

# A Universal 401(k) Plan

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With over \$12 trillion in assets, traditional pension trusts and 401(k)-style saving plans account for the vast majority of financial assets accumulated by households in recent years. For those with access, America's employer-based private pension system provides powerful saving incentives—both tax breaks and employer contributions—as well as the convenience and discipline of automatic payroll deduction. Unfortunately, employer-sponsored plans cover less than half of all workers. More than 70 million American workers do not participate in a tax-subsidized, payroll deduction saving plan—and therefore they tend to save very little for retirement. As a result, a projected 40 percent of today's baby boomers are likely to depend almost entirely on Social Security's poverty-level benefit after age 70.

As a nation, we are saving too little and not doing enough to give lower-paid workers the combination of opportunity and security they need to cope with accelerating technological and economic change. We need to facilitate pension portability while simultaneously shifting the burden of subsidizing basic benefits from American business to society as a whole.

The solution is a Universal 401(k) plan that gives *every* worker access to an automatic, professionally administered

retirement saving plan—an Individual Career Account (ICA). The plan would supplement, not supplant, the existing private pension system. All workers not participating in an employer plan, including recent hires and part-time employees, would be signed up to contribute automatically by payroll deduction, although an individual could choose not to save. The government would match voluntary contributions by workers and their employers with refundable tax credits deposited directly into the worker's account. Workers participating in their employer's plan would receive stronger tax incentives to save, but otherwise see no difference. Contributions for workers not participating in an employer plan would be forwarded to a federal clearinghouse, which would manage small accounts at low cost and could even convert account balances into guaranteed income for life at retirement. Individuals could maintain the account throughout their careers, since it would remain open as they moved from job to job. This supplemental system would make saving easier, automatic, and fair.

## Limitations of our Industrial-Era Pension System

America's postwar pension system has been a great success in many important respects. From 1945 to the late 1970s, the percentage of private-sector

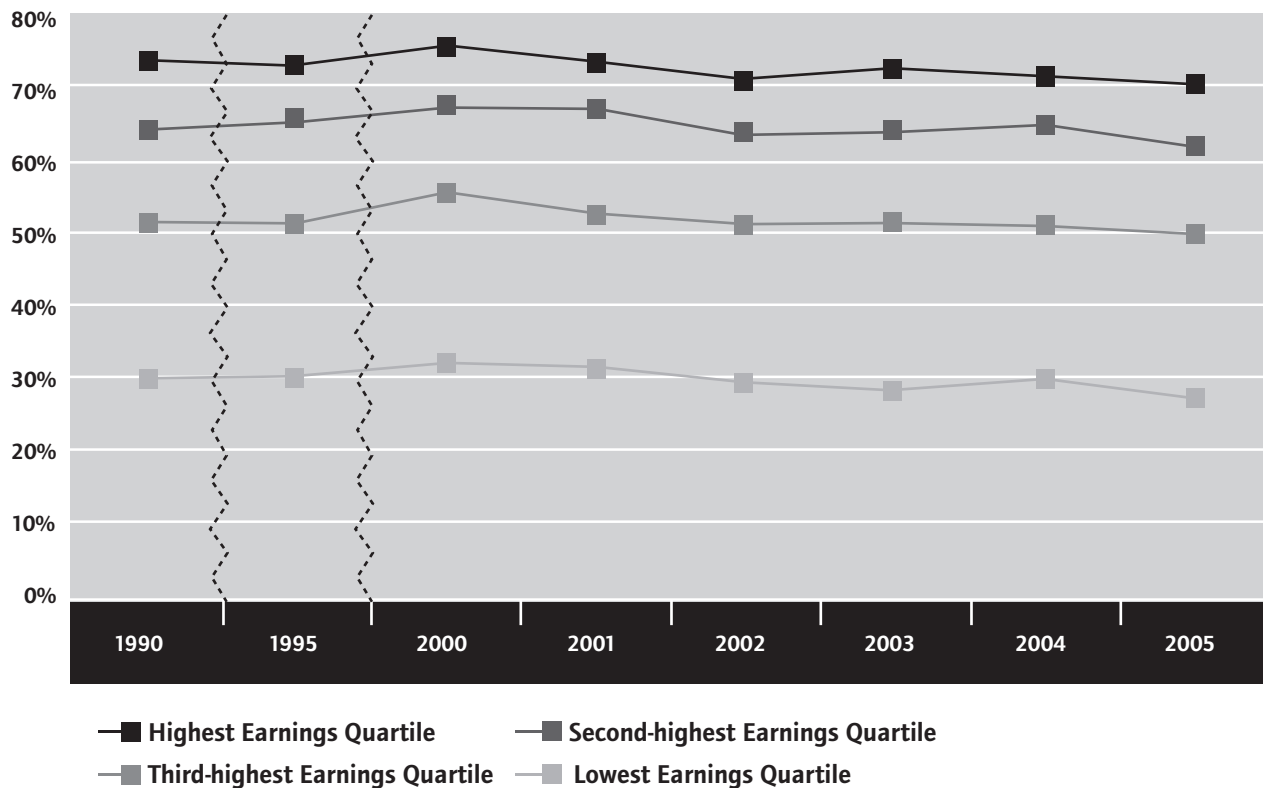
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workers covered by pension plans grew rapidly from 20 percent to just above 50 percent. The working and middle classes became shareholders and, with Social Security, accumulated the foundation for a secure retirement. Pension funds also steadily became the world's largest pool of "patient capital," boosting U.S. growth and innovation by underpinning the world's most sophisticated, liquid, and dynamic capital market.

