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RETIREMENT IN A DEFINED CONTRIBUTION ERA: MAKING THE MONEY LAST

DAVID PRATT*

I. INTRODUCTION

According to the great pension scholar Lefty Frizzell, “If you’ve got the money, honey, I’ve got the time.”¹ Unfortunately, with increased longevity, and an increasing reliance on defined contribution arrangements to supplement Social Security, many baby boomers are likely to find that they have plenty of time, but no money.

The American population is aging, resulting in financial pressures on Social Security and Medicare. Recent financial catastrophes such as the sub-prime mortgage fiasco, have focused new attention on the private pension system. These concerns are exacerbated by the recent, and probably irreversible, trend away from defined benefit plans to defined contribution plans.² Many prominent and profitable U.S. companies (including I.B.M.) have recently abandoned their defined benefit plans. Not enough Americans receive any private pension to supplement Social Security³ and, for many of those who do, the amount received is

* Professor of Law, Albany Law School. This article is dedicated to my son Sam, with love and thanks.

1. LEFTY FRIZZELL, *If You’ve Got the Money (I’ve Got the Time)*, on LISTEN TO LEFTY (Columbia 1953).

2. See, e.g., *Report of the Working Group on Planning for Retirement*, U.S. DEP’T. OF LABOR 1 (2001), available at www.dol.gov/ebsa/publications/AC_1114_01_report.html (quoting Sylvester Schieber, “In considering how to increase coverage and participation, we must focus on the type of plan to which our culture has driven us—401(k) plans—and quit beating our heads against a wall trying to bring back the “good old days” of the DB plan”).

3. “The percentage of people 65 and older receiving income from pensions rose until the early 1990s, peaking at 38% in 1992. The proportion of the elderly population receiving pension income has since fallen slightly. In 2004, 36% of people 65 and older received pension income.” Patrick Purcell & Debra Whitman, *Topics in Aging: Income of Americans Age 65 and Older, 1969 to 2004 Congressional Research Service*, CONG. RESEARCH SERV., RL33387, 20 (Apr. 20, 2006), available at http://assets.opencrs.com/rpts/RL33387_20060420.pdf.

inadequate.⁴ In 2004, those sixty-five and older with less than \$9,260 in income depended on Social Security for about \$4 out of every \$5 of that income.⁵ Pensions and asset income only accounted for 7% of their income.⁶

In addition, forty years after enactment of the Equal Pay Act, gender differences persist. From 1980 to 2004, men ages sixty-five and older saw an increase of 69% in median pension income from \$7,096 to \$12,000 annually, but women only saw an increase of 41% from \$4,347 to \$6,141 annually.⁷

One problem is the complexity of the federal pension laws and regulations, particularly those governing defined benefit plans.⁸ The nondiscrimination rules⁹ (and the related minimum coverage rules)¹⁰ have now become so complex that few pension professionals have more than a general understanding of how they operate in practice. Plan sponsors tend to be completely befuddled.¹¹

4. "Among people 65 and older who received pension income, the mean annual amount (in 2004 dollars) rose from \$8,848 in 1975 to \$13,953 in 2004, an increase of 58% or 1.5% per year." *Id.* at 20-21.

5. *Id.* at 22.

6. *Id.*

7. *Id.* at 25.

8. See, e.g., *Overview of Present-Law Rules Relating to Qualified Pension Plans*, JOINT COMM. ON TAX'N. (JCX-30-98) (May 4, 1998) (stating that the federal pension laws "are recognized as among the most complex set of rules applicable to any area of the tax law.").

The only way to learn the rules of this Game is to take the usual prescribed course, which requires many years; and none of the initiates could ever possibly have any interest in making these rules easier to learn . . . These rules, the sign language and grammar of the Game, constitute a kind of highly developed secret language . . .

Alvin D. Lurie, *Of Sticks But Not Carrots: A Process Made More Awry*, 8 AM. J. OF TAX POL'Y 69, 71-72 (1989) (quoting Herman Hesse).

9. I.R.C. § 401(a)(4)-(5)(2000); Treas. Reg. §§ 1.401-0 to 13 (1954).

10. I.R.C. § 410(b) (2000); Treas. Reg. § 1.410(b)-0 to 10 (1954).

11. See Pamela Perun & C. Eugene Steuerle, *Reality Testing for Pension Reform*, URBAN INST. 1, 2 (2003), available at http://www.urban.org/UploadedPDF/410797_reality_testing_pension_reform.pdf (quoting Dave Barry).

I'm staring at documents that make no sense to me, no matter how many beers I drink. . . . Apparently I have until Sept. 30 (in most instances) . . . to comply with something (but what?) called "GUST" . . . [for my Keogh plan and I] . . . must adopt EGTRRA prior to the end of the plan year beginning in 2002. I am, frankly, reluctant to adopt anything called "EGTRRA," which sounds like the name of a giant radioactive chicken that destroys Tokyo . . . the federal Tax Code is out of control It's gigantic and insanely complex, and it gets worse all the time. Nobody has ever read the whole thing. IRS workers are afraid to go into the same ROOM with it. They keep it locked in the basement, and once a day, they open the door, heave in a live taxpayer—some poor slob who failed to adopt EGTRRA in time to comply with GUST (and various other amendments)—then slam the door shut, before the screams start.

Complaints about complexity are not a recent phenomenon. Over sixty years ago, after enactment of the Revenue Act of 1942, one commentator wrote that the result of the legislation was “provisions so complicated that they are difficult to read and in some respects so vague that they may be hard to apply.”¹² At that time, there were only four basic plan qualification requirements set out in the Internal Revenue Code (“IRC”): today, there are thirty-six.¹³

The Joint Committee on Taxation has pointed to the ongoing conflict between retirement policy and tax policy:

[r]etirement income policy would argue for laws and regulations that do not unduly hinder the ability or the willingness of an employer to establish a retirement plan . . . tax policy requires a balancing of the tax benefits provided to an employer who maintains a qualified plan in relation to all other tax subsidies provided by the Federal tax laws This balancing has led the Congress (1) to limit the total amount of benefits that may be provided to any one employee by a qualified plan and (2) to adopt strict nondiscrimination rules to prevent highly compensated employees from receiving a disproportionate amount of the tax subsidy provided with respect to qualified pension plans.¹⁴

As a result of federal legislation enacted in 2001,¹⁵ there is now almost total portability of assets between all types of defined contribution plans. In general, any “eligible rollover distribution”¹⁶ from a tax-favored retirement plan, including an individual retirement account (IRA), may be rolled over into any other such

Id.

12. John W. Drye, Jr., *Pension and Other Deferred Compensation Plans under Section 162 of the Revenue Act of 1942*, 2 N.Y.U. INST. FED. TAX’N. 48, 50 (1943).

13. I.R.C. § 401(a)(1)-(36) (2000).

14. *Overview of Present Law Tax Rules Relating to Qualified Pension Plans*, JOINT COMM. ON TAX’N. (JCX-30-98) (May 4, 1998).

15. See The Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”), Pub. L. No. 107-16, 115 Stat. 38, 118-28 (2001) (expanding portability of assets between all types of contribution plans).

16. Any distribution is an eligible rollover distribution, except (A) Any distribution which is one of a series of substantially equal periodic payments (not less frequently than annually), made (i) for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of the employee and the employee’s designated beneficiary, or (ii) for a fixed period of 10 years or more; (B) A required minimum distribution (RMD) under Internal Revenue Code section 401(a)(9); or (C) A hardship distribution. See I.R.C. § 402(c)(4) (1986) (paraphrasing the I.R.C.).

Under the regulations, the following are also not eligible rollover distributions: (1) Certain corrective distributions, (2) unpaid loans from the plan that are treated as deemed distributions; (3) dividends paid on employee securities held by an employee stock ownership plan (ESOP); and (4) the taxable cost of life insurance protection under a qualified plan. Treas. Reg. § 1.402(c)-2.

plan which accepts such transfers.¹⁷ Accordingly, the main focus of attention with respect to defined contribution plans is to increase the number of employees who are covered by a plan, to increase account balances, particularly for middle—and low—income employees, and to reduce the amount of pre-retirement leakage from the retirement system.

The growing importance of defined contribution plans and IRAs (including rollover IRAs) as a source of retirement income raises concerns as to the management and distribution of those funds:

The accumulation of these assets in individual retirement accounts raises important questions for the next step in retirement security—the distribution of these assets. Will retirees be able to manage these assets in a manner so as not to outlive them? Do individuals understand that life expectancy is an *average*, and not a definite number of years that any given person will live? Are individuals aware of and/or do they understand products such as annuities that insure against longevity risk? The answers to these questions, as well as others, will determine if the build-up of these assets in IRAs ultimately will be successful in providing Americans security in retirement. It is not just the *accumulation* of assets, but also the appropriate *spending* of the assets that will determine whether Americans with IRAs and other retirement savings will be able to afford to maintain a comfortable retirement.¹⁸

II. INADEQUATE PENSION PROVISION¹⁹

A. Inadequate Coverage

As the Aspen Institute noted in a recent report, the U.S. personal savings rate is at its lowest point since the Great Depression.²⁰ Of the lowest 20% of households (in terms of income) only 10% own tax-favored retirement accounts, compared to 85% of the top 20% households.²¹ The median value of the accounts of the bottom 20% is \$4,500, compared to \$130,000 median for the

17. I.R.C. §§ 402(c)(1) (2000); 403(b)(8); 408(d)(3)(A), (D); 457(e)(16)(B).

18. Craig Copeland, *IRA Assets, Contributions, and Market Share*, 28 EBRI NOTES 1, 12 (Jan. 2007), available at http://www.ebri.org/pdf/notespdf/EBRI_Notes_01-20071.pdf.

19. See generally Patrick J. Purcell, *Order Code RL 30122, Pension Sponsorship and Participation: Summary of Recent Trends*, CONG. RESEARCH SERV. (Sept. 6, 2007), available at http://assets.opencrs.com/rpts/RL30122_20070906.pdf.

20. Lisa Menash, et al., *Initiative on Financial Security, Savings For Life: A Pathway To Financial Security For All Americans*, 2008 THE ASPEN INST. 1, 11, available at http://www.aspeninstitute.org/atf/cf/%7BDEB6F227-659B-4EC8-8F84-8DF23CA704F5%7D/Savings_for_Life.pdf.

21. *Id.*

top 20%.²²

Tax expenditures for private retirement plans, including IRAs, totaled one quarter of total annual Social Security contributions, \$114 billion in 2004.²³ Federal spending in the form of tax expenditures for 401(k) plans is expected to grow 28% by 2009 while that for traditional plans is expected to fall by 2.1%.²⁴

In the past, most reform proposals have focused on expanding coverage under the private retirement system, but those attempts have failed, repeatedly. "Only about fifty percent of the private-sector workforce has access to work-based retirement plans at any point in their working lives- a percentage that has varied little for decades."²⁵ Workers, who earn less than \$40,000 per year, are dramatically less likely to have access to retirement plans.²⁶ The number of employees with access to retirement plans fell from 52.5 million in 2005 to 51.2 million in 2006.²⁷ The number of those participating in plans fell from forty six million in 2000 to forty two million in 2006. By way of comparison, coverage rates by occupational schemes in the European Union in 2000 ranged from less than 10% in Greece and Portugal to 90% in Sweden and the Netherlands.²⁸

Several factors are closely correlated with coverage, including union membership, firm size,²⁹ age,³⁰ and earnings:

In 2006, 70.9% of year-round, full-time workers in the private sector with annual earnings in the top quartile were employed by firms

22. *Id.*

23. Teresa Ghilarducci, *The Changing Role of Employer Pensions: Tax Expenditures, Costs, and Implications for Middle-Class Elderly* 4 (The Levy Economic Institute of Bard College, Working Paper No. 469, Aug. 2006), available at <http://ssrn.com/abstract=906607> (follow "go to Document Download" hyperlink; then choose a deliverer).

24. *Id.*

25. Menash, *supra* note 20, at 25.

26. *Id.*

27. *Id.*

28. *Study on Pension Schemes of the Member States of the European Union*, INT'L. MKT. DIRECTORATE-GEN. 25, 38, 49, 62, (May 2000), available at http://www.efrp.org/downloads/eu_publications/may2000.pdf.

29. *Id.* Only 22.9% of workers at firms with fewer than twenty-five employees participated in an employer-sponsored retirement plan in 2006, compared to 42.6% of workers at firms with twenty-five to ninety-nine employees and 62.7% of workers at firms with one-hundred or more employees. *Id.* The proportion of year-round, full-time workers who were employed at firms that offered a retirement plan rose from 62.8% in 1990 to 66.3% in 2000, but fell to 57.2% in 2006. Purcell, *supra* note 19-21, at 27.

30. Young workers—ages twenty-five to thirty-four—were less likely than middle-aged and older workers to be employed at a firm that sponsored a retirement plan in 2006. *Id.* They also were less likely to participate in retirement plans than are older workers. *Id.*

that sponsored a retirement plan, and 66.7% of workers in the top earnings quartile participated in a retirement plan.

As one witness stated to a U.S. Department of Labor ("DOL") Working Group:

We get pension simplification, pension complication, tax reform, high marginal rates, low marginal rates, and one thing stays constant, and that is probably the vexing problem. All of the interventions that have been tried and all of the external forces that have influenced us over the last 20 years, it hasn't budged the pension coverage rate more than a percentage or two.³¹

B. Inadequate Benefits

At the same time, retirement income adequacy for most Americans has suffered a downward trend, despite the exceptionally healthy economy throughout the 1990s:

In 1998, every group of near-retirees except those at the very top lost ground compared with their counterparts in 1983. The contraction of traditional defined benefit pension plans and their replacement by defined contribution plans appears to have helped rich, older Americans but hurt a large group of lower-income Americans.³²

According to one recent study, the shift from defined benefit to defined contribution pension plans has reduced pension wealth and income; and between 1992 and 2004, the average household age fifty-one to fifty-six saw a decline in total pension wealth of about 10%, and a decline in pension replacement rates from 32% to 26%.³³

C. Employers That Do Not Offer a Pension Plan

In the United States, as in European countries, there is a mandatory social insurance system, Social Security that provides retirement, death and disability benefits to workers, self-employed individuals and their families. Employers have no obligation to offer a supplemental plan. In 1981, a Presidential Commission recommended a Minimum Universal Pension System (MUPS) for

31. See *Report of the Working Group on Increasing Pension Coverage, Participation and Benefits*, U.S. DEPT. OF LABOR (Nov. 13, 2001), available at www.dol.gov/ebsa/publications/AC_1114a01_report.htm (quoting Richard Hinz).

32. News Release, Edward N. Wolff, *Retirement Insecurity: The Income Shortfalls Awaiting the Soon-to-Retire*, ECON. POLICY INST. (2002), available at http://www.epi.org/content.cfm/press_releases_wolff0502_02b.

33. Olga Sorokina et al., *Pension Wealth and Income: 1992, 1998, and 2004*, CTR. FOR RET. RESEARCH AT BOSTON COLLEGE 1-5, (Jan. 2008) available at http://crr.bc.edu/images/stories/Briefs/ib_8_1.pdf?phpMyAdmin=43ac483c4de9t51d9eb41.

all workers, funded by employer contributions equal to 3% of pay, but the recommendation has never come close to being enacted.³⁴ In the present political climate, it is highly unlikely that any mandated pension proposal will receive serious consideration. Mandated pensions, like other benefit mandates, are vehemently opposed by small businesses, where most of the gaps in pension coverage exist.³⁵

In any event, if additional retirement benefits were to be mandated, it would be far simpler and more cost-effective to increase Social Security benefits, rather than requiring each employer to set up a separate plan to supplement Social Security. In the present climate of hostility toward Social Security, and concern as to how to finance the current benefits, this outcome is extremely unlikely.

Public-sector workers have traditionally had pension coverage. "In 1993, 91% of the 18.6 million federal, state and local government employees worked for agencies that sponsored pension plans, [and 77%] of all workers were actually covered."³⁶ By contrast, many private-sector employers (primarily smaller employers) do not offer any type of supplemental pension plan to their employees.

According to the 2002 Small Employer Retirement Survey (SERS) (involving employers with five to one hundred full-time workers), the most commonly cited "most important" reasons for having a plan were competitive advantage in recruitment and retention, positive effect on employee attitude and performance, and tax advantages for employees. The most commonly cited "most important" reasons for *not* having a plan were: employees prefer wages and/or other benefits; revenue is too uncertain to commit to a plan; a large portion of workers are seasonal, part time or high

34. PRESIDENT'S COMMISSION ON PENSION POLICY, *Coming of Age: Toward a National Retirement Income Policy*, 1981 GOV'T PRINTING OFFICE 131.

All employees over the age of 25, with one year of service and 1,000 hours of employment with their employer would be participants in the system. Vesting of benefits would be immediate. . . Those employers who do not wish to administer an employee pension plan could send their contributions to the portability clearinghouse within the Social Security Administration. These funds would be transferred to a central MUPS portability fund which would be established to invest the funds in the economy. The fund should be administered by an independent Board of Trustees appointed by the President.

Id.

35. See, e.g., Frank S. Swain & Lynne L. Garbose, *Mandated Pensions: The Next Hurdle for Small Businesses*, EMPLOYEE BENEFIT RESEARCH INST. 207, 212 (1987).

