The Retirement Security Project

Pursuing Universal Retirement Security Through Automatic IRAs

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RSP

Common sense reforms, real world results

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Introduction

Roughly half of all working Americans work for employers that offer no retirement plan. Thus about 78 million workers have no way to save on the job for the day when they stop collecting a paycheck. This circumstance, combined with a national saving rate that has been declining steadily for most of the past twenty years and the unlikelihood that Social Security will be able to provide increased benefits, makes inadequate retirement saving a major national problem.

This paper spells out an ambitious yet practical set of initiatives to expand retirement saving dramatically. We propose making saving automatic—and hence easier, more convenient, and more likely. This strategy has been shown to be remarkably effective at boosting participation in workplace-based 401(k) retirement savings. We would extend this strategy to most employees who have no access to 401(k) plans by combining several key elements of our current system: payroll-deposit saving; automatic enrollment; low-cost, diversified default investments; and individual retirement accounts (IRAs).

Automatic IRAs would not crowd out or compete with 401(k) plans. To the contrary, we would hope that successful experience with the new, automatic IRAs would lead more employers to step up to 401(k)s and then to match employee contributions—if not dollar for dollar, then perhaps fifty cents on the dollar or some other ratio. *Automatic* would be the operative word for the new IRAs. Once all the automatic processes described in this and other RSP publications have been developed and implemented, every step in the process, from saving for retirement to withdrawing the savings upon retirement, would occur automatically unless the individual employee or employer stepped in and affirmatively chose a different course.

How People Would Save

The automatic IRA approach, which was touted by President Barack Obama in his first address to a joint session of Congress, has been included in the president's proposed budget and has been endorsed by such diverse publications as the *New York Times* and the *National Review*.[1] It 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 (at least ten employees, for example) that had been in business for at least two years and did not sponsor any plan for their employees would allow employees to use their payroll system to channel their own money to an IRA.

—Employers would retain the option at all times of setting up a 401(k), a SIMPLE IRA, or other retirement plan instead of a payroll-deposit IRA. Those retirement plans offer employer contributions, much higher employee contributions, and larger tax credits for employers.

"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)

—These employers, as well as smaller or newer firms that voluntarily offered payroll deposit as a conduit for employee contributions, would receive a small, temporary tax credit based on the number of employees who participated.

—For most employees, payroll deductions would be made by direct deposit, similar to the common practice of depositing paychecks directly into employees' bank accounts.

—The arrangement would be market-oriented, with IRAs provided by the same private financial institutions that currently provide them.

—Each employer would send all deposits to a single IRA provider of its choice.

—As a fallback, individuals and employers that could not find an acceptable IRA on the market could use ready-made, low-cost, automatic IRA accounts through an online clearinghouse that connected employers with financial providers serving as IRA trustees or custodians. If that did not work, an IRA of last resort would be made available by a financial services industry consortium or nonprofit risk pooling arrangement, with investment management contracted out to the financial services industry.

—Enrollment would be automatic; employees would save a proportion of their pay in an IRA unless they affirmatively chose to opt 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. Automatic enrollment would thus harness the power of inertia to increase saving in sensible default investments.

Any employee declining to contribute would need to sign a waiver. If possible, the election form would be added or attached to IRS Form W-4, which new employees complete to make elections regarding payroll tax withholding. Evidence from the 401(k) universe strongly suggests that high levels of participation tend to result not only from automatic enrollment but also from the practice of requiring each eligible employee to decide explicitly whether to participate.

A national website would give firms a standard notice for informing employees of the payroll-deduction IRA option. It would include standard employee election forms and enrollment procedures. The website would also promote best practices as they evolve (about automatic enrollment, for example, and, potentially, automatic annuitization) and employee education regarding saving and investment. Finally, for employers that cannot find an acceptable IRA provider in their area, the website would connect them with interested IRA providers.

Employers that offer automatic payroll deposit 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 designated by employees or their employer, workers' contributions would automatically be directed to a diversified investment (such as a life-cycle fund) unless the employees chose a principal-preservation investment alternative or a different option. Initially, however, when accounts were very small, the automatic investment might be designed with a view to simplicity and to avoiding short-term losses (for example, using Treasury securities or special retirement bonds). Payroll deduction contributions would be transferred, at the employer's option:

—To IRA providers designated by the employer;

—To IRAs designated by employees (if the employer allowed employees to choose their own provider in addition to the provider that the employer had selected); or

—To a fallback collective retirement account if the employer or employee failed to designate a provider.

The proposal is designed to minimize the employer's administrative functions and should involve little if any out-of-pocket employer cost. Many firms already offer their workers direct deposit of paychecks. Many use automatic or electronic payroll arrangements (some of which are web-based) or payroll software, or they outsource to a payroll service provider. Virtually all make payroll deposits to comply with income tax withholding (federal and state) and withholding for such things as Social Security, Medicare, and unemployment insurance. 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 sponsor a plan; make any matching or other employer contributions; comply with federal plan qualification or retirement insurance security requirements; select investments for employees; set up IRAs or other accounts for employees; or 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 could have the option of piggybacking the payroll deposits to IRAs onto the federal tax deposits they currently make online, by mail, or by delivery to the local bank.

The self-employed and other workers without employers would be encouraged to contribute to IRAs by automatic debit. Professional and trade associations could arrange the automatic debit and the IRAs themselves. The self-employed could also send deposits to IRAs in conjunction 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 to an IRA in the same way as employees.

Automatic IRAs would be 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.

—The maximum permitted annual contribution to IRAs (currently $5,000 with an additional $1,000 for those age 50 or older) exceeds employees' average 401(k) contribution but is not enough to satisfy the appetite for tax-favored saving of business owners or decision makers. They would still have an incentive to adopt a SIMPLE plan, which allows tax-favored employee contributions of up to $11,500, or a 401(k), whose limit is $16,500. Together with employer contributions, which are allowed in the 401(k) and required in the SIMPLE, total contributions to a 401(k) can reach $49,000 (and $5,500 higher for employees 50 or older).

—The automatic IRA tax credit would be smaller than the tax credit small employers receive when adopting new retirement plans.

—To encourage employer retirement plans, firms would not be asked (or allowed) to contribute to automatic IRAs. Employers interested in contributing for their employees or saving more for themselves would have to adopt 401(k)s or other plans.

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

Within either the online clearinghouse that links employers with IRA providers or, if necessary a 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 or other similarly low-cost investment funds, economies of scale, and maximum use of electronic technologies. The Thrift Savings Plan for federal government employees would serve as a model for some aspects of the proposal. 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).

