

THE FINANCIAL SERVICES ROUNDTABLE **BLUE RIBBON REPORT ON RETIREMENT SECURITY**

Introduction

The Financial Services Roundtable's Blue Ribbon Commission on Retirement Security was established to develop proposals to strengthen retirement security for all Americans, especially low- and middle-income families. The Financial Services Roundtable is comprised of 100 financial services corporations that are among the leading intermediaries for all forms of individual savings, ranging from home ownership and traditional investment accounts, to insurance (including annuities) and individual and employer-based tax-favored savings programs. While each member of the Financial Services Roundtable offers different products and focuses on different aspects of savings, based on our collective experience we can provide important insights on how to build retirement savings.

In order to draw on our members' experience, the Commission divided into four working groups: (1) Social Security, (2) employer-based savings, (3) personal savings, and (4) retiree health care. Across these areas, some common themes emerged. We determined that our proposals should be directed at Americans whose retirement security is most at risk, generally low- and middle-income Americans. We also concluded that our proposals should address the fact that retirement security increasingly depends not just on adequate savings during the accumulation phase, but on appropriate financial planning in the distribution phase. Our proposals needed to recognize that both our industry and the three pillars of retirement security – Social Security, employer-based retirement savings, and personal savings – are increasingly integrated. Finally, we needed to keep in mind the nation's substantial projected Federal budget deficits.

This report is organized as follows. First, it provides some background on the degree to which Americans are saving adequately for retirement, and on demographic and market trends that are jeopardizing workers' retirement security. It then outlines proposals in the four areas of our working groups that we believe will restore and expand retirement security for current and future generations, by fulfilling the promise of Social Security, creating a universal savings platform, and providing the proper incentives to help ensure retirement security for all Americans. We start with Social Security because it is the foundation of retirement security. We then discuss employer-based retirement plans because they are where most workers currently save for retirement. Personal savings and retiree health are considered next. It is worth noting that there is substantial overlap between our proposals for retirement plans and personal savings so, for convenience, overlapping proposals are generally discussed in detail only in the retirement plan section. The report concludes by summarizing several educational initiatives that will be critical to the success of all of these proposals by ensuring that Americans plan appropriately for their retirement. An abbreviated list of our recommendations is provided in Appendix A.

The Retirement Security Crunch

Americans are not saving enough for retirement. Traditionally, retirement security has rested upon three pillars: Social Security, employer-sponsored retirement plans, and individual savings. Over the past several years, however, each of these pillars have become a less certain basis for retirement security.

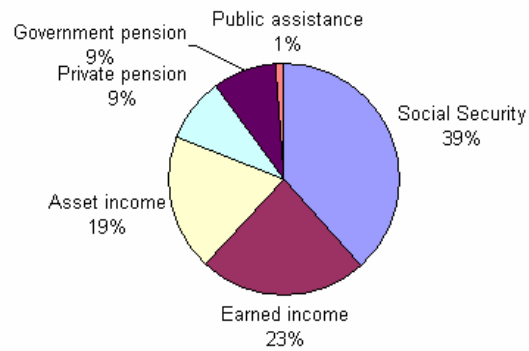
Social Security faces a long-term actuarial imbalance. In large measure, this is a result of the baby boom generation's impending retirement, increasing life expectancies and changes in the wage structure. In 2000, about one in eight Americans were over age 65, but by 2040, approximately one in five Americans will be.¹ Partially as a result, scheduled benefits under the Social Security system are projected to exceed payroll tax revenues in 2018, and it is generally accepted that reforms to the revenue or benefit elements of the program will be necessary in the coming years in order to restore solvency to the system.

Social Security is a critical element of retirement security for most Americans. Among Americans age 65 and older, Social Security comprises 39% of total income.² Furthermore, among the elderly in the bottom 40% of the income distribution, Social Security comprises over 80% of their retirement income,³ and Social Security is the only source of income for 18% of elderly households.⁴ Restoring solvency to the Social Security system and enhancing its ability to promote a comfortable retirement for all Americans are thus critical to retirement security.

Like Social Security, employer-sponsored retirement plans have also become a more uncertain foundation for retirement security. While coverage rates for retirement plans have been relatively stable over time, retirement plans are increasingly offered through defined contribution plans rather than defined benefit plans. In 1975, less than 30% of retirement plans were defined contribution plans. By 1998, almost 70% were defined contribution plans.⁵ While this trend toward defined contribution plans has many advantages, it has tended to reduce retirement security because, unlike defined

Sources of Income for Americans 65 and Older

Source: Social Security Administration (2002)



¹ FARRELL DOLAN & VAN HARLOW, LIFETIME INCOME PLANNING (FMR Corp., 2003).

² Social Security Administration, Income of the Population 55 or Older, 2000, tbl. 7.1 (2002), available at http://www.ssa.gov/policy/docs/statcomps/income_pop55/2000/sect7.html.

³ *Id.* at tbl.7.5.

⁴ *Id.* at tbl.7.5.& tbl.6.A1.

⁵ ALICIA H. MUNNELL, JAMIE LEE & KEVIN MEME, AN UPDATE ON EMPLOYER-SPONSORED PENSIONS fig.7 (Center for Retirement Research at Boston College, prepared for Conversation on Coverage, July 22, 2004).

benefit plans, defined contribution plans are frequently withdrawn prior to retirement and, if preserved until retirement, are withdrawn in ways that expose retirees to longevity and investment risk.

Exacerbating these threats to retirement security is the fact that coverage by employer-sponsored retirement plans has always been far from universal, and has always been lower among lower- and middle-income families. As a result, workers are not always able to supplement Social Security and insure against uncertainty regarding its future through greater saving in employer-sponsored retirement plans. The need to supplement Social Security is especially acute for middle-income families because Social Security does not replace as much of their pre-retirement income and because they tend to save very little.⁶ Employer-sponsored retirement plans cover about 50% of workers, including over 70% of workers in the top quintile of income, but under 15% of workers in the bottom quintile of income.⁷ While low- and middle-income workers can make contributions to tax-preferred individual retirement accounts, only 10% elect to do so.⁸

Expenses during retirement are also increasing. Retirees are living longer, and they must also direct an increasing share of their income to health care. For example, it is estimated that today the average couple retiring at age 65 will need to spend \$175,000 on Medigap insurance, comprehensive long-term care insurance, and other health care expenses that are not covered by Medicare during their retirement if they do not have an employer-sponsored retiree health plan.⁹ Coverage by an employer-sponsored retiree health plan has declined precipitously over the past decade and medical inflation rates are in the double digits, so retiree health care costs are only expected to rise further in the future.¹⁰

In the face of these threats to retirement security, Americans are not saving more for retirement. In 2001, the personal savings rate hit a low of 1.7% and in 2003 it was 2.1%. This was the lowest level of personal savings since 1938.¹¹ Thirty

⁶ See THE HERITAGE FOUNDATION, SOCIAL SECURITY BASICS (Web Memo #143, Sept. 12, 2002), available at <http://www.heritage.org/Research/SocialSecurity/wm143.cfm>; EDWARD N. WOLFF, RECENT TRENDS IN WEALTH OWNERSHIP, 1983-1998 (Jerome Levy Economics Institute Working Paper No. 300, Apr., 2000).

⁷ See ALICIA H. MUNNELL, JAMIE LEE & KEVIN MEME, AN UPDATE ON EMPLOYER-SPONSORED PENSIONS fig.3 (Center for Retirement Research at Boston College, prepared for Conversation on Coverage, July 22, 2004); ALICIA H. MUNNELL & ANNIKA SUNDEN, PRIVATE PENSIONS: COVERAGE AND BENEFIT TRENDS, fig.8 (prepared for Conversation on Coverage, July 24-25, 2001).

⁸ Peter J. Sailer & Sarah E. Nutter, *Accumulation and Distribution of Individual Retirement Arrangements, 2000*, in INTERNAL REVENUE SERVICE, STATISTICS ON INCOME BULLETIN 121 (Spring, 2004).

⁹ FIDELITY WORKPLACE SERVICES, RETIREE HEALTH ACCOUNTS: THE NEXT STEP TOWARD A WORKABLE SOLUTION (Dec., 2003).

¹⁰ In 1993, 40% of Medicare-eligible retirees from companies with over 500 employees were covered by an employer-sponsored retiree health plan. By 2000, this proportion had fallen to under 25%. FIDELITY WORKPLACE SERVICES, RETIREE HEALTH COSTS: ADDRESSING THE GROWING GAP (Sept., 2002).

¹¹ DEPARTMENT OF LABOR, BUREAU OF ECONOMIC ACCOUNTS, NATIONAL INCOME AND PRODUCT ACCOUNTS, Table 2.1 (Apr. 29, 2004), available at <http://www.bea.gov/bea/dn/nipaweb/index.asp>.

percent of all older workers do not have a retirement plan or IRA,¹² and four in ten workers say that they are not currently saving for retirement.¹³ Hence the retirement security crunch. New policies are desperately needed to preserve and enhance retirement savings.

Social Security

The first step toward strengthening retirement security for all Americans must be restoring solvency to the Social Security system and enhancing its ability to provide a safety net for retirees. Currently, scheduled benefits under the Social Security system are projected to exceed payroll tax revenues in 2018 and the trust fund balance is projected to reach zero in 2042.¹⁴ The long-term actuarial imbalance of the Social Security system is estimated at \$3.7 trillion in today's dollars.¹⁵ There are several causes of this actuarial imbalance, including the retirement of the Baby Boom generation, increasing longevity among retirees, and the fact that historically the Social Security system has paid benefits to retiring generations at levels that vastly exceed the value of their contributions.

Ultimately, Social Security reform will be a complex and difficult political process, requiring compromises on all sides. What is most important during this process, however, is to know what the end result should be. Accordingly, we have focused on developing a broad picture of what elements should and should not be part of Social Security reform, rather than on the details of what political compromises should be made to reach this end. Several principles have guided our efforts. We believe that Social Security reform should put Social Security on a sound financial footing. It should retain a defined benefit that provides a safety net for all Americans while creating a universal individual account system. It should be distributionally neutral. It should expand financial literacy and promote a net increase in national savings. Finally, it should have a neutral or positive effect on capital markets.

Based on these principles, we believe the best way to reform Social Security is to preserve a defined benefit program that operates especially at the low end of the income distribution, and to establish a truly universal system of individual accounts

¹² AMERICAN ASSOCIATION OF RETIRED PEOPLE, OLDER WORKERS' PENSION PLAN AND IRA COVERAGE, available at http://research.aarp.org/econ/dd91_retire.html (retirement plan coverage of workers age 55 and older in 1998).

¹³ RUTH HELMAN, WILL AMERICANS EVER BECOME SAVERS? THE 14TH RETIREMENT CONFIDENCE SURVEY, 2004 (EBRI Issue Brief No. 268, Apr. 2004).

¹⁴ SEE SOCIAL SECURITY AND MEDICARE BOARD OF TRUSTEES, STATUS OF THE SOCIAL SECURITY AND MEDICARE PROGRAMS: A SUMMARY OF THE 2004 ANNUAL REPORTS (2004), available at <http://www.ssa.gov/OACT/TRSUM/tr04summary.pdf>. To be clear, if the Social Security trust fund balance were to reach zero, the Social Security system still could pay some benefits, but they would be limited each year to the amount of payroll tax revenue received.

¹⁵ Hearing Testimony of the Honorable John W. Snow, Secretary of the Treasury, on the 2004 Social Security and Medicare Trust Fund Reports before the Committee on Ways and Means United States House of Representatives (March 24, 2004), available at <http://www.ustreas.gov/press/releases/js1256.htm>.

that is not integrated with the defined benefit element of the system. Basic Social Security benefits for the disabled and other disadvantaged groups should remain undisturbed and, in some circumstances, enhanced. Furthermore, penalties on retirees who continue to work before reaching the normal retirement age but after beginning to draw Social Security benefits should be eliminated.

