The Retirement Security Project

Pursuing Universal Retirement Security Through Automatic IRAs

J. Mark Iwry and
David C. John

N° 2007-2

The Retirement Security Project

RSP

Common sense reforms, real world results

www.retirementsecurityproject.org

The Retirement Security Project is supported by The Pew Charitable Trusts in partnership with Georgetown University's Public Policy Institute and the Brookings Institution.

1775 Massachusetts Ave., NW, Washington, DC 20036 • p: 202.741.6524 • f: 202.741.6515 • www.retirementsecurityproject.org

Summary[1]

This paper proposes an ambitious yet practical set of initiatives to expand dramatically retirement saving in the United States–especially for the 75 million Americans working for employers that do not offer a retirement plan.[2] Half of our workforce has no effective way to save at work because they have no employer plan. This fact, a national saving rate that has been declining steadily since the 1980s, and the expectation that Social Security is unlikely to provide increased benefits, make inadequate retirement saving a major national problem. Research and experience both point to a simple and effective solution, which we call the "automatic IRA."

The essential strategy we propose is to make saving more automatic–and hence easier, more convenient, and more likely to occur. Making saving easier by making it automatic has been shown to be remarkably effective at boosting participation in 401(k) plans, but roughly half of U.S. workers are not offered a 401(k) or any other type of employer-sponsored plan. We would take a new approach to extending the benefits of automatic saving to a wider array of the population by combining several key elements of our current system: payroll deposit saving, automatic enrollment, low-cost, diversified default investments, and IRAs.

The automatic IRA approach offers most employees not covered by an employer-sponsored retirement plan the opportunity to save through the powerful mechanism of regular payroll deposits that continue automatically. (This is an opportunity now limited mainly to 401(k)-eligible workers.) Under this approach,

- Employers above a certain size (e.g., 10 employees) that have been in business for at least two years and do not sponsor any plan for their employees are called upon to allow employees to use the employer's payroll system to channel the employees' own money to an IRA.
  - Employers would retain the option of setting up a 401(k), SIMPLE, or other retirement plan instead of payroll deposit IRAs at any time. Those retirement plans offer much higher contributions and tax credits.
- These employers – as well as smaller or newer firms that voluntarily offer payroll deposit as a conduit for employee contributions – receive a small temporary tax credit based on the number of employees who participate.
- For most employees, payroll deductions are made by direct deposit, similar to the common practice of direct deposit of paychecks to employees' bank accounts.
- The arrangement is market-oriented: IRAs are provided by the same private financial institutions that currently provide them.
- Employers choose whether the IRA provider is selected (1) by the employer (but allowing employees to transfer to other IRA providers if they so choose), or (2) directly by each employee.
- As a fallback, individuals and employers who cannot find an acceptable IRA on the market can use ready-made, low-cost automatic IRA accounts provided by an entity somewhat similar to the federal employees' Thrift Savings Plan (which might alternatively take the form of an industry consortium or nonprofit organization) with investments that are contracted out to the financial services industry.

"The best idea yet developed for making savings universal is an I.R.A. that is funded with automatic direct deposits from a paycheck. The brainchild of researchers from the Heritage Foundation and the Brookings Institution, the automatic I.R.A. would use a no-frills design and economies of scale to overcome the problem of high fees on small accounts. Congress should pass legislation to establish auto-I.R.A.'s, and the president should sign it."

The New York Times editorial (March 18, 2006)

"The savings rate in our country...is abysmal. This [the Automatic IRA] would dramatically turn that rate around, helping millions to build wealth and some measure of retirement security."

Donald Lambro
Chief Political Correspondent
The Washington Times
(April 12, 2007)

• Saving is automatic. Automatic enrollment – employees participate unless they affirmatively choose to opt out – and sensible default investments harness the power of inertia to maximize participation and increase saving.

While the presumptive method of enrollment would be automatic (employees would automatically contribute at a statutorily specified rate unless they opted out), employers not wishing to use this method with their employees could likewise opt out and instead have every employee make an explicit choice. In all events, while no employee would be required to participate, no employee could be left out simply because of inattention or inertia. Anyone declining to contribute would need to sign a waiver. Evidence from the 401(k) universe strongly suggests that high levels of participation tend to result not only from auto enrollment but also from the practice of eliciting from each eligible individual an explicit decision on whether or not to participate.

A national web site would give firms a standard notice informing employees of the payroll-deduction IRA option and standard employee election forms and enrollment procedures. (If possible, the election form would be added to IRS Form W-4.) The web site would also promote best practices as they evolve (such as automatic enrollment and potentially annuitization), innovation, and employee education regarding saving and investment.

Employers making payroll deposit available would be protected from potential fiduciary liability for investment performance and from having to choose or arrange default investments. Instead, whether the IRA provider was employee- or employer-designated or was the fallback standard account offered by the TSP-like entity, workers' contributions would automatically be directed to a diversified investment (initially, an asset-allocated life cycle fund) unless they chose a different option. Payroll deduction contributions would be transferred, at the employer's option,

• to an IRA provider designated by the employer,

• to IRAs designated by employees (and an employer that did not offer direct deposit of paychecks could simply forward all employee contributions along with the employer's federal tax deposits for remittance to the employees' designated IRAs), or,

• absent employer or employee designation, to a fallback collective retirement account.

The proposal is designed to minimize the employer's administrative functions, and should involve no out of pocket employer cost. Many firms already offer their workers direct deposit of paychecks; virtually all make payroll deposits to comply with income tax withholding. Payroll deposit to IRAs would not require much more effort from employers. They would facilitate employee saving by forwarding employees' contributions to their IRAs without having to: (1) sponsor a plan; (2) make any matching or other employer contributions; (3) comply with plan qualification or ERISA requirements; (4) select investments for employees; (5) set up IRAs or other accounts for employees; or (6) determine employees' eligibility to contribute to an IRA.

Many employers that still process payroll by hand would be exempted under the exception for very small employers. Firms not exempted would have the option of "piggybacking" the payroll deposits to IRAs onto the federal tax deposits they currently make, whether online, by mail, or by delivery to the local bank.

The self-employed and other nonemployees would be encouraged to contribute to IRAs by automatic debit (with electronic fund transfers), including on-line and traditional means of access. Automatic debit – replicating automatic payroll deduction – and IRAs could be arranged through professional and trade associations. The self-employed could also send deposits to IRAs with their quarterly estimated taxes or instruct the IRS to make direct deposit to IRAs of part or all of their income tax refunds. Independent contractors receiving regular payments from a business could arrange for automatic payroll deduction (direct deposit) to an IRA in the same way as employees.

The automatic IRA is carefully designed to avoid competing with or crowding out employer-based retirement plans and employer contributions for employees. In fact, for several reasons, extensive use of automatic IRAs can be expected to expand opportunities to market 401(k), SIMPLE, and other tax-favored plans to employers.

- First, the maximum permitted contribution to IRAs (currently $4,000) exceeds employees' average 401(k) contribution but is not enough to satisfy the appetite for tax-favored saving of business owners or decision makers (who would still have an incentive to adopt a SIMPLE plan or 401(k) because those plans allow contributions of up to $10,500 or $15,500, respectively).

- Second, the automatic IRA tax credit would be smaller than the tax credit small employers get when adopting a new retirement plan.

- Third, to encourage employer plans, firms would not be asked (or allowed) to match employee savings to automatic IRAs or otherwise contribute to them.[3] Employers interested in contributing for their employees or in saving more for themselves would adopt 401(k)s or other plans.

- Thus the proposal steers clear of any adverse impact on employers' incentives to sponsor actual retirement plans. In fact, the indirect intended effect of the proposal is to draw small employers into the private pension system by demonstrating the power of tax-preferred payroll deposit saving and whetting employees' appetite for it.

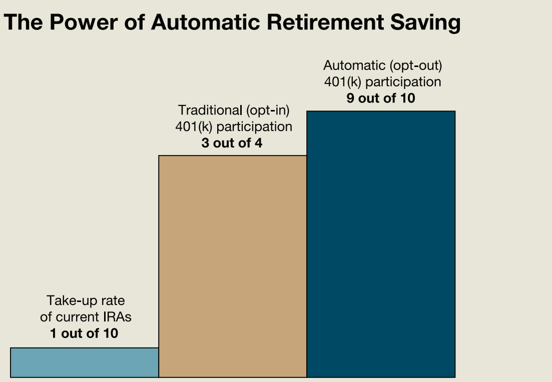
Within the fall-back investment platform, investment management, record keeping and other administrative functions would be contracted to private financial institutions to the fullest extent practicable. Costs would be minimized through a no-frills design relying on index funds, economies of scale, and maximum use of electronic technologies, and modeled to some degree on the Thrift Savings Plan for federal government employees. The investment menu would be kept simple: money would go to a low-cost, diversified, asset-allocated fund unless the individual instead selected from among a few low-cost, diversified alternatives (probably including Treasury inflation-protected securities). Once accounts reached a predetermined balance (e.g., $15,000) sufficient to make them profitable enough to attract the interest of the full range of IRA providers, account owners would have the option to transfer them to IRAs of their choosing.

In addition, a powerful financial incentive for individuals to contribute might be provided by means of matching deposits to the IRAs (not by employers). For example, private financial institutions that maintain the accounts could deliver matching contributions and be reimbursed through federal tax credits. Matching deposits are not, however, part of the basic automatic IRA proposal.

The Basic Problem and Proposed Solution

Many American families, especially middle- and lower-income households, find it hard to save, especially for retirement or other long-term needs. In 2004, half of all households headed by people age 55 to 59 had $13,000 or less in an employer-based 401(k)-type plan or tax-preferred saving plan account.[4] The U.S. personal saving rate has declined steadily over the last two decades and has been negative since 2005.[5] Moreover, traditional corporate defined benefit pension plans are declining, and few expect Social Security to provide increased benefits in the future.

In general, the households that tend to be in the best financial position to confront retirement are those 41 percent of the workforce that participate in an employer-sponsored retirement plan.[6] Generally, the rate of participation (those who contribute as a percentage of those who are eligible) for employer-sponsored 401(k) plans is on the order of 7 or 8 in 10, while the corresponding takeup rate for IRAs (which typically have no connection to the workplace or payroll system) tends to be on the order of 1 in 10. Moreover, an increasing share of 401(k) plans are including automatic features that make saving easier and raise participation, often to levels exceeding 9 in 10. (This paper uses the term "automatic" to refer not to arrangements that apply in all events but to arrangements that apply unless an individual explicitly chooses an alternative.)



The Automatic IRA proposal would extend payroll-based saving to the 75 million American workers not covered by an employer-based retirement plan. Participation in IRAs would increase by using payroll deduction and automatic enrollment.

Yet among 155 million working Americans, about half – some 75 million – work for an employer that does not offer a 401(k) or any other type of employer-sponsored plan. (Another 16 million failed to participate in or are not eligible for their employer's plan.) Among the subset of approximately 94 million *full-time, full-year* wage and salary workers between the ages of 21 and 64, 63 percent work for an employer that sponsors a plan, and 55 percent participate.[7]

These facts evidence the major gap between our public policy goals relating to retirement security and saving and what the market has accomplished in this area. In fact, the major federal tax expenditures and associated regulation of private pensions attest to a recognition of some need for public intervention to address this shortfall.

The causes of inadequate saving for retirement are several.

First, many people find it difficult to plan for retirement and to defer consumption. To many if not most, the necessary analysis, financial sophistication, and self-discipline do not come naturally or easily, and a number of typical behaviors and attitudes tend to hamper systematic and adequate saving for retirement.

Second, as discussed elsewhere in this paper, many people do not exercise the initiative required to make the decisions and take the actions necessary to save in an IRA.

