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Before the Subcommittee on Social Security and Family Policy of the Committee on Finance United States Senate

Using the Private Pension System and IRAs to Promote Asset Accumulation for Lower-Income Families

April 28, 2005

Chairman Santorum, Ranking Member Conrad, and Members of the Subcommittee, I appreciate the opportunity to appear before you to discuss the issues involved in building assets for low-income families.[2]

I am appearing today on behalf of The Retirement Security Project. The Retirement Security Project is supported by The Pew Charitable Trusts in

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The views expressed in this testimony should not be attributed to the staff, officers, or trustees of the Brookings Institution, to Georgetown University, to The Pew Charitable Trusts, or to any other institution or organization.

[2] This testimony draws on joint work with William Gale, Peter Orszag and Robert Greenstein. In addition, because I have been asked to address some of the same issues in previous congressional testimony before other committees of the Senate and the House of Representatives, this written statement draws heavily on previous written statements that I have submitted as testimony before other committees as well as on articles or policy briefs that I have authored or co-authored on these topics (including substantial passages drawn verbatim from the previous testimony and articles or policy briefs). The previous testimony and writings include Testimony of J. Mark Iwry Before the Special Committee on Aging, United States Senate(April 12, 2005); Testimony of J. Mark Iwry Before the Committee on Education and the Workforce, Subcommittee on Employer-Employee Relations, U.S. House of Representatives (April 29, 2004); Testimony of J. Mark Iwry Before the Committee on Education and the Workforce, Subcommittee on Employer-Employee Relations, U.S. House of Representatives (June 4, 2003); William G. Gale, J. Mark Iwry and Peter R. Orszag, "The Saver's Credit" (Retirement Security Project, February 2005); William G. Gale, J. Mark Iwry and Peter R. Orszag, "The Automatic 401(k): A Simple Way to Strengthen Retirement Savings" (Retirement Security Project, March 2005); William G. Gale, J. Mark Iwry, "Automatic Investment: Improving 401(k) Portfolio Investment Choices" (Retirement Security Project, April 2005).

The three listed policy briefs were written under the auspices of the Retirement Security Project and are available at www.retirementsecurityproject.org.

partnership with Georgetown University's Public Policy Institute and the Brookings Institution.

The goal of The Retirement Security Project is to work on a nonpartisan basis to make it easier and increase incentives for lower- and middle-income Americans to save for a financially secure retirement. The Project is dedicated to promoting common sense solutions to improve the retirement income prospects of millions of American workers.

Our nation's private pension system and IRAs, in their current form, have serious shortcomings as a platform for asset accumulation for lower-income households. However, as described in this testimony, there are a number of practical and highly promising reforms that could rapidly turn this situation around and dramatically increase opportunities for lower- and moderate-income households to build assets, savings, and retirement security.

This written statement, which focuses on asset building in the context of the current retirement savings system, is organized as follows: Section I (pages 3-11, below) briefly assesses the effectiveness of the nation's private pension system in raising national savings and accumulating assets for lower-income families, and identifies several general aspects of the system that need improvement to more effectively achieve these goals. Sections II through VI outline four strategies for reform that would make the private pension system and IRAs more effective in building assets for lower-income families:

- **Expand the Saver's Credit for 401(k) and IRA Contributions by Lower- and Moderate- Income Savers** (Section II, pages 13-21, below)

- **Facilitate and Increase 401(k) Asset Accumulation Through Automatic Enrollment, Automatic Escalation and Automatic Investment** (Sections III and IV, pages 21-35, below)

- **Encourage Contributions to IRAs By Allowing Taxpayers to Elect Direct Deposit of a Portion of Their Tax Refunds** (Section V, pages 35-41, below)

- **Exempt Retirement Savings When Applying Asset Tests in Public Means-Tested Benefit Programs** (Section VI, pages 41-42, below)

Other witnesses will be testifying before the Subcommittee regarding individual development accounts, proposed “KIDS accounts”[3], and the United Kingdom’s children’s trust account initiative, among other proposals. This testimony does not attempt to be comprehensive, and therefore does not address these or various other asset accumulation strategies or proposals (some of which may be beyond the scope of this hearing), such as “universal savings accounts,” the Administration’s “lifetime savings account” and “retirement savings account” proposals, the role of employer-sponsored defined benefit plans, or proposals relating to Social Security.

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

A. Taxpayers’ Current Investment in Private Pensions

For decades, the US tax code has provided preferential tax treatment to employer-provided pensions, 401(k) plans, and individual retirement accounts (IRAs) relative to other forms of saving. These tax preferences represent a significant investment by the taxpayers, who effectively are partially subsidizing the private pension system. The Treasury Department has estimated the cost of the tax-favored treatment for pensions and retirement savings – the amount by which the pension tax advantages reduce federal tax revenues – as having a present value in the neighborhood of $174 billion (for calendar year 2004). This present-value estimate is designed to take into account not only the deferral of tax on current contributions and on earnings on those contributions but also the tax collected when those contributions and earnings are distributed in the future, whether within or beyond the “budget window” period.[4]

Of this total, nearly half is attributable to section 401(k) plans (as opposed to other employer and self-employed plans and IRAs).[5] Because large portions of the employer-sponsored defined benefit plan universe are in each of the private sector and the public (mainly state and local government) sector, a significant

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[3] Chairman Santorum on April 21, 2005 introduced S. 868, the “America Saving for Personal Investment, Retirement, and Education Act of 2005” (also known as the “ASPIRE Act of 2005”), a proposal to establish “KIDS accounts”, co-sponsored by Senators Corzine, Schumer, and DeMint. A companion bill, H. 1767, was introduced in the House on the same date by Representative Harold E. Ford, Jr., co-sponsored by Representatives Phil English and Patrick Kennedy. Substantially similar legislation was introduced in the 108th Congress, 2d Session.

[4] Budget of the U.S. Government, Fiscal Year 2006, Analytical Perspectives (“FY 2006 Analytical Perspectives”), table 19-4 (## 19-22). The Treasury’s estimate of the annual value of the retirement savings tax expenditures on a cash basis for FY 2005 is $116 billion (table 19-1)(## 121-125, 130), and the roughly corresponding cash basis estimate prepared by the Joint Committee on Taxation for FY 2005 is $125 billion. See Joint Committee on Taxation, “Estimates of Federal Tax Expenditures for Fiscal Years 2005-2009” (JCS-1-05, January 12, 2005), Table 1, pages 36, 38-39. The cash basis estimates take into account incoming revenues for the current year associated with prior-year contributions and accrued earnings (as opposed to future revenues associated with current-year contributions).

[5] FY 2006 Analytical Perspectives. The budget documents also contain other tax expenditure estimates that are based on alternative methods.

percentage of the tax expenditure for non401(k) pensions is attributable to the plans in each of those sectors.

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

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

The system has been quite successful in important respects. It has provided meaningful retirement benefits to millions of workers and their families, and has amassed a pool of investment capital exceeding $11 trillion (including IRAs and retirement plans maintained by Federal, State, and local governments) that has been instrumental in promoting the growth of our economy[6]. Some two thirds of families will retire with at least some private pension benefits, and at any given time, employer-sponsored retirement plans cover about half of the U.S. work force.[7]

However, the benefits earned by many are quite small relative to retirement security needs. Despite the accumulation of vast amounts of wealth in pension accounts, concerns persist about the ability of the pension system to raise private and national saving, and in particular to improve saving among those households most in danger of inadequately preparing for retirement. Those moderate- and lower-income households are disproportionately represented among the roughly 75 million workers and spouses who are excluded from the system. They are far less likely to be covered by a retirement plan.[8] When they are covered, they are likely to have disproportionately small benefits and, when eligible to contribute to a 401(k) plan, are less likely to do so. (Fewer still contribute to IRAs.) Accordingly, the distribution of benefits – retirement benefits and associated tax benefits – among households by income is tilted upwards.

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

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

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

Yet providing retirement security for moderate- and lower-income workers – in other words, for those who need it most -- should be the first policy priority of our tax-qualified pension system. This is the case not only because public tax dollars should be devoted to enhancing retirement security as opposed to retirement affluence – minimizing the risk of poverty or near-poverty in old age, reducing retirees' need for public assistance and potentially reducing pressure on the nation's Social Security system.[9] It is also because targeting saving incentives to ordinary workers tends to be a more effective means of promoting the other major policy goal of our pension system: increasing national saving.

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

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

In contrast, contributions and saving incentives targeted to moderate- and lower-income workers – households likely to have little if any other savings or assets that could be shifted into tax-preferred accounts -- tend to increase net long-term saving rather than merely shifting assets.[10] This enhances retirement security for those most in need and advances the goals of our tax-favored pension system in a responsible, cost-effective manner.

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

> "First, tax preferences should create incentives for expanded coverage and new saving, rather than merely encouraging individuals to reduce taxable savings or increase borrowing to finance saving in tax-preferred

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[9] Treasury 1999 Testimony, page 3.

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

form. Targeting incentives at getting benefits to moderate- and lower-income people is likely to be more effective at generating new saving….

"Second, any new incentive should be progressive, i.e., it should be targeted toward helping the millions of hardworking moderate- and lower-income Americans for whom saving is most difficult and for whom pension coverage is currently most lacking. Incentives that are targeted toward helping moderate- and lower-income people are consistent with the intent of the pension tax preference and serve the goal of fundamental fairness in the allocation of public funds. The aim of national policy in this area should not be the simple pursuit of more plans, without regard to the resulting distribution of pension and tax benefits and their contribution to retirement security….

