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SAVING PRIVATE PENSIONS

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Options for Reform

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THIS IS AN UNCORRECTED TRANSCRIPT.

PANEL 2

MR. GENE STEUERLE: My name is Gene Steuerle. I'm a Senior Fellow at the Urban Institute and also one of the Co-Directors of the Tax Policy Center. We may not put out as many papers as we want, but we certainly have plenty of Co-Directors to keep you busy.

I've had the honor over the years of knowing and working with all three of the people on this panel and I'm going to keep the introduction extremely short.

Jane Gravelle is a Senior Specialist in Economic Policy at the Congressional Research Service. She is now also a Second Vice President of the National Tax Association, on her way up towards being President in a couple of years. Co-Editor of the Encyclopedia on Taxation, and many other remarkable talents have been displayed in her vitae. By the way, these weren't out when you first came in but they are out there when you leave if you're interested in the vitaes for the people.

Mark Iwry is here now, a Non-Resident Senior Fellow at the Brookings Institution. He was also Benefits Tax Counsel to the U.S. Department of Treasury. The fact that he's at Brookings says that he's willing to give up a lot. I happen to know what benefits tax counsels can make these days because I used to work with them, so he's giving up a lot to try to do these types of issues, partly because I think he's well known over the years as having a remarkable interest in the public interest and trying to figure out really works. If you look at his vitae you'll see that he's actually had a marked impact on a number of features of the current system such as the simple plan. He's been with Covington and Burling, has a remarkable pedigree of degrees from a variety of places like Harvard Law School.

Finally Pamela Perun is an Editor of the SSRN Journal on Employee Benefits. She has a degree both in gerontology, a PhD and a law degree as well. She's a pension lawyer who happens to be an independent consultant. She works closely with the Urban Institute and even at times writes papers with somebody who's name is very hard to pronounce, Steuerle or something like that.

So without further ado, I'm going to introduce you to -- Nobody has a preferred order. I think I'll just take them in the order they are in the agenda. And I'm going to try to keep you to ten minutes. The last moderator said the moderator for the previous session just didn't let the first speaker talk long enough, he had a lot more to say. But I'm going to have to keep these speakers limited as well.

MS. JANE GRAVELLE: Thank you. I know that bill already made this announcement, but the views that I'm about to present do not represent the views of the Congressional Research Service.

This material that I'm going to present here comes from a paper that I did for the Tax Policy Group called the Enron Debacle, Lessons for Tax Policy. Certainly this was I thought, the biggest lesson of all was issues regarding diversification and risk in defined contribution pension plans and in the pension system in general.

In addition to the paper there's two pages of notes. You don't have to look at them as I talk but you can take them away with you so you won't have to read the whole paper to see what I have to say about this.

Certainly the collapse of Enron focused attention on the dangers of concentration in employer stock. I think that worry seems to be dissipating as we get further and further away from that event, but at the time Enron's 401K plan had 62 percent of its assets invested in employer stock which of course became worthless. Why was that? Part of it was because Enron's own contributions were in their employer stock which was not permitted to be sold until age 55, I believe. And part of it was because the employees themselves invested their own contributions heavily in Enron stock.

That ability to invest a lot of your contributions in these defined contribution individual accounts like 401Ks are very different from what goes on with DB plans where we have pension insurance and restrictions on employer stock to 10 percent. A lot of people started to study how much of DC plan assets are invested in employer stock -- this was before the stock market fell so much, so who knows whether these are still accurate. But at the time in general most studies found that DC plans in general had anywhere from about 19 percent to 39 percent of assets in employer stock. A study by JO that included DB plans as well as DC plans found at least 11.5 percent, probably more. There's also enormous variability.

You have firms like Proctor and Gamble where 92 percent of assets are invested in employer stock; Home Depot, 72 percent. In the GAO study they found that the retail sector has 32 percent on average of total pension assets invested in employer stock.

The highest shares that will be found in employee stock ownership plans or ESOPs, which I'll have more to say about later, 98 percent. And in plans combined with ESOPs, one example is a KSOP where you combine an ESOP with a 401K plan, that was about 58 percent on average in those plans.

I will be referring to ESOPs over and over again, but ESOPs certainly played an important role in the machinations of Enron. Not only did they have a KSOP which included an

ESOP piece, but they had a very interesting role that their ESOP played in the ending determination of their DB plan and offset plan. If you want to read the sort of horrible things that can happen with pensions, you might want to take a look at that little discussion in my paper.

There's a diversification problem, a lot of people would say, because I think most investment counselors would probably say you should have no more than about ten percent invested in a single stock, and if you work for the firm you probably should have a little less. It is perhaps wise to obtain the return of investing in employer and other stock, but you can certainly do that with a diversified stock account. It's very foolish in general to have such a high concentration in one company's stock -- your own or anyone else's. But maybe a little more if it's your own because you're left without a job or without assets if something happens.

So what is the role of the tax system? What should the role of the tax system be in this whole issue?

Pensions are certainly the largest tax subsidy we have in the tax system. It's well over $100 billion a year in tax expenditures, and there are also a lot of pension contributions that are exempt from the payroll tax.