Our approach is intended to help households overcome these barriers by building on the successful use in 401(k) plans of automatic features which encourage employees towards sensible decisions while allowing them to make alternative choices. Since their inception, 401(k) plans have encouraged contributions through payroll deposits that continue automatically ("set it and forget it") until the employee takes the initiative to stop or modify them. Starting in 1998, the US Treasury Department and IRS have issued a series of rulings defining, permitting and encouraging the automatic initiation of those payroll deposits (which they called "automatic enrollment") and automatic rollover in 401(k) and other salary reduction retirement saving plans.[8] Over time, the 401(k) market has responded by moving to automatic enrollment, automatic investment choices and related automatic features. Last year the Congress added its voice to this process by eliminating or reducing several barriers to the adoption of automatic 401(k) features.[9]

Although workplace saving through employer contributions or regular payroll deposits tends to be the most effective vehicle, a majority of small employers do not adopt a retirement plan. Many are unaware of the low-cost, simplified 401(k) and SIMPLE plan options now available, often on-line; they misperceive plan sponsorship as a complex and costly undertaking. Small business owners may be concerned that they have no one on staff with the knowledge and time to sort through the options for plan adoption and to administer the plan on an ongoing basis. In addition, small businesses – unlike larger firms – cannot spread fixed plan administration and investment costs across a large number of employees in order to make per capita costs more manageable. They also lack the economies of scale and bargaining power of a large employer when negotiating fees and expenses with financial services providers.

Our proposal is designed to reduce the transaction costs for small employers that are involved in adopting and maintaining a plan and use the unused capacity for saving that is inherent in employer payroll systems. By taking smaller employers and their employees part of the way down the path toward plan sponsorship and participation, the automatic IRA approach would open up this market more widely to the financial providers, third party administrators, and professionals who market, provide and help administer employer plans.

Widespread use of payroll deposit to contribute to IRAs would lay the groundwork for a far deeper penetration of the small business market by 401(k) and SIMPLE plans. Either at the outset or after a year or two, many small business owners will ask how they or a key manager can save more for themselves than only $4,000 a year (the 2007 IRA limit) and some will be interested in exploring how they could make a very modest matching contribution for their employees, at least in a year in which business has been good. The answer to both questions is that the automatic IRA is designed with a modest contribution limit and no employer contributions in order to induce employers to graduate (eventually or immediately) to a 401(k) or SIMPLE plan. Employees can contribute on a tax-favored basis up to $15,500 in a 401(k), $10,500 in a SIMPLE, for 2007.[10] Employer contributions are allowed in the 401(k), and are required in the SIMPLE.

However, when firms do not choose to sponsor 401(k)-type plans, the automatic IRA proposed here would apply many of the lessons learned from 401(k) plans[11] so that more workers could enjoy automated saving to build assets – without imposing any significant burden on employers. Employers can help employees save simply by offering to transfer a portion of their pay to an IRA, preferably by direct deposit, at little or no cost to the employer.

Another reason that employer plans are less prevalent in the small business market is that many financial providers have found it less profitable or unprofitable to serve plans with a small average account size. To the extent that many small work forces have had lower-wage employees who have less ability or desire to contribute, it is more difficult to find larger accounts to cross-subsidize the costs of servicing smaller accounts. However, many financial providers might be interested in receiving rollovers from such accounts if and when they have grown to a profitable size.

Our proposal seeks to address this concern by providing a backstop arrangement contracted to the private sector that would give an option to those employee groups that the financial services industry is not interested in serving. As described below, pooling of contributions in a standard, low-cost automatic investment and a limited number of investment alternatives would be designed to lower costs through economies of scale, standardization, and elimination of most sales and marketing expenses. Once accounts have grown sufficiently, they could be rolled over to IRAs managed by other financial services companies, substantially increasing the financial industry's assets under management.[12]

Why Ensure Rather Than Merely Allow Employee Access to Payroll Deposit Saving?

The automatic IRA is a means of facilitating direct deposits to a retirement account, giving employees access to the power of direct deposit saving. In much the same way that millions of employees have their pay directly deposited to their account at a bank or other financial institution, and millions more elect to contribute to 401(k) plans by payroll deduction, employees would have the choice to instruct the employer to send an amount they select directly from their paychecks to an IRA. Employers generally would be required to offer their employees the opportunity to save through such direct deposit or payroll-deduction IRAs.

Direct deposit to IRAs is not new. In 1997, Congress encouraged employers not ready or willing to sponsor a retirement plan to at least offer their employees the opportunity to contribute to IRAs through payroll deduction.[13] Both the IRS and the Department of Labor have issued administrative guidance to publicize the payroll deduction or direct deposit IRA option for employers and to "facilitate the establishment of payroll deduction IRAs."[14] This guidance has made clear that employers can offer direct deposit IRAs without the arrangement being treated as employer sponsorship of a retirement plan that is subject to ERISA or qualified plan requirements.[15] However, it appears that few employers actually have direct deposit or payroll-deduction IRAs – at least in a way that actively encourages employees to take advantage of the arrangement. After some years of encouragement by the government, direct deposit IRAs have simply not caught on widely among employers and, consequently, offer little opportunity for employees to save.

With this experience in mind, we propose a new strategy designed to induce employers to offer, and employees to take up, direct deposit or payroll deposit saving.

Tax Credit for Employers That Serve as Conduit for Employee Contributions

Under our proposal, firms that do not provide employees a qualified retirement plan, such as a defined benefit pension, profit-sharing, or 401(k) plan, would be given an incentive (a temporary tax credit) to offer those employees the opportunity to make their own payroll deduction contributions to IRAs using the employers' payroll systems as a conduit. For the larger and more established small businesses that would be required to offer employees the opportunity to save through payroll deposits, the tax credit would represent a small recognition that the employer is being asked to give attention to a new procedure, albeit one that involves no out of pocket costs.

The tax credit would be available to a firm for the first two years in which it offered payroll deposit saving to an IRA, in order to help the firm recoup any modest administrative costs associated with the "automatic IRA." This automatic IRA credit would be designed to avoid competing with the tax credit available under current law to small businesses that adopt a new employer-sponsored retirement plan.

Small Business New Plan Startup Credit

Under current law, an employer with 100 or fewer employees that starts a new retirement plan for the first time can generally claim a tax credit for a portion of its startup costs. The credit equals 50 percent of the cost of establishing and administering the plan (including educating employees about the plan) up to $500 per year. The employer can claim the credit of up to $500 for each of the first three years of the plan.

To accomplish these objectives, the automatic IRA tax credit could be set, for example, at $25 per employee enrolled. It would be capped at $250 (or some other similar figure) per year in the aggregate for each of two years – low enough to make the credit meaningful only for very small businesses, and significantly lower than the $500 three-year credit available under current law for establishing a new employer plan. Employers would be precluded from claiming both the new 401(k) plan startup credit and the proposed automatic IRA credit; otherwise, somewhat larger employers might have a financial incentive to limit a new plan to fewer than all of their employees in order to earn an additional credit for providing payroll deposit saving to other employees. As in the case of the current new plan startup credit, employers also would be ineligible for the credit if they had sponsored a retirement plan during the preceding three years for substantially the same group of employees covered by the automatic IRA.

Employers with more than 10 employees that have been in business for at least two years and that choose not to sponsor any plan for their employees would be called upon to offer employees this opportunity to save a portion of their own wages using payroll deposit. However, employers that do sponsor a plan generally would be unaffected. Only if the employer sponsored a plan that was designed to cover only a subset of its employees (such as a particular subsidiary, division or other business unit) would it have to offer the automatic IRA to the rest of its workforce (i.e., employees not in that business unit), other than employees that may be excluded from consideration under the qualified plan coverage standards (union-represented employees, nonresident aliens, and those who are very part-time or have not completed a year of service).

Thus the arrangement would be structured so as to avoid, to the fullest extent possible, employer costs or responsibilities. The tax credit would be available both to those firms that are required to offer payroll deposit to all of their employees and to the small or new firms that are not required to offer the automatic IRA, but do so voluntarily. The intent would be to encourage, without requiring, the smallest employers to participate.

Example: Joe employs four people in his auto body shop, and currently does not sponsor a retirement plan for his employees. If Joe chooses to adopt a 401(k) or SIMPLE-IRA plan, he and each of his employees generally can contribute up to $15,000 (401(k)) or $10,500 (SIMPLE) a year, and the business might be required to make employer contributions. Under this scenario, Joe can claim the startup tax credit for 50 percent of his costs over three years up to $500 per year.

Alternatively, if Joe decides only to offer his employees payroll deposit to an IRA, the business will not make employer contributions, and Joe can claim a tax credit for each of the next two years of $25 for each employee who signs up to contribute out of his own salary.

Employer-sponsored retirement plans are the saving vehicles of choice and should be encouraged; the direct deposit IRA is a fallback designed to apply to employees who are not fortunate enough to be covered under an actual employer retirement plan.

Acting as a Conduit or Forwarding Agent for Employees' Contributions Entails Little or No Cost to Employers

For many if not most employers, offering direct deposit or payroll deduction IRAs would involve little or no cost. Unlike a 401(k) or other employer-sponsored retirement plan, the employer would not be maintaining a plan. It would essentially be a forwarding agent for employee contributions. Employer contributions to payroll deposit IRAs would not be required or permitted. Employers willing to make retirement contributions for their employees would continue to do so in accordance with the safeguards and standards governing employer-sponsored retirement plans, such as SIMPLE-IRAs, 401(k)s, and traditional pensions.[16]

Employer-sponsored retirement plans are the saving vehicles of choice and should be encouraged; the direct deposit IRA is a fallback designed to apply to employees who are not fortunate enough to be covered under an actual employer retirement plan. As discussed below, it is also intended to encourage more employers to decide, whether immediately or eventually, to "graduate" to sponsorship of an employer plan.

Payroll deposit IRAs also would minimize employer responsibilities. Firms would not be required to

- comply with plan qualification or ERISA rules,
- establish or maintain a trust to hold assets (since IRAs would receive the contributions),
- determine whether employees are actually eligible to contribute to an IRA,
- select investments for employee contributions,
- select among IRA providers, or
- set up IRAs for employees.

Employers would be required simply to allow employees to make a payroll-deduction deposit to an IRA (in the manner described below), with a standard notice informing employees of the automatic IRA (payroll-deposit saving) option, and a standard form eliciting the employee's decision to participate or to opt out. Employers then would implement deposits elected by employees. Employers would not be required to remit the direct deposits to the IRA provider(s) any faster than the timing of the federal payroll and withholding tax deposits they are already required to make. Those deposits generally are required to be made on a standard schedule, either monthly or twice a week depending on the size of the payroll. Nor would employers be required to remit direct deposits to a variety of different IRAs specified by their employees (as explained below).

Thus, a requirement to offer to forward employee contributions to an IRA by payroll deduction would by no means be onerous. It would dovetail neatly with what employers already do. Employers of course are already required to withhold federal income tax and payroll tax from employees' pay and remit those amounts to the federal tax deposit system. While this withholding does not require the employer to administer an employee election of the sort associated with direct deposit to an IRA, the tax withholding amounts do vary from employee to employee and depend on the way each employee completes IRS Form W-4 (which new hires fill out to help the employer comply with income tax withholding). The employee's payroll deposit IRA election might be made on an attachment or addendum to the Form W-4. Because employees' salary reduction contributions to IRAs would ordinarily receive tax-favored treatment, the employer would report on Form W-2 the reduced amount of the employee's taxable wages together with the amount of the employee's contribution.

Direct Deposit; Automated Fund Transfers

Our proposed approach would seek to capitalize on the rapid trend toward automated or electronic fund transfers. With the spread of new, low-cost technologies, employers are increasingly using automated or electronic systems to manage payroll, including withholding and federal tax deposits, and for other transfers of funds. It is common for employers to retain an outside payroll service provider to perform these functions, including direct deposit of paychecks to accounts designated by employees or contractors. Other employers use an on-line payroll service that offers direct deposit and check printing (or that allows employers to write checks by hand). Still others do not outsource their payroll tax and related functions to a third-party payroll provider but do use readily available software or largely paperless on-line methods to make their federal tax deposits and perhaps other fund transfers, just as increasing numbers of households pay bills and manage other financial transactions on line. (The IRS encourages employers to use its free Electronic Federal Tax Payment System for making federal tax deposits.)

For the many firms that already offer their workers direct deposit, including many that use outside payroll providers, direct deposit to an IRA would entail no additional cost, even in the short term, insofar as the employer's system has unused fields that could be used for the additional direct deposit destination. Other small businesses still write their own paychecks by hand, complete the federal tax deposit forms and Forms W-2 by hand, and deliver them to employees and to the local bank or other depositary institution. Our proposal would not require these employers to incur the cost (if any) of transitioning to automatic payroll processing or using on-line systems, although it might have the beneficial effect of encouraging such transitions.