This proposal has the advantage of ensuring a basic level of retirement security for all Americans, while also giving workers the opportunity to earn a higher rate of return than the existing Social Security system provides. By partially moving Social Security toward pre-funding, it would reduce the likelihood of future crises in the Social Security system as a result of demographic shifts. In addition, because individual accounts would be mandatory, this proposal would minimize administrative costs, ensure that all Americans save for retirement to some degree, and create a universal platform for enhanced savings. The value of this last innovation cannot be understated. The only way that we can make saving a habit for all Americans is by creating a system of universal accounts that provide a foundation for financial literacy and government policies to promote additional savings.

Like any Social Security reform proposal, our proposal will require some combination of reduced costs and increased revenue. There are a variety of reasonable ways to address these needs, but before describing them it is perhaps most helpful to describe two ways that we do *not* think the proposal should be funded. First, the Social Security trust fund should not be invested in the private market. Placing control over the investment of such large sums of money in the hands of a small group of government officials is likely to result in serious capital market disruptions because such officials are bound to encounter pressure to invest (or not invest) in certain regions, industries, or companies.

We also believe that individual accounts should not be integrated with the Social Security defined benefit program through offsets. Offsets involve reducing defined benefits paid to individual retirees based on the value of their individual accounts at retirement. While offsets can insure retirees against the possibility of differential returns on their individual accounts, they are administratively unworkable. They require complex and controversial actuarial calculations and create incentives for workers to invest in an overly aggressive and undiversified manner because the government bears any downside risk. Although our proposal will entail modest reductions in the defined benefit element of Social Security for many recipients, and although individual accounts will not match any such reductions perfectly, we believe that independent individual accounts will achieve a rough justice in compensating (and often more than compensating) for benefit reductions that is far preferable to any offset system.

With the previous options off the table, we turn to the variety of ways in which our proposal for Social Security reform could be funded that merit consideration. A mix of these options, depending on the vagaries of the political process, is likely. We have used the terms "benefit cuts" and "tax increases" because it is likely that any reforms will be described in this graphic manner. However, these options are principled reforms; many are best viewed as restoring the historic structure of Social Security that has been

altered as a result of inaccurate inflation estimates and changes in the wage structure and longevity. Restoring actuarial balance to the current Social Security system would require some combination of reduced costs and increased revenues equal to approximately 2% of taxable payroll.¹⁶ To the extent that individual accounts provide significant savings beyond current scheduled benefits, further adjustments may be warranted. Accordingly, in order to provide a sense of the impact of these options, we include estimates of how much each option would save or raise measured by reference to taxable payroll.

Benefit cuts

- Use more appropriate cost of living adjustments for Social Security benefits. Estimated cost savings equivalent to: 0.35% of payroll.¹⁷
- Increase the number of years of earnings used to compute benefits to reflect longer life expectancies and longer periods in the workforce. Estimated cost savings equivalent to: 0.21% of payroll.¹⁸
- Accelerate scheduled increases to the normal retirement age, reflecting longer life expectancies. Estimated cost savings equivalent to: 0.14% of payroll.¹⁹
- Reduce the replacement rate for higher-income workers. Estimated cost savings equivalent to: 0.18% of payroll.²⁰
- Adjust benefits for changes in life expectancy. Estimated cost savings equivalent to: 0.59% of payroll.²¹

¹⁶ Robert M. Ball, *Just a Little Maintenance: We Can Fix Social Security, If We Can Manage the Politics*, WASH. POST, at B4 (July 18, 2004). One of the most common ways of measuring the actuarial imbalance (and the one used here) is as a percentage of the payroll tax base. It should be noted, however, that this is a unit of measurement and not intended to suggest that the actuarial imbalance should be restored simply by increasing payroll taxes.

¹⁷ Letter from Stephen C. Goss, Chief Actuary, Social Security Administration to Representatives Jim Kolbe and Charles Stenholm (Feb. 11, 2004). This estimate assumes that benefits are indexed to a more accurate consumer price index developed by the Bureau of Labor Statistics, the “CPI-W.”

¹⁸ Letter from Stephen C. Goss, Chief Actuary, Social Security Administration to Representatives Jim Kolbe and Charles Stenholm (Feb. 11, 2004). This estimate assumes that by 2013 all years of earnings are included in the numerator of average indexed monthly earnings and that the denominator is increased to 40 for primary earnings (staying at 35 for secondary earners).

¹⁹ Letter from Stephen C. Goss, Chief Actuary, Social Security Administration to Representatives Jim Kolbe and Charles Stenholm (Feb. 11, 2004). This estimate assumes that scheduled increases in the normal retirement age are accelerated so that the normal retirement is age 67 for all individuals reaching age 62 after 2011.

²⁰ Letter from Stephen C. Goss, Chief Actuary, Social Security Administration to Peter Diamond and Peter Orszag (Oct. 8, 2003). This estimate assumes that the 15% replacement rate, which currently applies to average indexed monthly earnings over about \$3,700, is reduced gradually to 10% by 2031.

- Alternately, reflect longer life expectancies by gradually increasing the normal retirement age beyond scheduled increases. Estimated cost savings equivalent to: 0.50% of payroll.²²

Tax increases

- Increase the wage base for the payroll tax to its traditional levels. Estimated additional revenues equal to: 0.61% of payroll.²³
- Cover new state and local government employees to provide for universal coverage. Estimated additional revenues equal to: 0.19% of payroll.²⁴
- Increase the payroll tax rate. Additional revenues: 1% of payroll for every 1 percentage point increase in the payroll tax.
- Use general revenues to partially fund individual private accounts.

While all of the previous alternatives should be considered, we believe that the net effect of these changes should permit funding of universal private accounts. We also believe that the defined benefit portion of Social Security should not be funded in whole or in part with general revenues because, for basic political economy reasons, this could jeopardize the future solvency of this program. In addition, it is important to understand that the issue of whether to include new state and local government workers in the Social Security system raises important and historic issues of the relationship between the federal government and state and local governments, and that this option will not raise a large amount of revenue. Nevertheless, it may be desirable to include new state and local workers in any system of individual accounts, given their potential as a universal savings platform. While it is possible to include state and local government workers in the individual account program and not the defined benefit element of our

²¹ Letter from Stephen C. Goss, Chief Actuary, Social Security Administration to Representatives Jim Kolbe and Charles Stenholm (Feb. 11, 2004). This estimate assumes that after the adjustment discussed in footnote 19 is implemented, replacement rates are adjusted to reflect changes in life expectancy for persons reaching age 62 after 2011 relative to the preceding cohort. It excludes disabled beneficiaries from the change.

²² Letter from Stephen C. Goss, Chief Actuary, Social Security Administration to Representative Nick Smith (Sept. 10, 2003). This estimate assumes that after the adjustment discussed in footnote 19 is implemented, the normal retirement age is increased by one month every two years after 2011.

²³ Letter from Stephen C. Goss, Chief Actuary, Social Security Administration to Robert M. Ball (Oct. 10, 2003). This estimate assumes that the tax ceiling for the payroll tax is raised gradually over 22 years to 90% of covered earnings, as it was in 1983, and stays at 90% of covered earnings thereafter. Currently the cap on annual earnings subject to the payroll tax is \$87,900 or about 85% of taxable payroll. Raising it to 90% of taxable payroll implies a cap of about \$140,000 in today's dollars. JEFF LEMIEUX, RAISING THE CAP ON PAYROLL TAXES DOESN'T SOLVE THE SOCIAL SECURITY PROBLEM (Nov. 17, 2003), *available at* http://www.centrists.org/pages/2003/11/12_guest_wealth.htm.

²⁴ Letter from Stephen C. Goss, Chief Actuary, Social Security Administration to Peter Diamond and Peter Orszag (Oct. 8, 2003). This estimate assumes that all new state and local government employees hired after 2007 are covered.

proposal, this would make it even more necessary to avoid offsets when structuring the program.

Beyond funding sources, questions will arise about how individual accounts will be administered and withdrawn. Especially at the beginning of workers' careers, the accounts are likely to be quite small. Moreover, up to 28% of Americans do not have a bank account,²⁵ and such account holders would likely be overwhelmed by any requirement to immediately choose among financial institutions.

In order to address these problems, we recommend that the accounts initially be administered by the government in a manner similar to the Thrift Savings Plan (the federal government's version of a defined contribution 401(k) program).²⁶ Workers would be offered a limited array of diversified investment options, and the default option for those not making a selection would be a balanced, age-appropriate fund. Funds could not be withdrawn from the accounts prior to retirement, death or disability. Once an account reached a certain size, however, we believe the participant should have the option to roll the account into certain investment vehicles in the private sector and make additional voluntary contributions. These additional contributions should be encouraged and integrated as appropriate with existing tax-favored retirement savings programs.²⁷ This would take full advantage of the potential for the accounts to enhance retirement security, provide a universal savings platform and promote financial literacy, while at the same time protecting workers and reducing the potential capital market disruption as a result of large-scale government investment.

At the distribution phase, a guaranteed lifetime payout should be required for some portion of the accounts, and the extent of the requirement should relate to the size of the remaining defined benefit program. Options include requiring account holders to purchase longevity insurance (for example, insurance that begins at age 85), or to purchase an annuity with some percentage of their account (for example, an amount sufficient to purchase an annuity that provides a monthly distribution that is some percentage of the poverty line).

²⁵ GENERAL ACCOUNTING OFFICE, ELECTRONIC TRANSFERS: USE BY FEDERAL PAYMENT RECIPIENTS HAS INCREASED BUT OBSTACLES TO GREATER PARTICIPATION REMAIN (GAO-02-913, Sept. 2002). The Federal Reserve Board has estimated that closer to 10% of Americans are unbanked. *See* FEDERAL RESERVE BOARD, THE UNBANKED: WHO ARE THEY? (Capital Connections, vol. 3, no.2, Spring 2001), available at <http://www.federalreserve.gov/dcca/newsletter/2001/spring01/unbank.htm>.

²⁶ For further details on the Thrift Savings Plan, see Fred T. Goldberg, Jr. & Michael J. Graetz, *Reforming Social Security: A Practical and Workable System of Personal Retirement Accounts*, in ADMINISTRATIVE ASPECTS OF INVESTMENT-BASED SOCIAL SECURITY REFORM 9 (John B. Shoven, ed., 2000); MATT MOORE, THE THRIFT SAVINGS PLAN: A MODEL FOR SOCIAL SECURITY REFORM (Nat'l Ctr. for Policy Analysis, Brief Analysis 443, June 4, 2003), available at <http://www.ncpa.org/pub/ba/ba443/ba443.pdf>.

²⁷ The additional contributions also should receive the same tax treatment as existing tax-favored retirement savings programs. Specifically, voluntary additional contributions should be eligible for the Saver's Credit and distributions should be taxed to the extent funded with pre-tax dollars (as with traditional IRAs) and should be tax-free to the extent funded with after-tax dollars (as with Roth IRAs).

Putting these elements of the proposal together will result in a more sound, sustainable and generous Social Security system that provides a basic level of retirement income for all, increases national savings, and serves as a universal savings platform.

Employer-Based Savings

Restoring solvency to Social Security and enhancing its ability to provide a safety net for retirees is a necessary step to achieving retirement security, but it is not sufficient. Social Security always has been designed to function as only one element of retirement income, replacing 39% of pre-retirement income on average.²⁸ Employer-sponsored retirement plans are a critical second building block of retirement security because employers are uniquely positioned to educate workers about the need for retirement saving and streamline the process for saving, which has a dramatic effect on savings rates.²⁹

Despite the advantages of employer-based savings, however, only about 50% of workers are covered by an employer-sponsored retirement plan, with coverage rates especially low among smaller businesses and workers who are lower-income, younger or part-time.³⁰ There is also a need to raise participation levels; the average account balance in a 401(k) plan is only about \$40,000.³¹ Moreover, employer-based savings are increasingly withdrawn in ways that limit their ability to promote retirement security. Defined contribution plan accounts are rarely annuitized³² and 40% to 60% of all distributions from defined contribution plans made to people changing jobs are not rolled over into tax-deferred retirement savings vehicles.³³ These statistics have serious implications for retirement security because of the large number of jobs that the typical worker holds throughout their lifetime³⁴ and because employer-based savings

²⁸ ALICIA H. MUNNELL, JAMIE LEE & KEVIN MEME, AN UPDATE ON EMPLOYER-SPONSORED PENSIONS 14 (Center for Retirement Research at Boston College, July 22, 2004).

