SLOUCHING TOWARDS A CONSUMPTION TAX AND THE END OF RETIREMENT INCOME SECURITY

by

Norman Stein

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I. INTRODUCTION

In 2003, the Bush Administration proposed two ideas\(^1\) that I (and others) feared would undermine the retirement income security of millions of Americans.\(^2\) The first idea was to create two new tax-favored personal savings vehicles: the retirement savings account and the lifetime savings account.\(^3\) These tax-benefited accounts, which would have existed outside the employer-based retirement system and replace individual retirement accounts, would each have permitted annual contributions of $7,500 each, or $15,000 in the aggregate.\(^4\) (An individual could also have set up lifetime...


\(^2\) The 2003 proposal was opposed by pension trade groups generally aligned with business interest (such as the American Society of Pension Actuaries, see, ASPA, Statement for the Record, Committee on Ways and Means, Hearing on the Presidents’ Economic Growth Proposals, Mar. 5, 2003; and the Profit-Sharing 401(k) Council of America, see, Martin A. Sullivan, Economic Analysis: Does the Trickle-Down Theory for Pensions Hold Water?, 98 Tax Notes 1180 (2003) (hereinafter, Trickle-Down Theory for Pensions), and liberal organizations generally aligned with the interests of consumers, Leonard Burman, “Key Thoughts on RSAs and LSAs,” available at www.urban.org/url.cfm?ID=1000600 (Urban Institute); Robert Greenstein and Joel Friedman, “President’s Savings Proposals Likely to Swell Long-Term Deficits, Reduce National Savings, and Primarily Benefit Those With Substantial Wealth, available at www.cbpp.org/1-20-04tax.htm (Center on Budget and Policy Priorities); “Progressivity and Saving: Fixing the Nation’s Upside-Down Incentives for Savings,” Statement of Peter R. Orszag, Joseph A. Pechman Senior Fellow, The Brookings Institute, Before the House Committee on Education and the Workforce, Feb. 25, 2004, www.edworkforce.house.gov/hearings/108th/fc/pensions022504/orszag.htm Brookings Institute). Former Congressman Rob Portman, a Republican who had a strong interest in pension policy and was generally considered close to the White House, also opposed the proposal. See, Trickle-Down Theory for Pensions, 98 Tax Notes at 1180.

\(^3\) General Explanation, supra note 1, at ¶¶ 414-417.

\(^4\) Id.
savings accounts for family members without earned income, into which he could contribute $7,500 annually.) The contributions were to be made on an after-tax basis, but the earnings would be exempt from income tax, a schemata based on the Roth IRA. The RSA would impose penalties on pre-retirement withdrawals; the LSA would not. These ideas did not find favor in the Congress and were generally opposed by the business community, organized labor, and liberal think tanks, for reasons I will summarize shortly. Nevertheless, the White House and members of Congress have introduced similar proposals in 2004, 2005, 2006, 2007, and 2008, and the President’s Advisory Panel on Federal Tax Reform adopted retirement and lifetime savings accounts as part of its blueprint for reform, which was released in late 2005. Thus, the idea of these new accounts retains political and intellectual currency, like the proverbial bad nickel, and they, or variations on them, are almost certainly to survive the end of the Bush presidency.

The second new idea advanced by the White House in 2003 was the exclusion of stock dividends from taxation. Depending on which press account you credit, this idea resulted either from President Bush’s serendipitous courtesy drop-in on a panel at his Waco economic summit in which Charles Schwab advocated elimination of the so-called double tax on corporate income through exclusion of dividends, or from a direct remark by Schwab to him on the same topic. A toned-down variation on this idea was enacted by Congress in 2003, with dividend income taxed at a maximum 15% rate, the same rate that now sets the ordinary ceiling on taxation of

5. Id.
6. Id. Cf. IRC § 408A (treatment of Roth IRAs).
7. See, supra note 2.
8. See, Department of Treasury, General Explanation of the Administration’s Fiscal Year 2008 Revenue Proposals (Feb. 2007); Department of Treasury, General Explanation of the Administration’s Fiscal Year 2007 Revenue Proposals (Feb. 2006); Department of Treasury, General Explanation of the Administration’s Fiscal Year 2006 Revenue Proposals (Feb. 2005); Department of Treasury, General Explanation of the Administration’s Fiscal Year 2005 Revenue Proposals (Feb. 2004).
Slouching Towards a Consumption Tax

capital gain. Some observers see the 15% tax rate not as closing the door on the debate on either dividend taxation or the maximum capital gains rate, but rather as a foot in the door toward the elimination of any tax on dividend income or capital gains. And again, the President’s Advisory Panel on Federal Tax Reform included a plan that would exclude all corporate dividends from income.

On the surface, neither the expanded savings account idea nor the exclusion of dividends from income appears to threaten a person’s ability to save for retirement. Indeed, the RSA/LSA proposal would seem to increase opportunities to save for retirement, and the elimination of taxes on dividends would seem to make savings, including retirement savings, generally more attractive. But I will suggest in this paper that the proposals, individually and collectively, would negatively influence the creation of retirement savings for many and perhaps most working Americans.

Several of the arguments I develop in this paper relate to my assessment that providing tax-benefited investment alternatives to employer-sponsored retirement plans would make it less attractive for employers to sponsor retirement plans, resulting in fewer and less generous plans. There is reason to think that middle- and lower-income people would not use the new savings arrangements sufficiently to replace the retirement savings they would lose because of the White House proposals’ negative effect on employer-sponsored plans. Moreover, the new savings arrangements, by and large, would not require preservation of assets for retirement, nor would they provide mechanisms to help budget the use of retirement assets so that they are not exhausted before death. They would provide fewer spousal protections. They would subject participants to higher administrative costs and might adversely affect the rate of return many working people will realize on their savings. Finally, the tax treatment of the new savings arrangements may complicate the possible future task of

13. IRC § 1(h)(11) (qualified dividends treated as part of net capital gain).
15. This is certainly the view of the Department of Treasury, which in its press release on the proposals contended that “these bold new accounts will give more hardworking Americans the chance to save so they can enrich their lives and strengthen their retirement security.” See, Bush Proposes Tax Free-Savings Plans, supra, note 1.
16. See text accompanying notes 120-130, infra.
17. See text accompanying notes 131-141, infra.
18. See text accompanying notes 133, 142-143, infra.
19. See text accompanying note 134, infra.
20. See text accompanying notes 144-152, infra.
remedying the old age-security problems that I suggest will almost certainly be exacerbated if the White House proposals are ever adopted.  

The White House proposals also reflect a theme that Patricia Dilley and I explored in an earlier article: the continuing seismic shift in government retirement policy from collective retirement income security to individual wealth creation. The White House proposals would carry this theme further than anything that has emerged from Congress since the enactment of the income tax. In this respect, the proposals share an ideological mooring with the various proposals to privatize Social Security, which would also sacrifice the idea of shared societal responsibility for the income security of older Americans to the idea of individual creation of wealth.

On a broader and perhaps even more significant theme, as we amble down the road towards a tax system that favors savings over consumption, we also amble towards interference with our principal strategy to help working people save for retirement: using tax benefits to secure employer sponsorship of retirement savings plans covering a broad cross section of American workers.

The White House proposals did include one idea whose broad framework (but not necessarily its details) is attractive: the Employer Retirement Savings Account (“the ERSA”). The ERSA would redesign and streamline the complex and often irrational rules for the numerous employer-sponsored defined contribution plans, creating a single type of defined contribution format for such plans. This approach would build on rather than abandon the existing employment-based retirement regime and, if stripped from the other Bush proposals, could provide a vehicle for debate over how best to balance the employer interests in administrative simplicity and low compliance costs with the societal goal of providing meaningful benefits for individuals who otherwise would not save sufficiently for retirement.

This article proceeds as follows: the section immediately below provides an overview of the current employment-based retirement system, followed by a section describing the White House tax proposals as initially proposed in 2003, as modified in subsequent White House Budget proposals, and as again modified by the President’s Advisory Panel on Federal Tax Reform. The next section describes the ways in which the proposals (or

21. See text accompanying notes 153-158, infra.
similar proposals) would, if enacted, undercut the retirement income security of many working Americans. The succeeding section provides a reflection on the ideological underpinnings of the White House proposal. The final section, using the ERSA proposal as a starting place, provides some ideas to improve the ability of working people to prepare for retirement through incremental reforms to the current system. The final section also briefly discusses the shape that fundamental reform should take if we are to abandon the current employer-based system—which would likely be the effective result of a serious move toward a consumption tax—in favor of new ways to create retirement income security for American working people.

II. OVERVIEW OF CURRENT TAX-SUBSIDIZED RETIREMENT SYSTEM

The Internal Revenue Code endows certain advance-funded retirement arrangements with the benefit of relatively pure income tax deferral.\textsuperscript{25} Most of the deferral is initially traceable to investment return on employer contributions to employer-sponsored plans in both the private and public sector, although individuals may also contribute to individual retirement accounts\textsuperscript{26} or employer plans that accept employee contributions, such as the now-ubiquitous 401(k) plan.\textsuperscript{27} The associated tax expenditures for these retirement savings arrangements is projected to exceed $100 billion annually for the next fiscal five years\textsuperscript{28} (the period for which tax expenditures are projected).

The commonly accepted rationale for the income tax expenditure is to help as many Americans as possible create income security for that period of life when they are no longer supporting themselves with wage income.\textsuperscript{29} Given that the mechanism for the tax expenditure is tax deferral, that the benefits of tax deferral correlate with marginal tax rates, and that individuals with high marginal tax rates are the most likely class of individuals to save adequately for retirement without governmental incentives, the tax mechanism might strike us as an irrational means of effecting the goal of

\begin{itemize}
\item \textsuperscript{25} See, e.g., Gary Boren \& Norman Stein, Qualified Deferred Compensation Plans, Chapter 1; Michael J. Graetz, The Troubled Marriage of Retirement Security and Tax Policy, 135 U. Pa. L. Rev. 851 (1987).
\item \textsuperscript{26} IRC § 408 (IRA); IRC § 408A (Roth IRA).
\item \textsuperscript{27} See, e.g., IRC § 401(k). For a thoughtful discussion of some of the issues surrounding 401(k) plans and savings behavior, see, Alicia Munnell \& Ankia Sunden, Coming Up Short (2004).
\item \textsuperscript{28} Joint Comm. On Taxation, Estimate of Federal Tax Expenditures for Fiscal Years 2007-2011 (Sept. 24, 2007).
\item \textsuperscript{29} See, e.g., Dan McGill, Fundamentals of Private Pensions 75 (7th ed. 1996).
\end{itemize}
increasing retirement savings for as many working people as possible. Understood another way, however, this upside-down tax subsidy is an arguably rational component of a two-step governmental strategy to enlist the private sector in building retirement savings for lower- and moderate-income workers.

