EMPLOYER-BASED RETIREMENT INCOME—THE IDEAL, THE POSSIBLE, AND THE REALITY

Daniel Halperin

Based upon his presentation at the University of Illinois College of Law's Elder Law Lecture, Professor Daniel Halperin provides a clear outline of goals for the future of employer-based retirement plans, which currently fall below ideal expectations and leave low- and moderate-income workers with inadequate savings for retirement. Professor Halperin argues for tougher standards regulating the private employer-based plans and additional government subsidies to retirement savings for low-income workers in order to make these goals possible. His proposals include widening coverage by requiring that all employees be eligible, limiting the role of integration with Social Security, restricting testing for discrimination by comparing projected benefits, preserving benefits for retirement by immediate vesting, and transferring investment risk to employers.

Daniel Halperin is the Stanley S. Surrey Professor of Law at the Harvard Law School and former Deputy Assistant Secretary of Treasury for Tax Policy. Professor Halperin has been involved in pension law and policy for forty years, beginning as an associate at a large New York City law firm and continuing with his service with the government, where he participated in the Task Force which developed the legislative proposal that led to ERISA, and, later, in the development of section 401(k). Professor Halperin has taught courses in pension law and retirement income policy for twenty-five years and has written at least a dozen articles relating to the tax incentives for retirement savings.

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Introduction

The Enron debacle and the recent stock market decline have served as a wake-up call for many employees. They now realize that their retirement savings may be inadequate to finance their current standard of living.[1]

This is not surprising. Providing adequate savings for retirement is extraordinarily difficult. An individual desiring to continue her pre-retirement standard of living would have to predict her earnings path (including earnings at retirement), the performance of the stock market over her lifetime, the point that she would wish to retire (assuming her health would permit), and her life expectancy at that point. If at a latter time in her career a worker recognizes that savings are inadequate, there may be insufficient time to make the necessary correction.

Perhaps because of this difficulty, we do not leave individuals to freely choose whether or not to save for retirement. Rather, we view the potential plight of the retired as a public policy concern. The Supplemental Security Income (SSI) program provides a minimum level of income to everyone over sixty-five regardless of their prior work history.[2] Social Security, in effect, mandates a certain level of savings, or a reduced level of current spending, in order to have funds available at retirement. In addition, there are tax incentives for retirement savings.

SSI assures that the retired have at least sufficient income for a subsistence standard of living. Because of this program, low-income workers who, in the absence of other resources, would be eligible for SSI benefits would not have an incentive to save. Mandating savings through Social Security eliminates this moral hazard, which could make the SSI program far more expensive.[3]

1. Jonathan Clements, *Don't Think the Market Will Pump Up Your Nest Egg; You'd Better Start Saving*, WALL ST. J., June 12, 2002, at D1; *The Nest-Egg Blues: Got the Jitters About Your Retirement Savings? These Experts Discuss How to Regain Your Financial Balance*, WALL ST. J., June 24, 2002, at R10; David M. Walker, *GAO Testimony at Finance Committee Hearing on Retirement Security,* TAX NOTES TODAY, Feb. 28, 2002, LEXIS 2002 TNT 40–71.

2. The SSI program guarantees a minimum level of income for needy aged, blind, or disabled individuals, SOC. SEC. ADMIN., SUPPLEMENTAL SECURITY INCOME, PUBLICATION NO. 05-11000, PART ONE (2001), http://www.ssa.gov/pubs/11000.html (last visited Apr. 6, 2003).

3. *See* ALICIA H. MUNNELL, THE FUTURE OF SOCIAL SECURITY 11–12 (Brookings Inst. 1977).

Social Security, however, provides more than subsistence income for many workers. The maximum benefit is now approximately $20,000 per year.[4] On the other hand, Social Security has never been sufficient to fully replace employment income, even at the lowest levels of earnings.[5] I believe that we ought to guarantee full replacement for the lowest earners and probably should at least increase benefits for other low-income individuals. However, the level of benefits that should be provided by Social Security is a matter of judgment and many would argue that individuals generally ought to have flexibility over the level of spending throughout their lifetimes. In any event, even though this may be *ideal*, at least for low-income workers, it is unlikely that future Social Security benefits will achieve full income replacement. Because payroll tax revenues dedicated to Social Security are in the long run insufficient to provide for promised benefits,[6] it is more likely that future benefits will be less than the level of benefits currently promised by the program.[7]

4. Soc. Sec. Admin., Benefit Examples for Workers with Maximum Earnings, *at* http://www.ssa.gov/OACT/COLA/exampleMax.html (Oct. 18, 2002).

5. Social Security is said to replace about sixty percent of pre-retirement earnings for low-wage employees, forty-five percent for average earners, and thirty-four percent for those whose wages have always been equal to at least the maximum amount subject to annual payroll taxes. *See, e.g.*, C. EUGENE STEUERLE & JON M. BAKIJA, RETOOLING SOCIAL SECURITY FOR THE 21ST CENTURY 78. These figures are high because they assume retirement at age sixty-five when the majority retire earlier, many at sixty-two, accepting as much as a twenty percent reduction in annual benefits. These calculations also assume that individuals always earn at the same level while most workers receive promotions over their lifetime. Such promotions cause the actual replacement level to be lower than stated.

6. SOC. SEC. ADMIN., 2001 OASDI TRUSTEES REPORT, http://www.ssa.gov/OACT/TR/TR01/II_Conclu.htm#79298 (Mar. 19, 2001).

7. Maintaining the current level of benefits still raises the issues of whether it is appropriate to increase the retirement age at which full benefits will be paid, and also whether it is appropriate to provide for some portion of the benefits through individual defined contribution accounts rather than the current defined benefit system. *See infra* Part III.

A more complex question relates to the use of "wage indexing" to adjust benefits across cohorts. Under the current system, replacement rates under Social Security remain constant across generations even though the real income of the workforce is increasing. Thus, the average worker gets the same replacement rate even though the real earnings of the average worker increase. This is so because benefits are indexed to wages. Some would suggest that benefits be indexed to prices instead. This would cause replacement rates to decline overall, but under some versions of price indexing, the replacement rate for a given level of real wages would remain constant. *See* PRESIDENT'S COMM'N TO STRENGTHEN SOC. SEC. STRENGTHENING SOCIAL SECURITY AND CREATING PERSONAL WEALTH FOR ALL AMERICANS 119 (2001), *at* http://www.csss.gov/reports/Final_report.pdf. For a criticism of the price-indexing approach, see Sen. Joseph Lieberman & Sen.

Individuals, however, are not left entirely to their own devices to provide for the difference between Social Security and pre-retirement earnings. There are tax incentives for employer-based pension plans[8] and, to a lesser extent, for Individual Retirement Accounts (IRAs).[9] In essence, these arrangements allow assets to grow tax-free while other investments are subject to tax.[10] Still, many workers have little, if any, private savings. Given their immediate needs and low tax bracket, even a tax preference will not sufficiently encourage savings among low- and moderate-income workers. For example, only a small minority of households earning less than $25,000 have taken advantage of the opportunity to establish an IRA.[11]

Thus, although it is certainly not *ideal*, for now, achieving full replacement of pre-retirement earnings for low-income workers seems to depend upon employer-based plans. Employers have traditionally viewed pension plans as a means of managing the workforce. The promise of a pension can facilitate both retention of workers and re-

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Jon Corzine, *Lieberman, Corzine Release on Their Social Security Resolution*, TAX NOTES TODAY, Mar. 25, 2002, LEXIS 2002 TNT 57–64.

8. I.R.C. § 401 (West 2002).

9. *Id.* §§ 219, 408, 408(a). The maximum deductible contribution to an IRA is currently $3000. It is scheduled to increase to $5000 in 2008 and be indexed for inflation thereafter. Individuals fifty years and older receive an extra $500, $1000 in 2006. *Id.* § 219(b)(5)(A). The maximum deduction for contributions to an employer-sponsored defined-contribution plan is $40,000 (indexed for future inflation). *Id.* §§ 415(c)(1), 415(d)(1). An additional amount is allowed for elective contributions by individuals age fifty and over. The additional amount is now $2,000, and will rise to $5,000 in 2006 and be indexed thereafter. *Id.* § 414(v). In order to maintain the incentive for employer-based plans, it is important to limit the contributions to individual plans and maintain a significant differential between allowable contributions to IRAs and the permissible level of contributions to employer plans. For this reason, the Administration's 2004 Budget proposals for $15,000 of annual tax favored savings for all individuals, regardless of income level, is disturbing. The proposal is found in OFFICE OF MGMT. AND BUDGET, EXECUTIVE OFFICE OF THE PRESIDENT OF THE UNITED STATES, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2004: ANALYTICAL PERSPECTIVES 77 (2003), *available at* http://w3.access.gpo.gov/usbudget/fy2004/pdf/spec.pdf (last visited Apr. 6, 2003).

10. For a general discussion of how to analyze the impact of the timing of income and deductions, including a proposal for the treatment of nonqualified deferred compensation, see Daniel Halperin, *Interest in Disguise: Taxing the Time Value of Money*, 95 YALE L.J. 506 (1986) [hereinafter *Time Value*].

11. For example, in 1995, only fifteen percent of households earning between $10,000 and $25,000 established an IRA. *See* Daniel I. Halperin & Alicia H. Munnell, How the Pension System Should be Reformed 54 (Sept. 17, 1999), *available at* http://www.brook.edu/dybdocroot/es/events/erisa/99papers/erisa10.pdf (last visited Feb. 10, 2003). Unfortunately due to a delay in the publication of the volume in which it is to appear, that paper has not yet been published. This website presents the article in the form submitted at the time of the conference.

tirement of less productive workers. Workers who desire to save would welcome the opportunity for tax-free appreciation and, possibly, access to better investment opportunities and more fairly priced annuities that an employer plan may offer.[12] Thus, they would favor a reduction in cash wages in return for an employer-provided pension.

