68,000). However, the portion of active participants in the $50,000 to $100,000 compensation range declined slightly, while the percentages at the upper and lower ends of the scale increased. This led to a 1% decrease in the median compensation of active participants between 2002 and 2003, although both years round to $53,000.

27 Active plan participants, by compensation

Compensation	Percentage of active participants 2003	Percentage of active participants 2002
<$10,000	4%	4%
$10,000–$19,999	6%	6%
$20,000–$29,999	11%	10%
$30,000–$39,999	13%	13%
$40,000–$49,999	13%	13%
$50,000–$74,999	25%	26%
$75,000–$99,999	14%	14%
$100,000+	15%	14%
Total	**100%**	**100%**
Median compensation	$53,000	$53,000
Mean compensation	$68,000	$66,000

Note: Compensation data throughout this report are based on active participants enrolled in plans for which Fidelity performs nondiscrimination testing. See the Methodology section for further information. Compensation data at the lower end may reflect partial year compensation for participants who were hired or left their employer during the course of the year.

As in previous years, the largest portion of participants (26%) earned \$50,000 to \$74,999 in 2003. However, this percentage was lower than in 2002. Another change in compensation patterns could be seen in a shift toward younger participants making up a larger portion of high earners. While the percentage of participants under age 40 earning \$50,000 or more increased, the percentage of participants age 50 or older at that income level decreased.

28 Distribution of active continuous participants' compensation, by age

	Age							
Compensation	20–29	30–39	40–49	50–59	60–64	65–69	70+	Overall
<\$10,000	4%	2%	2%	3%	6%	11%	22%	3%
\$10,000–\$19,999	7%	4%	3%	4%	8%	14%	26%	4%
\$20,000–\$29,999	17%	10%	9%	9%	12%	15%	16%	10%
\$30,000–\$39,999	20%	14%	13%	12%	14%	14%	10%	14%
\$40,000–\$49,999	16%	14%	14%	13%	13%	10%	5%	14%
\$50,000–\$74,999	25%	27%	26%	27%	22%	16%	8%	26%
\$75,000–\$99,999	8%	15%	15%	15%	11%	8%	4%	14%
\$100,000+	3%	13%	19%	17%	14%	11%	8%	15%
Total	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**

As noted above, a significant percentage of younger participants are in the higher compensation brackets. Participants younger than age 40 make up 35% of the participants who earn between \$75,000 and \$100,000, and 26% of the participants who earn \$100,000 or greater.

29 Distribution of active continuous participants' ages, by compensation

	Age							
Compensation	20–29	30–39	40–49	50–59	60–64	65–69	70+	Total
<\$10,000	14%	23%	24%	25%	9%	4%	3%	100%
\$10,000–\$19,999	16%	23%	26%	22%	7%	3%	2%	100%
\$20,000–\$29,999	16%	27%	29%	21%	5%	1%	1%	100%
\$30,000–\$39,999	14%	28%	31%	21%	4%	1%	0.2%	100%
\$40,000–\$49,999	11%	28%	33%	23%	4%	1%	0.1%	100%
\$50,000–\$74,999	9%	28%	34%	24%	3%	1%	0.1%	100%
\$75,000–\$99,999	5%	30%	37%	24%	3%	1%	0.1%	100%
\$100,000+	2%	24%	43%	27%	4%	1%	0.2%	100%
Overall	**10%**	**27%**	**34%**	**23%**	**4%**	**1%**	**0.3%**	**100%**

Note: Data in the above two tables are for active continuous participants (i.e., those employed by the plan sponsor and with an account balance on both 12/31/02 and 12/31/03) in plans for which Fidelity performs nondiscrimination testing.

PARTICIPANT BEHAVIOR

Participation rates

The gradual multiyear trend toward lower participation rates continued in 2003, as the overall rate decreased from 68% in 2002 to 66% in 2003. Looking at participants by age group, the 20–29 age group showed the largest decline (2.8 percentage points). The 30–49 age groups experienced slight declines, the 60–69 age groups increased their participation rates, and the 50–59 age group held steady. The correlation between age and participation rates, meanwhile, continued to be strongly evident, with younger eligible employees participating at lower rates than older eligible employees. The greatest difference occurred between the 20–29 age group (38% participation rate) and the 30–39 age group (61% participation rate). A gradual increase then continued for employees in their 40s and 50s, after which the pattern reversed in the older age groups. Results for participants in continuous plans* were quite similar to the total population of plans for most age ranges.

30 Participation rates, by participant age

	Average participation rate (all plans)			
Age	2003	2002	2001	2000
20-29	38%	41%	41%	43%
30-39	61%	62%	62%	63%
40-49	67%	68%	68%	69%
50-59	69%	69%	71%	72%
60-64	67%	66%	67%	68%
65-69	56%	54%	55%	57%

	Average participation rate (continuous plans)	
Age	2003	2002
20–29	37%	42%
30–39	61%	63%
40–49	67%	69%
50–59	70%	71%
60–64	67%	68%
65–69	55%	57%

*Continuous plans are plans present in both 2002 and 2003.

Participation rates continue to correlate strongly with both age and compensation. Within every age group, there is a strong correlation between increasing compensation levels and increasing participation rates. Participation rates ranged from a low of 11% for 20 to 29 year olds earning less than $10,000 to a high of 90% for 40 to 65 year olds earning $100,000 or more.

Note: The overall participation rate of 60% shown in this table is lower than the 66% shown in Table 6 due to a

31 Participation rates, by age and compensation

	Age						
Compensation	20–29	30–39	40–49	50–59	60–64	65–69	Overall
<$10,000	11%	19%	20%	23%	26%	23%	**17%**
$10,000–$19,999	22%	33%	37%	41%	46%	40%	**32%**
$20,000–$29,999	37%	47%	52%	57%	62%	58%	**48%**
$30,000–$39,999	52%	59%	64%	68%	70%	68%	**61%**
$40,000–$49,999	64%	68%	70%	73%	76%	72%	**69%**
$50,000–$74,999	75%	77%	78%	79%	81%	79%	**77%**
$75,000–$99,999	81%	85%	86%	86%	86%	84%	**85%**
$100,000+	83%	89%	90%	90%	90%	87%	**90%**
Overall	**38%**	**61%**	**67%**	**69%**	**67%**	**56%**	**60%**

difference in methodology. This table counts all eligible employees equally, whereas Table 6 counts all plans equally. Refer to the Methodology section for more details.

Deferral rates

The overall average pretax deferral rate for highly compensated participants (HCPs) between the ages of 20 and 69 increased in 2003 by one-tenth of a percentage point. Conversely, the average for non-highly compensated participants (NHCPs) decreased by two-tenths of a percentage point in 2003. The biggest decrease was in NHCPs in the 20–29 age group, where the average was two-tenths of a percentage point lower. HCPs in that same age group, however, had the biggest increase in deferral rate, 1.5 percentage points. Looking at multiyear trends, HCP average deferral rates were higher in 2003 than they were in 2000 across all age groups.

Results for participants in continuous plans, in deferral as well as participation rates, were quite similar to the total population of plans for most age ranges.

32 Deferral rates, by participant age

	All plans							
	HCP active participant average deferral rates				NHCP active participant average deferral rates			
Age	2003	2002	2001	2000	2003	2002	2001	2000
20–29	7.1%	5.6%	7.5%	6.9%	5.6%	5.8%	6.0%	5.7%
30–39	7.1%	6.9%	6.9%	6.6%	6.4%	6.6%	6.6%	6.4%
40–49	6.8%	6.8%	6.6%	6.3%	6.8%	7.0%	7.0%	6.7%
50–59	7.3%	7.2%	6.8%	6.5%	8.0%	8.0%	8.0%	7.8%
60–64	7.9%	7.7%	7.1%	6.8%	9.0%	8.9%	8.8%	8.5%
65–69	7.9%	7.9%	7.2%	6.8%	9.7%	9.5%	9.1%	8.9%

	Continuous plans			
	HCP active participant average deferral rates		NHCP active participant average deferral rates	
Age	2003	2002	2003	2002
20–29	7.1%	5.4%	5.6%	5.9%
30–39	7.1%	6.9%	6.5%	6.5%
40–49	6.8%	6.8%	6.9%	6.9%
50–59	7.4%	7.2%	8.0%	7.9%
60–64	8.0%	7.6%	9.0%	8.7%
65–69	8.0%	7.5%	9.6%	9.3%

As with participation rates, age and compensation were key drivers of deferral rates. Employee pretax deferral rates tended to increase with age across all age groups. They also gradually increased with compensation level for non-highly compensated participants. For highly compensated participants, on the other hand, deferral rates decreased in the higher compensation ranges, which likely is a reflection of regulatory limits that constrain HCP contributions.

33 Deferral rates, by age and compensation

	Age						
Compensation	20–29	30–39	40–49	50–59	60–64	65–69	Overall
<$10,000	4.4%	5.4%	6.0%	7.2%	8.3%	9.0%	**5.8%**
$10,000–$19,999	4.3%	5.2%	5.7%	6.7%	7.9%	8.8%	**5.6%**
$20,000–$29,999	4.3%	5.0%	5.5%	6.7%	7.7%	8.8%	**5.5%**
$30,000–$39,999	4.9%	5.4%	6.0%	7.2%	8.5%	9.4%	**6.0%**
$40,000–$49,999	5.8%	6.0%	6.6%	8.0%	9.3%	10.2%	**6.7%**
$50,000–$74,999	7.2%	7.1%	7.5%	8.8%	10.2%	11.1%	**7.7%**
$75,000–$99,999	7.8%	8.1%	8.1%	9.1%	10.1%	10.8%	**8.4%**
$100,000+	6.7%	6.8%	6.5%	6.9%	7.3%	7.0%	**6.7%**
Overall	**5.6%**	**6.5%**	**6.8%**	**7.8%**	**8.8%**	**9.4%**	**6.9%**

Note: Deferral rate for each age-compensation combination is calculated as the average of the deferral rates of the individual participants falling within that age-compensation cohort. The figures in the "Overall" column and row were calculated in the same manner, rather than representing averages of averages. This table includes both HCPs and NHCPs.