36. AMERICAN ACADEMY OF ACTUARIES, FINANCING THE RETIREMENT OF FUTURE GENERATIONS, THE PROBLEM AND OPTIONS FOR CHANGE, PUBLIC POLICY MONOGRAPH, NO. 1, 10, (1998) available at <http://www.actuary.org/pd/fpension/retirement.pdf>.

turnover; required company contributions are too expensive; and it costs too much to set up and administer a plan.³⁷

According to the 2000 Small Employer Retirement Survey:

Small employers that offer retirement plans tend to have higher revenues than those that do not have retirement plans. They are less likely to be a family-owned business. These differences persist even when sponsors and nonsponsors of similar sizes are compared. . . . Employees in companies without plans tend to be younger, have lower earnings, have less formal education, and remain with the company for less time.³⁸

Employers that do not currently sponsor plans could be encouraged to offer plans by a combination of educational outreach and economic incentives. Similarly, educational outreach efforts and economic incentives could also be targeted at employees of non-sponsoring employers, to encourage them to ask their employers to make a plan available.³⁹ However, in an era of increasing income inequality, when the average worker is less well off than he or she was thirty years ago, and even families with two-full time workers find it hard to make ends meet, how can we realistically expect lower-income workers to set aside funds for their future retirement needs, rather than current needs (food, housing, health insurance, etc.)?⁴⁰

Those employers that are not willing to contribute to the cost of providing pensions should at least be required to facilitate tax-

37. *Most Small Businesses Unaware of New Tax Law Incentives to Sponsor a Retirement Plan*, SMALL EMPLOYER RET. SURVEY 1, 2 (2002), available at <http://www.ebri.org/pdf/pr596.pdf>.

38. *Small Employers Without Plans*, EBRI SMALL EMPLOYER RETIREMENT SURVEY 1 (2002), available at <http://ebri.com/pdf/surveys/sers/2002/02sers1.pdf>.

39. *See id.* (concluding that:

[L]ong-term efforts to increase coverage among small employers have the greatest potential for success if they include: education of workers, so that they view retirement planning and saving as a personal priority and communicate their desire for a retirement plan to their employer; ongoing good economic conditions, so that business profits and the affordability of plan sponsorship improve; and policy approaches such as simplification and tax credits that help make plans more affordable.)

40. News Release, *18th Annual Retirement Confidence Survey*, EMPLOYEE BENEFITS RESEARCH INST. (Apr. 9, 2008), available at http://ebri.com/pdf/PR_796a_09Apr08.pdf. When asked what they think is the most pressing financial issue facing most Americans today, only 5% of workers 4% of retirees cited saving or planning for retirement. *Id.* Instead, they listed making ends meet or the cost of living (17% of workers, 19% of retirees); paying for health insurance or medical expenses (16% of workers, 25% of retirees); making mortgage payments or paying for housing (16% of workers, 10% of retirees); paying down debt or loans (13% of workers, 5% of retirees); fuel or energy costs (9% of workers and retirees); and job uncertainty (6% of workers, 8% of retirees). *Id.*

favored retirement savings by making available to their employees voluntary payroll deductions for retirement savings and forwarding those savings to an appropriate pension provider.⁴¹ “Only 14% of US households contributed to IRAs in 2006, . . . [but IRAs are owned] by forty six million households and hold more than \$4.6 trillion in assets.”⁴²

D. Workers Who Are Not Eligible to Participate in Their Employers’ Plans

The Treasury regulations implementing the coverage and nondiscrimination rules⁴³ are exceptionally complex, and often require detailed numerical computations. They reflect a change to supposedly objective mathematical tests from the facts and circumstances approach that prevailed before enactment of the Tax Reform Act of 1986 (“TRA 86”).

Many workers are not eligible to participate in their employers’ plans, for any of several reasons. First, they may not yet be eligible to participate. Generally, the employer may require attainment of age twenty-one and completion of one year of service with the employer before the employee is covered by the plan, and coverage is then prospective only.⁴⁴ For the typical employee who changes jobs several times during a working career, the requirement to satisfy a waiting period with each new employer will result in several years of no pension coverage.⁴⁵

For this purpose, and also for vesting purposes, a year of service is generally defined as a twelve month period in which the employee is credited with at least 1,000 paid hours (working or

41. See, e.g., Mike Zapler, *Bill Would Give Workers Savings Plan, Targets Those Who Lack 401(k)*, SAN JOSE MERCURY NEWS (Apr. 10, 2008).

[California] workers who aren’t offered a retirement plan by their employers would be able to set up a 401(k)-style account through the state of California, under a proposal unveiled by a Democratic lawmaker and backed by Gov. Schwarzenegger Assembly Bill 2940 would make California the first state to open its public retirement plan to workers in the private sector, although several other states are considering the idea Employers could choose to provide matching investments. Workers would be able to carry the accounts from job to job.

Id.

42. *IRA Savers Preserving IRA Assets As Long As Possible: ICI Study*, CCH PENSION AND BENEFITS NEWS (Feb. 14, 2008), available at <http://hr.cch.com/news/pension/021408a.asp>.

43. Treas. Reg. §§ 1.401(a)(4)-0 to -13, 1.410(b)-0 to -10 (1954).

44. Employee Retirement Income Security Act of 1974, I.R.C. § 410(a), as amended (“ERISA”) § 202(a), 29 U.S.C. § 1052(a) (2000).

45. In January, 2004, 23% of workers had a year or less of tenure with their current employer. Bureau of Labor and Statistics, *Employee Tenure Summary*, U.S. DEP’T. OF LABOR (Sept. 21, 2004), available at http://www.bls.gov/news.release/History/tenure_09212004.txt.

non-working).⁴⁶ Accordingly, permanent part-time or seasonal employees may never become eligible or, if eligible, may never acquire vested rights. In both the public and private sectors, there is a major difference in coverage between part-time and full-time employees.⁴⁷

Second, the employer is not required to include all of its employees in the plan, even if they have satisfied the age and service eligibility requirements described above. Participation may be limited to certain categories of employees (e.g., salaried employees) or to certain divisions or locations of the employer. In general, an employer may exclude at least 30% of its non-highly compensated employees (NHCEs) from plan participation for almost any reason.⁴⁸ A qualified plan must cover a minimum percentage of the employer's NHCEs.⁴⁹ The minimum percentage is determined by reference to the percentage of highly compensated employees (HCEs) who benefit under the plan.

Assume that an employer has one thousand NHCEs. The pension plan requires an employee to have one year of service and to attain age twenty one before he or she is eligible to participate, and two hundred of these employees have not yet satisfied these requirements. The plan will qualify if it covers at least 560 (70% of 800) of the NHCEs. If the plan covers only 50% of the employer's HCEs, then the plan need only cover 280 (70% of 50% of 800) of the NHCEs.⁵⁰

The current 70% threshold—though sanctioned by long usage—is too low. Why should an employer be able to exclude at least 30% of its non-excludable employees—as well as all of its excludable employees—for any reason it chooses?⁵¹ At a

46. I.R.C. § 410(a)(3), ERISA § 202(a)(3), 29 U.S.C. § 1052(a)(3) (as amended 2006).

47. According to a 1998 study, only 12% of part-time workers in the private sector participated in pension plans, versus 50% of full-time workers. Am. Academy of Actuaries, *Trends in Retirement Income Security*, POLICY MONOGRAPH 1 (1998), available at www.actuary.org. In the public sector, 30% of part-timers were covered in 1993, while 85% of full-time workers were covered. *Id.*

48. The exclusion may not, however, violate the laws that prohibit discrimination on the basis of gender, race, age or disability.

49. I.R.C. §§ 401(a)(3), 410(b). The minimum coverage rules were originally enacted in 1942. Internal Revenue Code of 1939, §165(a)(3), added by The Revenue Act of 1942, §162, 56 Stat. 798, 862.

50. I.R.C. § 410(b).

51. Michael W. Melton, *Making the Nondiscrimination Rules of Tax-Qualified Retirement Plans More Effective*, 71 B.U. L. REV. 47, 107 (1991).

[I]t is not clear why any ratio less than one hundred percent is acceptable in noncontributory plans If participation by the lower- and middle-income employees is the primary justification for the tax expenditure created by the special treatment afforded qualified plans, then no policy justifies allowing the exclusion of thirty percent or more

Congressional hearing in 1942, a Treasury official said that the 70% threshold was selected because it was “reasonable.”⁵² I support the position taken by Daniel Halperin and Alicia Munnell: generally, a qualified pension plan should cover all employees (in a given line of business), and this, “[n]ondiscrimination would mean that the same provisions cover all employees. If the plan failed this simple test, none of the participants would be eligible for favorable tax treatment.”⁵³

Third, most tax-favored retirement arrangements are (and are generally required to be) limited to *employees* of the firm or firms sponsoring the plan.⁵⁴ Thus, if the worker is an independent contractor rather than an employee, he or she is not allowed to participate.

Nearly one-third of the workforce is in “non-standard” jobs; part-time, temporary, contract worker, or self-employed. This “free agency” workforce makes traditional pension coverage less adequate, especially for working mothers.⁵⁵

These problems should be addressed by tightening the employee coverage rules. In particular, (1) The 70% rule, which has been in effect since 1942, makes no sense and should be repealed. Employers should be required to cover all employees who

of these workers from noncontributory plans.

Id.

52. See *Revenue Revision of 1942: Hearings Before the House Comm. on Ways and Means*, 77th Cong., 2d Sess. 87 at 2407 (1942) (quoting Randolph Paul, Special Tax Advisor to the Secretary of the Treasury). The Treasury apparently did consider requiring 100% coverage but believed such a requirement would be too stringent. *Id.* at 1-17 (1942) (quoting Hon. Henry Morgenthau, Secretary of the Treasury).

53. Daniel I. Halperin & Alicia H. Munnell, *How the Pension System Should Be Reformed*, Brookings Institution Conference on ERISA After 25 Years: A Framework for Evaluating Pension Reform (Sept. 1999); see also Collins, *Reviving Defined Benefit Plans: Analysis and Suggestions for Reform*, 20 VA. TAX REV. 599 (2001) (stating that:

[p]lans should be required to cover all employees, including part-time employees, but with retention of modified QSLOB rules. As a trade-off for this extension of coverage, employers should be permitted to exclude employees from participating in the plan until they complete two years of service, rather than the one year of service rule currently in effect under Code section 410(a) and used by most employers.)

54. The only significant exceptions to this rule, found in the opening words of § 401(a), are self-employed individuals (who are treated as employees by § 401(c) and leased employees (as defined in § 414(n)).

55. *Report of the Working Group on Increasing Pension Coverage, Participation and Benefits*, U.S. DEP'T. OF LABOR (Nov. 13, 2001), available at www.dol.gov/ebsa/publications/AC_1114a01_report.html.

are at least twenty one years old and have completed a short period of service (somewhere between 30 and 90 days). (2) The number of hours of service required for eligibility and vesting should be reduced from 1,000 to no more than 250.

E. Eligible Employees Who Do Not Participate

When ERISA was enacted in 1974, relatively few plans required employee contributions as a condition of participation. Outside the governmental sector, where contributory plans are still the norm, contributory defined benefit plans were (and are) very rare. Some employers maintained contributory defined contribution plans (often called thrift plans), but the vast majority of plans were funded entirely by the employer.

This picture has changed dramatically since the 1978 enactment of section 401(k) of the Code. Originally seen as a way to supplement benefits provided by another plan (typically a defined benefit plan), 401(k) plans have become the dominant type of retirement plan in the United States, at the same time as the number of defined benefit plans has steadily declined.

Under some 401(k) plans, the amount of the employer contribution for an employee is independent of whether, or how much, the employee voluntarily contributes to the plan. Thus, for instance, the plan may provide that the employer will contribute annually, for each eligible employee, 5% of his or her compensation for the year. However, under the vast majority of 401(k) plans, at least part of the employer contribution is a matching contribution which is made only for employees who have agreed to contribute their own funds, so that employees who do not contribute do not receive any matching contributions.

The matching contribution approach is attractive to employers for three major reasons. First, many employers believe that the cost of saving for retirement should be, and should be seen to be, shared between the employer and the employee. Second, the contributions by the employees reduce the cost to the employer of providing a given level of retirement benefits. Third, the availability of matching contributions is one of the best ways to encourage employees (particularly lower-paid employees) to contribute their own funds, which is desirable from a retirement planning viewpoint and is also generally necessary to the qualification of the 401(k) arrangement.

A rational employee who can afford to do so should contribute at least the amount which will entitle him or her to receive the maximum available matching contribution from the employer.⁵⁶

56. For instance, under a common matching formula the employer agrees to make a 50% matching contribution on employee contributions up to 6% of pay, so that the maximum available matching contribution is 3% of pay. Here, it

However, some are unwilling, or feel unable, to do so.⁵⁷ Employee participation in 401(k) plans has for some time averaged in the mid-70% range,⁵⁸ but participation rates are 80% or higher in plans with a 100% employer match.⁵⁹

Research has shown that educational efforts on the part of plan sponsors can improve participation and contribution rates in 401(k) plans.⁶⁰ However, when the effectiveness of employer education is judged by subsequent investment behavior, rather than intentions following the seminar, the success is more limited.⁶¹

Participants' desire for financial assistance is clear. In a 2006 survey, over three-quarters of those surveyed stated that they would like expert investment advice. Close to the same proportion wanted an expert to "support and affirm their investment decision." However, the survey also found that less than half of individuals who are offered financial planning or investment advisory services by their employer actually use them.⁶²

would be rational for the employee to contribute 6% of pay, and the survey evidence confirms that many employees do exactly that.

57. In 2005, according to a study by Hewitt Associates, 42.5% of participants aged 20 to 29 contributed under 5% of pay, compared to 35.6% in 2004. Hewitt Associates, *How Well Are Employees Saving and Investing in 401(k) Plans, 2006 Hewitt Universe Benchmarks* (2005). Nearly 40% of participants with less than one year of tenure contributed under 5% of pay, compared to 35.4% in 2004. *Id.* Almost half (49.4%) of participants earning less than \$20,000 per year contributed under 5% of pay versus 40% in 2004. *Id.* 21.8% of participants did not contribute enough to obtain the full company match. *Id.* Approximately 30% of participants contributed only enough to their plan to obtain the full employer match. *Id.*

58. Press Release, Hewitt Associates, *Hewitt Research Shows U.S. Employees Not Interacting with 401(k) Plan for Optimal Benefit*, (July 8, 2002), available at <http://was.hewitt.com>.

59. *Report of the Working Group on Planning for Retirement*, U.S. DEP'T. OF LABOR (Nov. 14, 2001), available at www.dol.gov/ebsa/publications/AC_111401_report.html.

60. Society of Actuaries, *Financial Education and Retirement Savings, Conference Proceedings from the Retirement Implications of Demographic and Family Change Symposium* (2002).

61. ADVANTAGE BENEFITS GROUP, *Advice Efforts by Providers Go Unused*, available at <http://www.advantageben.com/Advice%20Efforts%20by%20Providers%20Go%20Unused.pdf>.

Although retirement plan providers supply investment education materials to 56% of participants surveyed by Spectrem Group, only 12% said they refer to these materials on a regular basis and 22% never use them Procrastination was given as the primary reason participants do not utilize investment advice arrangements. According to the study report, 61% of respondents stated they simply have not gotten around to it.

Id.

62. Julie Agnew, *Personalized Retirement Advice and Managed Accounts: Who Uses Them and How Does Advice Affect Behavior in 401(k) Plans?*, (CRR

Research also demonstrates the influence of plan design on savings and asset allocation decisions. For example, a 2004 paper⁶³ indicates that the probability of participation falls as the number of investment choices increases, suggesting that individuals may be susceptible to choice overload:

While people generally value the ability to choose, it is recognized that having to choose complicates any decision and may even reduce their ability to make rational decisions. . . . Researchers have now begun to quantify the effects of "choice overload" as it relates to retirement plan participation, finding that for every 10 funds added to a plan the predicted participation rate drops by 2%.⁶⁴

A General Accounting Office report⁶⁵ found that a majority of persons without pension coverage had at least one of the following characteristics: low income, part-time employment, employment at small firms, or youth. The report found a strong correlation between having one or more of these traits and either not wanting coverage or being unable to save for retirement. A Department of Labor Working Group concluded that:

Significant reasons why more employees do not participate in pension plans sponsored by their employers include: the growing predominance of elective plans over traditional defined benefit plans that provide automatic coverage; employees give cash wages a higher priority than pension coverage; employees give health insurance a higher priority than pension coverage; a lack of personalized information or knowledge; inertia and fear; employment patterns; a sense that pension coverage is unnecessary or futile; the lack of the incentive of an employer matching contribution; and the lack of tax incentives for lower income workers.⁶⁶

Working Paper 2006-9, Ctr. for Ret. Research at Boston College 2006).

63. Sethi-Iyengar, Huberman and Jiang, *How Much Choice is Too Much? Contributions to 401(k) Retirement Plans*, in *Pension Design and Structure: New Lessons From Behavioral Finance* (Pension Research Council Working Paper 2004, 83-95).

