

Retirement Income Security After the Fall  
Daniel Halperin

Adequacy of retirement income requires first that benefits be provided and adequately funded, second that accumulated funds be protected and third that distributions be deferred until retirement. In theory we rely on the so-called three-legged stool of Social Security, employer provided benefits and individual savings. However, for at least 40% of the workforce only the first leg, Social Security, really exists and it in and of itself is inadequate.<sup>1</sup>

The Center for Retirement Research has prepared a National Retirement Risk Index which shows that even if workers stay employed until 65 and utilize all their financial assets including reverse mortgages on their homes, 44% of retirees will not be able to continue their pre-retirement standard of living. This number rises to 61% if health care costs are considered and increases over time.<sup>2</sup> Thus, even before the market Fall, there were holes in the provision for retirement security.

In addition, the already challenged system for providing retirement income security was hammered by the decline in stock and other financial assets in 2008. Those employees with substantial accumulation in 401(k)s or other defined contribution plans are obviously worse off than they thought, many disastrously so. The sharp decline in the balance of 401(k) accounts, left

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<sup>1</sup>See generally Virginia P. Reno and Joni Lavey, Social Security and Retirement Income Adequacy (National Academy of Social Insurance May 2007) (hereinafter Reno).

<sup>2</sup> Alicia H. Munnell, Francesca Golub-Sass, Mauricio Soto and Anthony Webb, Do Households Have A Good Sense of Their Retirement Preparedness? 1 (Center for Retirement Research (August 2008)

employees, particularly older employees, wondering how they would finance their retirement.<sup>3</sup> *We need to focus on whether it is possible to offer this group greater protection against similar events in the future.* The possibility of large losses has also focused more attention on whether balances were adequate to begin with and will be preserved for retirement.

Employees lucky enough to be participating in defined benefit plans would seem to have dodged a bullet but this is not necessarily so. The employer may have suffered both a business downturn and a significant decline in plan assets putting the plan in jeopardy.<sup>4</sup> A bankruptcy filing may endanger even already accrued benefits for higher income employees above the limits insured by the PBGC.<sup>5</sup> Further, employers suffering a meltdown may be inclined to freeze or terminate a plan resulting in substantially lower benefits than expected.. The requirement that investment loss generally be made good over 7 years contributes to the employer's distress.<sup>6</sup> *We need to consider whether the risk of termination and the potential benefit loss when termination occurs can be mitigated.*

The financial market disaster has not directly affected the retirement security for, perhaps the 60% of the work force who had little or no pension accumulation to begin with. The problem

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<sup>3</sup> See Big Slide in 401(k)s Spurs Calls for Change, Wall Street Journal January 8, 2008 at A1

<sup>4</sup>Alicia H. Munnell and Dan Muldoon, Are Retirement Savings too Exposed to Market Risk 3 (Center for Retirement Research (October 2008). Many employers have eliminated section 401(k) match.

<sup>5</sup> In 2008 the maximum benefit insured by the PBGC is \$51750 for those claiming benefits at 65; less for those claiming at younger ages.

<sup>6</sup> See generally, Alicia H. Munnell, Jean-Pierre Aubry and Dan Muldoon, The Financial Crisis and Private Defined Benefit Plans (Center for Retirement Research November 2008).

of achieving adequate security for this group, which relies nearly exclusively on Social Security remains. Social Security, however, may be in more difficulty to the extent that the unprecedented size of the near term federal deficit forecloses some options for solving the pre-existing disconnect between promised benefits and projected funding.

*Do these events suggest modifications in this system? Would it make sense to aim for more adequate benefits for at least the lower income through Social Security? Is this achievable? If not, is it feasible to create another tier of retirement benefits between Social Security and employer-based plans? Would participation in such a program be voluntary or mandatory and where would the funds come from? Finally, if none of this works, is it possible to increase the viability of employer-based plans for the lower earning 40%? If this requires a government subsidy, what form should such a subsidy take and is it affordable?*

The questions raised in the prior paragraph are not new. They have plagued us for a long time. However, now that the vulnerability of all aspects of the employer-based system has been more exposed, these questions take on a greater urgency. Before turning to them however, I will consider the issues, raised above, which are directly related to the financial crisis. Since there is no obvious cure, in the end I raise more questions than I supply answers.