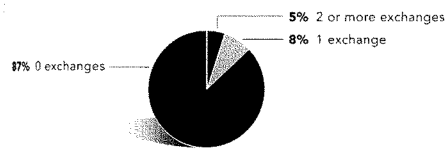
PARTICIPANT USE OF EXCHANGES, LOANS, AND WITHDRAWALS

Participants' exchange, loan, and withdrawal behavior in 2003 were all consistent with age and account-balance factors, and they revealed no significant changes from patterns observed in previous editions of *Building Futures*. This was true even though the stock market performance in 2003 was dramatically different than in the previous three years.

Exchanges

The percentage of participants who did not initiate exchanges in 2003 remained virtually the same as in previous years—87%—despite significant differences in stock market performance during those years. These participants may not be actively managing their accounts and may need to rebalance to ensure that their asset allocation remains as they originally intended it.

34 Overview of percentage of participants who made exchanges



Of participants who made exchanges, the distribution of participants by exchange frequency was essentially unchanged as well. Among the 2% of participants who made exchanges on four or more days in 2003, two-thirds made exchanges on four to seven days, and 90% made exchanges on fewer than 20 days.

35 Percentage of participants who made exchanges

Number of exchanges	2003	2002	2001
0 exchanges	87%	87%	88%
1 exchange	8%	8%	7%
2 exchanges	2%	2%	2%
3 exchanges	1%	1%	1%
4 or more exchanges	2%	2%	2%
Total	**100%**	**100%**	**100%**

Note: Exchanges are defined as any recordkept participant exchange of assets between investment options within a plan. The number of exchanges tallied for each participant is counted as the number of days during 2003 on which the participant had at least one exchange. Exchanges within self-directed brokerage accounts are not included. See the Methodology section for further information.

Participant exchange activity correlated closely with account balance, with participants having larger balances being more likely to make exchanges. While only 4% of participants with balances below $5,000 made exchanges in 2003, 12% of participants with balances of $20,000 to $29,999 made at least one exchange, and 29% of participants with balances of $150,000 or more made one or more exchanges.

36 Percentage of participants who made exchanges, by account balance

Account balance	Percentage of participants
<$5,000	4%
$5,000–$9,999	8%
$10,000–$19,999	10%
$20,000–$29,999	12%
$30,000–$39,999	14%
$40,000–$49,999	16%
$50,000–$69,999	17%
$70,000–$99,999	19%
$100,000–$149,999	22%
$150,000+	29%

Loans

Loan activity was essentially unchanged in 2003, as only 20% of active participants took loans, even though 93% of active participants had access to loans in their plans.

37 Percentage of active participants with loans outstanding

Number of loans	2003	2002
0 loans	80%	80%
1 loan	15%	15%
2 loans	4%	4%
3 or more loans	1%	1%
Total	**100%**	**100%**

Note: Loans are counted based on all loans outstanding as of December 31, 2003. Because many plans require loans to be repaid upon or within a short period of termination, the analysis of loans is limited to active participants. See the Methodology section for further information. The availability of loans varies from plan to plan; however, 93% of active participants have access to loans in their plans.

As in previous years, loan activity in 2003 tended to be greatest among participants in the middle age ranges. Consistent with typical financial demands by life stage, loan usage was highest for 30 to 59 year olds and lowest for participants in their 20s and 60s.

38 Percentage of active participants with loans outstanding, by age

Age	2003	2002
20–29	13%	12%
30–39	21%	20%
40–49	23%	23%
50–59	20%	20%
60–64	13%	14%
65–69	8%	8%
70+	4%	4%
Overall	**20%**	**20%**

Similarly, participants with the highest and lowest account balances were less likely to have borrowed against their accounts than were other participants. However, participants with balances of \$5,000 to \$29,999 were slightly more likely to have a loan outstanding in 2003 compared with 2002, while participants with balances of \$30,000+ were slightly less likely to have a loan outstanding.

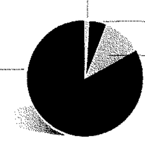
39 Percentage of active participants with loans outstanding, by account balance

Account balance	2003	2002
<\$5,000	11%	11%
\$5,000–\$9,999	25%	24%
\$10,000–\$19,999	26%	24%
\$20,000–\$29,999	25%	24%
\$30,000–\$39,999	23%	24%
\$40,000–\$49,999	22%	24%
\$50,000–\$69,999	21%	24%
\$70,000–\$99,999	20%	22%
\$100,000–\$149,999	19%	20%
\$150,000+	14%	16%
Overall	**20%**	**20%**

Withdrawals

In 2003, 83% of participants did not take withdrawals. Of those who did, 6% took either partial only or partial and full withdrawals, many of them withdrawing retirement income.

40 Composition of recordkept participants taking partial and full withdrawals



Withdrawal activity in 2003 was again consistent with expected age-driven behavior. Of the almost 17% of participants who made at least one withdrawal in 2003, the age groups with the highest portion of participants taking withdrawals were those 60 and older. These age groups included a larger proportion of retired employees who were not subject to early-withdrawal penalties as were younger age groups. Participants in the 70+ age group were by far the most likely to make a withdrawal—79% did so—which is consistent with minimum required distribution (MRD) rules. The portion of withdrawing participants making partial withdrawals increased significantly with age, particularly for those in their 60s and older. Systematic withdrawal payments (SWPs), whereby eligible participants automatically receive distributions periodically, were a key component of such partial withdrawals for older participants. Withdrawal activity among younger participants, meanwhile, heavily favored full versus partial withdrawals, reflecting the fact that withdrawals for these participants were more likely to be driven by job changes.

41 Percentage of recordkept participants taking partial and full withdrawals, by age

Age	Percentage taking withdrawals	Percentage taking no withdrawals
20–29	15%	85%
30–39	13%	87%
40–49	12%	88%
50–59	13%	87%
60–64	23%	77%
65–69	26%	74%
70+	79%	21%
Overall	**17%**	**83%**

Age	Percentage taking partial withdrawals only	Percentage taking full withdrawals only	Percentage taking partial and full withdrawals	Partial withdraw… participants a percent… of all withdraw… particip…
20–29	[illegible]	12%	0.4%	17%
30–39	[illegible]	10%	0.3%	23%
40–49	[illegible]	9%	0.3%	28%
50–59	[illegible]	9%	0.4%	31%
60–64	[illegible]	13%	1%	46%
65–69	[illegible]	13%	1%	50%
70+	[illegible]	5%	7%	94%
Overall	**6%**	**11%**	**0.5%**	**31%**

Note: Withdrawal statistics shown in Tables 40 and 41 reflect those of all participants who made a withdrawal in 2003, whether or not they were still a participant (i.e., still had an account balance) as of 12/31/03. Partial withdrawals consist of in-service and hardship withdrawals as well as systematic withdrawal payments (SWPs). Participants who made more than one withdrawal are counted only once. Recordkept participants as of year-end 2003 were used as the denominator in these calculations.

SECTION 4 | Plan Investment Options

To see an online version of the report, go to *http://buildingfutures.fidelity.com*.

The analyses included in this section examine the patterns and trends surrounding the investment options that are available to Fidelity-recordkept participants. The 2003 data showed a continuation of the trend toward more investment options being available to participants and, correspondingly, the gradual increase in the average number of investments that participants hold. These trends are consistent with the use of diversification as a method of lowering risk, although neither diversification nor asset allocation ensures a profit or guarantees against loss.

Sponsors of Fidelity-recordkept plans continued to offer more investment options, on average, in 2003 than in previous years. The distribution of the options among investment asset classes was consistent with the pattern seen in previous years—with domestic equity and balanced options heavily favored.

NUMBER OF INVESTMENT OPTIONS OFFERED

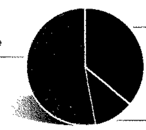
The average number of investment options available to participants in 2003 increased to 18, continuing a trend among Fidelity-recordkept plans to add an average of two options per year. This trend was consistent, for the mean and median number of investment options, across most plan-size groupings. Also evident in 2003, as in previous years, was the propensity of large plans to offer more investment options than small plans. Large plans also were more likely to offer a Mutual Fund Window, which makes a large universe of investment options available to participants. Such Mutual Fund Windows accounted for the spread between the mean and median figures in the largest plan-size groupings.

42 Average number of investment options available, by plan size (number of partici

	2003		2002		2001		2000	
Plan size	Mean	Median	Mean	Median	Mean	Median	Mean	Median
<25	13	13	12	11	10	10	8	8
25–49	17	16	15	14	13	12	10	10
50–149	17	15	16	14	13	13	11	10
150–499	19	17	17	15	14	14	12	11
500–999	22	17	20	16	16	14	14	12
1,000–2,499	24	18	21	17	18	15	16	13
2,500–4,999	24	18	22	17	20	16	17	14
5,000–9,999	24	18	22	17.5	23	16.5	22	15
10,000–24,999	43	19	45	18.5	46	16	34	14
25,000+	49	20.5	46	21	50	21.5	47	20
Overall	**18**	**16**	**16**	**14**	**14**	**12**	**12**	**10**

The continuing trend toward offering more investment options is evident in the percentage of plans that increased their investment options in 2003 (36%) versus the portion that decreased their options (11%).