At the same time, we would not be inclined to deny the benefits of payroll deduction savings to all employees of employers that do not yet use automatic payroll processing (and we would not want to give small employers any incentive to drop automatic payroll processing). These employees would benefit from the ability to save through regular payroll deposits at the workplace whether the deposits are made electronically or by hand. Employees would still have the advantages of tax-favored saving that, once begun, continues automatically, that is more likely to begin because of workplace enrollment arrangements and peer group reinforcement, and that need not cause a visible reduction in take-home pay if begun promptly when employees are hired.

Accordingly, we would contemplate a three-pronged strategy with respect to employers that do not use automatic payroll processing.

First, a large proportion of the employers that still process their payroll by hand would be exempted under the exception for very small employers described below. As a result, this proposal would focus chiefly on those employers that already offer their employees direct deposit of paychecks but have not used the same technology to provide employees a convenient retirement saving opportunity.

For the many firms that already offer their workers direct deposit, including many that use outside payroll providers, direct deposit to an IRA would entail no additional cost.

Second, employers would have the option of "piggybacking" the payroll deposits to IRAs onto the federal tax deposits they currently make. The process, including timing and logistics, for both sets of deposits would be the same. Accompanying or appended to the existing federal tax deposit forms would be a similar payroll deposit savings form enabling the employer to send all payroll deposit savings to a single destination. The small employer who mails or delivers its federal tax deposit check and form to the local bank (or whose accountant or financial provider assists with this delivery) would add another check and form to the same mailing or delivery.

Third, as noted, the existing convenient, low-cost, on-line system for federal tax deposits could be expanded to accommodate a parallel stream of payroll deduction saving payments.

Since employers making payroll deduction savings available to their employees would not be required to make contributions or to comply with plan qualification or ERISA requirements with respect to these arrangements, employers would incur no out-of-pocket cost and only minimal cost of any kind. Administering and implementing employee elections to participate or to opt out through their payroll systems might occasionally require employers to address mistakes or misunderstandings regarding payroll deductions and deposit directions. The time and attention required of the employer could generally be expected to be minimized through orderly communications, written or electronic, between employees and employers, facilitated by the use of standard forms that "piggyback" on the existing IRS forms such as the W-4 used by individuals to elect levels of income tax withholding.

Exemption for Small and New Employers

As has already been discussed, the requirement to offer payroll deposit to IRAs as a substitute for sponsoring a retirement plan would not apply to the smallest firms (e.g., those with up to 10 employees) or to firms that have not been in business for at least two years. However, even small or new firms that are exempted would be encouraged to offer payroll deposit through the employer tax credit described earlier.

A possible alternate approach to implementation of this program would be to require payroll deposit for the first year or two only by non-plan sponsors that are above a slightly larger size. This would try out the new system and could identify any potential improvements that are needed before broader implementation begins.

Employees of small employers that are exempted-like other individuals who do not work for an employer that is part of the payroll deposit system outlined here-would be able to use other mechanisms to facilitate saving. These include the ability to contribute by instructing the IRS to make a direct deposit of a portion of an income tax refund, by setting up an automatic debit arrangement for IRA contributions (perhaps with the help of a professional or trade association), or by making their IRA contributions together with their quarterly estimated tax payments.

Employees Covered

Employees eligible for payroll deposit savings might be, for example, all employees who have worked for the employer on a regular basis (including part-time) for a specified period of time (such as three months), but not including those who are covered under a retirement plan (or eligible to contribute to a 401(k)) or those who are excludable from coverage under the qualified plan rules (union-represented employees, those under age 18, those who have not completed a year of service working at least half-time, nonresident aliens). Employers would not be required, however, to offer direct deposit savings to employees they already cover under a retirement plan, including employees eligible to contribute (whether or not they actually do so) to a 401(k)-type salary-reduction arrangement. Accordingly, if an employer sponsors a retirement plan, it would not be required to provide payroll deposits to automatic IRAs unless its plan excluded a portion of the work force (such as a division or subsidiary).

Choosing the Type of IRA: Traditional or Roth

Like a 401(k) contribution, the amount elected by the employee as a salary reduction contribution generally would be tax-favored. It either would be a "pre-tax" contribution to a traditional, tax-deductible IRA – deducted or excluded from the employee's gross income for tax purposes – or a contribution to a Roth IRA, which instead receives tax-favored treatment upon distribution. An employee who did not qualify to make a deductible IRA contribution or a Roth IRA contribution (for example, because of income that exceeds the applicable income eligibility thresholds), would be responsible for making the appropriate adjustment on the employee's tax return. The statute could specify which type of IRA was the default. In any event, the firm would have no responsibility for ensuring that employees satisfied the applicable IRA eligibility requirements or contribution limits.

The need to choose between a traditional and a Roth IRA is another decision that can impede participation. Making this choice based on an informed and rational analysis would not be easy for most individuals. The factors weighing on both sides of the decision would make it a close call for millions of eligible employees (especially the significant portion of the eligible population who currently have income tax liability). (This question is further discussed in the Appendix to this paper.)

In the interest of sparing households the need to make the analysis and the decision, we strongly believe that one or the other type of IRA should be automatically prescribed. Of course, presented with the automatic choice, many households will not feel compelled to engage in the comparative analysis, but will simply go along with the standard option. Others will feel compelled to do some analysis in order to decide whether to choose the other alternative. Accordingly, the automatic approach is one way to strike a balance between simplicity and individual choice.

However, a reasonable case can also be made for going further and simply prescribing one or the other type of IRA as the only available receptacle for contributions to automatic IRAs. Such a prescriptive approach would weigh the gains in simplicity more heavily than the loss of individual choice in these circumstances. The circumstances include a public policy choice that, in our view, is not obvious or easy; a decision that, for many, would be complex or a close call, or both, but for some would seem to be relatively clear; and a possibility, albeit uncertain, of being able in the future to convert from traditional to Roth. To date, we have been inclined to make the traditional IRA the presumptive choice for automatic IRA deposits, while permitting individuals to elect a Roth instead if they so choose. However, given the arguments on both sides, we do not feel so strongly about which type of IRA should be prescribed, but believe it is important to simplify by prescribing one type, at least as the standard (automatic) option.

Automatic IRAs in Congress

Hearings: The automatic IRA proposal was featured at a hearing of the Senate Finance Committee's Subcommittee on Long-Term Growth and Debt Reduction held on June 29, 2006, concerning strategies for expanding pension coverage. See J. Mark Iwry and David C. John, *"Pursuing Universal Retirement Security Through Automatic IRAs,"* Testimony before Long-Term Growth and Debt Reduction Subcommittee of the Committee on Finance, United States Senate (June 29, 2006) available at *www.retirementsecurityproject.org*.

Bill: The automatic IRA proposal was introduced in the 109th Congress as the "Automatic IRA Act of 2006" (S. 3952) by Senators Jeff Bingaman (D-N.M.) and Gordon Smith (R.-Ore.), cosponsored by Senator John Kerry (D-Mass.); as sections 101-104 of S. 3951 sponsored by Senators Smith, Kent Conrad (D-N. Dak.) and Bingaman, cosponsored by Senator Kerry; and as H. 6210 sponsored by Rep. Phil English (R.-Pa.).

In addition, another bill that takes an approach that is very similar to most aspects of our proposal has been introduced by the Chairman of the Senate Finance Committee, Senator Max Baucus (D.-Mont.), S. 2431 (109th Cong., 2d Sess.).

The Automatic IRA

Obstacles to Participation

Even if employers were required to offer direct deposit to IRAs, various impediments would prevent many eligible employees from taking advantage of the opportunity. To save in an IRA, individuals must make a variety of decisions and must overcome inertia. At least five key questions are involved in the process for employees:

a) whether to participate at all;

b) where (with which financial institution) to open an IRA (or, if they have an IRA already, whether to use it or open a new one);

c) whether the IRA should be a traditional or Roth IRA;

d) how much to contribute to the IRA; and

e) how to invest the IRA.

Once these decisions have been made, the individual must still take the initiative to fill out the requisite paperwork (whether on paper or electronically) to participate. Even in 401(k) plans, where decisions (b) and, unless the plan offers a Roth 401(k) option, (c) are not required, millions of employees are deterred from participating because of the other three decisions or because they simply do not get around to enrolling in the plan.

Overcoming the Obstacles to Participation through Automatic Enrollment

These obstacles can be overcome by making participation easier and more automatic, in much the same way as is being done increasingly in the 401(k) universe. An employee eligible to participate in a 401(k) plan automatically has a savings vehicle ready to receive the employee's contributions (the plan sponsor sets up an account in the plan for each participating employee) and benefits from a powerful automatic savings mechanism in the form of regular payroll deduction. With payroll deduction as the method of saving, deposits continue to occur automatically and regularly – without the need for any action by the employee – once the employee has elected to participate. And finally, to jump-start that initial election to participate, an increasing percentage of 401(k) plan sponsors are using "automatic enrollment."[17]

Automatic enrollment, which has typically been applied to newly hired employees rather than to both new hires and employees who have been with the employer for some years, has produced dramatic increases in 401(k) participation.[18] This is especially true in the case of lower-income and minority employees. In view of the basic similarities between employee payroll-deduction saving in a 401(k) and under a direct deposit IRA arrangement, the law should, at a minimum, permit employers to automatically enroll employees in direct deposit IRAs.[19]

The conditions imposed by the Treasury Department on 401(k) auto enrollment would apply to direct or payroll deposit IRA auto enrollment as well: all potentially auto enrolled employees must receive advance written notice (and annual notice) regarding the terms and conditions of the saving opportunity and the auto enrollment, including the procedure for opting out, and all employees must be able to opt out at any time.

It is not at all clear, however, whether simply *allowing* employers to use auto enrollment with payroll deposit IRAs will prove to be effective. A key motivation for using auto enrollment in 401(k) plans is to improve the plan's performance under the 401(k) nondiscrimination test by encouraging more moderate- and lower-paid ("nonhighly compensated") employees to participate, and to contribute as much as possible. That in turn increases the permissible level of tax-preferred contributions for highly compensated employees. This motivation is absent when the employer is merely providing payroll deposit IRAs, rather than sponsoring a qualified plan such as a 401(k), because no nondiscrimination standards apply to payroll deposit IRAs.

Similarly, the absence of nondiscrimination standards in payroll deposit IRAs gives the employer less incentive than a 401(k) sponsor to provide for automatic increases in the initial contribution rate. Such gradual automatic increases in 401(k) contribution rates have been found to make automatic 401(k) enrollment more effective. The automatic contribution rate can increase – unless the employee opts out of the increase – either on a regular, scheduled basis, such as 4 percent in the first year, 5 percent in the second year, etc., or in coordination with future pay raises.[20]

A second major motivation for using 401(k) automatic enrollment in many companies is management's sense of responsibility or concern for employees and their retirement security. Many executives involved in managing employee plans and benefits have opted for automatic enrollment and other automatic 401(k) features (such as asset-allocated default investments) because they believe far too many employees are saving too little and investing unwisely and need a strong push to "do the right thing" and take advantage of the 401(k) plan. Closely allied to this motivation to use automatic enrollment is the employer's interest in recruiting and retaining valuable employees, especially when labor markets are tight.

There is reason to believe, however, that employers impelled by these interests tend to be those that have already chosen to sponsor a 401(k) or other retirement plan. By contrast, those that have not sponsored a plan are more likely to be among the group of employers that have a more laissez-faire approach to this issue. The non-sponsors include many smaller employers that may not feel that it is their role to encourage employees to save. Some may be disinclined to encourage employees to save because the employer does not have a health plan for employees, which both employees and employer might view as a higher priority, or because, if the employer has a health plan, rising health care premiums for employees are thought to be eating up any income that the employee might otherwise be able or willing to save.

Public opinion polling shows strong support among registered voters for making saving easier by making it automatic... 59 percent of respondents preferred a workplace IRA with automatic enrollment to one without.