### I Investment Risk in Defined Contribution Plans

Even if contributions are sufficient, benefits could be inadequate because of excessive fees or disappointing earnings. Unhappy investment returns could come from three sources. One, the employee makes unwise decisions, perhaps, taking on too much or too little risk or not sufficiently diversifying, possibly by putting too many eggs in employer stock. Second, even for

identical investment strategies, the employee may have the bad luck to be born in the wrong year, retiring when the market is down or when a decline in interest rates makes annuities more expensive. Third, the market is just too risky and uncertain for even seasoned professionals to produce returns which would provide a decent retirement in all circumstances. Can steps be taken to protect employees participating in defined contribution plans **against investment risk**.

#### A. Lack of competence

Allocating the responsibility for investments to a large share of the population, many of whom lack training and education, seems even crazier than all of us pumping our own gas. Some, of course, have a greater taste for individual responsibility than I do, but, at a minimum, defined contribution plans should be required to offer, perhaps as a default option, a managed account perhaps allowing the employee to set certain parameters such as high and low retirement income targets and taste for risk.<sup>7</sup> In any event, it seems sensible to impose some responsibility on the employer to make educational materials available and perhaps to monitor choices that are clearly inappropriate for the particular employee.

#### B. Cohort Rule

As Gary Burtless has shown similar investment and retirement strategy can lead to vast differences in replacement rates depending upon the state of the market and the cost of annuities in the year of retirement.<sup>8</sup> Life cycle funds are apparently intended to mitigate this risk. We need

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<sup>7</sup> See Retirement Engine Rebuilt Harvard Magazine January February 2009 (interviewing Robert Merton about SmartNest). See also Regina T. Jefferson, Rethinking the Risk of Defined Contribution Plans, 4 Fl. Tax Rev. 607, 636 (2000)

<sup>8</sup> See Alicia H. Munnell, Anthony Webb and Golub Sass, How Much Risk is Acceptable? 4 (Discussing Burtless' work). (Center for Retirement Research (November 2008) (hereinafter CRR)

to understand how well they worked in the present crisis and whether improvement is possible.

While employees as a group cannot earn more than the market, a possible goal could be to even out returns so that less depends upon the year one happens to retire. Perhaps, traditional defined benefit plans operate in this way. Apparently, the reduction in salaries, which occurs when employers sponsor a plan, reflected the contributions required based on projected returns from plan investments (not the higher cost of a risk-free return) even though the employee had not accepted a market risk. I am not an expert on investment, but just to think out loud for a moment, would it be possible to devise an instrument which averaged market returns over cohorts so that each group gets the benefit of the “long run” market return rather than the return during the period of their working life? Could a private entity manage this risk or would it require a government agency?

### C. Uncertainty of Returns

If the market over time is just too risky, risk can be avoided by opting for guaranteed returns. But, up to now, at least, the conventional wisdom is that fixed returns will result in lower (presumably inadequate) retirement income. Does the market fall suggest that the conventional wisdom needs to be rethought?

It would seem theoretically possible to guarantee some minimum return, in excess of a risk free rate, to employees who follow certain restrictions on investments and give up some upside potential. However, Munnell assumes a guaranteed return would require government involvement and could not exceed 3%, which would approximate the return on Treasuries.<sup>9</sup>

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<sup>9</sup> See CRR supra note 8 at 5 and footnote 12. See also Regina T. Jefferson, Rethinking the Risk of Defined Contribution Plans 4 Fl. Tax Rev.607, 649-69 (2000); Hearings before House Committee on Ways and Means 107<sup>th</sup> Cong. 2d Sess. (February 26, 2002 Serial # 107-66).

Others seem to agree.

One possibility is to make it easier for employees participating in defined contribution plans to initially invest in annuity contracts. If insurance companies could invest without restrictions perhaps competition would require that they guarantee rates which would be reasonably equivalent to market results over the long term. Again it may be that the reserve requirements for insurers issuing fixed annuities are such that companies cannot offer much more than a risk free return.

It is noteworthy that the PBGC, in the case of a defined benefit plan, does insure investment results. While in a traditional defined benefit plan, the PBGC most significantly provides protection for past service liabilities which were not yet required to be funded, in a plan, such as a cash balance plan, which has no past service liabilities, inadequate investment returns would seem to be the primary reason for an asset shortfall. However, protection against investment risk in defined contribution plans may create a moral hazard, which could be more pronounced than in a defined benefit plan, where the employer assumes the initial responsibility for promised benefits.

