

Automatic IRAs: A Step in the Wrong Direction

This paper is about personal retirement savings, and one proposal to fortify the savings “leg” of the retirement income stool by making it simpler and less burdensome for workers to defer and incrementally invest a small portion of their income over time. It is important to acknowledge at the outset that increased personal savings, without more, will not solve the problem of retirement insecurity for the vast majority of workers in the United States. However, unlike Social Security and pension plans,¹ personal savings is a mechanism that individual workers can harness in the near-term to prepare for their retirement future, without relying on the government or employers to make prudent choices for them. This particular moment in history—mid-recession, with deficits soaring and foreclosures mounting—presents an especially compelling opportunity for Americans to get back into the habit of saving. In other words, although personal saving is not *the* solution to the retirement income problem, it is still a necessary piece of the puzzle, and well worth discussing in today’s rather ominous economic climate.

The decline of personal savings in this country is a well-known phenomenon. The savings rate shrank from a high of about 11% in 1982 to less than zero in 2005.² In the 2010 Retirement Confidence Survey, 27% of workers surveyed reported having no significant savings (less than \$1000), compared to 20% in the previous year.³ Less than half (46%) said that they or their spouse had tried to calculate how much money they would need to accumulate before retirement in order to live comfortably as retirees.⁴ This dearth of saving and planning ahead is especially troubling in view of the decreasing generosity of pension plans overall. Defined contribution (DC) plans, particularly 401(k)s, are steadily taking the place of defined benefit (DB) plans in the private sector, and it now seems clear that the traditional company-sponsored pension has forever lost its place as the predominant private sector retirement plan. The shift has

only increased the likelihood of retirement insecurity for many Americans. It is projected that between 44% and 47% of Baby Boomers and Gen Xers are at risk of not having adequate income to cover basic expenses like housing, food and health care during retirement.⁵ The Employee Benefit Research Institute (EBRI) estimates that 41% of Baby Boomers in the lowest quartile of earners will run out of money within *ten years* of retirement.⁶ In the absence of a full-blown overhaul of the retirement system, individuals will simply have to start setting aside a greater portion of their earnings for consumption in retirement.

David C. John of the Heritage Foundation and J. Mark Iwry⁷ of the Brookings Institution propose a solution in the form of automatic Individual Retirement Accounts (IRAs).⁸ The idea is simple: because so many people are incapable of *choosing* to save, skip the “choosing” step altogether by compelling employers to defer part of their salary into retirement accounts on their behalf, with no action required on the employees’ part. In its most recent legislative manifestation, the Automatic IRA Act of 2010 (S. 3760 and H.R. 6099), this scheme would require all employers with ten or more employees who do not currently sponsor a qualified retirement plan⁹ to establish an IRA for each non-covered employee, and to transfer a percentage of the employee’s pay into the account *automatically*. It is hoped that automatic enrollment in IRAs will replicate the recent gains in pension coverage that have occurred as a result of increasing automatic enrollment in 401(k) plans.

Under the new law, all automatic IRAs (auto-IRAs) will offer three standardized investment choices, consisting of principal preservation, life-cycle or blended investment, and a more equities-driven “alternative” investment option. If the employee takes no action, 3% of her pay is automatically deposited into a Roth IRA in the principal preservation fund; when her balance reaches \$5,000, it is transferred to the life-cycle fund. The employee may opt out at any

time. Crucially, the employer may not provide a match and is not a fiduciary under the Employee Retirement Income Security Act of 1974 (ERISA); it is merely a conduit for the funds. Iwry and John contend that this scheme will provide at least some of the benefits of tax-deferred, institutional investing afforded those with qualified retirement plans, without deterring employers from sponsoring such plans. Indeed, they argue that employers will be *more* inclined to sponsor retirement plans as they come into greater contact with investment firms and consider the advantages of qualified plans over IRAs, such as higher contribution limits and greater tax savings.

This paper proceeds in three stages. First, it provides a description of the current IRA universe and the proposed changes contained in the Automatic IRA Act of 2010. Second, it assesses the likelihood that the auto-IRA scheme will accomplish the immediate objectives that its advocates seek to achieve: expanded participation in retirement savings, maximized retirement accumulations, and an increase in the number of employers offering qualified pension plans. Finally, it considers whether auto-IRAs are realistically capable of achieving the ultimate goal stated by John and Iwry, namely, “universal retirement security,” and concludes that more radical reforms are needed.

Background on IRAs

The Individual Retirement Account was established under ERISA to achieve two basic objectives: first, to provide a tax-deferred investment vehicle to individuals lacking access to employer-sponsored plans, and second, to enable retirees and workers changing jobs to roll over assets from employer-sponsored plans into tax-deferred individual savings accounts.¹⁰ Today there are several flavors of IRAs. For individuals, traditional IRAs provide tax-deferred savings,

Roth IRAs offer tax-free distributions, and payroll-deduction IRAs allow employees to save through voluntary, automatic deductions from their pay.¹¹ Although payroll-deduction allows an employer to funnel a portion of the employee's paycheck into an IRA (either Roth or traditional) on the employee's behalf, the employer is not subject to the fiduciary requirements in Title I of ERISA so long as it comports with Department of Labor guidelines.¹² However, the Government Accountability Office (GAO) reports that "some employers are hesitant to offer a payroll-deduction IRAs to employees for fear of being subject to ERISA requirements."¹³ IRAs geared towards individuals have a low contribution limit of \$5,000, and employer contributions are not permitted.¹⁴

Employers may also *sponsor* IRA savings in a manner that imposes limited fiduciary duties under ERISA Title I;¹⁵ these plans provide higher overall contribution limits than their unsponsored counterparts. The Simplified Employee Pension (SEP) IRA allows the highest contribution (up to 25% of the employee's pay, not to exceed \$49,000), but it does *not* permit employee contributions.¹⁶ The Savings Incentive Match Plans for Employees (SIMPLE) IRA, by contrast, allows employee contributions of up to \$11,500, and also enables the employer to match contributions up to certain limits.¹⁷ The SIMPLE IRA is only available to employers with 100 or fewer employees. Both the SEP and SIMPLE IRAs were designed to incent small employers to sponsor retirement plans without being subject to the annual financial reporting requirements that accompany regular pension plans under ERISA. Unfortunately, it appears that cost and lack of information have discouraged adoption. The precise number of small businesses offering these plans is unknown, but the Bureau of Labor Statistics reported that in 2005, only 8% of workers in small (<100) firms had SIMPLE IRAs, and only 2% participated in an SEP IRA.¹⁸

IRAs are underutilized by individuals, as well. The Congressional Budget Office estimated that just 7% of all workers contributed to a Roth or traditional IRA in 2003.¹⁹ While IRAs hold more assets than traditional defined contribution and defined benefit plans, the majority of all IRA assets come from rollovers from other types of accounts.²⁰ In other words, IRAs more often serve as asset-preservation vehicles than as independent saving mechanisms. Of employees who lack access to employer-sponsored retirement plans—that is, the very employees whom Congress had in mind when it created these accounts—only one in ten makes annual contributions to an IRA.²¹ Lower income taxpayers are more likely to save in an employment-based plan than make individual contributions to an IRA.²² John and Iwry point to several obstacles that contribute to the underutilization, aside from the natural tendency to use wealth now rather than consume it later, i.e., “hyperbolic discounting.” Individuals face a myriad of decisions when it comes to opening up their own retirement account: whether to participate, with which financial institution to invest, whether a traditional or a Roth IRA is appropriate, how much to invest, and in which funds to invest. These choices create complexity, which deters individuals from establishing IRAs on their own behalf. Automatic IRAs promise to reduce or remove each of these hurdles.

