S. HRG. 112–555

TAX REFORM OPTIONS: PROMOTING RETIREMENT SECURITY

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

SEPTEMBER 15, 2011

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

76–170—PDF WASHINGTON : 2011

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
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TAX REFORM OPTIONS: PROMOTING RETIREMENT SECURITY

THURSDAY, SEPTEMBER 15, 2011

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:08 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Cardin, Hatch, and Thune.

Also present: Democratic Staff: Russ Sullivan, Staff Director; Lily Batchelder, Chief Tax Counsel; and Thomas Reeder, Senior Benefits Counsel. Republican Staff: Jeff Wrase, Chief Economist; Jim Lyons, Tax Counsel; and Preston Rutledge, Tax and Benefits Counsel.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The committee will come to order.

I apologize for the delay. This so-called super-committee meeting lasted longer than intended. It was a very good meeting, and I am very heartened with its progress, but it did cause some delay here.

Franklin D. Roosevelt once said, “True individual freedom cannot exist without economic security and independence.” For true economic security, Americans approaching retirement need to know they will have enough money every month to get by. Retirement security is often described as a 3-legged stool. The first of those legs, Social Security, is crucial to the stability of that stool.

Prior to Social Security’s enactment, half of all seniors lived in poverty. Since that time, seniors in Montana and across the country have come to rely on Social Security benefits they have earned through years of hard work. So we must, and we will, do what it takes to ensure that leg of the stool remains sound.

The average Social Security beneficiary receives only slightly more than $14,000 each year. As a result, most Americans will not be able to retire on Social Security alone. So today we examine the other two legs of the retirement stool: personal savings and employer-provided retirement plans.

Our tax code has several key provisions that encourage Americans to save for their retirement with tax benefits applied to pensions, individual retirement accounts, and employee stock ownership plans. These tax incentives add up; in total, they cost more than the tax preference for employer contributions to health insurance plans, and they cost nearly 50 percent more than the tax expenditure on the home mortgage interest deduction.

The United States has the most successful private retirement system in the world, but, for the amount our country spends on retirement savings, are we getting enough bang for our buck? For much of the period from World War II through the mid-1980s, the majority of retiring American workers could depend on a pension plan from their employer. These defined benefit plans provided life-long monthly payments to retirees. The retiree could not outlive his retirement plan.

In 1980, 84 percent of Americans working for large and medium-sized employers participated in these plans, but by 2007, less than one-third of workers in large and medium-sized companies participated in this type of plan. These numbers continue to shrink.

This dramatic trend away from pension plans has been coupled with a trend toward defined contribution plans. In a defined contribution plan, workers receive a lump sum when they retire. Under these types of plans, both the employer and employee commonly have the opportunity to contribute to the employee's account. The increasing reliance on defined contribution plans blurs the line between personal savings and retirement benefits.

The individual manages his or her own account. This account does not necessarily have to be used for retirement purposes. A retiree must avoid the temptation to spend these savings prior to retirement or spend too much too early in retirement. Unlike defined benefit plans, defined contribution plans do not provide life-long payments that can be used to cover long-term care expenses.

This means the retiree can outlive his retirement savings, whether due to inflation, market declines, unexpected health expenses, or even the good fortune of living longer than expected. And many do. In spite of the tremendous tax preferences for retirement savings, many Americans are left without sufficient resources to maintain a comfortable retirement.

The Government Accountability Office found that the median retirement account balance for Americans aged 60 to 64 was $60,000. This means the average retiree could only spend about $4,200 per year on top of Social Security, given current life expectancy. That same report indicated that nearly 30 percent of all Americans in the workforce for 25 or more years had zero retirement savings.

Perhaps most troubling is that fewer than half of all American workers work for an employer that sponsors a retirement plan, and half of Americans who do not have access to an employer-sponsored retirement plan are almost entirely middle- or low-income. This means they are far less likely to have other forms of savings. These numbers do not paint a pretty picture for a large chunk of the Baby Boom generation approaching retirement. We have to do better. We need to look for ways to do more with less.

I look forward to the hearing today. I look forward to hearing from the panelists on their views whether there are steps we can take to improve these numbers for those nearing retirement today. We must do what we can to make sure future generations do not find themselves in the same boat.

So let us find ways to improve and increase retirement savings for millions of Americans. Let us look to make our retirement savings system more efficient. And let us work to ensure that more hardworking Americans have the savings they need to enjoy the retirement they deserve.*

[The prepared statement of Chairman Baucus appears in the appendix.]

The CHAIRMAN. Senator Hatch?

OPENING STATEMENT OF HON. ORRIN G. HATCH, A U.S. SENATOR FROM UTAH

Senator HATCH. Well, thank you, Mr. Chairman. I appreciate you holding this hearing. It is a timely hearing. The issue of retirement security has never been more important than it is today. With respect to public programs, the retirement of the Baby Boom generation is putting enormous stress on both Social Security and Medicare.

Congress is going to have to address the solvency of both of these programs, not in the long term, but certainly in the short term. Fortunately, the private employer-based pension system has become the greatest wealth creator for the middle class in history, especially through 401(k) plans and individual retirement accounts, or IRAs. Despite the ups and downs of the stock market and historically low interest rates, millions of Americans have managed to save trillions of dollars for retirement.

We all may be a little bit surprised to learn that more money has been set aside for retirement in defined contribution plans and IRAs than in Social Security. That is right. The Social Security Trust Fund holds $2.6 trillion in Treasury securities, but private employer-based defined contribution plans hold $4.7 trillion, and IRAs hold even more: $4.9 trillion.

Think of that: IRAs, a voluntary savings vehicle that was only created in 1974, now hold $2.3 trillion more than the entire Social Security system, a mandatory program that has been with us since 1935. That is almost double the assets just in IRAs. The numbers suggest that 401(k) plans and IRAs have been a resounding success. Can we improve them? There is always room for improvement.

But limiting access to these savings vehicles is not progress, in my view. Putting aside the issue of retirement income, when you consider the fact that your average American will face over $200,000 in out-of-pocket post-retirement medical costs alone, we should probably be expanding opportunities to save.

But make no mistake. Even as currently structured, these savings programs work for millions of Americans, yet all of the reforms I have read about lately seem directed toward reducing the amount of money that people may set aside in defined contribution plans and IRAs.

For example, the National Commission on Fiscal Responsibility recommended capping pre-tax contributions at $20,000. The Congressional Budget Office, or CBO, describes a proposal to reduce annual contributions to 401(k)-type plans by $7,650 for older workers, largely by repealing the ability of workers at age 50 to begin

* For more information, *see also,* "Present Law and Background Relating to the Tax Treatment of Retirement Savings," Joint Committee on Taxation staff report, September 13, 2011 (JCX–44–11), *http://www.jct.gov/publications.html?func=startdown&id=4357.*

making catch-up contributions. IRA contributions also would be cut by $1,500 for older individuals.

Now, many of these proposals are offered in the name of greater progressivity in the tax code and helping low-wage workers, but this just does not make sense. Trying to help lower-wage workers save for retirement by reducing the 401(k) and IRA contribution limits is like trying to cure a headache with a guillotine: the cure is worse than the disease. I am concerned that if these proposals were adopted, many employers would throw up their hands in disgust and just drop their plans. Congress has already covered this ground. We already made this policy call.

In 2001, Congress increased the limits for contributions to 401(k)s and IRAs. At the time, 401(k) contributions were limited to $10,500 per year and IRAs were limited to $2,000. This year, a worker age 50 and over may contribute up to $22,500 to a 401(k). An older individual may contribute up to $6,000 to an IRA.

Now, here is what Congress concluded in 2001, as reported in the blue book published by the Joint Committee on Taxation: "The Congress believed that increasing the dollar limits on qualified plan contributions and benefits would encourage employers to establish qualified plans for their employees. The Congress understood that, in recent years section 401(k) plans have become increasingly more prevalent. The Congress believed it was important to increase the amount of employee elective deferrals allowed under such plans, and other plans that allow deferrals, to better enable plan participants to save for their retirement."

Well, it worked. Since 2000, retirement assets in defined contribution plans have grown from $3 trillion to $4.7 trillion, despite the market downturn in 2008. Assets in IRAs have grown from $2.6 trillion to $4.9 trillion. In fact, increased contribution limits work so well that, in 2006, Congress made those provisions permanent. The vote to make them permanent was an overwhelming 93:5.

Today I expect that the committee will hear about proposals to fundamentally change the 401(k) and IRA system. One of the proposals would eliminate pre-tax contributions to 401(k) plans and IRAs. Instead, workers would make after-tax contributions, receive a tax credit, and then pay ordinary income taxes again when the money is withdrawn in retirement.

Now, I am sure these proposals are well-intentioned, and I will listen to them with an open mind. But I must say that I am skeptical that this type of approach is wise tax and retirement policy, to experiment with our current defined contribution and IRA retirement savings system—a system benefitting many millions of Americans—by taking away pre-tax contributions and converting the system into a refundable tax credit program.

I want to thank you, Mr. Chairman. These hearings have been really worthwhile, and you deserve a lot of credit for them. I just want to thank you for them.

The CHAIRMAN. Thank you very much, Senator. I appreciate that.

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

The CHAIRMAN. I might add that Senator Cardin is here. Senator Cardin and Senator Portman, when both were in the House, worked very hard on our pension system. I thank them very much for their hard work.

I would now like to introduce our panel. We will first hear from Dr. Jack VanDerhei. Jack is a research director of the Employee Benefit Research Institute. Also, thank you very much, Jack, for your valuable contribution in the State of Montana when you came out to our Butte Economic Development Summit. People really appreciate your advice and your insights. We appreciate it very, very much.

Next, we will hear from Dr. William Gale, who is a senior fellow at the Brookings Institution. Dr. Gale is a director of the retirement security project and co-director of the Urban-Brookings Tax Policy Center, and holds the Arjay and Frances Miller chair in Federal economic policy at Brookings.

Next, we will hear from Judy Miller, chief of actuarial issues and director of retirement policy at the American Society of Pension Professionals and Actuaries. Welcome back, Judy. We have missed you very much. I want to thank you as well for your excellent contribution to the Butte Economic Development Summit last year. You all out there in the audience are wondering what is the Butte Economic Development Summit. This is something we put on every few years. It is a success. It is really super. Thank you both for helping make it so good. Your efforts to help small businesses adopt and maintain retirement savings plans are much appreciated, Judy. Thanks for working with them.

Rounding out the panel will be Karen Friedman, executive vice president and policy director of the Pension Rights Center, an organization dedicated to protecting and promoting the retirement security of American workers, retirees, and their families. Thank you very much, Karen.

Thank you for coming. Let us make this a great hearing. Your prepared statements will be made part of the record. I urge you to summarize them and just get straight to the point; say what you want to say. This is the only opportunity we have. Thank you.

Dr. VanDerhei, why don't you proceed? Go ahead.

STATEMENT OF DR. JACK VanDERHEI, RESEARCH DIRECTOR, EMPLOYEE BENEFIT RESEARCH INSTITUTE, WASHINGTON, DC

Dr. VANDERHEI. Chairman Baucus, Ranking Member Hatch, members of the committee, I am Jack VanDerhei, research director of the Employee Benefit Research Institute. EBRI is a nonpartisan institute that has been conducting original research on retirement and health benefits for the past 33 years. EBRI does not take policy positions and does not lobby.

My testimony today will focus on retirement security and the potential impact of various types of tax reform options on retirement income adequacy. This draws on the extensive research conducted by EBRI on these topics over the last 12 years, with its Retirement Security Projection Model, as well as annual analysis of the behavior of tens of millions of individual 401(k) participants dating back, in some cases, as far as 1996.

EBRI research has shown repeatedly that the traditional type of 401(k) plan under current tax incentives has the potential to generate a sum that, when combined with Social Security benefits, will replace a sizeable portion of the employee's pre-retirement income for those with continuous coverage.

Our research has also shown that the automatic enrollment type of 401(k) plan, when combined with automatic escalation provisions, appears to have the potential to produce even larger retirement accumulations for most of those who are covered by such plans.

Last year EBRI updated its simulation model and determined that the overall retirement income adequacy for U.S. households has substantially improved since 2003. Even with these improvements, however, almost one-half of Baby Boomer and GenXer households were determined to be at risk of not having sufficient retirement income to cover even basic expenses and uninsured health care costs.

However, the study was also able to document the degree to which eligibility for participation in qualified retirement plans matters with respect to at-risk status. For example, the at-risk probability for GenXers varies from 60 percent for those with no future years of eligibility in a DC plan to only 20 percent for those with 20 or more years. In fact, it can be argued that much of the problem with retirement income adequacy in this country is one of whether a household is covered by an employer-sponsored retirement plan, and for how long.

As Senator Hatch mentioned, in December of 2010 the National Commission on Fiscal Responsibility and Reform put forth a tax reform plan that would modify retirement plans by capping annual contributions to the lower of $20,000 or 20 percent of income. This new constraint would substantially reduce the current limits available under qualified defined contribution plans.

Earlier this year, EBRI provided preliminary evidence of the impact of these so-called 20/20 caps on projected retirement accumulations. Assuming the caps are imposed starting in 2012, the annual percentage reductions in 401(k) balances at retirement age are displayed in Figure 2 of my written testimony.

The 20/20 cap would, as expected, most affect the highest-income workers—as much as a 15-percent average reduction for those currently ages 36 to 45—but would also cause a significant reduction in retirement accumulations for the other workers, including those in the lowest-income quartiles.

Dr. Gale will be describing his proposal next; however, public policy consideration of this proposal will undoubtedly be subject to some type of a cost/benefit analysis beyond one that is going to assume retirement saving contributions remain constant. It is very difficult to determine how certain employees will react to this new set of incentives, but, until this type of information is available, any accurate assessment of the benefit portion of the cost/benefit analysis will be problematic.

However, EBRI is currently in a position to provide the committee with guidance on what some of the likely costs will be in terms of reduced benefits for those currently in the 401(k) system. Based on self-reported responses to EBRI's 2011 Retirement Confidence Survey, Figure 3 in my written testimony provides the average percentage reductions in 401(k) balances at retirement age expected as a result of permanently modifying the exclusion of employee contributions.

As expected, the younger cohorts would experience larger reductions given their increased exposure to this proposal. Focusing on those currently 26 to 35, the average percentage reductions vary from 11 percent for the highest income quartile to 24 percent for the lowest income quartile.

As the analysis of this figure was intended to look exclusively at the impact of changing the exclusion of employee contributions from taxable income, it was assumed that the total matching contributions would remain constant.

However, it may be instructive to assess the additional reduction in 401(k) accumulations if employers were to drop their plan matches to 401(k) participants and would instead have only the 18-percent match provided by the government. Figure 5 in my written testimony models the same changes in tax incentives but, unlike Figure 3, assumes the plan sponsors completely drop their plan match and that employees are left with only the government match of 18 percent.

Given that most 401(k) sponsors currently match at a rate greater than 18 percent, it is not surprising that the average reductions increased in Figure 5. For those currently 26 to 35, the average reduction varies from 31 percent for the highest income quartile to 41 percent for the lowest income quartile.

In conclusion, given that the financial fate of future generations of retirees appears to be so strongly tied to whether they are eligible to participate in employer-sponsored retirement plans, the logic of modifying, either completely or marginally, the incentive structure of employees and/or employers for defined contributions at this time needs to be thoroughly examined.

The potential increase of at-risk percentages resulting from either employer modifications to existing plans or a substantial portion of low-income households decreasing or eliminating future contributions to savings plans needs to be carefully analyzed when considering the overall impact of such proposals.

Thank you. I look forward to your questions.

The CHAIRMAN. Thank you very much, Doctor.

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

The CHAIRMAN. Next, Dr. Gale.

STATEMENT OF DR. WILLIAM G. GALE, SENIOR FELLOW, BROOKINGS INSTITUTION, WASHINGTON, DC

Dr. GALE. Thank you very much, Chairman Baucus, Ranking Member Hatch, members of the committee, Mr. Cardin. I particularly welcome the opportunity to offer a proposal today, given that it has already been critiqued and, I think, mischaracterized at least once.

So let me say I would like to offer a proposal that will help improve the retirement system, will help reduce long-term fiscal deficits, all without raising statutory tax rates, all without reducing contribution limits in the basic form, and without even touching the employer deduction. Before I turn to that, let me just add, it would improve incentives to contribute to retirement accounts for about 90 percent of the population. How that supposedly translates into a 24-percent reduction in 401(k) balances among low-income workers, as Dr. VanDerhei suggests, is not credible. The lowest-income workers will get the biggest improvement in incentives under this plan.

Before I turn to this, let me just say the opportunity to reform the retirement system is very timely, for two reasons. First, everything that has happened in the last few years—the drop in housing wealth, the rise in unemployment, the volatility in the stock market—has made it harder for people to make ends meet and, hence, has pushed people to pull out of the retirement system or to reduce their contributions. The chance to offset those factors by encouraging contributions specifically among low- and middle-income households by increasing their incentives to participate would be very helpful for the goal of ensuring that people reach retirement with adequate resources. The current events have exacerbated the existing flaws in the retirement system.

Second, as we begin to debate long-term fiscal reforms, we need to think about enhancing saving outside Social Security for the simple reason that, to the extent that Social Security benefits or Medicare benefits are reduced, retirees will find it even harder to make ends meet, so encouraging saving for retirement could help offset some of those changes. However, given that the goal is to reduce the long-term deficits, the challenge is to raise retirement saving without revenue loss to the government, and possibly even with a revenue increase to the government.

With that as background, let me turn, briefly, to the retirement system. You have already heard people wax eloquent about what a great system it is, and, for some people, it is a great system. Some people are doing quite well. But 30 years into the 401(k) experiment and the IRA experiment, it is obvious that there are huge concerns with the system.

One concern is that many workers are not doing very well. They are left behind by the retirement system. Only about half of workers have access to a 401(k) or a pension. Chairman Baucus mentioned the GAO study showing very little accumulation among a large segment of the population. Many of those who participate contribute very little.

In a recent study, the median 401(k) and IRA balance among 55- to 59-year-olds who had 401(k)s and IRAs—not even including the large number who do not—the median among those who had 401(k)s and IRAs was less than $10,000. That is nowhere near close to providing an adequate retirement income base for those households.

The second problem is that the immediate subsidies that are generated are upside down. Seventy-five percent of the population gets either a 15-percent deduction or less. If you are in a 10-percent tax rate, you get only 10 cents that you save on the dollar per dollar contribution. If you face a 35-percent tax rate, you save 35 cents immediately per dollar of contribution.

That gives a subsidy, the largest subsidy and the most expensive subsidy, to those who need it least, and it reduces the subsidy or eliminates the subsidy to those who need it most, not just in terms of current income but in terms of—if you look at what studies say about which households are not saving adequately for retirement, it is mainly low- and middle-income households. Of course, they are the ones that are getting the lowest incentives from the current deduction.

On top of that, the current upside-down structure gives the biggest subsidies to those whose 401(k) contributions are most likely to represent shifting of assets, and it gives the smallest 401(k) subsidy to those whose contributions are most likely to represent new additions to net saving.

So we can all celebrate the very large sums of money that are in 401(k)s and IRAs right now, but it is worth noting that the national saving rate—the personal saving rate—has gone down in the last 30 years. It has gone down markedly in the 30 years since we have moved away from the traditional system and moved toward 401(k)s and IRAs.

The key issue is not whether people are taking advantage of this tax subsidy, the key issue is whether, by doing so, they are actually raising retirement preparedness on a net basis, whether they are raising national saving. So far, there is nothing in the data that suggests that these things are effective in raising national saving by very much.

The third problem is that the deduction is given to the individual as cash back rather than putting it in the account. So the proposal, although I am running out of time, is to build on the strengths of the 401(k) system, including the payroll deduction, and to try to resolve some of the weaknesses, mainly lack of participation and low contributions among many households.

The proposal in its simplest form would change the individual deduction to a matching contribution by the government. There would be a flat-rate contribution, so the structure would not be upside-down. The match would be placed directly in an individual's account, which would likely increase the impact on saving rather than giving the money back to people as cash, encouraging them to spend it.

In the simplest form, a 30-percent matching contribution would be revenue-neutral relative to current law. It would improve incentives and retirement benefits for 90 percent of the population. If instead we had an 18-percent matching contribution, the proposal would raise $250 billion over the next decade, again, without touching marginal tax rates, without reducing contribution limits, and without affecting the employer deduction. It would raise $250 billion, and it would still benefit and give incentives, raising the rate of return on saving for low- and middle-income households.

The proposal can be extended to include employer matching. If you did that, it would raise $450 billion. In any case, I would be happy to take questions about the actual proposal and discuss its actual effects. I thank you again for the opportunity to discuss these issues here.

The CHAIRMAN. Thank you very much, Doctor.

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

The CHAIRMAN. Ms. Miller, you are next.

STATEMENT OF JUDY A. MILLER, CHIEF OF ACTUARIAL ISSUES AND DIRECTOR OF RETIREMENT POLICY, AMERICAN SOCIETY OF PENSION PROFESSIONALS AND ACTUARIES, ARLINGTON, VA

Ms. MILLER. Thank you. Thank you, Chairman Baucus, Ranking Member Hatch, and members of the committee for the opportunity to speak with you today. I am Judy Miller, chief of actuarial issues and director of retirement policy for the American Society of Pension Professionals and Actuaries.

We want to thank this committee for its leadership in passing the Pension Protection Act of 2006. PPA had overwhelming bipartisan support from this committee and the entire Congress, and, by permanently extending changes to various retirement plan rules, PPA provided needed certainty for workplace retirement plans.

Proposals currently under discussion—slashing the contribution limits or turning the current year's exclusion into a credit—would discourage small business owners from setting up or maintaining a workplace plan. This is the exact opposite of what needs to be done. Data clearly shows the primary factor, in determining whether or not a worker is saving for retirement, is whether or not they have a retirement plan at work. When evaluating any current retirement policy proposal, the critical question this committee must ask is: "Will it improve access to workplace retirement savings?"

Many of these flawed proposals are based on some persistent myths.

Myth 1: Less than half of workers have access to retirement savings at work. This myth is dangerous because it gives the impression current incentives have failed, when facts show otherwise.

Bureau of Labor Statistics data shows 78 percent of all full-time workers have access to a workplace retirement plan, with 84 percent participating. If you look only at private sector workers, 73 percent have access to a plan, with 80 percent participating. This is a far cry from the "less than half" commonly cited.

Myth 2: The current tax incentive is upside down. This myth arises from a failure to recognize that the incentives for workplace retirement plans are different from just about any other tax incentive in the code. Non-discrimination rules make sure that retirement plan incentives do not discriminate in favor of the highly paid and limit pay that can be counted toward benefits.

The result is, the current tax incentive for employer-sponsored defined contribution plans is more progressive than the current income tax system. Based on an analysis by a former JCT economist, taxpayers making less than $50,000 pay only 8 percent of income taxes but receive 30 percent of tax incentives for defined contribution plans.

Households making less than $100,000 pay 26 percent of income taxes but get over 60 percent of the benefit of this tax incentive. By contrast, households making more than $200,000 pay 52 percent of income taxes but receive only 11 percent of the retirement plan tax incentives. Sixty percent of a tax incentive going to workers who pay less than 30 percent of income taxes is not upside down, it is very much right side up.

Myth 3: Small businesses will sponsor retirement plans without an appropriate tax incentive. I spent over 20 years talking to small business owners in Montana about why they should set up, and keep operating, a retirement plan. With rare exceptions, the current tax savings was a critical factor, often the only factor, supporting the decision to put in a plan.

It is not that small business owners are selfish or they do not want to help their employees save for retirement. In real life, most small business owners are not sitting on lots of cash. They use the savings generated from the retirement plan tax incentives to help pay for contributions required by the non-discrimination rules. Reducing the incentive literally reduces the cash the small business owner has to work with. There is not a doubt in my mind that reduced incentives will mean fewer plans or lower employer contributions for the plans that remain.

Myth 4: It does not matter if a new tax structure causes employers to terminate plans because re-engineering the tax incentive will lead more workers to save on their own. The truth is, the only way we have ever gotten working Americans to save for retirement is through employer-sponsored retirement plans. Over 70 percent of workers making $30,000 to $50,000 contribute when covered by a plan at work.

By comparison, less than 5 percent of workers at the same income levels save on their own in an IRA when there is no workplace plan. This is a startling difference in savings rates. Changing the exclusion to a credit will never make up this difference. Increasing plan coverage is a much simpler task, with more certain results.

Myth 5: Tax incentives for retirement savings are lost revenue. Unlike deductions for mortgage interest or charitable contributions, which are permanent deductions, the incentives for retirement savings are a deferral. Contributions and earnings are taxed at ordinary income rates when distributed from the plan.

The truth is, the revenue you think you gained in the budget window from cutting retirement savings is an illusion. Reduced contributions today means lower revenue outside the budget window when there will be less retirement savings to be withdrawn and taxed.

In summary, given existing pressures on Social Security, this is not the time for a massive experiment with workers' 401(k) plans. We need a tune-up, not an overhaul. The key to promoting retirement security is expanded workplace savings, and reduced incentives for small business owners to sponsor plans would be a big step in the wrong direction.

I would be pleased to discuss these issues further with the committee or answer any questions you have. Thank you very much.

The CHAIRMAN. Thanks, Ms. Miller.

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

The CHAIRMAN. Next, Ms. Friedman.

STATEMENT OF KAREN FRIEDMAN, EXECUTIVE VICE PRESIDENT AND POLICY DIRECTOR, PENSION RIGHTS CENTER, WASHINGTON, DC

Ms. FRIEDMAN. Hello. Thank you so much. Chairman Baucus and Ranking Member Hatch, members of the committee, we are pleased that you are holding this hearing today to examine tax reform options to promote retirement security.

Given the enormous challenges facing the country, this hearing could also be subtitled, "How to Better Use the Tax System to Rebuild the American Dream for Workers and Retirees," because that is what it is about.

At a time when the economy is in a tailspin and middle-class American families are facing enormous challenges, we want to make sure that those who have worked hard and played by the rules are able to retire with adequate income and dignity. In our country, this is a fundamental and shared ideal.

Yet too many people are facing a bleak retirement, as we have heard today. Half of all private sector workers have no pensions or retirement savings to supplement Social Security, and we have heard that. We have also seen how employers who sponsor secure pension plans are freezing or terminating these plans. And 401(k) plans, which are the predominant savings plan in America, have left most workers with insufficient assets. In 2007, half of all households had $45,000 in their accounts and $98,000 for those approaching retirement age. So you can see, that is not enough to make it through retirement.

While 401(k) plans can work as a supplemental savings plan, they do not work well as the primary retirement vehicle for most Americans. They put all of the risks onto individuals who then have to decide whether to participate, how much to contribute, what to invest in, and then figure out how to make the money last through retirement. That is a lot to put on folks who are struggling to hold onto a job, keep the house afloat, and keep the family above water.

According to a recent Gallup poll, Americans say their top financial concern right now is being able to save enough money for retirement. That even surpasses their concerns about paying for health care or paying the mortgage.

So, while Congress is addressing the long-term Federal deficit, there is another deficit facing the country that also needs urgent attention, and that is the retirement income deficit. According to the Center for Retirement Research at Boston College, the retirement income deficit facing Americans is an astonishing $6.6 trillion.

That number represents the gap between what people have saved as of today and what they should have saved to achieve a level of sufficiency in retirement.

Cutting Social Security would only add to the retirement income deficit, and we urge Congress to strengthen, not cut, this vital program for American workers and retirees.

So, in context of what we are talking about, what are the solutions to the retirement income deficit? There is no one magic bullet, but restructuring tax incentives for retirement savings can contribute to solutions.

Congress gives preferential tax treatment because it is hard to save for retirement, and Congress recognizes that. It is especially hard for workers struggling with their daily needs. These tax incentives are meant to encourage employers to set up plans and to encourage employees to save. However, as we heard from Bill Gale, these incentives end up disproportionately benefitting those who need them the least.

Today I would like to offer a range of possible reform ideas. The first reform bucket is short-term, meaning these things could be done now to make existing plans fairer. The second bucket includes ideas that are comprehensive, leading to a new universal secure and adequate system for future generations. I want to emphasize that we believe that this should be a time for re-envisioning the tax system, not a time for retrenchment.

Here is a list of some possible short-term reforms described in more detail in my written statement. First, expand the saver's credit and make it refundable so it reaches more workers and provides a stronger savings incentive for lower-paid and middle-income workers. Second, consider reverse matches for 401(k) plans and Simplified Employee Pensions. Third, consider ways to encourage employers to preserve good defined benefit plans and adopt new kinds of guaranteed defined benefit plans, such as those developed by the Common Ground Conversation on Coverage, which many of these participants were involved in—all the panelists today.

I want to also point out—in terms of Judy talking about the fact that workers do better when an employer sponsors a plan—well, defined benefit plans should not be written off. Too often we are saying, oh, they are dinosaurs, we cannot afford them anymore.

But it is through defined benefit plans that people still get guaranteed lifetime income that they cannot outlive, and that is something that we definitely need to be looking at. Also, we have some proposals in our written statement for stopping leakage, which is a huge problem, people withdrawing their assets before they reach retirement age.

But, while you are examining short-term reforms, we would like to encourage this committee to also examine a better system for future generations. The fact is that, regardless of the amount of tax incentives provided to employers and employees, the end result is that coverage is still too low. People have not saved adequately, and benefits are not secure. So to that end, the Center, along with partnering organizations, started a new initiative called Retirement USA.

Retirement USA is an initiative to design a new system on top of Social Security that basically has three over-arching principles: the system should be universal, meaning everyone should be covered by a plan; the system should be secure so people can count on a steady stream of benefits to supplement Social Security—and that is not being done in today's 401(k) system; and the system should be adequate. By adequacy we mean that people should have a basic level of sufficiency when they reach retirement age.

So, to achieve these goals, we believe there needs to be a pension system with shared responsibility, where assets are pooled and professionally managed, and assets are paid out and the benefits are paid out as lifetime annuities. These are not unreachable ideals, and there are many plans and proposals that meet these principles that I have outlined in my statement. Some of them, as you will see, have even been proposed by business groups.

So in closing, I have been struck recently by news coverage of Steve Jobs. He created a successful company, one of the most successful, because of his vision and his gumption. So today I am asking that we all try to have the can-do spirit of Steve Jobs and apply it to retirement policy by dreaming big.

With the economy in turmoil, we must be creative in deploying our tax system to meet the challenges of today's and tomorrow's retirees, because, when people have good pensions, they can contribute to their communities and live with dignity, as well as continue to buy goods and services, which is a boon for the economy and for society.

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

The CHAIRMAN. Thank you. Thank you very much.

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

The CHAIRMAN. Ms. Miller, you talked about tuning up the system, not overhauling it. What do you mean by tuning up? When you answer your question, please address some of the questions that have been raised, basically the underlying question that not enough people save.

Ms. MILLER. Sure.

The CHAIRMAN. Either they do not belong to a defined contribution plan because they do not work, or their plan is not that great, or people leave their jobs, and so on and so forth. If you could just please tell us how we tune up in a way that addresses the underlying problem.

Ms. MILLER. Sure. As I mentioned, I think the first real basic problem is access. In order to get more small employers, particularly, into the system, I think we need to look at ways to simplify qualified retirement plans and make the costs lower. If you look at any survey of small businesses that do not sponsor a plan and why they do not sponsor a plan, the top of the list is always economic concerns. The business is not stable, they are worried about having to make contributions, they do not like the idea of having to make contributions for a short-time person, that kind of thing—more business concerns.

So I think we can look at—there has been a lot of discussion lately about a structure called a multiple employer plan; for example, where you have a sponsor, and small businesses can join basically a large group to spread expenses, reduce costs. But there are some concerns about those right now, about who can sponsor them, how Treasury would be able to deal with them as a large group. It does not take a lot of changes. As I said, there are some proposals. We think they need improving, and we are working on a set of proposals ourselves for that. I think that could be very effective.

I think some of the issues that Karen mentioned are issues that sometimes arise from an artificial distinction made between defined benefit and defined contribution plans. I am an actuary, so I have strong affinity for a defined benefit plan, but you can have managed investments in a defined contribution plan. That might not be the tendency, but I think, in PPA, another great thing that you did was modifying the qualified default investment rules.

The CHAIRMAN. What about the point Dr. Gale makes, that the incentives are upside down?

Ms. MILLER. Well, as I said, I really just think that is wrong, and it is based on a misunderstanding of how the system works. There is a chart in my testimony that shows how the benefits are allocated compared to the portion of taxes that are paid. When over 60 percent of the benefits are going to people making under $100,000, that, I do not think, is an upside-down tax benefit. They are only paying less than 30 percent of the taxes, so it actually shifts them in that direction.

The CHAIRMAN. I will give you a chance, Dr. Gale. You have heard what Ms. Miller said. Is it or is it not upside down? Off the top, I do not think we want something that is actually too much upside down, or even very much upside down. I would just think you have to help people who are not participating.

Dr. GALE. Right. As long as you have contribution limits, you will have a distribution of 401(k)s being less progressive than the overall income tax, and that actually makes sense because the purpose of the retirement system is to subsidize or promote an adequate retirement. The purpose is not to promote unlimited tax sheltering via 401(k)s or IRAs or other vehicles.

So when I refer to upside down, I think the criteria that is relevant is the structure of the incentives that a low-income person faces versus a high-income person. Under the current system, a low-income person has an immediate deduction of zero, and you can understand why they may not want to participate.

Under the matching system, they would have a matching rate of 18 or 30 percent, depending on whether it was revenue-neutral or revenue-raising. You could understand that, under that system, they would have a much stronger incentive for immediate deduction than they currently do.

The CHAIRMAN. Thank you.

Ms. Miller is anxiously trying to get in here.

Ms. MILLER. I am because I think this analysis assumes that all contributions are elective deferrals, that is, contributions that people elect to make to the plan on their own behalf. In reality, we have these non-discrimination rules that make sure that, if an employer wants to get a significant contribution under these programs, they have to make a contribution too on behalf of employees.

Now, if they are making a 3-percent contribution or a 5-percent contribution—in most small businesses the minimum would be 3, and very commonly 5—that gets no credit. That individual has a zero-percent tax bracket. You are saying, oh, there is no benefit for that person from this system if you look strictly at the marginal tax rate times the contribution, whereas they are getting 3 percent of pay from that employer.

If you remove the incentive for that employer to put money into the plan, then these non-discrimination rules do not get to really fully operate, and they are not getting any contribution. So right now, instead of having to pony up some money, these lower-paid people are getting employer contributions, and it really works in a pretty slick fashion.

The CHAIRMAN. My time is running out, but, Doctor, I will give you 15 seconds if you could just be brief.

Dr. GALE. All right. I think we are talking past each other. As I said, the employer deduction could be separated from the other deduction, from the individual deduction. I am talking about the structure of the individual deduction. The individual gets zero. The employer obviously currently gets an employer deduction and could continue to under this proposal.

The CHAIRMAN. All right. I appreciate that very much.

Senator Hatch?

Senator HATCH. Thank you, Mr. Chairman.

Ms. Miller and Dr. VanDerhei, all of these proposals—I read about the Fiscal Commission's 20/20 proposal, Dr. Gale's Refundable Tax Credit proposal, the CBO option that would cap employee deferrals. All of them seem to rely on the premise that lower contribution limits for workers will increase their savings rate. At least that is the way I interpret it.

The proposals also assume that reduced tax incentives for companies will have no effect on the willingness of the business to keep its plan in operation or start a new plan. Well, I personally do not believe that. I think that, if we roll back the laws that Congress enacted in the last decade that increased the tax incentives to save, then two very bad things will happen, at a minimum.

First, I believe businesses will stop contributing to pension plans because they are too complex and expensive to put up with without adequate tax incentives, and number two, employees will stop saving as much because the tax incentives will be less for most workers. Now, I do not think academics understand either of these points, or at least that is my personal opinion.

Now, Ms. Miller, what does your real-world experience working with business people making these decisions tell you?

Ms. MILLER. Well, my experience is what you suspect it would be, sir, that the tax benefit is very, very key to setting up these arrangements. Usually you have an employer—you know, for a small business owner, it takes a few years to have a stable business. They finally have a stable business. They are looking at putting in a plan. It is key to them that there is enough of a tax benefit to help them make these contributions that are required by the non-discrimination rules. So the tax benefit gets them to put the plan in, and then it helps them spread that benefit to the other employees.

Senator HATCH. Well, Dr. VanDerhei, your extensive analysis of the savings behavior of workers, what does that tell you?

Dr. VANDERHEI. Well, I would agree entirely with what Judy said. In fact, if I could just add one quick addendum to the impact on employers.

Senator HATCH. Sure.

Dr. VANDERHEI. Since May, Judy and I, prior to this meeting was scheduled, had been working on what would be the impact on small plans if the 20/20 proposal were enacted. If I could just refer to page 15 of her written testimony, we have actually modeled what would be the likely impact on the small plans, and we find that we have reductions for the youngest cohort of anywhere from 14 to 22 percent with respect to average 401(k) balances at retirement.

With respect to the incentives for the employees, I agree with you 100 percent. With respect to the upside-down nature of the current incentives, we have had a lot of theoretical debate here. If I might be able to interject some empirical evidence, every year that we do the EBRI/ICI 401(k) update with over 20 million individuals, we do a chart looking at the ratio of account balances to salary, broken out by age and by tenure.

If indeed these incentives were upside down, one might expect that those ratios would be higher, account balances to salary, for higher-salaried people. If I could submit for the record page 22, figure 19 of our November 2010 issue brief, I will guarantee that you are going to look at a set of lines which is absolutely flat.

[The figure appears in the appendix on p. 144.]

So, in fact, looking at these incentives and seeing how they played out, because of things such as the non-discrimination requirements that Judy mentioned, talking about the current 402(g) limits, et cetera, in fact we are finding a system that has about as close to equal parity as anything I have ever seen.

Senator HATCH. That is interesting. Dr. VanDerhei, Dr. Gale says his proposal will not cap contributions. At least, that is what I understand. But will an 18-percent tax credit really not have the same effect? Dr. VanDerhei, I would ask you, then Dr. Gale can say anything he would care to say.

Dr. VANDERHEI. Would it have the same effect as capping the contributions? I am sorry.

Senator HATCH. Yes. Will it not basically have the same effect?

Dr. VANDERHEI. The primary impact of having an 18-percent credit in terms of a government match on these, I think, depends to a very large extent on how the plan sponsors react. If the plan sponsors have a situation in which they realize now they no longer need to make matching contributions to get the lower-paid individuals to participate and therefore be able to satisfy the non-discrimination requirements, I think you are going to be in a situation much like you were in the late 1980s with respect to defined benefit plans.

There was a situation in which a full funding limit was placed on sponsors, largely for revenue situations, that put, in essence, a holiday on the ability to make deductible pension contributions for a very large percentage of these individual firms. You found that after those holidays basically vanished, that many of the employers had then found better things to do with their corporate funds than to continue to fund these defined benefit plans.

My suspicion is, with increasing health care costs, many employers—in fact, some of the ones whom we have interviewed since this proposal first came up—have suggested that they would be more than happy to just allow the government to have the match, and they would divert their funds to other purposes.

My big problem, and something which Dr. Gale's previous research supports, is the level of the match in essence has a huge effect on what the employee's reaction is going to be. We did a lot of work back in 2000, 2001 for a Society of Actuaries conference that showed the higher the match rate, the more the employees are going to be contributing. So, if the employers do cut back on their match as a result of this, I think there would definitely be an impact on overall employee contributions.

Senator HATCH. Dr. Gale, I want to give you an opportunity, too.

Dr. GALE. All right. Thank you. I appreciate that.

First thing, let me be clear. There is no lower contribution limit, and there is no higher tax rate on companies in the individual version of the proposal. The company treatment can be exactly the same. The tax incentives will be improved for about 90 percent of workers, not reduced. They will be better for 90 percent of workers.

The issue about matching contributions, if I understand what Jack said, is almost Orwellian. The concern with the proposal is that so many people would contribute so much to their retirement account and get the government match, that employers would then cut back on their own matching contribution.

Oh, geez. Would that not be a good problem to have, that so many people were participating so actively in the retirement system? If we were concerned then, if that happened, that companies were then going to cut back on their match, well just change the non-discrimination rules so they still had to match at the same level that they do. But gee, that would be one of the best problems we could ever have, that so many people, this half of the workforce that is not participating, they responded so massively and so positively to this change in incentives, that would be great.

Senator HATCH. Dr. VanDerhei, did you have a comment about that?

Dr. VANDERHEI. I did not know Orwell wrote science fiction. But I think probably what is going on here is not necessarily that we assume because of this there is going to be such an increase with respect to the employee participation, but the employers, to a very large extent—if you go back and look at the history of 401(k) plans in this country, after the proposed regulations came out in 1981, there was a period in which—it was exponential growth in the 401(k) system.

For budget purposes, I think the consensus was there had to be cut-backs on these to stem some of the tax revenue lost. One of the things they came up with was the non-discrimination requirements, and many employers in essence are putting in matches as incentives to bring the low-income into the plans in an appropriate degree to be able to continue to sustain the salary deferrals that the highly compensated employees want to put in.

Again, if the government's match is going to be sufficient to produce that, I think—and I think this would be a great topic for a survey—a lot of employers would say, we no longer need to divert our funds to this particular goal, because the government match would take care of that.

The CHAIRMAN. Thank you very much.

Senator Cardin?

Senator CARDIN. Well, thank you, Mr. Chairman. I thank you not only for this hearing, but I thank you for your leadership on providing ways in which people can save for their retirement and we can increase private savings in this country.

Senator Hatch, I want you to know that I appreciate your statements. I agree with you on your observations on the limits, that it would be counterproductive to think that we are going to increase progressivity in retirement savings by reducing caps. To me, that would just reduce retirement savings, a goal that I think is wrong.

We need to increase private savings in America. We have had to do this for a long period of time. Even when the economy was performing in such a strong way, we did not have enough private savings and private retirement. I remember a hearing in the Ways and Means Committee—it may have been the same witnesses here, I am not sure—in which that question was asked. And I got a response from one of the questions I asked. They said, well, we do not have to worry about that because people are saving through the equities in their homes. So we need to increase retirement savings in this country.

The point, Ms. Miller, that you raised, your myth #5, is so relevant to this debate because, quite frankly, these hearings are being convened with the backdrop of this super joint committee, and what are we doing about deficit reductions, and how are we going to get revenues for this Nation.

What is interesting about retirement savings incentives, Mr. Chairman, is that we have received criticisms from the general public that a lot of our social safety net programs have accrued liabilities in the future, and our budget system does not really account for that. Well, it is interesting. The retirement savings is just the reverse. It is just the reverse.

It is a source of revenue for the future of this country that is not accounted for in the way that we do our budgeting. To me, it would be so counterproductive to dealing with the significant budget problems we have if we try to take the short-term revenue gains from retirement savings and say we are doing something about the deficit, because we will not. We will just make the situation worse.

So I know a lot of good suggestions have been raised by our panel. I agree with a lot of the points about the saver's credit. I think that is important to improve. I think automatic enrollment is an important way to increase savings. I agree with defined benefit plans. I think we have to do what we can to preserve the defined benefit world.

I also think we need to make sure retirement funds are used for retirement, and to the extent possible, encourage that to be used for annuitant retirement, because that, to me, is where the real pressure is on government programs, and on security when people retire.

My question is, we have a very successful program here in the Federal Government as an employer. We have the Thrift Savings Plan. I do not think there is a member of Congress who would suggest that the Thrift Savings Plan has not worked well for all of our workers. But it really indicates that, as important as the tax incentives are, deferrals, without additional money on the table, average workers are not going to put money away for their retirement. That is why we want to have employer-sponsored plans where the employer puts money on the table.

As the Federal Government, as an employer, puts money on the table, workers are going to take up that offer. And the saver's credit, of course, is a substitute for that, but to me the better plan is to have more employers willing to put a plan in place where they are willing to put money up so that their workers participate in a retirement plan.

So what would you suggest? What are the most important changes we could make in our retirement laws to encourage more employers, particularly the smaller employers, to sponsor plans where they encourage their workers to put money into retirement by match? What should we be doing?

Ms. FRIEDMAN. Well, I am going to both answer your question and also go beyond your question, if that is all right, Senator, because I have a few ideas that have been storing up that I want to kind of get out also, in response to some of the other questions here.

Senator CARDIN. I saw that you were really anxious on some of them.

Ms. FRIEDMAN. I do not know if I was anxious, but I was starting to think, what do I want to say? So I want to make a couple of points. One point I wanted to make throughout this is that we have to sometimes go from statistics to real people, right?

Just yesterday the Census data came out showing that poverty is on the increase, that the median wage for individuals has gone down to a 1997 level, and the fact is that people are struggling right now, and they are struggling to pay their everyday bills. They do not have a whole lot of money to put into retirement.

So I just want to pose, both to the committee and also to the panelists—because everybody here is super-smart—how do we create a system where all the risks and responsibilities are not just on individuals? We have been talking a lot today about just giving incentives so individuals save, giving incentives so employers set up plans. But the fact is, we have been doing that, and we still are stuck with coverage rates at 50 percent, inadequate savings, and people not having enough money for retirement.

So I want to propose two things in terms of—it is a little bit broader than your question, Senator. But the Conversation on Coverage, which was a common-ground dialogue that the Pension Rights Center ran with business groups, financial institutions, and others for 7 years—and virtually everybody on this panel, either organizationally or individually, has been involved in this.

We came up with new ideas to incentivize employers and employees to save. We came up with some new simplified defined benefit plans, something called the Plain Old Pension Plan, which I would love to bring to your attention. There are more details of it in my written statement. Judy had an idea for a multiple-employer plan. We think, let us look at new models.

But here is what I would want to say to you: let us not just have plans where all the risks and responsibilities are individuals'. What Retirement USA, which is the initiative I talked about, is also putting forward is, can we both design a new system but also work on today's plans to make sure that there is shared responsibility, employers and employees both contributing?

Senator CARDIN. My time has expired, so let me just welcome suggestions—not right this moment—from the panelists, because I think there is interest to try to get employers more engaged in establishing plans where money is on the table, because we know that will get people to save. We look at our Thrift Savings Plan as a prime example of that.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Would you expand, Ms. Miller, on the interesting point that Senator Cardin made about myth #5? Could you expand on that a little bit, please?

Ms. MILLER. Yes. Sure. Most tax preferences are really cash basis tax preferences. You have paid a lot of mortgage interest and——

The CHAIRMAN. Ms. Miller, could you suspend? I did not see Senator Thune.

Ms. MILLER. I am sorry.

The CHAIRMAN. No, no, no, no. Go ahead.

Senator THUNE. That is all right. Go ahead.

The CHAIRMAN. No, no, Senator. I missed you, and I apologize.

Senator THUNE. That is all right. Thank you, Mr. Chairman.

I appreciate the discussion this morning. It is an important one. I think, too, that savings is something we do not emphasize enough in this country, and obviously we have a long ways to go to get our savings rate up to where I think it provides the right kind of security for Americans as they approach those retirement years.

I wanted to direct this to Dr. VanDerhei and Judy—Ms. Miller—if I might. But I wonder if each of you could discuss the current limits on 401(k) and IRA contributions in the context of Americans clearly needing to save more for retirement, and would you propose to raise either of these limits, and if so, by how much?

Ms. MILLER. That is a very good question. I think that, as we look at this, the current limit for IRAs for somebody who is under age 50 is $5,000, and it is $16,500 for an elected deferral, a personal contribution to a 401(k) plan. If there is employer money, then it can go up to $49,000.

Now, a key component to us of maintaining the employer plan and encouraging it is that there be a differential between this $5,000 IRA contribution that you can make without making a contribution for your employees and the $16,500 that requires that you offer arrangements to your employees.

Now, if you are looking at a small business, there can be a problem here in that, as I said, a lot of small businesses just do not have much money. The small business owners are not in the 35-percent tax bracket. You talk to them about putting in a plan, and they cannot afford much more than $5,000 themselves.

They say, oh, I can do an IRA, my employees can do an IRA, what is the big deal? If we had something that was—and again, we do not have all the fine-tuning done, and many folks up here are already working on things like this. But if you had a multiple-employer plan, if you had the ability for a small business to start a plan and just give people the opportunity to contribute without incurring additional liability, it could be very helpful, so you could maybe set the limit at $8,000 instead of—put it somewhere in the middle.

Put them in a plan so that, the year they have a good year, it is already there. They can make contributions for everybody. But in the meantime, right now, for example, one of the problems is that we have had these different figures: 73 percent access, less than 50. A big part of that is, are we looking at part-time workers or not?

The incentives set up in the code have been deliberately set up substantially for full-time workers, so it is really not fair to say if they have been effective for everybody. You should be looking at full-time workers to see if they have been effective. If you want to expand them, go ahead and expand them, but you should be comparing results for the group that has been targeted. A small employer who decides to let somebody in whom they do not have to let in, suddenly they have to put 3 percent of pay in, and it is an additional challenge.

So, to answer your question, we always would like to see higher limits. I really do think that it would encourage more participation. But I think there is also room to expand coverage by looking in the middle, and seeing what can be done by simplifying rules, and creating options for employers that some day will want a plan that they can contribute to, but right now would be happy to help people contribute, if they saw any good reason to do it, other than figuring, oh, they can use an IRA.

Senator THUNE. All right.

Dr. VanDerhei?

Dr. VANDERHEI. I do not disagree with anything Judy said, but if I could expand your question just a bit, Senator. I think perhaps what is even more important today is that, with the exponential growth in automatic enrollment plans, there is still a great deal of concern in how high they will allow employee contributions to auto-escalate. One of the few limitations from PPA was the safe harbor that only would allow those contributions to go up to 10 percent.

Now, I think most financial professionals would tell you that, for a contribution rate to be sufficient, if you are only going to have the 401(k) and Social Security, it needs to allow employees to go beyond 10 percent with this auto-escalation provision. Personally, I would think, depending on your objective, if your objective is to increase retirement income adequacy for the largest percentage of U.S. households as possible—instead of going back and increasing the 402(g) or the 415(c) limits—you would want to have this auto-enrollment work the way it should work and, once you get an employee in and allow them to start auto-escalating their contributions year by year, to go back and look at the logic of having a hard cap on this 10-percent limit.

It is still too early to tell because, again, this was only passed in 2006, and we are still waiting to see what happens when employee contributions get that high. But if employees would still be willing to voluntarily increase their elective deferrals 1 percent per year once they hit 10 percent, I personally think you would be doing much more to improve retirement income adequacy by re-looking at that particular cap.

Senator THUNE. Just as a quick follow-up, if I might. As you know, we are talking about tax reform here. You have both touched on the benefits of our current tax preferences for savings. I am wondering what your thinking is with regard to continuing to encourage Americans to save without the current treatment of the various tax-preferred savings vehicles, in other words, interaction with the tax code. And, if we end up with a tax reform that does lower rates and broadens the tax base, is the incentive there still sufficient for putting money aside in some of these retirement vehicles.

Ms. FRIEDMAN. May I respond to that?

Senator THUNE. Sure.

Ms. FRIEDMAN. We may have a slightly different opinion than both Judy and Jack on this, but I think that when you are looking at these tax subsidies, you have to ask, what are they supposed to be doing? The government is now spending $123 billion in tax subsidies to encourage employers to set up plans that incent employees to save. As we heard earlier, about two-thirds of those incentives already go to the highest-paid employees who do not need those incentives to save.

We would be against raising the IRA and 401(k) contribution levels, particularly because right now, if you look at studies, there is a minuscule—I mean, we are talking very small—percentage of lower- and middle-income workers who are now putting in the maximum. So, if we are spending all this money to incentivize the system, what we are saying is, we should be looking at ways of getting more lower- and middle-income workers to save. The proposal to raise both the IRA limit and the 401(k) limit would help those people who already are saving. So, I just wanted to point that out. Thank you.

The CHAIRMAN. What is your view about whether non-discrimination rules work? Do they adequately spread out benefits between high- and low-income——

Ms. FRIEDMAN. You know, that is an interesting question, because I know what Judy was basically saying is that we have this system where we have non-discrimination rules to ensure that not all the benefits can be skewed to the higher-paid.

The CHAIRMAN. Right. They work. I think they work.

Ms. FRIEDMAN. The fact is, there is a lot of gaming of non-discrimination rules. Dan Halperin, who is a professor at Harvard Law School and also a fellow with the Pension Rights Center, just wrote an article on that that I would be happy to share with the committee, and, with your permission, I would like to submit that into the record.

The CHAIRMAN. Without objection.

[The article appears in the appendix on p. 42.]

The CHAIRMAN. What about saving for health care expenses? Fidelity came out with a number that people are going to need when they retire, about $240,000 for out-of-pocket health care expenses. That is a lot of money that is out of pocket. Does that sound about right to all of you? If it does, to what degree do these proposals we are talking about here address it? We will start with you, Dr. VanDerhei.

Dr. VANDERHEI. Well, I certainly agree. We have done similar simulations at EBRI now for quite some time, and we come up with the 50th percentile number very close to what Fidelity has. May I just add, though, that you may still not be looking at perhaps the most important health care expense, and that would be for a nursing home.

Long-term care insurance is something—every time we go back and run these simulations and look at, what is the optimal risk management decisions when you retire, should you buy an annuity, should you buy longevity insurance, should you buy long-term care insurance, the potential catastrophic expenses that could be incurred because of nursing home costs to a household that otherwise had done everything right and would have had adequate financial resources is the trigger point that hits most of these households more often than anything else. So not only does one need to worry about the savings for out-of-pocket costs such as Medigap and such as the Part B premiums, et cetera——

The CHAIRMAN. Right. Right.

Dr. VANDERHEI [continuing]. But I would very much encourage one to consider also dealing with the nursing home expenses.

The CHAIRMAN. Dr. Gale?

Dr. GALE. Thank you. The health expenses are obviously one of the major, if not the major, component of retirement expenses, so it is appropriate to link these two. Just as if we talk about combined Social Security and Medicare changes, we need to think about the interaction in reducing Medicare benefits as in some way the same thing as reducing Social Security benefits in terms of whom it affects.

I think the best way to do this is through encouraging saving generally rather than through target accounts for particular—you know, whether it is health, education, whatever. The argument is that, obviously, the goal for preparing for retirement and health care expenses is to move resources into that period of your life, but then, if you do not have the health expenses, if you happen to be healthier than otherwise, then you can use the money for other purposes if it is in this general account.

In the health care account, it is sort of stuck; it is kind of earmarked. So, I would prefer not to see a proliferation of accounts for every conceivable use, and I would prefer to see focus on streamlining and consolidating the accounts we have into kind of a broad-based saving account.

The CHAIRMAN. I am going to change gears here a little bit, because my time is expiring. Most of the proposals we are talking about here, with the exception of maybe one of yours, Dr. Gale, designed to try to encourage more savings, cost Federal money, and that is not where this Congress is today. This Congress—I am on this so-called super-committee that is trying to reduce the debt, and the big talk around here is tax reform. Let us broaden the base, lower the rate. But broaden the base.

Dr. GALE. Right.

The CHAIRMAN. So how do we fit the two together? You know, save some money—with the exception of one of your proposals, I guess—but yet encourage savings?

Ms. FRIEDMAN. I mean, I guess I will start on that just by saying I think that, when we have challenges in this country, we always meet them, and we find the resources to meet them. And as I said earlier, there is a $6.6-trillion retirement income deficit that is only going to get worse if we do not do something now to address it.

I want to just point out again that the Joint Tax Committee estimates that the government is spending $123 billion in tax subsidies to encourage employers and employees to save, and to repeat again that two-thirds of the value of those tax subsidies goes to the highest-paid, who do not need them.

So we would argue—and I want to say we agree with you, Senator Cardin, not exactly, but there is a lot of room for rejiggering some of the tax subsidies in a more creative way that we feel would make them fair and more effective. But I want to say exactly what Senator Cardin said, though: we think that any tax subsidies that are redirected elsewhere have to be used only for retirement solutions, not for general deficit reduction.

Then I am also going to put out just another idea that I know some of you will not totally agree with. But again, Harvard Law professor Dan Halperin has, because of the points I made earlier, suggested that we lower the limits that are now going to 401(k) plans to earlier levels, back to the pre-EGTRRA levels that I am sure—and I know, Senator Cardin, that you were a big advocate for that, but only because such a small number of low- and moderate-wage earners are actually able to even put in the maximum allowed. If you were to do that—and this is just a suggestion, I am not saying that we are telling you you should do this, but it is a suggestion to look at—then that money could go into what we feel are more effective and secure retirement solutions.

