



AUTOMATIC IRAS:

**ARE THEY ADMINISTRATIVELY FEASIBLE, WHAT ARE
THE COSTS TO EMPLOYERS AND THE FEDERAL
GOVERNMENT, AND WILL THEY INCREASE
RETIREMENT SAVINGS?**

A Preliminary Report Prepared for AARP

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TABLE OF CONTENTS

	<u>Page</u>
INTRODUCTION	1
I. SUMMARY AND CONCLUSIONS	4
II. OVERVIEW OF SAVINGS BEHAVIOR IN THE UNITED STATES	15
A. Availability of and Participation in Qualified Retirement Plans and IRAs.....	15
1. Access to qualified retirement plans by type of plan	15
2. Participation rates in defined benefit plans and 401(k) plans	16
3. Small employer qualified plan prevalence and participation rates	17
4. Statistics on IRA participation	19
B. Savings Behavior by Income Levels.....	20
1. Distributional picture of qualified plan savings	20
2. Total savings in the presence of qualified plan savings	23
3. Low income savers.....	24
C. Adequacy of Retirement Income Replacement Rates Under Current Law	27
1. Qualified retirement plans.....	29
2. Social Security	30
3. Individuals without qualified retirement plans.....	31
D. Current Law Impediments to Saving Through Qualified Plans.....	31
1. Costs to employers of setting up and maintaining qualified plans	32
2. Difficulty with 401(k) plans of getting employees to participate, particularly at low income levels	34
3. Low income individuals do not have discretionary income for for retirement savings	34
E. Effect of Current Law Incentives on Savings Behavior.....	35
1. Automatic 401(k) enrollment increases participation rates.....	35
2. Savers Credit	36

	<u>Page</u>
III. MAJOR STRUCTURAL ISSUES	41
A. The Role of the Federal Government in Establishing Automatic IRA Accounts and Handling the Recordkeeping Necessary to Track Automatic IRA Contributions, Investments, and Accounts	41
B. Choices Create Complexity.....	42
C. The Problem of Small Annual Automatic IRA Contributions.....	44
D. Effect of the Automatic IRA Proposal on the Incentives to Establish Or Continue to Maintain Qualified Retirement Plans.....	45
 IV. TECHNICAL ANALYSIS OF A PROPOSAL TO MAKE AUTOMATIC IRAs AVAILABLE TO EMPLOYEES WHO ARE NOT ELIGIBLE TO PARTICIPATE IN EMPLOYER-SPONSORED QUALIFIED RETIREMENT PLANS	47
A. Current Law	47
1. Overview of qualified retirement plans	47
2. Automatic enrollment in 401(k) plans	49
3. Saver’s Credit.....	50
4. Employer Federal tax deposit requirements	52
B. Automatic IRA Proposal.....	54
1. Overview of the Automatic IRA proposal	54
2. Eligible employees.....	57
3. Employers required to offer Automatic IRAs.....	60
4. Tax treatment and character of Automatic IRA accounts.....	61
5. Payroll deposit processing	63
6. Cost containment measures.....	70
7. Employer fiduciary issues.....	71
8. Employer tax credit.....	72
9. Self employed and others with no employer.....	74
10. Transition issues.....	74
 V. ANALYSIS OF COSTS OF THE AUTOMATIC IRA PROPOSAL	76
A. Costs to Employers	76
1. Overall administrative costs of establishing Automatic IRAs.....	76
2. Effect of potential employer tax credits.....	78
B. Costs to Employees	78

	<u>Page</u>
C. Revenue Costs	79
VI. ANALYSIS OF EXTENT TO WHICH AUTOMATIC IRAS WILL INCREASE	
RETIREMENT SAVINGS	81
A. In General	81
B. By Income Levels	81
Appendix A. – Profile of Likely Automatic IRA Participants	83
1. Qualitative description	83
2. Quantitative description	85
Appendix B. – Sample Account Balances	88

LIST OF GRAPHS

		<u>Page</u>
Graph 1	Percent of Workers with Access to Retirement Plans, by Size of Establishment.....	15
Graph 2	Percent of Workers with Access and Participating in Retirement Plans, by type of plan	16
Graph 3	Distribution of Employment and Establishments, by Firm Size, Year Ending 2003	17
Graph 4	Distribution of All Defined Contribution Plans, by Employer Size	18
Graph 5	Workers with Access and Participating in Retirement Plans, Firms with 1 to 99 Workers.....	19
Graph 6	Taxpayers with Pension Coverage, IRA Eligibility and IRA Participation, Tax Year 2002	20
Graph 7	Individual Income Taxpayers with Private Pensions, by Adjusted Gross Income.....	21
Graph 8	Distribution of Individual Income Taxpayers with Pensions as a percent of All Taxpayers, by Adjusted Gross Income	21
Graph 9	Eligible Taxpayers and Taxpayers Contributing to All IRAs, by AGI, Tax Year 2002.....	22
Graph 10	Eligible Taxpayers and Taxpayers Contributing to All IRAs, by AGI, Tax Year 2002.....	23
Graph 11	Personal Savings as a Percentage of Disposable Income, Years 1960 to 2005.....	24
Graph 12	Traditional IRA Contributions, as a Percent of Total Taxpayers Contributing and Total Contributions, AGI less than \$50,000, Tax Year 2002.....	25
Graph 13	Roth IRAs Contributions, as a Percent of Total Taxpayers Contributing and Total Contributions, AGI less than \$50,000, Tax Year 2002	25
Graph 14	Taxpayers with Pensions, as a Percent of Total Taxpayers with Pensions, AGI less than \$50,000, Tax Year 2002	26
Graph 15	Composition of Retirement Income.....	28
Graph 16	401(k) Plan Record keepers, 2005 Plan Year	33
Graph 17	Percentage of Plans with Automatic Enrollment, by Plan Size	35
Graph 18	Percent of 401(k) Plans Offering Automatic Enrollment	36
Graph 19	Distribution by Filing Status of Returns Claiming a Retirement Saving Contribution Credit, Tax Year 2004	37
Graph 20	Estimated Account Balances for Selected Annual Contribution Amounts.....	88

INTRODUCTION

Over the last 20 years, the rate of personal savings in the United States has followed a steady downward trend. In 2004, individuals in the United States dissaved, or spent more than they earned, at the rate of -0.4 percent of their personal income.

In addition, there is evidence that retirement saving by individuals will be inadequate to meet the needs for post-retirement income. Currently, the average income of individuals over age 65 in the United States is \$22,918 and the median income is \$14,650.¹ Social Security is the most prevalent form of retirement income for retired individuals. Projections suggest that if each worker began saving an additional five percent of compensation from 2003 until retirement age, significant percentages of individuals could be expected to have sufficient retirement resources.²

The problems with saving for retirement are particularly acute among lower wage workers, who are far more likely to rely solely on Social Security as their sole source of retirement income and less likely to have pension coverage. Savings rates tend to positively correlate with income; therefore, the larger an individual's current income, the more likely it is the individual will save for retirement. In addition, participation in an employer-sponsored retirement plan also correlates positively with income.

Historically, an important source of retirement savings has been the voluntary employer-based retirement plan system. Employers traditionally maintained defined benefit plans providing annuity income for life after retirement and employees who qualified to participate in the plan accrued retirement benefits without taking any specific action. The traditional American workforce tended to be stable with little job mobility and a defined benefit pension plan fit well with these demographics. However, the typical U.S. worker today has become far more mobile and employers have shifted away from traditional defined benefit pension plans to reduce their costs. Since the early 1980's, there has been a significant growth in the adoption of 401(k) plans. As employers have terminated their defined benefit plans and adopted more 401(k) plans, the onus of saving for retirement has shifted more to individual workers. Most 401(k) plans have historically required individuals to take affirmative action in order to participate in the plan, making the individual responsible not only for the decision to participate in the plan, but also making the individual responsible for selecting the level of contributions to the plan.

Statistics show that a significant percentage of individuals who are eligible to participate in a 401(k) plan do not actually participate. One study (TIAA-CREF) attributes this behavior to 3 factors: (1) individuals tend to procrastinate, particularly with respect to difficult decisions, (2) individuals tend not to be smart investors, do not understand how much they need to save, and can be intimidated by the variety of investment options

¹ VanDerhei, Jack, Craig Copeland, and Dallas Salisbury. *Retirement Security in the United States. Current Sources, Future Prospects, and Likely Outcomes of Current Trends*. Employee Benefits Research Institute. 2006.

² Id.

available to them, and (3) individuals have a tendency to value current consumption more than future consumption (hyperbolic discounting).³

A new trend in 401(k) plans has been to adopt automatic enrollment provisions that require an employee to take affirmative action not to participate in the plan. Studies have demonstrated that automatic enrollment 401(k) plans increase participation rates quite dramatically.⁴ Automatic enrollment flips an employee's tendency toward inertia so that an employee must take positive action NOT to save. Automatic contribution escalators are also used to overcome inertia and increase the amount of savings.

There is evidence to suggest that automatic 401(k) enrollment will improve the retirement savings of a significant percentage of American workers. However, there remain a substantial number of American workers who are not eligible to participate in an employer-based retirement plan. These workers tend to be lower income and have much greater job turnover. While many of these workers are eligible to contribute to Individual Retirement Arrangements (IRA), significant percentages of them do not.

The Automatic IRA presents a novel approach to the problem of individuals who do not qualify to participate in an employer-based retirement plan and who could participate in an IRA if offered in the workplace, but currently do not make contributions on their own. The theory behind Automatic IRAs is to create a vehicle that will overcome the savings inertia for employees who aren't otherwise eligible to participate in an employer's retirement plan. By implementing a system of payroll deduction at the employer level and making the employee act affirmatively NOT to save, the idea is that many more individuals will become retirement savers.

The Automatic IRA is a concept proposed by Mark Iwry of the Brookings Institution and David John of the Heritage Foundation. They have presented their conceptual approach to the Automatic IRA in two papers – a working draft dated February 12, 2006, and testimony for the Subcommittee on Long-Term Growth and Debt Reduction of the Senate Committee on Finance on June 29, 2006.⁵ In addition, at least two bills have been introduced in the U.S. Congress that would establish an Automatic IRA program.⁶

We have been asked to analyze the feasibility of the Automatic IRA proposal and to explore fully the problems that may be presented when trying to implement such a plan. As part of our research, we have considered the demographics of individuals who do not save under current law. In addition, we have attempted to provide an in-depth analysis of

³ Lord, Mimi, CFA, CFP, Associate Director, TIAA-CREF Institute. "Trends and Issues. Capitalizing on Inertia: Automation Boosts Retirement Savings." TIAA-CREF Institute. June 2006.

⁴ See the discussion in part III, E., 1, below.

⁵ Iwry, J. Mark and David C. John, *Pursuing Universal Retirement Security Through Automatic IRAs*. Iwry-John Working Paper – Draft of February 12, 2006. Iwry, J. Mark and David C. John, *Congressional Testimony, Pursuing Universal Retirement Security Through Automatic IRAs*. Testimony before the Subcommittee on Long-Term Growth and Debt Reduction, Committee on Finance, United States Senate, June 29, 2006.

⁶ The companion bills are S. 3952, introduced by Senators Bingaman and Smith on September 27, 2006, and H.R. 6210, introduced by Mr. English on September 27, 2006.

the Automatic IRA proposal, including (1) exploring the broad policy issues as well as the technical implementation issues of an Automatic IRA proposal and (2) considering the effect that Automatic IRAs may have on retirement savings specifically and overall savings in general. Finally, we have examined the possible Federal tax revenue implications of the proposal. The results of our research follow.

I. SUMMARY AND CONCLUSIONS

This report explores the feasibility of a proposal to utilize employment-based saving through individual retirement arrangements (IRAs) to improve the rate at which American workers save for retirement. This approach, referred to as Automatic IRAs, would require employers to make payroll deduction IRAs available to their employees who are not eligible to participate in a retirement plan of the employer.

The conceptual description of the Automatic IRA proposal is contained in two source documents. Iwry, J. Mark and David C. John, *Pursuing Universal Retirement Security Through Automatic IRAs*. Iwry-John Working Paper – Draft of Feb. 12, 2006. John, David C. and J. Mark Iwry, *Testimony before the Subcommittee on Long-Term Growth and Debt Reduction, Committee on Finance, United States Senate, June 29, 2006, Pursuing Universal Retirement Security Through Automatic IRAs*. The Heritage Foundation and The Retirement Security Project. In addition, bills have been introduced in the House of Representatives and the Senate that are based on the conceptual Automatic IRA proposal developed by Iwry and John. These bills are S.3952, introduced on September 27, 2006, by Senators Bingaman and Smith and H.R. 6210, introduced on September 27, 2006, by Mr. English. In addition, the Automatic IRA proposal was part of S. 3951, “The Women’s Retirement Security Act of 2006,” introduced on September 27, 2006, by Senators Smith, Conrad, Kerry, and Bingaman.

We believe that Automatic IRAs offer an intriguing approach to making retirement saving more automatic for working Americans. Although we believe that it is possible to design an Automatic IRA proposal that is administrable, critical to the success of such a proposal is strong centralized reporting and recordkeeping. Further, there are significant structural and implementation issues that should be carefully considered before an Automatic IRA proposal is enacted.

In this section, we briefly summarize the results of our research, including (1) the problems that have led to the development of the Automatic IRA proposal, (2) the major issues that need to be addressed in developing the Automatic IRA proposal and the problems that will be faced attempting to implement the proposal, (3) the employers and individuals who will be affected by the Automatic IRA proposal, (4) the costs to employers, employees, and the Federal government of the proposal, and (5) how the proposal might affect retirement savings.

Retirement savings in the United States remains inadequate

The United States has become a country of dissavers. Personal savings rates, particularly retirement savings rates, are too low. In 2005, Americans dissaved (i.e., spent more than their income) at a rate of -0.4 percent. As Social Security continues to be a significant source of retirement savings, especially among lower income individuals, it appears that many individuals will not have adequate income in their retirement years.

Access to employer retirement plans remains fairly constant and is positively correlated with income and size of employer. Thus, higher income individuals working for large employers are significantly more likely to be saving for retirement. Conversely, savings rates drop as income goes down. The evidence suggests that retirement savings will be inadequate for substantial numbers of older individuals.

Social Security continues to be the most prevalent form of retirement income for older Americans and constitutes 43 percent of overall retirement income, while pensions represent only 19 percent of retirement income. Nearly two-thirds of current Social Security recipients receive more than 50 percent of their retirement income from Social Security. Social Security is a much greater source of retirement for lower earning individuals, replacing about 60 percent of pre-retirement income.

The replacement rates for qualified retirement plans are difficult to calculate because of worker job mobility. But a look at the statistics of qualified plan availability helps to focus on the inadequacy of qualified plans under current law.

Access to and participation in retirement plans and IRAs

Since the 1980's, the percentage of workers participating in qualified employer retirement plans has remained fairly stable, hovering around 50 percent. Currently, 62 million of 115.4 million paid workers in the United States participate in a private pension plan.⁷ Of the workers with access to a retirement plan through their employer, 78 percent have access to a defined contribution plan compared to 44 percent with access to a defined benefit plan. Overall 85 percent of workers with access to a retirement plan participate in the plan; this percentage drops to 80 percent for defined contribution plans and drops further for participation in 401(k) plans, a very common form of retirement plan for employers to maintain.

A substantial percentage of U.S. workers are employed by small firms. More than 50 percent of workers are employed in firms with less than 500 employees. Fully 24 percent of the U.S. workforce is employed in firms with less than 50 employees.

Small firms are much less likely to make a qualified retirement plan available to employees. In firms with less than 100 employees, only 9 percent of employees have access to a defined benefit plan of their employer and only 41 percent have access to a defined contribution plan. Only 37 percent of workers in these firms actually participate in a qualified retirement plan of their employer.

In addition to firm size, income is a strong predictor of retirement plan participation. Using IRS-linked W-2 data, a distribution of pension participation by adjusted gross income (AGI) levels is possible. Of the 28.1 million taxpayers with AGI from \$10,000 to \$20,000, only 5.1 million (18 percent) have pension coverage. On the other hand, 55.8

⁷ See the Bureau of Labor Statistics, Pension and Welfare Benefits Administration and National Compensation Survey 2006.

percent of the 15.6 million taxpayers with AGI from \$100,000 to \$200,000 have pension coverage.

Individual retirement arrangement (IRA) data shows similar patterns. Nearly 80 percent of all taxpayers are eligible to make contributions to an IRA, but the actual participation rate is approximately 11 percent. Of the 20.2 million taxpayers with AGI of \$10,000 to \$20,000 eligible to make IRA contributions, less than 1 million (less than 5 percent) actually made such contributions, compared to 21 percent of eligible taxpayers in the \$100,000 to \$200,000 range.

Impediments to retirement savings

A variety of factors affect the rate of retirement savings in the United States – the costs of establishing and maintaining qualified retirement plans influences the willingness and ability of small business owners to set up plans for their employees; many employees have access only to a 401(k) plan in which the employee must take affirmative action to save for retirement; and many lower income individuals lack the discretionary income to save for retirement.

Costs to employers of setting up and maintaining qualified plans are cited as a major reason why small employers do not establish retirement plans. One study found qualified plan administrative costs ranged from \$24 to \$60 per participant per year. Larger employers face lower per employee costs because of economies of scale. Thus, smaller employers face higher per employee costs to make qualified plans available to their workers.

Many workers have access only to 401(k) plans and participation rates can be low, even with an employer match. 21.8 percent of 401(k) plan participants did not contribute enough to their 401(k) plan to fully utilize the employer match.

Low income individuals lack sufficient discretionary income to save for retirement. Participation and saving in defined contribution plans increases significantly for workers with income over \$30,000, but 35 percent of U.S. households have incomes below that level.

Automatic enrollment 401(k) plans improve retirement savings

A new trend in retirement savings – the automatic enrollment 401(k) plan – appears to significantly improve the rates of participation and saving in these plans. Studies have demonstrated the significant positive effect on participation of automatic 401(k) plan enrollment. A Hewitt survey found that participation increased from 75 percent to 85 and 95 percent in 401(k) plans adopting automatic enrollment features. A Profit Sharing Council of America survey found that enrollment in 401(k) plans increased from 68 percent to 77 percent with automatic enrollment. A further study (Choi, Laibson, and Madrian) found that automatic enrollment not only increased participation initially, but also retained the increased participation over time. Under that study, after 3 years, 401(k)

participation was 30 percent higher for those hired after automatic enrollment was implemented.

Automatic IRAs

A new proposal would build on the automatic enrollment 401(k) plan concept and introduce Automatic IRAs for individuals who are not eligible to participate in an employer's retirement plan. Under an Automatic IRA, retirement saving would occur through regular payroll deductions with an individual's employer and the amounts withheld would be contributed to IRAs that are selected by employees or a default account offered by an employer. The proposal contemplates two types of Automatic IRAs – a payroll deposit IRA (or “opt in” approach) under which an employee elects to have amounts withheld from the employee's pay and deposited in an IRA and an automatic enrollment IRA (or “opt out” approach) under which an employee is deemed to have elected to participate unless a specific election not to participate has been made. We use the term “Automatic IRA” to refer to both of these scenarios.

Under the “opt in” approach, employees would be required to elect whether or not to have amounts withheld from pay and contributed to IRAs. The “opt out” arrangement would be pure automatic enrollment so employees who fail to elect out would have a default amount withheld from pay and contributed to an IRA established for the employee.

Amounts withheld from employees' pay would be transmitted to the IRA an employee designates or, if no designation is made, to a default IRA selected by the employer. Employees would be allowed to select from a variety of investment options, but a default investment option would apply if an employee failed to make a specific election.

The proposal contemplates use of the existing payroll tax deposit and reporting system to help with the administration of the Automatic IRA proposal. Thus, the proposal suggests that notices to employees could be provided as part of the Form W-4 (Employee's Withholding Allowance Certificate) and deposits of employee IRA contributions would be made at the same time as Federal employment tax deposits, but no less frequently than monthly. Under the proposal, deposits would be made either to an IRA selected by an employee or a default IRA if the employee does not elect one. The introduced bills create the TSP II Board, a Federal entity similar to the Federal Retirement Thrift Investment Board, to assist in the administration of the proposal. Finally, Automatic IRAs would be required to have default investment options, which would include a variety of funds depending upon the employee's age; the proposal states that employees would have to make an affirmative election to move from the default investment.

Feasibility of Automatic IRAs

Our research explored the feasibility of Automatic IRAs as an approach to improving retirement savings for those American workers who do not have access to a workplace retirement plan. Our findings indicate that Automatic IRAs using employer-based withholding can work, but there are a number of thorny administrative issues that must be addressed. Further, some of these issues could be difficult to resolve.

We believe that there are three major issues in the development of an administrable Automatic IRA proposal:

1. Strong centralized recordkeeping and reporting are vital to the success of the Automatic IRA proposal. The introduced bills create a new TSP II Board in the Federal government, building on the Federal Thrift Savings Plan model. In order to be effective, the TSP II Board should set up system of recordkeeping and reporting that is, at a minimum, similar to what is done for Federal employees through the Federal Thrift Savings Plan. Employees should have online access to all information about their Automatic IRA contributions.
2. The Automatic IRA rules should be as simple as possible for employees, minimizing choices to only those that are critical to administrability. Consideration should be given to identifying the tax character of the accounts as traditional or Roth, but not both. Consideration should also be given to limiting the choices of service providers (e.g., those identified by the TSP II Board) and investments. The demographics of the group of individuals who are likely to be eligible for the Automatic IRA proposal suggests that these are individuals who are not likely to be savvy consumers and a multitude of choices may reduce the likelihood of these individuals saving through Automatic IRAs.
3. To reduce the potential adverse effects of administrative costs on employers and employee account balances and to reduce the potential for multiple IRA accounts being created for individuals, consideration should be given to pooling IRA contributions until individual employees build up a minimum balance.

We believe that strong centralized reporting and recordkeeping is the single most important factor in developing an administrable Automatic IRA proposal. This function could be performed at the Federal government level; the introduced bills suggest a strong Federal role in the administration of Automatic IRAs, but do not clearly delineate the amount of reporting and recordkeeping that would be required.

We note that some consideration should also be given on the possible effect of Automatic IRAs on an employer's willingness to establish or maintain a qualified plan. While the authors of the proposal have suggested that Automatic IRAs might be an approach that leads employers to adopt a qualified plan, we note that Automatic IRAs might also reduce employee demand for a qualified plan and might cause some small employers to defer or forgo the adoption of a qualified retirement plan for employees.

Employers required to make Automatic IRAs available to employees

Based on the introduced bills, employers with 10 or more employees who received at least \$5,000 in compensation in the preceding calendar year and employers who have been in existence for at least 2 years or who had at least 100 employees who received at least \$5,000 in compensation on any day of the preceding two calendar years are required to make Automatic IRAs available to their employees.

The following employers would not be required to offer Automatic IRAs to their employees: Federal, state and local government employers and employers that are churches or conventions or associations of churches.

Several issues arise with the definition of employers subject to the Automatic IRA proposal. First, in the case of employers in industries with very high turnover rates, employees may not work long enough for an employer to accrue any significant IRA contributions. Further, some high turnover industries (e.g., hospitality and leisure) could have large numbers of employees opt out of participation because they will be younger and lower wage employees. In these types of scenarios, the administrative costs to employers of the Automatic IRA proposal may be high relative to the increased retirement savings that occurs.

A separate issue is whether the appropriate threshold for an employer to be subject to the Automatic IRA proposal is fewer than 10 employees. This threshold excludes approximately 11 percent of workers (12.5 million) from Automatic IRAs unless an employer elects to offer them to employees. The fewer than 10 employee threshold corresponds with employers least likely to be utilizing electronic payroll processing. The proposal suggests that employers with electronic payroll processing may have fewer problems complying with the Automatic IRA requirements.

Finally, the Automatic IRA proposal includes an employer tax credit that is designed to help defray the administrative costs of the proposal for small employers. However, employers who are tax exempt or not in a taxpaying position will not be able to benefit from the proposed employer tax credits. Substantial percentages of small employers are likely to have no Federal tax liability in any given year, suggesting that the proposed employer tax credit may not provide any benefit to many of the intended recipients.

Employees eligible to participate in Automatic IRAs

The introduced bills would exclude from eligibility for an Automatic IRA several classes of employees. In each of the following classes there may be some overlap. The number of workers excluded from the Automatic IRA provisions would depend upon the final legislative language.

1. Employees covered under a collective bargaining agreement (approximately 15.7 million employees)
2. Employees who are nonresident aliens (approximately 6 million employees)

3. Employees who have not attained age 18 (4.8 million employees)
4. Employees who have not worked for their employer for at least 3 months (14 million employees at any point in time)
5. Employees who are eligible to participate in an employer's retirement plan (more than 60 million employees);
6. Employees who would be eligible to participate in an employer's retirement plan except that they have not met minimum age and service requirements (there are 8.5 million employees under age 21); and
7. Employees who work for an employer maintaining a SIMPLE plan (1.7 million SIMPLE arrangements).

The proposal does apply to employees who are part-time employees irrespective of number of hours worked per week. However, it is intended that the proposal will not apply to part-time employees of employers who maintain a qualified pension plan that excludes employees who do not work at least 1,000 per year.

To expand retirement savings as much as possible, the proposal should apply to the broadest classes of employees. For example, one might question why employees who have not met minimum age and service requirements for an employer's plan should not have Automatic IRAs available to them, particularly if an employer is required to make Automatic IRAs available to other employees of the employer. Applying the Automatic IRA proposal to employees who have not yet satisfied minimum age and service requirements for an employer's plan would permit them to begin retirement savings earlier rather than waiting to satisfy requirements for employer's plan.

On the other hand, if many employees are included who are not likely to save for retirement even with the proposal in place, the administrative burdens and costs for employers increase relative to the benefits of increased retirement savings that will occur.

Finally, complexity occurs when employers must identify numerous classes of employees who are not eligible for Automatic IRAs. These burdens would be greater for large employers, who may be better able to handle them administratively.

