"Broadly speaking, the short words are the best, and the old words when short are best of all."

— Winston Churchill,
Former British Prime Minister

J. Epilogue

Main Street, Wall Street, and both ends of Pennsylvania Avenue are all clamoring for tax simplification. Volcker and his tax reform advisory board would do the country a great service by forging bold and creative ideas for tax simplification. And Obama's political star would shine even brighter if he delivers on his commitment to tame the monster. But Will Rogers's maxim and the intervening K Street special interests likely will serve the death knell to legislative reform. Tax reform commissions can also provide wonderful political cover for a mission impossible.

So let's not bet the farm waiting for a legislative fix to tax simplification when the gold standard is 11 blocks down the street. Let's just ask the IRS to do what's right and honorable: Take the complicated mess Congress has created and, using tested, modern-day plain-language principles and techniques, tell us in simple, understandable words how to go about quickly and accurately reporting our fair share of the taxes we rightly owe. That's what PlainTaxTalk is all about — in plain language.

"If you can't say it simply, you probably don't understand it."

"Everything should be made as simple as possible — but no simpler."

— Albert Einstein,
Physicist

Beyond the Storm: New Reforms for 401(k) Plans

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The Financial Crisis and Retirement Saving

The cover page of a recent *Economist* magazine depicts a gaping black hole and the title, "Where have all your savings gone?" That question mirrors the sentiments of millions of Americans (and others around the world) who have seen their asset values nosedive as the stock market swiftly reclaimed six years of gains. The decline was particularly steep between October 2007 and March 2009 — the Dow Jones Industrial Average lost more than 50 percent of its value — and, over that period, the value of equity assets in workplace retirement funds fell by approximately $4 trillion.

Although the losses have been equally divided between defined benefit (DB) pension funds and 401(k)-type IRAs,[1] the immediate and direct impact has been felt mostly by persons with 401(k)-type plans and less so by those with DB plans. That is primarily because 401(k)-type plans are individual investment accounts and the funds in those accounts tend to be invested in equity markets, whereas DB pension plans offer a claim to benefits that are based on years of service and salary. Thus, losses in 401(k) account values have directly reduced workers' retirement funds while losses in DB pension funds have been absorbed mostly by firms, at least to date.[2]

To make matters worse, along with equity losses in 401(k) accounts, housing values have also dropped across the country. Nationally, the value of housing wealth fell

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[1]*See* Munnell, Aubry, and Muldoon (2008) for estimates of recent declines in the value of assets held in pension accounts.

[2]In the long run, workers with DB pensions may be affected by the market downturn because equity values affect the size of the pension fund from which payments are made. Federal regulations require firms to adequately fund pension accounts at all times; as a result, companies may have to contribute more to pension funds in periods of asset decline. For cash-strapped firms, the increased contributions could lead to higher employee layoffs and/or a reduction in employee pension benefits.

by 24.1 percent between October 2007 and January 2009.[3] Some employers, themselves affected by the downturn, are also cutting back on matching 401(k) contributions.

As a result, many workers are facing much lower resources with which to fund retirement than they had anticipated. Although younger workers could expect some recovery in 401(k) and home equity values over time, those who are near retirement (or already retired) do not have time to ride out the downturn. For those workers, the downturn may mean having to delay retirement or getting by with less.[4]

The crisis has thrown into sharp relief the higher investment risk faced by workers in 401(k) plans relative to workers with DB pensions. That, in turn, has raised questions about whether the movement away from DB plans to 401(k) accounts over the past 20 years has pushed too much risk onto the worker.