The CHAIRMAN. All right.

Senator Hatch?

Senator HATCH. Thank you, Mr. Chairman.

The opponents of the 401(k) retirement savings system ignore the fact that workers receive, in addition, Social Security. Now, Dr. VanDerhei, you published a paper a few years ago that analyzed the retirement income replacement rate that workers in various income groups could anticipate when they combined their 401(k) account with their Social Security benefit.

Now, you concluded that workers in the lowest income group receive as much as 103 percent of their pre-retirement income from a combination of 401(k) and Social Security benefits. Could you elaborate a little bit more on your findings for us?

Dr. VANDERHEI. Certainly. This is something that I did in conjunction with Sarah Holden from the Investment Company Institute. One of the big problems we had—and this was back around the time of Enron when a lot of calls were being made as far as the appropriateness of the 401(k) system as a result.

Senator HATCH. Right.

Dr. VANDERHEI. And people would take a look at just what the average 401(k) balance was and say, there is no way that is going to be able to support an adequate retirement. The problem is, of course, those look at people of all ages. Even if you do look at people approaching retirement age, people in their 60s, you have a tendency to combine people with very low tenure, people who may have just changed jobs and only had one or 2 years of contributions in their account, with other people who have been there for a very long time.

So we tried to be very, very specific, when we built this database, about looking at the potential for retirement income from 401(k) plans. But even at that time—because, again, 401(k) plans really had their genesis in November of 1981, and it was not until 1982 or 1983 that most of these plans really were installed, and most employees did not have the opportunity to be in a 401(k) plan for their entire career when they were retiring.

We had the benefit of having tens of millions of administrative records going back to 1996 to put together a simulation model that would allow you to look at how employees were reacting in terms of asset allocation and contribution behavior, and we put forth a baseline, assuming a 401(k) participant was always working for an employer who sponsored a 401(k) plan and assuming historical rates of return—we also did sensitivity analysis for some bear markets—what might they expect if, at 65, they took those accumulations and basically bought an annuity.

We found for the lowest income quartile that, again, if they were continuously covered and had been eligible to participate their entire career, 51 percent of their pre-retirement income could be replaced by an annuity, and when you combined it with the 48-percent replacement rate from Social Security, it basically gets you up to the 103 percent that you mentioned.

Now, obviously, given the way that the Primary Insurance Amount formula is defined with Social Security, the higher income quartiles would receive less from Social Security, so their combined replacement rate would be much less, but at least for the lowest income quartile, as you mentioned, they would have been able to replace more than 100 percent of their pre-retirement income just from the 401(k) and Social Security.

Senator HATCH. Dr. Gale, under your proposal, when an employee contributes after-tax dollars to a 401(k) plan, a check from the government in the amount of the refundable tax credit will be deposited into a 401(k) account, as I understand it, of the employee.

The IRS currently receives data on the 401(k) plans but not on the employee accounts within the plans. Now, your proposal would greatly expand, as I view it, government deposits to private 401(k) plan accounts. Now, how is the IRS supposed to administer this expanded refundable tax credit, and what sort of information, or new information, will employers be required to provide to the IRS?

When you get through answering this, I would like to have Ms. Miller explain, what are your views on the wisdom of expanding government deposits to private 401(k) accounts?

Dr. GALE. That is a good question. Basically there would be an expanded administrative capacity needed, but you could administer it as part of a refund, for example. When people file their income tax form, they can split refunds. The W–2 has a 401(k) contribution on it. It would not be that hard to list the 401(k) account number as one of the refund lines, and then the check gets cut.

Right now you can get cash back, or you can get money put into an IRA. This would just automatically put it into the 401(k). It strikes me that there is work to be done here, but it does not strike me as an insuperable or even a big administrative burden once the system is set up.

Senator HATCH. All right.

Ms. MILLER. I would like to back up to the small employer and the way the deduction creates cash flow because, if you have an employer who is counting on their personal deferral of income taxes to help pay for employee contributions, if that credit is going directly into their account, they no longer have that cash.

So it is a bit of a problem just from the small employer standpoint in terms of how this all fits together. If this credit, as was in the written testimony, applied also to employer contributions, then it would be devastating because they just plain would not have the money.

But getting beyond that and just saying, all right, we have some refundable credit, I think that there has been some groundwork laid in terms of in the 1040, allowing people to split their deposit and have some go to an IRA. I do not think necessarily all 401(k) providers would—it would take a lot for them to gear up to handle deposits. It think it would be more of an expense on the system, the record keepers, probably, than Treasury. But either way, there are certainly some challenges there.

The CHAIRMAN. Thank you, Senator.

Senator Cardin?

Senator CARDIN. Thank you, Mr. Chairman.

Ms. Miller, I want to get back to the point that you raised about the IRA limits and the other limits we have in our system. The IRA program has been very valuable in improving retirement savings, and it is very popular, but you raise a very valid point. It is important for low-wage workers to have an employer-sponsored plan where money is on the table. That would allow for greater accumulation of retirement savings for that lower-wage worker. We do not want to make the IRAs so attractive that particularly small companies choose to use the IRA route rather than an employer-sponsored plan. So what is your advice as to the right ratio here between these plans? What should we be looking at?

Ms. MILLER. Oh, that is a good question. When I spoke earlier, I said that I thought that the current ratio was effective, but that there is maybe room for, I guess it would be a special deferral-only safe harbor, maybe in the 401(k) environment, that is low enough so that there is still a lot of reason for employers to want to contribute on their own behalf, and put more money in, but also encourages them to put in one of these arrangements.

Senator CARDIN. In addition, of course, to limits, there are also complexity issues in different plans and other areas.

Ms. MILLER. Yes.

Senator CARDIN. So can you just give us your experience as to what we need to do within the IRA world to encourage smaller companies to set up plans where they are offering matches?

Ms. MILLER. So, in the IRA world, there is not really much room, I guess, for an employer match, so I think we ought to look more toward multiple-employer arrangements, where there can be a cost savings in terms of setting them up. There are challenges with IRAs in a group setting, in terms of the banking rules. And I am not an expert, but I know, in talking to some our members that would be interested in doing them on a volume basis, you have PATRIOT Act concerns and that kind of thing. So we need something that allows an employer to put in a plan that is kind of a mass plan, so to speak.

Now, I know any time we expand coverage, there are costs involved. If you do not mind for just a couple of seconds, I will get back to my myth 5, because the question has come up, and there have been statements made here, that it costs $120 billion a year, but it does not. We are not spending $120 billion a year on retirement savings incentives. These are deferrals. Unlike the mortgage interest deduction, the health exclusion, anything else, these are monies that are set aside that we are going to be paying taxes on later. So I do not think we should let that discourage us from expanding savings.

Senator CARDIN. Thank you. You made that point before.

The Roth treatment has been a very popular way in which particularly younger workers, who have the capacity, are able to put money away for their retirement. Do any of you have a view as to—and you have all expressed a preference to try to target our results on lower-wage workers to put more money away for their retirement. Does Roth treatment help us or hurt us in this regard? Do IRAs help us or hurt us? What do we need to do in regards to the popular retirement options—Roth treatment, IRAs—as far as encouraging an environment where lower-wage workers will participate in larger numbers for retirement.

Dr. GALE. Well, the most effective thing that could be done would be to make it possible to create automatic IRAs so that—this is a proposal that David John at The Heritage Foundation and Mark Iwry, who is now in the Treasury Department, put together several years ago under the auspices of the Retirement Security Project, which I run. And the idea would be, in the same way that automatic enrollment has helped raise enrollment in 401(k)s, to allow part of the workforce that does not have access to 401(k)s, and the part of the employer force, if you will, that does not want to or cannot set up pension plans, nevertheless, to let those workers benefit from the incentives that are put in the retirement system. I think in the same way that auto-401(k) was a very natural extension and was done in PPA 2006, auto-IRA is clearly the next step, if you will, to getting the rest of the workforce covered.

Ms. FRIEDMAN. I guess the Pension Rights Center's response to that is, while we think that the auto-IRA proposal is a positive step and that we are addressing the needs of people who now do not have employer-based plans, I think we would like to see something that goes a lot further, something that does not have all the risks and responsibilities on employees, where employees have to decide whether to participate, or there are no employer contributions even if there is automatic enrollment.

If people, especially in this economy, need that money, they will take it out, and they could be hit with a penalty tax, and lots of other things. We would rather see, as I said earlier, shared responsibility, and pooled investments, and things like that.

But it occurred to me, listening to Judy, that there are places where ASPPA and the Pension Rights Center and other organizations could work together to start coming up with better plans for the country that have employer and employee responsibility. You know, I think the problem with the way that the policy is going so much in this country is, we are putting so much onto individuals at a time when they really cannot accept all this risk.

Senator CARDIN. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

I have no more questions. Senator Hatch, do you have another question?

Senator HATCH. Could I ask one more?

The CHAIRMAN. Sure.

Senator HATCH. I just want to ask Dr. Gale another question. That is, I believe there is an important detail that we have not discussed here and was described in your proposal. And maybe I am wrong about this, but let me just ask it. Employer contributions and matching contributions to retirement plans on behalf of employees are exempt from payroll taxes. Under your proposal, employer contributions would be taxable income to the employee, including being subject to employer payroll taxes.

As I view it, this would increase the costs to small businesses making contributions. Now, my question is, do you not think that the extra burden on small businesses will discourage matching contributions as well as the adoption of new 401(k) plans?

I am concerned about that because I think that is—and then if you could, Ms. Miller or Dr. VanDerhei, what do you think the effect of the payroll tax increase will be on the decision of a small business to start or maintain a plan with a matching contribution? I would like to have both of your viewpoints on that.

Dr. GALE. The proposal left that unspecified. At one point it said it was treated just like wages; at the other point it said, here are the things that would change, and everything else would stay as is. It was not my intent to change the payroll tax treatment. A number of people who have read it have raised that issue with me in an e-mail last night, so I apologize for the confusion in the proposal. I was not at all proposing that employer contributions be subject to payroll tax.

As I stated in the oral testimony and as in the written testimony, you can separate changing the individual deduction to a credit from the notion of dealing with the employer deduction at all. So at an 18-percent credit, if you just change the individual deduction to a matching credit, you would raise $250 billion over the next decade. If you also changed the employer contribution, you would raise $450 billion, but that is conceptually, administratively, whatever, just a separate component of the proposal. It could be separated out.

The gist of the proposal is—in the spirit of what Judy said, the retirement system needs a tune-up, not an overhaul. The gist of the proposal is to convert the retirement deduction to a government matching contribution and, instead of giving the money back to the person in cash, to put the money into the account. That would both raise incentives and raise contributions and balances for the majority of workers.

That strikes me as a very favorable tune-up, especially in a time when the short-term economy is weak, and the long-term economy needs revenues. But it does not strike me at all as an overhaul of the retirement system, so I was kind of surprised to hear that idea characterized in that manner.

Senator HATCH. Yes?

Ms. MILLER. When I read the testimony, what I read was that the employer contribution would be treated like pay. So I think I would have assumed, in that circumstances, it would be FICA, and that would be very, very disruptive. If that is not the case, then that is an issue that, on its own, would be taken off the table. I would offer that there are other complications. Even if we take FICA off the table, if the employer contribution is part of this discussion in terms of a credit, there are other complications due to things like vesting schedules.

Again, on this proposal I worry about the cash flow aspects for the small business. If they are not getting their own tax benefit deferral to have cash available, then that would affect it, but obviously, if you are only looking at the elective deferral and not the employer contribution, the impact becomes a question of two things: is it deposited to the account or not, and what is the amount of the credit? I think until the committee had some formal numbers on that, it would be hard to say.

Senator HATCH. Well, I want to thank the four of you for your testimony here today. This has been really—I never thought this would be an interesting hearing. [Laughter.]

But I think it has been an interesting hearing, and the four of you have done yourselves well as far as I am concerned. I just appreciate the effort that you have all made to be with us. Thank you so much.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

I had somewhat the same reaction. These are all four great witnesses. You made it all very interesting. Thank you very much. It has been very helpful.

The hearing is adjourned.

[Whereupon, at 11:45 a.m., the hearing was concluded.]

APPENDIX

Additional Material Submitted for the Record

Hearing Statement of Senator Max Baucus (D-Mont.)
Regarding Tax Reform and Retirement Savings

Franklin D. Roosevelt once said, "True individual freedom cannot exist without economic security and independence."

For true economic security, Americans approaching retirement need to know they will have enough money every month to get by.

Retirement security is often described as a three-legged stool. The first of those legs – Social Security – is crucial to the stability of that stool. Prior to Social Security's enactment, half of all seniors lived in poverty. Since that time, seniors in Montana and across the country have come to rely on the Social Security benefits they've earned through years of hard work.

So we must – and we will – do what it takes to ensure that leg of the stool remains sound. But the average Social Security beneficiary receives only slightly more than $14,000 each year. As a result, most Americans will not be able to retire on Social Security alone.

So today we will examine the other two legs of the retirement stool: personal savings and employer-provided retirement plans.

Our tax code has several key provisions that encourage Americans to save for their retirement. The tax benefits apply to pensions, Individual Retirement Accounts, and employee stock ownership plans. These tax incentives add up. In total, they cost more than the tax preference for employer contributions to health insurance plans, and they cost nearly 50 percent more than tax expenditures on the home mortgage interest deduction.

The United States has the most successful private retirement system in the world, but for the amount our country spends on retirement savings, are we getting enough bang for our buck?

For much of the period from World War II through the mid-1980s, the majority of retiring American workers could depend on a pension plan from their employer. These defined benefit plans provided lifelong monthly payments to retirees. The retiree could not outlive his retirement plan. In 1980, 84 percent of Americans working for large and medium-sized employers participated in these plans. But by 2007, less than one-third of workers in large and medium-sized companies participated in this type of plan. These numbers continue to shrink.

This dramatic trend away from pension plans has been coupled with a trend toward defined contribution plans. In a defined contribution plan, workers receive a lump sum when they retire. Under these types of plans, both the employer and employee commonly have the opportunity to contribute to the employee's account.

The increasing reliance on defined contribution plans blurs the line between personal savings and retirement benefits. The individual manages his or her own account. This account does not necessarily have to be used for retirement purposes.

And, the retiree must avoid the temptation to spend these savings prior to retirement or spend too much too early in retirement. Unlike defined benefit plans, defined contribution plans do not provide stipends or insurance to cover long-term care expenses.

This means that a retiree can outlive his retirement savings whether due to inflation, market declines, unexpected health expenses, or even the good fortune of living longer than expected.

And many do. In spite of the tremendous tax preferences for retirement savings, many Americans are left without sufficient resources to maintain a comfortable retirement.

The General Accounting Office found that the median retirement account balance for Americans ages 60 to 64 was $60,600. This means the average retiree can only spend about $4,200 per year on top of Social Security given current life expectancy.

That same report indicated that nearly 30 percent of all Americans in the workforce for 25 or more years had zero retirement savings.

Perhaps most troubling is that fewer than half of all American workers work for an employer that sponsors a retirement plan, and the half of Americans who do not have access to an employer-sponsored retirement plan are almost entirely middle or low-income. This means they are far less likely to have other forms of savings.

These numbers do not paint a pretty picture for a large chunk of the baby boom generation approaching retirement. We have to do better. We need to look for ways to do more with less.

I look forward to hearing from today's panel on their views whether there are steps we can take to improve these numbers for those nearing retirement today. And we must do what we can to make sure future generations don't find themselves in the same boat.

So let us find ways to improve and increase retirement savings for millions of Americans. Let us look to make our retirement savings system more efficient. And let us work to ensure that more hard-working Americans have the savings they need to enjoy the retirement they deserve.

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PENSION RIGHTS CENTER

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STATEMENT OF THE PENSION RIGHTS CENTER

ON

TAX REFORM OPTIONS: PROMOTING RETIREMENT SECURITY

BEFORE THE

COMMITTEE ON FINANCE

U.S. SENATE

SEPTEMBER 15, 2011

Mr. Chairman, Members of the Committee, thank you for this opportunity to testify today. My name is Karen Friedman, and I am the Executive Vice President and Policy Director of the Pension Rights Center, the only consumer organization working exclusively to protect and promote the retirement rights of workers, retirees, and their families.

We commend you for holding this hearing today to examine tax reform options to promote retirement security. Given the enormous challenges facing the country, this hearing might be subtitled, "How to better use the tax system to rebuild and revitalize the American dream for workers and retirees." Because that's what it's about, isn't it? At a time when the economy is in a tailspin, and middle-class American families are facing challenges as never before in recent history, we want to make sure that those who have worked hard and played by the rules are able to retire with adequate income and dignity. This has always been a fundamental shared ideal in this country.

Yet too many people are facing a bleak retirement. Half of all private-sector workers have no pensions or retirement savings plan to supplement Social Security – and this has been a stubborn fact for more than a quarter of a century. And too many employers who sponsor pension plans that provide lifetime, guaranteed incomes are freezing, terminating, and otherwise cutting back those plans and replacing them with less-secure 401(k) plans. Thirty years ago, one out of two private-sector workers participated in defined benefit plans, and now that figure is closer to one in five. And 401(k) plans have left most workers with insufficient assets for retirement.

The fact is, while 401(k) plans can work as supplemental savings plans, they do not work well as the primary retirement vehicle for most Americans. 401(k) plans, unlike guaranteed pension plans, put all the risks and responsibilities onto individuals, who then have to decide whether to participate, how much to contribute, what to invest in, how to resist withdrawing the money before retirement, and finally, figure out how to make the money last. That's a lot to put on someone who is struggling to hold onto a job, pay for escalating health expenses, keep a house afloat, and a family above water. Even before the stock market crash, 401(k) plans were not addressing the nation's retirement needs. In 2007, half of all households had less than $45,000 in their accounts. For those approaching retirement, the median account balance was just about $98,000 – not nearly enough to last throughout retirement.

Public opinion polls reflect America's mounting anxiety. According to the National Institute on Retirement Security, 84 percent of Americans are concerned that current economic conditions are impacting their ability to achieve a secure retirement, with more than half (54 percent) of Americans very concerned. In a recent Gallup poll, the top financial concern for most Americans was not having enough money for retirement, surpassing concerns about paying for healthcare or paying the mortgage. And in a poll conducted for the Allianz life insurance company, a majority of mid-career workers said the fear of not having enough money for retirement was greater even than their fear of death.

This fear is captured in the heartbreaking stories we at the Pension Rights Center hear every day from people across the country. People like Shareen Miller, a home health care aide in Virginia. Shareen, who makes only $12 an hour, tells us that she and her husband together have been able to sock away only $100,000 in their 401(k) plans, and she worries that one health care crisis could wipe out their retirement savings. There's Karen O'Quinn, who is in her late 40s. She was laid off from corporate America, leading to a foreclosed home. She doesn't have a dime for retirement. David Muse, a sound technician, puts it bluntly, "I will be forced to work until I either fall apart...my health totally crumbles or I die. For me there is no retirement."

All of this taken together – the statistics, the polls and the stories – add up to the Retirement Income Deficit facing the nation, an urgent deficit that must be addressed by Congress. According to the nonpartisan Center for Retirement Research at Boston College, the Retirement Income Deficit facing Americans is an astounding $6.6 trillion. That number represents the gap between what people have saved as of today and what they should have saved to achieve a level of sufficiency in retirement. To arrive at this number, the Center on Retirement Research used a conservative methodology based on the one it uses to calculate the National Retirement Risk Index. The Center only looked at households in their peak earning years, between 32 and 64 years old, and assumed that people would continue to earn pensions, that they would contribute to 401(k)s, and that they would continue receiving Social Security benefits under today's formula. The Center also factored in the value of home equity as a source of income for retirement. Cutting Social Security would only add to the Retirement Income Deficit the country is facing.

So what are the solutions to the massive and urgent Retirement Income Deficit? We would say there is not one solution but many that need examination. And there is no question that restructuring the tax system can contribute to a solution.

Let's look at the nation's current investment in employer-provided retirement plans – both 401(k)-type plans and defined benefit plans – as well as Individual Retirement Accounts, which often hold roll-over money when an employee leaves a job. The costs come through tax incentives for for these plans, which Congress's Joint Committee on Taxation says will cost about $123 billion in lost revenue to taxpayers this year.[1] Tax expenditures just for 401(k)s, IRAs, and Keoghs add up to $70.2 billion. The reason Congress conferred preferential tax treatment is because policymakers recognize how hard it is for people to save for retirement –

[1] Table 1, Joint Committee on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 2010-2014, December 15, 2010.

particularly low- and moderate-income workers. These incentives are meant to encourage employers to set up plans and to encourage employees to save. However, the incentives end up disproportionately benefitting the nation's most affluent employees, who would almost certainly save for retirement even without tax incentives. Two-thirds of the value of tax expenditures for retirement savings plans goes to households in the top income quintile according to the Urban-Brookings Tax Policy Center. Many experts call the current inequities "upside-down" incentives because they help those who least need help.

So the U.S. Treasury is foregoing billions of dollars every year to encourage retirement saving, but the end result is that, despite these expenditures, fewer than half of all Americans are covered by retirement plans, many fail to contribute, and, among those who do, most contribute too little, pay too much in fees, invest poorly, and sometimes withdraw their money before retirement age. While some of these problems can be addressed by automatic features – automatic enrollment and automatic escalation of contributions – the fact is, while such features have merit, they are not a panacea and do not address the structural flaws of 401(k) plans as retirement vehicles. Those most in need of a supplement to Social Security are likely to opt out or contribute too little. And all are vulnerable to market downturns and to wrong guesses when it comes to figuring out how to make their money last through retirement.

While we recognize there is no one magic bullet to address the major problems in the retirement system, we would like to offer today some ideas for this Committee to consider. I will divide our ideas into two buckets: the first is short-term, meaning they can be done now to make existing plans work more efficiently and more equitably; the second bucket is long-term and comprehensive, and includes elements necessary for a secure and adequate system for future generations of retirees.

As I discuss potential solutions, I want to emphasize that we believe that this should be a time for re-envisioning the tax system as a means to promote retirement security, not for retrenchment.

Reforms that could help increase savings in the short-term under existing plans

- Expanded and refundable Saver's Credit: The Internal Revenue Code currently includes a Saver's Credit to encourage low- and moderate-income workers to contribute to a 401(k) plan or IRA. However, the credit is quickly phased out, and many low- and moderate-income taxpayers who do not pay income tax fail to qualify for the credit. Others qualify for a credit that is far too small to be much of an incentive to save for people living near the poverty line. There is a need to make the credit "refundable," which means that those at the lower-end of the wage spectrum who contribute to a retirement account would actually get a check from the government to put into their account. There should also be consideration of modifying the current phase-out provisions to make the credit a more powerful savings incentive for hard-working, moderate-income taxpayers. These ideas were generally endorsed by the Conversation on Coverage, a seven-year common-ground dialogue convened by the Pension Rights Center involving businesses, unions, financial institutions, consumer, and retiree groups.

- Reverse match: 401(k) plans currently permit an employer to make matching contributions for employees who contribute to a 401(k) plan. The problem is that people whose financial circumstances prevent them from contributing receive no employer contribution. Some experts have suggested that the 401(k) plan rules be modified to allow the employer to initially make a contribution to the plan for all participants (as a percentage of compensation) and then allow those participants who can afford to make contributions to match a multiple of the employer's contribution on a tax-deferred basis. (For example, if a 2:1 employee match was permitted, and an employer contributed three percent of pay, employees could contribute an additional six percent of pay, for a total contribution of nine percent.) This is an idea that should be on the table, if we are serious about wanting to expand the number of lower- and moderate-income taxpayers who receive benefits from 401(k) plans. As a minimum, such an idea should be explored for Simplified Employee Pensions (SEPs) to allow employees to match their employer's contribution on a tax deferred basis.

- Incentives for defined benefit plans. While some experts write off defined benefit plans as "dinosaurs," there are still millions of employees participating in these plans, and there are good reasons to find ways to preserve and encourage them. In defined benefit plans, employees are automatically enrolled, they do not have to make investment decisions, and the benefits are generally paid out at retirement as annuities that the employee and spouse cannot outlive. Employees bear neither investment nor mortality risk. Yet employers today prefer 401(k) plans because they are less expensive to fund and operate, and because they avoid contribution volatility due to market and interest rate fluctuations. The Conversation on Coverage developed a new type of simplified pension plan, the Plain Old Pension Plan[2], which could minimize funding volatility, and, thus, be attractive to both employers and employees. These types of plans should be encouraged, but there are rules under current law that would have to be changed to make them feasible. The Internal Revenue Code could also be designed to provide targeted tax incentives for small employers to adopt and maintain these simplified defined benefit plans. These ideas should also be discussed.

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[2] The Plain Old Pension Plan was designed to make it easy for small- and medium-sized employers to provide a straightforward defined benefit pension plan to their employees. The plan is a simplified career-average pension plan -- based on a benefit that can be as low as one percent of career earnings-- that provides a guaranteed stream of lifetime income to retirees while also providing predictable funding obligations for employers. The plan allows employers to provide generous past service credits for those employees who worked prior to the adoption of this plan. It also allows employers to give "bonus benefits" in years when the company is doing well – and then go back to a basic benefit in leaner years.

- Tax reform to limit leakage. One of the most serious and intractable retirement-savings problems for 401(k) plans and IRAs has been leakage: people withdraw the money in their retirement accounts before retirement. Under current law, experts are almost unanimous in identifying leakage as one of the most serious problems for low- and middle-income workers. Yet the main tax provision to control leakage is a 10 percent excise tax on certain pre-retirement use of retirement savings, which has served primarily as a steep and unfair additional tax on the poor and the middle-class, while doing little to actually control the problem. Thoughtful tax reform, however, can be used as a potent weapon against leakage. Congress could create voluntarily designated 401(k)s and IRAs that once designated could not be accessed prior to retirement—and use carefully targeted tax incentives directed at both employees and employers to encourage the use of such "lock-down" accounts. Moreover, the Saver's Credit itself might be locked down so that that the credit amount is not available until retirement. The design blueprint and rules for such accounts, and the creation of effective tax incentives for them, would present various challenges, but we think they are challenges worth undertaking.

Envisioning a better system

The Pension Rights Center, while examining short-term reforms, also is spurring a more comprehensive debate to envision a better system for future generations. The fact is that regardless of the amount of tax incentives provided to employees and employers, the end result is that coverage is still too low, people have not saved adequately, and benefits are not secure.

For this reason, the Center also believes that, while working to improve the current system, we should also begin to consider a new system on top of Social Security that covers everyone and that provides adequate and secure income. The question is, with the amount of money we are now spending now to encourage retirement savings, can we do better and create a system that ensures that all Americans can retire with adequate income?

To that end, the Center, along with the AFL-CIO, the Economic Policy Institute, the National Committee to Preserve Social Security and Medicare and the Service Employees International Union, launched a new initiative called Retirement USA to start the country dreaming big on the retirement front. This initiative now has 28 supporting organizations, including unions, retiree groups, and think tanks. We developed 12 principles that we think should underlie a new system and that borrow from the best parts of defined benefit plans and 401(k) plans. As a starting point, we all believe that any new private retirement savings program must build on top of an unreduced Social Security system. Social Security must be maintained and strengthened, because it is doing an unparalleled job of providing a basic foundation of income for retirees.

The key principles for a new system are:

(1) Universal Coverage. *Every worker should be covered by a retirement plan.* A new retirement system that supplements Social Security should include all workers, unless they already are in plans that provide equally secure and adequate benefits.
(2) Secure Retirement. *Retirement shouldn't be a gamble.* Workers should be able to count on a steady lifetime stream of retirement income to supplement Social Security.
(3) Adequate Income. *Everyone should be able to have an adequate retirement income after a lifetime of work.* The average worker should have sufficient income, together with Social Security, to maintain a reasonable standard of living in retirement.

Subprinciples for a new retirement system include shared responsibility – employers and employees should both contribute and the government should subsidize the contributions of lower-income workers. We also believe that pooled, professionally managed assets are key to a secure retirement, that there should be no leakage and benefits should be paid as a lifetime annuities. (The complete list of Retirement USA principles is attached).

These are not unreachable ideals, and there are many plans and proposals that we have looked to in developing our principles and ideas for a new system, both here and abroad. For instance, TIAA-CREF, the plan for academics and educators, has employer contributions, uses pooled investments, and pays out benefits as lifetime annuities. The Guaranteed Retirement Account, developed by Professor Teresa Ghilarducci and the Economic Policy Institute, requires shared contributions by employees and employers into accounts that would guarantee a minimum rate of return and benefits paid out as annuities. The ERISA Industry Committee has proposed a plan in which contributions would be pooled and professionally invested, there would be no leakage, and benefits would be paid as annuities. And, if we look to other countries, the Netherlands has an interesting model in which employees' savings are pooled and there is shared risk among employees and retirees – rather than all of the risks being borne by individuals or employers.

What differentiates most of the systems described above from proposals to simply incentivize individuals to contribute more to 401(k) plans and IRAs is that they require contributions to be pooled and paid out only at retirement in the form of lifetime payments. Most include employer and employee contributions and minimize the amount of investment and mortality risk shouldered by individual workers. All of these features would ultimately lead to the right system for this country.

We are not saying, get rid of the current system. No, let's fix it as much as possible. But we have to recognize the shortcomings of what we have and envision something better. While encouraging savings is a worthy goal, 401(k) plans are not a substitute for good secure pensions. Future generations of workers deserve a better private retirement system – one that supplements Social Security and that is universal, secure, and adequate.

I have been struck recently by news coverage of Steve Jobs. Just about every article I've read describes him as a "visionary thinker," someone who marched forward without looking at polls or consumer research and pursued his vision, and, in so doing, built a world-class company.

Today I am asking that we all try to become the Steve Jobs of retirement policy. We need to dream big to get where we need to be. While the economy is in turmoil, we must be even more creative in deploying our tax system and other mechanisms to meet the challenges of our workforce and our retirees. While the nation is focusing on making sure people have jobs while they are able to work, we can also start thinking of ways to make sure that people have a secure retirement when they become too old to work. After all, when people have adequate and secure retirement incomes they can continue to buy goods and services in their communities and nationally – and this can only be a boon to the economy.

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

Retirement**USA**

Working for a **Universal**, **Secure**, and **Adequate** Retirement System

Principles for a New Retirement System

Universal Coverage. *Every worker should be covered by a retirement plan.* A new retirement system that supplements Social Security should include all workers unless they are in plans that provide equally secure and adequate benefits.

Secure Retirement. *Retirement shouldn't be a gamble.* Workers should be able to count on a steady lifetime stream of retirement income to supplement Social Security.

Adequate Income. *Everyone should be able to have an adequate retirement income after a lifetime of work.* The average worker should have sufficient income, together with Social Security, to maintain a reasonable standard of living in retirement.

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Shared Responsibility. Retirement should be the shared responsibility of employers, employees and the government.

Required Contributions. Employers and employees should be required to contribute a specified percentage of pay, and the government should subsidize the contributions of lower-income workers.

Pooled Assets. Contributions to the system should be pooled and professionally managed to minimize costs and financial risks.

Payouts Only at Retirement. No withdrawals or loans should be permitted before retirement, except for permanent disability.

Lifetime Payouts. Benefits should be paid out over the lifetime of retirees and any surviving spouses, domestic partners, and former spouses.

Portable Benefits. Benefits should be portable when workers change jobs.

Voluntary Savings. Additional voluntary contributions should be permitted, with reasonable limits for tax-favored contributions.

Efficient and Transparent Administration. The system should be administered by a governmental agency or by private, non-profit institutions that are efficient, transparent, and governed by boards of trustees that include employer, employee, and retiree representatives.

Effective Oversight. Oversight of the new system should be by a single government regulator dedicated solely to promoting retirement security.

www.retirement-usa.org

Retirement Income Security After the Fall
Daniel Halperin

Adequacy of retirement income requires first that benefits be provided and adequately funded, second that accumulated funds be protected and third that distributions be deferred until retirement. In theory we rely on the so-called three-legged stool of Social Security, employer provided benefits and individual savings. However, for at least 40% of the workforce only the first leg, Social Security, really exists and it in and of itself is inadequate.[1]

The Center for Retirement Research has prepared a National Retirement Risk Index which shows that even if workers stay employed until 65 and utilize all their financial assets including reverse mortgages on their homes, 44% of retirees will not be able to continue their pre-retirement standard of living. This number rises to 61% if health care costs are considered and increases over time.[2] Thus, even before the market Fall, there were holes in the provision for retirement security.

In addition, the already challenged system for providing retirement income security was hammered by the decline in stock and other financial assets in 2008. Those employees with substantial accumulation in 401(k)s or other defined contribution plans are obviously worse off than they thought, many disastrously so. The sharp decline in the balance of 401(k) accounts, left

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[1]See generally Virginia P. Reno and Joni Lavey, Social Security and Retirement Income Adequacy (National Academy of Social Insurance May 2007) (hereinafter Reno).

[2] Alicia H. Munnell, Francesca Golub-Sass, Mauricio Soto and Anthony Webb, Do Households Have A Good Sense of Their Retirement Preparedness? 1 (Center for Retirement Research (August 2008)

employees, particularly older employees, wondering how they would finance their retirement.[3] *We need to focus on whether it is possible to offer this group greater protection against similar events in the future.* The possibility of large losses has also focused more attention on whether balances were adequate to begin with and will be preserved for retirement.

Employees lucky enough to be participating in defined benefit plans would seem to have dodged a bullet but this is not necessarily so. The employer may have suffered both a business downturn and a significant decline in plan assets putting the plan in jeopardy.[4] A bankruptcy filing may endanger even already accrued benefits for higher income employees above the limits insured by the PBGC.[5] Further, employers suffering a meltdown may be inclined to freeze or terminate a plan resulting in substantially lower benefits than expected.. The requirement that investment loss generally be made good over 7 years contributes to the employer's distress.[6] *We need to consider whether the risk of termination and the potential benefit loss when termination occurs can be mitigated.*

The financial market disaster has not directly affected the retirement security for, perhaps the 60% of the work force who had little or no pension accumulation to begin with. The problem

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[3] See Big Slide in 401(k)s Spurs Calls for Change, Wall Street Journal January 8, 2008 at A1

[4] Alicia H. Munnell and Dan Muldoon, Are Retirement Savings too Exposed to Market Risk 3 (Center for Retirement Research (October 2008). Many employers have eliminated section 401(k) match.

[5] In 2008 the maximum benefit insured by the PBGC is $51750 for those claiming benefits at 65; less for those claiming at younger ages.

[6] See generally, Alicia H. Munnell, Jean-Pierre Aubry and Dan Muldoon, The Financial Crisis and Private Defined Benefit Plans (Center for Retirement Research November 2008).

of achieving adequate security for this group, which relies nearly exclusively on Social Security remains. Social Security, however, may be in more difficulty to the extent that the unprecedented size of the near term federal deficit forecloses some options for solving the pre-existing disconnect between promised benefits and projected funding.

Do these events suggest modifications in this system? *Would it make sense to aim for more adequate benefits for at least the lower income through Social Security? Is this achievable? If not, is it feasible to create another tier of retirement benefits between Social Security and employer-based plans? Would participation in such a program be voluntary or mandatory and where would the funds come from? Finally, if none of this works, is it possible to increase the viability of employer-based plans for the lower earning 40%? If this requires a government subsidy, what form should such a subsidy take and is it affordable?*

The questions raised in the prior paragraph are not new. They have plagued us for a long time. However, now that the vulnerability of all aspects of the employer-based system has been more exposed, these questions take on a greater urgency. Before turning to them however, I will consider the issues, raised above, which are directly related to the financial crisis. Since there is no obvious cure, in the end I raise more questions than I supply answers.

I Investment Risk in Defined Contribution Plans

Even if contributions are sufficient, benefits could be inadequate because of excessive fees or disappointing earnings. Unhappy investment returns could come from three sources. One, the employee makes unwise decisions, perhaps, taking on too much or too little risk or not sufficiently diversifying, possibly by putting too many eggs in employer stock. Second, even for identical investment strategies, the employee may have the bad luck to be born in the wrong year, retiring when the market is down or when a decline in interest rates makes annuities more expensive. Third, the market is just too risky and uncertain for even seasoned professionals to produce returns which would provide a decent retirement in all circumstances. Can steps be taken to protect employees participating in defined contribution plans **against investment risk.**

A. Lack of competence

Allocating the responsibility for investments to a large share of the population, many of whom lack training and education, seems even crazier than all of us pumping our own gas. Some, of course, have a greater taste for individual responsibility than I do, but, at a minimum, defined contribution plans should be required to offer, perhaps as a default option, a managed account perhaps allowing the employee to set certain parameters such as high and low retirement income targets and taste for risk.[7] In any event, it seems sensible to impose some responsibility on the employer to make educational materials available and perhaps to monitor choices that are clearly inappropriate for the particular employee.

B. Cohort Rule

As Gary Burtless has shown similar investment and retirement strategy can lead to vast differences in replacement rates depending upon the state of the market and the cost of annuities in the year of retirement.[8] Life cycle funds are apparently intended to mitigate this risk. We need

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[7] See Retirement Engine Rebuilt Harvard Magazine January February 2009 (interviewing Robert Merton about SmartNest). See also Regina T. Jefferson, Rethinking the Risk of Defined Contribution Plans, 4 Fl. Tax Rev. 607, 636 (2000)

[8] See Alicia H. Munnell, Anthony Webb and Golub Sass, How Much Risk is Acceptable? 4 (Discussing Burtless' work). (Center for Retirement Research (November 2008) (hereinafter CRR)

to understand how well they worked in the present crisis and whether improvement is possible.

While employees as a group cannot earn more than the market, a possible goal could be to even out returns so that less depends upon the year one happens to retire. Perhaps, traditional defined benefit plans operate in this way. Apparently, the reduction in salaries, which occurs when employers sponsor a plan, reflected the contributions required based on projected returns from plan investments (not the higher cost of a risk-free return) even though the employee had not accepted a market risk. I am not an expect on investment, but just to think out loud for a moment, would it be possible to devise an instrument which averaged market returns over cohorts so that each group gets the benefit of the "long run" market return rather than the return during the period of their working life? Could a private entity manage this risk or would it require a government agency?

C. Uncertainty of Returns

If the market over time is just too risky, risk can be avoided by opting for guaranteed returns. But, up to now, at least, the conventional wisdom is that fixed returns will result in lower (presumably inadequate) retirement income. Does the market fall suggest that the conventional wisdom needs to be rethought?

It would seem theoretically possible to guarantee some minimum return, in excess of a risk free rate, to employees who follow certain restrictions on investments and give up some upside potential. However, Munnell assumes a guaranteed return would require government involvement and could not exceed 3%, which would approximate the return on Treasuries.[9]

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[9] See CRR supra note 8 at 5 and footnote 12. See also Regina T. Jefferson, Rethinking the Risk of Defined Contribution Plans 4 Fl. Tax Rev.607, 649-69 (2000); Hearings before House Committee on Ways and Means 107th Cong. 2d Sess. (February 26, 2002 Serial # 107-66).

Others seem to agree.

One possibility is to make it easier for employees participating in defined contribution plans to initially invest in annuity contracts. If insurance companies could invest without restrictions perhaps competition would require that they guarantee rates which would be reasonably equivalent to market results over the long term. Again it may be that the reserve requirements for insurers issuing fixed annuities are such that companies cannot offer much more than a risk free return.

It is noteworthy that the PBGC, in the case of a defined benefit plan, does insure investment results. While in a traditional defined benefit plan, the PBGC most significantly provides protection for past service liabilities which were not yet required to be funded, in a plan, such as a cash balance plan, which has no past service liabilities, inadequate investment returns would seem to be the primary reason for an asset shortfall. However, protection against investment risk in defined contribution plans may create a moral hazard, which could be more pronounced than in a defined benefit plan, where the employer assumes the initial responsibility for promised benefits.

II ***Market Impact and DB Plans***

At one time, most pension arrangements were what we refer to as defined benefit plans. Under these plans the employer promises to pay a specified benefit and bears the investment risk. The most common type of defined benefit plan is one based on a percentage of final pay

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For a discussion see Marie-Eve Lachance & Olivia S. Mitchell, Guaranteeing Defined Contribution Promises: The Option to Buy Back A Defined Benefit Promise, NBER Working Paper 8371 *available at* http://www.nber.org/papers/w8731 (averaged over a period such as 3 years) for each year of service.[10] Thus, an employee with a full career with one employer is assured that her pension will substantially replace her final pay regardless of the rate of salary increases or inflation during her career.[11] Moreover, if funds are insufficient, for any reason and the employer is unable to pay, a federal agency, the Pension Benefit Guaranty Corporation (PBGC), guarantees most benefits in these plans.

The number of traditional defined benefit plans has been declining for some time.[12] It seems likely that a financial downturn, particularly given the more stringent funding requirements enacted in 2005 (modestly adjusted in December 2008), would accelerate this trend. Some employers will switch to defined contribution plans or perhaps cash balance plans. If this occurs the actual benefit for the period of participation in the plan could be considerably less than the employee is anticipating. This is so because a large portion of the benefit from the plan accrues in the last years of service. Even moving to another employer with a traditional defined benefit plan, which would be the best result for the employee, would be insufficient to make up the difference.

Thus, under current law on termination or freeze of a traditional defined benefit plan or separation from service while participating in such a plan, the employee's benefit is based upon

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[10] See Lawrence A. Frolik and Kathryn L. Moore, Law of Employee Pension and Welfare Benefits (2d edition 2008)

[11] Plans often do not protect against post retirement inflation

[12] In addition to investment risk, employers may be concerned about increased administrative costs (including actuarial calculations), the volatile impact of plan liabilities on the financial statements and the liability for unfunded past service benefits upon plan termination.

her salary at the time of the event rather than her projected salary at the time of retirement. Therefore, employees participating in a number of traditional defined benefit pension plans over their career would receive significantly lower benefits than they would have received from continuous coverage under a single plan. Workers who remain with a plan receive benefits related to earnings just before retirement, but employees who switch jobs, say, every ten years would find that their pensions were based on a combination of earnings at ages thirty-five, forty-five, fifty-five, and sixty-five, for example. Thus, mobile employees face a serious loss of benefits under a traditional defined benefit plan, and this loss of benefits takes on greater importance as job mobility increases.[13] The seriousness of the problem further increases when plan terminations (or conversion to cash balance) and plan freezes become more common.

The benefit from a defined benefit plan could be based upon earnings over the entire career of the employee. In that case, even though accrued benefits are earned disproportionately later in life, if an employee participated in such a plan for her entire career, her benefit would not be affected by a change in jobs. However, if the employee changes jobs and the new employer has a plan with equal percentage contributions regardless of age, or if the original employer converts to such a plan, the employee will be worse off than she would be if she had participated in either type of plan for her entire career.

Plan change or separation from service does not necessarily entail a loss of benefits if (as in a traditional defined contribution plan) the employer makes equal contributions as a percentage pay for each employee and the accrued benefit is based on the account balance. Thus,

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[13]See Alicia H. Munnell and Steven A. Sass, The Decline of Career Employment 2 (Center for Retirement Research September 2008)

the impact of termination of a traditional defined benefit plan or separation from service when participating in such a plan could be alleviated by revising the method of calculating the accrued benefit in these circumstances to make the benefit more consistent with the concept of equal contributions.

It is worth noting in this regard that one option for determining the maximum deduction for contributions to pension plans is to calculate the amount required if equal amounts or equal contributions as a percentage pay were made over the remaining future service for all employees.[14] Employer contributions may follow this approach. If the accrued benefit under the plan was also based on the amount that would be accumulated (at the assumed investment return) if contributions had been an equal percentage of pay, an employees benefit for a particular year of service would not be affected by plan termination or separation from service.

The problem of mobile workers and plan termination could also be mitigated by requiring that the accrued benefit for a terminating employee reflect the projected earnings at the normal retirement age rather than earnings at the time of termination. In that case, the affected employee would not suffer a loss of benefits. However, projected earnings would be difficult to estimate, particularly if individual circumstances had to be taken into account. Alternatively, although this offers less protection, we could require the benefit paid to a terminated employee to reflect current salary indexed only for expected inflation, not real salary growth.

However, one of the motivations for establishing pension plans is to reduce turnover and retain skilled workers. Increasing benefits for terminated employees, under the two approaches just suggested, would interfere with this goal. It would also increase employer cost, unless

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[14] IRC§404(a)(1)(A)(ii)).

benefits for long service employees were reduced. This may significantly reduce the employer's incentive to establish the plan.

III. ***Funding***

The Pension Protection Act (PPA) tightened the funding requirements for defined benefit plans most significantly for this purpose requiring than any funding shortfall (caused by a decline in the value of assets) be made up over seven years.[15] This requirement may accelerate and increase the rate of decline of defined benefit plans.

As I understand it, the Administration approach, which led to this rule (cite), was based on the idea that pension plans as financial intermediaries should not take investment risk. Accordingly, it would be best if plans invested in long-term debt with maturities that matched the benefit obligation. Therefore, if a plan chose to invest in equities, it would be best if it made good any losses immediately. FASB has so required for balance sheet accounting but not yet for income statements.(cite)

At least based on past performance, if the Treasury's model were followed, it will lower the investment return making the plan more expensive, likely causing wages and salaries to be further reduced. It would suggest that for most employees the large bulk of their investment portfolio should be in debt instruments with a consequently lower expected standard of living. Query if this is what investment advisors would suggest, even following the fall.

The Treasury's concern was presumably the potential vulnerability of the PBGC in the event the employer is unable to pay. The PBGC effectively insures asset shortfalls caused by two

[15] Internal Revenue Code §430 Pension Protection Act of 2005.

types of events. First, when the funds have not yet been contributed to the plan, which can occur because 1) the minimum funding requirements allow for so-called past service benefits to be funded over time, [16] 2) the employer received a funding waiver or 3) the employer defaulted on its funding obligation. I would assume that the first reason is by far the most important.

The second insured event is actuarial error which I assume is primarily investment performance. There is no easy way to allocate this risk. It seems sensible for employers to have an extended period to remedy shortfalls in investment performance. However, given the nature of a defined benefit plan and the assumption that the investment risk be absorbed by the employer not the employee, the employer should be liable for any shortfall should the plan terminate before the deficiency is made up. If this discourages employers from establishing defined benefit plans, it means such plans are just not viable and we have to turn our attention elsewhere.

The hard question is who should bear the loss if the employer is unable to pay. Should it be the employee or the PBGC? The dilemma is that if the PGBC is to be responsible, there will be pressure for more immediate funding which could lead to plan freeze or termination. It is at least possible that employees as a whole could in the long run be better off by absorbing some of this risk. A possible compromise is to provide PGBC protection only as to the shortfall that would exist if funding is relatively rapid.

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[16]I have maintained for over 30 years, tentatively, at first, that the PBGC should not insure benefits that have not yet been required to be funded. I don't appear to have persuaded anyone, but that is not our concern today. Daniel I. Halperin, Retirement Security and Tax Equity: An Evaluation of ERISA XVII B.C. Ind. & Comm. L. Rev. 739, 777 (1976).

IV Improving Coverage and Retirement Benefits

A. Social Security

About one-third of the elderly gets at least 90% of their income from Social Security. And 60% get more than half.[17] In fact, pension benefits account for only 4% of the income of the lowest 20% of the population and only 7% for the next 20%.[18] However, even low income retirees will rarely be able to maintain their pre-retirement standard of living based on Social Security alone[19]. Further the replacement rate from Social Security is being reduced by the increasing income tax burden, the additional cost of Medicare Parts B and D and, for those who do not adjust their date of retirement, by the postponement of the age for full benefits from 65 to 66 and eventually 67. The replacement rate for the median employee retiring at age 65 which was 39% in 2002 will decline to 28% by 2030.[20]

Increases in the minimum Social Security benefit at least for low earners is the best approach to this problem. An increase for low earners has been recommended by many, including the members of the Social Security Commission appointed by President Bush[21] and by Peter Diamond and Peter Orszag.[22]

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[17] Reno supra note 1 at 6.

[18] Id. at 7

[19] Id. at 2

[20]CRR supra note 8 at 1

[21] President's Commission to Strengthen Social Security, Strengthening Social Security and Creating Personal Wealth for All Americans 120, 132 (2001)

[22] Saving Social Security 99-103 (Brookings 2004)

If the barrier to improving Social Security is money, repealing or significantly limiting the tax subsidy for employer based plans and IRAs and dedicating the money to Social Security would increase retirement security.[23] However, this step is not politically realistic. Moreover, funded arrangements have the advantage of increasing savings as opposed to Social Security which is likely to be significantly on a pay as you go basis.

B. Additional Mandatory Coverage

Bridging this gap between Social Security and adequacy will require another layer of mandatory retirement income, at least for the *really* low-paid workers. Over the years, there have been proposals for mandatory employer contributions to retirement savings. While this would increase retirement benefits, it would likely result in a reduction in wages. Since the contribution is mandatory, aside from situations where the minimum wage applies, employers should be able to eventually reduce wages by close to the amount of the required contribution. Reduction in current wages for workers who are already struggling to make ends meet may not be wise for many employees, particularly at certain points in the life cycle. It is not clear therefore that mandatory contributions for all is a good idea unless they are fully subsidized.

Therefore, I believe that the only sensible way to improve retirement benefits for low-income households is to increase their lifetime income through some redistributive device which would enable low-income workers to have more retirement income without a significant cut in their wages during their working years. This could take the form of direct government contributions to individual accounts under Social Security (in addition to the current level of

[23] Daniel Halperin, Special Tax Treatment for Employer-Based Retirement Programs: Is it "Still" Viable as a Means of Increasing Retirement Income? Should it Continue? 49 Tax L. Rev. 1, 49 (1993)

contributions) or tax credits for 100% of the contribution to mandatory privately funded arrangements.

In 1999 President Clinton's proposed universal savings accounts (USA) which would have provided direct contributions to individual accounts for the low income without any additional savings effort on their part. In addition, the proposal called for matching grants equal to a percentage of contributions for workers who had somewhat higher income.[24]

Theresa Ghilarducci has proposed universal Guaranteed Retirement Accounts for all workers[25]with an annual contribution of 5% of pay. A $600 refundable tax credit would cover the entire contribution for those making $12,000 per year or less.

C. Employer Plans

In 1993,[26] I asked these questions relating to "Special Tax Treatment for Employer-Based Retirement Programs:" One) "Is it "Still" Viable as a Means of Increasing Retirement Income? Two) Should it Continue? (Still was in quotes to suggest maybe it never had been) The problem, is that employer pension plans cover only about one-half of workers at any one time, with the uncovered coming disproportionately from the lowest paid. After considering the potential for expanding the coverage of employer-based plans, I concluded that repealing the tax subsidy for

[24] See Daniel I Halperin and Alicia H. Munnell, Ensuring Retirement Income for All Workers in William G. Gale, John B. Shoven and Mark J. Warshawsky (editors), The Evolving Pension System 155, 180-1 (Brookings 2005).

[25] She provides an exception for those participating in equivalent defined benefit plans but given the potential loss of benefits by participants in such plans who are not covered by the plan until normal retirement age, as discussed below, I am not sure excluded employees would get equivalent coverage.

[26] 49 Tax L. Rev 1

employer based plans and dedicating the money to Social Security would be a great step forward. If this were impossible, I recommended we retain the employer-based system because, as flawed as it is, it is likely to provide more retirement protection than alternative use of the funds.

Obviously, the system could be improved. I examined this question 10 years later in Employer- Based Retirement Income-"The Ideal, The Possible and the Reality"[27] Unfortunately, the conclusion was that with respect to the goal of universal coverage`the **reality** (and perhaps the **possible**) of employer-based plans was a long way from the **ideal.** Can we do better?

Full replacement of retirement income requires that employees participate, that the benefit levels be adequate and that benefits be preserved for retirement. This requires that more employers establish plans, that existing plans cover more employees and that the plan actually provide retirement benefits to the employees who are ostensibly covered.

To meet this goal, plans should be required to cover all employees in lieu of present law which allows a significant disparity between coverage of the high and low paid. In addition benefits once earned should be non-forfeitable.

Even if the discrimination rules were thus tightened, there remains the issue of employees not electing coverage even though they are given the opportunity to do so, as under section 401(k). If we were writing on a clean slate, elective plans are probably not a good idea but it does seem impossible to reverse direction. In 2006, however, Congress facilitated the adoption of a default option calling for automatic deferral in 401(k) plans unless the employee elects otherwise. President Obama would require automatic enrollment in all section 401(k) plans. Still, it would be best if elective contributions were allowed to employer plans only if significant non-elective

[27] 11 Elder Law J. 37 (2003).

contributions are made for all eligible employees. Similarly it would help to require employers (perhaps over a certain size) to provide automatic payroll deductions for contributions to IRAs unless the employee opts out.[28] President Obama has so proposed. Evidence clearly shows the power of inertia; significantly more employees chose to save when it occurs without any action on their part.

Further, we should reduce the opportunity to spend retirement savings for other purposes. We now impose a penalty on most withdrawals before 591/2. Additional exceptions as President Obama has proposed are unwise. Ideally, distributions should be prohibited before retirement and should be payable in the form of an annuity or periodic payments over the life expectancy of the employee and her spouse. This would also reduce the opportunity to outlive the pension. If this is not possible, particularly on separation from service, at the very least, any other distribution should be placed by the employer in an IRA in the hope that inertia will significantly reduce the likelihood these funds will be spent. Universal IRAs or 401(k)s which are not employer-based seem less likely to be spent when job change occurs.

In addition, we must preserve the real value of pension benefits against inflation. Even at 3 percent inflation, the real value of a nominal benefit declines nearly in half after twenty years. Twenty years is approximately the life expectancy at age sixty-five. At a minimum, all plans should be required to offer the option of an inflation-indexed annuity

Finally, as noted above, it is important to provide for more protection against market decline and against loss of expected benefits on plan termination and job change.

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[28] J Mark Iwry, and David C. John, Pursuing Universal Retirement Security Through Universal IRAs in Peter R. Orszag, J Mark Iwry and William G. Gale editors, Aging Gracefully 45 (The Century Foundation Press 2006)

These changes would likely increase coverage in plans that continue to exist. However, even under the more lenient rules now in force, many employers are unwilling to establish retirement plans. Moreover, these proposals would undoubtedly discourage new plans and could lead to the termination of some existing plans. We need to do more to encourage employers to establish plans.

As described below, the tax incentive to participate in these plans is greatest for the higher paid who need the incentive the least. In recognition of the fact that the low income individuals would be unlikely to respond to tax incentives, we have a nondiscrimination test for tax favored qualified plans. In theory at least, if the higher income wish to take advantage of the tax subsidies provided to employer based plans, the plans must cover some lower paid individuals as well. There is however a problem with this approach which explains why it works so poorly.

If lower wage earners do not value retirement savings enough to accept a wage cut, the plan will not be affordable unless the value of the tax benefits for those at higher income levels is sufficient to fund the additional cost of covering the lower income. Such use of the tax benefits detracts from the advantage to the higher paid. Further, the more we require coverage of the lower income, particularly while putting limits on benefits for the higher paid, the less likely that higher income can benefit from the plan If the higher paid do not benefit, a plan is not likely to exist.. We need to provide lower earners with a greater incentive to participate or eliminate the required coverage of the lowest earners. Only in this way can we make tough discrimination rules viable.

If low-earning workers are provided with adequate Social Security benefits or are covered by a government-financed supplementary retirement system which results in full replacement of pre-retirement earnings, as described above, employers need no longer be required to include these individuals in their plans. Furthermore, if this approach provided additional benefits for workers earning at the next level, it would reduce the amount that employer pension plans would have to provide for these workers to achieve full replacement of pre-retirement earnings. If these changes are made, employer-sponsored plans may become a more viable option for providing for employees somewhat higher up the income scale, who may be willing and able to contribute to their coverage.

But to be successful it is probably necessary to offer a tax incentive which would actually make saving less expensive for the lower income. This would be particularly important if we do not otherwise provide for the lowest income through the addition layer of savings discussed above.

While this is sometimes not well understood, employer-based qualified plans offer two potential advantages- No tax on investment earnings and the possibility of having your compensation taxed at lower rates at retirement compared to the rates that would be applicable when compensation is earned. The former will offer a significant benefit to taxpayers subject to a 35% marginal rate. For the low income who have the most difficulty saving, there may be little or no benefit.

