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Increasing Coverage in Today's Private Retirement System

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INCREASING COVERAGE IN TODAY'S PRIVATE RETIREMENT SYSTEM

*Regina T. Jefferson**

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INTRODUCTION

The *Drexel Law Review* Symposium, *ERISA at 40: What Were They Thinking?*, held on October 25, 2013, celebrated the forty-year anniversary of ERISA's passage in 1974.¹ Describing the process as a "decade-long quest to safeguard the retirement savings of American workers," the Symposium provided remarkable insight into the political and policy challenges faced by the framers of ERISA.² By posing the question, "What were they thinking?" to some of the key participants in ERISA's enactment, the organizers of the Symposium sought to create an oral history that captured noteworthy events, concerns, and developments leading to the passage of ERISA that otherwise may not have been recorded.³

ERISA established comprehensive changes in the regulation of private pension plans. These changes were designed to remedy identified defects in the retirement system believed to limit its overall effectiveness.⁴ With only 50% of the private, nonagricultural workforce covered by pension plans at the time, a purported objective of the ERISA legislation was to "promote a renewed expansion of private retirement plans and increase the number of participants receiving private retirement benefits."⁵

ERISA's framers, however, recognized that the voluntary characteristic of the private retirement system created a fundamental tension between having stricter coverage rules and the employers' willingness to offer retirement plans. Therefore, rather than mandating universal coverage, the drafters chose to address the coverage problem by setting limits that restricted the employers' ability to exclude certain workers from their plans, should the employers choose to offer them.⁶ The framers also chose to continue to rely on the use of tax incentives as a means of encouraging employers to voluntarily increase coverage in private retirement plans.⁷

1. Employee Retirement Income Security Act of 1974, 29 U.S.C. §§ 1001-1461 (2012).

2. Symposium, *ERISA at 40: What Were They Thinking?*, 6 DREXEL L. REV. 257 (2014).

3. *See id.*

4. *See* H.R. REP. NO. 93-533, at 1-2 (1973) (discussing the goals of pension reform legislation, including increasing the number of participants in the private retirement system).

5. *Id.* at 2; *see also* S. REP. NO. 93-383, at 19 (1973) ("One of the major objectives of the new legislation is to extend coverage under pension plans more widely.").

6. *See infra* Part I (discussing nondiscrimination).

7. *See* JOHN HEINZ ET AL., S. SPECIAL COMM. ON AGING, THE EMP. RET. INCOME SEC. ACT OF 1974: THE FIRST DECADE, S. PRT. NO. 98-221, at 30 (1984).

Since the passage of ERISA, coverage rates in the private retirement system have not changed significantly; however, the retirement savings culture has changed drastically. The predominant plan type has shifted from the defined benefit plan to the defined contribution plan, resulting in a reallocation between the employer and the employee of the burdens and risks associated with retirement savings.⁸

In defined benefit plans, the employer, rather than the participant, bears the risk of investment loss; this is because plan assets are pooled in an aggregate trust, and the participants are guaranteed pre-determined retirement benefits that are generally based on years of service and compensation.⁹ The employer is required to fund the plan sufficiently to pay the promised benefits—and is liable for payment—despite the investment performance of the plan assets.¹⁰

In contrast, in defined contribution plans there is no single trust; instead, employers make annual contributions to accounts assigned to individual participants. At retirement, participants receive the balance in their accounts. Thus, the success or failure of these savings programs depends on how much has been contributed and how well the assets have been managed. Because the plan does not guarantee a specific amount to be paid at retirement, the employee alone bears the risk of investment loss.¹¹

The cash or deferred arrangement, better known as the 401(k) plan, represents the fastest growing type of defined contribution plan and dominates new plan offerings in the private sector.¹² In 401(k) plans, employees elect to have portions of their compensation contributed to a qualified retirement plan, rather than to receive them as compensation in the year in which they are earned. Participant-directed 401(k) plans additionally require participants to decide the manner in which their accounts are to be invested, including whether, and to what extent, portions of their compensation are

8. See Regina T. Jefferson, *Rethinking the Risk of Defined Contribution Plans*, 4 FLA. TAX REV. 607, 613 (2000) [hereinafter Jefferson, *Rethinking*].

9. *Id.* at 610–11.

10. See *id.*; see also 29 U.S.C. §§ 1301–1310 (2012) (establishing the Pension Benefit Guarantee Corporation, which provides limited insurance when an employer fails to meet its pension obligations).

11. See Regina T. Jefferson, *Redistribution in the Private Retirement System: Who Wins and Who Loses*, 53 HOW. L.J. 283, 301 (2010) [hereinafter Jefferson, *Redistribution*]; see also Jefferson, *Rethinking*, *supra* note 8, at 612.

12. See Jefferson, *Redistribution*, *supra* note 11, at 302 nn.85 & 87.

contributed to the plan.¹³ Having such choices requires 401(k) plan participants to assume even more of the risks associated with their retirement savings than other types of defined contribution plans. Therefore, the dominance of 401(k) plans as primary retirement savings vehicles significantly restructures the retirement savings environment by presenting employees with decision making challenges that they previously did not face. This development has created the need to identify new and different ways of accomplishing ERISA's goal of maximizing the number of workers who receive meaningful retirement benefits from the private retirement system in the current pension landscape.¹⁴

This Reflection seeks to respond to this challenge by analyzing current coverage and participation rates in the private retirement system, and by proposing methods of achieving a broader and more equitable distribution of benefits received from 401(k) plans. Specifically, Part I of this Reflection describes and critiques the effectiveness of the existing nondiscrimination standards for encouraging increased coverage in the private retirement system. Part II examines current trends with respect to various segments of the working population and concludes that existing pension law and policies are providing inadequate retirement benefits to low- and middle-income workers participating in 401(k) plans. Part III proposes the following three recommendations for increasing participation rates in the current pension climate: (1) mandatory education programs for all 401(k) plans; (2) mandatory automatic features in 401(k) plans; and (3) an additional tax incentive to encourage greater participation of low- and middle-income employees, as measured by their vested accrued benefits.

I. THE COVERAGE CONCEPT

Expanding pension coverage for non-highly compensated workers has long been a goal of federal pension policy.¹⁵ The House Ways and Means Committee Report accompanying the Revenue Act of

13. See Regina Jefferson, *Balancing Greater Protection with Individual Choice in 401(k) Plans*, in *BEYOND ECONOMIC EFFICIENCY IN UNITED STATES TAX LAW* 193, 199 (David A. Brennen et al. eds., 2013) [hereinafter Jefferson, *Balancing*].

14. See *supra* notes 4-5 and accompanying text.

15. See, e.g., *General Tax Reform: Panel Discussions Before the H. Comm. on Ways and Means*, 93d Cong. 1122-23 (1973) (statement of Prof. Daniel Halperin, Law School, University of Pennsylvania); see also Bruce Wolk, *Discrimination Rules for Qualified Retirement Plans: Good Intentions Confront Economic Reality*, 70 VA. L. REV. 419, 426-29 (1984) (discussing the history of the nondiscrimination concept in tax law).

1942 refers to the function of the nondiscrimination standards as preventing “the [pension] trust device from being used for the benefit of shareholders, officials, or highly paid employees.”¹⁶ Also, in the Committee on Finance Report accompanying the Comprehensive Private Pension Security Act of 1973, one of the listed goals of the legislation was to “increase the number of individuals participating in retirement plans.”¹⁷ More recently, the Pension Protection Act of 2006 sought to expand coverage and participation in 401(k) plans by encouraging automatic enrollment and escalation features.¹⁸

Retirement plans that operationally meet the requirements of Internal Revenue Code section 401(a) are said to be “qualified” plans.¹⁹ The qualified status of a plan entitles employers as well as plan participants to substantial tax benefits.²⁰ The preferential tax treatment is justified as a method of encouraging employers to establish and maintain retirement plans that provide benefits not only to highly compensated employees, but also to low- and middle-income employees, who may find it difficult to save on their own.²¹ To ensure that plans operationally meet this objective and warrant the special tax treatment they receive, plans must satisfy a set of complex nondiscrimination rules designed to achieve broader coverage.²²

By relying on tax incentives, Congress effectively has chosen to pay a tax subsidy to high-income employees as a means of encouraging employers to establish and maintain plans that also cover lower-income employees.²³ Accordingly, from a pension policy perspective, the tax subsidy for qualified plans is justifiable only if it results in greater retirement savings for low- and middle-income

16. H.R. REP. NO. 77-2333, at 103-04 (1942), *reprinted in* 1942-2 C.B. 372, 450.

17. S. REP. NO. 93-383, at 1 (1973).

18. See Pension Protection Act of 2006, Pub. L. No. 109-280, § 902, 120 Stat. 780, 1033-40 (2006); see also Jack VanDerhei, *The Pension Protection Act and 401(k)s*, WALL ST. J., http://online.wsj.com/ad/employeebenefits-pension_protection_act.html (last visited May 29, 2014).

19. I.R.C. § 401(a) (2012).

20. See discussion *infra* Section III.C.

21. *Subcommittee Hearing on Pension Parity: Addressing the Inequities Between Retirement Plan Options for Small and Large Businesses: Hearing Before the H. Subcomm. on Fin. and Tax of the H. Comm. on Small Bus.*, 110th Cong. 8-9 (2007) (statement of Jim McCarthy, Managing Director, Retirement Plan Services Morgan Stanley, on behalf of the Securities Industry & Financial Markets Association).

