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The Smith-Conrad Retirement Security Legislation

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I. Introduction

On June 6, 2005, Senators Gordon H. Smith (R-OR) and Kent Conrad (D-ND) unveiled legislation to bolster retirement security. The legislation's objectives – to make saving for retirement easier and to provide better ways for families in retirement to avoid outliving their accumulated assets – are sound. Indeed, a growing body of empirical evidence, including a new study conducted by The Retirement Security Project in conjunction with H&R Block, suggests significant benefits if we make it easier for middle- and lower-income households to save for retirement and increase their incentives to do so. The Smith-Conrad bill highlights many of the common sense reforms that would move in this direction, and several of the provisions included in the legislation represent sensible steps toward the legislation's goals.

Unfortunately, however, many of the most prominent elements of the bill are problematic. The central provisions in the legislation either provide windfall subsidies for steps that would have occurred in the absence of the legislation -- thus dissipating federal revenue in exchange for little public benefit -- or fail to capture the significant potential that exists for making saving easier and increasing the incentives for middle- and low-income households to save. For example, tax incentives for life annuities are likely to be the most expensive component of the bill. Yet these tax incentives would be worth little to middle- and low-income households and thus do little to encourage them to purchase life annuities. Furthermore, some of the tax incentives would violate a key tax policy principle that tax-preferred retirement accounts should enjoy a tax preference on contributions or withdrawals, but not both.

The bottom line is that, despite its worthy goals and some well-designed elements, the Smith-Conrad legislation as a whole is likely to do more harm than good. This paper analyzes the provisions in the Smith-Conrad legislation in three key areas: making it easier to save, increasing the incentive to save, and providing better ways for families to avoid outliving their accumulated assets.

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II. Making it easier to save

The most beneficial part of the Smith-Conrad legislation involves its provisions to make it easier to save. The bill would encourage the use of automatic enrollment and automatic escalation in 401(k)-type plans, as well as allow households to deposit part of their tax refund directly into a retirement account. These steps hold substantial promise for increasing retirement saving. Even in the area of making it easy to save, however, the legislation includes problematic elements.

Automatic 401(k) provisions

A 401(k)-type plan typically leaves it up to the employee to choose whether to participate, how much to contribute, which of the investment vehicles offered by the employer to select, and when to pull the funds out of the plan and in what form. Workers are thus confronted with a series of financial decisions, each of which involves risk and a certain degree of financial expertise. Many workers shy away from these decisions and simply do not choose. Those who do choose often make poor choices.

To improve the design of the 401(k), policy-makers should recognize the power of inertia in human behavior and enlist it to promote rather than hinder saving.² Under an automatic 401(k), each of the key events in the process would be programmed to make contributing and investing easier and more effective.

- **Automatic enrollment:** Employees who fail to sign up for their company's 401(k) plan -- whether because of simple inertia or procrastination, or perhaps because they are not sufficiently well organized or are daunted by the choices confronting them -- would become participants automatically, although they would preserve the option of declining to participate. In other words, workers would be included unless they opted out, instead of being excluded unless they opt in.
- **Automatic escalation:** Employee contributions would automatically increase in a prescribed manner over time, for example raising the contribution rate as a share of earnings whenever a worker experiences a pay increase, again with an option of declining to increase contributions in this fashion.
- **Automatic investment:** Funds would be automatically invested in balanced, prudently diversified, low-cost vehicles, such as broad index funds, life-cycle funds, or professionally managed funds, unless the employee makes other choices. Such a strategy would improve asset allocation and investment choices while giving employers reasonable protection from potential fiduciary liabilities associated with these default choices.

