

II

Working Group II

Mission

The Working Group sought to develop new incentives and proposals to encourage more individual private-sector workers to save for retirement – particularly focusing on low- and moderate-income workers who are least likely to have access to a plan.

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Mission

The mission of Working Group II was to develop new incentives and proposals to encourage more individual workers in the private sector to save – not only those who do not have an employer plan, but also those who may not be eligible for their employer’s plan or who may not have chosen to participate. The Group focused on expanding coverage for low- and moderate-income workers, who are least likely to have access to a plan.

Background

The target population for the Working Group II proposals is substantial – more than half the private-sector workforce. In 2005, only 55 percent, or 52.5 million, of the 95.7 million full- and part-time employees in the private sector worked at companies that sponsor a retirement plan, according to the Current Population Survey.ⁱ Not all workers at companies that sponsor plans are eligible to participate in the plan. Some of those eligible to participate do not participate. In 2005, only 45 percent, or 43.1 million, of all private-sector workers were participating in a plan.ⁱⁱ This leaves a target population of 52.7 million workers who either have no access to a plan or are not participating in a plan.

To achieve its mission, Working Group II has taken two policy tracks:

- **First Track: Short Term.** The Group sought to take **incremental steps** to improve coverage and participation in the near term by developing incentives for employers to expand coverage and for individuals to participate in 401(k) plans. Among the ideas endorsed by the Group are automatic enrollment and expansion of the Saver’s Credit ⁱⁱⁱ (these ideas are discussed at the end of the report).
- **Second Track: Long Term.** As its primary accomplishment, the Group developed a proposal for a new national Clearinghouse structure to administer portable lifetime individual accounts – **the Retirement Investment Account (RIA) plan**. This proposed structure, in which eligible individuals can save either through payroll deduction or direct contributions, is designed to provide an easy and efficient way for workers who are not covered by a plan to save for retirement and to be able keep their account whenever they change jobs and lack employer-plan coverage. With the addition of tax credits, the RIA plan can be made to be more attractive to lower-income workers and help increase participation and savings.

How the Group Went About Its Assignment

The Working Group brought together a range of experts with widely different backgrounds to develop proposals to expand coverage. In the beginning of the process (in the Second Stage from 2003-2004), the Working Group met initially to develop the principles^{iv} that would guide their work. The Group agreed, for example, to support developing incentives and approaches that would prompt more employers to offer access to plans, as well as increase the overall level of retirement savings, particularly among low-wage workers. The Group then reviewed an array of proposals to help inform their work to develop initial concepts that would increase incremental coverage in already-existing 401(k) plans (see www.conversationoncover-

age.org for the interim report on the Conversation on Coverage, published in May 2005). The proposals designed to increase coverage in existing plans became the starting point for the building blocks of the Group's chief proposal, the Retirement Investment Account.

In the Third Stage of the Conversation on Coverage (2005-2006), the Group focused on resolving outstanding issues regarding the operating framework of the RIA plan. This effort was greatly assisted by bringing in experts to discuss in detail how financial institutions currently manage the investment of a large base of employees in plans with a range of investment options. These experts explained how costs can be kept down, and how small businesses with SIMPLE^v plans can handle contributions and fund choices without a payroll vendor. The insights gained in this effort helped the Working Group further refine the RIA plan and find consensus on a number of issues. The Group also spent a number of meetings developing guiding principles for the design of expanded tax credits that can apply to the RIA as well as other employer plans. In total, in the Third Stage, the Group met in more than a dozen full and subgroup meetings as well as by phone. When the Group was unable to devise details of a particular part of the plan design, the Group set forth guiding principles for a resolution of the issues or offered a choice among alternative solutions.

The Retirement Investment Account Plan (RIA)

The Building Blocks of the RIA Plan

A closer examination of the design elements demonstrates how each piece works to make the whole plan more effective. Below are descriptions of the RIA's major building blocks with an explanation of why the Working Group chose a particular design or approach.

Building Block 1

The plan will be administered by a national government-authorized Central Clearinghouse, which allows for lifetime portable accounts for workers.

The advantages and features of the Clearinghouse approach are as follows:

- **Portability across Employers.** Plan accounts are portable so that workers can contribute to the plan as they move from one workplace to another and find themselves uncovered by a contributory employer-sponsored plan (that is, a plan in which employees contribute their own money). In addition, plan accounts would be fully portable with those employer-sponsored plans that agree to accept rollovers, and with IRAs. Thus, workers could move accumulations from plan accounts to employer-sponsored retirement plans and vice versa in accordance with existing rules and arrangements.

Employers would be able to roll over funds from a terminated employee to an RIA when the account balance does not exceed \$5,000 and the employee does not make an explicit election. Presently, employers must roll over these amounts into IRAs.

- **Employers Have a Limited Role of Facilitating Contributions.** The employer's role is limited to providing eligible participants with the ability to contribute to the RIA through payroll deduction. The system will be set up to receive contributions from employees through payroll deductions in amounts indicated by employees on W-4 forms. The employer will be required to send the employee contributions to the Central Clearinghouse. After receiving the funds, the Central Clearinghouse will notify the U.S. Treasury of funds it has received for each individual with an account.
- **Private Sector Invests the Money.** In an approach like the Thrift Savings Plan^{vi} (a retirement savings plan for federal civilian workers), the Clearinghouse would contract the investment of funds out to the private sector. Competition for fund managers in the private sector would allow the Clearinghouse to locate providers with lower-cost funds and good service records. Moreover, competition for administrative functions provided by the private sector is expected to help the Clearinghouse keep down costs. The Clearinghouse will have clout when it negotiates with providers because of its size and its status as a government-sponsored entity.
- **Employee Advantages.** As described above, employees can maintain a single lifetime account for themselves where they work, even when they are in between jobs or self-employed. They can put money into the RIA whenever they are not covered by an employer-sponsored contributory retirement plan.
- **Education and Marketing.** The Clearinghouse will be responsible for educating workers about the existence of the RIA plan, how it works, and the need to save.