## **II *Market Impact and DB Plans***

At one time, most pension arrangements were what we refer to as defined benefit plans. Under these plans the employer promises to pay a specified benefit and bears the investment risk. The most common type of defined benefit plan is one based on a percentage of final pay

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For a discussion see Marie-Eve Lachance & Olivia S. Mitchell, *Guaranteeing Defined Contribution Promises: The Option to Buy Back A Defined Benefit Promise*, NBER Working Paper 8371 available at <http://www.nber.org/papers/w8731>

(averaged over a period such as 3 years) for each year of service.<sup>10</sup> Thus, an employee with a full career with one employer is assured that her pension will substantially replace her final pay regardless of the rate of salary increases or inflation during her career.<sup>11</sup> Moreover, if funds are insufficient, for any reason and the employer is unable to pay, a federal agency, the Pension Benefit Guaranty Corporation (PBGC), guarantees most benefits in these plans.

The number of traditional defined benefit plans has been declining for some time.<sup>12</sup> It seems likely that a financial downturn, particularly given the more stringent funding requirements enacted in 2005 (modestly adjusted in December 2008), would accelerate this trend. Some employers will switch to defined contribution plans or perhaps cash balance plans. If this occurs the actual benefit for the period of participation in the plan could be considerably less than the employee is anticipating. This is so because a large portion of the benefit from the plan accrues in the last years of service. Even moving to another employer with a traditional defined benefit plan, which would be the best result for the employee, would be insufficient to make up the difference.

Thus, under current law on termination or freeze of a traditional defined benefit plan or separation from service while participating in such a plan, the employee's benefit is based upon

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<sup>10</sup> See Lawrence A. Frolik and Kathryn L. Moore, *Law of Employee Pension and Welfare Benefits* (2d edition 2008)

<sup>11</sup> Plans often do not protect against post retirement inflation

<sup>12</sup> In addition to investment risk, employers may be concerned about increased administrative costs (including actuarial calculations), the volatile impact of plan liabilities on the financial statements and the liability for unfunded past service benefits upon plan termination.

her salary at the time of the event rather than her projected salary at the time of retirement. Therefore, 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. Workers who remain with a plan receive benefits related to earnings just before retirement, but employees who switch jobs, say, every ten years would find that their pensions were based on a combination of earnings at ages thirty-five, forty-five, fifty-five, and sixty-five, for example. 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.<sup>13</sup> The seriousness of the problem further increases when plan terminations (or conversion to cash balance) and plan freezes become more common.

The benefit from a defined benefit plan could be based upon earnings over the entire career of the employee. In that case, even though accrued benefits are earned disproportionately later in life, if an employee participated in such a plan for her entire career, her benefit would not be affected by a change in jobs. However, if the employee changes jobs and the new employer has a plan with equal percentage contributions regardless of age, or if the original employer converts to such a plan, the employee will be worse off than she would be if she had participated in either type of plan for her entire career.

Plan change or separation from service does not necessarily entail a loss of benefits if (as in a traditional defined contribution plan) the employer makes equal contributions as a percentage pay for each employee and the accrued benefit is based on the account balance. Thus,

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<sup>13</sup>See Alicia H. Munnell and Steven A. Sass, *The Decline of Career Employment 2* (Center for Retirement Research September 2008)

the impact of termination of a traditional defined benefit plan or separation from service when participating in such a plan could be alleviated by revising the method of calculating the accrued benefit in these circumstances to make the benefit more consistent with the concept of equal contributions.

It is worth noting in this regard that one option for determining the maximum deduction for contributions to pension plans is to calculate the amount required if equal amounts or equal contributions as a percentage pay were made over the remaining future service for all employees.<sup>14</sup> Employer contributions may follow this approach. If the accrued benefit under the plan was also based on the amount that would be accumulated (at the assumed investment return) if contributions had been an equal percentage of pay, an employees benefit for a particular year of service would not be affected by plan termination or separation from service.

The problem of mobile workers and plan termination could also be mitigated by requiring that the accrued benefit for a terminating employee reflect the projected earnings at the normal retirement age rather than earnings at the time of termination. In that case, the affected employee would not suffer a loss of benefits. However, projected earnings would be difficult to estimate, particularly if individual circumstances had to be taken into account. Alternatively, although this offers less protection, we could require the benefit paid to a terminated employee to reflect current salary indexed only for expected inflation, not real salary growth.