64. Shlomo Benartzi, *Implications of Participant Behavior for Plan Design*, ALLIANCE BERNSTEIN INV. (Jan. 2006), available at http://www.allianceberns tein.com/CmsObjectABD/PDF/Research_WhitePaper/R29284_Implications_01_31_WP.pdf.

65. PENSION PLANS: CHARACTERISTICS OF PERSONS IN THE LABOR FORCE WITHOUT PENSION COVERAGE, U.S. GEN. ACCOUNTING OFFICE GAO/HEHS-00-131 (2000), available at <http://www.gao.gov/archive/2000/he00131.pdf>.

66. REPORT OF THE WORKING GROUP ON INCREASING PENSION COVERAGE, PARTICIPATION AND BENEFITS, U.S. DEP'T OF LABOR (Nov. 13, 2001), available at www.dol.gov/ebsa/publications/AC_1114a01_report.html; see also *Retirement Plan Participation and Features, and the Standard of Living of Americans 55 or Older*, EBRI ISSUE BRIEF No. 248 (Aug. 2002), available at www.ebri.org. (stating that "[t]he predominant reason for choosing not to participate was that doing so was unaffordable.").

Many employees are insufficiently aware of the need to plan; Employees need to be more educated about the importance of planning for retirement and employers also need to overcome the employees' inertia by careful plan design.⁶⁷ Plans should be designed to automatically enroll participants, adopt higher default contribution rates, provide default investment funds with higher expected rates of return, and implement pre-commitment mechanisms for future contributions.⁶⁸

In 2005, the average participation rate for plans with automatic enrollment was fourteen percentage points higher, compared to plans across the entire Hewitt Associates database. With automatic enrollment, participation was thirty percentage points higher for workers with less than one year of tenure, and twenty-one percentage points higher for workers with less than \$20,000 in annual salary. For workers aged twenty to twenty-nine, participation was 22% higher under automatic enrollment. However, despite these improvements, enrollment for younger, lower-tenured, and lower-salaried workers remained relatively low. Nearly three quarters of workers in their forties and fifties contributed in 2005, but only 47.5% of workers in their twenties. Only 39% of eligible workers with salaries less than \$20,000 participated, and 61% of eligible workers earning \$20,000 to \$39,999 participated.⁶⁹ Section 902 of the Pension Protection Act of 2006 ("PPA") includes provisions to encourage automatic enrollment programs, generally effective for plan years beginning *after* December 31, 2007. It is too early to assess the effect of this change.

Until recently, an employer that sponsored a 401(k) plan generally had a strong incentive to encourage its lower-paid employees to save under the plan, because the maximum rate of savings available to highly compensated employees was determined by the average savings rate of the non-highly compensated employees.⁷⁰ Now, however, an employer can adopt a safe-harbor plan design that is automatically deemed to satisfy this test, even if no rank-and-file employee saves a dollar under the plan. There are two safe harbor plan designs: (1) The employer makes a fully vested, nonelective contribution of at least 3% of pay

67. Alicia H. Munnell, et al., *What Determines 401(k) Participation and Contributions?*, (Boston College Ctr. for Ret. Research Working Paper No. 2000-12).

68. James Choi, David Laibson, Brigitte Madrian and Andrew Metrick, *How to Increase 401(k) Saving*, www.nber.org/aginghealth/fall02/401kSaving.html.

69. Hewitt Associates, *How Well Are Employees Saving and Investing in 401(k) Plans* (2006), available at http://www.hewittassociates.com/_MetaBasicCMAssetCache/_Assets/Articles/401k2006Benchmarks.pdf.

70. I.R.C. § 401(k).

for each participant, regardless of whether the participant elects to contribute; or (2) The employer makes a fully vested, matching contribution for each participant who elects to contribute. The matching contribution must be at least equal to (i) 100% of the participant's deferrals up to 3% of pay, plus (ii) 50% of deferrals between 4% and 5% of pay, so that a participant who defers at least 5% of pay will receive a matching contribution of at least 4% of pay.⁷¹

It is not yet clear whether these safe harbor designs will reduce the level of employee savings. For many employees, the safe harbor employer contributions, in addition to being vested immediately, are larger than the employer contributions made previously. However, the concern is that the employer, particularly if it adopts the matching contribution safe harbor, no longer has an incentive to encourage employees to contribute: in fact, from a strictly financial viewpoint, the less the employees contribute, the less the cost will be to the employer.

Employees should be encouraged to participate by a combination of educational outreach⁷² and economic incentives. In 2001, The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") enacted a non-refundable tax credit, for lower-income individuals who contribute to an IRA or an employer-sponsored retirement plan.⁷³ The maximum credit is 50% of retirement contributions up to \$2,000. As originally enacted, the credit expired after the 2006 tax year.

The Pension Protection Act of 2006 ("PPA") made the credit permanent and provided for the eligible income brackets to be indexed for inflation.⁷⁴ However, "[b]ecause it is non-refundable,

71. I.R.C. § 401(k)(12).

72. See Olivia Mitchell and Stephen Utkus, *Lessons from Behavioral Finance for Retirement Plan Design*, 32-37 (Pension Research Council Working Paper 2003-6, 2003) (suggesting that "the current education model in 401(k) plans may have reached its effective limits" and concluding that "[i]t is because retirement savings decisions are at least an order of magnitude more complex than other economic decisions, that people need help"); see also Victor Saliterman & Barry G. Sheckley, *Adult Learning Principles and Pension Participant Behavior*, (Pension Research Council Working Paper 2003-17, 2, 2003) (suggesting that

participants who receive information about their retirement savings in accord with research-based principles of how adults learn best, will markedly increase contributions to their retirement plans. Educational activities that are learner-centered guide participants through a recognition of how they can use information about investment options to devise effective financial plans. Activities that engage participants as active, self-determining individuals who will benefit from assistance that helps them to reflect upon, make informed choices about, and take control of their retirement saving plans.)

73. I.R.C. § 25(B).

74. Pension Protection Act of 2006 (hereinafter "PPA"), Pub. L. No. 109-280,

some families may not benefit from the retirement savings tax credit because they have no net income tax liability. Also, the credit may not be large enough to provide a savings incentive for families with incomes near the upper limits.”⁷⁵

In order to be effective, the income thresholds should be increased, and the credit should be made refundable.

Finally, however, it may be unrealistic to expect increased savings by employees in the short-term, given that many of them are being required to contribute more to the cost of their health insurance which, for most employees, particularly those with young children, is significantly more important than future pension benefits.

F. Vesting

Prior to the enactment of ERISA in 1974, federal pension law did not require any vesting prior to attainment of normal retirement age which was typically (then as now) age sixty five. Those plans that did provide some pre-retirement vesting often required long periods (twenty to twenty five years) of continuous service. ERISA reduced the maximum permissible vesting period to fifteen years (not necessarily continuous) and limited significantly the ability of a plan to ignore service performed before a relatively brief break in service.⁷⁶

In 1986, plans were required to provide either (1) five year “cliff” vesting—no vesting before the completion of five years of service and 100% vesting thereafter—or graduated vesting: 20% after three years of service and an additional 20% for each subsequent year, resulting in 100% vesting after seven years of service.⁷⁷ In 2001, employer matching contributions were subjected to faster vesting rules: either three year “cliff” vesting or (2) graduated vesting: 20% after two years of service and an

§§ 812, 833(a), 120 Stat. 780, 1003-04 (2006); see Patrick Purcell, CONG. RESEARCH SERV., *The Retirement Savings Tax Credit: A Fact Sheet 2* (2007).

75. Purcell, *supra* note 74, at 2; see also William G. Gale, et al., *Improving Tax Incentives for Low-Income Savers; The Savers' Credit*, URBAN-BROOKINGS TAX POLICY CTR., Discussion Paper No.22 (June 2005) (discussing the problems with tax credits for low income families).

76. I.R.C. § 411; ERISA § 204; see also Frank V. Auriemma, et al., *Graying Teachers: A Report on State Pension Systems and School District Early Retirement Incentives*, U. of Or. Eric Clearinghouse (1992) (stating that these vesting rules do not apply to governmental or church plans). A 1992 study found that vesting periods for state retirement programs for teachers ranged from three to twenty years, with five and ten years being the most common periods. *Id.*

77. I.R.C. § 416. These faster vesting schedules for matching contributions have applied since 1982 to plans classified as “top-heavy,” under which more than 60% of all plan benefits have accrued for the benefit of certain owners and officers. *Id.*

additional 20% for each subsequent year, resulting in 100% vesting after six years of service.⁷⁸

The Pension Protection Act of 2006 (“PPA”) subjects all employer contributions to covered defined contribution plans to the same vesting requirements as now apply to matching contributions.⁷⁹ Accordingly, employer contributions must vest under either a three-year cliff schedule or a six-year graded schedule, beginning with 20% vesting after two years of service. Years of service before the effective date must be taken into account.

Despite these improvements, a significant number of plan participants still terminate employment—often with more than one employer during their work career, and particularly at younger ages—before becoming fully vested, so that part or all of their accumulated benefits is forfeited. Survey evidence indicates that the median job tenure in the American economy in January, 2004 was about four years,⁸⁰ which is less than the number of years of service needed for full vesting under three of the four minimum vesting schedules (five-year cliff, three to seven year graded and two to six year graded). About 25% of all workers had been with their current employer for twelve months or less.⁸¹

The solution here is relatively straightforward, and much less controversial than it would have been ten years ago: require all employer-provided benefits to be fully vested after (at most) two years of service. Benefits derived from employee contributions (voluntary or mandatory) are already required to be fully vested at all times.

G. Pre-Retirement Leakage

Almost all defined contribution plans and account-based defined benefit plans (such as cash balance plans) distribute benefits in a lump sum to participants who terminate employment before retirement. An increasing number of traditional defined benefit plans also do so.⁸²

78. *Id.*

79. PPA § 904, amending ERISA § 203 and I.R.C. § 411. The new rules are effective for contributions for plan years beginning after December 31, 2006. *Id.* The requirements do not apply to a participant until the participant has an hour of service after the effective date. *Id.* There are delayed effective dates for collectively bargained plans and certain leveraged ESOPs. *Id.*

80. Bureau of Labor and Statistics, *Employee Tenure in 2004*, U.S. DEPT OF LABOR USDL 04-1829, (Sept. 21, 2004). The median tenure in the private sector was 3.6 years (7.0 years in the public sector). Craig Copeland, *Employee Tenure: Stable Overall, But Male and Female Trends Differ*, EBRI NOTES 2 (2005).

81. *Id.* at 2.

82. Purcell, *supra* note 19, at 9. According to a 1998 Census Bureau Survey, 82% of workers included in an employer retirement plan participated

Available estimates suggest that the vast majority of defined benefit plan participants who leave an employer with less than 10 years of service take a lump-sum distribution; that over half of all defined benefit plans now offer a lump-sum distribution at retirement; and that nearly all of the individual account defined benefit plans (“cash-balance” plans) offer lump-sum distributions. Many of these distributions are spent, wholly or partly, rather than being kept in a retirement plan: the younger the recipient, and the smaller the amount distributed, the more likely it is that at least part of the distribution will be spent rather than saved for retirement.⁸³

There are also significant problems associated with lump sum distributions made at or after retirement age, notably the risk that the individual will outlive his or her retirement savings.

According to a 2000 study, 68% of 401(k) plan participants who change jobs between the ages of twenty and fifty-nine take cash instead of rolling over their account balance.⁸⁴ Participants with smaller account balances are more likely to cash-out their account balances than participants with larger account balances.⁸⁵ Part of the explanation may be that “a participant with a small account balance, especially early in her career, fails to perceive how large an effect cashing out that small account balance will have on her ultimate retirement benefit.”⁸⁶

If the present value of the participant’s benefit under an employer plan exceeds \$5,000, the benefit may not be distributed, prior to the later of age sixty-two or normal retirement age, without the participant’s consent.⁸⁷ If the value of the benefit does not exceed \$5,000, the benefit may be distributed without the participant’s consent, and without complying with the annuity rules.⁸⁸ This rule sends the (wrong) message that these relatively

in a plan that offered lump sum distributions. *Id.*

83. *Hearing on Retirement Security and Defined Benefit Pension Plans, Hearing Before the Subcommittee on Oversight of the House Committee On Ways and Means*, 107th Cong. (June 20, 2002) (Statement of Dallas L. Salisbury, President and CEO, E.B.R.I, Washington, D.C. (June 20, 2002)).

84. Press Release, Hewitt Associates, *Cashing Out Your Future? Hewitt Study Shows Majority of 401(k) Plan Participants in U.S. Opt for Cash When Changing Jobs, Regardless of Age* (May 30, 2000) (on file with author).

85. Albert Crenshaw, *Undermining Their Own Retirements*, WASH. POST, Nov. 9, 2003, at F04. A 2003 study by Hewitt Associates found 87% of workers with account balances less than \$5,000 opted to take cash. *Id.*

86. Susan J. Stabile, *Symposium: The Behavior of Defined Contribution Plan Participants*, 77 N.Y.U. L. REV. 71, 97 (2002); see also Hewitt Associates, *supra* note 84 (stating that “[a] mere 20% of distributions under \$3,500 was rolled over, whereas 95% of distributions over \$100,000 was rolled over The rollovers range from 26% of distributions made to individuals in their twenties to 89% for individuals aged 60 and over.”).

87. I.R.C. § 411(a)(11); ERISA § 203(e); Treas. Reg. § 1.411(a)-11(c)(4).

88. *Id.*

small distributions are not worth bothering about. For many low income employees, the best they can expect from the pension system may be a series of small payouts each time they change jobs. For instance, if a thirty year old employee receives a \$5,000 cash-out and earns a 9% annual return, it will be worth \$80,000 by the time he or she reaches age sixty two. The Employee Benefit Research Institute recently estimated that pre-retirement withdrawals and loans reduced the median replacement rate for the typical 401(k) plan participant in the lowest quartile from 70% to 50%.⁸⁹

Clearly, existing educational programs and tax incentives have proved insufficient. Code section 72(t) imposes a penalty tax on most distributions made before age fifty-nine and a half. The tax is equal to 10% of the amount includible in income, so does not apply to the portion of any distribution that is not currently taxable, for instance because it is transferred to another plan.

A 10% tax is clearly not sufficient to deter premature withdrawals, and spending, of retirement savings. One approach would be to increase the tax significantly, but this would disproportionately affect lower income plan participants, including some who have immediate needs for which they must use the money. Probably the only truly effective solution is for employer-sponsored retirement plans to be prohibited from making pre-retirement distributions.⁹⁰ The employee's vested accrued benefit should either be kept in the plan, for deferred distribution; transferred to a new employer's plan; or transferred to the payee's individual retirement account (IRA). Distributions before retirement age would be strictly limited, subject perhaps to narrow exceptions for cases of financial hardship.⁹¹

H. Recent Developments

Between October 2007 and March 2008, the major stock market indices lost about 14% of their value. "For someone retiring now with say, \$500,000 in savings, that would translate

89. Sarah Holden & Jack VanDerhei, *Can 401(k) Accumulations Generate Significant Income for Future Retirees*, EBRI ISSUE BRIEF 16 (Nov. 2002); see also Gary L. Engelhardt, *Pre-Retirement Lump Sum Pension Distributions and Retirement Income Security*, 55 NAT'L TAX J. 665 (2002) (discussing the impact of withdrawals on retirement security).

90. Hewitt Associates, *supra* note 84. The Advisory Council recommended that, subject to a hardship exception, all lump sums in excess of \$2,000 be required to be rolled over. *Id.*

91. Leonard E. Burman, Norma B. Coe, & William G. Gale, *What Happens When You Show Them the Money?: Lump Sum Distributions, Retirement Income Security, and Public Policy*, URBAN INST., 35 (Nov. 1999). "When a worker has, say, \$100,000 in a pension or IRA, but loses a job and is about to default on a mortgage, the correct policy might not be to require households to maintain pension balances until retirement." *Id.*

into a drop of about \$70,000.”⁹² Great West Retirement Services reported a 20% increase in the number of people citing “avoiding eviction or foreclosure” as the reason for hardship withdrawals in January 2008, compared with January 2007.⁹³

In the wake of the sub-prime mortgage crisis and falling home prices, retirement plan participants are taking out loans at an accelerated rate. The percentage of 401(k) participants who have taken a loan rose from 9% in 2005 to 18% in 2007.⁹⁴

Workers are more concerned about falling home prices, rising debt, and keeping up with monthly expenses than with saving for retirement. Some participants are taking hardship distributions, and paying income taxes, rather than loans,⁹⁵ which has two adverse effects: the money is no longer available for retirement and most plans impose a six month waiting period before the participant can recommence contributing to the plan.

In addition, as the falling real-estate and stock markets erode their savings, many Americans are delaying retirement.⁹⁶ In 1987, property and market values dropped in tandem but nowhere near the extent as is happening now.⁹⁷ Falls in stock value may cause even more acute problems for employees who own large amounts of their employer’s stock through a 401(k) plan or ESOP.⁹⁸

In the wake of these events, the percentage of workers very confident about having enough money for a comfortable retirement has decreased sharply, from 27% in 2007 to 18% in 2008, the

92. Pedro Nicolaci da Costa, *Financial upheaval in U.S. reopens debate about 401(k)s*, REUTERS, Mar. 4, 2008.

93. *Id.*

94. *More Employees Borrowing Against 401(k) Plans: With the trend toward defined contribution plans, the decision-making has shifted from the employer to the individual*, INVEST. NEWS, March 20, 2008.

