

Statement

on

**America's Private Retirement System:
The Need for Reform**

by

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Introduction

The current tax law has a bias against saving and investment. That bias retards capital formation and reduces productivity, employment and wages. In general, income that is spent on consumption is taxed once, but income that is saved is taxed as many as four times:

- Income is taxed when earned, and if it is spent on consumption, there is generally no additional federal tax on the enjoyment of that consumption except for a few selective excise taxes.
- If the earnings are saved, however, the saver has to pay taxes on the rewards for the saving — interest, dividends and capital gains.
- If the saving was put into corporate stock, there was also a corporate tax to be paid before the income becomes a dividend or is retained by the company.
- If an individual has saved a great deal, the accumulated savings may be additionally subject to the estate and gift taxes.

These biases in the tax code affect behavior.

The Need to Save

Careful studies have shown that the greatest degree of inequality exists among senior citizens, and the single most important cause of that inequality is not differences in pre-retirement income but differences in the degree to which people with the same income save

rather than consume.¹ Clearly, some people are not saving enough. According to the “Survey of Consumer Finances,” conducted every three years by the Federal Reserve:²

- 37 percent of all families with workers between the ages of 24 and 64 have no retirement savings account.
- Of the 47.8 million families who do have an account, the median balance (half are larger, half are smaller) is \$27,000.

Among workers nearing retirement the picture improves only slightly:³

- 30 percent of families with workers age 55 to 64 have no retirement savings account.
- Among those who do have one, the median balance is \$55,000.

To put that in perspective, \$55,000 at retirement will provide a pension annuity of about \$400 a month. The failure to save adequately is a special problem for women. For example, one study found that:⁴

- Among employees age 18 to 62, the average in 401(k)s and similar accounts for women was half that of men.
- Among those nearing the retirement age, the average balance for women was only 20 percent of that of men.

¹ B. Douglas Bernheim, Jonathan Skinner and Steven Weinberg, “What Accounts for the Variation in Retirement Wealth Among U.S. Households?” National Bureau of Economic Research, Working Paper No. W6227, October 1997. <http://papers.nber.org/papers/W6227>.

² Data for 2001; taken from the Federal Reserve Board’s *Survey of Consumer Finances*. See Patrick J. Purcell, “Retirement Savings and Household Wealth: A Summary of Recent Data,” Congressional Research Service, December 11, 2003.

³ Ibid.

⁴ See Vickie Bajtelsmit, Alexandra Bernasek, and Nancy Jianakoplos, “Gender Differences in Defined Contribution Pension Decisions,” *Financial Services Review*, Vol. 8 (1999), p. 5.

In general, women more than men are experiencing the problem of inadequate retirement incomes. This is partly due to the fact that many senior women live alone. Nearly half of all women over age 65 are widows.⁵ This is important because compared to two-person households, one-person households have smaller retirement savings, smaller Social Security benefits and less personal savings. Of seniors living in poverty, almost three-fourths are women.⁶

Obstacles to Saving

In the area of retirement savings there are large differences between the amount of tax-free savings available to people at their workplace and what they can do on their own. Thus, employer-sponsored retirement plans have become a coveted part of employee compensation. Yet current vehicles for saving at work are far from perfect.

Problem: Lack of Portability. For most of the period since World War II, the dominant form of retirement plan provided by employers was the *defined-benefit plan*. Under these plans, employees acquire pension benefits, sometimes for the rest of their lives, based on their wages and years of service to the company. The plans promise a specific monetary sum, and the promise is backed by the employer. For employees who work for the same employer for their entire work lives, for example, the pension benefit is typically 60 to 70 percent of final pay.⁷

Although defined-benefit plans work well for people who work continuously for the same employer, they do not work well for employees who switch jobs. Although it is possible to design defined benefit plans otherwise, the majority of these plans calculate benefits under

⁵ Vickie Bajtelsmit, "Women as Retirees," *Women's Agenda: Ideas to Reform Institutions*, National Center for Policy Analysis, March 2002, p. 75-98.

⁶ C. Eugene Steuerle, "Divorce and Social Security," National Center for Policy Analysis, NCPA Brief Analysis No. 291, May 21, 1999.