The Automatic IRA proposal does not waive other IRA rules. For example, an individual may be eligible to make IRA contributions, but because the individual's spouse is an active participant in an employer plan, income limits apply that may affect the individual's IRA eligibility. Similarly, if an individual participates in an employer plan of one employer and has a part-time job with an employer who does not offer such coverage, the individual's IRA contribution may be limited because of the individual's income. The proposal will require specific mechanisms to address the problem of employer-based IRA contributions that are not permissible because of an employee's circumstances that arise outside of the employment relationship.

Keeping track of Automatic IRA information

Vital to the success of an Automatic IRA program is adequate tracking of employee information. The employees most likely to be affected by the proposal (employees who are more mobile and lower paid) must be able to keep track of what may be multiple IRAs set up for them by multiple employers. Employees will appreciate the value of saving for retirement only if they are fully aware of what they have saved and how it has grown. But employees who have Automatic IRAs set up for them because they failed to make an election are also more likely not to pay attention to their IRA accounts.

The adequate tracking of employee information suggests the need for centralized recordkeeping of all individual IRA contributions made through an employer and all IRA accounts established through the Automatic IRA proposal. In addition, there must be periodic reporting to individuals of the amounts they have contributed and the values of their accounts. A centralized recordkeeping system might also ensure that individuals who are not eligible to make Automatic IRA contributions (e.g., active participant with another employer) will be identified.

Choices create complexity

Studies of 401(k) plan participation have found that employees sometimes fail to make an election to participate in the plan because they are confused by an array of plan options presented to them. For example, some studies have attributed a lack of participation in 401(k) plans to employees being overwhelmed with the multitude of choices for investment funds.

The Automatic IRA proposal provides a variety of choices to employees – employees are entitled to designate an IRA to receive amounts withheld from their paychecks or can allow an IRA selected by their employer to be the default for their contributions; employees can choose among a variety of investment options; and employees can choose whether to characterize their Automatic IRA as a traditional IRA (in which the contributions are made on a pre-tax basis) or as a Roth IRA (in which the contributions are made on an after-tax basis).

The demographics of the employees expected to be eligible for Automatic IRAs suggest that these employees will tend to be lower paid, younger, more mobile, and have less education than their counterparts who are participating in an employer-sponsored retirement plan (and, therefore, not eligible for Automatic IRAs). These demographics also suggest that these employees are more likely to be overwhelmed by the decisions that they have with respect to Automatic IRAs. While the automatic enrollment feature may result in a high participation rate among these employees, they also will be more likely to be subject to the plan's default features by virtue of failing to make specific elections.

For the ease of employers and to minimize the number of difficult choices that employees must make, consideration should be given to simplifying the Automatic IRA by reducing the number of choices that are offered to employees.

For example, the proposal allows IRA contributions to be designated as Roth or traditional IRA contributions. Understanding the short and long-term consequences of such a designation may be difficult for the classes of employees eligible for Automatic IRAs. Indeed, because many of the employees who will be participating in Automatic IRAs may also be eligible for the Saver's credit and the partially refundable Child's Credit, the employee will need to calculate whether he or she is better off on a current basis to designate IRA contributions as Roth IRA contributions or traditional IRA contributions. For the classes of employees participating in Automatic IRAs, Roth IRA designation may be better because Roth IRA contributions may increase the value of the Saver's Credit the employee may claim. Unless the specific calculations are done, the result will not be clear but most employees (even higher income and better educated employees) will not be able to make this calculation without assistance. In addition, this analysis does not even address whether any particular employee may be better off for the long run to designate their contributions as Roth IRA or traditional IRA contributions. Identifying the specific tax characterization of the IRAs established under the proposal would reduce the complexity and potential for errors.

Demographics of Automatic IRA eligible employees

Federal tax incentives for retirement savings tend to provide the greatest benefits to qualified plan participants, offer greater benefits as contributions increase, and tend to focus on individuals that already save. Thus, Federal tax policy generally provides greater incentives for higher income taxpayers to save. The addition of the Saver's credit now provides some Federal tax incentives for retirement savings geared toward lower income taxpayers. Little is known about the population that does not save, does not contribute to retirement savings, or has not accumulated any other assets. However, this is the population most likely to participate in the Automatic IRA program.

Several studies characterize individuals who had access to qualified plans in the workplace, but did not participate, and show a general set of characteristics – nonwhite, unmarried, and with low educational attainment. Generally speaking, individuals who did not participate in a qualified plan were twice as likely to be African American or Hispanic. Most were younger and had never been married. With respect to educational attainment, most typically did not finish high school. Most studies also find that individuals without qualified plan coverage are more likely to be from the lowest income classes, among the lowest wage earners, and in poor health compared to those with coverage.

One other characteristic also seems to predict the lack of retirement coverage – being without health insurance. Individuals without health insurance coverage were more likely also to lack any retirement savings. The correlation between lacking health insurance and lacking pension coverage helps to further characterize the population most

likely to participate in Automatic IRAs. Research on the uninsured indicates a more balanced racial mix – finding that half of low-income uninsured are white. They further find that the majority of uninsured are in a household with at least one full-time worker. This is an important characteristic, as it suggests that the uninsured without pension coverage will be in the workforce and likely to participate in an Automatic IRA.

We estimate that 47.9 million Americans will be eligible to participate in an Automatic IRA arrangement through an employer. We estimate that 50 percent of these individuals will have adjusted gross income (AGI) under \$20,000. Appendix A provides a projected income distribution of employees who will be eligible for Automatic IRAs. It is anticipated that Automatic IRA participation (like qualified plan participation) will tend to be higher among the upper income levels of individuals who are eligible for Automatic IRAs. Among the lowest income levels, the lack of discretionary income will adversely influence the ability to participate. At AGI levels under \$30,000, likely Automatic IRA contributions on an annual basis will be quite modest and will average, as an example, \$825 for taxpayers in the \$25,000 to \$30,000 AGI range.

Costs of Automatic IRA proposal

Employers may face considerable costs associated with implementing and maintaining Automatic IRA accounts for their workers. As with qualified plans generally, there are three major cost areas, collection and processing, account management, and determining contributions and enforcement costs. Each cost area brings certain complexities and nuances unique to the Automatic IRA program.

We looked at costs for maintaining qualified plans, costs attributable to the Federal thrift savings plan, and the estimated costs of social security private accounts. We found that employer costs for Automatic IRAs could be significant. The benefit of the employer tax credit designed to partially offset these costs is likely to have a limited impact. The credit would be of no current benefit to tax-exempt employers and the 49 percent of all businesses that do not report net income for Federal tax purposes.

Administrative costs of the Automatic IRA may also erode the benefits for the individual workers. While any positive savings would clearly represent a benefit to individual workers approaching retirement, the costs associated with the accounts may erode account balances significantly.

There are costs to the Federal government of the Automatic IRA proposal. In addition to the costs of the TSP II Board that is established under the introduced bill, which we have not specifically estimated, we estimate that the Automatic IRA proposal would reduce Federal fiscal year receipts by \$5 to 10 billion over ten years, depending upon participation.

Effect of Automatic IRAs on savings

The various proposals offer an opportunity to increase retirement savings for a segment of the U.S. workforce that currently does not save. The magnitude of this savings, on an individual basis, depends heavily on the age of the worker, the number of years contributing before retirement, the consistency of the contributions, the rate of return earned on the contributions, and the earnings capacity of the worker. (See Appendix B for estimated account balances for selected annual contribution amounts.)

Lower-income workers may opt-out of the Automatic IRA due to liquidity constraints. As the data suggests, many lower-income households without retirement plans are comprised of younger, non-white, non-married individuals. The Savers credit offers an important incentive to younger low- to middle- income household, but the value of the credit is limited under current law.

Further, introduction of the Automatic IRA may increase borrowing for many participants. Increases in aggregate savings, for certain segments of the population, are likely to be offset by consumer borrowing or debt. Therefore, it is difficult to estimate the macroeconomic effect on aggregate savings of Automatic IRAs.

Low-income individuals who participate in Automatic IRAs might accumulate about \$20,000 in assets after 30 years. However, these Automatic IRA accumulations (like accumulations of retirement benefits in defined contribution plans) may actually work against low-income individuals as they affect eligibility for Supplemental Security Income (SSI) benefits.⁸

For those individuals in income classes above the lowest twenty percent of wage earners, the Automatic IRA proposal has the potential to provide considerable balances in retirement savings. Middle-income individuals, having greater disposable income and the ability to defer greater amounts, have a greater probability of remaining in the Automatic IRA program. Once a saving regimen begins and balances accumulate, the incentive to continue such a program increases.

The following sections of this paper outline in greater depth the summary and conclusions contained in this section. Further, additional technical issues have been raised with respect to the implementation of an Automatic IRA proposal that are not specifically outlined in this section.

⁸ Defined benefit plan accumulations do not have the same effect on SSI benefits.

II. OVERVIEW OF SAVINGS BEHAVIOR IN THE UNITED STATES

A. Availability of and Participation in Qualified Retirement Plans and IRAs

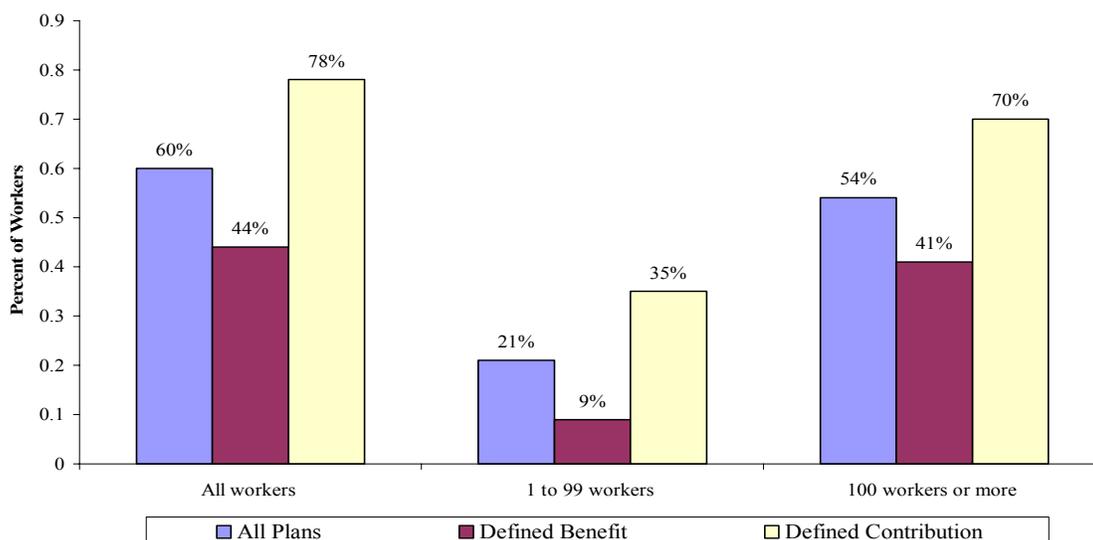
1. Access to qualified retirement plans by type of plan

Since the 1980s, the proportion of workers participating in private pension plans has been stable at approximately fifty percent. Currently, there are about 115.4 million paid workers in the United States and about 62 million have some form of private pension coverage.⁹

According to the 2006 National Compensation Survey of the Bureau of Labor Statistics (BLS), about 60 percent of all workers have access to qualified retirement plans through their employers. Graph 1 depicts the availability of retirement plans by type of plan and firm size. Two significant trends become apparent. First, workers employed in larger firms (those firms with 100 or more workers) are significantly more likely to have access to retirement plans. 54 percent of workers employed in firms with 100 or more workers have access to retirement plans compared to 21 percent of workers employed in firms with fewer than 100 workers.

Graph 1 Percent of Workers with Access to Retirement Plans, by Size of Establishment

Source: Bureau of Labor Statistics, National Compensation Survey, 2006



⁹ 2006 Bureau of Labor Statistics National Compensation Survey. Paid employment consists of full and part-time employees, including salaried officers and executives of corporations, who were on the payroll in the pay period including March 12. Included are employees on sick leave, holidays, and vacations; not included are proprietors and partners of unincorporated businesses.

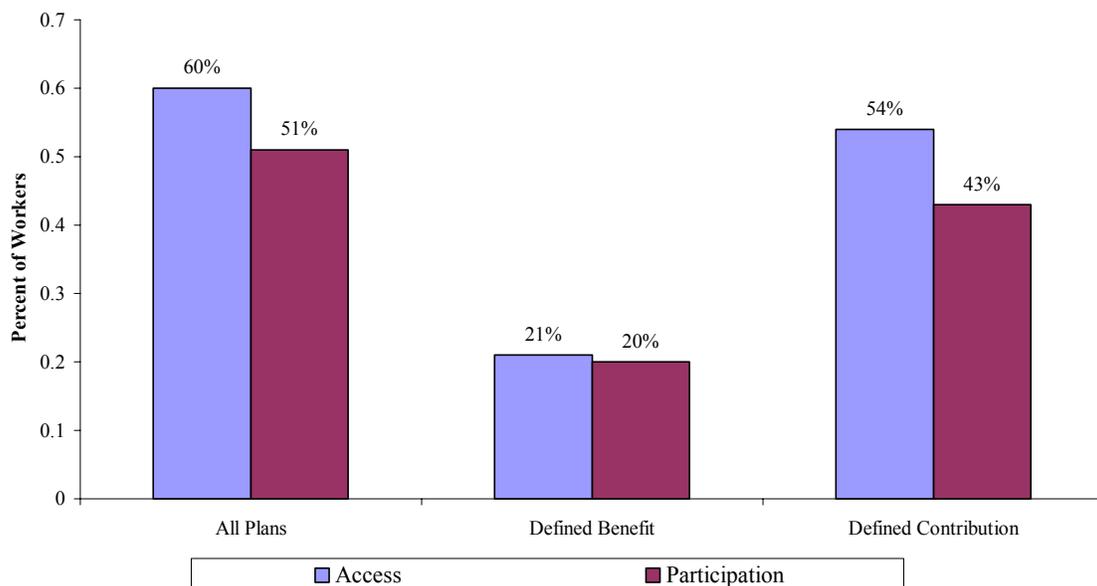
Second, the trend toward defined contribution plans is readily apparent. Seventy-eight percent of workers have access to defined contribution plans compared to 44 percent of workers with access to defined benefit plans. As shown in Graph 1, above, the availability of defined contribution plans is greater in firms with 100 or more workers. Specifically, 70 percent of workers employed in firms with 100 or more workers have access to defined contribution plans compared to 35 percent of workers employed in firms with fewer than 100 workers.¹⁰

2. Participation rates in defined benefit plans and 401(k) plans

Closer examination of worker response to the availability of qualified retirement savings reveals that not all workers take advantage of the employer-provided plans. Graph 2 displays worker access and participation in retirement plans, by type of plan. Overall, 85 percent of workers with access to retirement plans actually participate in those plans. However, differences exist between participation in defined benefit and defined contribution plans. 80 percent of workers with access to defined contribution plans participate in these plans, compared to 95 percent of workers with access to defined benefit plans. This occurs because the universe of defined contribution plans includes 401(k) plans, many of which require an affirmative election by employees to participate.

Graph 2 Percent of Workers with Access and Participating in Retirement Plans, by type of plan

Source: Bureau of Labor Statistics, National Compensation Survey, 2006



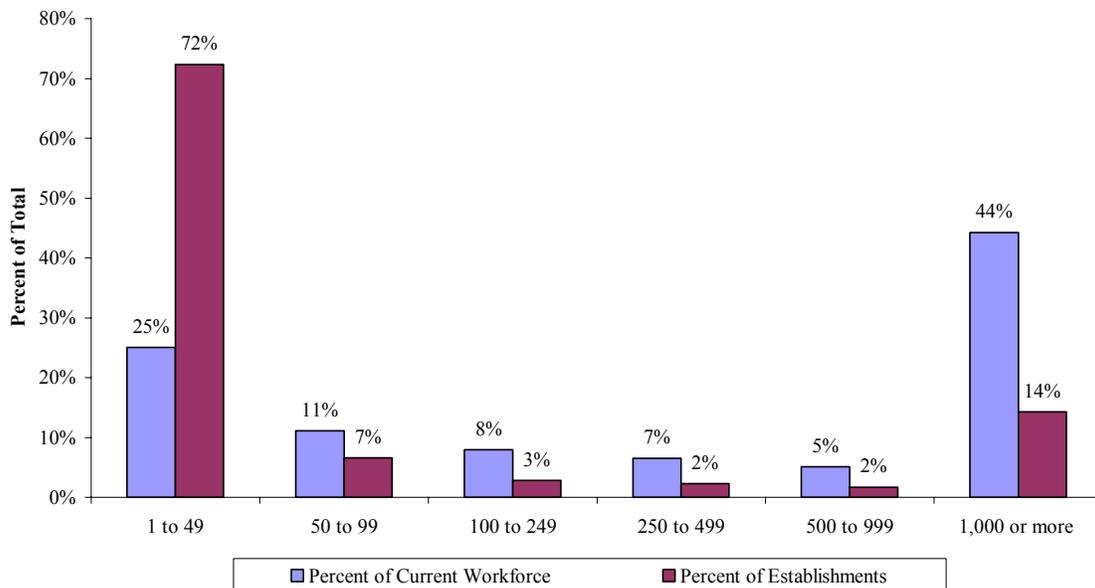
¹⁰ The same trend exists for defined benefit plans, with 41 percent of workers in firms with 100 or more employees having access to defined benefit plans compared to 9 percent of workers in firms with fewer than 100 employees.

3. Small employer qualified plan prevalence and participation rates

Before considering the availability and participation rates in small employer plans, it is important to understand the distribution of the U.S. workforce by firm size. Based on the most recent economic census of businesses, employers with 500 workers or more employ approximately 49 percent of all workers (final two columns of graph 3). The balance of the US workforce is distributed among firms with fewer than 500 workers.

Contrasting the workforce distribution with the establishment distribution demonstrates that the number of small establishments far outweighs the number of larger establishments. Consequently, the availability of private pension plans among smaller employers is an important aspect of pension coverage.

**Graph 3 Distribution of Employment and Establishments,
by Firm Size, Year Ending 2003**
Source: US Census Bureau, Statistics of US Business

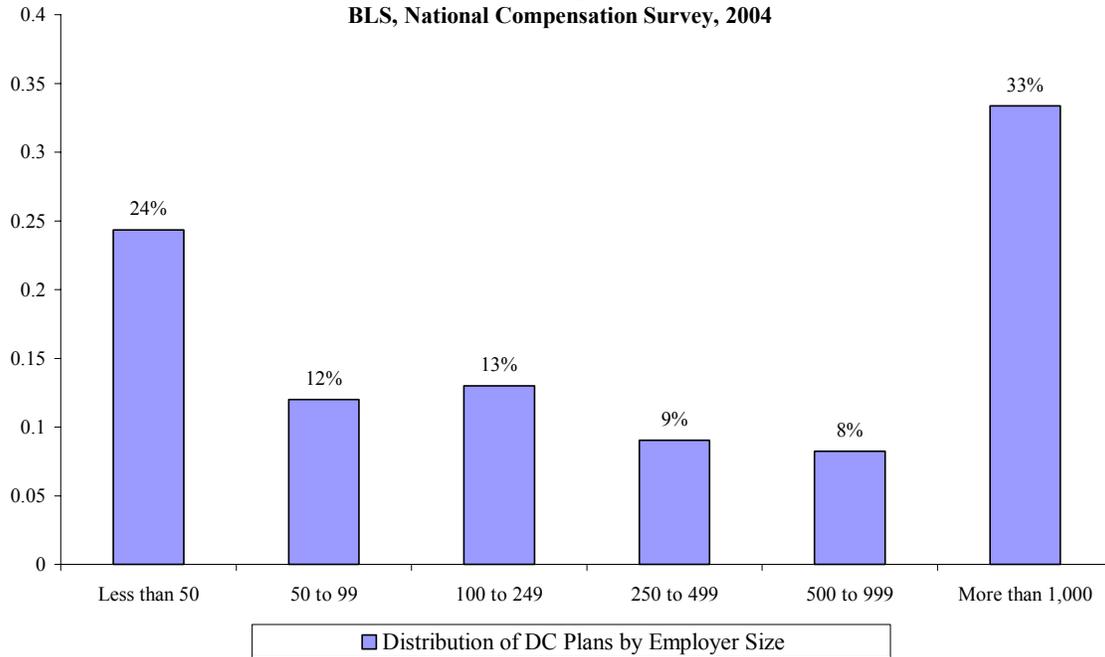


Consider more closely the distribution across firm size of defined contribution plans. According to the 2004 National Compensation Survey, there is a bi-modal distribution of defined contribution plans with the greatest availability in the smallest and largest employers. Not surprisingly, the defined contribution plan distribution parallels the workforce distribution.

However, it is important to recall that the percentage of small establishments is far greater than the percentage of defined contribution plans. The NCS data shown in Graph 4 suggests that a significant proportion of small plans do not offer private pension coverage to their workers.

Graph 4 Distribution of All Defined Contribution Plans, by Employer Size

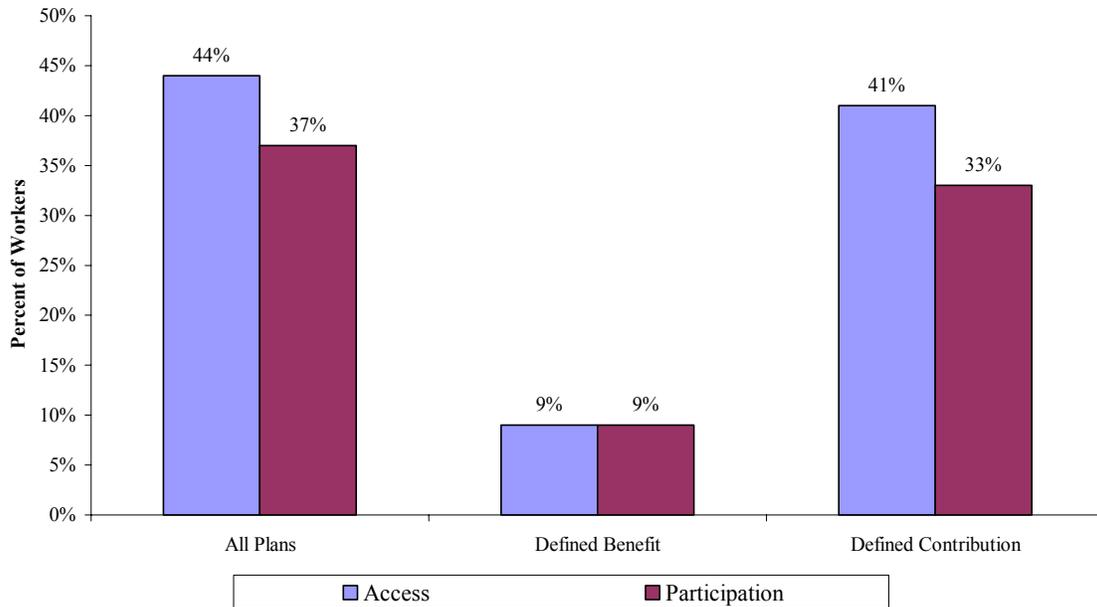
BLS, National Compensation Survey, 2004



The worker in a smaller firm or establishment is less likely to have private pension coverage and if such coverage is available, they are less likely to participate. The following graph considers participation in retirement plans for small firms. Graph 5 displays access and participation rates for employees in firms with fewer than 100 employees. In this case, participation rates in defined benefit plans are higher than those of defined contribution plans. Nearly all workers employed in firms with fewer than 100 employees participate in a defined benefit plan that is offered to them compared to 80 percent participating in defined contribution plans that are offered.

Graph 5 Workers with Access and Participating in Retirement Plans, Firms with 1 to 99 Workers

Source: Bureau of Labor Statistics, National Compensation Survey, 2006



4. Statistics on IRA participation

The Internal Revenue Service (IRS) recently conducted a detailed study of retirement savings with an emphasis on Individual Retirement Arrangement (IRA) savings behavior. They found that, in 2002, approximately 78 percent of the 181 million individual income tax returns filed were eligible to contribute to IRAs. However, the actual contribution rates were dramatically lower than those found in employer-provided retirement plans.

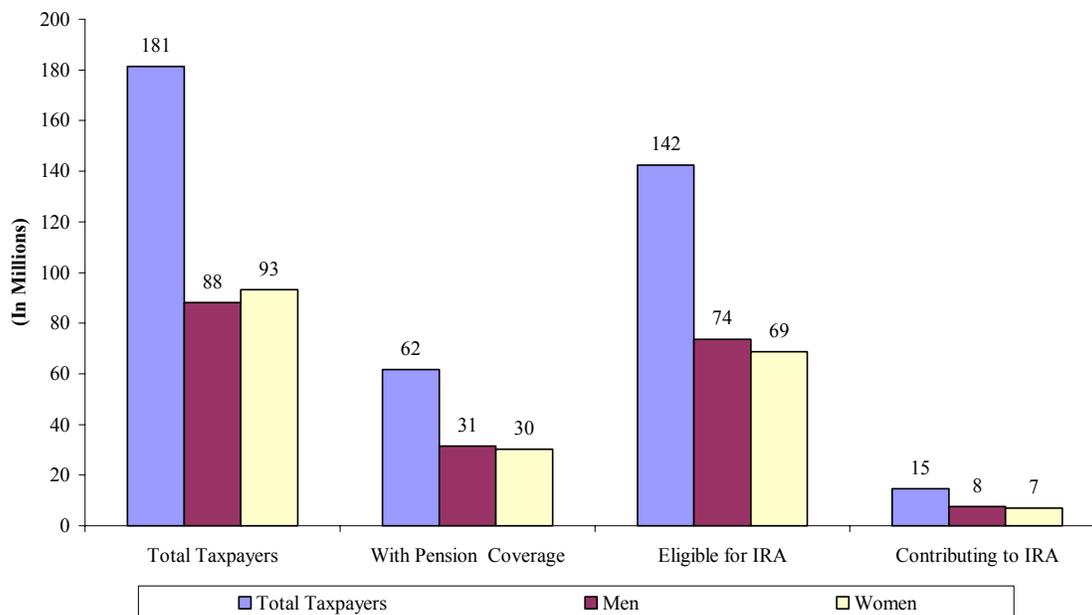
Approximately 11 percent of those eligible actually contribute to an IRA compared to 85 percent of workers that have access to qualified retirement plans in the workplace. The IRS study also reports that 62 million taxpayers report having pension plans (other than IRAs).¹¹

Graph 6 summarizes the result of the IRS study. The individual income tax returns identified the individual represented on the return in order to identify eligibility and participation based on wage and salary information reporting.