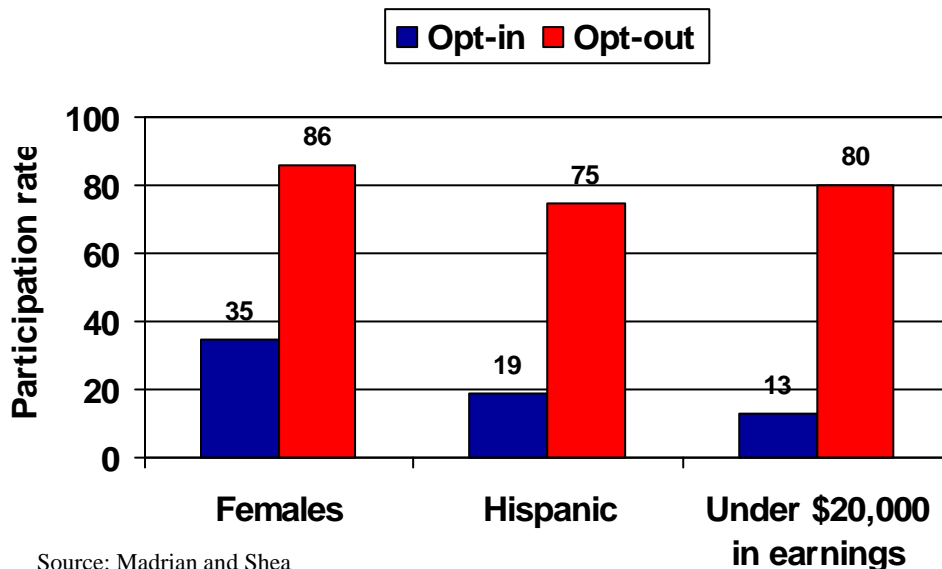
² William G. Gale, J. Mark Iwry, and Peter R. Orszag, "The Automatic 401(k): A Simple Way to Strengthen Retirement Savings," Retirement Security Project Policy Brief No. 2005-1, March 2005.

- Automatic rollover:** When an employee switches jobs, the funds in his or her account would be retained in the existing plan or automatically rolled over into an IRA, 401(k) or other plan offered by the new employer. At present, many employees receive their accumulated balances as a cash payment upon leaving an employer, and many of them spend part or all of it. Automatic rollovers would reduce such leakage from the tax-preferred retirement saving system. At this stage, too, the employee would retain the right to override the default option and place the funds elsewhere or take the cash payment.

In each case – automatic enrollment, escalation, investment, and rollover – workers can always choose to override the defaults and opt out of the automatic design. Automatic retirement plans thus do not dictate choices any more than does the current set of default options, which exclude workers from the plan unless they opt to participate. Instead, automatic retirement plans merely point workers in a pro-saving direction when they decline to make explicit choices of their own.

Empirical evidence suggests that these steps could prove significantly beneficial. For example, one of the strongest empirical findings from behavioral economics is that automatic enrollment boosts the rate of plan participation substantially (Figure 1).³ As the figure shows, automatic enrollment is particularly effective in boosting participation among those who often face the most difficulty in saving.

Figure 1: Effects of automatic enrollment on participation rates



Source: Madrian and Shea

³ Brigitte Madrian and Dennis Shea, “The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior,” *Quarterly Journal of Economics* 116, no. 4 (November 2001): 1149-87; and James Choi and others, “Defined Contribution Pensions: Plan Rules, Participant Decisions, and the Path of Least Resistance,” in *Tax Policy and the Economy*, Vol. 16, edited by James Poterba (MIT Press, 2002), pp. 67-113.



Despite its demonstrated effectiveness in boosting participation, automatic enrollment is relatively new – and a small but growing share of 401(k) plans today include this feature. According to a recent survey, about one-tenth of 401(k) plans (and one-quarter of plans with at least 5,000 participants) have switched from the traditional “opt-in” to an “opt-out” arrangement.⁴ Another recent survey suggested that in 2005, 9 percent of large plans offer automatic escalation and 10 percent more plan to offer it in the next 12 months.⁵ Policy changes could help to speed the adoption of automatic 401(k) plans.

The Smith-Conrad legislation offers important incentives for employers to adopt automatic enrollment and automatic escalation within their 401(k)-type plans. For example, language in the bill limits fiduciary responsibility for employers regarding the investment of the funds contributed as a result of automatic enrollment and preempts state labor law to clarify that automatic enrollment is permissible. These steps are beneficial.

The bill’s proposed changes to the non-discrimination rules, by contrast, are problematic. Many firms are attracted to automatic enrollment because they care for their employees and want them to have a secure retirement, while others may also be further motivated by the associated financial incentives, which stem in large part from the 401(k) nondiscrimination standards. These standards were designed to condition the amount of tax-favored contributions permitted to executives and other higher-paid employees on the level of contributions made by other employees. In encouraging automatic enrollment, therefore, policy-makers should be careful about how they alter these rules. In particular, broader adoption of automatic enrollment would represent a Pyrrhic victory if it increased the number of middle- and low-income households participating in the 401(k)-type plan but *reduced* the amounts accumulated by existing middle- and low-income participants.