Rationale: The national Central Clearinghouse approach to make accounts portable across employers – as they are all administered in one place – will lower the cost of administration and result in savings for participants.

Building Block 2

The plan has broad employee eligibility rules for the uncovered to significantly boost coverage.

The RIA plan is designed to provide a retirement savings vehicle for all workers not covered by or eligible to participate in a contributory workplace retirement savings plan. To reach the broadest possible share of the target population of uncovered workers, eligibility for the RIA is open to any wage earner who is not eligible to contribute to any kind of employer-sponsored retirement savings plan or whose employer does not offer such a plan. This approach has the potential of making important strides toward the goal of closing the coverage gap. While some members supported making the plan available to all workers, it was agreed that the RIA should be restricted to uncovered workers because (1) uncovered workers are the target population under the Group's mission; and (2) the Group did not want the RIA to discourage employers from retaining their own retirement savings plans – or discourage them from starting up a new plan.

The target population of uncovered workers is defined as broadly as possible to be sure all uncovered workers have an opportunity to save for retirement through payroll deduction. The eligibility rules recognize that large segments of the working population are not covered: contract workers, contingent workers, part-time workers, on-call workers, or workers who are under other types of alternative working arrangements. For example, the Bureau of Labor Statistics counted 10.3 million workers or 7.4 percent of the private workforce in 2005 who were independent contract workers.^{vii} In addition, there are many contingent workers whose jobs by definition are not expected to last, a group estimated in 2005 to represent between 2.2 percent to 4.9 percent of total employment.^{viii} These workers are eligible for the RIA, as explained below. Groups of employees who are eligible for the RIA are specifically identified in the proposed plan design to better clarify who is covered.

- **Targeted Employee Eligibility Groups.** The RIA is open to any wage earner who is not eligible to contribute to any kind of employer-sponsored retirement savings plan.

The Group defined this to include the following specific groups:

- Any worker in a company that does not have a retirement plan.
 - Any worker whose employer has a 401(k) plan or other contributory defined contribution plan in which the worker is not eligible to participate – either because the worker has not met participation criteria or because the worker is a member of an excluded group.
 - Any worker who is covered only by a non-contributory plan – that is, a plan in which only employers contribute, such as a defined benefit plan, a cash balance plan or a profit-sharing plan – would be eligible for payroll deduction into an RIA.
- **The Plan Removes Eligibility Restrictions.** The RIA is free of a number of restrictions to eligibility that can be found in some workplace plans. For example, there is no minimum income eligibility requirement (although contributions cannot exceed wage income). There is no age restriction. Part-time and seasonal workers are eligible. Contingent workers are eligible. Contract workers, sole proprietors, and other self-employed individuals are eligible. Leased employees would generally be provided access through the companies that lease them to an employer.
 - **Treatment of Spousal Contributions.** The general consensus was that, at least in the early stages, only wage earners could participate and spousal participation could be added later in the process.

The Group had a lengthy discussion on this topic with many perspectives presented. Those in favor of spousal accounts said that spouses who work in the home should be valued, and spouses should be able to take advantage of the RIA plan's portability features and benefit from the lifetime account concept. It was also noted that women have the highest poverty rates in retirement and could benefit from saving. Those opposed to spousal accounts argued that if non-working spouses were to contribute to the plan, it would add administrative burdens because payroll deduction, a critical component of the RIA proposal, would be unavailable. It was also noted that a non-working spouse can already participate in a spousal Individual Retirement Account.

Building Block 3

Self-employed individuals can open accounts and contribute directly, while all workers can contribute when income taxes are filed.

Self-employed individual workers, including contract workers, can open accounts and send contributions directly to the Clearinghouse. Additionally, the Group agreed that any worker could contribute at the time income taxes are filed. The decision to allow self-employed workers and contract workers to contribute was made because such workers could not contribute through payroll deduction and it would fulfill the goal of the Group to reach as many workers as possible. The decision to allow all workers to contribute when filing income taxes was made partly to increase the opportunities for saving, especially to take advantage of refunds.

- **Self-employed individuals** can send quarterly contributions to the Clearinghouse when they send their quarterly taxes to the Internal Revenue Service (IRS). This would, of course, involve writing a separate check. The Clearinghouse would notify the IRS of contributions it has received.
- **Individuals**, whether self-employed or not, can also contribute to an RIA account through direct deposit by the IRS of part or all of their income tax refunds, as designated when they file their income tax returns.^{ix} The IRS would forward the funds to the Clearinghouse.

Rationale: While the Group recognized that the RIA would be most efficient for those with payroll deduction access, they also wanted to include self-employed people, such as contract workers, to ensure that these important sectors of the workforce are covered by the plan, thereby increasing its coverage potential.

Building Block 4

Eligible workers will be automatically enrolled in the RIA and contributions placed into a default investment. For employees who wish to choose, there will be three additional investment options.

Automatic enrollment was endorsed as a way to ensure that more eligible employees would participate. Research has found that when employees are automatically enrolled into an employer-sponsored retirement plan, between 70 to 90 percent of those enrolled remain in the plan and do not opt out.^x

- **Default Investment.** Employee contributions to the plan will be placed in a default investment pool that could be a diversified balanced fund^{xi} or a life cycle fund.^{xii} The Clearinghouse will develop the default investment, which will be consistent with the investment options specified in the Department of Labor's default investment regulations.