A Closer Look at Auto-IRAs

The Automatic IRA Act of 2010²³ would amend the Internal Revenue Code to establish a “right to automatic IRA arrangements at work” for employees not otherwise covered by a qualified retirement plan.²⁴ It is designed to be a “set it and forget it,” low-cost, diversified investment vehicle into which employees make periodic contributions unless they affirmatively opt out of the scheme.²⁵ Employers that have ten or more employees²⁶ earning at least \$5,000

annually are required to establish these accounts, or else become subject to an excise tax of \$100 for each employee not covered. Employers that already offer a qualified retirement plan are exempted from the requirement; there are also exemptions for employers not in existence for two years, as well as church and governmental employers. Workers who are already covered by a collective bargaining agreement, under the age of 18, or who have been with the employer for less than three months, are excluded.²⁷ Moreover, those workers who are not enrolled in the employer's qualified plan solely because they do not meet the minimum age and service requirements for enrollment also are not entitled to have an auto-IRA.²⁸

Under this scheme, the employer may choose the investment firm, and the employee may choose which type of account to invest in and where to invest; however, the law provides for defaults when no choice is made at either end. Employers select an investment firm from a list of providers made available by the Labor or Treasury Secretary on a central website, which also contains forms, model notices for employers, and investment guidelines.²⁹ The Senate bill authorizes the Secretary to establish standards with which investment firms must comply before they can be included in the online list of providers.³⁰ If the employer does not wish to choose an IRA provider, then under the Senate bill a service provider is randomly assigned from a pool of firms pre-approved by the Treasury Department.³¹ The employer may also opt to send employee contributions directly to Treasury along with its regular payroll tax deposits, in order to ease administrative burdens; such deposits are then used to purchase retirement bonds, or "R-Bonds," created specifically for auto-IRA investing.³² Finally, the employer can leave the choice of service provider up to the employee.³³ The employer may periodically move around employees' balances into other retirement plans or R-Bonds, as long as the employer provides a standard written notice to employee.³⁴

Whichever provider is chosen, the default contribution is 3% of the employee's salary, or an amount set by the Secretary of Treasury between 2% and 6%.³⁵ The employee may adjust the contribution amount at any time. Through Treasury regulations, periodic increases could begin to occur after two consecutive years of enrollment, with increases occurring annually.³⁶ The automatic escalation feature serves as a safeguard against locking in contributions at an anemic rate; the House bill directs the Secretary to consider specifically "the potential effects on lower-income employees as well as on adequacy of savings" when establishing regulations for the initial contribution level and auto-escalation.³⁷

The Obama administration has indicated that employees who fail to choose between a Roth and a traditional IRA will receive a Roth IRA by default.³⁸ Employees may invest in *only* one of the following three standardized options:

- 1) Principal Preservation Fund: passbook-style savings accounts, certificates of deposit, insurance contracts, US savings bonds including R-Bonds, and similar assets.
- 2) Life-Cycle or Blended Investment Option: broadly diversified class of assets or fund similar to target date, life-cycle, balanced or similar funds (in the House bill, this includes any qualified default investment alternative as defined by Department of Labor Regulations in 29 CFR 2550.404c-5(e)(4)(i)).
- 3) Alternative or "Balanced" Option: including a higher concentration of equities than the life-cycle option (the House bill simply refers to DOL Reg. 2550.404c-5(e)(4)(ii)).³⁹

Under the Senate bill, if the employee makes no election as to which fund to use, contributions are initially placed in the principal preservation fund until the account balance reaches \$5,000.⁴⁰

At that point, the entire balance is transferred by default into a life-cycle fund, and all future contributions are made into that fund unless the employee specifies otherwise. The placement of

assets in the target date or life-cycle fund also occurs automatically if the employer has forwarded contributions to Treasury for the purchase of R-bonds; once it reaches a value of \$5,000, the bond is redeemed and the proceeds are periodically forwarded to the employee's IRA.⁴¹ By contrast, the House bill relies on individual workers to transfer the money from the R-Bond into a private IRA, while "encouraging and assisting" workers to make the transfer.⁴² The Senate bill requires providers to report all fees and expenses in accordance with new regulations; they are then be made available to the public on the central website "in such a manner that employers and employees will be able to easily compare fees of all providers under the various investment options."⁴³ In both versions of the law, providers are prohibited from imposing fees "solely on the basis that the balance in an automatic IRA is small."⁴⁴

The Act directs Treasury and Labor jointly to establish an Automatic IRA Advisory Group, whose purpose is "to make recommendations regarding the automatic IRA investment options" to be offered by providers, including disclosure of fees and establishment of low-cost investment options.⁴⁵ Advisors will draw on the staffs of both Treasury and Labor and use the resources of both Departments. Within one year of its formation the Group must issue a report containing its recommendations.

The auto-IRA is meant to be a convenient savings mechanism for individuals whose employers do not already offer them a pension plan, but it is not treated as a qualified plan, nor should it be considered a substitute. The law makes clear that employers who establish auto-IRAs do not have any fiduciary liability under Title I of ERISA.⁴⁶ In addition, employers who offer auto-IRAs have very limited duties in general. The Senate version of the law, which seems to impose more duties than the House bill, requires only that employers (1) remit employee contributions within one month of each payday, (2) not engage in self-dealing, and (3) provide

employees with a standardized form explaining the program and investments options.⁴⁷ In order to be shielded from ERISA liability, the Senate bill also requires the employer to select a provider from the list of Treasury-approved investment firms on the central website.⁴⁸ The employer fulfills the requirements of the statute as long as it asks employees to make a “yes” or “no” election and advises them of their right to an IRA, and establishes an IRA for employees who make no election.⁴⁹ The individual worker retains responsibility for monitoring the tax consequences of her IRA contribution; the automatic deferral of income into the IRA “shall be taken into account in applying limitations on contributions . . . as if the contribution or purchase had been made directly by the employee.”⁵⁰ To be absolutely clear, Congress specified that employers have “no responsibility” for ensuring that contributions do not exceed the deductible limit in any given calendar year, although they *may* limit employee contributions to prevent overages.⁵¹

In order to reduce the cost of implementation for small employers, companies with 100 or fewer employees are eligible to receive a temporary “startup” tax credit.⁵² The credit is modest: \$25 per employee for whom contributions are made, with a maximum total credit of \$250. The credit is only available in the first two years of the auto-IRA arrangement. At the same time, the law encourages small businesses to offer qualified retirement plans by doubling the maximum credit for first-time sponsors.⁵³ This credit is comparatively generous: 50% of the cost of establishing and administering the plan, including education costs, up to a new maximum of \$1,000 during the first *three* years that the plan is offered.⁵⁴ In addition, the Act directs Treasury and Labor to develop final guidelines for the use of multiple employer plans, and to develop a model plan document that satisfies all tax and ERISA requirements.⁵⁵ The architects of the law

expect that these incentives will prevent auto-IRAs from eroding support for qualified plans, and instead promote their expansion.

In addition to the reforms actually in the bill, the Automatic IRA Act calls on Treasury and Labor to undertake a joint study of how best to implement two other provisions: spousal consent requirements and annuities.⁵⁶ The bill proposes modeling spousal rights on the Thrift Savings Plan, the DC plan offered to federal employees, and asks that studies determine whether similar requirements would be appropriate in the auto-IRA context. So, for instance, future auto-IRAs could require spousal consent before permitting participants to make pre-retirement withdrawals. With respect to annuities, the bill calls for the study to consider “the appropriate means of arranging for, or encouraging, individuals to receive at least a portion of their distributions in some form of low-cost guaranteed lifetime income.”⁵⁷

The Argument for Auto-IRAs

Iwry and John envision using the auto-IRA as a means for employees to “access the power of direct-deposit saving”:

In much the same way that millions of employees have their pay directly deposited to their account at a bank or other financial institution, and millions more elect to contribute to 401(k) plans by payroll deduction, employees would have the choice to have their employer to send an amount they select directly from their paychecks to an IRA.⁵⁸

They basically argue that making saving logistically simpler for both the employer and the employee will help reverse the current trend of under-saving. The key evil that Iwry and John seek to wipe out seems to be the tendency of workers with no access to retirement plans to fail even to consider saving for retirement. Thus their proposal for the auto-IRA includes the feature giving employers the option to have all employees make an explicit choice, rather than

automatically enroll them and allow for opt-outs. “In all events, while no employee would be required to participate, no employee could be left out simply because of inattention.”⁵⁹ The bulk of their proposal focuses on the easy, automatic nature of the investment, and “the power of inertia to increase saving in sensible default investments.”⁶⁰ They contend that having a “limited investment menu” will help contain costs, as will the use of electronic fund transfers and record-keeping.⁶¹ The Senate version enshrines the priority of cost-containment by calling on the Secretaries of Labor and Treasury to write regulations requiring that the three standard investment funds “be based on low-cost investment options, which may include index funds, and provide that such investment options avoid undue complexity.”⁶² Lower costs with diversified investing, they argue, will help maximize accumulations.

John and Iwry also contend that their proposal will encourage small businesses to begin to offer qualified retirement plans. This objective clearly informs the proposed legislation, as well, given its expansion of the startup credit for employers who offer qualified plans. John and Iwry attribute the current failure of many small employers to offer such plans to the fact that many of them “mistakenly perceive plan sponsorship as a complex and costly undertaking,” despite the fact that 401(k) plans and SIMPLE IRAs are available at a low cost, often online.⁶³ Once employers are introduced to the auto-IRA concept, however, they will begin to see that deferring part of employees’ salaries into retirement plans is feasible. Further, “many small business owners will ask how they or a key manager can save more for themselves than only \$5,000 a year Some will be interested in exploring how they could make a very modest matching contribution for their employees, at least in years when business has been good.”⁶⁴ These benefits, they contend, will lead more small employers to establish qualified plans.