Third, in the case of payroll deposit IRAs, employers might have greater concern about potential employee reaction to auto enrollment because there is no employer matching contribution. The high return on employees' investment delivered by the typical 401(k) employer match helps give confidence to 401(k) sponsors using automatic enrollment that they are doing right by their employees and that they need not worry unduly about potential complaints from workers who fail to read the notice informing them that they would be automatically enrolled unless they opted out.

On the other hand, some employers might be more inclined to use automatic enrollment with payroll deposit IRAs because greater employee participation will not increase the employer's matching costs. In addition, recognizing some of this disparity in employer incentives to maximize participation in an automatic IRA (as compared to a 401(k)), our proposal provides that the amount of the two-year tax credit for employers using automatic IRAs is based on the number of employees who participate..

Flexible Form of Automatic Enrollment for Automatic IRAs

One possible response would be to require employers to use automatic enrollment (including automatic contribution increases) in conjunction with the direct deposit IRAs (while giving the employers a tax credit and legal protections). The argument for such a requirement is that it would likely increase participation and contributions dramatically while preserving employee choice, and that, for the reasons summarized above, employers that do not provide a qualified plan or a match are unlikely to use auto enrollment voluntarily. The arguments against such a requirement include the concern that a workforce that presumably has not shown sufficient demand for a qualified retirement plan to induce the employer to offer one might react unfavorably to being automatically enrolled in direct deposit savings without a matching contribution. In addition, some small business owners who have only a few employees and work with all of them on a daily basis might take the view that automatic enrollment is unnecessary because of the constant flow of communication between the owner and each employee.

It is noteworthy, however, that public opinion polling shows strong support among registered voters for making saving easier by making it automatic, with 71 percent of respondents favoring a fully automatic 401(k), including automatic enrollment, automatic investment, and automatic contribution increases over time, with the opportunity to opt out at any stage.[21] A vast majority (85 percent) of voters said that if they were automatically enrolled in a 401(k), they would not opt out, even when given the opportunity to do so. In addition, given the choice, 59 percent of respondents preferred a workplace IRA with automatic enrollment to one without.

Requiring Explicit "Up or Down" Employee Elections

An alternative approach that has been used in some 401(k) plans and might be particularly well suited to payroll deposit savings is to require all eligible employees to submit an election that explicitly either accepts or declines direct deposit to an IRA. There is evidence suggesting that requiring employees to elect one way or the other can raise 401(k) participation nearly as much as auto enrollment does. Requiring an explicit election picks up many who would otherwise fail to participate because they do not complete and return the enrollment form due to procrastination, inertia, inability to decide on investments or level of contribution, and the like.[22]

Accordingly, a possible strategy for increasing participation in payroll deposit IRAs would be to generally require employers to obtain a written (which could include an electronic) "up or down" election from each eligible employee either accepting or declining the direct deposit to an IRA. Of course, employers that chose to automatically enroll their employees in the direct deposit IRAs would be excused from the requirement that they obtain an explicit election from each employee because all employees who failed to elect would automatically participate.

What if an employer that opted for this "up or down" election procedure was unable for some reason to obtain an election from a particular employee? Under our approach, the employer would inform such an employee that failure to respond would lead to automatic enrollment at the specified automatic contribution rate and in the specified investment, and would give the employee a final election opportunity.

This might be viewed as tantamount to requiring all employers to use automatic enrollment, insofar as it carries out what is arguably the primary function of automatic enrollment – ensuring that mere inertia, procrastination or indecision do not keep anyone from participating. However, an "up or down" election procedure may not frame the choice for the employee in a manner that "tilts" in favor of participation, does not convey the same implicit employer endorsement of participation that automatic enrollment does, and does not necessarily steer individuals to a particular automatic package of contribution rate and investment because it does not frame the choice around a presumptive package unless employees initially fail to elect.

This exemption-treating an employer's use of auto enrollment as an alternative means of satisfying its required-election obligation-would add an incentive for employers to use auto enrollment without requiring them to use it. Any firms that prefer not to use auto enrollment would simply obtain a completed election from each employee, either electronically or on a paper form. And either way – whether the employer chose to use auto enrollment or the required-election approach – participation would likely increase significantly, perhaps even approaching the level that might be achieved if auto enrollment were required for all payroll deposit IRAs.

This combined strategy for promoting payroll deposit IRA participation could be applied separately to new hires and existing employees: thus, an employer auto enrolling new hires would be exempted from obtaining completed elections from all new hires but not from existing employees, while an employer auto enrolling both new hires and existing employees would be excused from having to obtain elections from both new hires and existing employees.

The required election would not obligate employers to obtain a new election from each employee every year. As in most 401(k) plans, the initial election would continue throughout the year and from year to year unless and until the employee chose to change it. Similarly, an employee who failed to submit an election form and was auto enrolled by default in the payroll deposit IRA would continue to be auto enrolled unless and until the employee took action to make an explicit election.

However, after some period of time, employees could be offered automatic increases in their automatic IRA contribution rates, on terms similar to those applicable to the initial automatic contributions. Employers would be able to use flexible automatic enrollment with respect to these increases, either obtaining an election regarding increases from each employee or providing that employees who do not submit elections will be deemed to have elected to increase their automatic IRA contributions at a specified gradual rate.

To maximize participation, employers would receive a standard enrollment module reflecting current best practices in enrollment procedures. A national web site would give firms standard employee notice and election forms as well as standard enrollment procedures. The web site and the fallback automatic IRA platform would promote employee education and best practices as they evolve, such as automatic enrollment and potentially annuitization. Especially with the decline of traditional defined benefit pension plans, there is an increasing need for readily available, low-cost, guaranteed lifetime income – and for innovative ways of delivering it – in individual account saving vehicles. The fallback automatic IRA account would provide a national platform that could facilitate innovation and development of annuity products suitable for IRAs and other account-based retirement vehicles. The use of automatic enrollment would be encouraged in several ways. First, the standard materials provided to employers would be framed so as to present auto enrollment as the presumptive or perhaps even the default enrollment method, although employers would be easily able to opt out in favor of simply obtaining an "up or down" response from all employees. In effect, such a "double default" approach would use the same principle at both the employer and employee level by auto enrolling employers into auto enrolling employees.   Second, as noted, employers using auto enrollment to promote participation would not need to obtain responses from unresponsive employees, and the ultimate outcome, if an employee failed to submit a required election, would be automatic enrollment. Finally, the employer tax credit would give employers a modest incentive to encourage participation, which auto enrollment is likely to do.

Compliance and Enforcement

Employers' use of the required-election approach would also help solve an additional problem – enforcing compliance with a requirement that employers offer direct deposit savings. As a practical matter, many employers might question whether the IRS would ever really be able to monitor and enforce such a requirement. Employers may believe that, if the IRS asked an employer why none of its employees used direct deposit IRAs, the employer could respond that it told its employees about this option and they simply were not interested. However, if employers that were required to offer direct deposit savings had to obtain a signed election from each eligible employee who declined the payroll deposit option, employers would know that the IRS could audit their files for each employee's election. This by itself would likely improve compliance.

In fact, a single paper or e-mail notice could advise the employee of the opportunity to engage in payroll deduction savings and elicit the employee's response. The notice and the employee's election might be added or attached to IRS Form W-4. (As noted, the W-4 is the form an employer ordinarily obtains from new hires and often from other employees to help the employer comply with its income tax-withholding obligations.) If the employer chose to use auto enrollment, the notice would also inform employees of that feature (including the automatic contribution level and investment and the procedure for opting out), and the employer's records would need to show that employees who failed to submit an election were in fact participating in the payroll deduction savings.

Employers would be required to certify annually to the IRS that they were in compliance with the payroll deposit savings requirements. This might be done in conjunction with the existing IRS Form W-3 that employers file annually to transmit Forms W-2 to the government. Failure to offer payroll deposit savings would be backed up by an excise tax on the employer for each employee affected by the violation. This sanction would be far less than the one employers face if they violate the requirement to offer employees COBRA health care continuation coverage, but would be subject to an array of exceptions and opportunities for mitigation and relief that is generally based on the corresponding COBRA exceptions.

Portability of Savings

IRAs are inherently portable. Unlike a 401(k) or other employer plan, an IRA survives and functions independently of the individual saver's employment status. Thus the IRA owner is not at risk of forfeiting or losing the account or suffering an interruption in the ability to contribute when changing or losing employment. As a broad generalization, the automatic IRAs outlined here presumably would be freely transferable to and with other IRAs and qualified plans that permit such transfers, although as discussed below, there may be a need for some restrictions on those transfers.

Making a Savings Vehicle Available

Most current direct deposit arrangements use a payroll-deduction savings mechanism similar to the 401(k), but, unlike the 401(k), do not give the employee a ready-made vehicle or account to receive deposits. The employee must open a recipient account and must identify the account to the employer. However, where the purpose of the direct deposit is saving, it would be useful to many individuals who would rather not choose a specific IRA to have a ready-made fallback or default account available for the deposits.

Under this approach, modeled after the SIMPLE-IRA, which currently is estimated to cover up to three million employees, individuals who wish to direct their contributions to a specific IRA would do so. The employer would follow these directions as employers ordinarily do when they make direct deposits of paychecks to accounts specified by employees. At the same time, the employer would also have the option of simplifying its task by remitting all employee contributions in the first instance to IRAs at a single private financial institution that the employer designates.[23] However, even in this case, employees would be able to transfer the contributions, without cost, from the employer's designated financial institution to an IRA provider chosen by the employee.

By designating a single IRA provider to receive all contributions, the employer could avoid the potential administrative hassles of directing deposits to a multitude of different IRAs for different employees, while employees would be free to transfer their contributions from the employer's designated institution to an IRA provider of their own choosing. Even this approach, though, still places a burden on either the employer or the employee to choose an IRA. For many small businesses, the choice might not be obvious or simple. In addition, the market may not be very robust because at least some of the major financial institutions that provide IRAs may well not be interested in selling new accounts unless they seem likely to grow enough to be profitable within a reasonable time. Some of the major financial firms appear to be motivated at least as much by the objective of maximizing the average account balance as by the goal of maximizing aggregate assets under management. They therefore may shun small accounts.

The current experience with automatic rollover IRAs is a case in point. Firms are required to establish these IRAs as a default vehicle for qualified plan participants whose employment terminates with an account balance of not more than $5,000 and who fail to provide any direction regarding rollover or other payout. The objective is to reduce leakage of benefits from the tax-favored retirement system by stopping

IRAs are inherently portable...the IRA owner is not at risk of forfeiting or losing the account or suffering an interruption in the ability to contribute when changing or losing employment.

involuntary cash outs of account balances between $1,000 and $5,000.[24] Because plan sponsors are required to set up IRAs only for "unresponsive" participants – those who fail to give instructions as to the disposition of their benefits – these IRAs are presumed to be less likely than other IRAs are to attract additional contributions. Accordingly, significant segments of the IRA provider industry have not been eager to cater to this segment of the market. As a result, plan sponsors have tended to reduce their cashout level from $5,000 to $1,000 so that new IRAs would not have to be established.

To the extent that they start small, many payroll deposit IRAs may be expected to be less profitable to IRA providers than some other products. As a result, employers and employees might find that providers are not marketing to them aggressively and that the array of payroll deposit IRA choices is comparatively limited. However, automatic IRAs differ importantly from automatic rollover IRAs. Even if they start small, they are likely to experience continuing growth, by contrast to the automatic rollover IRAs that result from an account not exceeding $5,000 whose owner has failed to respond to the plan sponsor's notices. Their unresponsiveness suggests that many of the owners are unlikely to continue contributing after the account has been rolled over without their involvement to an IRA. By contrast, there is no reason to expect automatic IRA owners generally to be unresponsive or unlikely to continue contributing. Accordingly, the automatic IRAs hold much more promise for financial providers.

In addition, to benefit the financial institutions that serve as IRA trustees and custodians, the fallback automatic IRA arrangement outlined below might ultimately serve as both a source of rollovers to the financial services industry and a potential destination for their small and inactive or orphan IRAs. The path between industry and a collective standard IRA arrangement could be a two-way street. Pursuant to appropriate standards, IRA providers might be given the opportunity to "dump" a certain number of very small IRAs that are unprofitable because they have been inactive (not receiving contributions) for an extended period (in some cases, because the owner is deceased). These IRAs could be transferred to the central arrangement, which could serve as a low-cost incubator of small inactive accounts. At the same time, owners of IRAs within the arrangement that have grown to a profitable size could roll them over to private-sector providers.