⁷ Although millions of employees are participating in such plans, virtually no defined-benefit plans are being established today.

formulas that are “back-end loaded.” That means the 40th year is weighted a lot more heavily than say the 10th year. To see what this means in practice, consider a worker who works for four different companies — each for ten years — and all four have identical pension plans. Upon retirement, she will get four separate pension checks, but her combined income will be less than half of what it would have been if she had stuck with just one company for the full 40 years.

Under this system, people will sacrifice substantial pension benefits if they switch employers frequently throughout their career, even though they remain fully employed for their entire work lives. It is a system that is not in sync with the needs of a dynamic, mobile labor market.

Unlike defined-benefit plans, *defined-contribution plans* are fully portable. As long as the employees are fully “vested,” they do not lose the employer match if they move to another employer. In all cases the amount of compensation that they have contributed remains in their account. Today more than half of all workers with an employer-provided retirement savings program are in a defined-contribution plan.⁸

Defined-contribution plans place the responsibility for saving and investing on the employee and better accommodate a dynamic, highly skilled workforce. However, while defined contribution plans have solved some of the problems of the older system, they have created a new set of problems on their own.

Problem: Vesting Requirements. The idea behind vesting is that employees must work for an employer for a certain number of years before they obtain full rights to the promised retirement benefits. An employee who leaves before fully vesting in a defined-benefit plan will

⁸ More than 48 million workers have accumulated more than \$1.8 trillion in defined-contribution plans. See Abstract of 1997 Form 5500 Annual Reports, U.S. Department of Labor, Pension and Welfare Benefits Administration, “Private Pension Plan Bulletin,” No. 10 (Winter 2001).

receive a smaller pension during the retirement years because of that fact. Employees who make contributions to a defined-contribution plan are automatically entitled to whatever they have contributed. But they typically are not entitled to the full amount of an employer's matching contribution until they have logged a minimum number of years of service. At one time, it was not unusual for employers to require 10 or 15 years of service before vesting was complete. Today the law requires vesting periods to be no longer than three years. But even a three-year vesting requirement has a disparate effect on women⁹ and interferes with workforce mobility.

Why have vesting at all? One could argue that some vesting period makes sense, to allow the employer to recover some administrative costs in cases of employees who pop in and out of employment. However, many employers, competing for highly skilled workers, have dropped vesting requirements altogether, and match employees' contributions from their first day on the job. By contrast, other employers see long vesting requirements as a way to reward employees who are "loyal" (i.e., those that don't leave to work for a competitor), and to punish those who are not. Thus, vesting requirements are among employers' recruitment and retention tools.

In a free labor market, employees and employers would be able to strike any compensation bargain that both sides agree to. If it makes sense to reward long-term employment, employers should be free to do that. But retirement plans involve something more than voluntary exchange. The ability to build up funds tax-free involves a taxpayer subsidy, and the social purpose of that subsidy is to encourage the private sector to make private provision for retirement income needs.

⁹ K. Ferguson and K. Blackwell, *The Pension Book: What You Need to Know to Prepare for Retirement* (New York, NY: Arcade Publishing, 1995), pp. 37-47.

Employers who exact onerous vesting requirements are using a tax-subsidized vehicle created to achieve a socially desirable end in order to achieve a purely private, corporate end. In pursuing their own goals, these employers are hindering the achievement of the social goal. Vesting requirements not only undermine the social goal of encouraging people to have a reasonable retirement income, they also interfere with the labor market mobility that our modern economy requires.

Problem: Arbitrary Limits on Contributions. One of the most remarkable characteristics of our retirement system is the completely arbitrary limits that are placed on the opportunities of different people to engage in tax-deferred saving:

- Some people are able to deposit as much as \$40,000 per year in tax-deferred savings plans.¹⁰
- Others are limited to the \$12,000 maximum in allowed contributions to a 401(k) plan.¹¹
- Yet those who do not have access to an employer-sponsored plan, including those who are not in the labor market at all, are limited to a \$3,000 maximum contribution to an IRA account.¹²

¹⁰ Employer plus employee total annual contributions to a defined-contribution plan like a 401(k) or 403(b) is limited to \$40,000 per year, or 25 percent of the employee's compensation, whichever is less. The Economic Growth and Tax Relief Reconciliation Act of 2001 raised the previous \$30,000 limit to \$40,000 in 2002.