Because the establishment of a pension plan does not, therefore, imply an overall increase in compensation, it may seem strange that employers sometimes resist pension coverage for all or part of their workforce. Why not take advantage of the favorable tax treatment of retirement savings only available through employer-based plans? The problem is, however, that many employees would be "reluctant savers" and would resist a reduction in cash wages, even for subsidized retirement savings. If other employers are paying compensation solely in cash, employers who establish plans must provide equal cash compensation for reluctant savers in order to compete. Therefore, they cannot afford to maintain plans covering all workers unless the value of the tax savings for the willing savers, the higher earners, enables employers to reduce the compensation of this group sufficiently to fund the additional cost of unappreciated coverage for reluctant savers.[13]

Thus, left on their own, employers would establish plans only for a select group of employees. However, the tax preference for employer-based plans is limited to so-called qualified plans which benefit a broad cross-section of employees. In general, contributions or benefits (as a percentage of pay) cannot discriminate in favor of highly compensated employees and against the lower paid.[14] By so limiting the tax preference, we hope to rely on the desire of the higher paid for

12. Daniel I. Halperin, *Special Tax Treatment for Employer-Based Retirement Programs: Is It "Still" Viable as a Means of Increasing Retirement Income? Should It Continue?,* 49 TAX L. REV. 1, 8–11 (1993) [hereinafter *Special Tax Treatment*].

13. *See* Joseph Bankman, *The Effect of Anti-Discrimination Provisions on Rank-and-File Compensation,* 72 WASH. U. L.Q. 597 (1994); Joseph Bankman, *Tax Policy and Retirement Income: Are Pension Plan Anti-Discrimination Provisions Desirable?,* 55 U. CHI. L. REV. 790 (1988); *Special Tax Treatment*, *supra* note 12, at 14–16; Bruce Wolk, *Discrimination Rules for Qualified Retirement Plans: Good Intentions Confront Economic Reality,* 70 VA. L. REV. 419, 429–34 (1984). Employers may also be concerned about administrative costs and potential fiduciary liability.

14. I.R.C. §§ 401(a)(3), 410(b) (2000). In 2003, "highly compensated" includes employees earning over $90,000. *IRS Announces Pension Plan Limitations for 2003*, TAX NOTES TODAY, Oct. 21, 2002, LEXIS 2002 TNT 203–19.

tax exempt earnings to get retirement savings for the rank and file worker.[15]

Ideally, every employer would have a plan covering all their employees. Employees would all earn a pension that, when combined with Social Security, would fully replace their final earnings, and this pension would be indexed for inflation.[16]

As of now, however, the private retirement system has failed the lower earners. In *reality*, at any one time, at best no more than fifty percent of the workforce is participating in employer-based plans.[17]

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15. I have discussed this matter extensively in previous articles, including a paper which makes similar suggestions in 1999 with Alicia Munnell. Halperin & Munnell, *supra* note 11. Prior work includes: *Regulating Tax Qualified Pension Plans in a Hybrid World*, *in* NEW YORK UNIVERSITY FIFTY-EIGHTH INSTITUTE ON FEDERAL TAXATION: EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION (2000) (coauthored by Marla Schnall) [hereinafter *Hybrid World*]; Halperin, *supra* note 12; TAX POLICY AND RETIREMENT INCOME: A RATIONAL MODEL FOR 21ST CENTURY IN SEARCH FOR A NATIONAL RETIREMENT INCOME POLICY 159 (1987) [hereinafter TAX POLICY]; *Cash or Deferred Profit-Sharing Plans and Cafeteria Plans*, 41ST ANNUAL NYU INST. ON FEDERAL TAXATION 39-1 (Loula Barkas ed., 1983) [hereinafter *Cash or Deferred*]; *Retirement Security and Tax Equity*, 17 B.C. INDUS. & COMM. L. REV. 739 (1976); NAT'L TAX ASS'N, TAX REFORM ACT OF 1986 AND THE EQUITY OF THE NATION'S RETIREMENT SYSTEM, 80TH ANNUAL CONFERENCE 93 (1987). This piece draws on my prior work, in particular my three most recent articles. However, my views have continued to evolve reflecting intervening events including the extensive legislative changes in 2001 under the Economic Growth and Tax Relief Reconciliation Act of 2001, the implosion of Enron with the loss of retirement savings, the continuing debate over "privatization" of Social Security, and the "Conversation on Coverage" convened by the Pension Rights Center in July of 2001, information at http://www.pensioncoverage.net/INDEX.htm (last visited Feb. 10, 2003).

16. Ideally, retirement benefits should enable workers to maintain the same standard of well-being in retirement as they enjoyed while they were employed. Most analysts assume that retirement income does not need to replace one hundred percent of pre-retirement earnings because of lower clothing and transportation expenses as a result of not working, the reduction in taxes, particularly the payroll tax, and less need to save. As a rough benchmark, retirement income equal to eighty percent of pre-retirement earnings should be more or less adequate. *See* Symposium, *Federal Tax Policy in the New Millennium: Universal Pensions,* 2 CHAP. L. REV. 95 (1999).

17. *See* Employee Benefits Sec. Admin., U.S. Dep't of Labor, The Report on the Working Group on Increasing Pension Coverage, Participation and Benefits (2001), *at* http://www.dol.gov/ebsa/publications/ac_1114a01_report.html (last visited Feb. 10, 2003). "Despite various efforts to promote plan sponsorship and participation through income tax incentives, education and other means, roughly 50% of private sector workers lack pension benefits on the job and this coverage rate has not budged more than a few percentage points in the past 20 years or more." *Id.* Forty-four percent of retirees receive only Social Security benefits. U.S. Dep't of Labor, *Percent of Private Sector Workers and Retirees Ages 55 and Older Receiving Various Combinations of Employer Provided Pensions and Health Benefits and Social Security Benefits Based on Prior Employment* (1994), *available at* http://www.dol.gov/ebsa/programs/opr/redbook/a_2.htm (last visited Apr. 6, 2003). Many of the remaining fifty-six percent will fall well short of the replacement level they seek; this

Importantly, for those who end up in the bottom forty percent of the income distribution after retirement, employer-based plans are largely irrelevant. For those over age sixty-five in 1996, pensions accounted for only three percent of the retirement income of the lowest quintile, and seven percent of the income of the second-lowest quintile.[18] Multiple factors explain this result.[19]

Many employers, particularly small employers, have never established plans. When plans exist, despite the nondiscrimination test, employers can exclude workers based upon their job classification, age, or length of service. Sometimes eligible employees can choose whether or not to participate. For covered workers, employers can provide lower percentage contributions for those who earn less.

When benefits are earned, employees who change jobs often forfeit their benefits or claim their retirement savings and use the funds for other purposes. Even when benefits are preserved, certain pension arrangements discriminate against those who do not stay with one employer or in the same type of plan for a full career. Moreover, although even moderate inflation can cut the value of a pension by more than half, retirement benefits are rarely indexed for inflation. Finally, benefits might be less than expected because of a market decline or poor investment decisions.

This raises the question as to whether employer plans are up to the task. Is it *possible* to expect employers to establish retirement programs that, together with Social Security, would enable employees who work for an entire career to maintain their pre-retirement standard of living once they stop working? For this to occur the employer must have a plan, the employee must participate, and the benefit level must be both adequate and protected against inflation. Moreover, once benefits are earned, they must be preserved for retirement and not lost by market decline, forfeiture, or a change in jobs. If these conditions are not satisfied, even the existence of an employer plan may not provide adequate retirement protection.

group will no doubt increase unless the market fully recovers. President Clinton noted in 1999 that only seven percent of the tax benefits for retirement go to families with income of $50,000 a year or less. *See Clinton Details Universal Savings Accounts Including 401(k) Matches*, TAX NOTES TODAY, Apr. 15, 1999, LEXIS 1999 TNT 72-1.

18. Halperin & Munnell, *supra* note 11, at 2.

19. *See generally* Norman P. Stein & Patricia E. Dilley, *Leverage, Linkage and Leakage: Problems with the Private Pension System and How They Should Inform the Social Security Reform Debate*, 58 WASH. & LEE L. REV. 1369 (2001).

It is not difficult to develop rules that would require an employer plan to satisfy these conditions. However, private pensions are a voluntary arrangement. The greater the pressure put on employers to provide more widespread benefits, the less likely it is they will maintain pension plans at all. Because, as noted above, some employees would resist a pay cut in return for retirement benefits, the more coverage and benefits we require employers to provide for the lower paid, the less likely it is that employers will be willing to establish plans. This is particularly true if, at the same time, we reduce the amount of allowable benefits for the higher paid.[20] Therefore, how can we hope to achieve increased retirement protection for those who work for employers that now offer pension plans without causing some of these plans to terminate? Moreover, with respect to employers who have not established qualified plans, particularly small business owners, the existing combination of tax benefits and regulations has not encouraged plan adoption. Thus, it would be even more difficult in the face of increased regulation to expect the large number of employers who do not now maintain plans to do so.[21]

In light of this dilemma, I discuss here what could *possibly* be done to achieve wider coverage, including full replacement of earnings for low earners. This article proceeds as follows. Part I discusses the *ideal* plan, the changes that would be required to assure that existing plans provided adequate retirement income for all employees. Part II considers possible steps which might encourage more employers to adopt such plans. This part suggests adding incentives for coverage of lower-level earners,[22] possibly by way of additional special accounts outside of employer plans. Part III considers the relationship of such accounts to Social Security. Part IV is the conclusion. It should be clear that the proposals made by President Bush in his 2004 budget, while expressing a willingness to spend resources to foster retirement savings, move decidedly in the wrong direction, in part by

20. *Special Tax Treatment*, *supra* note 12, at 14–21.

21. About one-quarter of workers without pension coverage are employed by firms sponsoring pension plans, while the remainder work for employers without plans. *See* Alicia H. Munnell et al., Ctr. for Retirement Research at Boston Coll., *How Important Are Private Pensions*, AN ISSUE IN BRIEF, Feb. 2002, at 4, *available at* http://www.bc.edu/centers/crr/issues/ib_8.pdf (last visited Feb. 10, 2003).

22. The ultimate question, which is not discussed in this piece, is whether the subsidy for employer-based plans is worth retaining if significant improvement proves to be impossible. *See Special Tax Treatment*, *supra* note 12, at 46–50.

increasing the disparity between contributions for the lower and higher paid.

I. The Ideal Plan—Improving Participation and Protecting Retirement Income

Full replacement of preretirement income requires that employees participate, that the benefit level be adequate, and that benefits be preserved for retirement. The next three sections discuss what is needed in order to achieve this goal. In short, I suggest the following:

- all employees be covered and vested immediately upon hire;[23]
- with limited exceptions, contributions should be an equal percentage of pay for all participants;
- elective contributions should be tolerated only if significant non-elective contributions are made for all eligible employees;
- all preretirement distributions should be made to an IRA;
- employees in defined-contribution plans should be protected against a market decline.