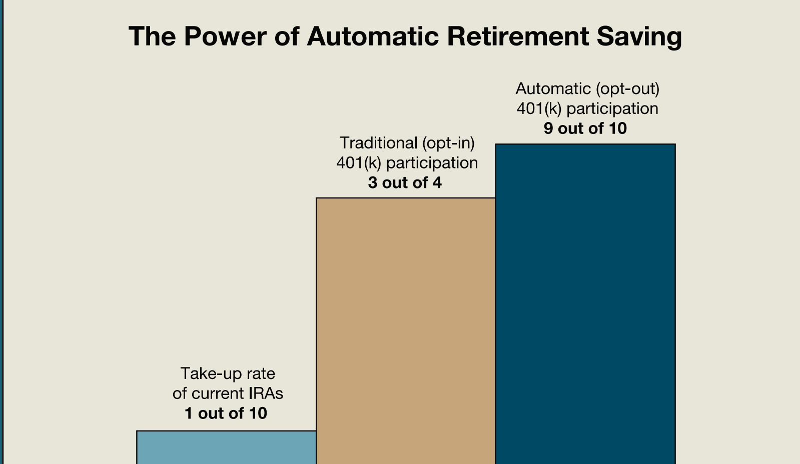
In addition, a powerful financial incentive for individuals to contribute might be provided by matching deposits to their IRAs. Employers could offer no such match, but the private financial institutions that maintain the accounts could deliver matching contributions and be reimbursed through federal tax credits. Alternatively, the Saver's Credit for voluntary contributions might be expanded to provide a match. Matching deposits are not, however, part of the basic automatic IRA proposal.

Saving Up Is Hard to Do

Many American families, especially those with lower or middle incomes, find it hard to save, especially for retirement or other long-term needs. In 2004 half of all households headed by people aged 55 to 59 had $13,000 or less in employer-based 401(k)-type plans or tax-preferred saving plans.[2] The personal saving rate in the United States has declined steadily over the last two decades and in recent years has hovered around zero.[3] Moreover, traditional corporate defined-benefit pension plans are becoming rarer, and few expect Social Security to provide increased benefits in the future.

In general, those who tend to be in the best financial position to confront retirement are the 41 percent of the workforce that participate in employer-sponsored retirement plans.[4] About seven or eight of every ten workers who are eligible participate in employer-sponsored 401(k) plans, while the corresponding take-up rate for IRAs (which typically have no connection to the workplace or payroll

The Power of Automatic Retirement Saving



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.

Madrian, Brigitte, and Dennis, Shea. 2001. "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior." Quarterly Journal of Economics 116(4):1149-87. And EBRI Notes, "401(k)-Type Plans and Individual Retirement Accounts (IRAs),"

system) tends to be less than one in ten. Moreover, an increasing share of 401(k) plans include automatic features that, by applying to all workers except those who explicitly choose an alternative, make saving easier and raise participation to rates often exceeding nine in ten (figure 4-1).

Yet among 155 million working Americans, some 78 million—about half—work for an employer that does not offer a 401(k) or any other type of employer-sponsored plan. Another 16 million fail to participate in or are not eligible for their employer's plan. Among the approximately 94 million full-time, full-year wage and salary workers aged 21 to 64, 63 percent work for an employer that sponsors a plan, and 55 percent participate.[5]

These facts reveal a major gap between our public policy goals relating to retirement security and the market's ability to meet those goals. 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. Many people find it difficult to plan for retirement and to defer consumption. For many if not most, the necessary financial sophistication and self-discipline do not come naturally or easily. Many people do not exercise the initiative required 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 that lead employees toward 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") unless the employee takes the initiative to stop or modify them. Starting in 1998, the U.S. Treasury Department and the Internal Revenue Service (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.[6] Over time, the 401(k) market has responded by moving to automatic enrollment, automatic investment choices, and related automatic features. In 2006 Congress added its voice to this process by eliminating or reducing several barriers to the adoption of automatic 401(k) features.[7]

Although workplace saving through employer contributions or regular payroll deposits tends to be the most effective vehicle for building retirement savings, a majority of small employers do not offer a retirement plan. Many of them, unaware of the low-cost, simplified 401(k) and SIMPLE IRA plan options now available (often online), mistakenly perceive plan sponsorship as a complex and costly undertaking. [8] 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 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 adopt and maintain an automatic IRA for their employees by using the spare 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 $5,000 a year, the general 2009 IRA limit. Some will be interested in exploring how they could make a very modest matching contribution for their employees, at least in years when 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 to induce employers to graduate to a 401(k) or SIMPLE plan. Even when firms did not choose to sponsor 401(k)-type plans, however, the automatic IRA proposed here would apply the key lessons learned from 401(k) plans so that more workers could enjoy automated saving to build assets, without imposing any significant burden on employers.[9] Employers could help their employees save simply by transferring a portion of their pay to an IRA, preferably by direct deposit, at little or no cost.

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. Many small workforces have lower-wage employees with less ability or desire to contribute, and it can be 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 lower costs through economies of scale, standardization, and elimination of most sales and marketing expenses. Once accounts had grown sufficiently, they could be automatically reinvested or could be rolled over, substantially increasing the financial industry's assets under management.[10]

The Proposed Solution

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 have their 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.

Payroll 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.[11] Both the IRS and the Labor Department 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."[12] This guidance has made clear that employers can offer direct-deposit IRAs without having the arrangement treated as employer sponsorship of a retirement plan, which would subject it to federal Employee Retirement Income Security Act (ERISA) or qualified-plan requirements.[13] 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, payroll-deposit IRAs have simply not caught on widely among employers and offer little opportunity for employees to save.

Our Proposal from the Employer's Perspective

Our strategy is designed to induce employers to offer, and employees to take up, direct-deposit or payroll-deduction saving. To the fullest extent possible, the arrangement would be structured to avoid imposing costs and responsibilities on employers.

Under our proposal, firms that do not offer employees a qualified retirement plan, such as a defined-benefit pension, profit-sharing, or 401(k) plan, would receive a temporary tax credit if they let their employees use their payroll system to make payroll-deduction contributions to IRAs. For the larger and more established small businesses that would be required to offer employees this opportunity, the tax credit would represent a small recognition that the employer is being asked to institute a new procedure, albeit one that involves little if any out-of-pocket cost.

To help firms meet those costs, the tax credit would be available for the first two years that its payroll-deposit saving program was in operation. 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 such as a 401(k) or other qualified plan or a SIMPLE IRA. Under current law, an employer with 100 or fewer employees can generally claim a tax credit of half the cost of establishing and administering a new retirement plan (including educating employees about the plan) up to $500 a year for each of the first three years of the plan.

The automatic IRA tax credit could be set, for example, at $25 per employee enrolled, and it could be capped at $250 a year for its two years of availability. That would make it meaningful only to very small businesses. The larger credit for establishing a new employer plan would still favor 401(k) and SIMPLE plans over automatic IRAs.