Rationale: If there is a default investment, the great majority of workers will likely stay with the default, as past behavior has shown. In 401(k) plans, the default fund has often been an option, such

as a money market account, with very low risk and which preserves the principal. Often workers, especially lower-income workers, choose these low-risk options and thereby are not able to benefit from the higher returns of a diversified investment approach that includes a mixture of asset classes, including equities and fixed-income securities. By having an asset-allocated automatic default, workers are likely to have more accumulated savings when they retire.

- **Clearinghouse Chooses a Single Default Option.** The Clearinghouse will decide what the default option should be.

Rationale: Having a single default option meets the plan's goal of keeping the system simple in order to make it cost efficient and thereby save on administration costs.

- **Limit of Three Additional Investment Options.** The Group agreed that the plan should be limited to three options beyond the default option for participants who choose to opt out of the default. Additional investment options can include a bond index fund and Treasury Inflation-Protected Securities. In addition, there should be at least one investment choice that is low risk and preserves the principal, since low-income workers tend to be more risk adverse and may not participate if there is no low-risk option. Participants who choose to invest in the low-risk option will be periodically automatically redirected to the default option and will have to opt out each time if they wish to stay in the low-risk investment option.

Rationale: The Group identified a number of reasons for limiting the investment choices to three options beyond the default option. The choice of three options was based partly on ERISA's rules on participant-directed accounts, which state that plans should offer employees at least three investment choices. The Group's decision came after a meeting with experts on operations from financial institutions. The meeting helped the Group to better understand how costs increase with additional investment options. Fewer investment options would reduce the administrative costs (such as processing and call center costs) for the Clearinghouse, which would translate into savings for participants. The Group agreed with the experts that it is less costly to do daily valuations rather than monthly ones, and that the system should be made as paperless as possible. The Group further supported the direct deposit of funds by employers because it is more cost-effective than having funds sent separately.

Building Block 5

Employers are required to provide access to the RIA plan to all employees who are not covered by an employer-sponsored retirement savings plan.

Under the design of the RIA plan, all employers are required to offer workers the opportunity to participate in the RIA if they are not covered by an employer-sponsored contributory retirement plan.

This building block was chosen to be part of the plan design to make sure that all workers not now covered would have the opportunity to save for retirement through payroll deduction.^{xiii} Under this provision

employers must offer access to all groups of eligible workers, which are identified in Building Block 2. The Group discussed at length whether or not an employer must offer the plan to uncovered workers and concluded that the potential burden on employers would be negligible, based on an examination of current practices among employers both with and without payroll firms who handle their business.

Further, it was felt that if the plan did not require employers to provide access to uncovered workers, the full potential for reaching uncovered workers would not be realized. At the same time, the Group was aware that for some very small employers, there may be a need for an exemption to the rule that employers must provide access. Here are the requirements for employers:

- **Uncovered Workers.** Employers that do not sponsor a defined contribution retirement plan would be required to offer all eligible employees the opportunity to contribute to an RIA through payroll deduction. Employers who do sponsor a defined contribution retirement plan will be required to offer employees who are ineligible for the company plan a chance to contribute to an RIA through payroll deduction.
- **Automatic Enrollment.** Employers will automatically enroll all employees who are eligible to participate. Employees can still opt out of participation when employers automatically enroll them.
 - **Exemption from Automatic Enrollment for Very Small Employers.** While the Group did not recommend a specific design for the exemption, the Group agreed that any exemption that is drawn up should be tied to the number of workers at the firm. Exemptions should be based on size limitations already in the law, so that new regulations would not have to be issued specifically for this exemption. Members suggested the following potential exemption thresholds to consider: (i) a size restriction like the one for COBRA^{xiv} (Consolidated Omnibus Budget Reconciliation Act), which affects health insurance; (ii) employers with 10 or fewer workers; or (iii) employers with four or fewer workers. The exemption should affect a very small share of the workforce. Members were opposed to setting the exemption so high that it would allow too many employers to opt out of the requirement to provide employees the opportunity to make payroll deduction contributions to the RIA.
 - **Employer Tax Credit to Encourage Automatic Enrollment.** The Group supported the concept of a modest employer tax credit for employers that are included within the automatic enrollment exemption. The tax credit was supported as an incentive to encourage employers to offer their employees the opportunity to contribute to the RIA through payroll deduction.

Rationale: Automatic enrollment and payroll deduction may be impractical for some very small businesses that do not electronically process payroll. Recognizing this reality, the members of the Working Group agreed to leave open the possibility of providing a very narrowly-constructed exemption that would apply to only a small portion of the workforce.

- **Flow of Funds from the Employer.** The Group explored how financial institutions handle retirement plan contributions from employees to gain insights into how to structure the

Clearinghouse. From conversations with experts on plan operations, the Group came up with a number of recommendations for handling the flow of funds to the Clearinghouse. Contributions for the current year to the RIA could flow from the employer to the Clearinghouse through the employer's payroll vendor. For employers who do not have a payroll vendor, the Clearinghouse could provide web-based services to handle the transfer of funds and associated recordkeeping. Such a web-based mechanism for contributions would allow employers to transmit to the Clearinghouse a list of employees and deduction amounts, which could then transfer funds from the employer's bank account. Funds would flow from the Clearinghouse into private-sector investment funds (an illustration of the Funding Process Flow can be found in Appendix G).

Building Block 6

Contribution limits should be set at an amount that is less than the limits for employer-sponsored plans but higher than that for IRAs.

The RIA plan design does not include specific recommendations for employee contribution limits. However, the Group agreed that there should be guidance on where those limits would be set. In principle, it was agreed that the limits should be set at an amount that is less than the limits for employer-sponsored plans but higher than that for IRAs. Below are the principles the Group agreed should govern decisions on where the limits should be set in relation to employer-sponsored retirement savings plans.