95. Christine Dugas, *401(k)s Tapped to Save Homes: But withdrawals trigger penalties*, USA TODAY, March 11, 2008, at 1A.

96. Jennifer Levitz, *Americans Delay Retirement AS Housing Stocks Swoon: Nest Eggs Shrink, Deferring Dreams; 'Freaked Out' Elite*, WALL ST. J., Apr. 1, 2008.

97. *Id.*

98. See Jack VanDerhei et al., *401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2006*, EBRI ISSUE BRIEF No. 308, 1 (Aug. 2007) at 1 (reporting that in 2006, average holdings of company stock in 401(k) plans amounted to 11% of total assets, down from 19% in 1996. Of those in plans with company stock as an option, 7.3% of 401(k) participants have 90 % or more of their 401(k) assets in company stock); see also *The New Retirement Drama: ESOPs*, TREASURY & RISK, Mar. 25, 2008 (stating that: “Bear Stearns workers own 30% of the financial services company; investments that were rendered pretty much worthless even as bidder JPMorgan Chase increased its takeover offer five-fold to \$10.”). “But they aren’t the only ESOP participants concerned about their savings. Last year, 11.2 million Americans held \$928 billion in employee-stock-ownership plans, stock bonus plans and profit-sharing plans that primarily invest in company stock.” *Id.*

biggest one-year drop in the eighteen-year history of the Retirement Confidence Survey. Retiree confidence in having a financially secure retirement also decreased, from 41% to 29%. The decrease in confidence occurred across all age groups and income levels, but was particularly acute among younger workers and those with lower incomes.⁹⁹

The percentage who are very confident of having enough money to take care of basic expenses decreased from 40% in 2007 to 34% for workers, and from 48% to 34% for retirees. Additionally, fewer workers are confident about having enough money for medical expenses (43%, up from 32% in 2007) and for long-term care expenses (54% in 2008, compared with 44% a year ago).¹⁰⁰

These results are very different from those reported by AARP in November 2007, finding that, despite being ill-prepared for retirement, many financial decision-makers in working households had a false sense of security. "At least half are very or somewhat confident that they will be able to cover their basic expenses in retirement, have enough money to live comfortably throughout retirement, have enough money to cover medical expenses, and be able to afford to retire when desired."¹⁰¹

III. SOURCES OF INCOME

In 2006, Social Security was the largest source of income for those currently age sixty-five and older, accounting for 39.8 % of their income on average. Pension and annuities income was 19.3 %, income from assets 15.4 %, and income from earnings was 23.7 %. Nearly all individuals (89.7%) age sixty-five and over were receiving income from Social Security in 2006, while 55.3% received income from assets, 35.4% received income from pensions and annuities, and 18.9% received income from earnings.¹⁰²

In 2006, the lowest income quintile among the elderly received 87.6% of its income from Social Security, and the highest income quintile received 18.5% of its income from Social Security. The other three main sources of the elderly's income (pensions and annuities, assets, and earnings) all increased in importance for the higher-income quintiles. In 2006, the lowest-income quintile received 2.6% of its income from pensions and annuities, 5.3% from assets, and 1.9% from earnings. By comparison, the highest-

99. Ruth Helman, et al., *The 2008 Retirement Confidence Survey: Americans Much More Worried About Retirement, Health Costs a Big Concern*, EBRI ISSUE BRIEF No. 316, 1 (Apr. 2008).

100. *Id.* at 4.

101. Colette Thayer, *Preparation for Retirement: The Haves and Have-Nots*, AARP KNOWLEDGE MANAGEMENT (Nov. 2007).

102. Ken McDonnell, *Income of the Elderly Population Age 65 and Over, 2005*, EBRI NOTES 1, 2 (May 2007).

income quintile received 22.6% of its income from pensions and annuities, 20.5% from assets, and 36.4% from earnings.

For the two younger age groups (sixty-five through sixty-nine and seventy through seventy-four) earnings from work increased significantly as a source of income from 1985 to 2006. For the youngest group (sixty five to sixty nine year olds) the increase was most significant, increasing sixteen percentage points from 1985 to 2006. Elderly women derived a greater share of their income from Social Security and assets than elderly men in 2006. Social Security accounted for 47.8% of elderly women's income, compared with 34.0% of elderly men's income. Income from assets accounted for 17.5% of elderly women's income, compared with 13.8% of elderly men's. By comparison, elderly men derived a larger share of their income from employment-based sources, including pensions and annuities and earnings, than elderly women. In 2006, pensions and annuities accounted for 21.6% of elderly men's income, compared with 16.1% of elderly women's. Income from earnings accounted for 28.5% of the elderly men's income, compared with 17.1% of elderly women's.¹⁰³

One possible source of additional income is income from reverse mortgages, to take advantage of the housing wealth of the elderly. However, this market has not yet matured, and anecdotal evidence suggests much abusive selling:

[H]undreds of people who have sought reverse mortgages- in lawsuits, surveys and conversations with elder-care advocates- have complained about high-pressure or unethical sales tactics they say steered them towards loans with very high fees. Some say they were tricked into putting proceeds of their loans into unprofitable investments, while sales agents pocketed rich commissions.¹⁰⁴

Given the heavy reliance of the elderly upon Social Security, Congress should address the appropriate thresholds for income taxation of Social Security benefits. As recent experience with the alternative minimum tax shows, the failure to adjust tax thresholds for inflation can have pernicious long-term effects.

Tax provisions affecting the treatment of Social Security benefits have not changed since 1993, but the share of Social Security benefits included in taxable income is continually increasing under current law because the threshold levels for inclusion of benefits in income are not indexed for inflation.¹⁰⁵

103. Ken McDonnell, *Income of the Elderly Population Age 65 and Over, 2006*, EBRI NOTES 13 (Dec. 2007).

104. Charles Duhigg, *Tapping Into Homes Can Be Pitfall for the Elderly*, N.Y. TIMES, Mar. 2, 2008, at A1.

105. Barbara A. Butrica et al., *How the Income Tax Treatment of Savings and Social Security Retirement Benefits May Affect Boomers' Retirement Incomes*, 2008 URBAN INST. 1, 13.

The \$25,000 and \$32,000 thresholds were enacted in 1983, and the \$34,000 and \$44,000 thresholds were added by OBRA 1993. Only 39% of beneficiaries paid taxes on their Social Security benefits in 2000, but a growing share of beneficiaries will be required to pay taxes on their Social Security benefits in the future.

Another concern is that the average replacement rate of Social Security benefits for earned income will decrease dramatically from a consistent 40% to less than 30% by 2030. The decrease will be even greater for higher income retirees.¹⁰⁶

In addition, the Medicare Part B premiums for higher-income individuals will increase every year through 2009 to 35% of actual Medicare costs, for single beneficiaries with \$80,001 to \$100,000 (indexed) of modified adjusted gross income (MAGI) and up to 80% of actual Medicare costs for single beneficiaries with more than \$200,000 (indexed) of MAGI. These higher Medicare premiums will reduce net Social Security benefits significantly.

IV. INCOME INEQUALITY

Another recent trend that does not bode well for future retirement security is the growing income inequality in the United States.

A state-by-state examination of trends in income inequality over the past two business cycles finds that inequality has grown in most parts of the country since the late 1980s. The incomes of the country's highest-income families have climbed substantially, while middle- and lower-income families have seen only modest increases.¹⁰⁷

On average, incomes have declined by 2.5% among the bottom fifth of families since the late 1990s, while increasing by 9.1 % among the top fifth. For the richest 5%, income growth since the late 1990s has been much faster than among the poorest fifth of families. Families in the middle of the income distribution have fallen farther behind upper-income families in many states since the late 1990s. "The federal tax cuts of the early 2000s, which were targeted primarily on wealthy families, helped widen the income gap between the wealthiest families and those with low and moderate incomes."¹⁰⁸ Factors contributing to the growing income gaps in most states include growth in wage inequality (the biggest factor), expansion of investment income, and government policies.

106. Francine J. Lipman, *Shrinking Boomer Social Security Retirement Benefits*, 2007 A.B.A. SEC. TAXATION NEWS QUARTERLY 27 (Fall 2007).

107. Jared Bernstein et al., *Pulling Apart, A State-by-State Analysis of Income Trends*, 2008 CTR. ON BUDGET AND POLICY PRIORITIES 1, 7 (Apr. 2008).

108. *Id.* at 8.

Government actions—and, in some cases, inaction—have contributed to the increase in wage and income inequality in most states. Examples include deregulation and trade liberalization, the weakening of the social safety net, the lack of effective labor laws regulating the right to collective bargaining, and the declining real value of the minimum wage. In addition, changes in federal, state, and local tax structures and benefit programs have, in many cases, accelerated the trend toward growing inequality emerging from the labor market.¹⁰⁹

IRS data show that federal income tax rates for the 400 taxpayers with the highest incomes have fallen from 30 % of income in 1995 to 18% in 2005.¹¹⁰ The average pre-tax income of this group rose by 235% between 1992 and 2005, after adjusting for inflation. The average income of the top 1% of filers rose by 89% between 1992 and 2005, after adjusting for inflation. “Income inequality, by many measures, is now greater than it has been since the 1920’s. The top 1% of earners in the United States made 19% of all income in 2005, up from 8% in 1975, according to an analysis by Emmanuel Saez and Thomas Piketty, two economists.”¹¹¹

V. SOCIAL SECURITY AND MEDICARE

This paper is not about Social Security and Medicare: yet how can a paper about retirement income security *not* talk about the financial condition of those two programs? The good news, slight though it is, is that the projected cost outlook for both Social Security and Medicare has improved relative to that described in the 2007 trustees’ reports.¹¹² What follows will be only a very brief discussion of a major issue.

No one can deny that the financial condition of Social Security must be improved. However, the “crisis” is nowhere near as severe as alarmists would suggest. The Center on Budget and Policy Priorities recently pointed out, again, that whereas, according to the 2008 trustees’ report, Social Security faces an estimated total shortfall of 0.56% of Gross Domestic Product (GDP) over the next seventy five years, this is less than the estimated cost over the same period of extending the 2001 and 2003 tax cuts for *only* the top 1% of households, 0.6% of GDP. Currently, households in the top 1% make more than \$450,000 per year.¹¹³ Extending all of the

109. *Id.* at 10.

110. *CBPP Says Tax Rates Fell For Taxpayers With Highest Incomes*, TAX NOTES TODAY, Mar. 28, 2008, (on file with author).

111. *Id.*

112. *SSA Summarizes Annual Social Security, Medicare Trust Fund Reports* [hereinafter *SSA*], TAX NOTES TODAY (Mar. 26, 2008) (on file with author).

113. Kris Cox and Richard Kogan, *Long-Term Social Security Shortfall Smaller Than Cost Of Extending Tax Cuts For Top 1 %*, CTR. ON BUDGET AND

tax cuts (not just those for the top 1%) would cost 1.95 % of GDP, three and a half times the size of the Social Security shortfall.¹¹⁴

Medicare is a much greater crisis than Social Security. The Medicare Hospital Insurance Trust Fund faces a shortfall triple the size of that facing Social Security. This is a serious problem because of the rising costs of healthcare in America.¹¹⁵

According to the 2008 Medicare trustees' report, the Medicare crisis could be resolved by an immediate 122% increase in the payroll tax to 6.44% from 2.9%, or an immediate 51% reduction in the program's benefits or a combination of these approaches.¹¹⁶

The financial problems facing Social Security and Medicare are not new. Congressional inaction, and acquiescence in tax cuts, during this period displays a staggering degree of irresponsibility. Perhaps the only bright spot is that the situation is now so bad that reform is inevitable.

VI. DEFINED BENEFIT PLANS

With respect to defined benefit plans, there are two separate problems: the general decline in the number of defined benefit plans¹¹⁷ and "portability losses" that result when an employee

POLICY PRIORITIES (Mar. 31, 2008)

114. *Id.*

115. *Id.* at 2.

116. SSA, *supra* note 112.

117. Pension and Welfare Benefits Admin. (PWBA), *Abstract of 1997 Form 5500 Annual Reports*, U.S. DEPT OF LABOR (Winter 2001), available at <http://www.dol.gov/ebsa/publications/bullet97/intro.htm>. According to the U.S. Dep't of Labor ("DOL"), the number of private sector defined benefit plans fell from 175,000 in 1983 to 63,700 in 1996 and to 59,500 in 1997, and the number of small defined benefit plans (those with fewer than 100 participants) fell from 149,164 in 1983 to 47,104 in 1996 and to 43,647 in 1997. *Id.* There were 632,566 defined contribution plans in 1996 and 660,542 in 1997. *Id.*; see also U.S. DEPT OF LABOR, PWBA Advisory Council, *Report of the Working Group on the Merits of Defined Contribution vs. Defined Benefit Plans, With an Emphasis on Small Business Concerns*, (Nov. 13, 1997), available at www.dol.gov/pwba (reporting that the number of defined contribution plans increased from 208,000 to 618,500 between 1975 and 1993); see also Pension Benefit Guaranty Corporation (PBGC), *PENSION INSURANCE DATA BOOK 1999*, PBGC SINGLE-EMPLOYER PROGRAM, NO. 4 (Summer 2000), at 33. (citing Table S-17 which shows that the number of single-employer defined benefit plans covered by PBGC fell from 112,208 in 1985 to 48,748 in 1996 and to 37,536 in 1999); see also Watson Wyatt, *The Unfolding of a Predictable Surprise: A Comprehensive Analysis of the Shift from Traditional Pensions to Hybrid Plans*, WATSON WYATT INSIDER (Mar. 2000) (stating that "[t]he percentage of private sector U.S. workers covered by traditional pensions has dropped dramatically—from 39% in 1975 to 23% in 1995. If just the same percentage of U.S. workers were covered by defined benefit pensions today as in 1975, an additional 16 to 20 million workers would be participating in this system than are doing so today."); see also *Portability of Defined-Benefit Pensions (hereinafter "PDBP")*, 17 RECORD OF SOCIETY OF ACTUARIES 1041, 1042 (1991)

changes jobs. One positive aspect of the conversion of many traditional defined benefit plans to account-based defined benefit plans is that the latter provide significantly greater accrued benefits at younger ages.¹¹⁸

According to a 1988 DOL study, portability losses are principally experienced by shorter-service workers who are covered under defined benefit plans, with at least 75% of all portability losses the result of plan design characteristics. Approximately 59% of covered workers experience some portability loss, with the average pension loss equal to 25% of the single career benefit.¹¹⁹

Most defined benefit plans calculate the amount of the annual pension by reference to length of service with that employer and final average salary with that employer. Accordingly, for an employee who has more than one employer during his or her working career, the total pension will be lower than if he or she had worked for only one employer, even if he or she is covered by an identical defined benefit plan throughout. The possible solutions to this dilemma (including cost of living adjustments to deferred pensions, reciprocity agreements between unrelated employers, and requiring employers to credit service with other employers) merit further investigation. However, they all involve cooperation between employers and/or additional pension expense which, for the foreseeable future, is unlikely to occur.

As Steven Willborn points out, the pension portability debate

[i]nvolves very difficult questions about the costs and distributional effects of changes in the rules relating to portability. . . . Those costs and distributional effects pose an empirical challenge: it is difficult to determine what they are with an acceptable degree of precision. And they pose a normative challenge: with its costs and distributional effects, does portability provide a net benefit? . . . Second, the portability debate is difficult because any changes affect, not only the ability of employees to transfer benefits, but also the calculus employers make when they decide whether to offer pensions as an employee benefit. . . .¹²⁰

(stating that “[t]he regulatory environment is already demotivating defined-benefit plans. Any portability legislation in this area is likely to make it worse.”).

118. Katherine Elizabeth Ulrich, *You Can't Take It With You: An Examination of Employee Benefit Portability and Its Relationship to Job Lock and the New Psychological Contract*, 19 HOFSTRA LAB. & EMP. L.J. 173, 210 (2001) (citing Towers Perrin, *Hot Topics, Perspectives on Cash Balance Plans: Time Out for Facts*, www.towers.com/towers/hottops/htcbp2.htm).

119. *Id.* at 207 (citing *Labor Department Study Describes Impact of Job Mobility on Pensions*, 15 PENS. & BEN. REP. (BNA) 1152 (July 18, 1988)).

120. Steven L. Willborn, *The Problem with Pension Portability*, 77 NEB. L. REV. 344, 345 (1998); see also PDBP, *supra* note 117, at 1042 (stating that “it

As John Turner has noted,¹²¹ portability in defined benefit plans can be achieved in at least three ways. The first is to preserve the real value of benefits or assets within a single employer plan.¹²² The failure to index for inflation the deferred vested benefits of terminated employees may account for up to two-thirds of all portability losses.¹²³ The second is to pool pension assets across employers in a multiemployer plan. This “would permit employees to have complete portability between member employers, akin to the voluntary plans in Europe.” However, one disadvantage to pooling is that firms have to overcome competing with one another in order to coordinate the establishment of plans. Unfortunately these barriers are so high that most multiemployer plans are coordinated by a union

or are in a nonprofit setting . . . Another disadvantage, related to the first, is that the arrangements are voluntary. When one firm views its liability as much less than average they will have incentive to leave.¹²⁴

The third approach is to transfer pension assets or credited service between plans:

In 1997, the most recent data currently available, only 8 % of full-time employees with a defined benefit plan working in medium and large private establishments were in a plan that had a portability feature of the third type, involving a transfer across plans. This percentage differs across types of workers, being 10 % for blue collar and service employees, compared to 4% for professional, technical, and related employees.¹²⁵

is difficult to make portability voluntary because employers establish pension plans to attract employees and to keep them. Employers do not want to motivate their employees to leave, and the better deal they make for portability, the more they are motivating their employees to leave.”).