The shift in plan types has been dramatic: Between 1975 and 1998, the proportion of active participants in pension plans with a defined contribution (DC) plan as their primary pension rose from 13 percent to 56 percent.[5] That trend away from DB pensions to 401(k) plans appears likely to continue, particularly because the recent financial crisis has also placed considerable burden on cash-starved employers to fund their pension plans.[6]

Concern over excessive risks and the significant decline in 401(k) accounts has prompted calls to reform the private pension system by dismantling 401(k) plans and moving toward an alternative that shifts much of the risk to the federal government.[7] We argue, however, that this call for fundamental reform might be premature. In many ways, such as portability and faster vesting, 401(k) plans are more suited to today's workforce than DB plans. While there are aspects of the 401(k) system that expose workers to more risks than DB plans, reform initiatives under way — primarily changes to the default options in 401(k) plans — go a long way toward mitigating many of those risks. Although the current reforms do not solve all the problems associated with DC plans, such as exposure to uncertain and fluctuating investment returns and income, additional reform proposals might mitigate those and other drawbacks of a 401(k)-based system. Dismantling the 401(k) system without giving the existing and proposed reforms time to develop would be akin to throwing the baby out with the bathwater.

How Do 401(k) Plans Compare With DB Plans?

There has long been a debate over the relative benefits and risks of 401(k) and DB plans. On the positive side, 401(k)-type retirement plans offer greater portability because account balances remain with the worker even if he changes jobs. Section 401(k) plans also offer faster vesting of employer contributions and (generally) more rapid accrual of benefits than DB plans.[8] DB plans tend to accrue benefits at rates that are proportional to job tenure and earnings; thus, workers who switch jobs may lose pension benefits if they leave before they are vested and their benefits start over in a new job. The 401(k)-type plans are therefore better suited for an increasingly mobile workforce that tends to have shorter tenure with a firm.

Also, in 401(k) plans, individuals have full control over their assets and can tailor a saving and investment strategy that best fits their preferences. The advantage of this system is that workers reap the benefits of investment gains when times are good. However, when financial markets perform poorly — as we have observed in recent months — workers also bear the full burden of the loss. Sometimes, those losses can be devastating.

An increasingly apparent disadvantage of DC plans, such as 401(k)s, is that workers are responsible for managing their workplace retirement accounts. In a traditional 401(k) plan, workers who are offered 401(k) plans are not enrolled until they opt into the savings plan. Enrollment, however, involves multiple steps. Not only must workers elect to participate in a plan, they must also decide how much of their salary to contribute each pay period and how to invest their contributions. Those are complicated decisions, and many workers simply do not have the time or the inclination to make timely and prudent choices. Thus, under that system, those who are eligible do not always participate — because they postpone or avoid making complicated decisions — and those who do participate do not always make prudent choices.[9]

Even when they retire, participants must also choose the manner in which to take distributions from their 401(k) account. Many employers offer multiple distribution options, such as withdrawing the lump sum value of the account, withdrawing the assets in installments, or purchasing an annuity. But many retirees fail to appropriately value all their distribution options. They generally tend to elect the lump sum option, which is more

[3]Calculation derived from the S&P/Case-Shiller 20-City Composite Index. The S&P/Case-Shiller 10-City Composite Index fell by 24.7 percent over the same period.

[4]The losses in asset and equity values have generally affected all households and not just 401(k) participants. In a recent survey of older workers, 20 percent stopped contributing to a retirement account, 69 percent said they would spend less in retirement, and 65 percent said they planned to delay retirement and work longer because of the financial crisis (AARP, 2008).

[5]Employee Benefit Research Institute (2008).

[6]Employers offering DB plans to workers may cope with the downturn in asset values through a variety of channels, including laying off workers, freezing contributions to DB pension plans, and filing for bankruptcy.

[7]*See, e.g.*, a proposal to establish Guaranteed Retirement Accounts by Teresa Ghilarducci, *available at* http://www.sharedprosperity.org/bp204/bp204.pdf.

[8]Employer contributions to DC plans must vest as fast as 100 percent after three years, or ratably beginning at two years and reaching 100 percent after six years. DB plans vest either as fast as 100 percent after five years or ratably beginning at three years and reaching 100 percent after seven years.

[9]For instance, some workers tend to be too conservative in their investment choices — investing primarily in stable-value funds (such as money market funds) that pay low returns — while others make decisions that expose them to too much risk — such as overinvesting in their employer stock or failing to rebalance their portfolio as they approach retirement.

familiar and administratively less complicated than an annuity. However, taking the lump sum over the annuity option means retirees must manage their retirement assets rather than receive a guaranteed stream of lifetime payments. That choice potentially exposes them to fluctuating returns, unpredictable income, and the possibility of outliving their resources.