Expanding Participation in Retirement Savings

Backers of the auto-IRA state that the proposal will target the roughly 78 million workers who lack access to employer-sponsored retirement plans. The number is misleading, because the law does not reach a significant portion of such workers. The AARP notes that 15% of the workforce is employed by businesses with fewer than ten employees, who would be unaffected by the law.⁶⁵ It is also worth remembering that many millions of workers either fail or *would* fail to meet the requirements for participation in a qualified plan, for instance because they work fewer than 1,000 days per year or are under the minimum age; the Act does not extend to these individuals. EBRI found that when the population is narrowed to full-year employees aged 21 to 64, earning \$5000 or more and working for an employer with ten or more employees, the number who did not have access to a retirement plan in 2008 was 29.5 million.⁶⁶ Thus, the number of employees who could realistically expect to be covered by an auto-IRA would probably be closer to 30 million than 78 million. EBRI further determined that of those employees without access to a plan, 27 % had annual earnings of less than \$10,000, and 57% worked for employers with fewer than 100 employees.⁶⁷ The data highlight the “structural reasons” that explain why so many Americans lack employment-based retirement benefits: “They don’t work full time, they work at small firms, [and] they are very low-income.”⁶⁸ The question, then, is how successful auto-IRAs will be in encouraging low-income and part-time employees to participate—particularly those employed by small businesses.

Intuitively, it makes sense that auto-IRAs will expand coverage, since they will remove some of the decisional problems that prevent workers from opening IRAs for themselves. First, the employee must at least consider whether to participate. Even if the employer escapes the automatic enrollment requirement by simply asking employees to make a “yes” or “no” choice,⁶⁹

the possibility of saving is more likely to be actively considered. Deciding with whom to invest is no longer a hurdle, since the employer picks the investment firm, or else contributions are made to a randomly-assigned provider or the Treasury Department. The additional three questions that savers must answer—which type of account to use, how much to invest, and in which funds to invest—are similarly resolved by the provision of defaults. If the employee does not specify otherwise, a Roth IRA will be established, and 3% of her income will be directed into principal preservation or blended funds, depending on the size of her account balance (or else into R-bonds, if her employer so chooses). She does not even have to affirmatively decide to increase investments over time: this will occur automatically in accordance with Treasury regulations that provide for periodic boosts in her savings rate. Undoubtedly many workers with IRAs will continue grappling with investment questions, but the Automatic IRA Act will help ensure that the questions themselves do not deter investment to the degree that they do now.

The provision in the Act allowing employers to fulfill their obligation simply by giving employees the opportunity to affirmatively decide whether or not to participate should not be overlooked. Although this provision still requires employers to enroll employees who make no election, there will still be many employees who vote “no” because of all the decisional obstacles previously discussed, in addition to financial constraints. This reduces the power of the automatic enrollment feature to capture individuals who would not otherwise participate. It also ignores an important part of the rationale for passing this law: its framers seek to replicate the recent expansion of plan participation resulting from the increasing popularity of auto-enrollment in 401(k)s since the passage of the Pension Protection Act of 2006 (PPA). The PPA encouraged automatic enrollment by limiting employers’ liability under ERISA for enacting such schemes, requiring employees to “opt out” of enrollment by default instead of giving them an affirmative

choice to “opt in.” As a result, more workers actually enrolled in the plans offered to them; in one study, the “opt out” approach increased enrollment from 37% to 86%.⁷⁰ Increased enrollment led to an expansion in pension coverage and an overall increase in retirement security. Between 2003 and 2010, the percentage of Baby Boomers considered “at risk” of having insufficient savings during retirement declined by 11 to 12 percentage points; EBRI researchers attribute this improvement largely to the increase in participation rates among low income employees captured through automatic enrollment.⁷¹ (Low income employees are more likely to be at risk of not having enough money saved for retirement, so increasing their participation rates tends to produce a significant impact.)

Simply giving employees a choice of whether or not to enroll in an IRA is akin to the old “opt in” approach to 401(k) enrollment, and it is demonstrably much less effective than enrolling employees automatically. Thus the “affirmative election” provision in the Act is one of its key flaws, and is likely to curtail severely the law’s potential for expanding coverage. This failing is especially serious in light of evidence that low-income workers are not very likely to participate in a retirement plan when given a choice. For instance, the Center for Retirement Research (CRR) estimates that only 60% of low-income workers who are offered voluntary 401(k) plans actually enroll.⁷² This opt-in rate is much lower than the overall rate of about 80% for workers at all income levels.⁷³

The CRR recently published a brief estimating how many workers *would* participate in an employment-based retirement plan if it were extended to those who currently *lack* coverage—basically, those targeted by the auto-IRA proposal. The researchers hypothesized that the take-up rate would be lower for these workers, partly because many of those who already have access to 401(k)s deliberately sought out jobs that offered such plans (that is, they “self-selected”),

while many non-covered employees did not give much weight to pension coverage in their job search.⁷⁴ The researchers reviewed data from the Survey of Income and Program Participation (SIPP) for 1996, 2001, and 2004 in order to discover variables that favor 401(k) participation, and to predict the rate at which newly covered workers would elect to participate in a scheme such as auto-IRAs. The data showed that factors tending to increase participation in a 401(k)-style plan included being older, married, well-educated, employed by the same firm for a longer time, and employed by a firm that provides a match. Consistent with numerous other studies, high income and high net worth were positively correlated with participation.

Unlike other studies, here the researchers took the further step of controlling for the self-selection problem, estimating the probability that participation would occur while discounting the impact of individuals who would go “above and beyond” to find a job offering pension coverage.⁷⁵ The study predicted that the overall participation rate among newly-covered employees would be 58%, or about 20% less than take-up rate among those who already have access to an employment-based plan. Lower-income workers were projected to be even less likely to enroll; controlling for self-selection, the study predicted that just 34% of workers in the lower tercile would participate.⁷⁶ The study concluded: “[O]n the surface at least, it seems that expanding the opportunity to participate in a retirement savings plan through an Auto-IRA could be a very effective strategy. Our analysis, however, shows that this picture may be too optimistic.”⁷⁷ However, the researchers were careful to note that they did not factor in the effect of automatic enrollment, so that the 34% figure probably represents the “lower bound of the potential increase in participation” among lower earners.⁷⁸

Combining the CRR’s overall projected participation rate (58%) with EBRI’s estimate of the number of workers who would be covered under the Automatic IRA Act (approximately 30

million), the total number of employees who can be expected to enroll once the law is fully implemented would be around 17.5 million.⁷⁹ This estimate may be too high because it does not account for the lower participation rate of low-income workers, or too low because it only considers full-year workers (assuming that some seasonal workers would qualify for an auto-IRA arrangement). Give or take a few million workers, though, the number still represents only a fraction of the 78 million workers currently lacking a pension plan. Those who work in the smallest firms, those who remain deterred by complexity, and those who simply cannot afford to defer a portion of their income will remain without a work-based retirement fund. The evidence suggests that more workers would participate if the auto-IRA arrangement were mandatory for employees; to a lesser extent, modifying the proposed bills so that there were no “opt-in” alternative for employers would also increase participation, by making the IRAs truly automatic. In sum, the Act as proposed promises to expand coverage significantly, but the effect will not be as dramatic as its proponents suggest. Many if not most workers who currently lack pension access will remain outside of the private employment-based retirement system.

Maximizing Accruals

Besides expanding coverage, auto-IRAs are designed to maximize the growth of retirement savings of low-income workers, through low-cost investing, use of the Roth IRA, and automatic escalation of contributions. Each of these factors will be considered below. First, I must briefly explain why the Senate version of the Act must be adopted if growth-maximization is the goal.

Unlike the House bill, the Senate bill heavily favors default contributions to private, diversified investment vehicles; when both the employer and the employee fail to make

elections, the employee automatically invests in a “blended” fund with a randomly selected, pre-approved provider. In addition, even if the employer chooses to invest an employee’s contributions in R-Bonds, once his account balances reach the \$5,000 threshold, it is automatically transferred to a blended fund unless the employee makes an election to keep the money in R-Bonds. By contrast, the House version provides that when the employer fails to open IRAs with a private firm, the default action is for contributions to be made to Treasury for the purchase of R-bonds.⁸⁰ Then, instead of automatically rolling the account balance into an IRA once it has reached the threshold, Treasury merely *notifies* the employee of the rollover option.

The House-designed auto-IRA would exacerbate one of the key problems that the PPA was designed to eliminate, which is the tendency of employers to use default funds that emphasize preservation over performance, robbing employees of much-needed asset growth.⁸¹ Because workers placed in default investment options generally leave those assets where they are, this initial choice by the employer often locks in workers to slow or no growth.⁸² The PPA sought to compensate for these natural tendencies by encouraging employers to invest in default diversified funds that met guidelines set by the Department of Labor. Incidentally, these “qualified default investment alternatives” now serve as the model for the standardized investment options in both versions of the Act. But the House bill would rely on the employer and employee to *opt* for those investments, which perpetuates the pattern of inaction previously discussed. Just as relying on employees to open a retirement account through the “opt in” approach depresses enrollment, relying on them to choose their investments hurts asset growth. The Senate bill is superior because it builds on the progress already made by the PPA in encouraging smart investment behavior *by default*. If the employee does nothing, her money is

invested for long-term growth. She still has the option of making more conservative choices, but she will not be subjected to lower returns simply because she failed to elect otherwise. The Senate version of the Act stays truer to the objective of getting more workers to invest wisely. Thus, it is the better bill in terms of maximizing accruals.

