EBRI

T-81

Statement on

Pension Trends, Small Firms, and Coverage/Simplification Proposals

Hearing on "The Illusory Promise of Retirement Security"

Before the United States House of Representatives,
Select Committee on Aging,
Subcommittee on Retirement Income and Employment

10 July 1991

by

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Pension Trends, Small Firms, and Coverage/Simplification Proposals: Summary

Hearing Before the House Select Committee on Aging Subcommittee on Retirement Income and Employment, July 10, 1991

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Policies that seek to enhance future retirement security by strengthening or extending employer-sponsored retirement programs must recognize the implications of current plan-design trends and the obstacles to plan sponsorship at small firms.

Employer-sponsored programs are moving toward more individual choice and responsibility, away from "paternalism." Decisions regarding participation, how much current pay to defer, and whether to save deferrals for retirement or spend them sooner, are shifting away from plan sponsors, toward participants. By 1987 32 percent of plan participants, up from 13 percent in 1975, participated in defined contribution plans only, and 39 percent participated in supplemental defined contribution plans, up from 21 percent. By 1988, cash or deferred arrangements (CODAs)—mostly private 401(k) plans—served as the primary plan for 16 percent of participants, and as a supplement for another 16 percent. While 39 percent of all workers had a vested right to a benefit in 1988, 28 percent could receive all or part of it as a lump sum upon separation from service.

Plan participation slipped to 48 percent of the work force by 1988, as the role of CODAs grew. Participation in these voluntary plans is lower than in plans generally, especially among younger workers and lower earners. In addition, as opportunities for preretirement cash outs proliferate, the contribution of employer-sponsored programs toward retirement security may decrease—again, especially among lower earners, who are less likely to save.

The role of employer-sponsored programs is constrained by persistently low rates of plan sponsorship among small firms. Eighteen percent of workers at private firms with fewer than 25 employees worked for a sponsor in 1988. These low rates are attributable to a number of factors, including complexity, lack of flexibility, economic forces, and possibly access to information.

The proportionately higher administrative costs faced by smaller firms might be alleviated by simplification. Yet, simplified employer pensions (SEPs) remain unpopular—just 1 percent of full-time workers at small establishments participated in 1990—suggesting that simplification alone is not sufficient to spur sponsorship.

Small firms may resist SEPs in part because SEPs offer little flexibility regarding the allocation of benefits among workers. Flexibility might foster sponsorship, but might frustrate efforts to distribute tax preferences broadly by leaving some workers without substantial benefits.

Small-firm plan sponsorship is also impeded by relatively low pay levels, which suggest a less skilled and possibly less attached work force. Lower earners may prefer not to defer pay, and small firms may be reluctant to add benefits atop pay for perceivedly shorter-term employees. Therefore, substantial increases in participation at small firms might require large subsidies.

Finally, small employers might lack easy access to pension information. Private marketing efforts are often given partial credit for the historical popularity of IRAs and, at large firms, 401(k) CODAs. If policies spur pension marketing toward small firms, sponsorship might rise.

Policies that offer employers simplicity with additional but limited flexibility would likely have a positive, but modest, effect on small-firm plan sponsorship and participation. If increased flexibility were extended to traditionally high-coverage larger firms, and this extension resulted in a growing role for flexible plans such as CODAs, participation in that sector might slip, especially among lower earners. In general, policies that foster plan sponsorship might not ensure broad participation. Nonetheless, proposals to increase participation must recognize employer interests that determine plan sponsorship.

Increased participation is not synonymous with increased retirement security for those workers who take and spend preretirement distributions. However, restrictions on preretirement cash outs might sometimes conflict with individual interests that influence savings decisions.

INTRODUCTION

Good afternoon Mr. Chairman, and members of the Subcommittee. I am Joseph S. Piacentini, Research Associate at the Employee Benefit Research Institute. I am pleased to testify at this important hearing on issues confronting the U.S. system of employer-sponsored retirement programs. EBRI is a nonprofit, nonpartisan, research and education organization, dedicated to providing objective information on benefit-related policy issues. As such, it does not advocate particular policies. Any opinions expressed here are my own and should not be attributed to EBRI or any other party.

Employer-sponsored retirement programs play an important and growing role in the retirement income security of U.S. retirees. According to base-line projections, the proportion of all aged families that benefit from these programs could grow from 40 percent in 1988 to 77 percent in 2020, reflecting increases in participation that continued until the late 1970s, tighter vesting standards imposed after 1974 and 1986, and recent increases in labor force attachment among women.

Despite these gains, however, protection under employer-sponsored retirement programs remains less than universal, with 48 percent of all nonfarm workers participating in 1988. Persistently low levels of retirement plan sponsorship in certain sectors—particularly among small private firms—represent a constraint on future levels of pension receipt reflected in projections. Moreover, recent trends in plan design toward voluntary participation and preretirement access to benefits have contributed to small declines in pension participation (even as plan sponsorship has remained nearly stable) and increased the potential for preretirement consumption of benefits. If these trends continue, future benefit receipt could lag base-line projections, which assume constant plan designs within sectors.

Policy proposals that seek to enhance future retirement income security by strengthening or extending employer-sponsored retirement programs must recognize the obstacles to plan sponsorship in certain sectors and the implications of current plan design trends. High levels of plan sponsorship and participation in small firms will likely remain elusive unless large subsidies are offered or strict mandates are imposed. Either of these approaches would be costly. Increasingly flexible plan designs, which generally appeal to employers and participants and foster plan sponsorship, might simultaneously threaten retirement security if workers elect to contribute little or cash out early.

This testimony provides background on current trends in employer-sponsored retirement programs, with particular attention to small firms. It describes trends in plan design and participation, and offers evidence on worker behavior where participation and preservation are voluntary. In this context it considers the likely effects of POWER[1] and other proposals to strengthen employer-sponsored retirement programs, with attention to the role of complexity relative to other factors in the plan sponsorship decision, and the obstacles that lie between plan sponsorship and benefit delivery in retirement.

PLAN DESIGN TRENDS

Since the enactment of the Employee Retirement Income Security Act (ERISA) in 1974, employer-sponsored retirement plans have changed dramatically. There has been a shift away from traditional defined benefit plans toward an increasingly diverse array of defined benefit and defined contribution plans, and assorted plan combinations and hybrids. Along with this shift have come several fundamental changes in how employer-sponsored plans contribute to workers' retirement security. Participation, traditionally automatic in covered jobs, is now frequently voluntary and contingent on employee contributions. Benefits, traditionally distributed as a monthly annuity in retirement, are increasingly available as lump-sum cash outs upon separation from

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[1]The "Pension Opportunities for Workers Expanded Retirement" proposal, unveiled April 30, 1991, by the U.S. Department of Labor.

service. Investment risk and decisions are also shifting from sponsors to participants. In general, there has been a shift away from more "paternalistic" plan designs, toward more individual choice and responsibility. These trends, evident among both large and small private-sector employers and in the public sector, appear to be continuing.