A. More Coverage for the Rank and File

Despite the antidiscrimination rules that purportedly condition favorable tax treatment for highly compensated employees on a high level of participation by rank and file employees, employers have a variety of means for excluding employees.[24] For example, workers need not be covered until they reach age twenty-one and have completed one year of service.[25] Because service means employment for at least twenty hours per week, part-time workers may be excluded even if they are "permanent" employees.[26]

23. There could be up to a one-year waiting period for participation, provided that coverage was retroactive for those who met this standard.

24. I.R.C. § 410(a)(1)(A) (West 2002).

25. *Id.*

26. *Id.* § 410(a)(3). Workers who are members of a collective bargaining unit need not be covered if pension benefits have been the subject of good-faith bargaining. *See id.* § 410(b)(3)(A). The employer can also exclude independent contractors and in some case workers who are employed by independent service providers, such as the cleaning crew or security guards, for example. *See* Vizcaino v. Microsoft Corp., 120 F.3d 1006 (9th Cir. 1997).

In addition, the Treasury regulations require only that the classification for participation be "reasonable,"[27] and that the level of participation from the highly compensated group is not too much greater than the level of participation from the remainder of the work force.[28] Specific requirements arise only when participation of the non-highly compensated is less than seventy percent of that of the highly compensated.[29] In that case, under a rule enacted in 1986, the employer must establish that (taking account of all of the employer's plans) the average benefit for the non-highly compensated as a percentage of pay is at least seventy percent of that for the highly compensated as a percentage of pay.[30] Thus, the nondiscrimination requirement actually permits a substantial disparity between the coverage for different groups.

Moreover, employers may also offer the worker an option to take cash wages in lieu of participation.[31] Thus, about thirty percent of pension participants are covered only under section 401(k) and other arrangements, which allow employees individually to choose between current and deferred compensation.[32] Because employees

27. Treas. Reg. § 1.410(b)-4 provides that the reasonable classification requirement is met when

> based on all the facts and circumstances, the classification is reasonable and is established under objective business criteria that identify the category of employees who benefit under the plan. Reasonable classifications generally include specified job categories, nature of compensation (i.e., salaried or hourly), geographic location, and similar bona fide business criteria. An enumeration of employees by name or other specific criteria having substantially the same effect as an enumeration by name is not considered a reasonable classification.

Id.

28. Prior to 1994, the regulations allowed a "reasonable difference" between coverage of the two groups. Treas. Reg. § 1.410(b)-1(d)(2). Now the regulations specify a safe harbor and a minimum unsafe harbor and apply a facts and circumstance test for coverage ratios falling in between. *Id.* § 1.410(b)-4(c). The safe harbor depends upon the percentage of non-highly compensated in the workforce and ranges from fifty percent, where the concentration of non-highly compensated is sixty percent or less down to 20.75%, where ninety-nine percent of the employees are non-highly compensated. *Id.* The minimum permitted coverage of the non-highly compensated is twenty percent of the percentage of highly compensated covered (applicable when eighty-seven percent or more of the workforce is non-highly compensated), rising up to forty percent when the percentage of non-highly compensated is sixty percent or less. *Id.*

29. I.R.C. § 410(b)(1).

30. *Id.*

31. *Id.* §§ 402(e)(3), 401(k).

32. *See* U.S. DEP'T OF LABOR, HIGHLIGHTS FROM THE 1997 FORM 5500 REPORTS, *at* http://www.dol.gov/ebsa/programs/opr/bullet97/hilites.htm (last visited

may elect out, these plans do not ensure that pension coverage will reach as large a share of the work force as do traditional plans under which contributions are made on behalf of some employees who would not elect to defer compensation if presented with the choice.

To more closely approximate the *ideal*, all employees should be eligible and the role of choice should be minimized.

ELIGIBILITY

Ideally, there should be one simple requirement for non-elective plans—all employees in a given line of business[33] (including those part-time workers who work at least ten hours per week) must be provided with equivalent coverage.[34] Administrative concerns suggest that a waiting period, perhaps six months or a year, be satisfied before coverage begins. However, once the employee begins to participate, coverage should be retroactive to the date of hire, and all benefits should be immediately vested at that point.

Unlike current law, this approach would not tolerate any disparity between the coverage for the higher and lower paid. No longer would it be acceptable for the participation from the highly compensated to be not "too much" greater than the level of participation from the remainder of the work force. Nondiscrimination would mean that all employees are covered. If the plan failed this simple test, none of the participants would be eligible for favorable tax treatment.

Minimizing the Impact of Employees' Failure to Choose Pension Coverage

Ideally, choice would not be a factor. However, if, as is clearly the case, section 401(k) is here to stay,[35] it is important that these

Feb. 10, 2003). Calculations suggest about 53 million participants of which about 17 million have access only to 401(k) plans. *Id*.

33. If uniform coverage were required for all employees of a company, the company might have difficulty meeting competition if the level of benefits in one line of business is higher than that provided by competitors of other operations. *See Special Tax Treatment*, *supra* note 12, at 39–40.

34. Halperin & Munnell, *supra* note 11, at 18; *Special Tax Treatment*, *supra* note 12, at 38. Perhaps the current permission to exclude employees under age twenty-one could continue. The issue of employees in a collective bargaining unit, independent contractors, and contract employees is beyond the scope of this piece.

35. *See Cash or Deferred, supra* note 15, at 39-6 to -11 (discussing the origin of and justification for § 401(k)); *see also* TAX POLICY, *supra* note 15, at 171-6.

arrangements guarantee some level of participation by the rank and file. To accomplish this, the following conditions should apply:

- participation should be assumed unless the employee elects not to participate;
- actual participation by rank and file employees in the elective plan should be measured in testing for discrimination (the opportunity to participate is insufficient);
- all employees, even those who elect out, should earn some benefits;
- there should be a significant incentive to maintain an additional, non-elective, plan.

First, instead of employees having to elect to participate in the plan, the default rule should require participation unless the employee elects out. The Internal Revenue Service has approved this approach,[36] and evidence indicates that it results in a substantially higher level of participation.[37] It has been noted, however, that employees tend to stick with the default contribution level and investment selection, which could actually reduce the accumulation for retirement. Thus, it has been suggested that the contribution level should rise when the employee receives a raise.[38] Furthermore, the default investment perhaps should be an appropriate balanced portfolio.

Second, there must be actual equivalent elective participation by the rank and file, not merely an equal opportunity to participate. Under the original 401(k) law, the permitted level of contributions by the highly compensated depended upon the average contribution by the workers who were not highly compensated.[39] With this rule in place,

36. Bonner Menking, *Officials Describe Past and Future Employee Plan Guidance,* 86 TAX NOTES 612, 613 (2000).

37. Peter Orszag, *A Progressive Pension Package, at* http://www.pensioncoverage.net/orszag.htm (last visited Feb. 10, 2003); Brigitte C. Madrian & Dennis F. Shea, *The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior*, 116 Q. J. OF ECON. 1149–1187 (2001); James Choi et al., *Defined Contribution Pensions: Plan Rules, Participant Decisions, and the Path of Least Resistance,* 16 TAX POL'Y & ECON. 67–113 (2002).

38. *See generally* Carl R. Sunstein & Richard H. Thaler, Libertarian Paternalism and the Law (Jan. 21, 2003 (unpublished manuscript, on file with the Elder Law Journal).

39. I.R.C. § 401(k)(3) (West 2002). President Bush has proposed that this test be made less stringent. DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2004 REVENUE PROPOSALS (2003), *available at* http://benefitslink.com/articles/2003_budget_bluebook.pdf (last visited Feb. 10, 2003) [hereinafter REVENUE PROPOSALS].

the employer had an incentive to educate moderate and low earners about the virtues of saving for retirement, or if that failed, the employer could make non-elective contributions to the 401(k) plan. The law was later amended to create a "safe harbor" provision. Specifically, if the employer offers to match employee contributions at a certain rate, the pension plan qualifies for favorable tax treatment even if no non-highly compensated employees choose to participate.[40] Clearly, this provision considerably alters the incentives for employers. Namely, the employer has nothing to gain from educating reluctant savers and encouraging them to participate. In fact, because the employer's costs increase when employees choose to participate, there is a disincentive for the employer to encourage greater participation. Requirements that employers notify employees and encourage participation can mitigate these perverse incentives but cannot overcome them.[41] Therefore, the safe harbors should be repealed and actual participation required.

Third, elective plans *ideally* should require a substantial employer contribution for all potential participants.[42] Some have suggested limiting elective contributions to some multiple of non-elective employer contributions.[43]

Finally, there should be a significant incentive to establish traditional plans that provide non-elective contributions, in addition to 401(k) plans. Thus, the overall annual limit on contributions to qualified plans ($40,000[44]) is significantly higher than the limit on elective contributions ($15,000[45]). The 2001 Act eroded the difference by the allowance of an additional $5000 of elective so-called catch-up contributions for all those over fifty[46] and the impending permission for so-called Roth 401(k)s, which effectively increase the limit on contribu-

40. I.R.C. § 401(k)(12). President Bush has proposed that the safe harbor be made even less stringent. REVENUE PROPOSALS, *supra* note 39.

41. The notice requirement is provided for in I.R.C. § 401(k)(12)(D).

42. The so-called top heavy rules may require a minimum employer contribution in some circumstances. *Id.* § 416(c)(2). President Bush has proposed that the top heavy rules be repealed. REVENUE PROPOSALS, *supra* note 39.

43. A summary of the Pensions 2000 Proposal presented by Norman Stein at Conversation on Coverage is available at http://www.pensioncoverage.net/Stein.htm. *See* Pension ProSave Act, S. 957, 105th Cong. (1997) (as introduced by Senators Jeff Bingaman and James Jeffords).

44. I.R.C. § 415(c).

45. *Id.* § 402(g)(1)(B). The limit is currently $12,000. It will reach $15,000 in 2006.

46. *See id.* § 402(g)(1)(C); Daniel Halperin, *Why Pension Reform Legislation Is a Bad Idea*, 89 TAX NOTES 958, 960 (2000).

tions.[47] *Ideally*, these enhancements to section 401(k) should be removed.[48]

B. Achieving Adequate Benefit Levels

The *ideal* pension plan would combine with Social Security to allow low- and moderate-income employees to maintain their preretirement standard of living. However, because no employer is required to have a pension plan in the first place, it is not *possible* to require existing plans to provide a given level of benefits. The only rational requirement is to mandate that pension contributions for lower-paid employees be equivalent as a percentage of pay to the contributions provided for the higher paid. The expectation would be that the desire of the higher paid for adequate retirement benefits would assure equivalent protection for the rank and file.