¹¹ Employee contributions to 401(k)s, 403(b) and other tax deferred accounts is limited to \$12,000 in 2003. The Economic Growth and Tax Relief Reconciliation Act of 2001 incrementally raises the maximum annual individual contribution by \$1,000 per year to \$15,000 by 2007.

¹² Individuals (under age 50) who are not participating in an employer-sponsored plan can only contribute \$3,000 to an IRA in 2003. The Economic Growth and Tax Relief Reconciliation Act of 2001 incrementally raises the maximum contribution to \$5,000 by 2008. While this limit will increase under current law, it is still only about half of the contribution allowed to an employer-sponsored plan.

If it is socially desirable for some people to save for their own retirement, presumably it is just as desirable for others to do so as well. There is no socially justifiable reason why the amount of tax-free saving a person is allowed should be conditioned on where a person happens to work or whether the person is in the labor market.

Problem: Poor Investment Choices. Defined-contribution plans not only allow employees to make their own investment choices, they virtually require it. While many employees cherish this freedom, for others it is an unwelcome burden. Moreover, employees nationwide appear to do a very poor job investing their own money. A study of 503 employers by Watson Wyatt company found that from 1990 through 1995:

- The defined-benefit plans averaged an annual rate of return 1.9 percentage points better than the 401(k) plans — 10 percent versus 8.1 percent.¹³
- To illustrate what difference that makes, consider investing \$4,000 a year for 30 years: at 10 percent, the account will grow to about \$690,880, while at 8.1 percent the account will grow to only \$480,224 — a difference of \$210,665!¹⁴

One might suppose that the investment results would be highly sensitive to the type of work employees perform, with better-educated, more sophisticated employees doing better. But this is not necessarily the case. A study by the National Center for Policy Analysis looked at the 401(k) performance of employees of firms that specialize in investing other people's money and/or giving advice on how money should be invested. The conclusion: over a four-year period ending in 1998, none of the financial service firms' average 401(k) earnings came close to

¹³ "Investment Relations: Defined-Benefits vs. 401(k)," Watson Wyatt Insider, September 1998.

¹⁴ Brooks Hamilton and Scott Burns, "Reinventing Retirement Income," National Center for Policy Analysis, NCPA Policy Report No. 248, December 2001.

matching the performance of the stock market as a whole or a mixed portfolio of stocks and bonds.¹⁵

Why is the performance of 401(k) plans so poor? There are a number of reasons, but the most important is that all too often unsophisticated investors make one or both of two bad investment decisions: (1) they invest in their employer's stock, and/or (2) they invest in what they think is safe.

As the experience of Enron employees makes clear, putting all your financial eggs in one basket is a risky strategy — not a safe one — even if the basket is the company you work for. Enron employees invested heavily in their employer's stock and suffered large losses. This case is not unique. A recent survey of 105 larger public companies found 40 in which more than half of 401(k) assets were invested in the employer's own stock.¹⁶

The other mistake employees make is to be too conservative: They invest in securities that are safe, but pay a low rate of return. This is especially true of lower-paid employees. One study found that:¹⁷

- Almost two-thirds of the assets invested by the lowest-paid employees were in a money market fund or bond fund.
- By contrast, about 85 percent of the assets invested by the highest-paid employees were in stocks.

¹⁵ Hamilton and Burns, "Reinventing Retirement Income."

¹⁶ Brooks Hamilton, "Learning Our Lesson from Enron," *Washington Times*, February 2, 2002.

¹⁷ Hamilton and Burns, "Reinventing Retirement Income," p. 12.

To put this in perspective, compare two portfolios: one consisting of all stocks and the other consisting of all bonds. Based on historical averages, the all-stock portfolio will accumulate 10 times as much wealth as the all-bond portfolio over the course of a work life.¹⁸

Interestingly, there are important differences in the investing behavior of men and women when other things are equal. On the one hand, a number of studies have found that women are more risk averse. For example, they are significantly more likely to choose bonds over stocks — given a choice.¹⁹ On the other hand, men are more likely than women to engage in frequent changes in their portfolios. Such excessive trading reduces the net returns on men’s investments by a full percentage point, relative to women.²⁰ Part of the problem is that men are excessively confident in their own abilities, according to a number of psychological studies. As one economist put it, “Men tend to think their successes are the result of their own skill rather than dumb luck.”²¹

Problems: Getting Reliable Investment Advice. Surprisingly, a number of employees in 401(k) plans do not actually make an investment choice. For example, at least one-third of the lowest-paid employees have their funds invested in the “default” option, either by choosing it or by letting the employer choose for them. In these cases, the employees’ investments are simply “defaulted” into a money market fund.²² Why don’t employers “default” employees into

¹⁸ For example, Vickie L. Bajtelsmit, “Conservative Pension Investing: How Much Difference Does It Make?” *Benefits Quarterly*, Vol. 12, No. 2, 1996, pp. 35-39.

