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Why Not a “Super Simple” Saving Plan for the United States?



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An Urban Institute Project Exploring Upward Mobility

REPORT 3

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Given the chance, many low-income families can acquire assets and become more financially secure. Conservatives and liberals increasingly agree that government's role in this transition requires going beyond traditional antipoverty programs to encourage savings, homeownership, private pensions, and microenterprise. The Urban Institute's *Opportunity and Ownership Project* and *Retirement Policy Project* reports present findings, analyses, and recommendations to increase asset building.

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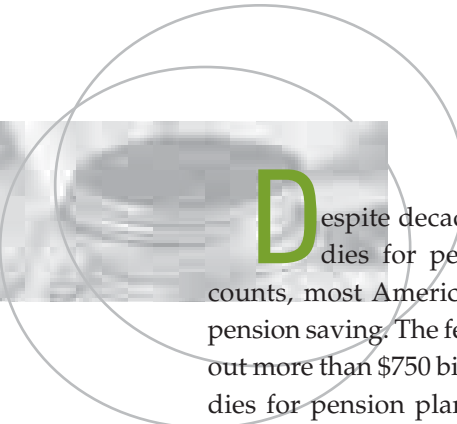
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Executive Summary



Despite decades of significant tax subsidies for pensions and retirement accounts, most Americans retire with little or no pension saving. The federal government will give out more than \$750 billion in estimated tax subsidies for pension plans between 2007 and 2011, and yet, many low- to middle-income families have too few financial assets to afford retirement.

The United States needs a pension system that addresses 21st century needs, one that complements and is able to accompany any Social Security reform the nation is likely to see in the near future. This paper describes one way forward, following the lead of a new system to accelerate the growth in personal retirement assets about to be implemented in the United Kingdom. The United Kingdom moved boldly to reform its private pension system by encouraging significantly greater accumulation of pension assets and protections in old age for the vast majority of the population.

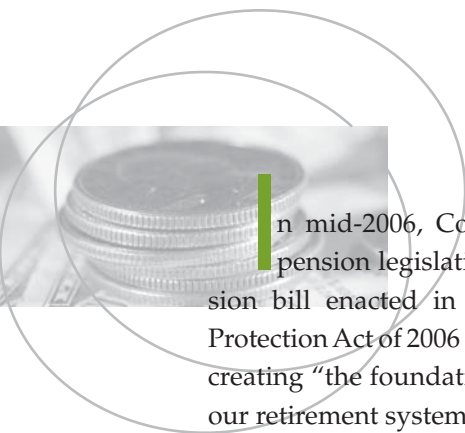
The United States has its own pension history, so it must apply the British lesson to its own circumstances. This paper suggests that it is possible to create—using the language of the pension world¹—a “Super Simple” saving plan that would provide a basic, low-cost, easily administrable plan with the potential to increase significantly the retirement assets available to moderate- and middle-income individuals.

The basic features of the Super Simple plan resemble the U.K. reform plan, but within a U.S. context. The Super Simple plan would (1) create solid minimum levels of employer contributions for low- and moderate-income workers, (2) include

automatic contribution features for employees who do not formally opt out, (3) remove many of the complex discrimination rules surrounding retirement plans, (4) create a significant government match for savers to replace the largely symbolic match now in existence for only a few taxpayers, and (5) streamline today’s multiple 401(k)-type plans through a simple plan design attractive to employers and employees alike.

We realize that we are suggesting the most substantive set of reforms since the Employee Retirement Income Security Act of 1974. Almost all subsequent reforms have mainly patched the existing system while trying not to take any options away. Any simplicity gains under one new option considered in isolation were often more than reduced by the complexity of having so many options to understand. Most important, their effect on increasing the net saving of households has been modest, if any. A few reforms have been quite creative—particularly the movement toward auto-enrollment. But their primary failing is their inability to establish a base of retirement security for low- to middle-income individuals.

The problems posed by the pending increase in retirees (soon close to one-third of the adult population will be receiving Social Security), the unavoidable reform of Social Security, and our poor record on national saving despite the abundance of available tax subsidies now compel action. And they require more than ad hoc tinkering. It is time for a radical structural change, yet one rooted in simplicity and in the American private pension system. And, maybe in this case, our mother (country) does have something to teach us.



In mid-2006, Congress passed significant pension legislation. The fourth major pension bill enacted in three years, the Pension Protection Act of 2006 (PPA) has been heralded as creating “the foundation on which the future of our retirement system rests.”² This report argues that much more needs to be done. The paramount problem is that most Americans, particularly low- and moderate-income Americans, don’t have the minimal amount of savings they will need when they retire (Munnell et al. 2007). PPA’s reforms fail to provide a comprehensive solution to this problem.

Our analysis begins with a description of the challenges facing the American retirement system. We next examine some of the obstacles to saving by low- and moderate-income Americans embedded in today’s employer-based 401(k) plan system. We then show how pension system reforms now under way in the United Kingdom are structured to increase private saving for retirement income.

Similar reforms could simplify and improve the American private pension system for the benefit of all savers. This report describes how—using the language of the pension world—a “Super Simple” saving plan could form the basis of a 21st century savings policy that stimulates increased savings behavior through better pension plan design. Replacing most of today’s 401(k) plans, the Super Simple plan could significantly increase the retirement assets available to low- and moderate-income individuals. Several crucial elements of the Super Simple aim at the same goal as the U.K. reform: creating a minimum base of individual, employer, and government contributions for most workers.

The Need for a Better Private Pension System

Sometime in the next 25 years, the American retirement system is headed for a train wreck or a major overhaul. Simply put, the three primary sources of retirement income—Social Security, pensions, and personal savings—are faltering. Although Social Security is not the subject of this paper, this mainstay of retirement income for many Americans is clearly due for a major reform that could reduce benefits to restore balance.