Fees

One of the downsides of individual IRAs in comparison with DC plans like 401(k) arrangements is their higher susceptibility to fee losses. To a certain extent, all investment plans suffer from this pitfall; service providers charge all sorts of administrative fees to cover the costs of record-keeping, communication to educate participants, audits, legal activities, and individual transactions such as distributions. Individual IRA owners are further subject to the higher costs of retail investing, because they cannot take advantage of the volume discounts of institutional investors and lack group bargaining power. Individuals cannot, for instance, issue a request for proposal to providers in order to achieve lower fees. “[R]etail mutual funds are available to investors with relatively low assets and usually have higher fees, whereas institutional mutual funds under the same service provider often have lower fees because investors with large pools of assets can obtain pricing advantages.”⁸³

These disadvantages are significant, as even small increases in the fee-to-asset ratio can lead to major reductions in accumulations over time. The Department of Labor projected that adding just one percentage point to fees (1.5% as compared with 0.5%) produced dramatically different returns; a worker who starts with 401(k) account balance of \$25,000 and averages a 7% investment return over a period of 35 years will end up with \$227,000 assuming she is charged the lower fee, compared to \$163,000 if she is charged the higher fee.⁸⁴ In other words, the one-percent difference in fees and expenses would reduce the account balance at retirement by 28%.

Similarly, GAO calculated that for a retirement account starting with a \$20,000 balance, a fee increase from 0.5% to 1.5% would yield a loss of over \$10,000 in total asset accumulation after twenty years.⁸⁵

The GAO findings were the result of a study on the impact of fees on retirement income. This study found that participants in 403(b) plans⁸⁶ and individual IRAs were more likely to invest in retail products that charge more than other investments, in contrast to the lower-cost investing of other DC plans. GAO observed that the disparity was partly due to the fact that sponsors of 403(b) plans “keep sponsor involvement to a minimum, which limits the opportunities to pool assets and decrease fees.”⁸⁷ This hands-off approach is possible because the Department of Labor defined a “safe harbor” provision for 403(b) plans sponsored by tax-exempt organizations, so that employers that follow the guidelines are not considered subject to Title I of ERISA.⁸⁸ Such employers *must* restrict their involvement in the plan or else risk becoming subject to Title I obligations.⁸⁹ Thus 403(b) plans suffer from the same problems as individual IRAs that stem from a lack of effective sponsorship.

The Act takes several important steps to address the problem of fees in auto-IRA arrangements. It requires service providers to disclose their fees on a central Treasury website, for easy comparison. It also requires that before service providers can be listed on the website, they must meet certain specifications set forth by the Treasury Secretary, which presumably would include maximum allowable fees. The Act explicitly forbids charging fees on the basis of low account balances, and the Senate version calls on the Secretaries of Labor and Treasury to issue regulations favoring simple, low-cost investments.⁹⁰ Finally, the Treasury Secretary must use a competitive bidding process to determine which providers are eligible for random

assignment to investors, considering in particular “the value such options offer to participants (taking into account the relative fees).”⁹¹

Despite these steps, there remains significant potential for workers with auto-IRAs to see their retirement savings erode over time as a result of fees. First, the Act does not provide a mechanism for workers to pool their retirement savings in order to achieve economies of scale. The small employers who are so important to the auto-IRA scheme simply do not have the same bargaining power that their larger counterparts have. Second, the Act does not explicitly restrict the number of transactions that employees may make, the number of statements they can receive during the year, or any other type of service that may lead to higher costs for the provider (and the participant). There is nothing in the Act itself to prevent service providers from retaining such features. However, the Senate bill gives Labor and Treasury the power to establish regulations for cost-containment, and the Treasury Secretary sets the terms for service providers to gain access to the website from which employers select. With the help of regulations, then, auto-IRAs may achieve the efficient, “no frills” design that their creators envisioned. The degree of cost-containment will depend on the specific regulations.

Third, GAO’s exploration of why 403(b) plans are so expensive relative to 401(k)s foreshadows similar problems for auto-IRAs. 403(b) plans are costly because the employer is not a fiduciary and has no incentive to select a low-cost provider for employees. If anything, the employer may shy away from doing any sort of due diligence for fear of accidentally transforming itself into a fiduciary under ERISA § 3(21)(A). Unfortunately, the lack of fiduciary responsibility is a characteristic that the 403(b) plan and the auto-IRA have in common. Employers offering either type of plan cannot be relied on to seek out the best deal for workers. Thus it will be up to individual employees to research fees and determine whether they should

keep the provider selected by their employer or by the Treasury Department. It is inevitable that some if not most workers, taking advantage of the automatic nature of their investments, will take no action to change their provider even if there are lower-cost options available.

There is reason to hope that employees who are randomly assigned to a provider will end up investing at a relatively low cost, given the competitive bidding process that those service providers must survive. It also seems correct that the standardization of investment options will help to keep retail costs down, even in the absence of pooling. However, it is important to remember that a reasonably-priced investment at the retail level may still be considered high-cost relative to institutional investors like large DC plans. This is one of the important ways in which auto-IRAs offered through small employers simply cannot replicate the cost-containment of traditional DC plans offered by larger employers. They fare even worse compared to ultra-efficient DB plans.⁹²

Another expense that auto-IRA investors must worry about is not precisely a “fee,” but rather the excise taxes imposed on excess contributions into their IRAs. Employees remain responsible for making sure their IRA contributions do not exceed the maximum allowable limit in any year, i.e., \$5000 in 2010. This is a puzzling, if necessary, feature of the auto-IRA scheme. On one hand, Congress wants to minimize the burdens on small businesses as a result of the Act, and one way to do this is to make the employee *solely* responsible for keeping track of the tax consequences of his investments. On the other hand, if the idea is for auto-IRAs to be “set it and forget it” investment vehicles that accumulate savings for workers whether or not they are paying any attention, it seems a bit counterproductive to leave the monitoring of those investments in the hands of oblivious employees. Even if the employee is aware of the \$5,000 contribution limit, he may fail to take account of his salary from a second employer that also makes contributions

into another account. More likely, an employee may not consider that he is disqualified from making IRA contributions because his spouse is covered by a qualified plan at her job, and their income exceeds the phase-out dollar limitations.⁹³ Excess contributions may lead to painful tax penalties upon discovery by the individual or the IRS.

Finally, another quasi-fee is the cost that small employers pass onto workers in the form of reduced pay. Besides diverting part of their salary into IRAs, it seems likely that many employers will draw on their workers' pay in order to cover the administrative costs of setting up auto-IRAs.⁹⁴ The AARP found that "employer costs for Automatic IRAs could be significant."⁹⁵ Many of the small employers that are targeted by the law will not be using automated payroll already, and will expend significant resources putting such systems in place. All employers will have to spend some money when choosing a provider, establishing accounts, and determining which employees are eligible. The temporary credit will help to cover startup costs for some employers, but it will not always be sufficient. 49% of employers will not currently benefit from the credit because they do not report net income and pay no taxes; many more will not benefit because they do not have 100 or fewer employees.⁹⁶ Thus, some employers will pass the cost of implementing and running the auto-IRA scheme onto their employees, giving rise to another implicit fee.

The Roth IRA as the Default Account Type

Iwry and John point to several reasons why the Roth IRA is the better default account type. They point out that it "may be more beneficial for lower-income and moderate-income workers who lack sufficient taxable income to take full advantage of the traditional IRA tax deduction at the time of contribution but who may expect to be in higher tax brackets late in their careers."⁹⁷ Automatic investors will also be spared the unpleasant surprise faced by owners of

tax-deferred accounts (such as the traditional IRA) that a significant part of their accumulated savings will be lost to taxes. “The Roth generally avoids this unpleasant surprise, permitting the individual to plan for retirement without having to adjust projected or actual savings for an uncertain future tax bite.”⁹⁸ One important kind of tax uncertainty that the Roth helps to reduce is the question of what portion of a retiree’s Social Security benefits will be taxed.

In addition to these long-term benefits, the AARP notes that in the near-term, lower income workers might also benefit from using Roth accounts in order to take better advantage of the non-refundable Saver’s Credit and the partially refundable Child Credit. Because the taxpayer will take a deduction for contributions to a traditional IRA, he may not have enough tax liability to claim both credits as much as he could by investing in a Roth account.⁹⁹ For these reasons, setting up a Roth IRA by default will enable some auto-IRA participants to accumulate greater savings than they would with a traditional IRA. Of course, the tax advantages of using the Roth over the traditional IRA cannot be known for certain, unless the investor can divine her precise career trajectory and marginal tax rate at retirement. In many cases, the advantages of the Roth will not make up for the fact that a worker winds up in a lower tax bracket at retirement. The only safe conclusion is that it cannot truly be determined *ex ante* that Roth IRAs are the better default option for maximizing the accrual of contributions for a majority of investors.