- **Guidance for Setting Limits.** In principle, employee contribution limits should be set at levels higher than those for IRAs but lower than the limits for the SIMPLE.
- **Contribution Percentage.** The members of the Working Group agreed the plan will enroll employees at a target of five to six percent of pay, which was identified as an appropriate level of saving for retirement. However, the Group also agreed the contribution percentage of pay could be lower if research were to show that a higher percentage level would lead employees to opt out of the plan.

Rationale: The recommendation for contribution limits was set at levels that the Group agreed were not likely to detract from the appeal of an employer-sponsored plan, but high enough to make the RIA more attractive than the IRA.

Building Block 7

The plan will not initially provide for employer contributions; this approach eliminates the need for nondiscrimination rules.

The Group deliberately set down rules governing the plan in such a way that it would not detract from the appeal of employer-sponsored plans, recognizing the value of 401(k) plans that use matching

contributions to expand participation and increase savings for a broad spectrum of employees. While there were some members who supported employer contributions, the Group generally agreed to prohibit employer contributions.

- **Nondiscrimination Rules Not Required.** Employer-sponsored plans are governed by nondiscrimination regulations and tests. These were set up to prompt employers to design their plans in such a way that more benefits would be spread across rank-and-file workers instead of being too concentrated among owners and top executives. Without employer contributions, and with a high auto-enrollment contribution rate, the RIA plan will not require a nondiscrimination regulatory regime.

Rationale: It was felt that employer contributions would, for example, complicate the ability of an employer to pass nondiscrimination tests in other plans if the match encouraged workers to contribute only to the RIA plan. Those who opposed employer contributions also said that allowing employer contributions in an RIA would increase the risk of employers dropping existing plans in favor of an RIA. They also noted that such contributions would require an appropriate regulatory regime to meet nondiscrimination concerns, which would greatly complicate the plan, increase costs for the Clearinghouse, and add to administrative burdens on employers.

Building Block 8

The plan will have essentially the same tax treatment that now governs traditional IRAs and 401(k) plans.

This tax treatment would include the following:

- **Pre-Tax Contributions.** Like 401(k) and traditional IRA contributions, employee contributions to the RIA plan would be made on a pre-tax basis.
- **Tax-Exempt Earnings.** Like a 401(k) plan and a traditional IRA, the assets in the RIA plan would grow tax-free.
- **Taxable Distributions.** Like 401(k) and traditional IRA distributions, RIA distributions would be fully taxable as income to the participant when made.
- **Coordination of Limits.** Although RIA contribution limits would be lower than 401(k) plan limits (see Building Block 7), they would be coordinated with the contribution limits for 401(k) plans. For example, RIA participants who subsequently participated in a 401(k) plan later in the same year would have their RIA contributions taken into account when applying the annual employee deferral contribution limits set by the law⁵⁷ (in the same manner that these limits apply to workers who participate in two 401(k) plans in the same year).

Rationale: The RIA has the same tax treatment as other plans, giving workers a deduction for contributions, allowing capital gains without taxation, and deferring taxation until there are withdrawals. This gives the RIA the same tax appeal as other plans and because it does not add additional preferences, it does not have a competitive edge over employer plans, achieving one of the goals of the Working Group.

Building Block 9

A refundable^{xvi} federal matching tax credit can help encourage more workers to save for retirement through the RIA plan.

The Working Group determined that while the RIA plan could function without tax credits, the credits would provide strong incentives to encourage low- and moderate-income workers to save. The Working Group agreed that an initial specified amount of savings by employees would be matched by a tax credit for low- and moderate- income workers. The contributor's eligibility for the tax credit would be reconciled annually through the tax return process.

Today's federal income tax deduction for qualified retirement saving provides no incentive at all for tens of millions of low-earning households who pay the 15.3 percent payroll tax, but who do not have current income tax liability to offset. Even middle-income taxpayers in the 10- and 15-percent tax brackets receive a weak subsidy compared to the deduction for taxpayers earning more than \$200,000 a year, who are typically in the 35 percent federal income tax bracket.

Members spent a considerable amount of time discussing how a tax credit regime might be designed for the RIA plan with the expectation that whatever tax credits were approved for the RIA plan would, like the Saver's Credit, also apply to all employer-sponsored retirement savings plans.

- **Two Policy Goals for the Design of the Tax Credit.** The Group tried to construct the guiding principles for a tax credit that would reach the targeted group. In addition, members sought to design a credit that would be workable; that is, it would prompt more low- and moderate-income workers to contribute, while also being easy for participants to understand and uncomplicated for employers, the Clearinghouse and the IRS. There were two key goals the Group had in mind as it discussed how to design the tax credit:
 - **Target Credit to Low- and Moderate-Income Workers.** The tax credit should be structured to reach the targeted population without further rewarding those who already benefit greatly from retirement savings tax expenditures.
 - **Credit Must Be Deposited into a Retirement Savings Account.** It is preferred public policy to require that the matching tax credit be deposited into a retirement savings account and not be made available to spend on current consumption by the participant. Members supported

this approach because they preferred that the credit add to overall saving for retirement rather than being spent immediately.