The vast majority of workers goes into retirement with only modest retirement assets relative to the value of their Social Security and Medicare benefits. Most Americans are not saving enough on their own to be prepared financially for what now adds up to about two decades of retirement for many single adults and more than a quarter-century for the longer living of two spouses. Meanwhile, the private pension system needs substantial reform (Perun 2006). Under current trends, it seems inevitable that Americans will have to choose between higher tax rates and lower retirement benefits to support an aging society. Another alternative is that people might work longer to save more, especially since they are living longer (MacDonald 2006; Penner, Perun, and Steuerle 2003).

One part of the solution, then, is to scale up the American private pension system to provide more assets for retirement. Historically, the U.S. private pension system, despite the size of its aggregate assets, has never provided significant resources for more than a minority of the workforce. For decades, for instance, it has covered fewer than half of private-sector workers. Today’s many part-time and mobile employees never qualify for their employers’ plans. In addi-

tion, most retirees cannot count on defined benefit plans for retirement income despite PPA's new rules, or perhaps because of them. At one point, the decline in defined benefit plans might have been attributed mainly to plan terminations by smaller employers or employers in distressed industries. Now, however, even healthy companies are terminating their plans. Many others are either not admitting new workers or reducing future benefit accruals for everyone (Munnell et al. 2006). Few private companies are creating new defined benefit plans.

The pension system today is an intricate system with multiple plan types characterized by complex rules and regulations (Perun and Steuerle 2005b). Plans are complicated to administer because of regulatory requirements, the sophistication of investment products and services, and the evolving American workplace.³ The result is a private pension system requiring significant-administrative support with associated fees and costs paid to human resource personnel, accountants and auditors, insurance companies, consultants, salespeople, actuarial firms, legal advisors, and financial intermediaries. Such costs tend to lower U.S. output, raise product costs for producing stateside, and lower the net returns from saving to workers.⁴

The Need for a Better 401(k) Plan System

Without question, the 401(k) plan has been the growth engine in the private pension system over the past 10 years (Copeland 2005, 2007).⁵ In a 401(k)-type plan, workers can save a portion of their wages for retirement in return for special tax benefits. By one measure, 401(k)-type plans have been an enormous success. They represent 70 percent of all defined contribution plans, 75 percent of all defined contribution plan assets, more than 85 percent of all defined contribution plan participants, and 40 percent of all private-sector retirement assets (defined benefit and defined contribution plan assets combined) (Vanguard

2004). Despite its popularity, however, today's 401(k) plan system has significant, inherent defects that affect the ability of low- and moderate-income savers to accumulate assets for retirement.

Little Saving Subsidy for Low- and Middle-Income Workers

Between 2007 and 2011, income tax subsidies to pension plans are estimated to cost more than \$750 billion, and a large proportion will flow to 401(k) plans (Joint Committee on Taxation 2007a). Because the value of these subsidies increases with income, higher-income savers receive incentives to save that they generally do not need, while few benefits flow to those around median income or below (roughly, less than \$50,000) (Orszag 2004).

Further, in 401(k) plans, low- and moderate-income savers lose an important tax subsidy—exempting employer contributions from the Social Security tax. Most economists suggest that such subsidies over time benefit employees by reducing the cost of labor. In 401(k)s and most other pension plans, employer contributions, even matching contributions, are exempt. Employee contributions are not; contributions by employees earning under the Social Security wage base (\$102,000 in 2008) remain fully subject to Social Security tax. With the rapid evolution of 401(k) plans and their increasing dependence on employee contributions as a funding source, those employer subsidies are being lost. Meanwhile, the income tax exclusion for contributions to either type of plan, which rises in value with income tax rates, is retained. Thus, low- and middle-income employees are increasingly left with a smaller share of total subsidies.

In recent years, Congress created a new subsidy for low- and moderate-income workers—the saver's credit. This credit, however, is more symbol than substance. It is a nonrefundable credit, so, unlike the Social Security tax exclusion, many low- and moderate-income savers who owe no income taxes are not eligible for it. Yet it is phased out at

moderate income levels. The maximum benefit is almost never available! The subsidy phases out before taxpayers can earn enough income to pay enough tax to be eligible for the maximum benefit (Purcell 2007). Finally, it is paid directly to taxpayers, not deposited into a retirement account, so few believe that much of the subsidy ends up in retirement saving.

The ultimate evidence of the saver’s credit’s trivial effect is that it is estimated to cost only \$690 million in 2007, falling to \$580 million in 2012—about \$5 per worker. By way of contrast, in the same year, the net exclusion of pension contributions and earnings from the income tax is estimated to cost more than \$100 billion (Office of Management and Budget 2007). The net exclusion of employer contributions from the Social Security tax is not estimated by the government in the tax expenditure budget but, by simple comparison with the income tax exclusion, it must involve revenue losses on the order of tens of billions of dollars a year.

Low Savings Rates

Saving through a 401(k) plan requires “the employee to decide whether or not to join the plan, how much to contribute, how to invest the contributions and when to re-balance, what to do about company stock, whether to roll over accumulations when changing jobs, and how to use the money in retirement” (Munnell and Sundén 2006, abstract). In response, many potential savers exhibit “inertia” and fail to save.⁶ Recent studies confirm that savers are often inhibited by the many decisions and choices required in 401(k) plans (Beshears et al. 2006; Choi, Laibson, and Madrigan 2006, 2007; Gale and Iwry 2005; Goodman and Orszag 2005; Mitchell, Utkus, and Yang 2005a, 2005b; Mitchell et al. 2005; Utkus and Young 2005).

It is not surprising that 401(k) plans have limited success in generating significant rates of saving, particularly among low- and moderate-income workers. Some industry statistics report

participation rates in 401(k)-type plans in the mid-70 percent to low-80 percent range (Vanguard 2004). About a third of eligible workers save nothing (Hewitt 2005; Vanguard 2005). Among participating workers, savings rates vary widely, but average rates are low among both lower- and higher-income savers. The typical worker contribution is between 5 and 7 percent of pay (Vanguard 2004; Purcell 2005).

Recent calculations, however, paint a more pessimistic picture. The GAO’s analysis of 2004 survey data finds a 36 percent participation rate in defined contribution plans with half of workers having account balances below \$22,800 (just \$50,000 for workers age 55 to 64 and \$60,600 for those age 60 to 64) (GAO 2007).