A Standard Automatic Account

The prospect of tens of millions of personal retirement accounts with relatively small balances likely to grow relatively slowly suggests that the market may need to be encouraged to develop widely available low-cost personal accounts or IRAs. Otherwise, for "small savers," fixed-cost investment management and administrative fees may consume too much of the earnings on the account and potentially even erode principal.[25]

To facilitate saving and minimize costs, we believe that a strong case can be made for a standard IRA account that would be automatically available to receive direct deposit contributions after enabling without forcing either the employee or employer to choose among IRA providers and without requiring the employee to take the initiative to open an IRA. Under this approach, if neither the employer nor the employee designated a specific IRA provider, then (and only then) the contributions would go to a personal retirement account within a plan that would serve as a "fallback" and would in some respects resemble the federal Thrift Savings Plan (the 401(k)-type retirement savings plan that covers federal government employees).

These standard accounts would be maintained and operated by private financial institutions under contract with the federal government. To the fullest extent practicable, the private sector would provide the investment funds, investment management, record keeping, and related administrative services. To serve as a standard account for direct deposits that have not been directed elsewhere by employers or employees, an account need not be maintained by a governmental entity. Given sufficient quality control and adherence to reasonably uniform standards, various private financial institutions could contract to provide the default accounts, on a collective or individual institution basis, more or less interchangeably – perhaps allocating customers on a geographic basis or in accordance with other arrangements based on providers' capacity. These fund managers could be selected through competitive bidding. Once individual standard accounts reached a predetermined balance (e.g., $15,000) sufficient to make them potentially profitable for many private IRA providers, account owners would have the option to transfer them to IRAs of their choosing that are managed by other financial services firms.

Cost Containment

Both the direct deposit IRAs expressly selected by employees and employers and the standardized direct deposit IRAs would be designed to minimize the costs of investment management and account administration. It should be feasible to realize substantial cost savings through index funds, economies of scale in asset management and administration, uniformity, and electronic technologies.

In accordance with statutory guidelines for all direct deposit IRAs, government contract specifications would call for a no-frills approach to participant services in the interest of minimizing costs. By contrast to the wide-open investment options provided in most current IRAs and the high (and costlier) level of customer service provided in many 401(k) plans, the standard account would provide only a few investment options (patterned after the Thrift Savings Plan, if not more limited), would permit individuals to change their investments only once or twice a year, and would emphasize transparency of investment and other fees and other expenses.[26]

Specifically, costs of direct deposit IRAs might be reduced by federal standards that, to the extent possible,

- Limit the number of investment options under the IRA.
- Allow individuals to change their investments only once or twice per year.
- Specify a low-cost automatic investment option and provide that, if any of an individual's account balance is invested in that option, all of it must be.
- Prohibit loans (IRAs do not allow them in any event) and perhaps limit pre-retirement withdrawals.
- Limit access to customer service call centers.
- Contemplate moderate fees instead of large commissions.
- Make compliance testing unnecessary.
- Give account owners only a single account statement per year (especially if daily valuation is built into the system and is available through some other means to account owners).
- Encourage the use of on-line, electronic and other new technologies for enrollment, fund transfers, record keeping, and communications among

IRA providers, participating employees, and employers to reduce paperwork and cost. Electronic administration has considerable potential to cut costs.

The availability to savers of a major low-cost personal account alternative in the form of the standard account may even help, through market competition, to drive down the costs and fees of IRAs offered separately by private financial institutions. Through efficiencies associated with collective investment and greater uniformity, the standard account should help make smaller accounts more feasible by creating a low-cost alternative to the retail-type cost structure characteristic of current IRAs. It should also help create a broad infrastructure of individual savings accounts that would cover most of the working population.[27]

In conjunction with these steps, Congress and the regulators may be able to do more to require simplified, uniform disclosure and description of IRA investment and administrative fees and charges by building on previous work by the Department of Labor and trade associations relating to 401(k) fees. Such disclosure should help consumers compare costs and thereby promote healthy price competition.

Another approach would begin by recognizing the trade-off between asset management costs and investment types. As a broad generalization, asset management charges tend to be low for money market funds, certificates of deposit, and certain other relatively low-risk, lower-return investments that generally do not require active management. However, it appears that limiting individual accounts to these types of investments would be unnecessarily restrictive. As discussed below under "Automatic Investment Fund Choice", passively-managed index funds, such as those used in the Thrift Savings Plan, are also relatively inexpensive.[28]

A very different approach to cost containment would be to impose a statutory or regulatory limitation on investment management and administrative fees that providers could charge. One example is the United Kingdom's limit on permissible charges for management of "stakeholder pension" accounts-an annual 150 basis point fee cap for five years that is scheduled to drop to 100 basis points thereafter.[29] As another and more limited example, the U.S. Department of Labor has imposed a kind of limitation on fees charged by providers of automatic rollover IRAs established by employers for terminating employees who fail to provide any direction regarding the disposition of account balances of up to $5,000. Labor regulations provide a fiduciary safe harbor for auto rollover IRAs that preserve principal and that do not charge fees greater than those charged by the IRA provider for other IRAs it provides.

Presumably, a mandatory limit would give rise to potential cross-subsidies from products that are free of any limit on fees to the IRAs that are subject to the fee limit – a result that could be viewed either as an inappropriate distortion or as a necessary and appropriate allocation of resources. This cost cap is widely considered to be a major reason why the UK's stakeholder pensions have failed to attract support from financial firms and have fallen short of their objectives. It could have a similar impact in the US. We would view a mandatory limit as a last resort, preferring the market-based strategies outlined above.

Automatic Investment Fund Choice

Both the IRAs explicitly selected by employers or employees from among those offered by private financial institutions and the standard IRAs would serve the important purpose of providing low-cost professional asset management to millions of savers, presumably improving their aggregate investment results. To that end, all of these accounts would offer an automatic investment fund for all deposits unless the individual chose otherwise. We contemplate that this automatic investment choice would at least initially be a highly diversified "target asset allocation" or "life-cycle" fund comprised of a mix of equities and fixed income or stable value investments, and probably relying heavily on index funds. (The life-cycle funds recently introduced into the federal Thrift Savings Plan are one possible model.) A portion or all of the fixed income component could be comprised of Treasury inflation protected securities ("TIPS") to protect against the risk of inflation.

The mix of diversified equities and fixed income would be intended to reflect the consensus of most personal investment advisers, which emphasizes sound asset allocation and diversification of investments-including exposure to equities (and perhaps other assets that have higher-risk and higher-return characteristics), at least given the foundation of retirement income already provided by Social Security and assuming the funds will not shortly be needed for expenses. The use of index funds would avoid the costs of active investment management while promoting wide diversification.[30]

This automatic investment would actually consist of several different funds, depending on the individual's age, with the more conservative investments (such as those relying more heavily on TIPS) applicable to older individuals who are closer to the time when they might need to use the funds. Individuals who selected the automatic fund or whose contributions were automatically placed into it would have their account balances entirely invested in that fund. However, they would be free to exit the fund at specified times and opt for a different investment option among those offered within the IRA.

The standard automatic investment would also serve two other key purposes. It would encourage employee participation in direct deposit savings by enabling employees who are satisfied with the default to simplify what may be the most difficult decision they would otherwise be required to make as a condition of participation (i.e., how to invest). Finally, the automatic investment should encourage more employers to use automatic enrollment (and thereby boost employee participation) by saving them from having to choose a standard investment. This, in turn, would make it easier to protect employers from responsibility for IRA investments, especially employers using automatic enrollment (as discussed below).

We would not fully specify the automatic investment by statute. It is desirable to maintain a degree of flexibility in order to reflect a consensus of expert financial advice over time. For example, some contend that a balanced fund reflecting the participant's appetite for risk is preferable to a life cycle fund because the latter tend to transition to a relatively low percentage of equities by age 60 or 65, even though the participant might continue to hold the investment for another three decades. However, for the presumably large percentage of the population that can be expected not to take the initiative to adjust their asset allocation as they age, some automatic adjustment might be preferable to no adjustment. In addition, the prospect that participants will make explicit choices may be far greater as they confront retirement, when they might be able to focus on a one-time basis sufficiently to adjust a life cycle fund to suit their preferences, taking into account when they expect to draw down the funds.

Accordingly, general statutory guidelines would be fleshed out at the administrative level after regular comment by and consultation with private-sector investment experts.

Two variations on the automatic investment fund may be worth considering. One is the addition of a short-term transitional guaranteed investment at the front end of the process. To simplify and streamline administration – especially within the backstop automatic IRA arrangement – while minimizing costs, the standard investment could begin as a principal-preservation fund in much the same way that the federal employees' Thrift Savings Plan began with the "G" (government securities) Fund.[31]

A temporary guarantee of principal might also help some households that have no previous investment experience to ease into the process of saving and investing. Behavioral research has produced evidence that many smaller savers are particularly averse to losses of principal, so that they weigh the risk of any loss far more heavily than the prospect of gain.

However, we are skeptical of the merits of a "safe" investment – with no risk of loss but no significant potential for growth over time – for more than a limited period. There is evidence that favorable investment returns over the long terms are attributable not so much to successful selection of individual stocks or other investments but far more to judicious asset allocation – an appropriately balanced and diversified mix of asset types and classes (including substantial exposure to diversified equities or other assets with growth potential) that have risk characteristics designed to be uncorrelated with one another.[32] Accordingly, we contemplate that the automatic investment would take the form of a balanced "asset allocated" fund either from the start or after a limited transition period, while giving individuals the ability to opt for a principal preserving investment as an alternative.

Another intriguing possibility that is worth exploring might be to offer, as one of the alternatives to the standard investment, a variation on the life cycle fund that adds a nominal principal guarantee or even a guarantee of principal including inflation. This would be intended to help induce participation by those who are risk averse but still hope to preserve the potential for growth – those savers and investors whose fear of loss exceeds their hope for gain – without placing them in an investment that offers little prospect of growth over the long term. The key question would be the extent of the limitation on the upside potential of the investment that would be necessitated by a nominal guarantee of principal (as opposed to a guarantee of a fixed positive rate of return).

The Other Investment Options

An additional and major design issue is whether the standard, limited set of investment options for payroll deposit IRAs should be only a minimum set of options in each IRA, so that the IRA provider would be permitted to provide any additional options it wished. Limiting the IRAs to these specified options would best serve the purposes of containing costs, improving investment results for IRA owners in the aggregate, and simplifying individuals' investment choices. Behavioral research has suggested that eligible employees or other consumers who are confronted with numerous choices often tend to avoid the decision (here, participation in saving) altogether or revert to relatively arbitrary decision rules.[33] At the same time, such restrictions would constrain the market, potentially limit innovation, and limit choice for individuals who prefer other alternatives.

One of the ways to resolve this tradeoff would be to limit the prescribed array of investment options to the automatic IRAs in which individuals would invest when neither the employee nor the employer has affirmatively elected another IRAs. While all payroll deposit IRAs would be required to offer the default investment, the only ones constrained to offer the limited list of other fund options would be the automatic IRAs. Alternatively, all payroll deposit IRAs could be made subject to the limited list of investment alternatives in addition to the default option.

In either case, no comparable limits would be imposed on other IRAs, and owners of the default IRAs or all payroll deposit IRAs would be able to transfer or roll over their account balances between the various classes of accounts. Under this approach, the owner of an automatic or payroll deposit IRA could transfer the account balance to other unrestricted IRAs that are willing to accept such transfers (but perhaps only after the account balance reaches a specified amount that would no longer be unprofitable to most IRA providers). While such a transfer to an unrestricted IRA would deprive the owner of the cost-saving advantages of the no-frills, limited-choice model, such a system would still enable individuals to retain the efficiencies and cost protection associated with the standard low-cost model if they so choose.[34]

Within the TSP-style IRA arrangement, we contemplate that one method of containing recordkeeping, reporting and related costs would be to limit participants' ability to switch from one investment option to another, for example, by restricting such transfers to one per year. This would be in keeping with the long-term orientation of the saving program.