22. See discussion *infra* Section I.B.

23. See Jefferson, *Redistribution*, *supra* note 11, at 297-98. The tax subsidy for retirement savings was introduced in the 1920s. Revenue Act of 1921, ch. 136, § 234(a)(1), 42 Stat. 227, 254 (providing a deduction for business expenses such as “salaries or other [including deferral] compensation”); see also *infra* Section III.C. (discussing tax benefits of qualified plans).

workers.²⁴ Furthermore, as a fiscal policy matter, the ideal subsidy level should be no greater than is required to cover the additional costs to the employer for covering low-income workers.²⁵

A. Defining "Coverage" and "Participation"

To prevent abuse of the tax subsidy, the nondiscrimination rules establish limits on the employer's ability to disproportionately shift contributions and benefits to highly compensated employees in qualified plans.²⁶ Compliance with the rules requires that coverage and participation rates of highly and non-highly compensated employees be calculated and compared.²⁷ Enforcement of the rules hinges on a quantifiable level of permitted disparity between the participation rates for these two classes.²⁸

Although the terms "coverage" and "participation" are essential to the nondiscrimination concept, they are not used consistently within the pension community.²⁹ Common usage of the terms generally refers to whether a worker is benefitting from a plan in a given year; however, individuals and entities collecting the data on coverage and participation rates in the private retirement system often use criteria other than current accruals.³⁰ As a result, coverage and participation rates in the private retirement system may be misleading, particularly among certain groups.³¹

24. See, e.g., 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, 1389 (2001) (quoting Bruce Wolk, *Discrimination Rules for Qualified Retirement Plans: Good Intentions Confront Economic Reality*, 70 VA. L. REV. 419, 433 (1984)) (noting that "[f]rom Congress's perspective, the optimum level of tax subsidy is that which encourages the establishment of a retirement plan only if the social benefit of the plan equals or exceeds its costs").

25. See JOHN H. LANGBEIN ET AL., *PENSION AND EMPLOYEE BENEFIT LAW* 410-11 (Robert C. Clarke ed., 5th ed. 2010).

26. See, e.g., Russell K. Osgood, *The Ages and Themes of Income Taxation: Savings and Investments*, 68 CORNELL L. REV. 521, 527 (1983) (arguing that because "[n]ondiscrimination does not flow logically from the deduction provided for contributions . . . [t]he nondiscrimination principle is based on a congressional determination that discrimination against lower paid people is unfair").

27. I.R.C. § 401(m) (2012). If 401(k) plans meet one of the design-based safe harbors, they are deemed to satisfy the "actual deferral percentage" tests, which are the special participation and nondiscrimination rules for 401(k) plans. See *id.*

28. See *id.*

29. See *id.*; see also John Turner et al., *Defining Participation in Defined Contribution Pension Plans*, 126 MONTHLY LAB. REV. 36, 36-37 (2003), available at <http://www.bls.gov/opub/mlr/2003/08/art3full.pdf>.

30. See Turner et al., *supra* note 29, at 36-37.

31. See *id.* at 37.

The concepts of “coverage” and “participation” are related but distinct. Coverage is used to broadly describe a worker’s association with an employer-sponsored pension plan.³² There are numerous reasons why a worker may not be associated with a plan sponsored by his or her employer.³³ One reason is that the worker may not be the type of employee the plan is established to benefit.³⁴ Employers are permitted to design their plans to exclude certain categories of employees so long as they satisfy the nondiscrimination rules.³⁵ Thus, for example, it is common practice for employers to differentiate plan offerings based on factors such as whether an employee is salaried or paid hourly, or geographic location.³⁶

Another reason a worker may not be associated with a plan is because the worker is not “participating” in the plan.³⁷ The term “participation,” used in this context, refers to whether or not a worker is actually benefiting from a plan in a given year.³⁸ Thus, workers can be covered by a plan while not participating in it. This situation generally occurs when a worker, although a member of the covered class of employees, has not satisfied applicable minimum age and service requirements imposed by the plan.³⁹

The term “participation,” however, has a different meaning depending on whether it is used in reference to a defined benefit or a defined contribution plan.⁴⁰ In defined benefit plans, where retirement benefits are paid as a set amount, workers are considered participants whenever they annually accrue portions of their retirement

32. *See id.*

33. *See* Craig Copeland, Emp. Benefit Research Inst., *Retirement Plan Participation and Retirees’ Perception of Their Standard of Living*, 289 ISSUE BRIEF 5 (2006), available at http://www.ebri.org/pdf/briefspdf/EBRI_IB_01-20061.pdf (noting that some workers are not eligible to participate and others are unable to afford the employee contributions).

34. *Id.* at 40 n.11.

35. Susan J. Stabile, *Is It Time to Admit the Failure of an Employer-Based Pension System?*, 11 LEWIS & CLARK L. REV. 305, 322–23 (2007).

36. *See* Daniel L. Halperin, *Retirement Security and Tax Equity: An Evaluation of ERISA*, 17 B.C. INDUST. & COM. L. REV. 739, 742 (1976) (noting that some employers exclude workers in certain divisions or make distinctions based on whether the employee is hourly and salaried). Workers classified as independent contractors are also exempted from ERISA’s nondiscrimination calculations. *See* *Nationwide Mut. Ins. Co. v. Darden*, 503 U.S. 318, 323–24 (1992) (applying common law agency principles to classify workers as employees or independent contractors under ERISA).

37. Turner et al., *supra* note 29, at 36–37.

38. *Id.* at 36.

39. *See* I.R.C. § 410(a)(1)(A) (2012) (allowing employers to exclude workers under the age of twenty-one or those with less than one year of service from the retirement plan).

40. *See* Turner et al., *supra* note 29, at 36.

benefits under the plan.⁴¹ In contrast, in defined contribution plans, where the balances of the individual retirement accounts determine the benefits, workers generally are considered participants if they receive allocations of contributions or forfeitures to their accounts in a given year.⁴² In 401(k) plans, where employees voluntarily choose to participate, workers are considered participants if they are eligible to make elective contributions, whether or not they choose to do so.⁴³ Consequently, an individual could be considered as actively participating in a 401(k) plan in a given year even if there were no contributions or forfeitures credited to his or her account during that year.

The determination of whether an individual is participating in defined contribution plans can be further complicated by whether a participant has an outstanding loan balance or not.⁴⁴ When workers borrow from their plans, some defined contribution plans will not permit them to make contributions to the plan until the loan balance is paid off.⁴⁵ As a result, in some cases individuals could be considered to be participating when they not only have no new accruals but also are not allowed to make new contributions to their retirement plans.⁴⁶

The fact that the term “participation” is not consistently defined among those who compile data to be used for empirical studies relating to participation rates in defined contribution plans suggests that the results may be misleading with respect to the rates of workers actually receiving benefits from such plans. For example, in the Form 5500, which is used to report detailed statistical information about a plan to the Department of Labor, “active participation” for defined contribution plans is determined by whether a current worker has a positive account balance with the employer.⁴⁷ This definition allows workers who are not contributing to their retirement plans to be counted as “actively participating.”⁴⁸ Accordingly, a

41. See Barbara A. Butrica et al., *The Disappearing Defined Benefit Pension and Its Potential Impact on the Retirement Incomes of Baby Boomers*, 69 SOC. SEC. BULL., no. 3, 2009 at 2, available at <http://www.ssa.gov/policy/docs/ssb/v69n3/v69n3p1.pdf>.

42. See Turner et al., *supra* note 29, at 36.

43. *Id.* at 36–37.

44. See Thomas Olson, *401(k) Leakage: Crafting a Solution Consistent with the Shift to Employee-Managed Retirement Accounts*, 20 ELDER L.J. 449, 463 (2013).

45. See *id.*

46. See *id.*; see also Turner et al., *supra* note 29, at 36–37.

47. See Turner et al., *supra* note 29, at 37.

48. See Geoffrey Sanzenbacher, *Estimating Pension Coverage Using Different Data Sets*, 51 CENTER FOR RETIREMENT RES. B.C. ISSUE BRIEF 1, 1 (2006), available at <http://crr.bc.edu/>

worker who was once allocated a forfeiture, or who elected to make a single contribution in a prior plan year, would be considered to be actively participating for all subsequent years of service prior to separation or retirement. Such an expansive interpretation of the term appears to overstate participant rates and also is at odds with the underlying policy and purpose of the nondiscrimination rules.⁴⁹

Accurately calculating the percentage of workers covered by and participating in employer-provided private retirement plans is an important task. This information is necessary to quantify the coverage problem and to measure the outcomes of policymaking efforts to broaden benefit distribution. Currently, because workers are counted as participating in defined contribution plans when contributions are being made neither by the employer nor the worker, the participation and coverage are unreliable measurements of the number of workers who are actively saving for retirement.⁵⁰

This result is problematic because it both obscures the issue and understates the coverage problem. One of the primary objectives of ERISA was to expand private retirement plans in order to increase the number of participants receiving retirement benefits. Therefore, the emphasis of initiatives to increase coverage in the private retirement system should be on actual retirement savings as measured by the vested account balances rather than on amounts made available by the employer for retirement savings, or on the aggregate number of plans that are offered in the private retirement system.⁵¹ Furthermore, as 401(k) plans are increasingly used as primary retirement savings vehicles, the accurate measurement of meaningful participation in these plans will become more important in evaluating the effectiveness of the private retirement system, particularly as it relates to low- and middle-income workers.⁵²

B. The Nondiscrimination Rules

The nondiscrimination rules are exceedingly technical and complex.⁵³ For the most part, the complexity is due to a mix of compet-

briefs/estimating-pension-coverage-using-different-data-sets/(noting that Form 5500 often overestimates the number of active participants in retirement plans).