Employers could not claim both the 401(k) plan startup credit and the proposed automatic IRA credit; otherwise, some employers might exclude some employees from a new 401(k) plan to earn an additional credit for providing them with an automatic IRA. Employers also would be ineligible for the automatic IRA credit if they had sponsored a retirement plan during the preceding three years for substantially the same group of employees. Employers that sponsor a retirement plan for their employees would generally be unaffected by the automatic IRA provision. But an employer offered the retirement plan only to employees in a particular subsidiary or division or other business classification would be required to make an automatic IRA available to the others (except for employees who may be exempted under qualified plan coverage standards, specifically employees under age 18, those represented by unions, Employer-sponsored retirement plans are the saving vehicles of choice and should be encouraged; payroll-deposit IRAs are a fallback designed for employees not fortunate enough to be covered by an actual employer retirement plan.

nonresident aliens, and those who work only a few hours a week or have not completed a year of service).

Thus the arrangement would be structured 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.

For example, assume that Joe employs ten people in his auto body shop and does not sponsor a retirement plan for his employees. If he chooses to adopt a 401(k) or SIMPLE IRA plan, he and each of his employees generally can contribute up to $16,500 for a 401(k) or $11,500 for a SIMPLE each year, and the business might be required to make employer contributions. Joe can claim a start-up tax credit of half of his costs over three years, up to $500 a year. Alternatively, if Joe decides only to offer his employees payroll deposits 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 contributes out of his own salary (in this case up to the maximum automatic IRA tax credit of $250 a year).

For many if not most employers, offering payroll-deposit IRAs would involve little or no cost. Unlike a 401(k) or other employer-sponsored retirement plans, the employer would not be maintaining a plan but simply acting as a forwarding agent for employee contributions. Employer contributions to payroll-deposit IRAs would not be required or even permitted. Employers willing to make retirement contributions for their employees would continue to be able to do so by sponsoring a retirement plan, such as an SIMPLE IRA, 401(k), or pension plan.

Employer-sponsored retirement plans are the saving vehicles of choice and should be encouraged; payroll-deposit IRAs are a fallback designed for employees not fortunate enough to be covered by an actual employer retirement plan. They are also intended to encourage more employers to decide, whether immediately or eventually, to sponsor a plan of their own.

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 (because the IRAs would receive the contributions)

—Determine whether employees were eligible to contribute to IRAs

—Select investments for employee contributions;

—Select among IRA providers

—Set up IRAs for employees

Employers would be required simply to allow employees to make payroll-deduction deposits to an IRA, with a standard notice informing employees of the automatic IRA saving option and a standard form eliciting the employee's decision to participate or opt out. Employers would then implement deposits elected by employees. Employers would remit the direct deposits to their IRA providers on the schedule they were already following for federal payroll and withholding tax deposits—usually biweekly or monthly.

Thus a requirement to offer to forward employee contributions to an IRA by payroll deduction would not be onerous but would dovetail neatly with what employers already do. The employee's payroll-deposit IRA election might be made on an attachment or addendum to the federal income tax withholding form. Because employees' salary reduction contributions to IRAs would ordinarily receive tax-favored treatment, the employer would report on Form W-2, the federal salary and wage reporting form, the reduced amount of the employee's taxable wages together with the amount of the employee's contribution.)

Direct Deposit

Our proposal seeks 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 systems to manage payroll. Many employers hire a payroll service provider to perform these functions, including direct deposit of paychecks to accounts designated by employees or contractors. Some keep their payroll-tax and related functions in house but use readily available software or largely paperless online means of making federal tax deposits and perhaps other funds transfers, just as increasing numbers of households pay bills and manage other financial transactions online.

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 and reporting forms 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 online 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.

For employers that do not use automatic payroll processing, we contemplate a three-pronged strategy. First, a large proportion of the employers that still process their payroll by hand would be exempted as very small employers. Our proposal would focus on employers that already offer their employees direct deposit of paychecks but have not used that technology to provide employees a convenient way to save for retirement.

Second, employers would have the option of piggybacking their payroll deposits to IRAs onto their federal tax deposits. The process, including timing and logistics, for both sets of deposits would be the same. Accompanying the existing federal tax deposit forms would be similar payroll deposit savings forms enabling employers to send all payroll deposit savings to a single

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.

destination. Small employers that mail or deliver their federal tax deposit checks and forms to the local bank would add another check and form to the same mailing.

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

The cost to employers making payroll deduction savings available to their employees would be minimal. Employers would not be required to make contributions or to comply with plan qualification or federal requirements with respect to these arrangements. Implementing employee decisions to participate or to opt out might occasionally require employers to address mistakes or misunderstandings regarding payroll deductions and deposit directions. The time and attention required of employers 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.

The requirement to offer payroll deposits to IRAs as a substitute for sponsoring a retirement plan would not apply to the smallest firms (say, those with fewer than ten employees) or to firms that have not been in business for at least two years. However, even exempt firms would be encouraged to participate. A possible alternate approach to implementation of this program would be to require payroll deposit for the first year or two only by employers above a slightly larger size. This tryout of the new system could identify improvements before broader implementation began.

Employees who do not work for an employer that offers a payroll-deposit system would be able to use other mechanisms to facilitate saving. These include instructing the IRS to deposit a portion of an income tax refund into an IRA, setting up an automatic debit arrangement for IRA contributions from employees' bank accounts (perhaps with the help of a professional or trade association), and making IRA contributions together with quarterly estimated tax payments.

The Proposal from the Employee's Perspective

In the case of an employer that does not sponsor a retirement plan, 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), which would exclude the highest-turnover employees and seasonal workers, As noted, if an employer sponsored 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).

Like a 401(k) contribution, the amount elected by the employee as a salary reduction contribution generally would be tax favored. If channeled to a traditional IRA, the contribution would be excluded from taxable income when it was made, but it—and whatever earnings it generated—would be taxed upon withdrawal from the IRA. A Roth IRA is quite different. Funds deposited into a Roth IRA are taxed, but withdrawals—those representing earnings that meet certain conditions as well as deposits—are entirely tax free. The statute authorizing automatic IRAs could specify which type of IRA was the default. (Employees who did not qualify to make a deductible IRA contribution or a Roth IRA contribution (for example, because their income exceeded eligibility thresholds) would be responsible for making the appropriate adjustment on their tax return. The firm would have no responsibility for ensuring that employees satisfied the applicable IRA eligibility requirements or contribution limits.)

The choice between a traditional and a Roth IRA is another decision that can impede participation. For many individuals, making this choice based on an informed and rational analysis would not be easy. In the interest of sparing households the need to make the decision, we strongly believe that one or the other type of IRA should be automatically prescribed (with, perhaps, the choice to opt for the other). Many households would simply go along with the standard option, while others would try to figure out the better alternative for them.