Auto-Escalation of Contributions

Expanded enrollment in retirement savings will be of limited usefulness without periodic increases in employee contributions; the result would be many low-balance accounts that one could not really consider a “nest egg.” A brief published by the Urban Institute in 2008 concluded that “the full promise of auto-enrollment [in retirement plans] is inevitably tied to the success of auto-contribution features.”¹⁰⁰ The Automatic IRA Act allows for this convergence to

occur in the IRA setting. Assuming that the Secretary of Treasury promulgates regulations that implement a by-default periodic increase in employee contributions, the problem of low account balances will be ameliorated somewhat. The extent to which contributions are maximized will depend on the specific regulations set forth by Treasury, and on the frequency with which employees opt out.¹⁰¹ Of course, IRAs are subject to much lower annual limits than 401(k)s and other employment-based plans.¹⁰² For instance, workers may contribute to a Roth or traditional IRA less than half of what they could put in a SIMPLE IRA. The SIMPLE IRA, moreover, allows for an employer match. This is an inherent limitation of the non-employment-based IRA.

A recent study by the Employee Benefit Research Institute (EBRI) considered the impact of four design factors on 401(k) balances projected to be available at retirement for workers with 31 to 40 years of 401(k) eligibility.¹⁰³ The four factors examined were (1) the maximum level of employee contributions allowed, (2) increased auto-escalation of contributions, (3) whether employees are assumed to opt out of automatic escalation, and (4) whether employees retain the previous level of contributions when they change jobs, or revert to the default. The study defined “success” as the achievement of 80% income replacement when combined with Social Security benefits. Considered in isolation, the most important factor by far in achieving success was the maximum level of allowable employee contributions. For the lowest-paid quartile of workers, applying this one factor (a maximum deferral rate of 15% of compensation) increased the probability of success by 16.4%.¹⁰⁴ When all four factors were combined, the probability of success for the lowest earners increased over thirty percentage points, from 45.7% to 79.2%.¹⁰⁵

Applying the lessons of the EBRI study to the auto-IRA context, it appears that this new vehicle has the *potential* to achieve three out of the four factors: annual increases in contributions, participation in those increases, and maintenance of boosted contribution levels

after a job change. However, there is no telling how many workers will allow automatic escalation to occur, and no guarantee that employees will maintain elevated contributions when they change jobs. Worse, non-employment-based IRAs are inherently limited in their ability to address the factor of higher maximum contributions. For example, an employee with an adjusted gross income of \$40,000 per year will be unable to reach the 15% contribution rate, as that would exceed the cap on Roth and traditional IRAs. His maximum allowable rate would be more like 12%, and it seems highly doubtful that such an individual could afford to defer that much income. The limitations of IRAs are even more pronounced for higher earners, whose contributions are limited to a smaller proportion of their income.

It would not be fair, though, to reject auto-IRAs simply because they do not provide the same level of benefits as employer-sponsored plans, because they are *deliberately* designed not to be as attractive an option as employment-based plans. John and Iwry explain that they want to prevent employers who already sponsor plans from dropping their coverage, and to encourage those who do not sponsor plans yet to do so. If auto-IRAs had higher limits than regular IRAs, or allowed for employer contributions, then they would likely erode employer support for sponsorship of pension plans. Thus the auto-IRA *must* be an inferior plan. Iwry and John explain that employers will still want to “trade up” to a 401(k) or SIMPLE IRA “and complete the journey to a qualified plan in order to obtain the added benefits in terms of recruitment, employee relations, and larger tax-favored saving opportunities for owners and managers.”¹⁰⁶

Effect of Auto-IRAs on Qualified Retirement Plans

The designers of the auto-IRA argue that it will spur the growth of qualified retirement plans for two reasons: first, qualified plans offer higher contribution limits, and second, the tax

credit offered to small employers to establish qualified plans is substantially larger than that offered for setting up auto-IRA arrangements. Iwry and John contend that the reason higher contribution limits are such a powerful incentive is that business owners and managers will recognize that they can save more effectively for *themselves* by establishing qualified plans.¹⁰⁷ However, employers will have to weigh these advantages against the significant benefits of auto-IRA arrangements. The Automatic IRA Act exempts employers from the fiduciary duties listed in Title I of ERISA, leaving them less vulnerable to litigation costs, and it relieves employers of the cost of complying with ERISA and qualified plan requirements; perhaps most importantly, it requires no contributions from the employer whatsoever. As one study on auto-IRAs observed, “Because the Automatic IRA proposal relieves many of the burdens of qualified plan sponsorship, the proposal may have the effect of reducing the incentive for small employers to either stay in or adopt qualified plans for their employees.”¹⁰⁸ Minimizing the costs of implementing auto-IRAs is undoubtedly critical to their adoption among small and mid-sized firms. However, “it is just these features that may tip the balance in favor of Automatic IRAs for some employers.”¹⁰⁹

It is impossible to predict the exact impact of auto-IRAs on the adoption or retention of qualified retirement plans. However, the shift from DB plans to DC plans over the past three decades may be instructive. It is worth remembering that DB plans allow significantly higher contribution limits than DC plans.¹¹⁰ DB plans also offer comparatively generous benefits per dollar because of their ability to pool longevity risk, their ability to maintain a diversified portfolio over time, and their superior investment returns attributable to lower fees and professional management of assets.¹¹¹ Despite these advantages, DB plans have experienced a steady decline over the past thirty years, while 401(k) plans have multiplied. Whereas in 1983

62% of workers had a DB plan only, compared to 12% with only a 401(k) plan, by 2004 the situation had become inverted: just 17% of workers had a DB plan only, compared to 63% with 401(k) plans only.¹¹² Experts attribute this dramatic shift largely to legislative and regulatory changes that dramatically increased the costs of maintaining DB plans.¹¹³ In other words, employers weighed the costs of each type of plan and determined that DB plans were not worth the trouble on balance, *despite being better investment vehicles in terms of benefits*. The potential benefit of DB plans to business owners and managers evidently has not been a good enough reason to prevent most employers from unloading those plans.

The shift from DB to DC plans suggests that the majority of employers are more concerned with cost-containment than the generosity of their retirement plans. If this conclusion is correct, it casts serious doubt on the hypothesis of John and Iwry that auto-IRAs will encourage employers to adopt qualified plans. It seems just as likely that many employers will decide that the relatively generous benefits of qualified plans do *not* outweigh their costs compared to the cheaper auto-IRA plans. Some small business owners will undoubtedly decide to forgo the benefits of higher tax-deferred savings under a qualified plan in order to avoid the costs of establishing and administrating such a plan. Just as there are still some employers who go to the trouble of using DB plans despite their costs, others will take the more onerous route of establishing a qualified plan for their employees rather than relying on auto-IRAs. But it stands to reason that the *majority* will lean towards the administratively and financially least burdensome option, auto-IRAs.

Given the many advantages of auto-IRAs to employers, like lower administrative costs and no ERISA liability, it seems unlikely that a temporary tax credit will have much influence on those who are most worried about costs. As previously discussed, about half of employers will

be unable to take advantage of the credit due to a lack of current tax liability. Moreover, the \$500 startup credit that is currently in place has not been very successful in encouraging employer-sponsored plans among small businesses so far. As of 2008, 63% of small businesses still offered no pension coverage of any kind.¹¹⁴ Doubling the credit can be expected to have a limited effect. But most businesses considering the long-term costs of sponsoring a qualified plan are unlikely to be swayed by short-term benefits.

Will Auto-IRAs Yield “Universal Retirement Security”?

The main focus of this paper so far has been to determine whether auto-IRAs can achieve certain intermediate goals: expanding retirement savings, maximizing the growth of those savings, and encouraging the adoption of qualified pension plans by small employers. As I hope the forgoing discussion illustrates, it appears that the Automatic IRA Act will probably come up short in each area. It would expand retirement savings, but not to all 78 million workers who currently lack access to qualified plans, and certainly not to those workers who have access but elect not to participate. The Senate bill would help workers to grow their savings, but the fees associated with retail investing and the low contribution limits on IRAs would seriously dampen the effect. Finally, the belief that auto-IRAs will cause qualified pension plans to proliferate seems misguided at best. I am skeptical that the auto-IRA proposal can succeed, even when judged on its own terms.

But the more fundamental question is whether, even assuming that auto-IRAs can meet all of these rather moderate objectives, they will give us universal retirement security. The answer is a resounding “no.” This is because auto-IRAs do not address growing concerns that even the workers who do have 401(k)s will probably face a serious shortfall in the retirement

income they will need. Instead, the proposal *embraces* the expansion of DC plans, and continues the trend of putting the entire burden of retirement readiness on the individual employee.