"Third, pension tax policy must take into account the quality of coverage: Which employees benefit and to what extent? Will retirement benefits actually be delivered to all eligible workers, whether or not they individually choose to save by reducing their take-home pay?"[11]

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

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

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

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

[11] Treasury 1999 Testimony, pages 3-4.

contributions saves $2,100 in tax if they are in the 35 percent marginal tax bracket, but only $600 if they are in the 10 percent bracket.[12]

The income tax incentive approach, as currently structured, thus reflects a mismatch between subsidy and need. The tax preferences tend to encourage saving least for those who most need to save more to provide for basic needs in retirement, and most for those who need to increase their saving least (who are least likely to need additional saving to achieve an adequate living standard in retirement).[13] As discussed in the next section of this testimony, below, tax credits – even nonrefundable tax credits such as the saver's credit for 401(k) and IRA contributions under section 25B of the Internal Revenue Code -- would help address this problem.

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

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

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

Reflecting these structural deficiencies, the nation's pension system betrays several serious shortcomings. First, only half of workers are covered by an employer-based pension plan in any given year, and participation rates in IRAs are substantially lower. Second, even workers who participate in tax-preferred retirement saving plans rarely make the maximum allowable contributions. Only 5 percent of 401(k) participants make the maximum contribution allowed by law, and only 5 percent of those eligible for IRAs make the maximum allowable contribution.[14] Third, despite the shift from defined benefit to defined contribution

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[12] Some of this difference may be recouped when the contributions are withdrawn and taxed, if families who are in lower tax brackets during their working years are also in lower tax brackets in retirement.

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

[14]For example, an unpublished study by a Treasury economist found that only 4 percent of taxpayers eligible for conventional IRAs in 1995 made the maximum allowable $2,000 contribution. Robert Carroll, "IRAs and the Tax Reform Act of 1997," Office of Tax Analysis, Department of the Treasury, January 2000. For IRA contributors at the limit, see also Craig Copeland, "IRA Assets and Characteristics of IRA Owners," *EBRI Notes,* December 2002. Other studies have found only a small percentage of 401(k) contributors to be constrained by the statutory dollar maximum. For example, the General Accounting Office (now the Government Accountability Office) found that an increase in the statutory contribution limit for 401(k)s would directly benefit fewer than 3 percent of participants (General Accounting Office, "Private Pensions:

plans, many households approach retirement with meager defined contribution balances.[15] The median 401(k) and other defined contribution (including IRA) balance among all households ages 55 to 59 was only $10,000 in 2001. Excluding the 36 percent of households who had no IRA or defined contribution plan account, the median balance for this age group was still only $50,000.

D. Targeting Incentives More Effectively to Promote Savings and Security

Given this reality, focusing incentives for retirement saving on lower- and moderate-income households makes sense for two reasons. First, such incentives are more likely to bolster long-term economic security and reduce elderly poverty, since higher-income households already tend to have substantial assets and to be better prepared to provide for their needs in retirement than other households. For some low-income families, income may be so modest that it is impossible to save after paying for necessities. Yet 60 percent of households at or below the poverty line indicate that they save at least something.[16] Experience with programs (including individual development account (IDA) programs) that provide tax incentives and matching funds to encourage saving among low-income families suggests that they will participate in savings programs if presented with incentives to do so.[17] The evidence on the efficacy of automatic enrollment also suggests that low-income workers will save if presented with incentives and a sound structure within which to do so.

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

Issues of Coverage and Increasing Contribution Limits for Defined Contribution Plans," GAO-01-846, September 2001). Data from the Congressional Budget Office suggest that only 6 percent of all 401(k) participants made the maximum contribution allowed by law in 1997. (Calculations based on Congressional Budget Office, "Utilization of Tax Incentives for Retirement Saving," August 2003, table 27.) See also David Joulfaian and David Richardson, "Who Takes Advantage of Tax-Deferred Saving Programs? Evidence from Federal Income Tax Data," Office of Tax Analysis, U.S. Department of the Treasury, 2001.

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

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

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

Since those with modest or low incomes are less likely to have other assets to shift into tax-preferred pensions, focusing pension tax preferences on moderate- and lower-income workers increases the likelihood that lost tax revenue will reflect additional contributions rather than shifts in assets.[18] The empirical evidence suggests that tax-preferred retirement saving undertaken by lower- and middle-income workers is much more likely to represent new saving than tax-preferred retirement saving undertaken by higher-income workers.[19]

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

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

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

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

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

[19]See, for example, Eric M. Engen and William G. Gale, "The Effects of 401(k) Plans on Household Wealth: Differences Across Earnings Groups," Working Paper 8032 (Cambridge, Mass.: National Bureau of Economic Research, December 2000), and Daniel Benjamin, "Does 401(k) Eligibility Increase Saving? Evidence from Propensity Score Subclassification," *Journal of Public Economics* 87, no. 5-6 (2003): 1259-90.

percent, while the share having only a 401(k) or other defined contribution plan had risen to nearly 60 percent.

Conventional analyses tend to describe this solely as a trend away from defined benefit plans and toward defined contribution plans. Such a characterization tends to focus attention on the increased portability of pensions from one job to another and the shifting of investment risk from employer to employee. But perhaps an even more fundamental development is the extent to which the accumulation of retirement benefits under the plan has come to depend on active and informed worker self-management and initiative. Traditional defined benefit and profit-sharing plans require the covered workers to make almost no important financial choices for themselves before retirement.[20] The firm enrolls all eligible workers within a defined classification, makes contributions on their behalf, and decides how to invest those contributions (or retains professional investment managers to do so). A worker's only real choices are when and in what form to collect benefits. In 401(k)-type plans, in contrast, the burden of all these decisions rests with the employee.

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

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

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

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

For many if not most workers, however, the 401(k) revolution has fallen short of its potential.[21] Most workers are not covered by a 401(k) plan at all. Among those covered, many do not participate. Among those who participate, many contribute little to their accounts, and others take the money out before reaching retirement age. As a result, most households have few 401(k) assets. As noted earlier, 36 percent of households aged 55 to 59 had neither a 401(k) (or other defined contribution plan) nor an IRA in 2001, and, among those who did, the median balance in such plans was only about $50,000.

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

The next three sections of this testimony outline approaches designed to address each of these major shortcomings: the upward-tilted structure of our tax incentives (Section II, relating to expansion of the Saver's Credit) and the

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

practical impediments to saving in a 401(k)-dominated system (Sections III and IV, relating to automatic enrollment and automatic investment).

F. Employer-Sponsored Retirement Plans and IRAs

The saving and asset accumulation strategies outlined in this testimony below build on our existing system of employer-sponsored plans and IRAs. The automatic enrollment, escalation and investment in 401(k)s relates to employer plans; the ability to split refunds for direct deposit relates to IRAs; and the Saver's Credit expansion as well as the relief from asset tests that count retirement savings balances relate to both employer plans and IRAs.

Employer plans and individual accounts such as IRAs each play an important role in building assets for lower-income families. IRAs provide a tax-favored saving opportunity for those who are not covered by an employer plan and for lower-income households that may wish to supplement their employer plan coverage with their own stand-alone accounts. Employer plans, for their part, play a particularly important role for moderate- and lower-income families.

Employer plans have attributes that tend to facilitate saving for lower-income households and that account for the fact that, on average, two out of three eligible employees participate in 401(k) plans while the rate of participation in IRAs is less than one out of ten. These advantages of employer plans include

- The possibility of automatic employer contributions or other automatic coverage (as under profit sharing plans or under 401(k) plans that use automatic enrollment);

- Cross-subsidies enforced through the nondiscrimination standards that use high-income individuals' eagerness to save on a tax-preferred basis to encourage more saving by reluctant savers who are typically in lower tax brackets;

- The possibility that such encouragement will take the form of employer matching contributions geared to employee contributions;

- The availability of professional investment management;

- Economies of scale and risk pooling that can reduce the cost of investment management, life annuities, and general administration;

- Employer-provided education regarding saving and investment; and

- Potential peer group reinforcement for saving.

It is important to bear in mind that policy changes intended to make individual

accounts more attractive can have indirect effects on employer plans, and some of those effects can be devastating. For example, individual accounts with tax-favored treatment can be designed to be more attractive to high-income individuals than employer plans (potentially because of high contribution limits, high income eligibility limits, highly advantageous tax treatment, liquidity, and cost-savings resulting from the absence of nondiscrimination standards and other worker protections). The availability of individual accounts that present a more favorable package of costs and benefits to business owners and decisionmakers than employer plans would tend to reduce the decisionmakers' interest in sponsoring plans for their employees. The resulting substitution of individual accounts for employer plans would deprive lower- and moderate-income families of the advantages of employer plan coverage as described above.

Similarly, if individual accounts are made more attractive to moderate- and lower-income employees than employer-sponsored 401(k) plans, 401(k) plan sponsors will likely be unable to achieve favorable or acceptable nondiscrimination results. This in turn will reduce the advantages of the plan to the higher earners who generally make the decision whether to sponsor the plan. In order to promote saving and asset building for lower-income families, policymakers must be sensitive to these potential interactions.

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

A. In General

In 2001, Congress took a first step toward addressing the first structural problem described above -- the upward-tilted structure of the current deduction-based pension tax incentives – by enacting the Saver's Credit. The Saver's Credit in effect provides a government matching contribution, in the form of a nonrefundable tax credit, for voluntary individual contributions to 401(k) plans, IRAs, and similar retirement savings arrangements. Like traditional pension subsidies, the Saver's Credit currently provides no benefit for households that owe no federal income tax. However, for households that owe income tax, the effective match rate in the Saver's Credit is higher for those with lower income, the opposite of the incentive structure created by traditional pension tax preferences.

The Saver's Credit is the first and so far only major federal legislation directly targeted toward promoting tax-qualified retirement saving for moderate- and lower-income workers.[22] Although this is a historic accomplishment, the credit as

[22] Retirement saving for these workers is promoted – or designed to be promoted — indirectly by nondiscrimination and certain other provisions of the Internal Revenue Code of 1986 (IRC) and the Employee Retirement Income Security Act of 1974 (ERISA). Those provisions, which are subject to extensive exceptions, are intended to impose some constraint on the degree to which tax-favored benefits

enacted suffers from key design problems, not the least of which is the credit's scheduled expiration at the end of 2006.