There's also been a long history or a long period when DB plans have been declining and DC plans have been rising. Again, increasing risk to some extent. Some of that could be due to the complexity of the tax system. Some of it is probably due to this delightful little plan called the 401K which is only about 20 years old but it allows you enormous flexibility, a very attractive plan.

We have for a long time had special benefits for employee stock ownership plans. They date back to when Senator Russell Long had lunch or dinner with a guy named Louis Kelso and became entranced with the notion that somehow you could save America by letting employees own their own companies. That began a series of very special benefits for employee stock ownership plans including the ability to leverage assets.

ESOPs have about $410 billion of assets. A lot of them are thought to be, at least if you see people up testifying on Capitol Hill it's always small business people who talk about ESOPs saved their company, but in fact the vast majority of ESOPs are in very large firms and they've been in some large firms that failed including Polaroid and United Airlines.

Ironically, just as Enron and other companies were sliding towards the abyss, the Congress was enacting another special benefit for ESOPs in the 2001 tax cut. It was a revision that allowed the option of deducting dividends paid on ESOP stock, allowing firms to deduct dividends of ESOP stock as long as the employees had the option of taking it in case. They could do it before if you took it in cash, but now they have plans that allow you to leave your assets in the plan and they're the only stock asset that has that kind of benefit.

In the wake of the Enron debacle, there are a number of legislative proposals developed. Some of them have direct restrictions on the amount of employer stock in 401K plans; some of them said you can have the employer contribute the employer's share in stock but not offered as a choice to the employee, or the other way around but you couldn't have both. Legislation that might actually be enacted would require contributed stock by employers to be allowed to be sold within a few years, usually three years or five years, requiring a minimum of three investment options, requiring companies to provide independent investment advice, and there has already been a rule requiring notification of a lock-down in advance. That was one problem with Enron. As you perhaps all know, there was a lock-down of the plan while the stock was falling.

There's no mention of ESOPs. ESOPs are excluded from every one of these proposals.

So what are the public policy issues? We spend a lot of money on this so the question is what are we getting for our dime and what do we want to get for it?

What we don't get is protection against risk, apparently. For DB plans in 1974 we enacted pension insurance and we also restricted portfolios. There was none of that for the defined contribution plans and in fact that's the year we enacted the first special benefits for ESOPs which are designed, most of them, to be invested in employer plans.

I go through in my paper a lot of arguments for encouraging retirement savings which I won't go into now, but I think sort of the overwhelming one it seems is that people may not make optimal decisions. It's very hard to -- You only live one life and have a chance to make decisions about retirement, and you don't make those, may not be able to make good decisions. So we want to kind of encourage people to do that.

The sort of ironic thing is when you start talking about restricting portfolio choices or asset choices in employer plans the first thing you get is this interferes with my freedom of choice. Yet if we believe that people need help in making optimal decisions about the quantity of assets, then it's kind of a tail-biting argument to come back and say well but you're free to invest in your uncle's laundry business or anything you want. I think there's just as much of a rationale for restricting the allocation.

The other argument is it would reduce the employer's participation. Again we have to ask whether spending our dime is worth this. It's great for the employer to make contributions in stock. It doesn't cost them anything immediately. The stockholders may not notice. The employees may not really be aware of what a risky asset they have. But the government and the government subsidy should be looking after the interest of the stockholder and the interest of the employee. So I think there's a very strong case to introduce a direct restriction on the allocation of assets in plans like 401K plans. One has to be careful about increasing the administrative costs when you do that, so if I were doing it I would put the restriction on contributions and not assets so you don't have to keep coming back and fixing assets.

In the minute I've got left let me say that none of these plans do anything with ESOPs. It's like ESOPs are not even there on the horizon. There are no restrictions on ESOPs. In fact there's not even talk of saying maybe we should take back that little benefit that we gave to ESOPs that made them so much better than everything else.

Especially when we have two sort of conflicting objectives here that we need to think about. One I think is employee retirement security, which I think is a legitimate objective. The other is we've got this notion that employee ownership of employer stock is going to dramatically boost productivity.

People have tried to study that. I think the evidence is mixed and very hard to come up with. But I think there's not very powerful evidence that this happens in large companies and people would be silly to work so hard to get one-one-thousandth of a penny for every additional bit of effort they make.

So I would just like to quote what I said in my paper that sums up one of the things that I want to say in analysis of what happened with Enron and what's going on with diversification. Which is "To argue as a matter of public policy that employees should diversify investments away from employer stock, and yet to maintain incentives for doing that very thing must undermine the credibility of the government's position. While it may not be desirable or politically feasible to do away with ESOPs," or their special benefits, "it surely makes sense to give them no more benefits than any other pension plan."

MR. STEUERLE: Thanks, Jane.

We've had a slight switch here. We're going to have Mark go next.

MR. MARK IWRY: Thanks, Gene.

I'd like to outline briefly for your consideration two specific approaches to expanding coverage and retirement savings.

First expanding the savers credit that Peter in particular has talked about, and second, facilitating automatic saving. In a sense, these proposals pick up very much where Bill Gales and Peter Orszag's discussions today left off, and where Jane Gravelle's left off.