One of the changes made by the Smith-Conrad legislation is to the “matching safe harbor” exemption to the non-discrimination rules. The matching safe harbor provision exempts an employer from the non-discrimination standards that would otherwise apply as long as the firm merely *offers* a specified employer matching contribution. It does not matter whether employees actually take up the match offer -- all that matters is that the offer was made. Firms using this safe harbor may have less interest in widespread employee participation in 401(k)s than other firms, thus posing an obstacle to wider adoption of automatic enrollment.⁶

⁴ Profit Sharing/401(k) Council of America, 47th Annual Survey of Profit Sharing and 401(k) Plans (2004).

⁵ “Survey Findings: Trends and Experiences in 401(k) Plans 2005” (Hewitt Associates, June 2005: For more information visit www.hewitt.com).

⁶ It should be noted that it is unclear how widespread this particular obstacle is, since only a small share of firms appear to use the matching safe harbor design. Industry officials suggest that one important disincentive to using the matching safe harbor is that employer matches are required to vest immediately if this approach is adopted; under other mechanisms for satisfying the non-discrimination tests, employer matches can vest more gradually.

One auspicious approach to addressing this impediment to automatic enrollment would restrict access to the safe harbor to plans with automatic enrollment features. That approach would eliminate the disincentive created by the existing rules: Firms wishing to continue using the matching safe harbor would have to adopt automatic enrollment, so the matching safe harbor would no longer be an impediment. Instead of this approach, however, the Smith-Conrad legislation creates a new safe harbor for automatic enrollment plans with a less restrictive matching requirement. The problem with the Smith-Conrad approach is that firms taking advantage of the existing matching safe harbor would have no new incentive to adopt automatic enrollment *unless they reduced their match at the same time.*⁷ This concern is only made stronger by the observation that automatic enrollment could be implemented in a fashion that would generate less impressive results than the studies to date -- for example, if employers emphasized that participation meant less take-home pay, and all that workers had to do to avoid that outcome was to sign the form opting not to participate. In that case, existing participants would experience a reduction in the matches received but few if any new participants would be added.

Split refunds

One important step in making it easier for households to save involves allowing tax refund recipients to deposit *part* of their refund into a savings vehicle. Taxpayers may currently instruct the Internal Revenue Service to deposit their entire refund in a designated account at a financial institution. The direct deposit, however, can be made to only one account. This all-or-nothing approach discourages many households from saving any of their refund. Some of the refund is often needed for immediate expenses, so depositing the entire amount in a saving account is not a feasible option.

Allowing taxpayers to split their refund could make saving simpler and, thus, more likely -- especially if combined with stronger incentives to save. Since federal individual income tax refunds exceed \$200 billion a year, even a modest increase in the proportion of refunds saved could represent a significant increase in saving.

The Smith-Conrad legislation allows recipients of a tax refund to directly invest part of that refund to an IRA, which is beneficial. The Administration, however, has already committed to implementing split refunds by 2007.⁸ The Smith-Conrad legislation would accelerate that date by at most one year.

⁷ Under current law, a firm meets the matching safe harbor test if it offers a match of 100 percent on the first 3 percent of pay in contributions, and a match of 50 percent on the next 2 percent of pay in contributions. Thus the maximum required employer match is 4 percent of pay. Under the Smith-Conrad legislation, firms would also have a new option: They could satisfy the non-discrimination rules by offering a plan with automatic enrollment and a match of 50 percent on the first 6 percent of pay in contributions. This match is less generous than under the existing matching safe harbor: The maximum required employer match is 3 percent of pay.

⁸ In January 2005, a dozen members of Congress wrote to IRS Commissioner Everson requesting the IRS adopt technical changes that would enable split refunds. In March 2005, Everson replied that the IRS was

III. Increasing Incentives

In addition to making it easier to save, policy-makers should significantly expand the incentives for middle- and lower-income households to do so. A new study conducted by The Retirement Security Project in conjunction with H&R Block underscores the significant effect that incentives have on retirement contributions, even among middle- and low-income households.⁹ The study reports evidence from the first large-scale, randomized field experiment ever conducted regarding the effects of matching rates on the willingness of low- and middle-income families to contribute to IRAs. The results suggest that the combination of a clear and understandable match for saving, easily accessible saving vehicles, the opportunity to use part of an income tax refund to save, and professional presentation and explanation of the match and its advantages could generate a significant increase in retirement saving participation and contributions, even among middle- and low-income households.