The Shift Toward Defined Contribution Plans

One aspect of the trend from paternalism toward growing individual choice is the ongoing shift from defined benefit to defined contribution retirement plans. Much defined contribution growth is attributable to salary reduction cash or deferred arrangements (CODAs), including private-sector 401(k) plans and similar arrangements, in which participation is voluntary and contingent on employee contributions. In addition, defined contribution plans allow preretirement cash outs more commonly than do defined benefit plans.

Since 1974, many employers have curtailed or eliminated their defined benefit plans, often supplementing or replacing them with defined contribution plans. Probably more important, the sectors of the economy where traditional defined benefit plan coverage is most firmly established, including heavily unionized and older industrial sectors, have generally contracted or grown more slowly than other sectors where plan diversity is greater. As a result, an increasing proportion of all employer-sponsored retirement plan participants derive all or part of their work-based retirement protection from defined contribution plans.

In 1987, defined contribution plans accounted for 78 percent of all private plans, up from 67 percent in 1975. At the same time, the defined contribution share of total participation grew from 26 percent to 48 percent. The proportion of all active participants whose primary plan was defined contribution grew from 13 percent to 32 percent, and the proportion with supplemental defined contribution participation grew from 21 percent to 39 percent.

A similar trend is evident in private plan finances. Between 1975 and 1987, the defined contribution shares of total assets, contributions, and benefits grew from 28 percent to 39 percent, 35 percent to 67 percent, and 32 percent to 46 percent, respectively (see table).[2]

The Growing Role of Defined Contribution Plans in the Private Sector

	1975	1987
% DC of all plans	67%	78%
% DC of total participation	26%	48%
% of active participants with primary DC	13%	32%
% of active participants with supplemental DC	21%	39%
% DC of total assets	28%	39%
% DC of total contributions	35%	67%
% DC of total benefits	32%	46%

Source: EBRI tabulations based on U.S. Department of Labor, Pension and Welfare Benefits Administration data.

The shift toward defined contribution plans is continuing. Defined benefit terminations accelerated after 1987, according to Internal Revenue Service and Pension Benefit Guaranty Corporation statistics. Participation in defined contribution plans—especially in CODAs—continued to grow through 1989, a Labor Department survey of medium and large private establishments suggests.[3]

[2]The particularly sharp rise in the defined contribution share of total contributions is probably partly attributable to the reductions in defined benefit contributions that followed the favorable financial market performance of the mid-1980s.

[3]These findings are summarized in greater detail in Joseph Piacentini, "U.S. Pension Trends and Implications for Portability and Preservation," a paper presented May 2, 1991, at an EBRI-ERF Policy Forum on "Pension Portability and Preservation: Assuring Adequate Retirement Income into the 21st Century." Copies are available from EBRI.

Small Employers and Plan Design

Proportionately fewer small employers than large sponsor any kind of retirement program. Among those who do sponsor plans, smaller employers more commonly sponsor defined contribution plans. Forty-two percent of full-time employees in private establishments with fewer than 100 employees participated in any retirement plan in 1990, compared with 81 percent of those at larger establishments in 1989. However, defined contribution participation surpassed defined benefit at small establishments; at large establishments the reverse was true (see table).

Percentage of Full-Time Employees Participating in Employer-Sponsored Retirement Programs

	Establishments with fewer than 100 employees, 1990	Establishments with 100 or more employees, 1989
Any plan	42%	81%
Defined benefit	20%	63%
Defined Contribution	27%	36%

Source: U.S. Bureau of Labor Statistics.

Both small and large private employers appear to be shifting from defined benefit to defined contribution plans. The defined contribution share of total active participation has increased in both large and small private sector plans. In plans with fewer than 100 participants, defined contribution plans accounted for 79 percent of active participation in 1987, up from 62 percent in 1975. In larger plans, the defined contribution share reached 52 percent, up from 25 percent.[4]

The Effect of Voluntary Participation and Preservation

As plan design trends toward greater individual choice and responsibility have continued, overall participation levels have slipped, and the potential for preretirement

[4]EBRI tabulations based on U.S. Department of Labor, Pension and Welfare Benefits Administration data.

dissipation of benefits has increased. Where participation is voluntary, plan sponsorship does not ensure that workers will accrue substantial benefits. Where preretirement cash outs are available, participation does not ensure that benefits will be preserved for use during retirement.

Voluntary Participation

The growing role of salary reduction CODAs, including private-sector 401(k) plans and other similar arrangements, is associated with decreasing overall participation—especially among lower earners.

Between 1979 and 1988, participation declined as a proportion of the work force, even as plan sponsorship remained nearly stable. Put another way, a growing proportion of those who worked for plan sponsors failed to participate. At least some of this growing rift between plan sponsorship and participation is associated with the growing role of voluntary plans.

In 1988, 59 percent of all nonfarm workers reported that their employers sponsored a "pension or retirement plan," down from 61 percent in 1979. However, some workers do not identify deferred profit sharing or stock plans or CODAs—plans that were relatively uncommon in 1979—as "pension or retirement" plans. Including these workers, in 1988 63 percent reported that their employers sponsored some kind of retirement plan. Taken together, these figures suggest that overall retirement plan sponsorship has remained nearly stable and may have edged up slightly. Nonetheless, by any measure, participation has fallen. While 50 percent of workers in 1979 reported participating in a "pension or retirement plan," by 1988 48 percent reported participating in a "pension or retirement" or "deferred profit sharing or stock" plan or CODA. Viewed another way, in 1988, 76 percent of workers who reported that their employer sponsored some kind of retirement plan participated, compared to 81 percent of workers who in 1979 reported that their employer sponsored a pension or retirement plan (see table).

Participation in Employer-Sponsored Retirement Plans

	All Nonfarm	Private Sector	Public Sector
Percentage of all workers reporting:			
Employer sponsors pension or retirement, 1979	61%	55%	87%
Employer sponsors pension or retirement, 1988	59	52	92
Employer sponsors pension or retirement, deferred profit sharing or stock plan, or CODA, 1988	63	57	93
Participating in pension or retirement, 1979	50	43	77
Participating in pension or retirement, 1988	44	38	77
Participating in pension or retirement, deferred profit sharing or stock plan, or CODA, 1988	48	42	78
Percentage of all workers whose employers sponsor plans reporting:			
Participating in pension or retirement, 1979	81%	79%	88%
Participating in pension or retirement, 1988	75	72	83
Participating in pension or retirement, deferred profit sharing or stock plan, or CODA, 1988	76	73	84

Source: EBRI tabulations of May 1979 and May 1988 Current Population Survey supplements.

Much of this growing rift between plan sponsorship and participation is probably attributable to the growing role of CODAs. Of all nonfarm workers who reported that their employer sponsors a plan in 1988, 43 percent were offered a CODA as either a primary or supplemental plan. Among all participants, 16 percent reported that a CODA served as their primary plan; another 16 percent reported participating in a supplemental CODA (see table).

	All Non-farm	Private Sector	Public Sector
% offered CODAs, of all workers at plan sponsors	43%	43%	42%
% with primary CODAs, of all retirement plan participants	16%	18%	11%
% with supplemental CODAs, of all ret. plan participants	16%	17%	14%

Source: EBRI tabulations of the May 1988 Current Population Survey employee benefit supplement.