B. Basic Design and Evolution

The Saver's Credit was enacted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA).[23] In principle, the credit can be claimed by moderate- or lower-income households who make voluntary retirement saving contributions to 401(k) plans, other employer-sponsored plans (including SIMPLE plans), or IRAs. In practice, however, the nonrefundability of the credit means it offers no incentive to save to the millions of low- and moderate-income households with no income tax liability.

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

C. Higher Matching Rates for Lower-Income Savers

The matching rates under the Saver's Credit reflect a progressive structure — that is, the rate of government contributions per dollar of private contributions falls as household income rises. This pattern stands in stark contrast to the way tax deductions and the rest of the pension system subsidize saving. The Saver's Credit is currently a small exception to this general pattern: as noted, the Treasury Department estimates that the tax expenditures associated with retirement saving preferences in 2005 will total roughly $150 billion, of which only $1 billion is attributable to the Saver's Credit.[24]

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accrue to a limited number of owners and executives rather than the large majority of workers. The IRC and ERISA also protect and regulate the accumulation and preservation of retirement benefits. For additional discussion of these issues by the Treasury Department, see Donald C. Lubick, Assistant Secretary (Tax Policy), U.S. Department of the Treasury, Testimony before the House Committee on Ways and Means, Subcommittee on Oversight, March 23, 1999.

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

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

The Saver's Credit applies to contributions of up to $2,000 per year per individual.[25] As table 1 shows, the credit rate is 50 percent for married taxpayers filing jointly with adjusted gross income (AGI) up to $30,000, 20 percent for joint filers with AGI between $30,001 and $32,500, and 10 percent for joint filers with AGI between $32,501 and $50,000. The same credit rates apply for other filing statuses, but at lower income levels: the AGI thresholds are 50 percent lower for single filers and 25 percent lower for heads of households.[26] Of course, the figures in table 1 assume that the couple has sufficient income tax liability to benefit from the nonrefundable income tax credit shown.

The credit's effect is to correct the inherent bias of tax deductions or exclusions in favor of high-marginal-rate taxpayers. A $100 contribution to a 401(k) by a taxpayer in the 35 percent marginal federal income tax bracket generates a $35 exclusion from income, resulting in a $65 after-tax cost to the taxpayer. In contrast, without the Saver's Credit, a taxpayer in the 15 percent marginal bracket making the same $100 contribution to a 401(k) gets only a $15 exclusion from income, resulting in an $85 after-tax cost. The tax deduction is thus worth more to the higher-income household.[27] However, if the lower-income taxpayer qualifies for a 20 percent Saver's Credit, the net after-tax cost is $65 ($100 minus the $15 effect of exclusion minus the $20 Saver's Credit). Thus, the Saver's Credit works to level the playing field by increasing the tax advantage of saving for moderate- and lower-income households.

The credit represents an implicit government matching contribution for eligible retirement savings contributions. The implicit matching rate generated by the credit, though, is significantly higher than the credit rate itself. The 50 percent *credit* rate for gross contributions, for example, is equivalent to having the government *match* after-tax contributions on a 100 percent basis. Consider a couple earning $30,000 who contribute $2,000 to a 401(k) plan or IRA. The

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

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

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

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

D. Enhancement of Employer-Sponsored Plans

The Saver's Credit was very deliberately designed to support, rather than undermine, employer pension plans. Employer-sponsored plans encourage participation through employer contributions, nondiscrimination rules designed to require cross-subsidies from eager to reluctant savers, the automatic character of payroll deduction, peer group encouragement, and, often, professional assistance with investments (for example, through employer selection of investment options or provision of investment management). To support these benefits of employer-sponsored plans, the Saver's Credit matches contributions to 401(k) and other plans by moderate- and lower-income employees.[28]

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

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

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

Employee 401(k) contributions that qualify for the Saver's Credit also count toward meeting the employer's 401(k) nondiscrimination tests. Accordingly, to the extent the Saver's Credit encourages increased participation among lower earners, higher earners may also benefit, since their ability to contribute on a tax-favored basis depends on the level of contributions by less highly paid employees.[29]

Recognizing the potential benefits of the Saver's Credit for plan sponsors, the Internal Revenue Service (IRS) has provided employers a model notice to inform employees of the credit.[30] Moreover, some employers that have refrained from adopting a 401(k) plan because of expected difficulty in meeting the nondiscrimination test may be encouraged by the Saver's Credit to set up a plan. The credit not only makes it easier for the employer to pass the nondiscrimination test but also gives eligible employees a greater incentive to demand a 401(k) plan.

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

E. Effects of the Saver's Credit

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

1. Eligibility.

The nonrefundability of the credit substantially reduces the number of people eligible for it. Further, the low match rates for moderate-income households substantially reduce the number of people eligible to receive a significant incentive. Nonrefundability results in a credit that provides no incentives to tens

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

[30]IRS Announcement 2001-106.

of millions of low-income filers who qualify on paper for the 50 percent credit rate, but who have no income tax liability against which to apply the credit.

Table 4 shows that 59 million tax filers in 2005 will have incomes low enough to qualify for the 50 percent credit.[31] Since the credit is nonrefundable, however, only about one-seventh of them actually would benefit from the credit *at all* by contributing to an IRA or 401(k). Furthermore, only 43,000 — or fewer than one out of every 1,000 — of filers who qualify based on income could receive the maximum credit ($1,000 per person) if they made the maximum contribution. These are the households who have sufficient tax liability to benefit in full from the Saver's Credit but sufficiently low income to qualify for the highest match rate.

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

2. Usage

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

3. Effects on Private Saving

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

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

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

of these clients were first-time contributors to a retirement savings plan.[33]

F. Options for Expansion

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

1. Eliminating the 2006 Sunset

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

2. Making the Credit Refundable

As noted above, tens of millions of low-income workers are unable to benefit from the credit because it is nonrefundable. To extend the intended saving incentive to most lower-income working families would require making the Saver's Credit refundable.[34]

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

Making the credit refundable would help equalize the tax benefits of saving for higher- and lower-income households, leveling the playing field between income tax payers and workers who pay payroll tax but have no income tax liability. Short of direct income tax refundability, other variations and alternatives are

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

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

possible. For example, a bill introduced by Senator Jeff Bingaman (D-NM) in 2002 would in effect make the Saver's Credit refundable, but only by matching qualifying contributions of individuals with no income tax liability who purchase an inflation-indexed U.S. savings bond that they cannot redeem until retirement age.[35] Another possibility would involve providing a tax credit to financial institutions for contributions that they make to their clients' savings accounts, as was proposed in the Treasury Department's February 2000 Retirement Savings Accounts approach.[36] The effect would be similar to that of a refundable tax credit at the individual level. A final possibility would be to deposit the refund directly into the saving account or 401(k), which would raise significant technical issues.[37]

3. Expanding Eligibility to More Middle-Income Households

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

First, the 20 percent and 10 percent credit rates available to eligible joint filers with AGI between $32,500 and $50,000 could be raised to 50 percent.[38] This would make the 50 percent credit available to tens of millions of additional households who, for the most part, confront zero, 10 percent, or 15 percent marginal income tax rates and therefore have relatively little to gain from the traditional income tax incentive structure.

Second, the 50 percent credit rate could be expanded to working households

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

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

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

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

with AGI up to $60,000 or $70,000 (for joint filers).[39] Some of these households — about 5 percent under the option that increases eligibility for the 50 percent credit to $70,000 for joint filers — are in the 25 percent marginal tax bracket and therefore already receive a somewhat larger incentive to save under the traditional system of tax subsidies. The vast majority, however, are in the 15 percent bracket, and many of these households have somewhat more disposable or discretionary income remaining after meeting essential short-term needs than do lower-income families in the same tax bracket. These households may thus be more likely than lower-income households to respond to the incentive, and more likely than higher-income households to respond by increasing their net saving rather than merely shifting assets.

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

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

III. Automatic Enrollment and Escalation of Contributions

A. Factors That Discourage 401(k) Participation

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

To enroll in a 401(k), an eligible employee usually must complete and sign an enrollment form, designate a level of contribution (typically a percentage of pay to be deducted from the employee's paycheck), and specify how those contributions will be allocated among an array of investment options. Often the

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

employee must choose from among 15, 20 or more different investment funds. An employee who is uncomfortable making all of these decisions may well end up without any plan, because the default arrangement—that which applies when the employee fails to complete, sign, and turn in the form—is nonparticipation.

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

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

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

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

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

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

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

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

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

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

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

In each case – automatic enrollment, escalation, investment, and rollover – workers can always choose to override the defaults and opt out of the automatic design. The integrated strategy of using default arrangements to promote saving without sacrificing individual choice was first formulated – and began to be implemented – between 1998 and 2000 by the U.S. Treasury. The Treasury and the Internal Revenue Service (IRS) approved automatic enrollment for 401(k) plans in 1998 and first permitted automatic rollover in 2000. In 2001 Congress enacted legislation making automatic rollover mandatory for small lump-sum distributions, to take effect this year. Both automatic enrollment and automatic

rollover were designed also to lay the groundwork for automatic investment: both generally, by establishing the principle that pro-saving defaults should apply to major retirement decisions, and specifically, by requiring plans to prescribe default investments to be used in conjunction with automatic enrollment and automatic rollover.

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

C. Automatic Enrollment

Under a plan that uses automatic enrollment, unless an employee affirmatively expresses a different preference, the default mode is that the employee participates at a stated percentage of compensation.[40] This, as a practical matter, is particularly geared toward encouraging participation by moderate- and lower-income employees, who are least likely to participate without it. Studies suggest that autoenrollment can boost the rate of 401(k) plan participation from a national average of about 75 percent of eligible employees to between 85 and 95 percent. Particularly dramatic increases are seen among those subgroups of workers with the lowest participation rates. For example, one study found that, among employees with between 3 and 15 months, automatic enrollment increased participation from 13 percent to 80 percent for workers with annual earnings of less than $20,000, and from 19 percent to 75 percent for Hispanics.[41] (Automatic enrollment, like the Saver's Credit, also enables higher-paid employees to contribute more by making it easier to obtain favorable results under the 401(k) nondiscrimination test.)