A reasonable case can also be made for simply prescribing one or the other type of IRA as the only available receptacle for contributions to automatic IRAs. We are tentatively inclined to make the Roth IRA the presumptive choice for automatic IRA deposits, because the Roth may be more beneficial for lower-income and moderate-income workers who lack sufficient taxable income to take full advantage of the traditional IRA tax deduction at the time of contribution but who may expect to be in higher tax brackets late in their careers. In addition, the Roth is often thought to be preferable by those who expect high federal budget deficits to eventually drive up future tax rates. 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.

A number of other factors may militate in favor of defaulting to the Roth. First, for many, it comes as an unpleasant surprise that the account balance they have accumulated for decades in a deductible IRA or a traditional deductible 401(k) is worth far less than expected because it cannot be drawn upon without losing a substantial portion to taxation. The Roth generally avoids this unpleasant surprise, permitting the individual to plan for retirement without having to adjust projected or actual savings for an uncertain future tax bite.

Second, the Roth IRA, by producing less taxable income in retirement years, could avoid exposing some individuals to a higher rate of income tax on Social Security benefits in retirement. Third, while it is hoped that few participants would choose to withdraw funds from their IRAs before they reach or approach retirement age, those who do withdraw from a deductible IRA not long after contributing generally will be subject to both income tax and a 10-percent early withdrawal penalty on the entire amount withdrawn. In contrast, withdrawals from a Roth IRA within a few years after contributions are made will not be subject to income tax or the 10-percent penalty on the withdrawal except to the extent that it consists of earnings (which are likely to comprise a relatively small portion of the account of those who withdraw relatively soon).

Finally, the fact that all but very high-income employees are eligible to contribute to a Roth IRA may make the automatic IRA program somewhat simpler to administer because virtually all of the target population would be eligible. Individuals saving in a deductible IRA may need to be mindful of their possible eligibility for a qualified plan in another, concurrent job or of their spouse's eligibility. Some may be ineligible to make deductible contributions but permitted to make nondeductible contributions to a traditional IRA, which could be viewed as an advantage or as a drawback because of the additional layer of complexity it entails.

Automatic IRAs in Congress:

Hearings: The Automatic IRA proposal was featured at a hearing of the House Subcommittee on Select Revenue Measures held on June 26, 2008, concerning strategies for expanding pension *coverage. See J. Mark Iwry and David C. John, "Pursuing Universal Retirement Security Through Automatic IRAs," Testimony before Select Revenue Measures Subcommittee of the Committee on Ways and Means, United States House of Representatives (June 26, 2008) 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

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 answer at least five key and often thorny questions:

—Should they participate at all?

—At which financial institution should they open an IRA (or, if they have an IRA already, should they add to it or open a new one)?

—Should the IRA be a traditional or a Roth?

—How much should they contribute?

—How should they invest their IRA money?

Once these decisions have been made, the individual must still take the initiative to fill out the requisite paperwork to participate. Even in 401(k) plans, millions of employees are deterred from participating because inertia prevents them from making these important financial decisions or from getting around to enrolling.

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. The employer or other 401(k) plan sponsor sets up an account in the plan for each participating employee, making a savings vehicle ready to receive regular payroll deductions from the employee. Once the employee has elected to participate, deposits continue to occur automatically and regularly, without the need for any action by the employee. To get the ball rolling, an increasing percentage of 401(k) plan sponsors are using automatic enrollment.[14]

Automatic enrollment, which typically has been applied only to newly hired employees, rather than to all nonparticipating employees, has produced dramatic increases in 401(k) participation, especially by lower-income and minority workers.[15] In view of the basic similarities between employee payroll-deduction saving in a 401(k) and a direct-deposit IRA arrangement, federal law should, at a minimum, explicitly permit employers to automatically enroll employees in direct-deposit IRAs.[16]

The conditions imposed by the Treasury Department on 401(k) automatic enrollment would apply to payroll-deposit IRA automatic enrollment as well: all employees who could potentially be automatically enrolled must receive advance written notice (and annual notice) regarding the terms and conditions of the saving opportunity and the 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 automatic enrollment with payroll deposit IRAs would prove effective. A key motivation for using it in 401(k) plans is to improve the plan's performance under the 401(k) nondiscrimination test by encouraging moderate- and lower-paid ("non-highly 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 employer self-interest is absent from payroll-deposit IRAs, which lack nondiscrimination standards.

Similarly, the absence of such standards in payroll-deposit IRAs gives the employer less incentive than a 401(k) sponsor to provide automatic increases in the initial contribution rate. 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 of salary in the first year, 5 percent in the second, and so forth, or in coordination with future pay raises.[17]

A second major motivation for using 401(k)-style automatic enrollment in many companies is management's sense of responsibility or concern for employees' 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." Closely allied to this motivation is the employer's interest in recruiting and retaining valuable employees.

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. These include many smaller employers that may not feel that encouraging employees to save is their role. Some may offer health insurance, and both employees and employer might regard contributions to employees' share of health premiums as a higher-priority use for employees' limited resources than retirement saving contributions, especially in view of the rising cost of health insurance.

Third, in the case of payroll-deposit IRAs, employers might have greater concern about potential employee reaction to automatic enrollment because there is no employer matching contribution. With 401(k) plans, the employer match gives the appearance of a high rate of return on the employees' investment. That gives confidence to 401(k) sponsors that automatic enrollment does 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 would not increase the employer's matching costs. In addition our proposal provides that the amount of the two-year tax credit for employers using automatic IRAs would rise with the number of employees participating.

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

A good case can be made for requiring, rather then merely allowing, employers to use automatic enrollment and automatic contribution increases for their direct-deposit IRAs. Automatic enrollment would probably increase participation sharply while leaving employees the option to decline enrollment. But employers that do not offer a qualified plan or a match are unlikely to use automatic enrollment voluntarily.

The arguments against such a requirement include the concern that a workforce whose demand for a qualified retirement plan was too weak to get 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 every day might regard automatic enrollment as unnecessary because of the constant flow of communication between owner and employees.

It is noteworthy, however, that public opinion polling shows strong support among registered voters for making saving automatic: 71 percent of respondents favored automatic enrollment, investment, and contribution increases, with the opportunity to opt out at any stage.[18] A vast majority (85 percent) said that if they were automatically enrolled in a 401(k), they would not opt out. And 59 percent preferred a workplace IRA with automatic enrollment to one without.

Auto Enrollment or Required Response. Short of automatic enrollment in an IRA, employees could be required to explicitly accept or decline enrollment in an IRA. With 401(k) plans, evidence suggests that this approach can raise participation nearly as much as automatic enrollment does. Requiring an explicit choice picks up many who would otherwise fail to participate because they did not complete and return the enrollment form either because they could not decide on contribution levels or investments or because they just did not get around to it.