- **Policy Challenges Associated with Deposited Tax Credit.** While the Group agreed that the tax credit should be directly deposited into a retirement savings account, they were unable to agree on how to design the credit so that this goal could be accomplished. During the discussion the following key points were made:
 - **Concerns about Complexity and Delays.** There were concerns that if the tax credit went directly into an account, there could be administrative complexity for employers and the IRS, since an individual's income eligibility for the credit may not be known until the following year (see the discussion on eligibility for tax credit below). For this reason, there could be considerable delays in depositing the credit to an individual's account, delaying the time when it would be earning a return.
 - **Concerns about Where to Deposit the Credit.** Even if administrative complexities could be resolved, there were also unresolved questions about where to deposit the credit if it were limited to deposits in retirement accounts only. These concerns arise because the Working Group envisioned that the tax credit, like the Saver's Credit,^{xvii} would be available to all contributory retirement savings plans. For those with only an RIA, it would obviously be deposited there. But what about those in 401(k) plans? Employers might not want to facilitate the deposit of a tax credit into their 401(k) plans, some members argued, especially if the delay resulted in plans receiving deposits for former employees, which would add administrative burdens to the employer.
 - **Concerns about Early Withdrawals of Tax Credit.** Members were also concerned that participants might take early withdrawals of the tax credit and spend them for non-retirement purposes. It was suggested there could be restrictions and penalties on withdrawing the tax credit. However, such restrictions would require three separate tracking "buckets" for the administrator: one for all contributions, another for the tax credit, and a third for earnings on the tax credit. There was concern that this would increase administrative costs.
 - **Plan May Need to Allow for a Flexible, Refundable Tax Credit.** The complications associated with penalties for early withdrawal, administrative complexity, and delays in depositing the credit led some in the Group to conclude that, while it is preferable that the refundable tax credit be automatically saved, in the end, it might be appropriate to make the refundable tax credit available to employees to spend as they wish in order to have a workable tax credit design. Some argued that, for lower-income individuals, receiving money back would provide an additional incentive to save.
- **Match Rate and Income Caps for the Tax Credit.** Members discussed how a tax credit match might help prompt more low- and moderate-income workers to save. Based on studies of the saving experience of employees in response to various employer matches, the Group generally agreed to the following:

- **Match Rate Should Be Sufficient to Generate a Good Response.** The percentage match for contributions should be a strong one; that is, higher rather than lower. Members agreed it would be preferable to apply a higher matching rate to a lower amount of initial saving rather than apply a lower matching rate to a higher level of saving. Support for a higher match rate was based on studies, such as one by H&R Block^{xviii}, which found a match at the 50 percent level prompts a significantly higher percentage of workers to make a contribution, while lower matching rates prompt lower response levels.
- **Example of Suitable Match Rate and Income Cap.** An illustrative example of a match/income cap combination that the Group favored would be one with a match level up to 50 percent applied to a lower portion of income, such as the first \$2,000 – as opposed to a lower match rate, such as 10 percent applied a larger amount of income, such as the first \$10,000.
- **Ways to Limit the Credit to Low- and Moderate-Income Workers.** Members of the Group discussed how they could design a tax credit so that it would benefit primarily, or even solely, this target population. The Saver’s Credit, for example, applies to couples filing jointly who earn below \$52,000. While the Group was unable to design the details of a structure that would limit the tax credit, the following agreements and observations were made:
 - **No Income Cliffs.** Members generally agreed that in no case should the design of the tax credit have income cliffs; that is, it should not be structured so that someone would be eligible at \$50,000 and not eligible at \$50,001.
 - **Phase-Out Design.** The Group discussed the feasibility of having a gradual phase-out of the tax credit for households with incomes between \$50,000 and \$60,000 per year. There was concern, however, that with a phase-out that affected more than a small portion of workers, one would not know one’s income until the year ended. That uncertainty was seen as potentially leading some workers to decide not to participate at the beginning of the year.
 - **Credit for All Workers.** One member proposed providing the tax credit to all workers to eliminate uncertainty about qualifying for the credit for current year contributions. Providing the tax credit to all workers, while simplifying administration and uncertainty over eligibility, would be more costly in terms of lost tax revenues. Furthermore, some of the tax credit would be earned by households that have no need of additional tax subsidies to save.

To reduce the cost of the credit, it was suggested that the tax credit be given to all households, but recaptured by adjusting the overall marginal income tax rate for households with incomes of \$60,000 or more. With adjustments in the overall income tax rate schedule, one can attain approximately the same level of progressivity as one can attain with a phase-out. However, the distribution of benefits and taxes would not be exactly the same. It was seen as politically and technically difficult to adjust income tax rates to compensate for the effects of the tax credit on higher income earners if the RIA proposal were part of a pension reform package only.

However, if it were part of a broader tax package, it would be easier politically and technically to incorporate the adjustments into the broader bill.

- **Limits on Eligibility for Tax Credits.** This approach was taken to deter affluent families and family-owned businesses from taking advantage of the rules and receiving credits on unearned income. Thus, the following rules apply: (i) The amount of any savings eligible for a matching tax credit cannot exceed earned income. (ii) An employee must be at least 16 years old and not a dependent to be eligible for the tax credit.

Building Block 10

Rules governing withdrawals seek to keep the plan simple, while also seeking to preserve assets as much as possible for use in a participant's retirement years.

The Group agreed on some provisions on distributions that are similar to current rules governing 401(k) plans. However, in other cases, the RIA plan disallows some 401(k) options on distributions.

- **Retirement Age.** The Group agreed to apply to the plan the basic retirement age rules of current federal pension law and regulation for 401(k)s. Under this approach, workers who save in retirement saving plans cannot withdraw funds free of an early withdrawal tax until they reach age 59½. When participants reach age 59½, they can withdraw part or all of the funds in the account and pay tax at their income tax rate. Some members supported a requirement that tax credits and their earnings be kept in the plan until a worker reaches Social Security retirement age. The members agreed the normal retirement age be set at 59½ for all contributions, whether from the employee or the government (via tax credits) or the employer, if and when they might be allowed.
- **Hardship Allowed.** Early withdrawals for hardships are allowed under simple rules that reduce the administrative burden for the Clearinghouse. The RIA plan will require, as under 401(k) plans, that the borrower has taken all other available funds and has no money from other sources. The rules will also require that those who apply will document that the requirements have been met. There would be no review of the hardship claim by the plan, and the participant would not have to substantiate the claim.