121. John Turner, *Remarks at the Exploratory Workshop: Cross-Border Portability of Pension Rights: An Important Condition for an Integrated Market for Pension Provision*, (Feb. 28 – Mar. 1 2003) (remarking on John Turner, PUBLIC POL’Y INSTITUTE, AARP, *Pension Portability in the United States* (June 2002)).

122. See David Blake and J. Michael Orszag, *Portability and Preservation of Pension Rights in the U.K.*, REPORT OF THE DIRECTOR GENERAL’S INQUIRY INTO PENSIONS 6 (The Pensions Institute, London, U.K., July 1997) (reporting that “[o]ur conclusion is that the outcome of U.K. legislation over the past two decades has been a dramatic improvement in the position of early leavers”).

123. Ulrich, *supra* note 118, at 209 (citing Dep’t of Labor data).

124. Teresa Ghilarducci, *De-linking Benefits from a Single Employer: Alternative Multiemployer Models*, PENSION RESEARCH COUNCIL 1, 28 (2001).

125. Turner, *supra* note 123 (citing Bureau of Labor Standards survey data); National Council on Teacher Retirement, *Broadening Pension Portability for Public School Teachers Through Interstate Reciprocity - Survey of Current Statutes and Model Legislation* (Aug. 25, 2003), available at <http://www.nctr.org/resources/studiesandsurveys.html>.

The value of the benefits accrued under a typical defined benefit plan is very small for many years, whether expressed as a deferred monthly pension or as a lump sum present value. Consideration should be given to requiring earlier accruals: again, this would involve additional expense for sponsoring employers, but this may be more manageable and less controversial than other possible changes discussed, particularly as it is consistent with the reasons given by many large employers for converting to cash balance plans.

As a matter of overall pension policy, employers should be encouraged to provide at least part of the retirement benefit under a defined benefit plan. One possible approach would be to use the multiemployer plan model which has worked well for union employees in many industries. Under this approach, employers would make their contributions (and any employee contributions) to a national or regional fund or clearinghouse. The employers' only responsibility would be to make the stipulated contributions: all other administrative and investment functions would be performed by the fund. There would be portability of service credits between the group of contributing employers,¹²⁶ but there would be no portability outside the group. For this reason, the ideal administrator would be Social Security, which already manages portable pension benefits for over 95% of American workers, at a very low administrative cost.

VII. DEFINED BENEFIT AND DEFINED CONTRIBUTION

Unlike a defined benefit plan or Social Security, which provides a monthly income for life which, in the case of Social Security benefits, is indexed for inflation, a retiree whose retirement benefits are held in a defined contribution plan or IRA has to determine how much he or she should withdraw each year. Withdraw too much, and the fund will be exhausted before death; withdraw too little and he or she may be depriving himself or herself of enough income to maintain a comfortable lifestyle. Unfortunately, most of the data needed to make this calculation are unknown: how long the individual will live; the rate of return on investments, each year for the rest of his or her life; future tax rates; future inflation rates; out of pocket medical expenses; and whether he or she will need long term care.

In a rational world which, unfortunately, bears little resemblance to the one we live in, an excellent way to improve

126. See Ann C. Foster, *Portability of Pension Benefits Among Jobs*, MONTHLY LABOR REVIEW 1, 45 (July 1994) (noting that in 1987, nearly half of all multiemployer funds included reciprocity agreements, and that the two reciprocity systems most widely used in multiemployer defined benefit plans are pro rata reciprocity and "money follows the man.").

retirement security would be to increase benefits under the highly efficient Social Security system:

With its proven track record, it holds the best prospect for using new money effectively to improve retirement security. Wise policy would first balance Social Security finances without cutting benefits. It would then make benefits more adequate before subsidizing other retirement income tools.¹²⁷

Regina Jefferson has proposed an insurance program for defined contribution plans that, unlike the defined benefit plan insurance program under Title IV of ERISA, would be voluntary and provided through private insurers. She argues that the failure to provide insurance to defined contribution plans may have been justified in 1974, when Congress couldn't foresee the shift to defined contribution plans, but it is unacceptable today.¹²⁸

VIII. RISKS IN DEFINED CONTRIBUTION PLANS

Perhaps the most pernicious single effect of the switch from defined benefit plans to defined contribution plans is the resulting transfer of risk from the employer—which is generally more sophisticated, has more resources, and can spread its risk over its entire workforce and over a long period of time—to the individual employee, who enjoys none of those advantages. “[T]he 401(k) revolution has done far more good to Wall Street than to the financial security of retired workers.”¹²⁹

In a defined contribution regime, retirees face several major risks: the risk of outliving their assets; inflation that erodes the value of their assets; lower than expected earnings from investments; and large unpredictable expenses, particularly for medical expenses or long term care.¹³⁰

One little-understood risk is the risk of assuming that investment earnings will be constant.¹³¹ A recent CRS report to

127. Virginia P. Reno, *Building on Social Security's Success*, ECON. POLICY INST., Briefing Paper #208, (Nov. 20, 2007).

128. Regina T. Jefferson, *Rethinking the Risk of Defined Contribution Plans*, 4 FLA. TAX REV. 607, 640-41 (2000).

129. Jeff Madrick, *The Specter Haunting Old Age*, 55 N.Y. REVIEW OF BOOKS, (Mar. 20, 2008) (reviewing Robin Blackburn, *Age Shock: How Finance Is Failing Us* (2007); Alicia H. Munnell & Steven A. Sass, *Working Longer: The Solution to the Retirement Income Challenge* (2008); Greg Anrig, *The Conservatives Have No Clothes: Why Right-Wing Ideas Keep Failing* (2007); Jacob S. Hacker, *The Great Risk Shift: The Assault on American Jobs, Families, Health Care, and Retirement and How You Can Fight Back* (2006); and Teresa Ghilarducci, *When I'm Sixty-four: The Plot Against Pensions and the Plan to Save Them* (2008)).

130. Pamela Perun, *Putting Annuities Back Into Savings Plans*, SOC'Y OF ACTUARIES, SYMPOSIUM ON MANAGING RETIREMENT ASSETS 1, 6 (Apr. 1, 2004).

131. *Structuring Income for Retirement*, RESEARCH INSIGHTS REP. 1, 7

Congress makes the point that there is a wide variance in future retirement plan investment returns, and that there is a 5% likelihood that the 5.5% annual return projected in the report could be as little as 1.7%.¹³²

IX. AVERAGE ACCOUNT BALANCES IN DEFINED CONTRIBUTION PLANS

The first major flaw in the private retirement system is lack of coverage.¹³³ the second is inadequate benefits. A 2001 report found that nearly 30% of active plan participants had a total plan balance less than \$5,000.¹³⁴ In 1998, the mean value of all IRA and 401(k) accounts was \$35,000 and the median value was only \$14,000. For ages fifty-five to sixty-four, the average account balance was about \$57,000. A \$57,000 account for a sixty-five year old in May 2001 would have bought a single life annuity of only \$450 per month.¹³⁵

Workers shoulder much more of the risk of 401(k) plans than their employers.¹³⁶ At the end of 2006, the average 401(k) account balance was \$121,202. However, the median account balance was only \$66,650. Even for the minority of long-tenured participants (thirty years or more with the current employer) in their sixties,

(Fidelity Research Inst., Boston, M.A., Aug. 2007).

132. See Patrick Purcell & Debra Whitman, *Retirement Savings: How Much Will Workers Have When They Retire?* CONG. RESEARCH SERV. REP. 1, 37 (Jan. 29, 2007) (“A worker who is told that the most likely real rate of return on his or her investments is 5.5% might save more or less than if he or she were told that the most likely real rate of return will be between 1.7% and 9.3%. Both statements are true, but the second more clearly conveys the uncertainty that characterizes any estimate of likely future rates of return on investment.”)..

133. See *Pensions at a Glance/Public Policies Across OECD Countries*, 2007 ORG. FOR ECON. COOPERATION AND DEVELOPMENT 1, 77 (noting that only 47% of Americans are covered, compared to 90% for Australia, 90% for Denmark, 57% for Germany, 58% for Hungary, 90% for Iceland, 90% for the Netherlands and 90% for Norway).

134. *Employee Benefits Security Administration, Report of the Working Group on Planning for Retirement*, U.S. DEPT OF LABOR (Nov. 14, 2001), available at www.dol.gov/ebsa/publications/AC_111401_report.html.

135. *Id.* See also *Pension Plans: Characteristics of Persons in the Labor Force Without Pension Coverage, Report to Congressional Requesters GAO/HEHS-00-131*, 2007 U.S. GEN. ACCT. OFF. 1, 27 (reflecting on the CRS Analysis of the 1996 Panel of the Census Bureau’s Survey of Income and Program Participation). The mean and median values of all retirement accounts in a household were, respectively, as follows:

Workers 25 to 34: \$20,2598,000
 Workers 35 to 44: \$41,58220,000
 Workers 45 to 54: \$57,84528,000
 Workers 55 to 64: \$72,34736,668.

Id.

136. *Savings for Life: A Pathway to Financial Security for All Americans*, 2007 ASPEN INST. 25.

the median account balance was less than \$100,000 for those earning \$60,000 or less.¹³⁷ Only six of the thirty OECD countries have lower “pension wealth” than the U.S.: the Czech Republic, Hungary, Mexico, Poland, the Slovak Republic and Turkey.¹³⁸

Even with Social Security, the accumulated pension benefits are low:

Currently, the average American head of household between age 62 and 65 only has about \$110,000, if you add the median 401(k) account balance to the median rollover IRA balance- or less than twice the median salary of \$61,600 for that age group. If the typical Social Security benefit for that income level is about \$18,500 a year, that person will only receive a total of about \$27,200 a year in retirement income when added to the \$8,700 a year generated from the \$110,000 nest egg- or less than 45% of pre-retirement income. And that’s assuming that the retiree ONLY lives another 20 years.¹³⁹

A large part of the problem is low employer contribution rates. Most companies provide a 50% match on employee contributions, often subject to a cap. Only 4% of companies match 100% of employees’ contributions on up to 6% of pay, and only a third of all companies make an automatic contribution.¹⁴⁰ By contrast, seven of the OECD countries have 401(k) style plans that include mandatory employer contribution rates averaging 7.5% of pay, more than twice the U.S. average.¹⁴¹

By U.S. standards, IBM is making unusually generous contributions to its new 401(k) plan: all its employees will receive an automatic contribution, from 1% to 4% of pay; some older employees who were covered by the defined benefit plan will get an additional 5% of pay each year; and IBM gives participants a

137. Jack VanDerhei et al., *401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2006*, 308 EMP. BENEFIT RESEARCH INST. ISSUE BRIEF 24 (2007).

138. Jane White, *Filling America’s Empty Nest Eggs: The Crisis Nobody’s Talking About*, EMP. BENEFIT NEWS (2008).

139. *Id.* See also Patrick Purcell et al., *CRS Report for Congress: Retirement Savings: How Much Will Workers Have When They Retire*, 2007 CONG. RESEARCH SERVICE 1, 6. “An individual retiring at age 65 in January 2007 with \$119,500, the median retirement account balance among married-couple households head by persons age 55 and older could purchase a level, single-life annuity that would pay \$826 per month (\$9,912 per year) or a joint and 100% survivor annuity paying \$662 per month (\$7,944 per year), based on the current annuity interest rate of 5.25%.” *Id.*

140. Mark Bruno, *IBM raises the bar with new 401(k) plan*, PENSIONS AND INV., Mar. 17, 2008, available at <http://www.pionline.com/apps/pbcs.dll/article?AID=/20080317/REG/950467789/1030/TOC>.

141. Australia, 7.25% of pay; Denmark, 11.8%; Hungary, 8%; Mexico, 6.5%, Norway, 2%; Poland, 7.3%; Slovak Republic, 9%; Sweden, 4.5%. *Pensions at a Glance/Public Policies Across OECD Countries*, Organization for Economic Cooperation and Development, Paris, France: OECD 2007: 25-30.

dollar-for-dollar match on contributions up to 6% of pay. Even so,

[t]he company expects to realize big long-term savings compared with the cost of maintaining its traditional pension plans. IBM estimates all the changes to its various plans will allow it to reduce worldwide retirement expenses by a total of \$2.5 billion to \$3 billion by 2010 -substantial savings, even for a company that generated \$10.4 billion in income last year off almost \$100 billion in revenue.¹⁴²

According to a recent report,¹⁴³ declines in annual performance-based bonuses and stock-option awards have cut the rate of growth of CEO pay, but CEO pension benefits were up more than 25%. In 2007, for companies with consecutive years of data under the new SEC disclosure rules, (1) the median value of accumulated pension benefits for S&P 500 chief executives was \$6,106,986, an increase of 29.5% over the median of \$4,716,206 in 2006, and (2) the median value of deferred compensation plan balances increased by 54.3% from 2006 to 2007, climbing to a median value of \$4,517,488. In light of these findings, it is hard to argue with Jane White and Rick Meigs when they assert that

Companies that can afford to compensate executives with eye-popping paychecks and pensions should be able to cough up \$17,600 or so toward the nest egg of a typical highly productive rank-and-file employee, compared to the typical contribution of \$5,866. We arrived at that sum by assuming 9% of a \$48,000 salary that increases by 1.1% a year for four years, the average job tenure for American workers, compared to the typical 3% contribution rate offered by U.S. employers.¹⁴⁴

American employers may claim that Americans enjoy a higher standard of living, which makes it possible to save on our own. However, the median wage for U.S. workers is, in fact, relatively low: of the 30 OECD countries, 16 have higher average wages than the U.S.¹⁴⁵

According to Jane White and Rick Meigs, assuming a typical (3%) employer contribution, "even the tiny minority of participants who are savvy enough to start contributing at age 25 must save 10% of their salary to build an adequate nest egg by age 65." Waiting until age 35 increases the contribution rate to more than 17%; waiting until age 40 increases it to more than 23% of pay; and waiting until age 50 requires 48% of pay.

142. Bruno, *supra* note 140.

143. Press Release, *S&P 500 CEO Compensation Rises 1.3% to 8.8 Million*, EQUILAR, Apr. 10, 2008, available at http://www.equilar.com/press_20080410.php.

144. Jane White and Rick Meigs, *Employers owe employees 401(k) contributions*, EMP. BENEFIT NEWS, Apr. 1, 2008.

145. *Pensions at a Glance*, *supra* note 133.

[I]n a 2006 study of its participants only 11% of Vanguard Group's participants save the maximum allowed (\$15,000 in 2006) and the median contribution rate is 6% of pay. What's more, the average contribution rate (medians weren't available) doesn't rise significantly over people's life spans; it's only a little more than twice for those over 60 as it is for folks in their twenties. The average rate is only 4.25% for those under 25, 5.80% for those between the ages of 25-34, 6.75% for those age 35-44, 7.77% for those age 45-54, 9.14% for those age 55 to 64 and 10.81% for those age 65 and older.¹⁴⁶

These numbers suggest two conclusions. First, a 3% contribution rate—the rate most often suggested by advocates of mandatory employer contributions—is too low, even for young employees.¹⁴⁷ Secondly, the automatic enrollment design encouraged by the Pension Protection Act of 2006 includes a default rate that is too low for job-changers: most plans will probably start them at 3% each time they switch jobs, regardless of their age.

X. REPLACEMENT RATIOS

One goal for a retirement income policy is to help retirees to continue to enjoy approximately the same standard of living that they enjoyed before retirement. One way of measuring this goal is to calculate the required replacement ratio, i.e. the percentage of pre-retirement income that is needed in retirement. This involves difficult threshold issues: first, individuals' needs and consumption patterns in retirement are not uniform; second, many of the major expenses incurred by retirees, notably out-of-pocket medical expenses and long-term care expenses, are unpredictable. In addition, to focus exclusively on replacement ratios would be to ignore a basic fact: a retiree's assets and investment strategy must provide enough cash to pay the bills. "One way to help ameliorate [market] risk is to get a handle on a client's estimated spending over the first five to ten years of retirement and set part of her portfolio aside to make sure her income needs can be met whatever happens in the market."¹⁴⁸

146. *How America Saves, A Report on Vanguard 2006 Defined Contribution Plan Data*, VANGUARD GROUP 1, 15, (2007), available at https://institutional.vanguard.com/iip/pdf/CRR_HAS_2007.pdf.