Low participation and poor investment choices are not issues for workers in DB plans. In those plans, workers do not have to make any decision about saving, and assets in the pension plan are professionally managed. Those features ensure that workers begin to accrue benefits as soon as they are eligible and that their assets are diversified and rebalanced over time. Further, when they retire, those workers generally receive payments as an annuity, which provides predictable income and protects them against outliving their resources should the retirees live longer than expected.[10]

In times of financial turmoil, the difference between DB and DC plans is particularly evident among workers near retirement and those who have recently retired. As a result of declines in 401(k) account values, workers nearing retirement may have to postpone retirement and continue working, or expect to get by with less than anticipated for retirement. Those with DB plans would likely face little change to their expected retirement timing and benefits. But retirees who opted for a lump sum distribution from their 401(k) accounts and chose to manage their assets have seen their retirement funds shrink markedly. Those retirees are therefore faring worse than those with DB plans, who generally would not expect to face a fall in their pension payments.

Existing Reforms That Increase 401(k) Savings

Recent reforms to 401(k) plans have already begun to address the above-mentioned shortcomings. Specifically, 401(k) plans are increasingly structured to incorporate the default features in DB pensions that would enable workers to save as soon as they are eligible and mitigate age-adjusted equity exposure. Those features (typically referred to as the automatic 401(k)) include automatically enrolling workers in the 401(k), automatically depositing a percentage of workers' paychecks into their accounts each pay period, and automatically investing assets in balanced and professionally managed accounts. Thus, workers do not have to actively make decisions regarding their 401(k) saving and immediately begin contributing toward their retirement. Workers still have the opportunity to opt out and make alternate saving and investment choices.

The main driver of the automatic 401(k) initiative is a growing recognition that individuals do not always make rational retirement saving decisions (that is, decisions expected by economists). When individuals are given too many choices or are confronted with complex and unfamiliar options — which is often the case in a traditional 401(k) plan — they tend to resort to heuristics or simple rules, or they simply postpone making a decision altogether. Neither heuristics nor avoidance generally results in prudent and sound retirement decisions. However, when saving in a 401(k) is the default option (that is, when it is status quo), saving becomes easier. Inertia, which previously inhibited saving, instead works in a pro-saving direction.

Automatic 401(k)s appear to be successful at increasing participation and saving rates: In plans that have implemented automatic enrollment, participation rates among newly eligible employees are significantly higher than in plans without automatic enrollment. For example, a recent study found that with automatic enrollment, participation rates among newly hired workers increased from 37 percent to 86 percent.[11] The increase was even more striking among minority, female, and lower-income workers. (See Figure 1.)

Automatic 401(k) plans do more than simply increase the number of workers who are saving, although that in itself is a positive step toward improving retirement security. Because workers are less likely to postpone enrollment, these plans also induce workers to save earlier than they otherwise would. Starting to save earlier has several benefits. First, workers are able to benefit from any employer 401(k) matching contributions, which help increase the value of retirement funds. Second, by saving earlier, workers take advantage of compounding returns over time. That either increases workers' stock of wealth later or reduces the amount they need to save each period for a comparable retirement goal. Third, because workers are saving incrementally over time, the cost of investing in assets at unfavorable times (when prices are high) is dampened by the lower cost at more favorable times (when prices are low). This dollar-cost averaging reduces the investment risk associated with fluctuating asset prices.