¹¹ After adjusting the total number of tax returns for retired taxpayers, the prevalence of pension plans reported on income tax documents is consistent with the BLS and NCS findings.

Graph 6 Taxpayers with Pension Coverage, IRA Eligibility and IRA Participation, Tax Year 2002

Source: IRS SOI, Accumulation and Distribution of IRAs, 2001-2002



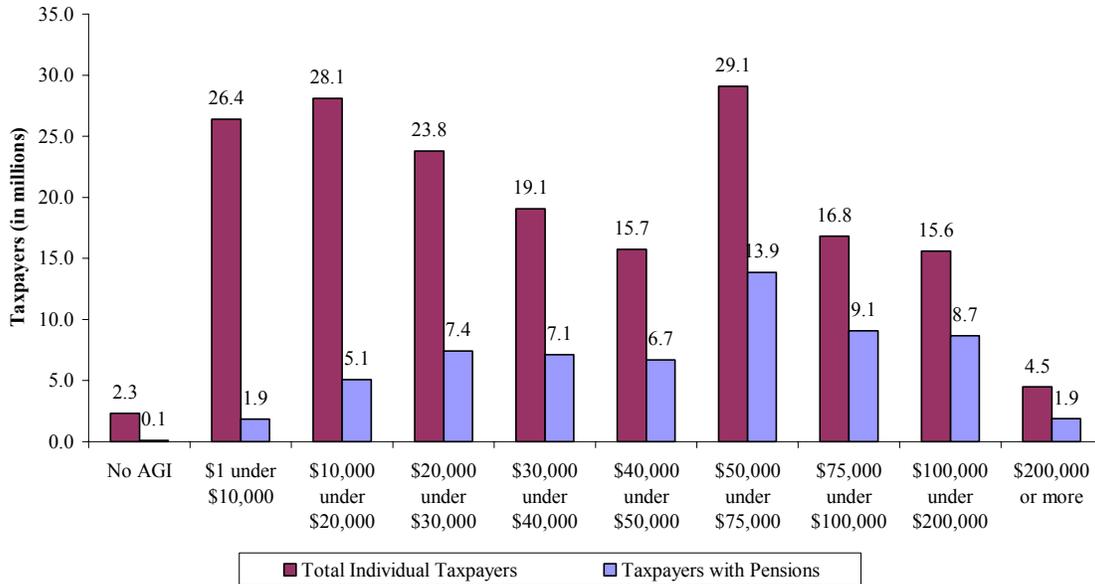
B. Savings Behavior by Income Levels

1. Distributional picture of qualified plan savings

In addition to firm size, income is also a strong predictor of pension participation. Graph 7 displays, by adjusted gross income, the number of individual income taxpayers reporting pension contributions. The IRS linked W-2 forms to individual income tax returns to determine the presence of pension participation by income levels. Pension participation increases with adjusted gross incomes (see Graph 8 for the percentage of taxpayers).

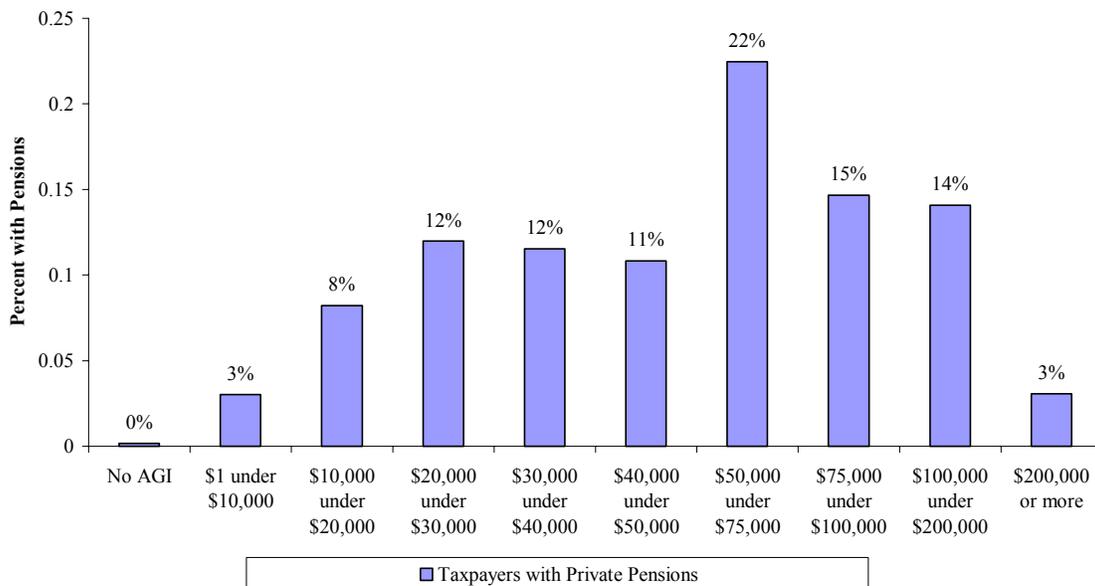
Graph 7 Individual Income Taxpayers with Private Pensions, by Adjusted Gross Income

Source: IRS SOI, Accumulation and Distribution of IRAs, 2001-2002



Graph 8 Distribution of Individual Income Taxpayers with Pensions as a percent of All Taxpayers, by Adjusted Gross Income

Source: IRS SOI, Accumulation and Distribution of IRAs, 2001-2002



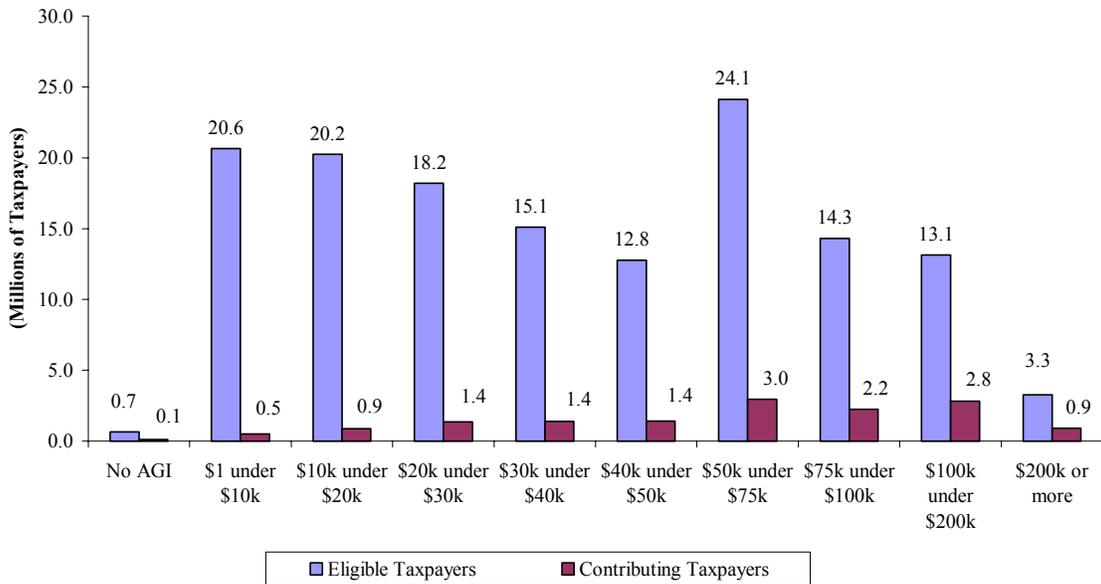
The same pattern emerges when considering IRA participation on individual income tax returns. Nearly 80 percent of all taxpayers are eligible to contribute to IRAs, but the

actual participation rate is approximately 11 percent. As the following graph shows, overall IRA participation is low, but it is particularly so among low-income taxpayers. Comparing worker participation in employer-sponsored retirement savings, the IRA experience suggests that individuals are significantly less likely to contribute to retirement accounts established outside the workplace. As Graph 9 indicates, there are approximately 142 million individual income tax taxpayers eligible to contribute to IRAs. However, the actual number of taxpayers contributing was approximately 15 million in 2002.

Graph 10 shows the distribution of income taxpayers with IRA contributions, expressed as a percentage of total taxpayers making a contribution to an IRA. As with pension participation, taxpayer participation in IRAs displays the same positive correlation with income.¹²

Graph 9 Eligible Taxpayers and Taxpayers Contributing to All IRAs, by AGI, Tax Year 2002

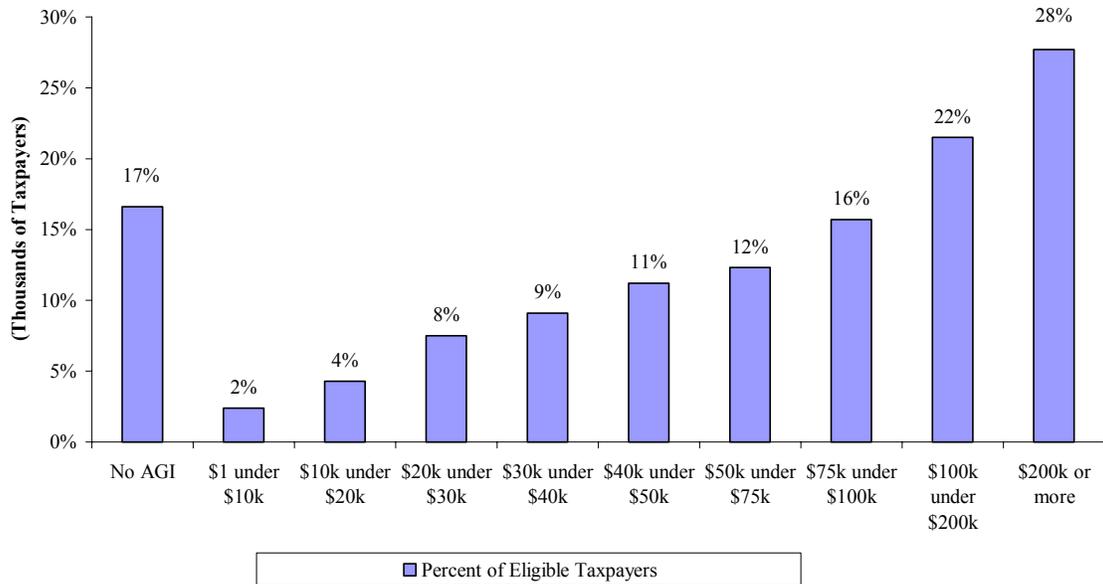
Source: IRS SOI, Accumulation and Distribution of IRAs, 2001-2002



¹² It is important to note that some returns showing no adjusted gross income may, in fact, have significant sources of income, but also report capital losses that offset this taxable income. Consequently, some wealthier taxpayers are included in this lowest income category. This accounts for much of the IRA participation found in this income class.

Graph 10 Percent of Eligible Taxpayers Contributing to All IRAs, by AGI, Tax Year 2002

Source: IRS SOI, Accumulation and Distribution of IRAs, 2001-2002



2. Total savings in the presence of qualified plan savings

Data from the National Income and Products Account (NIPA) of the Bureau of Economic Analysis show rates of personal savings declining steadily since the mid-1980s¹³. The NIPA defines personal savings as total personal income less personal outlays. Personal income is income received by individuals from participation in production and from current transfer receipts. This includes employee compensation, proprietor's income, rental income, personal receipts on assets and personal transfer receipts (such as welfare payments), minus current income taxes and contributions to Social Security or Medicare. In this case, personal outlays include personal consumption expenditures, interest payments on consumer debt, and current transfer payments.

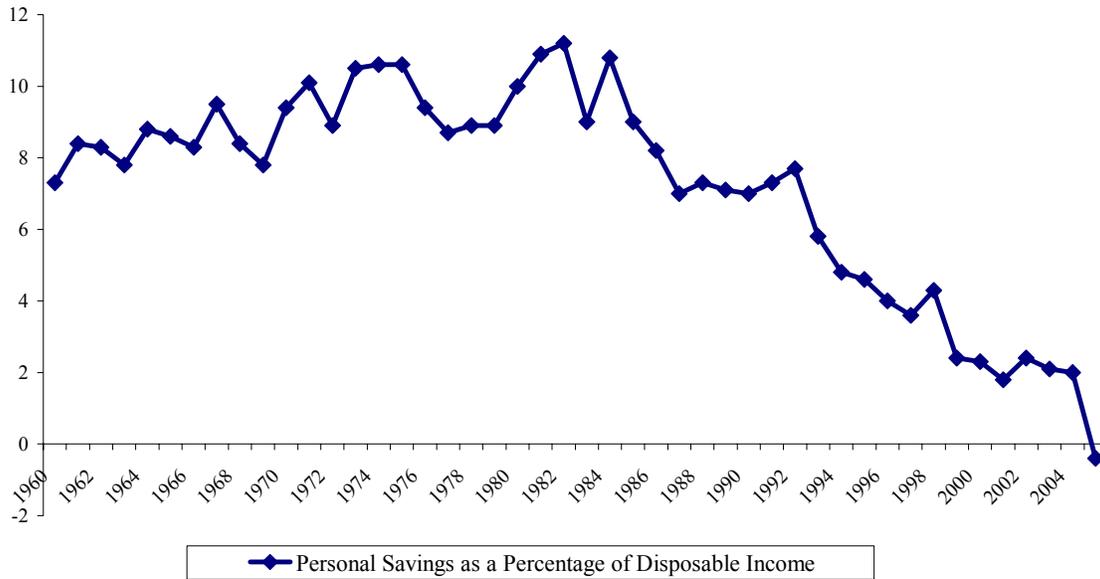
As Graph 11 shows, the personal savings rate became negative in 2005. This indicates that households are spending amounts greater than they are earning. It is important to note that the personal savings rates (as a percentage of disposable income) includes retirement savings, but does not include appreciation on assets held by the household. There are many theories about the appropriate measure of personal savings and the corresponding estimates offer savings rates greater and smaller than the NIPA

¹³ The NIPA relies primarily on data from the Survey of Current Business and the US Census.

estimates.¹⁴ However, the NIPA definition attempts to capture current savings behavior and adjusts both income and taxes for capital realizations.

Graph 11 Personal Savings as a Percentage of Disposable Income, Years 1960 to 2005

Bureau of Economic Analysis, 2005



Regardless of the definitions employed for personal savings, the downward trend remains the same. The absolute rate of personal savings may vary, but the relative change from year-to-year remains largely unchanged.

3. Low income savers

The following three graphs consider retirement savings participation rates by more detailed income classes, based on IRS Statistics of Income data. These graphs confirm that lower income taxpayers are less likely to have disposable income available for retirement savings. In fact, there are clear patterns of increased savings as income increases for these lower income taxpayers. For instance, as taxpayer incomes increase, their share of total contributions also increases.

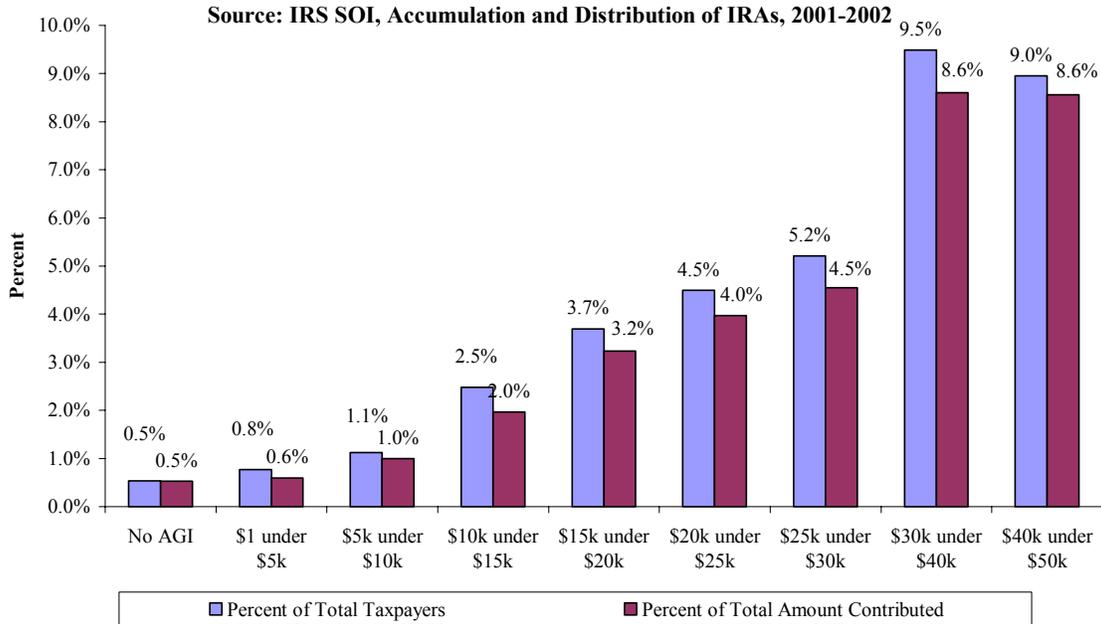
IRA contributions

Graph 12 shows the percentage of taxpayers contributing to traditional IRAs. The graph shows that the percentage of taxpayers making traditional IRA contributions increases as income increases, both as a percentage of total taxpayers and as a percentage of total

¹⁴ See “Alternative Measures of Personal Saving,” by Marshall B. Reinsdorf in the Survey of Current Business, Volume 17, September, 2004.

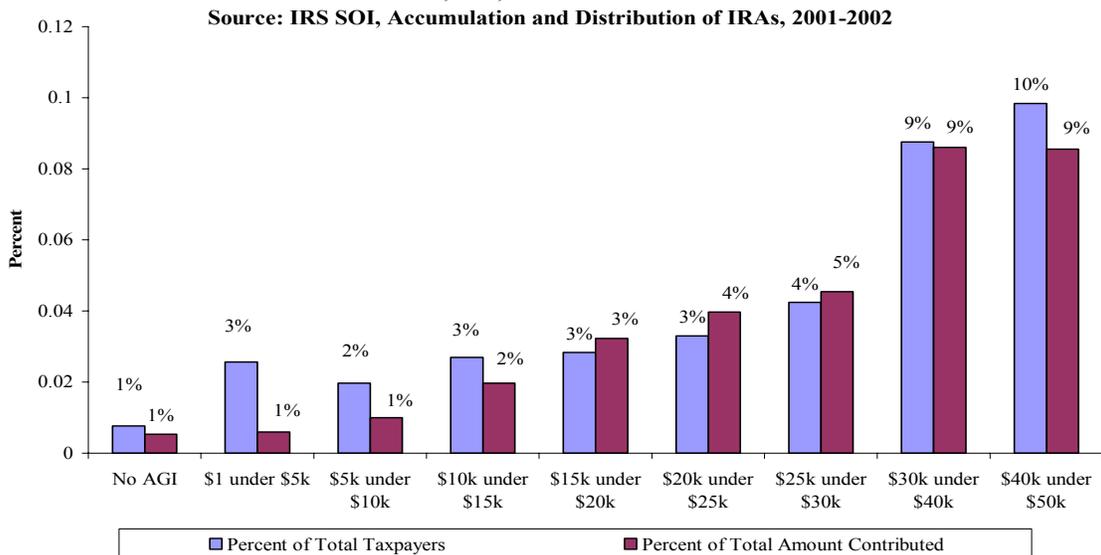
amount contributed. Graph 13 shows the same information with respect to Roth IRA contributions.

Graph 12 Traditional IRA Contributions, as a Percent of Total Taxpayers Contributing and Total Contributions, AGI less than \$50,000, Tax Year 2002



Considering Roth IRAs, the same pattern emerges as shown in Graph 13. In both cases, as adjusted gross incomes increase above \$30,000, the share of taxpayers and contributions increases substantially.

Graph 13 Roth IRAs Contributions, as a Percent of Total Taxpayers Contributing and Total Contributions, AGI less than \$50,000, Tax Year 2002

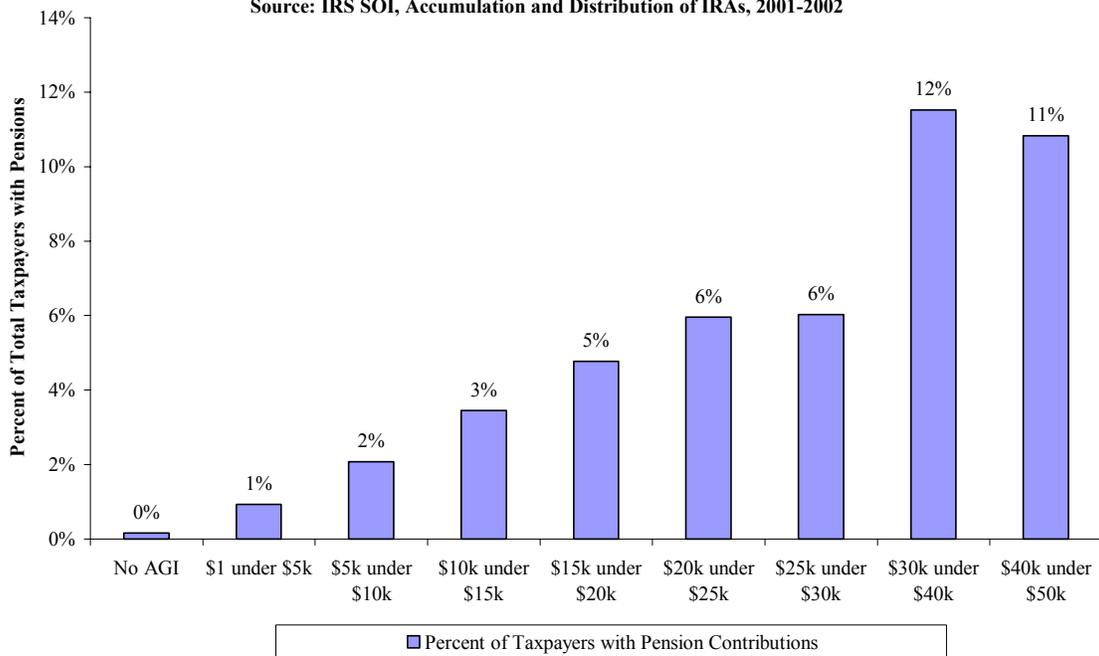


Qualified plans savings

The overall pattern of pension participation by taxpayers with incomes less than \$50,000 is consistent with that of IRA participation. However, these income classes represent a greater share of the total taxpayers participating in pension plans, suggesting that lower income taxpayers are more likely to participate in an employer's pension plan than make individual contributions to an IRA. In the case of IRAs, both Traditional and Roth, taxpayers with AGI less than \$50,000 represented about 37 percent of all returns. However, taxpayers with AGI less than \$50,000 represented about 46 percent of all returns with pension plans as shown in Graph 14. This suggests that the employer setting encourages greater savings among lower income taxpayers.

Graph 14 Taxpayers with Pensions, as a Percent of Total Taxpayers with Pensions, AGI less than \$50,000, Tax Year 2002

Source: IRS SOI, Accumulation and Distribution of IRAs, 2001-2002



Low Income savings rates

As mentioned above, lower income workers, those with incomes less than the median income, are less likely to have an employer-sponsored retirement plan compared to higher income workers.¹⁵ Further, if they are offered a plan through their employer, they are less likely to participate in that plan. Generally speaking, lower income households have few available resources to devote toward retirement savings programs.

¹⁵ Currently, median income in the US is approximately \$44,000. For purposes of this discussion, we display information for those taxpayers with less than \$50,000 in income as reported on their tax return.

Recent research suggests that about one-third of all households (and 60 percent of African American households) have zero or negative financial net worth.¹⁶ Estimates suggest that approximately 40 to 70 million Americans are low income and currently unable to save. A recent study released by the Consumer Federation of America (CFA) suggests that the wealth-gap between low- and high-income individuals is growing.¹⁷

The CFA study found that while 52 percent of Americans had some retirement savings, only 13 percent of the poor (lowest one-fifth of households) had any retirement savings.¹⁸ Their profile of the working poor suggests that they had a median income of \$9,868 compared to the US median income of \$40,088. Further, the working poor were less likely to be married and less likely to have finished high school than their counterparts with higher incomes.

Many that promote such programs as the Individual Development Accounts (IDA) and Saver's Credit believe that the U.S. Federal tax system does not match the tax subsidy with need. Rather the current system provides the greatest benefit to high-income individuals, who are likely to have sufficient resources to save. Because tax subsidies for savings are delivered in the form of deductions or exclusions, rather than tax credits, most of these tax incentives are worth less to those with lower income compared to those with higher income.

Analysis of data from the IDA experience indicates that programs designed to provide saving incentives for low-income individuals are successful. The desire to save appears to be present for certain low-income individuals, and when offered appropriate incentives, they are likely to begin saving and establish saving habits that continue throughout their lives.

C. Adequacy of Retirement Income Replacement Rates Under Current Law

Low personal savings rates raise questions about the adequacy of retirement savings to maintain living standards in retirement. The declining and more recent negative savings rates suggest that in aggregate, households are consuming more than they are earning. Further, it suggests that they are spending past savings and liquidating assets to maintain their current living standard.

As employers continue to move away from defined benefit to defined contribution plans, it is important to evaluate individually and collectively the components of retirement income to determine the adequacy of these balances. Generally, retirement income is

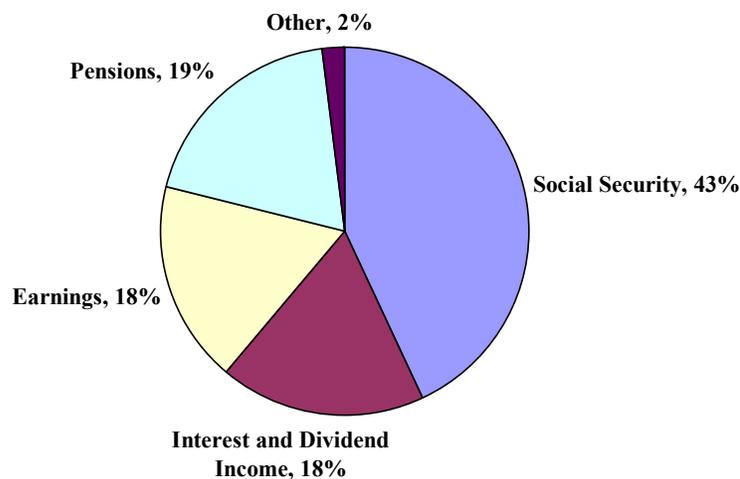
¹⁶ John P. Caskey, *Lower Income Americans, Higher Cost Financial Services* (Wisconsin: Center for Credit Union Research and the Filene Research Institute, 1997), page 8.