147. PRESIDENT'S COMMISSION ON PENSION POLICY, *Coming of Age: Toward a National Retirement Income Policy*, GOV'T PRINTING OFFICE 1, 131 (Feb. 26, 1981). The 3% rate was recommended in the 1981 Minimum Universal Pension System (MUPS) proposal, and is also generally the minimum required contribution to a top-heavy defined contribution plan [Code section 416] and under certain 401(k) safe harbor designs. *Id.*

148. W. Van Harlow & Moshe A. Milevsky, *Structuring Income for Retirement* (2007), available at <http://financialpage.blogspot.com/2007/08/structuring-income-for-retirement.html> (full

Currently, the Social Security Administration estimates that for a career-long average-wage earner retiring at the full retirement age, Social Security will replace about 41% of their career-average earnings. For a career-long low-wage earner, Social Security will replace an estimated 55% of average earnings. For a career-long high-wage earner, Social Security will replace just 27% of their average earnings.¹⁴⁹ These replacement ratios will almost certainly decline over the next twenty to thirty years.

The replacement rate for a medium earner retiring at age 65 is now about 39% after deducting the premiums for Medicare Part B, which pay for doctors' bills and are deducted directly from Social Security checks. By 2030, the net replacement rate for a similar 65-year-old retiree will drop to about 32%. Reasons for this decline include the legislated increase in the "full-benefit age" for receiving Social Security benefits and rising Medicare premiums that are deducted directly from Social Security benefits.¹⁵⁰

The growing cost and tax burdens associated with Medicare alone suggest that even the most conservative target replacement rates may be inadequate.¹⁵¹

Traditional retirement income replacement rate models typically conclude that a retiree needs retirement income of 70% to 80% of pre-retirement income in order to maintain his or her pre-retirement standard of living. A recent study argues that "One of the biggest weaknesses of replacement rate models is that one or more of the most important retirement risks is ignored: investment risk, longevity risk, and risk of potentially catastrophic health care costs" and suggests that far higher replacement rates may be necessary if the retiree is to have a 50% or better probability of retirement income adequacy. A one size fits all model is inadequate for workers, who are different ages, have different levels of income, and different health care needs.¹⁵²

How much additional income will 401(k) plans provide?

An individual retiring at age 65 in January 2007 with \$119,500, the median retirement account balance among married-couple households headed by persons age 55 and older, could purchase a level, single-life annuity that would pay \$826 per month (\$9,912 per year) or a joint and 100% survivor annuity paying \$662 per month

document on file with author).

149. Purcell & Whitman, *supra* note 132, at 20.

150. Virginia P. Reno, *Building on Social Security's Success*, ECON. POLICY INST. 1, 13 (2007).

151. Alicia H. Munnell, *Medicare Costs and Retirement Security* 1, (Ctr. for Ret. Research at Boston College 2007).

152. Jack VanDerhei, et al, *Measuring Retirement Income Adequacy: Calculating Realistic Income Replacement Rates*, 297 EMP. BENEFIT RESEARCH INST. ISSUE BRIEF 5 (2006); see also Peter J. Brady, *Measuring Retirement Resource Adequacy*, INV. CO. INST. (2008).

(\$7,944 per year), based on the current annuity interest rate of 5.25%. These amounts would replace just 19% and 15%, respectively, of the median household earnings of \$52,000 among all married-couple households headed by individuals who were 60 to 64 years old in 2004.¹⁵³

Most studies suggest that the situation will get worse.

The National Retirement Risk Index (NRRI) has shown that even if households work to age 65 and annuitize all their financial assets, including the receipts from reverse mortgages on their homes, nearly 45 % will be 'at risk' of being unable to maintain their standard of living in retirement.¹⁵⁴

XI. THE IMPACT OF MEDICAL EXPENSES

Out of pocket medical expenses have a major effect on the financial security of the elderly, and on their retirement decisions:

Median out-of-pocket health care spending as a share of income totaled 14 percent for adults age 65 to 74 in 2003 and 22 percent for those age 85 and older. . . A typical older married couple could devote about 35 percent of its after-tax income to health care in 2030.¹⁵⁵

Over the immediate future, the average annual growth in health expenditures is expected to be 6.7%,¹⁵⁶ far higher than general inflation or the rate of increase in Social Security benefits. Advisors should help their clients identify and manage risk in health care.¹⁵⁷

The general revenue contribution to Part B of Medicare is 1.3 % of GDP; by 2040 that will rise to 3.4 % of GDP. "Assuming all else stays unchanged, rising SMI costs would require Americans, including retirees, to face an 18.5 % increase in income tax rates in 2040."¹⁵⁸

In 2005, only 33% of employers with more than 200 employees offered retiree health benefits, down from 68% in 1988.¹⁵⁹ In 2007, the Centers for Medicare and Medicaid Services

153. Purcell & Whitman, *supra* note 132.

154. Alicia H. Munnell et al., *Is There Really a Retirement Savings Crisis? An NRRI Analysis*, 2 (Ctr. for Ret. Research at Boston College 2007).

155. Richard W. Johnson et al., *Do Out-of-Pocket Health Care Costs Delay Retirement* 2 (Ctr. for Ret. Research at Boston College 2008).

156. Sean Keehan et al., *Health Spending Projections Through 2017: The Baby-Boom Generation Is Coming to Medicare*, 27, Health Affairs web exclusive, (2008).

157. See www.IncomeAtRisk.com (developing new retirement structures that focus on the risks involved with the rising costs of healthcare).

158. Munnell, *supra* note 154, at 2.

159. Kaiser Family Foundation, *Employer Health Benefits: 2005 Annual Survey: Retiree Health Benefits* 1, 114 (2005), available at <http://www.kff.org/insurance/7315/sections/upload/7315Section11.pdf>.

(CMS) estimated that Medicare out-of-pocket expenses were approximately \$3,800 for one person, \$7,600 for a couple. Items not covered by Medicare (dental, hearing aids, glasses) may add \$500 per person.¹⁶⁰

Another recent report found a wide range of possible costs for a worker aged 35 in 2006 who is assumed to retire at age 60:

[W]e see a wide range of potential results: these start at a low of \$76,000 for a typical FAS 106 trend (if the employer pays 100 % of cost— probably unlikely in 2031) to a high of \$2.26 million with a 10 % trend and the retiree paying full cost. Note that the values vary importantly with changes in trend, discount rate, mortality, and other assumptions. While these hypothetical examples illustrate potential outcomes, results for individuals can vary significantly.¹⁶¹

For those lucky enough still to have employer-provided retiree health benefits the trend, as with plans for active employees, has been to increase the retiree's share of the total cost:

The Mercer 2004 Survey showed that 38% of employers offering retiree health care plans required enrollees to pay the entire premium as well as out-of-pocket benefit costs: such plans offer coverage, but not necessarily affordable coverage. Only 13 % of employers provided coverage at no cost to retirees. For the 49 % that shared the cost with retirees, the average retiree portion was 34 % of the plan cost. The results for Medicare-eligible plan coverage were similar: 37 % require the retirees to bear the full cost; 15 % provide coverage at no cost to retirees; and 47% share the cost, requiring retirees to pay 35 % of it.¹⁶²

160. 2007 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplemental Medical Insurance Trust Funds, BOARD OF TRUSTEES, FEDERAL HOSPITAL INSURANCE AND FEDERAL SUPPLEMENTAL MEDICAL INSURANCE TRUST FUNDS, available at <http://www.cms.hhs.gov/rep-ortstrust-funds/downloads/tr2007.pdf>.

161. George Wagoner, et al., *Risk-Sharing in Retiree Medical Benefits* 2005 PENSION RESEARCH COUNCIL 15; see also Richard W. Johnson et al., *Will Health Care Costs Erode Retirement Security* 1, 3 (Ctr. for Ret. Research at Boston College 2004) (projecting that health care spending for older married couples will increase from 16% of net after-tax income in 2000, to 35% in 2030; that unmarried older adults will face an increase from 17% to 30%; and that the problems will be most severe for lower income people, and for unhealthy individuals). According to EBRI, out of pocket medical expenses will cost \$295,000 for a 65 year old couple retiring without employer provided health benefits and living to an average life expectancy, without including long term care. *Financial Advisers Help Investors Plan for Retirement Amid Increased Health Care Costs* (2006), available at http://www.Kaisernetwor.org/daily-reports/rep_index.cfm?hint=3&DR_ID=41501. According to another analyst, a retired couple without retiree health benefits needs \$225,000, up from \$215,000 in 2007, and 160,000 in 2002. Eileen Alt Powell, *Retired Couple Needs \$225K for Medical*, NEWSVINE, Mar. 5, 2008.

162. Wagoner, *supra* note 161, at 11.

The lack of adequate health insurance, particularly for those not yet eligible for Medicare, is a growing problem. "Surveys have found that retiree health insurance plays a bigger role in the timing of retirement than pensions do".¹⁶³ For those who are not yet retired, the answer is straightforward, if unpalatable:

The dual problems of accessibility and affordability of coverage mean that employees will have to save more money for retiree health care expenses, allocate more financial resources to health care, work longer, rely on help from family, or use a combination of these approaches.¹⁶⁴

And, as Alicia Munnell points out:

The National Retirement Risk Index has shown that even if households work to age 65 and annuitize all their financial assets, including the receipts from reverse mortgages on their homes, 44 % will be 'at risk' of being unable to maintain their standard of living in retirement.¹⁶⁵

This analysis did not address rising health care costs. If health care is included, the percentage of households 'at risk' rises to 61%. If people do not plan, and accumulate funds for health care costs in retirement, the percentage at risk increases to 67%.¹⁶⁶

XII. LONG-TERM CARE

As Richard Kaplan has noted, the need for, and cost of, long-term care is the single most unpredictable financial hazard of old age: "the funding of long-term care is the single greatest gap in retirement planning, even though this potential black hole could totally eclipse all of the carefully constructed parameters of pre-retirement calculations."¹⁶⁷

The coverage of long-term care (at home or in a nursing home) under Medicare or Medicare supplemental (Medigap) insurance is very limited, generally covering only care in a skilled nursing facility for the period immediately following in-patient hospital treatment.¹⁶⁸ Most long term care is custodial, rather than medical, so does not satisfy the basic requirement for Medicare coverage.

163. See John O'Neil, *Want to Retire Early and Hang a Shingle? It'll Cost You*, N.Y. TIMES, Apr. 11, 2006 available at <http://www.nytimes.com/2006/04/11/business/retirement/11gap.html> (quoting Cara Jareb, director of retiree health consulting at Watson Wyatt).

164. Wagoner, *supra* note 161, at 13.

165. Alicia H. Munnell, et al, *Health Care Costs Drive Up the National Retirement Risk Index 1* (Ctr. for Ret. Research at Boston College 2008).

166. *Id.*

167. Richard L. Kaplan, *Retirement Planning's Greatest Gap: Funding Long-term Care*, 11 LEWIS & CLARK L. REV. 407, 409 (2007).

168. *Id.* at 419-20.

In the absence of Medicare, there are three possible sources of payment: personal assets, long term care insurance or Medicaid.¹⁶⁹ Coverage under Medicaid generally requires almost total depletion of the individual's assets.¹⁷⁰

Long-term care expenses exemplify the type of expenses that *should* be covered by insurance: they are more likely to be incurred than most other insured risks (e.g., a house fire), their incidence is unpredictable, and the financial consequences are potentially devastating. Accordingly, my view is that the risk and the costs should be spread as widely as possible through a universal federal program, financed from general revenues or from a dedicated tax. The federal and state governments are already paying the bulk of the cost, through Medicaid, under a system that is patently unfair and arbitrary.

The best estimates suggest that less than 10% of older Americans have long-term care insurance. The federal government has sought to increase this number by providing tax incentives, principally the deductibility of long-term care insurance premiums; and by approving state-level "partnerships" that allow a Medicaid applicant to retain a certain level of assets if he or she is covered by a qualifying partnership insurance policy.¹⁷¹ These efforts have been largely unsuccessful: the tax benefit is often of little value (particularly because it is an itemized deduction and limited in amount), and not enough individuals are convinced that it is in their best interests to buy a policy.

It is also difficult to get an accurate estimate of how likely it is that an individual will need long term care. According to one study, almost 70% of Americans who turned 65 years old in 2005 will eventually require some long-term care,¹⁷² but other estimates are far lower. The risk is significantly higher for women than for men, because women as a group live longer. Most long-term care is still provided at home, by unpaid family members. Some people require care for very short periods: others spend 15 years or more in a nursing home.

According to a 2005 survey conducted for the Society of Actuaries, 52% of retirees are *very* or *somewhat* concerned about having enough money to pay for extended care at home or in a nursing home. 61% of pre-retirees are concerned about having enough money to pay for long-term care. Both retirees and pre-retirees are more likely to try to save for long-term care costs rather than insure themselves against this risk. They are either

169. *Id.* at 410-12.

170. *Id.* at 447.

171. *Id.* at 437-38.

172. *Id.*

currently saving (34% of retirees, 16% of pre-retirees) or intend to save (15%, 34%) against the possibility of needing long-term care or having large health expenses. Only about one-third of retirees indicate they already have (20%) or intend to purchase (14%) long-term care insurance and four in ten pre-retirees say they already have (16 %) or intend to purchase (27%) this insurance. 16% of retirees and pre-retirees have made or intend to make arrangements for care through a continuing care retirement community.¹⁷³

Apart from the expense of good coverage, it seems clear that many potential purchasers are deterred by the bewildering variety of features offered by different policies: few insurance contracts are simple, but long-term care products are more complex than most. Shopping for Medigap policies has been greatly simplified by the mandatory standardization of policy features, and this should also be mandated for long-term care insurance. “[S]tandardizing the variety of LTC insurance policies now being sold would make it easier for consumers to compare premiums, might lead to more competition among insurers, and could make policies generally more understandable.”¹⁷⁴

Finally, studies have shown that implementing a long-term care program with group features “can result in employer costs very similar to a dental plan.”¹⁷⁵ Some (generally larger) organizations, including the California Public Employees’ Retirement System, offer long term care insurance. The Federal Employee Health Benefits Program offers insurance at rates 10-20% below typical individual rates, due to reduced marketing expenses and economies of scale. If the employer pays the premiums for long-term care insurance for an employee—or the employee’s spouse or dependents—then the premium—like health insurance premiums—is excluded from the employee’s taxable income.¹⁷⁶ However, there is no exclusion if the benefits are provided through a flexible spending or similar arrangement.¹⁷⁷ Many more employers would be likely to offer this option, if they could do so through a flex plan, so this rule should be changed.

173. Am. Soc’y of Actuaries, *2005 Risks And Process Of Retirement Survey* 12 (2005).

174. Congressional Budget Office, *Financing Long-Term Care for the Elderly* 27 (2004), available at <http://www.cbo.gov/ftpdocs/54xx/doc5400/04-26-LongTermCare.pdf>.

175. Jon Shreve, *I’m not going to pay a lot for this long-term care plan*, MILLIMAN, Dec. 1, 2007, available at <http://www.milliman.com/expertise/healthcare/publications/true-group-ltc/im-not-going-to-pay-LTC12-01-07.php>.

176. I.R.C. § 106(a).

177. I.R.C. § 106(c).

XIII. LIFE EXPECTANCY

Life expectancy continues to increase. The average life expectancy of Americans born in 1960 was 69.7 years. It has been estimated that those who were born in 2005 will live for an average of 77.8 years.¹⁷⁸

However, the growth is not uniform: “New government research has found “large and growing” disparities in life expectancy for richer and poorer Americans, paralleling the growth of income inequality in the last two decades.” Federal officials found “widening socioeconomic inequalities in life expectancy” at birth and at every age level.¹⁷⁹

XIV. WORKING LONGER

The statistical evidence is clear: in recent years, there has been a significant increase in the number of older Americans in the workforce,¹⁸⁰ for a variety of reasons: better health, increased life expectancy, concerns about the adequacy of retirement income, concerns about health insurance and medical expenses, and an increased recognition by some employers of the need to retain the

178. Patrick Purcell et al, *CRS Report for Congress: Pension Sponsorship and Participation: Summary of Recent Trends*, 2006 CONG. RESEARCH SERVICE 1. See also Olga Sorokina, et al., *Pension Wealth And Income: 1992, 1998, and 2004* 1, 6 n.12 (Ctr. for Ret. Research at Boston College 2007) (“According to the Social Security Cohort Mortality Tables, life expectancy of an average 65-year-old man increased from 15.8 years in 1992 to 16.7 years in 2004. During the same time period, life expectancy of an average 65-year-old woman increased from 19.2 to 19.8 years.”).

179. Robert Pear, *Gap in Life Expectancy Widens for the Nation*, N.Y. TIMES, Mar. 23, 2008, at A1.

180. Patrick Purcell, *CRS Report for Congress: Older workers: Employment and Retirement Trends*, Summary (Congressional Research Service 2006). The report states:

Recent Census Bureau data show that the percentage of men and women age 62 and older who work in paid employment has risen over the past 10 years. In March 2006, 52% of men aged 62 to 64 were employed, compared with 43% in 1995 and 42% in 1990. Of men aged 65 to 69, 31% were employed in March 2006, compared with 27% in 1995 and 26% in 1990. Among women 62 to 64 years old, 41% were working in March 2006, compared with 32% in 1995 and 28% in 1990, whereas among women 65 to 69 years old, 23% were working in March 2006, compared with 17% in 1995 and 1990. There also has been a trend toward more full-time employment among older Americans who work.