The GAO also notes that low-income workers have less opportunity to participate in a plan and less participation when a plan is available. Under GAO projections, nearly 37 percent of workers will reach retirement without any retirement plan assets. The GAO estimates that 401(k) plans could provide persistent savers with retirement assets equivalent to 22 percent in replacement income on average. But projections also show that the bottom fifth of earners would probably have a replacement rate of only 10.3 percent on average (with 63 percent having NO plan savings at retirement). The top fifth of earners would have an average replacement rate of 34 percent (GAO 2007).

The workers most likely to use a 401(k) plan are older, more-highly educated, and better-paid (Smith, Johnson, and Muller 2004). Savings incentives based on tax subsidies are not strong for low- and moderate-income savers. Also, the trend to 401(k) plans has reduced the net government subsidies for saving because employee contributions, their primary source of funding, are subject to Social Security tax. Research reveals, however, that Americans at lower income levels can and do save when more relevant incentives, such as matching contributions, are available (Maki and Palumbo 2001; Duflo et al. 2005; Sherraden and Barr 2005).

Less Plan Availability

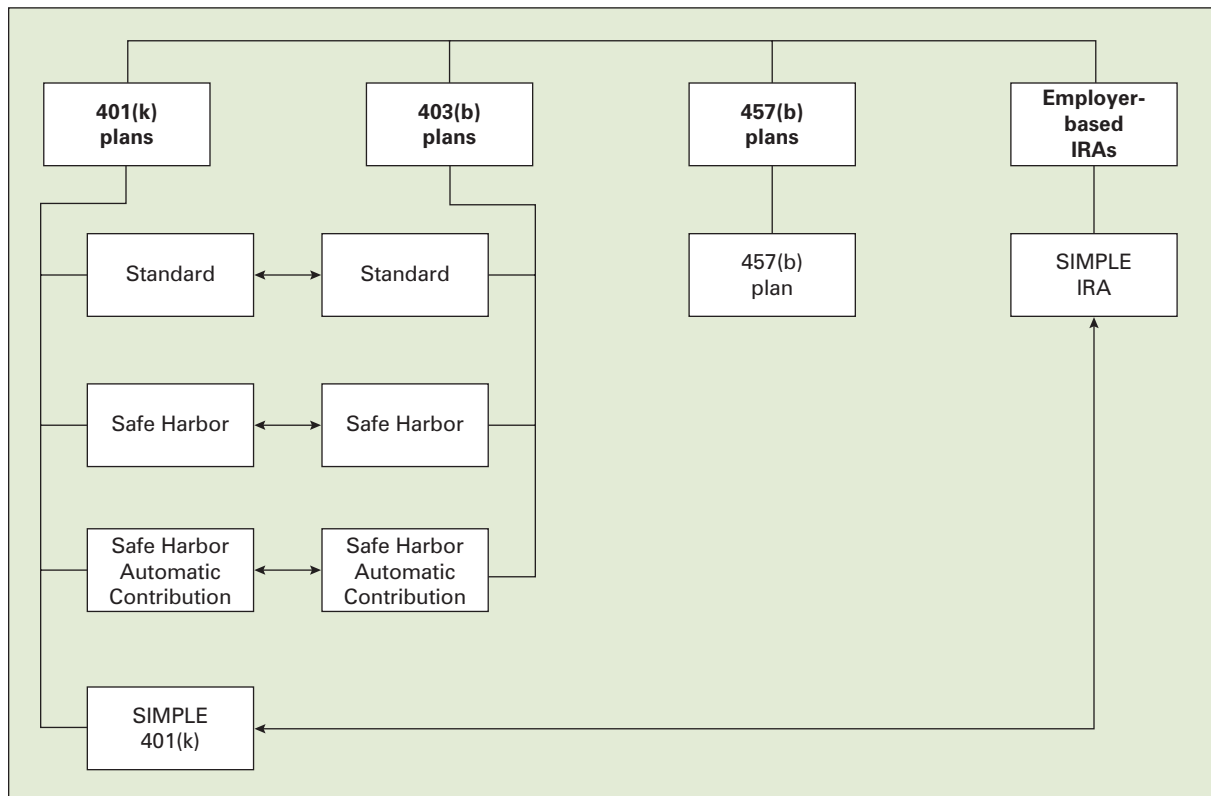
Workers can only participate in 401(k)-type plans if their employers decide to offer one. No definitive statistics exist on how many employers offer this optional plan. The most comprehensive data are found in federal tax forms that most employers are required to file for their plans (DOL 2008).⁷ The 2005 data recently released by the Department of Labor indicate that 401(k)-type plans account for almost 70 percent of all defined contribution plans. Some 55 million workers, or less than half of the full-time labor force, were covered by a plan.⁸

Most workers with a 401(k) plan worked for large employers; more than 65 percent were enrolled in plans with more than 1,000 participants. A 401(k) plan was the sole retirement plan for 65 percent of workers. Among workers with another plan, roughly half were in plans with

more than 20,000 participants, which means they worked for very large employers.

The failure of large numbers of employers, especially medium and small employers, to offer 401(k)-type plans is discouraging. For decades, Congress has struggled to create plans attractive to all types of employers, especially very small employers. Figure 1 illustrates the family tree of available 401(k)-type plans.⁹ Large corporate employers can choose a Standard 401(k), a Safe Harbor plan, or the Safe Harbor Automatic Contribution plan. Small corporate or sole-proprietor employers have those same choices plus a simplified version either through a 401(k) plan, known as a “SIMPLE 401(k)” plan, or through an IRA-based plan, known as a “SIMPLE IRA.” Public-school and nonprofit employers can choose any of those 401(k) and IRA-based options; they also have access to a separate family of plans, known as 403(b) plans. In the 403(b) fam-

Figure 1. The Family of 401(k)-Type Plans



ily, employers can choose a Standard 403(b) Plan, a Safe Harbor plan, or the Safe Harbor Automatic Contribution plan. State and local government employers technically may not offer 401(k) plans, but they may offer a 457(b) plan with a number of similar features.¹⁰

Although many rules have been harmonized in recent years, the different plan families fall under different regulatory regimes. Table 1 describes the basic rules that apply to each plan type. Significant differences can be seen in which workers are eligible for a plan, how much they can contribute, whether employers match contributions, and when workers become vested in employer contributions. In addition, some plan types require complicated administrative and testing requirements, while others do not.