49. See *supra* notes 15–16 and accompanying text.

50. See Sanzenbacher, *supra* note 48.

51. See discussion *infra* Section I.C.

52. See Turner et al., *supra* note 29, at 42.

53. See LAWRENCE A. FROLIK & KATHRYN L. MOORE, LAW OF EMPLOYEE PENSION AND WELFARE BENEFITS 437 (2d ed. 2008).

ing interests that creates tension in the structure of the rules. This tension exists because the private retirement system is voluntary, making it necessary to give tax benefits to highly compensated employees in qualified retirement plans so that non-highly compensated employees can also benefit from such plans.⁵⁴ Thus, on the one hand, the rules are designed to encourage broad participation and prevent excessive disparity in participation between non-highly and highly compensated employees. On the other hand, they are designed to permit some level of disparity in favor of highly compensated employees, who presumably could save on their own without tax incentives, so as not to discourage employers from establishing qualified retirement plans.⁵⁵

To ensure that qualified plans cover a significant percentage of the non-highly compensated workforce, the Internal Revenue Code has numerous nondiscrimination rules.⁵⁶ One set of rules considers all of the employees of the employer to determine whether a sufficient percentage of non-highly compensated employees are participating relative to the rate of participation of highly compensated employees.⁵⁷ Another set of nondiscrimination rules considers percentages of participation based on the actual level of contributions or benefits provided by the plan to participants in order to determine whether the plan discriminates in favor of highly compensated employees.⁵⁸ In addition to these rules that apply to all types of qualified plans, there are special nondiscrimination rules that apply

54. See *id.* at 436–37.

55. See S. REP. NO. 93-383, at 18–19 (1973) (warning that increasing coverage too expansively could lead employers to reduce benefits or stop offering new plans).

56. See G.A. Mackenzie & Jonathan B. Forman, *Reforming the Second Tier of the U.S. Pension System: Tabula Rasa or Step by Step?*, 46 J. MARSHALL L. REV. 631, 646 (2013). In addition to those described in this section of the article, there are the rules found in I.R.C. § 401(a)(26) that apply only to defined benefit plans. These rules provide:

an objective test to determine whether the defined benefit plan actually covers enough employees. It is intended to address two concerns. First, it is designed to limit the extent to which employers may create different benefit formulas for different groups of employees and thus maximize the benefits in favor of highly compensated employees. Second, it limits the extent to which a defined benefit plan can operate as an individual account for a single employee or a small group of employees.

FROLIK & MOORE, *supra* note 53, at 436. Also, I.R.C. § 401(a) “permits certain plans to have a higher level of discrimination in contributions or benefits than would be permitted under I.R.C. § 401(a)(4)” when Social Security benefits are taken into account for purposes of the nondiscrimination tests. *Id.* at 437.

57. See I.R.C. § 410(b) (2012).

58. See I.R.C. § 401(a)(4).

to 401(k) plans.⁵⁹ These rules recognize that contributions to 401(k) plans depend on an employee's choice to defer compensation, and accordingly require that the deferral rates by highly compensated employees are proportional to those of non-highly compensated employees.⁶⁰

Employers, of course, can completely avoid the complexity of all of the nondiscrimination rules by providing uniform benefits to all employees covered by a plan.⁶¹ Many employers, however, do not choose the broadest coverage solution because they desire to reduce the costs of their plans.⁶²

C. Weaknesses of the Rules

A significant weakness of the nondiscrimination rules is that they fail to distinguish between vested and non-vested accrued benefits.⁶³ Vesting is a concept that determines the rights of plan participants to receive the accrued benefits attributable to employer contributions in the event that employment is terminated prior to retirement.⁶⁴ The rationale for permitting forfeitures is that it gives employers a method of promoting worker retention by rewarding long-term service.⁶⁵

The minimum vesting standards require that benefits become non-forfeitable after a prescribed period of years of service with an employer.⁶⁶ The applicable vesting periods depend on the type of plan offered by the employer and the type of contribution.⁶⁷ Benefits derived from an employee's own contributions must be fully vested immediately, regardless of plan type.⁶⁸ Benefits attributable to em-

59. See I.R.C. § 401(k)(3). See also I.R.C. § 401(k)(12) (outlining a "safe harbor" to ease the administrative burden on 401(k) plans that make a minimum employer contribution or meet specified matching requirements).

60. See § 401(k)(3). There are, however, safe harbor rules for 401(k) plans that permit greater disparity between the levels of contributions made to and by highly and non-highly compensated employees.

61. See FROLIK & MOORE, *supra* note 53, at 437. See also I.R.C. § 410(b).

62. See Kathryn L. Moore, *An Overview of the U.S. Retirement Income Security System and the Principles and Values It Reflects*, 33 COMP. LAB. L. & POL'Y J. 5, 46 (2011).

63. See Sanzenbacher, *supra* note 48, at 1.

64. See Halperin, *supra* note 36, at 743.

65. See 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, 8-9 (1993) (describing how workers who frequently change jobs will lose unvested benefits).

66. See I.R.C. § 411(a)(2).

67. See § 411(a)(2)(A)-(B).

68. § 411(a)(1).

ployer contributions made to defined contribution plans must either vest fully after three years of service, or vest incrementally with a minimum percentage of 20% after two years of service and 100% after six years.⁶⁹ Benefits attributable to employer contributions made to defined benefit plans must either vest fully after five years of service, or vest incrementally with a minimum of 20% after three years of service and 100% after seven.⁷⁰

Vesting rates correlate strongly with earnings levels.⁷¹ As a general rule, the lower the compensation, the higher the turnover.⁷² This relationship occurs because higher-paid employees tend to have more stable and lasting employment relationships with their employers than do lower-paid employees.⁷³ According to a 2003 Employee Benefit Research Institute study, only 12% of workers with an annual income below \$5000 were vested, as compared with 47% in the \$20,000–\$24,999 bracket, and 73% in the \$50,000-and-over bracket.⁷⁴ As a result, it can be predicted that lower-paid employees are more likely to forfeit portions of their accrued benefits than are higher-paid employees.

Therefore, considering the goals of pension policy generally and the purpose of the nondiscrimination rules specifically, the use of vested accrued benefits, rather than accrued benefits alone, would appear to be a better indicator of the level of benefits received by plan participants from private retirement plans. Furthermore, because non-highly compensated employees are more likely to leave before becoming fully vested than highly compensated employees, the failure to use vested accrued benefits may disproportionately overstate the level of benefits actually received by non-highly compensated workers. This result, coupled with the expansive definition of “participation” used in the measurement of participation rates, suggests that private retirement plans may provide even fewer re-

69. See § 411(a)(2)(B).

70. See § 411(a)(2)(A).

71. See EMP. BENEFIT RES. INST., DATABOOK ON EMPLOYEE BENEFITS, Table 10.9 (last updated May 2011), <http://www.ebri.org/pdf/publications/books/databook/DB.Chapter%2010.pdf> [hereinafter EBRI DATABOOK].

72. See, e.g., Rachel Harvey, Note, *Labor Law: Challenges to the Living Wage Movement: Obstacles in a Path to Economic Justice*, 14 U. FLA. J.L. & PUB. POL'Y 229, 248 (2003) (“When employees receive higher wages they do a better job, as reflected in their improved morale, lower rate of absenteeism, lower turnover, and improvement in the quality of applicants.”).

73. See *id.*

74. See EBRI DATABOOK, *supra* note 71.

irement benefits to low- and middle-income workers than the data indicates.⁷⁵

II. WHO IS COVERED AND WHO IS NOT

Regardless of how broadly or narrowly the term is defined, participation, like vesting, correlates very strongly with income.⁷⁶ By any measurement, those who lack pension coverage tend to be low-income employees and those who have it tend to be high-income.⁷⁷ Other factors that correlate with participation and coverage rates are worker demographics and employer characteristics.⁷⁸

A. Participation Rates and Income

As of 2006, only 13% of individuals earning less than \$5000 annually participated in a private retirement plan, as compared with 51% in the \$20,000–\$24,999 bracket, and 78% in the \$50,000-and-over bracket.⁷⁹ This result occurs partly because of the progressive tax rate structure of the federal income tax system, which makes exclusions, deductions, and tax deferral more valuable to taxpayers with higher marginal tax rates.⁸⁰ Consequently, high-income workers gain substantial economic benefits from the ability to accrue tax-free income in qualified retirement savings plans, whereas low-income workers do not.⁸¹

The disparity in participation rates relative to income is of special concern in considering the effectiveness of 401(k) plans in light of

75. See Sanzenbacher, *supra* note 48, at 1.

76. See Craig Copeland, Emp. Benefit Research Inst., *Employment-Based Retirement Plan Participation: Geographic Differences and Trends*, 392 ISSUE BRIEF 9-10 (2013), available at http://www.ebri.org/pdf/briefspdf/EBRI_IB_011-13.No392.Particip.pdf (noting that participation rate varies according to the employer's size, industry, hours worked by the employee, age of the employee, and gender of the employee).