43 Continuous plans'* changes to their investment options—from December 31, 2002, to December 31, 2003



Note: Values above represent Fidelity's corporate DC plans overall, with plans of all sizes counting equally in the percentage calculations.

*Continuous plans are plans present in both 2002 and 2003.

The trend toward offering more investment options held across all plan-size groupings except one– the 25,000+ participant group—in which 38% of the plans reduced the number of available investment options, while 31% increased their options. Overall, a majority of plans chose to make no changes in the number of investment options offered. This was true across all but the largest and smallest plan-size groupings.

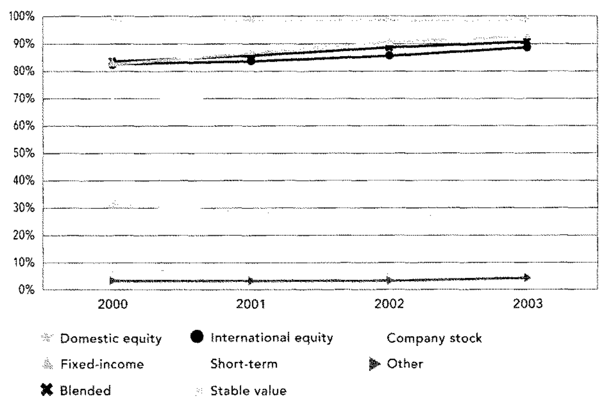
44 Continuous plans' changes to their investment options from December 31, 200 to December 31, 2003, by plan size

Plan size	Percentage of plans that increased their number of investment options	Percentage of plans that reduced their number of investment options	Percentage of plans that made no changes
<25	37%	21%	42%
25–49	37%	12%	51%
50–149	34%	6%	60%
150–499	39%	4%	57%
500–999	39%	4%	58%
1,000–2,499	32%	9%	59%
2,500–4,999	24%	15%	61%
5,000–9,999	28%	15%	57%
10,000–24,999	35%	24%	41%
25,000+	31%	38%	31%
Overall	**36%**	**11%**	**53%**

ASSET CLASSES AND INVESTMENT VEHICLES OFFERED

Consistent with previous years, the four asset classes offered most often by Fidelity-recordkept plans were domestic equity (99% of plans), fixed-income (93%), blended (91%), and international equity (89%). Fixed-income exhibited the greatest change over time, with the percentage of plans offering fixed-income investment options increasing from 83% in 2000 to 93% in 2003.

45 Trends in the percentage of plans offering investment options in each asset class



For the four asset classes most often offered, as noted on page 49, the percentage of plans offering them varied very little across plan-size groupings, except for the very smallest. Smaller plans were much less likely than larger plans to offer company stock and stable value investment options. Short-term investment options were significantly more prevalent than stable value for small plans, and about equally prevalent for larger plans.

46 Percentage of plans offering investment options in each asset class

	Short-term	Stable value	Fixed-income	Blended	Domestic equity	International equity	Company stock	Other
2003 Plan size								
<25	78%	6%	81%	83%	98%	78%	0%	0%
25–49	85%	17%	96%	92%	100%	89%	1%	1%
50–149	78%	28%	98%	94%	100%	91%	1%	2%
150–499	72%	43%	98%	96%	100%	94%	4%	6%
500–999	67%	55%	96%	97%	100%	95%	12%	11%
1,000–2,499	72%	57%	97%	98%	99%	98%	26%	16%
2,500–4,999	70%	60%	94%	97%	98%	97%	50%	20%
5,000–9,999	55%	69%	92%	96%	97%	96%	66%	21%
10,000–24,999	66%	73%	96%	98%	98%	99%	74%	22%
25,000+	65%	86%	90%	92%	98%	96%	84%	14%
2003 Overall	**76%**	**29%**	**93%**	**91%**	**99%**	**89%**	**7%**	**5%**
2002 Overall	74%	28%	91%	89%	99%	86%	7%	4%
2001 Overall	72%	29%	87%	86%	99%	84%	7%	4%

Note: A glossary of terms used in this section, including definitions of asset classes and investment vehicles, is contained in the Methodology section. "Other" consists primarily of self-directed brokerage.

The average number of investment options by asset class tended to increase with plan size, but the differences between median values were smaller than between mean values. Across plans of all sizes, multiple investment options were much more prevalent in the domestic equity and blended asset classes than in any other class. The mean number of domestic equity options was especially high among plans with 10,000 or more participants, due largely to the fact that these plans were more likely to offer a Mutual Fund Window, which significantly inflates the mean. Domestic equity investment option medians, on the other hand, show that the prevalence of such investment options was fairly consistent across plan-size groups.

47 Average number of investment options in each asset class for plans offering that class

	Short-term		Stable value		Fixed-income		Blended		Domestic equity		International equity		Company stock		Other	
Plan size	Mean	Median	Mean	Median	Mean	Median	Mean	Median	Mean	Median	Mean	Median	Mean	Median	Mean	Median
<25	1.0	1.0	1.0	1.0	1.6	1.0	2.7	2.0	7.5	7.0	1.3	1.0	1.0	1.0	1.0	1.0
25–49	1.0	1.0	1.0	1.0	1.6	1.0	4.2	5.0	8.9	8.0	1.5	1.0	1.1	1.0	1.0	1.0
50–149	1.0	1.0	1.0	1.0	1.5	1.0	5.0	6.0	8.4	7.0	1.4	1.0	1.2	1.0	1.0	1.0
150–499	1.1	1.0	1.0	1.0	1.8	1.0	5.6	6.0	9.1	7.0	1.7	1.0	1.3	1.0	1.0	1.0
500–999	1.1	1.0	1.0	1.0	2.3	1.0	6.0	6.0	10.4	7.0	2.2	1.0	1.2	1.0	1.0	1.0
1,000–2,499	1.1	1.0	1.0	1.0	2.5	1.0	6.1	7.0	11.1	7.0	2.5	1.0	1.2	1.0	1.0	1.0
2,500–4,999	1.1	1.0	1.0	1.0	2.5	1.0	6.0	6.0	11.3	7.0	2.7	1.0	1.3	1.0	1.0	1.0
5,000–9,999	1.2	1.0	1.0	1.0	2.2	1.0	6.2	7.0	11.0	7.0	2.6	1.0	1.3	1.0	1.0	1.0
10,000–24,999	1.3	1.0	1.1	1.0	5.4	2.0	7.1	6.0	21.7	8.0	6.5	2.0	1.6	1.0	1.0	1.0
25,000+	1.3	1.0	1.0	1.0	6.8	2.0	7.3	4.5	24.9	10.0	7.9	3.0	2.4	2.0	1.0	1.0
Overall	**1.0**	**1.0**	**1.0**	**1.0**	**1.8**	**1.0**	**4.6**	**5.0**	**9.0**	**7.0**	**1.7**	**1.0**	**1.3**	**1.0**	**1.0**	**1.0**

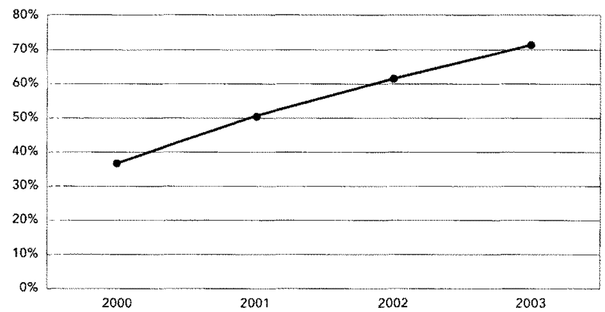
Note: If a plan offered a self-directed brokerage vehicle, it was counted as a single investment option, independent of the number of underlying securities or funds available to or held by participants, and is classified under "Other." Means are calculated as the total number of investment options in that asset class for that plan-size grouping, divided by the number of plans in that plan-size grouping offering at least one option in that asset class.

LIFE-STAGE FUNDS

For participants who choose to hold a single investment option, life-stage funds offer a convenient and appropriate method for allocating assets across several investment types. These funds give participants exposure to stocks, bonds, and short-term investments in ratios that are age appropriate based on an expected retirement date. Although there are various life-stage fund families, the analyses in this report are limited to Fidelity Freedom Funds.®

The percentage of plans with assets in at least one Freedom Fund continued to increase across all plan sizes in 2003, rising 10 percentage points to 72% overall. The increase in plans offering such life-stage funds has probably been the most significant trend in plan investment options over the past three years. In fact, the percentage of plans offering at least one Freedom Fund has nearly doubled, from 37% in 2000 to 72% in 2003.

48 Freedom Fund adoption



● Percentage of plans offering one or more Freedom Funds

Of the plans with assets in only one or two Freedom Funds, the vast majority correspond to plans with fewer than 25 participants. Of those, the most commonly held Freedom Funds were Freedom 2010, Freedom 2020, and Freedom 2030. These results indicate that some of Fidelity's smallest recordkept plans simply did not have enough participants of the appropriate ages to have assets in every Freedom Fund offered.