For various reasons, even this milder goal may not be achieved under existing law. Thus, the nondiscrimination standard may consider coverage to be equal even though greater contributions, as a percentage of pay, are made for the higher paid. This can occur for two reasons. First, because Social Security provides greater proportional benefits to the lower paid, employer plans are said not to discriminate if they favor the higher paid to a "similar" extent.[49] This practice is referred to as "integration."

Second, even after taking account of Social Security, contributions need not be equivalent. An employer can use one of two tests, either equivalent contributions or equivalent benefits, to establish that a plan does not discriminate against the rank and file.[50] Under contributions testing, a plan is not discriminatory if the employer can show that *contributions* as a percentage of pay are no higher for highly compensated employees than for the rank and file. However, a plan is not necessarily considered to discriminate merely because the employer makes higher percentage contributions for the higher paid. Thus, higher contributions for older employees, based on age or length of service, would not be considered discriminatory, even though the older employees are more likely to be higher paid, if the employer can

47. *Id.* § 402A (applicable after 2005); *see* Daniel Halperin, *I Want a Roth IRA for Xmas*, 81 TAX NOTES 1567 (1998).
48. Halperin, *supra* note 46, at 959.
49. *See* I.R.C. § 401(a)(5)(C).
50. *See id.* § 401(a)(5)(B).

show that the *benefits* promised by the plan are no higher as a percentage of pay for the highly compensated employees than for the non-highly compensated—benefits testing.[51] Although the contributions are larger for older employees, the benefit earned as a percentage of pay would not be because the funds would be invested for a shorter period of time.

The younger worker, however, can only achieve the promised benefit if she participates in this type of plan for her whole career. An employee who participates in a plan that uses benefits testing when she is young and in a plan that provides equal contributions when she is older, either because the employer switches plans or the employee changes jobs, will not fare as well as she would if she were in either type of arrangement for her whole career. Moreover, in some situations, the benefits testing approach is harmful to employees who change jobs even if they continue to participate in a similar plan. The next sections consider how more equal contributions might be required.

"INTEGRATION" WITH SOCIAL SECURITY

Ideally, tax-favored plans generally should be required to provide benefits or contributions that are equal in proportion to income without regard to Social Security. The only exception would be those instances where the plan provides replacement rates for full-career employees that, in combination with Social Security, equal or exceed eighty percent of preretirement income.[52]

One rationale for the "integration rules" is that, in the absence of integration, plans designed to achieve full replacement for high-income workers may provide low-income workers with retirement in-

51. The pension universe is divided into "defined-benefit plans" (the plan promises a specific benefit and the employer undertakes to provide adequate funding to provide the benefit), and defined-contribution plans (the plan calls for specific contributions and the benefit depends upon the accumulated assets). In the latter case, the investment risk is on the employee. However, the form of the discrimination test does not depend upon the type of plan. Both defined benefit and defined-contribution plans can test on the basis of either contributions or benefits. *Hybrid World*, *supra* note 15, at 5-5.

52. Nancy J. Altman, *Rethinking Retirement Policies: Nondiscrimination, Integration, and the Quest for Worker Security*, 42 TAX L. REV. 435, 494–98 (1987); *see* TAX POLICY, *supra* note 15, at 167–71. See *supra* note 16, for a discussion of what is required for full replacement. Commendably, President Bush has proposed that integration be prohibited in defined-contribution plans. REVENUE PROPOSALS, *supra* note 39.

come in excess of full replacement—that is, more than eighty percent or so of preretirement income. Excessive pension benefits could unnecessarily reduce preretirement earnings for this already struggling group. With integration, however, many low and moderate earners end up with pension income that is well below the recommended replacement level. This outcome is not consistent with the goals of pension policy. Hence, only if the employer can show that the combined expected benefits from Social Security and the private plan would replace eighty percent or more of preretirement income should the sponsor be permitted to take account of Social Security to provide less than equivalent contributions or benefits for lower earners.

REQUIRING EQUAL CONTRIBUTIONS

In general, equal percentage contributions should be required. Testing for discrimination on the basis of benefits should be available only to allow for plans that explicitly replace a portion of final pay and perhaps to allow for past service benefits for lower earners. In the first case, the employer must be required to protect employees from a job change or from a plan change when the latter reduces contributions for older employees.[53]

If benefits testing is limited as suggested, it will minimize the number of instances when younger employees will be harmed from a failure to remain in the plan for a full career. Moreover, those plans which retain benefits testing will offset the risk to the younger employees by the advantage it offers to career employees in the form of a benefit targeted to final pay.

Justification for Benefits Testing Benefits testing is problematic because of the risk it imposes on young employees. This is particularly true if, later in life, the employee switches to a new plan which tests on the basis of contributions. Nor, as discussed below, can it be said that benefits testing is essential in order for the employer to assume the investment risk. However, there are three reasons which might justify higher contributions for older employees.

53. For a more detailed discussion of this issue, see *Hybrid World*, *supra* note 15. However, the conclusion here is even more skeptical of the value of benefits testing.

First, it may be consistent with a sensible pattern of savings. Younger people have the expense of purchasing a home, raising children, and paying for education. It is only when they reach their late forties or early fifties that they can afford to save substantial amounts for retirement. Thus, older people value retirement savings more highly and are more willing to forgo cash wages. However, even if we assume that pension contributions reduce cash wages overall, it is not clear that there is a direct dollar for dollar correlation between the contribution benefiting a particular worker and the wage reduction that worker suffers. Moreover, employees, who have had families late in life and will be paying for college until close to their retirement, might have had more savings capacity when they were young and childless and had two full incomes. In addition, employers sometimes appear to find higher contributions for older employees unsatisfactory because they provide too little for those who leave early and too much for those who are hired late. This impact may make it awkward to discharge younger employees, who will suffer a large loss in expected benefits and too expensive to hire older ones. Therefore, on balance, this rationale for benefits testing should not be given much weight.

Second, higher contributions for older employees allow the employer to provide past service benefits for employees who are in mid-career when the plan is adopted, as well as greater benefits for those who may not have had coverage from their earlier jobs. At an earlier stage of the development of pension coverage, it was often the case that an employer did not establish a pension plan until it faced the prospect of the imminent retirement of long service workers with limited resources. Unless the plan covered past service, it was of little help to these employees. Moreover, it may be that younger workers are less likely to be in jobs that have pension coverage. Although it may now be more common for companies to adopt retirement programs earlier in their lives, thus mitigating these concerns, it may not be unreasonable to allow for higher contributions for older employees in order to make up for lack of earlier coverage, at least if contributions are made solely on behalf of workers who cannot be assumed to have saved adequate amounts on their own. Still, this reason for benefits testing seems less compelling than it might have been in the past.

The most important justification for benefits testing is that it facilitates a defined-benefit plan which promises a benefit that is a per-

centage of final pay, thereby focusing directly on the goal of earnings replacement. These plans would, at a minimum, require increased contributions for older workers whose salary increased faster than anticipated.

For workers who remain with one employer throughout their working lives, these plans have the advantage of offering a predictable benefit. The benefit, which is usually a specified percentage for each year of service,[54] may be sufficient to fully replace preretirement earnings. Even if the benefit might be insufficient for this purpose, the plan sends a clear message and allows the employee time to provide additional savings.[55] Furthermore, the employer assumes the investment risk, the risk of unexpected increases in salary, and perhaps, the mortality risk as well. The employer also is required to provide adequate funding and, in the event of employer default, the PBGC guarantees the bulk of benefits.

Alleviating the Harm to Mobile Workers However, even if vesting were immediate, mobile employees participating in a number of traditional defined-benefit pension plans over their career would receive significantly lower benefits than they would have received from continuous coverage under a single plan. This difference arises because earnings at the time of separation usually determine benefits. Workers who remain with a plan receive benefits related to earnings just before retirement, but employees who switch jobs, say, every ten years, would

54. The incidence of these defined-benefit plans is much less common than it used to be. "Between 1979 and 1996, the percentage of pension-covered workers whose primary pension was a defined-benefit plan (i.e., had a defined-benefit plan or a defined-benefit plan and a defined-contribution plan) dropped from 83% to 50%." Pension Benefit Guar. Corp., Summary of Comments on Defined Benefit Plans Received by the PBGC Defined Benefit Plan Working Group (1998), *at* http://www.pbgc.gov/about/findings.htm.

55. In the case of a defined-contribution plan, the inadequacy of the expected benefit may not be exposed. A sponsor of a defined-contribution plan may have a benefit target and set contributions to reach the target by making an assumption as to when employees will begin participation, retire, and die, and by estimating the rate of investment return and salary growth. The target will be achieved, however, only if the employer makes the promised contributions and the employee follows the assumed salary path, achieves the predicted investment performance, conforms to both the beginning and retirement ages, and either purchases an annuity or lives to the expected average age of death. Little wonder that workers covered by a defined-contribution plan appear to have very little idea of the annual income stream that can be provided by a given level of accumulation. *See* Halperin & Munnell, *supra* note 11, at 23, 66 n.36.

find that their pensions were based on a combination of earnings at ages thirty-five, forty-five, fifty-five, and sixty-five, for example.[56] Thus, mobile employees face a serious loss of benefits under a traditional defined-benefit plan, and this loss of benefits takes on greater importance as job mobility increases.[57] The impact should be alleviated by revising the method of calculating the accrued benefit upon separation from service to make the benefit more consistent with the concept of equal contributions.

One permissible method for determining the deductibility of contributions is to calculate the amount required if equal contributions as a percentage of pay were made over the remaining future service for all employees.[58] This is reminiscent of a so-called target benefit plan that calls for contributions, which, if the assumed rate of return is achieved, will be sufficient to provide a benefit equal to a specified percentage of pay.[59] These plans are defined-contribution plans, so the investment risk is on the employee. However, there is no reason why the employer could not guarantee the investment return. If the target were based on projected rather than current earnings and the accrued benefit equaled the assumed account balance,[60] these plans would call for equal contributions except as necessary to adjust for salary growth, higher or lower than anticipated. This would be *ideal*, and it seems inappropriate to totally prohibit benefits testing, because that would make it impossible for such plans to exist.