¹⁷ See "New Research Shows Growing Wealth Gap between the Poor and the Rest of America," by the Consumer Federation of America, released in February, 2004.

¹⁸ This finding is consistent with other research. The Retirement Security Project publication, "The Saver's Credit: Expanding Retirement Savings for Middle- and Lower-Income Americans," No. 2005-2 found that 12.5 percent of low income workers participated in retirement savings plans.

likened to a three-legged stool that supports itself with pension income, social security income, and personal savings. However, more recently, statistics suggest that a fourth leg – continued employment – is necessary to support retirement. Based on one recent study, working throughout retirement as a source of retirement income is as important as pensions (see graph 15). This behavior has become known as the fourth pillar of retirement security.

Graph 15 Composition of Retirement Income



When evaluating adequacy of retirement savings, most studies include Social Security. Social Security is a pivotal part of most workers’ retirement security. In fact, Social Security provided 43 percent of all income received by Americans aged 65 or older in 2002. Nearly two-thirds of the current 40 million Social Security recipients receive more than half of their retirement income from this source.¹⁹ One current policy debate centers on reforming the Social Security system, which faces significant solvency issues in the future. Social Security will not have the legal authority to pay promised benefits when the trust fund balances are exhausted.²⁰

Depending upon the solutions adopted, Social Security reform could mean that retirees may need to rely much more heavily on qualified retirement plan savings and personal savings. This would make these forms of savings an even more critical component of retirement savings. However, most studies indicate that retirement savings, both in

¹⁹See Montalto, CP, “Retirement Savings of American Households: Asset Levels and Adequacy,” for further statistics and analysis.

²⁰EBRI Data Book, 4th Edition, Chapter 7. See also, Ettliger, Michael and Chapman, Jeff, “Social Security and the Income of the Elderly,” EPI Issue Brief #206, March 23, 2005.

qualified retirement plans and private saving, are inadequate to substitute for the potential loss of Social Security income.

Most analyses that evaluate the adequacy of retirement savings measure the ability of those savings to produce income that will replace pre-retirement income. The analysis measures the replacement rate of the combined sources of retirement income.

Before examining replacement rates, one should consider the importance of defining clearly the measure of income to replace. For instance, replacement rates that measure retirement benefits (at age 65) as a percentage of the estimated final year of income (at age 64) may overstate the replacement rate. One reason for this overstatement is that, according to the Social Security Administration the average low income worker has lower wages in the early and later years of employment and higher in the middle earning periods. Consequently, replacement rates based on retirement benefits as a percentage of estimated average income or lifetime earnings might be considerably lower.²¹

In light of the potential problems in defining the ‘correct’ replacement rate, it is important to incorporate the need for Social Security income, poverty rates of the elderly, as well as replacement rates when considering adequacy of retirement income.

As mentioned above, Social Security income constitutes more than half of all retirement income for nearly two-thirds of all retirees. Therefore, the solvency of the system tends to assume greater importance when considering rates of replacement for older Americans. The CFA study found that 36 percent of the lowest one-fifth of Americans by income levels are over the age of 65 (compared to 21 percent of the general population being over age 65).²² This is consistent with tax return data that suggest that about one third of taxpayers over the age of 65 do not file Federal income tax returns.²³ With respect to the current research on replacement rates, it is important to note that estimated replacement rates more often reflect the intended benefits provided by the plan, assuming a worker maintains continuous employment under that plan. Based on worker turnover, spells of unemployment for low-income workers, and the lack of available qualified plans to certain workers, these replacement rates often represent the upper limit, rather than the actual realized rates.

1. Qualified retirement plans

Estimating replacement rates for retirement benefits poses a difficulty empirically. The difficulties arise from the wide range of pension plans covering the workforce at any given point in time. Further difficulties arise in identifying actual workforce patterns of turnover and tenure. Currently, the BLS estimates that the average tenure of current

²¹ The correct comparison depends entirely on the goal of the analysis and is largely a normative or judgment call.

²² See “New Research Shows Growing Wealth Gap between the Poor and the Rest of America,” by the Consumer Federation of America, released in February, 2004.

²³ Taxpayers must have adequate sources of other income to make taxable any portion of their Social Security benefits.

workers is about 4.7 years.²⁴ For most defined benefit plans, job tenure is inadequate for full vesting of benefits. And for defined contribution plans, studies suggest that discontinuities in participation dramatically reduce replacement rates.

Given these difficulties, most empirical estimates are illustrative, relying on assumptions about (continuous) worker participation and average or composite plan characteristics.²⁵ With these assumptions in mind, estimates suggest that private defined benefit pension plans would replace approximately 47.3 percent of pre-retirement earnings. Federal employees receiving benefits under the Civil Service Retirement System and the Federal Employee Retirement System would replace approximately 63 percent and 36.6 percent, respectively, of pre-retirement earnings.²⁶

Replacement rates in defined contribution or 401(k) plans depend heavily on assumptions about worker tenure and worker turnover. When workers move to and from employers and do not participate continuously, the defined contribution plans replacement rates decline precipitously. However, under certain conditions, studies suggest that workers are able to save adequately in a defined contribution plan to replace a significant proportion of their pre-retirement income. The estimated replacement rates range from 45 to 66 percent of pre-retirement incomes.

2. Social Security

Social Security benefits are weighted in favor of workers with low average lifetime earnings and those with families. The program goals are to achieve social adequacy as well as individual equity.²⁷

While higher earning workers receive higher benefits in absolute dollars, their replacement rate is lower than that of lower earning workers. Lifetime lower earning workers receive benefits that replace about 60 percent of their pre-retirement income (sub-minimum wage earners). Average earning workers receive about 42 percent and higher earning workers receive about 26 percent of their pre-retirement income.

The SSA estimates that without the current weighting system, in favor of lower earning workers, approximately 4 times more older Americans would live in poverty. Nearly half of all retirees rely on Social Security benefits for the majority of their income.²⁸

²⁴ See BLS, Job Opening and Labor Turnover Statistics, Business Employment Dynamics, various years.

²⁵ See EBRI/ICI estimates of replacement rates (Perspective, Volume 11, Number 2, July, 2005) and Patricia P. Martine, "Comparing Replacement Rates Under Private and Federal Retirement Systems, (Social Security Bulletin, Volume 65, Number 1, 2003/2004).

²⁶ Workers covered under the Civil Service Retirement System do not receive Social Security benefits. However, those covered under the Federal Retirement System would receive Social Security benefits.

²⁷ See the SSA program policy and benefits calculations. Social adequacy provides a floor of income. Individual equity means that a person receives a reasonable return on his/her contribution to Social Security.

²⁸ "Fast Facts & Figures About Social Security" Social Security Administration, 2004.

3. Individuals without qualified retirement plans

The Social Security Administration provides Supplemental Security Insurance (SSI) to the lowest income Americans, including the elderly who are dually eligible for Medicare and Medicaid as well as those individuals with disabilities. SSI is the public pension plan of last resort, creating an income floor for those individuals without alternative income sources or assets.²⁹

In December of 2003, there were 6.9 million SSI recipients, including 5.9 million adults. Of these adult recipients, 2.3 million received Social Security (Old Age, Survivor, and Disability Insurance (OASDI)) or approximately one-third of all adults receiving SSI. Half of those adults receiving SSI and Social Security were either retired or disabled. The remaining adults received benefits as auxiliary or survivor benefits. The Social Security Administration estimates that 73 percent of adult SSI recipients had insufficient work history to gain eligibility for OASDI.³⁰

Under current rules, the SSA reduces SSI benefits by defined benefit plan benefits, after the individual retires. If the individual has assets in excess of \$2,000 (in a defined contribution plan or other savings), the individual becomes ineligible for SSI benefits.

The SSA reports that about one percent of SSI recipients also received pension benefits in December 2003. They do not know how many applicants were denied benefits as a result of defined contribution plan holdings. However, the SSA believes that those with defined contribution plans that were denied benefits are likely to have similar attributes to those with SSI benefits and some pension income. Specifically, both groups have some workforce participation that resulted in some form of pension benefits. However, many of those eligible for SSI benefits are likely to have inadequate work experience to establish OASDI benefits.³¹

SSI benefits provide a minimum level of income, \$7,236 for individuals and \$10,848 for couples, attempting to sustain recipients just above the poverty level.

D. Current Law Impediments to Saving Through Qualified Plans

Various impediments to qualified plan saving exist for both the employer and the employee. Workforce patterns are a critical problem, both for achieving adequate levels of retirement savings as well as for the likelihood of employers to offer plans in the first place.

²⁹ See “Defined Contribution Pension Plans and the Supplemental Security Income Program,” Policy Brief No. 2006-1, March 2006, Social Security Administration.

³⁰ In 2006, SSI benefits were \$603 per month for eligible individuals and \$904 per month for eligible couples.

³¹ In light of the trends in private pension benefits, moving from DB to DC plans, the SSA is considering recommending legislative change in its treatment of pension plan accumulations. However, currently the \$2,000 asset limit remains in effect.

Worker turnover presents a significant problem for both employers that sponsor plans and employees wanting to participate. When worker turnover is high, employers often feel reluctant to sponsor or maintain a retirement plan. The employer faces ongoing costs when former employees leave small inactive accounts. When workers are entitled to the benefits, many plans do not want to hold inactive accounts for former employees.

Also, workers with frequent job changes often are not fully vested when leaving the firm. In this case, they will forfeit some or all of their accumulated plan benefits each time they move to a new employer. Further, workers with small vested accounts will frequently take their benefit in a lump sum distribution, pay the penalty and income taxes, and use the money for some other purpose.

1. Costs to employers of setting up and maintaining qualified plans

Employers face a variety of costs in establishing and maintaining qualified plans. Generally, these costs can be classified into three groups: processing and collecting contributions, overseeing and managing assets (including administrative costs and determining benefits), and determining contributions and employee benefits.

In light of these costs, some employers might prefer to pay current wages instead of contributions to a qualified retirement plan because:

- There are significant regulatory burdens and costs to establishing and maintaining a qualified retirement plan;
- Certain types of qualified retirement plans (*e.g.*, defined benefit pension plans) require a long and ongoing commitment of contributions and the employer may be concerned for various reasons (*e.g.*, projected profits) to take on such a commitment; or
- Employees do not prefer to have contributions made to a qualified retirement plan (*e.g.*, if the employees generally are lower paid and cannot afford to save for retirement).

Most studies focus on the direct administrative costs, as these are the most easily identifiable and quantifiable costs facing plans. Studies suggest that administrative costs vary with the plan assets and number of plan participants. For instance, the Congressional Budget Office reports that one empirical study found administrative costs varied from \$24 to \$60 per participant per year for private plans.³² Large plans with approximately 4,000 participants and \$20 million in assets were likely to face the lowest per participant administrative costs due to the economies of scale. Alternatively, small

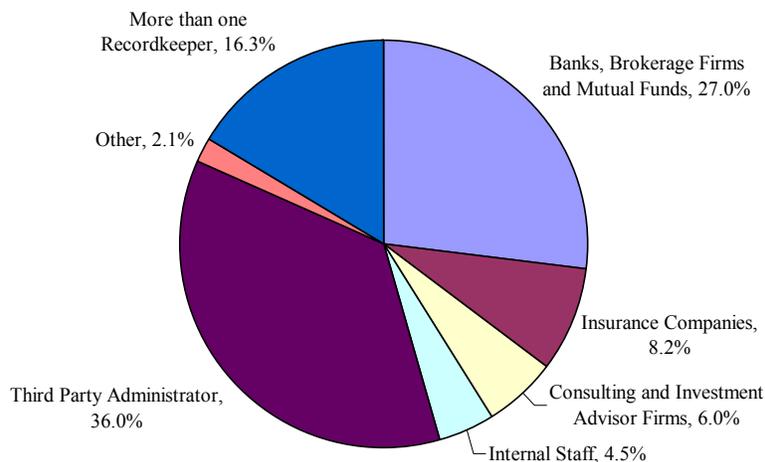
³² Congressional Budget Office, "Administrative Costs of Private Accounts in Social Security," March 2004.

plans with 100 participants and \$2 million in assets were likely to face the highest per participant costs.³³

In addition to the direct administrative costs, offering a plan involves a considerable amount of record keeping for which the employer is responsible. The Profit Sharing Council of America (PSCA) reports in its Annual Survey that 36 percent of plans use a third party plan administrator to handle the record keeping for their plan.³⁴ Another 16.3 percent use more than one outside source to maintain their plan's records.

Graph 16 401(k) Plan Recordkeepers, 2005 Plan Year

Source: Profit Sharing Council of America, 49th Annual Survey



A recent report by Fidelity Investments suggests that 43 percent of small businesses with fewer than 20 employees cited cost as the reason they did not establish a plan. Many investment houses are creating plans more amenable to small businesses to address this concern.³⁵

Given the small percentage of firms that rely on their own internal staff (4.5 percent), the administrative cost is likely to represent a considerable barrier for many small firms.

³³ The Department of Labor, Pension and Welfare Benefits Administration and the GAO examined Form 5500 data and found average administrative costs of \$49 and \$103, respectively. The GAO excluded all plans reporting zero costs.

³⁴ See the Profit Sharing Council of America, 49th Annual Survey of Profit Sharing and 401(k) Plans, 2006.

³⁵ Recent litigation suggests that the small employer responses may not be misguided. Suits were filed against seven large employers (Bechtel Group, Caterpillar, Exelon, General Dynamics, International Paper, Northrop Grumman, and United Technologies) for violating the Employee Retirement Income Security Act by allowing 'excessive' fees on their 401(k) plans.

2. Difficulty with 401(k) plans of getting employees to participate, particularly at low income levels

Employers who offer a 401(k) plan face an additional problem because these plans are subject to special nondiscrimination rules intended to ensure that the plan does not discriminate against lower compensated participants in favor of highly compensated participants. In practice, the nondiscrimination rules for 401(k) plans impose often present a difficult problem for employers, as lower earning workers are less likely to participate compared to their higher earning counterparts. This makes satisfying nondiscrimination rules more difficult for many firms.

The PSCA reports that approximately 39 percent of 401(k) plans did not pass the nondiscrimination tests for 401(k) plans without having to adjust the elections of highly compensated employees. The statistics on nondiscrimination testing suggest that either low income workers are not participating (or contributing a very low rate) or highly compensated workers are being constrained in the amount of their contributions as a result of nondiscrimination testing. For individual firms, the likely experience probably consists of elements of both situations.

One study reports that 21.8 percent of plan participants do not contribute enough to take advantage of all employer matching funds.³⁶ This suggests that some plan participants face liquidity constraints and thereby limit their contributions to a specified amount, rather than maximizing the inherent benefits in the plan design.

3. Low income individuals do not have discretionary income for retirement savings

Generally, lower income individuals do not have adequate disposable income for retirement savings. Disposable income is defined as money income after tax payments. On average, disposable income represents approximately 89 percent of money income.³⁷ Empirical studies suggest that participation and saving in defined contribution plans increases for workers with incomes in excess of \$30,000. Currently, 35 percent of U.S. households have money incomes less than \$30,000.³⁸ The ability to save for retirement is correlated with income and, for lower income workers, the presence of an employer plan.

Lower income workers are less likely to have an available plan in the workforce and are less likely to participate when a plan is available. Consequently, lower income workers without a workplace plan are the least likely to save for retirement.

³⁶ See National Center for Policy Analysis, Brief Analysis, Number 567, August 15, 2006.

³⁷ Money income is defined as receipts before payments for personal income taxes, social security, union dues, Medicare deductions, etc. Therefore, money income does not reflect the fact that some families receive part of their income in the form of non-cash benefits.

³⁸ See US Census Department, "Income, Expenditures and Wealth," 2005.

E. Effect of Current Law Incentives on Savings Behavior

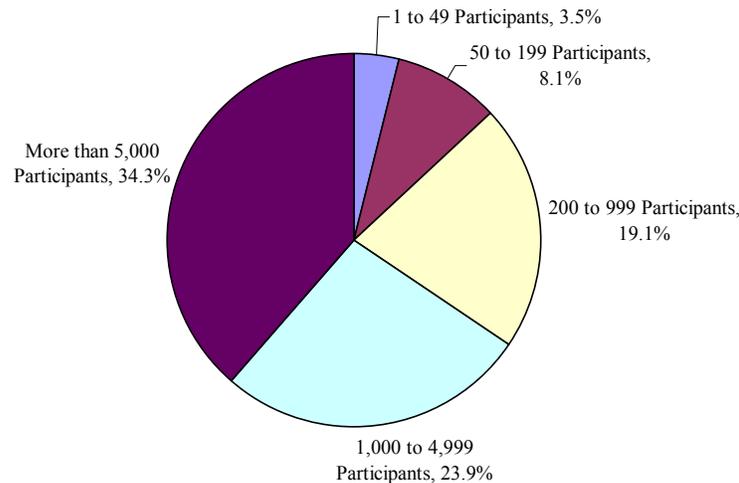
Currently, there are several effective incentives that are beginning to demonstrate increased rates of saving and participation for lower income workers. Early statistics and empirical evidence suggests that two, automatic enrollment in 401(k) plans and the Saver's Credit, are likely to improve saving rates among those least likely to save for retirement.

1. Automatic 401(k) enrollment increases participation rates

The PSCA survey found that 17.5 percent of their survey respondents have automatic enrollment in their 401(k) plan. This percentage increases with the size of the employer. As Graph 17 shows, 34.3 percent of firms with greater than 5,000 participants had automatic enrollment compared to only 3.5 percent of firms with fewer than 50.

Graph 17 Percentage of Plans with Automatic Enrollment, by Plan Size

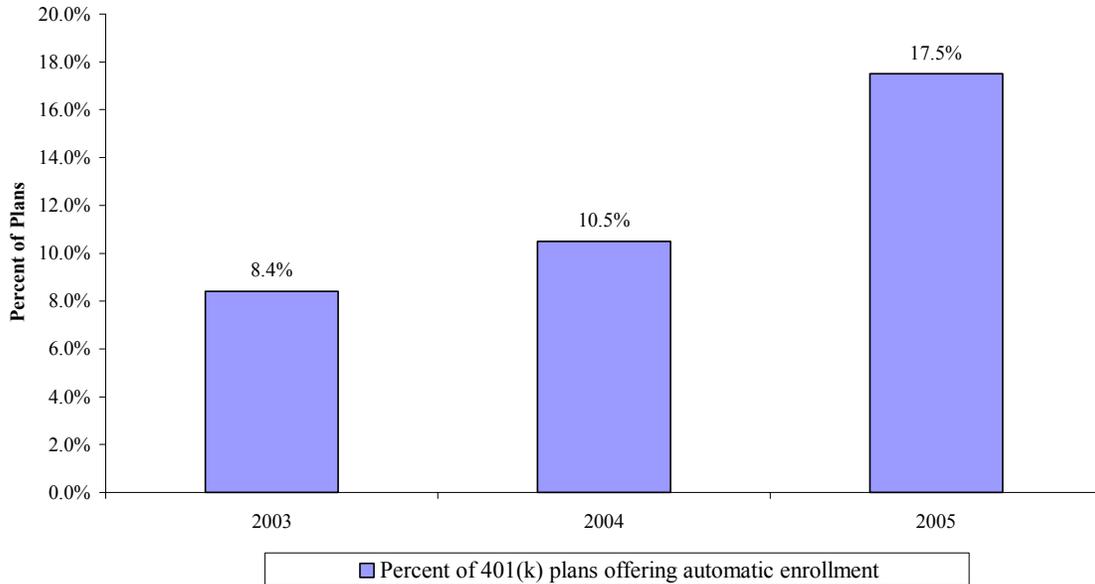
Source: Profit Sharing Council of America, 49th Annual Survey



The PSCA survey found that automatic enrollment increased steadily since 2003. Despite the lower prevalence in small firms, they did find that the increases since 2003 occurred across firms of all sizes.

Graph 18 Percent of 401(k) Plans Offering Automatic Enrollment

Source: Profit Sharing Council of America, 49th Annual Survey



Estimates suggest that automatic enrollment increases significantly overall plan participation. The Congressional Research Service cites a Hewitt survey finding that plan participation increased from 75 percent to 85 and 95 percent in most firms.³⁹ Other studies confirm this result. The PSCA surveyed 25 firms with automatic enrollment and found that automatic enrollment increased participation from 68 percent (prior to the introduction of automatic enrollment) to 77 percent.

Choi, Laibson, and Madrian found that automatic enrollment has a similar effect, increasing overall enrollment to between 86 and 96 percent. However, their work looked at the effects on participation of auto enrollment over time. They found that after three years, participation rates were 30 percent higher for employees hired under automatic enrollment compared to those hired before the company implemented the policy.⁴⁰

2. Saver's Credit

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) created for certain taxpayers a nonrefundable credit for contributions to qualified plans and IRAs. The credit was available on a temporary basis, but was made permanent in 2006 as part of the Pension Protection Act. Estimates suggest that approximately 59 million taxpayers

³⁹ See Congressional Research Service, "Automatic Enrollment in Section 401(k) plans," by Patrick Purcell, RS21954, August, 2006.

⁴⁰ James J. Choi, David Laibson, and Brigitte C. Madrian, "Plan Design and 401(k) Savings Outcomes," *National Tax Journal*, Volume 52(2), June 2004, pp. 275-298.

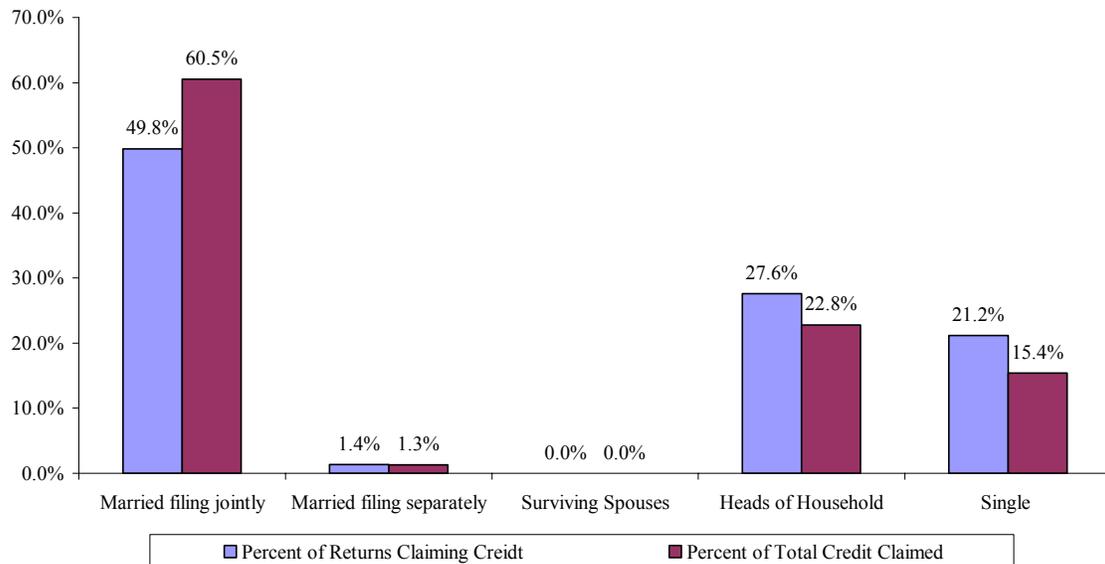
or nearly 47 percent of all taxpayers were eligible for some portion of the Saver’s Credit in 2002.⁴¹

The credit is intended to stimulate participation for lower income individuals for whom retirement saving is often out of reach. A June 2002 survey by Diversified Investment Advisors found that 71 percent of plan sponsors believe that the credit is responsible for higher participation.⁴² Eighteen percent of those surveyed believed the credit stimulated a major participation surge.

Early statistics from the IRS and a recent analysis of the IRS data support this survey finding. Specifically, in 2002 there were 5.3 million returns that claimed the credit receiving just over \$1 billion in credit amounts. In 2004, there were just under 5.3 million returns receiving \$1 billion in credits for retirement savings contributions.

Graph 19 Distribution by Filing Status of Returns Claiming a Retirement Saving Contribution Credit, Tax Year 2004

Source: IRS SOI, 2004 Individual Income Tax Returns: Sources of Income, Adjustments, Deductions, Credits, and Tax Items, by Filing Status



Married taxpayers represented slightly more than half of those returns claiming a credit, but received the majority of retirement savings contribution credits, claiming nearly 62 percent. The balance of the credit was claimed by single or head of household taxpayers.

The full credit is available to married taxpayers with incomes below \$30,000. For married taxpayers with incomes greater than \$30,000 but less than \$50,000, the credit

⁴¹ See Gary Koenig and Robert Harvey, “Utilization of the Saver’s Credit: An Analysis of the First Year,” National Tax Journal, Volume LVII, No. 4, December 2005.

⁴² See Tax Policy Center, “Credit Boosts Plans Participation Among Low-Income Workers,” September 15, 2003.

phases out. Single taxpayers with incomes below \$15,000 may claim the full credit and the credit phases out for income greater than \$15,000 but less than \$25,000. Head of household taxpayers with incomes below \$22,500 may claim the full credit and the credit phases out for income greater than \$22,500 but less than \$37,500.

Based on the most recent IRS data, approximately 43 percent of all married returns have incomes that would qualify for the credit. Approximately 80 percent of head of household and 63 percent of single returns would qualify for some portion of the credit.

Table 1.—Percent of Tax Returns Eligible for the Retirement Savings Contribution Credit, Tax Year 2004					
Filing Status	Total Returns	Returns Eligible for Retirement Saving Contribution Credit	Percent of Total Returns Eligible for the Credit	Returns Claiming the Credit	Percent of Eligible Returns Claiming the Credit
Married Returns	54.4 million	23.3 million	42.9%	2.7 million	11.6%
Head of Household Returns	19.6 million	15.7 million	80.1%	1.5 million	9.3%
Single Returns	58.1 million	36.5 million	62.8%	1.1 million	3.1%

Harvey and Koenig recently published a detailed analysis of the 2002 experience with the Saver’s Credit.⁴³ Their research highlights several important limitations imposed by the credit which may impede the desired outcome of the policy.