Employers Protected from Risk of Fiduciary Liability

Employers traditionally have been particularly concerned about the risk of fiduciary liability associated with their selection of retirement plan investments. This concern extends to the employer's designation of default investments that employees are free to decline in favor of alternative investments. In the IRA universe, employers transferring funds to automatic rollover IRAs and employer-sponsored SIMPLE-IRAs retain a measure of fiduciary responsibility for initial investments.

By contrast, under our proposal, employers making direct deposits would be insulated from such potential liability or fiduciary responsibility with respect to the manner in which direct deposits are invested in automatic IRAs regardless of whether the IRA provider or investments are selected by the employer or the employee, nor would employers be exposed to potential liability with respect to any employee's choice of IRA provider or type of IRA. This protection of employers would be facilitated by regulatory designation of standard investment types that reduces the need for continuous professional investment advice.

ERISA protects plan fiduciaries from liability for losses that result directly from employees' investment choices. The Department of Labor, in accordance with the Pension Protection Act of 2006, has recently proposed regulations that would extend this protection from fiduciary liability under ERISA to certain types of investments employees select by default, i.e., even when the employee makes no affirmative election and is therefore placed in a default investment designated by the employer unless the employee affirmatively opts for a different investment. Because the proposed regulations would extend this type of fiduciary protection to default life cycle funds, balanced funds and professionally managed accounts, regulatory designation of a life cycle or balanced fund as the default investment for automatic IRAs would be consistent with the proposed ERISA fiduciary regulations.

In addition, employers providing payroll deposit IRAs would be able to avoid fiduciary responsibility even for the selection of an IRA provider for their employees by either allowing each employee to designate the employee's preferred IRA provider or by specifying the government-contracted default automatic IRA. An employer that

Employers making direct deposits would be insulated from such potential liability or fiduciary responsibility with respect to the manner in which direct deposits are invested in automatic IRAs, regardless of whether the IRA provider or investments are selected by the employer or the employee.

Among registered voters surveyed, 83 percent of respondents said they would be agreeable to having their employer offer to sign them up for an IRA and allow them to contribute to it through direct deposit of a small amount from their paycheck to help them save for retirement.

wished to choose the IRA provider for its employees would be responsible for doing so prudently. Another possible alternative would be for the regulators to specify an approved list of providers (based on capital adequacy, financial soundness, and other criteria) from which employers could choose if they wished to have another means of avoiding any fiduciary responsibility.

Public Opinion Polling

Public opinion polling has shown overwhelming support for payroll-deduction direct deposit saving. Among registered voters surveyed, 83 percent of respondents said they would be agreeable to having their employer offer to sign them up for an IRA and allow them to contribute to it through direct deposit of a small amount from their paycheck to help them save for retirement.

In addition, the polling shows very strong support for a requirement that goes far beyond our proposal, that every company offer its employees some kind of retirement plan-such as a pension or 401(k), or at least an IRA to which employees could contribute. Among registered voters surveyed in August 2005, 77 percent supported such a requirement (and 59 percent responded that they were "strongly" in support).[35] As discussed, the approach described in this paper would not require employers to offer their employees retirement plans, but would give firms a financial incentive to offer their employees access to payroll deduction as a convenient and easy means of saving, and would require firms above a certain size and maturity to extend this offer to their employees.

The Importance of Protecting Employer Plans

Employer-sponsored pension, profit-sharing, 401(k), and other plans can be particularly effective – more so than IRAs – in accumulating benefits for employees. As noted earlier, the participation rate in 401(k)s, for example, tends to range from 7 to 8 of 10 eligible employees, in contrast to IRAs, in which about 1 in 10 eligible individuals participates.

Employer plans tend to be far more effective than IRAs at providing coverage because of a number of attributes: for one thing, pension and profit-sharing plans, for example, are funded by employer contributions that automatically are made for the benefit of eligible employees without requiring the employee to take any initiative in order to participate. Second, essentially all tax-qualified employer plans must abide by standards that either seek to require reasonably proportionate coverage of rank-and-file workers or give the employer a distinct incentive to encourage widespread participation by employees. This encouragement typically takes the form of both employer-provided retirement savings education efforts and employer matching contributions. The result is that the naturally eager savers, who tend to be in the higher tax brackets, tend to subsidize or bring along the naturally reluctant savers, who often are in the lowest (including zero) tax brackets.

Employer-sponsored retirement plans also have other features that tend to make them effective in providing or promoting coverage. As noted, the proposal outlined here seeks to transplant some of these features to the IRA universe. These include the automatic availability of a saving vehicle, the use of payroll deduction (which continues automatically once initiated), matching contributions (further discussed below), professional investment management, and peer group reinforcement of saving behavior.

Our approach to providing for payroll deposit contributions to IRAs is therefore designed carefully to avoid competing with or crowding out employer plans (such as pension, profit sharing, 401(k) or SIMPLE plans) and to avoid encouraging firms to drop or reduce employer contributions or to refrain from adopting employer plans. Owners and others who control the decision whether to adopt or continue maintaining a retirement plan for employees should continue to have incentives to sponsor such "real" plans, which must adhere to standards requiring reasonably broad or proportionate coverage of moderate- and lower-income workers and various safeguards for employees, and which often involve employer contributions. Instead, payroll-deduction direct deposit savings, as envisioned here, would promote wealth accumulation for retirement by filling in the coverage gaps around employer-sponsored retirement plans. Moreover, as described below, the arrangements we propose are designed to set the stage for small employers to "graduate" from offering payroll deduction to sponsoring an actual retirement plan.

Probably the single most important protection for employer plans is to set maximum permitted contribution levels to the automatic IRA so that they will be sufficient to meet the demand for savings by most households but not high enough to satisfy the appetite for tax-favored saving of business owners or decision-makers. The average annual contribution to a 401(k) plan by a nonhighly compensated employee is somewhat greater than $2,000, and average annual 401(k) contributions by employees generally tend to be on the order of 7 percent of pay.[36] A $3,000 contribution is 7.5 percent of pay for a family earning $40,000, and 6 percent of pay for a family earning $50,000.

IRA contribution limits are already higher than these contribution levels. Accordingly, at the most, payroll deposit IRAs should not permit contributions above the current IRA dollar limits, and could be limited to a lower amount such as $3,000. (A 3% of pay contribution would remain below $3,000 for employees whose compensation did not exceed $100,000.) Imposing a lower limit on the payroll deduction IRA would reduce to some degree the risk that employees will exceed the maximum IRA dollar contribution limit because of auto enrollment, combined with possible other contributions to an IRA.[37] That is already a risk under current law, but the automatic nature of auto enrollment increases the risk, especially if auto escalation is implemented. There is a tradeoff between the desirability of limiting the contribution amount (to mitigate both this risk and the risk of competing with employer plans) and the simplicity of using an existing vehicle (the IRA) "as is".

In any event, the employee – not the employer – would be responsible for monitoring all of their IRA contributions to comply with the maximum limit (in part because employees can contribute on their own and through multiple employers). The ultimate reconciliation would be made by the individual when filing the federal income tax return.

In addition, the automatic IRA is designed to avoid reducing ordinary employees' incentives to contribute to employer-sponsored plans such as 401(k)s. If workers perceive a program such as direct deposit savings to IRAs as a more attractive destination for their contributions than an employer-sponsored plan (for example, because of better matching, tax treatment, investment options, or liquidity), it could unfortunately divert employee contributions from employer plans. This in turn could have a destabilizing effect by making it difficult for employers to meet the nondiscrimination standards applicable to 401(k)s and other plans and therefore potentially discouraging employers from continuing the plans or their contributions. While a detailed discussion of these points is beyond the scope of this paper, it is important to maintain a relationship between IRAs and employer-sponsored retirement plans that preserves and protects the employer plans.

Our approach to providing for payroll deposit contributions to IRAs is designed carefully to avoid competing with or crowding out employer plans.

Our approach is designed not only to avoid causing any reduction or contraction of employer plans, but actually to promote expansion of employer plans.

Automatic Payroll Deduction Can Promote Marketing and Adoption of Employer Plans

Our approach is designed not only to avoid causing any reduction or contraction of employer plans, but actually to promote expansion of employer plans. Consultants, third-party administrators, financial institutions, and other plan providers could be expected to view this proposal as providing a valuable new opportunity to market 401(k)s, SIMPLE-IRAs and other tax-favored retirement plans to employers. Firms that, under this proposal, were about to begin offering their employees payroll deduction saving or had been offering their employees payroll deduction saving for a year or two could be encouraged to "trade up" to an actual plan such as a 401(k) or SIMPLE-IRA.

Especially because these plans can now be purchased at very low cost, it would seem natural for many small businesses to graduate from payroll deduction savings and complete the journey to a qualified plan in order to obtain the added benefits in terms of recruitment, employee relations, and larger tax-favored saving opportunities for owners and managers.

The following compares the maximum annual tax-favored contribution levels for IRAs, SIMPLE-IRA plans and 401(k) plans in effect for 2007 (as noted earlier):

	IRA	SIMPLE-IRA	401(k)
Under age 50	$4,000 per spouse ($5,000 after 2007)	$10,500	$15,500
Age 50 and above	$5,000 per spouse ($6,000 after 2007)	$13,000	$20,500

In addition, as noted, small employers that adopt a new plan for the first time are entitled to a tax credit of up to $500 each year for three years, while the automatic IRA tax credit for employers would be half that amount for two years. This too maintains the incentive for employers to go beyond the payroll deposit IRA and adopt an actual plan such as a SIMPLE, 401(k), or other employer plan.

Encouraging Contributions by Nonemployees

The payroll deposit system outlined thus far would not automatically cover self-employed individuals, employees of the smallest or newest businesses that are exempt from any payroll deposit obligation, or certain unemployed individuals who can save. A strategy centered on automatic arrangements can also make it easier for these people to contribute to IRAs.

Encouraging Automatic Debit Arrangements

For individuals who are not employees or who otherwise lack access to payroll deduction, automatic debit arrangements can serve as a counterpart to automatic payroll deduction. Automatic debit enables individuals to spread payments out over time and to make payments on a regular and timely basis by having them automatically charged to and deducted from an account-such as a checking or savings account or credit card-at regular intervals on a set schedule. The individual generally gives advance authorization to the payer that manages the account or the recipient of the payment, or both. The key is that, as in the case of payroll deduction, once the initial authorization has been given, regular payments continue without requiring further initiative on the part of the individual. For many consumers, automatic debit is a convenient way to pay bills or make payments on mortgages or other loans without having to remember to make each payment when due and without having to write and mail checks.

Similarly, as an element of an automatic IRA strategy, automatic debit can facilitate saving while reducing paperwork and cutting costs. For example, households can be encouraged to sign up on-line for regular automatic debits to a checking account or credit card that are directed to an IRA or other saving vehicle. With on-line sign-up and monitoring, steps can be taken to familiarize more households with automatic debit arrangements and, via Internet websites and otherwise, to make those arrangements easier to set up and use as a mechanism for saving in IRAs.

Facilitating Automatic Debit IRAs Through Professional or Trade Associations

Professional and trade associations could facilitate the establishment of IRAs and the use of automatic debit and direct deposit to the IRAs. Independent contractors and other individuals who do not have an employer often belong to such an association. The association, for example, might be able to make saving easier for those members who wish to save by making available convenient arrangements for automatic debit of members' accounts. Association websites can make it easy for members to sign up on line, monitor the automatic debit savings, and make changes promptly when they wish to. Although such associations generally lack the payroll-deduction mechanism that is available to employers, they can help their members set up a pipeline involving regular automatic deposits (online or by traditional means) from their personal bank or other financial accounts to an IRA established for them.

Facilitating Direct Deposit of Income Tax Refunds to IRAs

Another major element of a strategy to encourage contributions outside of employment would be to allow taxpayers to deposit a portion of their income tax refunds directly into an IRA by simply checking a box on their tax returns.[38] Beginning in 2007 (tax year 2006), the IRS has made the administrative changes to allow tax refunds to be split among different accounts. Allowing households to split their refunds to deposit a portion directly into an IRA could make saving simpler and, thus, more likely. Since federal income tax refunds total nearly $230 billion a year (more than twice the estimated annual aggregate amount of net personal savings in the United States), even a modest increase in the proportion of refunds saved every year could bring about a significant increase in savings.

