CONGRESSIONAL TESTIMONY

PURSUING UNIVERSAL RETIREMENT SECURITY THROUGH AUTOMATIC IRAS

Testimony before the
Subcommittee on Health, Employment, Labor and Pensions
Committee on Education and Labor
United States House of Representatives

November 8, 2007

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

Our statement focuses on our joint proposal – introduced as H.R. 2167 and S. 1141 -- to expand retirement savings for small business workers – the Automatic IRA[2]. We are pleased by the positive reaction the proposal has received and are grateful to our colleagues, including those in government and in various stakeholder organizations, who have contributed to these ideas.[3]

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The Retirement Security Project is supported by The Pew Charitable Trusts in partnership with Georgetown University's Public Policy Institute and the Brookings Institution.

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

[2] This testimony is based on a more detailed proposal the witnesses have set forth in a series of research and policy papers (see, e.g., Retirement Security Project Publication No. 2007-2 "Pursuing Universal Retirement Security through Automatic IRAs") which are available at *www.retirementsecurityproject.org.* (Major portions of this testimony are taken verbatim from the witnesses' research and policy papers cited above.) The proposal has been introduced in the 110th Congress as the "Automatic IRA Act of 2007", H.R. 2167, sponsored by Rep. Richard Neal (D-MA) and Rep. Phil English (R-PA), and S. 1141, sponsored by Senators Jeff Bingaman (D-NM) and Gordon Smith (R-OR).

[3] See http://www.retirementsecurityproject.org/pubs/File/AutoIRAQuoteSheetFinal7.6.07.pdf. Crenshaw, Albert, "Automatic IRAs – a Quick Fix for Workers Without Pensions?" Washington Post, February 19, 2006; "The Way to Save" Editorial, New York Times, February 20, 2006; Bernard, Tara, "Groups Propose Payroll Deductions for IRAs," The Wall Street Journal, February 16, 2006; Editorial, Newsday, February 22, 2006; Marketwatch.com (February 16, 2006); Lambro, Donald, "A Broader Retirement Plan," The Washington

With the looming retirement security crisis facing our country, policy-makers from both parties are focused on ways to strengthen pensions and increase savings. Our proposal for automatic IRAs would provide a relatively simple, cost-effective way to increase retirement security for the 75 million Americans working for employers (usually small businesses) that do not offer a retirement plan.[4] It would enable these employees to save for retirement by allowing them to have their employers regularly transfer amounts from their paycheck to an IRA.

These people – half of our workforce – have no effective way to save at work. This fact, a national saving rate that has been declining steadily since the 1980s, and the expectation that Social Security is unlikely to provide increased benefits, make inadequate retirement saving a major national problem. Research and experience both point to a simple and effective solution, which we call the "automatic IRA."

We are by no means suggesting that the automatic IRA proposal is the only step that should be taken to expand retirement savings for small business workers or others. In fact, we have long believed in the primacy of employer-sponsored retirement plans as vehicles for pension coverage.[5] Additionally, the Retirement Security Project continues to advocate strongly for the expansion of pension coverage through automatic features in 401(k) and similar retirement savings plans[6] and for several other initiatives designed to expand retirement security,

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Times, April 12, 2007; "Another Black Eye for H&R Block" Editorial, New York Times, March 18, 2006; Quinn, Jane Bryant, "A Nest Egg for Low Earners," Newsweek, February 26, 2007; Commission on the Regulation of U.S. Capital Markets in the 21st Century, Report and Recommendations, March 2007. The automatic IRA proposal emerged as one of the leading recommendations of the 2006 National Summit on Retirement Savings (Saver Summit).

[4] Craig Copeland, "Employment-Based Retirement Plan Participation: Geographic Differences and Trends, 2005: Employee Benefit Research Institute Issue Brief No. 299," November 2006 (referred to below as "Copeland, EBRI Issue Brief No. 299"), Figure 1, p. 7. An additional 16 million workers either are not eligible for their employer's plan or are eligible but fail to participate. Similar but updated figures for 2006 are available in the Employee Benefit Research Institute Issue Brief 311.