The exemption for investment earnings, which is the primary advantage, allows the benefit to accumulate at the pre-tax, rather than the after-tax, rate of return. Thus, if the employee is not subject to income tax, there is no advantage to the qualified plan A tax credit for low income individuals could be designed to at least approximate the benefit available to those in the highest bracket.

The Savers credit now provides a credit for as much as 50% of the first $2000 of employee contribution to an IRA or elective (including by default) deferrals to a 401(k) plan.[29] Since this reduces the out-of-pocket cost for a given amount of contributions, savings would be more likely to occur. However, the 50% credit is for the most part an illusion. Most of the individuals eligible for a credit at that level have little or no income tax liability. In fact, in 2005 only one in seven of the eligible income group actually paid income taxes and less than 1 in 1000 paid enough tax to take advantage of the maximum credit.[30] For the credit to work, it has to be made refundable and the cliff which reduces the credit to 20% with an additional dollar of income must be replaced by a gradual phase-down of the maximum credit. Of course, the savers credit would have to be coordinated with any new tier of mandatory benefits.

President Obama has proposed a refundable credit of 50% of contributions up to $500 per individual or a maximum credit of $250 per person. This focuses the incentive on the lowest earners which makes sense in the absence of another layer of retirement savings in the manner suggested above.

Hopefully these measures–including more stringent participation requirements and an effective tax credit which reduces the cost of savings–will achieve greater participation by the lower income in employer plans.

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[29] IRC Section 25B

[30] Peter R. Orszag, Introduction Common Sense Reforms to Promote Retirement Security in Peter R. Orszag, J Mark Iwry and William G. Gale editors, Aging Gracefully 11 (The Century Foundation Press 2006)

D. Paying for a subsidy

Of course a more attractive credit costs money. The obvious source would be to limit the benefit for qualified plans but an overall curtailment is probably not viable. Still some funds could be raised by eliminating savings incentives which make little sense.. In 2006 Congress made permanent the increase in maximum contributions to qualified plans, 401ks and IRAs. It also allowed employees of tax exempt entities to double tax preferred savings by utilizing plans under section 457(b). Congress also made permanent the ability to make contributions to Roth 401(k)s which, along with Roth IRAs, effectively increase the amount of savings which can be accumulated tax-free.[31] Conversion of traditional IRAs to Roth accounts, allowed by the 2006 legislation to individuals at all income levels beginning in 2010, similarly increases the amount of savings which can be accumulated in subsidized accounts.[32] In the long-run this conversion opportunity is also extremely expensive despite the claim of a revenue gain during the budget window. The Roth alternative should be eliminated. If not, the provision allowing conversions by the higher income starting next year should not take affect. At the very least, conversion of a balance derived from nondeductible contributions to traditional IRAs should be prohibited.

Since only a relatively few take advantage of the maximum contribution, these measures will just reduce the tax savings of the well off without for the most part decreasing savings which would not otherwise occur. In contrast, incentives focused on the low income who are not currently saving, such as improving the Saver's credit will actually increase national savings.

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[31]Daniel Halperin, I Want a Roth IRA for Xmas Tax Notes December 21, 1988 at 1567

[32]Daniel Halperin, Fun and Games with the Roth IRA Tax Notes July 10, 2006 at 167.

The maximum level of benefits in qualified plans can also be reduced by changes in the so-called combined plan rules. The Internal Revenue Code limits contributions to defined contribution plans and the level of benefits that can be provided by defined benefit plans. An employer is allowed to have both a defined contribution and defined benefit plan up to the applicable limit. As currently interpreted these rules make no sense. As I understand it, the idea was to allow an employer to have both a defined benefit plan which benefitted older workers and a defined contribution plan which called for equal percentage contributions for all. Further, alternative limits make some sense because it would be difficult to apply a benefit limit to a defined contribution plan when the accrued benefit depended upon the account balance and hence the investment performance. Similarly, it is impossible to limit contributions to a defined benefit plan since the employer is responsible for providing the promised benefits regardless of investment performance.

However, in practice these rules have not worked as envisioned. For example, a cash balance plan is a defined benefit plan described in terms of contributions and a hypothetical account balance. Therefore, applying a benefit limit to such plans is not straight forward. Further, since both a defined contribution plan and a defined benefit plan can be tested for discrimination on the basis of either promised or projected benefits, both plans can favor older workers. This makes no sense particularly in the case of a closely held business. If an employer has two plans, one should be tested on the basis of contributions.

In fact, equal contributions **as a percentage of pay** should be required in any plan in which business owners, or perhaps, certain very highly compensated employees are entitled to a very substantial part of the accrued benefits. Such plans are often adopted when the principal owner is older and the supporting staff is much younger. Furthermore, an owner may have sufficient control over the age and tenure of the work force to minimize the cost of a plan, notwithstanding the generous amount she, herself, receives. These plans also represent the greatest risk of plan termination before younger employees will earn significant benefits. In short, they contribute little to retirement security and just waste revenue.

Senate Finance Committee Hearing
"Tax Reform Options: Promoting Retirement Security"
September 15, 2011
Questions for Karen Friedman, Pension Rights Center

<u>**Questions from Senator Max Baucus**</u>

1. **Workers are being required to shoulder more and more of the burden of retirement savings as employers are terminating or freezing their traditional pension plans. With this increased burden comes a need for more knowledge of the importance of saving, how to save, and how to manage the assets that one has saved.**
   a. **Are workers being provided enough information as to the need for retirement savings and how to manage their savings?**
   b. **If not, who should provide that education? Are there changes that should be made to the Internal Revenue Code or other laws (such as ERISA) that would encourage employers to provide more financial education to their employees, or is that something that should be provided elsewhere?**

While we believe that workers should be as educated as possible about their 401(k) plans, education alone is not going to be enough to overcome the structural deficiencies of these do-it-yourself savings plans. The fact is, 401(k) plans place all the risks and responsibilities on to workers, who then have to decide how much to contribute to the plan, how to invest the money, and then how to make the money last. Even sophisticated investors have made mistakes in investing their money – and simply knowing about investing would not have changed the impact of the Great Recession on account balances. Also, millions of workers who are struggling to keep their jobs and address the enormous challenges of daily living cannot be expected to be investment experts – nor do we think they should be. That is why there should be efforts to spawn new forms of retirement plans that are professionally managed and that share risks and responsibilities among employees, employers, and the government.

Private employers, financial institutions, consulting firms, and organizations, such as the American Savings Education Council and the Center for Retirement Research, and federal, state and local governments have already spent millions of dollars on financial literacy campaigns. However, there is little data to show that these efforts have succeeded in getting people to save, invest more wisely, or otherwise significantly improve their prospects for retirement.

From our perspective, the federal government should be using its scarce resources to develop and enforce regulations that protect plan participants and to introduce programs that will improve retirement security more directly than financial literacy campaigns.

For example, on the 401(k) front, the Department of Labor should have the resources it needs to enforce its new regulation on fee disclosure, which requires that retirement savings plans, such as 401(k)s, provide information about the plan's investment options, and tell account holders how much they are being charged in record-keeping, investment management, and other fees. The DOL should be given the necessary resources to ensure that employers are complying with this important regulation. The DOL should also be directed to develop additional model notices and revisit notices already written to ensure that employers are delivering this kind of useful information to participants.

Also, if Congress is interested in promoting true financial literacy, we believe that it should not focus simply on the importance of saving, asset allocation, and compound interest. A true financial literacy agenda should also educate consumers about the information they need to enforce their rights under the law – to protect themselves in both defined benefit pension plans and 401(k)-type plans. Here are items that we believe are key to such an agenda:

- Employees should be able to reasonably rely on information given to them about their plans in their summary plan descriptions (SPD) and individual benefit statements. If there is a discrepancy between the legal plan document and the SPD or benefit statement, a participant should be able to rely on the documents that are given to them by the plan rather than the highly technical legal plan document that they ordinarily do not see. Benefit statements for 401(k) participants should include realistic estimates of the lifetime monthly benefit payments that the amounts accumulated in their accounts, as of the date of the statements, could provide at retirement age.
- In both 401(k) plans and defined benefit plans, people should be able to get their summary plan description and individual benefit statements by mail, unless they affirmatively opt to receive them electronically.

2. **According to the Investment Company Institute, there were $17.5 trillion held in employer sponsored retirement plans and individual retirement accounts as of the fourth quarter of 2010. These assets – nearly all of which benefit from a significant tax preference – are being held not only to cover the retirement costs of millions of Americans, but they will also be used to pay emergency costs prior to retirement and to pass on to beneficiaries after the death of the plan participant or IRA holder. Although there is generally a penalty for withdrawing retirement funds prior to retirement, there are many exceptions to this rule and not a year goes by without a proposal for a new exception to the penalty. And there are many Americans who are using tax-preferred savings as an estate planning tool. For example, most investment advisors tell their wealthier clients to use other assets before using tax-preferred retirement savings since it is advantageous to save the tax-preferred assets to give pass to their heirs. However, many Americans for whom this money is being held – and many Americans who will**

not have any retirement assets at all – are at risk of not having enough to have a comfortable retirement.

a. Is it appropriate to have tax incentives to accumulate money to pass to heirs?

We believe that retirement money should be used for retirement purposes only – for the retiree and his or her spouse or significant other. Congress conferred tax benefits on retirement plans because retirement is remote, making it difficult for most people to save for retirement in the face of more pressing immediate demands. Taxpayers should not be paying billions of dollars in tax incentives to help people build tax-advantaged estates for their descendants. Congress should encourage fair and transparent annuities with spousal benefits that would ensure that retirement money is not simply passed on to heirs.

b. Should there be more incentives in the Internal Revenue Code to save for other purposes?

If there is data to show that lower- and moderate-income individuals need additional tax incentives to save for specific non-retirement purposes, it may be appropriate for Congress to explore whether it should create new kinds of savings accounts for these purposes. As noted below, our concern is that if retirement accounts are used for other purposes, the money will not be there for retirement.

c. Should the existing retirement savings incentives be opened up more for other purposes?

No. Absolutely not. 401(k) plans get a hefty tax subsidy, because Congress recognized how difficult it is to save for retirement. Taking money from a 401(k) plan for other purposes will jeopardize Americans' already-fragile retirement security. With half of all retirees over age 65 currently receiving less than $16,500 a year in income, the country is already facing a retirement crisis. Allowing employees to use their 401(k) plans for additional non-retirement purposes will only make a bad situation worse.

3. Employees of federal, state, and local governments are usually covered by a traditional defined benefit plan, but they are usually required to pay for a portion of that benefit. For example, most federal employees pay 0.8 percent of their pay towards the Federal Employees Retirement System. Nearly all governments are facing significant budget shortfalls today and many are looking to employees to shoulder more of the cost of their benefit. An increasing number of private sector employers have made a business decision to terminate or freeze their traditional pension plans.

a. Should governments be doing the same?

Research shows that traditional defined benefit pensions are the most efficient way to provide retirement savings for workers in both the private and public sectors – and these plans, despite rhetoric to the contrary, can actually be provided at a lower cost overall than 401(k) plans. Even with today's economic turmoil, the vast majority of state and local pension plans have funding ratios that are comparable or better than plans in the private sector. And the problems are, in any event, temporary, attributable in large measure to poor stock performance and historically low interest rates.

Only a handful of states have serious problems, and these states are already taking steps to address their problems and enhance the overall sustainability of pensions in the long-term. It would be short-sighted and deeply unfortunate for both the states and their employees to terminate or freeze their plans and replace them with 401(k)-type plans, which will lead to insecure and inadequate income for millions of older Americans who have devoted their careers to serving the public.

b. Is it reasonable that government employees should have a more secure retirement than millions of similarly situated private employers?

We would ask the question in reverse. Why shouldn't private sector employees have an equally secure benefit to government workers?

It wasn't too long ago that most corporations provided their employees with good solid pensions, but, over the last decade, companies have increasingly frozen these plans or terminated them. Award-winning journalist Ellen Schultz has written a new book, *Retirement Heist*, which documents how companies have manipulated pension laws to use retirement funds for corporate purposes – to finance downsizings and restructuring deals, and to artificially pump up their bottom lines. Now many companies say that their plans are so underfunded that they have to cut the benefits of their workers and retirees, yet they continue to lavish out-sized pensions to top management. What is needed is a thorough reexamination of the current private system, and the creation of a new system on top of Social Security – one that is secure and adequate and benefits *all* workers.

c. Should government employees be asked to pay more for their retirement benefits?

Contrary to some news stories, the pensions paid to public workers are generally quite modest, just a little over $22,000 on average. And in many cases, public workers – such as teachers, firefighters and police officers – were attracted to doing their important work because they were promised a more secure retirement. Also, some public workers are not eligible for Social Security benefits, so their pension plan is not a supplement to Social

Security but rather a replacement for it. Frankly, we do not understand the argument that middle-class people who have been promised a reasonable but modest retirement benefit should now be asked to pay more or receive less, especially since the typical government worker paid into the system for years, even when the plan sponsor took funding holidays.

4. **The Internal Revenue Code requires that the amount saved be actually paid out once an individual reaches a certain age – now 70½. This requirement prevents many retirees from saving more of their account for their later retirement years. On the other hand, the rules as currently structured allow many people to pass large portions of their retirement savings on to their heirs, a feature the Wall Street Journal has called a "stealth tax cut for the wealthy."**

   a. **Should individuals with small account balances be relieved of the required minimum distribution rules?**

It is unlikely that those with small balances will be able to keep their money in as long as 70-1/2. The only ones to do so are probably the well-to-do, who have accumulated a range of other assets for retirement, and they may be keeping the money in their plans to build tax-free for estate planning purposes. In these cases, Roth vehicles, as has been documented by the *Wall Street Journal* and others, are particularly egregious offenders. They allow deferral until death and then further deferral for the lifetime of the account-holder's children or grandchildren. Deferring payout of 401(k) money only defers payment of taxes, which is counter-intuitive at a time when there is so much emphasis on solving the country's budget crisis. Of course, there will always be certain situations in which middle-income individuals would arguably be better served by permitting them to defer payout until after age 70-1/2, but we think these situations are uncommon and are not an issue that requires a change in the law.

If changes were to be considered, they should be limited to people with moderate incomes and moderate aggregate account balances. And Congress should repeal the special exemption that Roth vehicles currently enjoy from the minimum distribution rules. It is important to note that the rule does not generally require distribution from qualified plans for people over age 70-1/2 if they are still employed by the plan sponsor.

b. Should large account balances be required to be paid out faster than they are now?

We do not have a position on this, although we do believe that Roth vehicles should be subject to the same distribution rules as other plans.

5. The Pension Benefit Guaranty Corporation (PBGC) is facing a funding shortfall on the order of $23 billion. How should that shortfall be closed?

This would only be an immediate problem if the PBGC closed its doors tomorrow and had to pay off all its benefits at once, but this is not the case. While we recognize the deficit could be cause for concern, we don't want to induce panic among employees and retirees that the agency is going to go under and not pay their benefits. Actuaries estimate that $10 billion of the PBGC's deficit could be eliminated simply by a rise in today's historically low interest rates, especially if accompanied by an increase in the performance of investment assets. Moreover, the PBGC's deficit would be reduced if it used the same rules that are used to measure the liabilities of the plans that they insure. It is critical that the PBGC remain strong to protect people in defined benefit plans. In our view, the best way of helping to reduce the PBGC funding shortfall is to encourage new forms of traditional guaranteed plans and protect existing ones.

a. If premiums need to be raised, should Congress set the increase or is the PBGC in a better position to determine how to allocate the increase?

Congress should set the increase.

<u>Questions from Senator Michael B. Enzi</u>

1. Currently, our 401(k) and Individual Retirement Account (IRA) system allows individuals to choose between "traditional" and "Roth" variations. Has this and other retirement investment alternatives provided expanded options for individuals to save for retirement or has it made retirement investing too confusing?

For many Americans, the option of choosing between traditional and Roth vehicles has added a measure of confusion. We are also concerned that the Roth vehicle is being used primarily by relatively affluent individuals to reap extra tax benefits not available to most Americans.

Roth vehicles serve as an accounting gimmick for the federal government: they increase tax revenues in the near term but decrease aggregate tax revenues in the long term, saddling our children and grandchildren with more debt. We advocate eliminating Roth vehicles, or, at the very least, eliminating their exemption from the minimum distribution rules and ending the ability to convert traditional vehicles into Roth vehicles. These features do not contribute to retirement security and are useful primarily to affluent taxpayers engaged in estate planning.

As mentioned at the hearing, traditional 401(k) and IRA accounts are tax deferred. Eventually, the taxes are paid back to the government when the individual takes money out of the system. Under federal budget and related laws/rules generally only the first ten years' worth of savings/expenditures are counted. Since the deferred taxes on retirement savings are not paid back until years into the future any beneficial changes or expansion of traditional 401(k) and IRA accounts cost significant amounts of money. Should these laws/rules be amended to take into account the deferred nature of the taxes?

This is a complex issue, but, contrary to testimony at the hearing, the tax cost of plans is extraordinary, whether accounted for on a cash-flow basis or a present value basis.

One problem with a present-value accounting is that it is extraordinarily sensitive to the assumptions used on interest, tax rates, date of retirement, length of retirement, pattern of withdrawals during retirement, relative utilization of Roth vehicles, time of Roth conversions, rate of pre-retirement withdrawals, and other factors. The Department of the Treasury's Office of Tax Analysis provides both a cash-flow and present-value accounting of the tax expenditures associated with retirement savings vehicles. Significantly, the Treasury's present-value accounting results in a higher aggregate tax cost than the cash-flow methodology. The Treasury's present-value analysis also results in a considerably higher tax expenditure figure than the present-value figures presented to the Committee by another witness at the hearing. Given the discrepancy between the Treasury and the figure provided by the witness, we suggest that the Committee might want to undertake a thorough examination of the assumptions underlying each analysis.

Senator Kohl and I introduced the Savings Enhancement by Alleviating Leakage in 401(k) Savings Act of 2010, (SEAL Act), S. 1121, to help prevent retirement monies from leaking out of defined contribution plan accounts and not being replenished. What other items should we be considering to prevent leakage from defined contribution accounts?

We support the SEAL Act, which we think will at least modestly decrease leakage. As stated in our testimony, we think that consideration should be given to the idea of providing a tax credit or other tax incentive, or additional employer matching contributions, for "lock-down" accounts that cannot be accessed before retirement.

2. **At a recent hearing before the Committee on Health, Education, Labor and Pension on our nation's defined benefit system, it became apparent that the defined benefit system is unlikely to see a comeback. In fact of the Fortune 100 companies only 13 offer a defined benefit plan to their new employees. Business and their trade associations cite**

many reasons for this including volatility in the markets, stricter accounting rules adopted by the Financial Accounting Standards Board, more stringent funding requirements and the Administration's proposal to increase fees on companies sponsoring defined benefit plans by $16 billion. Since the defined benefit system is a voluntary employer-based system, can anything be done to change the system to make more businesses want to sponsor defined benefits plans? In light of the federal government's deficit, please assume that no new federal monies can be obligated to match or insure any private sector defined benefit monies.

We believe that there are good reasons to incentivize defined benefit plans – particularly in this uncertain economy. For seven years – from 2001-2007 – I directed the Conversation on Coverage (CoC), a common-ground dialogue aimed at developing new ways of expanding coverage. One of our working groups was devoted specifically to expanding coverage in defined benefit-type plans that addressed these employer concerns. The CoC developed and endorsed two new kinds of plans: the POPP (which is explained in my written testimony) and the GAP (the Guaranteed Account Plan), which is a hybrid type of plan similar to a DB-K. We support continued examination and expansion of these and similar types of plans.

3. **Earlier this year at a hearing before the Committee on Health, Education, Labor and Pensions, I put forth an idea to establish a multiple employer pension system to help small businesses band together to sponsor 401(k) plans and I am currently working on legislative language. What elements should be included in this legislative proposal to ensure that small businesses will adopt these plans? What current requirements/elements of 401(k) laws/regulations may be a hindrance in establishing multiple employer 401(k) plans?**

The Pension Rights Center supports the idea of developing innovative multiple-employer plans as a way of expanding coverage to employees of small businesses, and we applaud you for promoting this idea.

The Conversation on Coverage, described above, had a working group, Working Group III, that focused exclusively on expanding coverage among small employers. This group of diverse experts developed the Model T plan, which is a souped-up SIMPLE IRA that could be marketed as a multiple-employer plan.

One issue that continually arose in developing the Model T was how to remove fiduciary duties from small employers. This issue was a stumbling block because under ERISA an employer must prudently choose the financial institution to administer the plan and must make the initial selection of investment options, and then be responsible for ongoing monitoring of these options.

Working Group III addressed this issue by developing investment options that were simple (based on the default investment options approved by the Department of Labor). The Group believed limiting investment options will simplify choices, and, in so doing, help reduce the fiduciary burden on employers. The Group looked at the idea of transferring fiduciary duties to financial institutions, but was concerned that this could lead to conflicts of interest. Group participants then examined the idea of developing independent fiduciaries to address this issue, but were concerned about the difficulty of developing standards to truly ensure independence. The Pension Rights Center would be happy to reconvene a group of experts from the Conversation on Coverage to work with you on these types of issues.

<u>Questions from Senator Robert Menendez</u>

1. **Ms. Friedman, we hear a lot of talk around here about cutting spending, which appears to be a veiled synonym for entitlement cuts. The fact is, if we don't address our long-term fiscal challenges with a balanced approach there really is no option but significant cuts to retirement programs, Medicare, Social Security, that Americans believe in and increasingly rely upon. We saw the House Republican budget that, even with even with its radical transformation of Medicare to a private voucher program, couldn't make ends meet without an unrealistic assumption on domestic spending.**

   Your testimony references a lot of the research you've done on historical trends in retirement benefits offered to American workers. If changes are made to Social Security that lower the amount of financial security provided by the program to retirees, do you believe the trend in private sector benefits indicate to you a likelihood of increasing value to moderate that cut or is it more likely that seniors would simply have less income in retirement?

   There is no question that cuts in Social Security would decimate today's and tomorrow's retirees. Right now two-thirds of retirees rely on Social Security for 50 percent or more of their income in retirement, and one-third of retirees depend on it for nearly all their retirement income. And Social Security provides a bare-bones income: the average retiree receives only about $14,000 a year -- less than the annual income of a minimum-wage worker. Unfortunately, the trend in private-sector benefits is in a downward arc; the pension system is eroding, and 401(k) plans are not inadequate vehicles. Indeed, we are facing a retirement disaster.

   According to the Center for Retirement Research, there is a Retirement Income Deficit of $6.6 trillion in this country. The Retirement Income Deficit is the gap between what people have saved for retirement as of today and what they should have saved to meet a basic level of sufficiency in retirement. Cuts in Social Security benefits – even cuts that sound modest – will both increase that deficit and increase the misery of growing old. Little is happening with workplace retirement plans that could make up for such cuts.

Tax Reform Options: Promoting Retirement Security

Testimony Submitted to
United States Senate
Committee on Finance

September 15, 2011

William G. Gale[1]
Brookings Institution
Codirector, Urban-Brookings Tax Policy Center
Director, Retirement Security Project

Chairman Baucus, Ranking Member Hatch, and Members of the Committee:

Thank you for inviting me to testify today on tax reform options that promote retirement security. This hearing focuses on a set of issues that is both timely and important.

My testimony discusses a proposal that would reform public policies toward retirement saving by replacing the current deduction for contributions to retirement saving accounts with a flat-rate refundable credit that would be deposited directly into the saver's account. The proposal would (a) address long-standing concerns in the retirement saving system by improving incentives for most households to participate and by raising national saving, (b) offset pressures created by the current weak economy for households to reduce their retirement saving, (c) help solve the long-term fiscal problem facing the country by raising $450 billion over the next decade in a manner that is consistent with the principles of broad-based tax reform and distributes the fiscal burden in a progressive manner.

I. Introduction

Concerns with the adequacy and security of the retirement system in the United States are well-known and long-standing. Many households do not save for retirement, and many of those that do contribute too little, invest poorly, or withdraw funds early. These patterns leave households, and most particularly low- and middle-income households, vulnerable to insufficient savings to finance adequate living standards during old age and retirement.

A weak economy has exacerbated these issues. Unemployment in general (and long-term unemployment in particular) is exceedingly high relative to historical norms. Real wages have stagnated, housing prices have fallen far below previous peaks, and the stock market has grown more volatile. Each of these factors threatens to reduce the vitality of the retirement system—for

[1] The views presented are my own and should not be taken to represent the views of the Brookings Institution or the Tax Policy Center. I thank Samuel Brown, Ilana Fischer, David John, and Spencer Smith for assistance, Surachai Khitatrakun for model simulations, and David John and Donald Marron for comments.

example, by driving workers to stop participating in their 401(k) plans or IRAs, to contribute less for retirement saving, to invest more conservatively, or to withdraw funds early.

At the same time, the nation's medium- and long-term fiscal outlook is unsustainable, even with the recent debt-limit legislation. The retirement of the baby boomers, the aging of the population, and health care inflation will place increasing pressure on Social Security and Medicare (Auerbach and Gale 2011). Without reform, the Social Security trust funds will be depleted by 2036 (OASDI Trustees 2011) and will only be able to pay roughly three quarters of the benefits retirees have been promised. This will further weaken the retirement prospects of low- and middle-income households and make them more vulnerable to poverty in old age. As the Joint Select Committee on Deficit Reduction deliberates on medium-term budget options, consideration of reforms to strengthen the private retirement system would be appropriate and constructive, especially since any plausible long-term fiscal plan will involve some reductions in Social Security and Medicare benefits.

The Tax Policy Center estimates that the immediate, direct revenue loss associated with contributions to IRAs and 401(k) plans will exceed $1 trillion over the next decade, under current law. This figure is calculated as the product of contributions to such plans, multiplied by the marginal income tax rate applied to such contributions. It is presented to show the magnitude of the issue and the potential for revenue gain. It does not, however, represent a complete tax expenditure estimate for IRAs and 401(k) plans because it does not include the value of the tax treatment of accrued earnings (which would raise the figure) or the taxation of withdrawals (which would reduce the figure).

This paper offers a proposal to encourage additional retirement saving by converting the system of income tax deductions for retirement saving contributions to a system of flat-rate refundable credits, where the credits are deposited directly into the saver's account.[2] Stated simply, this proposal will make it viable for low- and middle-income households to increase their savings for retirement. The proposed reform has several notable features:

- The proposal would enhance the retirement saving system. By improving retirement saving incentives for the majority of households, the proposal would help address traditional concerns about take-up and usage of retirement saving vehicles.

- The proposal could help raise national saving. By promoting private saving among households in the middle and bottom of the income distribution (those least likely to sufficiently save) the proposal would encourage new contributions from precisely the type of households for whom 401(k)s and similar plans likely represent net increases in saving, rather than a re-allocation of saving that would have been done anyway. And, of course, deficit reduction would contribute positively and importantly to higher national saving.

[2] The proposal is similar but not identical to the one developed in Gale, Gruber, and Orszag (2006), with updated revenue and distributional figures provided. One major difference is that the current proposal maintains current contribution limits, while the earlier proposal reduced those limits.

- The proposal is timely. By improving retirement incentives for most households, it would help offset the pressure households face to reduce or eliminate their participation in retirement saving during a weak economy.

- The proposal is consistent with long-term deficit reduction and could raise substantial amounts of revenue: a reform that converted current deductions to a tax credit worth 18 percent of a taxpayer's retirement saving contributions would leave those in the 15 percent bracket unaffected. As discussed in more detail below, an 18 percent matching credit is the equivalent of a 15 percent deduction. Such reform would raise more than $450 billion in revenues over the next decade relative to current law.

- The proposal is consistent with principles of broad-based tax reform and reducing tax expenditures.

- The proposal is progressive. The proposal would help lower- and middle-income households significantly, decreasing their reliance on Social Security benefits as the primary source of retirement income, and it would distribute the benefits of retirement saving policy more equitably than the current system.

- In alternative version of the proposal, a 30 percent credit would be revenue-neutral for the next decade relative to current law and would be even more progressive. This reform would reduce taxes for 26 percent of the population (mainly in the bottom 90 percent of the income distribution) and decrease tax deductions for 6 percent of the population (largely in the top decile).

II. Background

Low retirement saving is not due to lack of eligibility for tax-favored retirement accounts. About half of workers are either enrolled in defined-benefit plans or eligible for 401(k) accounts through their employers, and almost all households can contribute to individual retirement accounts (IRAs). A principal explanation for low retirement saving is the lack of take-up—too many people fail to take advantage of the available tax-preferred retirement savings opportunities. Inadequate take-up, in turn, stems from two key factors: enrollment often requires people to act affirmatively, and some have little immediate financial incentive to enroll or contribute very much.

One reason people do not enroll in a 401(k) or IRA is that enrollment requires workers to take specific action to join. Furthermore, the plans sometimes present a difficult and confusing array of choices regarding investment allocations and other features, increasing the non-monetary cost of enrollment. Many people, as a result, procrastinate to avoid any decision, even though they recognize that they should save more. Thus, inertia tends to keep workers out of 401(k) plans and IRAs since participation usually requires an affirmative choice by the worker. The provision of automatic enrollment in 401(k) plans has helped to remedy this problem, and it has been further encouraged by features of the Pension Protection Act of 2006. Automatic enrollment in 401(k) plans has increased dramatically over the last decade, particularly in large plans (Beshears et al. 2008).

The extension of automatic enrollment to Individual Retirement Accounts would help expand participation further (Iwry and John 2006). A desirable policy goal would be to have every employer in the United States (with the exception of the smallest businesses) automatically enroll new workers in either a traditional defined-benefit employer pension plan, a 401(k)-type plan, or an IRA. Defined-benefit plans already tend to have automatic enrollment and typically do not involve employee contributions. Under the automatic 401(k) and IRA plans, workers would automatically contribute a share of each paycheck to such accounts (as would firms, if there were matching contributions). The funds would be automatically invested in broad-based stock and bond mutual funds with the option for individuals to override the default allocation if desired. This system would impose minimal responsibilities on firms and would respect the autonomy of individuals, yet it would likely substantially boost participation in retirement savings accounts.

That savings decisions are influenced by behavioral factors, such as defaults, does not mean economic incentives are irrelevant. Indeed, recent evidence suggests that the rate at which the government matches retirement savings contributions can significantly affect contributions. In a recent study, households were randomly offered different matching rates for IRA contributions at the time they were preparing their taxes. The experiment showed that households made significantly higher contributions when offered a higher match rate (Duflo et al. 2006, Saez 2009).

Thus, a second reason many people do not enroll in or contribute enough to an IRA or a 401(k) plan—and the focus of this paper—is that they have a weak or nonexistent immediate financial incentive to do so. This is true for the vast majority of middle- and low-income households; about three quarters of tax units face statutory marginal tax rates of 15 percent or less. For most of these plans, contributions are deductible from income in the year they are made, accrue tax-free until they are withdrawn, and are taxed as ordinary income at withdrawal. (The exception is "Roth" plans, where contributions are not deductible when made and not taxable when withdrawn. The immediate tax benefits, as a result, are non-existent.)

For a regular or traditional IRA or 401(k), the immediate value of excluding contributions from taxation depends on the income tax bracket into which a taxpayer falls. For example, consider two taxpayers, each of whom contributes $6,000 to a 401(k) and thus reduces taxable income by $6,000. One taxpayer has high income and faces a marginal tax rate of 35 percent; by contributing to the 401(k), she reduces taxes owed by $2,100 (35 percent of the $6,000 contribution). The other has relatively low income and is in the 10 percent tax bracket, so that the 401(k) contribution only reduces taxes by $600. The current system thus provides the smallest immediate benefit to taxpayers who face a zero or low marginal income tax rate, and who are typically characterized by low- or middle-income. These families are also typically most in need of increasing savings to meet basic retirement needs.

Not only do the existing tax rules provide less immediate benefit to low- and middle-income households, they are also relatively ineffective at inducing new saving. Contributions by high-income households to tax-subsidized retirement accounts are more likely to represent funds that are reshuffled from existing savings to take advantage of the tax benefit rather than a net new addition to saving (Engen and Gale 2000, Benjamin 2003). In other words, the current tax incentives to increase saving have relatively low "bang for the buck" because they merely subsidize shifting saving for high-income households rather than raising the total amount of saving in the economy.

This discussion suggests that the current system of tax incentives for retirement savings is flawed. By providing incentives for contributions through tax provisions that are linked to the marginal tax rates that people owe, current incentives deliver their largest immediate benefits to higher-income individuals in the highest tax brackets. These high-income individuals are precisely the ones who can respond to such tax incentives by reshuffling their existing assets into these accounts rather than by increasing their overall level of saving. As a result, the tens of billions of dollars in tax expenditures associated each year with 401(k) and IRA contributions could be targeted more effectively to increasing overall saving.

III. Restructuring Incentives

A. The Proposal

The proposal would provide a new incentive structure for contributions to retirement savings accounts. The plan would replace the existing tax deductions with a flat-rate refundable credit that serves as a matching contribution into a retirement savings account. The plan would thus change the treatment of retirement saving in three ways. First, unlike the current system, workers' and firms' contributions to employer-based 401(k) accounts would no longer be excluded from income subject to taxation, contributions to IRAs would no longer be tax-deductible, and any employer contributions to a 401(k) plan would be treated as taxable income to the employee (just as current wages are). Second, all qualified employer and employee contributions would be eligible for a flat-rate refundable tax credit, given to the employee. Third, the credit would be deposited directly into the retirement saving account, as opposed to the current deduction, which simply results in a lower tax payment than otherwise. (Note that some parts of the proposal are separable -- for example, the employer deduction could be left unchanged, or the matching contribution could be returned to the taxpayer via a lower tax bill or refund.)

Everything else would stay as is. Contribution limits would not change. Earnings in 401(k) plans and IRAs would continue to accrue tax-free, and withdrawals from the accounts would continue to be taxed as income. The Saver's Credit would continue to exist in its current form. Catch-up provisions, for workers aged 50 and older, would continue to apply. Roth plans and defined-benefit plans would be unchanged.

I analyze two different versions of the proposal: one with a 30 percent matching contribution (which is revenue-neutral under current law), the other with an 18 percent matching rate (which holds harmless those in the 15 percent income tax bracket).

B. Deductions versus Credits

There is a formal economic equivalence between the incentives created by a deduction at a given rate and those created by a tax credit of a different rate. For example, a 30 percent matching credit is the equivalent of an income tax deduction for someone with a 23 percent tax rate. For every $100 contributed to a retirement account by an individual with a 23 percent tax rate, the individual would receive a tax deduction worth $23. Thus for each dollar contributed, the individual's after-tax cost is $77. Under a 30 percent credit, the individual would receive a matching contribution of 30 percent, deposited into the account. If the individual made a contribution of $77, the government would provide a matching contribution of $23 (30 percent of $77), so—as with a 23 percent income tax deduction—the individual would have one dollar in his or her account at a cost of 77 cents. For similar reasons, an 18 percent matching credit is the equivalent of an income tax deduction for someone in the 15 percent income tax bracket.

C. Revenue Effects

According to estimates from the Tax Policy Center, the 30 percent credit would be revenue-neutral over the next 10 years relative to current law. The 18 percent credit would increase revenues by about $458 billion. (Making the credit nonrefundable would raise an additional $22 billion over the decade, but would dramatically reduce eligibility for the credit among low- and some middle-income households. Omitting any change in the employer deduction would reduce the revenue effect to just over $250 billion.)

D. Distributional Effects

Tables 1 and 2 show the distribution of winners and losers under the two versions of the proposal. Under the revenue-neutral change shown in Table 1, about 26 percent of tax filers would receive a reduction in tax liabilities, whereas 6 percent would see an increase. Tax increases would be concentrated in the top decile of the income distribution, while the bottom 90 percent of the distribution would receive, on net, a tax reduction.

Under the 18 percent credit reported in Table 2, about 12 percent of taxpayers would receive a tax cut while 19 percent would see an increase. The bottom 40 percent of the income distribution would receive a small tax cut, the middle quintile would experience no change in after-tax income, and the top 40 percent would face higher tax liabilities.

E. Effects on retirement contributions and national saving

The analysis underlying both of the tables and the revenue analysis holds retirement saving contributions constant. If retirement saving participation and contributions were to rise among lower- and middle-income households – as would be expected given the improvement in incentives they would receive – the revenue effects would decline and the progressivity would increase. I do not estimate these impacts.

The proposal also appears likely to raise national saving. In the revenue-neutral version of the proposal, there is no decline in government saving, and almost all low- and middle-income households have better incentives to contribute. As noted above, the evidence suggests that contributions to retirement accounts by such households are more likely to represent net increases in private saving than are contributions by high-wealth households, who can more easily shift funds from other assets. In the revenue-raising version of the proposal, government saving rises. Private saving would still likely rise, though perhaps not by as much as in the revenue-neutral version because incentives to contribute would have improved less.

While a deduction and credit are similar in economic terms, as discussed above, the proposal also differs from current law in that the matching contribution would be deposited directly into the retirement savings account, whereas the current system "delivers" the deduction in the form of higher after-tax income. It seems likely that depositing the match directly into the account would make it more likely to be saved than the tax deduction under current law; this would be above and apart from any improvement in the formal incentive to save for most households. Although I have no direct evidence on this point in the context of retirement savings, some evidence suggests that direct matches are more effective than equivalent tax rebates at inducing people to contribute to charities (Eckel and Grossman 2003). (However, it should also be noted that the provision of a flat-rate refundable credit could be separated from the provision that the credit is deposited directly into the account, as opposed to provided as a credit on the income tax form. This would allay concerns that such a deposit may prove difficult because of administrative or other reasons.)

F. Related Issues[3]

By making the regular or traditional 401(k) and IRA more attractive for low- and middle-income households, the proposal would effectively reduce the relative attractiveness of Roth vehicles for those households. Similarly, by making traditional vehicles less attractive for higher-income households, the proposal would make Roth options look relatively more attractive than under current law.

By converting the employer deduction for 401(k) contributions to a matching contribution given to the individual, the proposal -- if enacted -- could affect firms' willingness to offer 401(k) plans. However, several factors mitigate this effect. First, firms offer 401(k) plans for many reasons, including most importantly maintaining a competitive compensation package. Second, by maintaining the current contribution limits for 401(k) plans, which are much larger than for IRAs, the proposal would help preserve incentives. Third, the proposal might encourage defined-benefit plans, which would continue to enjoy the same tax treatment as under current law. For high-income workers, a defined-benefit plan would provide a tax break linked to the top income tax rate. By contrast, high-income workers would enjoy a smaller benefit under a 401(k) plan or IRA. To the extent that high-income workers influence choices made by firms about pension plans, the difference in tax treatment for such workers could encourage defined-benefit plans (which would then cover middle- and low-income workers as well).

Another potential concern is that the matches provided in this proposal may discourage employer matches to 401(k) plans. One motivation for employer matches is nondiscrimination requirements: to meet nondiscrimination rules, pension plans must ensure sufficient

[3] Gale, Gruber and Orszag (2006) discuss issues regarding withdrawal rules, transition, gaming, and interactions with state taxes and compare this proposal to alternative such as RSAs and expansion of IRA/401(k) contribution limits.

participation and contribution levels by low-income employees; the match is an incentive to encourage such participation. To the extent that the proposal raises 401(k) participation by low-income employees, it could erode the use of matching contributions by employers (since these matches would be less needed to satisfy the nondiscrimination standards). On the other hand, many potential motivations exist for employer matching. For example, the match -- like the 401(k) itself -- may be seen as part of a competitive pay package, and it may be offered as a way of furthering tax-free compensation for the highly-paid employees most likely to participate in 401(k) plans; such a motivation would still exist under the proposal but in a slightly dampened form.

III. Conclusion

It is possible to reform public policies toward retirement saving in ways that help (a) address long-standing concerns, (b) offset pressures in the current economy that would otherwise serve to reduce retirement saving, and (c) solve the fiscal problem facing the country, in a manner consistent with broad-based tax reform and equitable distribution of the fiscal burden. Converting the deduction for retirement saving to a refundable matching credit deposited directly into the saver's account would plausibly help achieve all of these goals.

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Table 1

Replacing the Retirement Saving Contribution Deduction with a Revenue-Neutral Government Matching Refundable Credit—Current Law Baseline

Distribution of Federal Tax Change by Cash Income Percentile, 2011 [1]

Cash Income Percentile[2,3]	Tax Units with Tax Increase or Cut [4]				Percent Change in After-Tax Income[5]	Share of Total Federal Tax Change	Average Federal Tax Change ($)	Average Federal Tax Rate[6]	
	With Tax Cut		With Tax Increase						
	Pct of Tax Units	Avg Tax Cut	Pct of Tax Units	Avg Tax Increase				Change (% Points)	Under the Proposal
Lowest Quintile	7.6	-274	0.0	0	0.2	14.6	-21	-0.2	1.4
Second Quintile	20.3	-337	1.7	44	0.3	40.5	-68	-0.3	6.9
Middle Quintile	32.0	-454	3.5	101	0.4	74.9	-142	-0.3	13.7
Fourth Quintile	49.7	-403	2.3	193	0.3	85.3	-196	-0.2	18.6
Top Quintile	33.1	-325	32.1	1,283	-0.2	-115.2	304	0.1	25.6
All	25.8	-380	6.0	1,002	0.1	100.0	-38	-0.1	20.4
Addendum									
80-90	50.1	-314	15.4	279	0.1	21.8	-114	-0.1	22.4
90-95	19.6	-333	50.3	692	-0.2	-26.2	283	0.2	24.9
95-99	12.1	-359	49.5	1,937	-0.4	-69.5	915	0.3	26.1
Top 1 Percent	13.2	-584	40.9	5,453	-0.2	-41.3	2,151	0.1	28.1
Top 0.1 Percent	7.3	-804	40.5	7,874	-0.1	-6.2	3,129	0.0	30.4

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0411-2).

* Less than 0.05

** Insufficient data

(1) Calendar year. Baseline is current law, proposal is replacing the retirement saving contribution deduction with a revenue-neutral government matching refundable credit.

(2) Tax units with negative cash income are excluded from the lowest income class but are included in the totals. For a description of cash income, see http://www.taxpolicycenter.org/TaxModel/income.cfm

(3) The cash income percentile classes used in this table are based on the income distribution for the entire population and contain an equal number of people, not tax units. The breaks are (in 2011 dollars): 20% $16,812; 40% $33,542; 60% $59,486; 80% $103,465; 90% $163,173; 95% $210,998; 99% $532,613; 99.9% $2,178,886.

(4) Includes both filing and non-filing units but excludes those that are dependents of other tax units.

(5) 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.

(6) Average federal tax (includes individual and corporate income tax, payroll taxes for Social Security and Medicare, and the estate tax) as a percentage of average cash income.

Table 2

Replacing the Retirement Saving Contribution Deduction with an 18 Percent Government Matching Refundable Credit—Current Law Baseline

Distribution of Federal Tax Change by Cash Income Percentile, 2011 [1]

Cash Income Percentile[2,3]	Tax Units with Tax Increase or Cut[4]				Percent Change in After-Tax Income[5]	Share of Total Federal Tax Change	Average Federal Tax Change ($)	Average Federal Tax Rate[6]	
	With Tax Cut		With Tax Increase						
	Pct of Tax Units	Avg Tax Cut	Pct of Tax Units	Avg Tax Increase				Change (% Points)	Under the Proposal
Lowest Quintile	7.6	-159	*	**	0.1	-1.7	-12	-0.1	1.5
Second Quintile	15.2	-165	6.9	140	0.1	-1.9	-15	-0.1	7.1
Middle Quintile	21.3	-174	14.2	266	0.0	0.1	1	0.0	14.0
Fourth Quintile	16.4	-180	35.6	446	-0.2	11.4	129	0.2	19.0
Top Quintile	1.5	-474	63.8	1,891	-0.6	92.1	1,198	0.4	26.0
All	12.5	-176	19.3	1,077	-0.3	100.0	186	0.3	20.7
Addendum									
80-90	2.2	-388	63.3	882	-0.5	21.3	550	0.4	22.9
90-95	0.7	-499	69.5	1,875	-0.9	24.4	1,299	0.7	25.4
95-99	0.7	-634	60.8	3,529	-0.8	33.0	2,142	0.6	26.4
Top 1 Percent	1.7	-1,260	52.4	6,611	-0.3	13.4	3,442	0.2	28.2
Top 0.1 Percent	1.8	-830	46.1	9,439	-0.1	1.7	4,332	0.1	30.4

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0411-2).

* Less than 0.05

** Insufficient data

(1) Calendar year. Baseline is current law, proposal is replacing the retirement saving contribution deduction with an 18 percent government matching refundable credit.

(2) Taxunits with negative cash income are excluded from the lowest income class but are included in the totals. For a description of cash income, see http://www.taxpolicycenter.org/TaxModel/income.cfm

(3) The cash income percentile classes used in this table are based on the income distribution for the entire population and contain an equal number of people, not taxunits. The breaks are (in 2011 dollars): 20% $16,812; 40% $33,542; 60% $59,486; 80% $103,465; 90% $163,173; 95% $210,998; 99% $532,613; 99.9% $2,178,886.

(4) Includes both filing and non-filing units but excludes those that are dependents of other taxunits.

(5) After-taxincome is cash income less: individual income taxnet of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.

(6) Average federal tax (includes individual and corporate income tax, payroll taxes for Social Security and Medicare, and the estate tax) as a percentage of average cash income.

STATEMENT OF HON. ORRIN G. HATCH, RANKING MEMBER
U.S. SENATE COMMITTEE ON FINANCE HEARING OF SEPTEMBER 15, 2011
TAX REFORM OPTIONS: PROMOTING RETIREMENT SECURITY

WASHINGTON – U.S. Senator Orrin Hatch (R-Utah), Ranking Member of the Senate Finance Committee, today delivered the following opening statement at a committee hearing examining tax reform options for retirement income security:

Thank you Mr. Chairman. This is a timely hearing. The issue of retirement security has never been more important than it is today. With respect to public programs, the retirement of the Baby Boom generation is putting enormous stress on both Social Security and Medicare. Congress is going to have to address the solvency of both of these programs — not in the long term, but in the short term.

Fortunately, the private employer-based pension system has become the greatest wealth creator for the middle class in history, especially through 401(k) plans and Individual Retirement Accounts, or IRAs. Despite the ups and downs of the stock market and historically low interest rates, millions of Americans have managed to save trillions of dollars for retirement.

You may be surprised to learn that more money has been set aside for retirement in defined contribution plans and IRAs than in Social Security. That's right. The Social Security Trust Fund holds $2.6 trillion in Treasury securities. But private, employer-based defined contribution plans hold $4.7 trillion. And IRAs hold even more: $4.9 trillion.

Think of that.

IRAs, a voluntary savings vehicle that was only created in 1974, now hold $2.3 trillion more than the entire Social Security system, a mandatory program that has been with us since 1935. That's almost double the assets, just in IRAs. The numbers suggest that 401(k) plans and IRAs have been a resounding success.

Can we improve them? There is always room for improvement. But limiting access to these savings vehicles is not progress.

Putting aside the issue of retirement income, when you consider the fact that your average American will face over $200,000 in out-of-pocket post-retirement medical costs alone, we should probably be expanding opportunities to save.

But make no mistake. Even as currently structured, these savings programs work for millions of Americans.

Yet all of the reforms I read about lately seem directed toward reducing the amount of money that people may set aside in defined contribution plans and IRAs. For example, the National Commission on Fiscal Responsibility recommended capping pre-tax contributions at $20,000. The Congressional Budget Office, or CBO, describes a proposal to reduce annual contributions to 401(k)-type plans by $7,650 for older workers, largely by repealing the ability of workers at age 50 to begin making catch-up contributions. IRA contributions also would be cut by $1,500 for older individuals.

Many of these proposals are offered in the name of greater progressivity in the tax code, and helping lower wage workers. But this just doesn't make sense. Trying to help lower wage workers save for retirement by reducing the 401(k) and IRA contribution limits is like trying to cure a headache with a guillotine. The cure is worse than the disease.

I am concerned that if these proposals were adopted many employers will throw up their hands in disgust and just drop their plans. And Congress has already covered this ground. We already made this policy call. In 2001, Congress *increased* the limits for contributions to 401(k)s and IRAs. At the time, 401(k) contributions were limited to $10,500 per year and IRAs were limited to $2,000. This year a worker aged 50 and over may contribute up to $22,500 to a 401(k). An older individual may contribute up to $6,000 to an IRA. Here is what Congress concluded in 2001, as reported in the Bluebook published by the Joint Committee on Taxation, and I quote:

> *The Congress believed that increasing the dollar limits on qualified plan contributions and benefits would encourage employers to establish qualified plans for their employees. The Congress understood that, in recent years, section 401(k) plans have become increasingly more prevalent. The Congress believed it was important to increase the amount of employee elective deferrals allowed under such plans, and other plans that allow deferrals, to better enable plan participants to save for their retirement.*

Well, it worked. Since 2000, retirement assets in defined contribution plans have grown from $3 trillion to $4.7 trillion, despite the market downturn in 2008. Assets in IRAs have grown from $2.6 trillion to $4.9 trillion. In fact, increased contribution limits worked so well that in 2006 Congress made those provisions permanent, and the vote to make them permanent was overwhelming: 93 to 5.

Today I expect that the Committee will hear about proposals to fundamentally change the 401(k) and IRA system. One of the proposals would eliminate pre-tax contributions to 401(k) plans and IRAs. Instead, workers would make after-tax contributions, receive a tax credit, and then pay ordinary income taxes again when the money is withdrawn in retirement.

Now I am sure these proposals are well intentioned, and I will listen to them with an open mind. But I must say that I am skeptical that it is wise tax and retirement policy to experiment with our current defined contribution and IRA retirement saving system, a system benefiting many millions of Americans, by taking away pre-tax contributions and converting the system into a refundable tax credit program.

Thank you Mr. Chairman.

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Testimony Submitted by Judy A. Miller
on behalf of the
American Society of Pension Professionals and Actuaries

Senate Finance Committee Hearing
Tax Reform Options: Promoting Retirement Security

September 15, 2011

Thank you Chairman Baucus, Ranking Member Hatch and members of the Committee for the opportunity to speak with you about how tax incentives for the employer-sponsored retirement system are working to promote retirement security. I am Judy Miller, Chief of Actuarial Issues and Director of Retirement Policy for the American Society of Pension Professionals and Actuaries ("ASPPA"). Before working for ASPPA, I had the honor of serving as Senior Benefits Advisor on the Committee staff from mid-2003 through November of 2007.

ASPPA is a national organization of more than 7,500 retirement plan professionals who provide consulting and administrative services for qualified retirement plans covering millions of American workers. ASPPA members are retirement professionals of all disciplines including consultants, administrators, actuaries, accountants, and attorneys. ASPPA is particularly focused on the issues faced by small- to medium-sized employers. ASPPA's membership is diverse but united by a common dedication to the employer-based retirement plan system.

The message I want to convey today is that the current tax incentives are working very well to promote retirement security for millions of working Americans. Modest changes can and should be made to expand coverage, but care should be taken to preserve and enhance the basic framework of the current incentives that motivate employers to sponsor retirement plans, and both employers and employees to contribute to these arrangements.

Background

The current system of tax incentives has been very successful at accumulating assets to improve the retirement security of millions of American households. Seventy percent of U.S. households now have an IRA or an employer-sponsored retirement plan. At the end of 2010, private employer-sponsored defined contribution plans held about $4.5 trillion in assets, private employer-sponsored defined benefit plans held $2.2 trillion and state and local retirement plans held $3.0 trillion. There was another $4.7 trillion held in IRA accounts. Although IRAs include contributions made by individuals to the IRA on their own behalf, a substantial portion of IRA assets are attributable to rollovers from employer-sponsored plans and direct employer contributions. Of the 49 million households that own IRAs, 55% report that their IRA accounts include a rollover from another retirement plan, and 9 million of the IRAs are employer-sponsored retirement savings arrangements such as SEPs and SIMPLE IRA plans.[1]

The past 20 years has seen a gradual shift in employer-sponsored arrangements from defined benefit plans to defined contribution plans. The number of participants (active, retired and deferred vested) reported as covered by defined benefit plans has been fairly stable - about 40 million in 1986, and 42 million in 2006, but an increasing proportion of those are retired participants. Over the same period, the reported number of participants in defined contribution plans increased from 37 million to 80 million. In 2009, about 61 million *active* workers participated in employer-sponsored retirement plans.[2]

Data shows that 401(k) and similar plans (such as 403(b) and 457(b) arrangements) have been very successful in getting workers to save for retirement. Contrary to the common assertion that only half of working Americans are covered by a retirement plan, a recent study from the Social Security Administration ("SSA") shows that about 70 percent of private sector workers have access to a retirement plan at work, and 80 percent of eligible workers with access to a plan participate in that plan. The success of saving through an employer-sponsored plan extends to low to moderate income workers. The chart below, based on data prepared by the Employee Benefit Research Institute (EBRI) updated to 2010, shows that over 70% of workers earning from $30,000 to $50,000 participated in employer-sponsored plans when a plan was available, whereas less than 5% of those without an employer plan contributed to an IRA.

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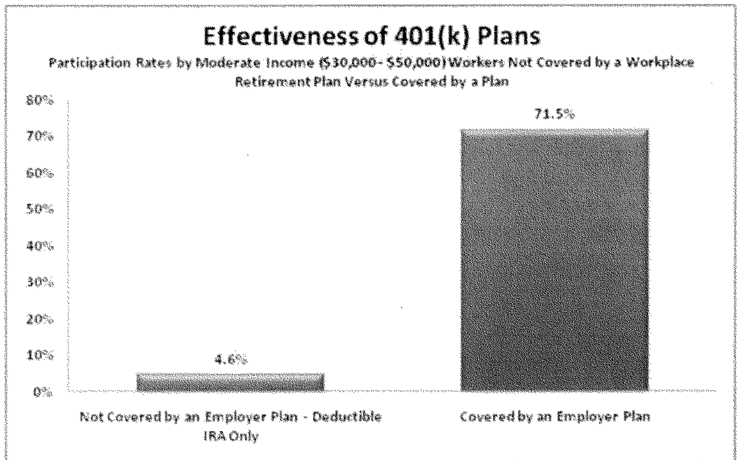
[1] *2011 Investment Company Fact Book: A Review of Trends and Activity in the Investment Company Industry*, Investment Company Institute, available at http://ici.org/pdf/2011_factbook.pdf.

[2] *EBRI Databook on Employee Benefits*, Employee Benefits Research Institute, available at http://ebri.org/publications/books/?fa=databook.



Source: Employee Benefit Research Institute (EBRI) (2010) estimate using 2008 Panel of SIPP (Covered by an Employer Plan) and EBRI estimate (Not Covered by an Employer Plan-IRA only)

ASPPA wishes to thank this Committee for its leadership in passing the Pension Protection Act of 2006 ("PPA"), which was supported by this Committee and the entire Congress overwhelmingly on a bi-partisan basis. By permanently extending previously enacted changes to various retirement plan rules, PPA greatly contributed to the continued maintenance and formation of workplace retirement plans by providing the certainty needed by both employers and employees.

Current Tax Incentives

What are the incentives?

Employer contributions made to qualified retirement plans are deductible to the employer when made. Income tax on investment earnings on those contributions is deferred until amounts are distributed from the plan. When a distribution is made to a plan participant, all amounts are subject to ordinary income tax. Employer contributions made on a participant's behalf are not subject to FICA. In addition, individuals with adjusted gross income ("AGI") of less than $27,750, and married couples with AGI of less than $55,500, may qualify for a Saver's Credit ranging from 10% to 50% of the first $2,000 the individual contributes to an IRA or employer-sponsored defined contribution plan.

Limits are placed on contributions to defined contribution plans, and on benefits payable from defined benefit plans:

- Certain defined contribution plans permit employees to contribute on their own behalf by electing to have a certain dollar amount or percentage of compensation withheld from pay and deposited to the plan. These "elective deferrals" are excludable from income for income tax purposes, but FICA is paid on the amounts by both the employer and the employee. For 2011, the maximum elective deferral to a 401(k) or similar plan is $16,500. Employees age 50 or over can also make a "catch-up contribution" of up to $5,500. Elective deferrals to a SIMPLE plan are limited to $11,500, plus a $2,500 catch-up contribution for those age 50 or over.

