The Retirement Security Project

The Automatic 401(k):

A Simple Way to Strengthen Retirement Savings

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A Simple Way to Strengthen Retirement Savings

William G. Gale, J. Mark Iwry, and Peter R. Orszag

Executive Summary

In most 401(k) plans, workers do not participate unless they actively choose to. Under an automatic 401(k), they *would* participate unless they actively choose *not* to.

Over the past quarter century, private pension plans in the United States have trended toward a do-it-yourself approach, in which covered workers bear more investment risk and make more of their own decisions about their retirement savings. Some workers have thrived under this more individualized approach, amassing sizable balances in 401(k)s and similar plans, which will assure them a comfortable and relatively secure retirement income.

For others, however, the 401(k) revolution has fallen short of its potential. Work, family, and other more immediate demands often distract workers from the need to save and invest for the future. Those who do take the time to consider their choices find the decisions quite complex: individual financial planning is seldom a simple task. For many workers, the result is poor decision making at each stage of the retirement savings process, putting both the level and the security of their retirement income at risk. Even worse, in the face of such difficult choices, many people simply procrastinate and thereby avoid dealing with the issues altogether, which dramatically raises the likelihood that they will not save enough for retirement.

A disarmingly simple concept—what we call the "automatic 401(k)"—has the potential to cut through this Gordian knot and improve retirement security for millions of workers through a set of common sense reforms. In a nutshell, the automatic 401(k) consists of changing the default option at each phase of the 401(k) savings cycle to make sound saving and investment decisions the norm, even when the worker never gets around to making a choice in the first place. Given the current structure of most 401(k) plans, workers do not participate unless they actively choose to. In contrast, under an automatic 401(k) they *would* participate unless they actively choose *not* to—and similarly for each major decision thereafter. Contributions would be made, increased gradually over time, invested prudently, and preserved for retirement, all without putting the onus on workers to take the initiative for any of these steps. At the same time, however, workers would remain free to override the default options—to choose whether or not to save, and to control how their savings are invested—but those who fail to exercise the initiative would not be left behind.

The steps involved in building an automatic 401(k) are not complicated, and the benefits could be substantial; indeed, a growing body of empirical evidence suggests that the automatic 401(k) may be the most promising approach to bolstering retirement security for millions of American families. A number of economists have undertaken important research and contributed practical suggestions concerning the actual and potential uses of automatic enrollment and related default arrangements in 401(k) plans.[1] Drawing on their contributions, this policy brief describes the motivation for, the features of, and the potential benefits of the automatic 401(k).

In 2001 half of all households headed by adults aged 55 to 59 had $10,000 or less in an employer-based 401(k)-type plan or tax-preferred savings plan account.

had private retirement plan coverage obtained it chiefly from employer-sponsored, defined benefit pension plans, and to a lesser extent from defined contribution plans such as profit-sharing and money purchase plans. Since then, pension coverage has shifted away from these programs and toward new types of defined contribution plans, especially 401(k)s. In 1981 nearly 60 percent of workers with pension coverage had only a defined benefit plan, while just under 20 percent had only a 401(k) or other defined contribution plan. By 2001, however, the share having a defined benefit plan as their only plan had dropped to slightly over 10 percent, while the share having only a 401(k) or other defined contribution plan had risen to nearly 60 percent.

Conventional analyses tend to describe this solely as a trend away from defined benefit plans and toward defined contribution plans. Such a characterization tends to focus attention on the increased portability of pensions from one job to another and the shifting of investment risk from employer to employee. But perhaps an even more fundamental development is the extent to which the accumulation of retirement benefits under the plan has come to depend on active and informed worker self-management and initiative. Traditional defined benefit and profit-sharing plans require the covered workers to make almost no important financial choices for themselves before retirement.[2] The firm enrolls all eligible workers within a defined classification, makes contributions on their behalf, and decides how to invest those contributions (or retains professional investment managers to do so). A worker's only real choices are when and in what form to collect benefits. In 401(k)-type plans, in contrast, the burden of all these decisions rests with the employee.

The trend away from the traditional, employer-managed plans and toward savings arrangements directed and managed largely by the employees themselves, such as the 401(k), is in many ways a good thing. Workers enjoy more freedom of choice and more control over their own retirement planning. In some ways, however, this increasingly 401(k)-dominated system—both the process it has evolved into and the results it is producing—leaves much room for improvement.