Given that CODA participation is typically voluntary and contingent on employee contributions, it is not surprising that participation among employees of plan sponsors is lower in these plans (57 percent of such nonfarm workers in 1988) than in plans generally (76 percent). Also not surprising, participation in CODAs is skewed toward higher earners more than is participation in retirement plans generally. In 1988, nonfarm workers earning less than $20,000 annually accounted for 53 percent of all workers, 37 percent of all participants in any type of plan, and 25 percent of all CODA participants (see table).

	All Non-farm	Private Sector	Public sector
% participating, of all CODA-eligible workers, among:			
all workers	57%	59%	50%
those earning less than $20,000 annually	43%	44%	41%
those earning $20,000 or more annually	64%	67%	55%
% earning less than $20,000 annually, of:			
all workers	53%	54%	47%
all retirement plan participants	37%	35%	40%
all CODA participants	25%	25%	29%

Source: EBRI tabulations of the May 1988 Current Population Survey employee benefit supplement.

A final piece of evidence that the increasing role of voluntary CODAs has contributed to the growing rift between plan sponsorship and participation: among all nonfarm workers whose employers sponsored some type of plan in 1988, 7 percent opted not to participate, including 10 percent of those earning less than $20,000 annually and 5 percent of those earning more (see table).

	All Non-farm	Private Sector	Public Sector
% opting out, of workers at plan sponsors, among:			
all such workers	7%	8%	4%
those earning less than $20,000 annually	10%	12%	6%
those earning $20,000 or more annually	5%	6%	2%

Source: EBRI tabulations of the May 1988 Current Population Survey employee benefit supplement.

These statistics focus on how commonly employees of plan sponsors participate in any plan to any degree. But voluntary plans affect benefit accruals in at least two additional ways. First, CODAs are often supplemental plans. Workers who participate in a primary plan but elect not to contribute to a supplemental CODA accrue fewer benefits for retirement than they might otherwise. Second, while under traditional plans benefit accrual levels are predetermined by formulas, under CODAs participants can contribute as little or as much (subject to certain maximums) as they choose. Hence, the effect of voluntary plans on participation might be accompanied by a downward effect on the magnitude of benefit accruals among some participants. Evidence on the size of elective deferrals is discussed later in this testimony.

Voluntary Preservation

While participation in employer-sponsored retirement plans has decreased as a proportion of the work force, vesting has risen. But a large proportion of vested workers are eligible to receive all or part of their benefits in a lump sum upon separation from service prior to retirement.

Between 1979 and 1988, the proportion of all nonfarm workers reporting eligibility to receive benefits from a pension or retirement plan upon reaching retirement increased from 25 percent to 29 percent. Counting workers reporting eligibility for a retirement benefit or a lump sum from any employer-sponsored plan, 39 percent were vested in some way in 1988. Twenty-eight percent attributed at least part of their vesting to lump-sum eligibility; 8 percent were vested for a lump sum only. Thirteen percent of all workers reported that they had become vested for benefits at a past job; 7 percent had received a lump sum, and 6 percent had already received all of their vested benefits from past jobs as lump sums (see table).

Vesting in Employer-Sponsored Retirement Plans

	All Nonfarm	Private Sector	Public Sector
Percentage of all workers reporting:			
Could receive benefit at retirement age from pension or retirement plan, 1979	25%	21%	45%
Could receive benefit at retirement age from pension or retirement plan, 1988	29	24	54
Could receive benefit at retirement age or lump sum on separation from service, from pension or retirement, deferred profit sharing or stock plan, or CODA, 1988	39	33	69
Percentage of all workers in 1988 reporting:			
Any vested benefits at current job	39%	33%	69%
Eligible for lump sum upon separation from current job	28	23	54
Eligible for lump sum, but not retirement benefit, at current job	8	7	14
Any vested benefits from any past job	13	12	16
Received lump sum from any past job	7	7	9
Already received all vested benefits from past job(s) as lump sum(s)	6	6	8

Source: EBRI tabulations of May 1979 and May 1988 Current Population Survey supplements.

Lower earners receiving smaller distributions are less likely to preserve cash outs for retirement. An estimated 8.5 million civilian workers in 1988 had received a lump sum distribution in the past. The average lump sum amounted to an estimated $6,800, and if invested in a qualified retirement vehicle (such as an individual retirement account) could have grown to between $13,900 and $19,800 by the time the recipient reached age 65. Eleven percent of these recipients reported rolling their entire cash out into such a vehicle. Thirty-four percent spent the entire distribution. Smaller distributions and distributions received by lower earners were less likely to be saved. Five percent of those receiving less than $1,000 rolled over the entire amount; 43 percent spent it all. Among recipients earning less than $20,000 in 1988, 7 percent rolled it over and 36 percent spent (see table).[5]

[5]Lump sums received after the Tax Reform Act of 1986 (which imposed a 10 percent penalty tax on cash outs that are not rolled over) were somewhat more likely to be saved, with 18 percent of recipients rolling it all and 26 percent spending it all. Detailed findings on worker eligibility to receive preretirement lump sum distributions and the receipt and use of such distributions are presented in Joseph S. Piacentini, "Preserving Portable Pensions: An Analysis of Pension Participation at Current and

May 1988 Workers' Reported Uses of Prior Lump Sums

Percent using entire distribution as indicated:	Qualified retirement saving	Current Consumption
of all recipients	11%	34%
of those receiving less than $1,000	5%	43%
of those earning less than $20,000 in 1988	7%	36%

Source: EBRI tabulations of May 1979 and May 1988 Current Population Survey supplements.

Cash outs may erode retirement benefits. Baseline projections of future benefit payments from employer-sponsored retirement programs generally assume constant plan design within economic sectors. In particular, they assume that within each sector, cash outs will be no more available in the future than they are today. If instead lump sum cash outs were universally available (and roll over rates remained constant), then 70 percent of aged families would receive employer-sponsored benefits in 2020, compared to 77 percent under baseline assumptions; the average total benefit received by recipients would be $7,725 (in constant 1988 dollars), rather than $8,920.[6]

RETIREMENT SAVINGS DECISIONS AND THE ROLE OF CODAS AND IRAS

One often-cited policy purpose for the elective tax deferrals permitted under IRAs and salary reduction CODAs is to encourage and facilitate the achievement of retirement income adequacy for individuals whose other earmarked retirement assets

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Prior Jobs, Receipt and Use of Preretirement Lump-Sum Distributions, and Tenure at Current Job," *EBRI Special Report* No. 7, June 1990.

[6]Research currently underway at EBRI will explore the variation behind these averages. More mobile workers and those most likely to spend lump-sum distributions would face the greatest variation in eventual pension receipt depending on lump-sum availability. For a thorough discussion of projected future pension receipt see Emily S. Andrews and Deborah Chollet, "Future Sources of Retirement Income: Whither the Baby Boom," in Susan M. Wachter, ed., *Social Security and Private Pensions: Providing for Retirement in the Twenty-First Century* (Lexington Books: Lexington, MA, 1988). For details on the assumptions and methods underlying the projections reported here, see Lewin/ICF, *Pension and Retirement Income Simulation Model (PRISM): Key Assumptions,* draft documentation dated June 1991.