Automatic features in 401(k) plans also help to more equitably distribute the tax benefits associated with retirement saving. The Joint Committee on Taxation recently estimated that the tax benefit for retirement saving amounted to $161.6 billion in 2007.[12] Generally, much of that benefit is realized by high-income taxpayers because they are more likely to participate in their employer's 401(k) plans to take advantage of the tax benefit, and they receive a larger tax benefit for each dollar they contribute (based on the structure of the tax incentive) than low-income taxpayers. However, with automatic 401(k)s, more lower-income workers are participating in a 401(k) plan and, as a result, more lower-income workers are realizing the tax benefits associated with 401(k) saving.[13]

Although the tax-benefit for each dollar contributed to the 401(k) is still lower for low-income taxpayers than for

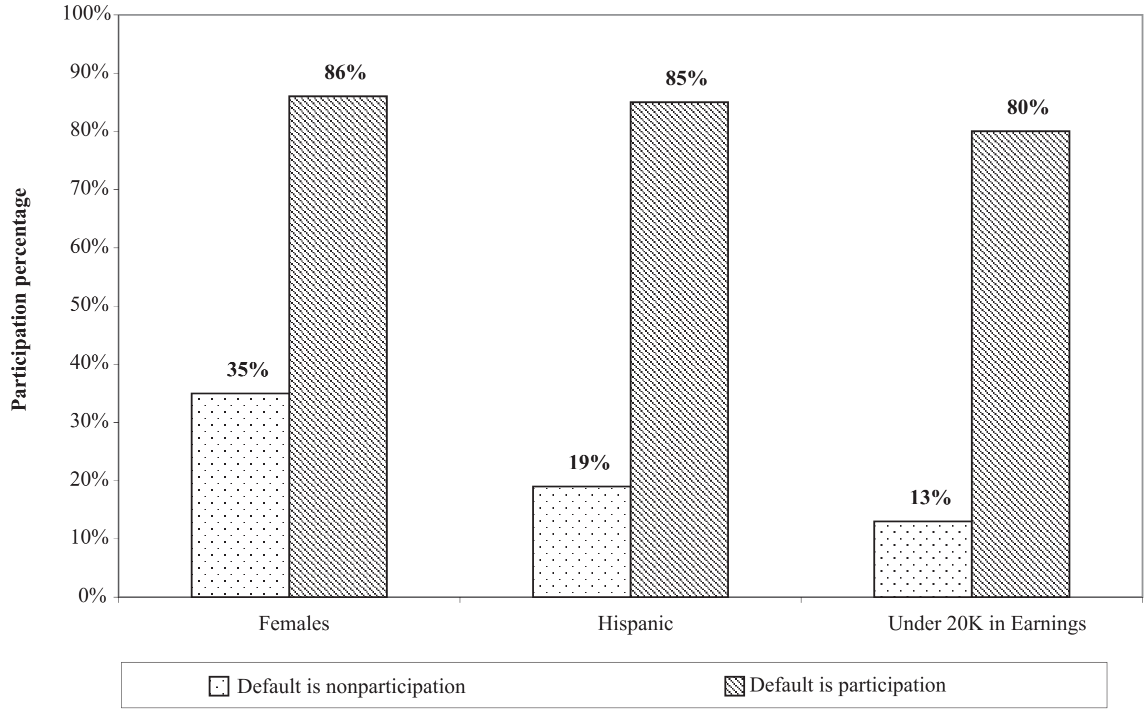
[10]In some DB plans, workers might have the option of taking retirement distributions in a form other than an annuity; however, if they choose not to make any decision, the default distribution option is an annuity.

[11]*See* Madrian and Shea (2001).

[12]Joint Committee on Taxation (2008).

[13]*See* Geissler and Harris (2008) for estimates of the distributional effect of automatic enrollment, and Burman et al. (2004) for estimates of the distributional benefits of existing retirement saving provisions.

Figure 1. Impact of Automatic 401(k) Enrollment
Percent of New Employees Participating in 401(k) Plan



Source: Madrian and Shea (2001). Participation rates of employees with between 3 and 15 months of tenure.

high-income taxpayers, 401(k) plans can work in conjunction with other saving incentives, such as the saver's credit, that target lower- and moderate-income taxpayers. Under the saver's credit, qualified low-income taxpayers who contribute to a 401(k) or IRA can receive a tax credit of up to 50 percent of their retirement saving contribution.[14] The combined incentives increase the total tax benefits to low-income families.