²⁹ For example, approximately two-thirds of workers eligible to participate in employer-sponsored 401(k)s elect to do so, while only 6% of workers eligible to make deductible contributions to individual retirement accounts elect to do so. WILLIAM G. GALE & PETER R. ORSZAG, PRIVATE PENSIONS: ISSUES AND OPTIONS 12-13 (Urban Inst., Discussion Paper no. 9, Apr., 2003).

³⁰ See *supra* note 7 & accompanying text; ALICIA H. MUNNELL & ANNIKA SUNDEN, PRIVATE PENSIONS, COVERAGE AND BENEFIT TRENDS 36, 56 (prepared for "Conversation on Coverage," Washington D.C., July 24-25, 2001).

³¹ INVESTMENT COMPANY INSTITUTE, FREQUENTLY ASKED QUESTIONS ABOUT 401(K) PLANS (Oct. 2003).

³² Only 4 percent of workers with defined contribution plan assets who leave their jobs after age 55 convert their retirement plan assets into annuities. See RICHARD W. JOHNSON, LEONARD E. BURMAN & DEBORAH I. KOBES, ANNUITIZED WEALTH AT OLDER AGES: EVIDENCE FROM THE HEALTH AND RETIREMENT STUDY 18 (Final Report to the Employee Benefits Security Administration, Dep't of Labor, May, 2004).

³³ See SECURITIES INDUSTRY ASSOCIATION, SECURITIES INDUSTRY FACT BOOK 2002, at 95 (2002); HEWITT ASSOCIATIONS, HEWITT DATA SHOWS U.S. EMPLOYEES CASH OUT OF 401(K) PLANS WHEN CHANGING JOBS (Nov. 5, 2003) (finding that 42% of all 401(k) distributions when workers changed jobs were cash distributions; the rate was 72% for accounts between \$5,000 and \$10,000 and 20% for accounts between \$40,000 and \$50,000).

³⁴ U.S. DEPARTMENT OF LABOR, BUREAU OF LABOR STATISTICS, NUMBER OF JOBS HELD, LABOR MARKET ACTIVITY, AND EARNINGS GROWTH AMONG YOUNGER BABY BOOMERS: RESULTS FROM MORE THAN TWO

increasingly occurs in defined contribution plans.³⁵ The employer-based savings pillar of retirement security thus needs to be updated to meet these changing circumstances.

Several objectives should guide any effort to strengthen employer-based savings. Reform proposals should support existing defined benefit plans, while increasing the number of employers offering retirement plans, participation rates, and the amount of worker contributions in all employer-based savings vehicles, whether in defined benefit, hybrid, or defined contribution plans. They should also ensure that the form of payouts from employer-sponsored retirement plans promotes retirement security. Finally, reform proposals should focus on the workers who currently participate least in the employer-sponsored retirement plan system.

To address these objectives, we recommend a set of interlocking proposals that can be grouped into several areas. Each are intended to apply to public and private employers equally. Some remove regulatory barriers to employers offering retirement plans. Some use tax incentives to raise participation rates and participation levels among workers who are covered by an employer plan. Others streamline and simplify the process of saving from a participant perspective in order to further increase participation rates and contribution levels. Still others use tax and regulatory policy to ensure that savings in retirement plans are preserved for income throughout retirement.

Removing regulatory barriers to offering retirement plans

When developing proposals to increase the number of employers offering retirement plans, the Commission first considered whether some of the existing employer-sponsored retirement savings vehicles should be consolidated. While complexity can be a factor in savings and simplification should be encouraged wherever possible, our members' experience is that potential plan sponsors generally are not deterred by the number of plan options. By contrast, complexity from a participant perspective appears to generate the greatest barriers to maintaining retirement savings as employees move from job to job. Most of our simplification proposals therefore focus on bottom-up portability. The Commission did conclude, however, that barriers to offering certain existing qualified plans should be removed, and that a new, simplified, employer-facilitated plan option should be created in order to increase coverage among small employers that are deterred by the administrative burdens and fiduciary liability that typically accompany plan sponsorship. Specifically, we propose establishing a new "Clearinghouse Plan." Before summarizing the proposal, however, we should emphasize that the details of this new plan must be designed in a way so as to not undermine traditional employer-based defined benefit and defined contribution plans.

The Clearinghouse Plan would in some respects resemble a payroll deduction IRA. Eligible financial institutions would market Clearinghouse Plans to small employers. If a small employer elected to make available the Clearinghouse Plan of one

DECADES OF A LONGITUDINAL SURVEY SUMMARY (Aug. 27, 2002) (finding that persons born from 1957 to 1964 held an average of 9.6 jobs between ages 18 and 36).

³⁵ See *supra* note 5 & accompanying text.

or more financial institutions, participating employees could then divert a portion of their payroll to the plan, subject to contribution limits that would be higher than those for IRAs, but lower than the elective deferral limits for defined contribution plans.³⁶ Rollovers to IRAs and other defined contribution plans would be freely permitted. Employers facilitating Clearinghouse Plans could also automatically enroll employees in the plan and could make contributions to the plan, provided that such employer contributions were included in compensation and counted toward the employee's contribution limit. Unlike existing retirement plans, however, employers facilitating Clearinghouse Plans could not exclude any employees (*e.g.*, part-time workers) from making contributions to the plan, and each plan would be administered by a financial institution, which would assume all associated fiduciary obligations and virtually all administrative responsibilities as well (thereby relieving the small employer from all such obligations and responsibilities).

The advantage of the Clearinghouse Plan is that it would remove many of the barriers that deter small employers from offering traditional retirement plans: complicated testing rules, detailed reporting requirements, and concern about fiduciary liability. Moreover, it would provide a way to offer annuities based on a group of workers from multiple employers and industries, which would reduce disincentives to annuitize posed by the high cost of annuities purchased on an individual or small employer basis. In addition, unlike SIMPLE plans, employer contributions would not be required. As such, the Clearinghouse Plan offers a one-size-fits-all approach for small employers that are hesitant to take on the burdens of offering a retirement plan, but are happy to facilitate retirement savings through payroll deductions.

While we believe that a properly designed Clearinghouse Plan would significantly increase plan sponsorship among small employers that currently are unwilling to offer retirement plans, there is a critical need to remove regulatory barriers to sponsoring existing retirement plans, some of which promote retirement security more robustly but entail greater administrative burdens for employers. In this regard, defined benefit plans merit special attention. In recent years, the number of defined benefit plans has declined precipitously, which is unfortunate because defined benefit plans are the only type of retirement savings (aside from Social Security) that cannot be withdrawn before retirement and that is typically annuitized over the beneficiaries' lives so that it relieves retirees from longevity and investment risk. Six reforms could address legitimate concerns employers have about offering defined benefit plans, and reinvigorate this type of retirement plan.

First, the funding requirements for defined benefit plans should be reformed so that employers can elect to fund plans at up to 125% of the current limits, and can reduce funding in bad years to the extent that they take advantage of this option. Under current law, if a plan sponsor fails to satisfy the minimum funding requirements, the sponsor will be subject to an initial excise tax of 10% of the deficiency, and possibly to a 100% excise tax if the underfunding is not corrected promptly. Conversely, if plan

³⁶ We generally view the Clearinghouse Plan as an alternative to a defined contribution plan for small employers, although, like defined contribution plans, theoretically it could be offered in conjunction with a defined benefit plan.

funding exceeds the full funding limitation, the plan sponsor may be denied a current deduction for the excess contributions and may be subject to penalties. Both of these thresholds are related to stock market performance and interest rates. As a result, the funding obligations for employers sponsoring defined benefit plans are volatile and require employers to decrease plan funding in good economic times and increase plan funding in bad economic times when they are least able to do so, all of which creates a tremendous disincentive against offering a defined benefit plan. By giving employers more latitude to increase funding in good years and decrease funding in bad years, the stability of defined benefit plans—and employers' willingness to offer them—would be increased.³⁷

Second, the funding requirements for private pensions should be further revised by permanently replacing the 30-year Treasury bond rate used for calculating funding obligations with a high-quality corporate bond rate. The Treasury Department stopped issuing 30-year bonds in 2001 and the rates on such bonds have plummeted over time. The result is that pension liabilities have been artificially but substantially inflated and participants face incentives to take lump-sum distributions—exactly the form of withdrawal that is generally most adverse to retirement security. A high-quality corporate bond rate would more accurately reflect pension liabilities and would eliminate incentives for beneficiaries to take lump-sum distributions.

Third, employees should be able to continue working for their current employer once they reach the normal retirement age for their defined benefit plan and begin receiving their pension at the same time. Unlike defined contribution plans, defined benefit plans currently do not permit in-service withdrawals. As a result, employees frequently leave employment prematurely, or leave and return as contractors, in order to receive their pension benefits. In light of the increasing importance of phased retirement to retirement security, this disparity between defined contribution and defined benefit plans should be eliminated.

Fourth, the rules governing hybrid plans should be clarified to remove the barriers to (and help foster) such plans. We believe that hybrid plans, as currently designed, are clearly consistent with current law and promote retirement security for many workers. The idea behind hybrid plans is to take away from employers some of the funding risk associated with traditional defined benefit plans by allowing benefits to be based on a notional account balance that accumulates over time. Hybrid plans also offer several advantages over both defined benefit and defined contribution plans—contributions are mandatory, distributions are annuitized, and workers who change jobs frequently are not penalized. As such, they should be encouraged rather than discouraged. The Administration (or Congress, if necessary) should remove barriers to all hybrid plans by confirming the validity of the basic plan design and by providing guidance on a number of specific compliance and interpretive issues.

Fifth, barriers to offering defined contribution plans should also be removed. One of the most significant barriers is the complexity of the nondiscrimination

³⁷ As noted below, this proposal could also have the effect of promoting sponsorship of retiree health plans.

rules. We recommend adopting safe harbors similar to those in President Bush's ERSA proposal.³⁸ Under these safe harbors, employers could avoid nondiscrimination testing altogether if either: (1) the average contribution percentage of non-highly compensated workers was over 6% of compensation (the average contribution percentage for highly compensated workers could then be any amount), or (2) the average contribution percentage of non-highly compensated workers was under 6%, but no less than one half of the average contribution percentage for highly compensated workers. These safe harbors would vastly simplify the nondiscrimination rules for many employers, while still ensuring that savings in defined contribution plans is not disproportionately done by higher-income workers. The first safe harbor would also probably require high match rates or substantial mandatory deferrals for lower-income workers, and thus would likely have the additional advantage of significantly boosting their contribution levels.

Finally, we recommend simplifying the Form 5500 reporting requirements for retirement plans sponsored by small employers in a manner similar to the proposal in Sec. 601 of The Pension Preservation and Savings Enhancement Act of 2003 (H.R. 1776). The current Form 5500 imposes an immense burden on small businesses. Simplification would entail no revenue cost and would increase coverage rates among this important group.

Tax incentives to increase participation rates and contribution levels

Our second group of proposals for strengthening employer-based retirement savings would use tax incentives to increase participation rates and contribution levels. Specifically, we propose increasing the elective deferral limits applicable to defined contribution plans, while expanding, making permanent, and making refundable the current law Saver's Credit.