The savers credit is the most significant and virtually the only major initiative in the pension area that promotes in a targeted way retirement income for moderate and lower income workers. I'd say the most significant initiative since ERISA, but probably the most significant initiative before or after ERISA. The 1942 Revenue Act introduced non-discrimination rules and this is probably comparable in magnitude to that, although as Peter pointed out it's been slimmed down so much in the legislative process.

The savers credit emerged as the end product of a much larger scale attempt to achieve universal pensions. Namely the universal savings accounts and the retirement savings accounts proposals that were developed between 1998 and 2000, largely by Len Berman's office and my office at the Treasury Department.

The aim was to help correct some of the problems that Bill has pointed out in the system. The very top-heavy nature of the distribution of benefits, the exclusion of about 75 million workers and spouses from employer pensions, and the arguably central defect in the tax incentive structure that marginal rates determine the value of the incentives because we give exclusions to contributions and exclusions to earnings that depend on your tax bracket for their value.

Those who need the additional retirement security the most therefore, as Bill outlined, have the least to gain from contributing or receiving contributions, and a tax credit, especially a refundable one, which is how we designed it to be, puts people in different brackets, essentially on the same footing relative to the incentive.

Also the savers credit was designed to help the employer's system rather than compete with it. By in effect matching contributions that are made by lower or moderate income people to their 401Ks. In addition to any employer match that might be provided by the K plan.

The savers credit encourages contributions by precisely the people who are least likely to contribute now. The people who are zeroes in the non-discrimination test that determines how much the higher paid employees can contribute. So the credit makes it easier for sponsors to pass non-discrimination 401K tests, and therefore to give the higher income folks more tax preferred saving opportunities.

I'd advocate four basic changes in the savers credit. First, make it refundable. Peter's talked about the tens of millions of people who are excluded from eligibility because the refundability was dropped during the legislative process.

As we were discussing earlier, if it proves to be politically impossible to make it refundable there may be other ways to get at the same goal such as providing a savings bond or some other instrument that people without tax liability could get but would be unable to consume before retirement. Others have argued in similar contexts for an income tax refund dependent on payroll tax liability. These folks are mostly paying payroll taxes even though they don't have income tax liability. Some would argue they should get a refund that is based on their payroll tax payments but without shorting the Social Security trust funds.

A second change would be to improve the phase-down of the credit. So that instead of 50 percent credit being limited to people with $30,000 in joint income and then having the credit jump down to 20 percent and 10 percent very quickly as income goes up, expanding the 50 percent credit in much the way the proposal was originally designed, to extend further into the middle class, up to perhaps $50,000 in joint income, phasing out at $60,000 or $65,000. These are people who earn enough that they might have a greater ability and propensity to save, given the opportunity.

Third, the phase-down of the credit ought to be smooth. Right now we've got cliffs. It goes from 50 percent, then very suddenly down to 20 percent, then suddenly down to 10 percent so you have a high marginal tax rate in effect when people earn enough money to go from the 50 to the 20 percent eligibility.

Finally, instead of sunsetting after five years which the credit now does, while ironically the rest of the provisions that were enacted with it to promote pensions largely for more higher income people lasts for ten years and are proposed to be made permanent, the credit ought to be at least of the same duration as the other provisions.

2002 was the first year that the savers credit was available. The evidence so far of its usage is, as far as I'm aware, two-fold. I'd be interested in anything that you all have that bears on this.

First, there was a survey of 401K sponsors by a private sector firm of diversified investment advisors in the middle of last year that reported that 71 percent of the plan sponsors surveyed said they thought the savers credit had increased plan participation. This is in 401Ks principally. And 18 percent said it had increased plan participation in a major way.

Second, based on IRS data so far regarding the 2003 filing season, it looks like we're on a path to some three or four million, probably closer to four million than to three, returns that will have claimed the savers credit for 2002.

Now as Peter says, virtually no one is eligible to get the full credit for the full amount of their contributions because of the unfortunate way that this was squeezed during the legislative process, but a lot of people are getting at least something. These are typically people getting a 20 percent or a 10 percent, in more instances a 10 percent credit. Too little, but something. One would hope that this suggests that it would be well worth expanding the credit both to make it refundable first and foremost, and second, upward to cover more of the middle income group.

My second and related proposal is that Congress and the agencies take further steps to promote an integrated soup-to-nuts approach to promoting retirement coverage and saving. An approach that's premised on a realistic view of human behavior that takes into account human frailty and the somewhat myopic behavior that most of us exhibit.

Our whole retirement system of course, is in a sense premised on that assumption since we're giving incentives to encourage people to save more than they otherwise would and consume correspondingly less.

My office at Treasury several years ago together with the Internal Revenue Service, Carol Gold is her, her organization in particular at IRS, initiated an effort to encourage retirement saving by prompting automatic enrollment and its variations and automatic roll-over. We published a ruling that was later highlighted in a speech by President Clinton that permitted automatic enrollment of employees in 401K plans and later 403B tax sheltered annuities and similar programs.

It was essentially a road map designed to encourage employers to make saving the presumptive mode, to take salary reduction contributions out of employees' pay automatically unless the employee elects to opt out of that.