Two Problems with Today's System

The most vivid manifestation of the shortcomings of today's private arrangements is the simple fact that many families approaching retirement age have meager retirement savings, if any.[3] In 2001 half of all households headed by adults aged 55 to 59 had $10,000 or less in an employer-based 401(k)-type plan or tax-preferred savings plan account. If the 36 percent of households who had no 401(k) or Individual Retirement Account (IRA) are excluded, the median balance for this age group was still only $50,000.

These households clearly have the option to save: most workers have accounts available to them in which they could save money on a tax-preferred basis for retirement, and any household lacking such an option could always contribute to an IRA. The problems lie elsewhere and are essentially twofold.

The first problem is that the tax incentives intended to encourage participation in employer-based retirement plans and IRAs consist primarily of deductions and exclusions from federal income tax. The immediate value of any tax deduction or exclusion depends directly on one's income tax bracket. For example, a taxpaying couple with $6,000 in deductible IRA contributions saves $1,500 in tax if they are in the 25 percent marginal tax bracket, but only $600 if they are in the 10 percent bracket.[4] The income tax incentive approach thus tends to encourage saving least for those who need to increase their saving most, and most for those who need to increase their saving least. In contrast, the Saver's Credit, enacted in 2001, provides a progressive government match for retirement savings by middle-income households. Other Retirement Security Project analyses examine ways to address the "upside-down" nature of existing tax incentives for saving, including through strengthening the Saver's Credit.[5]

The second problem, and the one addressed in this policy brief, is the set of complications involved in investing in a 401(k). Most 401(k)s place substantial burdens on workers to understand their financial choices and assume a certain degree of confidence in making such choices. Many workers shy away from these burdensome decisions and simply do not choose. Those who do choose often make poor choices.

The Complications of Participating in a 401(k)

A 401(k)-type plan typically leaves it up to the employee to choose whether to participate, how much to contribute, which of the investment vehicles offered by the employer to invest in, and when to pull the funds out of the plan and in what form (in a lump sum or a series of payments). Workers are thus confronted with a series of financial decisions, each of which involves risk and a certain degree of financial expertise.

To enroll in a 401(k), an eligible employee usually must complete and sign an enrollment form, designate a level of contribution (typically a percentage of pay to be deducted from the employee's paycheck), and specify how those contributions will be allocated among an array of investment options. Often the employee must choose from among 20 or more different investment funds. An employee who is uncomfortable making all of these decisions may well end up without any plan, because the default arrangement—that which applies when the employee fails to complete, sign, and turn in the form—is nonparticipation.

For those employees who do choose to participate, payroll deductions and associated contributions are made automatically each pay period, typically continuing year after year, unless the employee elects to make a change. Although the contributions continue over time, the traditional 401(k) arrangement does nothing to encourage participants to increase their contribution rates over time, or to diversify or rebalance their portfolios as their account balances grow. In other words, employees in a 401(k) not only must take the initiative to participate, they must further take the initiative to invest wisely and to increase their contribution rates over time.

Heavy reliance on self-direction in 401(k) plans made more sense when 401(k) plans were first developed in the early 1980s. At that time, they were mainly supplements to employer-funded defined benefit pension and profit-sharing plans, rather than the worker's primary retirement plan. Since participants were presumed to have their basic needs for secure

retirement income met by an employer-funded plan and by Social Security, they were given substantial discretion over their 401(k) choices. Today, despite their increasingly central role in retirement planning, 401(k)s still operate under essentially the same rules and procedures, based on those now-outmoded presumptions. Yet the risks of workers making poor investment choices loom much larger now that 401(k)s have become the primary retirement savings vehicle.

The Automatic 401(k): Key Features

The core concept behind the automatic 401(k) is quite simple: design a 401(k) to recognize the power of inertia in human behavior and enlist it to promote rather than hinder saving. Under an automatic 401(k), each of the key events in the process would be programmed to make contributing and investing easier and more effective.

- ***Automatic enrollment:*** Employees who fail to sign up for the plan—whether because of simple inertia or procrastination, or perhaps because they are not sufficiently well organized or are daunted by the choices confronting them—would become participants automatically.
- ***Automatic escalation:*** Employee contributions would automatically increase in a prescribed manner over time, raising the contribution rate as a share of earnings.
- ***Automatic investment:*** Funds would be automatically invested in balanced, prudently diversified, and low-cost vehicles, whether broad index funds or professionally managed funds, unless the employee makes other choices. Such a strategy would improve asset allocation and investment choices while protecting employers from potential fiduciary liabilities associated with these default choices.

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Would automatic 401(k)s boost net worth?