(generally entitlement to benefits from Social Security and nonelective employer-sponsored pensions) alone are insufficient. This testimony was asked to evaluate whether individual decisions regarding the use of these vehicles, particularly at younger ages and lower income levels, are consistent with this objective.

The evaluation offered here necessarily is less than definitive, for two reasons. First, a definitive evaluation would require comprehensive data on all individual resources for retirement and expected retirement needs; such data are not available. Second, it would require the acceptance of some subjective criteria for income adequacy, which is beyond the scope of this testimony. Nonetheless, data on IRA and CODA contribution decisions by income groups offer some insights.

Eligible Workers

Among eligible workers, CODAs are more popular than IRAs, at all income levels and ages. In 1987, 12 percent of eligible civilian workers aged 21 to 64 made deductible contributions to IRAs;[7] the following year 55 percent of eligible 1987 workers contributed to a salary reduction CODA.[8] Among eligible workers with 1987

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[7]Not all workers were eligible to make deductible contributions to IRAs in 1987, because the Tax Reform Act of 1986 restricted IRA deductions for workers with employer-sponsored pensions and income over certain thresholds. Affected workers remain eligible for nondeductible IRA contributions to the degree that they are restricted from making deductible contributions. (Some higher income workers remain eligible for deductible IRAs because they lack employer-sponsored pensions.)

In this discussion, workers eligible for salary reduction CODAs are compared to those eligible for deductible IRAs, because the tax incentives in these situations are most nearly the same. However, this approach may somewhat understate deductible IRA contributions relative to salary reduction CODA contributions, since workers excluded from eligibility for deductible IRAs are higher income workers, and higher income workers are more likely to contribute to IRAs. In 1982, when all workers were eligible for IRA deductions (and tax rates were higher), 18 percent of workers contributed. The effect of this bias is mitigated in the comparison of deductible IRA and salary reduction CODA contributions among eligible workers within income groups, which follows.

[8]Estimates of CODA eligibility and participation presented for comparison with IRAs differ slightly from those presented above for comparison with employer-sponsored plans generally, for two reasons. First, the former refer to 1987 civilian workers who were eligible for a CODA in 1988; the latter refer to 1988 nonfarm workers eligible for a CODA that year. Second, the former reflect imputed responses to

family incomes of less than $30,000 (in constant 1991 dollars) the proportions contributing were 7 percent to deductible IRAs and 39 percent to CODAs. Among those under age 35, the proportions were 6 percent and 47 percent.

While CODA participation is higher than deductible IRA participation among eligible workers at lower income levels, CODA participation—like IRA participation—rises with income. That is, eligible workers with higher incomes are more likely to participate in IRAs and CODAs than are those with lower incomes.

Only a small part of CODAs' superior popularity appears to be attributable to the matching contributions which employers commonly make to these plans. In CODAs lacking employer contributions, 52 percent of eligible workers contributed, including 34 percent of those with family incomes of less than $30,000 and 41 percent of those under age 35 (see table).

IRA and CODA Participation Comparison, Civilian Workers Aged 21-64

	IRA Participation			1988 CODA Participation Among Eligible 1987 Workers		
	Pre-TRA '86[a]	Post-TRA '86 all[b]	Post-TRA '86 eligible[c]	All	Employer contributes	No employer contribution
Participation Rates: Contributors as a Percentage of All Workers						
All Workers	18%	13%	12%	55%	56%	52%
Family Income (1991$)						
Less than $30,000	6	7	7	39	41	34
$30,000-$49,999	15	14	14	54	54	54
$50,000-$74,999	29	19	26	62	64	57
$75,000 or more	50	28	38	70	72	65
Age						
Under 35	8	7	6	47	49	41
35-54	22	16	14	59	60	56
55 or older	35	28	27	64	64	64

Source: EBRI estimates and projections based on Census Bureau data and Social Security Administration assumptions.

[a]1982, before the Tax Reform Act of 1986 (TRA '86) restricted IRA deductions for certain higher-inocme workers.

[b]All workers in 1987.

[c]Workers eligible for a $2,000 IRA deduction in 1987.

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survey questions where actual responses are missing; the latter reflect only actual survey responses as reported by the Census Bureau.

Given the popularity of even unmatched CODAs over deductible IRAs, high CODA participation rates may be attributable in part to psychology rather than economics. Unmatched CODAs and deductible IRAs provide similar economic opportunities for tax deferred retirement savings.[9] However, CODAs might be perceived as offering a more "painless" or more preemptive way of saving, through periodic salary reduction contributions, rather than out-of-pocket. Probably more important, employers who sponsor CODAs often make concerted efforts to persuade their employees to contribute. These efforts may reflect concern over employees retirement security and the desire to meet nondiscrimination requirements without restricting high-paid employees' contributions, among other factors. Provision of matching contributions and efforts to communicate plan features to employees are evidence that employers are concerned with participation levels. Sixty-four percent of CODA-eligible civilian workers in 1988 reported that their employer contributes to the plan.[10] CODA sponsors responding to a 1990 survey rated matching contributions and ease of payroll deduction as the greatest incentives for participation by non-highly compensated employees. But respondents also cited direct meetings with perspective enrollees as the best way to communicate enrollment information, and cited individual meetings and individual participant account statements (which periodically report account transactions and balances) as the most effective means of maintaining participant interest.[11] In a 1989 survey, 76 percent of responding CODA sponsors communicated their CODA to employees initially through employee meetings, 80 percent through individual explanations, and 88 percent through letters. Sponsors also commonly followed up communications efforts through employee

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[9]Although IRA contributions are generally subject to lower maximums, the treatment of the first $2,000 contributed is the same in both vehicles. Therefore, the participation decisions are economically similar, although decisions regarding contribution amounts are economically different.

[10]See Dallas L. Salisbury, "Individual Saving for Retirement—The 401(k) and IRA experiences," *EBRI Issue Brief* No. 95, October 1989.

[11]Massachusetts Mutual, *401(k) Survey Report,* 1990.

meetings (47 percent), individual explanations (65 percent), and letters (80 percent).[12]

The Work Force Overall

While among eligible workers CODAs are more popular than deductible IRAs, deductible IRA eligibility is more widespread, especially at lower income levels where it is generally universal.[13] Sixty-five percent of civilian workers were eligible for a $2,000 IRA deduction in 1987; the following year 29 percent of these workers were eligible for a salary reduction CODA. Among those with less than $30,000 in family income, 90 percent were eligible for an IRA deduction and 19 percent were eligible for a CODA. Higher income workers (with family incomes of $75,000 or more) were more likely to be eligible for a CODA (44 percent) and under current law less likely to be eligible for a fully deductible IRA (22 percent) (see table).