- If the employer also contributes to a defined contribution plan (such as a 401(k) plan), the maximum contribution for any employee is $49,000. This limit includes any elective deferrals other than catch-up contributions. This means a participant that is age 50 or over, and who makes the full $5,500 catch-up contribution, would have a total limit of $54,500.
- The maximum annual benefit payable from a defined benefit plan cannot exceed the lesser of the average of three year's pay or $195,000. If retirement is before age 62, the dollar limit is reduced. Employers can deduct the amount required to fund promised benefits.
- Annual IRA contributions are limited to $5,000, plus "catch-up" contributions of $1,000 for those age 50 or over.

Compensation in excess of $245,000 cannot be considered in calculating contributions or in applying nondiscrimination rules under either defined benefit or defined contribution plans. For example, if a business owner makes $400,000, and the plan provides a dollar for dollar match on the first 3% of pay the participant elects to contribute to the plan, the match for the owner is 3% of $245,000, not 3% of $400,000.

The higher contribution limits for qualified retirement plans – both defined contribution and defined benefit plans – come with coverage and non-discrimination requirements. For example, a small business owner with several employees cannot simply put in a defined contribution plan and only contribute $49,000 to his or her account. Other employees who have attained age 21 and completed 1 year of service with at least 1000 hours of work must be taken into consideration, and the employer must be able to demonstrate that benefits provided under the plan do not discriminate in favor of "Highly Compensated Employees" ("HCEs"), which would include the owner.

Safe harbors are available. For example, if all employees covered by a 401(k) plan are provided with a contribution of 3% of pay that is fully vested, the HCE can make the maximum elective deferral, regardless of how much other employees choose to contribute on their own behalf.

Age can also be considered when determining the amount of contributions that can be made on a participant's behalf. A larger contribution (as a percentage of pay) can be made for older employees because the contribution will have less time to earn investment income before the worker reaches retirement age (usually age 65).

How do retirement savings tax incentives differ from other incentives?

Unlike many tax incentives, the income tax incentives for retirement savings are not permanent deductions or exclusions from income. Taxes are *deferred* as long as the savings remains in the plan, but tax must be paid in later years when distributions are made from the plan. Furthermore, the distributions are subject to tax at *ordinary income* tax rates, even though lower capital gains and dividends rates may have applied if the investments had been made outside of the plan.

The tax incentives for qualified employer-sponsored retirement plans also come with stringent non-discrimination rules. These rules, coupled with the limit on compensation that can be considered under these arrangements, are designed to insure that qualified employer-sponsored retirement plans do not discriminate in favor of HCEs. Non-discrimination rules do not apply to other forms of tax-favored retirement savings. For example:

- IRAs share the incentive of tax deferral. However, if a small business owner makes a personal contribution to an IRA, there is no corresponding obligation to contribute to other employees' IRAs. However, under the current rules, the contribution limit for IRAs is set low enough (and the limit for employer-sponsored plans high enough) to make a qualified retirement plan attractive to a business owner who can afford it.
- Annuities purchased outside of a qualified plan share the benefit of "inside buildup" - the deferral of income tax on investment earnings until distributed from the arrangement – but have *no limit on contributions or benefits, and no non-discrimination requirements*. This means the attraction of a qualified retirement plan for a small business owner is heavily dependent on the interaction of non-discrimination rules and the contribution limits for a qualified retirement plan. [Note that at the end of 2010, there was $1.6 trillion in annuity reserves held *outside of* retirement plans.[3]]

How does tax deferral work to incent coverage?

The tax incentive for a small employer to sponsor a qualified retirement plan is a critical component to the establishment of a 401(k), defined benefit or other qualified retirement plan. The tax savings for the company's owner (or owners) can generate all or part of the cash flow needed to pay required contributions for other employees, which substantially reduces the cost of the plan to the owner (and transfers much of the apparent tax benefit to covered employees). Consider the following situation:

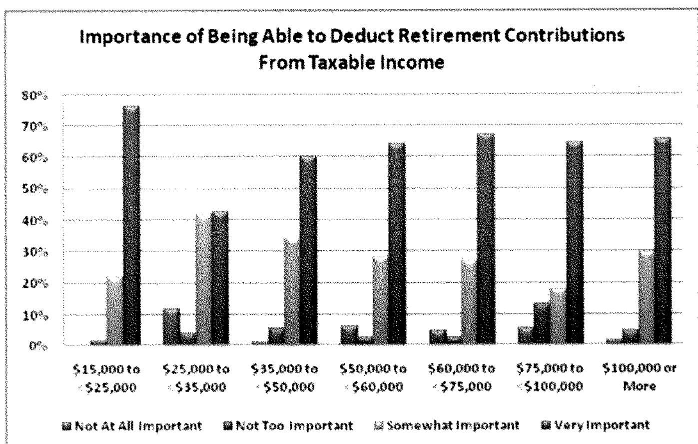
> ABC Company has been in operation for 5 years. The owner has some retirement savings in an IRA, but has never taken time to think about retirement. The business has 4 other employees earning from $35,000 to $70,000. The owner takes compensation of $10,000 per month during the year, then takes a year-end bonus of the amount of company profits. The owner pays individual income taxes on the full amount of the profits at a marginal rate of 28%.
>
> The owner meets with a retirement plan consultant. The owner is older than most of the other workers, so the consultant recommends a safe harbor 401(k) plan with an additional "cross-tested" contribution. Thanks to the

[3] *Retirement Assets Total $17.5 Trillion in Fourth Quarter 2010*, Investment Company Institute (Apr. 13, 2011), available at http://www.ici.org/pressroom/news/ret_10_q4.

nondiscrimination rules that apply to qualified retirement plans, putting $49,000 of the profits into the 401(k) plan for the owner means the owner must contribute at least 5% of pay for the employees. However, tax savings on the $49,000 will be more than enough to cover that 5% contribution, and the tax credit for the cost of setting up and operating a new plan helps defray any startup and initial operating costs. Setting up the plan becomes a simple question of "Do you want to give that money to your employees? Or add it to the check you are sending to IRS?"

The current tax incentives transform what would have been a bonus to the business owner, subject to income taxes, into a retirement savings contribution for the owner *and the employees*. Not only will the employees receive an employer contribution of 5% of pay, most will also make additional contributions on their own behalf.

The tax incentives are also used to encourage employees to join 401(k) plans and similar plans. Educational materials encouraging participants to enroll in, and contribute to, plans typically show the worker how tax savings will help them save more than they could through another savings arrangement. For example, materials will show how contributing $100 to your 401(k) account will only cost $85 (or $72 for higher income workers). As shown in the chart below, over 80% of workers in all income categories find this incentive somewhat or very important.



Source: Jack VanDerhei, *The Impact of Modifying the Exclusion of Employee Contributions for Retirement Savings Plans From Taxable Income: Results From the 2011 Retirement Confidence Survey*, ebri.org Notes (Mar. 2011), available at http://ebri.org/publications/notes/index.cfm?fa=notesDisp&content_id=4785.

Who Benefits

Who is participating?

The Bureau of Labor Statistics ("BLS") found that 78 percent of all full time civilian workers had access to retirement benefits at work, with 84 percent of those workers participating in these arrangements. For private sector workers, BLS found the access and participation rates are 73 percent and 80 percent respectively. Availability and take up rates are substantially lower for part-time workers, so if part time workers are included, BLS found that 68 percent of civilian workers had access to retirement plans, and 80 percent of those actually participate in the offering. For the private sector only, the access and participation rates for all workers are 64 percent and 76 percent respectively.[4] However, alternative research suggests these estimates are less than what is actually happening in the workplace.

A report from SSA shows that 72 percent of *all* employees who worked at private companies in 2006 had the ability to participate in a retirement plan, and 80 percent of those participated.[5] The SSA used data from a Census survey merged with W-2 tax records to correct for respondents' reporting errors. SSA found "among private-sector wage and salary workers, both employer offer rates and employee participation rates in *any* type of pension plan considerably increase when W-2 records are used, an indication of substantial reporting error." [6] The SSA results indicate the BLS statistics on availability are likely understated.

Part-time workers are far less likely to have a retirement plan available at work, and less likely to participate in a plan when it is available. BLS data shows only 37% of part-time private sector workers have a retirement plan available at work, and 54% of those participate in the plan. Similarly, employees that work for smaller employers are less likely to have a plan available. BLS data shows 49 percent of private sector employees who work for employers with less than 100 employees have a plan available at work. Sixty-nine percent of those workers do participate when a plan is offered, though. Employer surveys indicate business concerns are the primary driver of this low rate of sponsorship among smaller employers.

Participation in employer-sponsored defined contribution plans is heavily weighted toward middle class Americans. As the chart below shows, 38% of participants in defined contribution plans make less than $50,000 per year. Nearly three-quarters make less than $100,000.

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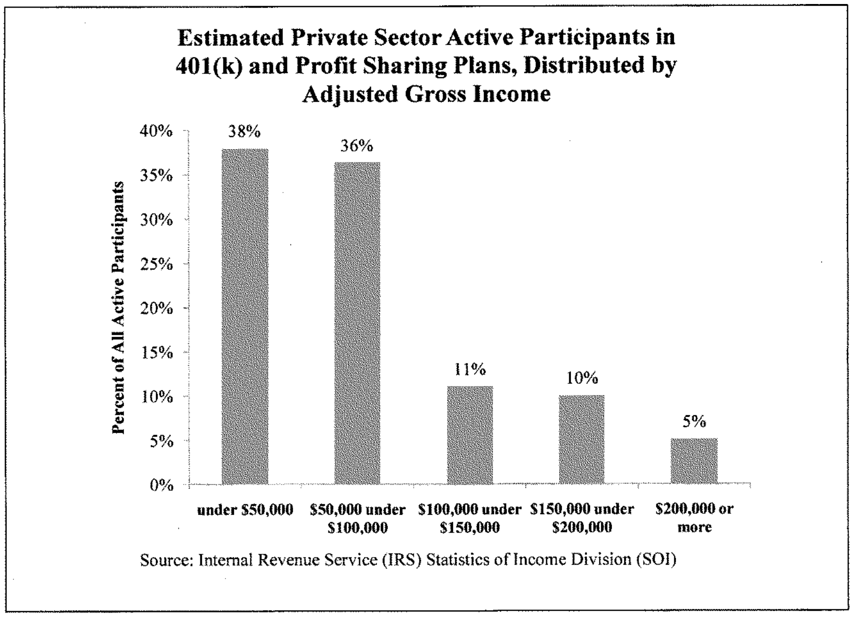
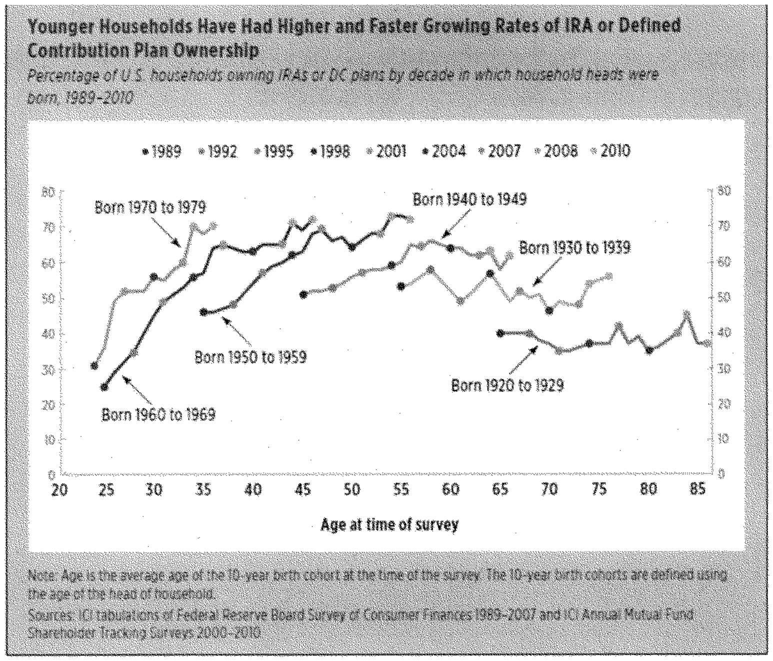
[4] Bureau of Labor Statistics, *Employee Benefits Survey: Retirement Benefits, March 2011: Retirement benefits: access, participation, and take-up rates: National Compensation Survey March 2011* available at http://www.bls.gov/ncs/ebs/sp/ebnr0017.pdf (hereinafter "BLS Survey").

[5] Irena Dushi, Howard M. Iams, and Jules Lichtenstein, *Assessment of Retirement Plan Coverage by Firm Size, Using W-2 Records*, Social Security Bulletin (2011), available at http://www.ssa.gov/policy/docs/ssb/v71n2/v71n2p53.pdf.

[6] *Id.* at 1 (noting "We find substantial reporting error with respect to both offer and participation rates in a retirement plan. About 14 percent of workers who self-reported nonparticipation in a defined contribution (DC) plan had contributed as indicated by W-2 records, whereas 9 percent of workers self-reported participation in a DC plan when W-2 records indicated no contributions.").



There is reason for optimism that coverage will increase over time. The following chart shows that younger workers have shown dramatic gains in ownership of retirement savings accounts over the past decade. The increasing use of automatic enrollment is also expected to increase take-up rates. (Most plans only automatically enroll new hires, so recognition of participation gains will occur gradually).



Source: 2011 Investment Company Factbook, Figure 7.4, page 103

<u>How is the tax benefit distributed?</u>

Distribution of the tax benefit is typically analyzed by applying the marginal tax rate to contributions allocated to an individual's account multiplied by the marginal tax rate.[7] Because the U.S. income tax system is progressive, the value of the tax incentive on a dollar of retirement savings *in the year of deferral* increases as the marginal tax rate increases. This progressive income tax structure, coupled with the assumption that the more income a worker has, the more he or she can afford to save, would lead one to expect the tax benefit for retirement savings would be more skewed than the incidence of income tax. However, the non-discrimination rules that apply to employer-sponsored retirement plans, coupled with the limit on compensation that may be considered for purposes of determining contribution allocations, leads to a very different result. The distribution of the tax incentive for retirement savings is *more progressive* than the current progressive income tax system. As the following chart shows, households with incomes of less than $50,000 pay only about 8% of all income taxes, but receive 30% of the defined

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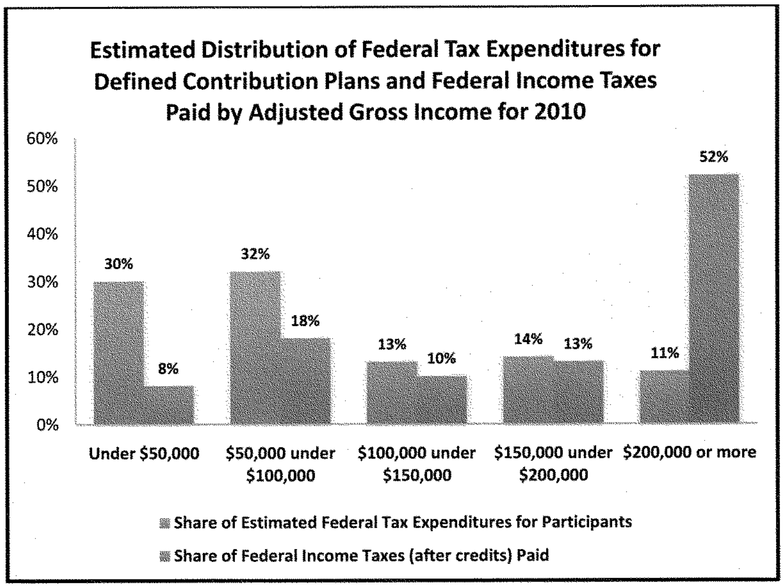
[7] For example, see Table 1 of the Hamilton Project paper "Improving Opportunities for Savings and Incentives for Middle- and Low-Income Households" by William Gale, Jonathan Gruber and Peter Orszag.

contribution plan tax incentives. Households with less than $100,000 in AGI pay about 26% of income taxes, but receive about 62% of the defined contribution plan tax incentives. [8]



What this clearly shows is that, contrary to one common myth, the tax incentives for retirement are *not* upside down at all. Thanks to the balance imposed by the current law contribution limits and stringent nondiscrimination rules, these tax incentives are *right side up* – even before properly considering other components of this incentive.

The standard methodology for measuring the benefit of the tax incentive (multiplying marginal rate times income deferred) shows that the tax incentives for employer-sponsored retirement savings are more progressive than the current income tax code. However, because of the unique nature of this tax incentive, this methodology actually *understates* how progressive the current tax incentives are:

- First, as illustrated in the "ABC Company" example on page 5, this measurement fails to consider that much, if not all, of this apparent tax savings to a small business owner is transferred to employees in the form of employer contributions. The standard methodology credits the small business owner contributing $49,000 on her

[8] *Estimated Benefits of Tax Expenditure Estimates for Defined Contribution Plan Participants and Retirees with Account Balances*, available at http://www.asppa.org/Main-Menu/govtaffairs/Testimony/2011/DistTaxExp_TaxesPaid_3-18-11.pdf.aspx.

own behalf with $13,200 "tax savings" (28% marginal rate times $49,000). If payroll for other covered employees is $200,000, the nondiscrimination rules require the employer to contribute at least 5% of pay, or $10,000, to the accounts of these other employees. Assuming for the sake of simplicity that the business tax rate is the same as the owner's rate of 28%, the net cost of the $10,000 contribution is $7,200. The small business owner's net benefit for the current tax year is therefore only $6,000 ($13,200 - $7,200). Assume the average marginal rate for the other employees is 15%. The rate times contribution method results in an apparent tax benefit of $1,500 (15% of $10,000). In fact the benefit is the full $10,000. So, although standard methodology would measure the tax incentive in the current year as $13,200 for the owner and $1,500 for the other employees, the true allocation is $6,000 for the owner and $10,000 for employees.

- Part of the cost of the retirement savings tax incentive is the deferral of income taxes on investment income. However, if a small business owner elected not to set up a qualified plan, and had simply paid income taxes instead of making retirement contributions for herself and the other employees, she could have gained identical deferral of income tax on investment earnings by investing the $49,000 in an individual annuity, or benefitted from lower capital gains and dividend tax rates on investment income by purchasing investments outside of a retirement savings vehicle. Therefore, the cost of the qualified retirement plan tax incentive should only reflect the cost of excluding the deferral in the year the contribution is made, plus deferral of tax on investment income on contributions in excess of an after-tax contribution amount, *less* the difference between ordinary income tax and capital gains and dividend taxes on investment income. (Note that for this small business owner, the after-tax value of the *employee* contributions would be available for investment outside of the qualified retirement plan, not just the after-tax value of the $49,000 contribution for the owner.)
- Analyzing the benefit for any given year during an accumulation period also fails to recognize the deferral nature of the savings tax incentive. When an individual saving $49,000 per year reaches retirement and distributions begin, the marginal income tax rate of those distributions will be substantially higher than for those with a history of lower contributions. (The fact that the amount of Social Security benefits includible in income, if any, depends on the amount of other retirement income received during a year increases the rate differential for retirees). As a result, this failure to consider taxes to be paid at a later date tends to overstate the relative benefits offered by the current system to those who make higher levels of contributions to these plans.

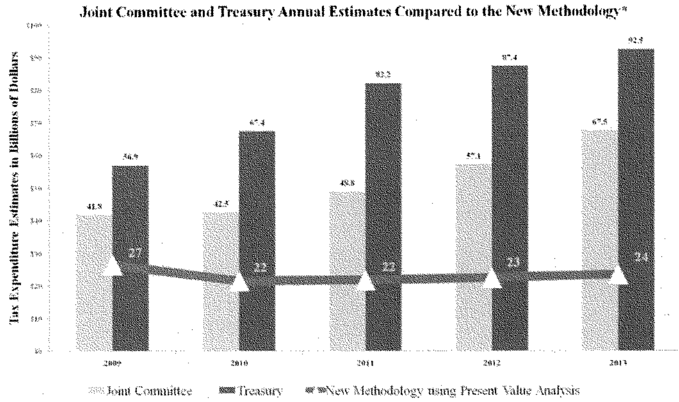
An analysis of the distribution of the tax incentives that considers these factors would show the current tax incentives for retirement savings are extremely efficient at distributing benefits to low- and moderate- income workers.

True Cost Overstated

Current budget rules require that the cost of most tax incentives be determined on a cash flow basis. Because the tax incentive for retirement savings is a *deferral*, not a permanent exclusion, basing the cost on current cash flow analysis – taxes not paid on contributions and investment earnings for the current year less taxes paid on current year distributions – misrepresents the true cost of the retirement savings incentives. Using a present value method, which recognizes that taxes will eventually be paid on distributions, produces very different estimates – more than 50% lower than JCT or Treasury estimates for a 5-year budget window.[9] The following chart illustrates the results.

Comparison of Tax Expenditure Estimates for Retirement Savings Incentives

Joint Committee and Treasury Annual Estimates Compared to the New Methodology*



* The new methodology estimates the tax benefit of the deferral and inside buildup, in present value terms. The Joint Committee and Treasury estimates rely on cash-flow analysis.

The danger in using the cash flow measurement is not just that the current cost is overstated, but the long-term impact of modifying the incentives is also hidden. Reducing the limits will generate revenue in the budget window, but will also lead to reduced revenue – and more demand for low income benefits such as Medicaid and Supplemental Security Income ("SSI") - in later years.

Adequacy of Benefits

The availability of a defined contribution plan at work is a key determinant in the likelihood for having a secure retirement. Benefits can be very meaningful ....

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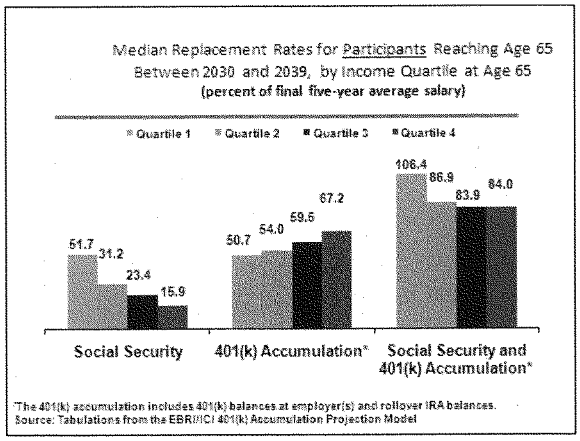
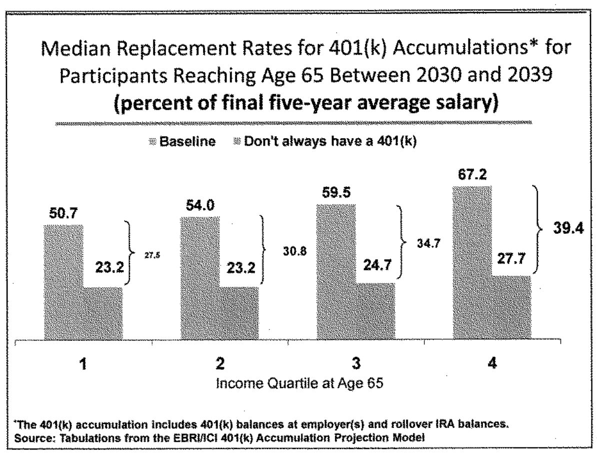
[9] Judy Xanthopoulos and Mary Schmidt, *Retirement Savings and Tax Expenditure Estimates* (May 2011), available at http://www.asppa.org/Main-Menu/govtaffairs/RET.aspx



if there is consistent availability of workplace savings.



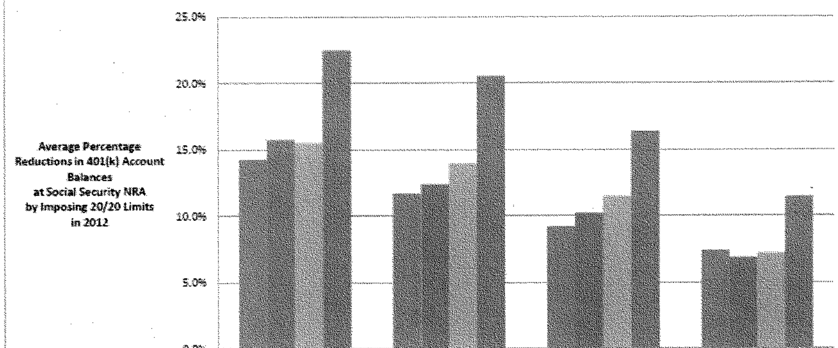
Impact of Proposed Changes

The Deficit Reduction Commission and the President's Economic Recovery Advisory Board ("PERAB") both floated the idea of reducing the current $49,000 maximum contribution for defined contribution plans to the lesser of 20% of pay or $20,000. Reducing the maximum contribution from the current $49,000 to $20,000 would mean the qualified retirement plan no longer makes financial sense for many small business owners. The result would be less access to retirement savings opportunities at work for rank and file employees. In a survey of "cross-tested" plans conducted by the American Society of Pension Professionals and Actuaries (ASPPA), 65% of plan sponsors indicated they were likely to terminate the cross-tested plan if the plan design were no longer available. A dramatic reduction in the limit would effectively make not only a cross-tested plan, but most other qualified defined contribution plans, unattractive to small business owners.

Even if some plans survived, contribution rates, and so projected balances, would decline. Employer contributions are often based on the level of contribution required to meet the nondiscrimination rules. Lower maximum contributions will mean nondiscrimination testing passes with a lower level of employer contributions, which means lower employer contributions for employees. Nonetheless, the reality for many small business retirement plans is that the reduced limits will mean the end of the plan. For many small businesses, even after reducing the level of employer contributions made on behalf of non-owner employees, the reduced tax incentive due to the lower limits will simply not create enough cash flow to justify continuing the plan at all.

The following chart shows the decline in projected account balances for participants in small plans, considering both changes in employee behavior and employer behavior, including the termination of plans, if the maximum contributions for defined contribution plans were reduced to the lesser of 20% of pay or $20,000.

20/20 analysis on small (less than 100 participant) plans, after employer behavioral modifications*, by age and salary quartile



	26-35	36-45	46-55	56-65
Lowest	14.2%	11.7%	9.2%	7.4%
2	15.7%	12.4%	10.2%	6.8%
3	15.5%	14.0%	11.5%	7.2%
Highest	22.5%	20.5%	16.4%	11.4%

Source: EBRI RSPM, version 110906c.
* This includes both reduced employer contribuion behavior as well as the plan termination scenario when there is a negative "net benefit" as a result of the 20/20 constraints, even after adjustments to contribuion levels.

Another recurring proposal would convert the current-year contribution exclusion from income into a uniform tax credit. How a proposal such as this affects plan sponsors and participants depends, of course, on what the level of credit is, and whether or not it is deposited to a retirement savings account or directly offsets income tax liability. The current proposal from William Gale[10] offers both a 30 percent credit, which the paper says would be revenue neutral, and an eighteen percent credit. This proposal purports to create additional savings by providing more incentive for taxpayers below the 23 percent and 15 percent marginal tax brackets to save. There appear to be several basic flaws in this proposal:

- Data shows the primary problem to be addressed in improving retirement security is increasing *access to workplace savings*, not a lack of incentive for take-up by participants with access. The proposal itself indicates that the current tax incentive for many decision makers would be reduced under the proposal. In fact, for the business owner, the reduction in the incentive would be more than illustrated in the proposal because contributions made on behalf of employees would become subject to FICA. In other words, the "problem" being addressed by this proposal is not the problem, and the "solution" will only make the situation worse.

[10] William G. Gale, *A Proposal to Restructure Retirement Savings Incentives in a Weak Economy with Long-Term Deficits* (Sep. 8, 2011).

- If the credit is an offset from income tax liability, the size of the credit for a small business owner would determine if setting up or maintaining the plan is still worthwhile. If the credit were deposited to a retirement account, in many cases the resulting drain on cash would necessarily result in lower contributions for the small business owner and employees, or termination of the plan. (We note that for larger employers, the size of the credit will in no way offset additional FICA liability. They would have to take on the additional cost, or decrease contributions.)

- The paper notes that a 30 percent credit is equivalent to a 23 percent deduction. Similarly, an 18 percent credit would be equivalent to a 15 percent deduction. The equivalency is based on the theory that only the after-tax amount of income will receive the credit. For example, if an employee defers $1,000 under the current incentive system and is in the 15 percent bracket, under current rules, $150 of income tax liability is deferred. Under the proposal, the after tax deferral would be $850. Eighteen percent of $850 is $150, so this credit is equivalent to the exclusion for income tax purposes. This analysis makes sense in the case of IRA contributions or elective deferrals, where FICA is already paid on the contribution amounts. It does not hold up, however, for employer contributions where there is currently no FICA liability for either employees or employers.

  Consider an employee in the 15 percent bracket contributing $1,000 as an elective deferral and receiving a $1,000 employer contribution. *If the level of employer contribution does not change*, the employee will not only offset the $1,000 elective deferral by the $150 income tax liability on the elective deferral, but also by the $150 income tax liability for the employer contribution and the $76 in FICA contributions the employee owes on this employer contribution amount. Instead of $2,000 in total contributions, there will be $1,624 ($2000 - $150-$150-$76). An eighteen percent credit applied to $1,624 is only $292. So the employee has lost over $80 in this change to an "equivalent" eighteen percent credit. For this situation, the equivalent credit would be about 23 percent. Note, however, that the higher the level of the employer contribution relative to the elective deferral, the higher the credit must be for the individual to break even. If there were a $2,000 employer contribution, an 18 percent credit would result in a reduction of over $171, after FICA is considered, and the equivalent credit would be over 25 percent.

Considering the FICA implications, this proposal has the effect of penalizing both business owners (through increased FICA taxes) and employees when the plan provides for matching or profit-sharing contributions, with the penalty increasing as the employer contribution increases. Regardless of the size of the credit, this is an incentive for all employers, not just small business owners, to reduce company contributions.

Simplification Myth

There is a persistent myth that the variety of retirement savings arrangements confuses small employers from setting up plans, and employees from participating in them. This line of reasoning leads to proposals to consolidate all types of defined contribution plans into a single plan with a single, safe harbor, contribution testing methodology. This myth is not supported by the facts for the employer-sponsored retirement system.

- Small employers that do not sponsor a retirement plan consistently point to business concerns as the main reason they do not sponsor a plan. In fact, the primary reason is uncertainty about revenue. Flexibility in plan design gives practitioners the tools to design arrangements that are attractive to more employers than a "cookie cutter" approach.
- Different types of employer-sponsored plans do not discourage employee participation. Potential plan participants are NOT asked to choose between a 401(k) or SIMPLE, or a 401(k) or 403(b) arrangement. Employees are simply asked if they want to enroll in the plan being offered by the employer – or are automatically enrolled.

In short, less flexibility would reduce coverage, not enhance it.

What Should be Done?

The current system is working very well for millions of working Americans. Expanding *availability* of workplace savings is the key to improving the system. There is no need for dramatic changes, but measures should definitely be considered to make it easier for employers, particularly small businesses, to offer a workplace savings plan to their employees.

I would be pleased to discuss these issues further with the Committee or answer any questions that you may have.

Senate Finance Committee Hearing
"Tax Reform Options: Promoting Retirement Security"
September 15, 2011
Response to Questions for Judy Miller

Questions from Senator Max Baucus

1. **Workers are being required to shoulder more and more of the burden of retirement savings as employers are terminating or freezing their traditional pension plans. With this increased burden comes a need for more knowledge of the importance of saving, how to save, and how to manage the assets that one has saved.**

    a. **Are workers being provided enough information as to the need for retirement savings and how to manage their savings?**

    Recent regulations under ERISA 404(a) will require that participants receive substantially more information on investment alternatives than has been required in the past. Since these new regulations are not yet effective, it would be premature to evaluate the impact of these disclosures. Although there is no requirement that participants receive disclosures or education relating to the importance of saving or the amount the participant needs to save for a secure retirement, most service providers do provide educational materials and planning tools to employees who are eligible to participate in 401(k) and similar plans.

    b. **If not, who should provide that education? Are there changes that should be made to the Internal Revenue Code or other laws (such as ERISA) that would encourage employers to provide more financial education to their employees, or is that something that should be provided elsewhere?**

    Public service announcements and educational materials at the high school level could be helpful in making workers aware of the need to save. However, given the success of "default" approaches to encouraging savings and directing investments, the most effective way to improve outcomes is to focus on improving the defaults. For example, the PPA provisions that encourage automatic enrollment have been very successful at increasing participation rates. However, there is general agreement that the minimum default rate of 3% of pay is too low, and unless it is accompanied by automatic escalation may tend to create a large number of "under-savers". Instead of trying to get workers enrolled at the default rate to increase this rate through education, it would be far more effective to amend the Code to increase the default rate, and raise the current 10% cap on auto-escalation.

2. **According to the Investment Company Institute, there were $17.5 trillion held in employer sponsored retirement plans and individual retirement accounts as of the fourth quarter of 2010. These assets – nearly all of which benefit from a significant tax preference – are being held not only to cover the retirement costs of millions of Americans, but they will also be used to pay emergency costs prior to retirement and to pass on to beneficiaries after the death of the plan participant or IRA holder. Although there is generally a penalty for withdrawing retirement funds prior to retirement, there are many exceptions to this rule and not a year goes by without a proposal for a new exception to the penalty. And there are many Americans who are using tax-preferred savings as an estate planning tool. For example, most investment advisors tell their wealthier clients to use other assets before using tax-preferred retirement savings since it is advantageous to save the tax-preferred assets to give pass to their heirs. However, many Americans for whom this money is being held – and many Americans who will not have any retirement assets at all – are at risk of not having enough to have a comfortable retirement.**

   a. **Is it appropriate to have tax incentives to accumulate money to pass to heirs?**

      Americans making decisions about how and when to take distributions from their retirement savings are concerned that savings they don't live to spend not be forfeited – this concern is a primary disincentive to purchase of annuities for many retirees. However, it is far more important to preserve incentives for retirement savings than to preserve the ability to pass tax-preferred benefits on to heirs who are not significant others or dependent children.

   b. **Should there be more incentives in the Internal Revenue Code to save for other purposes?**

      There are good policy reasons to encourage families to save for college, first-time home purchase, or unforeseen medical expenses, all of which can occur before retirement. However, saving for shorter-term needs is not comparable to retirement savings in terms of the potential for capital accumulation and, in the event of failure, increased demands on SSI and Medicaid.

   c. **Should the existing retirement savings incentives be opened up more for other purposes?**

      The goal of retirement savings is to defer income during working years to provide the resources to meet living expenses after you are no longer working. From the standpoint of retirement security, any pre-retirement distributions are troubling. From the standpoint of the tax preference given to encourage retirement savings, the fact that distributions are subject to income tax plus, in most cases, a penalty, is a self-correction mechanism and not troubling to me. Based on my personal experience as a practitioner, and largely confined to working with Montanans, very few plan participants take hardship withdrawals without being in the midst of a serious hardship.

There are steps that can be taken to mitigate the impact of these hardship withdrawals. The current rule that elective deferrals cannot be made for six months following a hardship withdrawal should be dropped. The penalty already discourages unnecessary withdrawals. If the participant desperately needs a larger sum of money now, that does not mean they cannot afford to continue making modest contributions from future pay checks, and the suspension just hurts their future security.

Also, the rules for whether or not a 10% penalty applies differ between IRAs and qualified retirement plan withdrawals. This is confusing, and the reasons for a distinction are not clear. Most Americans save through 401(k) plans. If an exception makes sense for an IRA withdrawal, it should also make sense – and would be more widely available – for distributions from 401(k) plans.

3. **Employees of federal, state, and local governments are usually covered by a traditional defined benefit plan, but they are usually required to pay for a portion of that benefit. For example, most federal employees pay 0.8 percent of their pay towards the Federal Employee Retirement System. Nearly all governments are facing significant budget shortfalls today and many are looking to employees to shoulder more of the cost of their benefit. An increasing number of private sector employers have made a business decision to terminate or freeze their traditional pension plans.**

   a. **Should governments be doing the same?**

   Although defined benefit plans are no longer as common as they once were in the private sector, they can and should continue to play a role in appropriate situations. Private employers look at what benefits are valued by the type of worker they want to attract, as well as how a retirement plan affects both cash flow and financial statements. Government should do the same analysis. It is important to note that switching to a defined contribution arrangement changes how costs accrue going forward, but does not affect the cost of benefits already earned. Different levers can be pulled to adjust the future cost of benefits whether defined benefit or defined contribution.

   b. **Is it reasonable that government employees should have a more secure retirement than millions of similarly situated private employers?**

   My personal opinion is that it is not reasonable to expect taxpayers to provide government workers with a better *compensation package* than similarly situated employees of private business, but the comparison should be made on the whole compensation package, not just retirement benefits. For many years the public perception was that if you went to work for the government, your take-home pay would be lower than if you worked for private business, but you would have more job security and great benefits – both health and retirement. It is not my area of expertise, so I cannot cite data as to whether or not this perception is, or ever was, true. If true, I don't think it is unreasonable to place more emphasis on retirement security than current pay for government workers.

c. Should government employees be asked to pay more for their retirement benefit?

Few private employers now require employees to contribute to defined benefit plans. The tax code does not permit pre-tax contributions to defined benefit plans for non-governmental workers, and the administrative difficulty of determining vested benefits when employee contributions are part of the mix also discourages this feature. That being the case, there is no easy comparison to private sector plans to inform the answer to this question. If contributions are increased, and if there is not already a minimum retirement benefit based on the annuity equivalent of accumulated employee contributions under FERS, one should be added to make sure participants with young entry ages get the full benefit of their contributions.

4. The Internal Revenue Code requires that the amount saved be actually paid out once an individual reaches a certain age – now 70½. This requirement prevents many retirees from saving more of their account for their later retirement years. On the other hand, the rules as currently structured allow many people to pass large portions of their retirement savings on to their heirs, a feature the Wall Street Journal has called a "stealth tax cut for the wealthy."

a. Should individuals with small account balances be relieved of the required minimum distribution rules?

Yes. Individuals with smaller account balances should be able to keep their account balance intact to help defray future catastrophic expenses, or simply supplement income late in life when they may need additional assistance.

b. Should large account balances be required to be paid out faster than they are now?

Most policymakers are concerned that the current required minimum distribution rules could result in empty account balances before the end of life, so care should be exercised when considering accelerating payments made during a retiree's lifetime.

5. The Pension Benefit Guaranty Corporation (PBGC) is facing a funding shortfall on the order of $23 billion.

a. How should that shortfall be closed?

The $23 billion shortfall is based on historically low interest rates, and should not serve as the basis for premium increases. When interest rates rise, this number will fall. PBGC itself says it has "more than sufficient funds to pay for benefits for the foreseeable future." Keeping healthy employers in this voluntary system, paying premiums, is the best way to preserve the financial health of PBGC. As a result, we strongly oppose the President's proposal to increase premiums by $16 billion over the next 10 years.

b. If premiums need to be raised, should Congress set the increase or is the PBGC in a better position to determine how to allocate the increase?

There is in truth no way to fairly allocate any increase in premium attributable to unfunded liabilities for plans that have already been dumped on PBGC by employers who no longer exist. Current defined benefit plan sponsors who operate well funded plans and will never place a single dollar of liability on PBGC bear no responsibility for those liabilities. Therefore, Congress should be responsible for whatever arbitrary method is used to defray these costs, and should be very careful not to base payments collected from current plan sponsors on an inflated measure of the liabilities companies dumped on PBGC in the past.

Premiums for insuring payment of promised benefits from active plans should be set for existing plan sponsors based on the expected future costs of these plans to PBGC. PBGC should be given responsibility for recommending premiums for expected future costs, but not final authority. The recommendations should be subject to approval by a commission that includes members of all interested parties (including small business plan representation), with authority for final approval retained by Congress.

<u>Questions from Senator Michael B. Enzi</u>

1. **Currently, our 401(k) and Individual Retirement Account (IRA) system allows individuals to choose between "traditional" and "Roth" variations. Has this and other retirement investment alternatives provide expanded options for individuals for individuals to save for retirement or has it made retirement investing too confusing?**

   The primary impact has been expanded options.

2. **As mentioned at the hearing, traditional 401(k) and IRA accounts are tax deferred. Eventually, the taxes are paid back to the government when the individual takes money out of the system. Under federal budget and related laws/rules generally on the first ten years' worth of savings/expenditures are counted. Since the deferred taxes on retirement savings is not paid back until years into the future any beneficial changes or expansion of traditional 401(k) and IRA accounts cost significant amounts of money. Should these laws/rules be amended to take into account the deferred nature of the taxes?**

   Yes. The current rules lead to a distorted view of both the cost and the impact of retirement savings tax incentives. The most serious and immediate danger of this distortion is to view short-term cash-basis revenue losses as permanently lost revenue, and conclude that long-term budget savings can be achieved by reducing retirement savings tax incentives. In reality, cash-basis savings in the 10-year budget window would turn into losses outside the window – lost retirement income and lost tax revenue. Failure to recognize the deferral nature of these incentives also inhibits the ability of Congress to pursue incentives to expand coverage which actually cost much less than what is shown in the score.

3. **Senator Kohl and I introduced the Savings Enhancement by Alleviating Leakage in 401(k) Savings Act of 2010, (SEAL Act), S. 1121, to help prevent retirement monies from leaking out of defined contribution plan accounts and not being replenished. What other items should we be considering to prevent leakage from defined contribution accounts?**

   As you know, ASPPA supports the SEAL Act and applauds your efforts to help Americans hold onto retirement savings until retirement. An important proposal in the SEAL Act would provide more time for loan repayment by terminated employees through extending the period for deposit of an equivalent cash amount to an IRA. Consideration should also be given to permitting (not requiring) IRAs to accept rollovers of participant loans from qualified plans.

4. **At a recent hearing before the Committee on Health, Education, Labor and Pension on our nation's defined benefit system, it became apparent that the defined benefit system is unlikely to see a comeback. In fact of the Fortune 100 companies only 13 offer a defined benefit plan to their new employees. Business and their trade**

associations cite many reasons for this including volatility in the markets, stricter accounting rules adopted by the Financial Accounting Standards Board, more stringent funding requirements and the Administration's proposal to increase fees on companies sponsoring defined benefit plans by $16 billion. Since defined benefit system is a voluntary employer-based system, can anything be done to change the system to make more businesses want to sponsor defined benefits plans? In light of the federal government's deficit, please assume that no new federal monies can be obligated to match or insure any private sector defined benefit monies.

The most immediate step is to reject the proposal to increase PBGC premiums by $16 billion over 10 years. Although PBGC claims to have a $23 billion deficit, this number will decline when interest rates rise, and PBGC itself says it has "more than sufficient funds to pay for benefits for the foreseeable future." New plan formation would be discouraged if sponsors face what would amount to a $70 per participant head tax for the right to sponsor a plan, and the most important factor in PBGC's future health is the continued existence of defined benefit plans covered by PBGC.

Congress should also make more flexible plans designs available. For example, pre-tax employee contributions cannot be made to private-sector defined benefit plans. Allowing employee deferrals with matching employer contributions as components of a cash balance plan should be considered. Defined benefit plans should be permitted to set normal retirement age as late as Social Security normal retirement age, and to permit in-service payment of benefits to commence as early as age 59 ½. All of these would help make defined benefit plan designs more competitive with defined contribution arrangements.

Congress should also simplify some of the funding rules implemented in PPA. We are still waiting on final regulations for some issues, but final IRC section 430 and 436 regulations make it clear how complicated some rules are in operation. For example, applying the benefit restrictions of section 436 to funded status determined without reducing assets by credit balances would better reflect the true funded status of a plan, and avoid the need to apply complicated presumed aftap rules that can result in unnecessary "burning" of credit balances.

We would be pleased to work with you and your staff on other ideas to encourage defined benefit plan sponsorship.

5. **Earlier this year at a hearing before the Committee on Health, Education, Labor and Pensions, I put forth an idea to establish a multiple employer pension system to help small businesses band together to sponsor 401(k) plans and I am currently working on legislative language. What elements should be included in this legislative proposal to ensure that small businesses will adopt these plans? What current requirements/elements of 401(k) laws/regulations may be a hindrance in establishing multiple employer 401(k) plans?**

401(k) plans are well suited to multiple employer arrangements (MEPs). To facilitate the establishment, adoption and proper operation of these plans, several issues should be addressed:

- Under current law, there is a "one bad apple" rule whereby a violation by one employer who has adopted a MEP disqualifies the plan for all adopting employers. The legislative proposal should assure that the actions of one adopting employer will not spoil the plan for all other adopting employers. Unfortunately, if the provider whom employers have trusted to see that the plan operates properly is not acting responsibly, employers may find that there are problems with the operation of the plan, or disqualifying provisions in the plan document, that affect more than one employer. Thus, for the protection of the adopting employers, we recommend that the MEP provider and its responsibilities be clearly identified to adopting employers, that the provider be identified in annual reports, and that the Service be permitted to audit the provider.

- One of the primary drivers of these plans will be controlled costs. In order to encourage the establishment of new MEPS, we recommend that the annual audit requirement be waived for MEPS with fewer than1000 participants provided no single employer has more than 100 participants under the plan. This will allow the MEP to avoid the cost of an audit until such time as there are enough adopting employers to spread the cost of the audit without making the MEP more expensive than a single plan.

- So-called "Open MEPS" are arrangements where the employer has nothing in common except having adopted the plan. This is clearly permitted under the Code, but there is some question as to whether these arrangements are a single plan under ERISA. Legislation should clarify that defined contribution retirement MEPS do not carry a commonality requirement other than adoption of the MEP. In addition, all employers that have adopted the MEP should be listed in an attachment to the MEP's annual report (Form 5500) so it is clear that the employer has met its annual reporting responsibilities through the MEP.

- Another major driver of the MEP is the ability of the employer to hand off responsibility for decision making with regard to the plan. Since MEPS come in different varieties – for example some with a named fiduciary managing investments, some with a broad menu of options that will be narrowed down by the adopting employer – there is confusion in the market place as to what an employer's responsibilities are with regard to these arrangements. Although many practitioners think ERISA is clear on these issues, it is telling that they don't all agree on what those responsibilities are. It would be unfortunate to encourage employers to join these arrangements, then ask them to go to court to litigate the limits of their responsibility. It would be helpful if legislation directed the Department of Labor to promulgate regulations that clarify the fiduciary responsibilities of these arrangements.

- There are rules that should be simplified for not just MEPS, but all small employer plans, to encourage employers to adopt a plan. For example, if employees are permitted to join a plan before meeting statutory eligibility requirements, plans should be able to test them separately for top heavy purposes. You might also consider a deferral-only safe harbor for plans with a contribution limit that is less than a SIMPLE arrangement. For example, set an $8,000 deferral limit with a $1,500 catch up amount (and no top heavy requirements).

Questions from Senator Orrin Hatch

1. **Ms. Miller, there was disagreement at the hearing about the percentage of employees that have access to retirement benefits at work. At least one witness said that less than half of workers have access, but your written testimony says that 78% of full-time civilian workers have access to retirement benefits at work and 84% of those participate. Please elaborate on your statement and explain what the appropriate measurement should be and why.**

   The statistics I quoted were from the Bureau of Labor Statistics, *Employee Benefits Survey: Retirement Benefits, March 2011: Retirement benefits: access, participation, and take-up rates: National Compensation Survey March 2011* available at http://www.bls.gov/ncs/ebs/sp/ebnr0017.pdf . This publication shows that 78% of full-time civilian workers have access to retirement benefits at work, and 84% participate. If you look at this March 2011 data, a "less than half" measurement would have to refer to the percentage of all private industry workers – including part-time workers - who actually *participate* in a plan at work. According to this survey, 64% of workers in this category have *access*.

   The base for the 78% measurement, *full-time* civilian workers, is the appropriate measurement to use in judging the effectiveness of the current tax incentives because the rules Congress placed on the tax incentives are geared toward substantially full-time workers. Employers can exclude anyone who does not have 12 months of service in which they worked at least 1000 hours. Congress may choose to expand those rules to include part-time workers but, until they do, it is not reasonable to include those workers in the baseline.

   The use of all *civilian* full-time workers instead of only private industry is appropriate because it is the tax incentives that drive access under most government plans as well as private industry plans. However, if we limit the measurement to private industry, 73% of full-time workers have access to a retirement plan at work, and 80% of those participate. Whether all civilian or private sector, full-time workers is the appropriate measurement base and access for these workers is over 70%, not less than 50%.

T-170

Senate Committee on Finance

Hearing on:

"Tax Reform Options: Promoting Retirement Security"

September 15, 2011

Submitted Testimony by

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1 Introduction

Chairman Baucus, Ranking Member Hatch, members of the committee, I am Jack VanDerhei, research director of the Employee Benefit Research Institute. EBRI is a nonpartisan institute that has been conducting original research on retirement and health benefits for the past 33 years. EBRI does not take policy positions and does not lobby.

My testimony today will focus on retirement security and the potential impact of various types of tax reform options on retirement income adequacy. This draws on the extensive research conducted by EBRI on these topics over the last 12 years with its Retirement Security Projection Model® as well as annual analysis of tens of millions of individual 401(k) participants dating back in some cases as far as 1996.

2 Why is it important to promote retirement security?

In 2010, EBRI[1] updated its Retirement Security Projection Model[2] and determined that the overall retirement income adequacy for households currently ages 36–62 had substantially improved since 2003.[3] Even with these improvements however, almost one-half of Baby Boomers[4] and Gen Xers[5] were determined to be at risk of not having sufficient retirement income to cover even basic expenses and uninsured health care costs.[6] The results, not surprisingly, were even worse for low-income households, as 70 percent of households in the lowest one-third when ranked by preretirement income were classified as "at risk." Moreover, 41 percent of those in the lowest preretirement income quartile are predicted to run short of money within 10 years of retirement.

In aggregate, the Retirement Savings Shortfalls (determined as a present value of retirement deficits at age 65) for these age cohorts (expressed in 2010 dollars) is $4.55 trillion, for an overall average of $47,732 per individual[7] still assumed to be alive at age 65.[8]

The study was also able to document the degree to which eligibility for participation in qualified retirement plans (especially defined contribution plans) matters with respect to "at-risk" status. For example, the at-risk probability for Gen Xers varies from 60 percent for those with no future years of eligibility in a defined contribution plan to 20 percent for those with 20 or more years.

In fact, it can be argued that much of the problem with retirement income adequacy in this country is one of whether a household is covered by an employer-sponsored retirement plan. Appendix B presents evidence from Copeland (2010) to show where potential legislation may exclude workers, or the number of workers who are already being reached, by certain demographic and employer characteristics, annual earnings, employer size, and work status (full-time/part-time).

3 Components of retirement security

In addition to individual savings and, to an increasing extent, part-time work in retirement, the major components of retirement security in this country for several decades have been Social Security and employer-sponsored retirement plans.

3.1 Social Security

The importance of Social Security retirement benefits for today's workers is shown in October 2010 Senate HELP testimony by EBRI:[9] 91 percent of the lowest-income households would be at risk of inadequate retirement income if they had no Social Security retirement benefits, compared with 76 percent at risk with current Social Security benefits. The other three higher-income quartiles also benefit from Social Security: Comparing the at-risk percentages with and without Social Security retirement benefits, 24-26 percent of households in the other three higher income groups are saved from at-risk status by Social Security.

Unfortunately, the latest projections of Social Security suggest that trust fund reserves will be exhausted in 2036. EBRI recently provided analysis of a generic type of Social Security reform proposal that, in essence, would keep Social Security retirement benefits in their current statutory form until 2037, and at that point subject all Social Security retirement benefits to a permanent 24 percent reduction.[10] As expected, the impact should be minimal for those currently on the verge of retirement—so the "at-risk" level for Early Boomers increases by only 0.3 percentage points. But Late Boomers will have a larger percentage of their expected Social Security benefits reduced as a result of this change, and their "at-risk" level increases by 1.6 percentage points under the baseline assumptions. Gen Xers will have even more years of their expected retirement affected by this change, and their increase in "at-risk" percentage is simulated to be 5.8 percentage points.

3.2 Defined benefit plans

According to EBRI estimates,[11] the percentage of private-sector workers participating in an employment-based defined benefit plan decreased from 38 percent in 1979 to 15 percent in 2008. Although much of this decrease took place by 1997,[12] there have been a number of recent developments[13] that have made defined benefit sponsors in the private sector re-examine the costs and benefits of providing retirement benefits through the form of a qualified defined benefit plan.[14] However, these plans still cover millions of U.S. workers and have long been valued as an integral component of retirement income adequacy for their households.

EBRI used its Retirement Security Projection Model (RSPM)® to evaluate the importance of defined benefit plans for households assuming they retire at age 65 and showed the tremendous importance of defined benefit plans in achieving retirement income adequacy for Baby Boomers and Gen Xers. Overall, the presence of a defined benefit accrual at age 65 reduces the "at-risk" percentage by 11.6 percentage points. The defined benefit plan advantage (as measured by the gap between the two at-risk percentages) is particularly valuable for the lowest-income quartile but also has a strong impact on the middle class (the reduction in the at-risk percentage for the second and third income quartiles combined is 9.7 percentage points which corresponds to a 19.5 percent relative reduction).

3.3 Defined contribution plans

Given the phenomenal growth of defined contribution plans (especially those with a 401(k) feature) in the private sector in the last three decades, it appears that this form of employer-provided retirement plan will provide a substantial percentage of non-Social Security retirement wealth for Baby Boomers and Gen Xers. Unfortunately, the "success" of these plans are sometimes measured by metrics that are not at all relevant to the potential for defined contribution plans to provide a significant portion of a worker's pre-retirement income. For example, some analysts will merely report the average balance in defined contribution plans (most commonly the 401(k) subset of this universe) and attempt to assess the value of these plans by determining the amount of annual income that this lump sum amount could be converted to at retirement age. Of course, this concept does not adjust for the fact that the vast majority of 401(k) participants are years, if not decades, away from retirement age. Moreover, even if one does look at the average balances for workers near retirement age, it is obviously not correct to look only at the 401(k) balance with the employee's current employer. [15]

In an attempt to provide meaningful statistics on the 401(k) system, EBRI entered into a collaborative effort with the Investment Company Institute (ICI) in 1996 known as the EBRI/ICI Participant-Directed Retirement Plan Data Collection Project. As of December 31, 2009,[16] the database included statistical information about:

- 20.7 million 401(k) plan participants, in
- 51,852 employer-sponsored 401(k) plans, holding
- $1.210 trillion in assets.

Since the inception of the project, average balances have been displayed as a function of both the participant's age and tenure with the current employer to allow more meaningful assessment of the accumulation potential of these plans. For the last 10 years, average balances are also computed for a "consistent sample" of participants to control for the downward bias that would otherwise exist from IRA rollovers when 401(k) participants change jobs.

However, even with these empirical techniques, it was difficult to obtain a true value of the 401(k) system's potential to generate significant 401(k) accumulations given that employees reaching retirement age only had the possibility to be covered by a 401(k) plan for a portion of their career.[17] In an attempt to control for these problems, EBRI and ICI produced a joint publication in 2002[18] with simulation results showing that under a continuous coverage situation, 401(k) participants could expect to replace someplace between 51 and 69 percent (depending on income quartile) of their pre-retirement income assuming the purchase of a (nominal) annuity at age 65.

When the 2002 study was performed, very few 401(k) sponsors had adopted any type of automatic enrollment (AE) provisions for their plans. In a 2005 follow-up study with ICI,[19] we looked at the potential change in 401(k)/IRA rollover accumulations as a result of changing the traditional voluntary enrollment (VE) 401(k) plans to AE plans. Although we had the advantage of using a database of tens of millions of 401(k) participants going back in some cases to 1996, we were limited in knowing how workers would react to AE provisions, and thus simulated the likely response using the results of academic studies.[20] What we found was that the overall expected improvement in retirement accumulations—especially for the lower-income quartiles—were nothing less than spectacular.

A year after this study was released, Congress passed the Pension Protection Act of 2006 (PPA), which eased some of the administrative barriers to providing AE and for the first time setting up safe harbor provisions for automatic escalation of employee contributions. Although it was too soon to know how plan sponsors would react to this new legislation, EBRI published a study in 2007[21] that showed how automatic escalation would make the AE results even more favorable under a number of different scenarios for both plan sponsor and worker behavior.

In 2008, EBRI included all the new PPA provisions in a study[22] that compared potential accumulations under AE and VE for several different age groups. Again, we found certain (high-income) groups that were likely to do better under VE than AE, but overall, the AE results dominated.