49 Percentage of plans offering one or more Freedom Funds, by plan size

Plan size	2003	2002	2001	2000
<25	60%	51%	42%	28%
25–49	75%	66%	56%	41%
50–149	75%	65%	55%	39%
150–499	78%	67%	55%	41%
500–999	79%	68%	57%	42%
1,000–2,499	77%	71%	55%	41%
2,500–4,999	74%	68%	58%	43%
5,000–9,999	77%	68%	54%	44%
10,000–24,999	62%	54%	47%	30%
25,000+	45%	37%	29%	33%
Overall	**72%**	**62%**	**51%**	**37%**

Note: Plans were included if they had assets in one or more Freedom Funds.

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An analysis of plans with assets in three or more Freedom Funds yielded very similar results as in the previous table—namely, there has been an increasing adoption of life-stage funds across all plan-size groupings over the last four years. Further, the percentage of plans with assets in three or more Freedom Funds was only slightly lower than those with one or more Freedom Funds, for all but the smallest plan-size groupings. The explanation is as described on page 53, which results in the large number of small plans pulling down the overall adoption rates for each of the four years shown.

50 Percentage of plans with assets in three or more Freedom Funds

Plan size	2003	2002	2001	2000
<25	27%	21%	18%	13%
25–49	64%	56%	46%	35%
50–149	71%	61%	51%	36%
150–499	76%	65%	52%	39%
500–999	78%	67%	55%	40%
1,000–2,499	75%	69%	53%	40%
2,500–4,999	72%	66%	58%	41%
5,000–9,999	76%	66%	54%	43%
10,000–24,999	59%	53%	47%	29%
25,000+	41%	35%	29%	33%
Overall	**60%**	**51%**	**42%**	**31%**

Note: A plan was considered to offer the family of Freedom Funds if it had assets in at least three Freedom Funds.

Before investing in any mutual fund, please carefully consider the investment objectives, risks, charges and expenses. For this and other information, call or write Fidelity for a free prospectus. Read it carefully before you invest.

SECTION 5 | Participant Investment Choices

To see an online version of the report, go to *http://buildingfutures.fidelity.com*.

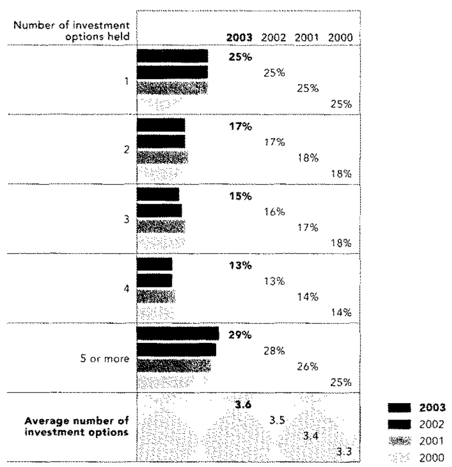
The data presented in this section represent the asset allocation choices participants make, and show that participants continued to gradually increase the number of investment options they held. On average, they also continued to allocate their assets in ways that are generally considered to be appropriate for their age group. Younger participants with long time horizons, for example, held a larger percentage of their assets in domestic equities—which have greater long-term growth potential but higher short-term volatility—than older participants whose assets would have less time to recover from market fluctuations.

An area to note is the fact that 25% of participants continued to hold a single investment option. This group tended to be concentrated among the youngest and oldest participants as well as those with the lowest account balances.

NUMBER OF INVESTMENT OPTIONS HELD

The weighted average number of investment options held by participants edged higher in 2003, to 3.6, from 3.5 in 2002. The portion of participants who held five or more options increased one percentage point, to 29%. At the other end of the scale, the portion of participants who held just one option remained unchanged, at 25%, where it has been for the past four years.

51 Percentage of participants holding different numbers of investment options



Note: These data are based on recordkept participants. The number of options available in the plan limits the number of options a participant can hold.

The general pattern of participants holding more investment options when their plan offers more choices was again evident in 2003. For example, the percentage of participants holding five or more options was 21% in plans with seven to 10 options, 31% in plans with 16 to 30, and 35% in plans with 31 or more. On the other hand, 42% of participants continued to hold just one or two options, even though more than 93% of total recordkept participants were in plans that offered 11 or more choices, up from 91% in 2002. Also, the number of available options had little effect on the percentage of single-option holders. Even in plans offering 16 or more options, the portion of participants holding one option was still nearly 25%.

52 Relationship of number of options available in the plan to the number of options held by participants

	Percentage of participants holding:					
Number of options available	1 option	2 options	3 options	4 options	5 or more options	Total
1 to 4	79%	16%	4%	1%	0%	**100%**
5 to 6	27%	25%	21%	13%	13%	**100%**
7 to 10	26%	19%	18%	15%	21%	**100%**
11 to 15	27%	18%	16%	14%	25%	**100%**
16 to 30	23%	17%	16%	14%	31%	**100%**
31 or more	24%	16%	13%	12%	35%	**100%**
Overall	**25%**	**17%**	**15%**	**13%**	**29%**	**100%**

ASSET ALLOCATION

Despite the stock market recovery that began at the end of the first quarter in 2003, participants continued a three-year trend toward allocating a lower percentage of their contributions to equity investment options and a higher percentage to short-term, stable value, and fixed-income options. The overall allocation percentage to domestic and international equities in 2002, for example, was 56% for employees, compared with 52% in 2003.

For plans with company stock, the pattern was similar overall to that of all qualified plans; namely, an increase in the share of contribution dollars to more conservative investment options. Employer contributions to company stock for those plans offering company stock were flat relative to 2002, while employee contributions to company stock were down slightly in 2003.

53 Allocation of employee and employer contributions, by plan size

	Short-term		Stable value		Fixed-income		Blended		Domestic equity		International equity		Company stock	
<25														
Employee	13%	N/A	2%	N/A	10%	N/A	11%	N/A	58%	N/A	5%	N/A	0.0%	N/A
Employer	19%	N/A	1%	N/A	10%	N/A	13%	N/A	52%	N/A	5%	N/A	0.0%	N/A
25–49														
Employee	12%	17%	2%	3%	10%	13%	14%	10%	57%	50%	5%	2%	0.3%	5%
Employer	14%	19%	3%	0%	10%	12%	17%	10%	51%	47%	5%	2%	0.3%	10%
50–149														
Employee	10%	4%	3%	16%	9%	7%	16%	15%	56%	46%	5%	3%	0.0%	10%
Employer	12%	12%	5%	9%	10%	4%	18%	9%	51%	34%	4%	3%	0.2%	27%
150–499														
Employee	9%	6%	5%	12%	9%	8%	15%	13%	57%	49%	5%	5%	0.2%	7%
Employer	10%	3%	5%	12%	10%	7%	17%	16%	52%	36%	5%	4%	1%	23%
500–999														
Employee	9%	8%	7%	9%	9%	8%	15%	10%	55%	55%	5%	4%	1%	7%
Employer	11%	4%	8%	7%	9%	5%	16%	8%	48%	36%	4%	3%	3%	37%
1,000–2,499														
Employee	9%	8%	9%	10%	8%	8%	13%	11%	54%	51%	5%	4%	2%	8%
Employer	10%	9%	13%	10%	9%	8%	14%	9%	45%	37%	4%	3%	6%	25%
2,500–4,900														
Employee	9%	9%	10%	10%	8%	7%	14%	12%	50%	47%	5%	4%	5%	12%
Employer	9%	7%	10%	10%	7%	6%	17%	10%	36%	27%	3%	2%	17%	39%
5,000–9,999														
Employee	6%	6%	12%	14%	8%	7%	14%	13%	50%	48%	5%	4%	5%	8%
Employer	7%	7%	11%	11%	6%	4%	14%	10%	36%	27%	4%	3%	22%	38%
10,000–24,999														
Employee	6%	6%	13%	12%	8%	8%	11%	11%	48%	47%	4%	4%	9%	12%
Employer	6%	4%	14%	13%	7%	7%	11%	10%	32%	29%	3%	3%	27%	35%
25,000+														
Employee	5%	4%	16%	17%	7%	7%	10%	9%	42%	41%	4%	4%	16%	18%
Employer	6%	5%	10%	12%	4%	4%	9%	7%	29%	19%	2%	2%	40%	50%
All plans 2003														
Employee	7%	5%	12%	14%	8%	7%	12%	10%	48%	45%	4%	4%	8%	14%
Employer	7%	5%	11%	12%	7%	5%	13%	9%	37%	25%	3%	2%	22%	41%
All plans 2002														
Employee	6%	6%	10%	11%	6%	5%	12%	11%	51%	48%	5%	4%	10%	15%
Employer	7%	6%	8%	8%	5%	5%	11%	8%	40%	29%	4%	3%	26%	41%
All plans 2001														
Employee	5%	5%	8%	9%	5%	5%	11%	9%	56%	51%	5%	5%	10%	16%
Employer	5%	4%	6%	6%	3%	2%	11%	9%	43%	30%	4%	3%	29%	47%

Percentage of contributions in each asset class—all qualified plans
Percentage of contributions in each asset class—qualified plans with company stock

Note: Percentages are based on total dollars contributed. "Other" category, consisting primarily of self-directed brokerage, is excluded. Data for plans with company stock were excluded in the "<25" plan-size category due to the small sample size. A glossary of terms, including the asset classes used in this table, is contained in the Methodology section.