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

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

especially for the moderate- and lower-income households that comprise a majority of the U.S. population.[7]

Making saving easier by making it automatic has been shown to be remarkably effective at boosting participation in 401(k) plans, but roughly half of U.S. workers are not offered a 401(k) or any other type of employer-sponsored plan. We would extend the benefits of automatic saving to a far wider array of the population by combining several key elements of our current system: payroll deposit saving, automatic enrollment, low-cost, diversified default investments, and IRAs.

The automatic IRA approach we propose offers most employees not covered by an employer-sponsored retirement plan the opportunity to save through the powerful mechanism of regular payroll deposits that continue automatically. The employer's administrative functions are minimal and should involve no out of pocket cost. In addition, the arrangement is market-oriented and realistic: it uses a well established and familiar vehicle, IRAs, provided by the same banks, mutual funds, insurance carriers, brokerage firms, credit unions, and other private financial institutions that currently provide them. As a fallback, if individuals or employers could not find an acceptable IRA on the market, they would be able to use ready-made, low-cost automatic IRA accounts provided by a consortium or pool of private-sector financial institutions or another nonprofit or government-contracted entity that contracts out asset management and other functions to the private sector.

The Basic Problem

In 2004 half of all households headed by adults aged 55 to 59 had $13,000 or less in an employer-based 401(k)-type plan or tax-preferred saving plan account.[8] The U.S. personal saving rate has declined steadily over the last two decades and has been negative since 2005.[9]

See also the description of the joint AARP, FINRA, Retirement Security Project "Retirement Made Simpler" campaign on page 10, below.

[7] See, for example, the following (all of which are available at www.retirementsecurityproject.org): J. Mark Iwry, William Gale, and Peter Orszag, "The Potential Effects of Retirement Security Project Proposals on Private and National Saving: Exploratory Calculations," Retirement Security Project Policy Brief No. 2006-2; Peter Orszag and Eric Rodriguez, "Retirement for Latinos: Bolstering Coverage, Savings and Adequacy," Retirement Security Project Policy Brief No. 2005-7; William G. Gale, J. Mark Iwry and Peter R. Orszag, "The Saver's Credit," Retirement Security Project Policy Brief No. 2005-2; J. Mark Iwry, "Using Tax Refunds to Increase Savings and Retirement Security," Retirement Security Project Policy Brief No. 2005-9; Peter Orszag, "Protecting Low-Income Families' Savings: How Retirement Accounts Are Treated in Means-Tested Programs and Steps to Remove Barriers to Retirement Saving," Retirement Security Project Policy Brief No. 2005-6.

[8] Even among those households that had savings in 401(k)s and IRAs, the median account balance was only $69,000. Authors' calculations using the 2004 Survey of Consumer Finances.

[9] As measured in the National Income and Product Accounts.

Moreover, traditional corporate defined benefit pension plans are declining, and few expect Social Security to provide increased benefits in the future. The households that tend to be in the best financial position to confront retirement are the 41 percent of the workforce that participate in an employer-sponsored retirement plan.[10]

The most vulnerable employees are those lacking access to an employer-sponsored plan. In a recent survey conducted by AARP with 700 private sector workers at companies with 10-250 employees that do _not_ offer a 401(k) or some other retirement plan, fewer than half of these workers without access to an employer plan said they had taken the following actions: Saved money in a non-retirement account (45%)**;** Saved money in a retirement account (35%)**;** Read articles or other information about retirement (35%); Talked with friends, relatives, and/or coworkers about retirement (31%)**;** Used a retirement calculator (14%).[11]