By 2009, many of the 401(k) sponsors who previously had VE plans had shifted to AE plans and EBRI was able to track the changes in plan provisions for hundreds of the largest 401(k) plans. This information was used in an April 2010 *EBRI Issue Brief*[23] to show, once again, the significant impact of moving to AE plans (for those currently ages 25–29, the difference in the median accumulations would be approximately 2.39 times final salary in an AE plan relative to a VE plan).

Later in 2010, EBRI and DCIIA[24] teamed up to do an analysis that focused not on a comparison of VE and AE, but rather how to improve plan design and worker education to optimize the results under AE plans with automatic escalation of contributions. While it is difficult to determine the correct "target" for retirement savings, we used what, by most financial planning standards, appears to be quite generous: an 80 percent REAL income replacement rate in retirement when 401(k) accumulations are combined with Social Security. The study found that with the proper choice of plan design and worker education, for employees simulated to have between 31 and 40 years of eligibility, the percentage of lowest-income quartile workers achieving the 80 percent threshold was 79.2 percent, and that of the highest-income quartile workers was 64 percent.

To summarize, it appears from both empirical analysis and simulation results based on tens of millions of individual participant observations (dating all the way back to 1996 in many cases), that the traditional (VE) type of 401(k) plan under the current set of tax incentives has the potential to generate a sum that when combined with Social Security benefits would replace a sizeable portion of the employee's preretirement income for those fortunate enough to have continuous coverage during their working careers. Moreover, the AE type of 401(k) plan when combined with automatic escalation provisions appears to have the potential to produce even larger retirement accumulations for many of those covered by such a plan during a significant portion of their working careers.

4 The potential impact of tax reform on retirement security

Prior to estimating the potential reductions in accumulations resulting from 401(k) contributions, a set of baseline results first need to be run to determine the likely values if the various tax reform options are not imposed on the current 401(k) system. The model used in this article is based on the 401(k) voluntary enrollment modules from the EBRI Retirement Security Projection Model® (RSPM) and is similar in many respects to the one used in Holden and VanDerhei (2002) in that it looks only at current 401(k) participants and does not attempt to include eligible nonparticipants[25] or workers who are currently not eligible.[26] However, unlike the 2002 model, this analysis assumes no job turnover, withdrawals, or loan defaults.[27]

Figure 1 shows the median real replacement rates at age 67 from 401(k) balances exclusively for participants currently ages 25–29 by income quartiles.[28] The values vary from a low of 53 percent for the lowest-income quartile to a high of 77 percent for the highest-income quartile.[29] The simulated rates of return are explained in more detail in VanDerhei and Copeland (2010), but they are based on a stochastic process with a mean equity return of 8.9 percent and a mean fixed-income return of 6.3 percent (expressed in nominal terms).

4.1 20/20 analysis

In December 2010, the National Commission on Fiscal Responsibility and Reform released their long-awaited document on federal debt reduction, "The Moment of Truth." Although their guiding principles and values (pages 13–14) specifically mention the need to keep America sound over the long run by implementing "policies today to ensure that future generations have retirement security, affordable health care, and financial freedom," the document puts forth a tax reform plan that would modify retirement plans by capping annual "tax-preferred contributions to [the] lower of $20,000[30] or 20% of income" (page 31). This is often referred to as the "20/20 cap."

Even if one were to ignore the potential interaction of the proposed limitations with the present values of accruals under defined benefit plans and/or the existing tax preferences available to some individual retirement account (IRA) contributions, this alternative formulation of capping tax-preferred contributions would substantially reduce the current limits available under qualified defined contribution (401(k)-type) plans. Currently, the combination of employee and employer contributions is the lesser of a dollar limit of at least $49,000 per year[31] and a percentage limit of 100 percent of an employee's compensation.[32]

VanDerhei (July, 2011) provides preliminary evidence of the impact of these "20/20 caps" on projected retirement accumulations under a set of assumptions explained in detail later. While this provides a first approximation of the potential impact of these constraints on workers, as well as the distribution of the impact by income, it does not tell the entire story. A follow-up study will also explore the likely impact of these constraints on retirement plan sponsor behavior and estimate the extent to which fewer employers would be willing to offer qualified defined contribution plans (especially among plans offered by small employers).[33]

If the 20/20 caps are assumed to be imposed starting in 2012, the annual percentage reductions in 401(k) account balances at Social Security normal retirement age are displayed in Figure 2 by age and age-specific income quartiles for all 401(k) participants with salaries in excess of $10,000 and tenure of at least two years.

Several points stand out immediately:

- With the exception of the earliest age cohort[34] (those currently 26–35), the average reduction for any income quartile decreases for older age cohorts. This is due to the fact that those closest to retirement age will have fewer years of future contributions subject to potential reduction as a result of the 20/20 caps.

- Within each of the four age cohorts, the highest-income quartile experiences the largest average percentage reduction from the 20/20 caps. This reaches a maximum value of 15.1 percent for the highest-income quartile for those currently ages 36–45 and falls to 8.6 percent for the highest-income quartile for those currently ages 56–65.
- The finding that the highest-income quartile within each age cohort experiences the largest average percentage reduction is no surprise, given the increased likelihood that workers in this cohort either currently exceed the $20,000 (indexed) limit when their contributions are combined with employer contributions or are predicted to do so in the future. However, for each age cohort other than the oldest one, the *lowest-income quartile* has the *second-highest average percentage reductions.* Although this may be due to several considerations,[35] it is almost always a result of their current or expected future contributions exceeding 20 percent of compensation when combined with employer contributions. Phrased another way, the 20/20 cap would, as expected, most affect the highest-income workers, but it also would cause a significant reduction in retirement accumulations for the lowest-income workers.

4.2 Replacing the current deduction for contributions to defined contribution plans with a flat-rate government match

Gale (2011) updates previous analysis by Gale, Gruber and Orszag (2006) and analyzes a plan that would replace the existing tax deductions with a flat-rate refundable credit that serves as a matching contribution in a retirement savings account. It reports estimates from the Tax Policy Center for both an 18 percent credit and a 30 percent credit. The paper includes a distributional analysis of the winners and losers under the two versions of the proposal; however, the underlying analysis holds retirement saving contributions constant (page 6). The author mentions that the proposal "could conceivably affect incentives for firms to offer 401(k)s or pensions" (page 7) but concludes that this seems unlikely. He also dismisses as likely overstated the concern that the matches provided in the proposal may discourage employer matches to 401(k) plans.

While these two papers provide an extremely interesting analysis of a proposal with profound public policy implications, it appears quite likely that some of the assumptions with respect to responses (or lack thereof) from employees and (more significantly) plan sponsors will be the subject of serious debate among those with first-hand knowledge of the decision-making process of employers who must decide whether or not to sponsor a defined contribution plan and, if they do so, how to best design the various plan parameters (including the match rate and match level) to meet their objectives.

Public policy consideration of this proposal will undoubtedly be subject to some type of a cost-benefit analysis beyond one that is assuming retirement saving contributions will remain constant. It is admittedly very difficult to determine how those employees not currently covered and/or participating in a defined contribution plan will react to this set of incentives, and EBRI will continue to work with data from sponsors who automatically enroll their employees in 401(k) plans to better assess some of the behavioral tendencies of this group.

Until this type of information is available it will be quite difficult to accurately assess the "benefit" portion of the cost-benefit analysis suggested above. However, EBRI is currently in a position to provide the Committee with guidance on what some of the likely "costs" will be in terms of reduced retirement benefits for those currently in the 401(k) system.

4.2.1 Results from the 2011 Retirement Confidence Survey

In recent years, proposals have surfaced to reform the 401(k) system based on the assumption that higher-income individuals receive more tax-related benefits from these programs than do individuals in lower marginal tax brackets (as well as those who may pay no federal income taxes in a particular year). Some of these proposals have included modifications of the current federal income taxation treatment that excludes some or all[36] of the contributions employees make to tax-qualified defined contribution plans. VanDerhei (March, 2011) provides an analysis of two new questions from the 21st wave of the Retirement Confidence Survey (RCS)[37] showing how workers[38] would likely react if they were no longer allowed to deduct retirement savings plan contributions from taxable income.

Although analysis based on financial economics suggests that higher-income employees would be the most likely to be negatively affected by a proposal to cut or eliminate the deductibility of 401(k) contributions (at least to the point they are constrained with respect to the annual funds available to contribute to a 401(k) plan),[39] behavioral economics has shown that the reaction of employees in situations similar to this are often at odds with what would have been predicted by an objective concerned simply with optimizing a financial strategy. In an attempt to better understand potential employee behavior with respect to a proposed elimination of deductions for 401(k) contributions, this year's RCS included two new questions. The first asked respondents how important is being able to deduct their retirement savings plan contributions from their taxable income in encouraging them to save for retirement. When confined to full-time workers (n=591), the weighted results were as follows:[40]

Not at all important	4.3%
Not too important	5.0%
Somewhat important	27.8%
Very important	61.5%

If one were to look at this from a strictly financial perspective, one would assume that the lower-income individuals (those most likely to pay no or low marginal tax rates and therefore have a smaller financial incentive to deduct retirement savings contributions from taxable income) would be least likely to rate this as "very important." However, those in the lowest household income category ($15,000 to less than $25,000) actually have the largest percentage of respondents classifying the tax deductibility of contributions as very important (76.2 percent).

The second question asked of those currently saving for retirement was "Suppose you were no longer allowed to deduct retirement savings plan contributions from your taxable income. What do you think you (and your spouse) would be most likely to do?" When confined to full-time workers (n=460), and eliminating those who refused to answer or responded that they did not know, approximately 1 in 4 full-time workers (25.6 percent) indicated that they would reduce (in some cases completely) their contributions if the ability to deduct them was eliminated. The lowest-income category ($15,000 to less than $25,000) has the largest negative reaction to this proposal, with 56.7 percent indicating a savings reduction.

A similar occurrence takes place when the percentage of those stating they would reduce the amount they are saving or stop saving altogether is displayed by the amount they currently have in savings and investments, not including the value of their primary residence or the value of defined benefit plans. There is a significant increase in the self-reported propensity to reduce savings for those in the lowest savings categories. For example, of the full-time workers who are currently saving for retirement who report that they currently have less than $1,000, 71.3 percent indicate they would reduce the amount saved. This value declines to 38.8 percent for those with savings of $1,000 to less than $10,000.

4.2.2 Impact of the proposal on 401(k) balances at retirement

For purposes of the today's analysis, the (filtered) RCS respondents are placed into one of three categories:[41]

- Stop saving for retirement altogether.
- Reduce the amount you save.
- Continue to save what you do now.[42]

The respective probabilities are computed for each family income category and the worker's reaction to the proposal is added as a stochastic response based on the model described above for the 20/20 analysis. Two assumptions need to be utilized before looking at the likely change in 401(k) balances as a result of the proposal:

- What is the appropriate percentage reduction for those in the second category above?
- What is the appropriate portion of the household salary represented by the salary of the 401(k) participant?

For purposes of the baseline results presented today, 50 percent is used for the first assumption and 100 percent is used for the second. The results will be sensitive to the values assumed for these two assumptions and additional sensitivity analysis is presented in Appendix C.

Figure 3 provides the average percentage reductions in 401(k) account balances at Social Security normal retirement age by permanently modifying the exclusion of employee contributions for retirement savings plans from taxable income in 2012 (by age and age-specific salary quartiles). As expected, the younger cohorts would experience larger reductions given their increased exposure to the proposal. Focusing on those currently 26–35, the average percentage reductions vary from a low of 11.2 percent for the highest income quartile to a high of 24.2 percent for the lowest income quartile. As this analysis was intended to look exclusively at the impact of changing the exclusion of employee contributions from taxable income, it was assumed that the total matching contribution would remain constant.[43]

In asking employers and providers how they thought employers would respond to the change in policy, it was suggested that they would allow the government to do the match to keep people contributing and use their dollars to pay for the increasing cost of employee health insurance. Although EBRI is currently working on a survey to elicit potential employer response to this proposal, it may be instructive to model this scenario to assess the additional reduction in 401(k) retirement accumulations if employers were to drop their plan matches and 401(k) participants would instead have only the 18 percent or 30 percent match provided by the government.

Figure 4 also provides the average percentage reductions in 401(k) account balances at Social Security normal retirement age by permanently modifying the exclusion of employee contributions for retirement savings plans from taxable income in 2012 (by age and age-specific salary quartiles) but, unlike Figure 3, assumes that plan sponsors completely drop their plan match and that employees are left with only the government match of 30 percent.

Given that most 401(k) plan sponsors currently match at a rate greater than 30 percent, it is not surprising that the average reductions increase in Figure 4. For those currently ages 26–35, the average reduction varies from a low of 24.6 percent for the highest-income quartile to a high of 36.0 percent for the lowest-income quartile.

Figure 5 provides the same analysis as Figure 4 but this time the 18 percent government match is modeled. As expected, this increases the average percentage reductions even more. For those currently ages 26–35, the average reduction varies from a low of 30.6 percent for the highest-income quartile to a high of 41.4 percent for the lowest-income quartile.

At this point it may also be useful to analyze the potential impact of the proposal on 401(k) retirement balances even if there were no employee behavioral response to the change in the exclusion of employee contributions. Figure 6 analyzes only the financial (not behavioral[44]) change in match rates (from what the employer had been providing to the 18 percent government match). In this case, for those currently ages 26–35, the average reduction varies from a low of 22.1 percent for the highest income quartile to a high of 23.1 percent for the lowest income quartile.

4.3 Caveats with respect to automatic enrollment

The previous results assumed none of the 401(k) participants were automatically enrolled in the retirement plan; instead, workers' escalation of contributions after the first year are driven primarily by age and income characteristics as opposed to tenure with the current employer, as they would be in auto-enrollment plans (especially those with automatic escalation of employee contributions).

The exclusion of auto-enrollment plans in this analysis was necessary given the current modeling assumption of no job change. It would be very difficult to provide a valid analysis of the average percentage reductions in 401(k) balance under auto-enrollment because very little, if any, information currently exists that can be used to track what automatically enrolled participants with automatic escalation of contributions would do upon job change. For example, if a participant has already been escalated to 8 percent of compensation and upon job change is automatically enrolled into another 401(k) plan, would they "remember" where they had been, or decrease contributions to the default rate of the new plan?

As additional information becomes available with respect to employees' behavioral responses for auto-enrollment, EBRI will update this analysis to provide a more robust model.

5 Future work

In addition to the expansion of the model used for the two analyses above to include 401(k) plans with automatic enrollment, EBRI plans to continue to conduct research in this area as public policy agendas dictate. While Gale (2011) includes a distribution of federal tax change by cash income percentile in 2011, it would be extremely useful to expand this analysis to include both employee and employer reactions to the proposal and to simulate the employees over time in an attempt to project future balances at retirement age.

While it is possible to analytically evaluate the change in incentives for an employer to sponsor a qualified plan and/or continue a match at the current level (if at all) as a result of 20/20 or the Gale proposal, it would be helpful (if not essential) to supplement this with a detailed set of surveys and/or focus group studies to increase the understanding of the employer's likely reaction to these changes before attempting to quantify the potential changes in retirement income resulting from such a massive shift in incentives.

The potential reaction of employee's not currently participating in 401(k) plans will be extremely difficult to model for new incentive structures similar to those proposed by Gale. For example, does the current experience under 401(k) plans allow researchers to extrapolate to this population with respect to:

- Initial participation decisions.
- Decisions to opt out once participation has begun.
- Contribution behavior.
- Asset allocation.
- Cash outs at time of job change.

Many of EBRI's previous simulation projects (see Appendix A for a brief chronology) will be directly applicable to such additional research and we will be happy to work with the Senate Finance Committee to provide cost/benefit assessments of these types of proposals in the future.

6 Conclusions

In 2010, EBRI[45] documented a significant reduction in the percentage of households "at risk" for inadequate retirement income between 2003 and 2010, based in large part on the advent of auto-enrollment in 401(k) plans; however, for the one-third of the households with the lowest-indexed[46] pre-retirement income, the at-risk percentages, while much smaller (they were 80 percent in 2003) are still extremely high (70 percent in 2010). Of course, when one limits the analysis to those who are simulated to be saving in the future, the numbers improve substantially: among Gen Xers without any future eligibility for participation in a defined contribution plan, the at-risk percentage is 60 percent, but it drops all the way to 20 percent for those with 20 or more years of future eligibility.[47]

Given that the financial fate of future generations of retirees appears to be so strongly tied to whether they are eligible to participate in employer-sponsored retirement plans,[48] the logic of modifying (either completely or marginally) the incentive structure of employees and/or employers for defined contribution plans at this time needs to be thoroughly examined. EBRI studies[49] have documented that defined contribution plans (and the IRA rollovers they produce) are the component of retirement security that appears to be generating the most non-Social Security retirement wealth for Baby Boomers and Gen Xers. However, the potential increase of at-risk percentages resulting from (1) employer modifications to existing plans, and (2) a substantial portion of low-income households decreasing or eliminating future contributions to savings plans as a reaction to the exclusion of employee contributions for retirement savings plans from taxable income, needs to be analyzed carefully when considering the overall impact of such proposals.

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8 Appendix A: A Brief Chronology of RSPM

The original version of Retirement Security Projection Model® (RSPM) was used to analyze the future economic well-being of the retired population at the state level. The Employee Benefit Research Institute and the Milbank Memorial Fund, working with the governor of Oregon, set out to see if this situation could be addressed for Oregon. The analysis[50] focused primarily on simulated retirement wealth with a comparison to ad hoc thresholds for retirement expenditures, but the results made it clear that major decisions lie ahead if the state's population is to have adequate resources in retirement.

Subsequent to the release of the Oregon study, it was decided that the approach could be carried to other states as well. Kansas and Massachusetts were chosen as the next states for analysis. Results of the Kansas study were presented to the state's Long-Term Care Services Task Force on July 11, 2002,[51] and the results of the Massachusetts study were presented on Dec. 1, 2002.[52] With the assistance of the Kansas Insurance Department, EBRI was able to create Retirement Readiness Ratings based on a full stochastic decumulation model that took into account the household's longevity risk, post-retirement investment risk, and exposure to potentially catastrophic nursing home and home health care risks. This was followed by the expansion of RSPM, as well as the Retirement Readiness Ratings produced by it, to a national model and the presentation of the first micro-simulation retirement income adequacy model built in part from administrative 401(k) data at the EBRI December 2003 policy forum.[53] The basic model was then modified for Senate Aging testimony in 2004 to quantify the beneficial impact of a mandatory contribution of 5 percent of compensation.[54]

The first major modification of the model occurred for the EBRI May 2004 policy forum. In an analysis to determine the impact of annuitizing defined contribution and IRA balances at retirement age, VanDerhei and Copeland (2004) were able to demonstrate that for a household seeking a 75 percent probability of retirement income adequacy, the additional savings that would otherwise need to be set aside each year until retirement to achieve this objective would decrease by a median amount of 30 percent. Additional refinements were introduced in 2005 to evaluate the impact of purchasing long-term care insurance on retirement income adequacy.[55]

The model was next used in March of 2006 to evaluate the impact of defined benefit freezes on participants by simulating the minimum employer contribution rate that would be needed to financially indemnify the employees for the reduction in their <u>expected</u> retirement income under various rate-of-return assumptions.[56] Later that year, an updated version of the model was developed to enhance the EBRI interactive Ballpark E$timate® worksheet by providing Monte Carlo simulations of the necessary replacement rates needed for specific probabilities of retirement income adequacy under alternative risk management treatments.[57]

RSPM was significantly enhanced for the May 2008 EBRI policy forum by allowing automatic enrollment of 401(k) participants with the potential for automatic escalation of contributions to be included.[58] Additional modifications were added in 2009 for a Pension Research Council presentation that involved a winners/losers analysis of defined benefit freezes and the enhanced defined contribution employer contributions provided as a quid pro quo.[59]

A new subroutine was added to the model to allow simulations of various styles of target-date funds for a comparison with participant-directed investments in 2009.[60] In April 2010, the model was completely reparameterized with 401(k) plan design parameters for sponsors that have adopted automatic enrollment provisions.[61] A completely updated version of the national model was produced for the May 2010 EBRI policy forum and used in the July 2010 *Issue Brief*.[62]

The new model was used to analyze how eligibility for participation in a defined contribution plan impacts retirement income adequacy in September 2010.[63] It was also used to compute Retirement Savings Shortfalls for Boomers and Gen Xers in October 2010.[64]

In October 2010 testimony before the Senate Health, Education, Labor and Pensions Committee, on "The Wobbly Stool: Retirement (In)security in America," the model was used to analyze the relative importance of employer-provided retirement benefits and Social Security.[65]

In February 2011, the model was used to analyze the impact of the 2008/9 crisis in the financial and real estate markets on retirement income adequacy.[66]

An April 2011 article introduced a new method of analyzing the results from the RSPM.[67] Instead of simply computing an overall percentage of the simulated life paths in a particular cohort that will not have sufficient retirement income to pay for the simulated expenses, the new method computes what percentage of the households will meet that requirement more than a specified percentage of times in the simulation.

Finally, the June 2011 Issue Brief allowed retirement income adequacy to be assessed at retirement ages later than 65.[68]

9 Appendix B: Number of Workers Without a Plan

An important policy topic resulting from an analysis of employment-based retirement plan participation is the number of workers who are *not* participants, as well as the number for those that work for an employer/union who does *not* sponsor a plan.[69] Copeland (2010) investigates these numbers to show where potential legislation may exclude workers, or the number of workers who are already being reached, by certain demographic and employer characteristics, annual earnings, employer size, and work status (full-time/part-time). He shows that in 2009, 78.2 million workers worked for an employer/union that did *not* sponsor a retirement plan and 93.2 million workers did *not* participate in a plan (Figure 7).[70] Focusing in on employees who did not work for an employer that sponsored a plan, 9.2 million were self-employed—meaning the worker could have started a plan for himself/herself without the need for action from his/her employer. Therefore, the number of workers who worked for someone else that did not sponsor a plan totaled 69.0 million in 2009.

Of those 69.0 million, 6.7 million were under the age of 21, and 3.6 million were age 65 or older. Approximately 33 million were not full-time, full-year workers, and 18.5 million had annual earnings of less than $10,000. Furthermore, many of these workers (39.4 million) worked for employers with less than 100 employees, including 10.2 million working for employers with 25–99 employees, 10.4 million for those with 10–24 employees, and 18.8 million for those with fewer than 10 employees

However, many of these workers would fall into many of these categories simultaneously, such as being under age 21, having less than $10,000 in annual earnings, and not being a full-time, full-year worker. Therefore, the bottom of the Figure 7 shows the number of workers who would remain in a targeted population, if exclusions are made for age, annual earnings, work status, and/or employer size. For example, if the population of interest is wage and salary workers ages 21–64 who work full time, make $5,000 or more in annual earnings, and work for an employer with 10 or more employees, 31.5 million worked for an employer that did not sponsor a retirement plan in 2008 (meaning that 46 percent of the total nonself-employed working for an employer that did not sponsor a plan fell into this group). Yet, if a more restrictive definition is placed on the targeted population, so that only workers who work full-time, full-year, make $10,000 or more in annual earnings, and work for an employer with 100 or more employees, only 5.5 million workers (or 11 percent) would be included among those working for an employer that did not sponsor a plan. Of course, another way to look at this last number is that 89 percent of these workers with those characteristics worked for an employer that did sponsor a retirement plan in 2009.

Appendix C: Sensitivity analysis on baseline assumptions for Figure 3

Average Percentage Reductions in 401(k) Account Balances at Social Security Normal Retirement Age by Permanently Modifying the Exclusion of Employee Contributions for Retirement Savings Plans From Quartiles Taxable Income in 2012, by Age and Age-specific Salary

	Percentage reduction	0.25	0.25	0.5	0.5	0.75	0.75
	Percentage of family income	0.5	1	0.5	1	0.5	1
26-35	Lowest income quartile	13.1%	15.4%	18.9%	24.2%	24.8%	33.1%
26-35	2	8.9%	12.0%	13.2%	18.5%	17.5%	25.0%
26-35	3	6.1%	11.6%	9.9%	15.8%	13.8%	19.9%
26-35	Highest	5.8%	7.2%	9.9%	11.2%	14.0%	15.2%
36-45	Lowest income quartile	11.6%	12.9%	16.9%	20.6%	22.1%	28.3%
36-45	2	6.3%	11.9%	9.8%	17.0%	13.2%	22.1%
36-45	3	5.3%	8.1%	9.0%	11.3%	12.6%	14.6%
36-45	Highest	5.2%	5.3%	8.8%	8.7%	12.4%	12.2%
46-55	Lowest income quartile	10.1%	11.3%	14.7%	18.1%	19.4%	24.9%
46-55	2	5.1%	9.8%	8.1%	13.8%	11.0%	17.9%
46-55	3	4.3%	6.4%	7.3%	9.1%	10.3%	11.9%
46-55	Highest	4.1%	4.1%	7.0%	6.9%	9.8%	9.7%
56-65	Lowest income quartile	8.6%	10.1%	12.6%	15.9%	16.5%	21.7%
56-65	2	4.7%	7.4%	7.1%	11.2%	9.5%	15.0%
56-65	3	3.1%	5.1%	5.3%	6.9%	7.4%	8.8%
56-65	Highest	3.0%	3.0%	5.0%	4.9%	7.0%	6.9%

Source: Author's calculations based on results from EBRI Retirement Security Projection Model Version 110910c2a-j

11 Endnotes

[1] VanDerhei and Copeland (2010).

[2] A brief chronology of RSPM is included in Appendix A.

[3] This improvement took place despite the financial and real estate market crisis of 2008/2009. For evidence on the impact of the recession on retirement income adequacy, see VanDerhei (February 2011).

[4] The post-World War II demographic wave of children born between 1948–1964.

[5] Americans born between 1965–1974 and currently between the ages of 36–45).

[6] These results assume retirement at age 65. For evidence on the impact of deferring retirement age beyond that age 65 see VanDerhei and Copeland (2011)..

[7] Household deficits for married couples are divided equally between the two spouses.

[8] VanDerhei (October 2010a).

[9] VanDerhei (October 2010b).

[10] VanDerhei and Copeland (2010).

[11] www.ebri.org/publications/benfaq/index.cfm?fa=retfaq14, last accessed July 26, 2011.

[12] For a historical review of causes of this decline see Olsen and VanDerhei (1997).

[13] See VanDerhei (July 2007) for a summary of the responses of defined benefit sponsors to the implementation of the new funding requirements under the Pension Protection Act of 2006 as well as the potential pension expense volatility under new FASB requirements.

[14] This does not necessarily imply that many existing defined benefit sponsors have or will terminate their existing defined benefit plans. Instead the process of freezing these plans for current and/or new workers has increased substantially in recent years. For more information on the impact of plan freezes on workers see VanDerhei (March 2006). For an analysis of whether "frozen" workers have been financially indemnified via enhanced employer contribution to defined contribution plans, see Copeland and VanDerhei (2010).

[15] For example, an employee age 60 may have very recently changed jobs and rolled over a substantial account balance from his previous employer to an IRA.

[16] Year-end 2010 data is currently being analyzed and the annual update should be available soon.

[17] The proposed regulations for 401(k) plans were published in November 1981 and much of the growth in these plans took place in the next few years.

[18] Holden and VanDerhei (2002).

[19] Holden and VanDerhei (2005).

[20] Choi, Laibson, Madrian, and Metrick (2002).

[21] VanDerhei (September 2007).

[22] VanDerhei and Copeland (2008).

[23] VanDerhei (April 2010).

[24] VanDerhei and Lucas (2010).

[25] See Holden and VanDerhei (2005).

[26] See VanDerhei and Copeland (2008).

[27] The full stochastic nature of the model will be included in future analysis.

[28] It is important to note that the annuitized accumulations in this analysis are from 401(k) contributions exclusively and do not include projected Social Security retirement benefits. This is in contrast to other EBRI research (e.g., VanDerhei and Lucas, November 2010) that includes both components. However, in the previous analysis, all workers were simulated and job change was allowed.

[29] These estimates compare quite favorably to those in Holden and VanDerhei (2002) when the difference between nominal and real replacement rates are considered. However, this is to be expected given the assumptions listed above (especially the lack of job turnover and therefore the suppression of cashouts prior to retirement).

[30] Presumably, the $20,000 figure would be indexed for inflation in the future similar to current treatment of IRC Sec. 415(c) limits.

[31] Employees age 50 or over may be allowed to contribute up to an additional $5,500 per year.

[32] Section 415(c) of the Internal Revenue Code.

[33] See testimony for this hearing by Judy Miller for an example of this analysis.

[34] The reason that the youngest age cohort does not follow this trend is due to their relatively lower current wages than older cohorts after adjusting for historic age/wage profiles.

[35] Although additional analysis needs to be performed before assessing relative importance of these factors, it appears that this result is caused by at least two factors. First, the definition of income quartile in RSPM is determined in a manner similar to the average indexed monthly earnings computation for Social Security with the following modifications: (a) All earned income is included up to the age of retirement (i.e., there is no maximum taxable wage base constraint and the calculation terminates at retirement age); (b) Instead of indexing for changes in average national wages, the model indexes based on assumed after-tax rate of return based on asset allocations that are a function of the individual's age in each year; and (c) Percentile distributions are established based on population statistics for each age cohort. Therefore, it is possible that an individual whose preretirement income ranks in the lowest quartile over their remaining work history may indeed end up with an income that would rank higher than the bottom quarter in one or more specific years. Second, the impact of the 20 percent limitation for the lowest-income quartile may fall disproportionately on the part-time workers. For example, a worker who enters the work force part time whose spouse already has a full-time job may be in a better situation to attempt to maximize retirement contributions on his/her income. Although EBRI is in the process of attempting to model the impact on part-timers on a longitudinal basis, the current analysis filtered out any 401(k) participants with annual income of less than $10,000 as well as those with less than two year of tenure.

[36] The elective deferral limit increased by $5,500 for 2011 and is currently limited to $16,500 by Internal Revenue Code Section 402(g)(1). A plan may permit participants who are age 50 or over at the end of the calendar year to make additional elective deferral contributions. Effective for years beginning on or after January 1, 2006, if a plan adopts a Roth feature, employees can designate some or all of their elective contributions as designated Roth contributions (which are included in gross income), rather than traditional, pre-tax elective contributions.

[37] These findings are part of the 21st annual Retirement Confidence Survey (RCS), a survey that gauges the views and attitudes of working-age and retired Americans regarding retirement, their preparations for retirement, their confidence with regard to various aspects of retirement, and related issues. The survey was conducted in January 2011 through 20-minute telephone interviews with 1,258 individuals (1,004 workers and 254 retirees) age 25 and older in the United States. Random digit dialing was used to obtain a representative cross section of the U.S. population. To further increase representation, a cell phone supplement was added to the sample. Starting with the 2001 wave of the RCS, all data are weighted by age, sex, and education to reflect the actual proportions in the adult population. Data for waves of the RCS conducted before 2001 have been weighted to allow for consistent comparisons; consequently, some data in the 2011 RCS may differ slightly with data published in previous waves of the RCS. Data presented in tables in this report may not total to 100 due to rounding and/or missing categories. In theory, the weighted sample of 1,258 yields a statistical precision of plus or minus 3 percentage points (with 95 percent certainty) of what the results would be if all Americans age 25 and older were surveyed with complete accuracy. There are other possible sources of error in all surveys, however, that may be more serious than theoretical calculations of sampling error. These include refusals to be interviewed and other forms of nonresponse, the effects of question wording and question order, and screening. While attempts are made to minimize these factors, it is impossible to quantify the errors that may result from them. The RCS was co-sponsored by the Employee Benefit Research Institute (EBRI), a private, nonprofit, nonpartisan public policy research organization, and Mathew Greenwald & Associates, Inc., a Washington, DC, based market research firm. The 2011 RCS data collection was funded by grants from more than two dozen public and private organizations, with staff time donated by EBRI and Greenwald. RCS materials and a list of underwriters may be accessed at the EBRI Web site: www.ebri.org/rcs

For more detail, see Helman, Copeland and VanDerhei (March 2011, online at www.ebri.org/surveys/rcs/2011/).

[38] In the RCS, *retiree* refers to individuals who are retired or who are age 65 or older and not employed full time.

Worker refers to all individuals who are not defined as retirees, regardless of employment status.

[39] Actually, the constraints would need to be compared to the 402(g) limit as well as any plan-specific constraints on tax contributions (primarily for the Highly Compensated Employees).

[40] 1.4 percent responded that they did not know.

[41] EBRI plans to expand this analysis with a complete set of sensitivity analyses in the near future.

[42] Future analysis will attempt to include a fourth category for those who would increase the amount they save for retirement in response to this proposal.

[43] For example if a 401(k) plan sponsor had been providing a 50 percent match prior to the introduction of a 30 percent government match, it was assumed that the plan sponsor would decrease the plan match to 20 percent under the proposal.

[44] The fact that we conducted this preliminary analysis without an employee reaction to the change in match rates should in no way should be interpreted that EBRI does not believe that a reduced employer match may have

significant consequences on employee contribution behavior. VanDerhei and Copeland (2001b) estimated a behavioral model that is able to control for the tendency of employers to substitute between the amount they match per dollar of employee contribution and the maximum percentage of compensation they are willing to match. EBRI intends to update that research and attempt to apply it for more formal evaluation of this proposal in the future.

[45] VanDerhei and Copeland (July 2010).

[46] See endnote 17 of VanDerhei and Copeland (July 2010) for more detail.

[47] VanDerhei (September 2010) also demonstrates that eligibility for a defined contribution retirement plan has a significant positive impact on reducing the additional compensation most families need to achieve the desired level of retirement income adequacy.

[48] See VanDerhei (August 2011) for evidence of the importance of participating in a defined benefit plan.

[49] VanDerhei and Copeland (2002a).

[50] VanDerhei and Copeland (2001).

[51] VanDerhei and Copeland (July 2002).

[52] VanDerhei and Copeland (December 2002).

[53] VanDerhei and Copeland (2003)

[54] VanDerhei (January 2004).

[55] VanDerhei (2005).

56 VanDerhei (March 2006).

[57] VanDerhei (September 2006)

[58] VanDerhei and Copeland (2008).

[59] Copeland and VanDerhei (2010).

[60] VanDerhei (2009).

[61] VanDerhei (April 2010).

[62] VanDerhei and Copeland (2010).

[63] VanDerhei (September 2010).

[64] VanDerhei (October 2010a).

[65] VanDerhei (October 2010b).

[66] VanDerhei (February 2011).

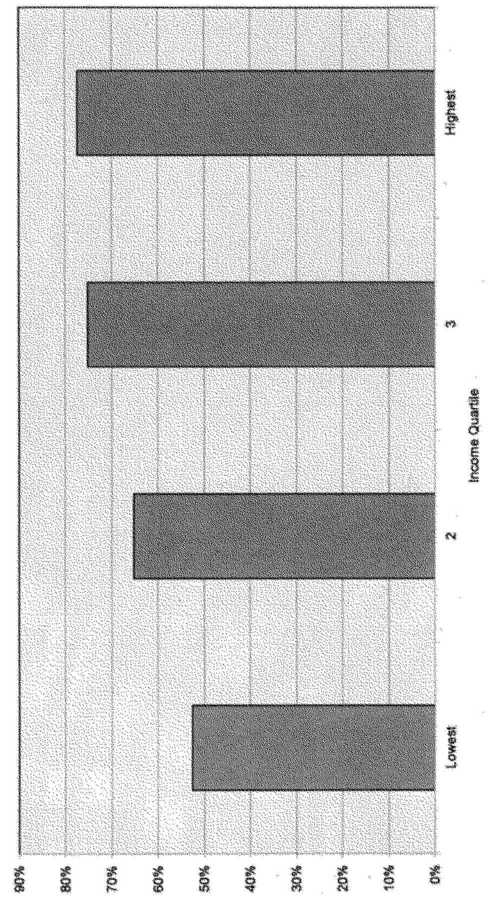
[67] VanDerhei (April 2011).

[68] VanDerhei and Copeland (June 2011).

[69] An employment-based retirement plan can be sponsored by an employer or by a union. "Employer sponsored" is used in this study for brevity, but it should be understood that it also means union.

[70] This includes the 78.2 million who worked for employer/union that did not sponsor a plan plus 15.0 million who worked for an employer that sponsored a plan but did not participate in the plan for whatever reason.

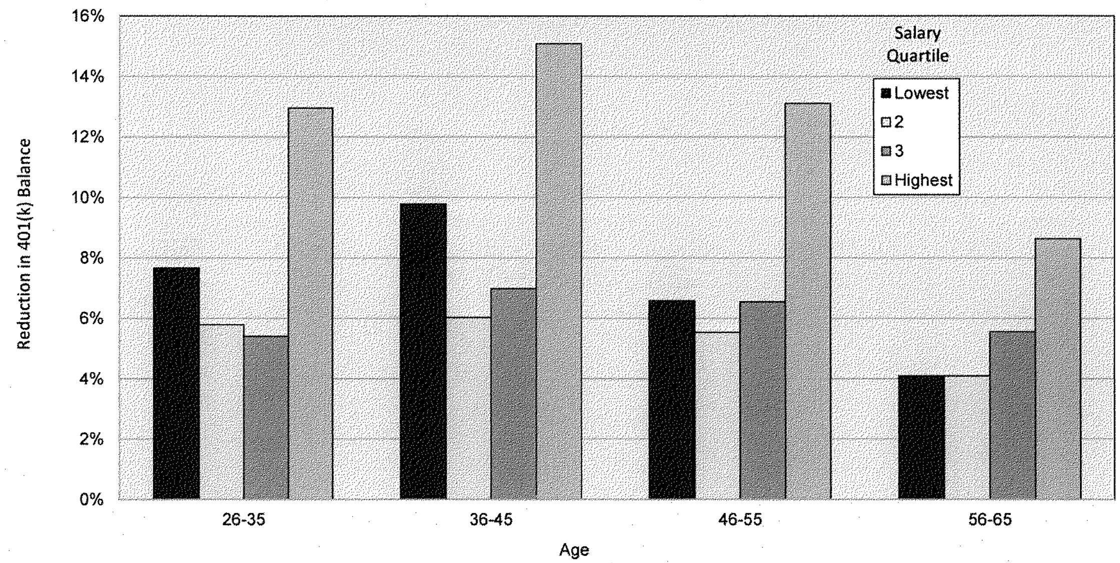
Figure 1
Median Real Replacement Rates at Age 67 From 401(k) Balances for Participants Currently Ages 25–29, by Income Quartile



Source: EBRI Retirement Security Projection Model Version 110503c.
The simulated rates of return for the baseline return scenario are the same as in VanDerhei and Copeland (July 2010). This version of the analysis models 401(k) participants who are not automatically enrolled and assumes no job turnover, withdrawals or loan defaults. The full stochastic nature of the model will be included in a future analysis.

Figure 2

Average Percentage Reductions in 401(k) Account Balances at Social Security NRA* by Imposing 20/20 Limits in 2012, by Age and Age-specific Salary Quartiles

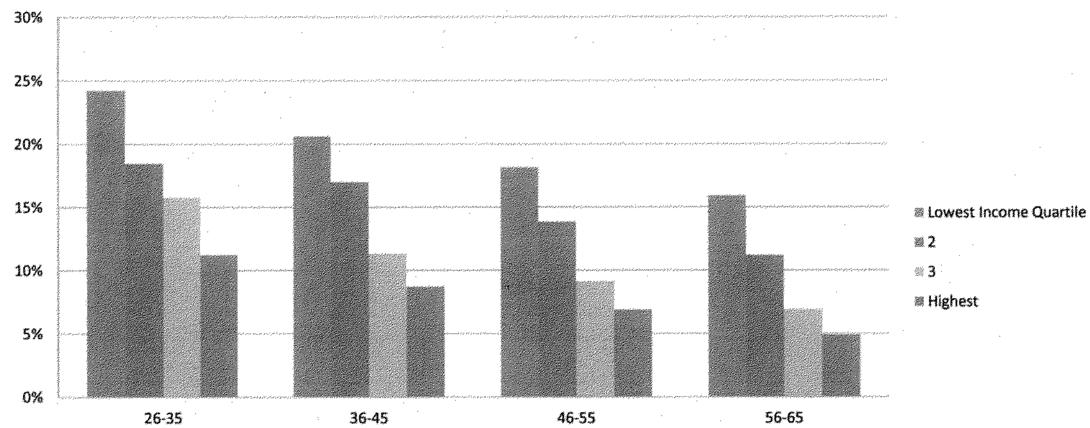


Source: EBRI Retirement Security Projection Model Version 110627c1.
NB: this simulation only models the financial impact of the expected reduction in 401(k) contributions for employees who are not automatically enrolled by imposing the new limits and does not attempt to assess behavioral modifications on the part of either the plan sponsor nor the employees assumed to be eligible for participation in the plan. The simulated rates of return are the same as in VanDerhei and Copeland (July 2010). This version of the analysis assumes no job turnover, withdrawals or loan defaults. The full stochastic nature of the model will be included in future analysis.
* Normal retirement age.

Figure 3

Average Percentage Reductions in 401(k) Account Balances at Social Security Normal Retirement Age by Permanently Modifying the Exclusion of Employee Contributions for Retirement Savings Plans From Taxable Income in 2012, by Age and Age-specific Salary Qua

Assumptions for this run (see Appendix C for sensitivity analysis on these assumptions): (1) 401(k) participant's share of household income = 100 percent; (2) 401(k) participants who "reduce" contributions are assumed to reduce them by 50 percent



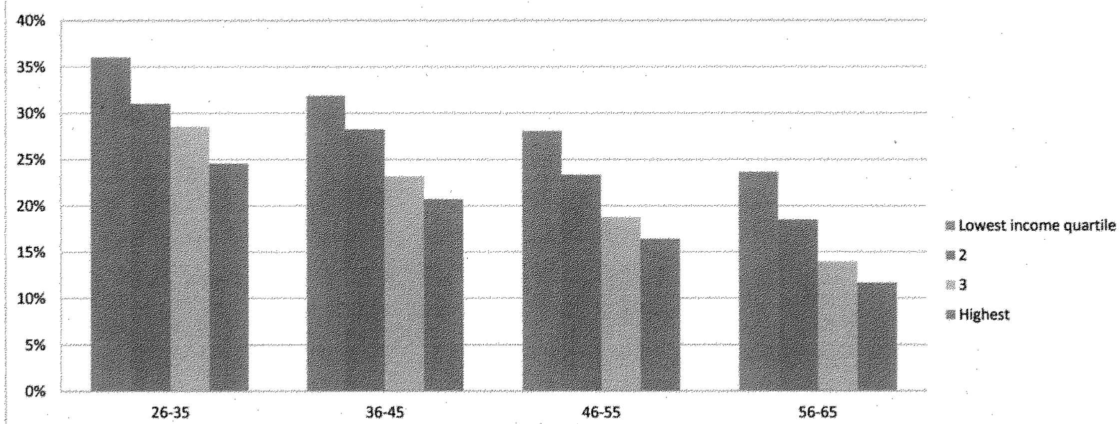
Source: Author's calculations based on results from EBRI Retirement Security Projection Model Version 110910c2 and responses to the 2011 Retirement Confidence Survey.

NB: This simulation only models the financial impact of the expected reduction in 401(k) contributions for employees who are not automatically enrolled by modifying the exclusion of employee contributions for retirement savings plans from taxable income and does not attempt to assess behavioral modifications on the part of the plan sponsor nor the eligible non-participants. The simulated rates of return are the same as in VanDerhei and Copeland (July 2010). This version of the analysis assumes no job turnover, withdrawals or loan defaults. The full stochastic nature of the model will be included in a future analysis.

Figure 4

Average Percentage Reductions in 401(k) Account Balances at Social Security Normal Retirement Age by Permanently Modifying the Exclusion of Employee Contributions for Retirement Savings Plans From Taxable Income in 2012 and Assuming that all Plan Sponsors Drop the Plan Match and all Employees Receive a 30 Percent Match from the Government, by Age and Age-specific Salary Quartiles

Assumptions for this run (sensitivity analysis on these assumptions are available on request from the author): (1) 401(k) participant's share of household income = 100 percent; (2) 401(k) participants who "reduce" contributions are assumed to reduce them by 50 percent



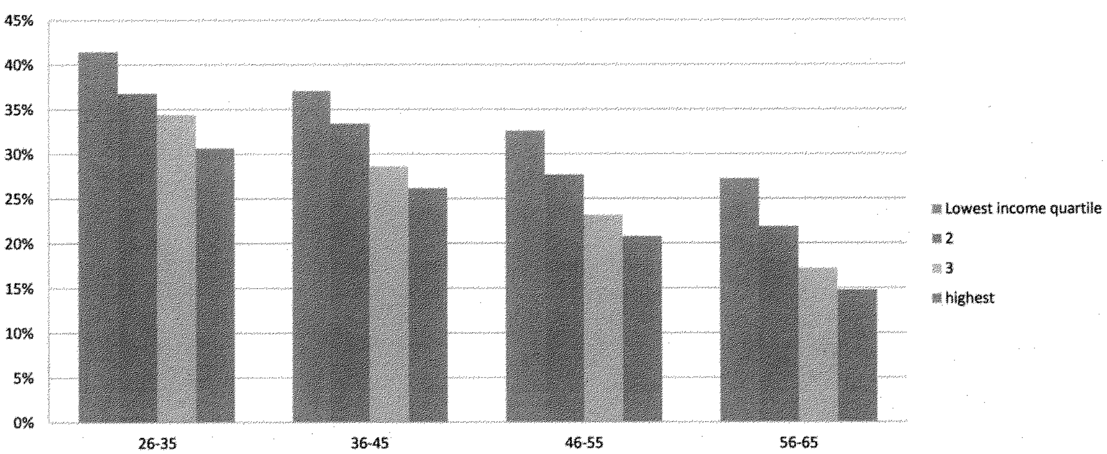
Source: Author's calculations based on results from EBRI Retirement Security Projection Model Version 110910c2a and responses to the 2011 Retirement Confidence Survey.

NB: This simulation only models the financial impact of the expected reduction in 401(k) contributions for employees who are not automatically enrolled by modifying the exclusion of employee contributions for retirement savings plans from taxable income and does not attempt to assess behavioral modifications on the part of the eligible non-participants. The simulated rates of return are the same as in VanDerhei and Copeland (July 2010). This version of the analysis assumes no job turnover, withdrawals or loan defaults. The full stochastic nature of the model will be included in a future analysis.

Figure 5

Average Percentage Reductions in 401(k) Account Balances at Social Security Normal Retirement Age by Permanently Modifying the Exclusion of Employee Contributions for Retirement Savings Plans From Taxable Income in 2012 and Assuming that all Plan Sponsors Drop the Plan Match and all Employees Receive a 18 Percent Match from the Government, by Age and Age-specific Salary Quartiles

Assumptions for this run (sensitivity analysis on these assumptions are available on request from the author): (1) 401(k) participant's share of household income = 100 percent; (2) 401(k) participants who "reduce" contributions are assumed to reduce them by 50 percent



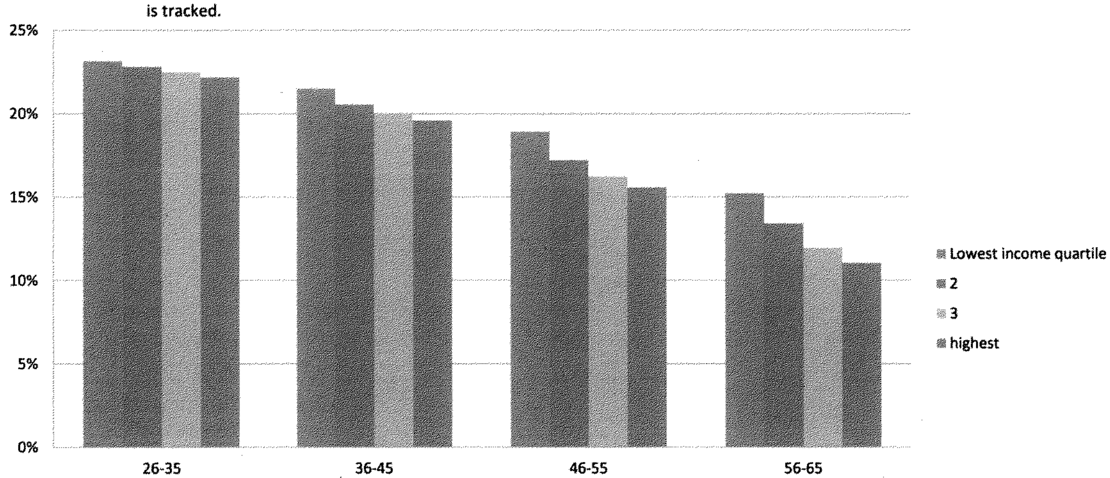
Source: Author's calculations based on results from EBRI Retirement Security Projection Model Version 110910c2b and responses to the 2011 Retirement Confidence Survey.

NB: This simulation only models the financial impact of the expected reduction in 401(k) contributions for employees who are not automatically enrolled by modifying the exclusion of employee contributions for retirement savings plans from taxable income and does not attempt to assess behavioral modifications on the part of the eligible non-participants. The simulated rates of return are the same as in VanDerhei and Copeland (July 2010). This version of the analysis assumes no job turnover, withdrawals or loan defaults. The full stochastic nature of the model will be included in a future analysis.

Figure 6

Average Percentage Reductions in 401(k) Account Balances at Social Security Normal Retirement Age by Permanently Modifying the Exclusion of Employee Contributions for Retirement Savings Plans From Taxable Income in 2012 and Assuming that all Plan Sponsors Drop the Plan Match and all Employees Receive a 18 Percent Match from the Government, by Age and Age-specific Salary Quartiles

Assumes no employee behavioral modifications. Only the difference in employer contributions vs. Government matches is tracked.



Source: Author's calculations based on results from EBRI Retirement Security Projection Model Version 110910c2b 1and responses to the 2011 Retirement Confidence Survey.

NB: This simulation only models the financial impact of the expected reduction in 401(k) contributions for employees who are not automatically enrolled by modifying the exclusion of employee contributions for retirement savings plans from taxable income and does not attempt to assess behavioral modifications on the part of the eligible non-participants. The simulated rates of return are the same as in VanDerhei and Copeland (July 2010). This version of the analysis assumes no job turnover, withdrawals or loan defaults. The full stochastic nature of the model will be included in a future analysis.

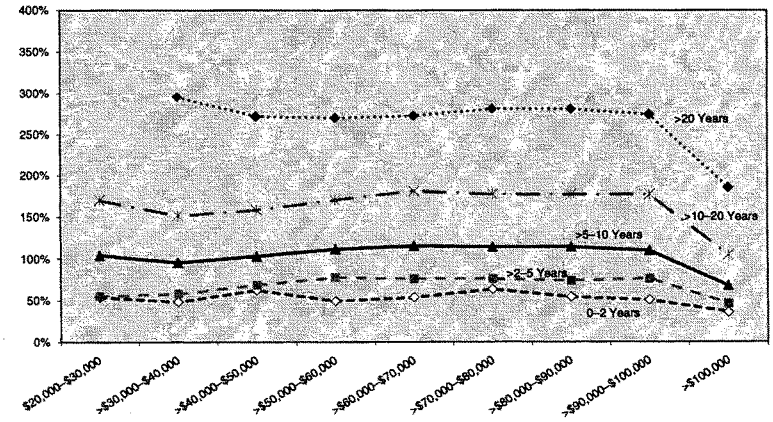
Figure 7 (updated)

Number of Workers Working for an Employer Who Does NOT Sponsor an Employment-Based Retirement Plan and Number of Workers NOT Participating in an Employment-Based Retirement Plan, by Various Demographic and Employer Characteristics, 2010

Characteristic(s)	Working for an Employer NOT Sponsoring a Plan	NOT Participating In a Plan
	(millions)	
Total	77.6	91.9
Self-Employed (Not Wage and Salary)	9.0	9.2
Net Wage and Salary	68.6	82.7
Under 21 Years Old	6.2	7.6
65 Year Old or Older	3.7	4.5
Not Full-Time, Full-Year	32.1	39.5
Full-time, part-year	11.4	14.0
Part-time, full-year	10.0	12.3
Part-time, part-year	10.6	13.2
Less than $5,000 in annual earnings	9.8	11.8
Less than $10,000 in annual earnings	17.2	21.0
Less than 100 employess	39.0	42.2
Fewer than 10 employees	18.3	19.0
10–49 employees	15.1	16.6
49–99 employees	5.6	6.6
Wage and Salary, Full-Year, Ages 21-64, $5,000 or more in annual earnings, 10 or more employees	29.9	37.5
Wage and Salary, Full-Year, Ages 21-64, $5,000 or more in annual earnings, 50 or more employees	19.8	27.5
Wage and Salary, Full-Time, Ages 21-64, $5,000 or more in annual earnings, 10 or more employees	31.6	39.4
Wage and Salary, Full-Time, Ages 21-64, $5,000 or more in annual earnings, 50 or more employees	21.9	28.8
Wage and Salary, Full-Year, Ages 21-64, $10,000 or more in annual earnings, 10 or more employees	27.4	35.5
Wage and Salary, Full-Year, Ages 21-64, $10,000 or more in annual earnings, 50 or more employees	19.7	26.0
Wage and Salary, Full-Time, Ages 21-64, $10,000 or more in annual earnings, 10 or more employees	29.9	37.3
Wage and Salary, Full-Time, Ages 21-64, $10,000 or more in annual earnings, 50 or more employees	20.8	27.3
Wage and Salary, Full-Time, Full-Year, Ages 21-64, $5,000 or more in annual earnings, 10 or more employees	25.3	31.2
Wage and Salary, Full-Time, Full-Year, Ages 21-64, $5,000 or more in annual earnings, 50 or more employees	17.6	22.9
Wage and Salary, Full-Time, Full-Year, Ages 21-64, $5,000 or more in annual earnings, 100 or more employees	14.6	19.3
Wage and Salary, Full-Time, Full-Year, Ages 21-64, $10,000 or more in annual earnings, 10 or more employees	24.9	30.8
Wage and Salary, Full-Time, Full-Year, Ages 21-64, $10,000 or more in annual earnings, 50 or more employees	17.4	22.6
Wage and Salary, Full-Time, Full-Year, Ages 21-64, $10,000 or more in annual earnings, 100 or more employees	14.4	19.1

Source: Employee Benefit Research Institute estimates from the 2011 March Current Population Survey.

Figure 19
Ratio of 401(k) Account Balance to Salary for Participants in Their 60s, by Tenure
Percentage, 2009



Source: Tabulations from EBRI/ICI Participant-Directed Retirement Plan Data Collection Project.
Note: The tenure variable is generally years working at current employer, and thus may overstate years of participation in the 401(k) plan.

Senate Finance Committee Hearing
"Tax Reform Options: Promoting Retirement Security"
September 15, 2011
Questions for Dr. Jack VanDerhei

Questions from Senator Max Baucus

1. Workers are being required to shoulder more and more of the burden of retirement savings as employers are terminating or freezing their traditional pension plans. With this increased burden comes a need for more knowledge of the importance of saving, how to save, and how to manage the assets that one has saved.

    a. Are workers being provided enough information as to the need for retirement savings and how to manage their savings?

        i. Yes. There is clearly enough information available to individuals from employers, financial firms, non-profits, etc. Including calculators (like the Ballpark E$timate at www.choosetosave.org) The challenge is low usage by individuals who are more focused on today.

    b. If not, who should provide that education? Are there changes that should be made to the Internal Revenue Code or other laws (such as ERISA) that would encourage employers to provide more financial education to their employees, or is that something that should be provided elsewhere?

        i. There is enough information available. Education, if expanded, should be k-12 when it can have a dramatic impact on financial literacy and capability. Where employers offer investment advice, courses, etc., utilization is generally less than 25%. Thus, encouraging employers to offer it does not solve the problem, which is generally at the level of the individual wanting the information.