When the landmark Employee Retirement Security Act (ERISA) became law in 1974, its fiduciary, funding, vesting and other provisions were designed to perfect what was then a system of employer-sponsored defined-benefit (DB) pensions. Employers made all the contributions and shouldered all the investment risk, managing pooled

trusts subject to government oversight at relatively low cost. Workers—at least those who clocked more than 20 hours per week—were automatically covered and received, at retirement, guaranteed monthly income for life. The federal government insured these traditional pension benefits against employer bankruptcy through the Pension Benefit Guarantee Corporation. Combined with Social Security, these pensions allowed workers who remained at a firm for 30 or more years to replace well over half of their pre-retirement income, with the primary risk being that inflation could reduce the purchasing power of their fixed pension benefit over time (particularly as, in recent years, most firms have stopped giving regular cost-of-living adjustments).

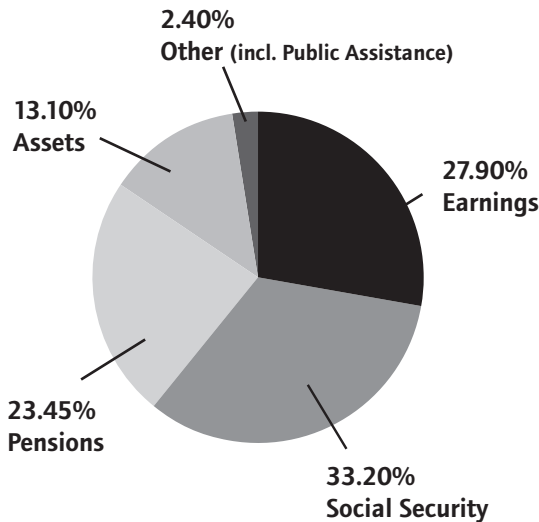
PARTICIPATION IN RETIREMENT PLANS BY ANNUAL EARNINGS  
PRIVATE-SECTOR WAGE AND SALARY WORKERS EMPLOYED YEAR-ROUND, FULL-TIME, AGES 25–64



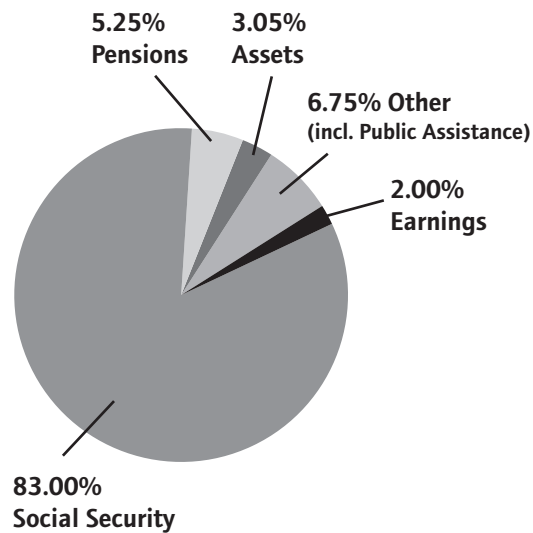
Source: Congressional Research Service Analysis of March 2005 *Current Population Survey*.