Generally, the rate of participation (those who contribute as a percentage of those who are eligible) for 401(k) plans is on the order of 7 or 8 out of 10. An increasing share of plans are including automatic features that make saving easier and raise participation, often to levels exceeding 9 out of 10. While more can and should be done to expand 401(k) and other employer plan coverage,[12] the fraction of the workforce that is covered by employer plans has hovered around half for at least three decades. The uncovered employees have no effective way to save at work. IRAs do not cover enough people because many fail to exercise the initiative required to make the decisions and take the actions necessary to save in an IRA. More broadly, many people find it too difficult or lack the financial sophistication to plan for retirement and defer consumption. As a result, only about 1 in 10 eligible individuals contributes to an IRA.

The AARP-commissioned study also shows that workers at companies that would be covered by the Auto IRA legislation favor the concept of automatic IRAs and are likely to participate: Over seven in ten (71%) of those without access to an employer-provided retirement savings plan agree that "employers who do not offer a 401(k) or other retirement plan should be required by law to offer workers the option to regularly save a part of their paycheck in an individual retirement account" and nearly eight in ten (79%) of those without access say they would be likely to participate if their company offered them the option to regularly save a part of their paycheck in an IRA through payroll deduction.

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[10] Copeland, EBRI Issue Brief No. 299, Figure 1, page 7. Similar but updated figures for 2006 are available in the Employee Benefit Research Institute Issue Brief 311.

[11] Thayer, Colette, "Automatic IRAs: Worker Attitudes and Likelihood of Participation," April 2007

[12] See William G. Gale, J. Mark Iwry, and Spencer Walters, The Pension Protection Act of 2006 and the Unfinished Agenda. (Retirement Security Project Publication No. 2007-1, April 2007).

The Automatic IRA

The automatic IRA approach is intended to help households overcome the barriers to saving by building on the successful use in 401(k) plans of automatic features which encourage employees toward sensible decisions while allowing them to make alternative choices. The automatic IRA would feature direct payroll deposits to a low-cost, diversified IRA. Employers above a certain size (e.g., 10 employees) that have been in business for at least two years but that still do not sponsor any plan for their employees would be called upon to offer employees this payroll-deduction saving option. The automatic IRA would apply many of the lessons learned from 401(k) plans so that more workers could enjoy automated saving to build assets – without imposing any significant burden on employers. Employers that do not sponsor plans for their employees could facilitate saving – without sponsoring a plan, without making employer matching contributions, and without complying with plan qualification or fiduciary standards. They would simply offer to act as a conduit, remitting a portion of employees' pay to an IRA, preferably by direct deposit, at little or no cost to the employer.

The automatic IRA is also designed to address the concern that financial providers have found it less profitable to serve groups of people with a small average account size. The proposal would provide a backstop arrangement contracted to the private sector that would give an option to any employee groups that the financial services industry is not currently interested in serving.

Little or No Cost to Employers

Direct deposit to IRAs is not new. In the late 1990s, Congress, the IRS, and the Department of Labor all encouraged employers not ready or willing to sponsor a retirement plan to at least offer their employees the opportunity to contribute to IRAs through payroll deduction.[13] However, employers did not respond to this option. Very few employers have ever adopted direct deposit or payroll-deduction IRAs – at least in a way that actively encourages employees to take advantage of the arrangement.

With this experience in mind, we propose a new strategy designed to induce employers to offer, and employees to take up, direct deposit or payroll deposit saving. For many if not most employers, offering direct deposit or payroll deduction IRAs would involve little or no cost. The employer would not be

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

maintaining a retirement plan, and employer contributions would be neither required nor permitted. Firms would *not* be required to

(1) comply with plan qualification or ERISA[14] rules,

(2) establish or maintain a trust to hold assets,

(3) determine whether employees are actually eligible to contribute to an IRA or are complying with the limits on contributions,

(4) select investments for employee contributions,

(5) select among IRA providers, or

(6) set up IRAs for employees.