Later working with people in the private sector, particularly the Profit-Sharing 401K Council Of America. Ed Ferigno is here and David Ray, we published a ruling that was designed in a somewhat similar way to limit leakage from the system by permitting employers to automatically roll over, cash out distributions. That is distributions that come from a plan that the employer could otherwise pay out to employees automatically without the consent of the employee. Or indeed larger distributions. Employers could set up an IRA for the employee and roll the money into the IRA if the employee's gotten disclosure first and the option to take the money instead if the employee wants to.

We proposed legislation following up on that, that actually requires employers in the case of a small, that is below $5,000 distributions, to roll the money to an IRA that the employer establishes on behalf of the employee. Again, unless the employee says no, give me the money; or no, roll it over to some other IRA or employer plan that I designate.

This automatic roll-over and the automatic enrollment initiatives reflect obviously a common strategy encouraging saving and retention of savings by making contributions and roll-overs the automatic or the default mode. Employees can avoid contributing, they can avoid rolling over if they wish to, but they have to expressly opt out.

The variations of automatic enrollment, some of which can be better than automatic enrollment itself, and automatic roll-over, essentially address the end points of the saving cycle. That is the contribution phase and the payout phase.

What I'm raising for your consideration today in addition to measures that would bolster and facilitate automatic enrollment and automatic roll-over, is another similar element of the same strategy. Plan sponsors could be encouraged gradually to roll back employee self-direction of 401K investments, and this picks up on what Jane was saying about the problems that we've seen in employee self direction and the relatively suboptimal results that a lot of individuals are getting from their investment choices.

The employer would provide one investment option that is either a standardized set of funds, a balanced, highly diversified portfolio -- index funds, perhaps inflation index funds as components of that. Or if the employer chooses it could provide professional investment management. That option would be part of every array of choices under a 401K plan.

A somewhat stronger version of that, which might be more feasible in a later phase if the first initiative were to take off, would be to require that standardized option or the professional investment management to be the default mode in the plan, so that employees could always get out of it if they wanted to, opt out and self-direct their own investments. But if the employer provides self-direction as an option it would need to make available this standard or professionally managed alternative.

I'd suggest that millions of people have neither the training nor the inclination to self-direct in 401K plans.

I've outlined the argument for this approach in greater detail in a draft paper on promoting 401K security that is out on the table.

In a sense, these approaches, this sort of automatic plan approach -- contributions, investments, roll-overs -- is intended to restore and retain what could be viewed as the cardinal virtues of our employer system, the traditional employer pension system. Employers taking the initiative to contribute for employees. Employers actively encouraging employees to contribute. And a wholesale rather than a retail approach to investment of retirement assets with the associated economies of scale and professional management.

I'd like to discuss a number of other ideas that don't fit within the timeframe available including possible approaches relating to the cash balance pension problems, relating to the heavy concentration of employer stock in 401Ks that Jane has talked and written about. And if anyone is interested in getting into these topics during the discussion period I'd be happy to talk about them and hear what people here have to say.

MR. STEUERLE: Thanks Mark.

Pamela?

MS. PAMELA PERUN: I only have about ten minutes to talk but that's okay. My job is to talk about pension simplification but the time limit isn't a problem. I've got it all figured out, at least as I define it and I'm sure you'll agree when I'm done.

I'm going to start out by comparing the two proposals for reform currently on the table and then propose an alternative.

The first proposal is Portman/Cardin II and the second is the Administration's attempt to consolidate employee savings plans.

In order to get you to where I end at, I need to get you to where I start from, so I'm going to start by showing you the nuts and bolts of the private pension system in the post-EGTRA world.

If you could turn to Figure 1 at the end of my paper.

Most people understand that we have both defined benefit and defined contribution plans, but not many know there is as much diversity within these types of plans as between them.

This figure shows the extraordinary constellation of plans that are available when EGTRA gets fully phased in by 2006.

Why are there so many plans? I think it's because we have historically focused on the tax attributes of employers when creating plans and have assumed that plans need as many different rules as are necessary and appropriate for each type of employer. This made some sense when defined benefit plans were dominant, but it makes much less sense today, now that employee savings are the driving force behind retirement savings.

Nevertheless in the tax code we retain separate families of plans. We have defined benefit and defined contribution plans under 401A. These were largely corporate plans when they started out but now have been expanded to other types of employers, and they're the most heavily regulated.

We also have special plans for tax exempt employers in public schools under 403.

Then we have 408 IRAs which were originally individual savings devices but now we've created a whole set of employer plans around them.

Finally we have 457B plans for governmental employers.

We also have this box called non-qualified deferred compensation. I just want to remind you, I'm not going to talk about it here, that we do have another pension system for the high paid called the non-qualified system where there are no holds barred, no rules apply, no limits enforced, and some day we're going to have to talk about that as part of the private pension system. It doesn't really impact the tax system as much as the qualified plans do but it certainly raises some equity issues.

Among these plan families we've had some minor convergence over time but the standard ones continue to exist, retaining their historic structures and traditional rules. The result, which I show in Table 1, is four pages of rules. It's a truly byzantine collection.

The first two pages are 401A and 403B rules, and the second two pages are 408 rules and non-qualified deferred comp rules.

EGTRA did bring about some long overdue changes such as rationalizing the limits on contributions, but when we have pension reform typically few rules disappear, usually just new rules are placed on top of them. We're in the process of doing that now, so we can make IRA contributions to qualified plans.