The complexity of the current system deters employers from sponsoring plans. Small employers, for example, cite costs and administration-related issues as important reasons for not sponsoring a plan (Munnell and Perun 2006). The standard 401(k) plan requires the services of lawyers, accountants, consultants, record-keepers, communication specialists, and investment advisors to remain in compliance with the law. The SIMPLE 401(k) and SIMPLE IRA are specifically designed to keep administrative costs low. In a recent survey of small employers, however, more than 33 percent had never heard of SIMPLE plans, and another 20 percent had heard of them but were not very familiar with them (EBRI 2003). Simplicity comes at a cost—lower contribution limits. Managers often decide against this type of plan because they want the greater tax deductions available through 401(k) plans. Also, the lower limits effectively lower tax subsidies.

Even if a plan is offered, low- and moderate-income workers are often excluded from participation. Employers with a standard 401(k) plan design have a great deal of flexibility in deciding which workers are covered. These plans must pass a “lower the ceiling” test set by tax law.¹¹ For

example, the plan must include a “good group” of workers (that is, a sufficient percentage of lower-paid workers in the employer’s workforce).¹² And, plan benefits for lower-paid workers must be “good enough” (that is, proportionate to those received by highly paid workers). Therefore, the amount higher-paid workers can save depends on how much lower-paid workers save. This test often obligates employers to allow in more lower-paid workers and provide incentives, such as matching contributions, to encourage higher rates of saving.

In reality, this plan design has proven modestly effective at best. Depending on their demographic and organizational structure, employers can legitimately exclude large numbers of low- and moderate-income workers. The current rules have not significantly expanded the participation rates and benefits of moderately paid workers.¹³ This approach has been pushed a fair degree already and likely will not be sufficient to scale up the 401(k) plan system much further.

SIMPLE and Safe Harbor plans use a “raise the floor” approach instead.¹⁴ An employer must provide minimum benefits for all workers, including low-income workers. In exchange, these plans are deemed to have satisfied tax law compliance rules automatically, and highly paid workers may contribute as much as they want up to legal limits. Again, however, the contribution maximum is often less than in the standard plans, making these plans unattractive to many employers and highly paid workers.

To enable more low- and moderate-income Americans to save more for retirement, the United States will need a better 401(k) plan system, one that features more plans, better plans, and better incentives for saving. Today’s system is one of cumulative advantage for higher-income Americans who are more likely to have a plan at work and to be included in that plan. They receive generous tax incentives for saving, they are better able to navigate complex savings decisions, and they have large account balances that are less affected by plan fees and

Table 1. Basic 401(k)-Type Plan Rules

| Plans | Standard 401(k)/403(b) | SIMPLE 401(k)/IRA | Safe Harbor 401(k)/403(b) | Safe Harbor Automatic Contribution |
|--|---|--|---|--|
| Who is eligible? | Employer decides; plan must be available to a broad group of employees | All employees who earned \$5,000+ in prior 2 years and are expected to do so in the current year | Same as Standard plan | Same as Standard plan |
| How much can each employee contribute? | Up to \$15,500 (\$5,000 more in catch-ups for older workers) | Up to \$10,500 (\$2,500 more in catch-ups for older workers) | Same as Standard plan | Same as Standard plan; if no opt-out, new participants must contribute 3% of pay in their first year, 4% in their second year, 5% in the third year, and so on, but not more than 10% of pay |
| Do employers match employee contributions? | Not required | Employer must match 100% of the first 3% of pay contributed by each plan participant | Lower-paid workers get at least a 100% match of contributions up to 3% of pay plus a 50% match for contributions between 3% and 5% of pay | Lower-paid workers get at least a 100% match of contributions up to 1% of pay plus a 50% match for contributions between 1% and 6% of pay |
| Are there alternatives to a match? | See below | If no match, all eligible workers get a 2%-of-pay contribution | If no match, low-paid workers get a 3%-of-pay contribution | If no match, all low-paid workers get a 3%-of-pay contribution |
| Can employers make extra discretionary contributions? | Yes, maximum employer + employee contribution in 2008 is \$46,000 per account, (without catch-ups) | No; 2008 maximum allocation per account is \$21,000 (without catch-ups) | Same as Standard plan | Same as Standard plan |
| Vesting for employer contributions? | 3-year cliff or 2–6 years graded | Immediate | Immediate, matching and alternative contributions; standard schedule, discretionary | 2 years, matching and alternative contributions; standard schedule, discretionary |
| Are there other nondiscrimination rules? | 401(k) and matching contributions for higher-paid workers depend on low-income workers' contributions | No | No match beyond 6% of pay; flat match required; match for higher-paid workers limited to lowest rate for low-income workers making same % of pay contribution | Same as Safe Harbor plan |
| Other rules | | Must have < 100 workers; no other plan | | |

Note: The amounts expressed in dollars in this table are adjusted for inflation from time to time.

costs. At each stage of the savings process, today’s plans put low- and moderate-income workers at a disadvantage, resulting in little or no accumulations for retirement by those who will need it most.

The Need for a “Super Simple” Saving Plan

Why is saving in America so complicated? Do employers really need all these different plan types? By shifting to defined contribution plans, employers have signaled they prefer less fiduciary involvement in their workers’ retirement security. Realistically speaking, many employers prefer merely to be facilitators of saving (Perun and Steuerle 2005a). Moreover, the move to 401(k) plans, with higher proportions of employee contribution, has resulted in a loss of Social Security tax subsidies that could have been shared by employers and employees. This trend suggests strongly that employers want simplicity, even if they have to pay for it.