Employers would be required simply to allow employees to make a payroll-deduction deposit to IRAs. This dovetails with what employers are already required to do by way of withholding income (and payroll) tax from employees' pay (based partly on employee elections on IRS Form W-4) and remitting those amounts to the federal tax deposit system.

Tax Credit for Employers that Serve as Conduit for Employee Contributions

Firms that do not provide employees a qualified retirement plan, such as a pension, profit-sharing, or 401(k) plan, would be given a temporary tax credit to establish automatic IRAs. The tax credit would be available to a firm for the first two years in which it offered payroll deposit saving to an IRA and would be designed to avoid competing with the tax credit available under current law to small businesses that adopt a new employer-sponsored retirement plan. Also, it would be available both to those employers required to offer payroll deposit and to very small or new firms that are not required to but do so voluntarily.

Tax Credit for Employers that Adopt a New Employer-Sponsored Retirement Plan

Under current law, an employer with 100 or fewer employees that starts a new retirement plan for the first time can generally claim a tax credit for startup costs. The credit equals 50 percent of the cost of establishing and administering the plan (including educating employees about the plan) up to $500 per employer per year for three years. To maintain employer incentives to adopt an employer plan, the automatic IRA tax credit would be lower, e.g. $25 per employee enrolled, capped at $250 in the aggregate per employer. Employers could not claim both the new plan startup credit and the proposed automatic IRA credit.

[14] Employee Retirement Income Security Act of 1974, as amended.

Direct Deposit and Automatic Fund Transfers

The automatic IRA would capitalize on automated or electronic fund transfers. Many employers retain an outside service provider to manage payroll, including withholding, federal tax deposits, and direct deposit of paychecks to accounts designated by employees or contractors. For the numerous firms that already offer their workers direct deposit, direct deposit to an IRA would entail no additional cost, even in the short term. A large proportion of the employers that still process their payroll by hand would be exempted under the exception for very small employers. As a result, our proposal focuses chiefly on those employers that already use electronic payroll but have not used the same technology to provide employees a convenient retirement saving opportunity. Employers that do not use electronic payroll would have the option of "piggybacking" the payroll deposits to IRAs onto the federal tax deposits they currently make, whether online, by mail, or by delivery to the local bank.

Employees Covered

Employees eligible for the automatic IRA would include those who have worked for the employer on a regular basis (including part-time) for a specified period of time and whose employment there is expected to continue. Employers would not be required to offer automatic IRAs to employees who are already covered by a retirement plan or are excludable from coverage (such as recently-hired employees, those who work less than 1,000 hours a year, union-represented employees or nonresident aliens without US source income) under the qualified plan rules. Accordingly, the proposal is not intended to apply to employers that offer 401(k), SIMPLE, pension or other qualified retirement plans to their employees.[15]

Portability of Savings Through Choice of Roth or Traditional IRA

Like a 401(k) contribution, the amount elected by the employee as a salary reduction contribution generally would be tax-favored. It either would be a contribution to a Roth IRA, which receives tax-favored treatment upon distribution, or a "pre-tax" contribution to a traditional, tax-deductible IRA. To spare households the need to undertake the comparative analysis of Roth versus traditional IRA, one or the other would be the default or presumptive choice. Of course, presented with an automatic or standard option, many households will simply go along with it, while others will consider whether to choose the other alternative. Accordingly, the automatic approach strikes a balance between simplicity and individual choice. In either case, the use of IRAs maximizes portability of savings. IRAs generally continue in existence without regard to

[15] The only exception would be an employer that sponsored a retirement plan but excluded a major portion of its workforce – for example, excluding an entire division or subsidiary that is not union-represented or foreign – in which case the employer would be required to offer payroll deposit saving to the rest of the workforce.

changes in the owner's employment status and, in general, are freely transferable by rollover to other IRAs or qualified plans.