Driven largely by the strong performance of equity markets, *overall asset allocation* shifted in favor of equities in 2003. Since a lower percentage of contributions was allocated to equities, this shift in asset allocation was, for the most part, due to stronger performance of the equity markets. The domestic equity asset class showed the biggest increase, from 38% in 2002 to 41% in 2003. The portion of assets in international equities increased from 3% to 4%, while the percentage in blended options remained the same, and the percentages in short-term, stable value, and fixed-income options all declined. The share of company stock assets increased slightly for plans that offered company stock.

Differences in asset allocation patterns were again evident across plan-size groupings. For example, while short-term investment options were more common than stable value investment options for small plans, and vice versa, the portion of assets held in stable value was more consistent across plan-size groupings than for short-term. As in past years, domestic equity and company stock asset share, when combined, remained quite consistent across all plan sizes, albeit at a higher level than in the past several years: 56% (for plans with 500 to 999 participants) to 60% (for plans with 10,000 to 24,999 participants) in 2003, up from 52% to 56% in 2002. The relative shares of company stock and domestic equity comprising this combined share move in opposite directions, with company stock being most prevalent for the largest plans.

54 Percentage of assets in each sub-asset class—all plans and in plans that make the class available

	Short-term		Stable value		Fixed-income		Blended		Domestic equity		International equity		Company stock	
2003 Plan size														
<25	13%	16%	2%	19%	8%	9%	13%	15%	55%	56%	6%	7%	2%	67%
25–49	12%	14%	3%	15%	7%	8%	14%	15%	57%	57%	6%	7%	0.4%	41%
50–149	9%	12%	5%	15%	7%	7%	15%	16%	56%	56%	5%	6%	2%	40%
150–499	8%	11%	6%	14%	7%	7%	14%	14%	57%	57%	5%	6%	1%	10%
500–999	7%	10%	11%	17%	6%	6%	14%	14%	53%	53%	5%	5%	3%	19%
1,000–2,499	7%	10%	12%	20%	6%	6%	12%	12%	51%	51%	5%	5%	6%	18%
2,500–4,999	6%	9%	14%	21%	5%	6%	12%	12%	44%	45%	4%	4%	14%	25%
5,000–9,999	5%	8%	15%	21%	5%	6%	11%	11%	44%	44%	4%	4%	15%	21%
10,000–24,999	4%	6%	16%	21%	6%	6%	10%	10%	41%	41%	4%	4%	19%	24%
25,000+	4%	6%	22%	24%	4%	4%	8%	9%	34%	34%	3%	3%	25%	27%
2003 Overall	**5%**	**8%**	**17%**	**22%**	**5%**	**5%**	**10%**	**11%**	**41%**	**41%**	**4%**	**4%**	**17%**	**25%**
2002 Overall	7%	10%	18%	31%	7%	7%	10%	11%	38%	38%	3%	3%	17%	24%
2001 Overall	6%	8%	15%	25%	4%	4%	10%	11%	43%	43%	3%	3%	19%	27%
2000 Overall	5%	7%	13%	21%	3%	3%	10%	10%	47%	47%	3%	4%	19%	27%

Percentage of assets in each asset class—all plans

Percentage of assets in each asset class—in plans that make the class available

Note: There were extremely few plans with company stock in the plan-size category "<25."

Asset allocation patterns by age were similar to those seen in 2002, with younger participants holding a greater share of assets in domestic and international equities, as well as in blended options, than their older counterparts. Asset percentages in stable value investment options, meanwhile, particularly increased with age, as did short-term investment option holdings, but to a much lesser extent. The share of fixed-income assets remained flat across age groups, a result driven by reclassification of several very large options held by large plans, from fixed-income to stable value. The share of company stock assets peaked for those participants in their 40s and 50s, but stayed within a narrow band across all ages.

55 Percentage of assets in each asset class, by participant age

Age	Short-term	Stable value	Fixed-income	Blended	Domestic equity	International equity	Company stock
20–29	5%	7%	5%	13%	49%	6%	15%
30–39	4%	6%	4%	11%	52%	5%	17%
40–49	4%	11%	5%	11%	47%	4%	18%
50–59	5%	18%	5%	10%	39%	3%	18%
60–64	6%	27%	5%	10%	32%	3%	16%
65–69	6%	35%	5%	9%	26%	2%	16%
70+	8%	43%	5%	9%	19%	1%	14%
Overall	**5%**	**17%**	**5%**	**10%**	**41%**	**4%**	**17%**

Note: The asset allocations in this table are weighted averages for all participants in each age range, whether or not they held assets in each asset class.

In plans that offered domestic equity investment options, the portion of participants holding at least one of those options, and their share of assets in those options, decreased with age. Overall, the portion of participants invested in domestic equity options remained the same in 2003 as in 2002, at 66%. The portion of their assets in domestic equities, however, increased to 54% from 51%, reflecting strong investment performance. The trend for international equities was similar, but on a smaller scale.

For participants in their 30s and beyond whose plans offered company stock, about two-thirds held company stock, corresponding to about a third of those participants' assets. Company stock asset share decreased slightly with age.

The portion of participants who invested in blended options when their plans made them available decreased with age, but the portion of assets in them remained relatively flat. A driver of this result is the composition of the blended asset class, which includes balanced funds, life-stage funds, "strategy funds," and other options containing multiple asset classes.

In plans offering a stable value investment option, the portion of participants holding such an option increased significantly with age, as did their share of assets. For plans offering a short-term investment option, the portion of participants choosing to hold short-term investment options was quite consistent across all age ranges at about one-third. This percentage has risen 2% during each of the past three years, and is perhaps reflective of participant concerns regarding market volatility.

For plans offering fixed-income options, the portion of participants who elected to hold them declined somewhat with age. However, when both age and compensation were taken into account, compensation was found to be a more significant driver than age. Across virtually all age groups, the higher the compensation, the greater the portion of participants holding fixed-income. These results are not unreasonable if compensation correlates with investment sophistication or level of interest, and fixed-income options are viewed as useful investment diversification tools. Finally, of those participants who chose to hold fixed-income assets, their fixed-income share of assets increased with age.

56 Participant use of asset classes, in plans that make the options available

	Short-term		Stable value		Fixed-income	
Age	Percentage of participants who invest in these investment options	Percentage of total assets these participants invest in these investment options	Percentage of participants who invest in these investment options	Percentage of total assets these participants invest in these investment options	Percentage of participants who invest in these investment options	Percentage of total assets these participants invest in these investment options
20–29	35%	30%	36%	31%	23%	18%
30–39	31%	23%	37%	25%	23%	18%
40–49	32%	22%	44%	30%	23%	19%
50–59	33%	25%	51%	39%	22%	21%
60–64	33%	30%	56%	51%	20%	25%
65–69	32%	34%	63%	59%	16%	29%
70+	32%	42%	70%	67%	13%	36%
2003 Overall	**33%**	**26%**	**44%**	**40%**	**22%**	**21%**
2002 Overall	31%	28%	44%	46%	21%	28%
2001 Overall	29%	30%	39%	41%	17%	23%
2000 Overall	27%	28%	38%	36%	18%	22%

Age	Blended: Percentage of participants who invest in these investment options	Blended: Percentage of total assets these participants invest in these investment options	Domestic equity: Percentage of participants who invest in these investment options	Domestic equity: Percentage of total assets these participants invest in these investment options	International equity: Percentage of participants who invest in these investment options	International equity: Percentage of total assets these participants invest in these investment options
20–29	38%	35%	58%	61%	22%	17%
30–39	36%	29%	71%	61%	26%	16%
40–49	35%	28%	70%	56%	22%	14%
50–59	33%	28%	64%	51%	18%	13%
60–64	29%	30%	56%	47%	14%	12%
65–69	24%	32%	46%	44%	9%	12%
70+	20%	38%	33%	41%	5%	12%
2003 Overall	**34%**	**29%**	**66%**	**54%**	**21%**	**13%**
2002 Overall	33%	30%	66%	51%	21%	12%
2001 Overall	33%	30%	68%	56%	21%	12%
2000 Overall	31%	29%	70%	59%	21%	14%

Age	Company stock: Percentage of participants who invest in these investment options	Company stock: Percentage of total assets these participants invest in these investment options
20–29	55%	37%
30–39	63%	36%
40–49	66%	35%
50–59	68%	33%
60–64	66%	31%
65–69	63%	31%
70+	54%	31%
2003 Overall	**64%**	**34%**
2002 Overall	64%	33%
2001 Overall	65%	36%
2000 Overall	65%	37%

Note: This table shows participant assets in each asset class as a percentage of those participants' total assets (i.e., it excludes all assets of participants in those plans who are not invested in the asset class). Percentages in each asset class should be viewed independently.

DIVERSIFICATION BEHAVIOR

As mentioned earlier, one-fourth of participants continued to hold a single investment option in 2003. As noted in *Building Futures IV*, this pattern could result from participants with low account balances—particularly those in the youngest and oldest age groups—feeling less need to diversify. With minor exceptions, the demographic characteristics of single investment option holders in 2003 were consistent with 2002.

One method that plan sponsors have employed for reducing the risk incurred by single investment option holders is to make life-stage fund options available. As noted in the Plan Investment Options section, in 2003 significantly more plans offered the family of Freedom Fund life-stage options than in 2002. (See Table 50.)

Single investment option holders

The age profile of single investment option holders changed very little in 2003. Participants under age 30 and over age 65 were the most likely to be invested in a single option—at least one in three participants. Although the 30–59 age groups made up the majority of single option holders (74%) because they represented a larger portion of the overall participant population than the youngest and oldest age groups, a smaller percentage of participants within this age group were single investment option holders (22% to 24%) than in other age groups.