¹⁹ See the review of the literature in Vickie L. Bajtelsmit and Alexandra Bernasek, “Why Do Women Invest Differently Than Men?” *Financial Counseling and Planning*, Vol. 7, 1996, pp. 1-10; and in Bajtelsmit, “Women as Retirees.”

²⁰ Brad Barber and Terrance Odean, “Trading is Hazardous to Your Wealth: The Common Stock Investment Performance of Individual Investors,” *Journal of Finance*, Vol. LV, No. 2, April 2000, pp. 773-806. <http://faculty.haas.berkeley.edu/odean/papers/returns/returns.html>

²¹ Hal R. Varian, “Economic Scene: Investor Behavior Clouds the Wisdom of Offering Wider Choice in 401(k)s,” *New York Times*, February 14, 2002.

²² Hamilton and Burns, “Reinventing Retirement Income,” p. 13.

portfolios that make more sense for retirement planning? The answer is that employers choose the most conservative investment alternative because they are afraid of lawsuits. For the same reason, most employers also do not give investment advice to their employees.²³

Many books have been written on investing, and an entire industry exists to give advice. But the nonprofessional investor does not need to read any of the books or pay any investment fees in order to invest wisely for the long term. There is a mountain of economic research that points to a simple conclusion: the best and most prudent strategy for the nonprofessional is to invest in the market as a whole. And an efficient way to invest in the market as a whole is through an “index fund.”

Take the 15-year period ending on December 31, 2001. An investment in the Vanguard 500 Index 15 years ago would have averaged an annual rate of return of 13.56 percent. This is considerably better than the average return generated by all other types of mutual funds, and it is almost a point and a half better than the return produced by the average equity fund. Financial columnist Scott Burns calls this the “couch potato” approach to investing. His columns over the years show that couch potatoes consistently do better than mutual funds managed by professional analysts.²⁴

It is very hard to beat the market. In fact, most people who try to beat the market, including most professional fund managers, do worse than the market as a whole. So an unsophisticated investor who is willing to settle for whatever return the market pays will do very well over time. In fact, such an investor will do better than the vast majority of professionals.

²³ Only about a third of large, multi-site corporations who are members of the Profit Sharing Council of America give investment counseling to employees, usually through online resources. Half of all members provide such advice, up from 35.2 percent in 2000. Source: David Wray, President, Profit Sharing Council of America.

²⁴ See for example, Scott Burns “Go Index Funds for the Long Term,” *Dallas Morning News*, February 12, 2002.

For this reason, a simple change in the law would greatly improve the performance of the 401(k) plans for millions of Americans.²⁵ The change would give employers a safe harbor against lawsuits if they default employees who do not make an investment choice into an index fund or similar broadly diversified portfolio, and encourage employees who do make choices to make similar investments.

Problem: Tax Deferral May Not Always Be A Good Idea.²⁶ Most people believe — and almost all investment advisers reinforce the belief — that deferring taxes through 401(k)s, IRAs and similar accounts will reduce their lifetime taxes. There are two reasons for this belief. First, tax deferral is like an interest-free loan. Instead of giving money to the government, the taxpayer is allowed to use it and invest it and pay the government much later in life. Second, most people expect that they will be in a lower tax bracket after they retire (since their incomes will be lower). So deferral means shifting the payment of taxes from the time when they are in a high tax bracket to the time when they are in a lower one.