SHARES OF U.S. RETIREMENT INCOME BY SOURCE, POPULATION 65 AND OVER, 2004

TOP TWO INCOME QUINTILES (HIGHEST 40%)



BOTTOM TWO INCOME QUINTILES (LOWEST 40%)



Source: Social Security Administration, *Income of Population 55 or Older, 2004*, released May 2006.

This industrial-era system was based on assumptions of career-long job tenure, stable corporate structures, pressure from strong unions, and large doses of employer paternalism—conditions, like traditional DB plans themselves, that have been rapidly disappearing over the past two decades. Since the first 401(k) plan emerged out of an unintended tax loophole in 1981, the number of U.S. firms with DB plans has plunged from 100,000 to fewer than 30,000 now. Today, we are a 401(k) nation. More than 60 percent of private-sector workers lucky enough to have any pension benefit work at firms that sponsor only a 401(k)-type contribution plan.

Even as 401(k)s and other defined-contribution accounts emerged as the dominant plan type, the nation’s fundamental approach to encouraging pension coverage and retirement saving has not changed. It continues to rely entirely on voluntary plan sponsorship by employers who are offered tax carrots in the form of deductions that disproportionately

benefit high-wage earners and are subject to regulatory sticks—antidiscrimination, fiduciary, and reporting requirements—that, however reasonable, discourage small employers in particular from helping their employees save.

**What Is Needed**

A renewed and updated effort to facilitate saving and retirement security for *all* Americans should be designed to address the following unmet needs:

**Improve individual retirement security.** America’s real retirement security crisis is not about Social Security or the many big companies freezing their traditional pension plans and switching to 401(k)s. The larger problem is that a minority of American adults are participating in *any* retirement plan—whether DB or 401(k) plans or Individual Retirement Accounts (IRAs). Participation in employer plans peaked during the 1970s and has remained on a plateau since. Only 45 percent of all private-sector

workers participated in a retirement plan in 2005, according to the Congressional Research Service. While participation is slightly higher among full-time workers (52 percent), it is also strikingly low among workers who are low-income, young, work part-time, or work at small firms. A General Accounting Office study found that 85 percent

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of Americans without a pension benefit at work shared one or more of these four characteristics. Thus, whereas 65 percent of full-time workers at firms with more than 100 employees participate in retirement plans, that rate sinks to 45 percent at firms with fewer than 100 employees, and it plunges to 25 percent for firms employing fewer than 25.

Fewer than 60 percent of today's older workers, those aged 47 to 64, are on track to maintain even

half of their pre-retirement standard of living during retirement. Too many individuals and families are headed toward retirement age with little more than Social Security's safety net. A great deal of the opposition to partial privatization of Social Security undoubtedly related to the average citizen's keen awareness of how many elderly desperately depend on the program's meager but guaranteed (and inflation-adjusted) monthly payment. Among the elderly, 40 percent rely on Social Security for 90 percent or more of their income—a dependency ratio that is even higher for widows and unlikely to improve for the baby boomer generation, according to government projections.

**Boost national saving and investment.** Despite the fact that baby boomers—the largest segment of the adult population—are in their prime saving years, the personal saving rate in 2005 was actually *negative* (-0.4 percent) for the first time since 1933, during

the Great Depression. If we truly want to promote national saving, reduce dependency on social insurance, and create an inclusive “ownership society,” we will need new mechanisms that extend the advantages of private pensions to everyone. After all, retirement plans are how America saves: tax-deferred pension plans (of all kinds) have accounted for more than 80 percent of personal saving in recent years.

