Testimony of J. Mark Iwry[1]

Before the Special Committee on Aging
United States Senate

April 12, 2005

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

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

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

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

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

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

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

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

A. Taxpayers' Current Investment in Private Pensions

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

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

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

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

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

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

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

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

[5] Board of Governors, United States Federal Reserve System, Statistical Release Z.1, Flow of Funds Accounts of the United States (March 6, 2003), tables L.119, 120. This rough figure is as of the end of 2002. It excludes amounts rolled over from plans to IRAs as well as other IRA balances. It is unclear how much of these accumulated assets in retirement plans represent net national saving (private saving plus public saving), because this dollar amount has not been adjusted to reflect the public dissaving attributable to government tax expenditures for pensions or to reflect any household debt or reduction in other private saving attributable to these balances. See Eric Engen and William Gale, "The Effects of 401(k) Plans on Household Wealth: Differences Across Earnings Groups." NBER Working Paper No. 8032 (Cambridge, Mass.: National Bureau of Economic Research, December 2000).

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

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

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

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

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

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

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

> "First, tax preferences should create incentives for expanded coverage and new saving, rather than merely encouraging individuals to reduce taxable savings or increase borrowing to finance saving in tax-preferred form. Targeting incentives at getting benefits to moderate- and lower-income people is likely to be more effective at generating new saving….
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> "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

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[8] Treasury 1999 Testimony, page 3.
[9] See Engen and Gale (2000) and Daniel Benjamin, "Does 401(k) Eligibility Increase Saving? Evidence from Propensity Score Subclassification," *Journal of Public Eonomics* 87, no. 5-6 (2003): 1259-90.

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

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

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

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

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

The income tax incentive approach, as currently structured, thus reflects a mismatch between subsidy and need. The tax preferences tend to encourage saving least for those who most need to save more to provide for basic needs in

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

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

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

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

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

Reflecting these structural deficiencies, the nation's pension system betrays several serious shortcomings. First, only half of workers are covered by an employer-based pension plan in any given year, and participation rates in IRAs are substantially lower. Second, even workers who participate in tax-preferred retirement saving plans rarely make the maximum allowable contributions. Only 5 percent of 401(k) participants make the maximum contribution allowed by law, and only 5 percent of those eligible for IRAs make the maximum allowable contribution.[13] Third, despite the shift from defined benefit to defined contribution plans, many households approach retirement with meager defined contribution balances.[14] The median 401(k) and other defined contribution (including IRA)

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

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

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

balance among all households ages 55 to 59 was only $10,000 in 2001. Excluding the 36 percent of households who had no IRA or defined contribution plan account, the median balance for this age group was still only $50,000.

D. Targeting Incentives More Effectively to Promote Savings and Security

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

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

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

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

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

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

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

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

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

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

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

Conventional analyses tend to describe this solely as a trend away from defined benefit plans and toward defined contribution plans. Such a characterization tends to focus attention on the increased portability of pensions from one job to another and the shifting of investment risk from employer to employee. But perhaps an even more fundamental development is the extent to which the accumulation of retirement benefits under the plan has come to depend on active and informed worker self-management and initiative. Traditional defined benefit and profit-sharing plans require the covered workers to make almost no

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

important financial choices for themselves before retirement.[19] The firm enrolls all eligible workers within a defined classification, makes contributions on their behalf, and decides how to invest those contributions (or retains professional investment managers to do so). A worker's only real choices are when and in what form to collect benefits. In 401(k)-type plans, in contrast, the burden of all these decisions rests with the employee.

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

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

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

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

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

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

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

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

A. In General

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

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

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

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

B. Basic Design and Evolution

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

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

C. Higher Matching Rates for Lower-Income Savers

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

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

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

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

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

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

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

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

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

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

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

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

D. Enhancement of Employer-Sponsored Plans

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

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

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

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

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

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

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

E. Effects of the Saver's Credit

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

1. Eligibility.

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

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

[29] IRS Announcement 2001-106.

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

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

2. Usage

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

3. Effects on Private Saving

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

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

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

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

F. Options for Expansion

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

1. Eliminating the 2006 Sunset

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

2. Making the Credit Refundable

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

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

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

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

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

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

3. Expanding Eligibility to More Middle-Income Households

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

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

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

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

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

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

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

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

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

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

III. Automatic Enrollment and Escalation of Contributions

A. Factors That Discourage 401(k) Participation

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

C. Automatic Enrollment

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

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

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

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

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

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

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

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

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

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

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

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

D. Automatic Escalation

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

E. Automatic Investment

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

F. Automatic Rollover

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

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

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

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

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

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

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

G. Other Potential Automatic Arrangements

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

IV. Automatic Investment

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

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

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

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

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

A. Sources of the Problem

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

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

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

B. Current Policy Responses

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

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

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

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

C. A General Strategy

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

1. Standard Investments

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

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

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

2. Managed Accounts

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

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

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

D. Policy Strategies Targeted More Specifically to Employer Stock

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

1. "Crowdout" of Employer Stock

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

2. Diversification Safe Harbor for Plan Sponsors

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

3. "Sell More Tomorrow"

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

4. Threshold Approach

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

E. Autoinvestment in General

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

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

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

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

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

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

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

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

A. Preliminary Matters

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

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

B. Cash Balance Conversion Relief and Employer Flexibility

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

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

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

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

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

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

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

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

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

C. Possible Framework for a Legislative Solution

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

D. Building Blocks for Constructing Conversion Safe Harbors

1. In General

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

2. Full Protection of Benefit "Expectations"

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

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

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

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

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

3. Preventing the Worst of Both Worlds

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

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

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

4. Preventing Wearaway

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

E. Conversion Safe Harbors

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

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

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

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

1. Full Protection of “Expected” Benefits

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

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

2. Preservation of Pre-Conversion Rate of Accrual

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

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

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

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

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

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

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

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

5. Safety Valve Facts and Circumstances Determination

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

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

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

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F. Treasury’s Legislative Proposal

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

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

1. Basic Elements

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

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

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

2. Comments

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

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

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

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

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

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

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

G. Dealing With Past Conversions

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

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

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

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

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

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

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

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

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

* * *

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

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

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

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

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

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

Table 1

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

Dollars except where stated otherwise

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

Source: Authors' calculations.

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

Table 4
Eligibility for 50 Percent Credit Rate

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

Source: Urban-Brookings Tax Policy Center Microsimulation Model.

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

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

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

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