So what we have in Figure A is all the 408 rules being imposed on the 401A rules, the 403B rules, and the 457 rules. In 2006 when Roth-type contributions come in again, we'll do the same thing all over again. This means not just new rules, but we'll have a completely new tax system which conflicts with our traditional pre-tax and after-tax regimes.

The result is an enormous expansion of rules, separate vesting rules, distribution rules, and recordkeeping and accounting requirements that will add tremendously to plan costs.

Even though EGTRA was passed just two years ago we now have Portman/Cardin II which is supposed to make the next generation of improvements and provide more innovative savings tools. Like EGTRA, it's a massive bill with more than 200 pages of highly technical rule changes.

I think Peter's gone over some of the rule changes that Portman/Cardin II would bring about so I'm not going to repeat them here. But it's important to recognize that as always there are going to be some new plan types. What Portman/Cardin II will do is make simple plans less simple. It will bring back salary reduction only plans, will add more flexible matching contributions, and will add more elective employer contributions.

Finally, I think this is my favorite if I could understand what it is. We're going to create a reverse matched salary reduction arrangement, simplified employee annuity for small steps.

Now none of these changes is particularly evil and many are in fact improvements if you assume that the system has to stay the way it is, but maybe we should ask. Does Portman/Cardin II really help move us towards systematic reform?

I don't really think it does. We'll have eight ways for employees to save depending on what type of employer they have. And for employers, distinguishing among all these plans will be difficult because they look so much alike.

I tried to add the new plans to Figure 1, but it wouldn't fit. So I think if we pass Portman/Cardin II we'll have the first private pension system centerfold, just of plans. [Laughter]

Now who really benefits from Portman/Cardin? I think certainly the plan compliance industry -- not that they need the additional work; the financial services industry will get more fees; and wealthier Americans will get more tax benefits; but it really does nothing that's constructive for the ordinary pension consumer, the not-so-large employer and the not-so-wealthy employee.

But there is another alternative on the table which is the Bush Administration's radical pruning of the employee savings plan

They would replace all of the existing plans with a new standard employer retirement savings account called an ERSA. Individual IRAs would be replaced with retirement savings accounts, RSAs which look like today's Roth's, and we'd have new lifetime savings accounts, LSA's II.

If you look at Figure 2 it's an example of how the private pension system might look if the Administration proposal were passed.

It has a structure with an appealing simplicity which we could even modify further by making ERSA's part of the regular defined contribution plans as 401K plans are today.

In Table 2 I've tried to describe how the rules might also be simplified. ERSA's would be available to all types of employers and have simplified qualification requirements, the same type of contributions that are available today, and the same tax rules.

Corporate employers would have simplified tests as well as some safe harbors and tax exempt and governmental employees would have the current rules.

It's certainly a simpler system but is it fairer than the one it would replace? Not necessarily, given the controversy that various people that various people have mentioned here about RSAs and LSAs which have been viewed as too generous and likely to exacerbate the coverage problem. Because with an RSA and an LSA and a non-qualified plan, many employers particularly the small ones, won't bother with a qualified plan for their employees.

ERSAs could use some work. We need better coverage and discrimination standards to protect low-paid workers and those standards should apply to all ERSAs. Keeping special rules for other employers is an anachronism especially where employee savings are concerned.

In the end neither proposal is very satisfactory. The first one just adds more complexity and we've been down this same road so many times we know how it will turn out. The Administration's proposal is simply bur fails on equity grounds.

So here's one alternative to both. We originally proposed it four years ago when ERISA turned 25. You can see it in Figure 3 at the end of the paper.

At that time we didn't think it was feasible for another 25 years, but there have been some intervening legal changes that make it no longer out of the realm of possibility.

In this proposal we call for a single simple defined contribution plan for employee savings and it would have the same uniform contribution and deduction limits and rules on portability that EGTRA brought about. It also calls for uniform Social Security treatment for contributions and it ignores the tax attributes of employers. All employees would have the same opportunity to save no matter where they work.

It also calls for an individual coordinated limit on savings between individual and employer-sponsored vehicles. This won't solve the coverage problem all by itself because there will still be many smaller employees who will find the current IRA limits an attractive alternative to a plan. But it will keep this plan from becoming the Trojan horse of the private pension system that RSAs and LSAs promise to be.

Finally, it recognizes we need to do more to make a tax-based system an effective savings tool for low-paid workers. Without this improvement it's not clear why we want to ever pretend that major reform has been achieved by any proposal or why we want to forego any revenues to get there, so we suggest government matching contributions. This seems less feasible today, but as other people have said we could make the existing savers credit refundable.

This would be fair to the majority of low-income savers who actually have no tax liability and provide an incentive similar to matching contributions.

This proposal is just one of many that could be made. It merely takes some good ideas along with the best elements of EGRA, Portman/Cardin II and the Administration's proposal and repackages them. It is one model for what a sensible and effective universal savings plan might look like.

The private pension system doesn't need more innovative savings tools, it just needs one that works.

MR. STEUERLE: Thanks to all of you for staying very much in time. I know all of you had a lot more you would have liked to have said.

I'm going to ask the first question and I'm going to ask each of you perhaps not to comment on your own paper, but if you might give a 30 second or one minute response to the other proposals you heard from the other people here. Maybe I'll have you go in the same order you went initially. What was your reaction, Jane?