Not surprisingly, pension participation is lowest among workers whose savings would truly *add* to net national saving: workers who earn less than the median wage. While the affluent can respond to tax incentives for saving by *shifting* rather than actually increasing their net saving effort, households that would not otherwise save generate net new national saving. Indeed, a majority of middle-to-low-income households are not responding to current incentives. Among the bottom 60 percent of all workers by income—those earning less than \$40,000—only about a third (36 percent) participate in employer plans, according to the Congressional Budget Office.

We might at least expect the workers lucky enough to participate in 401(k)-type plans to be accumulating significant savings. Among the subset of high-tax-bracket earners with steady access to a 401(k), this is the case. But participation rates in the bottom two quintiles of the earning distribution are far lower, and the average amount accumulated is barely above \$10,000. Even among 401(k) participants in the middle-earning quintile, the average account balance was only about \$30,000 in 2001. One reason for the low participation rates and accumulations is that even if a worker has coverage today, he or she may not have access to a plan next year in a new job. Even if the new employer sponsors a plan, new hires are not eligible to participate for at least one year. The result is gaps in coverage. What is needed is a seamless, lifelong saving system.

Even when lower-wage workers have consistent access to an employer plan, the tax incentives for saving are upside-down. The tax break for retirement saving is one of Washington's most expensive programs, costing a projected \$134 billion in uncol-

lected federal tax revenue this fiscal year alone. Yet about 70 percent of that subsidy goes to the most affluent 20 percent of taxpayers—and virtually none (2 percent) goes to encourage saving by the lowest-earning 40 percent. The reason is simple but too often overlooked even by liberal policymakers: a program subsidized by tax *deductions*, as opposed to refundable tax *credits*, is highly regressive.

Qualified retirement saving today reduces taxable income, a deduction that is worth 35 cents on the dollar to high-bracket taxpayers who need little incentive to save. In contrast, a tax deduction for saving is worth *zero* to the 35 million low-earning households who pay 15.2 percent in payroll taxes but don't have income tax liability to offset. Indeed, even median-income families in the 10 and 15 percent income tax brackets receive a weak subsidy compared to the 35 percent subsidy rate that applies to those earning over \$200,000 a year.

Another way to deliver a subsidy through the tax code is through a credit, which directly reduces taxes due. In fact, the Saver's Credit, enacted in 2001, creates this incentive, although it is limited to very low-income taxpayers with income tax liabilities to offset. The most powerful way to ensure that low-income workers receive an incentive at least as generous as an affluent worker is to make the Saver's Credit *refundable*, as the Earned Income Tax Credit (EITC) is, so that the low-wage worker receives it even if she has only payroll tax and not income tax liability.

**Increase benefit portability and workforce flexibility.** In yesterday's more stable, goods-producing economy, traditional pensions were designed to reward seniority and to retain older, long-tenured workers with firm-specific skills. Domestic firms were more insulated from foreign competition, unions were stronger, job tenures were longer, and a much higher share of the (predominantly male) workforce occupied standard full-time jobs.

The 21st-century workforce is very different. The service and information technology economy puts a premium on younger, more educated workers with transferable skills. Competition, both

foreign and domestic, creates enormous volatility for companies and workers alike. Median job tenure has declined significantly over the past two decades. Even at firms with retirement plans, an increasing number of workers cycle through jobs without earning employer-paid benefits, since it typically takes one year to be eligible to participate and five years to vest. A combination of two-income families and just-in-time labor strategies by firms has increased the share of nonstandard work arrangements. Nearly 30 percent of U.S. workers are working in part-time, temporary, or contract arrangements that rarely include pension coverage. While this emerging "free agent" workforce may be good for flexibility and productivity, it makes the current employer-based pension system increasingly inadequate.