The strategy is, first, to make the tax benefits of employer-sponsored plans sufficiently attractive to the tax-sensitive people who own and manage businesses so that they will decide to set up plans to capture tax benefits for themselves, and, second, to require such plans, once established, to provide meaningful benefits not only to the people who set them up, but also to lower- and moderate-income workers.30 The Code effects the latter part of the strategy through a series of statutory provisions, most prominently the nondiscrimination rules, which require plans to cover a percentage of a firm’s non-highly compensated employees31 and to provide them with benefits comparable, as a percentage of pay, to the benefits earned by the highly compensated.32 The pension economist Alicia Munnell described this elaborate two-step in this way: “the rationale for favorable tax treatment of qualified plans is that retirement benefits for rank-and-file employees will exist if Congress provides tax incentives that induce higher paid employees to support the establishment of employer-sponsored pension plans.”33

This carrot/stick pension tax regime has been subject to criticism.34 Many firms respond to the tax incentive to create plans, but manipulate the labyrinth complexities of the nondiscrimination rules to minimize benefits for rank-and-file employees and maximize them for more affluent employees, who in the absence of employer-sponsored plans would presumably save for retirement on their own, at least to some extent.35 Moreover, some firms (particularly marginal firms) simply do not respond to the incentives and fail to sponsor pension plans.36 Thus, the system is both

31. IRC § 410.
32. IRC § 401(a)(4).
35. Id.
36. Employee Benefits Research Institute, 2004 Small Employer Retirement Survey (only 28% of employees at firms of fewer than 100 are covered by retirement plans; only 20% of employers with fewer than 25 employees sponsor retirement plans).
over-inclusive in that it provides benefits for those who would save for their own retirement without the tax incentives, and under-inclusive because it fails to provide meaningful benefits to many low- and middle-income workers.

But the system does provide at least some benefits for many millions of people, with a coverage rate of approximately 50% of the full-time private workforce between ages 25 and 65. While one can argue whether the system is a cup half-full or half-empty, by the numbers we can say that the employer-sponsored retirement system provides an important source of some retirement income security for many individuals.

The societal goal of creating adequate retirement income security through tax-benefited savings arrangements requires more than wide participation: it also requires, first, that plan assets are invested prudently and free of conflicts of interest so that investment returns are maximized, and second, that the savings once created are used to provide retirement income.

The Internal Revenue Code, and especially Title I of ERISA, establish a scheme of fiduciary regulation based on traditional trust law and insights from modern portfolio theory, which at least in theory should maximize investment return. In particular, Title I of ERISA provides that plan fiduciaries act with appropriate prudence and loyalty to participants when they make investments, and that they diversify plan investments in most situations.

There are three related concerns to ensure that retirement savings are in fact used for retirement: first, that the savings are not invaded prior to retirement; second, that the savings are not exhausted prior to death; and third, that in appropriate circumstances the savings are available to the surviving spouse of the pensioner.

38. See, ERISA § 404(a).
39. See, IRC §§ 401(a)(9), (11) & (13).
41. ERISA § 404(a)(1), (2).
42. ERISA § 404(a)(3). Title I of ERISA also includes a series of rules prohibiting certain transactions between a plan and parties with a pre-existing direct or in some cases indirect relationship with the plan. See, ERISA §§ 406-408, 29 U.S.C. §§ 1006-1008. In addition to the Title I prohibitions, the Internal Revenue Code imposes an excise tax on such transactions. IRC § 4975. For an early, but still quite useful, summary of the rules, see, Arthur H. Kroll & Yale D. Tauber, Fiduciary Responsibility and Prohibited Transactions Under ERISA, 14 Real. Prop Prob. & Trust J. 658 (1979).
The Internal Revenue Code includes a series of rules that address, although imperfectly, each of these concerns.\textsuperscript{43} To limit pre-retirement access to retirement assets (i) longstanding treasury regulations prohibit distributions from pension (but not profit-sharing) plans prior to retirement, death, disability, or separation from service;\textsuperscript{44} and (ii) the Internal Revenue Code imposes an excise tax on most plan withdrawals prior to age 59.5 from any plan (unless the distribution is transferred to another plan or individual retirement account).\textsuperscript{45} To assist individuals to manage their retirement savings, pension plans (but not profit-sharing and 401(k) plans) must provide that the normal form of benefit is a life annuity (although if the plan permits, participants can elect other forms of benefits, including single-sum distributions).\textsuperscript{46} To protect the spouse of a pensioner, pension plans must provide that the life annuity for a married participant has a survivor benefit for the spouse (although the participant, with spousal consent, can elect other forms of benefits if permitted by the plan, including a single life annuity).\textsuperscript{47}

Finally, the Internal Revenue Code has provisions designed to ensure that the tax expenditures are limited to the amount needed to create retirement security and are not so extravagant that they result in plans that function more as general tax shelters and estate-planning devices than retirement plans. The most important of these provisions place outer limits on the amount that may be contributed annually to a defined contribution plan and on the size of the retirement annuity payable from a defined benefit plan, for any given individual.\textsuperscript{48} The theory here is that the tax subsidy embedded in plan savings should be used to furnish reasonable rather than unduly lavish retirement income levels.\textsuperscript{49} In addition, the Internal Revenue Code includes minimum distribution rules that require individuals to begin drawing down their retirement savings in their retirement in order to limit the utility of tax-deferred retirement accounts as a tax-benefited estate planning tool.\textsuperscript{50}

\textsuperscript{43} For a thorough treatment of the Internal Revenue Code’s distribution rules, see, Diane Bennett, et. al., Taxation of Distributions from Qualified Plans (2nd ed. 2002).

\textsuperscript{44} Treas. Reg. § 1.401(a)-2.

\textsuperscript{45} IRC § 72(i).

\textsuperscript{46} IRC § 411(a)(7).

\textsuperscript{47} IRC § 417.

\textsuperscript{48} IRC § 415. See, generally, Norman P. Stein, Simplification and IRC § 415, 2 Fla. Tax Rev. 69 (1994).

\textsuperscript{49} Id. at 4-6.

III. THE WHITE HOUSE SAVINGS PROPOSALS

The White House budget proposal in 2003 included three proposals that would have implications for the private, generally employment-based, savings arrangements that currently assist Americans in creating income security in their retirement. The White House proposals were: (1) the exclusion of dividends from income taxation; (2) the creation of two personal, non-employment based, tax-advantaged savings vehicles, the Retirement Savings Account and the Lifetime Savings Account; and (3) the creation of the Employer Retirement Savings Account.

A. Dividend Exclusion

The White House initial budget proposal included an exclusion for dividends. The initial purpose of the exclusion was two-fold: 1) to eliminate the so-called double tax on corporate earnings, and 2) to provide incentives for corporations to pay dividends, which a White House press release argued would promote more transparent corporate governance and more honest statements of income.\(^{51}\) Apparently in response to complaints by the corporate managerial class (who might not favor tax incentives to pay dividends\(^{52}\)), the White House proposal was revised so that corporations could also avoid double taxation through a shareholder basis adjustment for any retained earnings.\(^{53}\) Congress did not adopt the White House proposal as proposed, but did set an effective maximum tax rate of 15% on both dividends and capital gain from the sale of stock.\(^{54}\) This provision will sunset for tax years beginning after 2008, unless renewed by Congress.

B. New Personal Savings Accounts

The White House proposed two new personal savings arrangements: the retirement savings account, which is designed to assist people to accumulate retirement assets, and the lifetime savings account, which would allow people to save for any purpose on a tax-favored basis. These accounts

\(^{51}\) See, Bush Proposes Tax Free-Savings Plans, supra note 2.


\(^{54}\) Tax Reform Act of 2003, at § 1(h).
would replace the current individual retirement account, to which individuals below a certain income level can currently contribute up to $4,000 per year from earned income.\textsuperscript{55}

The new arrangements would replace the two types of IRA tax arrangements, which are sometimes referred to as “traditional” and “Roth” IRAS. In a traditional IRA, neither contributions nor investment earnings are currently taxed, but withdrawals are subject to tax.\textsuperscript{56} In a Roth IRA, contributions are currently taxable, but investments earnings and withdrawals are excluded from taxable income.\textsuperscript{57} As with employer plans, early withdrawals from regular IRAs (prior to the year in which the IRA owner attains age 59.5) are generally subject to a 10\% penalty tax, and distributions must commence on a ratable basis beginning no later than the April 1 after the IRA owner attains age 70.5.\textsuperscript{58}

Both the RSA and LSA differ in important ways from IRAs. Three key differences between IRAs and both RSAs and LSAs are: (i) there would be no maximum income limits for contributions to the new savings arrangements; (ii) contributions to the new savings arrangements would have to be made on a Roth (that is, after-tax) basis, with account distributions excludable from income; and (iii) there would be no minimum distribution rules requiring that distributions commence during an owner’s lifetime.\textsuperscript{59} Other differences between IRAS and the new savings arrangements are discussed below:

1. Retirement Savings Accounts

Under the 2003 budget proposal, an individual would have been able to contribute up to $7,500 from earned income to an RSA.\textsuperscript{60} In subsequent budgets, this amount was reduced to $5,000, perhaps in a nod to deficit control, but also perhaps in capitulation to some usual White House allies who initially opposed the proposals as a threat to employer provided health

\textsuperscript{55} IRC § 408, IRC § 219. The $4,000 limit increases to $5,000 in 2008 and thereafter will increase to reflect increases in the cost of living. Id.

\textsuperscript{56} IRC § 408.

\textsuperscript{57} IRC § 408A.

\textsuperscript{58} IRC § 408(b), (c). Roth IRAs are also subject to the excise tax on early distributions, but an owner of a Roth IRA is not taxed to the extent distributions reflect simply already taxed contributions. IRC § 408A(d)(4). Moreover, distributions from Roth IRAs are not subject to the minimum distributions rules. IRC § 408A(c)(5).

\textsuperscript{59} See, General Explanation (2003), supra note 1, at ¶ 119- 20.

\textsuperscript{60} Id. at 119.
care. An individual would also have been able to contribute up to the maximum amount for a non-working spouse. Distributions of investment income would have been subject to a 10% excise tax if made before the RSA-owner has attained age 58. Roth IRAs would have been automatically converted into RSAs. Traditional IRAs could be converted to RSAs on an elective basis by paying income tax on the converted amount and payment of the tax could be spread over a four-year period.