(Indeed, if auto-IRAs have the unintended effect of eroding support for qualified plans, the result will be more burden-shifting away from employers and towards workers.) I dedicate the remainder of this paper to exploring the fundamental flaws of the auto-IRA scheme, which echo the problems seen throughout the DC-based private pension system. Briefly, the three big problems are (1) not having enough income to save adequately, (2) the ability of workers to raid their “retirement” savings to meet short-term needs, and (3) unacceptable exposure to investment risk.

Inadequate Income

Testifying before the House Ways and Means Committee in 2008, Ross Eisenbrey of the Economic Policy Institute made the following statement:

Proposals like the automatic IRA cannot hurt. The problem is that they probably won't help much, either. This is because such proposals don't make 401(k)s or IRAs a better deal for ordinary workers. They make it physically easier for them to put money into an account, but not financially easier.¹¹⁵

Mr. Eisenbrey highlights a somewhat glaring problem that advocates of the auto-IRA plan tend to gloss over: many employees do not save for retirement because they perceive, sometimes correctly, that they cannot afford to do so. The CRR researchers who determined that low-income employees are less likely than others to participate in auto-IRAs observed that financial hardship would be a major factor in opting out. Looking at SIPP data, they found that most low-income males in the private sector who already had access to yet did not participate in a pension plan cited money as the reason for non-participation.¹¹⁶

The incentives built into the Internal Revenue Code do little to help low-income workers to save for retirement. A common criticism of the private pension system is that the current deductions and exclusions create an upside-down subsidy that gives the biggest advantages to the wealthy, when it is low-income workers who need the most help. The only incentive for low-income workers is the Saver's Credit, which is of limited usefulness because it is non-refundable and limited to the worker's total tax liability. Those who have zero tax liability are unaffected by the credit, while those who do have tax liability generally cannot tax full advantage of it. For instance, a worker with an adjusted gross income (AGI) of \$15,000 who makes a \$2,000 contribution to an IRA is eligible for the maximum credit, or \$1,000. However, after accounting for the personal exemption and the standard deduction, his tax liability would be significantly less than \$1,000. Because the credit cannot exceed his liability, he will not get the full credit.¹¹⁷

Many advocates of the auto-IRA suggest making the Saver's Credit refundable in order to encourage lower income workers to save. John and Iwry go as far as recommending that the credit take the form of a matching IRA contribution, deposited directly into the worker's account. However, the Act as proposed does not implement either change. It merely adds an automated saving mechanism to a system that offers low earners no real incentive to save.

Even if low-income workers did manage to save consistently throughout their careers, their accumulated savings might not be enough to generate the income stream they would need in addition to Social Security. In a recent study by the AARP, it was estimated that just over half of the workers would be eligible for auto-IRAs have AGIs of less than \$20,000.¹¹⁸ These workers will struggle to defer enough income to accumulate adequate savings, even starting relatively early. Saving at a rate of 3% in the early years, the average worker in this group would likely accumulate no more than \$20,000 after thirty years of income deferral—not enough to

fully supplement Social Security.¹¹⁹ Of course, saving something is better than saving nothing at all, and some low-income workers who start at a young age and continue investing in their auto-IRAs will generate sizeable accumulations. “However, it is likely that some lower-income workers may opt-out of the Automatic IRA due to liquidity constraints.”¹²⁰

While the Automatic IRA Act provides for the Departments of Labor and Treasury to “study” the possibility of annuitizing IRA savings, there is no provision in the law that helps workers afford annuities today. Purchasing a retail annuity is a costly proposition, and it currently deters the vast majority of retirees from converting their savings into a lifetime income product. But annuitization will necessarily be a critical for achieving universal retirement security, in order to handle the problem of longevity risk. In a DC-based system, the worker has to put away a large cushion of extra savings to account for the possibility that she will live longer than expected.¹²¹ The problem is worsened if the worker wishes to purchase an annuity with spousal survivorship rights. Auto-IRAs do nothing to help this problem. Again, the law perpetuates the flaw of asking the lowest income workers to insulate themselves against risk without giving them adequate tools to do so.

Leakage

What of the worker who fails to opt out initially but who subsequently needs extra money to cover unexpected expenses? Like all other individual IRAs, the auto-IRA would allow such an individual to make a pre-retirement withdrawal. The worker who believes his emergency is sufficiently dire to raid his retirement account will have no qualms about paying a 10% penalty and income tax for making a non-qualified withdrawal. If the worker has a Roth IRA, there is even less reason to hesitate, since he pays the penalty and tax on his investment gains only. This scenario suggests the second major problem with expanded IRA enrollment: leakage.

Leakage is a problem common to all DC plans, including the 401(k). Some policymakers believe that it is not really a “problem,” and that retirement accounts can and *should* pull double duty as savings accounts. The argument goes that allowing workers to make pre-retirement withdrawals incentivizes income deferral by ensuring participants that the money is never fully out of their reach, and available in case of an emergency. The Automatic IRA Act embodies this view, as its stated purpose is “to expand *personal* savings and retirement savings coverage by allowing employees not covered by qualified retirement plans to save for retirement through automatic IRAs, *and for other purposes*” (emphasis added).¹²²

While this attitude may be useful for encouraging regular savings, it will inevitably prevent the private pension system from ever achieving truly universal retirement security, because there will always be valid reasons for consuming today the money we have saved for our old age. The only way to *guarantee* that the money will be there at retirement is to enact a total ban on premature withdrawals. John and Iwry suggest “limiting, perhaps, pre-retirement withdrawals,” but they do not seem wedded to the idea. In recommending the Roth as the default account for auto-IRAs, they write that “while it is hoped that few participants would choose to withdraw funds from their IRAs before they reach or approach retirement age,” the Roth has the advantage of lower tax and penalties.¹²³ Since its inception, the auto-IRA proposal has implicitly accepted that premature withdrawals will sometimes occur.

It is logical that leakage will be an even bigger problem for auto-IRAs than 401(k)-style accounts. The population that is targeted by the Act is more resistant to saving than those who already have access to an employment-based retirement plan. They tend to be both poorer and younger than their counterparts with pension plans. Being younger renders them more susceptible to hyperbolic discounting, leading to more early withdrawals. Having less income

should also increase premature withdrawals, since lower-income workers have fewer assets to cover the unexpected costs. The one advantage that auto-IRA participants might have over 401(k) owners is that they will not be asked to “cash out” their IRA when they change jobs. Since the employer is merely a “conduit” for retirement funds in the case of auto-IRAs, termination does not present the same opportunity for leakage as it does with 401(k)s. On the other hand, there are many fewer restrictions and penalties when it comes to making premature withdrawals from a Roth. On balance, therefore, auto-IRAs will probably be more prone to leakage problems.¹²⁴ This is another reason why they are incapable of achieving universal retirement security.

Unacceptable Exposure to Market Risk

When the market tumbled in 2008, so did pensions plans. Anyone with a DC plan or an individual IRA is painfully and personally familiar with the result. It is a lesson Americans have repeatedly learned the hard way: investing is inherently risky. Despite this, one commonly hears the investment advice that young workers should invest heavily in equities because the stock market outperforms other types of investments in the long run. This is true enough in the aggregate, but it does not remove the role of luck for individual investors, who may be much better or worse off depending on *when* they retire—even if they adopt a relatively conservative investment strategy. Gary Burtless of the Brookings Institution illustrated this principle in dramatic fashion by estimating the income replacement rate for an investor who works forty years, contributing 4% of his salary and investing 50% in stocks and 50% in bonds, and annuitizes his aggregate savings at retirement. If the worker retired in 1999, he would have been able to replace about 50% of his income; yet if he had retired twenty years earlier, the rate would have been about 20%! Unsurprisingly, the hypothetical investor would not be much better off by

retiring today, with a replacement rate of less than 25%.¹²⁵ It is thus apparent that market swings do not “average out” over time, and having a system that relies heavily on private saving means that one’s retirement readiness boils down in large part to luck.

Auto-IRAs would do nothing to change the unfairness or the unpredictability of this system. They would make beneficial use of target-date funds, which dial down market risk as the worker nears retirement, but the exposure to risk at retirement is still substantial. For instance, the Vanguard 2010 Fund is currently comprised of half stocks and half bonds, meaning that investors who are retiring this year *still* have half of their money tied up in stocks. This is not to suggest that the standard investment choices of auto-IRAs should be made less risky, as that would merely guarantee lower returns. (Burtless’ study also illustrates that the more conservative strategy, while fluctuating less, consistently yields lower replacement rates than riskier equities-driven investing.¹²⁶) Rather, I wish to highlight that private pension system would remain fundamentally the same with or without auto-IRAs. Americans must step back and assess whether they want a retirement system in which one person who invests in the exact same way as another person may end up being twice as well-off in retirement. The problem of temporal unfairness is even more pronounced when one considers that the new investors created by auto-IRAs will generally have less money than current investors. For lower earners, a 50% replacement rate instead of a 20% rate could be the difference between comfort and poverty.