Extending Direct Deposit to Independent Contractors

Millions of Americans are self-employed as independent contractors. Many of these workers receive regular payments from firms, but because they are not employees, they are not subject to income tax or payroll tax withholding. These individuals might be included in the direct deposit system by giving them the right to request that the firm receiving their services direct deposit into an IRA a specified portion of the compensation it would otherwise pay them.

Compared to writing a large check to an IRA once a year, this approach has several potential advantages to independent contractors, which might well encourage them to save. These include the ability to commit themselves to save a portion of their compensation before they receive it (which, for some people, makes the decision to defer consumption easier); the ability to avoid having to make an affirmative choice among various IRA providers; remittance of the funds by the firm by direct deposit to the IRA; and, where payments are made to the independent contractor on a regular basis, an arrangement that, like regular payroll withholdings for employees, automatically continues the pattern of saving through repeated automatic payroll deductions unless and until the individual elects to change.

For individuals who are not employees..., automatic debit arrangements can serve as a counterpart to automatic payroll deduction.

In many cases, the independent service provider will not have a sufficient connection to a firm that receives the services, or both the independent contractor and the firm will be unwilling to enter into a payroll deposit type of arrangement. In such instances, the independent contractor could contribute to an IRA using automatic debit (as discussed above) or by sending the contribution together with the estimated taxes that the self-employed generally are required to pay quarterly.

Matching Deposits as a Financial Incentive

A powerful financial incentive for direct deposit saving by those who are not in the higher tax brackets (and who therefore derive little benefit from a tax deduction or exclusion) would be a matching deposit to their direct deposit IRA. One means of delivering such a matching deposit would be via the bank, mutual fund, insurance carrier, brokerage firm, or other financial institution that provides the direct deposit IRA. For example, the first $500 contributed to an IRA by an individual who is eligible to make deductible contributions to an IRA might be matched by the private IRA provider on a dollar-for-dollar basis, and the next $1,000 of contributions might be matched at the rate of 50 cents on the dollar. The financial provider would be reimbursed for its matching contributions through federal income tax credits.[39]

Recent evidence from a randomized experiment involving matched contributions to IRAs suggests that a simple matching deposit to an IRA can make individuals significantly more likely to contribute and more likely to contribute larger amounts.[40]

Matching contributions – similar to those provided by most 401(k) plan sponsors – not only would help induce individuals to contribute directly from their own pay, but also, if the match were automatically deposited in the IRA, would add to the amount saved in the IRA. The use of matching deposits, however, would make it necessary to implement procedures designed to prevent gaming – contributing to induce the matching deposit, then quickly withdrawing those contributions to retain the use of those funds. Among the possible approaches would be to place matching deposits in a separate subaccount subject to tight withdrawal rules and to impose a financial penalty on early withdrawals of matched contributions.[41]

Conclusion

American households have a compelling need to increase their personal saving, especially for long-term needs such as retirement. This paper proposes a strategy that would seek to make saving more automatic – hence easier, more convenient, and more likely to occur. Our strategy would adapt to the IRA universe practices and arrangements that have proven successful in promoting 401(k) participation. In our view, the automatic IRA approach outlined here holds considerable promise of expanding retirement savings for millions of workers.

Appendix

Choice of a Traditional IRA Versus a Roth IRA

It is often argued that a Roth IRA is the preferred alternative for lower-income individuals on the theory that their marginal income tax rates are likely to increase as they become more successful economically. In addition, the argument is often made that a Roth is preferable for many others on the assumption that federal budget deficits will cause income tax rates to rise in the future. On either of those assumptions, all other things being equal, the Roth's tax advantage for payouts would likely be more valuable than the traditional IRA's tax deduction for contributions. In addition, the Roth, by producing less taxable income in retirement years, could avoid exposing some individuals to a higher rate of income-related tax on social security benefits in retirement.

This point of view, however, may well overstate the probability that our tax system, including the federal income tax, social security taxes, and the tax treatment of the Roth IRA, will continue essentially as it is. It is possible that in future years the nation will make significant changes in its income tax system. It might move to a system that simplifies income tax compliance by exempting the bottom two or three quintiles of the population from income tax, or it might move to a consumption tax or value added tax. If a future Congress adopted one of these or another system that exempted savings or retirement savings from tax – or alternatively if a future Congress directly or indirectly reduced the value of the Roth income tax (and social security benefits tax) advantages – the choice of a Roth over a deductible IRA would entail giving up the proverbial bird in the hand for two in the bush.

Another scenario is that Congress will increase future marginal income tax rates, but generally will limit any future increase to the top rates. Most of the population eligible for the automatic IRA is unlikely ever to be in the top brackets. Indeed, to the extent the comparison between traditional and Roth IRAs turns on a prediction of whether a household's marginal income tax rate when its IRA balance becomes taxable is likely to exceed its current rate, that prediction will vary considerably for different segments of the eligible population. Among the segment that has no current income tax liability (slightly less than half), many might be expected to have higher marginal rates in the future, but many might not. For those who do have current income tax liability (slightly more than half of the eligible population), the prediction is quite uncertain: some might reasonably be expected to have higher rates, some lower rates, some the same rates, when their IRA balance is withdrawn and becomes taxable. This segment not only represents a slight majority of those who are eligible for the automatic IRA but, because they tend to have more disposable income than those in the zero percent bracket, are the ones more likely to use the automatic IRA.

Four other differences between the traditional and Roth IRAs are worth noting but affect only limited subgroups within the eligible population: the saver's credit, minimum required distributions, and the income eligibility limits.

The tax deduction associated with a contribution to a traditional IRA would reduce a taxpayer's adjusted gross income taken into account for purposes of determining eligibility for the saver's credit (the tax credit available for contributions by moderate- and lower-income taxpayers to an IRA or employer plan). Under current law, more households would become eligible for a saver's credit (or for a higher rate of saver's credit) by contributing to a traditional IRA than to a Roth. (For example, if a married couple's adjusted gross income was $54,000 and each spouse contributed $2,000 to a traditional IRA, the $4,000 joint deduction would reduce their adjusted gross income to $50,000, thereby making them eligible to claim the saver's credit.) However, this would affect only those whose deduction would move them from above to below one of the saver's credit income eligibility thresholds.

The Roth IRA would enjoy a similar advantage after retirement. Within ranges, the greater one's taxable income, the greater the rate of tax imposed on Social Security benefits. Because Roth IRA payouts generally are not taxable, they will not increase one's taxable income or the tax on Social Security benefits, but traditional IRA payouts will.

Unlike traditional IRAs, Roth IRA's are exempt from the requirement that an IRA balance gradually becomes taxable beginning after the owner reaches age 70 ½. (This is often referred to as "minimum required distributions" although the funds are not required to be consumed, only taxed.) This advantage for owners of Roth IRAs would be meaningful only to the relatively small percentage of the eligible population who might be expected to be sufficiently well off after age 70 ½ that their incentive to maximize tax deferral will exceed their need to use the retirement savings.

Another distinction between the Roth and traditional IRAs relates to the number of households that would have to take cognizance of the income eligibility limits. Most eligible taxpayers filing a joint return with income below $156,000 or single taxpayers with income below $99,000 (for 2007) generally are entitled to make a full Roth contribution. Most of the eligible population will be well below these limits and therefore will not need to take them into account. The same is true of the income limits on eligibility to make a full deductible contribution to a traditional IRA. These income limits ($80,000 for joint filers, $50,000 for singles for 2007) apply only if the individual is eligible to contribute to an employer's qualified plan. Only a small percentage of the population whose employer would have automatic IRAs (because it does not sponsor a retirement plan) would have another employer that does sponsor a retirement plan for which the individual is eligible so as to make the traditional IRA income eligibility limits applicable. We have not undertaken to estimate which subgroup affected by the income limits would be larger within the eligible population, because it seems likely that both subgroups would be relatively small. (If the size of these subgroups was significantly different, it would make a difference in terms of simplicity for eligible households.) Accordingly, this distinction would not seem to militate strongly in favor of either the Roth or the traditional IRA.

Because the automatic IRA proposal would encourage but not require individuals to save, the associated incentives for saving are important. The instant gratification that many eligible households can obtain from an immediate tax deduction – even if only at a 10 or 15 percent marginal rate – might do more to motivate many households than the government's long-term promise of an uncertain tax benefit in an uncertain future. In addition, by shifting the loss of tax revenues beyond the congressional budget "window" period, the Roth also presents a special challenge to a policy of fiscal responsibility. The decision whether to prescribe the Roth or the traditional IRA and whether to make one or the other the default should be based on an overall public policy analysis that is not limited to which is more likely to save particular households more on taxes.

[1]This paper does not address any issues relating to Social Security reform. The proposal is intended to have no implications, one way or the other, regarding proposals to finance individual accounts using Social Security taxes or to offset Social Security benefits by individual accounts. Also outside the scope of this paper are potential reforms to the private pension system (including employer-sponsored defined contribution and defined benefit plans). This paper builds on testimony given by the authors to the Long-Term Growth and Debt Reduction Subcommittee of the Committee on Finance, United States Senate (June 29, 2006; available at *www.retirementsecurityproject.org*).

[2]Craig Copeland, "Employer-Based Retirement Plan Participation: Geographic Differences and Trends: Employee Benefit Research Institute Issue Brief No. 299," December 2005 (referred to below as "Copeland, EBRI Issue Brief No. 299"), Figure 1, p. 7. An additional 16 million workers either are not eligible for their employer's plan or are eligible but fail to participate.

[3]While not a part of the Automatic IRA proposal, tax credits could be provided as a matching deposit to Automatic IRAs for workers in lower tax brackets, giving them another powerful financial incentive to save, similar to a 401(k) match.

[4]Even among those households that had savings in 401(k)s or IRAs, the median account balance was only $69,000. Authors' calculations using the 2004 Survey of Consumer Finance.

[5]As measured in the National Income and Product Accounts.

[6]Copeland, EBRI Issue Brief No. 299, Figure 1, p. 7.

[7]Copeland, EBRI Issue Brief No. 299, Figure 1, p. 7.

[8]Rev. Rul. 1998-30 clarified that automatic enrollment in 401(k) plans is permissible for newly hired employees. Treasury and IRS ruled in 2000 that automatic enrollment is allowed for current employees as well (Rev. Rul. 2000-8). Later rulings also extend IRS-Treasury approval to 403(b) and section 457 plans.

[9]See the Pension Protection Act of 2006 (Public Law No. 109-280), Section 902.

[10]For 2007, the IRA, SIMPLE and 401(k) contribution limits for individuals age 50 or older are $5,000, $13,000, and $20,500, respectively.

[11]See, for example, Alicia H. Munnell and Annika Sunden, Coming Up Short: The Challenge of 401(k) Plans (Brookings Institution Press, 2004).

[12]The preceding discussion draws on Section 1.02(3) of J. Mark Iwry, "Growing Private Pensions: A Supporting Role for the States," Tax Management Compensation Planning Journal, Vol. 34, No. 12 (Dec. 1, 2006).

[13]In the Conference Report to the Tax Reform Act of 1997, Congress stated that "employers that choose not to sponsor a retirement plan should be encouraged to set up a payroll deduction [IRA] system to help employees save for retirement by making payroll-deduction contributions to their IRAs" and encouraged the Secretary of the Treasury to "continue his efforts to publicize the availability of these payroll deduction IRAs" (H.R. Rep. No. 220, 105th Cong., 1st Sess. 775 [1997]).

[14]Department of Labor Interpretive Bulletin 99-1 (June 18, 1999), 29 C.F.R. 2509.99-1(b); IRS Announcement 99-2.

[15]Neither the IRS nor the Department of Labor guidance addressed the possible use of automatic enrollment in conjunction with direct deposit IRAs (discussed at length below).