First, as mentioned above, the credit phases out for incomes above the thresholds according to filing status. However, it is important to note that the Saver’s Credit is nonrefundable. The value of the credit, regardless of the rate at which the taxpayer qualifies, is limited by the taxpayer’s income tax liability. The amount of the credit may not exceed the final tax liability. Harvey and Koenig found that 43 percent of taxpayers that qualified for the full credit, in fact, had their credit limited by their tax liability.

Second, their research indicates that in addition to limitations imposed by the taxpayer’s tax liability, the Saver’s Credit also interacted with the partially refundable Child Credit. They indicate that 76 percent of head of household filers and 51 percent of joint filers who claimed the Saver’s Credit also claimed the Child Credit.⁴⁴

⁴³ Ibid.

⁴⁴ Ibid. See page 796 of the article for a detailed analysis of the other credits claimed by taxpayers claiming the Saver’s Credit.

However, because the Child Credit is a partially refundable credit and the taxpayer determines the amount of the Child Credit after claiming the Saver's Credit, the Saver's Credit may reduce the available amount for the Child Credit. They estimate that, in aggregate, the Saver's Credit reduced the available Child Credit by approximately \$20 million.

Third, Koenig and Harvey report that the average Saver's Credit varied by filing status and amount of the available credit. However, overall the credit amount averaged \$330 for all taxpayers claiming the credit. The following table provides some evidence of the variability in the Saver's Credit by filing status and credit rates. In addition, it highlights the percent of taxpayers that found their Saver's Credit limited by tax liability.

Table 2.—Percent of Tax Filers Limited by Tax Liability and Average Saver's Credit, Tax Year 2002		
Credit Percent by Filing Status	Percent Limited by Tax Liability	Average Saver's Credit
Joint Filers		
10 percent credit	0.9%	\$258
20 percent credit	7.0%	\$409
50 percent credit	44.7%	\$509
Head of Household Filers		
10 percent credit	1.8%	\$307
20 percent credit	0.7%	\$479
50 percent credit	37.9%	\$658
Single Filers		
10 percent credit	1.0%	\$188
20 percent credit	2.0%	\$375
50 percent credit	47.0%	\$378

Source: Koenig and Harvey, page 797.

Early empirical evidence suggests that this retirement saving contribution credit is reaching the targeted population, but that participation rates are still low relative to the total number of eligible returns.

This low participation may indicate that the Saver's credit is not widely recognized. According to Koenig and Harvey, approximately 2.7 million additional taxpayers could have claimed the credit in 2002, but did not do so. Many of these taxpayers made IRA contributions or participated in qualified plans, but did not claim the Saver's Credit forfeiting nearly \$500 million in unclaimed credits.

Apparently, the Saver's Credit is still a little known credit. Of the 2.7 million eligible taxpayers with contributions to retirement savings, many used paid preparers or commercially available software, but still appeared unaware of the credit. As stated, lower income individuals are less likely to have access to retirement savings through their

employers. Consequently, if they are not made aware of the credit's availability through their employer, they may not learn about it or participate outside the workplace.

III. MAJOR STRUCTURAL ISSUES

This section addresses some of the major structural issues that arise in designing an administratively workable Automatic IRA proposal. These structural issues present both broad policy considerations and significant implementation problems with an Automatic IRA proposal. The following section addresses in greater detail some of the technical implementation issues that are presented by the Automatic IRA proposal.

A. The Role of the Federal Government in Establishing Automatic IRA Accounts and Handling the Recordkeeping Necessary to Track Automatic IRA Contributions, Investments, and Accounts

Automatic IRAs contemplate that individuals who are not currently retirement savers will begin saving for retirement through payroll deduction contributions to IRAs. This proposal targets those people who are least likely to save suggesting that the typical individual targeted by the Automatic IRA proposal will be low or moderate income, younger rather than older, more likely to be a part-time employee, and likely to have higher than average job turnover. Each of these characteristics will identify individuals who are less likely to be saving for retirement. Of course, it is also true that the individuals most likely to become retirement savers as a result of the Automatic IRA proposal will be those individuals who are the higher end of income for the demographic group not saving, who are older rather than younger, who are more likely to be full-time employees, and who are more likely to have some job stability.

The demographics of the individuals who might become retirement savers as a result of the Automatic IRA proposal suggest a potential problem presented by the proposal. As these individuals have amounts withheld from their compensation for IRA contributions, there needs to be a mechanism that ensures that the individuals do not lose track of the IRA accounts that have been established for them. The proposal suggests that employers would not have significant recordkeeping and reporting requirements beyond the proper withholding and transmitting of IRA contributions. What this means is that some other entity must take a substantial role in the tracking of Automatic IRAs.

Ensuring that individuals understand the status of their retirement savings could lead one to conclude that a central recordkeeping and reporting authority is necessary. The introduced bills create the TSP II Board, which would be required to establish policies and procedures for (1) the establishment and maintenance of Automatic IRAs, (2) the investment and management of contributions to Automatic IRAs, (3) the functioning of automatic contribution arrangements, including the designation of investment funds, and (4) the issuance of regulations relating to Automatic IRAs. In the technical analysis section, below, more detailed discussions of payroll processing and withholding issues are discussed.

Vital to the success of an Automatic IRA proposal is ensuring that individuals recognize the value of the savings that occurs through payroll withholding. Under this theory, success with retirement saving through Automatic IRAs will breed further successes as individuals begin to see the accumulation of wealth that an Automatic IRA can provide. However, this success can only occur if individuals periodically are apprised of the value of their IRA accounts.

A separate problem relates to those Automatic IRA savers who are highly mobile. These individuals need to have a mechanism in place to ensure that they do not lose track of the IRAs that have been established with each of their employers.

A central recordkeeping and reporting entity could ameliorate some of these problems. If the TSP II Board is charged with the type of recordkeeping and reporting that is done for Federal employees under the Thrift Savings Plans, individuals will receive each year a report of their IRA contributions, their investment earnings for the year, their total IRA account balances, and how their IRA assets are invested. Whether this type of centralized recordkeeping is feasible will depend, in part, upon the amount of flexibility that employers and employees are given in establishing IRAs for their employees. For example, if employees are allowed to designate an IRA of their choice for the receipt of contributions, it may not be possible to provide the kind of annual, centralized reporting that will fully inform individuals of the status of their retirement savings. The issue of flexibility versus complexity is discussed below.

B. Choices Create Complexity

An inherent issue faced frequently in the qualified plan area is the complexity that occurs when employers or individuals are given options that increase their choices. This complexity of choice problem also occurs with the Automatic IRA proposal.

The Automatic IRA proposal contemplates that individual employees can either identify an IRA to which their contributions would be directed or allow their contributions to be deposited in a default IRA selected by their employer. To the extent that a centralized system of recordkeeping is deemed a necessary component of the success of the Automatic IRA proposal, allowing employees to choose from among multiple IRA service providers may make it more difficult for such centralized recordkeeping to be implemented. In addition, as discussed in the next section below, there is a separate issue of whether IRA service providers will be interested in the small dollar contributions that are likely to be prevalent with Automatic IRAs.

The Automatic IRA proposal also contemplates that individuals will be given a range of investment options, with a default investment option to apply if the individual fails to make a specific investment election. The number of options available to employees who are making Automatic IRA contributions will also add to the complexity of the proposal. Given the class of employees the Automatic IRA proposal is targeted to reach, it is more likely that these individuals will not make a specific investment election, but rather will allow their IRA contributions to be invested in whatever default investment option applies.

Additional complexity is created by the element of the proposal permitting Automatic IRA contributions to be designated as either traditional IRAs or Roth IRAs. The proposal suggests that lower income younger employees might prefer to make contributions to Roth IRAs because their marginal tax rate in retirement may be higher than their marginal tax rate at the time the IRA contributions are made. Recent data relating to utilization of Roth IRAs bears this out, showing that Roth IRA contributions are becoming more prevalent among younger taxpayers compared to traditional IRAs.⁴⁵

Automatic IRAs are intended to increase retirement savings among those individuals who appear to be the most resistant to saving under current law. This will be a class of individuals more intimidated by multiple choices and more likely to be default contributors (i.e., those individuals who are automatically enrolled in an IRA because they failed to execute an election not to participate). Although not entirely clear from the proposal, it is presumed that the default IRA for individuals who fail to make an election will be a traditional IRA, rather than a Roth IRA. Understanding the short and long-term consequences of the designation of an Automatic IRA contribution as a traditional IRA contribution or a Roth IRA contribution may be difficult for the classes of employees eligible for Automatic IRAs.

Because many of the employees who will be participating in Automatic IRAs may also be eligible for the Saver's credit and the partially refundable Child's Credit, the characterization of an employee's contributions as traditional or Roth IRA contributions can have implications beyond just the effect with respect to the contributions. The employee may be entitled to more or less Saver's Credit and Child Credit depending upon how an employee's IRA contributions are characterized. For the classes of employees participating in Automatic IRAs, they may be better off if their IRA contributions are designated as Roth IRA contributions because Roth IRA contributions may increase the value of the Saver's credit the employee may claim. Unless the specific calculations are done, the result will not be clear but most employees (even higher income and better educated employees) will not be able to make this calculation without assistance. In addition, this analysis does not even address whether any particular employee may be better off for the long run to designate their contributions as Roth IRA or traditional IRA contributions. Identifying the specific tax characterization of the IRAs established under the proposal would reduce complexity and potential for errors.

Further, the comparison of the tax advantages of Roth IRAs and traditional IRAs can be done only if it assumed that the Federal income tax laws do not change between the time an IRA contribution is made and the time it is withdrawn. The proposal notes that individuals who make Roth IRA contributions may find that they have lost all tax benefits if the U.S. Federal tax system is wholly or partially converted to a consumption tax system under which savings generally are not taxed. In such a case, the individual

⁴⁵ The age distributions for Roth and Traditional IRA contributions show dramatically different patterns. According to a recent IRS study, taxpayers under age 40 make 37 percent of all Roth IRA contributions while taxpayers under age 40 make only 16 percent of all Traditional IRA contributions.

would have been better off taking advantage of the traditional IRAs income exclusion at the time the contributions were made.

C. The Problem of Small Annual Automatic IRA Contributions

The Automatic IRA proposal does not address what may present a stumbling block in the implementation of the proposal – finding IRA service providers who are willing to accept the small Automatic IRA contributions likely to be made by many of the employees to whom the proposal applies. As we have noted in Appendix A, we estimate that 50 percent of Automatic IRA eligible contributors will have annual income of no more than \$20,000. Thus, the majority of Automatic IRA savers are likely to make relatively small annual contributions to IRAs. For example, assuming a 3 percent default contribution rate, an individual earning \$15,000 per year will have Automatic IRA contributions of \$450 annually. Appendix B shows the typical account accumulations that can be expected at various contribution levels for various periods of time.

We have not done an exhaustive review of current IRA service providers. However, a random review of IRA service providers indicates that many require a minimum monthly contribution (e.g., \$100) to set up an IRA or a minimum deposit (e.g., \$2,000). At a 3 percent default contribution rate, an individual would require \$3,000 of monthly compensation (\$36,000 per year) to reach a \$100 per month contribution level.

We understand that some large IRA service providers have expressed interest in the Automatic IRA proposal, suggesting that there may be a private sector market for small dollar contribution accounts. These IRA service providers may believe that the dollar thresholds for acceptable contributions may be lower than what is commonly required by IRA service providers under current law because the volume of IRA contributions made will be greater. This will occur only if an IRA service provider receives a substantial portion of an employer's Automatic IRA business.

One issue that should be considered is whether there ought to be a pooling of Automatic IRA contributions to reduce the administrative fees with respect to individual accounts. If a sizable share of Automatic IRA contributions are relatively small (reflecting the demographics of Automatic IRA eligible taxpayers), the creation of numerous small dollar accounts each subject to separate annual administrative fees may erode the total value of retirement savings that occurs. This effect could be ameliorated by pooling IRA contributions in a larger account until the minimum value of an employee's IRA contributions plus earnings exceed a minimum dollar level (e.g., \$2,000).⁴⁶ Under this type of pooling arrangement, employees who had Automatic IRA contributions made to the pool would have a right to their proportionate share of the assets in the pooled account. Pooling of contributions could be done on an employer-by-employer basis or could be done on a broader basis.

⁴⁶ Another possible threshold would be the \$15,000 threshold the introduced bills use to determine whether an employee is eligible to roll over Automatic IRA contributions to an existing IRA of the employee.

D. Effect of the Automatic IRA Proposal on the Incentives to Establish or Continue to Maintain Qualified Retirement Plans

The Automatic IRA proposal is designed to improve retirement savings by individuals who do not have access to an employer-sponsored retirement plan. The proposal notes that the Automatic IRA approach requires no employer contributions, no employer compliance with qualified plan or ERISA requirements, and no employer responsibility (or fiduciary liability) for selecting investments, selecting an IRA provider, or opening IRAs for employees. In addition, the proposal “steers clear of any adverse impact on employer-sponsored plans or on the incentives designed to encourage firms to adopt new plans.”

Because the Automatic IRA proposal relieves many of the burdens of qualified plan sponsorship, the proposal may have the effect of reducing the incentive for small employers to either stay in or adopt qualified plans for their employees. Small business owners will weigh the costs of establishing or maintaining a qualified retirement plan compared to the costs of complying with the Automatic IRA requirements. The cost differences could be substantial. To the extent that using the Automatic IRA structure reduces significantly employer costs (including the potential costs of fiduciary liability), employers may forego plans to adopt qualified retirement plans or may take the affirmative step to eliminate existing qualified retirement plans.

However, it should also be noted that small business owners may favor using a qualified plan in order to maximize the amount of tax-favored retirement savings for the business owner. Indeed, the Automatic IRA proposal states that “the arrangements we propose are designed to set the stage for small employers to ‘graduate’ from offering payroll deduction to sponsoring an actual retirement plan.”⁴⁷ Because annual contributions to Automatic IRAs are subject to the general IRA contribution limits, a qualified plan will permit significantly larger contributions for retirement savings, making it a more favorable vehicle for small business owners.

Small business owners will weigh the overall costs of maintaining a qualified plan versus the costs of the Automatic IRA proposal as well the individual benefits that may accrue to the owner under each vehicle. While a key emphasis of the Automatic IRA proposal is the ease of administration for small employers by utilizing existing employment tax processing procedures and by minimizing employer involvement, it is just these features that may tip the balance in favor of Automatic IRAs for some employers.

For a small employer contemplating whether to establish a qualified plan or merely complying with the Automatic IRA arrangement requirements, an additional consideration will be the credit for small employer pension plan startup costs versus the proposed credit for small employers maintaining automatic IRA arrangements. The pension plan startup credit is a maximum credit of \$500 per year available for the startup

⁴⁷ Draft of Feb. 12, 2006.

year and the following two years, whereas the Automatic IRA credit would be limited to \$250 per year up to two years.

IV. TECHNICAL ANALYSIS OF A PROPOSAL TO MAKE AUTOMATIC IRAS AVAILABLE TO EMPLOYEES WHO ARE NOT ELIGIBLE TO PARTICIPATE IN EMPLOYER-SPONSORED QUALIFIED RETIREMENT PLANS

A. CURRENT LAW

1. Overview of qualified retirement plans

Under current law, certain Federal tax benefits are provided to encourage employers to establish qualified retirement plans on behalf of their employees. These retirement plans are classified into two broad categories – defined benefit pension plans and defined contribution plans. A defined benefit pension plan generally promises a plan participant a specified annual benefit payable when the participant retires. Under a defined contribution plan, a participant is entitled to the contributions (plus earnings) in an account that has been established on the participant’s behalf. Under a qualified retirement plan, contributions may be made to the plan either by the employer, by the plan participants, or by both.

A significant difference between a defined benefit plan and a defined contribution plan is that a defined benefit pension plan (and ultimately, the employer contributing to the plan) bears the risk of investment losses. Thus, plan participants are entitled to their promised benefits at retirement irrespective of whether there are adequate assets in the plan. A minimum level of pension benefits is guaranteed by the Pension Benefit Guaranty Corporation in the event that a defined benefit pension plan has assets that are not sufficient to pay promised benefits.

The employer-based qualified retirement plan system is a voluntary system. Employers are not required to establish or maintain qualified retirement plans. An employer that chooses to establish a qualified plan is required to comply with a complex set of rules that govern a wide range of issues relating to the plan’s operation, including: (1) the employees who are required to participate in the plan, (2) the benefits that may be provided under the plan, (3) the extent to which the plan can favor highly compensated employees, (4) the contributions that may or must be made to the plan, (5) the deduction that is permitted for contributions to the plan, and (6) disclosure of information to plan participants and the Federal government. The plan must meet the approval of the Federal government both in form and in operation. The costs of complying with these rules are a significant reason why many employers either do not establish or terminate qualified retirement plans.

The rules governing defined benefit pension plans are particularly detailed and complex. These rules not only specify the extent to which an employer is required to make annual plan contributions to ensure that there will be adequate funds available in the plan to pay promised benefits, but also provide limits on employer contributions to prevent

overfunding of a plan. Substantial taxes are imposed on the termination of an overfunded defined benefit plan if the excess assets revert to the employer. Defined benefit pension plans carry significantly higher costs to establish and maintain than defined contribution plans. For small- to mid-sized employers, the burdens of complying with the rules for defined benefit pension plans often are prohibitively expensive.

The amounts that are withdrawn from qualified retirement plans by plan participants are subject to restrictions on both the timing and the nature of the benefit payments. Participants may be subject to a 15 percent tax penalty if they make a withdrawal prior to retirement or the attainment of age 59½, unless the amounts withdrawn are used for certain specified purposes.

In addition, a qualified plan participant who is no longer working is required to commence receiving retirement benefits and paying tax on such benefits at age 70-1/2 whether or not the individual needs the retirement income at that time. This provision encourages the depletion of retirement savings without regard to the specific needs of the individual.

Under current law, an employer is permitted, within limits, to deduct contributions to a qualified pension plan. The contributions are made to a trust that generally is exempt from Federal income tax. Employees who participate in these plans are not required to include amounts contributed to the plans in gross income until the amounts are withdrawn by the employee.

From an economics perspective, the tax benefits of a qualified retirement plan are generally equivalent to a permanent exemption from tax of the earnings on contributions made to the plan. This principle can be illustrated with the following example: Assume that a \$10,000 contribution is made to a qualified retirement plan on behalf of an employee. Assume that the employee's marginal tax bracket is 28 percent, so the employee would have \$2,800 of current income tax if the contribution had been received as taxable compensation. Assume that the \$10,000 earns an 8 percent return (\$800) in Year 1 so at the end of Year 1, there is a balance of \$10,800. Further assume that the \$10,800 is withdrawn in Year 2 and no penalty taxes apply to the withdrawal. In Year 2, the amount withdrawn is subject to \$3,024 of tax (\$10,800 times 28 percent), leaving a balance of \$7,776. If the taxpayer had received taxable compensation and invested in a taxable account, he or she would have had \$7,200 (\$10,000 minus \$2,800 (the tax on the compensation)) to invest. The earnings on this amount at 8 percent would be \$576, subject to tax of \$161.28 for a net of \$414.72. Thus, upon withdrawal, the taxpayer would have \$7,614.72. The difference in what the taxpayer has available is the tax on the earnings.

From a Federal tax perspective, an employer should be indifferent as to whether current wages are paid to employees or whether contributions are made on behalf of the employees to a qualified retirement plan because the employer generally is entitled to a current deduction with respect to both payments.

Employees generally should prefer to have contributions made to a qualified retirement plan on their behalf because it will reduce their current tax liability. However, employees would be indifferent to receiving compensation in the form of contributions to qualified retirement plans and other forms of tax-favored compensation that permit the accumulation of savings on a tax-free basis. Despite the Federal tax benefits for saving for retirement in a qualified pension plan, some employees might prefer to receive compensation in the form of current salary if they have insufficient disposable income to meet their current needs.

Some of the reasons that an employer might prefer a qualified retirement plan over current wages include:

- the owner of the business might prefer to defer paying taxes on some of his or her own current income and a qualified retirement plan provides one mechanism for doing this;
- employees as a group have indicated their preference to have a qualified retirement plan; and
- the employer feels that it has an obligation to assist employees in saving for retirement.

The desire of the owner of a business to defer paying taxes on some of his or her own current income is likely a significant factor in the formation of a qualified pension plan by small and mid-sized firms.

On the other hand, employers might prefer to receive current wages instead of contributions to a qualified retirement plan because:

- there are significant regulatory burdens and costs to establishing and maintaining a qualified retirement plan;
- certain types of qualified retirement plans (e.g., defined benefit pension plans) require a commitment of contributions beyond the current year; or
- employees, as a group, do not prefer to have contributions made to a qualified retirement plan (for example, if the employees generally are lower paid and cannot afford to save for retirement).

2. Automatic enrollment in 401(k) plans

A special feature of a defined contribution plan that is widely used by employers is a 401(k) plan or a cash or deferred arrangement. Under this type of plan or arrangement, employees are permitted to elect to defer receipt of their salary and have the amounts deferred contributed to a 401(k) plan. These plans are subject to special rules, including nondiscrimination rules designed to ensure that highly compensated employees are not disproportionately participating in the plan. Many employers utilize some form of matching contributions (i.e., contributions by an employer that match an employee's deferrals) in order to satisfy the special nondiscrimination rules for 401(k) plans.

A 401(k) plan is permitted to have an automatic enrollment feature. This feature permits an employer to automatically enroll an employee in a qualified cash or deferred

arrangement (401(k) plan) unless the employee affirmatively elects not to participate in the arrangement. Under automatic enrollment, the employee's wages are reduced by a fixed percentage or amount and contributed to the 401(k) plan unless the employee has affirmatively chosen not to have his or her wages reduced or has chosen to have his or her wages reduced by a different percentage. These contributions qualify as elective deferrals that are not currently included in the employee's income. The automatic enrollment feature has been an effective way for many employers to increase participation in their 401(k) plans.

The Internal Revenue Service (IRS) first issued a ruling in 1998 clarifying that automatic enrollment in 401(k) plans is permissible for newly hired employees.⁴⁸ The IRS subsequently issued a ruling holding that automatic enrollment is also permissible for current employees who do not participate in a 401(k) plan.⁴⁹

In 2006, the Congress further clarified the applicability of automatic 401(k) plan enrollment in the Pension Protection Act of 2006.⁵⁰ Under the Pension Protection Act, a 401(k) plan with a "qualified automatic enrollment feature" is treated as satisfying the special nondiscrimination rules that apply to section 401(k) plans and is not subject to the top-heavy plan rules. A qualified automatic enrollment feature must satisfy certain requirements relating to automatic deferral, matching and non-elective contributions, and notice to employees. By enacting the safe harbor provision, the Congress has made it easier for employers to adopt automatic enrollment features as part of their 401(k) arrangements.

Employers adopting automatic enrollment features in 401(k) plans generally must address a number of separate issues: whether to include automatic escalation of default contribution rates, what the default investment option will be for amounts contributed through automatic enrollment, and automatic rollover of contributions when an employee leaves employment.

3. Savers' Credit

The Saver's Credit is a nonrefundable tax credit intended to encourage low-income taxpayers to save for retirement.⁵¹ The credit is available for contributions to certain qualified retirement plans, such as elective deferrals in a 401(k) plan, a tax-sheltered annuity, an eligible deferred compensation arrangement of a state or local government, a SIMPLE plan, or a simplified employee pension (SEP); contributions to a traditional or Roth IRA; and certain after-tax employee contributions to a qualified retirement plan.

⁴⁸ Rev. Rul. 98-30.

⁴⁹ Rev. Rul. 2000-8. Automatic enrollment has also been extended to 403(b) annuity plans (Rev. Rul. 2000-35), section 457 plans of State and local government employers (Rev. Rul. 2000-33), and in prototype 401(k) plans adopted primarily by small employers (Rev. Rul. 2000-60).

⁵⁰ Pub. L. 109-280.

⁵¹ The Saver's Credit, as originally enacted, was a temporary credit. It was made permanent as part of the Pension Protection Act of 2006.

Up to \$2,000 of annual contributions are eligible for the Saver's Credit. The credit rate is 50 percent of the contributions, 20 percent, or 10 percent, depending upon the taxpayer's adjusted gross income (AGI). Thus, the maximum credit available is \$1,000, \$400, or \$200, depending upon the applicable credit rate. The credit is not available to taxpayers with adjusted gross income above \$50,000 (married couples filing joint returns), \$37,500 (heads of households) or \$25,000 (single and other taxpayers).

Table 3, below shows the AGI levels eligible for the Saver's Credit:

Table 3. Adjusted Gross Income Thresholds for Saver's Credit

	50% Credit	20% Credit	10% Credit	Credit Not Available
Married couple filing joint return	\$0-\$30,000	\$30,001-\$32,500	\$32,501-\$50,000	Over \$50,000
Heads of households	\$0-\$22,500	\$22,501-\$24,375	\$24,376-\$37,500	Over \$37,500
Singles and all other filers	\$0-\$15,000	\$15,001-\$16,250	\$16,251-\$25,000	Over \$25,000

Because the Saver's Credit is nonrefundable, it can only be used to offset income tax liability. If a taxpayer does not have income tax liability up to the full amount of credit to which the taxpayer would otherwise be entitled, the full value of the credit cannot be used. The following example illustrates this point:

Assume an individual who claims the standard deduction has AGI of \$15,000 and the individual makes a \$2,000 contribution to an IRA. Assume also that the individual has no other credits or adjustments and has no dependents. After taking one personal exemption of \$3,300 and the standard deduction of \$5,150 (amounts for 2006), the individual has taxable income of \$6,550. Under the 2006 Federal tax rate schedules, the individual has Federal tax liability of \$655 (10% times \$6,550). Because the individual's Federal income tax liability is less than \$1,000, the Saver's Credit will only be allowed up to \$655.