**Lighten the social benefit burden on business.** It's clear that most small and start-up companies either cannot or prefer not to shoulder the administrative burden and financial risk of sponsoring a pension plan. Indeed, despite the "carrot" of tax subsidies for pension plans, a majority of firms with fewer than 500 employees do not offer one. In addition, even very large companies with a predominantly low-income workforce—the Wal-Marts and McDonalds among employers—have little incentive to sponsor a plan for workers who (a) receive little or no financial benefit from a tax deduction and (b) without a strong incentive would prefer a higher wage now to an employer contribution for retirement. In contrast, big, high-wage employers—the Microsofts and Intels—use retirement plans to steer tens of millions of dollars in pension tax subsidies to their employees every year.

This creates the anomalous situation whereby the federal government provides more than \$100 billion in compensation subsidies to the employees of a minority of companies—most of which are large firms with workers paid above-average wages. Meanwhile, companies with a substantial percentage of low-wage workers that *do* offer good benefits (employers like Starbucks) are paternalistically shouldering a cost that should be borne by

society as a whole—and which will need to be if we want to achieve universal retirement security. If, instead, contributions by both workers and firms were matched by a refundable federal tax credit, then—as with the EITC—the after-tax value of benefits paid to low-wage workers would be less expensive, rather than more so.

### **Individual Career Accounts: A Universal 401(k)**

Today's private pension system works well for those workers who have consistent access to a plan and choose to save. One big reason retirement plans are effective in generating saving is the powerful incentives provided by immediate tax deductions and employer matching contributions. Another reason is infrastructure: employer-sponsored plans create the positive inertia of automatic payroll deductions while also managing the complexities of investment management at relatively low cost. These two key attributes—incentives and an infrastructure for automatic saving—is what needs to be replicated for all Americans.

An essential step is to give every working American access to a tax incentive and portable savings account *whether or not* his current employer sponsors a retirement plan. The fact that so few workers (less than 10 percent) save regularly in IRAs reinforces what demonstration projects in asset-building have found: it is not primarily access to a savings account that spurs participation, but the three “I’s”—Incentives, Infrastructure, and Inertia. The proposed Individual Career Account would recast federal pension policy by adding:

A tax *incentive* for saving that is more inclusive—and potent—by expanding the Saver's Credit, making it refundable and directly deposited into an ICA.

An account-based *infrastructure* that is citizen-based, rather than strictly employer-based, yet enables every worker to opt for regular contributions by automatic payroll deduction.

Default options that convert myopia into positive *inertia*, through automatic enrollment, automatic payroll deduction, automatic asset allocation, and automatic annuitization.

### **Basic Program Elements: Incentives, Infrastructure, Inertia**

A Universal 401(k) system can accomplish the various national policy objectives described above by combining the following basic elements:

**1. Incentives: matching, refundable, and deposited credits for new saving.** Just as most employers match contributions to 401(k) accounts, the government would match voluntary saving by providing a refundable tax credit that would be deposited directly into the worker's account. This would create a far more powerful saving incentive for middle- and low-wage workers than current law. As noted above, a tax *deduction* is neither an effective nor an equitable means to encourage pension saving among lower-income and younger workers, whether or not they participate in an employer plan. And although the current Saver's Credit provides (most commonly) a 10 percent tax credit for retirement saving by low-income taxpayers, the lack of refundability means that millions of working-poor families—who have payroll tax but no current income tax liability to offset—receive no credit at all.

Instead, a refundable credit would operate just like an employer match in a company 401(k) plan. Studies show that workers are far more likely to save if given generous matching credits—and once they develop the habit of saving by payroll deduction, most continue even when the match rate is reduced. A sliding-scale credit could give a greater incentive to low-income workers who are least likely to save. For example, workers in families earning below \$40,000 could receive a \$1 per \$1 (1:1) matching credit on their first \$2,000 in savings; whereas workers in families earning above that level could receive a \$0.50 per \$1 (1:2) matching credit on their first \$4,000 in savings. This would give all workers the opportunity to receive as much as \$2,000 each year in matching deposits to their accounts, but the higher-wage earners would need to make twice the saving effort.

Like the current Saver's Credit, the refundable credit should apply equally to contributions to 401(k)s and other employer-sponsored plans.

Eligibility for the credit would be reconciled annually through the income tax return process, which would also be used to encourage taxpayers to save all or a portion of their tax refunds.