Saver's Credit

The Saver's Credit, enacted in 2001, in effect provides a government matching contribution, in the form of a nonrefundable tax credit, for voluntary individual contributions to 401(k) plans, IRAs, and similar retirement saving arrangements.¹⁰ The results of the recent randomized experiment suggest that the presence of an easily understandable and transparent 50 percent match significantly raises participation in and contributions to IRAs. The results confirm the basic idea behind the existing Saver's Credit: offering a stronger incentive to save to low- and moderate-income households can encourage them to contribute significantly more to retirement accounts. The study also suggests, however, that the existing Saver's Credit could be made more effective in encouraging additional contributions. Some options to do so are already under active discussion among policy-makers.

First, the Saver's Credit contains steep declines in the credit rate as income rises, resulting in very high effective marginal tax rates for savers who use the credit. For example, consider a married couple contributing \$2,000 to an IRA. If the couple's AGI increases from \$30,000 to \$30,001, the tax credit for that contribution declines from \$1,000 to \$400 – a \$600 increase in tax liability triggered by a \$1 increase in income. The Smith-Conrad bill merely shifts these cliffs (for example, expanding the existing 20

“working toward making this program available as quickly as possible,” with a deadline of the 2007 filing season.

⁹ Esther Duflo, William Gale, Jeffrey Liebman, Peter Orszag, and Emmanuel Saez, “Saving Incentives for Low- and Middle-Income Families: Evidence from a Field Experiment with H&R Block,” Retirement Security Project Policy Brief No 2005-5, May 2005.

¹⁰ For more detail on the Saver's Credit, see William G. Gale, J. Mark Iwry, and Peter R. Orszag, “The Saver's Credit: Expanding Retirement Savings for Middle-and Lower-Income Americans,” Retirement Security Project Policy Brief, No. 2005-2, March 2005.



percent credit rate from \$32,500 to \$40,000 for married filers) rather than eliminating them.

Second, the non-refundability of the current credit complicates its presentation and substantially reduces the number of people eligible for it. In 2005, 59 million tax filers will have incomes low enough to qualify for the 50 percent credit.¹¹ Since the existing credit is non-refundable, however, only about one-seventh of them actually would benefit from the credit at all by contributing to an IRA or 401(k). Furthermore, only 43,000 -- or fewer than one out of every 1,000 -- filers who qualify based on income could receive the maximum credit (\$1,000 per person) if they made the maximum contribution. These are the households who have sufficient tax liability to benefit in full from the Saver's Credit but sufficiently low income to qualify for the highest match rate. The incentives provided by a matching program for retirement contributions should be extended to lower-income working families. Although many other recent proposals -- including one from former Rep. Rob Portman -- extend the incentive in this fashion, the Smith-Conrad legislation does not.

Third, it is possible that the credit would be more salient and effective if it were redesigned as a matching contribution that goes into the account, rather than a tax credit. The Smith-Conrad legislation does not incorporate this option.

Finally, the Saver's Credit is scheduled to expire in 2006. The Smith-Conrad bill does extend the Saver's Credit through 2010, which is a beneficial step. The legislation, however, fails to strengthen the Saver's Credit in the ways noted above -- perhaps because excessive resources are devoted to other measures, including the annuity provisions examined below.

The Smith-Conrad legislation thus ultimately fails a test that has been proposed by Chairman Bill Thomas of the Ways and Means Committee. As Rep. Thomas has emphasized, "It's absolutely essential at the bottom of the income level that we be as creative as we can and as inclusive as we can in setting up structures to assist people to save -- that we do so in a way that those least able to save are most comfortable and have an opportunity to save."¹² Merely extending the existing Saver's Credit through 2010 while expanding its 20 percent credit rate modestly up the income distribution is much too modest a reform in light of the critical need to bolster retirement security among middle- and lower-income households.

¹¹ These estimates are generated by the Urban-Brookings Tax Policy Center microsimulation model.

¹² Mike Allen, "Allies Advise Bush to Alter Plan, Urge Hill to Act," *The Washington Post*. May 20, 2005.

IV. Life annuities

Making it easier to save and increasing the incentives to do so would help middle- and low-income households accumulate more funds in their retirement accounts. But it would not address a major challenge for those who have accumulated such funds: How do they make sure that whatever funds they have saved in a 401(k) or IRA are not exhausted too soon during their retirement?¹³

Consider a woman aged 65. Based on projections from the Social Security Administration (SSA), she has roughly a 20 year life expectancy. But in evaluating how much to spend from her 401(k) or IRA, she would be taking a substantial risk if she simply assumed that she will live for 20 more years, to age 85. The SSA projections suggest that she faces more than a 30 percent probability of living past age 90, and almost a 15 percent chance of living past age 95.