Worker Eligibility for Pre-Tax Retirement Savings: Eligible Civilian Workers Aged 21-64 as a Percentage of All Such Workers

	$2,000 IRA Deduction, 1987	CODA, 1988 (of 1987 Workers)
All Workers	65%	29%
Family Income (1991$)		
Less than $30,000	90	19
$30,000-$49,999	75	31
$50,000-$74,999	20	38
$75,000 or more	22	44
Age		
Under 35	74	27
35-54	56	31
55 or older	64	34

Source: EBRI estimates and projections based on Census Bureau data and Social Security Administration assumptions.

IRA and CODA participation in the work force overall reflects an interaction of two patterns: the distribution of participation among eligible workers, and the distribution of eligibility within the work force overall. Deductible IRA participation among eligible workers is lower than CODA participation, and skewed toward higher

[12]Data from Buck Consultants.

[13]Workers whose incomes fall below the specified thresholds are eligible for a $2,000 deductible IRA contribution as long as they earn $2,000 or more that year.

incomes; deductible IRA eligibility higher than CODA eligibility but is skewed toward lower incomes. CODA participation is higher than IRA participation and less skewed toward higher incomes; CODA eligibility is lower than deductible IRA eligibility and somewhat skewed toward higher incomes. The interaction of these patterns is further complicated by the nondeductible IRA contributions made by some higher income workers who are not eligible for deductible contributions.[14]

The interplay of these factors recently resulted, coincidentally, in distributions of IRA and CODA participation in the work force overall that were nearly the same. Among all 1987 civilian workers, 1987 IRA participation (including both deductible and nondeductible contributions) increased with incomes from 7 percent of those with incomes of less than $30,000 to 28 percent of those with incomes of $75,000 or more. The following year, CODA participation increased with incomes along a similar pattern from 8 percent to 31 percent. Workers with family incomes under $30,000 accounted for 20 percent of all 1987 IRA participants and 19 percent of all 1988 CODA participants; those with family incomes of $75,000 or more accounted for 21 percent and 20 percent, respectively (see table).[15]

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[14]Including those eligible for a nondeductible or partially deductible IRA contribution, 98 percent of workers with family incomes of $75,000 or more were eligible to contribute $2,000 to an IRA in 1987. Under current law, the proportion of workers eligible for a fully deductible IRA is falling. See Joseph Piacentini, "IRA Deduction Eligibility Falls under TRA '86," *EBRI Employee Benefit Notes,* Vol. 12 No. 5, May 1991; and Dallas Salisbury, "Statement Before the Committee on Finance, U.S. Senate, Hearing on Savings and Individual Retirement Accounts," 16 May 1991, EBRI Testimony No. T-79.

[15]Since 1987, middle-income workers' IRA deduction eligibility has fallen, and under current law will continue to fall. This may reduce IRA participation among this group. See Joseph Piacentini, "IRA Deduction Eligibility Falls under TRA '86," *EBRI Employee Benefit Notes,* Vol. 12 No. 5, May 1991. At the same time, CODA eligibility continued to increase after 1988. (See Joseph Piacentini, "U.S. Pension Trends and Implications for Portability and Preservation," a paper presented May 2, 1991 at an EBRI-ERF Policy Forum on "Pension Portability and Preservation: Assuring Adequate Retirement Income into the 21st Century.") CODA participation in all income groups may have risen as well.

IRA and CODA Participation Comparison, Civilian Workers Aged 21-64

	IRA Participation			1988 CODA Participation	
	Pre-TRA '86[a]	Post-TRA '86 all[b]	Post-TRA '86 eligible[c]	Eligible1987 workers	All 1987 workers
Participation Rates: Contributors as a Percentage of All Workers					
All Workers	18%	13%	12%	55%	16%
Family Income (1991$)					
Less than $30,000	6	7	7	39	8
$30,000-$49,999	15	14	14	54	17
$50,000-$74,999	29	19	26	62	24
$75,000 or more	50	28	38	70	31
Age					
Under 35	8	7	6	47	13
35-54	22	16	14	59	18
55 or older	35	28	27	64	16
Percentage Distribution of Contributors					
All Contributors	100%	100%	100%	100%	
Family Income (1991$)					
Less than $30,000	15	20	34	19	
$30,000-$49,999	26	30	39	31	
$50,000-$74,999	31	27	14	30	
$75,000 or more	28	21	11	20	

Source: EBRI estimates and projections based on Census Bureau data and Social Security Administration assumptions.

[a]1982, before the Tax Reform Act of 1986 (TRA '86) restricted IRA deductions for certain higher-inocme workers.

[b]All workers in 1987.

[c]Workers eligible for a $2,000 IRA deduction in 1987.

Retirement Income Adequacy

A definitive evaluation of whether IRA and CODA participation patterns are consistent with the policy objective of retirement income adequacy is not possible. However, there is some evidence that retirement planning may sometimes be secondary to other concerns in individuals' participation decisions.

For example, while employer matching contributions are associated with higher CODA participation, participation often remains less than universal even where substantial matches are offered, especially among non-highly compensated employees. That workers often forgo these substantial subsidies to retirement saving suggests that some workers' retirement saving decisions may be complicated by perceived lack of affordability—that is, an unwillingness to defer any portion of current pay, regardless of subsidy. CODA sponsors responding to a 1990 survey reported a participation rate of 76 percent for non-highly compensated employees offered 100 percent matching—

higher than the 51 percent reported for those offered no matching, but less than universal.[16] A definitive study found near universal participation (99 percent) in 401(k) CODAs among non-highly compensated employees offered 100 percent matching in 1986, but less than universal participation (65 percent) of those offered matches of between 75 percent and 99 percent.[17]

In addition, actual CODA participation appears to fall short of the savings intentions workers express. Seventy-nine percent of adults responding to a 1990 EBRI/Gallup survey on retirement planning said if offered, they would contribute to an unmatched CODA that did not provide preretirement cash outs. The actual CODA participation rate among eligible nonfarm workers in 1988 was 57 percent. The difference was particularly acute at younger ages and lower incomes. Among those aged 18-34, 79 percent of adults say they would contribute, while 49 percent of eligible workers contributed in 1988. Among those with family incomes of less than $20,000, 72 percent of adults say they would contribute, while 43 percent of eligible workers did contribute. Similarly, intentions expressed regarding the amount of contributions exceed the actual contributions made by participants. Among adults who say they would contribute, intended contributions averaged 10 percent of pay, compared to the average 6 percent of pay actually contributed by nonfarm CODA participants in 1988.[18]

The relationship between IRA and CODA contributions and retirement income adequacy is further complicated by the potential for preretirement consumption of IRA and CODA accounts. CODAs typically allow full cash outs upon separation from service,

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[16]Massachusetts Mutual, *401(k) Survey Report,* 1990.

[17]U.S. General Accounting Office, *401(k) Plans: Participation and Deferral Rates by Plan Features and Other Information,* GAO/PEMD-88-20FS, April 1988.

[18]Public attitude statistics are from "Public Attitudes on Retirement Income and Savings," and EBRI Poll conducted by the Gallup Organization, Inc. during September 1990, EBRI Report No. G-16. CODA participation and deferral rates are detailed in Joseph Piacentini, "High-Earners' Elective Deferrals Exceed Those of Low and Moderate Earners," *EBRI Notes,* Vol. 12 No. 3, March 1991.

and IRA balances can be withdrawn. (Despite the adverse tax consequences of premature distributions, more than one million workers accepted such a cash out between January 1987 and May 1988.[19]) Thus, in order for IRAs and CODAs to achieve the policy objective of bolstering retirement income security, participation must be accompanied by preservation.