Interesting administrative variants exist that can accomplish much of what automatic enrollment does. One alternative would require that all employees make an explicit election to participate or not, rather than enroll them automatically if they make no election. In at least some cases this approach has

[40]Automatic enrollment was approved in IRS Revenue Ruling 2000-8 and in Treas. Regs. Section 1.401(k)-1(a)(3)(ii). The IRS has recently affirmed that plans are permitted to increase the automatic contribution rate over time in accordance with a specified schedule or in connection with salary increases or bonuses. See letter dated March 17, 2004, from the Internal Revenue Service to J. Mark Iwry.

[41]Brigitte Madrian and Dennis Shea, "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior," *Quarterly Journal of Economics* 116, no. 4 (November 2001): 1149-87.

produced participation rates in the same high range as automatic enrollment. In addition, firms could require that employees who opt out sign a statement acknowledging that they have read the plan's disclosures regarding the advantages of contributing.

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

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

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

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

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

thus gave plan sponsors an incentive to increase participation among their less highly paid employees. Automatic enrollment is one way for them to do this.

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

To restore the attractiveness of automatic enrollment to employers, policymakers could change the rules to allow the matching safe harbor only for plans that feature automatic enrollment and the other key parts of the automatic 401(k) (especially the automatic escalation feature described below). Plan sponsors currently using the matching safe harbor could be given a transition period in order to have sufficient time to plan to meet the new safe harbor conditions, comply with the nondiscrimination standards based on regular testing, or consider the 3% nonelective safe harbor.

D. Automatic Escalation

One potential drawback of automatic enrollment, highlighted by recent research, is that it can induce some employees to passively maintain the default contribution rate over time, when they might otherwise have elected to contribute at a higher rate. This adverse effect can be mitigated through automatic escalation, whereby contributions rise gradually and automatically over time (for example, from 4 percent of the worker’s pay in the first year to 5 percent in the second, 6 percent in the third, and so on). For example, in the “Save More Tomorrow” program proposed by Richard Thaler and Shlomo Benartzi, workers would agree (or not) at the outset that future pay increases will generate additional contributions. In one trial, “Save More Tomorrow” was shown to lead to a substantial increase in contribution rates over time for those who participated, relative to other 401(k) participants at the same company. Alternatively, workers could agree to future contribution increases even in the absence of pay raises. Automatic escalation plans have been explicitly approved by the IRS in a general information letter obtained by the witness.[42]

[42] General information letter from Internal Revenue Service to J. Mark Iwry, March 17, 2004 (copy attached).

E. Automatic Investment

A third and related approach is automatic 401(k) investment, which is discussed in Section IV of this testimony, below.[43]

F. Automatic Rollover

A similar automatic or default-based approach has already been applied to plan payouts before retirement, to limit leakage of assets from the retirement system. Currently, most people who receive distributions from 401(k) and similar plans take one-time cash payments. In general, the smaller this lump-sum distribution, the less likely it is to be saved by being transferred ("rolled over") to another employer plan or to an IRA. In fact, data suggest that, as of 1996, the median lump-sum distribution was $5,000, and a sizable majority of defined contribution plan participants who receive a lump-sum distribution of $5,000 or less do not roll it over to a qualified plan or IRA.16

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

Automatic rollover was designed to have a potentially valuable byproduct, namely, broader utilization of IRAs. Currently, fewer than 10 percent of those eligible to open and contribute to an IRA on a tax-preferred basis actually do so. Like enrolling in a 401(k), opening an IRA requires individuals to overcome inertia and to navigate their way through a number of decisions (in this case, choosing

[43] Many of the approaches outlined in this and the following section of this testimony are contained in H.R. 1508, the "401(k) Automatic Enrollment Act of 2005," introduced earlier this month by Representative Rahm Emanuel (D-IL). Another recently-introduced bill intended to promote automatic enrollment is S. 875, the "Save More for Retirement Act of 2005" introduced by Senator Bingaman (D-NM)(co-sponsored by Senators Snowe, Lieberman and Obama) on April 21, 2005.

among a vast number of financial institutions and investments). Automatic rollover instead calls upon the employer to take the initiative to set up an IRA and choose investments on the employee's behalf, again unless the employee chooses to do so. The intended result is not only to preserve the assets within the tax-favored retirement plan universe, but also to create an expanding infrastructure of portable, low-cost individual accounts for the millions of workers who have no IRAs but who are covered at some point by an employer-sponsored retirement plan. Automatic rollover thus has the potential to help achieve a far broader expansion of retirement plan coverage for middle- and lower-income households. Indeed, this broader agenda is explicitly reflected in the automatic rollover legislation, which directs the Treasury and Labor Departments to consider providing special relief for the use of low-cost IRAs.

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

G. Other Potential Automatic Arrangements

Alternative default options could also be considered for other aspects of retirement savings, including the form in which distributions are made at retirement. Current law reflects some preference for encouraging payouts to take the form of a lifetime annuity, which guarantees periodic payments for life (as opposed to a single cash payment, for example). Lifetime annuities are a sensible way to reduce the risk of retirees (other than those with very short life expectancies) outliving their assets, yet few people purchase them.

In defined benefit and money purchase pension plans, a lifetime annuity is generally the default mode of distribution. In contrast, 401(k) and most other defined contribution plan sponsors have been able for the most part to exempt themselves from such default requirements. (Proposals have been advanced to extend to 401(k) plans default arrangements (including spousal protection) based on those that apply to defined benefit and money purchase plans.) Products are needed, and are being developed, that would provide lifetime guaranteed income at reasonable cost in ways that are more flexible and more responsive to the needs of moderate- and lower-income families than most traditional annuity products.

IV. Automatic Investment

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

In addition, millions of workers are overconcentrated in their employer's stock.[44] This can prove especially costly: if the employer falls upon hard times, workers stand to lose not only their jobs but their retirement savings. But even when the plan sponsor does not collapse, poor investment choices impose unnecessary risk on workers, threaten the level and security of their retirement income, and reduce the public policy benefits from 401(k) tax preferences.

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

The risks of inadequate diversification are widely recognized. In fact, pension law generally requires plan trustees, who make investment choices in plans without employee self-direction, to diversify plan portfolios to reduce the risk of large losses. Virtually all investment professionals scrupulously avoid investing more than a minuscule fraction of assets under their management in any single company. Economic theory suggests that undiversified portfolios create significant risk without providing additional expected returns. Moreover, when the undiversified stock is that of the investor's employer, the risk is compounded, as noted above.

A. Sources of the Problem

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

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

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

B. Current Policy Responses

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

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

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

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

C. A General Strategy

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

1. Standard Investments

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

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

The law could provide explicit approval for short-term default investment in stable-value funds, which then switch to balanced or life-cycle funds thereafter. This option could be especially useful for firms that include automatic enrollment as part of their 401(k) plan. The purpose would be to ensure that workers who quickly changed their minds and wanted to opt out of the 401(k), perhaps

because they had not realized that they would be included as a result of automatic enrollment, would not experience capital losses.[45]

2. Managed Accounts

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

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

D. Policy Strategies Targeted More Specifically to Employer Stock

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

1. "Crowdout" of Employer Stock

A minimalist strategy for diversifying away from employer stock, in the context of the above proposals, would be to do nothing specifically about it, on the ground

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

that exposing employees' 401(k) accounts to professional investment management (or standardized default investments) is itself likely to reduce the concentration in employer stock over time. The gospel of sound asset allocation and diversification will become more pervasive, and professional expertise will permeate the system far more readily, once employees are no longer the only or primary managers of their plan portfolios. Accordingly, as professional management and standard investments increasingly replace employee self-direction, the practice of overconcentration in employer stock and poorly balanced portfolios would eventually give way to diversification and sound asset allocation.

2. Diversification Safe Harbor for Plan Sponsors

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

3. "Sell More Tomorrow"

Richard Thaler and Shlomo Benartzi suggest that plan sponsors offer employees the option of participating in a systematic program of gradual employer stock divestiture over a period of years.[46] Consistent with the employer-level safe harbor "glide path" approach suggested above, Thaler and Benartzi advocate this creative, employee-level approach (which they call "Sell More Tomorrow") as a way to encourage employees to take a possibly difficult step by arranging to do most of it in the future. By spreading out the sale of the shares over time, this approach also avoids potentially depressing the market for the stock and mitigates any risk of remorse on the part of employees for having sold at the wrong time.

4. Threshold Approach

Another possible approach to reducing overconcentration in employer stock would permit employees to invest employee contributions in employer stock only

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

to the extent that the contributions in a given year exceed some threshold. Such a threshold could be set, for example, at 7 percent of pay—a level slightly above the actual average 401(k) contribution rate.

E. Autoinvestment in General

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

V. Direct Deposit of Tax Refunds to IRAs[47]

A. The Potential

For many middle- and lower-income families, the best opportunity to save and accumulate assets outside an employer-based plan may arise when they file their federal income tax returns. Each year, over 100 million American households put themselves in a position to receive federal income tax refunds averaging more than $2,000 each (resulting mainly from overpayment of withholding taxes). For many families, the refund is the largest single payment they can expect to receive all year. Accordingly, individual income tax refunds present a unique opportunity – a "savable" or "savings" moment" -- to increase personal saving, whether for retirement or for shorter-term needs, and one that seems particularly well suited for moderate- and lower-income households.[48] This is particularly true since there is evidence suggesting that many people tend to view large, extraordinary payments (such as their tax refunds) as separate and different from their normal wages or other income.[49] Indeed, in the case of a tax refund, such separate "mental accounting" corresponds to the reality that the payment is initially segregated from other income or assets.