Expanding Saving through Automatic Features

Obstacles to Participation

Today, individuals who want to save in an IRA must make a variety of decisions to open an account. In addition, they must overcome a natural tendency to delay making important decisions until the last minute. At least five key questions are involved:

- whether to participate at all;
- which financial institution to use to open an IRA (or, if they have an IRA already, whether to use it or open a new one);
- whether the IRA should be a traditional or Roth IRA;
- how much to contribute to the IRA; and
- how to invest the IRA.

These obstacles can be overcome by making participation easier and more automatic.

Automatic Enrollment or an Explicit "Up or Down" Employee Election

Automatic enrollment (more often applied to newly hired employees but now increasingly applied to both new hires and other employees) has produced dramatic increases in 401(k) participation.[16] In view of the basic similarities between employee payroll-deduction saving in a 401(k) and under a direct deposit IRA arrangement, the law should, at a minimum, permit employers to automatically enroll employees in direct deposit IRAs.

However, simply allowing employers to use automatic enrollment with direct deposit IRAs may not be enough. Requiring employers to use automatic enrollment in conjunction with the payroll deduction IRAs (with a tax credit and legal protections) likely would increase participation dramatically while preserving employee choice. However, a workforce that presumably has not shown sufficient demand for a retirement plan to induce the employer to offer one might react unfavorably to being automatically enrolled in direct deposit savings without a matching contribution. In addition, some small business owners who work with

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[16] Brigitte Madrian and Dennis Shea, "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior," Quarterly Journal of Economics 116, no. 4 (November 2001): 1149-87; and James Choi and others, "Defined Contribution Pensions: Plan Rules, Participant Decisions, and the Path of Least Resistance," in Tax Policy and the Economy, vol. 16, edited by James Poterba (Cambridge, Mass.: MIT Press, 2002), pp. 67-113. See also Sarah Holden and Jack VanDerhei, "The Influence of Automatic Enrollment, Catch-Up, and IRA Contributions on 401(k) Accumulations at Retirement," Employee Benefit Research Institute Issue Brief No. 283 (July 2005).

all of their employees closely each day might regard automatic enrollment as unnecessary.

Accordingly, automatic enrollment would be the presumptive or standard enrollment method, but employers could opt out of it in favor of an alternative approach, which is in effect a variation on automatic enrollment. The alternative requires all eligible employees to submit an election that explicitly either accepts or declines payroll deposit to an IRA. Requiring an "up or down" election picks up many who would otherwise fail to participate because they do not complete and return the enrollment form due to procrastination, inertia, inability to decide on investments or level of contribution, and the like.[17] Any employee who fails to comply with the election requirement is automatically enrolled. In either case, to maximize participation, employers receive a standard enrollment module reflecting current best practices in enrollment procedures.[18]

In addition, employees like automatic enrollment. Retirement Made Simpler -- a coalition of advocacy, regulatory and policy organizations, including AARP, the Financial Industry Regulatory Authority (FINRA), and the Retirement Security Project (RSP) – was launched to encourage employers to help their employees be better prepared financially for retirement. Retirement Made Simpler recently released a survey on employee satisfaction with automatic enrollment. The survey, a first of its kind, reached out to employees who work at firms that use automatic enrollment. The results are striking. Of these employees, 97% agreed that they were satisfied with automatic enrollment, and 74% of them were "very satisfied." Agreement that automatic 401(k) has helped them start saving for retirement earlier than planned is 85%, with 62% at "Strongly agree". And agreement that automatic enrollment has made saving for retirement easy is 95%, with 71% at "Strongly agree." Even among those who opted out of their company's 401(k) plan, a full 79% were glad their company offered automatic enrollment to employees.

Compliance

Whether using automatic enrollment or explicit "up or down" elections from employees, employers would be required to obtain a written (including electronic) election from each nonparticipating employee. That way, no one would be left out by reason of inertia. If the employer chose to use automatic enrollment, the notice would also inform employees of that feature (including the automatic contribution level and investment and the procedure for opting out), and the employer's records would need to show that employees who failed to submit an

[17] James Choi, David Laibson, Brigitte Madrian, and Andrew Metrick, "Optimal Defaults and Active Decisions," NBER Working Paper No. 11074 (January 2005).