57 Single investment option holders as a percentage of total recordkept participants, by age

Age	Percentage of total recordkept participants who are single investment option holders	Percentage of all single investment option holders
20–29	35%	14%
30–39	24%	25%
40–49	22%	28%
50–59	23%	21%
60–64	27%	6%
65–69	33%	3%
70+	41%	2%
Overall	**25%**	**100%**

As in previous years, single investment option holders in large plans were most likely to be invested in company stock or stable value options, while those in small plans were most likely to hold short-term or domestic equity options. The only investment option categories that tended not to be held by single investment option holders across all plan-size categories were international equity, fixed-income, and other (consisting primarily of self-directed brokerage). Overall, the portion of single investment option holders in domestic equity and company stock options declined slightly from 2002, offset by a corresponding increase in the portion holding blended options, which may be due to the increase in the percentage of plans offering life-stage funds.

It is important to note that single investment option holders who held a blended option (18%) were likely to be more diversified than other single investment option holders.

58 Percentage of single investment option holder participants by plan size, by investment option category

Plan size	Short-term	Stable value	Fixed-income	Blended	Domestic equity	International equity	Company stock	Other
<25	42%	2%	5%	20%	30%	1%	1%	0.1%
25–49	41%	6%	5%	23%	24%	1%	0.4%	0.0%
50–149	37%	11%	4%	23%	23%	1%	1%	0.2%
150–499	31%	19%	5%	20%	23%	1%	1%	0.2%
500–999	29%	25%	4%	18%	21%	1%	2%	0.2%
1,000–2,499	30%	25%	4%	16%	18%	1%	6%	0.2%
2,500–4,999	25%	26%	3%	19%	15%	0.5%	12%	0.1%
5,000–9,999	21%	26%	6%	19%	11%	0.4%	17%	0.1%
10,000–24,999	19%	24%	3%	16%	12%	1%	24%	0.1%
25,000+	9%	28%	3%	18%	17%	0.2%	24%	0.0%
Overall	**20%**	**25%**	**4%**	**18%**	**16%**	**1%**	**16%**	**0.1%**

Consistent with results seen in previous years, the weighted average account balance of single investment option holders was about half the average of the total participant population in 2003. The median balance of single option holders, meanwhile, was even smaller by comparison—about one-fourth of the total population's median balance. Half of single option holders had account balances under $5,000.

59 Percentage of single investment option holders, by account balance

Account balance	Single investment option holders	All recordkept participants
<$100	11%	4%
$100–$499	11%	4%
$500–$999	7%	3%
$1,000–$1,999	8%	4%
$2,000–$2,999	5%	3%
$3,000–$3,999	4%	3%
$4,000–$4,999	3%	2%
$5,000–$9,999	12%	11%
$10,000–$19,999	12%	15%
$20,000–$29,999	7%	10%
$30,000–$39,999	4%	7%
$40,000–$49,999	3%	5%
$50,000–$69,999	4%	7%
$70,000–$99,999	3%	7%
$100,000–$149,999	2%	6%
$150,000+	4%	9%
Total	**100%**	**100%**
Weighted average account balance	$27,000	$55,000
Median balance	$5,000	$20,000

Single investment option holders' use of stable value investment options and, to a lesser extent, fixed-income, increased with age, presumably because they are conservative options. Company stock use also increased with age, potentially because older participants tend to have longer tenure and are more likely to have been participants when a plan sponsor made contributions in the form of company stock.

Relative to 2002, the percentage of single investment option holders by asset class remained relatively unchanged, although the use of blended investment options increased across almost all age groups but tended to be more widely used by younger single investment option holders than by older ones.

60 Percentage of single investment option holders, by age and investment category

Age	Short-term	Stable value	Fixed-income	Blended	Domestic equity	International equity	Company stock	Other	Total
20–29	25%	23%	2%	27%	[illegible]	0.4%	[illegible]	0.0%	**100%**
30–39	21%	21%	3%	19%	[illegible]	1%	[illegible]	0.1%	**100%**
40–49	20%	23%	4%	16%	19%	1%	[illegible]	0.1%	**100%**
50–59	18%	28%	5%	14%	16%	1%	[illegible]	0.1%	**100%**
60–64	17%	34%	5%	11%	[illegible]	1%	[illegible]	0.1%	**100%**
65–69	16%	41%	4%	9%	10%	0.4%	[illegible]	0.1%	**100%**
70+	16%	50%	4%	10%	6%	0.1%	[illegible]	0.0%	**100%**
Overall	**20%**	**25%**	**4%**	**18%**	**16%**	**1%**	**16%**	**0.1%**	**100%**

Single investment option holders were more conservative investors than participants overall (Table 55). As a group, they had a significantly higher portion of assets in short-term and stable value options than the total participant population, and a significantly smaller portion in domestic and international equities. The data also showed that a slightly higher portion of single investment option holder assets was in company stock across all age groups up to age 60.

61 Percentage of single investment option holders' *assets*, by age and investment category

Age	Short-term	Stable value	Fixed-income	Blended	Domestic equity	International equity	Company stock
20–29	14%	17%	[illegible]	24%	24%	1%	[illegible]
30–39	11%	13%	[illegible]	17%	[illegible]	1%	[illegible]
40–49	10%	19%	[illegible]	13%	[illegible]	1%	[illegible]
50–59	11%	32%	[illegible]	11%	[illegible]	0.5%	[illegible]
60–64	11%	48%	[illegible]	9%	[illegible]	0.4%	[illegible]
65–69	9%	56%	[illegible]	7%	9%	0.2%	[illegible]
70+	[illegible]	65%	[illegible]	8%	[illegible]	0.2%	[illegible]
Overall	**11%**	**32%**	**4%**	**12%**	**22%**	**0.5%**	**18%**

Life-stage fund holders

As noted in the Plan Investment Options section, life-stage funds offer participants the option of choosing a single fund that will provide an age-appropriate allocation over time. The analyses included here are limited to Fidelity Freedom Funds.

Nineteen percent of recordkept participants in plans that offer Freedom Funds had some portion of their DC assets in Freedom Funds. This adoption rate was highest for young participants and decreased in the older age ranges. Of those participants with assets in one or more Freedom Funds, approximately one-third of their assets were in Freedom Funds, on both weighted average and median bases. The two groups of participants with significantly more than one-third of their assets in Freedom Funds were the very youngest and the very oldest.

62 Participants' usage of Freedom Funds in plans offering Freedom Funds, by age

Age	Percentage of participants holding Freedom Funds in plans offering Freedom Funds	Weighted average percentage of these participants' account balances in Freedom Funds	Median percentage of these participants' account balances in Freedom Funds
20–29	26%	41%	51%
30–39	21%	33%	34%
40–49	18%	30%	32%
50–59	16%	30%	33%
60–64	13%	32%	36%
65–69	9%	31%	39%
70+	7%	37%	54%
Overall	**19%**	**31%**	**36%**

Among all participants who held a Freedom Fund, 95% held either one or two of them. In every age group, an overwhelming majority—84% to 89%—held a single Freedom Fund. There are several possible explanations as to why participants may choose to hold more than one Freedom Fund. Examples include having a retirement date between the dates of two Freedom Funds, or aiming to meet multiple financial goals such as retirement and college tuition.

63 Percentage of Freedom Fund holders, by number of Freedom Funds held, by age

	Number of Freedom Funds held				
Age	1	2	3	4+	**Total**
20–29	86%	10%	2%	2%	**100%**
30–39	84%	12%	3%	2%	**100%**
40–49	84%	12%	3%	2%	**100%**
50–59	84%	12%	3%	1%	**100%**
60–64	85%	12%	2%	1%	**100%**
65–69	86%	11%	2%	1%	**100%**
70+	89%	9%	2%	1%	**100%**
Overall	**84%**	**11%**	**3%**	**2%**	**100%**

Most participants who held a single Freedom Fund were in the fund appropriate to their age, based on an expected retirement date in their 60s. Participants not meeting this criterion, however, may also be invested appropriately. They may be targeting financial goals other than retirement or may be planning to retire earlier or later than their 60s. In addition, the participants included in this table are those holding a single Freedom Fund, independent of how many other investment options they hold in their plan, and therefore they may be using Freedom Funds in a manner different from their intended design. Finally, certain Fidelity DC plans adopted Freedom Funds through mapping strategies in which participant age was not taken into account, such as removing a balanced fund from a plan lineup and mapping all assets from that fund to a single Freedom Fund. Even in these extreme cases, however, Freedom Funds provide asset diversification, whether or not participants are in precisely the "correct" Freedom Fund for their age.

64 Single Freedom Fund holders, by age and Freedom Fund held

Age	Freedom Income	Freedom 2000	Freedom 2010	Freedom 2020	Freedom 2030	Freedom 2040	**Total**
20–29	8%	3%	7%	8%	25%	49%	**100%**
30–39	7%	3%	12%	17%	48%	12%	**100%**
40–49	7%	3%	20%	48%	19%	3%	**100%**
50–59	7%	6%	53%	27%	5%	2%	**100%**
60–64	10%	21%	53%	10%	4%	1%	**100%**
65–69	18%	39%	30%	9%	3%	1%	**100%**
70+	47%	15%	25%	10%	2%	1%	**100%**
Overall	**8%**	**5%**	**24%**	**27%**	**25%**	**12%**	**100%**

Note: Numbers in this table should be interpreted as follows: 48% of all single Freedom Fund holders between ages 30 and 39 have their Freedom Fund assets in Freedom 2030. Freedom 2005, Freedom 2015, Freedom 2025, and Freedom 2035 were introduced in November 2003. Due to the lack of time participants had to enroll in these new funds, they were not included in Tables 64 and 65.