Rationale: Policymakers in Washington have devised retirement savings plans with rules designed to preserve the savings until a worker is close to normal retirement age. However, low- and moderate-income earners are often reluctant to save in a retirement plan if they cannot have access to those funds for emergencies during their working years. Since the RIA was designed to close the retirement plan coverage gap among low- and moderate-income workers, the Group felt it was important to provide for some way for workers to tap their savings for hardships.

- **No Loans.** The RIA plan does not allow participants to take out loans on the balances in their accounts. Allowing loans from RIAs was seen as a costly feature that would be difficult to implement,

since the Clearinghouse would not be able to arrange for loan repayments via payroll deductions from compensation.

- **No Forced Withdrawals When Changing Jobs.** Under the RIA plan, as is the case in most employer-sponsored plans, there is no requirement to withdraw funds when an employee changes jobs.
- **Rollovers.** As noted in Building Block 1, the plan provides that accounts can be rolled over into employer-sponsored retirement savings plans and IRAs and vice versa. Automatic default rollovers from other plans for sums up to \$5,000 could be rolled over to an RIA instead of an IRA.
- **Government Tax Credits.** The Group was unable to resolve how it would treat early withdrawals of tax credits. Members supported a prohibition against early withdrawals of government tax credits deposited into plan accounts. This prohibition would also apply to withdrawals that are rolled over into another plan, such as a 401(k) or IRA, since early withdrawals are allowed from those accounts. Some members opposed tracking and treating tax credits differently, as it would create complexity and increase costs to the plan.
 - **Possible Resolution.** Two options were proposed to simplify the rollover rules.
 - (i) **Prohibit Rollover of Government Funds.** Prohibit workers from withdrawing or rolling over the portion of their RIA account balance attributable to government credits to employer-sponsored plans and IRAs, which would then permit withdrawals.
 - (ii) **No Tax Credit Restrictions.** Adopt the same rollover rules that apply to 401(k)s and allow rollovers from the RIA into an IRA, with no restriction on tax credits that are rolled over in the process.
 - **Hardship Withdrawals and Tax Credits.** Early hardship withdrawals of tax credits posed another policy dilemma for the Group. While the Group was not able to resolve this, one possible option was identified: treat early withdrawals of the tax credit for hardships the same way that 401(k) plans treat early withdrawals; that is, add a 10 percent tax penalty on top of the income tax that might be owed when a withdrawal is made.

Building Block 11

An independent governing body will oversee the operations of the Clearinghouse and act as a fiduciary.

The oversight body would act as the chief fiduciary for the plan. One of the responsibilities of the Clearinghouse will be to educate workers about the need to save and about the availability of the RIA – so people will find out how easy it is to save.

- **Central Record Keeper.** The Clearinghouse is a national central record keeper and general administrator for the RIA plan. It is a government-sponsored body that would contract out fund management and some administrative duties.
- **Fiduciary Oversight Body.** One possible governance model to consider is the one that governs the Thrift Savings Plan (TSP). The TSP has an oversight board and contracts out investment options to the private sector. The Group also identified as another possible approach the Social Security Administration's governance model, which has a Board of Trustees appointed according to statutory requirements.
- **Minimal Fiduciary Rules for Employers.** Given the automatic enrollment design of the RIA plan and the role of the Clearinghouse, the employer's fiduciary obligations would be limited. Nevertheless, the Working Group felt strongly that the plan should retain basic protections for participants. These protections would include requiring that employee contributions be forwarded by the employer in a timely manner. It would also include minimal disclosure rules, such as information to help participants make a decision about whether to opt out of the automatic enrollment and whether to go along with the default investment or make a different investment choice.

Incremental Steps

Considerable gains in participation and overall retirement savings can be made by expanding participation in existing plans. The Group considered and reviewed several proposals designed to expand coverage incrementally, and generally agreed to support several of them. Below are the details:

- **Automatic Enrollment into Employer Plans.** This means when workers are hired by an employer that sponsors a 401(k) or similar plan, they are automatically enrolled in the plan and the employer therefore begins to transfer a portion of the worker's pay into the plan every pay period. It can also mean that current workers not enrolled are automatically enrolled. In the case of both new hires and current workers, if an employee does not want to be enrolled, the employee gives the employer notice that the employee wants to opt out of automatic enrollment. Automatic enrollment tends to significantly increase the number and percentage of eligible workers who participate in an employer-sponsored plan. The Pension Protection Act of 2006 enables employers to automatically enroll eligible new employees and non-participating employees. Under the law workers must be given a chance to decide not to participate.
- **Automatic Escalation of the Contribution as Share of Pay.** Employers should be encouraged to not only automatically set the contribution rate for employees who do not opt out, but also to raise the rate automatically in subsequent years unless the worker chooses to opt out of such automatic escalation. The Pension Protection Act of 2006 encourages such escalation to the extent that it makes escalation a condition of a 401(k) nondiscrimination safe harbor available to plan sponsors. The Act states that employers can automatically enroll new workers and non-participating employees at three percent of pay, and escalate the percentage of pay contribution to four percent in the second year, five percent in the third year, and six percent in the fourth year. Under the Act, the contribution rate of pay is capped at 10 percent.

State-Based Strategies for Expanding Coverage

Working Group II was also interested in exploring the design of other approaches that use state public employees retirement plans, rather than a national clearinghouse, to promote retirement savings for workers not covered by an employer-sponsored plan.

The Group spoke with experts to learn about new approaches that would enlist the efforts of state governments, in partnership with financial institutions, to promote worker participation in 401(k) plans, SIMPLE plans, or payroll deduction IRAs.^{xx}

In Washington State, the Economic Opportunity Institute, a public policy think tank, has been promoting a proposal to establish Washington Voluntary Retirement Accounts.^{xxi} The central clearinghouse for the program is the state retirement system, which administers the public employee plan for the state. The idea is that the state retirement system would contract with one or more private-sector providers to offer employees in the state the opportunity to save.