[18] A national website could provide firms these standard enrollment and election forms, as well as provide an opportunity to promote employee education and best practices as they evolve, such as automatic enrollment and potentially, lifetime guaranteed income.

election were in fact participating in the payroll deduction saving. Employers would be required to certify annually to the IRS that they were in compliance with the payroll deposit saving requirements.[19]

Making a Saving Vehicle Available To Everyone

Under the automatic IRA, individuals who wish to direct their contributions to a specific IRA can do so. To make this happen, the employer has the option of either

- following employee directions as is ordinarily done when employers make direct deposits of paychecks to accounts specified by employees, or
- remitting all employee contributions in the first instance to IRAs at a single private financial institution (chosen by the employer), from which employees can transfer the contributions, without cost, to their own IRA.

However, if an employer or employees could not find an IRA provider willing to serve their market for an acceptably low fee, they could resort to a standard fallback IRA account, as described below.

A Low-Cost Standard Automatic Account

The fallback arrangement, which might take the form of an industry consortium or nonprofit organization, would make a standard IRA account automatically available to receive direct deposit contributions from employees. These accounts would be maintained and operated by private financial institutions under contract with the federal government. By contrast to the wide-open array of investment options provided in most current IRAs (which can be daunting for many savers) and the high (and costlier) level of customer service provided in many 401(k) plans, the standard account would provide only a few investment options (to maximize economies of scale and reduce cost). It would permit individuals to change their investments only once or twice a year, and would emphasize transparency of investment and other fees and expenses. Like the investment options under the federal Thrift Savings Plan for federal employees, it is contemplated that costs would be minimized through the use of passive investments such as index funds provided and managed by private financial institutions. This would not limit anyone's choices: individuals who preferred

[19] This might be done in conjunction with the existing IRS Form W-3 that employers file annually to transmit Forms W-2 to the government. Failure to offer payroll deposit saving would ultimately be backed up by an excise tax similar to (but much lower than) that imposed for employer violations of the COBRA health care continuation coverage requirements. The intent is that employers would never have to pay such an excise tax; it is simply a deterrent to noncompliance, accompanied by a rather forgiving array of exceptions, opportunities for correction, and relief for unintentional noncompliance that is generally patterned after the corresponding COBRA provisions. Compare Internal Revenue Code Section 4980B.

other IRA investments could simply continue contributing to an IRA outside the context of these proposed new arrangements.

Automatic Investment Fund Choice

The IRAs selected by employees or employers from among those offered by private financial institutions as well as the fallback standard IRAs would provide low-cost professional asset management to millions of savers, with a view to improving their aggregate investment results. To that end, these IRAs would offer an automatic or default investment fund (generally similar, at least initially, to the kinds of investments described as "Qualified Default Investment Alternatives" in Department of Labor regulations)[20] for all deposits unless the individual chose otherwise. This automatic investment choice could be a highly diversified "target asset allocation" or "life-cycle" fund comprised of a mix of equities and fixed income or stable value investments, and probably relying heavily on index funds. It could also make available some elements of guarantee against loss of principal, in exchange for a limited reduction in the rate of return. Because it is desirable to maintain a degree of flexibility in order to accommodate and reflect market creativity, best practices, and the evolving consensus of expert financial advice over time, the proposed legislation would not fully specify the automatic investment. General statutory guidelines would be fleshed out at the administrative level after a process of extensive consultation with private-sector investment experts. In addition, the IRAs employees or employers select from private financial institutions would also offer at least a few investment alternatives, consistent with normal market practice, but would not be limited to any prescribed array of investment options.