However, 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

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<sup>14</sup> IRC§404(a)(1)(A)(ii).

benefits for long service employees were reduced. This may significantly reduce the employer's incentive to establish the plan.

### III. *Funding*

The Pension Protection Act (PPA) tightened the funding requirements for defined benefit plans most significantly for this purpose requiring that any funding shortfall (caused by a decline in the value of assets) be made up over seven years.<sup>15</sup> This requirement may accelerate and increase the rate of decline of defined benefit plans.

As I understand it, the Administration approach, which led to this rule (cite), was based on the idea that pension plans as financial intermediaries should not take investment risk. Accordingly, it would be best if plans invested in long-term debt with maturities that matched the benefit obligation. Therefore, if a plan chose to invest in equities, it would be best if it made good any losses immediately. FASB has so required for balance sheet accounting but not yet for income statements.(cite)

At least based on past performance, if the Treasury's model were followed, it will lower the investment return making the plan more expensive, likely causing wages and salaries to be further reduced. It would suggest that for most employees the large bulk of their investment portfolio should be in debt instruments with a consequently lower expected standard of living. Query if this is what investment advisors would suggest, even following the fall.

The Treasury's concern was presumably the potential vulnerability of the PBGC in the event the employer is unable to pay. The PBGC effectively insures asset shortfalls caused by two

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<sup>15</sup> Internal Revenue Code §430 Pension Protection Act of 2005.

types of events. First, when the funds have not yet been contributed to the plan, which can occur because 1) the minimum funding requirements allow for so-called past service benefits to be funded over time,<sup>16</sup> 2) the employer received a funding waiver or 3) the employer defaulted on its funding obligation. I would assume that the first reason is by far the most important.

The second insured event is actuarial error which I assume is primarily investment performance. There is no easy way to allocate this risk. It seems sensible for employers to have an extended period to remedy shortfalls in investment performance. However, given the nature of a defined benefit plan and the assumption that the investment risk be absorbed by the employer not the employee, the employer should be liable for any shortfall should the plan terminate before the deficiency is made up. If this discourages employers from establishing defined benefit plans, it means such plans are just not viable and we have to turn our attention elsewhere.

The hard question is who should bear the loss if the employer is unable to pay. Should it be the employee or the PBGC? The dilemma is that if the PBGC is to be responsible, there will be pressure for more immediate funding which could lead to plan freeze or termination. It is at least possible that employees as a whole could in the long run be better off by absorbing some of this risk. A possible compromise is to provide PBGC protection only as to the shortfall that would exist if funding is relatively rapid.

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<sup>16</sup>I have maintained for over 30 years, tentatively, at first, that the PBGC should not insure benefits that have not yet been required to be funded. I don't appear to have persuaded anyone, but that is not our concern today. Daniel I. Halperin, *Retirement Security and Tax Equity: An Evaluation of ERISA XVII B.C. Ind. & Comm. L. Rev.* 739, 777 (1976).

## IV Improving Coverage and Retirement Benefits

### A. Social Security

About one-third of the elderly gets at least 90% of their income from Social Security. And 60% get more than half.<sup>17</sup> In fact, pension benefits account for only 4% of the income of the lowest 20% of the population and only 7% for the next 20%.<sup>18</sup> However, even low income retirees will rarely be able to maintain their pre-retirement standard of living based on Social Security alone<sup>19</sup>. Further the replacement rate from Social Security is being reduced by the increasing income tax burden, the additional cost of Medicare Parts B and D and, for those who do not adjust their date of retirement, by the postponement of the age for full benefits from 65 to 66 and eventually 67. The replacement rate for the median employee retiring at age 65 which was 39% in 2002 will decline to 28% by 2030.<sup>20</sup>

Increases in the minimum Social Security benefit at least for low earners is the best approach to this problem. An increase for low earners has been recommended by many, including the members of the Social Security Commission appointed by President Bush<sup>21</sup> and by Peter Diamond and Peter Orszag.<sup>22</sup>

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<sup>17</sup> Reno supra note 1 at 6.

<sup>18</sup> Id. at 7

<sup>19</sup> Id. at 2

<sup>20</sup>CRR supra note 8 at 1

<sup>21</sup> President's Commission to Strengthen Social Security, *Strengthening Social Security and Creating Personal Wealth for All Americans* 120, 132 (2001)

<sup>22</sup> *Saving Social Security* 99-103 (Brookings 2004)

If the barrier to improving Social Security is money, repealing or significantly limiting the tax subsidy for employer based plans and IRAs and dedicating the money to Social Security would increase retirement security.<sup>23</sup> However, this step is not politically realistic. Moreover, funded arrangements have the advantage of increasing savings as opposed to Social Security which is likely to be significantly on a pay as you go basis.