We propose a radical U-turn in pension policy with a plan centered on employees, not employers. After twenty-odd years of more plan types, more bells and whistles, and more compliance requirements—none of which has demonstrably increased saving—it is time for a “back to basics” approach. The fundamental building block of the American saving system should be a plan that puts savers, especially low- and moderate-income savers, first. That means a plan that makes the first step toward saving easy and builds in advantages for lifelong saving all along the way.

In our view, four principles should guide the design of such a plan:

- **Universality**—all workers should have the same opportunity to save, whether they work for a corporation, charity, or the government.
- **Equity**—better incentives should be available to low- and middle-income workers

to create a more equal savings playing field.

- **Adequacy**—tax law should focus primarily on increasing the retirement assets of low- and moderate-income workers rather than policing the behavior of high-paid workers.
- **Simplicity**—simpler designs that eliminate most consulting and compliance costs would boost the return to saving for workers.

One model for a pension system that embodies these principles is now being built in the United Kingdom, which is confronting the same challenges of an aging society as the United States is. In 2006, the United Kingdom proposed a new system for retirement income security based on three main initiatives: strengthening the existing state pension, building a strong system for private saving, and encouraging longer work (DWP 2006a, 2006b, 2007). The first initiative was enacted in The Pensions Act 2007, which made the retirement benefits available through the state pension system more generous, fairer to women and other caregivers, and more widely available.¹⁵ Changes to the state pension include decreasing the number of years of work required to qualify for a pension to 30, increasing benefits for inflation by wage growth (rather than prices), and gradually raising the age of eligibility to 68. The second initiative, which is working its way toward passage by Parliament by mid-2008, is intended to increase financial security in retirement through private saving. It makes partners of workers, employers, and the government to increase the retirement assets for low- to moderate-income workers (DWP 2006b, 2007).

In the United Kingdom’s pension initiative, employers will be required to contribute to a retirement saving plan for every worker beginning in 2012. Employers without a plan will be required to enroll workers into personal savings accounts. Workers will contribute a minimum of 4 percent of pay, employers 3 percent of pay, and the government 1 percent of pay through

The New U.K. Pension System

- Employers will be required to enroll workers automatically into a workplace plan or, if no equivalent plan is available, a personal savings account.
- Workers are allowed to opt out.
- Employers must contribute at least 3 percent of pay on earnings between (roughly) \$10,000 and \$65,000.
- Employers can keep their current plans (defined benefit or contribution) instead if they provide equivalent benefits.
- Workers must contribute at least 4 percent of pay.
- Government contributes 1 percent through tax relief.

tax relief for an annual, minimum, combined 8-percent-of-pay contribution to each account. Employees can opt out of contributing to a personal savings account but, by doing so, they forfeit the employer and government contributions. In addition, employers need not contribute for very low income workers on the theory that their state benefits will provide a high level of replacement income. Employers who maintain a plan—either defined benefit or defined contribution—that provides equivalent benefits are exempt from these new requirements. The administrative and investment system for these accounts is still being designed, but the intention is to provide simple, low-cost accounts that deliver a high return to saving.

With the U.K. proposal and our design principles as a guide, we can point the way toward a better saving system for low- and moderate-income workers: a Super Simple saving plan. It uses the current SIMPLE design but, without making it more complicated, scales up its features. The result is a basic savings plan that makes offering plans easier for employers while rewarding saving by low- and moderate-income workers. The Super Simple has four basic building blocks:

One: The Basic Saving Plan for Workers

The Super Simple would be universally available to all employers, unlike today’s SIMPLE plans. But like SIMPLE plans, all workers except very short-term workers would be covered by the plan.

Should the United States follow the U.K. model and require employers to offer a plan? Ideally, yes. All employers should be required to offer the Super Simple unless they provide a different plan with equivalent benefits, just as in the United Kingdom. But the U.S. private pension system has always been voluntary, partly because of burdensome costs on small employers. An optional system made sense when defined benefit plans, which require an uncertain, long-term financial commitment, were dominant. The switch to defined contribution plans presents an opportunity to rethink this issue as we move to a system with an employee-centric plan and a lower cost structure.

Republicans and Democrats have struggled with this issue before and at times have come out favoring systems that were essentially mandatory. Dodging the issue of what happens to Social Security in the future, for instance, President George W. Bush favored an individual account plan that involved mandated deposits to retirement saving accounts. President Bill Clinton proposed a system of universal saving accounts with an automatic government contribution for low-income workers—which essentially made them mandatory.

Perhaps, as part of a broader set of reforms to address an aging society, mandated saving will be re-introduced. Viewed by itself, however, we may be able to achieve most of the gains of a mandatory system while essentially allowing some employers to defer action. For some small and temporary employers, for instance, complexity remains a problem. Regardless of whether it is mandatory, simplifying and improving the current system is an important step toward a saving system that is more tolerable for employers.

The Super Simple Saving Plan

Plan Design

- Simple, low cost
- No annual testing or reporting
- Designed to replace all other 401(k)-type plans except the standard 401(k), which, through simple amendment, can adopt the Super Simple structure and take advantage of its simpler and more generous provisions

Availability

- Available to all employers
- Covers all but very short-term workers
- Automatic enrollment with opt-out for workers

Contributions

- Higher contributions than standard 401(k) plans
- Employee contributions permitted up to an annual limit minus employer contributions
- Like existing SIMPLE plans, required minimum contribution for employers adopting this plan structure; higher contributions permitted if a uniform percentage of pay for all employees
- Government matching contribution for low-income savers deposited into accounts through the tax system
- Reconfigured government match for most savers
- Employer and government matching contributions restricted for retirement; employee contributions available for distribution with limitations

Would the Super Simple replace today’s multiple 401(k)-type plans? Again, ideally yes. We view the Super Simple as an important tool for expanding coverage and building retirement assets for low- and moderate-income people. We recognize that some employers might prefer to keep their standard 401(k) plans. So we propose grandfathering existing standard 401(k) plans and retaining their testing requirements. But all standard 403(b) plans and SIMPLE and Safe Harbor plans would convert to Super Simples. We expect that many, if not most, employers would convert their 401(k)s to Super Simples because of the simpler design and more generous provisions. Employers and workers would benefit from the redesigned and more generous government match, the higher contribution levels than allowed in today’s plans, and the removal of more complex discrimination tests.