The problem is that the second of these assumptions is wrong for most young people in low- and moderate-income families. The reason: the Social Security benefits tax. Although this tax is nominally a tax on Social Security benefits, as a practical matter it turns out to be a tax on other income. And during the retirement years “other income” will mean income from pensions and savings accounts. Today the Social Security benefits tax is paid by only about one-fifth of seniors. But the impact of this tax will grow over time because the tax thresholds are not

²⁵ See the discussion in Hamilton and Burns, “Reinventing Retirement Income,” pp. 17-19. Hamilton and Burns would also discourage pre-retirement, lump sum distributions. A 1988 *Current Population Survey* found that women were 40 percent more likely than men to receive such a payment. Only half of each group rolled the payment over into another savings or retirement plan. See also Bajtelsmit and Berask, “Why Do Women Invest Differently Than Men?” p. 5.

²⁶ This section is based on Jagadeesh Gokhale and Laurence J. Kotlikoff, “Tax-Favored Savings Accounts: Who Gains? Who Loses?” National Center for Policy Analysis, NCPA Policy Report No. 249, January 2002.

indexed to inflation and eventually will be paid by virtually all young people during their retirement years.²⁷

Indeed, most people who are earning less than \$100,000 a year and who are in their twenties will be in a higher tax bracket during their retirement years than during their working years. Tax deferral in these cases means moving the payment of taxes from the time when they are in a lower tax bracket to the time when they are in a higher bracket. And the effect of being in a higher bracket during the retirement years can more than swamp the effects of the interest-free loan.

On the brighter side, researchers find that regardless of the amount invested, people almost always gain if they can invest through a Roth IRA.²⁸ Like a regular IRA, Roth IRAs allow tax-free growth. The difference is that deposits to the Roth IRA are made with after-tax dollars and withdrawals are tax free. For most people, the Roth IRA allows taxes to be paid at the time of life when the taxpayers are in the lowest tax bracket.

Problem: High — and Hidden — Administrative Costs and Management Fees.

Administering a 401(k) plan and managing its investments costs money. Many plans have selected low-cost funds, with fees fully disclosed to plan participants and often paid by the employers. However, many other plans have higher fees mostly paid by the participants. Some of the latter contain mutual funds with high retail price structures.²⁹ Participants often are unaware that they are paying administrative fees for these funds from their accounts. In some

²⁷ For the explanation of the Social Security benefits tax and how it affects marginal tax rates, see Stephen J. Entin, “Reducing the Social Security Benefits Tax,” National Center for Policy Analysis, NCPA Brief Analysis No. 332, August 2000.

²⁸ Gokhale and Kotlikoff, “Tax-Favored Savings Accounts.”

²⁹ Retail mutual funds generally charge higher management fees than institutional funds, which have lower expenses and generally are available only to institutional investors.

cases, especially with smaller employers, plan sponsors choose these funds because in return the mutual funds handle administrative chores such as keeping track of account balances, sending out statements and answering questions.

According to a *New York Times* report, some fund companies rebate part of the administrative fees to employers or outside plan administrators. The administrative fees, which the *Times* said usually amount to about 0.25 percent of the assets in an account for large plans, add up. For example:³⁰

- An investment of \$5,000 a year for 30 years with a 10 percent annual return amounts to \$863,594.
- Annual fees of 0.25 percent will reduce that amount by \$40,883.
- If fees are 1 percent, as they often are in smaller plans, the benefit reduction is \$151,387 (or 21 percent) — and some plans have costs exceeding 2 percent.

Even if there are no rebates or cost-shifting, companies sponsoring 401(k) plans have little incentive to monitor the fees closely or to negotiate lower fees for plan participants when the costs are paid from the participants' and not the company's funds.

Problem: Cashing Out. Even modest contributions to one's 401(k) at an early age can grow to a significant sum by the time of retirement. However, almost a third of people with accounts — and 39 percent of those ages 18 to 34 — cash them out when they change jobs. Plan sponsors can (but are not required to) cash out an account balance valued at under \$5,000 when the participant terminates employment.³¹ The employee can roll over the money into an

³⁰ Virginia Munger Kahn, "When Hidden Fees Erode 401(k)s," *New York Times*, July 22, 2001.

³¹ Beginning in 2002, this amount was reduced to \$1,000.

individual retirement account (IRA), move it to a new employer's plan, or take a lump sum payment minus income tax and a penalty for early withdrawal.³² The ERISA Advisory Council reported that only 20 percent of individuals who received lump sum distributions rolled the entire sum into another tax-deferred account.³³ A report to the advisory council recommended that all defined contribution plans be required to accept rollovers of cash from other qualified plans. Putnam Investments, a money management firm, estimates:³⁴

- Withdrawals amount to between \$33 billion and \$39 billion per year.
- Those withdrawing the money pay \$7.1 billion to \$8.3 billion in unnecessary federal taxes and penalties each year.