#### B. Additional Mandatory Coverage

Bridging this gap between Social Security and adequacy will require another layer of mandatory retirement income, at least for the *really* low-paid workers. Over the years, there have been proposals for mandatory employer contributions to retirement savings. While this would increase retirement benefits, it would likely result in a reduction in wages. Since the contribution is mandatory, aside from situations where the minimum wage applies, employers should be able to eventually reduce wages by close to the amount of the required contribution. Reduction in current wages for workers who are already struggling to make ends meet may not be wise for many employees, particularly at certain points in the life cycle. It is not clear therefore that mandatory contributions for all is a good idea unless they are fully subsidized.

Therefore, I believe that the only sensible way to improve retirement benefits for low-income households is 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. This could take the form of direct government contributions to individual accounts under Social Security (in addition to the current level of

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<sup>23</sup> Daniel 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, 49 (1993)

contributions) or tax credits for 100% of the contribution to mandatory privately funded arrangements.

In 1999 President Clinton's proposed universal savings accounts (USA ) which would have provided direct contributions to individual accounts for the low income without any additional savings effort on their part. In addition, the proposal called for matching grants equal to a percentage of contributions for workers who had somewhat higher income.<sup>24</sup>

Theresa Ghilarducci has proposed universal Guaranteed Retirement Accounts for all workers<sup>25</sup> with an annual contribution of 5% of pay. A \$600 refundable tax credit would cover the entire contribution for those making \$12,000 per year or less.

### C. Employer Plans

In 1993,<sup>26</sup> I asked these questions relating to "Special Tax Treatment for Employer-Based Retirement Programs:" One) "Is it "Still" Viable as a Means of Increasing Retirement Income? Two) Should it Continue? (Still was in quotes to suggest maybe it never had been) The problem, is that employer pension plans cover only about one-half of workers at any one time, with the uncovered coming disproportionately from the lowest paid. After considering the potential for expanding the coverage of employer-based plans, I concluded that repealing the tax subsidy for

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<sup>24</sup> See Daniel I Halperin and Alicia H. Munnell, Ensuring Retirement Income for All Workers in William G. Gale, John B. Shoven and Mark J. Warshawsky (editors), *The Evolving Pension System* 155, 180-1 (Brookings 2005).

<sup>25</sup> She provides an exception for those participating in equivalent defined benefit plans but given the potential loss of benefits by participants in such plans who are not covered by the plan until normal retirement age, as discussed below, I am not sure excluded employees would get equivalent coverage.

<sup>26</sup> 49 Tax L. Rev 1

employer based plans and dedicating the money to Social Security would be a great step forward. If this were impossible, I recommended we retain the employer-based system because, as flawed as it is, it is likely to provide more retirement protection than alternative use of the funds.

Obviously, the system could be improved. I examined this question 10 years later in *Employer- Based Retirement Income-“The Ideal, The Possible and the Reality”*<sup>27</sup> Unfortunately, the conclusion was that with respect to the goal of universal coverage`the **reality** (and perhaps the **possible**) of employer-based plans was a long way from the **ideal**. Can we do better?

Full replacement of retirement income requires that employees participate, that the benefit levels be adequate and that benefits be preserved for retirement. This requires that more employers establish plans, that existing plans cover more employees and that the plan actually provide retirement benefits to the employees who are ostensibly covered.

To meet this goal, plans should be required to cover all employees in lieu of present law which allows a significant disparity between coverage of the high and low paid. In addition benefits once earned should be non-forfeitable.

Even if the discrimination rules were thus tightened, there remains the issue of employees not electing coverage even though they are given the opportunity to do so, as under section 401(k). If we were writing on a clean slate, elective plans are probably not a good idea but it does seem impossible to reverse direction. In 2006, however, Congress facilitated the adoption of a default option calling for automatic deferral in 401(k) plans unless the employee elects otherwise. President Obama would require automatic enrollment in all section 401(k) plans. Still, it would be best if elective contributions were allowed to employer plans only if significant non-elective

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<sup>27</sup> 11 Elder Law J. 37 (2003).

contributions are made for all eligible employees. Similarly it would help to require employers (perhaps over a certain size) to provide automatic payroll deductions for contributions to IRAs unless the employee opts out.<sup>28</sup> President Obama has so proposed. Evidence clearly shows the power of inertia; significantly more employees chose to save when it occurs without any action on their part.