77. *Id.*

78. *See id.*

79. *See id.*

80. See STAFF OF J. COMM. ON TAXATION, 110TH CONG., A RECONSIDERATION OF TAX EXPENDITURE ANALYSIS 52 (Comm. Print 2008) ("[T]ax expenditures formulated as deductions will generally reduce the progressivity of the tax system, by reducing average tax rates more for higher marginal rate taxpayers than for lower marginal rate taxpayers.").

81. *Id.*; see also Jefferson, *Redistribution*, *supra* note 11, at 294. But see Eric Toder & Karen E. Smith, *Do Low-Income Workers Benefit from 401(k) Plans?*, 11-15 CENTER FOR RETIREMENT RES. B.C. ISSUE BRIEF 1, 1 (2011), available at http://crr.bc.edu/wp-content/uploads/2011/12/IB_11-15_508.pdf (noting that although low-income employees receive less of a direct benefit from the tax subsidy, the nondiscrimination rules provide an indirect benefit in the form of higher total compensation when employers make contributions to retirement plans).

their increasing popularity.⁸² These plans, which represent the fastest growing type of defined contribution plan, dominate new plan offerings in the private sector.⁸³ As of 2009, approximately 67% of all employers maintaining retirement plans offered 401(k) plans as their primary retirement savings vehicles, as compared to 35% ten years earlier.⁸⁴

The distinctive characteristic of 401(k) plans is that employees voluntarily elect to make pre-tax contributions to the plan as deferred compensation rather than receive those amounts as compensation in the year in which they were earned.⁸⁵ Notwithstanding the preferential tax treatment given to contributions made to qualified plans, low- and middle-income employees covered by elective contribution plans often choose not to contribute.⁸⁶ In fact, of all of the factors used to predict 401(k) plan participation, income level is the most important determinant of whether a worker will contribute or not.⁸⁷ Thus, to encourage greater participation among low- and middle-income workers, many employers offering 401(k) plans will match the employees' elected contribution at some level.⁸⁸ For example, the employer may match 100% of the first 1% of pay contributed by the employee, and 50% thereafter, up to a specified limit. Even with the prevalence of such incentives, however, less than 50% of all workers who earn \$30,000 or less per year contribute to their 401(k) plans, as compared to 87% of workers who earn \$100,000 or more.⁸⁹

82. See LANGBEIN ET AL., *supra* note 25, at 55.

83. See U.S. DEP'T OF LABOR EMP. BENEFITS SEC. ADMIN., PRIVATE PENSION PLAN BULLETIN HISTORICAL TABLES 19 (2008), available at <http://www.dol.gov/ebsa/pdf/privatepensionplanbulletinhistoricaltables.pdf> (showing that the number of 401(k) plans increased from 17,303 in 1984 to 436,207 by 2005).

84. See Jefferson, *Redistribution*, *supra* note 11, at 301 & n. 79.

85. See I.R.C. § 401(k)(2)(A) (2012). Employers are also permitted to match a certain amount of employee contributions, provided they comply with nondiscrimination rules. See I.R.C. § 401(m).

86. See William F. Bassett et al., *How Workers Use 401(k) Plans: The Participation, Contribution, and Withdrawal Decisions*, 51 NAT'L TAX J. 263, 270 (1998).

87. See *id.*

88. See Jefferson, *Redistribution*, *supra* note 11, at 302-03. However, for 2014, the total amount contributed to an employee's plan may not exceed the lesser of either the employee's salary or \$52,000. See *Retirement Topics—401(k) and Profit Sharing Plan Contribution Limits*, IRS, [http://www.irs.gov/Retirement-Plans/Plan-Participant,-Employee/Retirement-Tops---401\(k\)-and-Profit-Sharing-Plan-Contribution-Limits](http://www.irs.gov/Retirement-Plans/Plan-Participant,-Employee/Retirement-Tops---401(k)-and-Profit-Sharing-Plan-Contribution-Limits) (last updated Apr. 2, 2014).

89. See VANGUARD, HOW AMERICA SAVES 2013: A REPORT ON VANGUARD 2012 DEFINED CONTRIBUTION PLAN DATA 23 (2013), <https://institutional.vanguard.com/iam/pdf/HAS13.pdf>.

Not surprisingly, contribution rates also vary with income.⁹⁰ When low- and middle-income workers do contribute, their contributions represent a smaller percentage of income contributions of higher-income workers.⁹¹ In 1992, taxpayers with income below \$30,000 made contributions of only 4% of their income, while taxpayers with income over \$75,000 made contributions of 8%.⁹² In 2008, 54% of participating employees earning between \$20,000 and \$40,000 had savings rates so low that they annually saved less than \$5000 in their 401(k) retirement plans.⁹³ Such small amounts are grossly inadequate to provide retirement security for these workers.⁹⁴ Therefore, low- and middle-income workers using 401(k) plans as their primary retirement savings instruments are far less likely to accumulate adequate savings for retirement.

There are numerous explanations for low participation rates among low- and middle-income workers. One reason, referenced above, is that low- and middle-income workers have lower marginal tax rates and, therefore, benefit less from the preferential tax treatment of contributions to qualified retirement plans.⁹⁵ Another reason is that low- and middle-income workers have more immediate and pressing needs for their funds than saving for retirement.⁹⁶ Also, some low-income workers may be covered by means-tested welfare programs that discourage participation by effectively imposing high implicit tax rates on all savings.⁹⁷ Additionally, low participation rates may be the result of low-income workers undervaluing the benefits of retirement savings, or having reduced incentives to save for retirement because Social Security income-replacement rates are higher for low-income workers.⁹⁸

90. *Id.*

91. *Id.* at 28.

92. Jefferson, *Redistribution*, *supra* note 11, at 303.

93. See HEWITT, 2009 HEWITT BENCHMARKS - HOW WELL ARE EMPLOYEES SAVING AND INVESTING IN 401(K) PLANS 17 (2009), http://www.aon.com/attachments/thought-leadership/Hewitt_2009_Universe_Benchmarks.pdf.

94. See Jefferson, *Redistribution*, *supra* note 11, at 303.

95. See Dorothy A. Brown, *Shades of the American Dream*, 87 WASH. U. L. REV. 329, 341 (2009) (noting that tax deductions are less valuable for low-income workers).

96. See Bassett et al., *supra* note 86, at 270.

97. *Id.*

98. See AON CONSULTING, 2008 REPLACEMENT RATIO STUDY: A MEASUREMENT TOOL FOR RETIREMENT PLANNING 2 (2008), <http://www.aon.com/about-aon/intellectual-capital/attachments/human-capital-consulting/RRStudy070308.pdf> (finding that Social Security payments will replace about 60% of the pre-retirement income for a worker making less than \$30,000 per year).

When low-income workers do choose to contribute to 401(k) plans, the occurrences of “cash outs” are more likely to erode their retirement savings. Plans typically allow participants to liquidate their account balances when they separate from service prior to reaching retirement age. Some plans automatically liquidate relatively small account balances upon separation of service prior to retirement.⁹⁹ Cash outs occur when workers fail to roll over these distributions into other qualified retirement accounts. Although workers can avoid paying taxes and substantial penalties when they roll over the funds into either an IRA or another qualified plan, a significant number of workers choose not to do so.

In 2010, approximately 42% of terminated employees chose to cash out their funds rather than roll them over.¹⁰⁰ Within this population, lower-income workers were more likely than higher-income workers to liquidate their retirement savings in this manner.¹⁰¹ Over one-third of employees earning less than \$30,000 cashed out their account balances, as compared to only 10% of those who earned over \$100,000.¹⁰² Obviously, when distributions from retirement savings plans are not reinvested in other retirement savings instruments, it is far more likely that the funds will be used for non-retirement purposes.¹⁰³

B. Other Worker Demographics Correlating to Participation Levels

Factors other than income correlate with lower participation and coverage rates among low- and middle-income workers, including gender, age, and employer characteristics.¹⁰⁴ In the aggregate, women have slightly lower levels of participation than do men.¹⁰⁵ As of 2012, 45% of all male workers between the ages of twenty-one and sixty-four participated in a private plan as compared to 44% of women in the same category.¹⁰⁶ This result is attributable to numerous factors: women earn lower wages; work fewer hours; have more

99. See, e.g., I.R.C. § 72(t)(2)(A)(v) (2012) (workers can avoid a 10% tax on early distributions from the plan if they are separated from employment after age 55); I.R.C. § 401(a)(31)(B) (permitting mandatory distribution when balances are under \$5,000 total).