Automatic enrollment has been shown to increase participation rates in 401(k) plans, and automatic escalation has been shown to raise contribution rates and accumulations within 401(k)s over time. A promising topic for future research is the extent to which the added contributions due to these automatic features represent net additions to households' overall net worth and national savings. It could be that participants respond to automatic enrollment by decreasing their savings or increasing their borrowing outside of the plan.

It is plausible, however, that the net effects on both household wealth and national savings would be positive. Workers who become contributors through automatic enrollment tend to be younger and have lower incomes and less education than other participants. Evidence from the pension and 401(k) literature suggests that a significant portion of contributions by households with these characteristics is a net addition to household wealth and national savings.

- ***Automatic rollover:*** When an employee switches jobs, the funds in his or her account would be automatically rolled over into an IRA, 401(k) or other plan offered by the new employer. At present, many employees receive their accumulated balances as a cash payment upon leaving an employer, and many of them spend part or all of it. Automatic rollovers would reduce such leakage from the tax-preferred retirement savings system. At this stage, too, the employee would retain the right to override the default option and place the funds elsewhere or take the cash payment.

In each case – automatic enrollment, escalation, investment, and rollover – workers can always choose to override the defaults and opt out of the automatic design.[6]

The integrated strategy of using default arrangements to promote saving without sacrificing individual choice was first formulated by the U.S. Treasury in the late 1990s. The Treasury and the Internal Revenue Service (IRS) approved automatic enrollment for 401(k) plans in 1998 and first permitted automatic rollover in 2000. In 2001 Congress made automatic rollover mandatory for small lump-sum distributions, to take effect in March 2005. Both automatic enrollment and automatic rollover were designed also to lay the groundwork for automatic investment: both generally, by establishing the principle that pro-saving defaults should apply to major retirement decisions, and specifically, by requiring plans to prescribe default investments to be used in conjunction with automatic enrollment and automatic rollover.

It is worth stressing that none of these automatic or default arrangements are coercive. Workers would remain free to opt out at any point. More fundamentally, automatic 401(k)s do not dictate choices any more than does the current set of default options, which exclude workers from the plan unless they opt to participate. Instead, automatic 401(k)s

merely point workers in a pro-saving direction when they decline to make explicit choices of their own.[7] For example, the Treasury rulings authorizing automatic enrollment include provisions to ensure that employees retain control of enrollment and investment decisions. The plan must provide employees advance notice and an adequate opportunity to make their own, alternative choices before proceeding with the default arrangement. Similarly, under automatic rollover, employees have a variety of choices and must be given advance notice of those choices before the automatic arrangement takes effect.

Automatic Enrollment

Automatic enrollment has been shown to be remarkably effective in raising participation rates among eligible workers. Studies indicate that it boosts the rate of plan participation from a national average of about 75 percent of eligible employees to between 85 and 95 percent.[8] Particularly dramatic increases are seen among those subgroups of workers with the lowest participation rates. For example, one study found that, among employees with between 3 and 15 months, automatic enrollment increased participation from 13 percent

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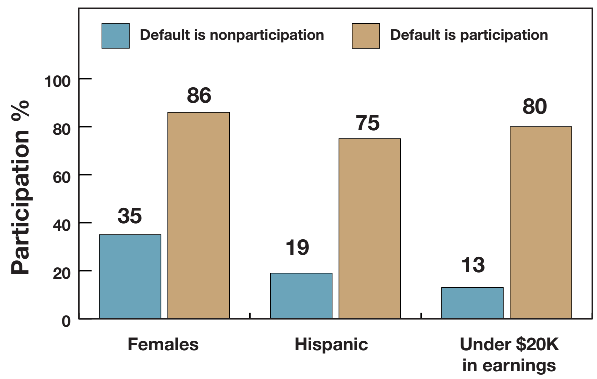
to 80 percent for workers with annual earnings of less than $20,000, and from 19 percent to 75 percent for Hispanics.[9]

Automatic enrollment can boost the rate of 401(k) plan participation to between 85 and 95 percent, with particularly dramatic increases among workers with the lowest participation rates.

Impact of 401(k) Auto Enrollment



Actual results from employees with between 3 and 15 months of tenure. Study by Brigitte Madrian, University of Pennsylvania's Wharton School, and Dennis Shea, UnitedHealth Group.

Despite its demonstrated effectiveness in boosting participation, only a small minority of 401 (k) plans today have automatic enrollment.