The Economic Growth and Tax Relief and Reconciliation Act of 2001 ("EGTRRA") gradually increased elective contribution limits and catch-up contribution limits for defined contribution plans until 2006, indexed them to inflation until 2010, and then sunsetted the increases thereafter. These increases should be accelerated and made permanent. The combined contribution limits for elective and employer deferrals are significantly higher than the elective deferral contribution limits, but many workers who would like to save at these higher levels cannot do so because their employer does not make contributions on their behalf. Raising the elective deferral limits and catch-up contribution limits while holding the combined contribution limits constant would mitigate this inequity between similarly situated taxpayers, and would help ensure that higher-income workers are able to save enough in employer-sponsored retirement plans to achieve adequate replacement rates in retirement. Moreover, increasing elective deferral and catch-up contribution limits should induce more employers to offer retirement plans in general and thereby result in increased retirement savings at the lower end of the income distribution as well.

³⁸ DEPARTMENT OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2005 REVENUE PROPOSALS 16 (Feb., 2004).

The retirement security of workers at the lower end of the income distribution would be enhanced greatly by expanding, making permanent, and making refundable the Saver's Credit. The Saver's Credit matches up to 50% of elective contributions to defined contribution plans, IRAs and Roth IRAs by low-income workers.³⁹ It has been remarkably successful at stimulating savings in defined contribution plans among even very low-income taxpayers.⁴⁰ Several elements of the credit, however, inhibit its effectiveness. First, the "notches" in the phase-out of the credit create inefficient discontinuities⁴¹ and provide weak incentives to save for lower-middle income taxpayers, who also receive relatively small incentives to save from deductions and exemptions for savings because their marginal tax rates are low. To address these problems, we recommend smoothing and extending the phase-out range for the credit. Second, the Saver's Credit is scheduled to sunset in 2006. It should be made permanent because it is good policy and because making it permanent should increase coverage rates by eliminating a source of uncertainty for potential plan sponsors. Finally, the Saver's Credit is not refundable, meaning that workers with no federal income tax liability cannot receive the credit. As a result, 80% of workers whose income is low enough that they would otherwise qualify for the 50% matching credit cannot in fact receive the credit because they do not owe any Federal income taxes.⁴² We recommend making the Saver's Credit refundable in order to stimulate savings among these very low-income workers whose retirement security is typically at great risk.⁴³ Consideration should also be given to providing employers with some incentive under the nondiscrimination rules to make sure that eligible workers are aware of and claim the credit in order to enhance the positive effects of the Saver's Credit on plan sponsorship and participation.

Streamline and simplify process of saving and investing

Tax incentives have a strong effect on savings decisions. However, recent research has found that people do not always respond rationally to economic incentives

³⁹ Specifically, the Saver's Credit provides a tax credit equal to 50% of the first \$2,000 of contributions per individual for married couples earning under \$30,000. The match rate declines to 20% for couples earning between \$30,000 and \$32,500, and to 10% for couples earning between \$32,500 and \$50,000. The income thresholds are lower for individuals and single parents. I.R.C. § 25B.

⁴⁰ See, e.g., William G. Gale, J. Mark Iwry, Peter R. Orszag, *The Saver's Credit: Issues and Options*, TAX NOTES 606 (May 3, 2004).

⁴¹ For example, the notches in the current credit structure result in some taxpayers losing \$600 in tax credits for \$1 more in income.

⁴² William G. Gale, J. Mark Iwry, Peter R. Orszag, *The Saver's Credit: Issues and Options*, TAX NOTES 604 (May 3, 2004).

⁴³ Making the credit refundable is good policy because it ensures that all low-income workers have tax incentives to save and that their ability to claim the credit does not depend on whether their income fluctuates. Under current law, if a married couple's adjusted gross income is \$15,000 in one year and \$35,000 in a second year, they can only receive the Saver's Credit in the second year. Refundability permits them to claim the credit in both years, just as they could if they earned \$25,000 each year instead. Moreover, during their entire lifetimes, most workers pay significant income taxes as their earnings increase and their situations change. For these reasons, refundable credits are best viewed as a practical and effective form of income averaging.

and that savings decisions are shaped significantly by institutional factors as well. In particular, streamlining the process of saving can result in dramatically higher savings rates. In a time of substantial projected Federal budget deficits, proposals to increase savings by changing the institutional context of savings decisions are especially appealing because they often entail little or no cost to the government and private sector. We recommend four such initiatives.

First, we propose eliminating barriers to employers offering “automatic enrollment” or “opt out” plans, where employees participate in the plan unless they opt out. Several studies have found significantly higher participation rates in such plans.⁴⁴ However, employers have few positive incentives to implement automatic enrollment plans and are often hesitant to structure their plans in this manner for fear that they may be subject to fiduciary liability under ERISA if the participant has not affirmatively chosen how deferrals are invested. Employers are also often concerned about how deferrals can be returned to employees who elect to opt out without violating plan restrictions on in-service withdrawals. To address these concerns and others, we recommend adoption of proposals similar to those in Sec. 403 of The Pension Preservation and Savings Enhancement Act of 2003 (H.R. 1776) and other appropriate measures to facilitate the offering of automatic enrollment plans, such as confirming that ERISA preempts state signature requirements for payroll deductions. We also recommend positive incentives to encourage automatic enrollment plans. For example, employers with automatic enrollment plans could be exempted from certain testing requirements, provided with additional administrative or substantive safe harbors, and provided with certain tax incentives (*e.g.*, a credit per participant to offset additional administrative costs). In addition, full consideration should be given to whether it would be feasible to require automatic enrollment plans under certain circumstances.

Second, we propose allowing taxpayers to use direct deposit to send a portion of their Federal income tax refund to a qualified retirement (or other) savings vehicle, while still being able to send the balance of the refund by mail or to a checking account to meet immediate needs. The average tax refund is over \$2,000 per year,⁴⁵ and tax refunds are probably the greatest potential source of savings for lower-income families. We believe that elective contributions to defined contribution plans would be significantly increased if it were easier for people to save right on their tax forms and to think of their refunds as “money to save” and “money to spend.” Community pilot programs have found that taxpayers, including the lowest income taxpayers, do save

⁴⁴ See, *e.g.*, JAMES J. CHOI, DAVID LAIBSON, BRIGITTE MADRIAN & ANDREW METRICK, FOR BETTER OR FOR WORSE: DEFAULT RULES AND 401(K) SAVINGS BEHAVIOR 38-39, fig. 1A-1C (Nat'l Bur. of Economic Research Working Paper No. 8651, Dec. 2001) (finding that after 2 years of employment, participation rates in 401(k)s are 30 to 40 percentage points higher among employees hired after automatic enrollment was instituted than among workers hired before automatic enrollment); PROFIT SHARING / 401(K) COUNCIL OF AMERICA, PSCA RELEASES AUTOMATIC ENROLLMENT 2001 STUDY (Apr. 19, 2001) (finding that participation rose from 68.1% three months prior to instituting automatic enrollment to 77.1% one year after).

⁴⁵ See INTERNAL REVENUE SERVICE, TAX STATS AT A GLANCE (June, 29, 2004), *available at* <http://www.irs.gov/taxstats/article/0,,id=102886,00.html> (statistic for tax year 2002).

substantially more if they are allowed to “split” their refunds.⁴⁶ This proposal requires no legislation and was included in the Administration’s 2004 budget,⁴⁷ but has not yet been implemented. We recommend implementation in time for the 2005 tax season.

Third, we propose simplifying the minimum distribution rules, which are unnecessarily complex from the employee perspective and tend to inhibit work at the early stages of retirement even though such employment is a growing component of retirement security. In particular, we recommend eliminating the “half-year” rules (*e.g.*, change 59½ to 59) and raising the age at which minimum distributions must begin from 70.5 to 75, at least for retirees who are still working full- or part-time.

Fourth, we recommend that the Treasury create a new form of savings bond—the R-bond—so that small amounts of retirement savings can be preserved for retirement without imposing unworkable administrative costs on plan sponsors, plan administrators, and financial institutions. The R-bond would be similar to existing savings bonds except that it could only be rolled over to a qualified retirement savings vehicle or redeemed in retirement, at which point it would be subject to the IRA rules. Rollovers would be free of restrictions. Because R-bonds would typically be held for a long period of time, they should pay a higher rate of interest than existing savings bonds. R-bonds would be a convenient and inexpensive way of investing small amounts on behalf of workers, and would provide a useful vehicle for rolling over small accounts by workers who change jobs frequently. In addition, R-bonds would be particularly useful in the context of automatic enrollment plans. If R-bonds are established, we also recommend modifying the option for employers to issue a lump-sum distribution to terminated employees with small accounts, and instead requiring them to distribute such accounts as R-bonds or IRAs as a default.

Policies to preserve balances for income throughout retirement.

Our final group of employer-based savings proposals seek to preserve balances accumulated in retirement plans for income throughout retirement. The shift from defined benefit to defined contribution plans has made it more important to prevent “leakage” from the retirement plan system through pre-retirement withdrawals. In addition, as discussed above, increasing longevity and health care costs—together with the rise of defined contribution plans—have increased the importance of proper financial planning during the withdrawal phase of retirement saving.

Allowing employers to distribute small balances in defined contribution plans as R-bonds is one way to prevent leakage. For large account balances, however, leakage is best prevented by minimizing outside claims on retirement assets and by

⁴⁶ For example, one pilot program by the Doorways to Dreams Fund and the Community Action Project of Tulsa County found that of 488 people offered the opportunity to split their refund, about one third wanted to participate. Participants on averaged deposited \$649 into savings accounts, which was 47% of their refunds. The average income of these participants was \$11,000 and two thirds had no prior savings.

⁴⁷ DEPARTMENT OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION’S FISCAL YEAR 2005 REVENUE PROPOSALS 10 (Feb., 2004).

enhancing portability between plans so that workers do not elect to take a non-qualified distribution in order to avoid the complexity of rolling over their account balance or maintaining multiple retirement plans.⁴⁸

Currently assets in defined contributions plans are frequently taken into account when determining eligibility for public and private means-tested programs, such as food stamps, Medicaid, and college scholarships, while defined benefit plans are not. As a result, workers who experience a financial setback, or who are trying to pay for their child's education, are frequently forced to exhaust their retirement assets saved over many years. In order to reduce this leakage from the retirement system, we recommend requiring that a certain amount of defined contribution plan assets that is significantly higher than current law (*e.g.*, \$10,000 to \$20,000) be excluded from eligibility determinations for means-tested programs, including financial aid determinations by public and private educational institutions.

With respect to portability, the first Portman-Cardin bill made significant headway, but work still remains. To this end, we recommend adopting proposals similar to those in Sections 301, 303, 304, 306 and 312 of the Pension Preservation and Savings Enhancement Act of 2003 (H.R. 1776), including allowing: (a) direct rollovers from defined contribution plans to Roth IRAs (the tax treatment and income limits for such rollovers would remain unchanged), (b) tax-free rollovers to spouses, regardless of whether the rollover follows death or divorce, (c) rollovers of after-tax amounts in 403(b) plans to 401(k)s and vice versa, and (d) transfers of assets from one type of retirement plan to another by plan sponsors if participant and spousal rights are protected.

Once a worker reaches retirement, the question becomes how to appropriately preserve their retirement savings for use throughout the duration of their remaining life. This presents a number of challenges because there is no right answer for all workers. Some may have a spouse or other family members who they wish to protect or provide for, some may expect to live a long time, and others may be ill and have reason to believe that they will not live for very long. As a result, we believe policies with respect to the distribution phase of retirement savings should be grounded in several principles.

All workers should have an adequate array of distribution options. They should be empowered to understand the ramifications of each option. They should also face as little friction as possible when choosing between them. And finally, all of this should happen in a context that does not unduly burden plan sponsors and administrators with costs and legal exposure.

⁴⁸ Currently, employees must be allowed to leave account balances in an employer-sponsored retirement plan if the balance exceeds \$5,000, unless the employee elects otherwise. I.R.C. § 411(a)(11)(A). If the balance is between \$1,000 and \$5,000, plan sponsors may rollover the balance to an IRA, but can only distribute the account balance as cash if the employee so elects. I.R.C. § 411(a)(31)(B). If the account balance is less than \$1,000, the plan sponsor can distribute the balance as cash to the employee if the employee does not make an election. I.R.C. § 411(a)(31)(A).