100. See Olson, *supra* note 44, at 459.

101. *Id.*

102. *Id.*

103. Regina T. Jefferson, *Striking a Balance in the Cash Balance Plan Debate*, 49 BUFF. L. REV. 513, 534 (2001).

104. See Copeland, *supra* note 76, at 10.

105. See *id.*

106. *Id.* at 11.

episodic work patterns; and have greater concentration in industries in which retirement plan coverage is low.¹⁰⁷ All of these factors correlate with lower participation rates, regardless of gender.¹⁰⁸

Interestingly, however, when measuring participation rates among workers in individual employment status categories that have lower participation rates, such as part-time or seasonal workers, women have higher participation rates than men.¹⁰⁹ For example, 22% of part-time, permanent female workers participate in plans, as compared to only 14% of men.¹¹⁰

Age is another factor that influences plan participation rates. Across all income levels, younger workers are less likely than older workers to participate in a retirement plan.¹¹¹ This disparity most likely reflects the fact that individuals are less willing to save for events that will occur decades in the future. Also, because ERISA exempts workers under the age of twenty-one from the nondiscrimination tests, employers are not penalized for excluding very young workers from their plans.¹¹² The combination of these factors reduces the effectiveness of the tax incentives in maximizing participation among younger workers in private retirement plans.

The size of a worker's employer is another significant factor in predicting plan participation. Smaller companies are far less likely to sponsor retirement plans for their workers than are larger ones. Approximately 20% of individuals working for employers with fewer than twenty-five employees participate in employer-sponsored retirement plans, whereas participation rates among employers with 1000 or more employees exceed 60%.¹¹³

Additionally, the type of industry in which the employee works correlates with plan participation. For instance, employees in the manufacturing, transportation, and financial industries are more likely to participate in employer-sponsored plans than employees in the service industry.¹¹⁴ Public sector workers are also more likely to participate in employer-sponsored plans than private sector work-

107. See LANGBEIN ET AL., *supra* note 25, at 28.

108. *Id.*

109. See Copeland, *supra* note 76, at 10.

110. *Id.* at 13, fig. 3.

111. *Id.* at 14.

112. See I.R.C. § 410(a)(1) (2012).

113. See William E. Even & David A. Macpherson, *Improving Pension Coverage at Small Firms*, in OVERCOMING BARRIERS TO ENTREPRENEURSHIP 123 (Diana Furchtgott-Roth ed., 2008) (reporting 2004 participation rates); see also Copeland, *supra* note 76, at 10 (reporting similar findings for 2012 rates).

114. See Copeland, *supra* note 76, at 10.

ers.¹¹⁵ This correlation occurs presumably because employers in certain sectors of the economy are more likely to offer plans than employers in others.

III. PROPOSALS TO INCREASE COVERAGE

Although 401(k) plans dominate new private plan offerings, their popularity has not increased overall coverage in the private retirement system. Coverage rates have hovered around 50% since the passage of ERISA, notwithstanding the shift from defined benefit to defined contribution plans.¹¹⁶ Therefore, there continues to be a need to explore ways of increasing coverage and participation rates, particularly among low- and middle-income workers, who in the absence of such incentives may be unable to save on their own. However, the methods used must be structured differently in the current pension landscape.

Section 401(k) plans present difficult tradeoffs for plan participants. Participants are given greater autonomy and flexibility on the one hand, but on the other they are exposed to greater burdens and risks. At every stage of their retirement savings process, workers are required to make critical decisions regarding their retirement savings. These decisions can include whether to contribute, what level of contribution to make, and which investment strategy to use, as well as what to do with distributions received prior to retirement.¹¹⁷

Regardless of the burdens and risks that these plans present to employees, they are more popular than traditional defined benefit plans because they are often less expensive, simpler, and less risky for employers to maintain.¹¹⁸ Thus, in spite of their shortcomings, the trend of using 401(k) plans as primary retirement savings instruments is well established and is unlikely to change in the near future. Without an option to offer a 401(k) plan, some employers may choose not to establish plans and, as a result, some employees may save even less for retirement.¹¹⁹ For these reasons, it would be difficult, even counterproductive, to eliminate 401(k) plans as retirement savings options because of their tremendous appeal to employees and employers alike.

115. *See id.*

116. *See Even & Macpherson, supra* note 113, at 2.

117. *See Bassett et al., supra* note 86, at 269.

118. *See Jefferson, Rethinking, supra* note 8, at 636.

119. *Id.*

Even so, the current benefit distribution in 401(k) plans does not effectively advance one of ERISA's primary objectives—to broaden participation in private retirement plans.¹²⁰ Furthermore, the current structure of the savings incentives in the private retirement system disproportionately benefits higher-income workers. Thus, to justify the tax subsidy given to qualified plans, affirmative measures must be taken to increase savings rates and broaden benefit distribution from 401(k) plans to include more low- and middle-income workers.

In response to these concerns, the remainder of this Reflection proposes the following: (1) mandatory education programs for all 401(k) plans; (2) mandatory automatic enrollment and escalation features in 401(k) plans; and (3) an additional tax incentive to encourage greater participation of low- and middle-income employees, as measured by their vested accrued benefits.

A. Mandatory Employer-Provided Education in 401(k) Plans

1. The benefits of financial education programs

Notwithstanding the importance and complexity of the retirement planning decisions that employers sponsoring 401(k) plans require employees to make, there is currently no requirement that employers provide financial education or training. This situation is problematic because most individuals are not equipped to manage their own retirement security, lacking both financial training and prior experience with complex financial and investment matters.¹²¹ Without such training or experience, the majority of individuals eligible to participate in 401(k) plans make less-than-optimum decisions throughout the retirement savings process.¹²²

Research shows that financial illiteracy in the United States is widespread across the spectrum of workers.¹²³ A survey conducted by the University of Michigan gave 1000 people between the ages of

120. See *supra* notes 4–5 and accompanying text.

121. See Susan J. Stabile, *Freedom to Choose Unwisely: Congress' Misguided Decision to Leave 401(k) Plan Participants to Their Own Devices*, 11 CORNELL J.L. & PUB. POL'Y 361, 392 (2002) (noting that "participant decisions in 401(k) plans are often the product of deficient information, inadequate knowledge, and cognitive biases").

122. WAGNER LAW GRP., NAVIGATING THE NEW REALITIES OF 401(K) PARTICIPANT EDUCATION 2 (2001), <http://www.wagnerlawgroup.com/documents/WPNavigatingtheNewRealitiesof401kParticipantEducation.pdf> (advising that 401(k) "[p]lan sponsors also have a strong incentive to educate participants on investment concepts and provide allocation decision support, which can reduce the incidence and severity of poor decision-making by participants").

123. See Olson, *supra* note 44, at 470–71 (noting that many Americans have limited knowledge of financial markets and prudent investing strategies).

eighteen and ninety-seven a financial literacy test.¹²⁴ The study found that, on average, respondents could only answer 67% of the questions asked.¹²⁵ These findings are disturbing because financial literacy is one of the best predictors of an individual's ability to effectively make prudent financial decisions, including those necessary for effective retirement planning.¹²⁶

Similar results were reported from studies with smaller samples that target more specific aspects of financial literacy.¹²⁷ For example, a study conducted in 1988 examined the level of knowledge workers had regarding their retirement plans.¹²⁸ That study found that a significant percentage of the subjects were unable to identify key features of their plans, including the plan's normal and early retirement ages and how much their retirement benefits would increase if they postponed retirement.¹²⁹ Other research has also determined that employees regularly misunderstand some of the key features of their plans.¹³⁰ A 2007 study specifically targeting 401(k) plans found that nearly 50% of non-participating employees in 401(k) plans had low financial literacy and, of the employees who participated, more than 20% had low financial literacy.¹³¹

Equally alarming, however, is the fact that a majority of employees not only fail to understand the features of their plans, but also substantially misestimate their expected benefits from both Social Security and their private retirement plans.¹³² This result is especially disturbing because Social Security and private retirement plans represent two of the three primary sources of retirement income, the third source being personal savings.¹³³ Thus, having accurate infor-

124. See Annamaria Lusardi & Olivia S. Mitchell, *Financial Literacy: Evidence and Implications for Financial Education*, May 2009, at 1, 2, available at https://www.tiaa-crefinstitute.org/public/pdf/institute/research/trends_issues/ti_financialliteracy0509a.pdf.

125. See *id.*

126. See *id.* at 5-6.

127. See *id.* at 2.

128. *Id.*

129. *Id.*

130. See Olson, *supra* note 44, at 472.

131. See *id.* (citing Julie R. Agnew et al., *Do Financial Literacy and Mistrust Affect 401(k) Participation?* CTR. FOR RET. RESEARCH ISSUE IN BRIEF, Nov. 2007, No. 7-17, at 1, 1-2, available at http://crr.bc.edu/wp-content/uploads/2007/11/IB_7-17.pdf).

132. *Id.*; cf. Colleen E. Medill, *Transforming the Role of the Social Security Administration*, 92 CORNELL L. REV. 323, 354 (2007) (proposing that the Social Security Administration should serve as the central authority providing education and advice on retirement savings and investment).

133. See Stephen F. Befort, *The Perfect Storm of Retirement Insecurity: Fixing the Three-Legged Stool of Social Security, Pensions, and Personal Savings*, 91 MINN. L. REV. 938, 939 (2007) (noting

mation about the expected benefits from these two sources is critically important in financial preparation for retirement.