2. According to the Investment Company Institute, there were $17.5 trillion held in employer sponsored retirement plans and individual retirement accounts as of the fourth quarter of 2010. These assets – nearly all of which benefit from a significant tax preference – are being held not only to cover the retirement costs of millions of Americans, but they will also be used to pay emergency costs prior to retirement and to pass on to beneficiaries after the death of the plan participant or IRA holder. Although

there is generally a penalty for withdrawing retirement funds prior to retirement, there are many exceptions to this rule and not a year goes by without a proposal for a new exception to the penalty. And there are many Americans who are using tax-preferred savings as an estate planning tool. For example, most investment advisors tell their wealthier clients to use other assets before using tax-preferred retirement savings since it is advantageous to save the tax-preferred assets to give pass to their heirs. However, many Americans for whom this money is being held – and many Americans who will not have any retirement assets at all – are at risk of not having enough to have a comfortable retirement.

a. Is it appropriate to have tax incentives to accumulate money to pass to heirs?
    i. That is a policy judgment and EBRI is not in the recommendations business. Should Congress want to limit incentives to retirement savings, given the fungibility of assets, that would be difficult. Should the objective be to require spend down, that is already being accomplished by the mandatory distribution rules beginning at 70 and ½.

b. Should there be more incentives in the Internal Revenue Code to save for other purposes?
    i. That is a policy judgment and EBRI is not in the recommendations business. However, given hardship withdrawal rules, loan provisions, and access to funds at a low penalty, along with consideration of IDA's and 529's, other incentives are provided today.

c. Should the existing retirement savings incentives be opened up more for other purposes?
    i. That is a policy judgment and EBRI is not in the recommendations business. However, as noted above, the money is largely available for other activities under current law, unless in a defined benefit plan with post normal retirement age annuity only distributions.

3. Employees of federal, state, and local governments are usually covered by a traditional defined benefit plan, but they are usually required to pay for a portion of that benefit. For example, most federal employees pay 0.8 percent of their pay towards the Federal Employee Retirement System. Nearly all governments are facing significant budget shortfalls today and many are looking to employees to shoulder more of the cost of their benefit. An increasing number of private sector employers have made a business decision to terminate or freeze their traditional pension plans.

a. Should governments be doing the same?
   i. That is a policy judgment and EBRI is not in the recommendations business. However, EBRI research indicates that the absence of retiree benefits leads to lower retirement rates and lower retention rates which may be a concern to governments as employers.

b. Is it reasonable that government employees should have a more secure retirement than millions of similarly situated private employers?
   i. That is a policy judgment and EBRI is not in the recommendations business. However, if similarly situated, then the private employees have the same benefits. If they do not have the same benefits they are not similarly situated and likely have different compensation, different work requirements, different training, and different turnover and retirement patterns. As employers, governments need to consider all of these factors, along with others, in setting their policies.

c. Should government employees be asked to pay more for their retirement benefit?
   i. That is a policy judgment and EBRI is not in the recommendations business. However, labor economic theory of total compensation that is the basis of tax expenditure and other theory, holds that the entire cost is borne by the employee, with pension contributions offset by adjustments in the balance of the compensation package. Some question this theory, but policy makers need to determine their view of this theory in setting policy on how employees are charged for their benefits.

4. The Internal Revenue Code requires that the amount saved be actually paid out once an individual reaches a certain age – now 70½. This requirement prevents many retirees from saving more of their account for their later retirement years. On the other hand, the rules as currently structured allow many people to pass large portions of their retirement savings on to their heirs, a feature the Wall Street Journal has called a "stealth tax cut for the wealthy."

   a. Should individuals with small account balances be relieved of the required minimum distribution rules?
      i. That is a policy judgment and EBRI is not in the recommendations business.

b. Should large account balances be required to be paid out faster than they are now?
    i. That is a policy judgment and EBRI is not in the recommendations business.

5. The Pension Benefit Guaranty Corporation (PBGC) is facing a funding shortfall on the order of $23 billion.

    a. How should that shortfall be closed?
        i. That is a policy judgment and EBRI is not in the recommendations business, However, the only real options are to reduce liabilities or increase revenue. That suggests lower benefit guarantees or higher premiums.

    b. If premiums need to be raised, should Congress set the increase or is the PBGC in a better position to determine how to allocate the increase?
        i. Without speaking to whether or not premiums should be raised, PBGC has the data to best make a premium recommendation, as it has done in the past. Congress always has the right of review in the sense of any action taken they do not like can be overturned by the Congress. Whether Congress should have to approve in advance or have the option of stopping an increase after it is announced, is a policy decision. Both approaches appear in public policy.

Questions from Senator Michael B. Enzi

1. Currently, our 401(k) and Individual Retirement Account (IRA) system allows individuals to choose between "traditional" and "Roth" variations. Has this and other retirement investment alternatives provide expanded options for individuals for individuals to save for retirement or has it made retirement investing too confusing?
    a. Behavioral research in all areas suggests that fewer choices is better, along with simplicity of the options. The current law has many plan options and many micro rules. Behavioral research suggests that simplification would be the best policy, if it can be accomplished within the policy goals of the Congress.

2. As mentioned at the hearing, traditional 401(k) and IRA accounts are tax deferred. Eventually, the taxes are paid back to the government when the individual takes money out of the system. Under federal budget and related laws/rules generally on the first

ten years' worth of savings/expenditures are counted. Since the deferred taxes on retirement savings is not paid back until years into the future any beneficial changes or expansion of traditional 401(k) and IRA accounts cost significant amounts of money. Should these laws/rules be amended to take into account the deferred nature of the taxes?

   a. EBRI has published in the past on this topic and found that a longer term approach that better evaluates the tax value to the individual over a longer time frame would be desirable. As noted, the nature of budgeting makes that difficult, as the entire concept of tax expenditures are just that, not deferrals of taxation. Treating deferrals differently would increase the accuracy of the numbers and the facts on which policy might be based.

3. Senator Kohl and I introduced the Savings Enhancement by Alleviating Leakage in 401(k) Savings Act of 2010, (SEAL Act), S. 1121, to help prevent retirement monies from leaking out of defined contribution plan accounts and not being replenished. What other items should we be considering to prevent leakage from defined contribution accounts?
   a. That is a policy judgment and EBRI is not in the recommendations business. EBRI has published work on the use of lump sums for decades, and has published analysis of what would be different if there were no leakage, or annuitization rather than lump sums. We would be please to share this information with the committee. Access to funds is believed by some to increase the participation and savings of many individuals, however.

4. At a recent hearing before the Committee on Health, Education, Labor and Pension on our nation's defined benefit system, it became apparent that the defined benefit system is unlikely to see a comeback. In fact of the Fortune 100 companies only 13 offer a defined benefit plan to their new employees. Business and their trade associations cite many reasons for this including volatility in the markets, stricter accounting rules adopted by the Financial Accounting Standards Board, more stringent funding requirements and the Administration's proposal to increase fees on companies sponsoring defined benefit plans by $16 billion. Since defined benefit system is a voluntary employer-based system, can anything be done to change the system to make more businesses want to sponsor defined benefits plans? In light of the federal government's deficit, please assume that no new federal monies can be obligated to match or insure any private sector defined benefit monies.
   a. In 2007, EBRI and Mercer Human Resource Consulting surveyed defined benefit sponsors to gauge their recent activity as well as planned modifications with respect to both defined benefit and defined contribution plans.[1] The survey

shows that the driving forces behind defined benefit changes such as closing the plan to new hires or freezing the plan for all members are implementation of an overall business strategy to restructure employee benefits, followed by a new law (the Pension Protection Act of 2006, or PPA) that has increased pension funding costs and/or major new and pending accounting rules by the Financial Accounting Standards Board (FASB). Any analysis of the retirement income adequacy of future retirees must factor in the extraordinary plan changes among defined benefit sponsors in the last few years, as well as their likely reaction to PPA and FASB rules—especially the widespread phenomenon of employers providing new or additional contributions to a defined contribution plan in an attempt to at least partially indemnify workers for the reduction in future pension benefits.

5. Earlier this year at a hearing before the Committee on Health, Education, Labor and Pensions, I put forth an idea to establish a multiple employer pension system to help small businesses band together to sponsor 401(k) plans and I am currently working on legislative language. What elements should be included in this legislative proposal to ensure that small businesses will adopt these plans? What current requirements/elements of 401(k) laws/regulations may be a hindrance in establishing multiple employer 401(k) plans?
    a. That is a policy judgment and EBRI is not in the recommendations business.

<u>Questions from Senator Orrin Hatch</u>

1. Dr. VanDerhei, please describe what your modeling shows will occur to the level of individual retirement savings, and annual contributions and deferrals, if the current system of pre-tax contributions and deferrals to defined contribution plans and IRAs is replaced with a system of after-tax contributions and a refundable tax credit of 18%. Please include all income groups in your answer, not just workers in tax brackets above 18%.
    a. While my testimony before the Senate Finance Committee on September 15th included analysis of how employees are likely to behave with respect to such a modification of the current tax system, EBRI is still in the process of attempting to assess the likely reaction from plan sponsors. Until that additional information is obtained, I have attempted to model the impact of the two extreme positions for plan sponsors:[2] (1) reduce employer matches only enough to keep the total matching contribution the same and (2) completely eliminate employer matches (but continue to sponsor the 401(k) plan[3]).

In the first case, the younger cohorts would experience larger reductions given their increased exposure to the proposal. Focusing on those currently 26–35, the average percentage reductions vary from a low of 11.2 percent for the highest income quartile to a high of 24.2 percent for the lowest income quartile. In the second case, the average percentage reductions increase. For those currently ages 26–35, the average reduction varies from a low of 30.6 percent for the highest-income quartile to a high of 41.4 percent for the lowest-income quartile.[4]

2. Dr. VanDerhei, the growing cost of retiree medical care is a significant, but often underestimated, issue. According to one study from Fidelity Investments, a typical couple retiring in 2010 would incur $250,000 in health care costs outside of their Medicare benefits. (a) What are your thoughts on the challenge of financing retiree health care? (b) How does the $250,000 figure compare with similar estimates from the Employee Benefits Research Institute? (c) Are existing savings vehicles for retirement income adequate to secure the savings that post-retirement health care will require? (d) And what policies should Congress consider in regard to retirement savings in light of already high retiree medical costs?
    a. The challenge of financing retiree health care costs needs to be bifurcated into those that are relatively easy to predict from year to year (e.g., Medicare premia, Medigap premia and out of pocket expenditures) and those that may not be incurred by all retirees and, even for those who do incur them, will likely incur them for only a portion of their retirement (e.g., nursing home costs). While the "average" cost for the latter category may be smaller than the former, it is precisely the low frequency/high severity nature of these costs that introduces a significant amount of risk into the process of retirement planning.

       At EBRI we have been assessing national retirement income adequacy with our Retirement Security Projection Model® since 2003. Although it is possible to categorize retiree expenditures into health care costs vs. all others, we have focused our attention on simulating what percentage of Baby Boomers and Gen Xers will be able to meet all expenses in retirement as well as the average retirement savings shortfalls that are likely to be faced by these retirees assuming a retirement age of 65.

Figure 1[5] (attached) shows the extreme importance of the "stochastic health" components (viz., nursing home and home health care costs). For example, the average retirement savings shortfall for a married early boomer is projected to be $29,467 – however that number decreases to only $5,887 if nursing home and home health care costs are removed. Similar differentials are observed for the other combinations of age cohort, family status and gender.

EBRI has published extensive research on the additional amounts that would need to be saved for all retirement expenses if one assumes a retirement age of 65[6] and has recently expanded the analysis to allow retirement to be deferred beyond age 65.[7] Moreover, a 2005 EBRI presentation[8] shows the value from a cost/benefit perspective of purchasing long-term care insurance (especially for those who would like to plan for more than a 50 percent chance of having sufficient funds for retirement).

b. The $250,000 figure you mention does not include nursing home and home health care costs and therefore would be most similar to the estimates provided in an August 2011 EBRI Notes article.[9] Assuming PPACA is not repealed, the EBRI estimates for a couple retiring in 2011 assuming median prescription drug expenses throughout retirement are $166,000 for a 50 percent chance of having enough savings, $231,000 for a 75 percent chance of having enough savings and $287,000 for a 90 percent chance of having enough savings. However, if one assumes a 90th percentile of prescription drug expenses throughout retirement, the numbers increase to $244,000 for a 50 percent chance, $332,000 for a 75 percent chance and $407,000 for a 90 percent chance.[10]

c. It is certainly possible for a couple retiring in 2010 to have saved the amounts enumerated above. For example if a couple had a joint income of $16,983 (in 2010 dollars) at age 25 and experienced a 4 percent annual wage growth,[11] a 6 percent rate of return and a contribution rate of 7 percent of compensation with an employer match equal to 3 percent of compensation, the account balance at age 65 would be $465,735 (before taxes). This assumes constant coverage and participation in a 401(k) plan and no leakages due to cash-outs, loans or withdrawals.[12]

d. That is a policy judgment and EBRI is not in the recommendations business.

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Endnotes

[1] VanDerhei (2007).

[2] This simulation only models the financial impact of the expected reduction in 401(k) contributions for employees who are not automatically enrolled by modifying the exclusion of employee contributions for retirement savings plans from taxable income and does not attempt to assess behavioral modifications on the part of the plan sponsor nor the eligible nonparticipants. The simulated rates of return are the same as in VanDerhei and Copeland (2010). This version of the analysis assumes no job turnover, withdrawals or loan defaults. The full stochastic nature of the model will be included in a future analysis. Additional assumptions for this run include: (1) 401(k) participant's share of household income = 100 percent and (2) 401(k) participants who "reduce" contributions are assumed to reduce them by 50 percent (see Appendix B of my testimony for sensitivity analysis on these assumptions).

[3] Under the assumption that the government match would provide sufficient levels of participation and contribution for non-highly compensated employees to allow the ADP nondiscrimination requirements to be met.

[4] Whereas the second analysis assumes that all current 401(k) plan sponsors completely drop their plan match (but not their plan), some might argue that plan sponsors may be more likely to keep their plans and retain the current match rates for the participants. Of course the actual result if this proposal were adopted would likely be somewhere between these two extreme positions but it may be useful to analyze what the likely impact on current 401(k) participants would be under the 18 percent government match scenario assuming no changes in either plan sponsorship or the employer matching provisions. This analysis will be provided as part of EBRI's November 2011 Issue Brief (available at: http://www.ebri.org/publications/ib/)

[5] See VanDerhei (October 2010) for details.

[6] VanDerhei and Copeland (July 2010).

[7] VanDerhei and Copeland (June 2011).

[8] VanDerhei (March 2005)

[9] Fronstin, Salisbury and VanDerhei (August 2011).

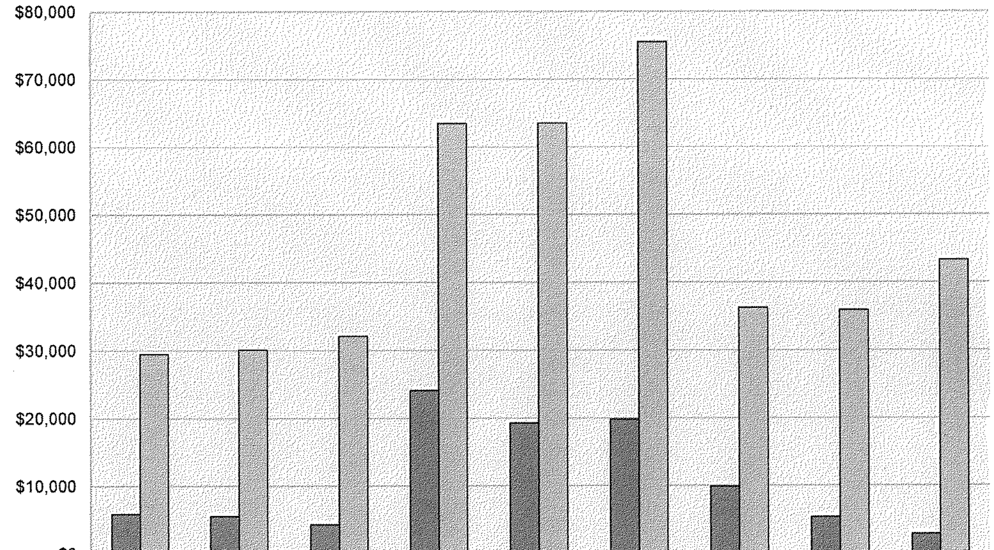
[10] Similar numbers for a 75th percentile of prescription drug expenses throughout retirement are $187,000 for a 50 percent chance, $260,000 for a 75 percent chance and $323,000 for a 90 percent chance.

[11] At this wage growth, the $16,983 would increase to $78,400 by age 65 which is the average annual family earnings in 2010 of two-earner couples with one of the family members being age 64 in 2010.

[12] It also implies that a very significant portion of the 401(k) balance would be applied solely to health care costs (sans nursing home and home health care costs).

Figure 1

Average Retirement Savings Shortfalls, by Gender, Marital Status and Age Cohort (in 2010 $): With and Without Stochastic Health



	Married: Early Boomers	Married: Late Boomers	Married: Gen Xers	Single Female: Early Boomers	Single Female: Late Boomers	Single Female: Gen Xers	Single Male: Early Boomers	Single Male: Late Boomers	Single Male: Gen Xers
without stochastic health	$5,887	$5,540	$4,292	$24,110	$19,254	$19,796	$9,890	$5,374	$2,876
with stochastic health	$29,467	$30,104	$32,098	$63,438	$63,510	$75,488	$36,254	$35,896	$43,290

Source: EBRI Retirement Security Projection Model™ versions 100920f1 and 100922f1.

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STATEMENT FOR THE RECORD
UNITED STATES SENATE COMMITTEE ON FINANCE
HEARING ON TAX REFORM OPTIONS: *PROMOTING RETIREMENT SECURITY*
SEPTEMBER 15, 2011

The American Benefits Council (Council) and the American Council of Life Insurers (ACLI) appreciate the opportunity to provide this written statement for the record in conjunction with today's U.S. Senate Committee on Finance Hearing on "Tax Reform Options: Promoting Retirement Security."

The Council is a public policy organization representing principally Fortune 500 companies and other organizations that assist employers of all sizes in providing benefits to employees. Collectively, the Council's members either sponsor directly or provide services to retirement and health plans covering more than 100 million Americans.

The American Council of Life Insurers represents more than 300 legal reserve life insurer and fraternal benefit society member companies operating in the United States. These member companies represent more than 90% of the assets and premiums of the U.S. life insurance and annuity industry. ACLI member companies offer insurance contracts and investment products and services to qualified retirement plans, including defined benefit pension, 401(k), 403(b) and 457 arrangements. ACLI member companies also are employer sponsors of retirement plans for their employees.

Summary:

Employer-sponsored defined contribution and defined benefit retirement plans are fundamental to our nation's retirement system. Retirement plans like those sponsored and administered by Council members successfully assist tens of millions of families in accumulating retirement savings and will provide trillions of dollars in retirement income. Congress has adopted rules that facilitate employer sponsorship of these plans, encourage employee participation, promote prudent investing, allow operation at reasonable cost, and safeguard participant interests through strict fiduciary obligations. While individuals have understandably heightened retirement income concerns resulting from the recent economic downturn, it is critical to acknowledge the vital role employment-based retirement plans play in ensuring personal financial security and in generating savings to fuel the type of capital investment the economy needs to generate long-term growth.

Today's retirement laws and policies are working well and are aiding individuals (supported by their employers) to accumulate savings and generate retirement income. For that reason, the first, and most important, principle we urge this Committee to consider in the context of tax reform is to **do no harm** to the existing retirement system. We urge policymakers to avoid any actions that would make it more difficult for individuals to save for retirement or that would discourage employers from starting or continuing to maintain retirement plans. Thus, the wisest course in most instances will be to *not* enact new laws and regulations that would interrupt the successes of the current system.

Dramatic changes in the rules and incentives governing retirement plans are perilous and unintended consequences are likely. We simply cannot afford to gamble with the retirement security of working and retired Americans. In this context, it is important to remember that the employer-sponsored retirement system is premised on its voluntary nature - employers can choose to provide retirement plans to their workers but they are not required to do so. Changes in the tax incentives would require each plan sponsor to reevaluate and completely redesign its retirement plan offerings and could force them to consider eliminating their plans entirely. Even seemingly small changes in laws and regulations often generate confusion and enormous costs for individuals and employers.

As this Committee considers the retirement area (in the context of tax reform or otherwise), it is critical that you focus on what policies will help individuals and employers generate retirement income sufficient for employees to maintain their standard of living. Too often, retirement policy is driven by extraneous considerations, such as the need to generate revenue for the federal government. When these revenue considerations are at the forefront, the result is often added and unnecessary complexity or cost of plan maintenance (such as the recent proposals to raise the premiums defined benefit plan sponsors must pay to the Pension Benefit Guaranty Corporation (PBGC)), or direct harm to Americans' retirement prospects (such as the repeated reduction in retirement plan dollar limits in the 1980s and early 1990s).

That does not mean more should not be done to encourage savings. Even under the current savings levels, many Americans are at risk of a financially insecure retirement. Policies that further bolster retirement security for future generations should be carefully considered - but those policies must build upon the existing successful structure to generate greater retirement savings.

The current employment-based retirement system is working for millions of American workers and retirees.

Today, the vast majority of large employers offer a defined contribution plan and an increasing number of small employers do as well. According to the Bureau of Labor Statistics, 73% of full-time and 64% of all private industry workers had access to retirement benefits as of May 2011.[1]

Over the past three decades, 401(k) and other defined contribution plans have grown dramatically in number, asset value, and employee participation. Private-sector defined contribution plans cover more than 80 million active and retired workers. In addition, more than 10 million employees of tax-exempt and governmental employers participate in 403(b), 457, and TSP defined

[1] See BLS, Employee Benefits in the United States, March 2011, available at http://www.bls.gov/ncs/ebs/sp/ebnr0017.pdf

contribution plans. There are also tens of millions of participants and retirees in private-sector defined benefit pension plans.

This broad coverage and participation results from the unique advantages employment-based plans bring to bear for employees when it comes to retirement savings and income. These advantages would likely not be available for millions of working Americans if it were not for the existing tax incentives that motivate employee saving and that encourage employers to maintain and contribute to retirement plans.

When discussing retirement plans, media focus is often on employee deferrals into 401(k) plans. Yet, many employers make matching, non-elective, and profit-sharing contributions to complement employee deferrals and share the responsibility for financing retirement. Other employers fund defined benefit plans that further add to the retirement security of their employees. Indeed, recent surveys of defined contribution plan sponsors found that at least 95% make some form of employer contribution.[2] While certain employers suspended matching and profit sharing contributions due to the current economic downturn (and, in some cases, because of a dramatic spike in their defined benefit plan funding obligations), the vast majority have not, and in many cases the suspended matches have already been reinstated.

Employees participating in employment-based plans also benefit from enhanced bargaining and purchasing power resulting from economies of scale, fiduciary decision-making and oversight, and access to beneficial products and services. Moreover, Congress has established detailed rules to ensure that benefits in defined contribution plans are delivered across all income groups. For example, extensive coverage, nondiscrimination and top-heavy rules promote fairness regarding which employees are covered by a defined contribution plan and the contributions made to these plans.

Employers are also in a strong position to know the retirement needs of their employee populations and can tailor retirement programs to these needs. With the growth in defined contribution plan coverage, those plans have continued to evolve and improve, with plan sponsors and service providers developing many features, including automatic contribution escalation, single-fund investment solutions, and investment education programs. These legislative changes and market innovations (often supported by legislative clarifications) have improved both employee participation rates and employee outcomes. For example, the Pension Protection Act of 2006 (PPA) included several landmark changes to the defined contribution system that are already beginning to assist employees. PPA encouraged automatic enrollment (which studies demonstrate significantly increases participation rates, particularly among lower-income, younger, and minority workers) and automatic contribution escalation. Adoption of these features has increased dramatically. In PPA, Congress also provided new rights to diversify contributions made in company stock, accelerating existing trends toward greater diversification of 401(k) assets.

And the fact is that these rules work and incremental changes adopted in recent years have made them operate even better. There are still gaps; more can and should be done to expand coverage and to increase contributions. But one of the most important advantages of the current retirement savings tax incentive structure is that it efficiently produces retirement benefits for millions of American families. Analyses have shown that for every dollar of tax expenditure devoted to tax-preferred workplace retirement plans, these plans deliver between four and five dollars in ultimate

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[2] Report on Retirement Plans – 2007, Diversified Investment Advisors (Nov. 2007).

retirement benefits to plan participants.[3] This multiplier effect produces a remarkable amount of benefits for retirees, with the Department of Commerce reporting that in 2010 employer-sponsored retirement plans paid out $836 billion in benefits,[4] substantially more than the $577 billion in retirement benefits paid by Social Security in the same year.[5]

The importance of the current system is demonstrated by the fact that retirement plans held approximately $18.1 trillion in assets as of March 31, 2011.[6] These trillions of dollars in assets, representing ownership of a significant share of the total pool of stocks and bonds, provide an important and ready source of investment capital for American businesses. This capital permits greater production of goods and services and makes possible additional productivity-enhancing investments -- investments that help companies grow and add jobs to their payrolls and raise employee wages.

The current tax incentive structure is the foundation of our successful retirement savings system.

The U.S. retirement savings system successfully encourages individuals to save for retirement by providing tax incentives -- typically income tax exclusions or deductions -- for contributions to employer-sponsored retirement plans and IRAs, up to certain limits. This tax structure provides a strong and effective incentive for individuals at all income levels to save for retirement and encourages employers to sponsor plans that deliver meaningful benefits to Americans up and down the income scale.

The fundamental building blocks of the current tax incentive structure are:

Contributions are Excludible or Deductible From Income: Contributions to qualified workplace retirement plans, both those made by employees and those made by employers, are generally excludable from employees' taxable income, and contributions to traditional Individual Retirement Accounts (IRAs) are tax-deductible in some instances. This pre-tax treatment allows individuals to save more from each paycheck than would be the case with after-tax contributions.[7] For a worker in the 25% income tax bracket, for example, a $20 deferral into a 401(k) plan will only reduce take home pay by $15, making saving into the plan an efficient economic proposition.

Employer Contributions are Exempt from Payroll Tax: Because employer contributions to plans are not regarded as "wages," neither employees nor employers owe payroll taxes on these amounts. These payroll tax savings are most significant for modest-income employees earning

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[3] *See, e.g.*, American Benefits Council, *Myths and Facts About the Savings Provisions of H.R. 1776* (July 2003) ("Benefits paid by employer-sponsored pensions are 4.5 times as large as the foregone federal tax collections attributed to them.") analyzing Department of Commerce and Office of Management and Budget data)); Association of Private Pension and Welfare Plans, *Benefits Bargain: Why We Should Not Tax Employee Benefits* (May 1990) ("The data suggest that in the pension area, the benefits paid by the plan are 4.6 times the foregone federal tax collections attributed to them.").

[4] 91 Bureau of Economic Analysis, U.S. Dep't of Commerce, Survey of Current Business 8, National Income and Product Accounts Table 6.11D (Aug. 2011).

[5] Social Security Trustees Report 2011.

[6] See http://www.ici.org/pressroom/news/ret_11_q1.

[7] Contributions to Roth 401(k) Accounts and Roth IRAs are not deductible or excludable, but they derive a comparable tax benefit when the taxpayer withdraws assets in the form of an exclusion from tax on earnings while the funds were in the account.

amounts below the Social Security wage base ($106,800 in 2010) since payments in cash rather than into the plan would be fully subject to payroll taxes.

Taxes on Investment Gains are Deferred: There is no tax on investment gains while funds remain inside the retirement plan. This deferral is critical for incenting savings as workers know they will not have to divert income year-by-year to pay tax on their retirement savings. It is critical to remember that pre-tax contributions made to defined contribution plans and IRAs - and the earnings on these contributions - do not escape taxation but rather are taxed when withdrawn. Thus, the federal tax incentives devoted to spur savings are not lost but are reclaimed as additional tax revenue when individuals make withdrawals.

Saver's Credit Supplements Exclusion/Deduction: The Saver's Credit, which provides a credit of up to $1,000 ($2,000 if married and filing jointly) to low- and middle-income individuals who contribute to defined contribution plans and IRAs, provides a more robust savings tax incentive for eligible individuals than would be provided by the exclusion or deduction alone. Between availability of the underlying income tax exclusion/deduction for contributions, payroll tax savings on employer contributions and the supplemental Saver's Credit, eligible individuals are provided with a very significant tax incentive to contribute to retirement accounts. It is one that far exceeds mere proportionality to their income tax bracket.

Contributions Are Limited and Rules Promote Fairness: Congress has imposed maximum dollar limits on individual contributions to defined contribution plans and IRAs. In 2011, the maximum individual contributions are generally $5,000 to IRAs ($6,000 if 50 or older) and $16,500 to defined contribution plans ($22,000 if 50 or older). Separate limits also apply to total combined employer and employee contributions for any employee and to the maximum benefit a worker can accrue at retirement in a defined benefit plans. These limits act to constrain the tax-preferred savings of upper-income savers while allowing robust tax-preferred savings by low- and middle-income households, and retaining enough of a personal incentive for business owners and decision-makers to set up and maintain plans for their workforce. In addition, a substantial statutory and regulatory regime requires employer plans to adhere to coverage, nondiscrimination and top-heavy rules, which are designed to ensure that individuals at all income levels receive fair benefits.

The first principle of retirement tax policy: Do no harm.

Today's retirement laws and policies are working well and are helping many millions of families (supported by their employers) accumulate savings and generate retirement income. For that reason, the first, and most important, principle we urge this Committee to consider in the context of tax reform is to **do no harm**. Policymakers should avoid actions that make it more difficult to accumulate savings and generate sufficient retirement income. Since the employment-based retirement system is the most effective and significant source of retirement saving, any changes in that area should in particular be approached with extreme caution. The wisest course in most instances will be to *not* enact new laws that would interrupt the successes of the current system.

Dramatic changes in the rules and incentives governing retirement plans are not warranted and would be perilous. Unintended consequences are likely and we simply cannot afford to play Russian roulette with the retirement security of working and retired Americans. In this context, it is important to remember that the employer-sponsored retirement system is premised on its voluntary nature - employers can choose to provide retirement plans to their workers but they are not required to do so. Changes in the tax incentives would require each employer to reevaluate and completely redesign retirement plan offerings and could lead to eliminating the plans entirely. Even seemingly small changes in laws and regulations generate confusion and enormous costs for individuals and employers.

Americans do not want to see their retirement plans changed. In a 2011 study, 88% of surveyed households were against *eliminating* the tax advantages of defined contribution plans and IRAs and 82% were against *reducing* such advantages.[8] Strong opposition to changing the tax incentives for defined contribution plans and IRAs existed *even* among households that did not have a defined contribution account or IRA (83% opposed elimination and 75% opposed reduction) and among households making less than $30,000 (84% opposed elimination and 74% opposed reduction).[9]

It is critical that employees' current retirement assets (and the assets they still need to accumulate in the future) not be raided now to fund other government initiatives. Those current (and future) savings should not be raided to finance more government spending, deficit reduction, or to offset other tax initiatives (including lower marginal tax rates). It is critical to note that proposals that purport to increase short-term Federal tax receipts by redirecting, eliminating, or eroding the existing retirement savings tax incentives achieve those additional taxes *largely because individuals are saving less for retirement.* We cannot afford to let that happen. Even though the current system is working, we need to do more, not less, in the way of promoting retirement savings.

Particularly troublesome is that any short-term revenue gain that might be derived from changes in the retirement tax incentives is largely illusory and cannot responsibly be used to offset other long-term government initiatives. The revenue scoring that is performed by the Treasury Department and the Joint Committee on Taxation generally produces estimates in five- and ten-year budget windows, using a cash-flow analysis. Under that methodology, the taxes an employee will pay when he or she retires and starts taking taxable plan distributions generally occur *outside* the budget window. Proposals that reduce retirement savings today will mean the government actually collects less revenue in years outside the budget window because retirees will have less taxable retirement income. As a result, any overall budgetary savings that might result would be considerably smaller than the short-term revenue estimates might suggest. In fact, a recent study completed by former staff of the Joint Committee on Taxation finds that the present value of tax benefits attributable to current-year retirement savings contributions is as much as *77% less* than estimates of revenue loss under Treasury's methodology. In effect, proposals that reduce retirement savings would actually increase the burden on future generations. That type of short-sighted thinking will not help the nation address its structural budget deficits, nor would it offset the long-range costs of other changes in the tax law.[10]

Two sweeping proposals that have gained some recent attention illustrate the dangers that could flow from otherwise well-intentioned rewriting of the current retirement rules.

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[8] Investment Company Institute, Commitment to Retirement Security (Jan. 2011) available at http://www.ici.org/pdf/ppr_11_com_ret.pdf.

[9] *Id.*

[10] Judy Xanthopoulos and Mary M. Schmitt, *Retirement Savings and Tax Expenditure Estimates*, American Society of Pension Professionals & Actuaries, May 2011, available online at: http://www.asppa.org/Document-Vault/pdfs/GAC/2011/RetirementSavingsAndTaxExpenditures_ASPPAMay2011.pdf.aspx

A "20/20" cap on retirement plan contributions would undermine retirement security.

One option for deficit reduction that was explored in the National Commission on Fiscal Responsibility and Reform Report was to lower the cap on annual total employer and employee retirement plan contributions to the *lesser* of 20% of the employee's compensation *or* $20,000. This proposal should be rejected. The serious harm to retirement security that would result from this tax increase cannot be justified by any short-term deficit reduction.

Today, total employee and employer contributions to 401(k) and other defined contribution plans cannot exceed the lesser of 100% of compensation or $49,000 per year.[11] Those contribution levels can only be reached for owners and higher-paid employees if the plan satisfies tough non-discrimination rules that ensure participation and contributions for rank-and-file workers. The existing tax incentives play a critical role in encouraging key decision-makers to sponsor and maintain plans. When a typical small business owner evaluates the significant legal responsibilities, risks, and costs of plan sponsorship, it is often the promise of meaningful tax benefits for key employees that constitutes the deciding factor in choosing to maintain a retirement plan. If tax benefits to decision-makers are substantially diminished, businesses that would have considered plan sponsorship will no longer do so and existing plan sponsors will reduce matching contributions or stop offering retirement plans altogether. All employees will suffer.

The 20/20 proposal would severely depress aggregate retirement savings *for all income levels.* The Employee Benefit Research Institute (EBRI) found that only 5% of workers save for retirement on their own without the benefit of an employer sponsored plan. By contrast, 70% of workers earning between $30,000 and $50,000 participate in employer-sponsored retirement plans when they are offered. Preliminary EBRI analysis of the 20/20 proposal projects reductions in 401(k) balances at retirement of between 5% and 14% across *all* income levels. Younger savers with the lowest income would be hit particularly hard, with projected savings at retirement dropping by about 10% for individuals under age 45 in the bottom income quartile.[12] And this EBRI analysis does not even take into account the fact that the 20/20 proposal could cause many plans to be terminated and would cause other employers to eliminate or reduce matching and other employer contributions.

Under current limits, working families with less than $100,000 in income receive 62% of the tax benefits associated with qualified retirement plans - despite paying only 26% of the total personal income taxes received by the Federal government.[13] In other words, lower- and middle-income taxpayers receive more than twice as large a share of savings tax breaks as the share of income taxes they actually pay. As a practical matter, those low- and middle-income plan participants would suffer the most under the 20/20 proposal when they lose access to employment-based retirement plans and the employer contributions that go with them.

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[11] In many cases, key employees of small businesses do not reach these levels every year. Many contribute more during years their business is doing well and less in other years.

[12] "Capping Tax-Preferred Retirement Contributions: Preliminary Evidence of the Impact of the National Commission on Fiscal Responsibility and Reform Recommendations." *EBRI Notes, Vol. 32,* No. 7 (Employee Benefit Research Institute, July 2011): 2-6.

[13] ASPPA Release May 31, 2011 available at: http://www.asppanews.org/2011/05/31/asppa-research-shows-savings-from-cutting-retirement-savings-plan-incentives-are-dramatically-exaggerated/

Replacing exclusions and deductions with tax credits could cause a dramatic decline in plan sponsorship and significantly reduce overall retirement savings.

One proposal before the Committee today suggests replacing all exclusions and deductions for retirement savings with a flat 18% tax credit that would be deposited directly into the individual's retirement savings account (the "18% match proposal"). This restructuring of the current system (and previous proposals like it) would be disruptive and counterproductive. It would cause a steep decline in retirement plan sponsorship and would lead directly to a significant reduction in retirement savings across all income classes.

Proponents of the 18% match assert that the current tax incentive system is not the optimal structure, finding fault with a retirement savings tax exclusion that provides a tax benefit proportional to an individual's income tax bracket. This critique is misplaced. While it is true that pre-tax treatment provides a greater percentage tax benefit to those in higher tax brackets, this is nothing more than the logical extension of our progressive income tax structure (under which nearly 47 million tax filers have *no* federal income tax liability and the top quintile of filers bear 87.5% of the liability). The fact that income tax benefits for retirement savings flow to those who pay income tax seems an insufficient basis to condemn the current structure. This critique also fails to recognize that 79% of the federal tax incentives for defined contribution plans are attributable to taxpayers with less than $150,000 of adjusted gross income.[14]

Proponents of the 18% match proposal assert that (1) many taxpayers would be better off under the proposal and (2) that $450 billion of deficit reduction would result over the next ten years. Those claims are based on data derived under the assumption that all savings would continue at the same level for all income classes under the proposal. That assumption is flawed. Many current participants would experience tax increases under the 18% match proposal because the tax incentive is reduced relative to current law. To make matters worse, they would also have lower retirement savings and, therefore, less retirement security. At best, even if savings behavior did remain unchanged as proponents assume, the 18% match would be a tax increase for all taxpayers with any income above the 15% tax bracket. Thus, the proposal would reduce the incentive to save for any individual with taxable income of over $34,500 (or over $69,000 for couples filing jointly). And taxpayers at all income levels would also face the very real risk of higher state income tax burdens under the 18% match proposal.

But the problems that would be caused by the 18% match proposal go well beyond its assumptions. Although many of the details of the proposal are undetermined[15], a few things are clear. First, as with the 20/20 proposal, the 18% match would substantially reduce the incentive for key business decision-makers to have a plan. Even where the business did keep a plan in place it is likely that any employer matching contributions would be curtailed substantially or

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[14] American Society of Pension Professionals and Actuaries, Estimated Benefits of Tax Expenditure Estimates for Defined Contribution Plan Participants and Retirees with Account Balances (Aug. 2009) (analyzing IRS data), available at http://www.asppa.org/document-vault/pdfs/mediaroom/LTENYT082509.aspx.

[15] To date, proposals such as these have been silent on the myriad critical details that would need answers in connection with implementation of a tax credit structure in lieu of the current exclusions. For example, the critical issue of how distributions would be taxed is not clear. If they are fully taxable, the proposal would, in effect, be double taxing certain income. If an adjustment is made, considerable complexity would be added. Other issues that are not clearly addressed include the payroll tax treatment of employer contributions, the transition to the new system, and rules that would prevent individuals from withdrawing the government match prematurely.

eliminated. The fact is that the 18% tax credit provides so little benefit to a business owner (especially when compared to other available investment options) that there would, in many instances, not be sufficient incentive for a business entrepreneur to take on the costs, responsibilities and risks of maintaining a retirement plan. As indicated above, when plan sponsorship declines, all employees suffer.

For those employers who might still continue to maintain plans under the 18% match, most other employer contributions to retirement plans, like profit sharing contributions, could well become a distant memory. The reason is simple. Under the 18% match proposal, if an employer were to contribute $1,000 to each employee's retirement account, the government would then contribute $180 to the individual's account. The $1,180 in the employee's account would be locked in. The employee could not access the $1,000 employer contribution without incurring substantial taxes and penalties. The $180 government match could not be withdrawn for any reason for some period of time (perhaps not until retirement). The problem is that employees would immediately owe income tax on the $1,000 employer contribution, even though they may not even have the money to pay the tax. Employers will not want to put their employees into a situation where they are forced to pay income tax today on wages they never saw, in order to get a small government match that they may not be able to access until retirement.

Furthermore, the majority of 401(k) plans with matching contributions provide a match of at least 50% with respect to employee contributions. This provides a powerful incentive to save. Employers have found that the match must be sufficiently large to get the employees' attention. It is not at all clear that the "government match" under the 18% match proposal would be a sufficient incentive to save. Younger employees, in particular - the very people who should be encouraged to save - will be reluctant to set aside money today in order to get a small government match.

Finally, moving to this complex new regime would create great confusion among individuals, thereby deterring savings. This would be extremely counterproductive at a time when all have agreed that the way to foster savings is to keep things simple. Reducing and impeding the incentives to save in plans and IRAs in this way would be particularly detrimental as such savings typically represent a significant share of families' total financial assets.

Changes in retirement policy should build on existing system, not erode it.

Promoting retirement savings must remain one of our nation's top policy priorities. We urge this Committee to continue its leadership in pursuing policies to improve our Nation's retirement system. But any changes that are made should build upon our existing and successful tax incentive structure so that it works even more effectively to facilitate retirement plan coverage and savings by American families.

As this Committee considers these issues in the future, the Council urges you to focus on four objectives when crafting specific retirement policies. These objectives are all designed to advance the goal of retirement income adequacy for American workers.

Accumulating Retirement Savings: The first and most important policy objective in helping Americans generate adequate retirement income is to assist them in accumulating retirement savings during their working lives (which can then be used to generate income in retirement). Current retirement policies and vehicles, particularly employer-sponsored plans, successfully assist American families in accumulating retirement savings and generating retirement income.

Employer retirement plans make effective use of payroll deductions, provide fiduciary oversight and group pricing, typically involve substantial financial contributions by employers to employees' benefits, and facilitate access to investment education and advice. But in order that as many Americans as possible accumulate the retirement savings they need, policy improvements can be made in the following areas:

- *Coverage* -- expanding access to individual and workplace retirement savings plans;
- *Adequacy* -- helping individuals (supported by their employers) to save at higher levels;
- *Investing* -- encouraging the wise investment of retirement assets; and
- *Preservation* -- promoting portability of retirement savings and avoiding spending of savings prior to retirement (leakage).

Translating Retirement Savings into Retirement Income: A second important policy objective is helping individuals understand how their accumulated retirement savings from all sources (including the savings and benefits of one's spouse, where applicable) may be converted into streams of income in retirement.

Supporting an Evolving Approach to Retirement: A third important policy objective is to facilitate a flexible and evolving approach to retirement in which individuals who need or choose to do so may continue paid work into the traditional retirement years and may reduce their level of work over time as they transition into full retirement.

Supporting Employer Efforts to Assist Individuals: Employer plan sponsors play an important role in helping workers accumulate retirement savings, but their continued ability to play this role depends upon a supportive and stable policy environment.

Unfortunately, given the fiscal condition of the federal government, it will be difficult to remove revenue considerations from policy debates, even in the retirement area. Some good proposals will likely have to be delayed at this time because they are simply too costly and the required federal resources are simply not available.

There are a number of positive proposals that have been suggested by Members of this Committee that would help move us closer to better meeting those objectives with only modest short-term cost to the Federal government. For example, tax reform efforts in the retirement area should focus on simplification and reducing the administrative burden on plan sponsors. For example, nondiscrimination rules could be simplified by creating simple easy to apply safe harbors and making sure they do not discourage inclusion of part-time and short-service employees. The number of required notices should be reduced and streamlined and rules should be updated to better accommodate electronic delivery. We urge you to consider those and similar proposals as you continue your review of tax reform options.

PRESERVE THE EMPLOYER-PROVIDED RETIREMENT SYSTEM

September 15, 2011

The undersigned organizations are committed to preserving and enhancing the voluntary employer-provided retirement system and the tax incentives that support it. These plans are helping millions of American families achieve a secure retirement. **We urge the Joint Select Committee on Deficit Reduction to preserve the current tax treatment that both encourages employers to offer and workers to contribute to retirement plans.**

- **Employer-provided plans are a key component of our nation's retirement system.** Together with Social Security and individual savings, employer-provided retirement plans produce significant retirement benefits for America's working families. There are approximately 670,000 private-sector defined contribution plans covering 67 million participants and over 48,000 private-sector defined benefit plans covering 19 million participants. Recently enacted enhancements to the defined contribution system including automatic enrollment and automatic escalation are expanding participation and improving retirement preparedness. The Bureau of Labor Statistics reports that in March 2011 employer-provided retirement plans were available to 73 percent of full time and 64 percent of all (i.e. both full-time and part-time) private-sector workers. This success includes millions of low and moderate-income workers, the focus of efforts to expand coverage.

- **Changing the tax treatment and/or lowering contribution levels will result in lower retirement savings and fewer workers being offered retirement plans by their employers.** A recent analysis by the Employee Benefit Research Institute reveals that the recommendation by the National Commission on Fiscal Responsibility to limit contributions to defined contribution retirement plans to the lesser of $20,000 or 20% of compensation will reduce retirement security for workers at all income levels, not just high-income workers. According to the study, those in the lowest-income quartile will have the second highest average percentage reductions. Small business owners may be less likely to offer a plan to their employees if contribution limits are lowered.

- **Employer-provided retirement plans offer key advantages to workers.** Employers voluntarily establish these plans and add immeasurable value by acting as fiduciary and investment management overseers, monitoring plan fees, selecting quality investment alternatives, making significant contributions, providing financial education, and encouraging and facilitating savings through payroll deductions. These plans must be operated for the exclusive benefit of and "solely in the interest of" the participants. They must meet broad coverage and nondiscrimination tests that ensure that the eligibility and operation of the plan are fair. Low and moderate income workers are much more likely to have retirement savings if they are offered a retirement plan at work. The Saver's Credit benefits lower-income workers who save through these plans.

- **Retirement plans play an important role in the capital markets.** As of March 2011, tax qualified retirement plans held $18.1 trillion in assets, of which approximately $14 trillion is attributable to employer-provided plans. This pool of capital helps to finance productivity enhancing investments and business expansion. Contributions by employees and employers to defined contribution plans continued even through the recent years of financial stress. Changes to the tax treatment of retirement plans that would reduce contributions or discourage the establishment and maintenance of plans could negatively impact the role of these pivotal players in the capital markets.

- **Taxes on retirement savings are deferred, not excluded. Deferral treatment is not equivalent to the exclusion associated with other tax expenditures.** As individuals begin to retire, distributions from retirement savings are taxed and revenue will flow to the U.S. Treasury.

Conclusion
The employer-sponsored retirement plan system has introduced tens of millions of American workers to retirement saving. Employers voluntarily establish and promote these plans to help their workers build assets for a secure retirement. Eliminating or diminishing the current tax treatment of employer-provided retirement plans will jeopardize the retirement security of tens of millions of American workers, impact the role of retirement assets in the capital markets, and create challenges in maintaining the quality of life for future generations of retirees. While we work to enhance the current system and reduce the deficit we must not eliminate one of the central foundations – the tax treatment of retirement savings – upon which today's successful system is built. The effects of such a change for individuals, employers and the system as a whole are simply too harmful and must be avoided.

AMERICAN BENEFITS COUNCIL

AMERICAN COUNCIL OF LIFE INSURERS

AMERICAN SOCIETY OF PENSION PROFESSIONALS & ACTUARIES

THE ERISA INDUSTRY COMMITTEE

THE ESOP ASSOCIATION

FINANCIAL EXECUTIVES INTERNATIONAL

FINANCIAL PLANNING ASSOCIATION

THE FINANCIAL SERVICES INSTITUTE

THE FINANCIAL SERVICES ROUNDTABLE

INSURED RETIREMENT INSTITUTE

INVESTMENT COMPANY INSTITUTE

NATIONAL ASSOCIATION OF INSURANCE AND FINANCIAL ADVISORS

NATIONAL ASSOCIATION OF MANUFACTURERS

NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION

NATIONAL TELECOMMUNICATIONS COOPERATIVE ASSOCIATION

PROFIT SHARING / 401k COUNCIL OF AMERICA

RETIREMENT INDUSTRY TRUST ASSOCIATION

SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION

SMALL BUSINESS COUNCIL OF AMERICA

SOCIETY FOR HUMAN RESOURCE MANAGEMENT

U.S. CHAMBER OF COMMERCE

U.S. WOMEN'S CHAMBER OF COMMERCE

ACLI
Financial Security. For Life.

The American Council of Life Insurers

Statement for the Record

for

"Tax Reform Options: Promoting Retirement Security"

Before the

United States Senate Finance Committee

September 15, 2011
10:00 AM
Dirksen Senate Office Building, Room 215

The American Council of Life Insurers
Statement for the Record
"Tax Reform Options: Promoting Retirement Security"
Senate Finance Committee
United States Congress
September 15, 2011

The American Council of Life Insurers (ACLI) commends this Committee for holding this hearing on how the tax code could better encourage Americans to plan and save for their retirement. We applaud Chairman Baucus (D-MT) and Ranking Member Hatch (R-UT) for focusing on the need for more Americans to save for their retirement and make informed decisions about their retirement savings.

The American Council of Life Insurers represents more than 300 legal reserve life insurer and fraternal benefit society member companies operating in the United States. These member companies represent more than 90% of the assets and premiums of the U.S. life insurance and annuity industry. ACLI member companies offer insurance contracts and investment products and services to qualified retirement plans, including defined benefit pension, 401(k), 403(b) and 457 arrangements. ACLI member companies also are employer sponsors of retirement plans for their employees. As service and product providers, as well as employers, we believe that saving for retirement and managing assets throughout retirement are critical economic issues facing individuals and our Nation.

The ACLI strongly supports the current defined contribution (DC) retirement system. We believe that the voluntary employer-based retirement system affords individuals an efficient means by which to save for retirement through a payroll deduction mechanism. This is enhanced by features such as auto-enrollment, auto-escalation, an employer matching contribution, and investment education. For lower-income workers, the Saver's Credit provides an additional incentive to save. In return, participants benefit from the employer's role as a fiduciary who oversees investment management, monitors plan fees and services, and selects quality investment alternatives.

While it is critically important that Americans save for their retirement, academic proposals that would change the current tax incentive for such savings from a deduction or exclusion to a tax credit would be detrimental to the current system and would disproportionately impact lower-income workers. We urge this Committee to preserve the current system and examine ways to build its successes. A fuller examination of how a change to the current structure would impact workers and suggestions to build up on the current system, are discussed in greater detail in the joint statement submitted by the American Benefits Council and ACLI.

As the first wave of the baby boom generation reaches retirement age next year, policymakers are looking at the current retirement plan system's ability to provide retirement income for these and future retirees. Many current retirees are fortunate in that they are receiving both a Social Security benefit as well as an employer-provided pension. That situation is rapidly changing. Today, we are seeing an increasing number of workers retiring with only Social Security and their own savings. This raises the question as to how they might manage these savings to last throughout their retirement. These workers should consider augmenting Social Security with additional amounts of guaranteed lifetime income, so that anticipated monthly expenses can be covered by a guaranteed lifetime income stream, thereby shifting the risk of outliving one's savings to a life insurer. ACLI believes that, given information about guaranteeing some level of savings, workers will have the knowledge to make informed decisions about their lifetime income options and therefore make decisions that enable them to maximize their guaranteed lifetime income.

At the Committee's request to address the key features of defined benefit plans that can be incorporated into defined contribution plans, this statement summarizes ACLI's submission to the Departments of Labor and Treasury's ("Departments") Request for Information regarding lifetime annuities and similar lifetime income options available to defined contribution plans. Our submission describes the:

- role of life insurers in providing guaranteed lifetime income and other risk protection products to employer plans (in-plan) and directly to individuals (out-of-plan);
- important role employers have played in helping employees protect against risks by providing information about and access to life insurance, disability insurance, annuities and other risk protection products;
- variety of annuities and other guaranteed lifetime income options that are available today; and
- legislative and regulatory recommendations to enhance the retirement income security of participants and individuals by facilitating the use of guaranteed lifetime income options.

Life Insurers

The life insurance industry provides protection for individuals and families against the risk of adverse financial consequences due to premature death, long-term care needs, disability, and outliving one's financial assets or living at a substantially reduced standard of living. Financial protection provided by the life insurance industry to American households reaches across all ages and income levels. For example, in 2010, life, disability, long-term care, and annuity products provided over $151 billion in benefits to contract beneficiaries.[1] This protection is offered both directly to individuals and through employers.

Employers

Employers are key stakeholders in helping individuals obtain financial protection provided by life insurers. Employers offer financial protection to employees on a group basis which enables the employer to pass cost savings along to their employees. Half (51 percent) of all employees report obtaining the majority of their financial protection products, such as life, disability income, and long-term care insurance, as well as annuities and retirement savings plans, through the workplace.[2] This commitment by employers helps to increase employee awareness and understanding of the nature and benefits of these products. Whether employers pay for all or part of these products or permit employees to pay for them through payroll deduction, by making

[1] ACLI calculations based on preliminary data release of 2010 NAIC Annual Statement data.
[2] 7th Annual Study of Employee Benefits Trends, MetLife (2009).

these products available at the workplace employers encourage employees to take action to protect themselves and their families.

ACLI members provide these financial protection products through employers (in-plan), directly to individuals (out-of-plan), or on a combination in-plan and out-of plan basis. Employer engagement has helped Americans understand the importance of life insurance and disability insurance. The financial protection that can be provided by guaranteed lifetime income may be less understood than the benefits of life and disability insurance and other insurance products. This difference may be partly attributed to the prevalence in the past of defined benefit plans which provided lifetime income without the need for the employee to make a decision to obtain the benefit. As more and more employers choose to offer defined contribution plans rather than defined benefit plans, we believe that employers should play a key role in helping employees understand the benefits of, and gain access to, the protection provided by guaranteed lifetime income.

Guaranteed Lifetime Income Products

Guaranteed lifetime income products have evolved significantly over the past decade. The industry has responded to both individuals' interests and concerns with traditional annuities. The range of lifetime income products available today is significantly different from what was available even six years ago. As we sometimes say, "This isn't your father's annuity." Today, there is an array of guaranteed lifetime income options that are generally available through ERISA and non-ERISA employer-sponsored plans, as well as on an individual basis.[3] The new products include more traditional payout or "income" annuities that provide periodic payments, typically for life, commencing "immediately" after purchase as well as new products that provide for payment on a "delayed" or "deferred" date past retirement, e.g., at age 85 (a "longevity annuity" or "longevity insurance,"). Newer payout (income) annuities can be purchased with a single premium or incrementally on a periodic basis, e.g., by monthly payroll deductions.

Annuities offer many additional features that enable the purchaser to customize the income stream to meet their particular needs, thereby enabling the purchaser to only pay for the protection that is needed. Annuities can include a variety of optional features to address needs such as survivor benefits, liquidity for emergencies, and inflation. Deferred accumulation annuities may include optional guaranteed living benefits that provide protection during the life of the owner against investment risk by guaranteeing a level of annuity payments and/or withdrawal amounts prior to annuitization. Annuities may include features that insure against premature death such as annuities based on joint lives, annuities that refund the remaining premium, or annuities with minimum payment period guarantees. Annuities may include some form of adjustment for inflation. Life insurers offer a variety of lifetime income protection products to address a variety of needs.

Recommendations to Enhance the Use of Guaranteed Lifetime Income

Academics write of the "annuity puzzle," i.e., why so few retirees annuitize defined contribution benefits when annuities provide much needed income protection. ACLI believes that efforts to educate employers and employees about the value of guaranteed lifetime income and to reframe

[3] The Employee Retirement Income Security Act of 1974 ("ERISA") covers private employer sponsored qualified retirement plans. Governmental plans and many not-for-profit plans are exempt from ERISA.

individuals' thinking of defined contribution plan savings as a source of guaranteed lifetime income will help to solve the annuity puzzle. From a recent survey, employees are interested in guaranteed lifetime income options and find it valuable to see how much guaranteed lifetime income they could obtain by using their retirement plan savings.[4] It is important to note that ACLI believes that most workers should annuitize **some** of their retirement savings to support their monthly expenses and that annuitizing all of one's savings is not appropriate for most people.

New laws and regulations can help employers assist their employees in obtaining guaranteed lifetime income in the same way they have assisted employees in obtaining life insurance, disability insurance, and other financial protection products. New laws and regulations can also create an incentive to use guaranteed lifetime income as part of an employee's overall retirement income plan.

Recommendations to Encourage Employers to Offer Annuities

1. Provide Employers with Guidance on Lifetime Income and Education. In our RFI submission, we urged the DOL to revise and extend Interpretive Bulletin 96-1 beyond guidance on investment education to include guidance on the provision of education regarding lifetime income and other distribution options, both "in-plan" and outside the plan, to assist participants and beneficiaries in making informed decisions regarding their distribution choices.