Matching credits should be available for both individual and employer contributions. This would give employers a greater incentive to make deposits on behalf of their low-wage workers. Yet, by extending pension saving incentives to all workers as individuals, employers would have the option to provide a pension benefit without the need to administer a pension plan. Employers could decide from year to year whether to contribute to their workers' accounts—although in doing so, they should be required to contribute either a flat percentage or a flat dollar amount for all their payroll employees (otherwise ICAs could undermine ERISA antidiscrimination rules to ensure that employers are not using the tax subsidies to favor only their higher-wage employees).

**2. Infrastructure: automatic payroll deduction and account administration.** Equally important is replicating the retirement plan infrastructure that is key to the success of employer-sponsored 401(k) plans. As with 401(k) plans, every worker should have access to the convenience, discipline, and protections provided by automatic payroll deduction and professional asset management. When a worker fills out the required IRS Form W-4 (used to calculate tax withholding), he or she can simply specify a monthly saving deduction. That's the only decision a worker needs to make—a choice to save.

The sole burden on employers would be to forward this automatic payroll deduction to the employer's own retirement saving plan (if there is one and the employee participates) or to a government clearinghouse. Since most employers today use automated payroll processing services, there would be virtually no cost to forward the deduction to a central clearinghouse. Even employers who do not automate payroll must forward income and payroll tax withholding to the IRS, so including withholding amounts for saving would be a minor burden.

A new entity—a clearinghouse akin to the Federal Thrift Savings Plan (TSP), which manages very low-cost 401(k)-style saving accounts for 3 million federal military and civilian personnel—would receive all deposits and be the default administrator for small accounts. Record keeping would be centralized, but the investment management would be contracted out to private investment firms, as with TSP. The clearinghouse would strive to keep costs and complexity to a minimum. As with TSP, participants should have at most a choice among a small number of very low-cost index funds. Although payroll-deducted savings and matching tax credits would flow through the clearinghouse, the assets should be fully portable and transferable at any time at the worker's request to another qualified financial institution, or to a future employer's pension plan.

**Individual Career Accounts would supplement, not supplant, the existing private pension system.**

**3. Inertia: default options for enrollment, investment and annuitization.** The W-4 form required of every worker would provide a simple means of indicating how much an individual wanted withheld and saved each pay period. Even better, the Universal 401(k) system could convert myopia into positive inertia by making participation the default option. (Studies have shown that automatic enrollment has boosted 401(k) participation rates among low-income workers from 13 to 80 percent.) Unless the worker decided to opt out, the W-4 would give notice of the amount to be deducted and saved each pay period. The initial default contribution could be modest—3 or 4 percent of each paycheck—increasing by 1 percent a year thereafter, as pay increased, until it reached a level likely to achieve an adequate accumulation over time.

If a worker did not wish to participate in his employer's plan, the payroll deduction would flow automatically to the federal clearinghouse and into

his Individual Career Account. Although the worker should be able to switch, periodically, between a very limited number of broad and low-cost index funds, there would be a default asset allocation for workers who made no choice at all—most likely a life-cycle fund that would automatically adjust the mix of stocks and bonds to match the worker’s age and years until retirement age.

Finally, at retirement age, the default option should be monthly payments rather than lump-sum withdrawals to ensure that retirees do not outlive their benefits, replicating the great advantage of a defined-benefit plan. Although individuals could choose to withdraw (or roll over) all or part of their nest egg, there should be incentives to encourage and facilitate annuitization. This an-

nuity benefit could be contracted to one or several private insurers, or taken on by the Pension Benefit Guarantee Corporation, the federal pension insurer that currently manages guaranteed annuity payments each month for millions of private-sector retirees who were participants in a defaulted employer plan.

While Americans clearly support retaining Social Security’s defined-benefit safety net, neither Social Security nor the inadequate coverage of today’s private pension system is providing enough income in retirement. Thus, a citizen-based, portable, and automatic system—providing those who find it most difficult to save with powerful right-side-up tax incentives—may be exactly the retirement revolution we need.❖