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[47] Most of this Section of the testimony is extracted verbatim from a forthcoming Retirement Security Project issue brief by the witness: J. Mark Iwry, "Tax Refunds as a Retirement Savings Opportunity " (Retirement Security Project, forthcoming, May 2005).

[48] In fiscal year 2004, individual income tax refunds amounted to $228 billion and went to 106 million out of a total of 131 million individual income tax returns (*IRS Databook FY 2004,* publication 55b, tables 1, 2, 8, 9. See also P. Orszag, "Tax Fact, Individual Income Tax Refunds," *Tax Notes* (January 31, 2005).

[49] Hersh M. Shefrin and Richard H. Thaler, "Mental Accounting, Saving, and Self-Control," in *Choice Over Time*, edited by G. Loewenstein and J. Elster (New York City: Sage Foundation, 1992).

For families who routinely make ends meet with their regular paychecks, the annual refund may be viewed, at least in part, as discretionary funds that could be saved rather than immediately consumed. A moderate- or lower-income household that wishes to save can do so by forgoing immediate use of part of the refund, rather than having to come up with out-of-pocket funds. Moreover, the size of the refund generally is known before it is received. This enables households, if they wish, to commit themselves to saving the funds ahead of time, such as by deposit to an IRA or other savings vehicle, when the amount of the refund has been determined but before the refund is actually in hand. This may be a particularly opportune moment for households to make a decision to save.

Currently, households that are willing to save the entire refund have a ready means of implementing such an advance commitment: a household can elect on its income tax return to have the refund directly deposited to an IRA or other account at a financial institution instead of being mailed to the household in the form of a paper check. The opportunity for precommitment thus arises in two stages. First, regular tax deductions are made automatically from each paycheck without the need for any action by the individual (at least once the initial decision has been made to initiate the pattern of paycheck deduction and accumulation). This series of deductions gives rise to the refund. Second, at the time the return is filed, households can precommit themselves to saving by instructing the government to make a direct deposit of the refund. This may make saving easier for many who, in principle, would like to save the refund but are struggling against the temptation to spend it.

B. The All-or-Nothing Versus Dividing the Refund

Unfortunately, this refund-saving strategy currently suffers from a major practical obstacle: the direct deposit of a federal income tax refund is now an all-or-nothing proposition. The household can direct that the entire refund be deposited to a single account at a bank or other financial institution, or can receive a check in the mail for the entire refund amount, which takes longer to arrive.[50] But the federal income tax system does not currently provide the option of bifurcating a refund. Households, for example, cannot direct a portion of the refund to one or more accounts (such as IRAs) for saving while receiving the balance (as a check or as a direct deposit to a checking account) to meet more immediate spending needs. In addition, a married couple filing jointly cannot split their refund into, for example, separate IRA contributions for each spouse.

[50] Another option available to taxpayers is to direct on the return that the refund be applied to pay estimated taxes. Private tax-preparation firms also offer options for tax filers to gain more rapid access to their refunds, but some of these (“refund anticipation loans”) have proven to be controversial because of the fees charged.

Accordingly, while more than 49 million tax filers in 2004 received their federal tax refunds by direct deposit, they did not have the choice to allocate the direct deposit to more than one account.[51] This might help explain why less than 4 percent of those who filed their return by April 1, 2005 indicated on their return that the account to receive the direct deposit of the refund is a "savings" account as opposed to a "checking" account (indicated by about 53 percent of early filers). Yet both intuition and evidence suggest that households would be more likely to contribute part of their refunds to saving accounts such as IRAs if they could choose, on their tax return, to divide their refunds. Many households that require much or most of the refund for immediate needs might be willing to save a portion of it if they had an easy and convenient way to do so—by simply checking a box on the tax return form.[52]

Some preliminary empirical evidence suggests that the ability to split a tax refund by direct deposit could increase deposits to savings accounts even by lower-income households. A forthcoming issue brief from the Retirement Security Project will explore the evidence from a pilot project that allowed lower-income households to put part of their refund into a savings account, while also receiving part in a more liquid form. This evidence -- along with the significant size of aggregate refunds, the fact that over 49 million refund recipients chose direct deposit, and that millions of moderate- and lower-income households can claim a tax credit (the Saver's Credit) for direct deposits of refunds to an IRA -- suggests that allowing households to deposit part of their tax refunds directly into a savings account is likely to be beneficial.[53]

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[51] Some have access to private-sector services that allocate refunds among multiple accounts, although low-income taxpayers may be less likely to be customers who are offered such services.

[52] By way of analogy, the evidence shows, as discussed above, that participation in 401(k) plans has been significantly increased by automatic enrollment. Similarly, there is preliminary evidence suggesting that 401(k) participation increases even when newly hired employees are simply forced to complete a form explicitly electing or declining to participate; this reduces the risk that employees will fail to enroll because they postpone the decision, lose the form, etc. Direct deposit of a refund on a tax return is somewhat similar, in that most taxpayers are effectively forced to complete a form (the tax return) on which they can commit themselves in advance to save funds that are not yet in hand. Excess income tax withholding is a more universally available method of accumulating savings than 401(k) payroll withholding. It also has the advantage of avoiding the inefficiencies that may be caused by persistently very small contributions under payroll deductions, but this efficiency comes at the cost of forgone interest or earnings for the taxpayer.

[53] Lower- and moderate-income households that make direct deposits of only a portion of their tax refunds to IRAs would also be able to claim the saver's credit (the retirement savings tax credit) with respect to those direct deposit contributions, provided that Congress extends the credit beyond 2006, as suggested above. However, as discussed earlier, the saver's credit currently is also not refundable and, therefore, depending on which other credits the taxpayer is claiming, may fail to give such households additional incentive to contribute to IRAs, 401(k)s, and similar plans.

C. Other Implementation Issues

1. Issues for Individuals

To realize these benefits of refund splitting, households must have a savings account or establish one. Some already have IRAs to which they could direct the deposit of a portion of their refunds. In addition, those who use commercial tax preparers might be able to open an IRA with the preparer (sponsored by an IRA trustee or custodian working with the preparer) when their return is prepared. An example of this approach is H&R Block's "Express-IRA" product, which allows clients to establish an IRA on-site and deposit some of their refund in it while receiving the balance in a check or separate direct deposit. H&R Block has reportedly opened more than 440,000 such IRAs.[54]

Unfortunately, many lower-income tax filers who would benefit from saving do not have a savings account.[55] The availability of refund splitting directly through the IRS and the increased use of direct deposit, however, might prompt the financial services industry to develop easier and more efficient ways for such households to open accounts. New approaches might focus on creating accounts before, during, or after the filing of the tax return. For example, one might imagine financial providers effectively disseminating routing transit and account numbers to encourage households to open accounts when splitting their refunds. However, current signature requirements to open an account may present an obstacle to such practices; indeed, at least some appropriate safeguards would seem to be necessary to help prevent efforts to misuse routing transit and account numbers to misappropriate households' refunds.

2. Issues for the Internal Revenue Service

The Internal Revenue Service could provide a split refund option by administrative action without the need for legislation. However, changes of this nature would ordinarily involve significant administrative tasks affecting IRS systems, including programming, processing, transcription, and testing (as well as an additional schedule to the Form 1040) and would entail associated administrative costs. (A number of these issues are explored in a forthcoming Retirement Security Project issue brief.) However, on balance, none of these administrative issues appears to present an insuperable obstacle; they ultimately

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[54] Peter Tufano and Daniel Schneider, H&R Block and Everyday Financial Services, HBS Case No. 205-013 (Boston: Harvard Business School Publishing, 2004).

[55] See, for example, Michael S. Barr, "Banking the Poor," 21 Yale Journal on Regulation 121 (2004).

should be resolvable, and the associated costs would seem to be outweighed by the significant potential of split refunds to encourage saving.[56]

However, administrative concerns and potential costs may help explain why efforts within the Department of the Treasury and IRS since the late 1990s to implement refund splitting have not yet come to fruition. The current administration's budget states that saving will be "simplified and encouraged" by administrative changes to the tax filing process that will "allow taxpayers to have their tax refunds directly deposited into more than one account."[57] Similar language was included in each of the last two Treasury explanations of the administration's tax-related budget proposals, and the current budget specifies that the availability of split refunds is "planned for the 2007 tax-filing season."

During the past year, bipartisan efforts in Congress and the private sector have sought to encourage the IRS to move forward. Chairman Santorum on April 29, 2004, and a bipartisan group of 12 Members of the House of Representatives on January 31, 2005, wrote to the IRS urging it to implement a program that would allow taxpayers to split the direct deposit of refunds. A similar letter was sent to IRS Commissioner Everson by a wide array of organizations in October 2004.[58] In March 2005, Congressman Rahm Emanuel (D-Illinois) introduced HR 1048, the Direct Deposit Savings Act of 2005, which would require the IRS to offer refund splitting. On March 25, 2005, Commissioner Everson responded to one of these letters, stating that an IRS implementation committee was being formed to work toward making refund splitting available by 2007.[59]

D. Possible Variations on the Tax-Refund IRA

As noted earlier, a key obstacle that might limit participation in refund splitting is the need to have an IRA (or other saving account) to receive the refund. If the tax filer does not already have an IRA, an IRA has to be set up—including choosing a vendor, choosing investments, and taking any other steps necessary to open

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[56] See Michael Sherraden and Michael S. Barr, "Institutions and Inclusion in Saving Policy," Paper presented at "Building Assets, Building Credit" Symposium at the Joint Center for Housing Studies, Harvard University, November 17-19, 2003 (March 2004); Michael S. Barr, "Banking the Poor," 21 Yale Journal on Regulation 121 (2004).

[57] "Analytical Perspectives," *Budget of the United States Government, Fiscal Year 2006,* p. 282. See also Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2006 Revenue Proposals* (February 2005), p. 8; Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2005 Revenue Proposals* (February 2004), p. 10.