Financial education programs are helpful in improving this situation by enabling workers to make better decisions and appreciate the risk of shortage if they fail to do so. A 2009 study conducted by the Federal Reserve Bank of Chicago found a positive correlation between employer-provided education programs and greater employee 401(k) contributions.¹³⁴ The study further concluded that educating employees on the importance of planning for retirement raised overall retirement savings rates.¹³⁵ Other studies supporting these findings show that individuals who attend financial education programs generally save more than individuals who do not.¹³⁶

2. A financial education requirement

To ensure that 401(k) plan participants have access to financial education, an education requirement should be imposed on all employers sponsoring such plans. In the absence of a mandate, many plan participants will be forced to make important financial decisions regarding their retirements without the benefit of financial education.¹³⁷ Furthermore, requiring employers to assume some responsibility for educating plan participants also helps to justify the tax

that these three sources of retirement income are commonly referred to as the “three-legged stool”). The personal savings rate in America has fallen dramatically since the 1980s. *Id.* at 960.

134. See Olson, *supra* note 44, at 474–75 (citing GENE AMROMIN ET AL., FINANCIAL LITERACY AND THE EFFECTIVENESS OF FINANCIAL EDUCATION AND COUNSELING: A REVIEW OF THE LITERATURE 12–15 (2010), available at http://www.chicagofed.org/digital_assets/others/region/foreclosure_resource_center/more_financial_literacy.pdf (last visited May 29, 2014)).

135. *Id.*; see also William J. Arnone, Ernst & Young LLP, Educating Pension Plan Participants, Address at the 2004 Pension Research Council Symposium at the Wharton School in Philadelphia, Pennsylvania (Apr. 26–27, 2004), available at <http://pfeef.com/speeches/Educating-Pension-Plan-Participants.pdf>.

136. See, e.g., Robert L. Clark et al., Financial Education and Retirement Savings, Presentation at the Conference: Sustainable Community Development: What Works, What Doesn’t, and Why (Mar. 27–28, 2003), available at http://www.federalreserve.gov/communityaffairs/national/CA_Conf_SusCommDev/pdf/clarkrobert.pdf (noting the general consensus that financial education programs increase employee savings rates).

137. The Pension Protection Act of 2006 (PPA) encouraged employers to offer education plans by amending ERISA to include an exemption from fiduciary liability for plans that provide investment advice to participants under eligible investment advice arrangements. See Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780; Employee Retirement Income Security Act of 1974, 29 U.S.C. § 1108(g) (2012); I.R.C. § 4975 (2012); 29 C.F.R. § 2550.408(g)-1 (2013). Prior to the PPA, the fiduciary rules of ERISA deterred employers from providing financial education programs because of the possibility that the programs could be considered investment advice, which under certain circumstances would be prohibited. See Jefferson, *Balancing*, *supra* note 13, at 206.

subsidy that employers receive in connection with their sponsored 401(k) plans.¹³⁸

The success of an education program is determined both by its availability and its quality of instruction. Therefore, the proposed education requirement regulates the timing, the type, and the content of the information to be provided in the following manner: First, education programs satisfying the proposed mandate would be required to utilize a variety of educational media, including a complement of written materials, seminars, and financial planning software. This approach responds to evidence showing that printed information is less effective than other modes of communication in aiding the investment education of plan participants.¹³⁹

Second, the proposed education program would require that financial education be made available on a regular basis to plan participants throughout their employment, regardless of age.¹⁴⁰ Researchers have found that higher frequency of financial education programs is correlated with higher contribution levels among low-income workers.¹⁴¹ Many employers presently offer one-time planning sessions to older employees, believing that only those approaching retirement need financial education. However, imprudent investment decisions can be just as devastating—if not more so—for younger employees. This is because younger employees have longer investment horizons; consequently, the negative impact of their mistakes are compounded over greater periods of time. In order to ensure that both older workers and younger workers have access to financial training, under the proposed education program, employers sponsoring 401(k) plans would be required to provide investment information periodically to all workers eligible to participate in the plan.¹⁴²

The proposed financial education programs would also include instruction on the importance of not only contributions and investment allocation, but also the timing and forms of distribution. This information is essential in financial training because decisions re-

138. See *supra* notes 21–23 and accompanying text.

139. See Jefferson, *Balancing*, *supra* note 13, at 207 & n.103; see also WAGNER LAW GRP., *supra* note 122, at 11 (“Many participants will not respond to passive education or written materials Accordingly, plan sponsors should consider providing active education through a provider that engages participants and provides meaningful decision-making assistance to participants.”).

140. See Olson, *supra* note 44, at 475, 480 (arguing for recurring, regular financial education plans).

141. See *id.* at 475.

142. See Jefferson, *Balancing*, *supra* note 13, at 207.

garding these matters have long-term effects on retirement security. For this reason, under the current law there are rules that encourage some forms of distribution over others, while other rules restrict early access to retirement plan assets.¹⁴³ These rules advance pension policy because the goal of the private retirement system is to assist workers in both saving for retirement and managing their assets to last throughout retirement.

B. Mandating Automatic Enrollment and Escalation

1. The concepts of automatic enrollment and escalation

Initially, 401(k) plans were offered primarily as tax-preferred, supplemental accounts for employees who wished to save additional amounts for retirement.¹⁴⁴ Generally, employers who sponsored these plans also offered traditional defined benefit plans that provided non-elective predetermined retirement benefits.¹⁴⁵ Therefore, because it was not anticipated that workers would rely on the 401(k) funds for their retirement security, it was appropriate to require employees to both take affirmative steps to enroll in the plan, and to assume all of the risks associated with it.¹⁴⁶ However, as 401(k) plans are increasingly used as primary retirement savings instruments, a design that makes non-enrollment the default setting no longer seems appropriate.¹⁴⁷

Research shows that newly hired employees are very slow to elect to participate in 401(k) plans. After as many as three years of employment, nearly 33% of workers eligible to enroll have not elected to do so.¹⁴⁸ Although it may appear that the choice to enroll is a simple one, there are a variety of savings and investment decisions involved in the process that can easily explain the delay.¹⁴⁹ To enroll, workers often must decide not only whether to contribute, but also

143. See *id.* at 208 n.105; see also LANGBEIN ET AL., *supra* note 25, at 511-35 (explaining that both ERISA and the Internal Revenue Code restrict the timing and character of distributions from qualified plans).

144. See SHLOMO BENARTZI, SAVE MORE TOMORROW: PRACTICAL BEHAVIORAL FINANCE SOLUTIONS TO IMPROVE 401(K) PLANS 3-4 (2012); see also Kara M. Klaas, *Left in the Dark: Sarbanes-Oxley and Corporate Abuse of 401(k) Plan Blackout Periods*, 29 J. CORP. L. 801, 804 (2004).

145. See FLA. PUB. PENSION TRS. ASS'N, 401(K) PLANS ARE NOT RETIREMENT PLANS 6 (Mar. 10, 2010), available at http://www.fppta.org/FPPTA/MR_Articles.aspx.

146. See BENARTZI, *supra* note 144, at 4-5.

147. See *id.*

148. See *id.* at 5.

149. See *id.*

how much to contribute, how to select investments from a wide array of options, and when and whether to increase contributions. Thus, the decision to enroll requires consideration of numerous complex concepts that many workers may not feel comfortable or equipped to make.¹⁵⁰ This discomfort causes some individuals to fall into the pattern of putting off the decision until they have an opportunity to acquire more information, which oftentimes never occurs.¹⁵¹ As a result, these individuals miss out on valuable economic benefits, including the tax advantages of saving in a qualified retirement plan, the value of compound growth, and, in some cases, employer matched funds.¹⁵²

Thankfully, these challenges are not insurmountable and can be addressed by providing financial education, as discussed above. They also can be significantly minimized by reversing the default setting of the plan from non-enrollment to enrollment.¹⁵³ Under such a design, immediately after workers become eligible to participate in 401(k) plans, they are deemed to have elected to defer a predetermined percentage of their compensation to the plan, with predetermined asset allocations.¹⁵⁴ Workers who are automatically enrolled in this manner are free to “opt out”; however, behavioral finance research indicates that most individuals will not because they are not active decision makers.¹⁵⁵ The principle of “inertia” explains that most individuals will remain with a default option because they will fail to take affirmative measures to change.¹⁵⁶ Accordingly, when the plan has a default setting of saving, workers will not act to change the setting and will save; when the plan has a default setting of not saving, workers will not act to change the setting and will not save.¹⁵⁷

The auto-enrollment concept has been studied over the last two decades and has proven to be very effective in increasing participa-

150. See *supra* subsection III.A.1.

151. See *Tax Reform and Tax-Favored Retirement Accounts: Hearing Before the H. Comm. on Ways and Means*, 112th Cong. 92 (2012) (statement of David C. John, Senior Research Fellow in Retirement Security and Financial Institutions, The Heritage Foundation).

152. See BENARTZI, *supra* note 144, at 45–46 (describing the compound effect of retirement decisions made early in a worker’s career).

153. See LANGBEIN ET AL., *supra* note 25, at 430 (citing Treas. Reg. § 1.401(k)-1(a)(3)(ii) (as amended in 2009)); see also BENARTZI, *supra* note 144, at 38–56.