The standard way that she could protect herself against living past age 85 is to convert the funds in her 401(k)-type plan or IRA into a lifetime annuity, which guarantees periodic payments for life and thus addresses the risk of outliving one's accumulated assets.¹⁴ Encouraging more annuitization is thus sound public policy. Yet for most middle- and low-income families, lifetime annuities purchased on the individual market involve a steep financial cost. The Smith-Conrad legislation includes provisions that are intended to offset part of this cost and increase purchases of life annuities. The provisions, however, are heavily tilted toward higher-income households who already annuitize at least part of their assets and are unlikely to generate a significant shift in behavior among middle- and lower-earners. They also violate an important principle in tax law -- that tax-preferred retirement accounts should be granted a tax preference on contribution or withdrawal, but not both -- and thereby run the risk of setting a dangerous precedent. The legislation does, however, include beneficial provisions intended to promote life annuities provided in conjunction with employer-based plans.

Background

The market for lifetime annuities is currently quite small, amounting to sales of about \$15 billion per year. Lifetime annuity products represent only about 5 percent of new sales annually for life insurance firms. Numerous explanations for the weak consumer demand for lifetime annuities have been put forward. Retirees, for example, may want to bequeath their money to heirs, which is not possible with fully annuitized funds. Some people may feel that they already have sufficient annuitized wealth through

¹³ Some of the ideas in this section are drawn from National Association of Social Insurance, *Uncharted Waters: Paying Benefits From Individual Accounts in Federal Retirement Policy*. Responsibility for the specific form of the ideas presented here, however, rests solely with the authors.

¹⁴ Various types of lifetime annuities exist. One interesting form of a lifetime annuity involves "longevity insurance," in which the payments are delayed until a specific age (e.g., 75 or 80) and then last as long as the beneficiary is alive.

Social Security and Medicare benefits, and therefore do not want to transform any more of their wealth into a lifetime annuity. Lifetime annuities are also not particularly attractive for financial advisors to market, because the commissions they earn from the sale of such products are lower than those from other types of insurance products.¹⁵

Lifetime annuity products may be unattractive to retirees for other reasons. For example, current lifetime annuity products are typically not protected against the risks of inflation. Although inflation has been low in recent years, even a low steady inflation rate can significantly erode the real value of income from an annuity over time: \$100 today will be worth less than \$75 after ten years of 3 percent inflation and less than \$50 after 25 years. Unexpected increases in inflation, furthermore, can be even more devastating to the real value of fixed retirement income.¹⁶

Even more fundamentally, lifetime annuities must be priced to the life expectancy of those who annuitize their accounts. Annuitants tend to have longer life expectancies than the population as a whole, in part because they tend to be higher income. In other words, the average annuitant has a significantly longer life expectancy than the average person. As a result of this selection effect and the administrative cost loadings on annuities, purchasing a lifetime annuity involves an expected value loss of about 15 percent for the average person.¹⁷ For moderate-income workers, who tend to have shorter life expectancies than the average worker, the reduction would be even larger.

¹⁵ Commissions from the sale of deferred annuities, tax-preferred accounts that may be converted to lifetime annuities (although infrequently are), are usually around 6 percent, while advisors typically earn only 4 percent from lifetime annuities. Additionally, the sale of a deferred annuity leaves open the possibility of future business for the advisor with the customer, while the purchase of a lifetime annuity effectively ends all prospects of future business with that customer. For further discussion, see National Association of Social Insurance, *Uncharted Waters: Paying Benefits From Individual Accounts in Federal Retirement Policy*.

¹⁶ Another shortcoming in the private market involves default risk. Currently, insurance companies are regulated by the states as set out in the McCarran-Ferguson Act of 1945. States are also responsible for setting up protections for policy-holders in the case of insurance company failure. This is accomplished through state guaranty funds, which are not pre-funded but rather cover losses from the failure of one company by taxing other insurance companies in the state. These funds generally cover policies only up to \$100,000, and additional policies above that level are unlikely to be recovered. Since many insurance companies do business in more than one state, the National Organization of Life and Health Guaranty Associations (NOLGHA) was formed in 1983 to help deal with insurance company insolvencies involving three or more states. Despite NOLGHA's existence, many important questions remain regarding who exactly would be responsible for recouping customer's losses in the case of an annuity provider's failure.