Participants who held a single Freedom Fund tended to have about one-third of their plan assets in that Freedom Fund. By age and specific Freedom Fund, this portion of assets varied from a low of 19% to a high of 51%. These results reflect, in part, the manner in which Freedom Funds were added to plans. For example, for participants who were participating in a plan before Freedom Funds were added to the plan lineup, it may be unrealistic to expect them to have exchanged 100% of their assets into a single Freedom Fund. They may have been more likely to exchange some of their assets into a Freedom Fund and/or direct future contributions into that Freedom Fund.

65 Percentage of single Freedom Fund holders' account balances in specific Freedom Funds

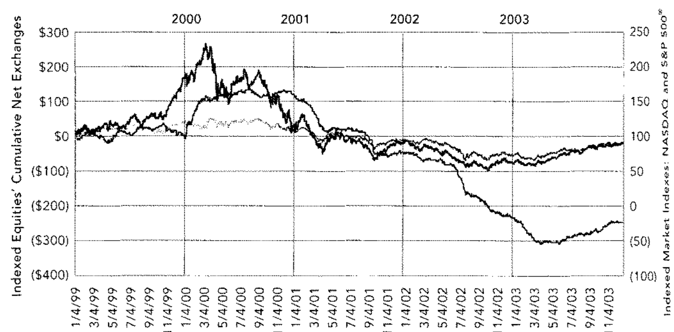
Age	Freedom Income	Freedom 2000	Freedom 2010	Freedom 2020	Freedom 2030	Freedom 2040	**Weighted Average**
20–29	**26%**	23%	**26%**	34%	41%	51%	**41%**
30–39	19%	20%	**22%**	30%	37%	37%	**32%**
40–49	**19%**	19%	**25%**	32%	**31%**	28%	**29%**
50–59	21%	27%	**30%**	31%	**25%**	25%	**29%**
60–64	24%	36%	31%	29%	**25%**	22%	**31%**
65–69	**31%**	33%	**32%**	26%	**20%**	26%	**31%**
70+	37%	45%	**32%**	30%	**36%**	39%	**36%**
Overall	**22%**	**29%**	**28%**	**32%**	**34%**	**36%**	**30%**

Note: Numbers in this table should be interpreted as follows: Out of all single Freedom Fund holders age 30–39 who invested in Freedom 2030, 37% of their Fidelity-recordkept DC assets were in Freedom 2030.

PARTICIPANT RESPONSE TO STOCK MARKET ACTIVITY

In 2003, the domestic and international equity markets declined during the first quarter, followed by strong growth through much of the remainder of the year. The equity markets' poor performance in the first quarter resulted in participants' continuing equity investment option net exchange outflows during that period. During the second quarter, as the equity markets experienced strong growth, participants' equity investment option exchanges in and out balanced one another. Finally, during the third and fourth quarters of 2003, as the equity markets continued to rise, participants made net positive exchanges into their plans' equity investment options.

66 Cumulative net exchanges into equities (January 1999–December 2003)



Cumulative net exchanges into equities (domestic, international, company stock)

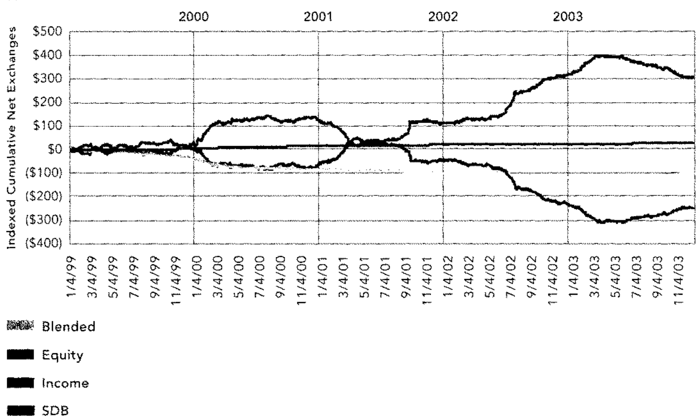
S&P 500® Index

NASDAQ Composite ex. div.

Notes: Cumulative net exchanges in Tables 66, 67, and 68 represent total net exchanges into that asset class from 1/4/1999 until the date in question. An upward sloping trend indicates that participants are, in aggregate, exchanging into that asset class. A downward sloping trend indicates that participants are, in aggregate, exchanging out of that asset class. A horizontal trend indicates that participants are, in aggregate, holding a level position in that asset class (i.e., exchanges in are balanced by exchanges out). Equities include domestic equity, international equity, and company stock. Exchanges from one equity investment option into another net to zero and thus are not reflected in this chart. Values are indexed to 12/31/1998. It is not possible to invest directly in a market index.

As was reported in Building Futures IV, the chart below depicts cumulative net exchanges between asset classes and reinforces the correlation between stock market performance and net exchanges between asset classes. A key aspect of this chart is the mirror-like image of the lines tracking cumulative net exchanges for equity investments (domestic, international, and company stock) and "income" investments (fixed-income, stable value, and short-term). The chart shows that in early 2000, before the market's peak, assets were being exchanged out of income options and into equities. Then, through nearly the end of 2000, net exchanges between asset classes were minimal. Beginning in late 2000, after the market had already fallen considerably, and continuing through the end of 2002, assets were exchanged out of equities and into income investment options. Participants reacted to the stock market's recovery that began late in the first quarter of 2003 by exchanging into equities and out of income investment options in the second half of 2003.

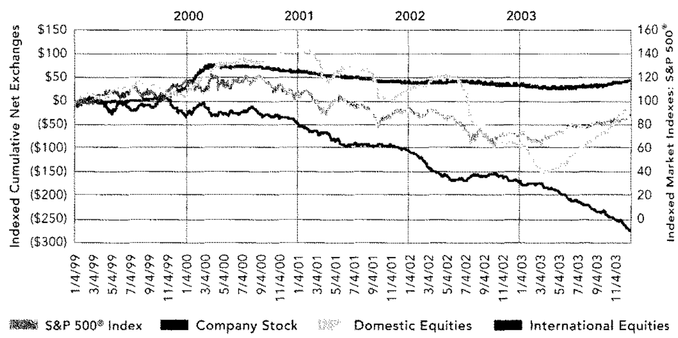
67 Cumulative net exchanges by asset class (January 1999–December 2003)



Note: The summary asset categories used in this chart are consistent with those used throughout this report. "Equity" consists of domestic equity, international equity, and company stock. "Income" consists of fixed-income, stable value, and short-term. SDB (self-directed brokerage) is a subset of "Other." Exchanges entirely within an asset class (e.g., from one equity investment option into another) net to zero, and therefore are not reflected in this chart. Values are indexed to 12/31/1998.

A decomposition of exchange activity into equity investment option sub-asset classes— domestic equities, international equities, and company stock—provides further insight into what is driving overall participant exchange activity. Of note is the strong correlation between the S&P 500® Index and participants' net exchange activity into and out of domestic equity investment options. The lag between market movement and participants' corresponding domestic equity exchange behavior, however, illustrates the downside of attempting to time the market. Also of note, there has been a long-term net exchange flow out of company stock since the market's peak in early 2000. Relative to domestic equity investment option exchange activity, company stock experienced participant net exchange inflows to a much smaller extent when the market was up. Further, company stock experienced significant net exchange outflows in the last three quarters of 2003, a time when the S&P 500 had very strong performance, which was reflected by strong participant net exchange inflows to domestic equity investment options. This activity suggests that corporate governance issues may have played a role in participants' decisions to divest some of their company stock holdings while increasing their domestic equity holdings. This activity is consistent with plan sponsors' easing of company stock exchange restrictions, as shown in *Building Futures IV*. Finally, while net exchanges were strong into international equities in the months leading up to the early 2000 equity market peaks, they experienced slow and gradual net flows out through early to mid-2003, and only then did they again experience net inflows.

68 Cumulative net exchanges, by equity asset class (January 1999–December 2003)



Note: Although only the S&P 500 Index is shown, the Morgan Stanley EAFE Index for international equities has a very similar trend for the 1999–2003 period. Exchanges entirely within an asset class net to zero, and therefore are not reflected in this chart. Values are indexed to 12/31/1998. It is not possible to invest directly in a market index.

Before investing in any mutual fund, please carefully consider the investment objectives, risks, charges and expenses. For this and other information, call or write Fidelity for a free prospectus. Read it carefully before you invest.

3)

APPENDIX | Report Methodology and Important Legal Information

To see an online version of the report, go to *http://buildingfutures.fidelity.com.*

General background and definitions

Building Futures is based on data for all 10,136 corporate defined contribution plans recordkept by Fidelity Employer Services Company with a balance as of year-end 2003, and their corresponding 8.2 million participants. These plans include both qualified and assetized nonqualified plans as well as single-fund plans, which include Employee Stock Ownership Plans (ESOPs). Plans sponsored by Fidelity Investments for the benefit of its own employees are excluded. Plans recordkept with Fidelity Investments Institutional Services Company, Inc., which includes distribution through a variety of financial institutions, including banks, insurance companies, broker/dealers, financial planners, and pension fund administrators, also are excluded.

Analyses of participation rates, deferral percentages for eligible employees, and deferral rates for active participants exclude nonqualified plans, since these analyses are based on data gathered for nondiscrimination testing (NDT) purposes that is conducted only on qualified plans.