Problem: Hardship Distributions and Consumer Loans. Many plans allow an employee to make a hardship withdrawal, usually to purchase a primary residence, pay college tuition, pay unreimbursed medical expenses or prevent eviction from or foreclosure on a principal residence. These withdrawals are subject to income tax and a 10 percent early withdrawal penalty.³⁵ Further, the participant cannot contribute to the account for one year after a hardship withdrawal, thus losing any matching contribution from the employer.³⁶

Most 401(k) plans also allow a participant to borrow from his or her account for non-hardship purposes, such as buying a boat or a big-screen television, and to repay the loan to the account with interest. This can be tempting because the interest rate is lower than credit card

³² "Retirement Savings in an Unsettled Economy," survey for Putnam Investments, May 22, 2001.

³³ "Are We Cashing Out Our Future?" Working Group Report to the ERISA Advisory Council on Employee Welfare and Pension Benefits, November 13, 1998.

³⁴ Ibid.

³⁵ The 10 percent tax penalty may apply if the employee is under age 59 ½; there is no penalty for withdrawal if one becomes disabled as defined by the Internal Revenue Service.

³⁶ Under legislation effective in 2002, the one-year prohibition is reduced to six months.

interest and the interest goes into the participant's own account. However, the interest is paid with aftertax money, which will be taxed again when it is withdrawn in retirement. In addition, the participant loses the return while the funds are out of the 401(k).

Bush Administration Proposals

2001 Reforms. At President Bush's urging a tax bill passed in 2001 addressed some of these issues. Over time, the act raises the allowable contribution to IRAs and Roth IRAs from \$2,000 to \$5,000 per person by 2008. This will narrow somewhat the arbitrary difference between the maximum allowed contribution to 401(k) and IRA accounts. The act also will allow employers to offer a 401(k) plan that is taxed like a Roth IRA, beginning in 2006. However, all these provisions are scheduled to disappear and the nation will revert to the old tax rules after 2010!

New Tax-Advantaged Savings Accounts. The President also has proposed two new savings vehicles for all Americans: Retirement Savings Accounts and Lifetime Savings Accounts. Both accounts would essentially create universal Roth IRAs, in which workers invest after-tax money and distributions would be tax free.

The first type of account is "Retirement Savings Account," to which individuals could contribute \$7,500 a year and from which they could withdraw funds tax-free after age 58. A recent NCPA study shows that every income group would benefit from taking advantage of this form of taxation. But it is especially beneficial to low- and moderate-income families who, if they save on a tax-deferred basis, can expect to face higher tax rates after they retire." The second new account is a "Lifetime Savings Account" to which people could contribute similar amounts and from which they could withdraw funds any time for any purpose. Lifetime savings

accounts will simplify personal savings because American families can save for their child's education, save for a house or save for medical expenses, all in the same tax-advantaged account.

Health Savings Accounts. As part of the recently-passed Medicare prescription drug bill, non-elderly Americans can now own a Health Savings Account — or HSA — which is coupled with a high-deductible insurance policy. In his State of the Union address, President Bush proposed taking the next step by making high deductible insurance premiums tax deductible to encourage greater participation in HSAs. Currently, the maximum contribution that can be made to the HSAs is \$2,600 for an individual; and about twice that amount for a family. Over a period of 30 or 40 years, funds have the potential to accumulate. HSAs can become a tremendous source of funds for long term care or medical expenses in retirement, as well as for non-healthcare needs.

Goals of Reform

In general, a well-functioning retirement system that meets the needs of men and women, married and single, should strive to:

- Create retirement plans that are personal and portable, traveling with people as they move from job to job.
- Eliminate rules that arbitrarily punish people who work part-time, or switch jobs frequently, or move in and out of the labor market.
- Eliminate arbitrary ceilings on retirement savings plan contributions that unfairly favor people in some sectors over people in other sectors.
- Establish procedures that encourage people to invest wisely and prudently over the course of a work life.

- Establish a system for taxing retirement income that does not unfairly penalize people because of changes in their tax bracket over time.