Accordingly, a possible strategy for increasing participation in payroll-deposit IRAs would be to generally require employers to obtain written or electronic notification from each eligible employee—an explicit up-or-down election—either accepting or declining the direct deposit to an IRA. Employers that chose to enroll their employees in the direct deposit IRAs automatically would be excused from the requirement 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 the 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. After all, it carries out what is arguably the primary function of automatic enrollment: ensuring that mere inertia, procrastination, or indecision does 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 an automatic 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 automatic enrollment as an alternative means of satisfying its required-response obligation—would add an incentive for employers to use automatic enrollment without requiring them to use it. Any firms that preferred not to use automatic enrollment would simply obtain a completed election form from each employee. And under either approach, participation would likely increase significantly, perhaps even approaching the level that might be achieved if automatic 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. An employer that automatically enrolled new hires would be exempted from obtaining completed elections from all new hires but not from existing employees. An employer that automatically enrolled both new hires and existing employees would be excused from having to obtain elections from both groups.

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

After some period of time, however, 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 did not submit elections would 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 website would provide firms with standard employee notice and election forms as well as standard enrollment procedures. The website and the fallback automatic IRA platform would promote employee education and best practices as they evolved, such as automatic enrollment and, potentially, automatic annuitization. Especially with the decline of traditional defined benefit pension plans, the need is increasing 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 to present auto enrollment as the presumptive or perhaps even the default enrollment method, although employers would be able to opt out easily 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, automatically enrolling employers into automatically enrolling employees.

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

Second, as noted above, employers using automatic enrollment to promote participation would not need to obtain responses from unresponsive employees, and the ultimate outcome for an employee who 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 elections by employees would help solve an additional problem: enforcing compliance with the 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 might believe that, if asked by the IRS why none of its employees used direct-deposit IRAs, they could respond that their employees were told about the option but were not interested. However, if employers had to obtain a signed election from each eligible employee who declined the payroll-deposit option, 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 the IRS tax-withholding form that new hires must complete. If the employer chose to use automatic 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 W-2 forms to the government. Failure to offer payroll-deposit savings would, if necessary, trigger an excise tax on the employer for each employee affected by the violation. This sanction would be less than the one employers face if they violate the federal requirement (known as COBRA) to offer certain employees who lose their health benefits to continue their coverage, and would be subject to exceptions and opportunities for mitigation and relief that are generally based on the corresponding COBRA exceptions.

In addition, employees would be protected from an employer's failure to remit employee payroll-deduction contributions by a compliance and enforcement regime substantially similar to the one that applies to an employer's failure to remit payroll tax deductions.

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 of 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.

How They Would Invest

Most current direct deposit arrangements use a payroll-deduction savings mechanism similar to the 401(k); unlike the 401(k), however, the employee does not have 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 some 3 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 could simplify its task by remitting all employee contributions in the first instance to IRAs at a single private financial institution that the employer designates.[19] 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 401(k) and other 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 involuntary cash-outs of account balances between $1,000 and $5,000.[20] 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 to attract additional contributions. Accordingly, significant segments of the IRA provider industry have not been eager to cater to this segment of the market.

Automatic IRAs differ importantly from automatic-rollover IRAs, however. Even if they start small, they are likely to experience continuing growth. In contrast to automatic-rollover IRAs, whose owners have failed to respond to the plan sponsor's notices, 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 receptacle 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 relatively small personal retirement accounts with a likelihood of relatively meager growth suggests that the market might need to be encouraged to develop widely available, low-cost IRAs. Otherwise, for small savers, fixed-cost investment management and administrative fees might consume an unacceptably large share of earnings and even erode principal.[21]

We believe that a strong case can be made for a standard IRA that would be automatically available to receive direct-deposit contributions after either the employee or the employer had a chance to choose among IRA providers. We recognize, however, that some geographic areas or small business segments may be underserved by locally available IRA providers. For that reason, we propose that one of two national platforms be made available to any small business that has trouble finding an acceptable IRA.

The first and preferable approach would be the creation of at least one national website that could match employers with IRA providers interested in their business. Employers that went to the site would enter in basic information about their company and its workforce, and the site would connect the firm to providers willing to provide IRAs to the firm's employees. Ideally, the site would then allow the employer to set up accounts and a method to transfer IRA contributions from its employees to their auto IRAs.

However, if it proved impossible to find IRA providers interested in serving all small employers that are required to offer auto IRAs to their employees, then (and only then) the contributions would go to standard IRAs in a platform 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.

Although this arrangement resembles the federal Thrift Savings Plan (the 401(k)-type retirement savings plan for federal government employees) in certain respects, a standard account to receive direct deposits that have not been directed elsewhere by employers or employees 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 (say, $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 own choosing.

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 possible to realize substantial cost savings through economies of scale in asset management and administration, uniformity, electronic technologies, and investments in index funds or other low-cost funds.

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 and possibly more limited). It 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.[22]

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

—Limiting the investment menu under the IRA to a standard default investment and only two or three alternatives

—Allowing individuals to change their investments only once or twice a year

—Specifying a low-cost automatic investment option and providing that, if any of an individual's account balance is invested in that option, all of it must be

—Prohibiting loans from the employee account (IRAs do not allow them in any event)

—Limiting, perhaps, pre-retirement withdrawals

—Limiting access to customer service call centers

—Contemplating moderate fees instead of large commissions

—Making compliance testing unnecessary

—Giving account owners only a single account statement a year (especially if daily valuation is built into the system and such valuation reports are available through some other means to account owners)

—Encouraging the use of online, electronic, and other new technologies for enrollment, fund transfers, record-keeping, and communications among IRA providers, participating employees, and employers. 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.[23]

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 Labor Department 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, Treasury bonds, and certain other relatively low-risk, low-return investments that generally do not require active management. However, it appears that limiting individual accounts to these types of investments, at least over the long term, would be unnecessarily restrictive. As discussed below, passively managed index funds such as those used in the Thrift Savings Plan are also relatively inexpensive.[24]

A very different approach to cost containment would be to impose a statutory or regulatory limit on investment management and administrative fees. One example is the United Kingdom's limit on permissible charges for management of "stakeholder pension" accounts—an annual fee cap of 150 basis points for five years that is scheduled to drop to 100 basis points thereafter.[25] Another example is the limit the U.S. Labor Department has imposed 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. These labor regulations provide a fiduciary safe harbor for these IRAs that preserves principal and that does not charge fees greater than those charged by the IRA provider for its other IRAs.

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. The U.K. cost cap is widely considered to be a major reason for the failure of stakeholder pensions to attract support from financial firms. It could have a similar impact in the United States. We would view a mandatory limit as a last resort, preferring the market-based strategies outlined above.