2. Help Employers Select an Annuity Provider. The DOL took an important step by changing the so-called "safest annuity standard" in Interpretive Bulletin 95-1 by adopting a safe harbor for the selection of annuity providers for individual account plans. While this regulation provided some helpful guideposts, it contains a requirement that the fiduciary "conclude that the annuity provider is financially able to make all future payments." This standard is difficult to meet, in part because it is hard to know how to draw this conclusion. While it is part of a "safe harbor," this prong makes it difficult to use the safe harbor and thus is an impediment to the offer of annuities in defined contribution plans. ACLLI believes that changes can be made to these rules which will make it easier for employers to meet their duties while at the same time ensuring a prudent selection. The Department of Labor should revise or eliminate this requirement and make it easier for employers to meet their duties while at the same time ensuring a prudent selection.

3. Annuity Administration. Employers take on a number of duties in administering a retirement plan, and the administration of an annuity option would increase those duties. The qualified joint and survivor annuity ("QJSA") rules provide important spousal protections. The notice and consent requirements provide spouses with an opportunity to consider the survivor benefits available under a joint and survivor annuity. However, these rules add an additional layer of administrative complexity as well as technical compliance issues that most plan sponsors choose to avoid by excluding annuities from their plans.

   There are a number of ways that the rules can be modified to make it easier for employers to administer this important requirement while protecting survivors, including:

[4] ACLI Study on Retirement Choice, Mathew Greenwald & Associates 2010 (see Appendix 2).

- model plan amendments for employers to add guaranteed lifetime income options;
- simplify QJSA notice requirements; and
- the use of electronic signatures, widely accepted in financial transactions today.

ACLI proposes allowing those employers who choose to do so to transfer the duties and liabilities of administering qualified joint and survivor annuity rules to an annuity administrator. Also, employers need guidance that confirms that a participant's purchase of incremental deferred payout annuities should not be subject to the QJSA rules until the participant has elected to take the annuity payout.

4. Partial Annuitization Option. Some employers view annuitization as an "all-or-nothing" distribution offering. In our RFI submission, we asked the Departments to provide guidance making clear that plans may provide retirees with the option to use a portion of the account value to purchase guaranteed lifetime income, including model amendments to simplify the adoption of such provision.

Recommendations to Encourage Workers to Elect Annuities

1. Illustration. To reframe retirement savings as a source of lifetime income, ACLI supports legislative proposals to include an illustration of participant accumulations as monthly guaranteed lifetime income on defined contribution plan benefit statements. ACLI thanks Senators Bingaman, Isakson and Kohl for their bi-partisan sponsorship of S. 267, the Lifetime Income Disclosure Act, which will help workers understand how their retirement savings might translate into guaranteed lifetime income. We hope that other Members of this Committee will support this important legislation.

2. Information. In our RFI submission, we asked the Treasury Department to modify the 402(f) rollover notice requirements and the safe harbor notice to include information on guaranteed lifetime income, including the importance of income protections and the availability of lifetime income plan distribution options, if any, as well as lifetime income options available outside the plan.

3. Using a Portion of a Retirement Account to Purchase Guaranteed Lifetime Income. ACLI supports efforts to facilitate a retiree's election to use a portion of his or her defined contribution account to obtain guaranteed income for life.

    - "Longevity Insurance" in Employer Plans and IRAs. The current required minimum distribution rules discourage the use of longevity insurance, i.e., deferred payout income annuities with an annuity start date later in retirement, such as age 85. ACLI supports past legislation that would facilitate the use of longevity insurance in qualified plans and IRAs by excluding the longevity insurance premium amount when calculating an individual's required minimum distributions.

    - Partial Annuitization. ACLI supports efforts to facilitate a retiree's election to use a portion of his or her account to obtain guaranteed income for life.

Conclusion

Workers need better tools to plan for retirement. A lifetime income illustration will help workers visualize how their savings will address their basic month-to-month living expenses after retirement. With this information, workers can better decide whether they need to increase their savings, adjust their 401(k) investments or reconsider their retirement date, if necessary, to assure the quality of life they expect when their working days are over.

Similarly, workers need more information on guaranteed lifetime income options and the risks of outliving their savings. Long-term retirement planning can be a daunting task for workers. Guaranteed lifetime income options can help ease that burden by providing workers with a "paycheck for life" they can count on no matter how long they live.

Encouraging workers to consider guaranteed lifetime income options, such as by facilitating the availability of longevity insurance and partial annuitization, represents sound public policy as the baby boom generation reaches retirement age.

While employers are understandably concerned about increased fiduciary responsibilities, we believe any added burdens can be eased through adjustments in existing regulations. These include making it easier for employers to meet their fiduciary duties in selecting annuity providers and allowing insurers to assume the duties of administering the QJSA rules.

Taking these important steps today can help address tomorrow's retirement income security crisis.

Attachments:

"ACLI Retirement Choices Study," by Mathew Greenwald & Associates, Inc, April 2010

"Encourage Annuity Options for Defined Contribution Plans," ACLI proposal, February 2009

ACLI Retirement Choices Study

Online Survey with

Near-Retiree Defined Contribution Plan Participants

Report of Findings

Prepared for:

ACLI

Financial Security. For Life.

by:

Mathew Greenwald & Associaties, Inc.

April 2010

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Introduction and Methodology

In an effort to gauge retirement plan participants' interest in (1) having their employers offer additional options for what they can do with their retirement plan accumulations after they retire and (2) being able to see an illustration of how much guaranteed lifetime income they may be able to get using the money in the plan, the American Council of Life Insurers (ACLI) commissioned independent research firm, Mathew Greenwald & Associates, to conduct a study of plan participants nearing retirement.

An online survey was conducted with 750 workers ages 45 to 65, who are participating in a defined contribution plan available through their current employer. Respondents were also screened to ensure that they had a minimum retirement plan account balance of at least $40,000 and were not expecting any retirement income from a defined benefit pension plan.

- Potential respondents for this study were selected from among members of eRewards Consumer Research Panel.
- The survey fielded between March 26 and March 31, 2010.

The survey data were weighted by gender, age, and education to reflect the composition of retirement plan participants ages 45 to 65 with account balances of at least $40,000. Population statistics were based on data from the 2007 Survey of Income and Program Participation (SIPP).

A similarly-sized random sample of 750 respondents would have a margin of error at the 95% confidence level of plus or minus 3.7 percentage points.

Key findings and a detailed discussion follow this section.*

*Percentages in the tables and charts may not total to 100 due to rounding and/or missing categories.

Key Findings

Seeing an illustration of how much guaranteed monthly income they could get for life may prompt many plan participants to save more.

- Just over nine in ten respondents say that it would be valuable to have their employer show them an illustration of how much monthly income they could get guaranteed for life based on the value of their retirement plan account, including more than half who feel that it would be very valuable.
- Three out of five say that if this illustration showed that the monthly income that could be generated would not be enough to meet their needs, they would start saving more immediately. Another one-third say that, after seeing this illustration, they would monitor how their savings affected the illustration and consider saving more later.
- Eighty-five percent express an interest in having this information available in their regular retirement statement or on a secure website hosted by either their employer or their plan provider.

An overwhelming majority support the idea of having employers offer an option in their retirement plans that would use some of their retirement plan savings to provide employees with guaranteed monthly income for the rest of their lives once they retire.

- Nearly nine out of ten plan participants surveyed report that they favor a proposal to have employers offer an option that would use their plan savings to generate a guaranteed stream of income for life.
- A similar share – fully 90% – say they favor the idea of their employer offering them this type of option, and would be interested in learning more about it, if it were available.

Given the overall favorable impression of this option, it's not surprising that positive statements about why such an option should be made available resonate more than arguments against it.

- More than nine in ten agree that employers should be encouraged to offer choices to help employees attain financial security, and nearly all agree that an option that offers to guarantee income for life can help accomplish this.
- Although a large majority of respondents say they feel at least somewhat confident about their ability to personally manage their finances after they retire, this confidence may be an overstatement, since more than nine in ten agree that it is difficult for "many workers" to know how to manage their money after they retire, and feel it would be helpful if employers offered an option to help with this.

- Likewise, seven in ten disagree that employees know how to use their savings to generate a retirement income for themselves and don't need an option from their employer to do it for them.
- Half disagree with the statement that "employers have no responsibility for helping employees determine what to do with their retirement plan savings after they retire."

Respondents' confidence in being able to manage savings and investments after retirement is lower than their confidence about managing money prior to retirement.

- Currently, eight in ten plan participants feel at least somewhat knowledgeable when it comes to selecting the savings and investment options within their plan that are best for them.
- Yet, fewer seem as optimistic about their ability to manage their assets after they retire – including being able to pick the appropriate savings and investment products, determine the right withdrawal amounts, and making their money last for the rest of their lives. While about one-quarter strongly agree that they are knowledgeable about selecting their investments right now, half as many describe themselves as being very confident in their ability to manage their money after they retire.
- Moreover, just 7% feel very confident in their ability to make savings and investment decisions once they reach their 80s or 90s.
- Perhaps as a result, three out of four plan participants indicate that they are concerned about not having enough money in retirement to meet their needs.

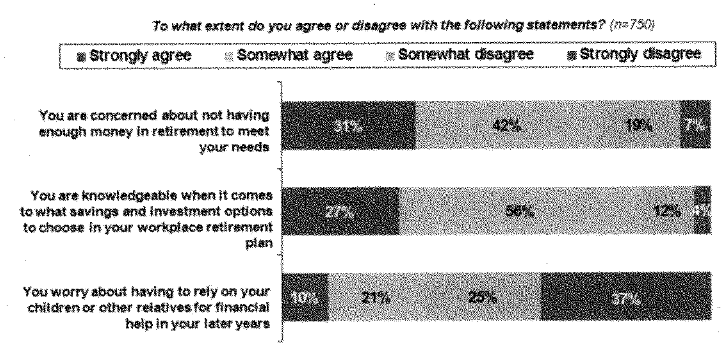
Detailed Findings

Retirement Outlook

Eight in ten plan participants say they are knowledgeable when it comes to selecting investment options inside their workplace retirement plan.

- Most plan participants (83%) describe themselves as knowledgeable when it comes to selecting savings and investment options within their employer-sponsored retirement plan, though just one-quarter strongly agree that they are knowledgeable in this area (27%).
  - Men are more likely to feel knowledgeable about selecting retirement plan investment options (86% v. 78% women).
- At the same time, nearly one-third (31%) strongly agree that not having enough money in retirement is a concern, and another four in ten (42%) suggest they are at least somewhat concerned about running out of money.
- In fact, one out of three (31%) agree that they are worried about having to rely on their children or other relatives for financial help in their later years. Women are especially likely to worry about this (38% v. 27% men).

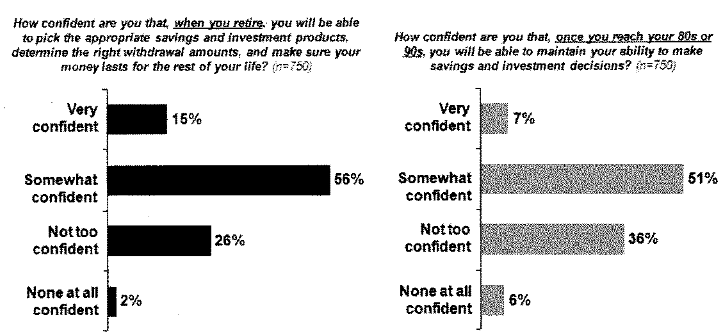
Retirement Outlook



Fewer feel confident that they will be able to pick the appropriate products, determine withdrawal amounts, and make their money last after they retire.

- Although 27% strongly agree that they are knowledgeable about selecting current retirement plan options, only 15% of plan participants feel very confident that – when they retire – they will be able to pick the appropriate savings and investment products, determine the right withdrawal amounts, and be able to make their money last for the rest of their of lives.
- A far larger share (56%) feel somewhat confident, and one-quarter (28%) say they are not too or not at all confident in their ability to manage their money in retirement.
- Even fewer feel very confident (7%) that they will maintain their financial decision-making ability into their 80s or 90s, though most (51%) remain at least somewhat confident that they will be able to make sound savings and investment decisions in their later years.

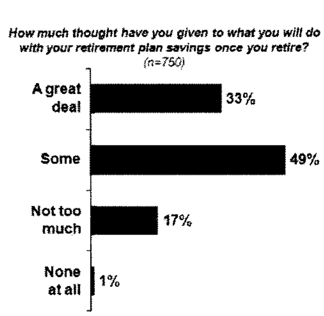
Confidence in Managing Retirement Finances

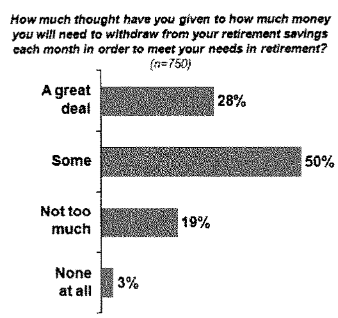


A majority have given at least some thought to what they will do with their retirement plan assets when they retire and how much they can withdraw each month.

- More than eight in ten retirement plan participants (82%) say they have given at least some thought to what they will do with their retirement plan assets once they retire. Still, only one-third have given this a great deal of thought, and two in ten (18%) indicate that they haven't given it too much thought at all.
  - Not too surprisingly, the likelihood of having thought this issue through increases with age (and proximity to retirement), such that 92% of those ages 60 to 65 say they have given at least some thought to what they will do with their plan assets, compared to 73% of those ages 45 to 49.
- Nearly as many say they have given at least some thought to how much they will need to withdraw each month from their retirement savings in order to meet their financial needs, though half (50%) say they have given this just some thought.
  - Those who are older (and closer to retirement) (88% of those age 60-65) are more likely than younger plan participants (72% of those age 45-49) to say they have thought about this to at least some extent.

Thought Given to Retirement Plan Assets and Withdrawals



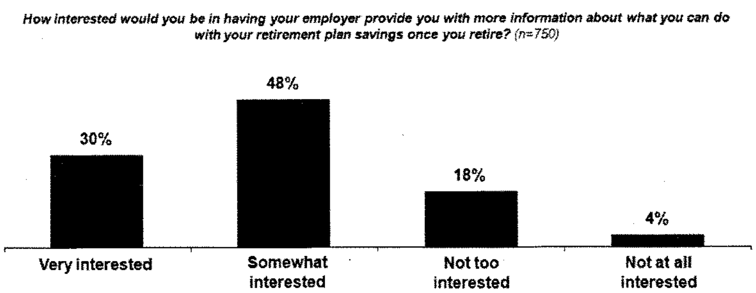


Interest in Information On and Options for Guaranteed Lifetime Income

Almost eight in ten would be interested in having their employer tell them more about what they can do with their retirement plan assets once they retire.

- Nearly eight out of ten (78%) express an interest in having their employer provide them with more information about what they can do with their retirement plan savings once they retire, including three in ten (30%) who would be very interested.

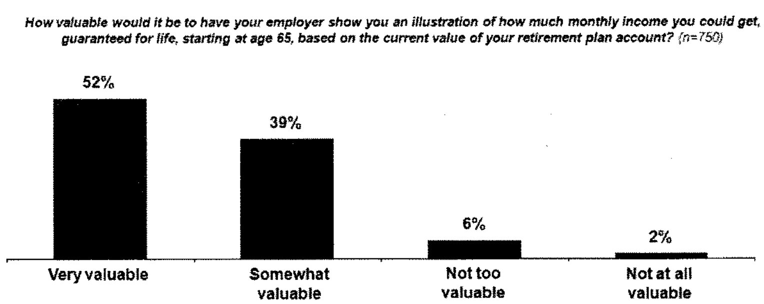
Interest in Information On Options for Retirement Plan Assets



An overwhelming majority feel it would be valuable to see how much guaranteed lifetime income they could get using their retirement plan savings.

- Just over nine out of ten plan participants (91%) suggest that it would be valuable to have their employer show them an illustration of how much guaranteed monthly income they could get for life, starting at age 65, based on the current value of their retirement plan account. This includes more than half (52%) who feel such an illustration would be very valuable.
  - Plan participants who presumably still have more time to plan for retirement (92% of 45-59 year olds) are more likely than those who are older (86% of 60-65 year olds) to feel that this illustration would be at least somewhat valuable.
  - Those with incomes under $100,000 (95%) are also more likely than their counterparts (89% of those with $100k+) to feel an illustration of how much guaranteed monthly income they could get would be valuable.
  - Interestingly, those who have not given a lot of thought to what they will do with their retirement plan savings after retirement (96%) are especially apt to say this type of illustration would be valuable, compared to those who have already thought about what they will do (90%). This suggests that showing plan participants this type of illustration may help some begin thinking about how to use their retirement savings who haven't previously given it much thought.

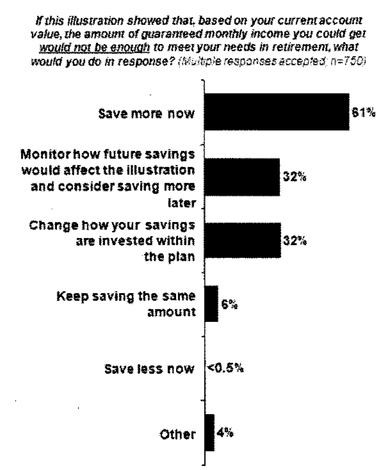
Value of Guaranteed Monthly Income Illustrations



An illustration of how much guaranteed monthly income could be generated would prompt many to save more, if the current amount seemed insufficient.

- Six in ten plan participants (61%) say that if they saw an illustration that suggested the amount of guaranteed monthly income that could be generated by their retirement plan account would not be enough to meet their needs, it would prompt them to start saving more.
  - Plan participants between the ages of 45 and 49 (68%) are particularly likely to suggest they would start saving more (v. 58% of those ages 50-65).
  - Those with incomes of $100,000 or more (69%) are more apt than those with lower household incomes (55%) to react by saving more.
- One-third (32%) say they would continue to monitor how their savings affected the illustration and would consider saving more later.
- Others (32%) indicate that seeing an illustration like this would cause them to re-evaluate and change their asset allocation.
- Only 6% say they would continue saving the same amount and less than 1% would save less as a result of seeing the illustration.

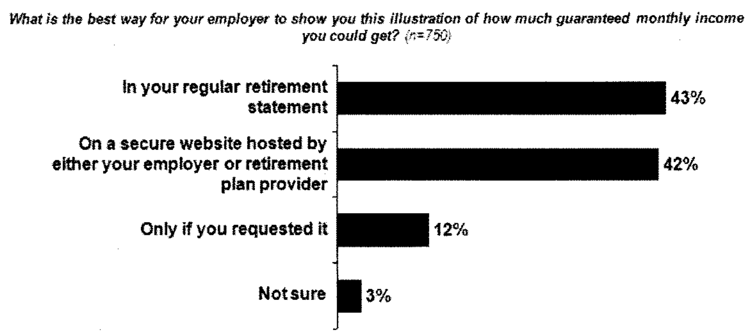
Response to Inadequate Income Illustration



Five in six (85%) want to see an illustration of how much guaranteed monthly income they could get on a regular basis, only 12% want it available only on their request.

- Eighty-five percent of plan participants indicate that the best way for them to see an illustration of how much guaranteed monthly income they could get is either in their regular retirement statements or on a secure website hosted by either their employer or their retirement plan provider.

Showing Illustration of Guaranteed Monthly Income



Nearly nine in ten plan participants favor a proposal to have employers offer an option of receiving guaranteed income for life.

- Eighty-six percent of plan participants surveyed favor a proposal that would have employers offer their employees an option in their retirement plan that would use some of the participants' assets to generate a guaranteed stream of income for life.
  - Women (92%) are significantly more likely than men (83%) to favor this proposal.
  - This proposal is viewed especially positively by plan participants nearing retirement, as 48% of those ages 55 to 59 say they strongly favor the proposal, which is significantly higher than those older (32% of 62-65 year olds) and those younger (36% of those age 45-54).
  - Those with incomes under $100,000 (91%) are more likely than higher earners (82%) to express their support.

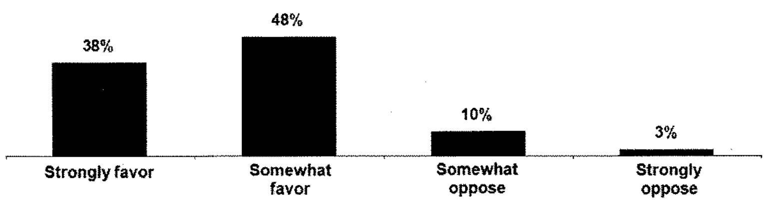
Attitude Toward Employers Offering Guaranteed Income for Life Option

Some financial planning experts believe that employers should offer an option in their retirement plans that would provide employees with guaranteed monthly income for the rest of their lives once they retire.

Employees would be able to choose whether or not to select this option. If they did choose it, they could put in any amount of money from their retirement plan that they wanted to.

The monthly income payments would never go down and it would be paid as long as the employee lives. Married employees could also have the option to have the payments last as long as either they or their spouses are alive.

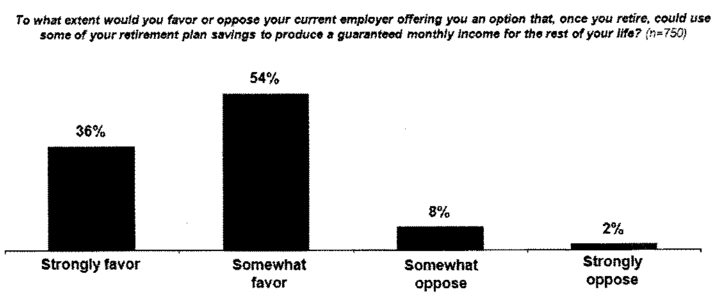
How strongly do you favor or oppose having employers offer their employees the option of getting guaranteed income for life, if they want it? *(n=750)*



Nine in ten favor the idea of their own employer offering them an option for guaranteed lifetime income.

- Fully ninety percent say they strongly (36%) or somewhat (54%) favor the idea of their employer offering an option that, once they retire, they could use some of their retirement plan savings to produce a guaranteed monthly income for the rest of their lives.
  - Again, women (94%) and those with household incomes under $100,000 (93%) are more inclined than their counterparts to say they favor the idea of their employer providing this option (88% of men, 87% of those earning $100,000 or more).
  - Plan participants who say they tend to be investment risk averse (52%) are more likely than those who are willing to take average to above average investment risk (35%) to strongly favor having their employer offer this option.

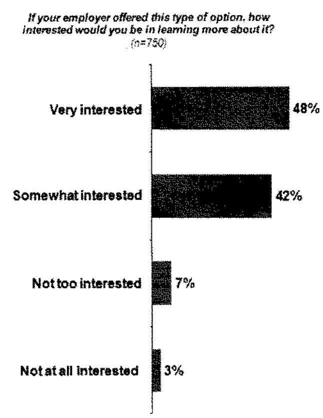
Desire for Own Employer Offering Guaranteed Income for Life Option



Given these positive reactions, it's not surprising that nine in ten also say they'd be interested in learning more about this option, if it were available.

- Nearly half of plan participants (48%) say they would be very interested in learning more about this option, if their employer offered it. And another four in ten (42%) say they would be somewhat interested in learning more.
  - Those who favor the proposal overall (96%) are more likely than those who oppose it (56%) to say they would be interested in learning more.
  - However, plan participants who have not previously given much thought to what they will do with their retirement plan assets (97%) are especially likely to say they would want to learn more about a guaranteed lifetime income option (v. 89% of those who have already given some thought), suggesting that the very offer of this option might prompt some to think through these issues in more detail.
  - Those with retirement plan account balances between $40,000 and $75,000 (96%) are more apt than those with higher balances (87%) to express an interest in more information on this option.

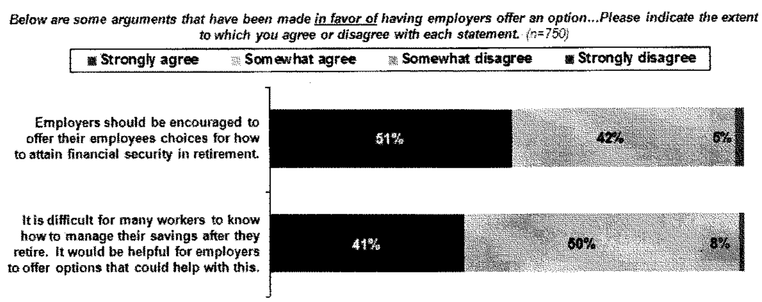
Interest in Learning More About Guaranteed Income for Life Option



Nine in ten believe that employers should offer choices to help employees attain financial security in retirement; many feel it may be difficult to do this on their own.

- Half of plan participants (51%) strongly agree, and more than four in ten somewhat agree (42%), that employers should be encouraged to offer their employees choices for how to attain financial security in retirement.
- Moreover, 91% of plan participants strongly or somewhat agree that it is difficult for many workers to know how to manage their assets after they retire and it would be helpful if employers offered options to help with this.

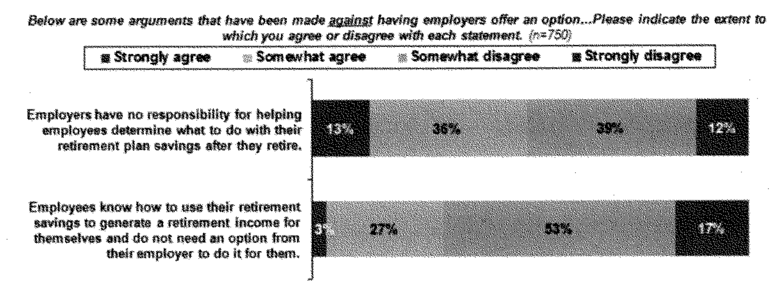
Agreement with Statements in Favor of Employers Offering Guaranteed Income Option



Seven in ten disagree that employees know how to use their income to generate income in retirement and do not need the help of employers.

- Half (51%) disagree with the statement that employers have no responsibility for helping employees manage their retirement plan savings after they retire.
- Still, the vast majority – seven in ten (70%) – disagree that employees know how to use their retirement savings to generate retirement income for themselves and therefore do not need an option from their employer to do this.

Agreement with Statements Against Employers Offering Guaranteed Income Option



February 2009

Encourage Annuity Options for Defined Contribution Plans

Problem: Currently, about one-half of employees' retirement savings is in defined contribution plans. Most defined contribution plans do not contain guaranteed lifetime income (annuity) distribution options notwithstanding that annuitization of account balances on retirement is the best way of assuring that retirement funds will not be exhausted during the participant's life. Early exhaustion of account balances may also adversely affect surviving spouses.

A major reason that defined contribution plans do not provide guaranteed lifetime income options is that, if they do so, the plan must then comply with burdensome statutory requirements relating to joint and survivor annuities. The J & S rules impose costly and burdensome administrative requirements involving notifications to spouses, waivers by spouses, and prescribe the form and amount of spousal benefits. A major reason for the shift to defined contribution plans is a desire by employers to avoid the administrative cost and complexity associated with defined benefit plans, including compliance with joint and survivor annuity requirements.

A potential solution to this problem would be for the plan sponsor to outsource the administration of the joint and survivor annuity rules to the annuity provider. However, in the event of a failure of the annuity provider to properly administer the rules, the plan and plan sponsor would still be liable for a claim for benefits under Section 502 of ERISA.

Solution: Where the plan sponsor and the annuity provider have agreed that the annuity provider will be responsible for administration of the joint and survivor annuity rules, provide that enforcement actions for failure to comply with the joint and survivor annuity rules may only be maintained against the annuity provider, provided that the plan sponsor or administrator has prudently selected and retained selection of the annuity provider. Make this provision applicable only to administration of the joint and survivor annuity rules under defined contribution plans. The electronic delivery rules should be modified to allow greater use of electronic means for administration of the J & S rules.

Rationale: The ability to shift responsibility for the administration of the joint and survivor annuity rules would make guaranteed lifetime income (annuity) options more attractive to plan sponsors and could result in significantly wider availability of such annuity payment options under defined contribution plans. While this approach would retain the cost and complexity of the annuity rules, it would preserve spousal protections and would permit the plan and plan sponsor to shift responsibility to an experienced third party annuity provider. This provider would be an insurance company with experience in annuity administration and a secure financial ability to pay annuities. These factors makes shifting responsibility to annuity issuers more beneficial to and protective of plan participants, beneficiaries (including surviving spouses) and the plan sponsor than leaving responsibility with the plan and plan sponsor.

Electronic administration is more cost efficient and has become more widely used. DOL has indicated that they are modifying their regulation on electronic delivery, although it is not known whether the modification will cover the QJSA rules.

Encourage Annuity Options for Defined Contribution Plans

SECTION __

(a) AMENDMENTS TO THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974.---

(1) IN GENERAL --- Section 402(c) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1102(c)) is amended ---

(A) in paragraph (2) by striking "or" at the end;

(B) in paragraph (3) by striking the period at the end and inserting "; or"; and

(C) by adding at the end the following new paragraph:

"(4) that a named fiduciary, or a fiduciary designated by a named fiduciary pursuant to a plan procedure described in section 405(e), may appoint an annuity administrator or administrators with responsibility for administration of an individual account plan in accordance with the requirements of Section 205 and payment of any annuity required thereunder."

(2) Section 405 (29 U.S.C. 1105) is amended by adding at the end the following new subsection:

"(e) Annuity Administrator

If an annuity administrator or administrators have been appointed under section 402(c)(4), then neither the named fiduciary nor any appointing fiduciary shall be liable for any act or omission of the annuity administrator except to the extent that ---

(1) the fiduciary violated section 404(a)(1) ---

(i) with respect to such allocation or designation, or

(ii) in continuing the allocation or designation; or

(2) the fiduciary would otherwise be liable in accordance with subsection (a). "

(3) Section 205(b) (29 U.S.C. 1055) is amended by adding at the end the following new sentence:

"Clause (ii) of subparagraph (C) shall not apply if an annuity administrator or administrators have been appointed under section 402(c)(4)."

(b) AMENDMENTS TO THE INTERNAL REVENUE CODE OF 1986 ---

(1) IN GENERAL ---Section 401(a)(11) of the Internal Revenue Code of 1986 (relating to requirements of joint and survivor annuities and preretirement survivor annuities) is amended by adding at the end the following new sentence:

"Clause (iii) (II) shall not apply if an annuity administrator or administrators have been appointed under section 402(c)(4) of the Employee Retirement Income Security Act of 1974."

(c) ELECTRONIC DELIVERY

(1) IN GENERAL --- The Secretary of the Department of Labor shall modify the regulations under section 104 or section 205 of the Employee Retirement Income Security Act of 1974 to provide a broad ability to administer the requirements of section 205 of the Employee Retirement Income Security Act of 1974 by electronic means.

AMERICANS FOR
SECURE RETIREMENT

Written Testimony: Thomas Bartell
Chairman of Americans for Secure Retirement

Senate Finance Committee Hearing
"Tax Reform Options: Promoting Retirement Security"
September 15, 2011

Chairman Baucus, Ranking Member Hatch and distinguished members of the committee, on behalf of Americans for Secure Retirement (ASR), I welcome the opportunity to submit for the record our statement on the need to implement policies that will encourage Americans to save and plan for retirement.

Americans for Secure Retirement is a broad-based coalition of more than 70 member and affiliate organizations committed to raising awareness of the increasing challenges Americans face in having a financially secure retirement. In particular, ASR often focuses on those Americans with little or no access to employer sponsored plans. Our coalition includes organizations that advocate for Hispanics, women, small businesses, farmers and others, united in an effort to ensure that all Americans have access to guaranteed streams of retirement income that cannot be outlived.

This hearing is both timely and of great interest to the millions of baby boomers who will soon rely on America's retirement system. We are pleased that this committee recognizes the importance addressing the challenges that lie ahead for many Americans in having financially secure retirement.

As this Committee is well aware, the United States is facing a looming retirement crisis. People are living longer, and traditional sources of guaranteed retirement income, such as Social Security, cover less and less of what is needed in retirement. At the same time, it is a reality that pensions are disappearing, and many workers do not have access to any kind of employer-sponsored retirement plan. For those whose employers do offer a retirement plan, defined contribution plans, such as 401(k)s, have become far more common than defined benefit plans that provide a guaranteed stream of income in retirement. Moreover, as the instability of the U.S. economy continues, we are reminded of the 2008 declines when the plummeting stock values sent the average balances in 401(k) plans down to about $67,002. In that year, workers aged 45-54 making contributions to a 401(k) plan for at least 20 years saw the value of their retirement fund decrease by nearly 30 percent. This continued volatility in the stock market magnifies the gap left with by the disappearing pensions.

Annuities are the only product that can provide Americans with a guaranteed stream of lifetime income through retirement – a "paycheck for life" – to ensure that they will not outlive their income. With guaranteed streams of lifetime income through an annuity, retirees can not only receive the same financial security associated with pension but also the peace of mind.

American Agriculture Movement
American Agri-Women
American Corn Growers Association
American Council of Life Insurers
merican Homeowners Grassroots Alliance
merican Small Business Coalition
Association for Advanced Life Underwriting
Black Women Enterprises
Business and Professional Women/USA
Citizens Against Government Waste
Committee of Annuity Insurers
Federation of Southern Cooperatives
Financial Services Roundtable
Hispanic Alliance for Progress Institute (HAPI)
Hispanic Business Roundtable
Hispanics Impacting Public Policy
Insured Retirement Institute
Intertribal Agriculture Council
The Latino Coalition
National Association for Female Executives
National Association of Farmer Elected Committees
National Association of Hispanic/Latino Farmers and Ranchers
National Association of Independent Life Brokerage Agencies
National Association of Insurance and Financial Advisors
National Association of Small Disadvantaged Businesses
National Caucus and Center on Black Aged
National Community Pharmacists Association
National Consumers League
National Taxpayers Union
Oklahoma Farmers Union
Small Business and Entrepreneurship Council
Soybean Producers of America
U.S. Chamber of Commerce
Women Entrepreneurs, Inc.
Women Impacting Public Policy
Women in Need Industries
Women's Institute for a Secure Retirement
Women Involved in Farm Economics
Women President's Organization

It is clear that retirement savings lag behind need. For individuals nearing or at retirement, data compiled by the Federal Reserve in conjunction with the Center for Retirement Research at Boston College shows that the median household headed by a person aged 60 to 62 with a 401(k) account has less than one-quarter of what is needed in that account to maintain its standard of living in retirement.[1]

This draws similar comparisons to a 2009 study conducted by ASR and prepared by Ernst & Young which found that three out of five Americans entering retirement at age 65 can expect to outlive their financial assets. To avoid outliving their savings, the report indicated that Americans retiring today with no guaranteed source of income beyond Social Security will have to reduce their standard of living by an average of 32 percent. Americans who are seven years away from retirement will most likely have to reduce their standard of living by an average of 45 percent. This study also found that those with guaranteed retirement income beyond Social Security, such as lifetime annuities, are much better prepared for retirement than those without.[2]

The challenge is even greater for particular segments of the American population, including women, Hispanic Americans, small business owners and those who work in the agricultural sector. In general, these groups lack access to traditional employer-sponsored retirement plans. They may also be affected by unique factors that limit their opportunities to build up and manage their retirement assets, including income disparities, unpredictable income based on commodity prices, limited access to traditional savings vehicles and, for women, longer life expectancy. Consider the following:

- ***Women.*** Women face unique retirement challenges compared to their male counterparts. On average, women have fewer full-time working years than men and have median annual earnings that are about $10,000 less than those of working men. Women typically live longer than men and are likely to spend some of their retirement years alone due to widowhood or divorce. These disparities lead to lower savings and retirement income and smaller payouts from Social Security, ultimately resulting in a greater risk of poverty in retirement.[3]

- ***Hispanic Americans.*** While Hispanics work in all sectors of the economy, they are more heavily concentrated in jobs that lack traditional retirement options and typically earn a lower income, affecting their ability to save for retirement. For example, a recent study conducted by The Hispanic Institute and ASR reported that only 25.6 percent of Hispanics are covered by pension plans, compared to 42.5 percent of whites and 40 percent of African-Americans. Recent trends indicate that Hispanics have actually become less prepared for retirement over the past few years.[4]

- ***Small Business.*** Small businesses are the engine of our economy, but instability and retirement insecurity has been a complicating factor in many business decisions. Today many small business owners face unique challenges that put them at risk of falling short in retirement. Many small owners reinvest significant portions of their income into their businesses, and therefore cannot afford the cost of establishing and maintaining traditional defined benefit or defined

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[1] Browning, E.S. "Retiring Boomers Find 401(k) Plans Fall Short." *Wall Street Journal*, February 19, 2011. (http://online.wsj.com/article/SB10001424052748703959604576152792748707356.html)

[2] Americans for Secure Retirement: Updated Retirement Vulnerability Analysis: The likelihood of outliving their financial assets, by Ernst & Young LLP, June 2009; (http://paycheckforlife.org/userfiles/file/Updated%20Retirement%20Vulnerability%20Analysis_2009_FINAL.pdf)

[3] Americans For Secure Retirement: The Female Factor, 2008; by Cindy Hounsell, WISER (Women's Institute for a Secure Retirement); (http://paycheckforlife.org/uploads/ASR-white_paper_FINAL.pdf)

[4] Hispanics And Retirement: By The Hispanic Institute, For Americans For Secure Retirement 2009, (http://paycheckforlife.org/uploads/white-paper-hispanics-and-retirement-english.pdf)

contribution plans for themselves and their employees. These entrepreneurs often expect to use the proceeds from the future the sale of their business to finance their retirement.

- ***Rural and Farming Communities.*** America's rural and farming communities are influenced by factors that make obtaining a secure retirement uniquely difficult. Farmers are less likely to be covered by traditional pensions, forcing them to rely on Social Security at a much greater rate than those in other sectors. This comes at a time when Social Security, on average, only covers two-thirds of retirement needs. In addition, there is extreme variability in farm income due to largely uncontrollable fluctuations in commodity prices, weather, and macroeconomic policies making it more difficult for farmers to adequately plan and save for retirement. [5]

Public opinion echoes these facts. A recent survey conducted by Mathew Greenwald & Associates for the National Institute of Retirement Security found that an astonishing 84 percent of Americans believe economic conditions are impacting their ability to have a secure retirement, with 73 percent believing the volatility of the stock market makes it impossible to predict what they will have in their nest egg. Conversely, lifetime income relieves retirement anxiety. According to that same poll, 84 percent respondents believe that workers with pensions are more likely to have a secure retirement. For those without access to a pension, annuitization can provide an individual with their own personal pension plan, and is looked upon with similar favorability. A 2009 Gallup poll found that annuity owners felt much more secure and prepared for their retirement because of the stream of income received from this retirement vehicle.[6]

To address these challenges, Americans for Secure Retirement strongly supports public policy that makes secure retirement vehicles, such as annuities with their various ways of guaranteeing lifetime income, more accessible and affordable both to those who participate in an employer sponsored plan and to those who do not. Annuities are the only product that can provide Americans with a guaranteed stream of lifetime income through retirement – a "paycheck for life" – to ensure that they will not outlive their income. This is particularly true given the disappearance of traditional pensions. By providing the growing number of Americans who do not have access to pensions with the option of a guaranteed stream of lifetime income through annuities, retirees can achieve the financial security previously associated with pensions.

We believe that encouraging employers to provide their employees with the option to receive lifetime annuity income with a portion of their defined contribution retirement accounts must be part of the solution. And we must encourage employees to take advantage of such options by providing various flexible and innovative vehicles that address varying needs, including traditional deferred annuities, traditional payout annuities, longevity insurance and annuities with guaranteed lifetime withdrawal benefits. Congress also should look at similar ways to encourage the large number of Americans who do not have access to employer based retirement plans or whose retirement savings are held outside of employer plans to obtain the benefit of guaranteed lifetime income from annuities. The need for guaranteed lifetime income vehicles to help manage retirement savings is not limited to participants in employer-based retirement programs.

For example, in the 111th Congress, bipartisan legislation was introduced to encourage Americans to place a portion of their savings in lifetime annuities, taking a sensible approach to encouraging Americans to plan for the long-term.

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[5] Lifetime Income Crucial to Farmer's Retirement Security," American Corn Growers Association and Americans for Secure Retirement, (http://paycheckforlife.org/uploads/Ag_Issue_Brief_FINAL.PDF)

[6] The Committee of Annuity Insurers, 2009 Survey of Owners of Non-Qualified Annuity Contracts; by The Gallup Organization and Matthew Greenwald and Associates; (http://annuity-insurers.org/pdfs/09.17.09.atta.Final2009GallupSurvey.pdf)

It should be among our top priorities to ensure all Americans are provided with the tools to help them adequately prepare for retirement and manage savings so they last a lifetime. Our coalition members represent a broad swath of those populations hit disproportionately hard in retirement, and stand ready to provide additional information and insight regarding the importance of lifetime income. We are encouraged by your demonstrated interest in addressing retirement challenges and look forward to helping you in these efforts. Thank you.

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Comments for the Record

United States Senate Committee on Finance

Tax Reform Options: Promoting Retirement Security
Thursday, September 15, 2011, 10:00 AM
215 Dirksen Senate Office Building

By Michael Bindner
Center for Fiscal Equity
4 Canterbury Square, Suite 302
Alexandria, Virginia 22304

Chairman Baucus and Ranking Member Hatch, thank you for the opportunity to address this topic. Tax reform can definitely be used to promote retirement security in two areas – funding Social Security and preserving Medicare and Medicaid.

Social Security was part of a new social compact which, along with very high marginal tax rates and partnership with organized labor, built the middle class while keeping corporate capitalism in place. In a very real way, these programs were a reaction to not only the Great Depression, but a preventative to a very real movement toward more direct employee control and ownership of the workplace by the union movement. The passage of Taft-Hartley Act restrictions on concentrated ownership of the workplace were set in place as much to protect management from being swept away as they were a desire to diversify pension assets to protect workers.

This social context is important to understanding options for the future of Social Security.

Payroll taxes began at the 2% level for employers and employees, with increasing rates and income caps over time to accommodate the growth of the number of covered retirees from zero to entire generations.

In the early 1980s, Social Security was close to having to draw from the General Fund. Ronald Reagan's conservatism was ascendant, with recently passed income tax cuts being phased in over a three year period and a beginning of the end of the bargain with the union movement to maintain labor peace in exchange for not pushing for a larger ownership share. Indeed, for all practical purposes, labor had become de-radicalized over time. It had moved to seeking to preserve benefit levels rather than advancing the interests of workers into the management suite.

In this context, a new grand bargain was created to save Social Security. Payroll taxes were increased to build up a Trust Fund for the retirement of the Baby Boom generation. The building of this allowed the government to use these revenues to finance current operations, allowing the President and his allies in Congress to honor their commitment to preserving the last increment of his signature tax cut, where the only other realistic option at the time was to abandon some or all of them, which was politically unacceptable given Republican control of the White House and the Senate.

Actions should be taken as soon as possible, especially when they must be phased in, as it is a truism that a little action early will have a larger impact later.

This trust fund is now coming due, with the expectation that shortfalls in Social Security payroll taxes will be covered by both income from interest income from the Social Security trust fund and eventually revenue from the general fund. The cash flow problem currently experienced by the Trust Fund is not the Trust Fund's problem, but a problem for the Treasury to address, either through further borrowing – which will require a quick resolution to the debt limit extension or through higher taxes on those who received the lion's share of the benefit's from the tax cuts of 1981, 1986, 2001, 2003 and 2010. At some point, Congress must ignore the interests of its major donors (to both parties) and honor the bargain it made to shore up the trust fund. This is entirely appropriate, given the fact that much of the Trust Fund was built up in order to preserve the income tax cuts of 1981.

As luck would have it, adequate personal income tax increases to finance repaying the Trust Fund will occur automatically on January 1, 2013. This revenue profile, not current tax rates, must be considered the baseline on which any new bargain is formed.

The complication, and there are always complications, is that low tax rates enacted on capital gains, income and dividends during the Clinton and Bush administrations have created two asset based recessions, the first in the technology sector and the second in housing.

The recent recession is more accurately described as a Depression, since the financing of the real estate bubble has still not been resolved, even while economic growth numbers have begun to rebound. This new has both temporary and permanent effects on the trust fund's cash flow. The temporary effect is a decline in revenue caused by a slower economy and the temporary cut in payroll tax rates to provide stimulus.

The permanent effect is the early retirement of many who had planned to work longer, but because of the recent recession and slow recovery, this cohort has decided to leave the labor force for good when their extended unemployment ran out. This cohort is the older 99ers who need some kind of income now. The combination of age discrimination and the ability to retire has led them to the decision to retire before they had planned to do so, which impacts the cash flow of the trust fund, but not the overall payout (as lower benefit levels offset the impact of the decision to retire early on their total retirement cost to the system).

It would be entirely inappropriate to renege on promises to the baby boomers to fund further income tax cuts by further extending the retirement age, cutting promised Medicare benefits or by enacting an across the board increase to the OASI payroll tax as a way to subsidize current spending or tax cuts. The current fiscal crisis should not be an excuse to use regressive Old Age and Survivors Insurance payroll taxes to subsidize continued tax cuts on the top 20% of wage earners who pay the majority of income taxes. Retirement on Social Security for those at the lowest levels is still inadequate. Any change to the program should, in time, allow a more comfortable standard of living in retirement.

The ultimate cause of the trust fund's long term difficulties is not financial but demographic. Thus, the solution must also be demographic – both in terms of population size and income distribution. The largest demographic problem facing Social Security and the health care entitlements, Medicare and Medicaid, is the aging of the population. In the long term, the only solution for that aging is to provide a decent income for every family through more generous tax benefits.

The free market will not provide this support without such assistance, preferring instead to hire employees as cheaply as possible. Only an explicit subsidy for family size overcomes this market failure, leading to a reverse of the aging crisis.

The recommendations for raising net income are within the context of comprehensive tax reform, where the first 25-28 percent of personal income tax rates, the corporate income tax, unemployment insurance taxes, the Hospital Insurance payroll tax, the Disability Insurance payroll tax and the portion of the Survivors Insurance payroll tax funding survivors under the age of 60 have been subsumed by a Value Added Tax (VAT) and a Net Business Receipts Tax (where the net includes all value added, including wages and salaries).

Net income would be adjusted upward by the amount of the VAT percentage and an increased child tax credit of $500 per child per month. This credit would replace the earned income tax credit, the exemption for children, the current child tax credit, the mortgage interest deduction and the property tax deduction. This will lead employers to decrease base wages generally so that the average family with children and at an average income level would see no change in wage, while wages would go up for lower income families with more children and down for high income earners without children.

Gross income would be adjusted by the amount of tax withholding transferred from the employee to the employer, after first adjusting net income to reflect the amount of tax benefits lost due to the end of the home mortgage and property tax deductions.

This shift in tax benefits is entirely paid for and it would not decrease the support provided in the tax code to the housing sector – although it would change the mix of support provided because the need for larger housing is the largest expense faced by growing families. Indeed, this reform will likely increase support for the housing sector, as there is some doubt in the community of tax analysts as to whether the home mortgage deduction impacted the purchase of housing, including second homes, by wealthier taxpayers.

Within twenty years, a larger number of children born translates into more workers, who in another decade will attain levels of productivity large enough to reverse the demographic time bomb faced by Social Security in the long term.

Such an approach is superior to proposals to enact personal savings accounts as an addition to Social Security, as such accounts implicitly rely on profits from overseas labor to fund the dividends required to fill the hole caused by the aging crisis. This approach cannot succeed, however, as newly industrialized workers always develop into consumers who demand more income, leaving less for dividends to finance American retirements. The answer must come from solving the demographic problem at home, rather than relying on development abroad.

This proposal will also reduce the need for poor families to resort to abortion services in the event of an unplanned pregnancy. Indeed, if state governments were to follow suit in increasing child tax benefits as part of coordinated tax reform, most family planning activities would be to increase, rather than prevent, pregnancy. It is my hope that this fact is not lost on the Pro-Life Community, who should score support for this plan as an essential vote in maintaining a perfect pro-life voter rating.

Obviously, this proposal would remove both the mortgage interest deduction and the property tax deduction from the mix of proposals for decreasing tax rates while reducing the deficit. This effectively ends the notion that deficit finance can be attained in the short and medium term through tax reforms where the base is broadened and rates are reduced. The only alternatives left are a generalized tax increase (which is probably necessary to finance future health care needs) and allowing tax rates for high income individuals to return to the levels already programmed in the law as of January 1, 2013. In this regard, gridlock is the friend of deficit reduction. Should the President show a willingness to let all rates rise to these levels, there is literally no way to force him to accept anything other than higher rates for the wealthy.

This is not to say that there is no room for reform in the Social Security program. Indeed, comprehensive tax reform at the very least requires calculating a new tax rate for the Old Age and Survivors Insurance program. My projection is that a 6.5% rate on net income for employees and employers (or 13% total) will collect about the same revenue as currently collected for these purposes, excluding sums paid through the proposed enhanced child tax credit. This calculation is, of course, subject to revision.

While these taxes could be merged into the net business income/revenue tax, VAT or the Fair Tax as others suggest, doing so makes it more complicated to enact personal retirement accounts. Our proposal for such accounts differs from the plan offered in by either the Cato Institute or the Bush Commission (aka the President's Commission to Save Social Security).

As we wrote in the January 2003 issue of Labor and Corporate Governance, we would equalize the employer contribution based on average income rather than personal income. We would also increase or eliminate the cap on contributions. The higher the income cap is raised, the more likely it is that personal retirement accounts are necessary.

A major strength of Social Security is its income redistribution function. We suspect that much of the support for personal accounts is to subvert that function – so any proposal for such accounts must move redistribution to account accumulation by equalizing the employer contribution.

In the unlikely even that personal accounts find consensus, we propose directing personal account investments to employer voting stock, rather than an index funds or any fund managed by outside brokers. There are no Index Fund billionaires (except those who operate them). People become rich by owning and controlling their own companies. Additionally, keeping funds in-house is the cheapest option administratively. I suspect it is even cheaper than the Social Security system – which operates at a much lower administrative cost than any defined contribution plan in existence.

Safety is, of course, a concern with personal accounts. Rather than diversifying through investment, however, I propose diversifying through insurance. A portion of the employer stock purchased would be traded to an insurance fund holding shares from all such employers. Additionally, any personal retirement accounts shifted from employee payroll taxes or from payroll taxes from non-corporate employers would go to this fund.

The insurance fund will save as a safeguard against bad management. If a third of shares were held by the insurance fund than dissident employees holding 25.1% of the employee-held shares (16.7% of the total) could combine with the insurance fund held shares to fire management if the insurance fund agreed there was cause to do so. Such a fund would make sure no one loses money should their employer fail and would serve as a sword of Damocles' to keep management in line. This is in contrast to the Cato/ PCSSS approach, which would continue the trend of management accountable to no one. The other part of my proposal that does so is representative voting by occupation on corporate boards, with either professional or union personnel providing such representation.

The suggestions made here are much less complicated than the current mix of proposals to change bend points and make OASI more of a needs based program. If the personal account provisions are adopted, there is no need to address the question of the retirement age. Workers will retire when their dividend income is adequate to meet their retirement income needs, with or even without a separate Social Security program.

No other proposal for personal retirement accounts is appropriate. Personal accounts should not be used to develop a new income stream for investment advisors and stock traders. It should certainly not result in more "trust fund socialism" with management that is accountable to no cause but short term gain. Such management often ignores the long-term interests of American workers and leaves CEOs both over-paid and unaccountable to anyone but themselves.

Progressives should not run away from proposals to enact personal accounts. If the proposals above are used as conditions for enactment, I suspect that they won't have to. The investment sector will run away from them instead and will mobilize their constituency against them. Let us hope that by then workers become invested in the possibilities of reform.

Indeed, real reform is only possible if workers become more radicalized to the possibilities of workplace ownership and democracy. The purpose of this testimony is to remind workers of the bargain struck in the Roosevelt era, which I mentioned at the outset, to allow capitalism to exist in exchange for moving workers into the middle class. As that bargain has been abandoned on one side, there is no reason for workers not to pick up old demands for workplace democracy. Indeed, it is essential that they do so in order to quit losing ground.

All of the changes proposed here work more effectively if started sooner. The sooner that the income cap on contributions is increased or eliminated, the higher the stock accumulation for individuals at the higher end of the age cohort to be covered by these changes – although conceivably a firm could be allowed to opt out of FICA taxes altogether provided they made all former workers and retirees whole with the equity they would have otherwise received if they had started their careers under a reformed system. We suspect, though, that most will continue to pay contributions, with a slower phase in – especially if a slower phase in leaves current management in place.

The Center also has less ambitious proposals for Medicare and Social Security reform, which we will now outline.

Bruce Bartlett wrote in the New York Times Economix Blog on May 17 on the nature of the Medicare financial problem and how to fix it. The information he imparted is invaluable, however I disagree with his solution, which is to stop doing the Doc Fix. He relates that the ACA expansion of funding brought the Hospital Insurance Trust Fund (Part A) into balance, with parts B (doctor visits) and D (Drug coverage) responsible for most of the unsustainable cost growth, as patient premiums are set to 25% of program costs and with drug coverage premiums covering even less.

Stopping doctor bills from going up on the demand side will not work. We know that because it did not work for Medicaid - since restricting payments have stopped most doctors from taking Medicaid). This finding has a great deal of impact on what is possible in preventing the doctor fix.

The problem with Medicare Part B is that increases cannot keep up with costs, like they do in the private market, because doing so violates the commitment to not cut Social Security benefit checks. The cost of living adjustment must be high enough to cover the premium increase each year - although for many that is all it does. Further cuts bring up the specter of seniors eating cat foot to make ends meet, hence the reason that the Fiscal Commission was called the Cat Food Commission by progressives.

Premium support and not patching doctor fees are attempts to make doctors restrict their costs - both to seniors and overall. Prices naturally rise more quickly than inflation because these services are subsidized, so any co-pay must be increased to slow demand from users in exactly the same way the market would without subsidies or insurance. The desire to make doctors pay more is a recognition that the main impact of both insurance and subsidies (and subsidies for insurance) is higher income for doctors and a larger medical care sector than would otherwise occur in a free market.

Our hybrid system is the most expensive option - either going to much less comprehensive insurance for everyone or an entirely governmental system would be cheaper, but is politically untenable (at least until private insurance collapses or is eventually supplanted by an ever expanding public option).

Going after doctors still won't work, however, as the Medicaid experience clearly shows. Premium support is a way to have insurance companies go after doctors instead, but that will likely yield the same result. Shifting the financial obligation to employers and past employers as part of a Net Business Receipts Tax would likely control doctor fees, although such a proposal will face resistance from both the medical and insurance sectors, even though it is the most likely to save money. Even if such a program is adopted, some employers are too small to support a medical staff or support retiree health care, so some kind of public program is still necessary, with reform all the more crucial.

Making patients more conscious of their care might do the trick, both with more realistic premiums for Part B and Part D, with both rising to absorb half the cost - although premiums could be lowered by increasing co-pays and providing seniors with Flexible Spending and/or health savings accounts. The problem is that this is untenable when dealing with a population with largely fixed incomes. That problem, however, is not unsolvable.

The obvious solution, which no one has yet suggested, is to change how COLAs are calculated, moving from the wage index to an index based on what seniors actually buy - especially health care. If premiums were increased quickly, COLA changes would have to be as rapid.

Such a proposal would hasten the date that the Old Age and Survivors Insurance fund needs rescue. It also impacts lower income seniors to a greater extent than higher income seniors, since they have less left over after any mandatory co-pay. Either bend points would have to be reset or the entire complicated system of bend points would have to be replaced a new method of crediting contributions, where employer contributions are credited equally rather than as a match to the employee contribution - thus moving redistribution from the benefits side to the revenue side.

An average employer contribution would provide even more incentive for increasing the amount of income subject to benefits - or even eliminating the cap altogether. Of course, if you do the latter, we might as well simply use a Net Business Receipts Tax or a VAT to replace the employer contribution (which captures all income with the latter burdening imports as well)

Thank you for the opportunity to address the committee. We are, of course, available for direct testimony or to answer questions by members and staff.

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September 13, 2011

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Set forth below is a statement from The ESOP Association for the Committee's hearing on "Tax Reform Options: Promoting Retirement Security." The official statement is in quotation marks.

"Chair Baucus, Ranking Member Hatch, and distinguished members of the Senate Committee on Finance:

This statement is for the official hearing of the Committee's September 15, 2011, hearing on "Tax Reform Options: Promoting Retirement Security."

This statement is submitted by:

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The author of this statement is J. Michael Keeling, President of The ESOP Association at the address and phone number above. Mr. Keeling's email address is michael@esopassociation.org.