2. Lifetime Savings Accounts

In the 2003 budget, an individual would have been able to contribute $7,500 annually to an LSA; there was no requirement that the individual have earned income to make such contribution. Subsequent budgets have reduced the figure to $5,000. Moreover, an individual can contribute to any other person’s LSA, although contributions by or on behalf of any particular individual could not in the aggregate exceed the maximum amount. Thus, a married couple with two children could have contributed $30,000 annually to LSAs for family members (if the limit were, as initially proposed, $7,500 per individual).

There were no restrictions or excise taxes imposed on withdrawals from LSAs. It has thus been suggested by some financial columnists that should the Bush proposals be adopted, individuals would generally want to contribute the maximum to an LSA before contributing to an RSA, since pre-age-58 withdrawals from an RSA could result in imposition of excise taxes. Although an LSA could be used to save for any purpose, the White House proposal did not eliminate special-purpose savings vehicles currently

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62. General Explanation (2003), supra note 1, at 120.

63. Id.

64. Id.

65. Id.

66. Id. at 119-20.


68. General Explanation (2003), supra note 1, at 120.

available under the Internal Revenue Code (such as Coverdale education accounts, qualified state tuition plans, and medical savings accounts). \(^{70}\)

**C. Employer Retirement Savings Accounts**

One of the potential virtues of defined contribution plans (compared to defined benefit plans) is their relative simplicity of form. \(^{71}\) The regulatory structure that governs such plans, however, sometimes perverts this simplicity of form into extreme complexity, in two ways: first, by providing extraordinary flexibility through which firms can design plans that minimize participation and benefits for rank-and-file employees, and second by imposing administrative and compliance complexity as the toll charge for such flexibility. \(^{72}\) These two types of complexity (although related) can be conceptualized as design complexity, on the one hand, and administrative complexity on the other.

To illustrate, consider an employer that wants to minimize benefits for rank-and-file employees. The employer could design its plan to exclude (in some cases) more than 50% of its rank-and-file employees while covering all of its highest paid employees, and could provide benefits that are significantly higher (as a percentage of pay) for the latter than for the former. \(^{73}\) The tools an employer might use to so design a plan could include cross-testing, \(^{74}\) a 401(k) structure, \(^{75}\) integration with Social Security, \(^{76}\) etc.

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70. General Explanation (2003), supra note 1, at 120. See, IRC § 529 (qualified state tuition plans); IRC § 530 (Coverdale savings accounts); IRC § 223 (health savings accounts). There have been a number of articles highly critical of health savings accounts, and particularly the tax treatment of such accounts. See, Leonard E. Burman, New Health Care Tax Proposals: Costly and Counterproductive, 110 Tax Notes 779 (Feb. 9 2006); Amy B. Monahan, The Promise and Peril of Ownership Society Health Care Policy, 80 Tulane L. Rev. 777 (2006); Norman Stein, The HSA: Health Savings Accounts or Health (Policy) Sabotaged Again, 64 NYU Institute on Federal Taxation, Employee Benefits and Executive Compensation (2006). In 2006, the White House proposed a dramatic expansion of the tax benefits available to HSAs. See, Berman, infra.


73. Id. at 634-39; IRC § 410(b)(3).

74. Id.

75. IRC § 401(k). Section 401(k) permits employees to decide whether to participate, and how large a percentage of their compensation to contribute, with generally less exacting nondiscrimination requirements. Id.
providing small benefits for its lowest-paid workers and large benefits for higher-paid rank-and-file workers,77 use of a complex average benefits test,78 a separate-line-of-business test,79 catch-up contributions,80 the adoption of different plans for different employees,81 and the careful fashioning of a vesting schedule.82 These tools all impose complexity in the design and administration of a plan.

Some have argued that the law’s complexity discourages some firms from sponsoring plans,83 but this is not precisely accurate, since an employer can mostly or entirely avoid the complexity by adopting a plan covering all employees under a uniform and simple benefit formula. It would be more accurate to say that some firms are discouraged from adopting defined contribution plans because design and compliance complexity makes it expensive to set up plans that aggressively favor highly-paid employees in coverage and benefits.

In some sense, the holy grail of private pension reform would be to quantify the maximum tolerable amount of benefit and coverage disparity between highly and non-highly-paid employees and then put forth a single plan template that accommodates, with minimum complexity, up to but no more than this amount of disparity.84 This is, I think, the idea of the ERSA.

76. IRC § 401(l) (describing Social Security integration requirements); see, also, Stein and Orszag, supra note 72, at 635; see, generally Nancy J. Altman, Rethinking Retirement Income Policies: Nondiscrimination, Integration, and the Quest for Worker Security, 42 Tax L. Rev. 435 (1987) (providing excellent discussion on Social Security integration).


79. See, IRC § 414®).

80. See, IRC 402(g)(1)(c). This section permits a section 401(k) plan to accept an additional $5,000 contribution from a participant who is at least age 50, without nondiscrimination testing of any sort. Id. In many cases, the employees over 50 who will be able to afford this contribution will be higher paid employees.


82. See, Stein & Orszag, supra note 72, at 638.


84. There is at least one problem with this approach: under current law, a firm will incur various professional and compliance costs if it wishes to design a plan that aggressively favors higher paid employees; the methodologies described in the text can act as a toll charge for such plans. If the statute is modified to make it simpler to minimize coverage and benefits for rank-and-file workers, it is plausible that some firms, no longer facing a toll charge, will reduce coverage for such
which would create a simplified regulatory structure for all defined contribution plans. It would do so, at least in the Administration’s 2003 proposals, by eliminating several complexity-creating tools that under current law are used to create high levels of disparity between highly and non-highly compensated employees, i.e., integration, the average benefits test, and cross-testing. These changes would reduce the amount of disparity between the two groups of employees that employers can effect today through plan design.

The rules governing the ERSA, in tacit recognition of the loss in plan sponsor ability to use these tools to favor higher-paid employees, would increase the permissible degree of disparity between the two groups for elective contributions and eliminate the “top-heavy rules” – special rules requiring minimum contributions and more accelerated vesting for participants in plans whose benefits are primarily allocable to certain “key” employees.

IV. CRITIQUE OF WHITE HOUSE PRIVATE SAVINGS PROPOSALS

The White House private savings initiative (the RSA, LSA, and dividend exclusion) would strongly push the country towards a consumption tax base, which has a political constituency primarily among those employees. It is also plausible that inclusion of such express statutory provisions will result in benefits consultants designing template plans, which will act as the default for most employers, even those who might have been inclined to provide more generous benefits for rank-and-file employees if that had been presented as an option.

85. In the most recent incarnation of the ERSA, however, cross-testing would be permitted. See, General Explanation of the Administration’s Fiscal Year 2006 Revenue Proposals Dept. of Treas., at 129 (Feb. 2008).

86. IRC § 416. The accelerated vesting provisions of Section 416 are moving toward the scrapheap of irrelevancy, as Congress improves the overall minimum vesting rules, which currently require all defined contribution plans to satisfy the same vesting rules as section 416. IRC § 411(a)(2)(B). In addition, cash balance plans are now subject to 3-year cliff vesting, a more demanding standard than imposed on plans because they are top-heavy. IRC § 411(a)(13).

87. There is a rich and growing literature on a consumption tax. The classic articles in the legal academic literature include William D. Andrews, A Consumption-Type or Cash Flow Personal Income Tax, 87 Harv. L. Rev. 1113 (1974); Alvin C. Warren, Jr., Fairness and a Consumption-Type or Cash Flow Personal Income Tax, 88 Harv. L. Rev. 931 (1975); William D. Andrews, Fairness and the Personal Income Tax: A Reply to Professor Warren, 88 Harv. L. Rev. 947 (1975); Alvin Warren, Would a Consumption Tax Be Fairer than an Income Tax?, 89 Yale L.J. (1980); Barbara Fried, Fairness and the Consumption Tax, 44 Stan. L. Rev. 961 (1992). As I will discuss briefly in the text of the article, the White House
concerned more with national economic growth than with distribution and among those who believe that tax equity is judged better on a lifetime than an annual basis. The proposals might, as their advocates predict, increase aggregate national savings and might improve tax equity by certain metrics of fairness. In doing so, however, they would likely break the back of the employer-sponsored pension system, on which approximately half of working Americans rely for retirement savings. The proposals would do this by reducing the number of employer-sponsored plans and by likely reducing both the contribution levels and investment return for rank-and-file employees who participate in the plans that remain. Moreover, there is reason to believe that the private savings initiatives would not adequately replace the retirement income security that most working Americans would lose from employer-sponsored plans.

This section of the paper provides the analysis that undergirds this pessimism about the effects of the White House proposals on retirement income security. The section considers (i) possible effects of the private savings proposals on employer sponsorship and employee use of employment-based retirement plans; (ii) the prospects that middle and lower income workers will use the new savings initiatives to create new retirement savings to compensate for the diminishment of the importance of employer-sponsored retirement plans; (iii) the effect of the savings initiative on investment return on retirement savings for middle and lower income Americans; and (iv) some tax and budget consequences of the savings initiative.