MS. GRAVELLE: Gene was hoping we were listening right? [Laughter]

MR. STEUERLE: Right.

MS. GRAVELLE: I thought Pam's notion of bringing some order out of this chaos. I'm not sure I'm the expert to figure out how to do it. In some ways I think I'm a little concerned about totally abandoning DB plans because DB plans have a lot of attributes were they to be done properly that I think are available. That includes the pooling of risk with other employees and also DB plans you can kind of first have annuitized payments. So that was kind of my one little reservation.

I guess the way that DB plans actually happened in practice where they often weren't indexed to inflation and where employers do face a great deal of risk with uncertainty of life -- Maybe we just can't hope to have that kind of -- But that's the one thing that bothers me about the idea of going to DC plans is not having broader risk-sharing amongst individuals.

I think as far as savings, the savings credit Mark talked about, I do think if you go the route of the credit against the income tax liability you might as well quit before you get started. I think the tax community views the pension credit as just one more claimant for refundable tax credits, and they have been very very resistant historically to doing any sort of refundable tax credit, although I think the idea of making it refundable against the payroll tax would be a good idea. That would certainly be an easy way to go. And of course there's just the possibility of making a direct contribution the way the Clinton Administration proposals were.

But it does seem to me that we're leaving low-income people out in the cold, particularly the more that we move in the direction of not imposing income tax liability on them. That's one of the costs of freedom from the tax.

MR. STEUERLE: So your last comment is making it an expenditure instead of a tax credit.

MS. GRAVELLE: Yes, of course nobody likes that but -- Or make it against the payroll tax. That might be a way out of that particular difficulty without the Trust Fund suffering from it obviously, which we don't need.

MR. STEUERLE: Mark?

MR. IWRY: I agree with Jane's agreement with my ideas. [Laughter]

I think that Jane's pointing out in her paper what, as she noted, is an issue that may have come down on the radar screen a little bit. That is the over-concentration in employer stock in our DC plans because the entire plans have declined in value so much.

The portion of the investment strategy that many employees have followed that is less than rational, I would argue, is when they have over-concentrated an employer stock, and I think Jane is pointing out that that really does need -- validly pointing out, that does need to be dealt with by Congress. I believe that it needs to be dealt with, as I think she does, by more than merely giving employees the ability to liberate themselves from employer-imposed restrictions to keep invested in company stock.

Both of us have papers on this and I invite folks to react to those when you have a chance if you have a chance to read them with a variety of proposals.

I very much like Pamela's notion of government matching contributions to augment employer contributions, and indeed as Jane said in the previous Administration, at Treasury we proposed that. The downside of government matching contributions that go right into people's accounts and therefore get saved instantly rather than potentially getting consumed as a tax credit does, the downside is that it's scored as an outlay and may of you savvy Washington players in this room know that getting scored, as Gene mentioned, as an expenditure, as an outlay, has its own huge set of political problems that is comparable to the political problems of advocating refundability.

So that is why we ultimately transformed it. That's one reason we ultimately transformed that government match into a government tax credit match, to make it a tax proposal, a revenue proposal rather than an outlay.

Of course refundability would be scored as an outlay and we're advocating for that. So one way or another we're coming to I think a similar view.

MR. STEUERLE: The Clinton people were pretty good at converting expenditures into tax cuts. [Laughter] It was a political issue.

MR. IWRY: Right, it was really a political issue and we thought that the best way to go was actually to have the government send money to people's accounts where it would have to stay until they retired.

MR. STEUERLE: Pamela?

MS. PERUN: I heartily endorse Mark's suggestion that employers should have model investment portfolios as part of their self-directed plan. I did work in one law firm where that was done and it was such an immense relief for all the secretaries and other workers to know there was some brain behind a particular selection of investment choices and they couldn't go too far wrong by staying within that. And at the same time, lawyers being what they are, they opened up the investment choices to anything. So anybody who wanted to be an investment cowboy could be.

Jane, I didn't mean to suggest that I was shoving defined benefit plans off center stage. I really haven't thought through how to save those. They're a valuable piece of the private pension system, but on the other hand we have this huge proliferation of savings plans that doesn't make sense, so I was just focusing my attention on that aspect. And in fact in Figure 3 of the paper there are some thoughts about how you might change defined benefit plans and standardize them in a way that makes sense going forward.

MR. STEUERLE: It's up to you, audience. Anyone want to take on some of these suggestions?

QUESTION: I'm going to continue the question I asked before which is, it's a naive question coming from somebody who lives in Washington, but I don't understand the political economy of this. We have the members of Congress who just want to add a little box with their name attached to it, it seems. Where are the advocates? Where is labor? Where are consumer groups? Where are the people who obviously ought to be promoting what appears to be politically impossible from all the remarks that I've heard on stage?

MR. IWRY: Actually I'd be interested in some of the people here addressing the question you just raised before we say anything. Is anyone here interested or willing to comment on that? Respond to the gentleman's question.

QUESTION: Debby Chalpy, National Women's Law Center.