SMALL FIRMS: A PERSISTENTLY LOW COVERAGE SECTOR

The relatively low levels of pension coverage found at small firms have long commanded the attention of policymakers. Yet despite policy efforts to encourage small employers to establish plans to cover their employees, generally no measurable progress has been made. This lack of progress suggests that small firms' relative reluctance to sponsor plans is rooted in circumstances that are resistant to policy intervention. This hypothesis is supported by research.

Plan Sponsorship Levels

Policymakers' concern about small firms is founded in fact. In May 1988, just 18 percent of private-sector nonfarm workers in firms with fewer than 25 employees reported that their employer sponsored any type of retirement plan. At larger firms, reported sponsorship was higher: 47 percent at firms with 29 to 99 employees, 62 percent at those with 100 to 249, and 83 percent at those with 250 or more.[20] Moreover, small-firm plan sponsorship appears to be falling. In 1988, 17 percent of nonfarm workers at firms with less than 25 employees reported that their employer sponsored a "pension or retirement" plan, compared with 21 percent in 1979.[21] In 1983, 68 percent of "core workers" (those aged 25 to 64 who work 1,000 hours or

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[19]Joseph S. Piacentini, "Preserving Portable Pensions: An Analysis of Pension Participation at Current and Prior Jobs, Receipt and Use of Preretirement Lump-Sum Distributions, and Tenure at Current Job," *EBRI Special Report* No. 7, June 1990.

[20]Joseph S. Piacentini and Michael A. Anzick, "Employee Benefits in Total Compensation," *EBRI Issue Brief* No. 111, February 1991.

[21]Joseph S. Piacentini, "Pension Coverage and Benefit Entitlement: New Findings from 1988," *EBRI Issue Brief* No. 94, September 1989.

more annually) who lacked this type of coverage worked for firms with 25 or fewer employees.[22]

Complexity, Flexibility, and the Prospects for Increased Sponsorship and Participation

There is broad consensus that since the enactment of ERISA in 1974, the rules governing the administration of retirement plans have become increasingly complex. Complex rules may discourage plan sponsorship, particularly among small firms, which do not enjoy the economies of scale in certain aspects of plan administration that large companies do. By 1991, the annual per-participant ongoing administrative cost of plans with 15 participants was $455 for defined benefit plans (up 181 percent in 10 years) and $228 for defined contribution plans (up 99 percent in 10 years). This compares with 500-participant plan costs of $133 for defined benefit plans (up 136 percent) and approximately $85 for defined contribution plans (up 56 percent). Thus, per-participants administrative costs generally are higher and have grown faster at smaller firms than at larger ones.[23]

Complexity in pension regulations often reflects attempts to reconcile policymakers' goals with employers' concerns. For example, policymakers generally strive to ensure that the tax benefits associated with retirement plans are broadly distributed among rank-and-file workers rather than concentrated among higher-paid employees, in accordance with their own subjective standards of equity and in light of associated federal revenue losses. Employers commonly seek to retain flexibility in designing the compensation structure for different employees or employee groups, considering labor productivity and labor costs. Policymakers, realizing that such

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[22]Emily S. Andrews, *Pension Policy and Small Employers: At What Price Coverage?* (Employee Benefit Research Institute: Washington, DC, 1989).

[23]Hay/Huggins Company, Inc., *Pension Plan Cost Study,* report prepared for the Pension Benefit Guaranty Corporation, September 1990.

employer concerns are related to plan sponsorship, strike compromises in the form of complex regulations specifying just how much flexibility is allowed.

The resulting complexity conflicts with another employer goal—the desire to control administrative costs. In a sense, because economies of scale help larger firms cope with administrative complexity, larger firms can buy some measure of flexibility more easily than can smaller firms.

In 1978, Congress established Simplified Employee Pensions (SEPs),[24] in response to the perception that complex administrative, record keeping, and reporting requirements were discouraging small employers from sponsoring retirement plans. SEPs were designed to allow simple administration, no routine reporting, and flexibility regarding the amount of contributions each year. In principal, a SEP can be operated with relatively little administrative cost. Yet despite these efforts, small-firm plan sponsorship has remained low. By 1990, just 1 percent of full-time workers at private establishments with fewer than 100 employees participated in a SEP.[25]

In numerous surveys, small employers cite regulatory and administrative burdens as a major impediment to plan sponsorship.[26] This is not surprising given the disproportionately high administrative costs facing small firms that sponsor traditional defined benefit plans or (to a lesser degree) traditional defined contribution plans. However, it raises the question: why are SEPs not more popular?

Part of the answer may reside in SEPs' lack of flexibility regarding the allocation of contributions among employees. With very limited exceptions, SEP

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[24]In 1986, this concept was expanded with the introduction of salary reduction SEPs, or a hybrid CODA and SEP.

[25]According to the U.S. Bureau of Labor statistics. See "BLS Reports on its First Survey of Employee Benefits in Small Private Establishments," U.S. Department of Labor, Bureau of Labor Statistics, *News,* USDL 91-260, 10 June 1991.

[26]Emily S. Andrews, *Pension Policy and Small Employers: At What Price Coverage?* (Employee Benefit Research Institute: Washington, DC, 1989).

sponsors are required to contribute to all employees' accounts in proportion to their pay, subject to certain maximums.[27]

While SEPs are relatively simple and inexpensive to administer, some small employers may find SEPs' lack of flexibility prohibitive. If employers view the provision of proportionate benefits to certain employees (for example, those expected to be short-term employees) as contributing little to labor productivity, they might view the cost of providing those benefits as an unacceptable regulatory burden. Regulatory burden, in this context, refers not to administrative complexity but to lack of flexibility. In other words, while SEPs may offer relief from the regulatory burden of administrative complexity for small employers, they carry the additional regulatory burden of reduced flexibility.

This testimony was asked to consider the potential for reduced complexity to bolster plan sponsorship and participation. The low popularity of SEPs suggests that simplicity alone is insufficient to spur small-firm plan sponsorship. Adding flexibility to simplicity might increase sponsorship, but the effect on participation is uncertain. If firms excluded many employees from flexible plans, participation could suffer, and policymakers' desire to distribute tax benefits broadly could be frustrated.

Economic Obstacles, Access to Information, and the Prospects for Increased Sponsorship and Participation

Along with regulatory burdens, what other factors underlie small-firms' low rate of plan sponsorship? And what types of policy tools might raise that rate, and along with it participation among small-firm employees? Research suggests that there are sound and substantial economic reasons why small employers rarely sponsor plans, and that policy tools that would increase sponsorship and participation in small firms are

[27] As a result of this rigid allocation criterion, SEP sponsors are spared the administrative burden of certain complex nondiscrimination requirements associated with other plans.

likely to be expensive. However, one factor that seems to affect plan sponsorship derives from profit-motivated private initiatives rather than government subsidies: the marketing of retirement plan products to employers by service providers. This last factor may be difficult to legislate.