Conclusion

Establishing auto-IRAs for millions of workers strikes me as a step in the wrong direction, because it would only reinforce the pattern of shifting too much risk and responsibility onto workers who are ill-equipped to bear it. Participants in the new scheme would still be

missing one leg of the retirement stool: an employer-sponsored plan. Their entire retirement strategy would consist of personal savings and Social Security, with no financial assistance from their employer. The result may be marginally improved savings, but not retirement security; that cannot be achieved without a full-blown overhaul of the current system. I have not addressed all of the shortcomings of private pension system here, as many thorough critiques have already been leveled against it. But the core criticisms are worth repeating: it gives too many savings incentives to the workers who least need them, and too little income security across the board. Auto-IRAs leave these flaws untouched.

For all of its problems, and despite the title of this paper, I am unwilling to oppose the Automatic IRA Act of 2010. The law is nowhere near the scale of reform needed to provide retirement security in the United States. On the other hand, today's highly divisive political climate suggests that radical change will not be forthcoming. The virtue of a plan like the Automatic IRA Act is that it is so intuitively appealing: it encourages without *compelling* socially beneficial behavior, and it is therefore unlikely to draw strong opposition on ideological grounds. A recent survey found that large majorities of Americans support the proposal: 84% of Democrats, 76% of Republicans, 84% of workers between the ages of 25 and 34, and 80% of workers with household incomes under \$40,000.¹²⁷ Many organizations came out in support of the legislation in the summer of 2010, including the AARP. Some small businesses have expressed opposition to the plan,¹²⁸ but the cost-reducing option that allows them to “piggyback” contributions onto payroll tax deposits may ameliorate their concerns.

Passing the Automatic IRA Act, without more, will not create universal retirement security. But taking a step in the *wrong* direction, trying an experiment that fails utterly, may finally be the shot in the arm that leads to real reform. The people who become investors as a

result of this legislation may one day add their voices to the chorus of workers who object to the unreasonable risks to which their retirement futures are subject, despite their best efforts to plan wisely. This is admittedly a rather optimistic view; the necessary confluence of disastrous events evidently has not yet occurred, despite the recent economic collapse. One wonders how bad things need to get before a paradigm shift can occur. But auto-IRAs may be one of the more realistic steps we can hope for in the near term.

Endnotes

¹ I use the term “pension plan” as it is used in the Employee Retirement Income Security Act, i.e., inclusive of traditional defined benefit as well as defined contribution plans, such as 401(k) plans. *See* ERISA § 3(2)(A).

² *See* AARP Study at 24.

³ *See* 2010 Retirement Confidence Survey at 5. These findings are based on a random nationwide survey of 1,000 individuals over the age of 24.

⁴ *See id.* at 6.

⁵ *See* VanDerhei & Copeland (2010) at 3.

⁶ *See id.*

⁷ Mr. Iwry currently serves as the Senior Advisor to the Secretary and Deputy Assistant Treasury Secretary for Retirement and Health Policy in the United States Treasury Department.

⁸ *See* Iwry & John (2006). The auto-IRA plan is the product of the authors’ research for the Retirement Security Project, sponsored by the Pew Charitable Trusts in partnership with Georgetown University’s Public Policy Institute and the Brookings Institution.

⁹ The Act defines “qualified plan” by reference to Section 219(g)(5) of the Internal Revenue Code, which lists the following plans: 401(a) plans including tax-exempt trusts, 403(a) annuities, civil servants’ plans, 403(b) annuities, 408(k) simplified employee pensions, and 408(p) simple retirement accounts. *See* Proposed § 408B(b)(1) of the Internal Revenue Code of 1986 [“IRC”] (House bill § 2(a) [p. 2]) and proposed § 438(i)(1) (Senate bill § 2(a) [p. 19]).

¹⁰ *See* GAO IRA Report at 7.

¹¹ *See id.* at 8.

¹² *See id.* at 9. There are not adequate data regarding payroll-deduction IRAs to estimate where and to what extent employers offer them today. Part of the beauty of payroll-deduction IRAs is that the employer is not required to tell the federal government that it is providing the service. *See Id.* at 21.

¹³ *Id.* at 25.

¹⁴ *Id.* at 10.

¹⁵ *See id.* at 31.

¹⁶ *See SEP Retirement Plans* at 4.

¹⁷ *See SIMPLE IRA Plans* at 2. The employer either provides a dollar-for-dollar match of employees’ elective personal contributions up to 3% of pay, or a 2% across-the-board contribution for *all* eligible employees.

¹⁸ *See* GAO IRA Report at 21.

¹⁹ *See* CBO Report on Tax Incentives at 7.

²⁰ See GAO IRA Report at 11. In 2004 IRA assets totaled \$3.5 trillion, while DC assets totaled \$2.6 trillion and DB assets totaled \$1.9 trillion. In 2004, IRA contributions totaled \$48 billion, compared to total rollovers of \$214 billion.

²¹ See AARP Study at 19.

²² See *id.* at 26 (“In the case of IRAs, both Traditional and Roth, taxpayers with AGI less than \$50,000 represented about 37 percent of all returns. however, taxpayers with AGI less than \$50,000 represented about 46 percent of all returns with pension plans . . .”).

²³ Relevant differences between the House and Senate bills are noted as appropriate.

²⁴ See IRC proposed § 408B (House bill § 2(a) [p. 2]) and proposed § 438 (Senate bill § 2(a) [p. 2]).

²⁵ Iwry & John (2009) at 8.

²⁶ Unlike H.R. 6099, the Senate bill provides for a gradual phase-in of the IRA mandate for small employers. In the first year after enactment, the provision applies only to firms with 100 or more employees; in the next year, 50 or more; in the third year, 25 or more; and in the fourth year, 10 or more. See IRC proposed § 438(h)(4) (Senate bill § 2(a) [p. 19]). This is meant to enable service providers and regulators to prepare for the expansion of IRA accounts. See Summary of Senate Bill at 1.

²⁷ See IRC proposed § 408B(c)(3)(B) (House bill § 2(a) [p. 6]) and proposed § 438(b)(2) (Senate bill § 2(a) [p. 3]).

²⁸ See IRC proposed § 408B(c)(3)(B) (House bill § 2(a) [p. 6]) and proposed § 438(b)(4)(B) (Senate bill § 2(a) [p. 4]).

²⁹ See IRC proposed § 408B(h)(3) (House bill § 2(a) [p. 23]) and proposed § 438(e)(3) (Senate bill § 2(a) [p. 14]). The House bill requires the Secretary of Labor to establish and maintain the website, while the Senate bill contemplates that the Treasury Secretary will establish the site “in consultation with the Secretary of Labor.” *Id.*

³⁰ See IRC proposed § 440(b)(3) (Senate bill § 2(a) [p. 26]). This is important because the Senate bill relieves employers of ERISA fiduciary liability as long as they have chosen from this pre-approved list. See IRC proposed § 438(g)(1)(A)(ii) (Senate bill § 2(a) [p. 17]). Similarly, the House bill states that auto-IRAs “shall not be treated as an employee pension benefit plan or pension plan if, under the arrangement, contributions are to be made to an automatic IRA the provider of which is included in the website list.” See proposed § 3(2)(C) of ERISA (House bill § 2(d) [pp. 25-26]).

³¹ See IRC proposed § 438(g)(1)(B) (Senate bill § 2(a) [p. 17]). The Secretary is directed to establish default providers through a competitive bidding process, according to the following criteria: (1) the provider’s willingness to accept all employers and their employees who are assigned, (2) the investment options offered, “particularly the value such options offer to participants (taking into account the relative fees),” and (3) the number of providers required to avoid excessive concentration of assets. See IRC proposed § 440(c) (Senate bill § 2(a) [pp. 26-28]).

³² See IRC proposed § 408B(f)(3) (House bill § 2(a) [p. 18]) and proposed § 438(g)(1)(C) (Senate bill § 2(a) [p. 17]). In addition, the Senate bill allows the employer to make arrangements with “authorized intermediary entities such as business, professional, or trade associations” for those employees who do not receive periodic payments. See IRC proposed § 438(c)(2)(B) (Senate bill § 2(a) [p. 7]).

³³ See IRC proposed § 408B(d)(2)(D) (House bill § 2(a) [p. 11]) and proposed § 438(d)(1)(B) (Senate bill § 2(a) [p. 8]). Under the Senate bill, if the employer has chosen to let employees pick their own service provider and has also elected to forward contributions to Treasury in order to avoid administrative burdens, then the Secretary must forward these payments to the provider of the employee’s choice. See IRC proposed § 440(d)(2)(C) (Senate bill § 2(a) [pp. 29-30]).