A. Savings Initiative and Employment-Based Retirement Plans

I have already suggested that scholars and policymakers believe that firms generally sponsor plans in response to preferences of firm owners and

savings proposals move us toward a consumption tax in an incomplete, and ill conceived, manner.


other highly-paid employees for tax-advantaged deferred compensation, with
the nondiscrimination rules then requiring that less well-paid employees also
be provided with some benefits. To appreciate the significance of the tax
benefits to highly paid individuals in an employer’s decision to establish and
maintain a plan, it is useful to think about the question first in a world
without an income tax. What are the considerations that would go into plan
sponsorship in such a world?
I begin with the observation that deferred compensation plans
predated the income tax (and thus the tax benefits that our income tax regime
confers on qualified plans), so there are certainly non-tax reasons for firms to
sponsor pension plans. One of the early motivations for pension plans was to
provide for the orderly superannuation of industrial and construction
workers, which was thought not only to ensure the retirement of older
employees with declining productivity, but also to raise the morale of active
workers and thereby increase their productivity. Some also saw pension
plans as satisfying a moral obligation of the employer to its elderly workers
who were no longer capable of working. Historically, employers have also
been able to use pension plans to create incentives for long job tenures,
which can be valuable in industries that invest heavily in their human
capital. In addition, some employees may value some degree of deferred
compensation at more than its cost to the employer even apart from its tax
benefits: employees may value the forced savings aspect of deferred
compensation; may enjoy relatively high rates of return due to economies of
scale and the professional investment management that plans offer; and, in
defined benefit plans, may appreciate both the benefit guarantees and the
pooling of mortality risk.
But employers also incur significant costs when they sponsor
retirement plans. Sponsorship of plans imposes design, administrative, and
compliance costs on the sponsoring firm. Employers also are subject to
potential liability to participants if they violate ERISA’s complex fiduciary
and other rules. Defined benefit plan sponsorship requires employers to
guarantee investment performance, assume mortality risk, and absorb the

90. See, text accompanying supra notes 29-36.
91. See, generally, Arthur Cloud, Pensions in Modern Industry (1930);
92. See, Lee Aquier, Old Age Dependency in the United States (1912).
93. See, John Langbein & Bruce Wolk, Pension and Employee Benefit Law
94. Employees who are assigned discretionary duties in administering a
plan can also be held personally liable under ERISA. See, ERISA § 3(21)(defining
fiduciary), and § 502(a)(3) and §§ 502(a)(3), 409 (creating personal liability for
fiduciaries in certain situations).
volatility of periodic funding obligations and the resulting need to sometimes make substantial contributions to plans in lean business years. And for some employers, the Internal Revenue Code’s nondiscrimination rules, which require plans to provide benefits to some non-highly compensated employees, impose perhaps the steepest cost of plan sponsorship. Some such employees benefit little from the qualified plan tax deferral and some (but certainly not all) will have a strong preference for immediate compensation. Thus, some employees for whom the employer provides deferred compensation will not value the compensation at its cost to the employer, which will increase the cost of total compensation for those employees.

In addition, the non-tax benefits of employer-sponsored retirement plans have become somewhat attenuated over the last two decades, particularly with respect to a firm’s ability to design a plan to advance human resource strategies. ERISA’s vesting rules have limited the employer’s ability to use a plan to encourage long job tenures. Moreover, demographers predict that labor markets will begin to tighten as baby boomers reach retirement age and thus some firms may have a reduced interest in retirement plans as a strategy to encourage older employees to retire.

96. IRC §§ 412, 430 (funding requirements for defined benefit plans).
97. See, IRC § 401(a)(4); Treas. Reg. § 1.401(a)(4).
99. IRC § 411(a)(requiring that vesting begin no later than five years after employment); IRC § 416(b) (requiring vesting to begin no later than three years for “top-heavy” plans). Moreover, the Pension Protection Act now requires that all defined contribution plans conform to the rules previously applicable to top-heavy plans, IRC § 411(a)(2)(B), and requires cash balance and other hybrid defined benefit plans to provide 100% vesting after three years, IRC § 411(a)(13).
It should also be said that non-tax explanations for whatever employee preference for deferred compensation exists, perhaps never strong, are weaker now than in 1974, when Congress enacted ERISA. The wide availability of mutual funds has made it possible for small investors to benefit from professional money management without the intervention of an employer-sponsored retirement plan. Moreover, the market decline of the early 2000s may have made some employees wary of defined contribution plans, and defined benefit plans, which shield employees from market and mortality risk, are themselves in decline, in large measure because of their costs to the firm, especially in industries with aging workforces. And in an increasingly mobile workforce, individuals may be less inclined to want what might be a relatively short-term employer to be entrusted with custody of their retirement savings.

This brings us to the question of whether employer-sponsored retirement programs would exist in the absence of the tax deferral that those plans currently effect. At least for small firms, the conventional understanding – that firms generally establish plans to satisfy a tax-driven preference for such plans by firm owners and highly-paid employees – seems accurate. Small firms are not likely to derive meaningful non-tax benefits from retirement-plan sponsorship (other than in the recruitment and retention of relatively highly paid employees who value the tax savings), and the fixed costs of plan sponsorship cannot be spread over a large workforce. Without the tax benefits realized by firm owners and highly-paid employees, small firm sponsorship of retirement plans would certainly be less common than it now is, perhaps far less common.

For large firms, the answer is less clear. Such firms are more likely than small firms to be able to use plans to advance human resource goals and have more potential plan participants among whom to spread the fixed costs of plan sponsorship. Moreover, we inhabit an existing world, not a world of pure theory, and in that existing world almost all large firms sponsor retirement plans. Firm culture and experience with retirement plans may result in increased employee appreciation for such plans. And many large

101. See, Fidelity’s Study Defines New Directions for Vendors and Sponsors, DC Plan Investing (Nov. 9, 2004) (overall participation rates for 401(k) plans declined by 2% between 2002 and 2003); Kathy Chu, Employee 401(k) Participation Slips – only 76% of Eligable Workers Utilized Plans Last Year, Down From 80% in 2002. Wall St. J. (Oct. 6, 2004), at C15. (participation declined by 4%).

102. Retirement Policy: Decline in Use of Defined Benefit Plans May be Due More to Workers Than Firms, 32 BNA’s Pension & Benefits Reporter 1114 (2005), available on Westlaw at 32 BPR 114 (citing Stephanie Aaronson & Julia Cioronado, Are Firms or Workers Behind the Shift Away from DB Pension Plans? Fin. and Econ. Discussion Series, Division of Research & Statistics and Monetary Affairs, Fed. Reserve Board, Working Paper No. 205-17, 2005).
firms have invested resources in educating their employees about the value of retirement benefits. In addition, it can be difficult to take away a benefit that employees have been conditioned to expect. Thus, while we can speculate about whether in the absence of tax benefits large firms would decide to sponsor retirement plans if they were not already doing so, it does not seem likely that such firms would immediately extinguish such plans if the tax advantages of such plans were suddenly reduced or even withdrawn. Still, it should be said that if the tax benefits were withdrawn or reduced, there would almost certainly be diminished interest in retirement plans among large firms, at least in the long run.

The role of collective bargaining should also be noted: unions often bargain for retirement benefits, both for single-employer plans in large firms and for multi-employer plans in some industries with numerous firms and high rates of employee mobility between those firms. Tax benefits for their membership may be one reason why unions negotiate for such plans, but there are other reasons as well. Unions represent employees at all points on a demographic line through the workforce and older employees nearing retirement can be expected to place a high value on retirement income. Unions may also be motivated by the long-term welfare of their membership, which would include retirement income security, even when younger workers may not appreciate the value of retirement benefits. In addition, unions can, and do, educate their membership about the value of retirement income, which may result in some younger workers attaching value to retirement benefits. I would expect, then, that many unions would continue to negotiate for retirement benefits even if the tax advantages embedded in those benefits were reduced.

But overall, the tax benefits of qualified plans are an important driver of firm willingness to sponsor retirement plans, particularly for small firms. Equally important, under the nondiscrimination rules, the benefits of highly compensated employees are constrained by the benefit levels and participation rates of rank-and-file employees in the plan. As a result of this, some firms, in order to provide higher levels of benefits to highly-paid employees, cover more rank-and-file employees and/or set higher benefit levels for them than they otherwise would.

105. Id.
If tax benefits for highly paid employees participating in plans were eliminated or reduced, we would expect, then, to see two effects on qualified retirement plans: fewer firms would sponsor plans (particularly smaller firms), and benefit levels for moderate- and lower-income employees would be reduced in some of those plans that remained.

There are two ways that the tax benefits of highly paid plan participants can be reduced. One way is direct: either increase the effective tax rate on investment return from the retirement plan, as was the case in a short-lived 15% excise tax on aggregate plan distributions to the extent they exceeded $150,000 annually, or decrease the limits on the benefits that can be provided to higher-paid individuals. The other is indirect: decrease the effective tax rate on investment return outside the retirement plan, which would reduce the comparative benefit of investing inside of an employer-sponsored retirement plan. The White House savings proposals would have the latter effect: the 2003 proposal would eliminate income tax on dividends or stock appreciation caused by retained earnings and would also eliminate tax on any type of investment held in an RSA or LSA. The concern, then, is that highly paid employees would no longer have incentive to participate in an employer-sponsored retirement plan since they could realize similar after-tax returns by investing in stock or by holding other types of investments in an RSA or LSA.

The Bush proposals would not, however, entirely eliminate the tax benefits of investing through the medium of a qualified plan, for at least two reasons. First, and most important, to the extent appreciation in stock value resulted from factors other than retained earnings, gain on the stock would be subject to capital gains taxation on stock held for more than one year. Second, even if gain on investment were entirely exempted from taxation, the pricing of stock should under normal market conditions adjust upward to reflect the tax-advantaged treatment of dividend distributions. In other words, returns on stock, even though nominally exempt from tax, can be expected to reflect an implicit tax burden. Investment assets whose returns were not broadly exempted from income taxation should thus pay a higher before-tax rate of return than the tax-free return on stock, to account for the explicit tax to which such returns would be subject. Since holding such assets in a qualified plan would defer the tax until benefit distribution, qualified plans could still carry a tax benefit by investing in assets generating taxable returns.


Thus, if the White House’s proposal were adopted and included only the elimination of the double tax on corporate earnings, there would likely continue to be some, albeit diminished, demand among high-income taxpayers to participate in qualified plans. But the Bush proposals also would create the RSA and LSA, tax-exempt private savings vehicles. Thus, highly paid individuals could use RSAs and LSAs until they reached the limits of those accounts. The limits of the accounts in the 2003 White House proposal were nominally $7,500 per individual (but in subsequent proposals less), but contributions could be made to an RSA on behalf of a non-working spouse and contributions could be made to an LSA on behalf of any individual. Thus, a single person could have made contributions of $15,000 annually to these accounts as initially conceived; married couples could have made contributions of $30,000 annually; and a married couple with two children could have made contributions of $45,000 annually.

These contributions are, however, after tax; the contribution limits are thus higher than nominally identical contribution limits would be for the more familiar pre-tax contributions to an IRA or 401(k) plan. For an individual with a 36% marginal tax rate, a $15,000 before-tax contribution is the equivalent of an after-tax contribution of $23,437.50. Another way of conceptualizing the difference between after-tax and before-tax contributions is by looking at the cost of the contribution: an after-tax contribution of $15,000 costs the taxpayer $15,000, while a before-tax contribution costs the taxpayer $15,000 plus the $8,437.50 in tax that the taxpayer must pay in the year of contribution. Thus, the actual contribution limit for a single taxpayer (with a 36% marginal tax rate) is equivalent to a $23,437.50 before-tax contribution; a couple’s contribution would be the equivalent of a $46,875 before-tax contribution; and a two-child couple’s contribution would be the equivalent of a $70,312.50 before-tax contribution. The individual would have a tax incentive to contribute to an employer plan only to the extent she desired to invest in taxable assets in excess of these amounts.