Id.; see C. Schooler, L. Caplan, & G. Oates, *Aging and Work: An Overview in Impact of Work on Older Adults*, SPRINGER PUBLISHING, INC. (1997) (discussing the effects of aging on the ability to continue working); see also Murray Gendell, *Older workers: increasing their labor force participation and hours of work*, MONTHLY LABOR REVIEW, Jan. 2008; Senate Special Committee on Aging, *Report of the Taskforce on the Aging of the American Workforce*, (2008).

expertise and work ethic of older employees.¹⁸¹

A recent study by the Urban Institute discusses four current strategies to employ and retain older workers: flexible work arrangements; phased retirement plans; job search assistance resources; and programs to train older workers.¹⁸²

Some observers welcome this trend: others deplore it, as they think that those who do continue to work are generally compelled to do so by the inadequacies of the social safety net.¹⁸³

[R]aising the Medicare eligibility age, perhaps to age 67 to make it consistent with the eligibility age for full Social Security retirement benefits for people born in 1960 and later, could lead many workers to delay retirement. But enhanced protections for people with serious health problems should accompany any new restrictions on Medicare eligibility, because many people facing the steepest health care costs in later life are physically unable to extend their work lives.¹⁸⁴

Another recent study came to a more optimistic conclusion about the ability of older Americans to keep working: The decline in physically demanding occupations will likely improve employment prospects for older adults, but the growth in cognitive demands may limit options for some older people, especially those with limited education.¹⁸⁵

In addition to improving the economic outlook, working longer can enhance individual well-being. Two recent changes to the Social Security benefits entitlement rules—the gradual increase in

181. See, e.g., Marsha King, *Companies find ways to retain expertise of older workers*, SEATTLE TIMES, Apr. 9, 2008, at A1.

182. Lauren Eyster et al., *Current Strategies to Employ and Retain Older Workers*, URBAN INST. 1 (2008).

183. “The proposed ‘so-called’ winning solution to strained pension budgets of people working until age 70 may not be possible as jobs held by the elderly become more difficult. In addition, though some elderly may find work attractive; as retirement income fails older people lose the ability to seek the work on their terms, and those of the employer prevail.” Teresa Ghilarducci, *The Changing Role of Employer Pensions: Tax Expenditures, Costs, and Implications for Middle-Class Elderly*, LEVY ECON. INST. OF BARD COLLEGE 1, 2 (2006). As the famous English actor, Peter Cook, observed, “All in all I’d rather have been a judge than a miner. And what is more, being a miner, as soon as you are too old and tired and sick and stupid to do the job properly, you have to go. Well, the very opposite applies with the judges.”

184. Johnson, *supra* note 165, at 33. “If every worker delayed retirement by five years, relative to retirement plans based on current work patterns, the additional income and payroll taxes they would pay would more than cover the Social Security trust fund deficit for the foreseeable future.” *Government Spending on the Elderly*, 2007 DIMITRI B. PAPADIMITRIOU ED., PALGRAVE MACMILLAN 1, 141.

185. Abstract of Richard W. Johnson, et al., *Employment at Older Ages and the Changing Nature of Work* (Nov. 1, 2007) available at <http://www.urban.org/publications/1001154.html>.

the full retirement age (FRA) from sixty-five to sixty-seven and the abolition of the earnings test for people over FRA but under age seventy—should also encourage people to work longer. By working until age sixty-seven instead of retiring at age sixty-two, for example, a typical worker could gain about \$10,000 in annual income at age seventy-five, net of federal income taxes and health insurance premiums.¹⁸⁶

Recent research suggests that a one-size-fits-all approach would be ineffective and inequitable:

We find that career paths are changing significantly- and in different ways for different parts of the population- over time. For women, work history is increasing rapidly, with more educated women demonstrating the strongest average work histories. For men, work histories are more similar by education; still, men with less than a high school education on average work less- not more- than other men by middle and pre-retirement age.¹⁸⁷

And, as Teresa Ghilarducci points out:

A fundamental question for policy makers and for our scrutiny of federal spending on the elderly is whether federal policy is creating more older workers because they want jobs or because they have lost pensions. Clearly, some workers will want to work longer, at least part time. It is not clear, however, that employers will provide the jobs older workers want.¹⁸⁸

Finally, John Shoven suggests that, instead of focusing on attained age, we should look instead at remaining life expectancy.¹⁸⁹

186. Butrica, et al., *Does Work Pay at Older Ages*, URBAN INST. (2004). Individuals can increase Social Security lifetime benefits by delaying the claim, even if they do not work. Because of increasing life expectancy, the increases exceed the actuarially fair amount, thus over-compensating those who delay. Courtney Coile, et al., *Delays in Claiming Social Security Benefits*, 11-19, NAT'L BUREAU OF ECON. RESEARCH 199; see also Steven A. Sass et al, *When Should Married Men Claim Social Security Benefits?* 1, (Ctr. for Ret. Research at Boston College 2008) (exclaiming that “[i]f married men delayed claiming Social Security benefits, retirement income security would significantly improve.”).

187. Melissa M. Favreault & C. Eugene Steuerle, *The Implications of Career Lengths for Social Security*, URBAN INST. vi-vii (2003).

188. Ghilarducci, *supra* note 183, at 26-27.

189. John B. Shoven, *New Age Thinking: Alternative Ways of Measuring Age, Their Relationship to Labor Force Participation, Government Policies and GDP* Abstract, NAT'L BUREAU OF ECON. RESEARCH (2007).

XV. HOW DO CURRENT RETIREES FARE?

“For 39% of elderly recipients, Social Security contributes more than 90% of their income, and for one-quarter of recipients, it is their only source of income.”¹⁹⁰ According to EBRI, individuals with the highest amounts of pension or annuity income tend to fare better, but future retirees will be less likely to receive pension or annuity income (other than Social Security).¹⁹¹ In 1980, there were 30.1 million active participants in private sector defined benefit plans: by 2003, this had declined to 21.3 million.¹⁹²

A 2007 EBRI study found that most 65 to 75 year olds fared well between 1992 to 2004, but that those who were losing money were losing it fast. Among those who participated in the study, 50% saw an average wealth decline of 5% from 1992-2004.¹⁹³ However, those declines in wealth were not correlated with age.¹⁹⁴

By contrast another recent study found that the elderly experienced an increase in wealth from the years 1998-2004.¹⁹⁵ This is explained by a desire to accumulate funds to pay for rising medical costs and to bequeath assets to children.¹⁹⁶

The official poverty rate declined from over 33% of elderly people in 1960 to less than 10% today.¹⁹⁷ Poverty rates are higher among elderly women (12%), elderly African Americans (25%) and elderly Hispanics (20%).¹⁹⁸

However, many scholars believe that the official poverty statistics significantly underestimate the numbers, because “the poverty thresholds fail to capture the growth since 1963 in housing, health, and other costs relative to food costs. For example, people today spend closer to one-sixth of their income on food rather than one-third.”¹⁹⁹

The authors conclude that proposed Medicare reforms for increases in cost sharing should exclude poor elderly people.²⁰⁰

190. Patrick Purcell, *CRS Report for Congress: Income and Poverty Among Older Americans in 2006*, Summary Cong. Research Service (2006).

191. Craig Copeland, *How Are New Retirees Doing Financially in Retirement*, 302 EMP. BENEFIT RESEARCH INST. ISSUE BRIEF 1 (2007).

192. Purcell, *supra* note 190, at t.1.

193. Copeland, *supra* note 191, at 15.

194. *Id.*

195. David A. Love, et al., *Finance and Economics Discussion Series: The Trajectory of Wealth in Retirement*, FED. RESERVE BD. (2008).

196. *Id.*

197. Purcell, *supra* note 190.

198. *Id.* at 9.

199. See Barbara A. Butrica et al., *How Many Struggle to Get By in Retirement?*, URBAN INST. 1, 3 (2008) (citing John Iceland, *Measuring Poverty: Theoretical and Empirical Considerations*, vol.3, iss.4 MEASUREMENT: INTERDISCIPLINARY RESEARCH & PERSPECTIVE 199 (2005)).

200. Barbara A. Butrica, et al., *How Many Struggle To Get By In Retirement*,

Even using the official numbers, many older Americans are among the near-poor:

In 2006, while just 9.4% of people aged 65 and older had incomes below the poverty thresholds of \$9,669 for an individual and \$12,186 for a couple, 22% of older Americans had family incomes below 150% of the thresholds (\$14,504 for an individual and \$18,279 for a couple). Thirty-six percent of people 65 and older had incomes less than twice the poverty thresholds (\$19,338 for an individual and \$24,372 for a couple).²⁰¹

In addition, it seems clear that things are likely to get much worse. According to the EBRI-ERF Retirement Security Projection Model, in 2030, many American retirees would not be able to afford nursing homes or home health providers. The projected aggregate retirement income deficit in 2030 is at least \$400 billion.²⁰²

XVI. IS RETIREMENT SECURITY POSSIBLE?

A thought-provoking article by Jeffrey Gordon asks whether retirement security is actually possible, and says:

A robustly competitive economy is likely to increase social wealth overall and thereby to increase the capacity to fund social promises (or guarantees) of retirement payouts, but it is also likely to increase the risks borne by firms and individuals. Another complication is that a government guarantee entails not only funding concerns but may create moral-hazard effects at the firm or individual level. The prudent retiree rule reminds us that absolutes in this area are not possible, but also that we should take a sophisticated view of the factors relevant to fashioning a reasonable balance.²⁰³

He also points out that it is overly simplistic to assume that defined contribution plans are always inherently more risky for employees than defined benefit plans.²⁰⁴

Several major life insurers have recently rolled out variable annuities that de-emphasize costly life insurance features in favor of guaranteed long-term withdrawal benefits- a feature once limited to income annuities. Mutual funds emulate the systematic withdrawal features of variable annuities without offering

URBAN INST. (2008), available at www.urban.org/UploadedPDF/411627_howmanystruggle.pdf.

201. Patrick Purcell, *Income and Poverty Among Older Americans in 2006*, Cong. Research Service, Order Code RL32697, updated Sept. 24, 2007.

202. EBRI, *Can America Afford Tomorrow's Retirees: Results From the EBRI-ERF Retirement Security Projection Model*, EBRI ISSUE BRIEF No. 263 (Nov. 2003).

203. Jeffrey N. Gordon, *The "Prudent Retiree Rule": What To Do When Retirement Security Is Impossible?*, 11 LEWIS & CLARK L. REV. 481 (2007).

204. *Id.*

guarantees and their costs. International banks sell high-net-worth investors structured notes that offer guarantees while providing returns linked to market indices. Numerous defunct firms promised or guarantees that they could not fulfill, e.g. Mutual Benefit Life. "To fund its guarantees, the insurer made riskier and riskier bets on real estate. Then the property market imploded and Mutual Benefit went bust."²⁰⁵

XVII. RETIREMENT INVESTING

To maximize benefits under a defined contribution regime, successful investment performance is very important, both in the saving (accumulation) phase and in the spending (decumulation) phase. Unfortunately, most individuals are not skilled investors, and it is unrealistic to expect them to absorb the often-contradictory advice peddled by the pundits of the day, or to be able to evaluate risk and reward in today's uncertain investment climate. One leading scholar, Zvi Bodie, suggests the following guiding principles:

First, to enable participants in employer-sponsored 401k-type plans to hedge minimum levels of retirement income, employers should offer inflation-protected annuities in the plan. Second, advisors should explicitly take account of the individual's willingness to postpone retirement in suggesting an optimal asset allocation. The greater the willingness to continue working past the expected retirement date, the greater the proportion to invest in stocks. Third, sponsors of self-directed investment plans can enhance the risk-reward opportunities available to investors by offering option-like securities or contracts as an additional asset class. These assets can provide a means of leveraging participation in stock market gains while protecting one's minimum standard of living.²⁰⁶

For the ten year and fifty year periods ending December 31, 2006, the investment class that produced the highest average annual returns was small stocks (13.5% and 14.5% respectively, compared to 8.45 and 10.6% for the S & P 500 and 7.7% and 7.1% for long-term corporate bonds); returns, however, on stocks are more volatile: during that same period, the worst 5, 10 and 20 year average returns for stocks were -2.4%, 1.2% and 6.5%.²⁰⁷ How long will your retirement savings last? Again, this depends largely on

205. William Glasgall, *The New Retirement Wave*, FINANCIAL ADVISOR, Oct. 2007; see also Phyllis C. Borzi, Martha P. Patterson, *Regulating Markets for Retirement Payouts: Solvency, Supervision and Credibility*, (Working Paper No. 2007-21).

206. Zvi Bodie, *Retirement Investing: A New Approach* (Boston University School of Management Working Paper No. 2001-03, Feb. 2001).

207. Iris Mack Dayoub, *Asset Allocation and Retirement: Do You Need to Make a Change*, AAI JOURNAL (2008), available at www.aai.com (citing Ibbotson Associates, Inc., *Stocks, Bonds, Bills and Inflation- 2006 Yearbook*).

how much you withdraw each year, and the rate of return you achieve each year.

The following table shows the number of years retirement savings will last, assuming that the annual payout increases by 4% a year and (unrealistically) that you can achieve the same rate of return each year.

First Year	Investment Return						
Payout %	4%	5%	6%	7%	8%	9%	10%
2	50	67.6					
3	33.3	39.9	52				
4	25	28.4	33.5	42.4	69		
5	20	22.1	24.9	28.9	35.8	53.1	
6	16.7	18.1	19.8	22.1	25.4	30.8	42.8
7	14.3	15.3	16.5	18	20	22.7	26.9
8	12.5	13.2	14.1	15.2	16.5	18.1	20.4
9	11.1	11.7	12.4	13.1	14	15.2	16.6
10	10	10.5	11	11.6	12.3	13.1	14.1

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Many advisors advocate the use of target-date funds. However, individual funds have markedly different characteristics, and they are new enough that they have only limited track records. Vanguard cites the following "key considerations": the asset allocation glide path; passive versus active management; packaged or customized solution; and the impact on participant portfolios.²⁰⁹

For its new 401(k) plan, IBM has developed in-house life-cycle funds, which it customizes for participants.²¹⁰ A recent CRS report stresses the unpredictability of future investment returns for an individual participant, even given a rigorous analysis.²¹¹ While the predicted annual average return was 5.5%, there was a 5% chance that the return would be 9.3% and a 5% chance that it would be only 1.7%. Unfortunately, the 401(k) world is not Lake Wobegon, so not all investors will be above average, and for an investor in the unlucky 5% it is probably little comfort to be told that all of his or her peers did better.²¹²

208. *Id.*

209. Vanguard Investment Consulting and Research, *Evaluating and Implementing Target-date Portfolios: Four Key Considerations* (Mar. 4, 2008), available at <https://institutional.vanguard.com/iip/pdf/ICR4KC.pdf>.

210. Bruno, *supra* note 140.

211. Purcell & Whitman, *supra* note 149.

212. Peter Cook bemoaned, "I've always been after the trappings of great luxury. But all I've got hold of are the trappings of great poverty. I've got hold of the wrong load of trappings, and a rotten load they are too, ones I could have very well done without." Alan Bennett, et al., *Beyond the Fringe: A Revue* 47 (Samual French Inc. 1964).

Some commentators criticize the emphasis on equities in target-date funds.²¹³ The returns on equities are so volatile that they create an uneven distribution of wealth with extreme winners and extreme losers. According to Russell Investments' Russell 10/30/60 Retirement Rule, investment earnings during retirement could be made up from 10% savings during the working years, 30% pre-retirement investment growth, and 60% from growth after retirement.²¹⁴ The theory all depends on having the right asset mix of bonds and equities. The Russell Retirement Essentials Portfolio (RREP), recently launched in Canada, has a 35% allocation to equities and a 65% allocation to bonds.²¹⁵

A related issue, which has received attention recently from DOL and Congress, is the level of fees charged to plan participants. There is substantial evidence that neither plan sponsors nor participants understand this issue well enough. According to a recent study by Chatham Partners, 77% of surveyed sponsors indicated that current fee disclosure levels are sufficient, but only 58% feel confident about their understanding of their plan's overall costs. Sponsors are also dissatisfied with fees being easy to compare to other providers (34%), revenue sharing disclosure (38%), and fee transparency (42%).²¹⁶

The current fund distribution system used by most plans is also unduly expensive for participants: "The legacy distribution system can cost an individual 40% of the retirement accumulation, as compared to low-cost individual distribution or low-cost retail distribution."²¹⁷

XVIII. ANNUITIES IN DEFINED CONTRIBUTION PLANS

These uncertainties have led a growing number of (mainly larger) employers to consider offering annuities to their 401(k) plan participants. IBM's new 401(k) plan offers a rollover annuity option: at retirement, participants can roll over all or part of their savings to an annuity, and they get institutional pricing rather than retail pricing.²¹⁸

213. Seth Ruthen, *Creating the Next Generation Glidepaths for Defined Contribution Plans*, PIMCO, available at <http://www.pimco.com/LeftNav/Viewpoints/2007/Glidepath+Paper-82007.htm>.

214. *Equity Allocation in Retirement Key to Making Savings Last*, PLAN SPONSOR MAGAZINE (April 3, 2008), available at http://www.plansponsor.com/pi_type10/?RECORD_I=40952

215. *Id.*

216. News Release, Andrew McCollum, *Looking Beneath The Surface*, CHATHAM PARTNERS (March 14, 2008), available at: <http://www.chathampartners.net/Looking%20Beneath%20the%20Surface%20Press%20Release.pdf>.