Automatic Investment Fund Choice

Automatic 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. The standard automatic investment would serve several key purposes. First, 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—how to invest. Second, 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. The advisability of such an approach has become more evident in view of the nearly unprecedented fall in equity values and worldwide recession in 2008–09, which has sparked fresh differences of opinion concerning the prospects for realizing an "equity premium" over medium- and longer-term time horizons and the extent to which it may be advisable to invest retirement funds in diversified equities or in investments that emphasize minimization of risk. Whatever one's views on the merits of these issues, the fact that many 401(k) and IRA participants have seen a decade worth of gains evaporate during the past year has made many U.S. households far more risk averse than they were before the recession, leading to a general loss of confidence. At least for some time to come, many may be reluctant to contribute to an automatic IRA arrangement that does not guarantee a return of principal. Accordingly, general statutory guidelines would be fleshed out at the administrative level after regular comment by and consultation with private-sector investment experts.[26]

At least initially, we contemplate that this automatic investment choice would be a highly diversified "target asset allocation" or life-cycle fund comprising a mix of equities and fixed-income or stable-value investments and probably relying heavily on index funds or other low-cost alternatives. (The life-cycle funds that are offered by the federal Thrift Savings Plan are one possible model.) A portion or all of the fixed-income component could consist of Treasury inflation-protected securities (TIPS) to protect against the risk of loss and inflation.

The mix of diversified equities and fixed income would be designed to reflect a degree of consensus among personal investment advisers for sound asset allocation and diversification of investments, including exposure to equities and perhaps other assets that have higher risk and greater potential return. This strategy recognizes the foundation of retirement income already provided by Social Security and would apply to IRAs that will not shortly be needed for expenses. The use of index funds would be one way to avoid the costs of active investment management while promoting wide diversification.[27]

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 switch at specified times to a different investment option among those offered within the IRA.

A variation on the automatic investment fund may be worth considering. A temporary guarantee of principal—as might be provided by a bond similar to a Treasury savings bond or TIPS—might ease some households, especially those that have no investment experience, into the process of saving and investing. Behavioral research has produced evidence that many smaller savers—the 2008–09 market downturn aside—are particularly averse to losses of principal and weigh the risk of loss far more heavily than the prospect of gain.

On the other hand, a "safe" investment, with no risk of loss but no significant potential for growth over time, raises concerns about the adequacy of the likely long-term accumulation. Some evidence suggests that favorable investment returns over the long term are attributable not so much to successful selection of individual stocks or other investments but 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.[28] Accordingly, we contemplate that the automatic investment could take the form of a balanced "asset-allocated" fund either from the start or after a limited transition period, while giving risk-averse individuals the ability to choose a principal-preserving investment as an alternative.

Another intriguing possibility might be to offer a variation on the life-cycle fund that guarantees that the investor will not lose money on a nominal or even a partly inflation-adjusted basis. This variation would be intended to help induce participation by those who are risk-averse but still hope for growth. The key question would be the extent of the limitation on the upside potential of the investment that would be required by a guarantee of principal.

Yet another possibility worth exploring would be the inclusion of some form of annuity purchase as part of the life-cycle fund, perhaps as a replacement for the bond component. This option would allow savers to ensure that their accounts could provide some level of guaranteed lifetime income, thus helping to address longevity and investment risks, regardless of the rises and falls of the stock market and of interest rates. Because balances in automatic IRA are likely to be smaller on average than balances in 401(k) plans, annuity purchases might have to be phased in as the account grew, or perhaps balances could be transferred at regular intervals from the bond component into an annuity. Other technical and policy questions, such as portability of such annuities, would need to be examined before such an approach could be fully recommended.[29]

Certain IRA savers will have lower-than-average earnings and thus fairly low balances in their accounts. These accounts will be both less attractive to IRA providers and more likely to be seriously eroded by administrative fees. A potential strategy for handling these low balances would be to place them in a short-term transitional guaranteed investment, such as a government bond or a bank certificate of deposit (CD), until balances reached a specified level, at which point they would be automatically transferred into the standard automatic investment option.

The transition account could be either a standard bank savings or short-term CD account, or it could begin as a principal-preservation fund in much the same way that the federal Thrift Savings Plan began with the G (government securities) Fund.[30] In either case, the account would include the same early withdrawal disincentives as any other IRA account. When the account balance reached a specified level, it would be automatically rolled over into the standard automatic investment option, with all future contributions going directly into that standard option.

Other Investment Options

An additional, 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, allowing the IRA provider to offer 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) or revert to relatively arbitrary decision rules.[31] 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 trade-off would be to limit the prescribed array of investment options to the "backstop" automatic IRAs, in which individuals would invest when neither the employee nor the employer had affirmatively elected another IRA. While all automatic 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 "backstop" automatic IRAs. Alternatively, all automatic 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 were willing to accept such transfers (but perhaps only after the account balance reached a specified amount deemed sufficient to overcome profitability concerns for most IRA providers). While a system that permitted transfers 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 leave individuals free not to make such a transfer and instead to retain the efficiencies and cost protection associated with the standard low-cost model.[32]

Protecting Employers

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 for the manner in which direct deposits are invested in automatic IRAs, regardless of whether the IRA provider is 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 employer protection would be facilitated by regulatory designation of standard investment types, an approach that would reduce the need for continuous professional investment advice.

ERISA protects plan fiduciaries from liability for losses that result directly from employees' investment choices. Labor Department regulations, in accordance with the 2006 Pension Protection Act, extended this protection from fiduciary liability under ERISA to certain types of employer-chosen investments that employees select by default, without making an affirmative election. Regulatory designation of a life-cycle or balanced fund as the default investment for automatic IRAs would be consistent with these ERISA fiduciary

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

Among workers surveyed in 2007 who would be eligible for an automatic IRA, 86 percent said that it would be a useful way to save, and 83 percent found the proposal easy to understand.[33]

regulations, which extend this type of fiduciary protection to default life-cycle funds, balanced funds and professionally managed accounts. The regulatory approach to the design of the automatic-IRA default investment could reflect any modifications to these 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 either by allowing each employee to designate a preferred provider or by specifying the government-contracted default automatic IRA. An employer that 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 has shown overwhelming support for payroll-deduction, direct-deposit saving. Among workers surveyed in 2007 who would be eligible for an automatic IRA, 86 percent said that it would be a useful way to save, and 83 percent found the proposal easy to understand.[33]

Another poll shows very strong support for a requirement 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).[34]

Protecting Employer Plans. Employer-sponsored pension, profit-sharing, 401(k), and other plans tend to be far more effective than IRAs in accumulating benefits for employees. For one thing, pension and profit-sharing plans, for example, are funded by employer contributions that are made automatically for the benefit of eligible employees without requiring the employees to take any initiative to participate. For another, essentially all tax-qualified employer plans must abide by standards that either seek to require reasonably proportionate coverage of rank-and-file workers and management 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 in the lower brackets.