110. To some extent, this would depend on how large the spread is between the rate of return on stock and the before-tax rate of return on assets generating taxable returns. As long as there is some spread, there will be some tax benefit to investing in such assets through the intermediary of a tax exempt vehicle, such as a qualified retirement plan. It is beyond the scope of this article to predict the amount of the spread between taxable and nontaxable assets and whether the resulting tax benefits to highly compensated individuals would sufficiently offset the costs of plan sponsorship to make plan sponsorship attractive to the employer.

111. This is an illustration of the equivalency of exemption of capital from taxation (through deduction) or exclusion from income) and exemption of taxable income on capital from income taxation. See, generally, E. Cary Brown, Business-Income Taxation and Investment Incentives, in Income, Employment and Public Policy, Essays in Honor of Alvin H. Hansen (1948).
The universe of individuals able to invest beyond the indicated levels is certainly not large. Thus, to the extent that plan sponsorship, and the generosity of coverage and benefits in plans, hinges on the plan’s utility to highly compensated individuals, the result of the Bush initiatives would likely be fewer and less generous pension plans. As suggested earlier, smaller firms are likely to be particularly sensitive to reductions in tax preferences for highly paid individuals.\textsuperscript{112} I offer two examples that may be typical of some small-firm responses to the Bush savings proposals, if enacted.

Assume a closely held corporation employing the owner and five other employees. The owner’s compensation from the business last year was approximately $100,000, and she expects to have approximately the same amount of compensation this year. The owner is 55 and last year established a safe-harbor 401(k) plan,\textsuperscript{113} to which she contributed $10,000 on behalf of herself. The safe-harbor plan uses a matching formula, which requires a 100% match on the first 3% of compensation, and 50% of the next 2% of compensation.

Three of the five other employees are eligible to participate in the 401(k) plan and two of them do so. The two employees earn $25,000 each and elect to defer $1,250 each to the 401(k) plan. The sole proprietorship must, under the safe harbor matching formula, contribute an additional $1,000 for each of the electing employees. Moreover, if we also assume that the employer incurs $500 in expenses to maintain the plan, the employer will incur $2,500 in direct costs of plan sponsorship.\textsuperscript{114} In addition, we can assume that the plan also imposes some indirect costs, including the expenditure of some of her time. Finally, let us assume that the owner, who has little savings outside the plan, is concerned about her ability to access savings inside the plan.

If the original Bush savings proposals had been enacted, the owner could use the $10,000 contribution to make a $7,200 after-tax contribution to an LSA. The owner could now terminate the 401(k) plan, saving the $2,500 additional plan costs. In addition, since an LSA does not penalize premature distributions, the owner will have unrestricted access to the LSA if she needs the money before retirement. The consequence of the owner’s actions is that the two employees who participated in the 401(k) plan will no longer receive matching contributions.\textsuperscript{115}

\textsuperscript{112} See, text accompanying supra note 91.
\textsuperscript{113} IRC § 401(k)(12).
\textsuperscript{114} This may not be strictly accurate, for the employer may through the matching contributions attract more productive workers, but this is speculative.
\textsuperscript{115} Note that the matching contribution not only added to the employees own savings, but also may have been an important incentive for the employees to
The second example is a doctor’s office, which employs the doctor and eight other employees. The doctor, who is age 50, earns approximately $300,000 annually and has been saving $45,000 annually in his retirement plan. He has a non-working spouse and two children. In addition to his retirement savings, he saves $30,000 each year outside the plan, which he divides equally between stocks (mostly through a mutual fund), municipal bonds, and real estate. He also contributes $5,000 to section 529 plans for each of his children.

His practice currently sponsors two plans: a safe harbor “match” 401(k) plan and an age-weighted profit-sharing plan. He elects to contribute $20,000 to the 401(k) plan (which included a $5,000 “catch-up” contribution) and receives a matching contribution of $8,000, for a total contribution of $28,000. His practice also contributes $17,000 to his account in an age-weighted profit-sharing plan.

Four of the employees elect to participate in the 401(k) plan and six employees participate in the age-weighted profit sharing plan. The doctor contributes $8,000 in matching contributions to the 401(k) plan and $6,000 to the age-weighted profit sharing plan for the employees. In addition, the doctor pays $500 for administrative expenses for the 401(k) plan and $750 for the age-weighted profit-sharing plan.

If the White House’s savings proposals are enacted, the doctor could set up RSAs and LSAs for himself and his spouse, in which he can deposit $30,000. Let us assume, however, that the doctor will want to move $10,000 of his non-plan investments into the LSAs, reducing the amount of qualified plan savings that he can shift to the RSA/LSAs for himself and his spouse to $20,000. But since the RSA/LSAs are made with after-tax contributions, the $20,000 before-tax contribution limit is the equivalent of a $31,250 after-tax contribution (the basis on which his contributions were made to the qualified plans). The doctor can now contribute $31,500 to the LSA/RSAs that would have been contributed to the retirement plans, which accounts for all but $13,500 of what the doctor would, but for the RSA/LSA vehicles, have contributed to the practice’s qualified plans. The doctor has a choice of what to do with the $13,500. First, the dividend exclusion, and the shift of some non-plan savings to the LSAs, will have increased the future effective after-tax rate of return on those investments, which might result in the doctor deciding to reduce his aggregate savings. A second choice would be to shift some of the $13,500 to LSAs for his two children, if that fits with his family wealth-management strategies. This choice would allow the doctor to save at all, since they would not have received the matching contributions if they had not contributed to the 401(k) plan themselves.

116. For details on age-weighted profit-sharing plans, see, Orszag & Stein, supra note 72.

117. See, supra note 109, and accompanying text.
achieve the same deferral that he accomplished through qualified plans without the use of any qualified plan. If the doctor makes this choice, his employees will lose the $14,000 that the doctor had been contributing for them and the advantages of a workplace savings program.

But suppose that the doctor neither wishes to reduce his savings rate nor establish LSAs for his children; in that case, he will still have $13,500 he will want to defer to a qualified plan. One option would be for him to establish a SIMPLE 401(k) plan, which requires a matching contribution equal to the first 3% of compensation. The doctor could effectively contribute the entire $13,500 to the plan and his contributions on behalf of his other employees to this plan would be $4,800. He would not need to make any contributions to the age-weighted profit-sharing plan, which he could freeze or terminate. The other employees would thus lose 66% of the employer-provided benefits that would have otherwise been made to their accounts. Moreover, some of the doctor’s employees might reduce their elective contributions in response to the reduction in the employer matching contributions.

This article does not make a claim that all firms, or even all small firms, would discontinue plan sponsorship or reduce employer-funded benefits for rank-and-file employees in response to the White House savings proposals. Nor does it argue that firms that do not currently have retirement plans would never adopt them if the Bush savings proposals are enacted. As the article earlier observed, there is an array of reasons that firms sponsor plans, of which the tax incentive for highly compensated employees is only one. But for many firms it is the primary reason, and the Bush proposals, by sapping out of the tax law much of the vitality of the tax incentives for employer-sponsored plans, could be expected to reduce both their numbers and their generosity to ordinary working Americans.

B. Efficacy of Bush Savings Proposals for Creating Retirement Income Security for Middle and Lower Income Workers

In the previous subsection, I suggested that the White House savings proposals, by providing tax-advantaged savings opportunities outside qualified retirement plans, would reduce the incentives for highly paid individuals to save in qualified plans. I also suggested that this would result in a universe in which fewer firms sponsored qualified retirement plans and that some of the remaining plans would be less generous. The retirement-policy question that follows is to what extent rank-and-file employees would use the new private savings vehicles to replace the lost retirement income from their employer-sponsored retirement plans.

118. IRC § 401(k)(11).
119. See, supra notes 102-05 and accompanying text.
The answer, I fear, is that much of what is lost will not be replaced. I have two concerns in particular: first, that many of the rank-and-file employees who today participate in qualified plans would not utilize the Bush personal savings accounts; and second, that much of what is saved in the Bush personal savings accounts will be consumed prior to retirement.

1. Obstacles to Rank-and-File Utilization of Bush Savings Proposals

There are reasons to suspect that rank-and-file employees may not exhibit a robust response to the Bush personal savings proposals, at least compared to their response to qualified retirement plans (when such plans are offered to them). I start with the observation that many rank-and-file employees are what some have referred to as “reluctant savers,” people who find it difficult to save for retirement on their own, because of pressing needs for present consumption. Indeed, as this paper earlier suggested, the traditional explanation for the qualified-plan tax expenditure is that qualified retirement plans will create retirement income for reluctant savers.

Qualified plans can create retirement income for such savers in either of two ways. In plans funded exclusively with employer dollars, the Internal Revenue Code’s nondiscrimination rules require coverage of some rank-and-file employees automatically, without action on their part and without any corresponding reduction in their immediate compensation. In such plans, then, reluctant savers are forced to save for retirement.

Other plans, primarily 401(k) plans, do not force employees to save: in such plans, an employee must elect to participate, and there is a direct cost to the employee who does so elect: lower immediate compensation. But the law encourages, and arguably coerces, participation among reluctant savers. Employees are in part encouraged to participate because their 401(k) contributions enjoy the benefit of tax deferral. More important, to enjoy qualified tax status, 401(k) plans must comply with a special set of nondiscrimination rules, which can be satisfied through annual testing that compares the deferral rate of the highly compensated employees with the deferral rate of rank-and-file employees. In effect, the amount of income that highly-paid employees can defer in a 401(k) plan depends on the amount that non-highly compensated employees defer. Thus, many firms encourage employee participation in their 401(k) plans through employer-provided matching contributions and educational programs on the value of saving for retirement.

121. See, supra notes 29-37, and accompanying text.
122. See, supra note 29-36, and accompanying text.
123. IRC § 401(k)(3).
And the Internal Revenue Code also offers safe-harbor alternatives that exempt a plan from annual non-discrimination testing if the plan provides either a statutorily defined matching contribution or provides a mandatory non-matching contribution for each participant. Moreover, behavioral economists have observed that individuals are more likely to save if they can pre-commit to saving a portion of future earnings: 401(k) plans offer employees a pre-commitment mechanism.