The problem of mobile workers could also be mitigated by requiring that each employer provide the terminating employee with a lump sum that reflected the value of benefits based on projected earnings at age sixty-five, rather than earnings at the time of termination. In that case, the mobile employee would suffer no loss of benefits. However, projected earnings would be difficult to estimate, particularly if individual circumstances had to be taken into account. More-

56. Change of jobs would not affect the benefit if each of the plans based their benefit on average pay over a "career" rather than final pay. However career average plans do not guarantee that the benefit will be related to final pay. *See* Halperin & Munnell, *supra* note 11.

57. *Id.* at 22.

58. I.R.C. § 404(a)(1)(ii) (West 2002). (For purposes of the funding requirements, the employer must take account of projected rather than current earnings.)

59. Contributions to these plans are often adjusted as pay increases.

60. Whether this approach produces more or less of a benefit for the mobile worker depends upon the assumed salary growth. At higher rates of assumed growth, the mobile worker might get a greater benefit than the career employee. *See Hybrid World*, *supra* note 15, at 5-18, 5-36 tbl.II.

over, one of the motivations for establishing pension plans is to reduce turnover and retain skilled workers. Increasing benefits for terminated employees, under the two approaches just suggested, would interfere with this goal. It would also increase employer cost, unless benefits for long-service employees were reduced. This may significantly reduce the employer's incentive to establish the plan. It might be more *possible* to require the lump sum paid to a terminated employee to reflect current salary indexed only for expected inflation, not real salary growth.[61]

Plan Change A similar problem arises when employers switch plans midway through an employee's career so that a worker is covered by a plan subject to benefits testing when she is young and one subject to contribution testing when she is older. This is harmful because contributions made on the worker's behalf when she was young would be inadequate to hit the desired target and, just as she reached the point where she would expect to receive disproportionately large contributions, the plan would change to require equal contributions for all participants. As a result, such employees would do less well than if they had been covered by the same type of plan for a full career.[62] To avoid this inequity, when employers change plans, they should be required to protect the expectations of any employee with a significant period of service, either by continuing accruals under the old plan[63] or by giving the employee the benefit of the new plan retroactive to the date of hire.

Limits on Benefits Testing In any event, the forgoing concerns suggest that benefits testing should be allowed only in limited circumstances, rather than as a matter of course. Benefits testing is not appropriate when the employer has no responsibility for assuring that the ultimate benefit will be related to final pay. For example, so-called age-weighted profit-sharing plans, which determine the contribution as the amount necessary, assuming a specified return, to replace the

61. Halperin & Munnell, *supra* note 11, at 24.

62. This pattern explains much of the outcry from mid-career employees whose employers switched from a traditional defined-benefit plan to a cash balance plan. *See* Mary Williams Walsh, *It May Be Time to Plumb Your Pension's Depth,* N.Y. TIMES, Dec. 15, 2002, § 3, at 8.

63. S. 9, 108th Cong. § 406 (2003).

same percentage of current pay for each participant, should not be allowed.[64] A so-called career average defined-benefit plan is identical to the age-weighted profit sharing plan just described, except that if the investment performance falls short of what is anticipated, the employer must make up the difference.[65] Career average plans could have a target equivalent to final pay plans if the benefit for each year of service is somewhat higher to take account of the fact that career average earnings on which the benefit is based will be lower than final pay. However, the benefit will only hit the target if the employer's earnings projection is accurate. Thus, these plans place the risk of an inaccurate salary projection on the employee. This result is inconsistent with the major reason for allowing benefits testing.[66]

Benefits testing is even less appropriate for so-called cash balance plans, which call for "contributions" as a given percentage of pay[67] and a fixed investment return that is usually equivalent to the rate on long-term Treasury bonds.[68] Here, the benefit, while determinable, has no stated relation to final pay. Instead, these plans emphasize the "account balance" available upon separation from service. Thus, in these plans the stated contribution should be equal and not increase with age or service.

The conclusion is more difficult, however, with respect to a target benefit plan which adjusts contributions to attempt to achieve a benefit equal to a given percentage of final pay. Although the investment risk is on the employee, these plans provide information as to the stated target. Therefore, target benefit plans can make a stronger case for benefit testing, at least if the target were based on projected rather than current earnings.

64. Commendably, President Bush has so proposed. REVENUE PROPOSALS, *supra* note 39. In these plans, the employee assumes the risk that the investment return and her final salary will be consistent with the amount assumed in determining the level of contributions. In addition, annual contributions are not required.

65. Of course, the employer can reduce contributions if the return is higher than anticipated.

66. I recognize that these arrangements will provide somewhat more for employees who experience an above average increase in earnings than plans which call for equal percentage contributions.

67. Because these plans do not have individual accounts, the employer need not necessarily make the stated contributions if it expects to make a higher rate of return than promised. However, because this is a defined-benefit plan, the employer is responsible for the benefits and PBGC insurance is required.

68. Although the employee assumes the risk as to the Treasury rate, this could be viewed as roughly equivalent to a fixed real rate of return.

In any event, equal contributions *certainly* should be required in any plan in which business owners, or perhaps certain very highly compensated employees, claim a very substantial part of the accrued benefits. Such plans are often adopted when the principal owner is older and the supporting staff is much younger. These plans also may provide for generous current benefits and for past service benefits that benefit only the owner. Furthermore, an owner may have sufficient control over the age and tenure of the work force to minimize the cost of a plan, notwithstanding the generous amount she herself receives. These plans create the greatest risk of plan termination before younger employees will earn significant benefits.

C. Preserving Accrued Benefits for Retirement

Even if employees participate in a plan for a lifetime and accrue benefits that were projected to adequately replace preretirement income, they may not actually receive such benefits upon retirement. Benefits may be forfeited on a job change, or they may be withdrawn and spent. Further, while accrued benefits generally cannot be reduced by plan amendment, there is no prohibition against allowing benefits to erode through inflation. Most importantly, benefits can be lost through market decline. The next sections discuss how expected benefits might be preserved for retirement.

VESTING

Ideally, participation should be required after, at most, one year of service, and vesting should be immediate at that point.[69] Under current law, benefits need not vest until the employee completes five years of service. Although understandable from the perspective of an employer trying to reduce turnover, delayed vesting makes no sense from a retirement security perspective. If the employee wants to protect against potential forfeiture, she would have to engage in what may amount to wasteful double savings.[70]

69. *See supra* text accompanying note 34.
70. TAX POLICY, *supra* note 15, at 176–78.

LIMITING DISTRIBUTIONS BEFORE RETIREMENT

Ideally, in-service distributions should generally be prohibited and plan loans severely limited. Further, all lump-sum payments should be required to be rolled over to an IRA.

Although there may be a penalty that discourages distributions,[71] there is currently no prohibition against distribution upon separation from service or, with limited exceptions,[72] upon plan termination. In addition, distribution can be made at retirement age[73] even if employment continues. Moreover, 401(k) plans allow hardship distributions during employment,[74] and traditional profit sharing plans allow in-service distributions almost without limit.[75] Further, plans can make loans to participants even when distributions would be prohibited.[76] Finally, distributions, when allowed, can be made in a lump sum.[77]

In concert, these rules lead to a substantial dissipation of accumulated benefits before retirement is reached.[78] *Ideally*, therefore, distributions should be prohibited before normal retirement age[79] and

71. There is a ten-percent penalty on early distributions in some cases. I.R.C. § 72(t) (West 2002).

72. *Id.* §§ 401(k)(10), 403(b)(7)(A)(ii), 403(b)(11) (as to salary reduction), 457(d)(1).

73. In the case of a pension plan, distributions are allowed at normal retirement age, which is the earlier of age sixty-five or the age stated by the plan. *Id.* § 411(a)(8). Sometimes there is a statutory age at which distributions are permitted, either 59½, *id.* § 401(k), 403(b)(7)(A)(ii), 403(b)(11)(A), or 70½, *id.* § 457(d)(1)(A)(I).

74. *Id.* § 401(k)(2)(B)(i)(IV). This is also true of section 403(b) plans in some circumstances where in-service distributions are otherwise prohibited. *Id.* § 403(b)(7)(A)(ii), (11)(B). Section 457 plans allow distributions only in the case of unforeseeable emergencies. *Id.* § 457(d)(1)(A)(iii).

75. Distributions are allowed after sixty months of participation or sooner for contributions made more than two years prior to distribution. Rev. Rul. 68-24, 1968-1 C.B. 150 (1968).

76. See I.R.C. § 72(p) for restrictions on loans.

77. Sometimes the consent of the employee and her spouse is required. *Id.* § 401(a)(11).

78. For example, the Employee Benefits Research Institute estimated that pre-retirement withdrawals and loans reduced the median replacement rate for the typical 401(k) participant in the lowest quartile from about seventy percent to fifty percent. Sarah Holden & Jack VanDerhei, *Can 401(k) Accumulations Generate Significant Income for Future Retirees?,* EBRI ISSUE BRIEF, Nov. 2002, at 16, *at* www.ebri.org/pdfs/1102ib.pdf (last visited Feb. 10, 2003). *But see* Gary V. Engelhandt, *Pre-Retirement Lump-Sum Pension Distributions and Retirement Income Security*, 55 NAT'L TAX J. 665 (2002).

79. Age sixty-two would be consistent with the age at which Social Security benefits are first payable. LAWRENCE A. FROLIK & RICHARD L. KAPLAN, ELDER LAW IN A NUTSHELL (2d ed. 1998).

required to be made in the form of an annuity or periodic payments over the life expectancy of the employee and her spouse. There is a dilemma, however, in that reducing access to funds might increase resistance to retirement savings in lieu of cash wages.[80] Nevertheless, I would favor a prohibition against in-service distributions except in the case of elective deferrals. Earlier distributions in the latter case could be limited to hardship, preferably unforeseeable situations as is the case for section 457 plans.[81]

Although distributions also could be prohibited before retirement age, even following separation from service or plan termination, there are difficulties in requiring employers and employees to keep track of each other in these circumstances. Although I would prefer it, it also may be difficult to require annuities, or even periodic distributions, in lieu of a lump sum. At the very least, in the case of any distribution other than periodic distributions during retirement years, the employer should be required to place the funds in an IRA rather than to give them directly to the employee.[82] Although funds can be withdrawn from an IRA, the expectation behind this rule is that the need for affirmative action to access these funds will significantly reduce the likelihood that they will be spent.