I can just say based on my experience pensions are a difficult area to learn so there are not a lot of consumer advocates who are involved in the pension area and the ones who are greatly underfunded and outmatched -- [Laughter] -- by the financial services industry, the employer industry, the plans. They're out there. The advocates are out there. That's why there were some stops put on cash balance plans before they just went riding away. That's why there have been some improvements in women's pension rights over the years. That's why there have been some protections for workers. But the advocate community, those who are advocating on behalf of workers are up against an incredibly well financed, well organized group of folks who have a financial self-interest in structuring three rules in ways that benefit them.

MR. IWRY: I can give also a very quick comment as well, having worked at Treasury many years. Table 1 in the paper that Pamela and I have actually was something I tried to do at Treasury and couldn't get someone to do it and then went on the outside world and had to involve several pension lawyers including a former employee benefits counselor, Harry Connoway, who initially helped us do this. And even he didn't know all the details.

So there's really no one out there who really knows all these details generally. They know parts of it, some of them work with private DBs, some with private DCs. You end up with a community of perhaps a couple million workers between the mutual funds and the insurance companies and employee benefits people in firms. You name it. You probably have a couple of million people who have some stake in the existing system but they don't know the system as a whole and they're threatened by change unless it's the patch that allows them to do what they think they know how to do a little bit better.

An example of this in a more controversial area is the conversion of defined benefit plans to cash balance plans which is a very controversial area. The current defined benefits structure discriminates economically against very young workers, it discriminates against very old workers who get fewer benefits than people sort of right in the middle.

So you decide you want to change the system. There are winners and losers all over the lot so you earned up with highly controversial fixes which don't divide up in the normal liberal/conservative ways. It's not Republican versus Democrat, it's kind of people who have figured out how to exist in the existing system, whatever it does, they're not sure what it does vis-a-vis the others. So it's a very strange politics that plays in employee benefits. It's very different. It's not like whether you want the tax system more progressive or not, although that comes in. It's are you willing to tolerate change and tolerate some of the winners and losers and the complications that also derive from change in a complicated system.

QUESTION: I'm Ed Fregno with the Profit-Sharing 401K Council of America.

I think your question really is saying why isn't there a hue and cry about this system? I would offer that there isn't a hue and cry against the system because it's working very well. We have a system, a voluntary system, where when we offer it 75 percent of the people that we offer it to participate. We know that when the non-highly-paid person decides to participate, they contribute seven percent of their pay. We know that the average contribution from the employer is three percent. So we've got people saving ten percent of their pay for their savings.

We also know that the key to making this work is to have the employer offer a plan. It's kind of like build it and they will come. If we offer a plan we get substantial participation from non-highly-paid workers who realize significant benefits. You say where's the hue and cry? The hue and cry isn't there because the vast majority of people are very satisfied with the system.

We support the savers credit. I think the savers credit is terrific. But it doesn't work if there's not a plan offered. So you have to understand that you have to have incentives in place in the small business sector to get them to offer a plan. Couple that with things like the savers credit and you're in good shape.

QUESTION: I'm David Beedy. I'm with the Commerce Department.

I was wondering if you could give us some numbers maybe of what the cost of the complexity of the system is versus what the simplified versions might be in terms of all the various costs we had of employee benefits managers, of consultants and mutual fund managers and all that sort of thing.

MS. PERUN: I don't think anybody's able to estimate that. I've looked at 5500 data and it's not complete because you have reported expenses that are paid out of the plan but you don't have the cost of expenses that employers put up and you certainly don't have the cost of expenses that are hidden in mutual fund fees. So I don't think there's any data out there but it would certainly be a wonderful study to do.

MR. IWRY: I think it's also fairly clear that even if there was a simple plan one could adopt, you look at this array and most people would be so threatened by it they have to go to highly professional help. How that ends is very difficult to know.

QUESTION: I think if you look at the evidence on who doesn't have pension coverage it's primarily employees of small employers. Most of those employers do not object in principle to providing plans, but their employees do not attach as high a priority to retirement savings as they do to current wages or health benefits and I don't see any way that's going to change because for a family person if you can't pay your bills, if you don't have health insurance coverage for your children, those are much more important, more current concerns.

So I don't think any system that relies on employees buying into the system is ever going to cover, and we've been hovering at around 50 percent coverage for the last 30 years. We've had all sorts of different initiatives. None of them really mean anything -- We gain five points here, we lose five points somewhere else. Unless there's some sort of universal system that everyone is compulsorily covered but I don't think we're ever going to solve the problem.

MR. STEUERLE: Let me just add to this 50 percent coverage, too. Many people withdraw their money before retirement. Many have only small deposits. My own calculations show that the present value of Social Security and Medicare is higher than the entire asset value of pensions, housing and everything else for 80 percent of the population who's retiring today. Most people do not save for their retirement despite the fact that we do get some who save in some plans on occasion.

MS. GRAVELLE: If we go back to defined benefit plans which have been disappearing, and I kind of see that as sad in a lot of ways. One of the things that happened is they kind of got caught in the budget crunch of the '80s. You have to have restrictions under these plans to make sure that they're financially sound and you have to have restrictions to make sure they're not being abused. And so how you design that system I think to deal with those restrictions is one of three things that makes it so complex.

So you have situations where when your assets are really performing well you know you're overfunded and you've got to do something.