To achieve these objectives, we recommend that policies be put in place to encourage Americans to manage their retirement savings in such a way that ensures that a portion of their retirement savings, sufficient to meet their needs in retirement, will last throughout their actual remaining lives.

As part of this proposal, we recommend policies that will encourage plan sponsors to offer the full range of potential distribution options and provide plan participants with information regarding them. These options include distributing plan assets only to the extent required by the minimum distribution rules, lump sum distributions, periodic payments, rolling over assets to other tax-favored savings vehicles, and purchasing a guaranteed lifetime income stream. The goal is to ensure that all participants can select the distribution option or options that best fit their circumstances, a critical element of retirement security.

An essential aspect of this proposal is the need to address arrangements providing for a guaranteed lifetime income stream. These arrangements merit particular attention because they insure against investment and longevity risk, both of which retirees tend to undervalue. At present, guaranteed lifetime income streams are generally only available through life annuities, although other products serving a similar function may well develop over time. References below to “annuities” are intended to encompass this broader range of products that may develop in the future.

Unfortunately, under current law, plan sponsors are understandably and appropriately hesitant to offer an annuity option because, unlike the other distribution options, the annuity option exposes plan sponsors to complex and unclear fiduciary duties and significant administrative burdens. This means that many plan participants currently must follow quite cumbersome procedures in order to obtain a guaranteed lifetime income stream (in general, rolling over plan assets to an IRA and then using those funds to acquire an annuity priced on an individual basis in the private annuities market). Not only is this process unwieldy, but it also denies the participants cost savings that they might otherwise obtain if they could purchase an annuity priced on a group basis.

The best way to encourage plan sponsors to offer annuity payout options is to remove the barriers imposed by current law.⁴⁹ Uncertainty about how to comply with the safest available annuity standard after the much publicized failure of Executive Life is one significant deterrent to plan sponsors offering an annuity option. This standard should be revised to provide clear and practical guidance on how plan sponsors and their third party administrators may reasonably fulfill their fiduciary obligations in selecting an annuity provider. It should also be clarified that state law regarding annuities is preempted with respect to qualified plans.

⁴⁹ Other private and public enhancements may also be needed to ensure that the market for lifetime guaranteed income streams are responsive to the retirement needs of the baby boom generation (e.g., enactment of proposals for an optional Federal charter to provide consistent and uniform regulation; market-based arrangements to address concerns over long-term credit and inflation risk).

A second barrier relates to ERISA’s qualified joint and survivor annuity (“QJSA”) requirements. These rules impose extensive paperwork that is a substantial burden to plan sponsors. In particular, today plan sponsors offering an annuity option are required to obtain notarized spousal consent if a qualified joint and survivor annuity is waived by a married participant, even though most 401(k) plans are administered electronically, with very few paper transactions involved. At a minimum, electronic forms of obtaining QJSA waivers should be permitted, for example through use of PIN codes or other technological methods, in order to reduce these administrative costs. More fundamentally, we believe that the joint and survivor annuitization rules should be re-examined in the context of protecting spousal rights, administrative costs, and the changing demographics of the workforce.

To further mitigate barriers to plans sponsors offering an annuity option, we also recommend allowing plan sponsors to rollover the accounts of employees who want an annuity to a third party administrator who would assume full responsibility for annuitizing (or arranging for the annuitization of) the funds. These intermediaries would assume all applicable fiduciary obligations and satisfy whatever QJSA rules (if any) continue to apply. Despite the administrative and fiduciary burdens, we believe third party administrators would be willing to take on this role if the safest available annuity standard were clarified because of the economies of scale they would enjoy.

Finally, policies are also needed to address the fact that retirees tend not to understand the value of a guaranteed lifetime income stream and the protection it affords against longevity and investment risks. Therefore, in addition to the proposals listed above and educational efforts described below, we recommend appropriate tax incentives, for example along the lines of Section 305 of The Pension Preservation and Savings Enhancement Act of 2003 (H.R. 1776),⁵⁰ in order to encourage plan participants to take a portion of their distributions in the form of a guaranteed lifetime income stream.

Personal Savings

While employer-based savings is the best way to supplement Social Security for most workers, the reality is that only 50% of workers are covered by an employer-sponsored retirement plan. Even if coverage increases, it will never reach 100%. Accordingly, personal savings will always be a critical third component of retirement income security.

Unfortunately, presently personal savings is not helping enough to fill the gap between Social Security benefits and retirement income needs for many workers, especially those who do not participate in an employer-sponsored retirement plan. Currently, the net worth of families in the bottom 40% of the wealth distribution is approximately \$1,000, and the net worth of families in the middle quintile of the wealth

⁵⁰ Under this proposal, retirees could exclude a portion of the first \$20,000 of income each year from a lifetime annuity contract purchased with funds with qualified savings, subject to income limitations.

distribution is approximately \$61,000.⁵¹ Meanwhile, the value of a family's principal residence accounts for 60% of the wealth of those in the 20th to 80th percentiles of the wealth distribution, and defined contribution accounts comprise 12%.⁵²

In addition, participation rates and contribution levels for personal retirement savings vehicles are quite low. The average account balance in an IRA is approximately \$37,000,⁵³ and among workers eligible to make deductible contributions to IRAs in a given year, less than 10% do so.⁵⁴ Moreover, the low-income workers who are least likely to be covered by an employer-sponsored retirement plan are also least likely to participate in an IRA or Roth IRA. For example, 4% of eligible taxpayers earning between \$10,000 and \$20,000 participate in a given year, while 21% of eligible taxpayers earning between \$100,000 and \$200,000 participate.⁵⁵ This difference may result from the fact that the tax benefits associated with IRAs generally are of little or no value to lower-income households because they have little tax liability.⁵⁶ In total, more than 40% of workers do not participate in an employer-sponsored plan, IRA or Roth IRA.⁵⁷ These workers are disproportionately low-income.⁵⁸ IRA funds are also very rarely annuitized and pre-retirement withdrawals occur with great frequency.⁵⁹ Thus, the personal savings pillar of retirement security needs to be significantly strengthened and broadened.

Several objectives should guide efforts to expand personal retirement savings. Proposals should remove barriers to savings for all, but should focus incentives on those who are not covered by employer-sponsored retirement plans, especially low- and middle-income workers. They should increase retirement savings without

⁵¹ EDWARD N. WOLFF, RECENT TRENDS IN WEALTH OWNERSHIP, 1983-1998, at tbl.3 (Jerome Levy Economics Institute Working Paper No. 300, Apr., 2000).

⁵² EDWARD N. WOLFF, RECENT TRENDS IN WEALTH OWNERSHIP, 1983-1998, at tbl.5 (Jerome Levy Economics Institute Working Paper No. 300, Apr., 2000).

⁵³ Craig Copeland, *Retirement Accounts and Wealth, 2001*, in EBRI NOTES (Vol. 25, No. 5, May 2004).

⁵⁴ Peter J. Sailer & Sarah E. Nutter, *Accumulation and Distribution of Individual Retirement Arrangements, 2000*, in INTERNAL REVENUE SERVICE, STATISTICS ON INCOME BULLETIN 121 (Spring, 2004).

⁵⁵ Peter J. Sailer & Sarah E. Nutter, *Accumulation and Distribution of Individual Retirement Arrangements, 2000*, in INTERNAL REVENUE SERVICE, STATISTICS ON INCOME BULLETIN 121 (Spring, 2004).

⁵⁶ Approximately 30% of tax units have income tax liability of \$500 or less, and another 13% of tax units do not file, generally because their income is so low that they do not owe income taxes. Peter R. Orszag & Matthew G. Hall, *Nonfilers and Filers with Modest Tax Liabilities*, TAX NOTES 723, August 4, 2003.

⁵⁷ See Alicia H. Munnell & Annika Sunden, *Private Pensions, Coverage and Benefit Trends* 36, 56 (prepared for "Conversation on Coverage," Washington D.C., July 24-25, 2001); Peter J. Sailer & Sarah E. Nutter, *Accumulation and Distribution of Individual Retirement Arrangements, 2000*, in INTERNAL REVENUE SERVICE, STATISTICS ON INCOME BULLETIN 121 (Spring, 2004).

⁵⁸ William G. Gale, J. Mark Iwry, Peter R. Orszag, *The Saver's Credit: Issues and Options*, TAX NOTES 601 (May 3, 2004).

⁵⁹ For example, during 2000, workers age 25-54 contributed \$26,532,615 to IRAs and withdrew \$24,089,193. Withdrawals therefore accounted for 90% of contributions. See PETER J. SAILER & SARAH E. NUTTER, ACCUMULATION AND DISTRIBUTION OF INDIVIDUAL RETIREMENT ARRANGEMENTS, 2000 (July 20, 2004), available at <http://www.irs.gov/pub/irs-soi/00retire.pdf> See also *supra* note 46.

undermining the employer-sponsored retirement saving system. They should address the reasons that people are not saving more currently, including limited financial expertise, overwhelming choices, easy access to credit, and lack of understanding that traditional guaranteed monthly pension benefits are disappearing. Finally, reform proposals should strive to ensure that more personal retirement savings are preserved until retirement and paid out in a way that helps ensure that people do not outlive their assets.⁶⁰

To address these objectives, we recommend extending many of our proposals for employer-sponsored retirement plans to personal retirement savings vehicles. For example, allowing taxpayers to split their refunds and direct a portion into an IRA or Roth IRA should significantly increase participation rates and participation levels in these vehicles by removing barriers to savings, and should increase savings that are not tax-preferred as well.⁶¹ R-bonds would also eliminate barriers to saving by allowing workers to accumulate small amounts in retirement savings vehicles until the amounts are large enough to make rolling over the funds to an IRA administratively feasible for financial institutions. And portability provisions similar to those in Sections 301, 303, and 304 of The Pension Preservation and Savings Enhancement Act of 2003 (H.R. 1776) would help reduce leakage from the retirement savings system when funds are moved from employer-sponsored retirement plans or between IRAs and Roth IRAs.⁶²

In addition, our proposals to exclude defined contribution plan assets from public and private means-tested programs should apply equally to IRAs and Roth IRAs. And, like employer-based retirement plans, IRAs and Roth IRAs generally should be protected from creditor claims and during bankruptcy. Further, we believe that our proposals described above that are designed to encourage Americans to manage their savings in such a way that ensures a portion of their retirement savings, sufficient to meet their needs in retirement, will last throughout their actual remaining lives should be extended to IRAs and Roth IRAs. This includes encouraging financial institutions sponsoring IRAs and Roth IRAs to offer the full menu of distribution options and to educate participants about these options, eliminating barriers to offering the option of a guaranteed lifetime income stream, and providing appropriate tax incentives to encourage participants to take a portion of their distributions in the form of a guaranteed lifetime income stream. Together, these proposals will help ensure that savings for retirement is protected until retirement, and spread appropriately across workers' retirement years during the distribution phase.

While adoption of these proposals would go a long way toward increasing and broadening personal retirement savings, ultimately we believe other tax incentives

⁶⁰ As always, there is a tension between preserving assets for retirement and increasing retirement savings because strong limits on access prior to retirement tend to discourage retirement savings.

⁶¹ H&R Block recently developed a system whereby they effectively split refunds themselves and opened 100,000 new IRAs and Roth IRAs in the first two months of the tax season. *Betting on Bigger Returns for H&R Block*, BUSINESSWEEK ONLINE (March 25, 2002).

⁶² The relevant proposals include allowing tax-free rollovers between the IRAs of spouses, tax-free rollovers between the IRA of a decedent and the IRA of their non-spouse beneficiary, and direct rollovers from employer-sponsored plans to Roth IRAs.

are necessary as well. When structuring expanded tax incentives, universality is key. What differentiates personal retirement savings from savings in employer-sponsored retirement plans is that personal savings is the only backstop for workers who are not covered by an employer plan as they try to bridge the gap between Social Security and their retirement security needs. Paradoxically, however, the tax incentives for personal retirement savings are less universal than the tax incentives for retirement saving in the context of an employer-sponsored plan. Our tax system should create incentives for *all* workers to save for retirement.