There are two tiers to the system. In the first tier, employers would be required to make payroll-deduction IRAs available to all employees without a plan (the requirement that employers offer the IRAs to all eligible employees was tested in focus groups among Washington State employers). In the second tier, employers could choose to offer 401(k) plans or SIMPLE plans to their employees.^{xxii}

There are many other states considering such approaches (including Maryland, Michigan, and Vermont).^{xxiii} In September 2006, Conversation on Coverage staff and some of the Working Group members attended a conference called “State Solutions: Universal Retirement Savings” to lend their expertise and learn more about these efforts.^{xxiv} The discussions on state-based approaches helped reinforce Working Group II’s belief in the importance of the employer’s role in providing access to the plan, as well as shed light on the broad bipartisan appeal of plans aimed at closing the gap in coverage. The Group was interested in how these approaches demonstrate the way states can act as laboratories for developing new policies that might find application nationwide.

- **Preempt State Laws on Written Employee Consent.** Encourage automatic enrollment by affirming that, to the extent necessary to permit automatic enrollment, ERISA preempts state laws that prevent deductions from employee pay without the advance written consent of the employee. The Pension Protection Act of 2006 addresses this issue.
- **Allow Unwinding of Automatic Enrollment Very Early Without Penalty.** Allow plan sponsors to “unwind” the contributions made by employees through automatic enrollment within three to six months after automatic enrollment occurred so that plans could give employees their money back without regard to the restrictions of 401(k) plan withdrawals or the 10 percent early withdrawal tax that would ordinarily apply. The Pension Protection Act of 2006 addresses this issue.
- **Reduce Employer Fiduciary Liability.** Reduce the potential fiduciary liability of plan sponsors of participant-directed retirement savings plans when they specify default investment options that allocate assets in a diversified manner among several asset classes, such as managed accounts, life cycle funds, and balanced funds. The Pension Protection Act of 2006 addresses this issue.
- **Make the Saver’s Credit Permanent.** The Saver’s Credit provides a tax credit of 10-50 percent of 401(k) or IRA contributions up to \$2,000 a year. The credit is aimed at low- and moderate-income workers whose income is \$52,000 or less. The Saver’s Credit was originally set to expire at the end of 2006. The Working Group supported making the credit permanent, which was accomplished with the Pension Protection Act of 2006.

- **Expand the Saver’s Credit and Make it Refundable.** All of those who are eligible for the Saver’s Credit should be eligible for the 50 percent credit rate (i.e., the 10 percent and 20 percent rates should be eliminated). The Saver’s Credit should be refundable. Both changes conform to the design of the Saver’s Credit as it was originally proposed.^{xix}

What’s Next

The Conversation on Coverage will put together a task force of Working Group members, and potentially other interested parties, to determine the appropriate future course of action for moving forward with the RIA. The Group would determine how the remaining details of the proposal would be resolved, including how the governance of the system would be structured, as well as potentially the type of tax credit regimen that would apply to the RIA. Since this proposal cannot be implemented under current law, the Group would determine appropriate future steps.

There are also likely to be opportunities for RIA-type plans in states to test how a new type of clearinghouse approach might work. See sidebar on state-based strategies for expanding coverage on the previous page.

Endnotes

ⁱ Congressional Research Service analysis of the Current Population Survey of March 2005. Data reported in following source document: Patrick Purcell, “Pension Sponsorship and Participation: Summary of Recent Trends,” Updated August 31, 2006, Congressional Research Service, Table 2, p. 6.

ⁱⁱ Ibid.

ⁱⁱⁱ The Saver’s Credit was part of the Economic Growth and Tax Relief Reconciliation Act of 2001. It was made permanent in the Pension Protection Act of 2006.

^{iv} Principles and Standards. Members of the Working Group generally agreed on a list of principles and standards by which it would evaluate proposals. The principles included: The effort would be collaborative while inviting diverse thinking. It would focus on workers with incomes below the median, especially low-income workers, and it would consider the unintended consequences of proposals. Proposals should be efficient to administer and simple to communicate to workers and have a nationally consistent set of rules. Proposals should be politically viable, both in the short term and the long term. Proposals, when considered in total, should be equitable in their benefits and contributions. They should be equitable “horizontally” (meaning that it affects people the same whether or not they have access to an employer-sponsored plan), as well as when viewed “vertically” (meaning across all income levels). Proposals would be judged on whether they are economically efficient and feasible, both in the short term and the long term, as well as whether or not they involve minimal interference in economic, investment and labor markets. Proposals would be judged on whether or not they offer flexible terms and rules for both employees and employers.

^v SIMPLE IRAs and SIMPLE 401(k)s are employer-sponsored retirement plans that are available to small business with fewer than 100 employees, as well as self-employed people. SIMPLE stands for Savings Incentive Match Plan for Employees.

^{vi} The Thrift Savings Plan offers only a handful of few investment options, which is generally seen to make it easier for participants to use and make decisions about investing. The TSP offers, for example, the following five choices: a Government Securities Investment (G) Fund, a Fixed Income Index Investment (F) Fund, a Common Stock Index Investment (C) Fund, a Small Capitalization Stock Index Investment (S) Fund, and an International Stock Index Investment (I) Fund.

^{vii} Bureau of Labor Statistics, “Contingent and Alternative Employment Arrangements, February 2005,” Press Release dated July 27, 2005, p.1. This document can be found at <http://stats.bls.gov/news.release/conemp.nr0.htm>.

^{viii} Ibid, pp. 1 and 4.