154. See LANGBEIN ET AL., *supra* note 25, at 430.

155. *Id.* (citing Richard Thaler & Shlomo Benartzi, *Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving*, 112 J. POL. ECON. 164, 164–87 (2004)).

156. See *id.* at 10, 38–40 (advising that workers who initially chose to opt out of a plan should still be continuously asked when they would like to be enrolled in the future).

157. See *id.* at 430.

tion rates among eligible employees.¹⁵⁸ Some studies have shown increases of up to 20%, from mid-60% levels to mid-80% levels, as a result of this approach.¹⁵⁹ Automatic enrollment has been especially effective in increasing participation rates among populations that otherwise tend to have lower savings rates, such as low- and middle-income workers, women, and younger workers.¹⁶⁰ Some studies have shown a rate increase of more than 65%, from the mid-teens levels to the mid-80% levels for these groups.¹⁶¹

Although automatic enrollment can significantly increase participation rates in 401(k) plans, it does not necessarily increase the overall savings rates in these plans.¹⁶² In fact, some have argued that the opt-out design actually lowers overall savings rates because it encourages participants to remain at very conservative default positions for both contribution levels and investment allocations.¹⁶³ In other words, these skeptics explain that those who would have elected to save at higher rates in the absence of the opt-out design may actually save less by remaining at the lower rates.¹⁶⁴ To the extent that this decrease is not offset by an increase in savings among those who would not have elected to save in the absence of the opt-

158. See Jack VanDerhei & Craig Copeland, *The Impact of PPA on Retirement Savings for 401(k) Participants*, 318 EMP. BENEFIT RESEARCH INST. 1 (2008), available at http://www.ebri.org/pdf/briefspdf/EBRI_IB_06-20087.pdf.

159. See *Tax Reform and Tax-Favored Retirement Accounts: Hearing Before H. Comm. on Ways and Means*, 112th Cong. 86 (2012) (statement of David C. John, Senior Research Fellow, Heritage Foundation).

160. See *id.*

161. See *id.*; see also Press Release, Fidelity Invs., Fidelity Analysis Highlights Positive Impact of Pension Protection Act on 401(k) Plans and Their Participants (Nov. 30, 2011), available at <http://www.reuters.com/article/2011/11/30/idUS155072+30-Nov-2011+BW20111130> (finding that auto enrollment increased the participation rate of workers age twenty to twenty-four from only 20% up to about 76%).

162. See Barbara A. Butrica & Nadia S. Karamcheva, *How Does 401(k) Auto-Enrollment Relate to the Employer Match and Total Compensation?*, 13-14 CENTER FOR RETIREMENT RES. AT B.C. 5 (2013), available at http://crr.bc.edu/wp-content/uploads/2013/10/IB_13-14.pdf; see also LANGBEIN ET AL., *supra* note 25, at 430.

163. See Butrica & Karamcheva, *supra* note 162, at 5 (“While auto-enrollment will increase saving for workers who would not have participated without it, those who would have participated on their own may end up saving less due to relatively low employer match rates and low default contribution rates.”); see also Larry W. Beeferman & Matthew B. Becker, *Going on Automatic: The Right Path Toward Retirement Income Security for All?* 6 HARV. PENSION & CAPITAL STEWARDSHIP PROJECT OCCASIONAL PAPERS 52 (2010), available at <http://www.law.harvard.edu/programs/lwp/pensions/publications/occpapers/occasionalpaper6.pdf> (“[T]hat very inertia which is said to make automatic enrollment effective also operates against increases in contributions: because workers are said to be passive, they not only do not act to opt out after being automatically enrolled, but also do not act to change their contribution rate.”).

164. See Beeferman & Becker, *supra* note 163, at 52.

out design, the net result is a wash, or potentially even a decrease in overall savings.¹⁶⁵

An automatic escalation feature that provides for gradual increases in employee contributions over time can mitigate this effect. Although participants are free to opt out of such arrangements, they tend not to because of the same effect of inertia that prevents them from opting out of enrollment.¹⁶⁶ Thus, if the default setting is to increase savings rates over time, they will; if the default setting is to remain at the same level, they will. Accordingly, the use of automatic escalation in conjunction with automatic enrollment can result in both increased participation rates and increased overall savings levels.¹⁶⁷

Initially, some commentators expressed concern that such automatic features would not retain sufficient employee choice to qualify a plan as a "cash or deferred arrangement."¹⁶⁸ The law, however, now expressly authorized automatic plan designs.¹⁶⁹ Furthermore, the Pension Protection Act of 2006 (PPA) created incentives for employers that sponsor 401(k) plans to implement this approach by adding safe harbor auto enrollment and auto escalation provisions.¹⁷⁰

2. *The automatic enrollment and escalation proposal*

Because of the proven benefits that automatic features provide, this Reflection proposes that all employers offering 401(k) plans as primary retirement savings instruments be required to use automatic enrollment and automatic escalation in their plan design. These design features have been shown to have significant and positive impacts on participation and savings levels, even under the most conservative assumptions.¹⁷¹ Thus, mandating the use of automatic

165. See Butrica & Karamcheva, *supra* note 162, at 4 ("Employers with auto-enrollment may be aiming to keep their compensation costs roughly constant. While they end up spending more on workers who would not have participated without auto-enrollment, they spend less on workers who would have signed up anyway.").

166. See *supra* note 161 and accompanying text.

167. BENARTZI, *supra* note 144, at 118-20 (showing that plans using automatic enrollment and automatic escalation of contribution percentages are the most effective in ensuring that workers amass adequate retirement savings); see also VanDerhei & Copeland, *supra* note 158, at 5.

168. LANGBEIN ET AL., *supra* note 25, at 430 (citing Treas. Reg. § 1.401(k)-1(a)(3)(ii) (as amended in 2009)).

169. *Id.*

170. See VanDerhei & Copeland, *supra* note 158, at 6-7 (noting that these safe harbors preempted any state laws which would have prohibited these automatic plan features).

171. See *id.* at 1.

plan provisions in certain qualified 401(k) plans would make these saving arrangements more effective retirement savings vehicles.¹⁷²

The benefits from automatic features are numerous. Default settings for savings rates, asset allocation, and incremental increases significantly simplify the retirement savings process, eliminating the necessity of workers making complex financial decisions.¹⁷³ Additionally, because many participants wait several years before enrolling in 401(k) plans, mandatory automatic design would mean that some workers would begin to save much earlier than they otherwise would, which positively impacts their retirement security.¹⁷⁴ Also, mandating automatic provisions increases the likelihood that a cross section of workers will actually receive more meaningful levels of benefits from the plans that their employers sponsor.

Opponents may argue the proposed mandate is unduly burdensome or excessively paternalistic. However, compliance with an automatic plan design is cost effective and relatively simple. Furthermore, as I argued in the case of mandatory education, requiring employers to take measures to increase plan participation and make the savings process simpler for employees is a way to justify the substantial tax benefits that employers who sponsor 401(k) plans receive.

C. Additional Tax Advantage Based on Vested Accrued Benefits of Non-Highly Compensated Workers

As a means of encouraging more meaningful participation of low- and middle-income workers in private retirement plans, and also of achieving a more equitable distribution of benefits from qualified plans in today's retirement savings culture, this Reflection proposes that an additional tax incentive for retirement savings is offered in the form of a new employer credit. The proposed credit would be provided in conjunction with the tax benefits that qualified plans currently receive.

172. See Jon Vogler, *Auto Focus: Voluntary Plans Morphing to Mandatory?*, ADVISOR PERSPECTIVES (Oct. 7, 2013), http://advisorperspectives.com/commentaries/invesco_100413.php (noting that automatic provisions are supported by the Obama administration and many members of the investment company industry).

173. See GENE AMROMIN ET AL., FINANCIAL LITERACY AND THE EFFECTIVENESS OF FINANCIAL EDUCATION AND COUNSELING: A REVIEW OF THE LITERATURE 2 (2010), http://www.chicagofed.org/digital_assets/others/region/foreclosure_resource_center/more_financial_literacy.pdf (discussing the problem of financial illiteracy and considering the effectiveness of financial education programs).

174. See BENARTZI, *supra* note 144, at 5.

1. *Current tax advantages of qualified plans*

Under current law, the preferential tax treatment of qualified plans provides three main advantages. First, the employee, or the beneficiary of the employee, is not subject to taxation until contributions are actually distributed.¹⁷⁵ Second, the employer receives an income tax deduction for amounts contributed to the plan at the time they are made.¹⁷⁶ This advantage is an exception to the general rule that an employer is not permitted to take a tax deduction for salary-related expenditures as an ordinary and necessary business expense before the employee includes the payments in income.¹⁷⁷ Third, the investment earnings on the contributions held by the plan are exempt from taxation.¹⁷⁸

Although the tax advantages afforded by qualified plans are not limited to a specific sector of the population with respect to income, wealth, or other qualifiers, the domination of 401(k) plans in the private retirement system disproportionately benefits high-income workers.¹⁷⁹ This result occurs, as discussed earlier, because highly compensated workers are (1) more likely to participate in 401(k) plans than non-highly compensated workers, (2) more likely to contribute greater percentages of their earnings than non-highly compensated workers, and (3) less likely to forfeit their benefits than non-highly compensated workers.¹⁸⁰ Furthermore, because the progressive tax rate structure of the federal income tax makes deductions and tax deferral more valuable to high-income workers, employers with greater numbers of high-income workers are more likely to offer plans than employers with greater numbers of lower-wage workers. Thus, the employer deductions taken in connection with 401(k) plans overwhelmingly reflect the retirement benefits ultimately received by highly compensated workers.