PRESERVING THE REAL VALUE OF PENSION BENEFITS AGAINST INFLATION

Inflation can erode pension benefits after retirement, but private sector defined-benefit pension plans generally do not provide postretirement cost-of-living adjustments. Consequently, even moderate rates of inflation can noticeably erode the purchasing power of benefits fixed in nominal terms. Even at three-percent inflation, the real value of a one-hundred-dollar benefit declines to sixty-four dollars after fifteen years, fifty-five dollars after twenty years, and forty-eight dollars after twenty-five years.[83] Given that life expectancy at age sixty-five is about twenty years, this erosion remains an important problem. *Ideally*, pension benefits should be indexed for inflation. At a minimum, all plans should be required to offer the option of an inflation-indexed annuity.

80. *See* TAX POLICY, *supra* note 15, at 178–82.
81. *See* I.R.C. § 457(d).
82. Some have suggested the establishment of a central fund as a depository for these distributions. *See* Pension ProSave Act, S. 957, 105th Cong. (1997).
83. Halperin & Munnell, *supra* note 11, at 12.

PROTECTION OF BENEFITS AGAINST MARKET DECLINE

The pension universe is divided into defined-contribution plans and defined-benefit plans. The latter promises a specific benefit, and ERISA protects participants from suffering a reduction in their promised benefits due to a market decline. Funding[84] and fiduciary standards[85] help to ensure that money will be available. If funds are insufficient, ERISA makes the employer liable for any shortfall[86] and establishes the Pension Benefit Guaranty Corporation (PBGC),[87] which guarantees most benefits in defined-benefit pension plans should the employer be unable to pay.[88]

On the other hand, in the case of defined-contribution plans, which are becoming increasingly predominant,[89] the employer merely promises to make contributions, and the investment risk is on the employee. In many cases, the employee has full investment discretion and the employer is relieved of fiduciary duty[90] as long as at least three diversified investment choices are available. *Ideally*, the investment risk should be on the employer but this may not be *possible*. Steps, possibly including differential tax benefits, should be taken to encourage employers to assume the investment risk in more circumstances. Importantly, it is not sensible to allow higher contributions to defined-contribution plans than can be made to defined-benefit plans promising equivalent benefits and elective contributions should be permitted even if the investment risk is on the employer. In addition, more protection should be provided for participants who bear the risks themselves.

Imposing the Risk on the Employer Employers have much greater capacity than employees to absorb the risks associated with investment performance. Besides benefiting from economies of scale, the employer can average out investment results among cohorts of retirees, so it need not worry about a temporary market downturn. Moreover, a plan which imposes the risk on the employer is not inconsistent with equal contributions. Under the recently popular cash balance plan,

84. *See* I.R.C. § 412.
85. *See* 29 U.S.C. § 1104 (2000); ERISA tit. I, § 404.
86. *See* 29 U.S.C. § 1362(b)(1)(A); ERISA § 4062.
87. 29 U.S.C. § 1302; ERISA tit. IV.
88. *See* 29 U.S.C. § 1322; ERISA § 4022.
89. *See supra* note 54.
90. 29 U.S.C. § 1104(c); ERISA § 404(c).

the promised benefit is the amount that could be provided from the cash balance that would accumulate if the employer made contributions equal to a certain percentage of pay and the plan earned a specified rate of return, such as the rate on Treasury bonds.[91] Of course, if all the employee seeks is the return on Treasury bonds, this could be achieved in a defined-contribution plan with very little investment risk. However, well-advised employees would take a greater risk in pursuit of higher returns. Failure to do so would likely result in inadequate retirement income even if the original contributions were sufficient. Does a cash balance plan have the same deficiency of a low return?

In practice, under a cash balance plan, the employer does not invest in Treasury bonds, but in higher yielding instruments such as equities. Because employers anticipate earning higher returns, they can contribute less than the stated percentage. Because the plan is a defined-benefit plan, employees are not put at risk if the investment performance turns out poorly. They are entitled to the promised benefit and the employer's promise is backed up by the PBGC.

This suggests that there is another way of viewing these plans. In essence, the employer is making a lower level of contributions than advertised, and the employee, without assuming any risk, is earning the expected return from a balanced portfolio. From this perspective, a cash balance plan is much like a traditional defined-contribution plan except that the investment risk is on the employer who, in my view, is better able to bear it.

But is this view of a cash balance plan accurate? If the employer is taking the investment risk, why should the employee get any more than the riskless rate of return available? If this is correct, the employer would consider the cost of the plan to be the nominal rather than the actual contributions and would seek to reduce cash payroll by that amount. However, if this is the case, why would the employer not consider the cost of a traditional defined-benefit plan to be the amount it would have contributed had the plan earned the riskless rate of return available, rather than its actual lesser contributions? It is noteworthy that the cost of a traditional plan is not usually de-

91. In such a plan, the employee retains the risk as to the rate of return on Treasury bonds but may attain something close to a fixed real rate of return.

scribed in this way,[92] and employees would be legitimately reluctant to subject so much of their savings to low-return investments.

In any event, is it reasonable to assume that cash balance plans will replace defined-contribution plans? Most, if not all, existing cash balance plans are conversions from traditional and probably overfunded defined-benefit plans. If the employer had adopted a traditional defined-contribution plan instead of a cash balance plan, the excess assets would not have been available to fund the new plan. A portion would generally be distributed to employees,[93] and the amount that reverts to the employer would be subject to an excise tax.[94] When starting from scratch, employers seem to prefer traditional defined-contribution plans where the investment risk is on the employee. Employees also would prefer this alternative if they consider the cash balance plan as providing a low rate of return.

However, three straight years of poor market results (2000–2002) may make employees more willing to accept cash balance plans and give up the opportunity for huge investment returns. The chances of this occurring might increase if employees understood cash balance plans, under the alternative view that I have suggested, to actually provide a higher rate of return than advertised. Employees should be willing to accept a somewhat lower return if they are free of risk, particularly because the employer's promise is guaranteed by the PBGC. Employers should be willing, at least in some cases, to assume the investment risk. If employers are better able to handle risk, as I have suggested, the "cost" to the employer of risk assumption should be less than the employee is willing to pay.

In any event, there is no reason to favor defined-contribution plans. We should allow 401(k) plans to impose the investment risk on the employer.[95] Current rules which allow excessive contributions to defined-contribution plans and inadequate contributions to defined-

92. *See Special Tax Treatment*, *supra* note 12, at 10. In a cash balance plan, because the investment risk is the only variable and the promised return is specified, the employer may be more likely to question the implication of offering a return above the riskless rate.

93. I.R.C. § 4980(d) (West 2002) (providing an increased excise tax unless this is done).

94. *See id.* § 4980(a).

95. Current law would prohibit elective 401(k) type contributions to a defined-benefit plan. *Id.* § 410(k)(1).

benefit plans should be revised to allow for equal treatment.[96] Moreover, whenever there is no guarantee of past service benefits, it should be possible to offer a reduced PBGC premium. If necessary, it may be advisable to provide a greater tax subsidy when the employer assumes the investment risk.

Mitigating the Employee's Risk As just discussed, it seems possible to hope for an increase in the number of plans where the investment risk will be borne by the employer instead of the employee. However, a substantial number of plans undoubtedly will continue to place the investment risk on the employee. In any event, it seems sensible to impose some responsibility on the employer to make educational materials available[97] and perhaps to monitor choices that are clearly inappropriate for the particular employee. It is also important to consider the possibility of guaranteeing benefits in these plans.[98] Although employees, as a group, cannot earn more than the market, the goal should be to even out returns so that less depends upon the year one happens to retire. One possibility is to make it easier for employees to initially invest in annuity contracts which, given competition, should provide earnings reasonably equivalent to market results over the long term. It may also be possible to offer some minimum guaranteed return to employees who follow certain restrictions on investments and give up some upside potential.

It is noteworthy that the PBGC, in the case of a defined-benefit plan where the employer assumes the initial responsibility, does insure investment results.[99] Although this may create a moral hazard,

96. *See Hybrid World*, *supra* note 15, at 5-31 to 5-36. The culprit here is the inability to anticipate the effect of inflation on the benefit and compensation limit and the so-called full funding limitation.

97. *See* Regina T. Jefferson, *Rethinking the Risk of Defined Contribution Plans*, 4 FLA. TAX REV. 607, 636 (2000).

98. *See id.* at 649–69; *see also Retirement Security and Defined Contribution Hearings Before House Comm. on Ways & Means*, 107th Cong. (2002). For a discussion, see MARIE-EVE LACHANCE & OLIVIA S. MITCHELL, NAT'L BUREAU OF ECON. RESEARCH, GUARANTEEING DEFINED CONTRIBUTION PROMISES: THE OPTION TO BUY BACK A DEFINED BENEFIT PROMISE (2002), *available at* http://www.nber.org/papers/w8731 (last visited Feb. 10, 2003).

99. The PBGC most significantly provides protection for past service liabilities which were not yet required to be funded. When a plan, such as a cash balance plan, has no past service liabilities, however, inadequate investment returns would be the primary reason for an asset shortfall. Other actuarial assumptions would less important and perhaps less volatile.

which could be more pronounced in a defined-contribution plan, the matter still seems worthy of consideration.

Congressional Action The implosion of Enron led to an increased congressional concern for poor investment results and the introduction of a number of bills, which went beyond the issue of excess investment in employer stock. As to the latter, no investment advisor is going to sanction investing a large percentage of retirement savings in employer stock. Putting all of one's eggs in one basket is a particularly bad idea when your job is in the same basket. It would seem obvious that, at the very least, the ten-percent limit applicable to defined-benefit plans[100] should be extended to defined-contribution plans as well. However, employers, who benefit from making contributions in stock,[101] opposed the limitation, and employees, many of whom appeared to think they were working for the next Microsoft, did so as well.

The bills passed by the House[102] and reported out by the Senate Finance Committee[103] merely required that the employee have the right to divest employer stock and choose from at least three other investment options. This option was to be exercisable at any time as to employee elective contributions, and after a three-year wait (either from the date of hire or from the time the stock was allocated to their account) with respect to employer matching contributions.[104] The Senate Labor Committee went further, in many cases prohibiting employer contributions in employer stock unless the employee did not have the option to so invest her elective contributions.[105] The Committee was influenced by the fact that when employers made contributions in employer stock, employees appeared to take it as a signal that

100. 29 U.S.C. § 1107(a) (2000); ERISA § 407(a).

101. Employers believe contributions in stock preserve cash and that employee ownership aligns the interest of the employees with that of the company, promotes stable stock holdings, and helps fend off takeover bids. *See* Alicia H. Munnell & Annika Sunden, Ctr. for Ret. Research at Boston Coll., *401(K)s and Company Stock: How Can We Encourage Diversification?*, ISSUE IN BRIEF, July 2002, at 1. In addition, dividends paid on employer stock held in certain pension plans are deductible. I.R.C. § 404(k) (West 2002).