Further, we should reduce the opportunity to spend retirement savings for other purposes. We now impose a penalty on most withdrawals before 59½. Additional exceptions as President Obama has proposed are unwise. Ideally, distributions should be prohibited before retirement and should be payable in the form of an annuity or periodic payments over the life expectancy of the employee and her spouse. This would also reduce the opportunity to outlive the pension. If this is not possible, particularly on separation from service, at the very least, any other distribution should be placed by the employer in an IRA in the hope that inertia will significantly reduce the likelihood these funds will be spent. Universal IRAs or 401(k)s which are not employer-based seem less likely to be spent when job change occurs.

In addition, we must preserve the real value of pension benefits against inflation. Even at 3 percent inflation, the real value of a nominal benefit declines nearly in half after twenty years. Twenty years is approximately the life expectancy at age sixty-five. At a minimum, all plans should be required to offer the option of an inflation-indexed annuity

Finally, as noted above, it is important to provide for more protection against market decline and against loss of expected benefits on plan termination and job change.

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<sup>28</sup> J Mark Iwry, and David C. John, Pursuing Universal Retirement Security Through Universal IRAs in Peter R. Orszag, J Mark Iwry and William G. Gale editors, Aging Gracefully 45 (The Century Foundation Press 2006)

These changes would likely increase coverage in plans that continue to exist. However, even under the more lenient rules now in force, many employers are unwilling to establish retirement plans. Moreover, these proposals would undoubtedly discourage new plans and could lead to the termination of some existing plans. We need to do more to encourage employers to establish plans.

As described below, the tax incentive to participate in these plans is greatest for the higher paid who need the incentive the least. In recognition of the fact that the low income individuals would be unlikely to respond to tax incentives, we have a nondiscrimination test for tax favored qualified plans. In theory at least, if the higher income wish to take advantage of the tax subsidies provided to employer based plans, the plans must cover some lower paid individuals as well. There is however a problem with this approach which explains why it works so poorly..

If lower wage earners do not value retirement savings enough to accept a wage cut, the plan will not be affordable unless the value of the tax benefits for those at higher income levels is sufficient to fund the additional cost of covering the lower income. Such use of the tax benefits detracts from the advantage to the higher paid. Further, the more we require coverage of the lower income, particularly while putting limits on benefits for the higher paid, the less likely that higher income can benefit from the plan. If the higher paid do not benefit, a plan is not likely to exist.. We need to provide lower earners with a greater incentive to participate or eliminate the required coverage of the lowest earners. Only in this way can we make tough discrimination rules viable.

If low-earning workers are provided with adequate Social Security benefits or are covered by a government-financed supplementary retirement system which results in full replacement of pre-retirement earnings, as described above, employers need no longer be required to include these individuals in their plans. Furthermore, if this approach provided additional benefits for workers earning at the next level, it would reduce the amount that employer pension plans would have to provide for these workers to achieve full replacement of pre-retirement earnings. If these changes are made, employer-sponsored plans may become a more viable option for providing for employees somewhat higher up the income scale, who may be willing and able to contribute to their coverage..

But to be successful it is probably necessary to offer a tax incentive which would actually make saving less expensive for the lower income. This would be particularly important if we do not otherwise provide for the lowest income through the addition layer of savings discussed above.

While this is sometimes not well understood, employer-based qualified plans offer two potential advantages- No tax on investment earnings and the possibility of having your compensation taxed at lower rates at retirement compared to the rates that would be applicable when compensation is earned. The former will offer a significant benefit to taxpayers subject to a 35% marginal rate. For the low income who have the most difficulty saving, there may be little or no benefit.

The exemption for investment earnings, which is the primary advantage, allows the benefit to accumulate at the pre-tax, rather than the after-tax, rate of return. Thus, if the employee is not subject to income tax, there is no advantage to the qualified plan A tax credit for low

income individuals could be designed to at least approximate the benefit available to those in the highest bracket.