The Super Simple would be simpler and cheaper to administer than many of today’s plans. By keeping costs down, more employer benefit dollars would flow into workers’ accounts rather than to the plan compliance industry. We believe these combined incentives would

succeed over time in making the Super Simple the dominant defined contribution plan.

Two: Automatic Saving Features

The Pension Protection Act blessed several new features for 401(k) plans that many believe are the best hope for raising savings rates in decades.¹⁶ The most popular is “auto-enrollment,” which enables employers to enroll workers automatically into a pre-programmed saving schedule unless they decide to opt out. The theory behind auto-enrollment is that it takes advantage of demonstrated behavior patterns of individuals responding to choices, and, as a consequence, both increases the number of workers who save and the amount they save.

Auto-enrollment is one of the most promising new ideas in the private pension system, but, like a ball sitting on top of a hill, it needs some additional force to get rolling effectively. The Super Simple does that by making auto-enrollment a basic plan feature. Workers may opt out of contributing to a plan, but plans must contain this feature.

What should the baseline saving formula be? There is no one answer for all workers. How much individual workers should save for a secure retirement depends on many personal factors, including their other financial resources. And how much individual workers can save depends on their other obligations and financial needs. The United Kingdom has settled on a 4-percent-of-pay contribution from workers, which seems reasonable. We suggest specifying a 4-percent-of-pay contribution in the first year and then escalating it to 8 percent through annual or, perhaps, biennial 1-percent-of-pay increases as workers spend more years on the same job.

Would employers be able to set a higher baseline contribution rate for workers? Yes, but to prevent employers from setting rates beyond the reach of most low- and moderate-income workers and discouraging their participation, imposing the 10 percent limit now found in the Safe Harbor Automatic Contribution plan seems sensible. Workers would always have the option to contribute more or less than the automatic saving formula suggests.

Three: New Savings Incentives

As promising as they are, automatic saving features are not likely powerful enough by themselves to raise retirement assets sufficiently for low- to moderate-income workers. Hewitt Associates reports that “most automatically enrolled employees remained at the default contribution rate and thus added less to their 401(k) plan than employees who contributed through traditional enrollment.”¹⁷ In addition, some employers have found that, without matching or other employer contributions, too many account balances remain small. The small balance problem is a concern. It increases the costs of maintaining plans per dollar invested and reduces the net return to saving for workers.¹⁸

The federal government projects a conservative take-up rate for auto-enrollment. The Joint Committee on Taxation, a nonpartisan agency of

Congress, estimates that automatic enrollment arrangements will cost about \$500 million in 2010 and \$800 million in 2014 (Joint Committee on Taxation 2007a). Some of those losses will result from the tax preferences for interest income on additional accumulations. Assuming that the \$500 million loss in 2010 is solely for additional net contributions and assuming an average tax rate of, say, 20 percent, the additional annual contributions projected by the Joint Committee would equal about \$2.5 billion in 2010. Although this amount is not trivial, it still represents only an additional \$20 or so a year per worker.¹⁹

Realistically speaking, low- and moderate-income workers will need more than very small tax incentives on their savings to build significant assets for retirement. Existing tax incentives increase with income, making them far less valuable to low- and moderate-income workers than to higher-income workers. Many do not benefit from other saving rewards available in standard 401(k) plans. If there is an employer match, for example, workers often do not stay with one company long enough to be vested because they are short-service or part-time workers. The Super Simple, therefore, builds in three different rewards to saving to boost the account balances of low- and moderate-income workers significantly:

- a mandatory, fully vested, minimum contribution from employers in return for higher contribution limits for all employees, including the highly compensated
- an improved incentive system including a better government matching contribution oriented toward low-, moderate-, and middle-income savers
- employer and government matching contributions delivered to accounts and restricted from distribution until retirement

First, we adopt the “raise the floor” approach of Safe Harbor and SIMPLE plans so, in return for a fully vested floor contribution by employers, all

workers can contribute as much as they like, up to the legal maximum. These plans offer employers a choice: either a minimum matching contribution or a minimum across-the-board contribution to all participants. There is no perfect formula for the Super Simple. In the SIMPLE plan, employers must match 3-percent-of-pay contributions or give an automatic 2-percent-of-pay contribution. The Safe Harbor plans require a total contributions match up to 3 percent of pay plus 50 percent of contributions between 3 to 5 percent of pay or a 3-percent-of-pay automatic contribution. The Safe Harbor Automatic Contribution plan requires less: a total match of 1-percent-of-pay contributions plus 50 percent of contributions between 1 to 6 percent of pay or an automatic contribution of 3 percent of pay.

Outside these plans, the most popular matching schedule in standard 401(k) plans seems to be a 50 percent match up to the first 6 percent of pay contributed (PSCA 2007). The U.K. proposal requires a 3 percent automatic employer contribution rather than a match.

We believe that some employers, particularly small employers, will initially be resistant to any substantial required contribution, despite the Super Simple's lower cost structure. So we propose an initial automatic, minimum employer contribution of 3 percent of pay, or any matching formula that would achieve the same end, given the minimum amount already contributed by the employee.²⁰ The 3 percent employer minimum combined with the 4 percent employee minimum would give low- and moderate-income workers annual contributions of at least 7 percent before the government match. An employer could contribute more, but only if the same percentage of pay is given to all employees.

The Super Simple also offers something more for higher-income workers: higher contribution levels. The maximum contribution would be much more generous without the distinction between employer and employee contributions. In 2008, workers can only contribute up to \$15,500 from their own funds; counting employer contri-

butions, a total of \$46,000 can be contributed to an individual account.²¹ The Super Simple would allow all workers to contribute up to a flat dollar amount, such as \$46,000, minus any employer contributions. Contribution levels would be monitored and enforced through the tax system, relieving employers of an administrative burden. Enabling higher-income workers to contribute more without complicated testing requirements would make the Super Simple an attractive alternative to today's standard plans.