Presently, the employers' deductions for contributions made to qualified plans are determined without regard to whether or not the retirement benefits are vested.¹⁸¹ As a result, employers receive the

175. See I.R.C. § 402(a) (2012). If the distribution is rolled over into an IRA or other qualified plan, however, taxation may be further deferred. I.R.C. § 402(c). Generally, rollovers must be made within sixty days. I.R.C. § 402(c)(3)(A).

176. See I.R.C. § 404(a); see also Jefferson, *Redistribution*, *supra* note 11, at 297.

177. See I.R.C. § 83(h).

178. See I.R.C. § 501(a).

179. See Jefferson, *Redistribution*, *supra* note 11, at 294.

180. See EBRI DATABOOK, *supra* note 71 and accompanying text; see also VANGUARD, *supra* note 89 and accompanying text.

181. See *supra* Section I.C.

same favorable tax treatment for non-vested contributions as they do for vested ones, although employees may forfeit their non-vested accruals if they terminate employment prior to becoming vested. As discussed earlier, this outcome is more likely to occur in the case of lower-income workers, who are more likely to leave before becoming fully vested.¹⁸²

To address this situation, measures should be taken to design tax incentives that both encourage greater participation among low- and middle-income workers, and also distinguish between vested and non-vested benefits as a method of achieving a more even distribution of benefits from the private retirement system. The remainder of this Reflection summarizes the basic structure and elements of a proposed employer credit designed to accomplish these objectives.

2. Basic elements of proposed credit

The proposed incentive is offered in the form of a tax credit rather than a tax deduction. Although both a tax deduction and a tax credit can effectively reduce the employer's income tax liability, their results have very different impacts. Tax deductions reduce taxable income; therefore, the value of a deduction is linked to a taxpayer's marginal tax bracket.¹⁸³ Accordingly, the deductions taken for contributions to qualified plans are more valuable to employers in higher tax brackets than they are to ones in lower brackets.¹⁸⁴ In contrast, because tax credits directly reduce a taxpayer's tax liability, they will have the same nominal value for all employers, regardless of the tax brackets.¹⁸⁵ As a result, the credit is effective in providing more even and widespread incentives for socially desirable behavior.¹⁸⁶

The purpose of the proposed incentive is to encourage a wide range of employers who sponsor 401(k) plans to increase participa-

182. See *supra* Section I.C.

183. See Thomas D. Griffith, *Theories of Personal Deductions in the Income Tax*, 40 HASTINGS L.J. 343, 352-54 (1989) (referring to tax deductions that favor high-income tax payers as "upside-down" tax subsidies).

184. See *id.*

185. See, e.g., Ctr. on Budget & Pol'y Priorities, *Policy Basics: Tax Exemptions, Deductions, and Credits 2* (2013), available at <http://www.cbpp.org/files/policybasics-exempt.pdf>. This is true as long as the employer's tax liability is at least equal to the credit.

186. See Lily L. Batchelder et al., *Policy Brief No. 156: Reforming Tax Incentives into Uniform Refundable Tax Credits*, THE BROOKINGS INSTITUTION 6 (2006), available at <http://www.brookings.edu/~media/research/files/papers/2006/8/taxes%20orszag/pb156.pdf> (explaining how tax credits can be used to encourage more workers to save for retirement).

tion and benefit distributions among low- and middle-income workers. Thus, a tax credit is the more appropriate mechanism to achieve this objective.¹⁸⁷

The proposed credit would be available to employers who covered 100% of workers with compensation below a specified amount. For administrative ease, the income limit for the proposed credit could be set at levels consistent with those of existing retirement programs.¹⁸⁸ For example, the single-filer income limits for the deductions of contributions to traditional IRAs could be used for this purpose. Accordingly, the credit would be based on workers with compensation of \$70,000 or less.¹⁸⁹

The employer credit for each worker would be calculated as a fixed percentage of the employee's vested accrued benefit, determined by total employer contributions made in a given year on behalf of employees with compensation under the specified amount. Thus, for example, if an employee with income below the specified dollar limit were 60% vested, and the employer's contributions in a given year on her behalf totaled \$10,000, the employer credit would be based on a contribution of \$6000 (i.e. 60% of \$10,000).

For purposes of calculating the credit, all employer contributions would be considered, including non-elective and matching contributions. Employee contributions, however, would not be considered in the calculation of the credit. Accordingly, in the example above, if the applicable percentage rate for the credit were 50%, the employer's credit on behalf of that particular worker would equal \$3000 (i.e. 50% of \$6000).

As a method of targeting lower-income workers and also limiting lost revenue, the proposed employer credit would phase out as workers' incomes increased. Therefore, the largest credits would be given for workers with the lowest incomes, and the smallest credits would be given for workers with the highest incomes. To illustrate, if the single-filer, phase out limits for deductions to traditional IRAs were used, the maximum employer credit would be given for workers with compensation of \$60,000 or less.¹⁹⁰ The credits for workers

187. See Ctr. on Budget & Pol'y Priorities, *supra* note 185.

188. Obviously, the limits could be determined on other bases as well.

189. See 2014 IRA Contribution and Deduction Limits, IRS, <http://www.irs.gov/Retirement-Plans/Plan-Participant,-Employee/2014-IRA-Contribution-and-Deduction-Limits---Effect-of-Modified-AGI-on-Deductible-Contributions-If-You-ARE-Covered-by-a-Retirement-Plan-at-Work> (last updated Feb. 19, 2014).

190. See *id.* (allowing only a partial deduction for IRA contributions when income is greater than \$60,000 but less than \$70,000).

with compensation of more than \$60,000 would begin to phase out. Once the compensation of a worker reached \$70,000, the credit would be completely phased out. Thus, in the above example, if the employee had compensation of \$60,000, the employer would receive the full credit of \$3000. If the employee had compensation of \$65,000, the employer would receive a credit of \$1500. If the employee had compensation of \$70,000, the employer would receive no credit at all in connection with that employee. The phase out would be indexed for inflation, so that the phase out ranges would remain fixed in real terms.¹⁹¹

The specific numbers and ranges used above are offered for illustrative purposes only. The use of revenue and cost estimates could result in the selection of different income limits and phase outs. The essence of the proposal is not the selected numbers, but rather the concept of an employer credit based on the vested accrued benefits of low- and middle-income workers.

The proposed employer credit would appear to advance pension policy by increasing retirement security among low- and middle-income workers, and also fiscal policy by tailoring the tax subsidy to benefits actually received by the targeted population. Furthermore, the structure of this proposal appears to be politically viable in the current retirement savings environment because it motivates employers to voluntarily broaden coverage among low- and middle-income workers, rather than mandating it.

CONCLUSION

The shift from the use of defined benefit plans to 401(k) plans as primary retirement savings instruments occurring since the passage of ERISA has not improved participation rates in the private retirement system. In fact, because of the structure of these plans, there is greater variance among taxpayers in different income groups regarding plan participation and benefit distribution than ever before. Additionally, the heavy use of 401(k) plans has challenged traditional views regarding the allocation of risk associated with retirement savings because 401(k) plans make it necessary for workers, rather than employers, to make critical financial and investment decisions at every stage of the retirement savings process. Thus, the trend of using

191. See, Jim Chen, *The Price of Macroeconomic Imprecision: How Should the Law Measure Inflation?*, 54 HASTINGS L.J. 1375, 1406-07 (2003) (noting that many provisions in the federal tax code are indexed to account for inflation).

401(k) plans as primary retirement vehicles has significantly changed the retirement savings culture and has created a need to develop new and different ways of increasing participation and contribution levels in 401(k) plans, particularly among low- and middle-income workers.

Requiring employers that sponsor 401(k) plans to provide investment education programs, and to use automatic plan designs, responds to these challenges without unduly burdening employers. Research shows that the use of both approaches—financial education and automatic plan design—positively impacts the participation and savings rates among all workers. Accordingly, these proposals address numerous concerns regarding the effectiveness of the use of 401(k) plans as primary retirement savings vehicles in the private pension system.

The proposed employer credit specifically targets the problem of low participation and contribution levels in 401(k) plans among low- and middle-income workers. The proposed credit advances pension policy in numerous ways. First, it is cost efficient, as the tax subsidy is linked to the benefits of low- and middle-income workers only—presumably the workers who are unable to save on their own. Second, the proposed credit is more effective, as it measures the eligible contributions on the bases of vested accrued benefits that are more likely to be received as retirement benefits by the targeted population than are non-vested benefits. Third, the proposed credit encourages broader participation and benefit distribution in 401(k) plans, which increases the overall fairness of the private retirement system. Additional incentives, such as these three proposals, will not provide retirement security for all workers, but will go a long way in ensuring that more workers actually benefit from their employer-sponsored plans.