The most important economic reason that small employers rarely offer plans is probably the overall lower compensation levels common to small employers. Nineteen percent of nonfarm workers at firms with fewer than 25 employees earned more than $20,000 annually in May 1988. This compares with 35 percent of workers at firms with 25 to 99 employees, 40 percent of those at firms with 100 to 249, and 50 percent of those at firms with 250 or more.[28]

Lower-paid employees typically face lower marginal tax rates than higher paid employees, and therefore have less incentive to defer income and taxes. In addition, given competing current consumption needs, they may be reluctant to defer a substantial portion of their pay, whether as elective contributions to a CODA or as automatic employer contributions to some other type of plan. Small employers may in turn be ill equipped to add retirement plan contributions on top of existing payroll, given tight or uncertain profit margins. Small firms that sponsor plans tend to be those with higher-paid, skilled work forces, according to one study.[29]

Low compensation is often associated with other economic factors that inhibit retirement plan sponsorship. For example, less skilled employees may be easier to replace, reducing emphasis on retention. And lower-paid employees may be younger or more loosely attached to the labor force; that is, they may be shorter-term employees. Retirement plans are often cited as retention tools. Moreover, because of gradual benefit

[28]Based on EBRI tabulations of the May 1988 Current Population Survey employee benefit supplement.

[29]Emily S. Andrews, *Pension Policy and Small Employers: At What Price Coverage?* (Employee Benefit Research Institute: Washington, DC, 1989).

accruals, vesting delays, and other plan design features, shorter-term employees generally tend to benefit less from retirement programs than do longer-term employees.

Because of low compensation, high administrative costs, and other economic circumstances facing small employers, direct government action could achieve large increases in plan sponsorship and worker participation at small firms only at substantial cost. For example, a tax credit of up to 14 percent of contributions[30] would have raised the 1987 participation rate in small private firms (with fewer than 25 employees) from 17 percent to 26 percent, and the overall participation rate from 41 percent to 44 percent, according to one estimate. The proposal would have cost the federal government $1.1 billion, or $380 per new plan participant, annually at 1987 levels. Making the tax credit refundable would raise the small-firm rate to 28 percent, at a cost of $1.7 billion.[31]

Despite the economic obstacles, however, there is evidence that private initiatives can sometimes accomplish what government subsidies either cannot accomplish or cannot accomplish alone. Research suggests that access to information on retirement plans may play a role in small employers' decisions. In one survey, plan sponsorship was related to the type of institutions that provided financial advice to the small firms.[32] This suggests that private marketing efforts by companies that provide retirement plan services can help spur plan sponsorship. Aggressive IRA marketing efforts that followed the extension of the IRA deduction to all workers in 1981 might well have contributed to the immediate and large increase in IRA contributions that followed. Similar efforts directed at large companies might have been an important

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[30]Such a tax credit was proposed, but not enacted, under the Small Business Retirement Benefit Extension Act of 1987 (S. 1496, H.R. 2793).

[31]Emily S. Andrews, *Pension Policy and Small Employers: At What Price Coverage?* (Employee Benefit Research Institute: Washington, DC, 1989).

[32]Emily S. Andrews, *Pension Policy and Small Employers: At What Price Coverage?* (Employee Benefit Research Institute: Washington, DC, 1989).

factor in the rapid growth of 401(k) CODA sponsorship that continued throughout the 1980s. And employer efforts to market CODA participation to rank-and-file employees likely contributes to the popularity of CODAs over IRAs among eligible employees.

POWER AND OTHER PROPOSALS TO STRENGTHEN EMPLOYER-SPONSORED RETIREMENT PROGRAMS

This testimony was asked to comment on the potential of POWER and other proposals to increase plan sponsorship among small firms, and to bolster future retirement security among today's low and moderate income workers. These two outcomes are not synonymous. Plan sponsorship is the first of many steps involved in fostering retirement security through employer-sponsored plans. In order to receive substantial benefits from employer-sponsored retirement plans, workers must work for plan sponsors. Next, either by means of elective contributions to a CODA or automatic employer or employee contributions to a nonelective plan, they must accrue substantial benefits. They must remain on the job long enough to meet any vesting requirements, so that benefits will be "portable" when they leave. Finally, they must preserve the value of their benefit to provide income up to and throughout retirement. The potential impact of POWER and similar proposals on future retirement income security must be assessed in view of effects on plan sponsorship, and the coincident prospects for participation, benefit accruals, portability, and preservation.

In general, the simplification provisions and relaxation of certain restrictions contained in current proposals would likely have a modest positive effect on small-firm plan sponsorship. Given the relaxed restrictions and the small size of uniform contributions required under some proposed simplified programs, the impact on participation and benefit accruals among low and moderate earners is likely to be more modest. Proposals to facilitate roll overs of benefit cash outs and to make less favorable the tax treatment of cash outs that are not rolled over could help foster preservation, but low and moderate earners receiving relatively small cash out would likely remain least likely to preserve these retirement assets. Hence, some of any increase in participation would result in the accrual and consumption of small benefits prior to retirement rather than the accumulation and preservation of substantial benefits for retirement.

Prospects for Increased Plan Sponsorship

At least four current proposals include provisions aimed at expanding retirement plan sponsorship, especially among small firms, through simplification and relaxation of restrictions. The Bush administration's POWER proposal in part would establish a new type of CODA for small firms. Firms with 100 or fewer employees would be exempt from CODA nondiscrimination rules that restrict the disparity between contributions made by or on behalf of highly compensated and non-highly compensated employees, provided that they contribute 2 percent of pay for all employees and have no other retirement plans. A bill entitled "The Pension Access Simplification Act of 1991" (H.R. 2730, introduced June 24 by House Ways and Means Committee Chairman Dan Rostenkowski) would provide similar relief in exchange for a uniform 3 percent contribution, and would simplify and relax nondiscrimination rules for all 401(k) CODAs. Two bills, each entitled "The Employee Benefits Simplification Act of 1991" (S. 1364, introduced June 25 by Senate Finance Committee Chairman Lloyd Bentsen on behalf of Sen. David Pryor, and H.R. 2641, introduced June 13 by Rep. Rod Chandler), would create safe harbors from 401(k) CODA nondiscrimination requirements for employers who provide certain contributions. The Pryor/Bentsen bill extends the safe harbor to employers providing uniform contributions equal to 3 percent of pay, or contributions that match nonhighly compensated employees' elective deferrals dollar for dollar on the first 3 percent of pay and 50 cents on the dollar on the next 2 percent. The Chandler bill's safe harbor would include employers that required all employees to defer 3 percent of pay, matched elective deferrals of up to 3 percent of pay dollar for dollar, or matched elective deferrals of up to 6 percent of pay 50 cents on the dollar.

Each of these proposals would likely have some positive effect on small-firm plan sponsorship. Safe harbors from 401(k) CODA nondiscrimination rules can help reduce the regulatory burdens associated with the administrative costs of complexity and restrictions on the allocation of employer and employee contributions. However, these positive influences on plan sponsorship would be mitigated by safe-harbor contribution requirements and other remaining obstacles to small-firm plan sponsorship.