Employers Protected from any Risk of Fiduciary Liability

Employers making payroll deposits would be insulated from potential liability or fiduciary responsibility with respect to the manner in which direct deposits are invested in automatic IRAs, regardless of whether the IRA provider is selected by the employer or the employee. Nor would employers be exposed to potential liability with respect to any employee's choice of IRA provider or type of IRA. This protection of employers would be facilitated by regulatory designation of standard investment types that reduces the need for continuous professional investment advice. In addition, employers could avoid responsibility even for the selection of an IRA provider for their employees by allowing employees to designate their preferred IRA providers (or by specifying the government-contracted fallback automatic IRA).

[20] "Default Investment Alternatives Under Participant Directed Individual Account Plans; Final Rule," Department of Labor Employee Benefits Security Administration, Federal Register (Vol. 72, No. 205), October 24, 2007. See also letter from J. Mark Iwry, Principal, Retirement Security Project, to Department of Labor Employee Benefits Security Administration, dated November 13, 2006 (available at www.retirementsecurityproject.org), commenting on the Department's proposed regulations.

The Importance of Protecting Employer Plans

The automatic IRA proposal is designed carefully to avoid competing with or crowding out employer plans. Probably the most important protection for employer plans is the use of IRAs, which have maximum permitted contribution levels of $4,000 (for 2007; $5,000 beginning in 2008, with an additional $1,000 if the contributor is age 50 or older). This is sufficient to meet the demand for saving by millions of households but not high enough to satisfy the appetite for tax-favored saving of business owners or decision-makers, who can contribute up to $15,500 of their own salary to a 401(k) (or $20,500 if age 50 or older) plus matching or nonmatching employer contributions that can bring the total annual 401(k) contributions on their behalf to $45,000 a year ($46,000 in 2008).[21] In addition, by design, the employer tax credit for providing access to automatic IRAs is significantly less than the small employer tax credit for sponsoring a new 401(k), SIMPLE or other retirement plan.

In fact, the automatic IRA is designed to actually promote more employer plans. First, any employer that wants to match its employees' contributions must adopt a qualified plan or SIMPLE; to preserve that incentive, the automatic IRA does not allow employer contributions. Second, the automatic IRA gives consultants, third-party administrators, financial institutions, and other plan providers a new way to penetrate the small business pension market with 401(k)s, SIMPLEs and other tax-favored employer plans. Because these plans can now be purchased at very low cost, it would seem natural for many small businesses – especially those whose owner would like to save more or to match employees' saving – to graduate from payroll deduction saving and complete the journey to a qualified plan.

Encouraging Contributions by the Self-Employed and Independent Contractors

For the self-employed and others who have no employer, regular contributions to IRAs would be facilitated in four principal ways:

- Expanding access to automatic debit arrangements, including through professional and trade associations that could help arrange for automatic debit and direct deposit to IRAs. Automatic debit essentially replicates the power of payroll deduction insofar as it continues automatically once the individual has chosen to initiate it.
- Extending the payroll deposit option to many independent contractors through direct deposit with firms from which they receive regular payments (without affecting the individual's status as an independent contractor);

[21] These 401(k) limits apply to both 2007 and 2008. IRA and 401(k) contribution limits (as well as the limits applicable to SIMPLE plans) are indexed for cost-of-living.

- Enabling taxpayers to direct the IRS to make direct deposit of a portion of their income tax refunds to an IRA (which became possible for the first time earlier this year); and
- Allowing the self-employed to transmit IRA deposits with their quarterly estimated income taxes.