^{ix} For a description of the split refund referred to here, see J. Mark Iwry, “Using Tax Refunds to Increase Savings and Retirement Security” (Retirement Security Project Policy Brief No. 2006-9 (Nov. 2005).

^x Employee Benefit Security Administration, Department of Labor, Proposed Default Investment Alternatives Under Participant Directed Individual Account Plans; *Federal Register*: September 27, 2006 (Volume 71, Number 187), From the Federal Register Online via GPO Access (wais.access.gpo.gov), p. 56818.

^{xi} A balanced fund aims to produce high rates of return over the medium to long term. In terms of risk levels, a balanced fund usually occupies a middle position. It is more volatile than a fund with primarily cash and fixed interest investments. It is less volatile than a fund which invests only in equities and real property.

^{xii} In a Lifestyle Fund, the choices about how much to put into equities, bonds and cash are based on the risk tolerance of the investors and the investor’s goals. Lifestyle Funds allow an investor to put all the assets in a single fund and not have to review or revise those investments. The fund periodically adjusts the allocation and gradually becomes increasingly more conservative as the investor moves toward retirement age.

^{xiii} Questions have been raised from time to time as to how the RIA proposal compares or relates to the automatic IRA proposal developed by Working Group member Mark Iwry and his coauthor. (J. Mark Iwry and David C. John, “Pursuing Universal Retirement Security Through Automatic IRAs,” Retirement Security Project working paper dated February 12, 2006 and Testimony Before the Subcommittee on Long-Term Growth and Debt Reduction, Committee on Finance, United States Senate (June 29, 2006).) Because its members include pension and retirement savings experts, the Group’s work, including the RIA proposal, naturally has drawn upon separate work that they and others have done, including the automatic IRA proposal and the Universal Savings Accounts proposed by President Clinton in 1999. However, the RIA and automatic IRA are by no means identical: Building Blocks 2, 3 and 5 and their component elements are generally the same as the automatic IRA proposal, for example, while other aspects of the RIA proposal differ from the automatic IRA.

^{xiv} Congress passed the landmark Consolidated Omnibus Budget Reconciliation Act (COBRA) health benefit provisions in 1986. The law amends the Employee Retirement Income Security Act (ERISA), the Internal Revenue Code, and the Public Health Service Act to provide continuation of group health coverage that otherwise would be terminated. COBRA contains provisions giving certain former employees, retirees, spouses and dependent children the right to temporary continuation of health coverage at group rates.

^{xv} A refundable tax credit is one of three approaches that the government might take to support employee contributions to the RIA. The three are as follows: (1) direct government contributions and matches into the RIA account; (2) a cash refundable tax credit; and (3) a non-cash refundable tax credit. A cash refundable tax credit is one where the recipient can receive the full value of the credit regardless of whether or not they have an income tax liability. A non-cash refundable tax credit is one where the recipient can receive only the value of the tax credit that is

equal to the recipient's tax liability. One member described both the refundable and nonrefundable tax credits as "spendable" tax credits to differentiate them from contributions from the government that are deposited into a savings account.

^{xvi}The tax credits in the Saver's Credit are available up to \$52,000 for married couples, \$26,000 for singles, and \$39,000 for heads of household. The credit rate ranges from 50 percent for the lowest income brackets to 10 percent for the highest income brackets. People whose incomes are above the income levels stated above do not qualify for the credit.

^{xvii}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." Washington, D.C.: The Retirement Security Project, sponsored by Pew Charitable Trusts in partnership with Georgetown University's Public Policy Institute and the Brookings Institution, No. 2005-5, May 2005.

^{xviii}The Saver's Credit provides 10 to 50 percent government matches for individual contributions of low and moderate income workers. For more details, see section titled "Expand Saver's Credit" in the interim report, *Covering the Uncovered, Common Ground Recommendations to Expand Retirement Savings for American Workers*, Working Report, May 2005, pp. 55-56.

^{xix}These are the 402(g) limits of the Internal Revenue Code that apply to employee deferrals into retirement savings plans such as SIMPLE, 401(k), 403(b), and 457 plans.

^{xx}Information on state-based approaches can be found in articles and congressional testimony by J. Mark Iwry, "State K: A strategy for Using State-Assisted Savings to Expand Private Pension Coverage," testimony before the Subcommittee on Long-term Growth and Debt Reduction, Senate Committee on Finance, June 29, 2006.

^{xxi}The Washington State Universal Savings Account proposal has been developed and promoted by the Economic Opportunity Institute's Executive Director John Burbank and Policy Director Marilyn Watkins. The Washington proposal was first inspired by a paper written by Working Group member Dean Baker, Co-Director of the Center for Economic and Policy Research. Mark Iwry, a Working Group member who is a Nonresident Senior Fellow at the Brookings Institution, proposed state-based savings approaches to Maryland, Michigan, Vermont and other states and provided extensive policy and strategic consultation and legislative drafting to Washington, suggesting frameworks to ensure these approaches are consistent with federal law.

^{xxii}Washington Voluntary Retirement Accounts program development has been funded by both the House and Senate budgets in the state of Washington. To learn more, visit <http://www.eoionline.org/Policy-WVA.htm>.

^{xxiii}In Michigan, the Governor embraced the concept of a state-based universal 401(k) in her 2006 State of the Union address; In Maryland the House of Delegates unanimously passed a bill to explore the feasibility of implementing such a program. See J. Mark Iwry, "Growing Private Pensions: A Supporting Role for the States," *Tax Management Compensation Planning Journal*, December 1, 2006.

^{xxiv}The conference was hosted by the Economic Opportunity Institute; the Economic Analysis and Research Network; and J. Mark Iwry, nonresident Senior Fellow, the Brookings Institution. It was funded by AARP, the Retirement Research Foundation, the Heinz Family Philanthropies, Economic Policy Institute and WISER.