A second set of incentives, this time from the government, would provide much more effective subsidies than the existing saver's credit. As in the British proposal, we suggest establishing a basic government match for contributions by low-, moderate-, and middle-income workers. Although PPA permanently extended the saver's credit, it did not extend its reach. The saver's credit gives a sliding scale tax credit for contributions by low-income workers. The maximum credit is \$1,000. To claim the credit, a worker must owe taxes, and only a few low-income workers are actually eligible for the credit. Despite pretenses of progressivity, the saver's credit costs little because it grants little to most employees. It is time, therefore, to admit that the saver's credit is largely symbolic and move onto something more substantial and more realistic to administer.

We are not wedded to any particular form here. One possibility would be to provide a government matching contribution equal to a given percentage of employer and employee contributions up to some low amount—for example, 20 percent of the first \$2,000 of deposits to each account. If the employer and worker contribute a total of \$2,000 (say, on 10 percent of pay for a worker earning \$20,000), the government subsidy would effectively equal \$400.

Another approach might simply be to adopt the British method and provide something like a 1-percent-of-pay match. Combined with the 3 percentage-point employer contribution and 4 percentage-point minimum employee contribution, some 8 percent of pay would then be

deposited into private contribution plans. The government match could apply to, say, the first \$20,000 of wages. Other alternatives are possible, such as a 2-percent-of-pay match on the first \$10,000 of wages. Unlike the British, we would make the credit available at the lowest income levels, unless or until we also undertook a Social Security reform that provided minimum benefits or other greater protections to low- and moderate-income workers.

What is important, however, is that the match should represent a greater percentage of pay for lower-wage individuals (in the above examples, this is achieved by capping the possible credit). It should also be provided in a form that is easy to administer, while maintaining the money within the retirement saving structure. If the credit amount is known with moderate certainty, then taxpayers do not run into what might be called the “earned income tax credit problem”: the inability during the course of the year to know how much subsidy is going to be available.

Although the existing saver’s credit may at first appear more progressive, it is hardly available to most savers. Also, since it is not directly deposited into a retirement account, it does little or nothing to provide retirement protection. The sample credits we demonstrate here stretch further up the wage scale, but, as noted, they partly replace Social Security tax subsidies that applied to most contributions to defined benefit pension plans. To avoid paying these credits at the highest wage levels, one could also calculate the maximum Social Security tax as net of these credits, or raise the maximum contribution limit for income tax deferral at a slower rate over time.

This saver’s credit option might also be tied into a reform of the Social Security tax exclusion and its somewhat-arbitrary application to employer but not employee contributions. However, this goes beyond the subject of this report, as various new options would work to supplement the other parts of the Super Simple plan.

Finally, we propose that government matching contributions be delivered directly to accounts through the tax system under a separate record-keeping system maintained by financial service firms. In addition, because the Super Simple is intended to build assets for retirement, we propose that both employer and government matching contributions be held in accounts for that purpose. Employees could withdraw from their own savings with limitations similar to those in effect today. We think it makes sense to reverse the current 401(k) plan practice where employees can usually access their employer’s contributions after a number of years but their own contributions are restricted until age 59½. If we ask employers who opt into a Super Simple plan to contribute toward their employees’ retirement, then those funds should be dedicated to that purpose. We also want to encourage employees to save throughout their careers but assure them access to their contributions for major life goals or unexpected emergencies.

Four: Deregulation

In our view, the “lower the ceiling” design has outlived its usefulness. The pension system has tried to woo employers into sponsoring plans by letting them choose which workers participate and what benefits are available. But then tax law scrutinizes those choices to make sure employers haven’t loaded the dice for highly paid workers. This elaborate cat-and-mouse game has been largely ineffective in protecting the interests of lower-paid workers. And, as the empirical evidence behind opt-out reforms indicates, complexity greatly deters participation.

For many employers, the relevant consideration is not choice but cost. Deregulating plans through simplification can lower plan costs significantly. The Super Simple adopts several “raise the floor” design features and adds more:

- There are no tests to ensure the plan covers a “good group.” All workers except

those earning nominal wages (for example, \$5,000 or less) are eligible.

- There is no need to track a worker’s employment history. All contributions (employer and worker) are fully vested.
- There are no tests or adjustment of contributions by higher-paid workers. Because the plan offers a uniform employer contribution to all, higher-paid workers can contribute up to the legal limit.
- There are no annual reports to be filed with the government. Contributions by both employers and workers are reported on W-2s. With simple credit design, workers can adjust excess payments, or in some cases, insufficient matching contributions, on their 1040 forms.

The Super Simple by design includes all workers, provides saving incentives beyond income tax deferral, ensures ownership of employer contributions for short-service workers, simplifies plan administration, and makes compliance with tax rules automatic. The trade-off for requiring a floor of benefits for lower-paid workers is raising the ceiling on how much higher-paid workers can contribute.

The result is a simpler plan with reduced expenses that increase the net return to saving for workers. By reducing most employer choices and the need to police those choices, the Super Simple minimizes administrative and regulatory requirements, relieving the employer of fiduciary liability as well. It also frees up the benefit dollars now used to pay for compliance services in today’s heavily regulated plan universe—dollars that could be contributed to workers’ pensions instead. Perhaps most important, it integrates a private pension reform into a broader reform of old age pensions, including Social Security—whether done simultaneously or separately.

The Super Simple is designed to work for all savers, not just those with high incomes. But we also recognize that many of our examples of potential parameters could and should be debated by reasonable people. Topics open for discussion are the size of the minimum employer contribution for employers opting into this simpler world and the automatic contribution schedule for workers. There is no one absolutely right choice. Other issues, such as the appropriate division of responsibility for saving between workers and employers, require ongoing political and economic decisions concerning broader Social Security and private pension reform. The British White Paper to which we have alluded offers private pension and Social Security reform together.

The Super Simple saving plan shows that it is possible to redesign employee saving plans around four critical principles. The Super Simple is much more *universal*, providing most workers with a convenient opportunity to save for retirement. It is *fair*: lower-income workers receive at least the same rate of contribution and match as higher-income workers. And low-income workers have better access to a plan than they typically do today. The Super Simple is *adequate*: it gives lower-income workers real, relevant incentives to save and leverages their contributions through employer and government contributions. And the Super Simple plan is *simple*. It is not one more patch onto an already complex pension universe with yet more complicated testing procedures.