I always wondered why we didn't adopt the simpler notion where you could be overfunded but you just, during a period that you're over-funded you just tax the return over the over-funded amount. It's always amazed me how simple ideas like that, maybe there's some horrible problem with that idea. I've been trying to push that idea for at least since the early '80s. If there's no constituency and nobody wants to go push an idea to simplify things it just never happens. I don't think anybody's interested in doing that.

What they were interested in in the '80s was putting some kind of tax on withdrawals from plans so they could deal with the short-run revenue problem.

So when you've got all those multiple motives going on at the same time, I think that's how you get -- Which is why you need one big all-time reform that takes everything and tries to fix it at once which of course is what Pam is proposing and something I applaud, but it sure is hard to do.

MR. STEUERLE: We have about three questions here. I'm going to have all of you give your questions real quick and not have responses, if you can keep them short so we can try to get all of you in, if that's okay.

QUESTION: Ilia Coronado, Federal Reserve Board.

I really appreciate the points you make about the oversight of the DC system, but you've characterized the DB system in a couple of ways that I just want to comment on.

You characterize the DB to DC trend as increasing the risk that participants bear, but in fact the back-loaded nature of DB plans imposes a huge risk on employees from job mobility. So they change jobs, they lose their pension. And in fact that is, the increasing mobility in my mind is what has led to the increasing popularity of DC plans.

So in fact the matrix of risks may very well be balanced pre- and post-401K popularity.

The second thing is the consensus seems to be that we want to address the needs of the lower income people that aren't currently benefitting from the private pension system, but the very cheapest most efficient way to do this seems to be, as someone had suggested, just expanding the Social Security benefit that these people realize.

QUESTION: Paul Bernam, Congressional Budget Office.

On the subject of disappearing DB plans, have you considered that by making the savers credit refundable and permanent, and those are -- and It's DC plans that are eligible for that credit -- that you might be providing an incentive for employers to terminate DB plans on the grounds that their employees would be better off using the credit.

MR. IWRY: Yes. [Laughter]

QUESTION: Broadly there are three classes of Americans. There are Americans who do not participate in the private pension plan system; there are Americans who participate in the regulated private pension plan system; and there are the Americans who participate in a completely unregulated, very few at the top who participate in a completely unregulated system, as Pamela mentioned.

I wonder if you would comment on why it is that we only give the one percent the chance to participate in the type that clearly has the most effectiveness and the most freedom for the largest number of, for the people who can afford to choose it. Who are allowed to choose it.

MR. STEUERLE: What I'd ask all of you to do is maybe just one at a time you can answer the questions and any last minute summary comments.

MS. GRAVELLE: I guess I want to go back and defend DB plans. I do think that when you allow people not to be required to annuitize and not to have group risk and to be able to invest freely in very dangerously risky assets, you are increasing risks for people. I think there's some kind of compromise hopefully, on mobility and on those sorts of things. But I'm just very troubled by the risk that people will end up with nothing when they're old except Social Security because they are free to take out lump sums and they have all the constraints removed from DB plans. I mean maybe there are other intermediate things that you could do like forced annuitization or something like that. But I do find, and nobody seems to shed a tear for DB plans. Since I have a DB plan, I find them attractive. I wouldn't want to give it up. [Laughter]

MR. STEUERLE: I think government workers get about half of all DB benefits --

Mark?

MR. IWRY: The gentleman who asked about the savers credit potentially crowding out DB plans, yes, we did think about that at length and the limit on the contributions that are eligible for the savers credit is set at such a level that it's not a threat to any employer plan. It’s $2,000, the former IRA limit.

Unfortunately, IRA limits are now crawling up to the point where they'll soon be $10,000 or $12,000 per couple as we were discussing earlier, and those could threaten small employer plans.

I'm very much also an advocate of preserving defined benefit plans. I think they play an important role. But I do think that there is so much involved in that debate and so much superficial conventional wisdom around the virtues of defined benefit versus defied contribution plans that it is an appropriate topic or a separate discussion or symposium.

In response to your fair point about the back-loaded nature of many DBs, I think that is true but as we see, many DBs can be less back-loaded and the cash balance plans have the virtue of being less back-loaded and providing an alternative that can be very constructive if the transition to the cash balance plans is done in a way to give older workers an appropriately soft landing.

MS. PERUN: I just wanted to address the point on non-qualified plans. I think what happened in the '90s is those plans got pushed farther and farther down to middle management. We have shadow 401K plans and other types of plans that make up for all the limitations under the qualified plans. And the problem is as participation is pushed down, people don't understand that they're not in a qualified plan. They think they're getting all the same protections that they are under their regular 401K plan if they put away extra money in the shadow 401K plan. I think there's a lot of work to be done in that area and I think there's a story at Enron that hasn't been explored. Enron had these plans all over the place, and just before bankruptcy a lot of people managed to get themselves vested and get distributions and other people were left with nothing.

So I think there is some interesting work to be done on non-qualified benefits, particularly just before bankruptcy.

MR. STEUERLE: Let's give our three speakers a hand.

[Applause]

MR. STEUERLE: Thank you very much for attending this Tax Policy Center forum. If you want to get these papers as well as others, I'll refer you to our TaxPolicyCenter.org web site.

Thank you.

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