This example illustrates that the full amount of the Saver's Credit is unlikely to be utilized by many taxpayers. If a single individual with the maximum amount of AGI eligible for the 50% credit cannot fully utilize the credit assuming one personal exemption and the standard deduction, it is unlikely that there are many scenarios in which the full \$1,000 credit can be claimed. As noted in section II.E.2, one study found that 43 percent of taxpayers eligible for the Saver's Credit in 2002 had their credit limited by their tax liability.

Furthermore, the lower an individual AGI, the more likely it is that the individual will not have sufficient disposable income to make the retirement contributions eligible for the credit.

4. Employer Federal tax deposit requirements

In general

Under current law, employers are required to deposit Federal income tax withheld from employees' wages plus the employer and employee shares of Social Security and Medicare taxes (FICA taxes). These amounts withheld are then deposited through the Electronic Federal Tax Payment System (EFTPS) or by delivering a check, money order, or cash to a financial institution that is an authorized Federal tax depository. The EFTPS is provided free by the U.S. Department of the Treasury and can be used by businesses and individuals to deposit all Federal tax payments either online or by telephone. As of January 2004, any business requesting a new employer identification number (EIN) and indicating that it will have Federal tax deposit obligations is automatically pre-enrolled in EFTPS and can activate their account by calling a secure 800 number.⁵²

According to the Federal government EFTPS web site, as of May 2006, there were approximately 6.6 million cumulative business enrollments in the EFTPS system. 2006 payments made to the Federal government through EFTPS (as of May 2006) were \$1.3 trillion.⁵³ This total includes payments made by businesses and individuals and includes other taxes in addition to withheld payroll taxes of businesses.

Timing of deposits

Generally, employers are subject to one of two deposit schedules – monthly or semi-weekly. An employer determines whether it is subject to monthly or semi-weekly deposits for a year based on its total tax liability for payroll taxes for a lookback period.⁵⁴ The deposit schedule is not determined by how frequently the employer pays its employees, but is instead determined by reference to the amount of the employer's payroll tax liability. Employers accumulating deposits of less than \$2,500 during a quarter may remit their payments with their quarterly employment tax return.

An employer is required to make monthly deposits of payroll taxes if the total taxes for the four quarters in the lookback period were \$50,000 or less. The employer's current payroll tax deposits are made on the 15th day of the month following the month in which the liabilities arise (i.e., the wages on which the taxes are based are paid). New employers are monthly depositors because their tax liability during the lookback period was zero.

An employer is a semi-weekly depositor if the total payroll tax liabilities for the lookback period were more than \$50,000. Deposits for payments made on Wednesday, Thursday,

⁵² *The Secure Way to Pay Your Federal Taxes*. Electronic Federal Tax Payment System. P. 4. www.eftpsouth.com/eftps/.

⁵³ *Monthly Fast Facts Statistics*. EFTPS Marketing Executive. www.eftpsouth.com/eftps/. May 2006. These totals include payments by businesses and individuals.

⁵⁴ The lookback period is the four quarter period beginning July 1 of the second year preceding the year for which the deposit timing requirement is being determined.

or Friday are required to be made on Wednesday of the following week; deposits for payments made on Saturday, Sunday, Monday, or Tuesday are required to be made on Friday of the current week.

Notwithstanding the normal deposit timing rules, an employer who accumulates at least \$100,000 of taxes on any day during a deposit period is required to deposit the taxes on the next banking day. In addition, a monthly depositor who accumulates at least \$100,000 of taxes on any day becomes a semi-weekly depositor for the rest of the current and following calendar years.

Methods of deposit

There are two methods for depositing payroll taxes – electronic deposit or deposits with Federal Tax Deposit (FTD) coupons and cash, check, or money order.

For 2006, employers are required to use electronic deposit of payroll taxes if (1) their total tax deposits in 2004 were more than \$200,000 or (2) the employer was required to use electronic deposit in 2005. Other employers are also permitted to use electronic deposit.

It is unlikely that very small employers are required to use the electronic deposit method because of the \$200,000 threshold. As an example, assuming a total tax liability of approximately 25 percent of wages for payroll tax deposits (15.3 percent for Social Security and Medicare taxes and an average of 9.7 percent for income tax withholding), the \$200,000 threshold would translate to approximately \$800,000 of total wages.⁵⁵ Assuming average wages of \$30,000 per employee, it would take a workforce of 27 employees to net \$200,000 of annual payroll tax liability.

Penalties

Employers are subject to deposit penalties ranging from 2 percent to 15 percent. Penalties can be assessed for (1) failing to make a deposit in a timely manner, (2) deposits made at an unauthorized financial institution, paid directly to the IRS, or paid with the employer's tax return, or (3) amounts subject to electronic deposit requirements, but not deposited in that manner.

In addition, an employer that is required to withhold tax on wages is liable for payment of the tax even if the withholding has not been collected. An employer is relieved of this liability, but not penalties, if the required tax is paid by the employee.⁵⁶ Any responsible person (typically a corporate officer or employee) who willfully fails to withhold or pay over withholding tax is subject to a penalty equal to 100 percent of the tax.⁵⁷

⁵⁵ If average wages are assumed to be higher, then the rate of income tax withholding would also be higher, meaning that the \$200,000 threshold would be reached with fewer employees.

⁵⁶ Section 3402 of the Internal Revenue Code of 1986.

⁵⁷ Section 6672 of the Internal Revenue Code of 1986.

B. Automatic IRA Proposal

The conceptual description of the Automatic IRA proposal below is taken from the following two source documents. Iwry, J. Mark and David C. John, *Pursuing Universal Retirement Security Through Automatic IRAs*. Iwry-John Working Paper – Draft of Feb. 12, 2006. John, David C. and J. Mark Iwry, *Testimony before the Subcommittee on Long-Term Growth and Debt Reduction, Committee on Finance, United States Senate, June 29, 2006, Pursuing Universal Retirement Security Through Automatic IRAs*. The Heritage Foundation and The Retirement Security Project. In addition, bills have been introduced in the House of Representatives and the Senate that are based on the conceptual Automatic IRA proposal developed by Iwry and John. These bills are S.3952, introduced on September 27, 2006, by Senators Bingaman and Smith and H.R. 6210, introduced on September 27, 2006, by Mr. English. When relevant, references to the specific details addressed in these bills are also discussed in this paper.

1. Overview of the Automatic IRA proposal

Description of the Proposal

In general

Under the proposal, employees who are not eligible to participate in an employer-sponsored retirement plan would be eligible to save for retirement through an Automatic IRA. This retirement saving would be accomplished through regular and automatic payroll deductions from the employee's paycheck. While the proposal discusses both payroll deposit IRAs, under which employees elect to make contributions to an IRA funded through payroll deductions, and Automatic IRAs, in which an employer establishes an IRA on behalf of an employee and then withholds amounts from the employee's paycheck to fund the IRA, we use the term "Automatic IRA" to refer to both scenarios. The key difference between the two scenarios as discussed below is whether employees are expected to "opt in" to a payroll deduction IRA or "opt out" of such an IRA.

Employers with a minimum number of employees (more than 10) who have been in business for at least two years would be required to make Automatic IRAs available to any of their employees not covered under a qualified retirement plan.⁵⁸ Employers would be required to notify their employees of the availability of the Automatic IRA and payroll deduction and would be required to elicit written responses from employees as to whether they want to participate in the Automatic IRAs.

As noted above, there are two possible approaches to making Automatic IRAs available. The first approach is the "opt in" approach under which an employee does not participate

⁵⁸ The proposal does not provide a specific minimum size for employers who will be subject to the Automatic IRA requirement, but suggests more than 10 employees as a possible threshold. The introduced bills adopt this more than 10 employee threshold.

in an Automatic IRA unless the employee affirmatively elects to participate. The second approach is an “opt out” or “automatic enrollment” approach under which an employee is enrolled in an Automatic IRA and a specified default Automatic IRA contribution is withheld from the employee’s paycheck unless the employee affirmatively elects not to participate.

Payroll deposit IRA arrangements (“Opt In” arrangements)

The introduced bills provide that all employers (other than specifically excluded employers described below) are required to offer eligible employees the right to participate in a payroll deposit IRA, which is a written arrangement under which an employee may elect to contribute to an individual retirement plan established by or on behalf of the employee through periodic payroll deposits (electronically or otherwise). Under this type of arrangement, the employer is required to make the applicable IRA deposits no later than the time that the employer makes deposits of Federal employment taxes or the 30th day following the last day of the month to which the payments relate. Thus, the deposits are generally required at the same time that Federal employment tax deposits are made, unless such deposits are made less frequently than monthly.⁵⁹ Under this type of arrangement, the employee can elect with reasonable notice to the employer to stop participating in the arrangement at any time and, once such an election has been made, the arrangement can specify that the employee cannot resume participating until the next calendar year.

The bills provide that employees must be given a 60-day period prior to the beginning of each calendar year (or at the beginning of employment) to elect to participate in the arrangement or to change an election with respect to the arrangement, such as the amount contributed to an IRA under the arrangement. Employers are required to give their employees notice of the right to elect to participate in the arrangement and the maximum amount that can be contributed to an IRA on an annual basis. If the arrangement includes an automatic contribution arrangement (an opt-out arrangement), as described below, separate notice requirements must also be satisfied.

The introduced bills state that employers who use the “opt in” approach are required to take “all reasonable actions to solicit from all employees eligible to participate in the arrangement an explicit election to either participate or not to participate in the arrangement.”⁶⁰ Employees who do not respond to an employer’s solicitation would be presumed to have elected to participate in the Automatic IRA program as if the arrangement included an automatic contribution arrangement.

Automatic contribution arrangement (“Opt Out”)

The proposal indicates that employers would be encouraged to use the “opt out” or automatic enrollment approach. Employers electing to use the automatic enrollment (or

⁵⁹ Employers who are only required to make quarterly deposits of employment taxes would be required to make the requisite IRA deposits at least monthly.

⁶⁰ Proposed sec. 408B(2)(F) of the Internal Revenue Code of 1986; bill section 2(a).

opt out) option would not be required to obtain responses from unresponsive employees. The proposal states that this would provide an incentive to employers to use this approach.

The introduced bills clarify the applicability of the automatic enrollment approach. The bills provide that an automatic enrollment arrangement must satisfy the same requirements as apply to eligible automatic contribution arrangements under an employer's 401(k) arrangement. Under an eligible automatic IRA contribution arrangement, an employee is deemed to have elected to contribute 3 percent of compensation. These contributions may be increased periodically, as provided in regulations, up to a maximum of 8 percent of compensation. In no event can the contributions exceed the applicable IRA dollar limits in effect for the calendar year. For 2007, an individual cannot contribute more than \$4,000 per year to an IRA, plus, if the individual is at least age 50 by the end of the year, an additional catch-up contribution of \$1,000.

The contributions are required to be transferred to (1) an Automatic IRA or (2) to an individual retirement plan of a designated trustee or issuer selected by the employer. The contributions are required to be invested in a life cycle fund similar to the funds offered under the Federal Thrift Savings Fund or in such other funds as are authorized by regulation and which involve asset allocation and extensive diversification.

The introduced bills specify that a model notice will be issued that is written in a manner calculated to be understandable to an average worker and simple for an employer to use. The notice would notify employees of the requirement that their employer must make Automatic IRAs available to them that satisfies the employee election requirements. This notice and elections could be provided to employees with the withholding exemption certificate (Form W-4).

Issues and Analysis

A source of complexity in the proposal relates to the application of the IRA contribution limits. Under current law, the IRA dollar limits are phased out over specified income ranges if the IRA contributor (or his or her spouse) is an active participant in an employer-sponsored qualified retirement plan. The introduced bills make clear that all of the applicable IRA contribution limit rules, including the rules relating to active participation in an employer-sponsored qualified retirement plan, apply in the case of Automatic IRAs. As a result, some individuals may have Automatic IRA contributions made on their behalf, but may be subject to the dollar phaseouts for individuals who are active participants in a qualified retirement plan. For example, this issue could arise if one spouse is an active participant in an employer-sponsored retirement plans, but the other spouse works for a small employer who does not maintain any retirement plans for employees. The spouse working for the small employer may have contributions made on his or her behalf to an Automatic IRA established by the small employer. If the couple has sufficient income, the contributions to the Automatic IRA may exceed what would otherwise be allowed. Indeed, one can imagine that an individual might fail to make an

election with respect to participation in an Automatic IRA arrangement of the small employer because the individual knows that he or she is not eligible to participate because of the income phaseouts.

This issue could also arise with respect to an individual who works for more than one employer, one of which provides a qualified retirement plan and one of which does not and is required to make Automatic IRAs available. If the individual fails to make an election to decline participation in an Automatic IRA, contributions will be made to an Automatic IRA on the individual's behalf that may not be permitted because of the individual's income level.

2. Eligible employees

Description of Proposal

The proposal states that employers would be required to make Automatic IRAs available to certain classes of employees. The proposal suggests, for example, that Automatic IRAs would be available to employees who have been employed with an employer on a regular basis for a minimum period of time (such as 30 days) and whose employment is expected to continue. Automatic IRAs would not be required to be made available to employees who are covered under an existing qualified retirement plan of the employer or to employees who are eligible for, but do not participate in, a qualified cash or deferred arrangements (sec. 401(k) plan) of the employer.

S. 3952 and H.R. 6210 specifically define the employees to whom the Automatic IRA proposal applies as including with respect to any calendar year any employee who was not eligible to participate in an employer's qualified plan or arrangement for the preceding calendar year and is not expected to be eligible to participate for the current calendar year. Employers can elect to exclude the following employees from eligibility for Automatic IRAs:

1. employees covered by a collective bargaining agreement (in 2005, approximately 15.7 million workers, or 12.5 percent of the workforce, were covered by collective bargaining agreements);⁶¹
2. employees who are nonresident aliens (estimates based on the March 2002 Current Population Survey indicate that there are approximately 6 million nonresident alien workers in the U.S. workforce);⁶²
3. employees who have not attained age 18 before the beginning of the calendar year (approximately 4.8 million workers are under the age of 19);⁶³
4. employees who have not worked for an employer for at least three months (the Bureau of Labor Statistics reports that approximately 4.7 million employees are

⁶¹ See Bureau of Labor Statistics, "Table 1. Union affiliation of employed wage and salary workers by selected characteristics."

⁶² See "Undocumented Immigrants: Facts and Figures," Urban Institute Immigration Studies Program, by Jeffrey S. Passel, Randy Capps, and Michael Fix. January 12, 2004.

⁶³ See U.S. Census, 2006 Statistical Abstract, "Table 579. Civilian Labor Force – Percent Distribution by Sex and Age."

- hired each month, suggesting that at any point in time, about 14 million employees would have tenure of less than 3 months),⁶⁴
5. employees who are not eligible to participate in an employer's qualified plan or arrangement merely because they have not satisfied the eligibility requirements for the plan (i.e., minimum age and service requirements under the plan, such as one year of service and attainment of age 21) (there are 8.5 million employees under the age of 21);
 6. employees who are eligible to make contributions to a tax-sheltered annuity arrangement (section 403(b) annuity program) (there are approximately 12 million workers covered by 403(b) and 457 plans, according to the Pension Rights Center); and
 7. all employees of an employer who maintains a SIMPLE retirement arrangement (an IRS Statistics of Income study found that, in 2002, there were 1.7 million taxpayers maintaining a SIMPLE arrangement).

Under the bills, a qualified plan or arrangement does not include any plan that has been frozen as of the first day of the preceding calendar year or, in the case of a plan in which employer contributions are discretionary, there has not been an employer contribution for at least a two plan year period and it is not reasonable to expect that an employer contribution will be made for the plan year ending in the preceding calendar year.

Issues and Analysis

The Automatic IRA proposal requires decisions as to what employees will not be included in eligible employees. Among the decisions that must be made include whether all part-time employees are required to be included or only employees with more than a minimum number of hours of service per week. Including only employees with more than a minimum number of hours of service per week would have the advantage of eliminating IRA contributions that will likely be de minimis. On the other hand, excluding employees who may work multiple part-time jobs reduces the number of employees able to utilize Automatic IRAs to save for retirement.

To the extent that the Automatic IRA proposal applies to a subset of all employees of employers, complexity of administration increases. Employers must make a determination of whether any individual employee is required to be included in the employees to whom Automatic IRAs apply.

The introduced bills identify specific classes of excluded employees. Seasonal employees are "excluded" unless they work for an employer for more than three months. Part-time employees are "included" without regard to the number of hours worked per week or the amount of compensation received from an employer. The inclusion of all part-time employees who have worked for an employer for at least three months may result in a large number of very small IRA contributions being made on behalf of these employees. However, it should be noted that it is our understanding that the intent of the

⁶⁴ See Bureau of Labor Statistics, "Table A. Job openings, hires, and total separations by industry, seasonally adjusted."

introduced bills is to exclude employees who work less than 1,000 hours per year if the employer maintains a qualified pension plan that excludes such individuals from coverage.⁶⁵

While there are a number of practical issues that must be addressed with respect to the classes of employees eligible to participate in Automatic IRAs, there is a broader issue that must be considered as well. Theoretically, the Automatic IRA proposal works best to achieve the goals of maximizing retirement savings by American workers if it is applied to the broadest possible classification of employees. Under this theory, all employees should be allowed to save through payroll deduction, irrespective of the number of hours they work, whether they are seasonal employees or students, and whether or not their employment is expected to continue. To the extent that a workable payroll deduction system can be structured, such an approach might also be the simplest for employers to administer because it would eliminate the need to make determinations of which of an employer's employees are eligible for Automatic IRAs.

On the other hand, there are additional issues raised by a broad rule that essentially includes all employees irrespective of the number of hours they work. A significant issue is the administrative burden imposed on an employer to provide Automatic IRA enrollment for a large number of employees who are low wage or low hour workers and who are among the least likely to prefer retirement savings and the most likely to elect not to have amounts withheld from their paychecks. In particular industries, this problem will be particularly acute. For example, in the fast food industry, the turnover rate of employees can easily exceed 100 percent in a year and the administrative burdens of complying with the Automatic IRA proposal for a large number of individuals who are likely to elect out of the proposal could be large relative to the benefits. The introduced bills partially address the issue of high-turnover industries by required Automatic IRAs to be available only to employees who have completed at least three months of service with an employer.

In addition, there is an issue (addressed below in the issues relating to depositories) as to whether there will be central depositories willing to accept what amount to de minimis Automatic IRA contributions.

One issue with respect to the introduced bills is the exclusion of employees who have not met minimum age and service requirements for an employer's qualified retirement plan. Applying the Automatic IRA proposal to employees who have not yet satisfied minimum age and service requirements would permit these employees to begin retirement savings earlier rather than waiting to satisfy requirements for an employer's plan.

⁶⁵ In general, a qualified plan is permitted to exclude from participation employees who have not completed a year of service with an employer. A year of service is generally defined as working at least 1,000 hours in a year.

3. Employers required to offer Automatic IRAS

Description of Proposal

Under the proposal, employers would be required to offer Automatic IRAs to their employees. The proposal contemplates that employers below a certain size (the proposal mentions employers with 10 or fewer employees) would not be required to comply with the Automatic IRA proposal. In addition, the proposal would not apply to employers who have been in business for fewer than two years.

The proposal indicates that employees of small employers that are exempt from the Automatic IRA proposal would have available other ways to facilitate savings. (These other alternatives would include – directing the IRS to contribute a portion of a tax refund to an IRA or by setting up an automatic debit arrangement for IRA contributions.)

Employers who sponsored a qualified retirement plan for only a portion of their employees (such as a particular subsidiary, division, or other business unit) would be required, under the proposal, to make Automatic IRAs available to all other employees. As noted above in the definition of eligible employee, certain employees could be disregarded for this purpose.

The introduced bills provide that the Automatic IRA provisions do not apply to an employer if:

1. The employer did not have more than 10 employees who received more than \$5,000 of compensation from the employer for the preceding calendar year; or
2. The employer was not in existence at all times during the preceding two calendar years and did not have more than 100 employees who received at least \$5,000 of compensation from the employer on any day during either of the preceding two calendar years.⁶⁶

For purposes of determining the number of employees, all members of the same family will be treated as one employee. In addition, the definition of an employer will include any predecessor employer so that the Automatic IRA proposal cannot be avoided by creating a new business every two years.

The introduced bills exempt the following employers from the requirement that they make Automatic IRAs available to their employees:

1. The Federal government, any state government or political subdivision, or any agency or instrumentality of the Federal government or state government or political subdivision; and

⁶⁶ The statutory language appears to incorporate the rule of section 408(p)(2)(C)(i)(II) under which an employer may continue to be treated as an employer with 100 or fewer employees for the two years after the number of employees exceeds 100. It is unclear whether it is intended that this rule apply to Automatic IRAs. The purpose of the rule under section 408 is to permit an employer to continue to maintain a SIMPLE plan for two years after the number of employees exceeds the 100-employee threshold. However, it is not clear how this rule would function with respect to the Automatic IRA proposal.

2. A church or convention or association of churches exempt from tax under section 501.

Issues and Analysis

A significant structural issue is the appropriate threshold for determining whether an employer is required to make Automatic IRAs available to employees. As drafted, the proposal would exclude the more than 50 percent of all U.S. businesses that have fewer than 10 employees. This would amount to excluding approximately 15 percent of the U.S. workforce.⁶⁷

If the threshold were raised to 20 employees, fully 65 percent of U.S. businesses would be excluded, accounting for 25 percent of the U.S. workforce.

The trade offs are obvious. The smaller the employer, the more administratively difficult the implementation of Automatic IRAs will be. The smallest employers are the least likely to use electronic processing of payroll. In general, it is expected that electronic processing of payroll and direct deposit of payroll checks will ease the administrative burdens of employers subject to the Automatic IRA proposal. In addition, per employee administrative costs are inversely related to firm size – smaller employers face higher per employee costs than larger employers. These administrative costs could be partially offset by a proposed employer tax credit, but it is not clear that the credit would fully offset such costs.⁶⁸

On the other hand, creating a minimum employee threshold of less than 10 workers excludes a significant percentage (approximately 15 percent) of the U.S. workforce from the Automatic IRAs proposal. Theoretically, the broader the reach of the Automatic IRA proposal, the more likely that retirement savings will increase among those U.S. workers most in need of assistance in saving for retirement.

4. Tax treatment and character of Automatic IRA accounts

Description of Proposal

Under the proposal, contributions to an Automatic IRA would be treated either as contributions to a traditional IRA or would be treated as contributions to a Roth IRA. Contributions to a traditional IRA generally are deductible when made, grow tax free, and are included in income when withdrawn.⁶⁹ Contributions to a Roth IRA are not deductible when made, grow tax free, and are not included in income when withdrawn.

⁶⁷ See www.bls.gov/opub/ted/2001/Mar/wk1/art04.htm.

⁶⁸ See, also, the discussion below discussing the fact that tax-exempt and nontaxable employers will not be able to utilize this tax credit.

⁶⁹ If an individual (or an individual's spouse) is covered under an employer's retirement plan, the deduction for IRA contributions may be limited by the individual (or couple's) income.

The proposal states that the statute would specify which type of IRA would be the default in the case of no specific election by an employee. In addition, the proposal would relieve the employer of any responsibility for ensuring that employees satisfied the applicable IRA requirements.

The proposal suggests (“as a broad generalization”)⁷⁰ that Automatic IRAs would be freely transferable to and with other IRAs and with qualified retirement plans that permit transfers to the plan. However, the proposal also suggests that restrictions on such free rollovers and transfers may be necessary because of the investment limitations and cost-containment features of the Automatic IRA proposal. It is presumed, although not clearly specified, that rollovers and transfers of Automatic IRAs to other IRAs and qualified retirement plans will be subject to the same restrictions that apply to such types of transfers under current law.

The introduced bills prohibit rollovers of Automatic IRAs unless the balance to the credit of the individual in the Automatic IRA is at least \$15,000.

Issues and Analysis

An employee’s current and future tax liability will be affected depending upon whether Automatic IRA contributions are designated as traditional IRA contributions or Roth IRA contributions. If an individual is subject to the same marginal tax rate and treatment at the time IRA contributions are made and when the contributions are withdrawn, then traditional IRAs and Roth IRAs will result in equivalent Federal tax benefits. However, Roth IRA contributions (in which the contributions are not deductible from income when made) generally are considered to be better for individuals who anticipate that their income will be higher when the contributions are withdrawn than when they are contributed. Deductible IRA contributions (in which the amounts withdrawn from the IRA are included in income) are considered to be better for individuals who expect their income to be lower when the contributions are withdrawn. This rule of thumb only holds true if the current Federal tax rate structure is assumed not to change between the time of contribution and the time of withdrawal. For example, the proposal notes that the value of Roth IRA contributions would decrease substantially if the United States were to enact a consumption-based tax system to replace the current income tax system.

In addition, the value of deductible versus Roth IRAs may also be affected by the state in which an individual resides when the contributions are made and when the contributions are withdrawn. If an individual resides in a state with an income tax system that mirrors (to some extent) the Federal income tax system and the individual plans to retire to a state that has no state income tax, the individual may be better off to make deductible IRA contributions rather than Roth IRA contributions because the value of the current tax deduction may be greater than the present value of the future benefit of Roth IRA contributions upon withdrawal.

⁷⁰ Draft of Feb. 12, 2006, p. 16.

The proposal also notes that the Roth IRA could be beneficial for individuals who might otherwise be subject to tax on their Social Security income after they retire.⁷¹ In such a case, the withdrawal of excludable Roth IRA contributions would not be treated as income for purposes of determining the amount of Social Security benefits required to be included in income in a year.

The proposal states that a Roth IRA may be preferable for lower income individuals who might be expected to see their income increase as they age. However, it is also generally accepted that post-retirement income tends to be lower than pre-retirement income. An individual's life cycle of earnings can be expected to start relatively low, increase with age and years of employment, and then level off or decrease in retirement. Thus, it could be argued that, assuming no other changes occur to the Federal income tax system, an individual should designate contributions as Roth IRA contributions early in his or her career when income levels are fairly low and then designate contributions as traditional IRA contributions when the individual's income levels rise and the individual approaches retirement age.