[58] The letter and associated effort was organized by Fred T. Goldberg Jr. (former IRS Commissioner, Assistant Treasury Secretary for Tax Policy, and for many years a leading advocate of promoting saving by refund splitting and other means), Reid Cramer (Research Director of the New America Foundation's Asset Building Program) on behalf of the New America Foundation, and the witness.

[59] The IRS letter is dated March 25, 2005 and is addressed to Representative Jim Cooper (D-TN).

the account. These steps may be a significant impediment in some cases. A possible response would be to allow households to direct on their returns that a portion of their refund be applied to the purchase of U.S. savings bonds. Such an option was made available to households from 1962 to 1968, but it was available only on an all-or-nothing basis: If any of the refund was invested in savings bonds, all of it had to be so invested. The option was terminated after 1968 because few households took advantage of it. However, the option to invest a *portion* of the refund in U.S. savings bonds might well prove to be more popular.[60]

Another alternative would allow households who do not have an IRA to direct on their tax returns that the government open an IRA in their names at a designated "default" financial institution that has contracted with the government to provide low-cost IRAs, with well-designed default investments, for this and related purposes. Any such approach would raise a variety of issues, including the challenge of designing an appropriate IRA to minimize costs, the allocation of costs between the private sector and the government, the need to avoid creation of a substantial government bureaucracy to administer the arrangement, the choice of default investment, and the issues relating to possible transfer of larger balances to regular IRAs.

These and other issues would arise in exploring possibilities such as permitting households to make direct deposits of refunds to accounts in 401(k) plans or to accounts held by some expanded form of the Thrift Savings Plan which is sponsored by the Federal Government as a 401(k)-type plan for its employees. Among the additional issues that would be raised are whether the IRS and Financial Management Services (a bureau of the U.S. Department of the Treasury that pays refunds and other amounts) could send direct deposits to the typical 401(k), which is organized as a trust fund with legal title to all of the assets held by the plan trustee, not by individual employees (who have beneficial interests in their accounts). In addition, if such refund deposits to a 401(k) could be arranged, they would be after-tax contributions; making refund splitting available to 401(k) plans might encourage households to make contributions via direct deposit that would fail to qualify for the exclusion from income associated with a salary reduction 401(k) contribution. Other potential complications would include the administrative tasks imposed on 401(k) plan sponsors and recordkeepers required to keep track of such deposits separately from other kinds of funds.

Before embarking on more ambitious approaches such as these, however, a good case can be made that the first step should be to allow refund recipients to split refunds among multiple direct deposits and to assess whether the IRA market is making it sufficiently easy to open new accounts.

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[60] See Peter Tufano and Daniel Schneider, *Reinventing Savings Bonds: A Modest Proposal*, HBS Working Paper, 2004.

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The ability to split tax refunds among multiple direct deposits appears to have great potential for increasing personal saving and building assets, especially in the case of moderate- and lower-income households. These tax filers might be deterred from saving by the need to come up with the funds needed to make the investment and by the sense that they cannot afford to save their entire refund, rather than using at least a portion of it to meet immediate needs. Allowing households to split their refund could facilitate saving, and since federal individual income tax refunds total some $228 billion a year, even a modest increase in the proportion of refunds saved could represent a significant increase in saving.

VI. Exempting Retirement Savings When Applying the Asset Tests in Means-Tested Public Programs[61]

Under major means-tested public assistance programs, such as Medicaid, the State Child Health Insurance Program (SCHIP), programs funded under the Temporary Assistance for Needy Families (TANF) block grant, and the Food Stamp Program, states are allowed or required to condition eligibility on satisfaction of certain asset tests. The federal Supplemental Security Income (SSI) program has similar tests. Some of the asset tests do not take into account defined benefit pension benefits as assets, but do take into account defined contribution plan or IRA balances. This application of the tests can force families that rely – or expect that they might need to rely in the future -- on these means-tested benefits to choose between spending down their retirement savings or forgoing benefits under the program. Low-income households that use or contemplate using these programs therefore face a disincentive to accumulate assets in retirement savings accounts – in effect, an implicit tax on such saving.

The treatment of retirement savings under the asset tests is not uniform across the various programs and often is not uniform within a single program across various states. The resulting uncertainty and potential confusion are likely to discourage saving by low-income families. As a general proposition, exempting defined contribution and IRA balances from the asset tests or otherwise modifying or even eliminating asset tests under these programs would remove an obstacle to asset accumulation by low-income households.

A forthcoming Retirement Security Project paper will describe in detail the asset tests and the manner in which they treat retirement savings, and will set out

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[61] This Section of the testimony borrows heavily from a forthcoming Retirement Security Project policy brief by Robert Greenstein et al. regarding the issues discussed in this Section.

specific recommendations regarding appropriate changes to the tests to encourage asset building by low-income families.

Conclusion

A number of practical and highly promising reforms could significantly encourage saving and the accumulation of assets by lower-income households. These include expansion of the saver's tax credit for contributions by moderate- and lower-income households to employer-sponsored retirement plans and IRAs; expanded use of automatic enrollment, automatic escalation, and automatic investment approaches in 401(k) and similar retirement savings plans; arrangements allowing taxpayers to have a specified portion of their federal income tax refunds deposited directly into IRAs or other saving accounts (without requiring that the entire refund be so deposited); and modifications to asset tests in means-tested public programs for low-income families that would exempt retirement savings account balances.

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

Table 1

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

Dollars except where stated otherwise

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

Source: Authors' calculations.

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

Table 2

Total Effective Match Rates with Saver's Credit and a 50 Percent Employer Matching Contribution[1]

Dollars except where stated otherwise

Credit rate (percent)	Tax credit for $2,000 before-tax employee contribution	Net after-tax contribution	Total contribution after 50 percent employer match	Ratio of total contribution to employee's after-tax contribution	Effective after-tax match rate (percent)
50	1,000	1,000	3,000	3	200
20	400	1,600	3,000	1.875	87.5
10	200	1,800	3,000	1.667	66.7

Source: Authors' calculations.

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

Table 3

Ownership of Assets in Retirement Accounts among Households Aged 55-59, by Income, 2001[1]

Dollars except where stated otherwise

Income percentile	Percentage of households in indicated income range with assets	Median assets		Share of aggregate assets of all households (percent)
		All households in income range	Households with assets only	
Below 20	25	0	8,000	1.1
20-39.9	49.6	0	12,000	4.2
40-59.9	61.6	7,200	28,000	8.6
60-79.9	91	50,000	54,000	16.7
80-89.9	95.4	148,000	190,000	18.8
90-100	92.1	215,000	299,000	50.6
All households	63.6	10,400	50,000	100

Source: Authors' calculations using the 2001 Survey of Consumer Finances.

(1) Throughout table, "assets" refer only to assets held in defined contribution plans or Individual Retirement Accounts.

Table 4
Eligibility for 50 Percent Credit Rate

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

Source: Urban-Brookings Tax Policy Center Microsimulation Model.

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

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

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

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

Table 5

Effect of the Saver's Credit[1]

Distribution of Income Tax Change by Cash Income Class, 2005

Cash Income Class (thousands of 2003 dollars)[2]	Tax Units[3]			Percent Change in After-Tax Income[4]	Percent of Total Income Tax Change	Average Tax Change ($)	Average Federal Tax Rate[5]	
	Number (thousands)	Percent of Total	Percent with Tax Cut				No Credit	Current Law
Less than 10	20,301	14.0	0.3	0.0	0.1	0	3.3	3.3
10-20	26,357	18.1	5.0	0.1	19.9	-15	5.5	5.4
20-30	20,537	14.1	9.9	0.1	26.3	-25	10.9	10.8
30-40	15,633	10.8	7.8	0.1	19.2	-24	15.0	14.9
40-50	11,543	7.9	10.9	0.1	16.1	-27	17.0	17.0
50-75	20,112	13.8	5.5	0.0	16.9	-17	19.0	18.9
75-100	11,773	8.1	0.3	0.0	0.6	-1	20.4	20.4
100-200	14,039	9.7	0.2	0.0	0.7	-1	22.6	22.6
200-500	3,588	2.5	0.1	0.0	0.0	0	25.6	25.6
500-1,000	593	0.4	0.0	0.0	0.0	0	27.6	27.6
More than 1,000	284	0.2	0.0	0.0	0.0	0	31.1	31.1
All	145,321	100.0	4.9	0.0	100.0	-14	20.7	20.7

Source: Urban-Brookings Tax Policy Center Microsimulation Model.

(1) Baseline is current law without the saver's credit.

(2) Returns with negative cash income are excluded from the lowest income class but are included in the totals.

(3) Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.

(4) After-tax income is income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.

(5) Average federal tax (individual income tax, net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax) as a percentage of average cash income.

Table 6
Alternative Estimates of Revenue Effects of Saver's Credit

Billions of dollars

Fiscal Year	Joint Tax Committee, revenue effect given 2006 sunset	Administration fiscal 2005 budget, tax expenditure estimate[1]	Revenue effect from eliminating sunset	
			Congressional Budget Office	Urban-Brookings Tax Policy Center
2002	1			
2003	2.1	0.9		
2004	2	1		
2005	1.9	1.1		
2006	1.8	1.2		
2007	0.9	0.7	0.6	0.6
2008	0.1		1.9	1.7
2009	0.1		1.7	1.6
2010	0.1		1.6	1.5
2011	0.1		1.4	1.6
2012			1.4	1.8
2013			1.3	1.7
2014			1.1	1.6
2015				1.5

Sources: Joint Tax Committee, Office of Management and Budget; Congressional Budget Office; authors' calculations using Urban-Brookings Tax Policy Center Microsimulation Model.

(1) Note that tax expenditure estimates do differ in certain respects from estimated revenue effects.