Thus, qualified plans either compel or encourage rank-and-file employees to save for retirement. The Bush personal savings vehicles are voluntary, so reluctant savers will not be compelled to save; in effect, this means that reluctant savers who save only because qualified plans compel them to will lose retirement savings if their qualified plan is terminated or cut back. Moreover, the Bush savings proposals will offer weaker incentives for voluntary savings than 401(k) plans. Indeed, the Bush savings accounts offer a single meaningful incentive for participation: the permanent exclusion of investment return on plan contributions from income taxation. They will not provide matching contributions and employers will not have incentive to sponsor savings educational programs. Perhaps most important, the Bush accounts do not incorporate the pre-commitment mechanism of 401(k) plans.

One might respond that vendors of investment products – the Fidelities and Vanguards of the world – would aggressively market RSAs and LSAs, and this is certainly probable. What is not probable, however, is that such vendors will be especially interested in establishing such accounts for small investors or that their marketing will be directed to people who will open small accounts. The reason for this prediction is simple: the fixed costs (and potential liabilities) of small accounts likely render such accounts only marginally profitable.

125. IRC § 401(k)(12).
127. It is, of course, possible to revise the Bush proposals to provide matching contributions.
contribution requirements; Vanguard, Fidelity, and T. Rowe Price, for example, will not open an individual retirement account with less than $1,000 and many of their fund options require substantially higher minimum contributions.\footnote{See, e.g., https://flagship2.vanguard.com/VGApp/hnw/content/AccountServ/Retirement/ATSTradIRAOverviewContent.jsp ($2,500 minimum investment for most Fidelity Investment funds).}

Moreover, the RSA/LSA accounts will be funded with after-tax dollars. Earlier this article discussed how the contribution of an after-tax dollar contribution to a Roth-type savings vehicle shields more investment income from taxation than a deductible contribution to a traditional retirement plan, but this is not an advantage to people who cannot afford to contribute beyond the contribution limits for such accounts (and this will be most people). Moreover, there is reason to suspect that such individuals generally prefer before-tax to after-tax contributions.\footnote{There are three possible explanations for this preference: first, that individuals have a behavioral preference for reducing taxes in the year of contribution; second, that individuals may fund part of their contribution with the immediate tax savings; and third, that middle and lower income individuals believe that they will have lower marginal tax rates in retirement. I have not been able to find any empirical research on the question posed in the text: whether traditional or Roth treatment is a stronger tax incentive for moderate income individuals. But I am reasonably confident that my hunch that before-tax treatment is a more effective incentive than Roth treatment for moderate income taxpayers. Others seem to share this view. See, Karen C. Burke and Grayson M. P. McCouch, Lipstick, Light Beer, and Back-Loaded Savings Accounts, 25 Va. Tax Rev. 1101, 1141 (2006).} Thus, the tax incentives for middle- and lower-income people to contribute to RSAs and LSAs may be weaker than the tax incentives for contributions to regular 401(k) plans. The White House proposals would eliminate traditional individual retirement plans, where contributions are made with pre-tax dollars.

2. Production of Retirement Income

Qualified retirement plans are designed, generally speaking, to provide individuals with a stream of income following their withdrawal from the labor market because of retirement or disability. The Internal Revenue Code, through regulatory restriction\footnote{Treas. Reg. § 1.401-1(b) (pension plan intended to pay income after retirement).} and excise taxes,\footnote{Discourages use of nonqualified annuities, see Treas. Reg. § 1.72-9, 1.72-12 (2001).} discourages use

notes, however, that some mutual funds might pursue the small investor in the expectation that with regular contributions and compounding of investment income, the small account of today will become the large account of tomorrow.
of such plans to provide pre-retirement income. In addition, pension plans (but not profit-sharing plans) must make benefits available as life annuities, which relieves participants from the planning necessary to prevent dissipation of retirement savings prior to death. Moreover, a participant’s spouse must consent to any benefit form a pension plan that does not include a survivor’s benefit for the spouse, making it more likely that benefits will not be exhausted before the death of a participant’s spouse.

In qualified plans these rules work imperfectly: we know, for example, that pre-retirement leakage occurs, and we know that some spouses consent to distributions that do not include a survivor benefit if the spouse outlives the participant. This can result in participants exhausting retirement savings prior to their death, or married couples exhausting benefits before they both die. But the rules do provide at least some restraints on consuming qualified plan savings in a manner inconsistent with the purpose of the qualified-plan tax subsidy: providing retirement income.

The White House savings proposals do not include equivalent restraints on non-retirement use of assets in the new savings accounts, but impose weaker and in some cases no rules limiting pre-retirement consumption or post-retirement exhaustion of RSA/LSA assets. This would, I fear, exacerbate the problem of old-age poverty, at least at the margins.

The LSA, to which individuals could contribute $7,500 per family member under the 2003 budget proposal, would impose neither regulatory restriction nor excise tax on pre-retirement withdrawals. The RSA, while imposing no direct regulatory restrictions on premature withdrawals, would impose an excise tax on distributions before age 58, which would discourage some pre-retirement RSA distributions. Most individuals, however, would probably choose to contribute first to the LSA (precisely because it does not impose a penalty on early distributions) and only contribute to an RSA to the extent that they are able to contribute in excess of the LSA limits. Thus, many individuals who use the new savings proposals will be subject to neither direct nor indirect restrictions on premature withdrawals of income.

132. A 10% excise tax is imposed on most qualified plan distributions made before the year in which the participant attains age 59.5. IRC § 72(t).
133. IRC § 411(a)(7); Treas Reg. 1.401-1(c)(1)(I).
134. IRC §§ 401(a)(11), 417.
135. Munnell and Sudden, supra note 122, at 125, et. seq.
137. General Explanation (2003), supra note 1, at 120.
138. Id.
139. See, How Bush’s Retirement System Overhaul Hits Home, supra note 60.
Moreover, the excise tax on RSAs would only apply to withdrawals of investment income, if not to withdrawals of the contributions themselves, and if we predict that the shape of withdrawal regulations will follow those applicable to Roth IRAs, withdrawals will be treated as coming from contributions rather than investment income until aggregate withdrawals exceed aggregate contributions. Thus, many pre-retirement withdrawals would be tax-free even from an RSA. Thus, compared to assets saved in qualified plans, assets saved in the White House savings proposals would be more likely to be used before a person stopped working.

Moreover, the Bush personal savings accounts neither require nor induce individuals to take benefits in annuity form. While an individual could certainly purchase an annuity using plan assets on the commercial insurance market, the cost of commercial annuities is high (especially for relatively small annuities). Thus, many holders of RSAs and LSAs will have to manage their retirement savings, not only investing appropriately but also planning withdrawals to ensure a more or less constant income stream until death. This is a difficult enterprise, and there is little reason for optimism that most Americans are equipped to manage their assets in this way. Compared to qualified pension plans, then, the Bush savings vehicles will probably result in fewer retired individuals receiving a lifetime stream of income after retirement.

Finally, the Bush proposals do not require spousal consent to a form of benefit without a survivor annuity. Indeed, nothing in the Bush proposal promotes protection of surviving spouses. Again, this is a step backward from the rules protecting spouses in qualified plans.

140. General Explanation (2003), supra note 1, at 120.
141. Footnote about double-bind: if you put limits, fewer people will contribute.
C. White House Savings Initiative and Rate of Return on Retirement Savings

The Bush savings proposals may have the effect of reducing the rate of return on retirement savings of middle- and lower-income individuals. This section suggests five reasons why this might occur.

1. Loss of Investment Opportunities

Qualified plan investment programs take one of two forms: assets are either pooled and invested by plan fiduciaries on behalf of all participants or are invested in accordance with the individual instructions of each plan participant (“self-directed plans”). In the latter case, the plan generally offers the participant an array of available mutual funds and other investment opportunities, which are initially chosen by a plan fiduciary. In both types of plans, the employer, or rather the fiduciary selected by the employer, serves in an agency relationship to the plan participants and presumably in most cases is more competent than the participants in managing funds or selecting investment options. Moreover, plans, which sometimes have substantial assets to invest, can bargain for investment options that might not otherwise be available to moderate- and lower-income individuals. For example, some mutual funds require investors to make a substantial minimum investment that is beyond the means of many individuals. Pooled funds, of course, have access to such investments and also to venture capital and real estate opportunities that may not be available to small individual investors, who in any event may not be capable of evaluating them in a sophisticated manner. Even self-directed account funds sometimes offer investment funds that would not be available to small investors outside plans.

In the RSA/LSA formats, employees would not benefit from the agency of plan fiduciaries or plan bargaining power and would thus lose access to some types of investments, which would undermine their ability to optimize portfolio diversification (and if you believe in such things, the opportunity to invest in assets that offer better risk/return ratios than typical mutual funds).

2. Fiduciary Protections

ERISA imposes fiduciary obligations on people who choose how to invest plan funds and/or choose investment options for participants in plans where participants direct investment choices. The obligations include

144. See, ERISA § 404(c), 29 U.S.C. § 1004(c).
prudence and loyalty, which require care in selecting, and in monitoring, plan investments. These obligations should in theory, and generally will in practice, discourage plan fiduciaries from investing plan resources in investments that carry uncompensated risk and/or that unnecessarily compromise portfolio diversity.

In contrast to qualified plans, RSAs and LSAs will remove the agency of the employer-designated fiduciaries. Individuals, who sometimes will not have extensive training or experience in investment management, will be saddled with the responsibility of investment management, including selecting appropriate investments, monitoring portfolio performance, and periodically adjusting asset allocations. Such individuals might lack the sophistication necessary to replicate the professional investment management provided by or through plan fiduciaries.

One can respond to this criticism, by noting that participants in self-directed qualified plans are currently required to choose among investment options. But at least in such plans the investment options themselves are selected by plan fiduciaries. Moreover, some observers of qualified plans have suggested that ERISA’s encouragement, if not mere tolerance, for participant-directed plans, has been a mistake and should be eliminated or at least reduced. The RSAs and LSAs move in the opposite direction.

3. Education

Employers sometimes provide investment education to employees participating in self-directed plans. It is not clear that vendors of investment products will provide similar education or advice, and if they do, there is at least some risk that the education may reflect the vendor’s own pecuniary interests.