Matching Deposits as a Financial Incentive

A powerful financial incentive for direct deposit saving by those who are not in the higher tax brackets (and who therefore derive little benefit from a tax deduction or exclusion) would be a matching deposit to their payroll deposit IRA. By increasing assets under management, a match would also increase private financial institutions' interest in providing IRAs. One means of delivering such a matching deposit would be via the financial institution that provides the payroll deposit IRA. For example, the first $500 contributed to an IRA by an individual who is eligible to make deductible contributions to an IRA might be matched by the private IRA provider on a dollar-for-dollar basis, and the next $1,000 of contributions might be matched at the rate of 50 cents on the dollar. The financial provider would be reimbursed for its matching contributions through federal income tax credits.[22]

Evidence from a randomized experiment involving matched contributions to IRAs suggests that a simple matching deposit to an IRA can make individuals significantly more likely to contribute and more likely to contribute larger amounts.[23] Matching contributions – similar to those provided by most 401(k) plan sponsors – not only would help induce individuals to contribute directly from their own pay, but also, if the match were automatically deposited in the IRA, would add to the amount saved in the IRA. The use of matching deposits would require procedures to prevent gaming – contributing to induce the matching deposit, then quickly withdrawing those contributions to retain the use of those funds.[24]

Guaranteed Lifetime Income

The automatic IRA could also serve as a natural platform or proving ground for best practices in retirement savings, possibly including, over time, an expanded

[22] This raises a number of issues. For further discussion, see discussion of proposed reforms of the Saver's Credit, e.g., William G. Gale, J. Mark Iwry, and Peter R. Orszag, "The Saver's Credit: Expanding Retirement Savings for Middle- and Lower-Income Americans" (Retirement Security Project Publication No. 2005-02, March 2005).

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

[24] Among the possible approaches would be to place matching deposits in a separate sub-account subject to tight withdrawal rules and to impose a financial penalty on early withdrawals of matched contributions.

use of lifetime guaranteed income. There is reason to believe that many households with savings but no lifetime income stream to supplement Social Security would be better off if they converted a portion of their savings to (appropriately priced) guaranteed income. Yet most are reluctant to do so. The same automatic strategy used to promote enrollment and sensible investment could encourage more workers to obtain the security of an annuity or other guaranteed lifetime income, including perhaps "longevity insurance" that provides a deferred annuity beginning at age 80 or 85, for example. The uniform default investment and the backstop automatic IRA for any employees who cannot find an appropriate IRA in the market may lend themselves to exploring means of encouraging greater use of low-cost guaranteed income in IRAs generally as well as in 401(k) and other employer plans.[25]

As former Chair of the Council of Economic Advisers Laura Tyson pointed out in a Wall Street Journal op-ed article last week endorsing the automatic IRA, "[j]ust as the Automatic 401(k) and Automatic IRA would help to ensure that employees have enough retirement savings, automatic guaranteed lifetime income would help to ensure that they do not outlive their savings"[26] and have an income stream they can count on.

Conclusion

American households have a compelling need to increase their personal saving, especially for long-term needs such as retirement. This testimony summarizes a strategy to make saving more automatic – hence easier, more convenient, and more likely to occur. By adapting to the IRA universe practices and arrangements that have proven successful in promoting 401(k) participation, the automatic IRA approach holds considerable promise of expanding retirement saving for millions of workers.

[25] Accordingly, H.R. 2167 and S. 1141 require a joint study by the Labor and Treasury Departments of the feasibility and desirability of promoting the use of low-cost annuities, longevity insurance, or other guaranteed lifetime income arrangements in automatic IRAs, including consideration of – (i) appropriate means of arranging for , or encouraging, individuals to receive at least a portion of their distributions in some form of low-cost guaranteed lifetime income, and (ii) issues presented by possible additional differences in, or uniformity of, provisions governing different IRAs. Section 4(b)(1)(B). The bills also would provide for a joint study of the feasibility and desirability of extending to automatic IRAs spousal consent requirements similar to, or based on, those that apply under the Federal employees' Thrift Savings Plan, including consideration of whether modifications of such requirements are necessary to apply them to automatic IRAs. Section 4(b)(1)(A).

[26] Laura D'Andrea Tyson, "Some No-Brainer Savings Ideas," Wall Street Journal, October 30, 2007, page A-18.