Table 7
Revenue Cost of Extending Saver's Credit and Making It Refundable

Billions of dollars

Fiscal Year	Extend existing credit beyond 2006	Extend and make refundable
2006	0	1.1
2007	0.6	3.8
2008	1.7	4.8
2009	1.6	4.7
2010	1.5	4.5
2011	1.6	4.3
2012	1.8	4.1
2013	1.7	4
2014	1.6	3.8
2015	1.5	3.7
Total, 2006-15	13.5	38.8

Source: Authors' calculations using Urban-Brookings Tax Policy Center Microsimulation Model.

Table 8

Effect of Making the Saver's Credit Refundable[1]
Distribution of Income Tax Change by Cash Income Class, 2005

Cash Income Class (thousands of 2003 dollars)[2]	Tax Units[3]			Percent Change in After-Tax Income[4]	Percent of Total Income Tax Change	Average Tax Change ($)	Average Federal Tax Rate[5]	
	Number (thousands)	Percent of Total	Percent with Tax Cut				Current Law	Proposal
Less than 10	20,301	14.0	3.8	0.2	8.4	-14	3.3	3.1
10-20	26,357	18.1	8.2	0.2	29.2	-36	5.4	5.1
20-30	20,537	14.1	8.1	0.2	30.6	-49	10.8	10.6
30-40	15,633	10.8	6.6	0.1	16.3	-34	14.9	14.8
40-50	11,543	7.9	4.6	0.1	7.1	-20	17.0	16.9
50-75	20,112	13.8	1.5	0.0	4.2	-7	18.9	18.9
75-100	11,773	8.1	0.3	0.0	1.0	-3	20.4	20.4
100-200	14,039	9.7	0.3	0.0	1.5	-3	22.6	22.6
200-500	3,588	2.5	0.1	0.0	0.2	-2	25.6	25.6
500-1,000	593	0.4	0.1	0.0	0.0	-1	27.6	27.6
More than 1,000	284	0.2	0.1	0.0	0.0	-2	31.1	31.1
All	145,321	100.0	4.5	0.0	100.0	-22	20.7	20.7

Source: Urban-Brookings Tax Policy Center Microsimulation Model.

(1) Baseline is current law.

(2) Returns with negative cash income are excluded from the lowest income class but are included in the totals.

(3) Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.

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

(5) Average federal tax (individual income tax, net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax) as a percentage of average cash income.

Table 9

Revenue Cost of Extending Saver's Credit and Expanding Eligibility for Top Credit Rate

Billions of dollars

Year	Extend existing credit beyond 2006	Extend and expand eligibility for 50 percent credit rate to joint filers with AGI up to		
		$50,000	$60,000	$70,000
2006	0.0	1.9	3.5	5.3
2007	0.6	6.0	10.4	15.4
2008	1.7	6.7	11.0	15.8
2009	1.6	6.3	10.4	15.1
2010	1.5	6.0	9.9	14.4
2011	1.6	6.2	9.9	14.3
2012	1.8	6.9	10.4	14.7
2013	1.7	6.6	9.9	13.9
2014	1.6	6.2	9.4	13.1
2015	1.5	5.9	8.9	12.4
Total, 2006-15	13.5	58.7	93.9	134.5

Source: Authors' calculations using Urban-Brookings Tax Policy Center Microsimulation Model.

The income cut-offs for single filers and heads of households would remain in the same proportion to the joint filer thresholds as under the current Saver's Credit

Appendix Table 1
Saver's Credit Options
Effect on Income Tax Revenues in $ Billions, 2006-2015

	Fiscal Year										
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Total 2006-2015
Current Law Baseline											
Extend Saver's Credit	0.0	-0.6	-1.7	-1.6	-1.5	-1.6	-1.8	-1.7	-1.6	-1.5	-13.5
Extend and Index	0.0	-0.7	-1.9	-2.0	-2.0	-2.3	-2.8	-2.8	-2.8	-2.9	-20.3
Extend and Make Refundable	-1.1	-3.8	-4.8	-4.7	-4.5	-4.3	-4.1	-4.0	-3.8	-3.7	-38.8
Extend, Index, and Make Refundable	-1.2	-4.0	-5.2	-5.3	-5.4	-5.3	-5.3	-5.4	-5.4	-5.5	-48.0
Extend and Increase Phaseout to $50,000	-1.9	-6.0	-6.7	-6.3	-6.0	-6.2	-6.9	-6.6	-6.2	-5.9	-58.7
Extend and Increase Phaseout to $60,000	-3.5	-10.4	-11.0	-10.4	-9.9	-9.9	-10.4	-9.9	-9.4	-8.9	-93.9
Extend and Increase Phaseout to $70,000	-5.3	-15.4	-15.8	-15.1	-14.4	-14.3	-14.7	-13.9	-13.1	-12.4	-134.5
Extend, Index, Increase Phaseout to $50,000, and Make Refundable	-3.9	-11.8	-13.0	-13.0	-13.0	-12.8	-12.7	-12.7	-12.7	-12.8	-118.5
Extend, Index, Increase Phaseout to $60,000, and Make Refundable	-5.7	-16.8	-18.0	-18.0	-18.0	-17.8	-17.6	-17.4	-17.3	-17.2	-163.9
Extend, Index, Increase Phaseout to $70,000, and Make Refundable	-7.5	-22.1	-23.2	-23.2	-23.1	-22.9	-22.7	-22.5	-22.3	-22.2	-211.8

Source: Urban-Brookings Tax Policy Center Microsimulation Model.

Appendix Table 2
Saver's Credit Options
Effect on Income Tax Revenues in $ Billions, 2006-2015

	Calendar Year										
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Total 2006-2015
Current Law Baseline											
Extend Saver's Credit	0.0	-1.7	-1.6	-1.6	-1.4	-1.9	-1.8	-1.6	-1.5	-1.4	-14.4
Extend and Index	-0.1	-1.9	-1.9	-2.0	-2.0	-2.8	-2.8	-2.8	-2.9	-2.9	-22.1
Extend and Make Refundable	-3.2	-4.8	-4.7	-4.6	-4.4	-4.1	-4.0	-3.9	-3.7	-3.6	-41.1
Extend, Index, and Make Refundable	-3.4	-5.2	-5.3	-5.4	-5.4	-5.3	-5.3	-5.4	-5.4	-5.5	-51.6
Extend and Increase Phaseout to $50,000	-5.5	-6.9	-6.4	-6.1	-5.8	-7.0	-6.7	-6.3	-6.1	-5.7	-62.5
Extend and Increase Phaseout to $60,000	-10.0	-11.3	-10.6	-10.1	-9.5	-10.6	-10.1	-9.5	-9.1	-8.7	-99.5
Extend and Increase Phaseout to $70,000	-15.0	-16.1	-15.3	-14.7	-13.9	-15.0	-14.2	-13.4	-12.7	-11.9	-142.2
Extend, Index, Increase Phaseout to $50,000, and Make Refundable	-11.1	-13.0	-13.0	-13.0	-12.9	-12.7	-12.7	-12.7	-12.8	-12.8	-126.8
Extend, Index, Increase Phaseout to $60,000, and Make Refundable	-16.2	-18.0	-18.0	-18.0	-17.9	-17.6	-17.5	-17.3	-17.3	-17.2	-175.1
Extend, Index, Increase Phaseout to $70,000, and Make Refundable	-21.5	-23.3	-23.2	-23.2	-23.0	-22.8	-22.6	-22.4	-22.2	-22.0	-226.1

Source: Urban-Brookings Tax Policy Center Microsimulation Model.

Appendix Table 3
Effect of Reforming the Saver's Credit[1]
Distribution of Income Tax Change by Cash Income Class, 2005

Cash Income Class (thousands of 2003 dollars)[2]	Tax Units[3]			Percent Change in After-Tax Income[4]	Percent of Total Income Tax Change	Average Tax Change ($)	Average Federal Tax Rate[5]	
	Number (thousands)	Percent of Total	Percent with Tax Cut				Current Law	Proposal
Less than 10	20,301	14.0	3.8	0.2	2.5	-14	3.3	3.1
10-20	26,357	18.1	9.8	0.3	10.6	-45	5.4	5.1
20-30	20,537	14.1	16.6	0.5	21.6	-117	10.8	10.4
30-40	15,633	10.8	16.8	0.4	16.8	-119	14.9	14.6
40-50	11,543	7.9	17.7	0.4	16.9	-163	17.0	16.6
50-75	20,112	13.8	17.8	0.3	29.1	-161	18.9	18.7
75-100	11,773	8.1	1.2	0.0	1.2	-11	20.4	20.4
100-200	14,039	9.7	0.6	0.0	0.8	-7	22.6	22.6
200-500	3,588	2.5	0.4	0.0	0.1	-3	25.6	25.6
500-1,000	593	0.4	0.2	0.0	0.0	-2	27.6	27.6
More than 1,000	284	0.2	0.1	0.0	0.0	-2	31.1	31.1
All	145,321	100.0	10.5	0.2	100.0	-76	20.7	20.6

Source: Urban-Brookings Tax Policy Center Microsimulation Model.

(1) Baseline is current law. Reform includes making the credit refundable, increasing the AGI limit for married couples filing jointly to $50,000, and phasing out the limit over $10,000.

(2) Returns with negative cash income are excluded from the lowest income class but are included in the totals.

(3) Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.

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

(5) Average federal tax (individual income tax, net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax) as a percentage of average cash income.