While allowing an individual the ability to designate IRA contributions as either traditional or Roth IRA contributions allows an employee to maximize the potential tax benefits with respect to the IRA contributions, it also introduces a level of complexity that should be carefully considered. Complexity generally increases costs and may lead to greater confusion among individuals. Many individuals will not be capable of making a reasonable assessment of whether they should make deductible or Roth IRA contributions and their decision will be made according to whatever default provision is in effect. This has the result of rewarding the more savvy individuals who are able to make a reasoned judgment with respect to the type of IRA contribution they should make.

5. Payroll deposit processing

Description of Proposal

Amounts withheld from employees' paychecks for automatic IRA contributions would be deposited in the IRA accounts of employees by employers. The proposal contemplates using the existing payroll tax withholding deposit system to facilitate these deposits.

Compliance and enforcement

The proposal suggests that employees would be provided with a paper or electronic mail notice of the opportunity to participate in an Automatic IRA through payroll deduction savings and would solicit the employee's response. This notice could, under the proposal, be associated with the provision of a Form W-4 (Employee's Withholding

⁷¹ Section 86 of the Internal Revenue Code of 1986 requires taxpayers with income above certain levels to include in income a portion of their Social Security benefits.

Allowance Certificate).⁷² If the employer elected to use an automatic enrollment approach, the notice would also be required to indicate the default level of contributions that will be withheld from an employee's paycheck, the default Automatic IRA that is used, and the way in which an employee can elect to change the default contribution or elect out of the Automatic IRA program entirely.

The employer would be required to keep records sufficient to demonstrate that Automatic IRA withholding was being applied to each eligible employee or that the employee had elected not to have withholding apply.

Under the proposal, employers would be required annually to certify that the Automatic IRA requirements have been satisfied. The proposal suggests that this certification could be done as part of the existing Form 941 (Employer's Quarterly Federal Tax Return), which is used to report employer withholding of taxes from employee paychecks.⁷³

The proposal indicates that an excise tax penalty would apply to each failure of an employer to offer Automatic IRA payroll deposit savings to an employee.

TSP II Board

The introduced bills provide for the creation of the TSP II Board, which would be a board established in the executive branch of the Federal government and would be similar to the Federal Retirement Thrift Investment Board established in connection with the Thrift Savings Plan for Federal employees. The Federal Retirement Thrift Investment Board administers the Federal Thrift Savings Plan (TSP) and contracts with the U.S. Department of Agriculture's National Finance Center (NFC) to serve as the TSP record keeper. Since Hurricane Katrina, much of the TSP recordkeeping has been outsourced to private firms.

The duties of the TSP II Board would include establishing policies and procedures for the following:

1. establishment and maintenance of individual retirement plans under the Automatic IRA proposal;
2. investment and management of contributions to such Automatic IRAs;
3. amount of contributions and investment of contributions under Automatic IRA arrangements; and
4. establishment of Automatic IRAs.

⁷² New employees of an employer are required to complete a Form W-4 to determine the amount that should be withheld from their paycheck for Federal taxes. Form W-4 can also be completed by employees if they want to change of amount of Federal taxes withheld from their paychecks.

⁷³ Generally, the actual deposit of withheld taxes is accompanied by Form 941-V (Payment Voucher), but in certain cases (e.g., the net taxes for a quarter are less than \$2,500) the payments accompany the filing of the Form 941.

It is unclear under the introduced bills whether the TSP II Board would be charged with the same recordkeeping responsibilities that the Federal Retirement Thrift Investment Board has with respect to the Federal Thrift Savings Plan.

Default investment fund

The proposal contemplates that Automatic IRAs would, irrespective of the depository used, include a specified set of default investment options. The proposal would identify the specific default investment option into which Automatic IRA contributions would be deposited in the absence of an election to the contrary. The proposal contemplates that this default investment option would be a “highly diversified ‘target asset allocation’ or ‘life cycle’ fund comprised of a mix of equities and fixed income or stable value investments.”⁷⁴ The proposal suggests that the life-cycle funds utilized for the Federal thrift savings plan would be one possible model, but that the mix of equities and fixed income would be intended to reflect industry consensus with an emphasis on sound asset allocation and diversification of investments.

The default investment option would be a variety of funds depending upon the individual’s age. Thus, for older individuals, the default investment option would reflect a more conservative investment mix than the default investment option for younger individuals. However, once a default investment option has been selected for an individual, all of the individual’s Automatic IRA contributions would be invested in that option even if the individual would otherwise “age” into a more conservative default option. The individual would be required to make an affirmative election to move funds from the default investment option.

The proposal identifies as a major design issue whether additional investment options will be permitted to be offered beyond the standard, limited investment options. The proposal notes that limiting investment options would have the advantages of (1) limiting overall costs, (2) improving overall investment results, and (3) simplifying the decision making process for Automatic IRA contributors. But such limited options would restrict individual choice and possibly reduce innovation in investments.

The proposal suggests addressing this issue by permitting Automatic IRA account holders to transfer or rollover their account balances between Automatic IRAs and other IRAs.

Issues and Analysis

According to the current Survey of Business Owners conducted by the U.S. Census Bureau, there are 5.8 million employer firms in the United States employing 115.4 million paid employees.⁷⁵ Of the total number of firms, slightly more than 107,700 firms

⁷⁴ Draft of Feb. 12, 2006, p. 20

⁷⁵ *2002 Survey of Business Owners*. United States Census Bureau, Company Survey, September 14, 2006. See, also, *Table 741. Employer Firms, Employment, and Annual Payroll by Enterprise Size and Industry*:

have 100 or more employees, accounting for more than 64 percent of the civilian workforce. There are 3.7 million firms with less than 10 paid employees (accounting for 12.5 million workers) and approximately 1.2 million firms with 10-99 employees (accounting for 28.4 million workers). Data from 1999 found that more than 70 percent of the private industry employees work for employers with less than 250 employees.⁷⁶

As of March 2006, 60 percent of workers in private industry had access to some form of retirement plan with their employer and 51 percent of workers participated in a plan.⁷⁷ Larger employers are much more likely to offer retirement plans to their employees with 54 percent of firms with 100 or more workers offering some form of retirement plan. For firms with fewer than 100 workers, only 47 percent offer a retirement plan. In addition, only 37 percent of workers in firms with fewer than 100 workers actually participate in a retirement plan, whereas 67 percent of workers in firms with 100 or more workers participate in such a plan.

The National Federation of Independent Businesses conducted a survey of small businesses in April and May of 2006.⁷⁸ According to the NFIB survey, 51.3 percent of small employers with at least 10 employees, but fewer than 250 employees, offer their employees a retirement plan, meaning that 48.7 percent of these employers do not offer such a plan. If employers with one to four employees are included in the statistics, the offer rate for retirement plans drops to 26.5 percent. The data suggest that the offering of retirement plans to employees of small employers continues to be a problem. The vast majority (77 percent) of plans offered by small employers are either 401(k) plans or SIMPLE plans.

A significant issue with respect to Automatic IRAs is the extent of the burdens imposed on small employers by the requirements to make payroll deposit IRAs available to employees. In order to implement an Automatic IRA system, a key element is the utilization of electronic payroll deposits and the ability to handle electronic deposits in more than one account. Thus, it is important to examine (1) the processes currently used by small employers to handle payroll administration, (2) the extent to which small business employers currently utilize electronic payroll deposits; (3) the payroll processing changes that would be required by Automatic IRAs, and (4) the costs likely to be imposed on small employers as a result of the Automatic IRA proposal.

2002. Statistical Abstract of the United States: 2006, p. 514. It should be noted that these statistics include private (i.e., nongovernmental) employers.

⁷⁶ *Majority of Private-Industry Employees Work in Small Establishments*. Monthly Labor Review: The Editor's Desk, originally published March 8, 2001. Bureau of Labor Statistics, United States Department of Labor. <http://www.bls.gov/opub/ted/2001/Mar/wk1/art04.htm>.

⁷⁷ *National Compensation Survey: Employee Benefits in Private Industry in the United States, March 2006*. U.S. Department of Labor, U.S. Bureau of Labor Statistics. August 2006.

⁷⁸ *NFIB National Small Business Poll*. Volume 6, Issue 1, 2006. For purposes of this survey, a small employer was defined as a business owner employing no fewer than one employee and no more than 249 employees. Rather than using a random stratified sample, the survey included a disproportionate number of employers with 10-19 employees and with 20-249 employees. This was done to ensure that an adequate number of responses were received from these categories given that nearly 60 percent of employers in the United States employ one to four employees.

Much of the foregoing discussion is based upon the NFIB survey of small employer payroll processing.⁷⁹

Current payroll practices

According to the NFIB survey, most small business employers (64.4 percent) do their payroll processing in-house; 14 percent hire a bookkeeper or accountant and 19.3 percent utilize a payroll service company. Of the small business employers who do payroll in-house, nearly 70 percent of small business owners either do the payroll themselves or have an unpaid spouse or other family member who does the work. Statistically, the smaller the employer, the more likely it is that payroll processing will be done in-house. Most very small employers continue to do their payroll in-house because they believe they have greater control or oversight over the work or because it is cheaper to do so.

In addition, the smaller the employer size, the more likely that payroll processing and payroll checks will be done by hand and the less likely that payroll processing will be tied electronically to a larger accounting system or that employees will be able to utilize direct deposit of payroll checks.

The time it takes most small businesses to complete their payroll processing is directly related to the size of the employer. For employers with fewer than 20 employees, the majority of employers indicated that payroll processing took one to three hours per pay period. However, for employers with 20-249 employees, payroll processing was more likely to take six or more hours per pay period.

For those small employers who utilize the services of an outside bookkeeper or accountant or who use a payroll services company, the NFIB survey asked about the costs of such services. The survey specifically asked whether the costs of these services were (1) less than \$100, (2) \$100 or more, or (3) rolled into a single payment for financial services. With respect to the use of an outside bookkeeper or accountant, 31.3 percent of small businesses said that the costs per pay period were less than \$100 and 20.2 percent said that the costs were \$100 or more per pay period. For small employers utilizing the services of an outside payroll services company, 22.5 percent indicated that the costs per pay period were less than \$100 and 34.1 percent indicated the costs were \$100 or more per pay period.

The data suggest that the costs of payroll processing for small employers are currently relatively small in both dollar and time terms. If the Automatic IRA proposal is enacted, then the costs to small employers of payroll processing will go up. The Automatic IRA proposal will, at a minimum, force more employers to utilize electronic processing of payroll deposits and will require more employer to offer employees the option of direct deposit of payroll checks.

⁷⁹ *NFIB National Small Business Poll*, p. 4.

Electronic processing of paychecks and payroll deposits

The data suggest that the smallest employers are less likely to utilize either electronic deposit of payroll tax liabilities or direct deposit of payroll checks for employees.

The NFIB survey found that 46.2 percent of employers with one to nine employees remit their payroll taxes with their quarterly employment tax return, compared to 33.3 percent of employers with 10-19 employees, and 21.1 percent of employers with 20-249 employees. Overall, 42.4 percent of small employers remit payroll tax liabilities on a quarterly basis, 27.3 percent remit payroll taxes monthly, and 13.3 percent remit such taxes more frequently than monthly.

The smaller the employer size, the less likely it is that the employer will use an Internet banking arrangement that allows for the electronic remittance of payroll taxes. However, in general, at least 50 percent of employers with at least 10 employees remit payroll taxes electronically, according to the NFIB survey.

According to the NFIB survey, 26 percent of small employers currently offer their employees the option of directly depositing their payroll checks into a checking or savings account. The percentages are higher when employers with fewer than 10 employees are excluded. Thus, 41.5 percent of employers with 10-19 employees and 54.5 percent of employers with 20-249 employees offer direct deposit of payroll checks. If employees are offered direct deposit, the NFIB survey demonstrates that employees are more likely than not to take advantage of it.

The NFIB survey also examined the extent to which employers with direct deposit allow employees to deposit their paychecks in more than one account. In general, a majority (52.5 percent) of small employers permit their employees to direct deposit their paychecks into more than one account. On the other hand, less than half of small employers (38.4 percent) permit their employees to direct the deposit of their paychecks into accounts of more than one financial institution.

Small employers have generally adopted direct deposit of payroll for two reasons – the belief that it is administratively easier and more reliable than paper checks or because the employer's employees have asked for direct deposit. Most of the employers who have adopted direct deposit (63.1 percent of small employers) believe that it has been helpful. Of the small employers who have not adopted direct deposit, the majority of employers indicate that they have not adopted direct deposit because of the paperwork and general hassle involved or because the employees don't care about it.

Payroll processing changes required by Automatic IRAs

The proposal contemplates utilizing electronic funds transfer as part of the Automatic IRA proposal.⁸⁰ However, the proposal also states employers that currently process

⁸⁰ June 29, 2006, draft, p. 11.

payroll by hand would not be required to make the transition to automatic payroll processing or use of on-line systems. The proposal would address this issue with the following rules:

(1) By exempting very small employers from the Automatic IRA rules, the proposal states that a large proportion of employers still processing payroll by hand would be exempt. The proposal states that this would focus the proposal on the employers that already offer their employees direct deposit of paychecks.

It is important to reflect on the NFIB statistics closely. While the description of the proposal suggests that most employers subject to the Automatic IRA proposal already utilize electronic processing of payroll tax deposits and already offer direct deposit of paychecks to employees, the statistics show that among employers with 10-249 employees (assuming that employers with fewer than 10 employees will be exempt from the Automatic IRA proposal), there will be significant numbers for which the Automatic IRA proposal will require a change in current practices. According to the NFIB survey, 40-50 percent of small employers in the 10-249 employee size range currently do not utilize internet banking arrangements to transmit payroll taxes electronically. Similarly, 25-30 percent of these small employers do not make direct deposits of paychecks available to their employees.

Thus, while exempting employers with fewer than 10 employees from the Automatic IRA provisions will reduce the impact of the proposal for a significant percentage of the very smallest businesses, there are significant numbers of small businesses for whom the Automatic IRA proposal will represent a real change in the way that payroll deposits and remittance are handled. Since the likelihood of use of electronic processing of payroll deposits and direct deposits of payroll checks is directly related to the size of the employer, a question can be raised as to whether the fewer than 10 employee threshold is the proper one if reducing potential administrative burdens of the Automatic IRA proposal is a major goal.

(2) The proposal contemplates that employers could “piggyback” the deposits of employee contributions to IRAs onto the Federal tax deposits they currently make. The proposal states that the timing and logistics of the IRA deposits would be the same as the payroll tax deposits that an employer makes.

If the employer is making deposits of withheld IRA contributions at the same time and in the same manner as the employer’s deposits of payroll taxes, then the timing of deposits will be semi-weekly, monthly, or quarterly. According to the NFIB survey, more than 27 percent of employers in the 10-249 employee size range currently remit their payroll taxes on a quarterly basis. If employers are permitted to remit their Automatic IRA contributions also on a quarterly basis, then employees will lose up to a quarter’s worth of earnings on their IRA contributions. Some thought should be given to whether such a delay in deposit and concomitant delay in the crediting of earnings is desirable from a policy standpoint. In addition, a lengthy delay between withholding and deposit may give rise to potential risks of loss to the employees. The introduced bills address this

issue by requiring Automatic IRA contributions to be made no less frequently than monthly.

(3) The proposal contemplates that employers would be permitted to use the existing system for transmittal of taxes (EFTPS) to make deposits of Automatic IRA contributions. Thus, the proposal contemplates the development of a parallel stream of payroll deduction savings payments through EFTPS.

The addition of a separate type of payment through EFTPS raises logistical issues that need to be thoroughly explored. Under the current EFTPS system, payments are made from employers to a single source – the general account of the U.S. Treasury. The proposal would add a new, significantly more complex layer of payment transmittal – the transmittal of employee funds from the employer to either a default Automatic IRA account or to a separate Automatic IRA account specified by each employee. Changing the existing EFTPS system to accommodate this “parallel” track of payments may present significant challenges from a programming and implementation perspective.

In essence, under the proposal, the Federal government will become a financial intermediary that will accept funds from employers and then transmit them to Automatic IRA accounts of employees. If the designation of an account by an employee is inadequate (e.g., because of improper account designation or the improper identification of an authorized financial institution), then rules will be needed to determine the appropriate action by the Federal government. Presumably, the Federal government could merely be required to deposit the amounts in a default Automatic IRA account, but it may be necessary to require the Federal government to notify the employer (and the employee) of the problem with the employee’s designation of an Automatic IRA account.

6. Cost containment measures

Description of Proposal

The proposal identifies as a key issue the development of Federal rules that would help to minimize the costs of investment management and Automatic IRA account administration. Among the possible features that the proposal identifies as cost-containment measures are the following:

- 1) Excluding brokerage services and retail equity funds from the investment options available under the IRA;
- 2) Limit the number of investment options under the IRA;
- 3) Allow individuals to change their investments only once or twice per year;
- 4) Specify a low-cost default investment option and provide that, if any of an individual’s account balance is invested in the default option, all of it must be;
- 5) Prohibit loans and perhaps limit pre-retirement withdrawals;
- 6) Limit access to customer service call centers;
- 7) Preclude commissions;
- 8) Make compliance testing unnecessary;

- 9) Give account owners only a single account statement per year (especially if daily valuation is built into the system and is available to account owners); and
- 10) Encourage the use of electronic and other new technologies (including enrollment on a web site) for fund transfers, record keeping, and communications between IRA providers, participating employees, and employers to reduce paperwork and cost.⁸¹

The proposal identifies as an alternative approach to cost containment the imposition of a statutory or regulatory limitation on investment management and administrative fees that could be charged. The proposal cites two examples – the United Kingdom’s approach of limiting administrative fees for the management of stakeholder pension accounts and the Department of Labor’s limitation on fees charged on rollover IRAs established by employers terminating a pension plan for employees of small accounts who fail to provide any indication of how to handle their account balances. Because of the potential for cross subsidization of the fees of Automatic IRAs by other types of accounts, the proposal’s authors favor the cost containment measures detailed above.

Issues and Analysis

Cost containment measures are an important consideration in the design of the Automatic IRA proposal. Administrative fees have the potential to erode the retirement savings that occur as a result of the proposal. In the previous section of this paper, we suggested exploring the possibility of asset pooling for employees until their Automatic IRA contributions reach a minimum level. This approach would provide another method of cost containment.

7. Employer fiduciary issues

Description of Proposal

The proposal states that employers who make direct deposit or payroll deductions available to employees for saving in Automatic IRAs would be protected from potential fiduciary liability. In addition, employers would not be required to choose investment options or arrange for default investments for employees who participate.

Issues and Analysis

The proposal exempts employers from the protections afforded by ERISA, including fiduciary liability rules, which means that employees will have fewer options for recourse if an employer improperly handles the employee’s money during the period between payroll deduction and remittance to an authorized financial institution. Thus, we believe that the proposal should address clearly the rights of employees if employers fail to deposit their Automatic IRA contributions in a timely manner. While many of the protections afforded by ERISA may appropriately be waived in the case of Automatic

⁸¹ Draft of Feb. 12, 2006, p. 19.

IRAs, serious consideration should be given to whether the ERISA protection of a civil right of action by an employee against an employer should be preserved in cases in which employers withhold Automatic IRA contribution amounts, but fail to remit them to the proper depository.

These potential issues are highlighted by the current-law problems with unpaid employment taxes, commonly referred to as trust fund taxes because an employer holds the employee's money in trust until the funds are remitted to the Federal government. The IRS considers unpaid employment taxes a "priority" under current law.⁸² The IRS refers the practices of some businesses to engage in "pyramiding," which entails repeatedly withholding employment taxes from employee paychecks but failing to remit them to the Federal government. The problems with the failure to remit withheld employment taxes are likely to be greater with small employers, who are more likely to face cash flow problems and other issues that might cause the employer to fail to remit withheld taxes.

Current law addresses the problems of failing to remit withheld employment taxes with a variety of enforcement actions, including the possibility of criminal actions against any individual responsible for the payment of the taxes.

For some employers, the removal of ERISA's fiduciary standards from Automatic IRAs makes these arrangements far more attractive than qualified retirement plans. As discussed previously, an issue with respect to the Automatic IRA proposal is the potential to reduce the number of employees who are covered by qualified retirement plans as employers migrate to a much lower cost, lower risk form of retirement savings for employees.

8. Employer tax credit

Description of Proposal

A temporary tax credit would be provided to employers that do not cover all of their employees under a qualified retirement plan as long as the employer makes regular payroll deposits to an Automatic IRA available to employees who are not eligible to participate in a qualified plan. Other employers that do not sponsor a plan and are not generally required to offer Automatic IRAs (i.e., employers with fewer than a specified number of employees or employers who have not been in business for a specified number of years) would also be entitled to the tax credit if they offer Automatic IRA savings to their employees. This portion of the proposal is intended to provide an incentive to the smallest employers to offer Automatic IRAs to their employees.

The temporary tax credit would be available to a firm during the first two years that the Automatic IRA payroll deposits are made available to employees. The proposal suggests

⁸² *Unpaid Trust Fund Taxes are Serious Business*. Headline Volume 179. Internal Revenue Service, Department of the Treasury. September 11, 2006.
<http://www.irs.gov/businesses/small/article/0,,id=162382,00.html>.

that the tax credit be set at \$50 plus \$10 per employee enrolled in Automatic IRAs, up to a limit of \$250 or \$300.⁸³ Employers would not be eligible for the credit if they had sponsored a qualified retirement plan during the preceding 3 years for substantially the same group of employees covered by Automatic IRAs.

The introduced bills provide eligible employers with a tax credit for a taxable year equal to \$25 times the number of eligible employees for whom Automatic IRA deposits are made for the calendar year in which the taxable year begins. The credit is capped at \$250. The credit is only available for taxable years beginning in the first two calendar years in which the employer maintains an Automatic IRA arrangement. The credit is not available if the employer utilizes the small employer pension start-up credit⁸⁴ in the same year.

Under the introduced bills, an eligible employer means an employer who did not have more than 100 employees for the calendar year preceding the calendar year for which the Automatic IRA arrangement is being maintained.

Issues and Analysis

The tax credit is designed to help offset the administrative costs of the Automatic IRA proposal. Because the credit is only available for the first two years that an employer is subject to the Automatic IRA proposal (or during the first two years an employer who is not subject to the proposal makes Automatic IRAs available to its employees), the credit will only help to defray initial costs. However, ongoing administrative costs will be an issue for employers. While these costs will be deductible business expenses, they will still represent an increased cost to employers. See the separate discussion of these costs below.

The proposal does not contemplate permitting employers to pass these administrative costs through to employees. However, it should be recognized that an employer can implicitly pass the costs through to employees with salary adjustments (either directly or by providing smaller increases in salary each year). If implicit pass-through of costs can occur, some consideration should be given to whether it is appropriate to permit the direct pass-through of costs (perhaps up to a specified dollar amount per year).

In addition, it is important to recognize that the tax credit will be of no value to two specific classes of employers required to make Automatic IRAs available to their employees – tax-exempt employers and those employers who have no current tax liability to utilize the credit.⁸⁵ Because the credit is only available to employers with sufficient tax liability to fully utilize the credit, employers with no tax liability will not benefit from this aspect of the proposal.

⁸³ June 29, 2006, testimony, p. 8.

⁸⁴ Sec. 45E of the Internal Revenue Code of 1986.

⁸⁵ While the employer tax credit is included in the general business credits and theoretically could be available for carry forward, there may be many employers who will not have sufficient Federal tax liability to utilize the credit fully before it expires.

9. Self employed and others with no employer

Description of Proposal

The proposal anticipates that the automatic contribution arrangements would be extended to self-employed individuals, employees of businesses not subject to the Automatic IRA requirements, and unemployed individuals who could save. The proposal suggests that these automatic contribution arrangements could be developed through:

1. Automatic debit arrangements under which contributions are automatically deducted from a checking or savings account or credit card at periodic intervals;
2. Automatic debit arrangements organized through professional or trade associations;
3. Direct deposits of income tax refunds into IRAs; and
4. Extending direct deposit to independent contractors.

The introduced bills direct the TSP II Board to develop procedures and disseminate information to facilitate the use of automatic debit and similar arrangements for investment in IRAs.

Issues and Analysis

Many of the technical and practical issues presented by Automatic IRAs in the employer/employee context will also be presented by automatic debit IRA contribution arrangements.

In addition, serious consideration should be given to whether it is appropriate to permit the use of credit cards as an automatic debit mechanism. If an individual substitutes current borrowing for retirement saving, net savings by the individual will either stay the same or may actually decrease. This occurs because the amount of the IRA contribution will be less than the total sum of the amount charged against the individual's credit card plus the costs of the borrowing (i.e., finance charges). Furthermore, consumer borrowing through credit cards typically carries the highest borrowing costs for individuals and generally should be discouraged, rather than encouraged.

10. Transition issues

Description of Proposal

The proposal suggests that a phase-in approach could be used during the first year or two after the Automatic IRA proposal is enacted. Under this transition approach, the Automatic IRA proposal would apply during the first year or two only to employers that do not sponsor qualified retirement plans and that are above a specified size level (the proposal does not suggest a size level that would be appropriate).

The introduced bills do not specifically address the issue of transition.

Issues and Analysis

Providing sufficient time and transition for employers to adopt and implement Automatic IRAs for their employees is important to the success of the program. The proposal suggests imposing the proposal initially only upon employers with a minimum number of employees. However, larger employers with high turnover rates may also have difficulty with compliance.

V. ANALYSIS OF COSTS OF THE PROPOSAL

A. Costs to Employers

1. Overall administrative costs to establishing automatic IRAs

Employers may face considerable costs associated with implementing and maintaining Automatic IRA accounts for their workers. As with qualified plans generally, there are three major cost areas, collection and processing, account management, and determining contributions costs. Each cost area brings certain complexities and nuances unique to the Automatic IRA program.

The first cost to employers, as mentioned in a previous section, is the collection and payroll processing of the funds.⁸⁶ Employers would maintain responsibility for collecting IRA contributions each pay period and transmitting this amount to the individual's account. These costs would depend upon whether the employer maintained an in-house personnel department or used a third-party processing service.

The second cost to employers is the account management costs. This area poses the greatest unknown for Automatic IRA account holders, as the market will determine if private entities or a single-centralized entity will hold the funds.