217. Scott Burns, *Broker System Costs You Years of Retirement Savings*, DALLAS MORNING NEWS, Mar. 9, 2008, at A1.

218. Bruno, *supra* note 140.

According to Hewitt Associates, 14% of plan sponsors now offer annuities as a rollover option outside of their plans, while another 5% offer an annuity or insurance product within the plan that will help retired participants withdraw funds while preserving their capital. Another 5% of plan sponsors polled by Hewitt said they plan to add one of these options in 2008.²¹⁹

For a participant, buying an annuity through a 401(k) plan may be as much as 50% cheaper than buying one individually. However, there are potential problems, including increased premiums based on adverse selection; lack of portability; high surrender charges; and lack of a survivor benefit in the event of a premature death.²²⁰

XIX. LACK OF INTEREST IN ANNUITIES

A 2003 Hewitt Associates survey found that 69% of workers and 86% of retirees rated guaranteed lifetime income as “very important.” Why do so few participants receive annuity distributions from individual account arrangements? There are, it seems, two main causes: lack of interest in annuities on the part of participants and concern among plan sponsors about the legal risks associated with offering annuity options.

As long as the demand for an annuity distribution payout is low, plan sponsors are not going to expend the time and resources necessary to follow the [safe harbor] process. This area is not going to command much plan-sponsor attention until the marketplace comes up with solutions that participants desire. It’s a demand-based issue.²²¹

Annuities are not attractive investments, partly because, as Pamela Perun has noted, it is not clear whether they are fairly priced, and the market currently lacks an annuity product that protects against inflation.²²²

For many, if not most, plan participants, the main source of information about retirement planning is their employer. Employers, however, typically do not include a discussion of guaranteed lifetime income options. Also, one wonders whether general dissatisfaction with insurers’ performance and behavior with respect to health benefits will make people more reluctant to

219. *Id.*

220. Matthew Mogul, *Annuities: The Next Big 401(k) Craze*, KIPLINGER RESOURCE CTR., Aug. 24, 2007, available at http://www.kiplinger.com/business_resource/forecast/archive/annuity_craze_070824.html.

221. Mark Schoeff Jr, *A Tepid Reception for Annuities as 401(k) Payouts*, WORKFORCE MANAGEMENT (citing David Wray, president of the Profit Sharing/401(k) Council of America), available at <http://www.workforce.com/section/02/feature/25/21/95/index.html>

222. Pamela Perun, *Putting Annuities Back Into Savings Plans*, ASPEN INST. (2004).

purchase annuities. The immediate life annuities market is currently small with annual sales of approximately \$6 billion in 2004.²²³ Also, some advisers argue that 401(k) plans should be used solely for the accumulation of assets; that it is too confusing to have income products inside these plans; and that the products lack portability, and are expensive.²²⁴

Overall two thirds of participants say it is extremely or somewhat important to arrange for a guaranteed amount of income during retirement, while only 12% of plan sponsors agree, and 48% say such an option is not important.²²⁵

When asked if they would change part of their Social Security benefits for an immediate lump sum, nearly 60% favored the lump sum if it were actuarially fair.²²⁶

XX. NEW PRODUCTS

Financial institutions have issued new products designed to reduce the risk that retirees will run out of money. However, unless the product is a true annuity—i.e., one that guarantees payments for the retiree's lifetime, or some other period—the risk is reduced, but not eliminated.

While annuities carry higher expense ratios, their payments are also guaranteed. With the new products, if the stock or bond market takes a hit, for example, a fund might have to dip into an investors' principal to come up with the money for the monthly payment. For that reason, the expectations for the payouts are kept modest.²²⁷

Research suggests that, generally, individuals should spend less than 5% of their assets in each year of retirement in order to have a high likelihood (not an absolute guarantee) of not running out of money within 30 years. A withdrawal rate of 4% is safe, but unrealistic. A more realistic 5.5–6% withdrawal rate is more

223. Kaja Whitehouse, *Annuities, Meet 401(k)s*, WALL ST. J., August 15, 2005, at A1.

224. Lisa Shidler, *Annuities for 401(k)s meeting resistance: Some advisers say the products are confusing, lack portability and are expensive*, INVESTMENT NEWS, Oct. 8, 2007, available at <http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20071008/FREE/710080329>.

225. Spectrem Group, *Disconnect, Participants Want Guaranteed Retirement Income but Sponsors Don't Think It's an Important Plan Option*, SPECTREM GROUP available at <http://www.spectrem.com/trendsandinsights/February2008/4.html>.

226. Jeffery R. Brown et al., *Who Values the Social Security Annuity? New Evidence on the Annuity Puzzle*, NAT'L BUREAU OF ECON. RESEARCH, available at <http://www.nber.org/programs/ag/rrc/NB0702%20Brown,Casey,Mitchell%20FINAL.pdf>.

227. News Release, Tim Paradis, *Retirement Funds Carry No Guarantee*, (Oct. 9, 2007) (on file with author).

achievable, but also comes with a 25–30% chance of running out of money when 75–100% of a portfolio is devoted to stock allocations.²²⁸

One recent paper points out that much of the earlier research assumes fixed consumption patterns.²²⁹ Consequently, most financial planning models are built on the same assumption.²³⁰ In reality, retirees will see spikes and troughs in their spending patterns over time.²³¹

Several major life insurers have recently rolled out variable annuities that de-emphasize costly life insurance features in favor of guaranteed long-term withdrawal benefits—a feature once limited to income annuities. Mutual funds emulate the systematic withdrawal features of variable annuities without offering guarantees and their costs.

For example, in April, 2008, John Hancock Retirement Plan Services launched Guaranteed Income for Life (GIFL), an optional 401(k) rider with a principal guarantee.²³² The plan locks in market gains on the anniversary of each participant's plan.²³³

Thrivent Financial for Lutherans has launched a customized service, Thrivent Retirement Income Optimizer (TRIO), to help retirees actively manage their assets and spending in retirement.

Instead of setting up a program that transfers assets to an annuity or other investments right at retirement, the service is ongoing throughout retirement, signaling retirees at least annually when it might be time to reallocate assets, hold invested assets instead of spending, move some assets into an inflation-adjusted stream of income, or take no action.²³⁴

TRIO's guiding principles are diversify assets for growth and income; guarantee inflation-adjusted income and manage withdrawals to make money last.

Some researchers advocate delayed (longevity) annuities, rather than immediate annuities, on the basis that they are more efficient.²³⁵ There are at least two insurance companies that offer

228. John J. Spitzer, Ph.D., et al., *Guidelines for Withdrawal Rates and Portfolio Safety During Retirement*, JOURNAL OF FINANCIAL PLANNING, Oct. 2007, available at http://www.fpanet.org/journal/articles/2007_Issues/jfp1007-art6.cfm.

229. Chris Robinson, Nabil Tahani, *Sustainable Retirement Income for the Socialite, the Gardener and the Uninsured* (Atkinson School of Administrative Studies, York University, (Oct. 25, 2007).

230. *Id.*

231. *Id.*

232. News Release, *John Hancock Retirement Services Officially Launches New 401(k) Guaranteed Income for Life Rider*, PLAN SPONSOR MAGAZINE, Apr. 9, 2008, available at www.plansponsor.com.

233. *Id.*

234. *Id.*

235. Jason S. Scott et al., *Efficient Annuitization with Delayed Payout*

longevity annuities: Retirement Income Insurance from MetLife, introduced in 2004, and The Hartford Income Security, introduced in 2006. Longevity annuities that begin payouts after age seventy may cause problems complying with the required minimum distribution rules, which generally require payments from employer plans and IRAs to begin at age seventy and a half.²³⁶ Currently, insurance companies do not even allow the elderly to purchase longevity annuities with IRA dollars.²³⁷ IRA assets must first be withdrawn and taxed before being used to purchase a longevity annuity.²³⁸ This is likely to prevent the adoption of annuitization options.²³⁹ Purchase of a longevity annuity is clearly consistent with the purposes underlying the minimum distribution rules, and the regulations should be amended to accommodate this option.

A life care annuity combines an immediate life annuity with long-term care insurance. The latest generation of variable annuity contracts contains equity put options plus longevity insurance. The marketing material for these products often claims that these new riders should induce purchasers to take on more financial risk.

XXI. SOME RECENT REFORM PROPOSALS

Given the longstanding failure of the private pension system to expand coverage of lower-income individuals, several reform proposals have suggested that provision should be made for them outside the traditional employer-based system by providing lower income workers with government financed matching credits and increasing tax benefits for employers who cover all workers in their organizations.²⁴⁰

On January 31, 2003, the Bush Administration issued radical proposals for increasing individual savings which have been

Annuities, PENSION RESEARCH COUNCIL (Nov. 2006); see also Martha M. Hamilton, *Live Long and Prosper*, WASH. POST, Aug. 12, 2007, at F01; Jason S. Scott, *Longevity Annuity: An Annuity for Everyone?*, SOCIAL SCIENCE RESEARCH NETWORK (June 2007), available at <http://ssrn.com/abstract=992423>.

236. I.R.C. §§ 401(a)(9), 403(b)(10), 408(a)(6), § 408(b)(3).

237. Scott, *supra* note 235.

238. *Id.*

239. *Id.*

240. Daniel I. Halperin & Alicia H. Munnell, *How the Pension System Should Be Reformed*, Brookings Institution Conference on ERISA After 25 Years: A Framework for Evaluating Pension Reform, Sept. 1999; see also Peter R. Orszag, *Reforming the Tax Code to Increase Retirement Savings*, TAX NOTES TODAY, May 9, 2006 (recommending a new program providing matching contributions from the federal government for deposits to 401(k) plans and IRAs).

reissued, with minor modifications, each year since then.²⁴¹ The main focus is a dramatic expansion of the tax-favored savings opportunities for those who can afford to save in the first place. The proposals would dramatically simplify the retirement plan rules for many employers—however—many commentators feared that they would also undermine the private pension system. The proposed plan could reduce incentives for small business owners to set up 401(k)s, and might even encourage large employers to abandon 401(k)s.²⁴²

Some proposals include developing a government authorized clearinghouse for portable individual accounts, and designing new multiple employer plans.²⁴³ In June, 2007, the ERISA Industry Committee (“ERIC”) issued a comprehensive reform proposal, *The New Benefit Platform for Life Security* (the “ERIC Proposal”).²⁴⁴ ERIC proposes a new structure that would provide benefits through independent Benefit Administrators, who would compete based on quality, use of information technology, plan design and cost. “Benefit Administrators, in many respects, would assume the role of today’s plan sponsors and, particularly with regard to health care, would be organized on a geographic basis. Employers and individuals would share funding of benefits.”²⁴⁵ Each Benefit Administrator would be required to offer plans for a core set of “lifetime security” benefits: health, retirement and short-term savings.

Employers could either (1) keep their own benefit plans, or (2) select one or more Benefit Administrators for their employees and dependents. Employers could also opt to provide funds to their employees, to buy benefits themselves from Benefit Administrators operating in that area. As the benefits would be administered separately from the employers, an employee could

241. For a description of the most recent version, see *Description Of Revenue Provisions Contained In The President's Fiscal Year 2009 Budget Proposal*, JOINT COMM. ON TAX'N, JCS-1-08, (Mar. 2008).

242. Aaron Bernstein, *Bush's Retirement Rx Is Bad Medicine*, BUSINESS WEEK ONLINE, Feb. 18, 2003, available at www.businessweek.com/careers/content/feb2003/ca20030218_8886_ca030.htm; see also Mary Williams Walsh, *Shifting Responsibility for Funding Pensions*, N.Y. TIMES, Feb. 20, 2003, at A1; Robert Greenstein & Joel Friedman, *Proposed "Savings Incentives" Would Cause Revenue Hemorrhage in Future Decades*, (Ctr. for Budget and Policy Priorities, Feb. 5, 2003), available at www.cbpp.org/2-5-03tax.htm (“The proposal is likely to lead to a reduction in pension coverage for ordinary workers.”).

243. See David A. Pratt, *Focus on . . . Employee Benefit Reform Proposals* 15 JOURNAL OF PENSION BENEFITS 1 (discussing in detail a draft of the report).

244. The proposal is available at www.eric.org. As it states on its web site, ERIC is “dedicated exclusively to representing the employee benefits and compensation interests of America’s major employers.”

245. *A New Benefit Platform for Life Security*, THE ERISA INDUSTRY COMMITTEE (May 2007).

stay with the same Benefit Administrator even after changing jobs, so the new employer could make contributions.

Anyone who does not receive employer-based benefits could participate equally under the New Benefit Platform, with full access to plans offered in that area by Benefit Administrators. "The federal tax consequences for an individual accessing benefits would be the same whether the benefits were accessed individually or through an employer. Contributions by employers providing coverage through an administrator would be tax deductible."²⁴⁶

The ERIC proposal is a valuable contribution to the debate on the future of retirement and health plan coverage. Its shortcomings can, perhaps, be attributed mainly to two causes: the complexity of the issues, which defy easy solution, and ERIC's constituency: very large employers who are, as they have been for some time, no longer convinced that the continued responsibility for providing employee and retiree benefits is worth the aggravation and cost. Although the ERIC Proposal would rationalize the system in many ways, it does not directly address the central issue: whether universal health or retirement plan coverage is possible within a voluntary system. The experience of other countries suggests strongly that the answer is no. Universal coverage will require some combination of employer mandates (which will be strongly resisted by small employers), individual mandates (which may be unaffordable for those above the increasingly unrealistic official poverty level) and government subsidies (which will be very expensive).

The principle of equal access for individuals, at equal cost and with equivalent tax treatment, is important, but difficult to achieve. The major problem is cost: equal access is meaningless unless the coverage is affordable, as Massachusetts officials are now discovering.

The widely publicized problems with the current system of employer-based retirement and health benefits have led some commentators to suggest that it is time for a new approach. Susan Stabile argues that the failures of the employer-based retirement system cannot be rectified by incremental changes and that:

there are really only two possible models. The first is to jettison the employer-based system entirely and provide a government pension [providing a livable pension for all elderly Americans] for everyone. The second is to retain the employment-based system but move to a mandatory system with more stringent regulation of defined contribution plans than currently exists.²⁴⁷

246. ERIC Proposal, *supra* note 244.

247. Susan Stabile, *Is it Time to Admit the Failure of an Employer-based Pension System?*, 11 LEWIS & CLARK L. REV. 305, 325 (2007).

Katherine Stone argues that the current system of benefits originated in the industrial era of the twentieth century, when employers sought to secure a stable workforce, that this employer-centered model of benefits has largely outlived its usefulness in the new “boundaryless” workplace of the twenty-first century, and that it must be replaced with an alternative that is more portable and more affordable for the vast majority of workers.²⁴⁸

Adam Carasso and Jonathan Barry Forman have suggested a universal pension system (UPS) requiring an annual employer contribution of 3% of earnings.²⁴⁹ A UPS, in the long run, would provide retirees with 13-14% more final wages.²⁵⁰

The Aspen Institute, through its Initiative on Financial Security, has recently issued a detailed report, *Savings For Life: A Pathway To Financial Security For All Americans*.²⁵¹ The report proposes that savings plans should be (1) targeted towards specific goals of education, home ownership and retirement, (2) available to all Americans regardless of income level, (3) simple enough for all participants to understand, (4) matched by the government, and (5) designed by financial experts in the private sector.²⁵² Based on those principles, the report describes four complementary savings vehicles: Child Accounts, Home Accounts and two retirement savings vehicles.

XXII. CONCLUSION

Currently, there are financial products in existence that, if used in retirement portfolios, can significantly increase the likelihood of sustained lifelong income.²⁵³

In the short term, policy makers should consider ways of encouraging plan sponsors to increase participation levels and make additional distribution options available, and to educate their participants about financial management in retirement. An important part of this will be to implement reforms to convince employers that by doing so they will not increase their fiduciary exposure or administrative burdens, e.g. by relaxing the well-

248. Katherine V.W. Stone, *A Fatal Mismatch: Employer-centric Benefits in a Boundaryless World*, 11 LEWIS & CLARK L. REV. 452 (2007).

249. Adam Carasso & Jonathan Barry Forman, *Tax Considerations In A Universal Pension System (UPS)*, Discussion Paper No. 28, Urban-Brookings Tax Policy Ctr. (Dec. 20, 2007).

250. *Id.*

251. Initiative on Financial Security, *Savings for Life: A Pathway to Financial Security For All Americans*, ASPEN INST., available at http://www.aspeninstitute.org/atf/cf/%7BDEB6F227-659B-4EC8-8F848DF23CA704F5%7D/Savings_for_Life.pdf.

252. *Id.* at 8.

253. W. Van Harlow, *Structuring Income for Retirement*, FIDELITY RESEARCH INST. (Aug. 2007).

meant but ultimately self-defeating requirements for overly detailed benefit explanations. In the long term, reforms to enhance retirement security should form part of the overdue reforms to ensure the long-term solvency of Medicare and Social Security.

Improving plan participation and the level of plan benefits is clearly important. It may also improve the quality of the employer's workforce and reduce the employer's risk of litigation.