Automatic enrollment in 401(k)s has been in place only since 2001; however, nearly 36 percent of plans have already adopted the initiative.[15] The speed of adoption is due, in part, to the striking enrollment increases. Early adopters of automatic 401(k) enrollment would typically enroll only new workers at a default contribution rate of 3 percent.[16] However, some employers are extending automatic enrollment to nonparticipating employees to reach more workers, are setting a higher default contribution rate (above the typical rate of 3 percent), or are gradually escalating contribution rates over time to increase saving rates.

Also, new rules under the Pension Protection Act of 2006 provide greater incentives for employers to offer balanced, professionally managed funds (rather than a stable-value fund) as the default investment option. Employers are provided relief from fiduciary liability if they direct funds into qualified default investment accounts (QDIAs). Assets in those accounts are diversified, rebalanced over time, and professionally managed. Workers who are defaulted into QDIAs will often benefit from higher equity returns. More importantly, diversification tempers workers' exposure to fluctuating returns (particularly given recent financial volatility), and continuous rebalancing away from equities further reduces that exposure as workers approach retirement age.

Reforms to 401(k) plans are thus moving in a new direction. As more plans implement those automatic features, many of the challenges noted earlier and highlighted by the financial crisis would be lessened for

[14]Qualified taxpayers can receive a 10 percent, 20 percent, or 50 percent tax credit for contributions of up to $2,000. *See* Gale, Iwry, and Orszag (2005) for more details regarding the saver's credit.

[15]Adoption of automatic enrollment varies by plan size: About 50 percent of large plans (those with more than 1,000 participants) have implemented automatic enrollment, whereas only 11 percent of small plans (those with 1 to 49 participants) have automatic enrollment. *See* Profit Sharing/401k Council of America (2007) for more detail.

[16]Research has found that although automatic enrollment leads to increased participation rates, it can also lead to decreased average contribution rates. *See* Choi et al. (2004).

future workers: Automatic enrollment encourages workers to save earlier, automatic escalation induces workers to save more, and default investment in professionally managed and diversified funds improves the risk-return balance. At the same time, those automatic 401(k)s still offer participants greater flexibility to direct and control their own assets (if they so choose) than DB plans, as well as greater portability and faster vesting.

Despite their strengths, the automatic features do not completely mitigate all the risks inherent in a DC system. For instance, even if automatic 401(k)s had been in place for decades and most workers had accumulated sizable balances through automatic enrollment and investment, workers and retirees with diversified investment portfolios would not have been completely insulated from the downturn. The decline in the stock market has been so prolonged and, in some sectors, so precipitous that even well-diversified accounts are likely to have lost significant value (although losses for a well-diversified account are likely to have been less than for an account overinvested in equities).

Further, although the automatic 401(k) reform initiatives already in place increase retirement saving, they do not address the risks associated with the distribution phase of 401(k)s, including investment risk (the risk that investments will underperform expectations) and longevity risk (the risk that a retiree will outlive her resources). New reform proposals, however, offer a potential solution to these issues.

New Reforms That Mitigate Longevity Risk

In this economic environment, retirees who are receiving annuity payments through their DB plans or who purchased private annuity contracts before the downturn (when interest rates were more favorable) are better off financially than those who are managing and drawing down their stock of wealth. For those who purchased private annuity contracts, their payments were determined and locked in at the interest rate that prevailed when they purchased their contracts, and their periodic payments remain unchanged despite the current fall in interest rates. Further, those payments are guaranteed for as long as the annuitant lives.

Despite those advantages, only one in five 401(k) plans offers the option to annuitize retirement assets, and only 6 percent of participants choose to annuitize when given that option. New reform proposals thus seek to extend lifetime income benefits to more 401(k) plans and participants through increased use of lifetime income products.