Employer-sponsored retirement plans also have other features that tend to make them effective in providing or promoting coverage. And our proposal seeks to transplant some of these features to the IRA universe. These include the automatic availability of a saving vehicle, the use of payroll deductions, matching contributions (which could be provided by the saver's credit, especially if expanded as proposed elsewhere), 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. Business owners and others who control the decision whether to adopt or maintain a retirement plan for employees should continue to have incentives to sponsor such plans, which require that coverage for lower-income workers be proportionate, to some degree, to coverage for highly-paid employees. 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 actual retirement plans.

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 and decisionmakers. The average annual contribution to a 401(k) plan by a non-highly compensated employee is less than $3,000 (7.5 percent of pay for a $40,000-a-year family, and 6 percent of pay for a $50,000-a-year family), and average annual 401(k) contributions by all employees are on the order of 7 percent of pay.[35]

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. (Only at incomes of $100,000 or more would employees who contributed 3 percent of pay bump up against such a ceiling.) Imposing a lower limit on the payroll-deduction IRA would reduce to some degree the risk that employees would exceed the maximum IRA dollar contribution limit because of automatic enrollment and possible other contributions to an IRA.[36] That is already a risk under current law, but automatic enrollment increases the risk, especially in combination with automatic escalation of contributions. There is a trade-off between the desirability of limiting the contribution amount (to reduce both this risk and the danger of competing with employer plans) and the simplicity of using an existing vehicle (the IRA) "as is."

In any event, employees, not employers, would be responsible for ensuring that all their IRA contributions comply with the maximum limit. The ultimate reconciliation would be made by the employees in their federal income tax returns.

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 perceived a direct-deposit savings to IRAs to be more attractive than an employer-sponsored plan (for example, because of tax treatment, investment options, or liquidity), they could be diverted 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.

Promoting Employer Plans. Our approach is designed not only to avoid causing any reduction or contraction of employer plans, but actually to promote them. 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-

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Retirement Plan Contribution Limits

	IRA tax-favored contribution limit	401(k) contribution limit (employee plus employer)	401(k) employee contribution limit	SIMPLE IRA employee contribution limit
Under age 50	$5,000	$49,000	$16,500	$11,500
Age 50 or older	$6,000	$54,500	$22,000	$14,000

2009 IRA Contribution and Deduction Limits: http://www.irs.gov/retirement/article/0,,id=202510,00.html
401(k) Resource Guide: http://www.irs.gov/retirement/sponsor/article/0,,id=151925,00.html

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. The results could include improved employee relations and larger tax-favored saving opportunities for owners and managers. Table 4-1 compares the maximum annual tax-favored contribution levels for IRAs, SIMPLE IRA plans. and 401(k) plans in effect for 2009. In addition, as noted, small employers that adopt a new plan (including qualified plans and SIMPLEs) would for the first time be 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. (As noted, the tax credit for new qualified plans could be increased, which would permit a larger automatic IRA credit while still maintaining a substantial edge in favor of the qualified plan credit.)

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, or certain unemployed individuals who can save. But a strategy centered on automatic arrangements could also make it easier for these people to contribute to IRAs.

For individuals who are not employees or who otherwise lack access to payroll deduction, automatic debit arrangements can serve in its stead. Automatic debit enables individuals to make payments on a regular and timely basis by having them automatically charged to or deducted from an account—such as a checking or savings account or credit card—at regular intervals. 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 online for regular automatic debits that direct funds from a checking account or credit card to an IRA or other saving vehicle. With online sign-up and monitoring, steps can be taken to familiarize more households with automatic debit arrangements and, through Internet websites and otherwise, to make those arrangements easier to set up and use as a mechanism for saving in IRAs.

Professional and trade associations could facilitate the establishment of IRAs and the use of automatic debit and direct deposit to them. 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 online, 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.

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.[37] Beginning in 2007 (tax year 2006), the IRS made it possible to split refunds among different accounts. Allowing households to split their refunds and deposit a portion directly into an IRA could make saving simpler and, thus, more likely. 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), so even a modest increase in the proportion of refunds saved every year could bring about a significant increase in savings.

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- or payroll-tax withholding. These individuals might be included in the direct-deposit system by enabling them to request that the firm receiving their services deposit a specified portion of their compensation directly into an IRA.

Compared with 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.

In many cases, the independent service provider and the hiring firm may not have a sufficient connection, or may be unwilling, to enter into a payroll-deposit arrangement. In such instances, the independent contractor could contribute to an IRA by using automatic debit or by sending the contribution together with the estimated taxes that the self-employed generally are required to pay quarterly. Matching Deposits. 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) would be a matching deposit to their direct-deposit IRA. One means of delivering such a matching deposit would be through 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.[38]

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.[39]

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.

Conclusion

American households have a compelling need to increase their personal saving, especially for long-term purposes such as retirement. This paper proposes a strategy that would seek to make saving more automatic, and thus easier, more convenient, and more likely to occur. Our strategy would adapt to the IRA universe the same practices 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.