[16]The SIMPLE-IRA is essentially a payroll deposit IRA with an employee contribution limit that is in between the IRA and 401(k) limits and with employer contributions, but without the annual reports, plan documents, nondiscrimination tests or most of the other administrative requirements applicable to other employer plans.

[17]William G. Gale, J. Mark Iwry, and Peter R. Orszag, "The Automatic 401(k): A Simple Way to Strengthen Retirement Savings," (The Retirement Security Project, Policy Brief No. 2005-1; available at www.retirementsecurityproject.org);

[18]Brigitte Madrian and Dennis Shea, "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior," Quarterly Journal of Economics 116, no. 4 (November 2001): 1149-87; and James Choi and others, "Defined Contribution Pensions: Plan Rules, Participant Decisions, and the Path of Least Resistance," in Tax Policy and the Economy, vol. 16, edited by James Poterba (Cambridge, Mass.: MIT Press, 2002), pp. 67-113. See also Sarah Holden and Jack VanDerhei, "The Influence of Automatic Enrollment, Catch-Up, and IRA Contributions on 401(k) Accumulations at Retirement," Employee Benefit Research Institute Issue Brief No. 283 (July 2005).

[19]Any such statutory provision could usefully make clear that automatic enrollment in direct deposit IRAs is permitted irrespective of any state payroll laws that prohibit deductions from employee paychecks without the employee's advance written approval. Assuming that most direct deposit IRA arrangements are not employer plans governed by ERISA, such state laws, as they apply to automatic IRAs, may not be preempted by ERISA because they do not "relate to any employee benefit plan."

[20]In 2004, the IRS affirmed that plans are permitted to increase the automatic contribution rate over time in accordance with a specified schedule or in connection with salary increases or bonuses. See letter dated March 17, 2004, from the Internal Revenue Service to J. Mark Iwry. The idea of coordinating automatic contribution increases with pay increases was developed by Richard Thaler and Shlomo Benartzi. See Thaler and Benartzi, "Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving," Journal of Political Economy 112, no. 1, pt.2, pp. S164-87.

[21]Between August 28 and 31, 2005, in a survey commissioned by The Retirement Security Project, The Tarrance Group, in conjunction with Lake, Snell, Mermin/Decision Research, interviewed 1,000 registered voters nationwide about retirement security issues. A full report of the survey findings can be found at *www.retirementsecurityproject.org.*

[22]James Choi, David Laibson, Brigitte Madrian, and Andrew Metrick, "Optimal Defaults and Active Decisions" NBER Working Paper No. 11074 (January 2005).

[23]Employers that sponsor a SIMPLE-IRA plan may deposit all employee contributions in IRAs at a single designated financial institution selected by the employer (IRS Notice 98-4, 1998-2 I.R.B. 25).

[24]Plan sponsors continue to have the option to cash out balances of up to $1,000 and to retain in the plan account balances between $1,000 and $5,000 instead of rolling them over to an IRA.

[25]Considerable challenges are involved in building and implementing a workable universal saving system based on employer direct deposits of contributions to IRAs. These challenges include dealing with the contingent workforce, with employees who have multiple jobs, who work part-time, and often who earn relatively low wages, and with small employers. A somewhat different and thoughtful approach to designing such a system can be found in the evolving work of the Conversation on Coverage, a collaborative effort among individuals (including one of the authors) drawn from a diverse range of stakeholder organizations. A final report from the Conversation on Coverage is expected in mid-2007. For its interim recommendations, see Conversation on Coverage Working Report, "Covering the Uncovered," (2006). For an analysis by a non-partisan expert panel (including one of the authors) of the issues involved in designing arrangements for distributions from individual accounts, see National Academy of Social Insurance, Uncharted Waters: Paying Benefits from Individual Accounts in Federal Retirement Policy (2005). There have been various other efforts to design such systems or programs, which this paper does not attempt to catalogue.

[26]Until recently the federal Thrift Savings Plan had five investment funds: three stock index funds (S&P 500, small and midcapitalization U.S. stocks, and mostly large-capitalization foreign stocks), a bond index fund consisting of a mix of government and corporate bonds, and a fund consisting of short-term, nonmarketable U.S. Treasury securities. Effective August 1, 2005, the Plan added a set of life-cycle funds, each one of which is composed of a mix of the other five investment funds.

[27]This was part of the impetus behind the 2001 statutory provision to the effect that the Secretaries of Labor and Treasury may provide, and shall give consideration to providing, special relief with respect to the use of low-cost individual retirement plans for purposes of automatic rollovers and for other uses that promote the preservation of assets for retirement income (Economic Growth and Tax Relief Reconciliation Act of 2001, Public Law 107-16, 115 Stat. 38, Section 657[c][2][B]).

In a similar vein, one of the co-authors has proposed a strategy for States to act as a catalyst in expanding coverage under standardized, low-cost payroll-deposit IRAs, SIMPLE-IRA plans, and 401(k) plans by facilitating the pooling of small businesses to offer these vehicles. The proposal has been outlined in "Expanding Retirement Savings at the State Level," Written Statement of J. Mark Iwry to the Legislature of the State of Washington (April 2003), has been described in oral testimony by Iwry to the Michigan Senate and to the Maryland House of Delegates, written testimony before the U.S. Senate Committee on Finance Subcommittee on Long-Term Growth and Debt Reduction (June 29, 2006), and is more fully described in J. Mark Iwry, "State K - A New Strategy for Using State-Assisted Saving to Expand Private Pension Coverage," NYU Review of Employee Benefits and Executive Compensation (2006) and "Growing Private Pensions: A Supporting Role for the States," BNA Tax Management Compensation Planning Journal, Vol. 34, No. 12 (December 1, 2006).

[28]The difference in expense between passively managed index funds and actively managed mutual funds has been estimated to be-as a broad generalization-roughly 100 basis points (1 percent) a year (William F. Sharpe, "Indexed Investing: A Prosaic Way to Beat the Average Investor" presented at the Spring President's Forum, Monterey Institute of International Studies (May 2002).

[29]One of the authors has testified before Congress regarding the British retirement plan system and has been critical of the UK's attempt to impose a limit on charges. See David C. John, testimony before the Subcommittee on Social Security of the Committee on Ways and Means, U.S. House of Representatives (June 16, 2005); David C. John, "What the United States Can Learn from the UK's Pensions Commission Report" (forthcoming).

[30]As noted, the federal Thrift Savings Plan consists mainly of index funds, which are the building blocks for the recently added life-cycle funds. The Thrift Savings Plan informational materials state that the life-cycle funds "provide a way to diversify your account optimally, based on professionally determined asset allocations. This provides you with the opportunity to achieve a maximum amount of return over a given period of time with a minimum amount of risk. . ." (Federal Thrift Savings Plan website, www.tsp.gov). To the extent that a professionally run "managed account" could achieve similar results at no greater cost, that might be another attractive option, and managed accounts are growing in popularity as an option in 401(k) plans. A question may be raised as to whether managed accounts are a better fit for 401(k) plans than for automatic IRAs, because 401(k)s tend to have more substantial account balances and greater flexibility to accommodate individual preferences while allocating costs to individuals who opt for costlier alternatives.

[31]The Federal Employees' Retirement System Act of 1986 (Public Law No. 99-335) established the Thrift Savings Plan as of January 1, 1987 with a government securities fund. The initial legislation called for two additional funds - fixed income and stock index - to become available on January 1, 1988.

[32]Gary P. Brinson, L. Randolph Hood, and Gilbert L. Beebower, "Determinants of Portfolio Performance," Financial Analysts Journal, vol. 42, no. 4 (July/August 1986): 39-48.

[33]Particularly concerning 401(k) trading behavior, see, for example, Takeshi Yamaguchi et al, "Winners and Losers: 401(k) Trading and Portfolio Performance," Pension Research Council Working Paper 2006-26, (Nov. 2006) and previously Shlomo Benartzi and Richard Thaler, "Naïve Diversification Strategies in Defined Contribution Saving Plans," American Economic Review, March 2001, 91(1), pp 79-98.

[34]The question of how best to fit the direct deposit IRAs, with their improved and simplified investment structure, into the larger IRA universe is related to a broader issue: the potential simplification of IRAs. We favor simplification and revision of the current array of IRA options. However, the specifics of any such proposals are beyond the scope of this testimony.

[35]The retirement security poll referred to in note 14, above, had a margin of error of 3.1 percent. The question that elicited these results was as follows: "Would you support or oppose a requirement that every company offer their employees some sort of retirement plan-either a traditional pension, a 401(k) or an IRA that the employer sets up but does not contribute to. The company would choose which one they wanted to offer employees. Would you support or oppose requiring every employer to give employees at least one of these options?" A full report of the survey findings can be found at www.retirementsecurityproject.org.

[36]See Craig Copeland, "Retirement Plan Participation and Retirees' Perception of Their Standard of Living," Employee Benefit Research Institute Issue Brief No. 289 (January 2006), pp. 1-6, Figure A4.

[37]It is conceivable that the risk of exceeding the IRA dollar limit could be mitigated to some degree through enrollment procedures that cap automatic enrollment at, say, $250 a month (for an annual total of $3,000) or $300 a month. However, because automatic enrollment would be administered at the employer level and might be based on paychecks provided weekly or every two weeks, the maximum dollar amount would need to be adjusted accordingly (e.g., $60 if weekly, $120 if every two weeks, or $250 if monthly).

[38]J. Mark Iwry, "Using Tax Refunds to Increase Savings and Retirement Security" (Retirement Security Project, Policy Brief No. 2006-1, Jan. 2006; available at www.retirementsecurityproject.org).

[39]Among the issues such an approach would need to address is the means of reimbursing those private financial institutions that have no federal income tax liability to offset because they are tax exempt or in a loss position.

An alternative mechanism would modify the existing saver's credit (a federal income tax credit to households with income below $52,000 for contributing to an IRA or employer plan) to convert it to a direct matching deposit to an IRA or other savings account. (As currently structured, the saver's credit reduces the household's federal income tax liability and is nonrefundable; thus, it is not automatically saved.) A variation would be to have such a direct matching deposit delivered by the financial institution that sponsors the IRAs or serves as financial provider to the 401(k) plan to which the individual contributes. One of the authors was involved in developing the Saver's Credit and, in congressional testimony and writings, has advocated its extension and expansion. See, e.g., William G. Gale, J. Mark Iwry, and Peter R. Orszag, "The Saver's Credit: Expanding Retirement Savings for Middle- and Lower-Income Americans" (Retirement Security Project Policy Brief No. 2005-2, March 2005; available at www.retirementsecurityproject.org). However, issues relating to the Saver's Credit and its potential expansion are beyond the scope of this paper. Another significant asset-building approach targeted to lower- and moderate-income households is reflected in the Individual Development Accounts (IDAs). See, e.g., Michael Sherraden, Assets and the Poor: A New American Welfare Policy (M. E. Shapre, 1992), and Ray Boshara, "Individual Development Accounts: Policies to Build Savings and Assets for the Poor" (Brookings, Policy Brief, March 2005).

[40]Esther Duflo, William Gale, Jeffrey Liebman, Peter Orszag, and Emmanuel Saez, "Saving Incentives for Low- and Middle-Income Families: Evidence from a Field Experiment with H&R Block" Quarterly Journal of Economics, Vol. 121, No. 4, November 2006, p. 1311-1346, (available at www.retirementsecurityproject.org).

[41]A detailed treatment of the matching deposit option is beyond the scope of this paper.

J. Mark Iwry is a Principal at The Retirement Security Project and a Nonresident Senior Fellow at the Brookings Institution.

David C. John is the Managing Director of the Retirement Security Project and a Senior Research Fellow with the Thomas A. Roe Institute for Economic Policy Studies at the Heritage Foundation.

The authors thank many individuals for helpful comments and Spencer Walters for outstanding research assistance.

Mission Statement

The Retirement Security Project is dedicated to promoting common sense solutions to improve the retirement income prospects of millions of American workers.

The goal of The Retirement Security Project is to work on a nonpartisan basis to make it easier and increase incentives for middle- and lower-income Americans to save for a financially secure retirement.

1775 Massachusetts Ave., NW
Washington, DC 20036
p: 202.741.6524 f: 202.741.6515
www.retirementsecurityproject.org

RSP