¹⁷ When an individual converts a retirement account to a lifetime annuity, the value of the savings in the account are likely to be reduced by roughly 3 to 5 percent to cover the annuity company's marketing expenses, commissions to agents, other administrative costs, and profits. The value of the savings in the account are likely to be reduced roughly another 10 percent to reflect the fact that people who purchase annuities tend to have longer-than-average life expectancies, and firms that sell annuities must price the annuities to reflect that reality. See Jeffrey Brown, Olivia Mitchell, and James Poterba, "Mortality Risk, Inflation Risk, and Annuity Products," National Bureau of Economic Research, Working Paper 7812, July 2000.



The bottom line, then, is that lifetime annuities available to individuals through private markets do not provide an attractive way for average families to protect themselves against outliving their assets. The policy question is how to facilitate better products for middle- and low-income households who want to ensure that whatever retirement assets they have accumulated are not dissipated too soon.

Smith-Conrad provisions

The Smith-Conrad bill proposes a tax break to increase the incentives for lifetime annuity participation. It would exclude from taxation 10 percent of each annuity payment from a 401(k)-type plan or an IRA, up to a maximum exclusion of \$2,100 per year. This exclusion does not provide a substantial incentive to bring in participants: The majority of elderly tax filers face a marginal tax rate of 15 percent or less, so the 10 percent exclusion amounts to a reduction of only 1.5 percent in the after-tax cost of a life annuity. It is unlikely that this “discount” would generate any significant shift in behavior. Instead, the tax exclusion would likely award the bulk of its subsidy to those who are already annuitizing their assets.

Another troubling aspect of the proposal is that it would exempt from taxation income that already has been granted substantial tax preferences: Contributions made to 401(k) or IRA accounts were tax-deductible, and the accumulation of funds within the accounts is not taxed. Providing yet another tax advantage to these funds -- by partially exempting withdrawals from taxation if an account is annuitized -- is not sound tax policy. The particular danger is that if this provision is enacted, the \$2,100 limit eventually will be raised. However well-intentioned this provision may be, it represents a dangerous precedent toward reducing taxes on those withdrawals. The budget projections contain roughly \$4 trillion in revenue from taxes imposed on withdrawals from retirement plans between now and 2040.¹⁸ The implications of a widespread reduction in taxes on withdrawals, as could gradually occur if reductions were allowed in particular cases and the span of permissible cases expands, are thus substantial – especially in light of the nation’s already dismal fiscal outlook.

Another provision in the Smith-Conrad legislation provides incentives for annuities from non-qualified accounts (that is, from accounts that do not have the same tax advantages as 401(k)-type accounts or IRAs). This provision would not violate the tax principle discussed above, but most of its benefits would likely accrue to higher-income households. Middle- and low-income households rarely have significant non-retirement assets to annuitize.

Other approaches to providing actuarially fair life annuities to middle- and low-income households are much more promising than these tax incentives. The Smith-Conrad legislation, for example, includes provisions intended to clarify liability rules and thereby promote life annuities provided through employer-based plans. Such plan-based annuities typically provide more attractive terms than life annuities purchased on the

¹⁸ Alan J. Auerbach, William G. Gale, and Peter R. Orszag, “Reassessing the Fiscal Gap: The Role of Tax-Deferred Saving,” *Tax Notes*, July 28, 2003.



individual market, so steps to promote plan-based life annuities could be beneficial. Other measures – potentially including having the government act as an intermediary for pools of annuitants or having the government offer such annuities directly (which has been proposed by Peter Fisher, who served as Undersecretary of the Treasury for Domestic Finance from 2001 until 2003) – should also be explored instead of pursuing the flawed tax incentive approach put forward in the Smith-Conrad bill.

IV. Conclusion

The Smith-Conrad bill addresses many of the essential issues regarding retirement savings and security. The bill includes provisions to increase savings through split refunds, the Saver's Credit, automatic 401(k)s, and life annuities. The split refund provisions, as well as some of the automatic 401(k) provisions and the proposal to promote plan-based life annuities, are useful policy steps for strengthening retirement security. Policy-makers seeking ways of increasing retirement security for America's families should accept these parts of the Smith-Conrad legislation. Other provisions in the bill, however, are problematic: The Saver's Credit changes, for example, do too little to strengthen incentives for middle- and lower-income households to save, and the potentially quite expensive tax incentives for life annuities are seriously flawed. Because of these provisions, the legislation as proposed is likely to do more harm than good.