Appendix Table 4
Effect of Reforming the Saver's Credit[1]
Distribution of Income Tax Change by Cash Income Class, 2005

Cash Income Class (thousands of 2003 dollars)[2]	Tax Units[3]			Percent Change in After-Tax Income[4]	Percent of Total Income Tax Change	Average Tax Change ($)	Average Federal Tax Rate[5]	
	Number (thousands)	Percent of Total	Percent with Tax Cut				Current Law	Proposal
Less than 10	20,301	14.0	3.8	0.2	1.7	-14	3.3	3.1
10-20	26,357	18.1	9.8	0.3	7.3	-45	5.4	5.1
20-30	20,537	14.1	16.6	0.5	15.2	-120	10.8	10.3
30-40	15,633	10.8	22.9	0.6	17.5	-181	14.9	14.4
40-50	11,543	7.9	18.5	0.5	12.9	-182	17.0	16.6
50-75	20,112	13.8	27.9	0.6	40.9	-329	18.9	18.4
75-100	11,773	8.1	7.1	0.1	3.4	-46	20.4	20.4
100-200	14,039	9.7	0.9	0.0	0.8	-9	22.6	22.6
200-500	3,588	2.5	0.6	0.0	0.1	-6	25.6	25.6
500-1,000	593	0.4	0.2	0.0	0.0	-2	27.6	27.6
More than 1,000	284	0.2	0.2	0.0	0.0	-2	31.1	31.1
All	145,321	100.0	13.2	0.2	100.0	-111	20.7	20.5

Source: Urban-Brookings Tax Policy Center Microsimulation Model.

(1) Baseline is current law. Reform includes making the credit refundable, increasing the AGI limit for married couples filing jointly to $60,000, and phasing out the limit over $10,000.

(2) Returns with negative cash income are excluded from the lowest income class but are included in the totals.

(3) Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.

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

(5) Average federal tax (individual income tax, net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax) as a percentage of average cash income.

Appendix Table 5
Effect of Reforming the Saver's Credit[1]
Distribution of Income Tax Change by Cash Income Class, 2005

Cash Income Class (thousands of 2003 dollars)[2]	Tax Units[3]			Percent Change in After-Tax Income[4]	Percent of Total Income Tax Change	Average Tax Change ($)	Average Federal Tax Rate[5]	
	Number (thousands)	Percent of Total	Percent with Tax Cut				Current Law	Proposal
Less than 10	20,301	14.0	3.8	0.2	1.3	-14	3.3	3.1
10-20	26,357	18.1	9.8	0.3	5.5	-45	5.4	5.1
20-30	20,537	14.1	16.6	0.5	11.5	-120	10.8	10.3
30-40	15,633	10.8	24.0	0.7	15.7	-216	14.9	14.3
40-50	11,543	7.9	24.7	0.6	11.4	-212	17.0	16.5
50-75	20,112	13.8	29.2	0.8	37.0	-395	18.9	18.3
75-100	11,773	8.1	26.5	0.4	16.1	-293	20.4	20.1
100-200	14,039	9.7	1.6	0.0	1.1	-17	22.6	22.6
200-500	3,588	2.5	0.7	0.0	0.1	-8	25.6	25.6
500-1,000	593	0.4	0.3	0.0	0.0	-4	27.6	27.6
More than 1,000	284	0.2	0.2	0.0	0.0	-3	31.1	31.1
All	145,321	100.0	15.6	0.3	100.0	-148	20.7	20.5

Source: Urban-Brookings Tax Policy Center Microsimulation Model.

(1) Baseline is current law. Reform includes making the credit refundable, increasing the AGI limit for married couples filing jointly to $70,000, and phasing out the limit over $10,000.

(2) Returns with negative cash income are excluded from the lowest income class but are included in the totals.

(3) Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.

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

(5) Average federal tax (individual income tax, net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax) as a percentage of average cash income.

J. Mark Iwry
1775 Massachusetts Avenue, N.W.
Washington, D.C. 20036-2188

Dear Mr. Iwry:

This general information letter responds to your request, dated December 15, 2003, for information regarding the use of automatic compensation reduction elections (also known as "automatic enrollment"), as described in Revenue Rulings 2000-8, 2000-1 C.B. 617, and 2000-35, 2000-2 C.B. 138 (the "Rulings"); Announcement 2000-60, 2000-2 C.B. 149; and section 1.401(k)-1(a)(3)(ii) of the Proposed Income Tax Regulations.

Section 3.06 of Revenue Procedure 2004-4, 2004-1 I.R.B. 125, describes a general information letter as a statement issued by the Internal Revenue Service that calls attention to a well-established interpretation or principle of tax law without applying it to a specific set of facts.

As used in this general information letter, the terms "automatic compensation reduction election" (in contrast to an "affirmative election"), "compensation reduction contribution," and "compensation reduction percentage" are intended to have the same meanings those terms have when used in Revenue Ruling 2000-8.

The compensation reduction percentage pursuant to an automatic compensation reduction election under an Internal Revenue Code ("Code") section 401(k) plan or a Code section 403(b) tax-sheltered annuity or custodial account is permitted to be any percentage of compensation that would be permitted in the case of an elective contribution or elective deferral made pursuant to an affirmative, explicit election (i.e., in which the default is no elective contribution or elective deferral). Accordingly, there is no special maximum limit on the automatic compensation reduction percentage and no safe harbor automatic compensation reduction percentage. The holdings in the Rulings therefore would be equally applicable to each of the plans described in the Rulings if the automatic compensation reduction percentage under the plan were any percentage greater or less than the percentages specified in the Facts sections of the Rulings. Thus, for example, the automatic compensation reduction percentage need not be limited to the percentage of compensation that limits, under the plan, the amount of elective contributions or elective deferrals that are matched by employer matching contributions. Of course the amount of an elective contribution or elective deferral is subject to the limitations imposed under or as a result of sections 401(a), 401(k)(3), 402(g), 403(b), 415, and any other applicable provision of the Code.

The analysis and the holdings in the Rulings would be equally applicable to the plans described in the Rulings if the automatic compensation reduction percentage under each plan increased or otherwise changed over time, pursuant to a specified schedule. However, this would be the case only if the notices provided to employees (explaining

the automatic compensation reduction election and the employee's right to elect to have no such compensation reduction contributions made to the plan or to alter the amount of those contributions, including the procedure for exercising that right and the timing for implementation of any such election) described the amounts and timing of any planned changes to the automatic compensation reduction percentage.

The analysis and the holdings in the Rulings would be equally applicable to the plans described in the Rulings if the automatic compensation reduction election under each plan, or an increase in the automatic compensation reduction percentage, applied in part or in whole to one or more future increases in or supplements to compensation (including pay raises and bonuses) or if the automatic compensation reduction election or increase in percentage was conditioned on or scheduled to take effect at the time of such compensation increases or supplements. However, this would be the case only if each of the notices provided to employees (explaining the automatic compensation reduction election and the employee's right to elect to have no such compensation reduction contributions made to the plan or to alter the amount of those contributions, including the procedure for exercising that right and the timing for implementation of any such election) described how the automatic compensation reduction election would apply to any such future compensation increases or supplements.

We hope this general information will be helpful to you. However, the information provided in this letter is not a ruling and may not be relied on as such.

If you have any questions concerning this letter, please contact Susan Taylor, ID # 50-07189 at (202) 283-9640.

Sincerely,

Frances V. Sloan
Manager, Employee Plans
Technical Group 3

J. Mark Iwry

Mark Iwry is Senior Adviser to the Retirement Security Project, a Nonresident Senior Fellow at the Brookings Institution, and former Benefits Tax Counsel at the U.S. Treasury Department from 1995 to 2001, serving as the principal Executive Branch official directly responsible for tax policy and regulation relating to the Nation's tax-qualified pension and 401(k) plans and other employee benefits. He practices law with the firm of Sullivan & Cromwell, specializing in pensions, compensation and benefits, and is a Research Professor in Public Policy at Georgetown University.

Mr. Iwry has often testified before congressional committees – representing the Treasury and Executive Branch and, since leaving government, testifying as an independent expert. He was formerly a partner in the law firm of Covington & Burling, and has chaired the D.C. Bar Employee Benefits Committee, co-authored a volume on 401(k) plans, served on the White House Task Force on Health Care Reform, addressed more than 250 professional, industry and other groups in the US and abroad, and serves on panels of experts advising the GAO, the National Academy of Social Insurance, and other public- and private-sector organizations on pensions and retirement savings.

A principal architect of the Saver's Credit to expand 401(k) and IRA coverage of moderate- and lower-income workers (claimed on 5.3 million tax returns in each of 2002 and 2003) and the "SIMPLE" 401(k)-type plan (covering an estimated 2 million workers), Mr. Iwry was also centrally involved in developing the sweeping Presidential proposals to expand retirement security and coverage through "Universal Savings Accounts" and related provisions (1999-2000). Under his direction, Treasury formulated and carried out a broad, integrated strategy to increase saving and coverage by – in addition to designing the Saver's Credit and the SIMPLE – approving and promoting 401(k) automatic enrollment and initiating automatic rollover to curtail pension leakage. He also was instrumental in improving oversight of the PBGC by its Board of Directors and the Executive Branch. Mr. Iwry initiated or orchestrated many other significant improvements and simplifications of the Nation's pension and health care system.

While in government, Mr. Iwry was widely recognized for his work with the business, financial, professional and nonprofit communities to expand coverage while simplifying and rationalizing pension and benefits law and regulation. In 2001 he received the Secretary of the Treasury's Exceptional Service Award "[i]n recognition of his outstanding leadership and accomplishments ….Widely respected as Treasury's benefits and pension expert, Mr. Iwry excelled at building coalitions of diverse interests… His technical acumen and leadership have garnered praise from colleagues within Treasury, the IRS, the Congress, and the employee benefits community at large."

At Treasury, he was credited with promoting an open regulatory process, actively drawing on a wide spectrum of private sector advice and feedback, including town hall meetings with benefits professionals and others around the country. Mr. Iwry received a special award from the IRS (Office of Chief Counsel) "[i]n recognition of the collegial working relationship you have fostered between [Treasury] and the IRS Office of Chief Counsel and of your many contributions to our nation's tax system."

He regularly advises Members of Congress and congressional staff on both sides of the aisle, and his views are frequently reported in the major media and trade press. Mr. Iwry is an honors graduate of Harvard College and Harvard Law School, has a Master of Public Policy degree from Harvard's Kennedy School of Government, is a Fellow of the American College of Employee Benefits Counsel, and is a member of the bar of the United States Supreme Court.