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- ³⁴ See IRC proposed § 408B(f)(2) (House bill § 2(a) [pp. 17-18]) and proposed § 438(d)(1)(C) (Senate bill § 2(a) [p. 8]).
- ³⁵ See IRC proposed § 408B(d)(4)(A)(ii) (House bill § 2(a) [p. 13]). The Senate bill sets a lower initial contribution rate limit of 4%. See IRC proposed § 438(d)(2)(A)(ii) (Senate bill § 2(a) [p. 10]).
- ³⁶ See IRC proposed § 408B(d)(4)(B) (House bill § 2(a) [p. 13]) and proposed § 438(d)(2)(B) (Senate bill § 2(a) [p. 10]).
- ³⁷ See IRC proposed § 408(B)(d)(4)(B) (House bill § 2(a) [p. 13]).
- ³⁸ See Hewitt Associates (2010) at 5.
- ³⁹ See IRC proposed § 408B(d)(5) (House bill § 2(a) [pp. 14-15]) and proposed § 439(c)(2) (Senate bill § 2(a) [pp. 21-22]).
- ⁴⁰ See IRC proposed § 438(d) (3)(A)(i) (Senate bill § 2(a) [p. 11]).
- ⁴¹ See IRC proposed § 440(d)(1)(B) (Senate bill § 2(a) [p. 28]).
- ⁴² IRC proposed § 408B(g)(5)(B) (House bill § 2(a) [p. 21]).
- ⁴³ IRC proposed § 439(d)(2) (Senate bill § 2(a) [pp. 23-24]).
- ⁴⁴ IRC proposed § 439(d)(1)(B) (Senate bill § 2(a) [pp. 23]). The House bill proscribes only “unreasonable” fees. See IRC proposed § 408B(d)(1)(D) (House bill § 2(a) [p. 9]).
- ⁴⁵ House bill § 2(i) [p. 31]; IRC proposed § 439(c)(2) (Senate bill § 2(i) [p. 42]).
- ⁴⁶ See House bill § 2(d) [pp. 25-27]; Senate bill § 2(f) [p. 39].
- ⁴⁷ See Summary of Senate Bill at 5.
- ⁴⁸ See IRC proposed § 438(g)(1)(A)(ii) (Senate bill § 2(a) [p. 17]).
- ⁴⁹ See IRC proposed § 408B(d)(8) (House bill § 2(a) [p. 16]) and proposed § 438(d)(4) (Senate bill § 2(a) [p. 13]).
- ⁵⁰ IRC proposed § 408B(d)(2) (House bill § 2(a) [p. 17]) and proposed § 438(f)(2) (Senate bill § 2(a) [p. 16]).
- ⁵¹ IRC proposed § 408B(d)(4)(C)(i) (House bill § 2(a) [p. 14]) and proposed § 438(d)(2)(C)(i) (Senate bill § 2(a) [p. 11]).
- ⁵² See IRC proposed § 45S(b) (House bill § 3(a) [pp. 34-35]; Senate bill § 3(a) [pp. 44-45]).
- ⁵³ House bill § 4(a)(1) [p. 37]; Senate bill § 4(a)(1) [p. 47].
- ⁵⁴ See IRC § 45E(b)(1).
- ⁵⁵ See House bill § 4(b) [p. 37]; Senate bill 4(b) [p. 47].
- ⁵⁶ See House bill § 5(a) [pp. 38-39]; Senate bill § 5(a) [pp. 48-49].
- ⁵⁷ *Id.*
- ⁵⁸ Iwry & John (2009) at 8.

⁵⁹ Iwry & John (2009) at 4.

⁶⁰ *Id.*

⁶¹ *Id.* at 21.

⁶² IRC proposed § 439(c)(3) (Senate bill [p. 22]).

⁶³ Iwry & John (2009) at 7.

⁶⁴ Iwry & John (2009) at 8.

⁶⁵ *See* AARP Study at 61.

⁶⁶ *See* VanDerhei & Copeland (2010) at 11. In contrast, the AARP calculated a much higher estimate of Americans who will be eligible to participate in an automatic IRA arrangement: 47.9 million. *See* AARP Study at 13.

⁶⁷ *See* VanDerhei & Copeland (2010) at 2.

⁶⁸ *Id.*

⁶⁹ *See* IRC proposed § 408B(d)(8) (House bill § 2(a) [p. 16]) and proposed § 438(d)(4) (Senate bill § 2(a) [p. 13]).

⁷⁰ *See* Munnell, Golub-Sass & Muldoon (2009) at 3.

⁷¹ *See* GAO Auto-Enrollment Report at 10, citing Brigitte C. Madrian & Dennis F. Shea, *The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior*, 116(4) Q. J. OF ECON. at 1149-1187 (2001).

⁷² *See* Karamcheva & Sanzenbacher at 1.

⁷³ *See* Munnell & Quinby at 1.

⁷⁴ Karamcheva & Sanzenbacher at 1.

⁷⁵ *See id.*

⁷⁶ *See id.* at 3.

⁷⁷ *Id.* at 4.

⁷⁸ *Id.*

⁷⁹ EBRI foresees a much smaller population of possible savers than the AARP, which projects that almost 50 million workers will have access to an automatic IRA arrangement. *See supra*, note 62.

⁸⁰ *See* IRC proposed § 408B(d)(3)(B)(ii) (House bill § 2(a) [p. 12]).

⁸¹ Perun (2008) at 3.

⁸² *Id.*

⁸³ GAO Retirement Savings Report at 17.

⁸⁴ *See* DOL Report on Fees at 2.

⁸⁵ See GAO Retirement Savings Report at 21.

⁸⁶ 403(b) plans are designed specifically for use by public education and tax-exempt entities. They are like 401(k) plans in that they allow contributions of pre-tax dollars into retirement accounts, but they are “generally limited to investing in annuity contracts issued by insurance companies and custodial accounts invested in mutual funds.” *Id.* at 4.

⁸⁷ *Id.*, Executive Summary.

⁸⁸ *Id.* at 10.

⁸⁹ *Id.* at 31.

⁹⁰ IRC proposed § 439(c)(3) (Senate bill § 2(a) [p. 22]).

⁹¹ IRC proposed § 440(c)(2)(A) (Senate bill § 2(a) [p. 27]).

⁹² Almeida & Fornia (2008) at 12 (explaining that the administrative costs of maintaining individual accounts are much higher than for pension funds, which need to contribute 26% less than their DC counterparts due to superior returns).

⁹³ See AARP Study at 56.

⁹⁴ See *id.* at 73.

⁹⁵ *Id.* at 13.

⁹⁶ See *id.* at 78.

⁹⁷ Iwry & John (2009) at 13.

⁹⁸ *Id.*

⁹⁹ AARP Study at 51.

¹⁰⁰ Perun (2008) at 4.

¹⁰¹ I must note that the language of both bills might be construed to limit the maximum contribution rate to either 4% in the Senate bill or 6% in the House bill. Such a limitation would make some sense in that it would keep many savers from over-contributing to their IRAs. However, this would severely constrain the usefulness of auto-escalation for low-income workers. I assume for the purposes of this discussion that the Treasury Secretary would be allowed to exceed the *initial* maximum contribution rate through automatic escalation.

¹⁰² The current maximum employee contributions are as follows: \$16,500 for 401(k)s, \$11,500 for SIMPLE IRAs, and \$5,000 for Roth and traditional IRAs.

¹⁰³ VanDerhei & Lucas (2010).

¹⁰⁴ *Id.* at 6.

¹⁰⁵ *Id.* at 8.

¹⁰⁶ Iwry & John (2006) at 72.

¹⁰⁷ Iwry & John (2009) at 8.

¹⁰⁸ AARP Study at 45.

¹⁰⁹ *Id.*

¹¹⁰ *See Choosing a Plan* (listing higher contributions, and therefore deductions, as an advantage of defined benefit plans). The IRS also notes that “[s]ignificant benefits [are] possible in a relatively short period of time.”

¹¹¹ *See Almeida & Fornia* (2008) at 4.

¹¹² *See Munnell, Golub-Sass & Muldoon* (2009) at 2.

¹¹³ *See Estreicher & Gold* (2007).

¹¹⁴ 2008 Ways and Means Hearing (testimony of Rep. Ron Kind).

¹¹⁵ *Id.* (testimony of Ross Eisenbrey, Vice President, Economic Policy Institute).

¹¹⁶ *See Karamcheva & Sanzenbacher* at 2.

¹¹⁷ AARP Study at 51.

¹¹⁸ *Id.* at 13.

¹¹⁹ *Id.* at 14.

¹²⁰ *Id.* at 81.

¹²¹ *See Almeida & Fornia* (2008) at 6.

¹²² Preamble of House bill and Senate bill.

¹²³ Iwry & John (2009) at 13.

¹²⁴ A topic for another paper: where auto-IRAs do not produce leakage, they may give rise to increased borrowing that will offset any savings gains they achieve. *See AARP Study* at 81.

¹²⁵ *See Burtless* (2008) at 7.

¹²⁶ *See id.*

¹²⁷ *See Emily Brandon, Survey: Strong Bipartisan Support for the Automatic IRA*, USNEWS.COM (Sept. 25, 2009).

¹²⁸ *See Kelly Greene, A “Whoa” to Retirement-Plan Idea*, WALL ST. J. (Mar. 7, 2009).

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