Assuming that private entities hold the Automatic IRAs, it is reasonable to draw upon the private pension plan system's cost experiences. Generally, private defined-contribution plans offer certain services to the participants. The services include a menu of investment options, account status or statements, and participant access to help-lines or account information (typically telephone or web-based services).

These costs can be expected to vary with the number of employees participating in the Automatic IRA program and the magnitude of the total contributions or total assets held by all Automatic IRAs. Most firms administering defined contribution-type qualified retirement plans assess a fixed per-participant cost as well as a variable cost that is a percentage of the returns earned by the assets. In the empirical literature, there are two general approaches to surveying these costs – soliciting bids for a hypothetical plan and relying on Form 5500 return data. Both have some limitations, but generally suggest that Automatic IRAs could incur costs, both to the employer and employee, that may negate some of the benefits of the accounts.

A recent study by the Congressional Budget Office (CBO) reports that a survey by Pension Dynamics Corporation (for Money Magazine) found fees for plans with 4,000 participants and \$20 million in assets had a \$24 per-participant fee plus 0.8 percent of earnings fee. They also reported that a smaller plan with 100 participants and \$2 million

⁸⁶ Please refer to the previous section for a more detailed discussion of this category.

in assets had a \$60 per-participant fee plus 1.0 percent of earnings fee.⁸⁷ Studies that rely on Form 5500 returns show that defined contribution plans reported average per-participant fees of \$49.⁸⁸ A similar study by the General Accountability Office (GAO) used the same data, but discarded returns that did not report costs. The GAO estimates were considerably higher finding that average per-participant fees were approximately \$103.⁸⁹

If a centralized entity holds Automatic IRA assets and manages the accounts suggests that it is reasonable to assume that Automatic IRAs might require an expansion of either the Thrift Savings Plan (TSP) or the Social Security Administration. The TSP reported initial fees of 0.3 percent of assets in 1988 and .07 percent of assets in 2002. However, these rates understate the true cost as certain administrative functions are performed by other Federal agencies and paid through other areas of the Federal budget.⁹⁰

During the policy debate on privatizing Social Security, estimates suggested that the Social Security Administration (SSA) would require additional staffing and resources to manage the new private accounts. Estimates by the SSA indicate they would require between 7,700 and 33,600 additional employees to administer the accounts.⁹¹ This cost would require Federal outlays to finance the operations. In addition, the Office of the Chief Actuary of the Social Security Administration estimates that private accounts with limited investment options would consume about 0.3 percent of the account assets each year.⁹² Since the number of Automatic IRA participants would likely be less than the number of Social Security private account holders, it is anticipated that this cost to the individual account could increase.

The third major cost to employers is calculating the appropriate contribution, based on the circumstances of each employee. This may pose significant costs for some employers and rather insignificant costs to others, depending upon the characteristics of the workforce. For instance, if the employee maintains more than one job (e.g. several part-time jobs), employers might have to coordinate amounts withheld to avoid exceeding the current law dollar limitation for IRA contributions. Other examples might include married couples, where the worker is married to a high-income earner who is covered by a qualified retirement plan. In this case, the low-income earner might be ineligible to contribute to an IRA.

⁸⁷ Congressional Budget Office, "Administrative Costs of Private Accounts in Social Security," March 2004,

⁸⁸ Department of Labor, Pension and Welfare Benefits Administration, "Private Pension Plan Bulletin: Abstract of 1998 Form 5500 Annual Reports," Winter (2001-2002).

⁸⁹ The General Accountability Office, "Private Pensions: Most Employers That Offer Pension Use Defined-Contribution Plans," GAO/GGD-97-1, October 1996.

⁹⁰ See the AARP Fact Sheet, "Administrative Costs for Social Security Private Accounts," which also provides a summary of administrative fees for systems in Chile (1.4 percent), Sweden (0.95 percent), and the United Kingdom (3.2 percent for ten years and 1.7 percent for 25 years).

⁹¹ Ibid, and OACT, SSA estimates found at www.ssa.gov.

⁹² Jason Furman, Center on Budget and Policy Priorities, "Top Ten Facts on Social Security's 70th Anniversary," August 11, 2005.

In some ways, collecting information about the employee's eligibility to contribute to an Automatic IRA may defeat the purpose of an opt-out system. The implied benefit of the opt-out system is that employees typically begin saving without having to make the decision. If the employer must determine eligibility or special circumstances that would affect eligibility, the implied benefits diminish. Further, this responsibility might increase administrative costs as the employer or third-party processing agent may have to reconcile IRA contributions and return excess contributions or those contributions not eligible under present law prior to the April 15 tax filing deadline. If employers are not required to perform this function, then presumably a Federal government entity will have this responsibility and the costs will shift to the Federal government.

2. Effect of potential employer tax credits

The employer tax credits provide a limited benefit to certain employers. Under the introduced bills, the credit is offered to very small employers providing a per participant credit amount up to a specified amount (\$250).

The benefit of the employer tax credit is likely to have a limited impact. One factor limiting the benefit is the availability to only certain small employers. While employers express cost as the greatest impediment to establishing a qualified plan, there are many employers that might benefit from the credit, but are excluded due to the number of employees in their workforce. Perhaps larger employers may have a greater ability to absorb increases to their total compensation costs, but there are a considerable number of mid-sized employers that may find the costs of mandated Automatic IRAs burdensome.

Another limitation with the credit is that 49 percent of all businesses do not report net income and, therefore, they are not paying Federal income taxes.⁹³ For these business taxpayers, there is no current value to the credit. The business taxpayer may include this credit in the balance with other unclaimed business credits and may be able to claim the credit at a later date. Further, the tax credit would generally provide no benefit to those tax-exempt employers that are subject to the proposal, which includes tax-exempt organizations other than churches under the introduced bills.

B. Costs to Employees

Administrative costs of the Automatic IRA may erode the benefits for the individual workers. While any positive savings would represent a clear benefit to individual workers approaching retirement, the costs associated with the accounts may erode significantly account balances.

The CBO estimates that, with respect to Social Security private accounts, per-participant fees and percent of earning fees could reduce the account balances by up to 19 percent.⁹⁴

⁹³ See Internal Revenue Service, Statistics of Income Division, Corporation Income Tax Returns, 2003.

⁹⁴ See Congressional Budget Office, "Administrative Costs of Private Accounts in Social Security, March 2004, page 14.

Great Britain's experience yielded similar, but substantially higher erosion, indicating that the fees associated with private accounts reduced benefits in retirement by 40 to 45 percent.⁹⁵

C. Revenue Costs

Two sources of direct revenue costs are associated with this proposal. First, there is a revenue loss associated with the employer tax credit. Second, there is a revenue loss associated with the individual income tax effects for Automatic IRA contributions.

Employer Tax Credit – The majority of the employer tax credit revenue loss depends upon the number of small employers that are required to make Automatic IRAs available to their employees. Once the number of eligible employers is estimated, there are various behavioral responses applied to that estimate.

The first step is to define the number of businesses eligible based on the number of employees. The aggregate number is adjusted to reflect those employers already providing qualified plans to their workers. Data from the Census Bureau, number of establishments by the size of the workforce, provides a distribution of all employers. Additional data sources are necessary to estimate the employers with qualified plans. BLS National Compensation Survey data provide a distribution of employers by firm size that offer qualified defined contribution plans. While the distribution does not provide the level of detail necessary to estimate precisely the number of establishments, the finer details are imputed by creating weights from the Census Bureau data.

The next step creates a subset of the small employers based on the specifications in the current proposal. Determining the estimated number of employers eligible depends on the various provisions meant to exclude certain employers (e.g. employers with unionized workers or employers with employees eligible for 403(b) plans).

Estimating the credit amounts, based on average employment, is the next step. And finally, adjustments to this estimate are made for:

- Employers that do not report having taxable income
- Employers that discontinue their qualified defined contribution plan in favor of the Automatic IRA
- Employer behavioral response in instituting the Automatic IRA program

We estimate that the Automatic IRA business tax credit proposal would reduce Federal fiscal year receipts by approximately \$250 million over ten years.

Individual Tax Effects – There are two major components to the revenue impact for individual income tax returns and several smaller components. The first major component is the revenue loss associated with those IRA participants that take traditional

⁹⁵ See the AARP Fact Sheet, “Administrative Costs for Social Security Private Accounts,” which cites the original reference to Murthi, Orzag and Orzag, 2001.

IRAs rather than Roth IRAs. The traditional IRA would reduce Federal tax liabilities by providing an above-the-line deduction for the contribution amount. The second major component is the revenue loss associated with the inside buildup of both traditional and Roth IRA contributions.

The smaller components of the overall revenue loss include several effects that both increase and decrease revenues. The first effect is the interaction of the Automatic IRA deduction with both the refundable portion of the Child Credit as well as the nonrefundable Saver's Credit. Generally, for eligible taxpayers saving for the first time, they would receive a Saver's Credit for a percentage of their contributions. This effect would reduce revenues. However, the revenue effect is slightly offset by the decrease in the available Child Credit (for some taxpayers) and the dampening effect of the Traditional IRA deduction on the amount of both the Saver's and Child tax credits.⁹⁶

The second smaller effect of the Automatic IRA proposal has a negligible revenue effect, but one that should be considered for policy grounds. There is the potential for individuals to increase borrowing as a result of the decrease in their disposable income for the Automatic IRA contribution. Some individuals, in addition to increased borrowing, may spend other accumulated savings. This has a small effect on revenue by replacing taxable interest income with tax deferred interest.

The final effect of the Automatic IRA proposal is the revenue effect associated with those individuals whose employer discontinues their qualified plan in favor of the Automatic IRA program. In most cases, this would provide a revenue offset, as it is likely that the previous amounts deferred under the qualified plan would exceed amounts deferred under the Automatic IRA.

We estimate that the individual income tax provisions in the Automatic IRA proposal would reduce Federal fiscal year receipts by \$2.5 to \$5 billion over ten years.⁹⁷

⁹⁶ Allowing a deduction for the Traditional IRA reduces the amount of taxable income and corresponding income tax liability. Approximately 43 percent of eligible taxpayers do not have sufficient tax liability to claim the entire Savers Credit.

⁹⁷ Consistent with revenue estimating conventions, the estimate assumes that total compensation remains fixed.

VI. ANALYSIS OF EXTENT TO WHICH AUTOMATIC IRAS WILL INCREASE RETIREMENT SAVINGS

A. In General

The proposal offers an opportunity to increase retirement savings for a segment of the US workforce that currently does not save. The magnitude of this savings, on an individual basis, depends heavily on the age of the worker, number of years of contributions before retirement, the consistency of the contributions, the rate of return earned on the contributions, and the earnings capacity of the worker. (See Appendix B for estimated account balances for selected contribution amounts.)

Clearly beginning an automatic IRA offers the greatest benefit to younger employees, as they have the opportunity to contribute over a longer period of time and accumulate deferred interest on these contributions. Further, if the younger workers choose a Roth IRA, they have an even greater opportunity to accumulate a sizeable account from which they could make tax-free withdrawals in retirement.

However, it is likely that some lower-income workers may opt-out of the Automatic IRA due to liquidity constraints. As the data suggests, many lower-income households without retirement plans are comprised of younger, non-white, non-married individuals. The Savers Credit offers an important incentive to younger low- to middle- income household. However, the credit still is not widely recognized. Consequently, without employer education and guidance, many low-income individuals will elect to not participate.

Further, introduction of the Automatic IRA may increase borrowing for many participants. Increases in aggregate savings, for certain segments of the population, are likely to be offset by consumer borrowing or debt. Therefore, it is difficult to estimate the macroeconomic effect on aggregate savings of Automatic IRAs.

B. By Income Levels

Some savings is preferable to *no* savings. However, it is important to recall that for certain income classes, the contribution rates may generate small annual contribution amounts.

Low-Income Individuals – With automatic deferral rates comparable to those for Automatic 401(k) enrollment (3 percent in the early years), low income individuals might accumulate about \$20,000 in assets after 30 years.

While this amount represents both a positive good to the individual as well as a social good, the asset may provide only limited security during retirement.⁹⁸ Clearly, if the IRA contributions were made to a Roth rather than a traditional IRA, the benefits in retirement might be greater. However, for lower income individuals, the decision to forego the current tax deduction (providing greater after-tax income) may overshadow the future benefits.

Middle-Income Individuals – For those individuals in income classes above the lowest 20 percent of wage earners, this proposal has the potential to provide considerable balances in retirement savings. Middle-income individuals, having greater disposable income and the ability to defer greater amounts, have a greater probability of remaining in the Automatic IRA program. Once a saving regimen begins and balances accumulate the incentive to continue such a program increases.

High-income Individuals – Currently, about 80 percent of high-income individuals participate in some form of retirement savings. Of those with adequate resources, but not reporting any qualified plan savings, it is likely that other (perhaps, consumption) motives dominate the saving motive. It is difficult to speculate why higher income individuals might not participate in qualified plans, if offered by an employer. However, for some in the higher income classes, it is likely that – to the extent that his or her employer is required to implement the program – Automatic IRAs would allow for significant account accumulations over their working career. This is particularly true for younger more highly educated workers. The benefits over time of contributing at the dollar limit to both a traditional and Roth IRA are well established.

⁹⁸ Estimates that consider both future price levels and future tax rates may provide a clearer picture of the true accumulated balance. However, modeling such estimates was beyond the scope of the present analysis.

Appendix A – Profile of Likely Automatic IRA Participant

Federal tax incentives for retirement savings tend to provide the greatest benefits to qualified plan participants, offer greater benefits as contributions increase, and tend to focus on individuals that already save. The value of current income exclusions and the exemption from current tax for earnings on contributions to qualified retirement plans are greater for higher income taxpayers who face a higher Federal marginal tax rate than for those taxpayers with lower marginal tax rates. Thus, the value of \$1 of retirement saving will be 15 cents for a low-income taxpayer and 36 cents for a high-income taxpayer. Until recently, with the introduction of the Saver's Credit, policy incentives to encourage lower- and middle-income households to contribute to retirement savings were largely non-existent. Consequently, little is known about the population that does not save, does not contribute to retirement savings, or has not accumulated any other assets. However, this is the population most likely to participate in the Automatic IRA program.

Defining this population is much like defining a negative. In other words, we know who is not eligible or likely to participate. We know who saves and approximately how much they save. However, little attention focuses on the non-saver and the characteristics of the non-saver. This analysis describes the process (qualitatively and quantitatively) by which the Automatic IRA participant is identified.

1. Qualitative Description

Several studies characterize individuals who had access to qualified plans in the workplace, but did not participate.⁹⁹ Researchers tend to agree on a general set of characteristics – nonwhite, unmarried, and with low educational attainment.

Generally speaking, individuals who did not participate in a qualified plan were twice as likely to be African American or Hispanic. Most were younger and had never been married. With respect to educational attainment, most typically did not finish high school.

Most studies also find that individuals without qualified plan coverage are more likely to be from the lowest income classes and are among the lowest wage earners. Further, the EBRI study characterized many without pension coverage as being in poor health compared to those with coverage.

One other characteristic also seems to predict the lack of retirement coverage – being without health insurance. Individuals without health insurance coverage were more likely also to lack any retirement savings. Unlike those without pension coverage, the policy debate has focused a considerable amount of attention on those without health insurance. The likely explanation, one might speculate, is that there is a current public

⁹⁹ For example, see EBRI, Issue Brief No. 286, October 2005 and Catherine Montalto for the Consumer Federation of America.

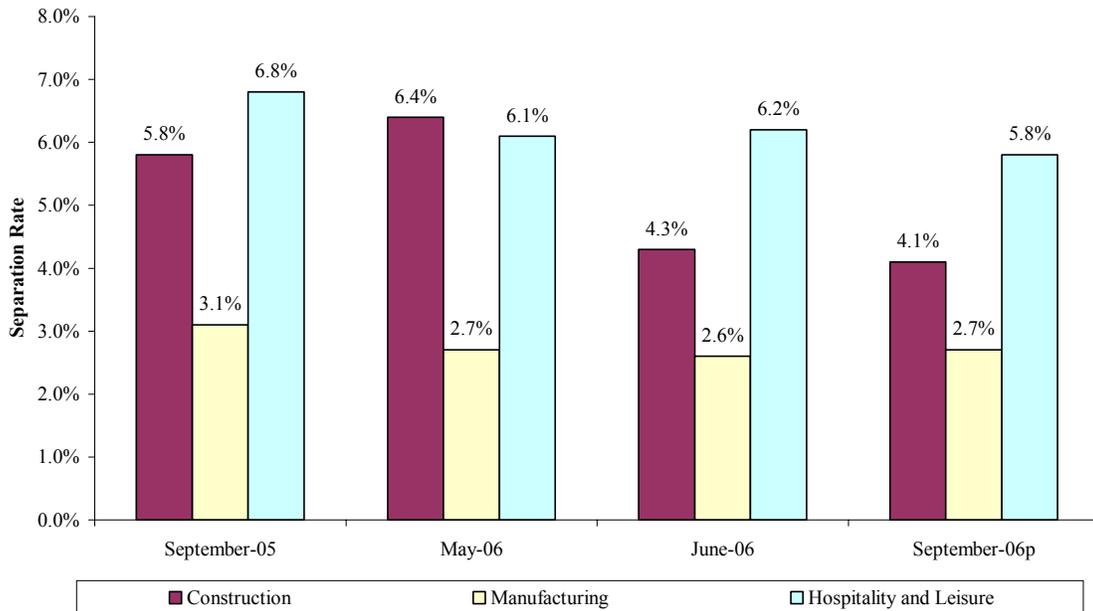
policy problem when an individual lacks health insurance, but the lack of pension coverage is one that takes decades to present.

The correlation between lacking health insurance and lacking pension coverage helps further characterize the population most likely to participate in Automatic IRAs. Research on the uninsured indicates a more balanced racial mix – finding that half of low-income uninsured are white. They further find that the majority of uninsured are in a household with at least one full-time worker. This is an important characteristic, as it suggests that the uninsured without pension coverage will be in the workforce and likely to participate in an Automatic IRA.

Certain industries are known to have higher turnover rates than others. Two such industries, construction and hospitality (includes food services) have the highest worker turnover rates. Health insurance or pension coverage is typically not available to workers in these industries. Further, high separation rates suggest that Automatic IRAs may be administratively difficult for these employers. The graph below shows the monthly turnover rate in three industries – construction, manufacturing, and leisure and hospitality. The graph shows that the construction and leisure and hospitality industries typically have 5-7 percent of their workforce turn over monthly, whereas manufacturing has a much lower 2-3 percent turnover rate.

Separation Rates for Selected Industries, Seasonally Adjusted

Source: Bureau of Labor Statistics, Job Openings and Labor Turnover, 2006



Automatic IRAs contemplate that individuals who are not currently retirement savers will begin saving for retirement through payroll deduction contributions to IRAs. This proposal targets those people who are least likely to save under current law. The data

suggest that the typical individual targeted by the Automatic IRA proposal will be low or moderate income, younger rather than older, more likely to be a part-time employee, and likely to have higher than average job turnover (which suggests employment in a high turnover industry). Each of these characteristics will identify individuals who are less likely to be saving for retirement. Of course, it is also true that the individuals most likely to become retirement savers as a result of the Automatic IRA proposal will be those individuals who are the higher end of income for the nonsaving demographic group, who are older rather than younger, who are more likely to be full time employees, and who are more likely to have some job stability.

2. Quantitative Description

Understanding the general characteristics of individuals without retirement savings is important, but for policy purposes, it is important to estimate the numbers of individuals who are in the likely Automatic IRA population as well as their likely income profile.

Estimating the likely Automatic IRA population begins with the population that is not covered by a qualified plan. The starting point for this is the 2002 IRS Statistics of Income study of individual income tax returns as well as W-2 information filings.

The first adjustment eliminates those individuals reporting pension coverage on their W-2 form. Taxpayers with pension coverage would not be eligible for the Automatic IRA program and were eliminated from the total.

The second adjustment eliminates retired taxpayers from the total. Currently, there are approximately 40 million seniors receiving Social Security and Medicare benefits. Of this number about one-third are non-filers or do not have sufficient income to require them to file a return. The majority of seniors are in lower income classes; however like the general population these individuals are proportionately represented in higher income classes.

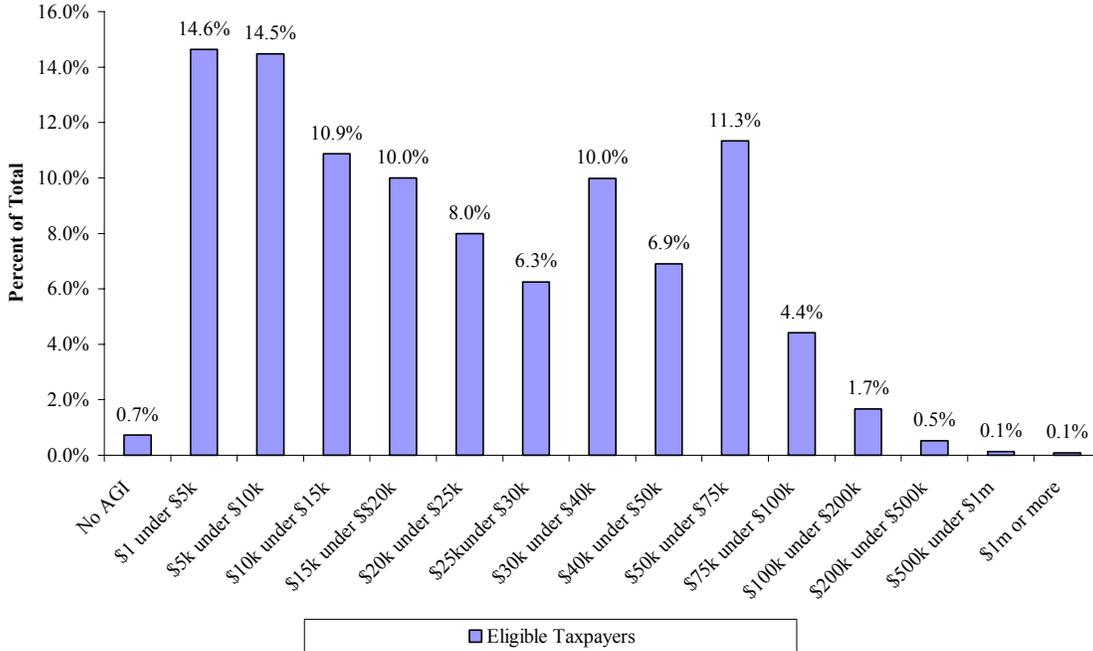
The third adjustment eliminates individuals who currently participate in IRAs or self-employed plans. In the case of IRA contributors, these individuals would most likely opt out of any employer program, as their current level of savings might exceed the Automatic IRA contribution. Self-employed participants in such plans as Keogh, SEP, or SEP-SIMPLE plans would also not participate in an Automatic IRA program.

Finally, minor adjustments consider the portion of the workforce who might be employed for short periods of time or experience consistent job turnover. The difficulty in characterizing this type of worker is fairly evident. A segment of the U.S. workforce includes a small percentage of workers who are new to the workforce or have been employed for a short duration (estimated at about 10 percent). Therefore, these workers would (most likely) not participate in the Automatic IRA.

The graph below shows the income distribution of taxpayers who we estimate will be eligible for Automatic IRAs through their employers based on AGI levels. We estimate that 50 percent of eligible taxpayers will have AGI of no more than \$20,000 per year.

Estimated Taxpayers, Eligible for Automatic IRA

Source: Author's Calculations Based on SOI and CPS data



We have also estimated the number of taxpayers who are eligible to make Automatic IRA contributions through their employers and the average amount of the contributions that is likely to be made. The results are presented in Table A-1. This table shows that, for low income taxpayers (below \$20,000 of AGI), the average Automatic IRA contribution will be relatively modest. See Appendix B for examples of the amount of assets that will accumulate over time assuming various annual contributions.

Table A1. Estimated Distribution of Taxpayers <i>Eligible</i> for Automatic IRA and Estimated Average Contributions		
Adjusted Gross Income	Estimated Number of Taxpayers (in thousands)	Estimated Annual Contribution to Automatic IRA (average dollars)
No AGI	350	\$ - 0 -
\$1 under \$5,000	7,010	\$ 75
\$5,000 under \$10,000	6,930	\$ 225
\$10,000 under \$15,000	5,210	\$ 375
\$15,000 under \$20,000	4,790	\$ 525
\$20,000 under \$25,000	3,830	\$ 675
\$25,000 under \$30,000	3,000	\$ 825
\$30,000 under \$40,000	4,780	\$ 1,050
\$40,000 under \$50,000	3,310	\$ 1,350
\$50,000 under \$75,000	5,430	\$ 1,875
\$75,000 under \$100,000	2,110	\$ 2,625
\$100,000 under \$200,000	800	\$ 3,000
\$200,000 under \$500,000	250	\$ 3,000
\$500,000 under \$1,000,000	60	\$ 3,000
\$1,000,000 or more	40	\$ 3,000
Total Eligible (not participants)	47,900	

Appendix B – Sample Account Balances

The following table presents estimated account balances for selected contribution amounts. The accumulated balances assume that the individual participates continuously for the duration of their work history. In addition, it is assumed that the account earns 4 percent annually on all contributions.

If an individual has only five years until retirement, that person might expect to accumulate approximately \$1,700 if they defer \$300 per year. However, deferring the same amount, a younger person might expect to accumulate approximately \$17,500 saving continuously for 30 years.

Table 1b – Sample Account Balances for Selected Annual Contribution Amounts and Selected Years of Participation					
<i>(Rate of Return = 4 percent, Amounts rounded to the nearest \$100)</i>					
	\$300	\$750	\$1,000	\$2,000	\$3,000
5 years	\$1,700	\$4,200	\$5,600	\$11,300	\$16,900
10 years	\$3,700	\$9,400	\$12,500	\$25,000	\$37,500
15 years	\$6,200	\$15,600	\$20,800	\$41,600	\$62,500
20 years	\$9,300	\$23,200	\$31,000	\$61,900	\$92,900
25 years	\$13,000	\$32,500	\$43,300	\$86,600	\$129,900
30 years	\$17,500	\$43,700	\$58,300	\$116,700	\$175,000

Graph 20 Estimated Account Balances for Selected Annual Contribution Amounts

Assumes 4 percent annual return