The ESOP Association is a national trade association of approximately 2,400 members. Its primary, and majority, of members are U.S. corporations that sponsor employee stock ownership plans, or ESOPs, as the plans are most commonly known.

The mission of the Association is simple: To advocate for, and education about, employee ownership through the ESOP model.

ESOPs are imbedded in the Employee Retirement Income Security Act of 1974, or ERISA. Prior to 1974 they were recognized in the Internal Revenue Code, first in 1921, as stock bonus plans.

The fact is that it was the leadership of the Senate Finance Committee that pushed codification of ESOPs in ERISA, and in 1981, 1984, 1986, and 1998, the Committee added provisions to the Internal Revenue Code to encourage the creation and operation of ESOPs. The primary leader for ESOPs was the much loved, and revered, former Senator, and former Committee Chair for many years, Russell B. Long of Louisiana. To be noted in addition to this single champion for employee ownership, there is no public evidence that any member of this Committee ever opposed the creation and expansion of ESOP policy.

As it should, the Committee, the Senate, and the entire Congress, will work on tax reform examining all the evidence about each provision of the Tax Code of 1986. You will seek evidence that that the ESOP model of employee ownership is good for employees and their retirement income security. At the same time, when you examine the evidence about current ESOP policy, you will also review, 'Are ESOP companies good for employees, good for the companies, good for their communities, and good for America?'

You will ask these questions, for as the legislative history proves beyond doubt, be it in Committee reports, from statements on the Senate floor, or from votes on the Senate floor, ESOPs are 'ownership' plans as well as retirement savings plans.

In short, you will seek answers to the questions about ESOP tax law using two measures: One, are they good retirement savings plans, and two, are they good ownership plans?

Set forth below is a summary of the very credible evidence that ESOPs are both good retirement savings plans for employees with ESOP accounts, and are good for companies, communities, and the United States.

1. In the book, *Shared Capitalism at Work: Employee Ownership, Profit and Gain Sharing, and Broad-Based Stock Options*, edited by Joseph R. Blasi, Douglas L. Kruse, of Rutgers University, and Richard B. Freeman of Harvard University, the editors set forth findings on shared capitalism. The book identifies ESOPs as a primary model of shared capitalism in the U.S. Below are the summarized findings.
   - Shared capitalism can increase wealth for workers at lower and middle income levels.
   - Shared capitalism improves the performance of firms. It is associated with greater attachment, loyalty, and willingness to work hard; lower chance of turnover; worker reports that co-workers work hard and are involved in company issues; and worker suggestions for innovations.
   - Shared capitalism improves worker well-being. It is associated with greater participation in decision-making; higher pay, benefits, and wealth; greater job security, satisfaction with influence at the workplace, trust in the firm, and assessment of management; and better labor management relations practices.
   - Shared capitalism complements other labor policies and practices. Firms with shared capitalism compensate more and are likely to have other worker-friendly labor policies and practices.

- The risk of shared capitalism investments in one's employer is manageable. Portfolio theory suggests employee ownership can be part of an efficient portfolio. Most workers have modest amounts of employee ownership within the ranges suggested by portfolio theory. Less risky forms of shared capitalism such as cash profit sharing and stock options where workers are paid market wages, or company stock is not financed by worker savings, can be prudently combined with riskier forms where workers purchase stock.

2. In August 2010, The ESOP Association and the Employee Ownership Foundation released the results of a survey conducted among the Association's 1,400 corporate members which confirmed positive benchmarks for ESOPs. The eye-opening statistics of the 2010 survey are the increase in age of the ESOP and account balances. In 2010, the average age of the ESOP was reported to be 15 years, demonstrating ESOP companies are sustainable. In addition, the average account balance has risen dramatically to \$195,222.65; a high figure compared to most data tracking defined contribution plans which correlates with the age of ESOPs participating in this year's survey. And approximately 90% of members reported having retirement savings plans in addition to the ESOP including the use of 401(k) plans, pension plans, stock purchase plans, and stock options. In terms of motivation and productivity, 84% of respondents agree that the ESOP improved motivation and productivity. The Company Survey is conducted every five years and was last completed in 2005. Prior to 2005, the survey was completed in 2000.

3. Also in September 2010, the Employee Ownership Foundation released the results of an extensive study it funded that evidenced that ESOPs provide more employee benefits than non-ESOP companies. The study, which reviewed data from the Department of Labor Form 5500 on defined contribution retirement plans, found: ESOP companies have at least one plan, the ESOP, but more than half (56%) have a second retirement savings/defined contribution plan, likely a 401(k) plan. In comparison, the Bureau of Labor statistics reports that only 47% of companies have some sort of defined contribution plan which shows that an ESOP company is more than likely to have two defined contribution plans than the average company is to have one plan.

   The project was done by the National Center for Employee Ownership (NCEO).

4. Also, in the summer of 2011, the Employee Ownership Foundation released its 20th Annual Economic Performance Survey (EPS), that evidenced a very high percentage of companies, 92%, declared that creating employee ownership through an ESOP was "a good decision that has helped the company."

5. In June 2008, Brent Kramer, a doctoral candidate at the City University of New York, now Ph.D., submitted a study, *Employee Ownership and Participation Effects on Firm Outcomes*, that "provides strong evidence that majority employee-owned businesses have a significant advantage over comparable traditionally-owned businesses in sales per employee." The average advantage, \$44,500, means that a typical 200 person ESOP businesses could be expected to have an almost \$9 million annual sales advantage over its non-ESOP counterpart.

6. In January 2007, the co-operative relationship between the Employee Ownership Foundation and the University of Pennsylvania's Center for Organizational Dynamics led to an important new and "fresh" study of the effectiveness of ESOPs and employee ownership as uncovered in 30 years of scholarly research on the issue. The study, "Effects of ESOP Adoption and Employee Ownership: Thirty Years of Research and Experience," authored by Dr. Steven F. Freeman, Affiliated Faculty and Visiting Scholar School of Arts and Sciences, University of Pennsylvania, confirms that employee-owned companies experience increased productivity, profitability, and longevity.

7. The most comprehensive and significant study to date of ESOP performance in closely held companies was conducted by Dr. Joseph R. Blasi and Dr. Douglas L. Kruse, professors at the School of Management and Labor Relations at Rutgers University, and funded in part by the Employee Ownership Foundation. The study, which paired *1,100 ESOP companies* with *1,100 comparable closely-held non-ESOP companies* and followed the closely-held businesses for *over a decade*, reported overwhelmingly positive and remarkable results indicating that ESOPs appear to increase sales, employment, and sales/employee by about 2.3% to 2.4% over what would have been anticipated, absent an ESOP. In addition, Drs. Blasi and Kruse examined whether ESOP companies stayed in business longer than non-ESOP companies and found that 77.9% of the ESOP companies followed as part of the survey survived as compared to 62.3% of the comparable non-ESOP companies. According to Drs. Blasi and Kruse, ESOP companies are also more likely to continue operating as independent companies over the course of several years.

8. In 1995, the U.S. Department of Labor released a study entitled "The Financial and Non-Financial Returns to Innovative Workplace Practices: A Critical Review." This study found that companies that seek employee participation, give employees company stock, and train employees, can positively affect American corporations' bottom lines.

So, based on the research cited, and there are many more studies, by the way, the Committee may agree, even agree strongly, that ESOP companies are good for our economy while providing in the vast majority of ESOP companies excellent retirement savings for the employee participants.

At the same time, however, it is legitimate for each Senator to ask as s/he thinks of our national tax system: 'Is the Federal tax revenue foregone because of tax law preferences for ESOP creation and operation worth it?' Or to ask differently, 'Is our nation benefitting from ESOPs as we, the Congress, and in particular, the Finance Committee, intended?'

Of course the ESOP community, as do advocates of all of our tax deferred retirement plans, reminds each and everyone that tax deferred ERISA plans do not, over a period of say 15 to 20 years, lower Federal tax revenues. It is only because the budget/tax expenditure estimating process looks at 5/10 year fiscal windows that ERISA plans seem to be revenue losers. Over time, as more and more Americans take money from their retirement savings plans, tax revenue is increased, and due to growth of the value of the plans, taxes paid on the distributions are more than the taxes foregone years earlier.

Let the record show that The ESOP Association endorses this view of the employer community that sponsors a variety of ERISA plans. The negative image of the tax preferential treatment of ERISA plans as revenue losers is a false image when these plans are viewed and analyzed beyond 5 to 10 years.

The ESOP community, however, has some special tax laws, primarily added as noted earlier by this Committee, that requires you to review these special rules for ESOPs beyond the general discussion of ERISA basic tax law preferences.

The special rules are consistently estimated by the Joint Committee on Taxation (JCT) and the Office of Management and Budget (OMB) for the past 10 to 15 years to lower Federal income tax revenue at approximately $2 billion to $2.5 billion per fiscal year. (A precise revenue score would have to be made in the context of the current law, and any proposals for change that might emerge. The numbers above come from the tax expenditure tables prepared by the JCT, and the OMB, both of which clearly explain that a tax expenditure estimate is not a revenue estimate, though everyone agrees that the tax expenditure number is nearly always in the ball park with a revenue estimate.)

To further explain, the special ESOP tax benefits number is divided about 75% to the corporation sponsoring an ESOP, and about 25% to individuals selling to an ESOP, and/or potential taxes paid by a potential shareholder of an S corporation sponsoring an ESOP. (It is murky how the S ESOP tax liability deferred until the ESOP participant receives a distribution is viewed by the estimators. An assumption may be that estimators view the ESOP trust, for estimating purposes, to be an individual S shareholder. Clearly as the Committee considers tax reform, clarity could be determined on these estimates about ESOP tax preferences.)

The $2 to $2.5 billion has to be put into context. The Federal government is estimated to collect $1.154 trillion in income tax revenue in Fiscal Year 2011. The Federal government will collect $2.174 trillion in total tax revenue. The Federal government will spend $3.819 trillion in Fiscal Year 2011. The Federal deficit will be $1.645 trillion in Fiscal Year 2011. The total GDP of the United States in Fiscal Year 2011 will be approximately $15.080 trillion.

Thus, the ESOP tax expenditures represent .0017% of total income tax revenue, .0009% of total revenue, .00052% of total Federal spending, .0012% of the Federal deficit, and .00013% of the annual GDP.

Thus, the Congress, with the agreement of the President, could repeal all of the ESOP tax preferences, and each taxpayer would have her/his $1 paid in tax reduced to approximately 2/10^{ths} of a penny or by such a miniscule amount it would not be noticeable. In lowering the taxes on a dollar by these minuscule amounts Congress would have abandoned a policy, for which there is ample evidence in the vast majority of instances provide very good retirement income security, creates more productive, more sustainable, more profitable, and better places to work, while ensuring the jobs are locally controlled.

In fact, given these facts of what ESOP companies provide to employees, do for communities, by keeping jobs locally controlled, and making these companies more competitive in the global market place as a result, the Congress should be passing new laws to encourage the creation of more ESOP companies.

But at the least, the Congress should not, based on the evidence, and based on the fact getting rid of special laws encouraging ESOP creation and operation will not provide any significant tax rate reduction, or Federal deficit reduction, restrict, or eliminate, current laws benefiting ESOP creation and operation.

As the Committee moves forward reviewing and modernizing our current Federal Internal Revenue Code of 1986, The ESOP Association, and we know the wonderful ESOP companies of America, will work with you, and your staffs, both Committee staff, and personal staff, to openly examine the reasons for our current national policy that modestly encourages creation of more employee ownership in our nation through the ESOP model.

We thank you for accepting our statement and placing it in the hearing record of your September 15th hearing, 'Tax Reform Options: Promoting Retirement Security'."

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Statement of the Investment Company Institute
Hearing on "Tax Reform Options: Promoting Retirement Security"
Committee on Finance
United States Senate

September 15, 2011

The Investment Company Institute[1] is pleased to provide this written statement in connection with the hearing in the U.S. Senate Committee on Finance titled "Tax Reform Options – Promoting Retirement Security." The Institute strongly supports efforts to promote retirement security for American workers. We thank Chairman Baucus and Ranking Member Hatch for their past support of retirement savings plan improvements, including provisions in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Pension Protection Act of 2006 (PPA). Reflecting these improvements, Americans currently have more than $18 trillion saved for retirement, with more than half of that amount in defined contribution (DC) plans and individual retirement accounts (IRAs).[2] About half of DC plan and IRA assets are invested in mutual funds, which makes the mutual fund community especially attuned to the needs of retirement savers.

For Americans, retirement planning has many components. Social Security is the primary element for the majority of American retirees[3] and replaces significant portions of income for lower-income retirees. Social Security replaces 71 percent of average annual lifetime household earnings for the lowest lifetime household earnings quintile, and 31 percent for the highest lifetime household

[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $12.9 trillion and serve over 90 million shareholders.

[2] *See* Tables 1, 6, and 12 in Investment Company Institute, "The U.S. Retirement Market: First Quarter 2011" (June 2011); available at www.ici.org/info/ret_11_q1_data.xls.

[3] Since 1975, there has been little change in the importance of Social Security benefits in providing retiree income. Social Security benefits continue to serve as the foundation for retirement security in the United States and represent the largest component of retiree income and the predominant income source for lower-income retirees. In 2009, Social Security benefits were 58 percent of total retiree income and more than 85 percent of income for retirees in the lowest 40 percent of the income distribution. Even for retirees in the highest income quintile, Social Security benefits represented more than one-third of income in 2009. *See* Figure 16 in Brady and Bogdan, "A Look at Private-Sector Retirement Plan Income After ERISA," *ICI Research Perspective* 16, no. 2 (November 2010); available at www.ici.org/pdf/per16-02.pdf.

earnings quintile.[4] Since the enactment of the Employee Retirement Income Security Act of 1974 (ERISA), increasing numbers of retirees also receive benefits from private-sector pension plans (defined benefit (DB) and DC) and receive more in benefits from these plans. Government household survey data indicate that in 2009, 34 percent of retirees received private-sector pension income and the median amount was $6,000 per person.[5] In 1975, only 21 percent of retirees received private-sector pension income and the median amount was only $4,515 (in 2009 dollars).[6] These statistics speak to the success of the changes implemented over the past 35 years. While the system is not perfect and can be improved, Congress should not throw out decades of progress and take away the ability of American workers to make full use of the retirement vehicles they value so strongly in supplementing their Social Security benefits. Consistent with the views of the overwhelming majority of Americans,[7] we urge Congress to maintain the current contribution limits, and allow our successful employer-provided retirement system to flourish.

Current Pension Coverage

The fact is that the majority of private-sector workers needing and demanding access to pensions as part of their compensation have pension plan coverage.[8] Discussions about coverage, however, often rely on misleading or incomplete coverage statistics. Household surveys, such as the Current Population Survey (CPS), typically show lower rates of pension coverage than surveys of business establishments, such as the National Compensation Survey (NCS). For example, the CPS data show that more than half (or 78.4 million) of all workers were without pension coverage in 2009.[9] The March 2011 NCS, on the other hand, shows that 64 percent of all private-industry workers and 73 percent of all full-time private-industry workers have access to a pension.[10]

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[4] Figures represent the median initial replacement rates for retired workers in the 1940s birth cohort. *See* Exhibit 10 in Congressional Budget Office, *CBO's Long-Term Projections for Social Security: Additional Information* (October 2010); available at www.cbo.gov/ftpdocs/119xx/doc11943/10-22-SocialSecurity_chartbook.pdf.

[5] Overall, in 2009, 47 percent of retirees had income from private-sector pensions, government pensions, or both. Data are ICI tabulations of the Current Population Survey (CPS). *See* Figure 17 in Brady and Bogdan, "A Look at Private-Sector Retirement Plan Income After ERISA," *ICI Research Perspective* 16, no. 2 (November 2010); available at www.ici.org/pdf/per16-02.pdf; and Figure A7 in Brady and Bogdan, "Appendix: A Look at Private-Sector Retirement Plan Income After ERISA," *ICI Research Perspective* 16, no. 2-A (November 2010); available at www.ici.org/pdf/per16-02_appendix.pdf.

[6] Ibid.

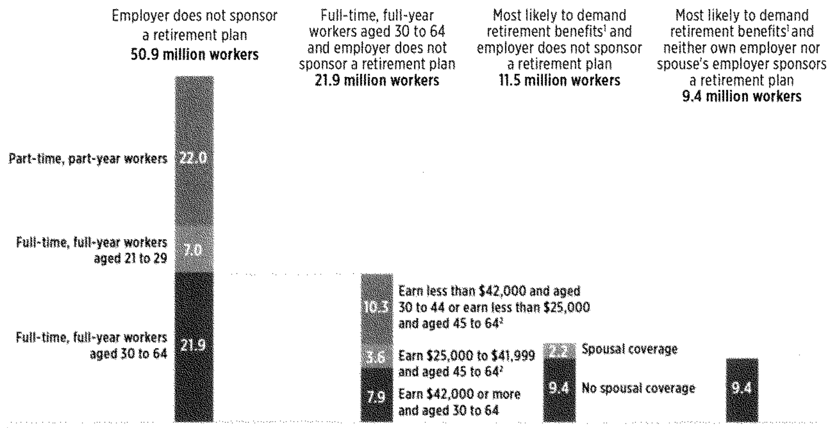
[7] *See* Figure 6 in Holden, Bass, and Reid, *Commitment to Retirement Security: Investor Attitudes and Actions*, Investment Company Institute (January 2011); available at www.ici.org/pdf/ppr_11_com_ret.pdf and discussed later in this statement.

[8] *See* Brady and Bogdan, "Who Gets Retirement Plans and Why: An Update," *ICI Research Perspective* 17, no. 3 (March 2011); available at www.ici.org/pdf/per17-03.pdf.

[9] Ibid (Figure A7). Pension coverage includes DB and/or DC plans.

[10] *See* Table 1 in U.S. Department of Labor, Bureau of Labor Statistics, "Employee Benefits in the United States – March 2011," News Release USDL-11-1112 (July 26, 2011); available at www.bls.gov/ncs/ebs/sp/ebnr0017.pdf. Pension coverage includes DB and/or DC plans.

A Closer Look at Workers Who Are Not Covered by an Employer Plan
Millions of private-sector wage and salary workers age 21 to 64, 2009



[1] Full-time, full-year workers who earn $42,000 or more and are aged 30 to 64 or earn $25,000 to $41,999 and are aged 45 to 64.
[2] Among full-time, full-year workers aged 35 to 44, $25,000 represents the top earnings of the 20th percentile of annual earnings and $42,000 represents the top earnings for the 50th percentile of annual earnings.
Note: Components may not add to the total because of rounding.
Source: Investment Company Institute tabulations of March 2010 Current Population Survey; see Brady and Bogdan, "Who Gets Retirement Plans and Why: An Update," *ICI Research Perspective* (March 2011)

However, even if one uses the CPS data for analysis, looking below the aggregate statistics paints a significantly different picture. Of the 78.4 million workers who report that their employer does not sponsor a pension plan, 18.5 million are either federal workers, state and local workers, self-employed, or work without pay.[11] This leaves 59.9 million workers who are private-sector wage and salary employees. Yet this still overstates the number on which to focus. Of these, 6.2 million are under age 21 and 2.7 million are age 65 or older. This leaves 50.9 million private-sector wage and salary employees age 21 to 64 who report that their employer does not sponsor a pension plan.[12] Of these, 22.0 million are part-time, part-year workers[13] and 7.0 million are full-time, full-year workers age 21 to

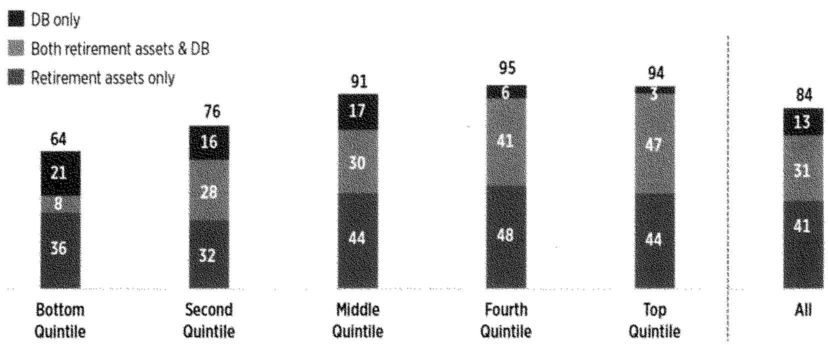
[11] Federal, state, and local government employees are excluded from the analysis because the focus of public policy typically has been to increase access to pensions among private-sector workers. Self-employed workers are excluded because, being their own employer, they can access an employer-provided plan by exercising their option to establish a plan. *See* Figure A7 in Brady and Bogdan, "Who Gets Retirement Plans and Why: An Update," *ICI Research Perspective* 17, no. 3 (March 2011); available at www.ici.org/pdf/per17-03.pdf. Pension plans include DB and/or DC plans.

[12] Ibid (Figure 19).

[13] Most part-time, part-year workers have low income and high replacement rates from Social Security. They are unlikely to save for retirement in the current year if they work full-time or year-round in other years. Ibid (Figure 19).

29.[14] This leaves 21.9 million full-time, full-year private-sector wage and salary workers age 30 to 64 who report that their employer does not sponsor a pension plan. Of these, 6.6 million earn less than $25,000 a year[15] and 3.8 million earn $25,000 to $42,000 a year and are age 30 to 44.[16] The result is 11.5 million private-sector wage and salary employees who are likely to desire to save in the current year and who do not have access to an employer plan. But 2.2 million of these have a spouse whose employer sponsors a plan. The final result is 9.4 million private-sector wage and salary employees who are likely to desire to save in the current year and who do not have access to an employer plan through their own employer or a spouse.

Percentage of Pre-Retiree Households with Retirement Assets and/or DB Pension, 2007
Households with working head age 55 to 64, by income quintile, excludes top and bottom one percent of the income distribution



Source: ICI tabulations of Federal Reserve Board Survey of Consumer Finances

Many more workers have access to an employer plan at some point during their working careers than is implied by looking at a snapshot of coverage at any point in time. This can be seen by examining data on households approaching retirement age. The figure above shows tabulations from the Federal

[14] Few in this age group save primarily for retirement. Workers age 21 to 29 save primarily for education, the purchase of a home, or for precautionary reasons. Ibid (see ICI tabulations from the 2007 Survey of Consumer Finances in Figures 1 and A1).

[15] The primary concern for workers earning less than $25,000 per year is they do not have enough to spend on food, clothing and shelter. In fact, many are eligible for government income assistance so that they will be able to spend more than what they earn on these items. Social Security replaces a high percentage of their lifetime earnings. In retirement, they may be considered well-off relative to their standard of living when they were working. Ibid (Figure A5).

[16] Workers age 30 to 45 who earn between $25,000 and $42,000 a year may have the ability to save, but have other saving priorities, such as starting a household and having children. Given that they get a substantial replacement rate from Social Security, they are likely to delay saving for retirement until later in life–perhaps after age 44. Ibid (Figure A5).

Reserve Board's 2007 Survey of Consumer Finances (SCF) for households approaching retirement (i.e., households with a working head age 55 to 64), including both private- and public-sector employees.[17] Eighty-four percent of these pre-retiree households had DB benefits and/or retirement account assets, and such retirement resources are spread across the income distribution. More than 90 percent of pre-retiree households in the top three income quintiles (with total household income over $55,500) had such retirement resources; three-quarters of pre-retiree households in the second income quintile (with income of $32,900 to $55,500) had such retirement resources; and almost two-thirds of pre-retiree households in the lowest income quintile (with household income of $7,200 to $32,900) had such retirement resources. Although lower-income households are less likely to have both DB plan promises and retirement account assets, this group also has less of a need to supplement Social Security with workplace or private savings to maintain their pre-retirement standard of living.

Pension Income Increasing

Retirement policy discussions often start from the premise that retirees' pension income has fallen over time. Looking at the entire period from 1975 to 2009, the data show that, contrary to conventional wisdom, private-sector pension income has become more, not less, prevalent over time. Across all income groups, retirement income from employer-sponsored retirement plans is more prevalent among retirees today than in the mid-1970s, when sweeping new retirement plan regulations were enacted under ERISA.[18] In 2009, 34.0 percent of retirees received income—either directly or through a spouse—from private-sector retirement plans, compared with 21.3 percent in 1975 (see figure below).[19] The median income received by those with private-sector pension income increased to $6,000 per person in 2009 from $4,515 in 1975 (in 2009 dollars). Further, because the survey data used to analyze retiree income do not fully capture payments from DC plans and IRAs, the increase in pension income since ERISA is likely understated.[20]

[17] Figures are ICI tabulations of the 2007 Survey of Consumer Finances. Retirement assets include DC plan accounts (e.g., 401(k), 403(b), 457, thrift plans) and IRAs.

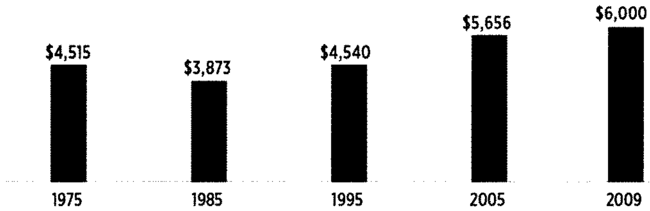
[18] *See* Brady and Bogdan, "A Look at Private-Sector Retirement Plan Income After ERISA," *ICI Research Perspective* 16, no. 2 (November 2010); available at www.ici.org/pdf/per16-02.pdf.

[19] *See* Figure A7 in Brady and Bogdan, "Appendix: A Look at Private-Sector Retirement Plan Income After ERISA," *ICI Research Perspective* 16, no. 2-A (November 2010); available at www.ici.org/pdf/per16-02_appendix.pdf.

[20] The CPS understates DC plan distributions and IRA withdrawals. Ibid and *see* discussion and Figure 20 in Sabelhaus and Schrass, "The Evolving Role of IRAs in U.S. Retirement Planning," *Investment Company Institute Fundamentals* 15, no. 3 (November 2009); available at www.ici.org/pdf/per15-03.pdf.

Retirees Receive More Income from Private-Sector Pensions (DB and DC)

On a per capita basis, median, 2009 dollars, selected years



	1975	1985	1995	2005	2009
Share of retirees with private-sector pension income	21.3%	28.1%	34.2%	34.3%	34.0%

Source: ICI tabulations of the March Current Population Survey; see Brady and Bogdan, "A Look at Private-Sector Retirement Plan Income After ERISA," *ICI Perspective* (November 2010)

This rise in private-sector pension income likely reflects changes in the pensions offered. Since ERISA, an increasing share of private-sector workers has worked for employers that sponsor DC plans, offsetting a decreasing share that has worked for employers that sponsor DB plans.[21] This rise in DC plan coverage has resulted in a rising number of households with retirement assets. In addition, stricter vesting requirements and other rule changes have led to more DB plan participants receiving benefits.[22]

DB plan coverage does not always translate into receipt of pension income. Many retirees may have worked for companies that offered DB plans, but, because private-sector workers change jobs often, the combination of long vesting periods and back-loaded benefit accrual resulted in many retirees receiving little or no retirement income from the plans. The belief in a golden age of pensions—a time in our history when most private-sector workers retired with a monthly pension check that replaced a

[21] By 1998, 56 percent of active participants in private-sector retirement plans were covered by a primary DC plan, and 36 percent had a supplemental DC plan. In contrast, in 1975, 87 percent of active participants in private-sector retirement plans had primary coverage through DB plans, dropping steadily over time to below 50 percent by the mid-1990s. Data reported are from reports published by the U.S. Department of Labor. Primary plan status and secondary plan status are not reported on Form 5500. For firms with multiple pension plans, the status was inferred by DOL analysts. Data are available through 1998; after 1998, DOL no longer inferred primary and secondary status for plans. For the 1975 data, *see* U.S. Department of Labor, Pension and Welfare Benefits Administration (now Employee Benefits Security Administration), *Private Pension Plan Bulletin, Abstract of 1992 Form 5500 Annual Reports*, no. 5 (Winter 1996). *See* also U.S. Department of Labor, Pension and Welfare Benefits Administration (now Employee Benefits Security Administration), *Private Pension Plan Bulletin, Abstract of 1998 Form 5500 Annual Reports*, no. 11 (Winter 2001–2001); available at www.dol.gov/ebsa/pdf/1998pensionplanbulletin.pdf. These data are summarized in Figure 2 in Brady and Bogdan, "A Look at Private-Sector Retirement Plan Income After ERISA," *ICI Research Perspective* 16, no. 2 (November 2010); available at www.ici.org/pdf/per16-02.pdf.

[22] *See* discussion on page 28 of Brady and Bogdan, "A Look at Private-Sector Retirement Plan Income After ERISA," *ICI Research Perspective* 16, no. 2 (November 2010); available at www.ici.org/pdf/per16-02.pdf.

significant amount of their salary—is not supported by the facts. Furthermore, the typical amount of private-sector pension income observed in the historical data can be generated by relatively modest accumulations in DC plans or IRAs. Indeed, Congressional Research Service analysis of pre-retiree households' balance sheets finds that the median accumulation in DC plans and IRAs is $100,000, which is estimated to generate $8,400 per household per year in retirement income.[23]

Success of Defined Contribution Plans

With most households having accrued DB promises, retirement assets, or both by retirement age, and with the overall pension income of retirees rising, the data suggest the shift to DC plans has been beneficial to American workers.[24] Nevertheless, DC plans continue to attract criticism and unfavorable comparisons to DB plans. As noted earlier, the reality is that workers never were universally covered by the DB system, and even those who were covered did not accrue significant benefits unless they stayed at one employer for an entire career. In contrast, because of their portability, DC plans are well-suited to a mobile workforce.[25] DC plans also serve households across all ages and incomes. There are a number of other indicators of the success of the DC plan system.

- 401(k) plan design provides discipline to save for retirement paycheck-by-paycheck and a range of investment options. On average, research conducted in a collaborative effort with EBRI finds that 401(k) plan participants have age-appropriate asset allocations.[26] ICI research finds that

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[23] CRS analysis of Survey of Consumer Finances data: "For example, if the median retirement account balance of $100,000 among households headed by persons 55 to 64 years old in 2007 were converted to an annuity, it would provide a monthly income of $700 per month ($8,400 annually) to a man retiring at age 65 in 2009." See Purcell, "Retirement Savings and Household Wealth in 2007," *CRS Report for Congress*, RL30922 (April 8, 2009).

[24] It is too soon to evaluate fully the impact of 401(k) plans because today's retirees have not had full careers with such plans. However, academic research finds that full careers with DC plans generate significant nest eggs: "Our projections suggest that the advent of personal account saving will increase wealth at retirement for future retirees across the lifetime earnings spectrum." *See* Poterba, Venti, and Wise, "The Changing Landscape of Pensions in the United States," *NBER Working Paper*, No. 13381 (September 2007); available at www.nber.org/papers/w13381. Furthermore, research between ICI and the Employee Benefit Research Institute (EBRI), the EBRI/ICI 401(k) Accumulation Projection Model, projects that 401(k) balances will be able to provide significant income in retirement after a full career with 401(k) plans. *See* Holden and VanDerhei, "The Influence of Automatic Enrollment, Catch-Up, and IRA Contributions on 401(k) Accumulations at Retirement," *ICI Research Perspective* 11, no. 2, and *EBRI Issue Brief* (July 2005); available at www.ici.org/pdf/per11-02.pdf.

[25] As an indicator of workforce mobility, consider average job tenure among American wage and salary workers. In January 2010, the median tenure that wage and salary workers age 25 or older had at their current employers was 5.2 years and ranged from 3.1 years among those age 25 to 34, to 7.8 years among those age 45 to 54, to about 10 years among those age 55 or older. See U.S. Department of Labor, Bureau of Labor Statistics, "Employee Tenure in 2010," News Release USDL-10-1278 (September 14, 2010); available at www.bls.gov/news.release/pdf/tenure.pdf.

[26] *See* Figures 21 and 30 in Holden, VanDerhei, and Alonso, ""401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2009," *ICI Research Perspective* 16, no. 3, and *EBRI Issue Brief* (November 2010); available at www.ici.org/pdf/per16-03.pdf.

401(k) investors have concentrated their mutual fund investments in lower-cost funds.[27] In recent years, the availability and use of target date funds have expanded.[28]

- Even though 401(k) plans have been around for about 30 years—not even a full working career—Americans have accumulated more than $3 trillion in these plans.[29] This figure does not include hundreds of billions of dollars saved in 401(k) plans and rolled over into IRAs.[30] Median 401(k) account balance statistics are often cited as evidence of inadequacy, but these statistics are misleading because they tend to ignore other accounts that an individual might have, including other 401(k) plan accounts and IRAs. It is important to judge the retirement system as a whole. Not all workers have the same need to save in DC plans, as some will receive higher replacement rates from Social Security and some will have DB plan benefits.

- DC plans have the potential to replace significant income in retirement. In 2002, EBRI and ICI projected what 401(k) plans could accumulate across a full career.[31] The EBRI/ICI 401(k) Accumulation Projection Model moves 401(k) participants through their careers, with decisions as they age that reflect actual participant behavior on contributions, asset allocations, job changes, rollovers, withdrawals, and loans. The study focuses on 401(k) participants who will turn 65 between 2030 and 2039 (now aged 37 to 46). For more than 60 percent of this cohort, their 401(k) accumulations are projected to replace more than half their salaries. Accounting for Social Security, the majority of the lowest income quartile of this cohort is projected to fully replace their salaries.

- DC plan participants and traditional IRA-owning households are responsible stewards of their retirement nest eggs. A common criticism of DC plans is that retirees relying on this type of plan could run out of money before death.[32] Anecdotally, many believe most distributions from

[27] *See* Holden, Hadley, and Lutz, "The Economics of Providing 401(k) Plans: Services, Fees, and Expenses, 2010," *ICI Research Perspective* 17, no. 4 (June 2011); available at www.ici.org/pdf/per17-04.pdf.

[28] *See* Holden, VanDerhei, and Alonso, ""401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2009," *ICI Research Perspective* 16, no. 3, and *EBRI Issue Brief* (November 2010); available at www.ici.org/pdf/per16-03.pdf. A target date fund pursues a long-term investment strategy, using a mix of asset classes, or asset allocation, that the fund provider adjusts to become less focused on growth and more focused on income over time as the fund approaches and passes the target date, usually mentioned in the fund's name.

[29] At the end of the first quarter of 2011, 401(k) plans had $3.2 trillion in assets. *See* Table 4 in Investment Company Institute, "The U.S. Retirement Market: First Quarter 2011" (June 2011); available at www.ici.org/info/ret_11_q1_data.xls.

[30] *See* Figure 8 in Brady, Short, Lutz, and Holden, *The U.S. Retirement Market: Third Quarter 2010*, Washington, DC: Investment Company Institute; available at www.ici.org/pdf/ppr_11_retire_q3_10.pdf.

[31] *See* Holden and VanDerhei, "Can 401(k) Accumulations Generate Significant Income for Future Retirees?" *ICI Perspective* 8, no. 3, and *EBRI Issue Brief* (November 2002); available at www.ici.org/pdf/per08-03.pdf. See also note 24.

[32] The danger of running out of money is not unique to DC plans. For example, just because a benefit plan payment may be regular or guaranteed for the life of the participant does not mean that the payment is sufficient to support the participant's retirement income needs.

DC plans are lump sums that are spent, which contributes to this popular belief that people will run out of money. Research shows that a majority of individuals do not spend their lump-sum payments upon distribution, but rather roll over these funds to IRAs or other tax-deferred plans.[33] At the juncture of retirement with a DC plan balance, households indicate that they consult multiple sources of advice and information when making the distribution decision.[34] Traditional IRA-owning households typically postpone withdrawals, take withdrawals based on life expectancy, and use withdrawals to pay for living expenses.[35]

Congress Should Continue to Foster DC Plans

Americans highly value their DC plans and the features typically associated with them. A 2010 household survey demonstrated American households' strong support for key features of DC plans, including their tax benefit, and their appreciation for the investment opportunity these plans provide.[36]

- **Overwhelming support for preserving the tax incentives for retirement saving:** Eighty-eight percent of all U.S. households disagreed when asked whether the tax advantages of DC accounts should be eliminated. Eighty-two percent opposed any reduction in account contribution limits.[37]

- **Many oppose altering key features of DC plans:** Nearly 90 percent of all U.S. households disagreed with the idea that individuals should not be permitted to make investment decisions in their DC accounts. More than eight in 10 disagreed with the idea of replacing all retirement accounts with a government bond.[38]

- **Investors like choice and control of investments:** Ninety-six percent of all DC account–owning households agreed that it was important to have choice in, and control of, the investment options in their DC plans. Eighty-three percent said their plan offers a good lineup of investment options.[39]

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[33] In addition, individuals also may leave the balance in the DC plan until a later date. For example, see the experience of The Vanguard Group in the DC plans that they recordkeep (Figures 90–95 in *How America Saves, 2011*; available at https://institutional.vanguard.com/iam/pdf/HAS11.pdf).

[34] *See* Sabelhaus, Bogdan, and Holden, "Defined Contribution Plan Distribution Choices at Retirement: A Survey of Employees Retiring between 2002 and 2007," *Investment Company Institute Research Series* (Fall 2008); available at www.ici.org/pdf/rpt_08_dcdd.pdf.

[35] *See* Holden and Schrass, "The Role of IRAs in U.S. Households' Saving for Retirement," *Investment Company Institute Fundamentals* 19, no. 8 (December 2010); available at www.ici.org/pdf/fm-v19n8.pdf.

[36] *See* Holden, Bass, and Reid, *Commitment to Retirement Security: Investor Attitudes and Actions*, Investment Company Institute (January 2011); available at www.ici.org/pdf/ppr_11_com_ret.pdf.

[37] Ibid (Figure 6).

[38] Ibid (Figure 6).

[39] Ibid (Figure 5).

- **Most households continue to have positive attitudes toward the 401(k) system:** Sixty-four percent of all U.S. households in 2010 had favorable impressions of 401(k) and similar plan accounts, similar to 2009.[40] Three-quarters of households expressed confidence DC plan accounts could help participants reach their retirement goals.[41]

ICI's household surveys during the past three years find that even in the depths of a bear market and despite a broad economic downturn, Americans continue to be committed to saving for retirement and value the characteristics, such as the tax benefits and individual choice and control, that come with DC plans.

* * *

One Labor Day more than three-and-a-half decades ago, with the enactment of ERISA, Congress made the call to place private retirement saving—whether through employer-sponsored plans or IRAs—on firm footing. More recently, Congress strengthened the private-sector retirement system by raising contribution limits in 2001 (EGTRRA) and making those provisions permanent in 2006 (PPA). It would be a mistake to reverse course now and begin to radically alter a successful system that tens of millions of U.S. households rely on to help them achieve retirement security.

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[40] Ibid (Figure 3).

[41] Ibid (Figure 7).

NSBA
National Small Business Association®

TESTIMONY OF TODD MCCRACKEN

PRESIDENT OF

THE NATIONAL SMALL BUSINESS ASSOCIATION[1]

Tax Reform: Promoting Retirement Security

Before the Senate Committee on Finance

September 15, 2011

[1] 1156 15th St., NW, Washington, DC 20005. (202) 293-8830.

My name is Todd McCracken and I am the president of the National Small Business Association (NSBA), America's oldest small-business advocacy organization. On behalf of the 150,000 small businesses the NSBA represents, I am pleased to provide our perspective on promoting retirement security through tax reform.

The NSBA strongly believes that the present tax system is irretrievably broken and constitutes a major impediment to the economic health and international competitiveness of American businesses of all sizes. To promote economic growth, job creation, capital formation, and international competitiveness, fundamental tax reform is required.

We would like to offer a brief statement on how the tax code is impeding retirement security. The two primary reasons are (1) that the current administrative burden imposed on small businesses considering implementing a retirement savings plan is too high and (2) the tax system is biased against savings.

Retirement Plans Under Current Law

When a small business owner is considering his or her retirement needs and those of his employees he must consider simplified employee pensions (SEPs), salary reduction simplified employee pensions, SIMPLE IRA plans, SIMPLE 401(k) plans, regular 401(k)s, profit-sharing plans, money purchase pension plan, Keogh plans, defined benefit plans, defined contribution plans, and employee stock ownership plans. Most of those plans are qualified plans subject to the minimum coverage requirements, minimum vesting standards, the actual deferral percentage test, the non-discrimination requirements, and the top heavy plan requirements.

If your eyes have glazed over, you would not be alone. The problem is that if a small business owner fails to figure all of this out and gets it wrong, then the entire plan may become subject to immediate taxation and penalty. Is it any wonder that many small businesses owners decide not to get involved in this morass? I think not.

This is not the forum for getting into a detailed critique of the current rules governing retirement savings. The bottom line is that it should not be this difficult for a small business owner to provide for his or her retirement and that of the business' employees. This can be accomplished under current law by radically changing and simplifying the defined contribution plan rules. Or it can be solved in the context of fundamental tax reform by eliminating the double taxation of savings.[2]

Congress should prioritize dramatic simplification of the law in the area of retirement savings. Congress may want to consider merging simplified employee pensions (SEPs), salary reduction simplified employee pensions, SIMPLE IRA plans, SIMPLE 401(k) plans and Keogh plans into a unified small business defined contribution pension plan. Some ideas for how this might be done include a reasonably large deduction (for example, up to 25 percent of salary) and

[2] The FairTax, the Flat Tax, a business transfer tax or a consumed income tax (sometimes called an expenditure tax, inflow-outflow tax or cash-flow tax) would all accomplish this result.

uniform simple, comprehensible non-discrimination rules. Moreover, employers should be permitted to elect to automatically enroll their employees (as under current law).

The Inadequacy of Savings in the United States

The Congress needs to act to improve the retirement savings climate in the U.S. U.S. retirement savings are inadequate. The median IRA balance is $20,444.[3] The median 401(k) plan balance is $17,794.[4] Median household financial assets owned declined from $31,300 to $29,600 from 2007 to 2009 and has probably not improved materially.[5] The median equity in primary residences has declined nearly 33 percent to $64,000.[6] These levels of savings are only enough to generate a few hundred dollars a month of annuity income. In other words, most Americans have entirely inadequate retirement savings.

The FairTax

There are a many ways to improve the tax system. To improve on the current system doesn't take a lot. But NSBA regards the FairTax (S. 13, H.R. 25) as the best fundamental tax reform proposal. It would have a dramatic positive impact on economic growth, job creation, real wages, investment and international competitiveness. It would treat all savings as if they were invested in a Roth IRA. A summary of why the FairTax deserves support:

1. The FairTax would be simple and dramatically reduce compliance costs that have a disproportionate negative impact on small firms. The resources currently used to comply with the present tax system can be better used growing businesses, creating new products, conducting research and development, purchasing productivity enhancing equipment or reducing prices to customers. Retirement plans could be based on business' and employees' needs not the complex morass in the tax law. Because the cost of maintain retirement or other savings plans would decline dramatically, it is probable that more employers would offer savings plans.

2. Consumption rather than income would be taxed. Savings would all be treated Roth IRA treatment and savings rates should increase substantially.

3. The FairTax would be neutral toward savings and investment and reduce the user cost of capital substantially. The capital stock would therefore grow. Productivity, innovation and real wages would increase.

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[3] Craig Copeland, "IRA Balances and Contributions: An Overview of the EBRI IRA Database," Employee Benefit Research Institute Issue Brief, September 2010, No. 346, p. 9.
[4] Jack VanDerhei , Sarah Holden and Luis Alonso, "401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2009," Employee Benefit Research Institute Issue Brief, November 2010, No. 350, p. 10.
[5] Jesse Bricker, Brian Bucks, Arthur Kennickell, Traci Mach and Kevin Moore, "Surveying the Aftermath of the Storm: Changes in Family Finances from 2007 to 2009," Board of Governors of the Federal Reserve System, March 2011, p.27.
[6] Ibid., p. 27. Figures derived from primary residence assets and liabilities data.

4. The FairTax has much lower marginal tax rates than the current tax system and has virtually the lowest possible marginal tax rate consistent with a neutral tax treatment of savings and investment.[7] It would dramatically reduce the tax disincentive to work, save and invest. The double taxation of corporate income (i.e. dividends and individual capital gains that are a function of retained corporate earnings) would be eliminated.

5. Entrepreneurial risk-taking and innovation would increase because more investment capital would be available and the tax on capital gains would be zero.

6. The U.S. would attract capital from throughout the planet. Investment in the U.S. whether by Americans or foreigners would not be taxed. The U.S. would, in effect, become the largest tax haven in the world. The "giant sucking sound" you would hear, to paraphrase Ross Perot's memorable metaphor, would be the U.S. attracting capital from throughout the world. Having adequate capital is important for all businesses but particularly important for small and start-up businesses.

7. For the first time, the tax system would impose the same tax burden on foreign produced goods and U.S. produced goods. The FairTax would eliminate the current origin principle system that places U.S. based firms at such a large disadvantage. This is because the FairTax is a destination principle tax (i.e. it is, in effect, border adjusted).

[7] The only reason it does not have the lowest possible rate theoretically possible is the rebate that prevents the poor from paying any federal income or payroll tax and reduces middle class effective tax rates substantially.

Statement
of
Kathy Hamor
The Savings Coalition of America

SUBMITTED TO THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
September 15, 2011

The Savings Coalition was established in 1991 to support incentives to increase personal savings in the United States. The Coalition's main objective is to enhance savings opportunities for all Americans. There are approximately 45 member organizations of the Savings Coalition representing a wide variety of private interests including banking, securities, financial services, consumer groups, engineering, home-building, realtors, tangible assets, trust companies, health care industry, insurance, education and business groups.

The Coalition commends the Committee for its efforts to make it easier for Americans to save for their retirements. Tens of millions of Americans are saving for retirement because of the enhancements and simplifications made to retirement savings vehicles.

BACKGROUND

The US retirement system is a comprehensive structure where private savings accounts play a fundamental role for ensuring Americans an adequate retirement. Traditionally, retirement security for Americans has been based on the so-called "three-legged stool" -- Social Security, employer-sponsored retirement plans and personal savings. The tax incentives, which encourage individuals to save for retirement, are a crucial part of the system.

MAJORITY OF AMERICANS HAVE RETIREMENT SAVINGS:

In March 2011, retirement assets have grown to $18.1 trillion[1]. According to the *2011 Investment Company Institute Fact Book, "seventy percent of U.S. households (or 82 million households) reported that they had employer-sponsored retirement plans, IRAs, or both in May 2010."*[2] Such resources represent an important source of investment capital for the economy, helping companies grow and creating jobs.

[1] Investment Company Institute, "The U.S. Retirement Market, First Quarter 2011" (June 2011). http://www.ici.org/info/ret_11_q1_data.xls.

[2] Investment Company Institute (2011) *2011 Investment Company Fact Book: A Review of Trends and Activity in the Investment Company Industry.* http://www.ici.org/pdf/2011_factbook.pdf

Despite the growth in retirement assets and in households with retirement accounts, many Americans are not prepared for retirement. As a result, retirement policies should emphasize enhancing savings incentives. Moreover, any policies examined in the context of tax reform or deficit reduction should be carefully considered to ensure they don't have the unintended negative consequence of reducing retirement preparedness.

TAXES ARE DEFERRED

The Joint Committee on Taxation (JCT) estimates that tax benefits for retirement savings represent one of the largest tax expenditures in the Internal Revenue Code. As a result, some have argued that these tax incentives should be reduced or eliminated in the context of deficit reduction or comprehensive tax reform. However, it is important to recognize that tax incentives for retirement merely represent a deferral of tax. American savers receive tax benefits when accumulating retirement savings, but they pay tax – at ordinary income tax rates – when amounts are withdrawn during retirement. As a result, much of the foregone revenue is repaid when distributions are taken from retirement accounts. A recent study by the American Society of Pension Professionals & Actuaries (ASPPA) found that revenue estimates from the JCT and the Treasury Department's Office of Tax Analysis (OTA) overstated the true cost of retirement tax incentives by as much as 77 percent because the estimates do not taken into account revenue that flows back to the Treasury when distributions are taxed during retirement years. According to the ASPPA study, "The one-year present value tax expenditure estimates are 34 percent lower than the JCT estimates and 54 percent lower than the Treasury one-year estimates. Similarly, the one-year present-value tax expenditure estimates are lower than the Treasury one-year present-value estimates by approximately 77 percent."[3]

Moreover, a reduction in retirement tax incentives could reduce plan formation and negatively impact retirement savings for Americans at all income levels, which could lead to increased reliance on Federal safety net programs.

DECREASING TAX BENEFITS WILL HARM LOWER-INCOME AMERICANS

In December 2010, the National Commission on Fiscal Responsibility and Reform released its report on federal deficit reduction. The report provided several illustrative examples of options for reducing the deficit through tax reform. One of the options included in the report would consolidate retirement accounts and cap annual tax-preferred contributions to the lower of $20,000 or 20% of income – an option that has come to be called the "20/20 plan."[4]

A recent study by the Employee Benefit Research Institute (EBRI) found that capping the tax benefit for retirement savings, as proposed under the 20/20 plan would reduce retirement security for workers at all income levels. According to the study, those in the

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[3] Xanthopoloulos and Schmitt, *Retirement Savings and Tax Expenditure Estimates,* American Society of Pension Professionals & Actuaries, May 2011

[4] The National Commission on Fiscal Responsibility and Reform, "*The Moment of Truth,*" December 2010, page 31

lowest-income quartile will experience the second highest average percentage reduction in retirement savings.

Lower-income workers would be negatively impacted by proposals to reduce the retirement tax incentive if small businesses are discouraged from offering retirement plans. In her written testimony submitted to this Committee, Judy Miller, testifying on behalf of ASPPA , stated that, *"Reducing the maximum contribution from the current $49,000 to $20,000 would mean the qualified retirement plan no longer makes financial sense for many small business owners. The result would be less access to retirement savings opportunities at work for rank and file employees. In a survey of "cross-tested" plans conducted by the American Society of Pension Professionals and Actuaries (ASPPA), 65% of plan sponsors indicated they were likely to terminate the cross-tested plan if the plan design were no longer available. A dramatic reduction in the limit would effectively make not only a cross-tested plan, but most other qualified defined contribution plans, unattractive to small business owners."*[5]

INVESTORS WANT AND VALUE RETIREMENT SAVINGS TAX INCENTIVES

A wide range of research demonstrates that Americans value and want to retain retirement savings tax incentives and that changes in the tax incentives could negatively impact savings behaviors.

- 83 percent of Fidelity retail customers indicated that retirement savings is an important tax benefit that they want Congress to protect[6]
- 82 percent of DC plan account owners indicated tax benefits incentivize plan participation, and 88 percent of all households do not want government to take away DC tax benefits.[7]
- Lower-income workers are more likely to reduce contributions to their retirement savings accounts if the tax deferral benefit is lowered or eliminated.[8]

CONCLUSION

Workplace pension plans, which combine tax incentives for retirement savings with employer matches and other features, such as auto enrollment and auto escalation, are extremely effective tools for increasing saving and enhancing retirement security. The system can be further strengthened through financial literacy and education about the existing programs and incentives, small business retirement plan enhancements and IRA reforms.

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[5] Miller, Testimony before the Senate Committee on Finance, September 15, 2011, page 14
[6] March 2011 Fidelity Survey
[7] December 2010 Investment Company Institute Survey
[8] March 2011 Employee Benefit Research Institute

Statement for the Record for Senate Finance Committee September 15, 2011 Hearing on "Tax Reform Options: Promoting Retirement Security"

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September 26, 2011

The tax treatment of S-ESOP firms reduces the bias against saving in the U.S. tax system and provides a structure under which worker-participants at S-ESOPs build savings for a more secure retirement. In addition to helping families prepare for retirement, the S-ESOP organizational form contributes to increased national saving and, as a result, to stronger investment, economic growth, and job creation. S-ESOPs thus work to meet two key U.S. economic challenges: inadequate retirement security for our workers and families, and insufficient national saving for the economy as a whole. Moreover, employee-ownership at S-ESOPs gives workers a direct stake in the success of the company and better incentives for firm growth. A 2010 study I co-authored for the Employee-owned S-Corporations of America (ESCA) found that S-ESOP firms were more resilient in the face of the recent recession, with better employment performance than non-ESOP firms.[1] Expanded opportunities for S-ESOPs would provide the benefits of this structure to more working Americans.

Firms organized as S-ESOPs enhance the retirement security of their workers, as contributions by the employer together with growth in the value of the stock over time can provide a powerful boost to employees' retirement savings. An S-ESOP is a business that provides flow-through tax treatment to its shareholders, and in which the shares are owned by the employees' qualified defined contribution retirement plan. Taxes on the appreciated value of the stock in the retirement plan are deferred until the employee eventually sells his or her shares while in retirement. This tax treatment is similar to that of a traditional defined benefit or defined contribution retirement plan.

S-ESOPs make substantial contributions to workers' retirement security. They do this by giving employees ownership of the company and building their retirement security with set-aside funds in ESOP accounts. This stands in stark contrast with the fact that, according to the Employee Benefit Research Institute, only half of Americans in 2008 worked for an employer that provided employees with any kind of retirement savings plan, and not much more than 40 percent of workers participated in such plans. A 2008 University of Pennsylvania study found that S-ESOPs contribute substantially in new savings to their workers beyond the income of what these workers would have otherwise earned.[2]

When nearly 60 percent of working Americans have no work-related retirement plan, S-ESOP firms play a vital role in contributing to their employee-owners' retirement security—an ownership stake in their employer is a form of diversification compared to workers who otherwise rely on government retirement plans such as Social Security. Further diversification is achieved for workers as they near retirement, as ESOP retirement plans are mandated to provide asset diversification for workers aged 55

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[1] Philip Swagel and Robert Carroll, March 2010. "Resilience and Retirement Security: Performance of S-ESOP Firms in the Recession."

[2] Steven F. Freeman and Michael Knoll, July 2008. "S Corp ESOP Legislation Benefits and Costs: Public Policy and Tax Analysis," University of Pennsylvania, Center for Organizational Dynamics, Working Paper #08-07.

and older. In addition, studies have found that 80 percent of S-ESOP firms offer workers retirement savings plans beyond the ESOP—and many of these firms make employer contributions to workers' retirement savings in these plans.

Employees of S-ESOP firms have employer-provided retirement contributions that are superior to those received by employees of firms in the overall economy. This is particularly the case for ESOP participants, demonstrating and reflecting the benefits of ownership. Moreover, S-ESOP employee-owners have substantially more resources accumulated for their retirement than typical workers at other firms. Among the findings of my recent study are:

- Employer contributions to retirement benefits rose by 18.6 percent for all employees in the S-ESOP firms surveyed. This compares to 2.8 percent growth of contributions by all employers to employee retirement plans.

- The employee-owners of S-ESOP firms accumulate substantial amounts for retirement. The value of S-ESOP assets per active participant was $100,000 in 2008, compared to only $45,500 for the average 401(k) account for the overall economy.

The pass-through nature of the S-ESOP structure enables the company to avoid the double-tax on saving inherent in the corporate tax system, while using those funds to the direct benefit of employees. In the S-ESOP structure, business income is taxed at retirement, close to when these savings are consumed, and at ordinary income rates that are higher than the capital gains rates applied to distributions from other qualified retirement savings accounts. The S-ESOP organizational form results in a lower cost of capital for S-ESOP firms and thus greater investment, growth, and job creation. This helps to address the key U.S. economic challenge of inadequate national saving that manifests as the trade deficit and as the U.S. fiscal imbalance.

Tax policies for retirement saving can be viewed through both the "micro" lens of how to improve retirement security for individual families and through the "macro" lens of how to boost overall national saving and thereby improve U.S. growth and job creation. On the individual level, the looming fiscal challenges facing the United States likely imply that families must anticipate having greater responsibility for preparing for retirement, because the U.S. government will be less able to participate directly in providing for retirees. The S-ESOP works to boost retirement preparedness while contributing to increase saving and U.S. economic vitality. This is good for workers, business and American taxpayers as a whole.

About the Author:

Phillip L. Swagel was Assistant Secretary for Economic Policy at the Treasury Department from December 2006 to January 2009. He was previously chief of staff and a senior economist at the White House Council of Economic Advisers from 2000-2005. Mr. Swagel is currently a professor at the University of Maryland's School of Public Policy, where he teaches classes on international economics and is a faculty fellow at the Center for Financial Policy at the Robert H. Smith School of Business. He is also a non-resident scholar at the American Enterprise Institute and an advisor to the Employee-owned S Corporations of America.