102. H.R. 3762, 107th Cong. (2002).

103. S. 1971, 107th Cong. (2002).

104. H.R. 3762 § 104; S. 1971 § 101; S. 1992, 107th Cong. § 101 (2002).

105. S. 1992 § 102.

they should make a similar investment choice and invested a higher percentage of their own contributions in employer stock.[106]

The bills had other requirements intended to address the potential problems with employer stock investments, including almost immediate electronic notice of insider trades,[107] imposing a fiduciary duty on the plan sponsor and administrator to disclose all material information on employer securities,[108] and distribution of investment guidelines which would include information about diversification.[109] The House bill requires a specific discussion of the risk of maintaining a portfolio that is overexposed to a single company's stock, including employer stock.[110]

In any event, protecting the employee against overexposure in employer stock would not solve the problem of insufficient investment expertise and inadequate ability to bear risk. The bills recognized this and sought both to require investment education, as noted above, and to improve the employee's access to professional investment advice. The Senate committees would encourage employers to make investment advisers available by relieving the employer of fiduciary responsibility for hiring and monitoring the adviser if certain minimal requirements were met.[111] The House would allow investment advice from the plan's investment manager, but the plan sponsor would remain responsible as a fiduciary for selecting and monitoring the adviser.[112] Although this may be the least expensive method of providing advice, some groups objected to it on the grounds that the adviser had a conflict of interest that may taint the advice.[113]

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106. The committee referred to this as the "endorsement effect." S. REP. NO. 107-226, pt. 1 (2002).

107. S. 1992 § 203.

108. S. 1971 § 304.

109. S. 1992 § 102.

110. H.R 3762, 107th Cong. § 101(b). The bill introduced by the Senate Democrats at the start of the current Congress, Senate Bill 9, requires the employee to be notified that she might be over-invested in employer stock when this comprises twenty percent or more of account value. S. 9, 108th Cong. (2003). Companies would also have to determine annually that employer stock is a prudent investment. *Id.*

111. S. 1971 § 306; S. 1992 § 103.

112. H.R. 3762 § 105. The Labor Department has allowed the plan provider to offer investment advice based on investment models created by an outside firm. *See Save for Retirement and Get Wisdom Too,* N.Y. TIMES, Jan. 19, 2003 § 3, at 7.

113. Donna Rosato, *Doors May Open to 401(K) Advice,* N.Y. TIMES, Sept. 1, 2002, § 3, at 9.

It is important to resolve these differences so that employees will be more likely to have access to investment advice on an individual basis. Education materials should also be made available. Most importantly, we should develop mechanisms which would, at least, allow employees to mitigate downside investment risk.

II. Increasing the Number of Plans and Coverage for Lower Income Earners

The changes suggested above would undoubtedly discourage new plans and could lead to the termination of some existing plans. This section considers how, despite tougher requirements, we might still develop an employer-based pension system which could offer the prospect of full replacement for low and moderate earners. A number of approaches have been suggested. These include mitigating administrative costs, increasing permitted contributions and benefits for high earners (possibly only for those plans which meet wider coverage rules), and mandating a certain level of contributions.[114] I believe it is best to provide additional government contributions, either directly or as a match, to contributions by lower-paid individuals or for employer contributions on their behalf. This can be accomplished by use of separate individual accounts or through employer plans. If additional aid for employer plans is limited to plans that disproportionately cover lower-paid individuals, the goal may be accomplished without providing a costly and undesirable windfall to those who would otherwise maintain such plans.

A. Mitigating Administrative Costs

Qualified employer pension plans involve administrative costs that do not apply to personal savings. Although some of these costs vary with the number of employees, the fixed costs are substantial. For an employer with many workers, the tax benefits derived from the use of a qualified plan make it sensible to absorb these costs. But if the work force is small, or if the need to subsidize the earnings of reluctant savers absorbs the bulk of the tax benefits, the administrative

114. I have also discussed whether it would be helpful to make nonqualified plans less desirable. *Special Tax Treatment*, *supra* note 12, at 43–44; *see* Daniel Halperin, *Ninth Circuit's Decision in Albertson's Is Outrageous*, 62 TAX NOTES 1083 (1994).

costs may be prohibitive. This might suggest subsidizing such costs for small plans that provide a high proportion of benefits to low- and moderate-income employees.[115]

B. Providing More Benefits to the Highly Paid

The 2001 Act, which derived from legislation introduced by representatives Portman and Cardin,[116] substantially increased the benefits available to highly compensated employees. The hope was that this would encourage more companies, particularly small businesses, to offer pension plans, because the owner would have access to an increased amount of tax-preferred savings and could possibly claim a greater share of the overall contributions for herself. I have described this effort as follows:

> [I]t is a shockingly bad example of "trickle down" economics at its worst. It is as if Congress noticed that not enough water (pension benefits) was reaching lower earners so it turned the faucet on full force (allowing more for the higher paid), but neglected to clean the pipes. In fact the bill throws more mud in the way.[117]

It just does not make sense to offer increased benefits for the higher paid without some assurance that the higher level of benefits only would be available to plans that provide a significant level of benefits to the rank and file.[118]

C. Additional Government Benefits for Low Earners

Social Security benefits alone do not provide full replacement of preretirement earnings and are inadequate to prevent workers with a history of low wages from living below the poverty line in retirement. For many, particularly those in the bottom forty percent of earnings, employer-based pensions have not filled the gap. Unless additional incentives are provided, this situation will not improve.

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115. I.R.C. § 45E as added in 2001 provides a credit equal to fifty percent of the "start-up" costs, up to a maximum of $500, for the first three years of the plan's existence. It is available to companies with up to 100 employees, and the plan must cover at least one non-highly compensated employee. As suggested in the text, I would target the credit to plans where a high proportion of the benefits were allocated to the latter group.

116. *See Unofficial Transcript of Ways and Means Hearing on Pension Issues*, TAX NOTES TODAY, May 5, 1998, LEXIS 98 TNT 90-89.

117. Halperin, *supra* note 46, at 958.

118. *See* Halperin & Munnell, *supra* note 11, at 40.

As noted above, for many lower-income employees the tax benefits of qualified plans are unlikely to be great enough to cause them to save when they otherwise would not. Deferral of tax until cash is received, combined with tax exemption for the pension fund, can be viewed as providing two potential benefits. First, wages are effectively taxed at the marginal rate of the employee at the time of distribution rather than the marginal rate at the time wages are earned. Second, the investment income is totally exempt. The extent to which an employee benefits from this treatment depends upon whether she can expect lower tax rates at retirement and the normal rate of tax on the form of investment income earned by the plan. For low earners, the gain is likely to be quite small.[119]

An employee may also be influenced by the impact on current spending. Contributions to qualified plans are not currently taxable, therefore, an employee, who is in the forty-percent bracket may view the decision to save as a choice between a $1000 contribution or $600 in current spending. If the employee is in the fifteen-percent bracket, however, the after-tax wages would be $850, and if the employee is not subject to tax, she can get $1000 either way.

If there is not enough of an advantage to make the prospect of savings seem worthwhile to low and moderate-income employees, one possibility is to mandate contributions by the employer.[120] If all employers were required to make contributions to a retirement plan, employees would not have potential jobs available which paid wages solely in cash. Therefore, unless constrained by a minimum wage, employers ought generally to be able to reduce cash compensation by the amount of the required contribution.[121] Moreover, mandated contributions are the only way that we could be certain to achieve a goal of full replacement.

However, even if mandated pensions were politically feasible, they might not be sensible in all circumstances. Some flexibility over

119. In some cases there could actually be an increase in the lifetime tax burden, primarily because of the impact of retirement plan distributions on the taxation of Social Security benefits. JAGADEESH GOKHALE ET AL., NAT'L BUREAU OF ECON. RESEARCH, DOES PARTICIPATION IN A 401(K) RAISE YOUR LIFETIME TAXES?, *available at* http://www.nber.org/papers/w8341 (last visited Feb. 10, 2003).

120. PRESIDENT'S COMM'N. ON PENSION POLICY, COMING OF AGE: TOWARD A NATIONAL RETIREMENT INCOME POLICY 42 (1981); *see Special Tax Treatment*, *supra* note 12, at 44-6.

121. This might not be so to the extent that workers dropped out of the workforce in reaction to the decline in cash wages leading to a shortage of workers.

the timing of lifetime spending may be desirable. Moreover, reduction in current wages for deferred pension benefits may not be desirable for low-income workers who are already struggling to make ends meet.[122] The only sensible way to improve retirement benefits for low-income households may be to increase their lifetime income through some redistributive device which would enable low-income workers to have more retirement income without a significant cut in their wages during their working years.

As suggested above, in some situations employers can maintain pension plans without significantly reducing cash wages for what I have called "reluctant savers." Thus, because of the tax benefits, high earners can benefit from participation in a qualified plan even if the sum of their cash wages and the contributions made to the plan on their behalf is less than the wages they earn. The amount thus saved can be used by the employer to make contributions to the plan for the lower paid. However, this form of cross-subsidization is only feasible if the tax savings for the highly paid are relatively high in relation to the cost of covering reluctant savers. It cannot be achieved if a substantial percentage of the work force is comprised of lower earners.

Therefore, in some situations an additional subsidy is necessary for the plan to be feasible. To be cost effective, the subsidy should not be for additional savings on behalf of high earners. Rather, it should be tied to contributions on behalf of the lower paid, perhaps ideally only when the lower paid enjoy a high percentage of the total benefits from the plan.

Thus, there have been a number of proposals calling for tax credits or their equivalent, government matching of contributions.[123] Generally, the size of the credit would decline as income increased, and the credit would be unavailable above a certain level of income. Some of these proposals were presented at the "Conversation on Coverage" sponsored by the Pension Rights Center in 2001,[124] and the participants developed a consensus in favor of this approach.[125]

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122. Halperin & Munnell, *supra* note 11, at 6, 31.
123. *See* Joint Comm. on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2001 Budget Proposal,* 2000 WORLD TAX DAILY, 47–32, ¶¶ 438–459 (2000).
124. Proposals by Peter Orszag, Michael A. Calabrese, and Pamela Perun, *at* http://www.pensioncoverage.net/Proposals.htm (last visited Feb. 10, 2003).
125. Confronting the Pension Coverage Challenge, Excerpts from the White Paper Conversation on Coverage I (on file with The Elder Law Journal).