Some of the reforms advocated by the Bush administration are a step in the right direction. Other steps are needed.

Suggestions for Private Pension Reform

The concept of defined contribution plans is a sound one. The assets are owned by the employee, are portable from job to job and a participant's benefits are not affected by job changes. However, as with most new concepts, there are flaws that can be eliminated to the benefit of both employees and employers. To remedy the flaws, pension consultant Brooks Hamilton and financial writer Scott Burns proposed a new type of 401(k) plan called the American Freedom 401(k).³⁷ Employees now in a 401(k) plan would have a choice of remaining there or moving to the American Freedom 401(k) plan. Employers who offer all the features of the American Freedom 401(k) plan would receive a "safe harbor" from litigation, explained below. The plan would have these features:

Enrollment and Minimum Contributions. Employers would automatically enroll all employees after they satisfy the plan's eligibility period unless they execute a rejection form opting out. The plan would also set an initial minimum contribution rate of about 4 percent to 6 percent of income — an amount that could prudently be expected to provide a reasonable retirement income — unless the employee specifically opts for a smaller amount.³⁸ This minimum contribution requirement would help limit a too-common practice today, where

³⁷ See Hamilton and Burns, "Reinvesting Retirement Income."

³⁸ This would not prevent the employee from later changing the contribution rate or withdrawing from the plan altogether.

company human resource departments, to make participation rates in 401(k) plans appear to be high, urge employees to “just contribute a dollar or two out of each paycheck.”

Premixed Portfolios and Professionally Directed Investments. Since index funds and the managers of defined benefit pension plans have historically produced higher yields on investments, companies adopting the American Freedom 401(k) plan would have to agree to include in participants’ options premixed efficient portfolios — ones that give the maximum rate of return at different risk levels — or a professionally directed investment option or both.³⁹ Companies should be encouraged (but not required) to provide employees who choose to manage their own accounts with access to investment advice.

Default Option. The contributions of a participant who made no initial choice of funds should go into a premixed efficient portfolio (e.g., 60 percent stocks and 40 percent bonds) or into the professionally directed investment as a default option.

Fees and Expenses. A plan sponsor either would pay all fees and expenses or would reimburse the plan. This would give employers an incentive to limit fees and expenses (currently there is no required oversight of such spending) and would raise the net returns received by plan participants. As an alternative, fees and expenses might be capped at, say, 1 percent, with the employer required to pay anything above the cap.

Automatic Rollover. The American Freedom 401(k) plan would prohibit benefit cash-outs by the plan or the employee following termination of employment before retirement, death or disability. Instead, the account could be rolled over into a similar qualified plan or could remain in the previous employer’s plan if the new place of employment has no qualified plan.

³⁹ Premixed portfolios typically would comprise one or more index funds.

Vesting. Vesting would be 100 percent and immediate.

Hardship Loans. The American Freedom 401(k) plan would have a new feature, the hardship loan, funded from and paid back to the plan's trust fund, not the participant's account. Consumer-type loans and hardship distributions to plan participants from their accounts, now permitted by most plans, would be prohibited. A hardship loan would simply be a loan from plan assets (not the borrower's account), limited to conditions that would meet the legal criteria for a current hardship distribution. This would enable participants to get money from the plan for a true hardship or emergency and pay it back with interest without (i) losing the matching employer contributions for a time, (ii) paying increased taxes due to the prohibition on personal contribution for a time, (iii) being subject to a tax and penalty on the hardship distribution and (iv) affecting the investment return on the account. At the same time, participants seeking a loan for some other purpose could turn to a source of consumer credit and leave retirement funds in the account to grow.

Safe Harbor for Employers. Because the American Freedom 401(k) plan would be so beneficial to participants, employers should be given an incentive to establish such a plan. Legislation should provide that, in exchange for providing a plan offering all the features, an employer would have to meet only the basic coverage and nondiscrimination requirements. In addition, the plan would be deemed to comply with technical testing standards now required.⁴⁰ Finally, the plan sponsor would receive "safe harbor" protection, exempting it from class action civil suits and similar actions alleging breach of fiduciary standards. We would expect industry service providers to respond quickly to such a program.

⁴⁰ The complex testing is supposed to ensure that more highly compensated employees do not receive better treatment than less highly compensated employees.