Notes

1. Obama's Republican rival, Sen. John McCain, also expressed support for the concept during the campaign.
2. 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 Federal Reserve Board 2004 Survey of Consumer Finance.
3. As measured in the National Income and Product Accounts, www.bea.gov/national/nipaweb/index.asp.
4. Craig Copeland, "Employment-Based Retirement Plan Participation: Geographic Differences and Trends, 2005." Issue Brief 299 (Washington: Employee Benefit Retirement Institute, November 2006), fig. 1, p. 7.
5. Ibid.
6. Rev. Rul. 1998-30 clarified that automatic enrollment in 401(k) plans was permissible for newly hired employees. Treasury and the IRS ruled in 2000 that automatic enrollment was allowed for current employees as well (Rev. Rul. 2000-8). Later rulings also extend IRS-Treasury approval to 403(b) and section 457 plans.
7. William G. Gale, J. Mark Iwry, and Spencer Walters, "Retirement Saving for Middle- and Lower- Income Households: The Pension Protection Act of 2006 and the Unfinished Agenda," Policy Brief 2007-1 (Washington: Retirement Security Project, 2007) and Pension Protection Act of 2006 (Public Law 109-280), Section 902.
8. 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.
9. See, for example, Alicia H. Munnell and Annika Sunden, Coming Up Short: The Challenge of 401(k) Plans (Brookings Institution Press, 2004).
10. The preceding discussion draws on Section 1.02(3) J. Mark Iwry, "Growing Private Pensions: A Supporting Role for the States," Tax Management Compensation Planning Journal 34 (Dec. 1, 2006).
11. 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." It encouraged the Treasury secretary to "continue his efforts to publicize the availability of these payroll deduction IRAs." See H. Rept. 220, 105 Cong., 1 sess., (1997), p. 775.
12. Department of Labor, "Interpretive Bulletin 99-1," 29 Code of Federal Regulations 2509.99-1(b) (June 18, 1999); IRS Announcement 99-2, 1999-2 I.R.B. 44 (Jan. 11, 1999), http://www.irs.gov/pub/irs-drop/a-99-2.pdf
13. Neither the IRS nor the Labor Department guidance addressed the possible use of automatic enrollment in conjunction with direct-deposit IRAs.
14. William G. Gale, J. Mark Iwry, and Peter R. Orszag, "The Automatic 401(k): A Simple Way to Strengthen Retirement Savings," Policy Brief 2005-1 (Washington: Retirement Security Project, 2005).
15. Brigitte C. Madrian and Dennis F. Shea, "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior," Quarterly Journal of Economics 116 (November 2001), pp. 1149–87; 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 (MIT Press, 2002), pp. 67–113; Sarah Holden and Jack VanDerhei, "The Influence of Automatic Enrollment, Catch-Up, and IRA Contributions on 401(k) Accumulations at Retirement," Issue Brief 283 (Washington: Employee Benefit Research Institute, July 2005); and Cass R. Sunstein and Richard R. Thaler, Nudge: Improving Decisions about Health, Wealth, and Happiness (Yale University Press, 2008).
16. Any such statutory provision could usefully make clear that automatic enrollment in direct-deposit IRAs was 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 the federal Employee Retirement Income Security Act (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."
17. 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, "Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving," Journal of Political Economy 112, no. 1, pt. 2 (2004), pp. S164–87.

18. 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.

19. 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).

20. 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.

21. 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, work part-time, and tend to 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 was published in 2007, see www.conversationoncoverage.org/about/final-report/covering-the-uncovered.pdf. For an analysis by a nonpartisan 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 (Washington: 2005). Although various other efforts have been made to design such systems or programs, this paper does not attempt to catalogue them.

22. For some years, the federal Thrift Savings Plan had five investment funds: three stock index funds (S&P 500, small- and mid-capitalization 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.

23. 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; see 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 authors has proposed a strategy for states to act as catalysts 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. See J. Mark Iwry, "Expanding Retirement Savings at the State Level," written statement to the Legislature of the State of Washington (April 2003). The proposal 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 in "Growing Private Pensions: A Supporting Role for the States," Tax Management Compensation Planning Journal (Bureau of National Affairs) 34 (December 1, 2006).

24. 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; see William F. Sharpe, "Indexed Investing: A Prosaic Way to Beat the

Average Investor," Paper presented at the Spring President's Forum (Monterey Institute of International Studies, May 2002).

25. One of the authors has testified before Congress regarding the British retirement plan system and has been critical of the United Kingdom'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). See also David C. John and Ruth Levine, "National Retirement Savings Systems in Australia, Chile, New Zealand and the United Kingdom: Lessons for the United States," Policy Brief 2009-1 (Washington: Retirement Security Project, 2009).

26. 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 tends 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 numbers of the population who 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.

27. 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. . . ." (see www.tsp.gov). A professionally run "managed account" that could achieve similar results at no greater cost 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.

28. Gary P. Brinson, L. Randolph Hood, and Gilbert L. Beebower, "Determinants of Portfolio Performance," Financial Analysts Journal 42 (July/August 1986): 39–48.

29. For additional information about strategies for the expanded use of annuities in connection with retirement savings, see William G. Gale, J. Mark Iwry, David C. John and Lina Walker, "Increasing Annuitization in 401(k) Plans with Automatic Trail Income," Policy Brief 2008-2 (Washington: Retirement Security Project, 2008). and J. Mark Iwry and John A. Turner, "Automati Annuitization: New Behavioral Strategies for Expanding Lifetime Income in 401(k)s," Policy Brief 2009-2 (Washington: Retirement Security Project, 2009).

30. The Federal Employees' Retirement System Act of 1986 (Public Law 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.

31. Particularly concerning 401(k) trading behavior, see, for example, Takeshi Yamaguchi and others, "Winners and Losers: 401(k) Trading and Portfolio Performance," Working Paper 2006-26 (University of Pennsylvania, Wharton School Pension Research Council, November 2006) and Shlomo Benartzi and Richard Thaler, ""Naïve Diversification Strategies in Defined Contribution Saving Plans," American Economic Review 91 (March 2001), pp 79–98.

32. The question of how best to fit 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 paper.

33. Prudential, "Saving for Retirement at Work: Employee and Business Reactions to the Automatic IRA Concept" (Newark, N.J.: January 2008).

34. See Gale, Iwry, and Orszag, "The Automatic 401(k)" for a full report of the survey findings.

35. Craig Copeland, "Retirement Plan Participation and Retirees' Perception of Their Standard of Living," Issue Brief 289 (Washington: Employee Benefit Research Institute, January 2006), pp. 1–6, fig. A4.

36. It is conceivable that the risk of exceeding the IRA dollar limit could be mitigated to some degree by capping 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 (say, $60 if weekly, $120 if every two weeks, or $250 if monthly).

37. J. Mark Iwry, "Using Tax Refunds to Increase Savings and Retirement Security" Policy Brief 2006-1 (Washington: Retirement Security Project, January 2006).

38. Among the issues such an approach would need to address is the means of reimbursing private financial institutions that have no federal income tax liability to offset because they are tax exempt or in a loss position. A proposed alternative mechanism would convert the existing Saver's Credit (a federal income tax credit to households with joint income below $55,500 for contributing to an IRA or employer plan) 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 have such a direct matching deposit delivered by the financial institution that sponsors the IRAs or that 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, for example, William G. Gale, J. Mark Iwry, and Peter R. Orszag, "The Saver's Credit: Expanding Retirement Savings for Middle- and Lower-Income Americans" Policy Brief 2005-2 (Washington: Retirement Security Project, March 2005). This proposal has been essentially incorporated in President Barack Obama's budget for fiscal 2010. Another significant asset-building approach targeted to lower- and moderate-income households is reflected in individual development accounts (IDAs). See, for example, Michael Sherraden, Assets and the Poor: A New American Welfare Policy (Armonk, N.Y.: M. E. Sharpe, 1992), and Ray Boshara, "Individual Development Accounts: Policies to Build Savings and Assets for the Poor" Policy Brief (Brookings, March 2005).

39. Esther Duflo and others, "Saving Incentives for Low- and Middle-Income Families: Evidence from a Field Experiment with H&R Block," Quarterly Journal of Economics 121 (November 2006), pp. 1311–46.

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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.

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