Simply changing the default option in 401(k) plans to automatically annuitize retirement assets may likely be insufficient to engage higher annuitization rates. Participants have many reasons to choose the lump sum distribution option over an annuity (even when annuities appear to be more favorable).[17] One potential reason is that the distribution setup makes it easier to take distributions as a lump sum and more complicated to purchase an annuity.[18] Another reason, perhaps more important, is that participants are biased against annuities, which tends to undermine the value of annuity contracts. Those biases prevail even though the market has addressed many of the obstacles that previously inhibited the demand for annuities, such as inflexible product design (irrevocable contracts, for example) and limited options for annuity features (such as a lack of inflation or principal protection).[19]

Biases against lifetime income products may stem from insufficient or incorrect information about these products. Gale et al. (2008), have developed a proposal that would give retirees an opportunity to test-drive an annuity product for a limited period — a trial annuity plan — so they can experience the benefits of receiving predictable monthly income without the need to actively manage one's account. Under the proposal, a portion of the retiree's 401(k) balance (between one-third to one-half) would automatically be converted into monthly payments for two years (the retiree may opt out of the trial income option), after which the retiree could choose to either continue the monthly payments or take an alternate distribution option.

The remaining portion of retirees' 401(k) assets would still be available for medical and other expenses and could be invested according to retirees' preferences. Those investment returns would be balanced by the portion that is annuitized, which is not subject to interest rate and stock value fluctuations. Thus, retirees will be able to depend on a meaningful level of guaranteed monthly payments, regardless of the performance of the stock market. Further, that payment (together with payments from Social Security) would provide insurance against retirees outliving their resources.

Annuity contracts are not without risks, however.[20] Annuity payments are determined by the prevailing interest rate when the contract is purchased. When interest rates are high, annuities payments would be high, but when interest rates are low, payments would be low. That risk would be particularly salient during this period of low interest rates, for instance. Workers who are close to retirement and facing a choice of distribution options might be hard pressed to choose between low annuity payments and stock market and interest rate uncertainty.

A complementary proposal from Iwry and Turner (2009) attempts to mitigate that risk for future workers by allowing them to incrementally purchase annuity units over time. Some portion of the worker's 401(k) contribution (such as the employer's match, for instance) could be directed to automatically purchase annuity units each

[17]*See* Gale et al. (2008) and Mulvey and Purcell (2008) for more detailed discussion about the benefits of annuitization and explanations for the low annuitization rate.

[18]Buying an annuity in plans that do not offer the distribution option requires first taking the lump sum distribution (or rolling over assets into an IRA) and then buying the annuity through the individual market.

[19]Insurers offer several different options for preserving a portfolio's principal. Known as "principal protection," they include options that guarantee payments for a specified number of periods, death benefits, or survival benefits.

[20]Also, there is the risk that the annuity provider might fail.

pay period. Annuities are commonly purchased by individuals who have already reached retirement age: In 2003, for example, the median age of an annuity purchaser was 70.[21] However, as the proposal outlines, there are benefits to purchasing the annuity at a younger age. One benefit is that when annuity units are purchased incrementally over time, they are purchased at different interest rates. Thus, low rates would offset high interest rates (much like dollar-cost averaging), which would mitigate the above-mentioned risk.

Conclusion

For millions of American workers in or near retirement, the ongoing financial crisis has been devastating. Workers expecting to retire in the near term have revised their retirement plans because existing account balances now seem inadequate to support a life without labor income. Some recent retirees now feel the pressure to either return to work or to cut back more than is comfortable in retirement. Those circumstances have provoked calls for a fundamental reform of the nation's retirement saving structure, reversing decades of progress toward a DC system.

As explained in this article, the effects of existing reforms have yet to be fully realized and promising new proposals for annuitization offer additional risk-protection. Indeed, the recent financial turmoil may be an impetus for policymakers to address some of the long-lingering shortcomings of a DC system. Rather than dismantle the existing system, policymakers should build on existing reforms and make the automatic 401(k) more widely adopted to help workers start saving earlier, and to help those already in the system save more and make better investment decisions.

Automatic enrollment is not a cure-all, and innovative proposals are needed to mitigate the risk borne by retirees and workers near retirement. For those workers who already have significant retirement assets, new mechanisms for encouraging the purchase of annuity products can help protect retirees against the risk of falling asset prices and unexpected longevity. Retirees should be given the opportunity to test-drive annuity products to realize the benefits of receiving stable retirement income, and near-retirees should be provided the option of incrementally purchasing annuity units over time to help mitigate the risk associated with varying interest rates. Those reforms will go a long way toward helping Americans better prepare for retirement.

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