Given the low popularity of current-law SEPs, it appears that simplicity alone is not sufficient to spur substantial increases in plan sponsorship. For purposes of expanding sponsorship, the proposed new plans differ from SEPs primarily in their allowance for greater flexibility in allocation of benefits. Because the proposals temper exemptions from nondiscrimination rules with certain contribution requirements, however, their effect on sponsorship is likely to be small.

All else equal, proposals that permit greater flexibility in allocation of benefits through less costly and less restrictive safe harbors from nondiscrimination tests, will likely add more plan sponsorship. For example, one of the safe harbors allowed under the Chandler bill—50 cents per dollar matching up to 6 percent of pay—would cost less than the uniform 3 percent of pay employer contribution required by the Rostenkowski safe harbor in all but the extreme case where all employees elected to defer 6 percent of pay or more. For this reason, the Chandler bill might add more new plans than the Rostenkowski bill.

Unfortunately, the magnitude of the effects of various proposals on plan sponsorship can not be estimated with confidence. Complete proposals typically include both provisions that foster sponsorship, such as simplification, and provisions that might discourage sponsorship, such as less favorable tax treatment of cash outs. Moreover, other federal policies, including tax rates, and economic factors, such as business cycles and compensation levels, also affect plan sponsorship decisions. However, given that (as noted above) substantial new tax subsidies have been estimated to only modestly increase plan sponsorship, the aforementioned proposals might have only limited impact on plan sponsorship.

In the face of such uncertainty, it is worth considering whether new policy initiatives might enjoy private assistance. Specifically, do service providers believe that the proposals will open up new markets? Vigorous marketing of retirement plan products to small firms by service providers could compliment new federal incentives, helping to spur plan formation.

Prospects for Increased Retirement Security

While the potential for increased plan sponsorship under current simplification proposals is modest, prospects for increased retirement security for low to moderate earners and employees of small firms are mixed. Retirement security prospects are complicated by participation, portability, and preservation issues. While these issues can be expected to moderate retirement security gains from any newly established plans, other aspects of current proposals might further the retirement security goals of both new and existing plans.

Because plan sponsorship does not ensure participation and accruals, proposals that relax nondiscrimination rules raise the potential for increased concentration of retirement plan tax benefits among higher-paid employees. However, by fostering plan sponsorship such proposals may increase opportunities for income and tax deferral for rank-and-file workers as well. The outcome would depend on individual deferral elections.

Proposals that provide safe harbors based on uniform contributions for all employees would essentially achieve 100 percent participation among employees of firms invoking the harbor. However, taken alone these contributions might be insufficient to provide a meaningful income supplement in retirement. For a worker earning $20,000 annually, a contribution of 2 percent (POWER) or 3 percent (Rostenkowski) would amount to $400 or $600, respectively, per year. Assuming pay and contributions increase with inflation and a real interest rate of 3 percent, after 20 years a worker would accumulate or 11,100 or $16,600, or enough for 15 annual inflation-adjusted payments $900 or $1,350, respectively (all in constant year 1 dollars). Proposals that allow safe harbors based on provision for matching contributions do not assure any accrual for rank-and-file workers. Therefore, the role of proposed simpler and more flexible CODAs in low and moderate earners' retirement income security depends on those workers' own deferral decisions.

Lower-paid workers do participate in elective CODAs in substantial numbers. Half of eligible nonfarm low and moderate earners contributed to CODAs in 1988, deferring an average of 6 percent of pay. Participation rates were slightly higher in plans to which firms also contributed.[33] This suggests that new simplified CODAs, if sponsored by firms that previously had no retirement plans, would mean participation and accruals for many additional low and moderate earners.

In this context, it is useful to distinguish simplification and flexibility proposals aimed at sectors where sponsorship is currently low, such as small firms, from those extended to all employers. The extension of safe harbors from nondiscrimination tests to existing plans which currently face these tests generally would not add to plan sponsorship or rank-and-file participation in the short run. (Some might contend that it would help ensure plan continuation in the long run). Instead, it might reduce the sponsoring firms' incentives to market CODA participation to their rank-and-file employees.

More generally, the establishment of new plans by former non-sponsors necessarily adds to participation. Even if participation in these new plans depends on elective salary deferrals, and no nondiscrimination standard is imposed, if eligibility is

[33]Joseph Piacentini, "High-Earners' Elective Deferrals Exceed Those of Low and Moderate Earners," *EBRI Notes,* Vol. 12 No. 3, March 1991.

extended broadly at least some additional participation among low and moderate earners will result. On the other hand, proposals that might help expand the role of CODAs among current plan sponsors, such as a universal relaxation of CODA nondiscrimination rules, might lower participation, particularly among lower earners who might elect to contribute little or nothing. In other words, expanding the role of CODAs in low-coverage sectors probably holds more promise for increased participation than does expanding the role of CODAs in high-coverage sectors.

If current proposals succeeded in adding to rank-and-file participation and accruals, the effect of this development on retirement security would depend on preservation. As noted earlier, lower earners receiving smaller cash outs are generally less likely than other participants to preserve their benefits for retirement, electing instead to forgo potential tax benefits and spend now. Because of this, proposals that allow for or emphasize flexibility might result in an allocation of new tax benefits and retirement security that is more concentrated among higher earners than participation is.

However, the new proposals contain provisions that might encourage more participants at all earnings levels to preserve retirement assets. For example, provisions to repeal 5-year forward averaging for lump-sum distributions, or to repeal transitional rules that permit 10 year averaging and other tax preferences for certain lump sums, would generally make preretirement consumption of these distributions less attractive. Other provisions that serve to ease or (in the case of the Pryor bill) require the roll over of certain distributions could further affect savings behavior. Such provisions might help foster retirement security for at least some participants, both in any new plans and in existing plans.

Yet, while rigid preservation provisions would certainly help target retirement assets and tax preferences toward retirement income supplementation, they might sometimes serve to thwart other policy goals. Workers who are reluctant to defer pay in the face of such restrictions might save less—possibly to the eventual detriment of their retirement security. Just as restrictions that seek to target tax benefits broadly among workers must be balanced with employer interests that determine plan sponsorship, so must restrictions that target tax preferences toward retirement income recognize individual interests that influence savings decisions.

CONCLUSION

POWER and other recently introduced simplification and coverage proposals recently introduced, whether deemed desirable or not, serve to focus attention on several important questions regarding the role of employer-sponsored retirement programs in future retirement income security. In this context, the proposals share many features. They draw attention to the persistently low-participation small-firm sector, and in so doing raise fundamental questions regarding plan sponsorship decisions. They confront the uneasy compromise between restrictions that target tax benefits and the flexibility that fosters plan formation. Historically these compromises have helped increase complexity; the new proposals strive to find compromises that offer greater simplicity. And they acknowledge and address the question of preservation of retirement assets. This testimony is intended not to advocate any particular alternative, but to frame these related issues, and fill in some relevant facts.