146. ERISA § 404(a), 29 U.S.C. § 1004(a).
147. See, Pension Plan Administration: Participant-Directed Accounts, supra note 145.
149. See, Pension Plan Administration: Participant-Directed Accounts, supra note 143.
150. The Pension Protection Act of 2006 added a prohibited transaction exemption for provision of investment advice by financial firms with potential conflicts of interest in rendering the advice, although the exemption does include some safeguards against abuse. See, ERISA § 408(b)(14).
4. Costs

Plans are able to spread fixed costs among all participants and will also generally be in a better position than individuals to negotiate low costs from fund vendors and service providers.\(^{151}\)

5. Effect of the Proposed Income Exclusion of Stock Dividends on Investment Returns

The White House proposal to eliminate tax on stock dividends should, according to conventional economic analysis, provide a one-time (arguably windfall) gain to holders of stock and should, over time, increase before-tax yields on taxable investment assets (such as productive real estate holdings and debt instruments).\(^{152}\) However, because there will continue to be some tax-exempt investors who purchase some stock, the discount on stock yields will probably not completely reflect the tax advantage that stock would enjoy.

A rational affluent investor, in reaction to the Bush savings proposals, could be expected to move qualified stock holdings outside tax-sheltered funding vehicles (such as qualified plans and RSA/LSAs) and to use tax-sheltered vehicles to hold investments that would otherwise be taxable. By doing so, such an investor could maintain a well-diversified portfolio while maximizing after-tax returns. Investors of moderate means, however, might not be able to achieve such results. First, they might not have the same access as affluent investors to the full range of taxable investments. Second, a moderate-income investor might find it difficult to maintain a diversified portfolio without substantial investment in stock, whose return can be expected to be burdened with a new implicit tax reflecting the exclusion of dividends from the income tax base outside the plan. The effect would be to reduce rates of return on new savings by at least some moderate-income individuals, either because of reduced return on stock investments or reduced portfolio diversification.

An interesting result of the exemption of dividends from tax would be that participants in qualified plans would be the only individuals who would effectively pay tax on dividends, since they would pay tax on plan distributions.


\(^{152}\) See, supra note 109.
D. Budget and Tax Considerations

The Bush savings initiatives will have budgetary and tax implications, implications that may make it more difficult for a future government to address social issues, including issues of old-age poverty, which I suggest in this article would be exacerbated by the Bush savings proposals.

The Joint Committee on Taxation estimated that the full dividend exclusion proposed in the 2003 budget proposal would cost $235 billion revenue over the ten years following its enactment. The RSA/LSA was expected, in the short term, to raise revenue during its first five years and thereafter to lose revenue. The proposal, then, would increase annual budget deficits as far as the eye can see, or at least as far as the Joint Committee estimates extend; the increased national debt would burden national fiscal policy in the future. As I argued in earlier sections of this paper, the beneficiaries of the revenue shortfalls would generally be the relatively affluent individuals who are most likely to use the Bush savings proposals.

The scoring of the Joint Committee assumes static tax rates. If debt repayment becomes an increasingly large part of the budget, which is certainly a possibility, it may become necessary to increase tax rates to pay for governmental programs, including programs to deal with old-age income insecurity. The Bush proposals, however, will have constricted the tax base by eliminating a shareholder level tax on corporate income and by exempting from tax returns on investments held by RSAs and LSAs, meaning that the increases in tax rates on income remaining in the tax base (primarily wages) will be steeper than they would have to be if the tax base were broader. Moreover, since distributions from qualified plans would be included in the tax base, retirees would share in the increased tax burden to the extent that their retirement income is generated by qualified plans but not to the extent it is derived from RSAs or LSAs, or through investments in stock. This may be disturbing to people concerned with either horizontal or vertical equity, the latter because the more affluent are more likely than the less affluent to derive substantial retirement income outside qualified plans; the former, because of the disparate treatment of different sources of investment income.


155. Id.
It would of course be possible for a future Congress to subject the Bush savings accounts and stock dividends to some level of tax, but this may prove politically difficult. Individuals who invested in such accounts would be able to contend that by choosing to contribute to such accounts with before-tax dollars, they had entered into a contractual-type agreement permanently entitling them to a tax exclusion for any investment income produced by such accounts. This may well be a compelling political argument.\textsuperscript{156}

Moving to reintroduce a second-level tax on corporate earnings may also prove difficult in the future, both on political and policy grounds. Politically, corporations and shareholders could be expected to oppose a reintroduction of a shareholder-level tax. Moreover, as a matter of first principles, a single-level tax on business income has unambiguous economic advantage, including roughly equivalent tax treatment of debt and equity investments in corporations, and of corporations and other forms of business, and these advantages would make it difficult, and perhaps unwise, to revert to a double tax on corporate income.\textsuperscript{157} Reintroducing a second level of tax on corporate income would almost certainly depress the value of such stock at a time when older individuals might be selling such stock to provide retirement income.

The tax on corporate income could also be increased directly, by increasing corporate tax rates. But there are practical limits on how high a direct tax on corporate income can be without creating strong tax-avoidance incentives and without disadvantaging domestic enterprises in the competition for capital. Moreover, as would be the case with reintroducing a shareholder level tax, increasing corporate rates in the future could depress stock values with an adverse effect on retirees.

To recap, the Bush savings proposals would be expensive, would benefit relatively affluent individuals who can be expected to save for retirement without governmental incentives, and to the extent we later have to pay for revenue costs, might be disproportionately paid for by individuals who would not, as a group, have derived much advantage from the proposals and indeed may have seen their own retirement savings diminished because of them.

There is one further troublesome aspect of the proposals that might become manifest in the future: the possibility that heirs of affluent individuals will be able to entirely escape income tax while supporting

\textsuperscript{156} But see, e.g., Daniel Shaviro, When Rules Change: An Economic and Political Analysis of Transition Relief and Retroactivity (University of Chicago Press, 2000).

themselves on income from investments. Let me illustrate with an extreme example. Assume, for example, a couple whose first and only child is born in the year that Congress gives birth to the Bush proposals. The couple, who have substantial wage income, establish and make maximum annual contributions to RSAs and LSAs for themselves and an LSA for their child. Their savings outside of the plan are invested entirely in long-term stock holdings.

If we assume a 6% return on investments, at age 30 the child’s LSA will have accumulated $800,000. Assume also at this point that the child begins living on his investment income, which is now $64,000. (This could, of course, be supplemented by additional tax-free income from stock transferred to him by his parents and imputed income from a home.) Assume that when the child is 50, his parents die, leaving him the beneficiary of the LSAs and RSAs. At this point, each of the four accounts will have accumulated $2.3 million, for a total of $9.2 million. The RSA will have to be distributed eventually, but the proceeds, which will be distributed free of tax, can be invested in stock. (Again, the total of assets generating tax-free income can be increased by bequeathing the child stock.) In any event, the child, and future generations, could enjoy substantial annual income without ever paying income tax (with capital gains avoided by not disposing of the stock).\(^{158}\)

Note that with respect to future generations, this is not exclusively a consumption tax regime; it is a tax on wage income and some but not all business income. Non-corporate business income passed through to an RSA or LSA will also receive a permanent exemption from income tax. The regressivity of such a tax system would, to my mind, be hard to justify, even if some affluent individuals continue to receive some wage income. Moreover, to ensure a meaningful tax on business income, there would have to be a thorough house cleaning of the corporate income tax, focusing on the aggressive tax planning that minimizes the corporate tax and deliberate preferences whose rationales are weaker in a single-level tax corporate tax system.

V. WEALTH ACCUMULATION V. RETIREMENT INCOME SECURITY

The Bush Administration’s savings proposals reflect two broad and casually related themes: income verses consumption/wage tax base, and social insurance verses wealth creation.

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158. It should, of course, be observed that corporate income would be taxed and thus anyone deriving dividend income or capital gain from corporate investments would be subject to an implicit tax. Nevertheless, to many wage earners, it may appear that such individuals are escaping all tax liability.
The first theme is the tax theme of what our nation should settle on as the appropriate tax base. The Bush proposals endorse further movement from our current mixed income/consumption tax base toward a purer consumption/wage base model. Proponents of a consumption base model argue that unlike an income tax, a consumption base is neutral with respect to lifetime consumption patterns (by not penalizing savings) and thus a fairer tax base.\footnote{159} They also argue that an income tax depresses aggregate national savings, and therefore that moving to a consumption tax base will increase our nation’s anemic savings rate.\footnote{160}

While I favor an income tax over a consumption tax base because I believe that the former is more adaptable to the equitable tax norm that taxes should be apportioned on relative abilities to pay, the preference for one base over another ultimately is a reflection of a proponent’s economic ideas and perhaps ethical values. There is, so far as I can tell, no mediating criteria of truth to resolve the debate over the preferred tax base.\footnote{161} But any movement toward a consumption base, in my view, should be conditioned on a national debate of the relative merits of competing bases. The Bush proposals, however, do not squarely join this issue, but advocate the proposals simply as a means to help taxpayers save for retirement and other long-term purposes (such as education or saving for a house or a medical emergency).\footnote{162} In this sense, the Bush proposals are a stalking horse for a move toward a consumption/wage tax, or perhaps more accurately a Trojan horse, disguised as a way to help taxpayers to save for retirement rather than as an event signaling a dramatic shift in tax base.

Moreover, the Bush proposals would nudge us only part way toward a consumption tax. As Professors Karen Burke and Grayson McCouch have noted, the savings proposals are based on a yield-exempt rather than cash-
flow consumption tax model and fail to address the issue of debt within such a model.¹⁶³

How to ensure retirement income for those who will not voluntarily save is itself a difficult issue in designing a consumption tax. In our income tax system, we do two things to encourage such savings: first, we privilege qualified-plan retirement savings over immediate consumption and other types of savings by deferring tax (or carving out a consumption tax niche for retirement savings); second, through the nondiscrimination rules, we employ more coercive measures to force many employers to provide retirement plan coverage for individuals for whom we suspect tax incentives alone would be inadequate to cause them to save adequately for retirement. In a consumption tax regime, all savings are equally privileged and business owners and managers will thus lack tax incentives to have their firms sponsor retirement plans that will provide retirement income for reluctant savers. (This latter point is, of course, a large part of my critique of the Bush savings proposals.)

It is possible, of course, for a society deriving revenue primarily from a consumption tax base to design policies that will address the issue of myopic retirement savings patterns.¹⁶⁴ A universal and adequate system of social insurance is one approach. Other approaches might provide cash or other incentives to employers to establish retirement plans or require all wage earners to save a percentage of their compensation in an individual account to which appropriate fiduciary protections would attach. We might also consider government matching or direct contributions or loans to low and moderate income individuals to save for retirement and/or establishing pre-commitment devices to improve the savings behavior of such individuals.¹⁶⁵ We might also, as a nation, make a greater investment in financial literacy education.