While this is only one hypothetical design, this type of plan points the private pension system toward including more workers, making saving simpler and more automatic, and building a stronger retirement saving base for those who need it most. If the Queen can give her royal assent to a minimum level of private retirement assets for her subjects, surely we Americans can figure out a way to do as well for ours.

Notes

1. SIMPLE is an acronym for Savings Incentive Match Plan for Employees, a simplified 401(k) or IRA available to small corporate or sole proprietor employers.
2. Sen. Mike Enzi, Wyoming Republican and then Chair of the Senate's Health, Education, Labor and Pensions Committee, quoted on August 3, 2006, at <http://www.cnn.com/2006/POLITICS/08/03/congress.pensions.ap/index.html>.
3. See ICI (2006), GAO (2006), and Joint Committee on Taxation (2007b) for descriptions of the multiple services, fees, and expenses that apply to 401(k)-type plans today.
4. Fees charged to 401(k)-type plans for investment, administrative, and other necessary services have sparked the latest wave of litigation by class action lawyers against plan sponsors. Several recently filed lawsuits have charged that the fee structure for these plans is often excessive, opaque to employers and employees alike, and filled with conflicts of interest. See Wasik (2006) and Kathy Chu, "Charges Can Be Hard to Find," *USA Today*, November 10, 2006 (available at <http://www.uselaws.com/news/news.php?id=57>) for more information about this litigation.
5. The term "401(k) plan" refers to a specific type of plan authorized by the Tax Code under IRC § 401(k). It provides workers with an opportunity to save on a tax-preferred basis. The Tax Code also authorizes different types of employers to offer similar employee saving plans under separate statutes. For the sake of simplicity, this report will refer to all such plans as a 401(k) plan or a 401(k)-type plan.
6. This is not to say, however, that inertia is the sole cause or even the most important cause of low saving rates. Turner and Verma (2007) indicate that inertia can explain a failure to participate in only about a third of such workers. They suggest that traditional economic factors such as low income or low incentives play a larger role than inertia.
7. Many nonprofit employers, churches, and state and local governments are not required to file these forms. The DOL data also exclude the filings of one-person plans, which are often found among the self-employed, or IRA-based SIMPLE plans. The DOL data reported above are based on the authors' calculations.
8. In 2005, there were about 116 million full-time workers over age 16 in the U.S. labor force (DOL 2005).
9. Multiple plan families are an anachronism from the days when defined benefit plans dominated the pension system. Pension law included different funding and deduction rules for employers with different tax attributes—that is, for-profit, nonprofit, and government employers. Even though defined contribution plans do not pose the same risk of tax abuse, pension law retains much of the tradition for separate legal rules for 401(k) plans sponsored by different types of employers.
10. Because 457(b) plans differ significantly, from a legal perspective, from other 401(k)-type plans, they will not be discussed further in this report.
11. For most plans, these rules are found in IRC §§ 401(a)(4), 401(k)(3) and 410(b).
12. The "good group of workers" test is rarely a problem for 401(k) plans because passage is measured by the number of workers eligible to contribute, not those who actually do.
13. The economic rationale and effectiveness of non-discrimination rules has recently been questioned by Brady (2007).
14. The concept of a "raise the floor" approach first became a feature of pension law during the Clinton administration with the creation of the SIMPLE plan for small employers. During that period, the IRS implemented an optional testing method in its nondiscrimination rules under which low- and moderate-income workers are guaranteed a minimum benefit. Treas. Reg §1.401(a)(4)-8(b)(1)(vi). Personal communication, J. Mark Iwry, former benefits tax counsel in the Clinton administration.
15. For more information, see <http://www.dwp.gov.uk/pensionsreform>.
16. Employers had been experimenting with similar features, although not on a large scale, for the past decade. Before PPA, however, there was some uncertainty about their legality under state law. In PPA, Congress amended pension law to clarify that federal, not state, law governs such features. These new rules are found in ERISA § 514 (e).
17. "Auto Enrollment May Soon Be Standard Feature of 401(k) Plans," http://www.plansponsor.com/pi_type10/?RECORD_ID=37807.
18. Kathleen Pender, "Automatic Enrollment in 401(k)," *The San Francisco Chronicle*, August 8, 2006 (available at <http://www.sfgate.com/cgi-bin/article.cgi?file=/chronicle/archive/2006/08/08/BUGDAKCNQ51.DTL&type=business>). As one industry study recently confirmed, "measured per dollar of invested assets, costs for plans with a small average account size will tend to be higher than similarly sized plans with a larger average account size," and "participants in plans that have many small accounts will typically pay higher fees per dollar invested than plans with fewer and larger accounts" (ICI 2006, 5 and 11).
19. The projections by the Joint Committee may prove wrong for various reasons. Largely ignored in the literature, employees pay Social Security payroll taxes on their plan contributions while employers do not. Thus, the Joint Committee may also be assuming that some employee contributions displace employer contributions in an expanded world of automatic enrollment. This would decrease the net tax subsidy provided per dollar of contributions but also reduce net government cost if contributions increase. How or whether this worked into the Committee's calculations, we don't know. The main point is that many plans that depend more heavily on employee

contributions also may cause a reduction in the government (Social Security) subsidy for retirement saving.

20. Suppose, for instance, an employer offered a 100 percent match up to 6 percent of pay. The employee opting into the plan would already be contributing 4 percent, assuming that was the minimum parameter set in the law. Accordingly, the employer match would be a minimum of 4 percent of pay if it chose this particular match rate.
21. This change might appear to take away an incentive for more employer contributions for lower-paid employees. Current rules for employer contributions, however, do not necessarily result in uniform allocations to employees by pay. Employers can take advantage of exotic testing methods such as cross-testing and Social Security integration that significantly skew contributions to the high-paid. If this change seems too generous to higher-paid employees, it would be better to increase the floor of employer contribution significantly than to keep the current rules.

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