A truly universal set of tax incentives for retirement savings will require changes at both the lower end and the higher end of the income distribution. At the low end, the Saver's Credit should be expanded, made permanent, and made refundable, as discussed above. Only then will all lower-income workers have incentives for retirement savings, and not just the workers whose employers offer matching contributions. Disabled taxpayers should also be able to contribute to IRAs and Roth IRAs on the same basis as other taxpayers even if they have no earned income. At the higher end of the income distribution, the income limits on IRAs and Roth IRAs should be eliminated. Even higher-income workers are not saving adequately for retirement at this point in time, and eliminating the income limits will encourage them to address their retirement security needs. Moreover, experience demonstrates that eliminating the income limits on IRAs and Roth IRAs is the most effective way to increase participation among low- and middle income workers because these vehicles will be marketed far more extensively.

Consideration should also be given to the creation of children's savings accounts as a universal savings platform. Recently legislation was introduced on a bipartisan basis to establish an account for every child born after 2005.⁶³ The accounts would be tax-free and parents could make additional tax-deferred contributions, with low-income parents eligible for refundable credits to match their voluntary contributions. While the accounts generally could only be used for education, home buying, and retirement, we believe that as an essential part of this proposal must be that the account holders cannot access a portion of the accounts, including earnings, until retirement. Over time, this would ensure that all Americans have access to a truly universal savings platform.

Finally, while the Commission believes that the contribution limits for IRAs and Roth IRAs should remain lower than the elective deferral limits for defined contribution plans in order to preserve incentives for employers to offer such plans, the contribution limits for IRAs and Roth IRAs are currently insufficient. Accordingly, we propose accelerating and making permanent the increased contribution limits (including catch-up contribution limits) for these vehicles in EGTRRA.

Some of these proposals will admittedly be costly and the nation's substantial projected budgetary shortfalls are cause for great concern. Ultimately,

⁶³ See The ASPIRE Act, S. 2751 (108th Cong.), H.R. 4939 (108th Cong.), introduced on July 22, 2004 by Senators Rick Santorum (R-PA) and Jon Corzine (D-NJ) and Representatives Pat Kennedy (D-RI), Harold Ford (D-TN), Tom Petri (R-WI) and Phil English (R-PA).

however, many of these costs will be borne by government and taxpayers (one way or the other) and the fiscal expense of these proposals is both necessary and appropriate to expand coverage and improve the adequacy of retirement income.

Retiree Health Care

The bulk of the Commission's work has focused on ways to increase savings for retirement in general. However, one type of retirement expense merits special attention: retiree health care costs. Retirees are being forced to devote an increasing share of their income to health care and, given that Medicare is expected to begin running immense deficits in the coming decades, it is unlikely that the government will be able to fill this gap through Medicare.⁶⁴

To give a sense of the size of this problem, it is estimated that the average couple today retiring at age 65 will need to spend \$290,000 on Medigap insurance, comprehensive long-term care insurance, and other health care expenses that are not covered by Medicare during their retirement if they do not have an employer-sponsored retiree health plan.⁶⁵ Employer-sponsored retiree health plan coverage has declined precipitously over the past decade so the number of retirees who must bear these expenses is only expected to grow.⁶⁶ Even retirees with an employer-sponsored health plan are responsible for an increasing share of their health care costs and all of their long-term care expenses, either by self-insuring or by purchasing long-term care insurance.

What's more, long-term care comprises a large and increasing share of retiree health expenses. In 2003, the annual cost for semi-private nursing home care averaged \$57,000 and home health care costs averaged \$20,000 per year. By 2030, these costs are expected to rise to \$200,000 and \$75,000 per year, respectively.⁶⁷ Because retirees cannot predict whether they will need long-term care, it is a classic candidate for insurance. Nevertheless, only about 11% of Americans over the age of 65 currently have a private long-term care insurance policy.⁶⁸ Medicaid has become the default financing

⁶⁴ The Social Security and Medicare Board of Trustees have projected that the Hospital Insurance (HI) Trust Fund will be exhausted by 2019 and that Medicare costs (the HI Trust Fund and the Supplemental Medical Insurance Trust Fund, including Part D for prescription drugs) will grow from 2.6% of GDP in 2003 to 13.8% in 2078. SOCIAL SECURITY AND MEDICARE BOARDS OF TRUSTEES, STATUS OF THE SOCIAL SECURITY AND MEDICARE PROGRAMS: A SUMMARY OF THE 2004 ANNUAL REPORTS (2004), *available at* <http://www.ssa.gov/OACT/TRSUM/trsummary.html>

⁶⁵ FIDELITY WORKPLACE SERVICES, RETIREE HEALTH COSTS: ADDRESSING THE GROWING GAP (Sept., 2002).

⁶⁶ In 1993, 40% of Medicare-eligible retirees from companies with over 500 employees were covered by an employer-sponsored retiree health plan. By 2000, this proportion had fallen to under 25%. FIDELITY WORKPLACE SERVICES, RETIREE HEALTH COSTS: ADDRESSING THE GROWING GAP (Sept., 2002).

⁶⁷ STATE INNOVATIONS TO ENCOURAGE PERSONAL PLANNING FOR LONG-TERM CARE (National Governor's Association, Center for Best Practices Aging Initiative, June 18, 2004).

⁶⁸ WHO PAYS FOR LONG-TERM CARE: FACT Sheet (Long-Term Care Financing Project, Georgetown University, 2003). About one-third of these policies are purchased through employers. STATE INNOVATIONS TO ENCOURAGE PERSONAL PLANNING FOR LONG-TERM CARE (National Governor's Association, Center for Best Practices Aging Initiative, June 18, 2004).

system for long-term care, covering about 45% of all long-term care expenses.⁶⁹ And, since Medicaid generally covers only nursing home stays and limited home care, but not assisted living facility stays or community-based services, the system often forces people into nursing homes sooner than they would choose.

We believe several objectives should guide efforts to address mounting retiree health care costs. First, the goal should be access to retiree health coverage for everyone. For those over age 65, the availability of Medicare (with the recent addition of a drug benefit), combined with long-term care insurance and either a Medigap policy or employer coverage, now meets this goal. The most vulnerable group in this regard is the middle class because Medicaid covers low-income retirees, and because middle-class retirees may avoid needed but uncovered health care in order to preserve assets for future living expenses. This leads to the second objective: Policymakers should promote the purchase of long-term care insurance so that retirees are not forced to exhaust their assets needed for future living expenses for themselves or a surviving spouse in order to qualify for Medicaid and cope with a catastrophic decline in health. Finally, policies should encourage employers to offer (or continue to offer) retiree health plans.

In developing proposals, the Commission decided to focus on ways to pre-fund retiree health expenses by increasing saving and insurance coverage for these expenses. Clearly, there are many other challenges that must also be addressed to maintain and improve access to health care in retirement. In particular, the exponential growth in the cost of health care must be addressed through redesign of the health care delivery system. Independent commissions will likely be necessary to think about how to control this growth in a structured and humane way. But we believe that our proposals are consistent with the broader health reform ideas that others may contemplate because ultimately, however the health care delivery system for retirees is redesigned, it will be essential to pre-fund a significant portion of the costs. To this end, the Commission has concluded that the principles outlined above are best met by a combination of regulatory changes to encourage employer-sponsored retiree health plans, and tax incentives to promote saving for retiree health and the purchase of long-term care insurance. We propose the following four initiatives.

First, in order to support existing employer-sponsored retiree health plans and encourage establishment of new plans, we recommend raising the funding limits on employer-sponsored retiree health plans so that employers can elect to fund plans at significantly higher amounts than under current law, and can reduce funding in bad years to the extent that they take advantage of this option. We also recommend reducing the barriers that plan sponsors face to using defined benefit plan surpluses to fund retiree health plans, including replacing the five-year maintenance of benefit requirement in I.R.C. Sec. 420 with a five-year maintenance of cost requirement.

⁶⁹ Long-term care accounts for about one-third of Medicaid costs. STATE INNOVATIONS TO ENCOURAGE PERSONAL PLANNING FOR LONG-TERM CARE (National Governor's Association, Center for Best Practices Aging Initiative, June 18, 2004).

As noted above, the funding obligations for employers sponsoring defined benefit plans currently are volatile and increase during bad economic times while increasing in good times.⁷⁰ The same situation applies to retiree health plans. By giving employers more latitude to increase funding of retiree health plans in good years, and decrease plan funding in bad times, plan sponsorship should increase. In addition, while employers sponsoring defined benefit plans that are overfunded currently can use the surpluses to fund retiree health plans, the process is fairly complicated and burdensome. These frictions should be reduced. Doing so would have the added benefit of meaning that our proposal to raise the funding limits on defined benefit plans would increase plan sponsorship and stability not only of defined benefit plans, but of retiree health plans as well.

Second, we recommend establishing a new savings vehicle, the Retiree Medical Benefit Account (RMBA), to increase savings for retiree medical expenses and long-term care insurance. RMBAs would be voluntary sidecar accounts for taxpayers with an IRA or defined contribution plan. Distributions from RMBAs would be tax-free and penalty-free if used for retiree medical expenses, including long-term care insurance purchased before or at retirement and Medigap policy premiums. For defined contribution accounts, the worker could elect to have a portion of their employee pre-tax contributions and employer matching or non-elective contributions allocated to a RMBA. Elections could be made at any interval and the allocation would not be treated as a deemed distribution triggering tax liability. Any contributions made to the RMBA would be subject to all existing contribution limits and nondiscrimination rules that apply to the underlying plan, and RMBA contributions would be capped at several thousand dollars, with higher catch-up contributions for the years immediately prior to retirement. Similarly, for traditional and Roth IRAs, the worker could elect, at any interval to have a portion of his or her contribution or account balance allocated to a RMBA and the allocation would not be treated as a distribution triggering tax liability. IRA contribution limits and income limits would apply to the RMBA and IRA combined, and the contribution limits specific to RMBAs would apply as well. In addition, HSAs could be rolled over to RMBAs. We believe these tax incentives underlying RMBAs will induce significantly greater savings for retiree health, and will induce more workers to begin purchasing long-term care insurance before or at the time they retire.

Third, we recommend providing an above-the-line deduction for long-term care insurance premiums and including long-term care insurance in cafeteria plans and Flexible Spending Accounts. As discussed, long-term care expenses can be massive and the cost of long-term care is expected to rise rapidly over time. In response, an increasing number of retirees who need long-term care spend down all of their assets or—pursuant to "Medicaid planning," transfer all of their assets—in order to qualify for Medicaid and its nursing home coverage. This is not a sustainable way to fund long-term care for the states or the federal government. Instead, we should be encouraging workers to save responsibly and purchase long-term care insurance on their own or through their employer. Currently, long-term care premiums are deductible only if the taxpayer

⁷⁰ See *supra* note 37 & accompanying text.

itemizes and, when combined with other health-related expenses, the premiums exceed 7.5% of adjusted gross income. Allowing taxpayers to deduct long-term care premiums without these limitations would be an important step toward increasing long-term care insurance coverage. And allowing inclusion of this coverage in cafeteria plans and Flexible Spending Accounts would provide another incentive for purchasing private coverage.

Finally, it should also be noted that some states have long-term care insurance public / private partnership programs to encourage their residents to purchase long-term care insurance and that these partnerships are a promising new model. Under these programs, a person who buys a long-term care policy approved by his state's partnership program may apply for Medicaid eligibility after he exhausts his policy benefits without first having to exhaust his assets. Generally, the amount of assets protected from Medicaid seizure equals the amount of benefits under his partnership policy.

While many think partnership programs have the potential to significantly increase private long-term care coverage, there are currently several problems surrounding these programs that need to be addressed. First, under current federal law, partnership programs are limited to a handful of states. Second, the policies are generally not portable. This means that if someone with such a policy moves to another state, the protections from Medicaid seizure will not be available. Third, many consumers mistakenly believe they will be able to continue to access the same coverage they had under their policy when they are covered by Medicaid. And finally, the lack of national contract and regulatory standards creates a serious administrative burden for long-term care insurers who might want to sell partnership policies.