The Savers credit now provides a credit for as much as 50% of the first \$2000 of employee contribution to an IRA or elective (including by default) deferrals to a 401(k) plan.<sup>29</sup> Since this reduces the out-of-pocket cost for a given amount of contributions, savings would be more likely to occur. However, the 50% credit is for the most part an illusion. Most of the individuals eligible for a credit at that level have little or no income tax liability. In fact, in 2005 only one in seven of the eligible income group actually paid income taxes and less than 1 in 1000 paid enough tax to take advantage of the maximum credit.<sup>30</sup> For the credit to work, it has to be made refundable and the cliff which reduces the credit to 20% with an additional dollar of income must be replaced by a gradual phase-down of the maximum credit. Of course, the savers credit would have to be coordinated with any new tier of mandatory benefits,

President Obama has proposed a refundable credit of 50% of contributions up to \$500 per individual or a maximum credit of \$250 per person. This focuses the incentive on the lowest earners which makes sense in the absence of another layer of retirement savings in the manner suggested above.

Hopefully these measures—including more stringent participation requirements and an effective tax credit which reduces the cost of savings—will achieve greater participation by the lower income in employer plans.

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<sup>29</sup> IRC Section 25B

<sup>30</sup> Peter R. Orszag, Introduction Common Sense Reforms to Promote Retirement Security in Peter R. Orszag, J Mark Iwry and William G. Gale editors, Aging Gracefully 11 (The Century Foundation Press 2006)

#### D. Paying for a subsidy

Of course a more attractive credit costs money. The obvious source would be to limit the benefit for qualified plans but an overall curtailment is probably not viable. Still some funds could be raised by eliminating savings incentives which make little sense.. In 2006 Congress made permanent the increase in maximum contributions to qualified plans, 401ks and IRAs. It also allowed employees of tax exempt entities to double tax preferred savings by utilizing plans under section 457(b). Congress also made permanent the ability to make contributions to Roth 401(k)s which, along with Roth IRAs, effectively increase the amount of savings which can be accumulated tax-free.<sup>31</sup> Conversion of traditional IRAs to Roth accounts, allowed by the 2006 legislation to individuals at all income levels beginning in 2010, similarly increases the amount of savings which can be accumulated in subsidized accounts.<sup>32</sup> In the long-run this conversion opportunity is also extremely expensive despite the claim of a revenue gain during the budget window. The Roth alternative should be eliminated. If not, the provision allowing conversions by the higher income starting next year should not take affect. At the very least, conversion of a balance derived from nondeductible contributions to traditional IRAs should be prohibited.

Since only a relatively few take advantage of the maximum contribution, these measures will just reduce the tax savings of the well off without for the most part decreasing savings which would not otherwise occur. In contrast, incentives focused on the low income who are not currently saving, such as improving the Saver's credit will actually increase national savings.

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<sup>31</sup>Daniel Halperin, I Want a Roth IRA for Xmas Tax Notes December 21, 1988 at 1567

<sup>32</sup>Daniel Halperin, Fun and Games with the Roth IRA Tax Notes July 10, 2006 at 167.

The maximum level of benefits in qualified plans can also be reduced by changes in the so-called combined plan rules. The Internal Revenue Code limits contributions to defined contribution plans and the level of benefits that can be provided by defined benefit plans. An employer is allowed to have both a defined contribution and defined benefit plan up to the applicable limit. As currently interpreted these rules make no sense. As I understand it, the idea was to allow an employer to have both a defined benefit plan which benefitted older workers and a defined contribution plan which called for equal percentage contributions for all. Further, alternative limits make some sense because it would be difficult to apply a benefit limit to a defined contribution plan when the accrued benefit depended upon the account balance and hence the investment performance. Similarly, it is impossible to limit contributions to a defined benefit plan since the employer is responsible for providing the promised benefits regardless of investment performance.

However, in practice these rules have not worked as envisioned. For example, a cash balance plan is a defined benefit plan described in terms of contributions and a hypothetical account balance. Therefore, applying a benefit limit to such plans is not straight forward. Further, since both a defined contribution plan and a defined benefit plan can be tested for discrimination on the basis of either promised or projected benefits, both plans can favor older workers. This makes no sense particularly in the case of a closely held business. If an employer has two plans, one should be tested on the basis of contributions.

In fact, equal contributions **as a percentage of pay** should be required in any plan in which business owners, or perhaps, certain very highly compensated employees are entitled to 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. 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 also represent the greatest risk of plan termination before younger employees will earn significant benefits. In short, they contribute little to retirement security and just waste revenue.