The Bush proposals, however, do not propose expanding our Social Security program to reflect retirement-income losses that the proposed movement to a consumption tax might cause. Nor do the proposals incorporate incentives and/or mechanisms that might result in retirement savings by otherwise reluctant savers. This should not, of course, be unexpected because the Bush administration packaged the RSA and LSA not as a step toward a consumption tax that might diminish the retirement security of low and moderate wage earners but as a self-contained means of increasing savings, including retirement savings, for all Americans.

¹⁶⁵ Id.
The second broad theme of the Bush proposals is the emphasis on individual wealth creation in contrast to a social contract in which wage earners are assured adequate income security in retirement. This preference for individual wealth creation verses social contract is more manifest in the proposals by the Bush administration, and others, to convert, at least partly, the Social Security system from a defined benefit plan to a defined contribution plan.

But the private pension system, which the Bush proposals would weaken, also exhibits important social-insurance elements. In private-sector defined benefit plans, for example, benefits historically if not still customarily are distributed in annuity form, thus socializing the mortality risk among the employee group and limiting the extent to which benefits can be converted from retirement income to unrestricted and freely transferable wealth. Defined benefit plans also limit the extent to which employees are subject to investment risk, both by the employer’s assumption of that risk and by mandatory benefit insurance through the Pension Benefit Guaranty Corporation. All plans limit the ability of employees to use resources prior to retirement, and minimum distribution rules moderate the use of plan tax deferral to build tax-advantaged estates (thus helping channel tax benefits to the production of retirement income). Finally, and most important, the nondiscrimination rules ensure that at least some of the tax benefits that plans enjoy are used to create retirement income for moderate income wage earners.

I do not argue that the private pension system is primarily a system of social insurance, only that it has some elements of such a system. Indeed, with the strong movement toward defined contribution plans, and within that trend toward 401(k) plans in particular, the private pension system also reflects themes of individual responsibility and wealth creation.166 The private pension system, then, is probably best understood as a hybrid system combining ideas of collective and individual responsibility, and the creation of retirement income and of wealth generally. Bush’s proposals would nudge, or perhaps shove, the system’s emphasis further toward individual responsibility and creation of wealth. Whether this is a good thing or a bad thing is open to debate, and like the debate about the proper tax base, has no correct answer, although few readers of this article will mistake on which side of the debate my own allegiance lies.

What I do not think is fairly debatable is that as we move toward individual responsibility and wealth creation, we move further from the ideal of universal retirement income security. The White House, however, pretends otherwise, justifying its proposals as a means for increasing

retirement savings among all Americans, including those with low and moderate income. If adopted, it would be a national catastrophe for some such individuals as they enter retirement unless we simultaneously adopt new approaches to help them save for retirement.

VI. THE ERSA AND NATIONAL RETIREMENT POLICY

Our current retirement system is famously, and inaccurately, likened to a three-legged stool. The stool’s purported legs are Social Security, employer pensions, and private savings. The stool, such as it is, is not sturdy. Many Americans accumulate little in the way of private savings, and fewer than half of Americans in the private work force will receive benefits, and a much smaller percentage meaningful benefits, from employer-sponsored retirement plans. Thus, for many Americans the more accurate metaphor might be a pair of stilts or a pogo stick. And Social Security does not provide sufficient income to permit a retiree to live above the poverty level without some other sources of income. This suggests that our national retirement policy, such as it is, is not much of a policy for many working Americans.

There are three approaches to improve national retirement policy. One approach would consciously move us toward a more comprehensive system of social insurance, either by a direct expansion of the Social Security program or through a mandate for employers to adopt retirement plans satisfying certain criteria (or a mandate for employees to put aside a percentage of their income for retirement). The idea of a mandated employer system found little political traction in years past and might not find much more today. A second approach is that implicitly advocated by the Bush White House in its personal savings proposals: treating the decision to save for retirement as an individual decision for each American, although using tax incentives to nudge tax-sensitive Americans to greater savings. For the reasons suggested in this paper, I have doubts about the efficacy of this approach. I am, however, optimistic that this approach faces political obstacles as formidable as those facing the more universal system that I prefer.

This leaves a third approach: improving rather than supplanting the existing voluntary employer-based retirement system. Since the system is voluntary, it is unlikely that changes to the system can ever result in universal coverage. It is a flawed system and, given that it is based on the voluntary adoption of plans by employers and that employers will generally not want to contribute much to such a system on behalf of workers who

167. Munnell, supra note 33, at 2.
would prefer cash compensation, it will almost certainly always remain a flawed system.

But the system can be improved, and the Bush ERSA proposal is right in approach even if wrong in some of its details. As this paper earlier described, the ERSA attempts to simplify the regulatory regime governing defined contribution plans by jettisoning several inordinately complex Internal Revenue Code provisions that, on the one hand, permit employers to design plans to limit coverage and benefits for lower-income employees and, on the other hand, require some plans that are excessively weighted toward key employees to provide at least minimum benefits to other employees. The 2003 ERSA would have been subject to a single set of relatively simple nondiscrimination rules.

In effect, the proposed ERSA rules identify a comparative level of benefit for rank-and-file employees that is adequate to justify the tax expenditure for the highly compensated and then creates a simple nondiscrimination test that assures that comparative benefit level while minimizing the employer’s design and compliance costs. The Department of Treasury put it thus: the ERSA “simplifies qualification requirements while maintaining their intent of providing broad-based coverage of employees. By reducing unnecessary complexity, the proposal significantly reduces employer compliance costs.”

The ERSA proposal has, from my perspective, three shortcomings. The first, and obvious, shortcoming is that the ERSA proposal is joined to the Bush personal account proposals, which this paper has already argued will dampen employer appetite for sponsorship of plans. The proposals, however, are severable.

The second problem is that the proposed nondiscrimination rules do not demand sufficient benefits for rank-and-file employees. The nondiscrimination tests are modeled after the rules for section 401(k) plans, and like 401(k) plans allow employers to design their plan either to satisfy a safe harbor or to tie the rate of deferral of highly compensated employees to a multiple of the average deferral rate of other employees. Both the safe harbor and the annual deferral-comparison test are less demanding than the tests under current law for section 401(k) plans. Presumably the argument for the less restrictive tests is the elimination of rules under current law that accommodate employers who wish to weight plan benefits aggressively toward higher-paid employees.

Consider first the safe harbor test. To come within a safe harbor, a plan would either have to make nonelective contributions equal to 3% of

compensation or to offer matching contributions of 50% of compensation on
the first 6% of pay. Given that the maximum matching contribution for an
employee would be 3% (50% of 6% of compensation), it is difficult to see
why an employer not predisposed to generosity to employees would choose
the non-elective deferral approach. In 401(k) plans the safe harbor match for
employees contributing 6% of compensation would be 4.5%. Thus, most
employers would presumably choose the matching safe harbor.

There are three problems with a matching safe harbor. First, the
employer has no incentive to encourage employees to contribute to the plan
since the employer’s cost is increased by such contributions. Second, a 50%
match on the first dollar contributed may not be high enough to stimulate
high rank-and-file contribution rates. In 401(k) plans, the safe harbor
requires a 100% match on the first 3% of compensation deferred, and 50% of
the next 3% of compensation. Third, no matter how high the match, some
employees will not elect to defer and thus will not earn retirement benefits.

If an employer elects not to use a safe harbor, the deferral rate for
highly compensated employees can equal up to twice the deferral rate for
other employees, although there is no limit on the former if the deferral rate
for the latter is 6% or greater. A problem with this system is that it looks to
average deferral rates, so just as with the safe harbors, not all employees will
have to save for retirement in order for the plan to satisfy the
nondiscrimination rules. Moreover, a high deferral rate can be achieved
despite low participation rates by making large non-elective contributions on
behalf of the lowest paid employees, which is an inexpensive way of raising
the average deferral rate for the non-highly compensated group.

A more effective, simplified nondiscrimination test might involve a
reverse match. Under this approach, the employer would make an initial
contribution for all participants and highly compensated employees’ elective
deferrals would be limited to a statutory multiple of the initial contribution
rate the employer made. For example, if Congress set the multiple at three
and the employer made 3% contributions, all employees, including highly
compensated employees, would be permitted to defer an additional 9% of
their compensation. This approach avoids complicated annual testing and has

170. General Explanation, supra note 2, at 126.
171. IRC § 401(k)(12).
172. Id.
173. The Department of Treasury and the IRS promulgated Treas. Reg.
1.401(k)-2, which places limits on but does not eliminate this strategy. See,
Retirement Plans; Cash or Deferred Arrangements Under § 401(k) and Matching
Contributions or Employee Contributions Under § 401(m) Regulations, 69 Fed. Reg.
78144 (Dec, 29, 2004).
174. Orszag and Stein, supra note 114, at 669-74 (proposing reverse match
nondiscrimination rule).
the important advantage over a “matching” safe harbor of ensuring that all participants are allocated an initial contribution. It also ties the amount that highly paid employees can defer to the amount being deferred for rank-and-file employees.

The third shortcoming of the Bush proposals is that they do not attempt to coordinate the proposed rules for defined contribution plans with equivalent rules for defined benefit plans. In some sense, this may be appropriate, since defined benefit plans are today in decline, and providing employers who sponsor them with design flexibility may increase their attractiveness if design flexibility is limited in defined contribution plans. But there is a danger that small firms will adopt aggressive defined benefit plans that will provide little in the way of benefit for lower-paid workers.

VII. CONCLUSION

This article argues that the Bush personal savings proposals – the creation of tax-advantaged personal savings accounts and the exclusion of corporate income from shareholder level tax – will have negative effects on the retirement income security of many Americans of moderate means. The article suggests that such savings accounts would reduce the number of employer plans, reduce benefit levels for employees in those plans that remain, provide no alternative means for savings that will be attractive to adversely affected workers, and reduce the rate of investment return for non-affluent individuals. The proposals would also impose significant revenue cost and might partly immunize the affluent beneficiaries of the proposals from tax increases that might be needed in the future to retire the national debt that would result from the revenue losses. Like a policy bad nickel, these ill-advised concepts keep turning up in proposals from the White House, from members of Congress, and from the President’s Advisory Panel on Federal Tax Reform.

In contrast, the ERSA, if isolated from the personal savings accounts and dividend exclusions, provides a helpful first step toward making useful adjustments to the current system. Through an ERSA-like approach, we can both reduce expensive compliance burdens and ensure that a reasonable share of the qualified plan subsidy provides meaningful levels of benefits to employees of moderate and low income. Of course, such a modification to the system would not result in either universal coverage or benefit adequacy, which can only be achieved through an expanded social insurance system (or some form of mandated savings). But it would do at least some good and no or little harm.