In order to encourage the establishment of long-term care insurance public / private partnership programs, we recommend repealing the restriction to certain states, in a manner similar to the proposal in H.R. 1406 (108th Cong.), and establishing a national partnership model through federal contract and regulatory standards that provide for uniformity, portability, and reciprocity across states. Together we believe that these proposals will result in partnership programs becoming more popular as a means of encouraging people to insure against the risk of needing long-term care services, while reducing state Medicaid budgets at the same time.

Financial Education

Ultimately, educational initiatives will be critical to the success of all of the proposals outlined above. Thus in conclusion we discuss several ways in which financial literacy about the need to save for retirement can be increased. Extensive research has documented how American's savings behavior is shaped not just by rational self-interest, but also by institutional factors like financial education. Financial education increases participation rates⁷¹ and contribution levels.⁷² In order to make sure that

⁷¹ See, e.g., B. DOUGLAS BERNHEIM & DANIEL M. GARRETT, THE DETERMINANTS AND CAUSES OF FINANCIAL EDUCATION IN THE WORKPLACE: EVIDENCE FROM A SURVEY OF HOUSEHOLDS (Nat'l Bur. Econ.

Americans take advantage of the opportunities to improve their retirement security outlined above, we therefore propose the following five initiatives.

First, the government should sponsor broad media campaigns designed to increase Americans' awareness of the need to save retirement. Possibilities include a "Got Savings" campaign, recognition of the "Ten Best Companies to Retire From," and publicity of a retirement savings pyramid. The public should be educated that saving for retirement is an essential task of adult life.

Second, existing governmental communications regarding retirement should be leveraged and existing financial education programs should be consolidated through interagency coordination led by the Treasury Department. In particular, the annual Social Security statement is an excellent avenue for financial education and should include, among other things, a simple method for calculating a rough estimate of the amount one needs to save for retirement, when combined with projected Social Security benefits, in order to provide a 70% replacement rate. Closer to retirement, the statement could be used to educate workers about what mix of distribution options from their retirement savings would help ensure that they will have a reasonable income stream throughout their actual remaining lives (taking account of Social Security benefits, available retirement assets, and anticipated retirement needs). The IRS should also notify eligible taxpayers who have not taken advantage of tax-favored savings opportunities. In addition, misunderstanding surrounding long-term care insurance is great. Many, if not most, people think Medicare covers long-term care services and a disproportionate number of people believe they have long-term care insurance, while only 15% of people are actually insured. Mailings by the Centers for Medicare and Medicaid Services and public service announcements should be used to educate the public about this important matter as well.

Third, we recommend establishing financial education as a high school graduation requirement, which could be integrated with a President's Council on Financial Literacy similar to the current President's Council on Physical Fitness. The easiest way to ensure retirement security is to begin saving early in life. And research has found that financial education in high school can have a positive effect on lifetime savings rates.⁷³

Research Working Paper No. 5667, July, 1996) (finding that availability of employer-provided retirement education increases participation rates in 401(k) plans by 12 percentage points).

⁷² See, e.g., B. DOUGLAS BERNHEIM & DANIEL M. GARRETT, THE DETERMINANTS AND CAUSES OF FINANCIAL EDUCATION IN THE WORKPLACE: EVIDENCE FROM A SURVEY OF HOUSEHOLDS (Nat'l Bur. Econ. Research Working Paper No. 5667, July, 1996) (finding that, controlling for other factors, availability of employer-provided retirement education increases employees' retirement savings rate on average by one percentage point, from 3% of income to 4%, and that increases are disproportionately among lower income workers).

⁷³ See, e.g., B. DOUGLAS BERNHEIM, DANIEL M. GARRETT & DEAN M. MAKI, EDUCATION AND SAVING: THE LONG-TERM EFFECTS OF HIGH SCHOOL FINANCIAL CURRICULUM MANDATES (Nat'l Bur. Econ. Research Working Paper No. 6085, July, 1997).

Fourth, policies should be put in place to encourage Americans to manage their retirement savings in ways that are appropriate to their needs. As part of this effort, it is important that Americans manage their retirement savings in such a way that ensures that a portion of their retirement savings, sufficient to meet their needs in retirement, will last throughout their actual remaining lives.

Finally, it is important to recognize the role the private sector can play in promoting financial education. Employers, financial institutions, and tax return preparers play a critical role in retirement savings decisions. We have discussed some ways in which their positions can be leveraged to increase retirement savings,⁷⁴ but other policies to encourage financial education by them about the need for retirement savings, and appropriate decisions regarding distributions of retirement savings, should be developed as well. For our part, we are confident that the proposals contained in this Report provide a robust and rational framework that we can use to promote retirement savings by all Americans, and a framework that is far superior to the current system.

Conclusion

In reaching agreement on this Report, members of the Financial Services Roundtable are acknowledging shared responsibility for enabling all Americans to provide for their retirement security. All of our individual members do not support all of the proposals with equal enthusiasm, but we believe that policies promoting retirement security for all Americans are in everyone's best interest. In making our recommendations, we recognize that Social Security reform will require hard choices, compromise and leadership by our elected officials. We also recognize that some of our proposals will have a significant revenue cost. It is worth noting, however, that a number of the more significant proposals can be implemented by the Administration under current law and at no significant expense to the government, while others that do require legislation have only a modest revenue cost. Even where our proposals do entail significant revenue costs, we believe these costs are acceptable, given the scope of the issues we are addressing and because, for the most part, they are costs that the country will incur one way or the other as the baby boom generation retires.

Considered as a whole, this Report provides a balanced and fiscally responsible framework that will fulfill the promise of Social Security, create a universal savings platform, and provide the proper incentives to help ensure retirement security for all Americans.

⁷⁴ See *supra* notes 45-49 & accompanying text.

APPENDIX A: PRINCIPLES AND RECOMMENDATIONS

Social Security Reform

- **Principles:** Any Social Security reform should:
 1. Put Social Security on a sound financial footing.
 2. Retain a defined benefit that provides a safety net for all Americans while creating a universal individual account system.
 3. Expand financial literacy and promote a net increase in national savings.
 4. Be distributionally neutral.
 5. Have a neutral or positive effect on capital markets.
- **Proposal:** Preserve a defined benefit program, especially at the low end of the income distribution. Establish a truly universal system of individual accounts. Participation in the accounts would be mandatory and the accounts would not be integrated with the defined benefit program. Do not disturb (and perhaps enhance) Social Security benefits for the disabled and other disadvantaged groups. Eliminate penalties on retirees who continue to work before reaching the normal retirement age but after beginning to draw Social Security benefits.
 1. **Funding:**
 - Funding should *not* be achieved: (1) by investing a portion of the Social Security trust fund in private markets, or (2) by offsetting a retiree's defined benefit based on the size of their individual account.
 - The proposal should be funded through a combination of the following. (As a point of reference, restoring the actuarial balance to the current Social Security system would require approximately 2% of taxable payroll.)
 - **Benefit cuts**
 - Use more appropriate cost of living adjustments for Social Security benefits. Estimated cost savings equivalent to: 0.35% of payroll.
 - Increase the number of years of earnings used to compute benefits to reflect longer life expectancies and longer periods in the workforce. Estimated cost savings equivalent to: 0.21% of payroll.
 - Accelerate scheduled increases to the normal retirement age, reflecting longer life expectancies. Estimated cost savings equivalent to: 0.14% of payroll.
 - Reduce the replacement rate for higher-income workers. Estimated cost savings equivalent to: 0.18% of payroll.
 - Adjust benefits for changes in life expectancy. Estimated cost savings equivalent to: 0.59% of payroll.

- Alternately, reflect longer life expectancies by gradually increasing the normal retirement age beyond scheduled increases. Estimated cost savings equivalent to: 0.50% of payroll.
 - *Tax increases*
 - Increase the wage base for the payroll tax to its traditional levels. Estimated additional revenues equal to: 0.61% of payroll.
 - Cover new state and local government employees to provide for universal coverage. Estimated additional revenues equal to: 0.19% of payroll.
 - Increase the payroll tax rate. Additional revenues: 1% of payroll for every 1 percentage point increase in the payroll tax.
 - Use general revenues to partially fund individual private accounts.
2. *Administration of private accounts:*
- Initially the accounts should be administered by government in manner similar to the Thrift Savings Plan. Participants could pick from a limited number of diversified investment options. The default option would be a balanced, age-appropriate fund. Funds could not be withdrawn from the account prior to retirement, death or disability.
 - Once an account reached a certain size, the participant should have the option to roll the account into the private sector, subject to certain investment restrictions, and to make additional voluntary contributions. Such additional contributions should be integrated with existing tax-favored retirement savings programs, and should be eligible for the same tax incentives and subject to the same rules governing withdrawals.
3. *Distribution of accounts:*
- A guaranteed lifetime payout would be required for some portion of the accounts. Options include requiring account holders to: (1) purchase longevity insurance (for example, past age 85), or (2) purchase a joint and survivor annuity with some percentage of their account (for example, an amount sufficient to purchase an annuity that provides a monthly distribution that is some percentage of the poverty line).

Employer-Based Savings

- *Principles:* Any reform should:
 1. Support existing defined benefit plans, while increasing the number of employers offering retirement plans, increasing participation rates, and increasing the amount of worker contributions in all employer-based savings vehicles, whether in defined benefit, hybrid, or defined contribution plans.
 2. Ensure that the form of payouts from employer-sponsored retirement plans promotes retirement security.

3. Focus on the workers who currently participate least in the employer-based retirement plan system.
- **Proposals:**

Remove regulatory barriers to offering retirement plans

 1. Create a new “Clearinghouse Plan,” designed to increase plan coverage among small employers that are deterred by administrative burdens and fiduciary liability. Similar to a payroll deduction IRA or SIMPLE plan in that it would remove many barriers to small employer participation (*e.g.*, testing, reporting, fiduciary liability), but participating employers would have to open the plan to all employees and employer contributions would not be required. Designed so as to not undermine traditional employer-based defined benefit and defined contribution plans.
 - Eligible financial institutions would market the plans to small employers.
 - If a small employer elected to make available the Clearinghouse Plan of one or more financial institutions, its employees could divert a portion of their payroll to the plan, subject to contribution limits that would be higher than those for IRAs, but lower than the elective deferral limits for defined contribution plans.
 - Rollovers to IRAs and other defined contribution plans would be freely permitted.
 - Participating employers could automatically enroll employees in the plan and could make contributions to the plan, provided that such employer contributions were included in compensation and counted toward the employee’s contribution limit.
 - Participating employers could not exclude any employees (*e.g.*, part-time workers) from making contributions to the plan.
 - The plan would be administered by the financial institution, which would assume all fiduciary obligations and virtually all administrative responsibilities, thereby relieving the small employer of those obligations and responsibilities.
 2. Reform the funding requirements governing defined benefit plans by in the following manner:
 - Permit employers to elect to fund plans at up to 125% of the current limits, and to reduce funding in bad years to the extent that they have elected to fund plans above the current limits previously.
 - Permanently replace the 30-year Treasury bond rate used for calculating funding obligations with a high-quality corporate bond rate.
 3. Allow employees to continue working for their current employer once they reach the normal retirement age for their defined benefit plan and to begin receiving their pension at the same time.

4. Clarify the validity of the basic plan design of all hybrid plans and provide guidance on an array of compliance and interpretive questions.
5. Simplify the nondiscrimination rules for defined contribution plans by adopting safe harbors similar to those in President Bush's ERSA proposal. Employers could avoid nondiscrimination testing altogether if either: (1) the average contribution percentage of non-highly compensated workers was over 6% of compensation (the average contribution percentage for highly compensated workers could then be any amount), or (2) the average contribution percentage of non-highly compensated workers was under 6%, but no less than one half of the average contribution percentage for highly compensated workers.
6. Simplify the Form 5500 reporting requirements for retirement plans sponsored by small employers by adopting proposals similar to those in Sec. 601 of H.R. 1776 (108th Cong.).