The participant analyses in the report are based on one of five participant populations: all recordkept, active, terminated, active nondiscrimination testing ("active NDT"), and eligible. All recordkept participants represent all participants with an account balance as of year-end 2003. Active participants represent those participants who both had an account balance and were still employed by the plan sponsor as of year-end 2003 (whether or not they actually made a contribution to the plan in 2003). Terminated participants represent those participants with an account balance as of year-end 2003 who were no longer employed by the plan sponsor. (The number of recordkept participants is the sum of all active participants and all terminated participants.) Active NDT participants represent participants in those plans for which Fidelity performs nondiscrimination testing who were employed by the plan sponsor and who made contributions to the plan during the test year. Eligible NDT participants (employees) represent employees in plans for which Fidelity performs nondiscrimination testing, who were employed by the plan sponsor and were eligible to participate in the test year, whether or not they were actually participating in the plan.

Unless otherwise indicated, the participant analyses in the report are based on all recordkept participants. Analysis with regard to compensation is limited to eligible NDT participants, as compensation data are available only for this population. Compensation data may include partial-year compensation data for active NDT participants who were hired or terminated during the test year. Thus, average balance, participation, and deferral rates at the lowest compensation levels may reflect this phenomenon in combination with the behavior of the truly lowest-income participants.

Of the 10,136 plans analyzed in this report, NDT data were available for approximately 40% of them in time for the report's analysis of participation rates, deferral rates, and compensation. Further use of active NDT participants and eligible NDT participants for analysis is described in "Calculation of participation rates, deferral percentages, and deferral rates for active participants," later in this Appendix.

In order to limit the complexity of the data presented in the report, population percentages generally were held to whole numbers, with numbers in tables being rounded to the displayed number of significant digits. Thus, they may not always appear to reconcile exactly with total or percentage figures stated in the tables or text. All such figures, however, were calculated using the actual nonrounded underlying figures, and are accurate.

Industry categories

The industry categorization used in the report is based on the North American Industry Classification System (NAICS). NAICS was the result of an initiative to update the Standard Industrial Classification (SIC) codes, completed in 1997. This effort was spearheaded by the Office of Management and Budget, and incorporated input from statistical government agencies in Canada and Mexico as well as in the United States.

Index definitions

The Lehman Brothers Aggregate Bond Index is an unmanaged total return index composed of fixed-rate debt issues, including government, corporate, asset-backed, and mortgage-backed securities. Issues included in the index are rated investment-grade or above and have maturities of at least one year.

The S&P 500® Index is a registered service mark of The McGraw-Hill Companies, Inc., and has been licensed for use by Fidelity Distributors Corporation and its affiliates. It is an unmanaged index of the common stock prices of 500 widely held U.S. stocks that includes the reinvestment of dividends.

3-Month Treasury bills are marketable securities with three-month maturities that the U.S. government sells in order to pay off maturing debt and raise the cash needed to run the federal government.

The Morgan Stanley Capital International Europe, Australasia, Far East (MSCI EAFE®) Index is an unmanaged market capitalization–weighted index of equity securities of companies domiciled in various countries. The index is designed to represent the performance of developed stock markets outside the United States and Canada and excludes certain market segments unavailable to U.S.-based investors.

The Wilshire 5000 is an unmanaged, market capitalization–weighted index of approximately 7,000 U.S. equity securities.

Calculation of participation rates, deferral percentages, and deferral rates for active participants

The participation rate for any plan is defined as the number of active NDT participants divided by the total number of eligible NDT employees. An eligible employee for NDT purposes is defined as any employee who was eligible to join the plan at any time during the test year (2003). An active participant for NDT purposes is defined as any eligible employee who made a pretax contribution at any time during the test year.

For analysis of participation rates by **plan** characteristics, the average participation rate within any category is derived by determining the participation rate for each plan and calculating the simple average of the plan participation rates across all plans in the category. These average rates are thus *unweighted*—the rate for each plan counts the same as every other plan toward the category average.

For analysis of participation rates by **participant** characteristics, the average participation rate within any category is derived by dividing the number of active NDT participants by the number of eligible NDT employees across all plans in aggregate in that category. Thus, these average rates are effectively *weighted*—larger plans generally will have greater representation within any participant category than smaller plans will.

NDT deferral percentages are typically presented separately for highly compensated employees (HCEs) and non-highly compensated employees (NHCEs). For 2003, HCEs were defined by statute as employees who either earned compensation in excess of $90,000 during the 12-month period preceding the first day of the plan year or who owned more than 5% of the employer in either the plan year or the 12-month period preceding the first day of the plan year. When applying the compensation threshold, plans may choose to limit the number of employees considered to be HCEs to 20% of their workforce. Because HCEs are more likely to have their deferrals capped by the statutory IRS limit ($12,000 in 2003) or plan maximum allowed, deferral rates must be analyzed separately for each type of employee.

For NDT purposes, deferral percentages must be calculated including eligible nonparticipants (counting their compensation and considering their contributions to be zero). In NDT, participation rates and deferral percentages are typically treated in tandem as an integrated metric of qualified plan performance. For this report, however, participation rates and then deferral percentages are considered sequentially as two distinct participant behaviors, and deferral rates are generally evaluated **for active participants only**. To reinforce this distinction, we refer to the two employee categories as highly compensated participant (HCP) and non-highly compensated participant (NHCP) in corresponding sections of the report. However, the active participants are designated HCP or NHCP using the NDT criteria for HCE and NHCE.

Deferral rates for active participants are calculated using 2003 plan-year employee pretax contributions divided by 2003 plan-year compensation. Compensation is defined as wages used for determining participants' Internal Revenue Code (IRC) Section 415 limits for 2003. As required under IRC Section 401(a)(17), compensation for NDT purposes was limited to $200,000 for 2003, however in calculating deferral rates for this report, full actual compensation was used.

Deferral rates for active participants are averaged in a weighted manner for analysis of both plan and participant characteristics. The pretax contributions for each HCP and NHCP in a given plan-size category or participant demographic category are divided by calendar year compensation for that HCP or NHCP. These individual deferral rates are then averaged for all the active NDT participants within the plan-size or participant demographic group.

Calculation of account balances, exchanges, and loans

Account balances represent holdings as of December 31, 2003, net of outstanding loan amounts (i.e., balances represent preloan balances minus the principal amount of any loans outstanding). For analysis within both plan characteristic and participant demographic categories, weighted average account balance is defined as the total assets held by participants in that category divided by the number of participants in the category.

Exchanges are defined as any participant-level exchange of assets between investment options within a plan. The number of exchanges tallied for each participant is counted as the number of days during 2003 on which the participant made at least one exchange. Exchanges between a self-directed brokerage account and other plan options are included. Exchanges within a self-directed brokerage account are excluded.

Loans were counted based on all loans outstanding as of December 31, 2003, regardless of the purpose of the loan (e.g., general or home). Because many plans require loans to be repaid upon termination, or shortly thereafter, the analysis of loans is limited to active participants.

Investment options

In the description of asset classes below, the fundamental types of investment vehicles are defined as follows:

Mutual fund: An investment that pools money from shareholders and invests in a diversified portfolio of securities.

Commingled pool: A group trust maintained by a bank or trustee for the collective investment of qualified pension or profit sharing plans combining the money of many investors who own units of the pool.

Separate account: An account, the assets of which are held by an independent custodian or trustee, established to provide investment management services to qualified pension funds, corporations, institutions, or high net worth individuals.

Investment contract: A group annuity contract issued by an insurance company, bank, or other financial institution to a tax-qualified pension and/or profit-sharing plan that guarantees principal and repays the investment plus interest at a stated maturity date or dates. Contracts issued by insurance companies are often referred to as guaranteed investment contracts (GICs), and those issued by banks are sometimes described as bank investment contracts (BICs).

Synthetic GIC: An investment in a stable value fund consisting of (1) an asset owned directly by the plan; and (2) a wrap agreement that provides for participant withdrawals at book value. Both elements must be present in one agreement to qualify for book value accounting. (A wrap agreement is a contractual agreement to maintain principal and benefit payments and participant investment transfers on a specified asset or group of assets at book value.)

For the report, all assets held in Fidelity-recordkept plans are grouped into eight mutually exclusive asset classes:

Domestic Equity: U.S. equity mutual funds, commingled pools, and separate accounts, both actively managed and indexed.

International Equity: International or world equity mutual funds, commingled pools, and separate accounts, both actively managed and indexed.

Blended: Mutual funds, commingled pools, and separate accounts composed of at least two asset classes, one being an equity, and the other either a fixed-income or money market. Included in the blended category are "strategies" (i.e., funds of funds, pools, and separate accounts) meeting the above conditions.

Fixed-income: U.S. and international fixed-income mutual funds, commingled pools, and separate accounts, both actively managed and indexed.

Short-term: Money market mutual funds, commingled pools, and separate accounts.

Stable Value: GICs, BICs, synthetic GICs, and "mixed portfolios" (consisting of GICs, BICs, and/or synthetics in combination with a fixed-income mutual fund, commingled pool, or separate account).

Company Stock: The plan sponsor company's own securities, whether accounted for on a share or unitized basis. Also includes balances in other companies' funds that may be held by participants in their defined contribution accounts as a result of a corporate action (e.g., a merger or acquisition).

Other: Securities not falling into the above categories, the majority of which are self-directed brokerage vehicles within defined contribution plans.