Congress stuck its toe down this path in 2001.[126] It provided a nonrefundable tax credit, ranging from ten to fifty percent of up to $2000 in contributions made by lower earners.[127] The credit applies to employee directed contributions to individual retirement accounts or to employer plans, including elective deferrals to 401(k) plans. Many of the employees we are concerned with have little or no taxable income; thus the current provision is of minimal use because the credit is not refundable.[128] However, even if the credit were refundable, the matching aspect would require the employee to forgo some current consumption.

The amount of the employee's decline in current consumption would depend upon the employees' marginal tax rate and the effect the credit or matching grant has upon the tax treatment of the pension contribution. If the deduction or exclusion from income remains equal to the entire contribution even though a portion is attributable to the credit, the credit is effectively tax-free.[129] Still, a nontaxable individual, entitled to a fifty-percent credit for a $2000 contribution, would have to reduce current spending by $1000. If income were taxed at fifteen percent, forgoing $700 of current spending would be necessary in order to achieve $2000 of savings.[130] Although the for-

126. I.R.C. § 25B (West 2002).

127. The credit is as follows:

Adjusted Income Not Over

Percent	Joint Return	Head of Household	Single
50	$30,000	$22,500	$15,000
20	32,500	24,375	16,250
10	50,000	37,500	25,000

128. Martin Fleisher, *Credit Sophistry,* 96 TAX NOTES 580 (2002). The Senate Democrats have introduced a bill to make the credit refundable. Pension Protection and Expansion Act of 2003, S.9, 108th Cong. (2003).

129. Assume an employee now contributes $1000 to an IRA. Suppose the availability of a fifty-percent credit causes her to increase her contribution to $2000. Although because of the credit the account is $1000 larger, her taxable income is effectively unchanged. This is obvious under the Roth alternative under which she is taxable on her wages in both cases. Under the regular IRA, the additional deduction for the $2000 contribution reduces her current income by $1000. However, there is now $2000 in the plan rather than $1000. The tax on distribution is effectively equivalent to an additional current tax of $1000, which offsets the additional deduction. *Time Value, supra* note 10, at 520–24.

130. It would seem that the sacrifice should be $850, the amount available after-tax from $1000 of income taxed at fifteen percent. However, as noted above, *current* taxable income would be reduced by $2000, even though the employee only contributed $1000 out-of-pocket. Thus, the immediate tax savings would be $300.

gone current consumption would be a smaller percentage of the additional savings if the employer matched the contribution, ultimately we might need a greater credit or perhaps a government grant which did not require employee matching in order to achieve adequate savings for the lowest earners.

President Clinton's proposal for Universal Savings Accounts (USA)[131] would have provided additional savings for low and moderate earners through the equivalent of direct grants regardless of savings effort.[132] In addition, it provided matching grants equal to a percentage of contributions. The automatic deposit was $300 to accounts of single workers earning up to $20,000 ($40,000 for married couples). For couples, the automatic deposit was reduced by $7.50 for each $1000 of income above $40,000 and phased out at $80,000. The proposal also would match voluntary contributions to the individual account or to an employer plan.[133] The match would be dollar for dollar for the lowest earners, declining to fifty cents on the dollar for married couples with income over $80,000. The program was designed so that there would be an annual $1000 contribution for each employee who took advantage of the maximum available match.

The $300 automatic deposit for individuals earning $20,000 or less, if applicable for a full career, was probably sufficient to provide full replacement for this group without any additional savings effort. Above $20,000, voluntary contributions probably would be required to accumulate enough savings for full replacement. It remains to be seen how large a credit would be needed to produce adequate savings.

Perhaps it would help if the credit were available for nonelective employer contributions as well. Although a credit for such contributions would not operate as a direct incentive for the employee to save, it would enable the employer to make contributions to the

131. *Clinton Details Universal Savings Accounts Including 401(k) Matches*, TAX NOTES TODAY, Apr. 15, 1999, LEXIS 1999 TNT 72-1.

132. In the following year, direct grants were eliminated from the proposal and only the match remained.

133. A direct government contribution to the employee's account may make it more likely that savings will actually increase. However, unless the deduction for contributions to an IRA or the amount of wages excluded from income by reason of the 401(k) contribution is increased to reflect the government contribution, the amount of the government grant would effectively be taxable. In other words, the result on future distribution is the same as described in *supra* note 129 as to the regular IRA (an additional tax effectively equal to the additional contribution), but there is no equivalent reduction in current tax.

plan on behalf of the employee without an equivalent reduction in salary. This should make it easier for employers to establish plans. Moreover, the lack of employee choice may actually increase the level of savings.

Allowing the credit to the employer, however, would necessarily base the credit on the earnings level from a particular job. This could allow a credit for contributions on behalf of apparent low earners who have other jobs or high family income and are not in need. On the other hand, if the credit could be limited to employers who are making a disproportionately high share of total contributions on behalf of low earners, it would be more targeted to savings that would not otherwise exist.[134]

Even if the credit is limited to elective contributions, it makes sense to allow it for such contributions to employer plans. This would result in the minimum interference with 401(k) plans and offers the opportunity for education as to the value of savings, and for mechanisms that could facilitate greater participation. However, some employers may fail to take advantage of the opportunity to establish plans. Therefore, in order to provide access to all workers, regardless of whether the employer maintains a plan, it is essential to make the credit available for contributions to individual accounts, as well as employer plans.

134. In order to be equivalent to a credit available to the employee, the employer's deduction should be reduced by the amount of the credit. *Cf.* I.R.C. § 280C (West 2002). To accommodate tax-exempt or nontaxable employers, the credit would have to be refundable. In addition, the credit should be tax-free to the employee.

It is possible that a credit at the employer level would be more generous than a credit offered to the employee. Thus, if the employer is entitled to a full deduction for its contribution and the employee is fully taxable, the ultimate effective tax burden would be the same only if the parties are in the same bracket which is unlikely because the credit is aimed at employees who would be nontaxable or subject to a fifteen-percent marginal rate.

For example, suppose the credit is fifty percent and the employer is in the forty-percent bracket. In that case, if the contribution were fully deductible, the employer would break even if it offers additional compensation of $1667 (which would be offset by the credit of $1000 and the tax savings from the additional deduction of $1667 (40% X $1667 = $667). Therefore, it can contribute $2000 and reduces cash wages by only $333.

In lieu of a nontaxable credit of $1000, the employee gets an additional $1667 which is taxable, either currently or on distribution. At a forty-percent rate, this is equivalent to $1000. However, if the employee's marginal rate is lower, this approach, providing the credit to the employer, offers an additional benefit.

III. Individual Accounts and Social Security

As just discussed, enhanced government contributions for retirement savings for low earners may be available through separate individual accounts as well as employer plans. The existence of government-sponsored individual accounts as a potential depository for both direct grants and matching credits under arrangements like the USA proposal raises the issue of the relationship between such a scheme and proposals for creating individual accounts under Social Security (so-called privatization).

Social Security wisely guarantees a minimum level of retirement income, indexed for inflation, regardless of market performance. It does not provide any individual with an option to claim the value of her benefits at an earlier time. Although there is no scientific way to determine the optimal or desirable level of guaranteed benefits, I believe Social Security should provide full replacement for the lowest earners and, at least, the current level of benefits for others. Individual accounts jeopardize benefits by placing the market risk on the employee. Therefore, I am strongly opposed to dedicating a portion of current revenues to individual accounts.

Of course, additional contributions dedicated to Social Security would be required to achieve the goal just described. Some have suggested that, politically, the public will not accept additional taxes unless the additional revenue and, perhaps, part of current revenue is dedicated to individual accounts.[135] However this political debate is ultimately resolved, acceptance of individual accounts for arrangements like USA does not mean acceptance of what is usually referred to as privatization. USA accounts are a different issue for two reasons. First, they are aimed at enhancing benefits rather than providing for the current level of benefits. Second, they represent new revenue that, as noted, might be otherwise difficult to raise.

IV. Conclusion

Government policy relating to employer-sponsored retirement programs has always involved a delicate balancing act. Lenient rules as to required coverage may encourage employers to maintain plans

135. NAT'L ACAD. OF SOC. INS., EVALUATING ISSUES IN PRIVATIZING SOCIAL SECURITY ES 12 (1998); *see* Robert C. Pozen, *Arm Yourself for the Coming Battle over Social Security,* HARV. BUS. REV., Nov. 1, 2002, at 52.

but does not necessarily provide retirement security to the most endangered group. Tough coverage rules of the kind advocated herein have been said to be likely to result in a reduction in the number of plans, which could reduce overall retirement security even though those plans that do continue would be more likely to be in accord with public policy goals. Thus, it is difficult to strike the right balance.

Nevertheless, the *reality* is that we spend a lot of money in the form of forgone tax revenue, but the bulk of the revenue loss subsidizes savings by higher-income employees, many of whom are already likely to have adequate savings. On the other hand, employer plans do a poor job of providing for the lower-income workers who are, therefore, largely unable to maintain their previous standard of living in retirement.

This article advocates a new approach: Tougher standards to make it more likely that employer plans will replace pre-retirement income for low and moderate earners and additional government subsidies to retirement savings for this group to make such plans feasible.

These tougher standards would first ensure wider coverage by requiring that all employees be eligible[136] and by reducing the role of choice, including providing some contributions for those who elect out. Second, more equal contributions would be achieved by limiting the role of integration with Social Security and the availability of testing for discrimination by comparing projected benefits. Third, benefits would be preserved for retirement by immediate vesting, an allowance for inflation, and the requirement that non-periodic distributions be placed in IRAs. Further, government subsidies should be designed to encourage the employer to assume the investment risk. If investment risk remains with the employee, we should provide more education and increase the availability of expert advice. In addition, we should devise mechanisms to limit the employee's exposure.

This program is possible only if we enhance the government subsidy for savings for lower-income individuals. This could take the form of tax credits for employer contributions, perhaps, only when the

136. As noted, this could be applied on the basis of a line of business rather than companywide, and there could be a delay in coverage for a reasonable waiting period as long as coverage were retroactive to the date of hire for those who qualify.

plan dedicates a high proportion of contributions to the target group, or through direct government grants and matching contributions for individual savings. These matching grants, perhaps in the form of tax credits, could be for both contributions to individual accounts or for elective contributions to employer plans.

These changes, if they worked, would make the retirement savings for low- and moderate-income employees closer to the *ideal* than the current *reality*.