Tax incentives to increase participation rates and contribution levels

1. Accelerate and make permanent the EGTRRA increases in elective deferral limits (including catch-up contribution limits) applicable to defined contribution plans.
2. Expand, make permanent and make refundable the Saver's Credit. Consider providing employers with some incentive under the nondiscrimination rules to make sure that eligible workers claim the Credit.

Streamline and simplify process of saving and investing

1. Eliminate barriers to employers offering "automatic enrollment" or "opt out" plans by adopting proposals similar to those in Sec. 403 of H.R. 1776 (108th Cong.) and other appropriate measures, such as confirming that ERISA preempts state signature requirements for payroll deductions.
2. Create positive incentives for offering automatic enrollment plans. For example, employers with automatic enrollment plans could be exempted from certain testing requirements, provided with additional administrative or substantive safe harbors, or provided with certain tax incentives (*e.g.*, a credit per participant to offset additional administrative costs). Consider requiring automatic enrollment plans in certain circumstances.
3. Permit taxpayers to split their tax refunds and direct deposit a portion of their refund to a retirement savings vehicle by the 2005 tax season. No legislation required. This proposal was included in the Administration's 2004 budget but has not yet been implemented.
4. Simplify the minimum distribution rules by eliminating the "half-year" rules (*e.g.*, by changing 59½ to 59) and raising the minimum distribution age from 70½ to 75, at least for retirees who are still working full- or part-time.
5. Treasury should create a new form of savings bond—the R-bond— so that small amounts of retirement savings can be preserved for retirement without imposing unworkable administrative costs on individual savers, plan sponsors,

plan administrators, and financial institutions. Similar to existing savings bonds except that it could only be rolled over to a qualified retirement savings vehicle or redeemed in retirement, at which point it would be subject to the IRA rules. No restrictions on rollovers. Because the holding period should be longer, R-bonds should pay a higher rate of interest than existing savings bonds.

Preserve balances for income throughout retirement

1. If R-bonds created, require employers to distribute small accounts as R-bonds or an IRA as a default option (instead of allowing issuance of a lump-sum distribution without employee consent).
2. Reduce the penalties on savings by low- and middle-income families, and reduce leakage from the retirement system, through the following proposals:
 - Increase the amount of defined contribution assets excluded from eligibility determinations for public means-tested programs.
 - Also increase the amount of defined contribution assets excluded from financial aid determinations by private educational institutions.
3. Enhance portability among plans by adopting proposals similar to those in Sections 301, 303, 304, 306 and 312 of H.R. 1776 (108th Cong.), including allowing: (a) direct rollovers from defined contribution plans to Roth IRAs (the tax treatment and income limits for such rollovers would remain unchanged), (b) tax-free rollovers to spouses, regardless of whether the rollover follows death or divorce, (c) rollovers of after-tax amounts in 403(b) plans to 401(k)s and vice versa, and (d) transfers of assets from one type of retirement plan to another by plan sponsors if participant and spousal rights are protected.
4. Put policies in place to encourage Americans to manage their retirement savings in such a way that ensures that a portion of their retirement savings, sufficient to meet their needs in retirement, will last throughout their actual remaining lives, including through the following proposals:
 - Encourage plan sponsors to offer the full range of potential distribution options and provide plan participants with information regarding them. These options include distributing plan assets only to the extent required by the minimum distribution rules, lump sum distributions, periodic payments, rolling over assets to other tax-favored savings vehicles, and purchasing a guaranteed lifetime income stream.
 - Revise the safest available annuity standard so that plan sponsors and administrators have clear cut and practical ways to satisfy their fiduciary obligations in selecting an annuity provider. Clarify that state law regarding annuities is preempted with respect to qualified plans.
 - Permit electronic forms of obtaining QJSA waivers, for example through use of PIN codes or other technological methods. Also, re-examine the joint and survivor annuitization rules in the broader context of protecting

spousal rights, administrative costs, and the changing demographics of the workforce.

- Allow the plan sponsor (including Clearinghouse Plan sponsors) to rollover the accounts of participants wanting an annuity to a third party administrator who would assume full responsibility for annuitizing (or arranging for the annuitization of) the funds, processing the QJSA paperwork, and fulfilling all applicable fiduciary obligations.
- Adopt appropriate tax incentives to encourage plan participants to take a portion of their distributions in the form of a guaranteed lifetime income stream, for example along the lines of Section 305 of H.R. 1776 (108th Cong.).

Personal Savings

- ***Principles:*** Any reform should:
 1. Remove barriers to savings for all, while focusing new incentives on those who are not covered by employer-sponsored retirement plans, especially low- and middle-income workers.
 2. Increase long-term, retirement savings without undermining the employer-sponsored retirement plan system.
 3. Address the reasons that people are not saving more currently, including limited financial expertise, overwhelming choices, easy access to credit, and lack of understanding traditional monthly pension benefits are disappearing.
 4. Help ensure that more personal retirement savings are preserved until retirement and are paid out in a way that ensures that people do not outlive their assets.
- ***Proposals:***
 1. Permit taxpayers to split their tax refunds and direct deposit a portion of their refund to a retirement savings vehicle by the 2005 tax season. No legislation required. This proposal was included in the Administration's 2004 budget but has not yet been implemented.
 2. Treasury should create a new form of savings bond—the R-bond— so that small amounts of retirement savings can be preserved for retirement without imposing unworkable administrative costs on individual savers, plan sponsors, plan administrators, and financial institutions. Similar to existing savings bonds except that it could only be rolled over to a qualified retirement savings vehicle or redeemed in retirement, at which point it would be subject to the IRA rules. No restrictions on rollovers. Because the holding period should be longer, R-bonds should pay a higher rate of interest than existing savings bonds.
 3. Reduce the penalties on savings by low and middle income families, and reduce leakage from the retirement system, through the following proposals:

- Increase the amount of IRA and Roth IRA assets excluded from eligibility determinations for public means-tested programs, creditor claims, and bankruptcy proceedings.
 - Also increase the amount of IRA and Roth IRA excluded from financial aid determinations by private educational institutions.
4. Enhance portability among plans by adopting proposals similar to those in Sections 301, 303, and 304 of H.R. 1776 (108th Cong.), including allowing: (1) tax-free rollovers between the IRAs of spouses, (2) tax-free rollovers between the IRA of a decedent and the IRA of their non-spouse beneficiary, and (3) direct rollovers from employer-sponsored plans to Roth IRAs.
 5. Put policies in place to encourage Americans to manage their retirement savings in such a way that ensures that a portion of their retirement savings, sufficient to meet their needs in retirement, will last throughout their actual remaining lives, including through the following proposals:
 - Encourage financial institutions sponsoring an IRA or Roth IRA to offer the full range of potential distribution options and provide participants with information regarding them. These options include distributing assets only to the extent required by the minimum distribution rules, lump sum distributions, periodic payments, rolling over assets to other tax-favored savings vehicles, and purchasing a guaranteed lifetime income stream.
 - Revise the safest available annuity standard so that financial institutions sponsoring IRAs and Roth IRAs, and third party administrators have clear cut and practical ways to satisfy their fiduciary obligations in selecting an annuity provider. Clarify that state law regarding annuities is preempted with respect to qualified plans.
 - Permit electronic forms of obtaining QJSA waivers, for example through use of PIN codes or other technological methods. Also, re-examine the joint and survivor annuitization rules in the broader context of protecting spousal rights, administrative costs, and the changing demographics of the workforce.
 - Allow financial institutions sponsoring personal retirement savings vehicles to rollover the accounts of participants who want an annuity to a third party administrator who would assume full responsibility for annuitizing (or arranging for the annuitization of) the funds, processing the QJSA paperwork, and fulfilling all applicable fiduciary obligations.
 - Adopt appropriate tax incentives to encourage participants to take a portion of their distributions in the form of a guaranteed lifetime income stream, for example along the lines of Section 305 of H.R. 1776 (108th Cong.).
 6. Establish a universal set of tax incentives for retirement savings through the following changes:

- Eliminate the income limits on IRAs and Roth IRAs.
 - Expand, make permanent and make refundable the Saver's Credit.
 - Permit disabled taxpayers to be able to contribute to IRAs even though they have no earned income.
 - Consider establishing children's savings accounts for every child born, and prohibiting access to a portion of the account prior to retirement, in order to create a universal savings platform.
7. Accelerate and make permanent the increased contribution limits (including catch-up contribution limits) for IRAs and Roth IRAs in EGTRRA.

Retiree Health Care

- ***Principles:*** Any reform should:
 1. Seek to achieve access to retiree health coverage for everyone. For those over age 65, the availability of Medicare (with the recent addition of a drug benefit) combined with long-term care insurance and either a Medigap policy or employer coverage now meets this goal.
 2. Promote the purchase of long-term care insurance.
 3. Encourage employers to offer, and continue to offer, retiree health plans.
- ***Proposals:***
 1. Raise the funding limits on employer-sponsored retiree health plans so that employers can elect to fund plans at higher amounts, and can reduce funding in bad years to the extent that they take advantage of this option. Reduce the barriers that plan sponsors face to using defined benefit plan surpluses to fund retiree health plans, including replacing the five-year maintenance of benefit requirement in I.R.C. Sec. 420 with a five-year maintenance of cost requirement.
 2. Create Retiree Medical Benefit Accounts (RMBAs) to increase savings for retiree medical expenses and long-term care insurance.
 - RMBAs would be voluntary sidecar accounts for taxpayers with an IRA or defined contribution plan. Workers could elect to have a portion of their contributions to such accounts (whether made by the employer or the employee) allocated to a RMBA without triggering tax liability. Any contributions made to the RMBA would be subject to all existing contribution limits, income limits and nondiscrimination rules that apply to the underlying plan. Contribution limits of several thousand dollars and higher catch-up contribution limits specific to RMBAs would also apply. HSAs could be rolled over to RMBAs.
 - Distributions from RMBAs would be tax-free and penalty free if used for retiree medical expenses, including long-term care insurance purchased before or after retirement and Medigap policy premiums.

3. Provide an above-the-line deduction for long-term care insurance premiums and include long-term care insurance in cafeteria plans and flexible spending accounts.
4. Encourage the establishment of state long-term care insurance public / private partnership programs by repealing the limitations on such partnerships to certain states, and by establishing a national partnership model through federal contract and regulatory standards that provide for uniformity, portability, and reciprocity across states.

Financial Education

1. Implement broad media campaigns, sponsored by the federal government and designed to increase Americans' awareness of the need to save retirement. Possibilities include a "Got Savings" campaign, recognition of the "Ten Best Companies to Retire From," and publicity of a retirement savings pyramid.
2. Leverage existing governmental communications regarding retirement and consolidate existing financial education programs through interagency coordination led by the Treasury Department. In particular:
 - Include financial education materials in the annual Social Security statement, including a simple method for calculating a rough estimate of the amount one needs to save for retirement, when combined with projected Social Security benefits, in order to provide a 70% replacement rate. Closer to retirement, use the statement to educate workers about what mix of distribution options would help ensure that they will have a reasonable income stream throughout their actual remaining lives.
 - Use mailings by the Centers for Medicare and Medicaid Services and public service announcements to educate the public about whether they have long-term care insurance and why they should purchase it.
 - Require the IRS to notify eligible taxpayers who have not taken advantage of tax-favored savings opportunities.
3. Establish financial education as a high school graduation requirement, which could be integrated with a President's Council on Financial Literacy similar to the current President's Council on Physical Fitness.
4. Put in place policies to encourage Americans to manage their retirement savings in such a way that ensures that a portion of their retirement savings, sufficient to meet their needs in retirement, will last throughout their actual remaining lives.
5. Enact policies to encourage financial education by employers, financial institutions, and tax return preparers about the need for retirement savings and appropriate decisions regarding retirement savings distributions.