Interesting administrative variants exist that can accomplish much of what automatic enrollment does. One alternative would require that all employees make an explicit election to participate or not, rather than enroll them automatically if they make no election. In at least some cases this approach has produced participation rates in the same high range as for automatic enrollment.[10] In addition, firms could require that employees who opt out sign a statement acknowledging that they have read the plan's disclosures regarding the advantages of contributing.

Despite its demonstrated effectiveness in boosting participation, only a small minority of 401(k) plans today have automatic enrollment. According to a recent survey, 8 percent of 401(k) plans (and 24 percent of plans with at least 5,000 participants) have switched from the traditional "opt-in" to an "opt-out" arrangement.[11] As already noted, automatic enrollment is a recent development, and therefore it may yet become more widely adopted over time, even with no further policy changes. But policymakers could accelerate its adoption through several measures.[12] Some of these policy measures would be appropriate only if automatic enrollment were adopted in conjunction with other features of the automatic 401(k), especially automatic escalation, which are discussed further on page 8.

First, the law governing automatic enrollment could be better clarified. In some states, some employers see their state labor laws as potentially restricting their ability to adopt automatic enrollment. Although many experts believe that federal pension law preempts such state laws as they relate to 401(k) plans, additional federal legislation to explicitly confirm this would be helpful. Any such explicit preemption should be undertaken only to the extent necessary to protect employers' ability to adopt automatic enrollment.

Second, some plan administrators have expressed the concern that some new, automatically enrolled participants might demand a refund of their contributions, claiming that they never read or did not understand the automatic enrollment notice. This could prove costly, because restrictions on 401(k) withdrawals typically require demonstration of financial hardship, and even then the withdrawals are normally subject to a 10 percent early withdrawal tax. One solution would be to pass legislation permitting plans to "unwind" an employee's automatic enrollment without paying the early withdrawal tax if the account balance is very small and has been accumulating for a short period of time.

Third, Congress could give automatic enrollment plan sponsors a measure of protection from fiduciary liability if the default investment they have prescribed is an appropriate one, such as a "balanced" mutual fund that invests in both diversified equities and bonds or other stable-value instruments. The exemption from fiduciary responsibility would not be total: plan fiduciaries would retain appropriate responsibility for avoiding conflicts of interest, excessive fees, lack of diversification, and imprudent investment choices. However, it would provide meaningful protection from prosecution under ERISA (the Employee Retirement Income Security Act of 1974, the principal legislation governing employer pension plans), thus encouraging more employers to consider automatic enrollment.

Fourth, Congress could establish the federal government as a standard-setter in this arena by incorporating automatic enrollment into the Thrift Savings Plan, the defined contribution retirement plan covering federal employees. The Thrift Savings Plan already has high participation rates, and therefore the benefits to federal workers from its adopting automatic enrollment would be modest. But its adoption of automatic enrollment, along with the other pieces of the automatic 401(k), would serve as an example and model for other employers.

Finally, broader adoption of automatic enrollment and the other key pieces of the automatic 401(k) could be encouraged by reforming the regulations governing nondiscrimination in 401(k) plans. Many firms are attracted to automatic enrollment because they care for their employees and want them to have a secure retirement, but others may be motivated more by the associated financial incentives, which stem in large part from the 401(k) nondiscrimination standards. These standards were designed to condition the amount of tax-favored contributions permitted to executives and other higher-paid employees on the level of contributions made by other employees. They thus gave plan sponsors an incentive to increase participation among their less highly paid employees. Automatic enrollment is one way for them to do this.

In recent years, however, employers have had the option to satisfy the nondiscrimination standards merely by adopting a 401(k) "matching safe harbor" design. The matching safe harbor provision exempts an employer from the nondiscrimination standards that would otherwise apply as long as the firm merely *offers* a specified employer matching contribution. It does not matter whether employees actually take up the match offer—all that matters is that the offer was made. Indeed, the more employees contribute, the greater the employer's cost to match those contributions, without any compensating improvement in nondiscrimination results. By thus attenuating employers' interest in widespread employee participation in 401(k)s, the matching safe harbor provision presents perhaps the largest single obstacle to wider adoption of automatic enrollment.

To restore the attractiveness of automatic enrollment to employers, policymakers could change the rules to allow the matching safe harbor only for plans that feature automatic enrollment and the other key parts of the automatic 401(k) (especially the automatic escalation features discussed on page 8). Plan sponsors currently using the matching safe harbor could be given a transition period to meet the new requirements.[13]

One form of automatic escalation has been shown to lead to a substantial increase in 401(k) contribution rates over time among those participating.

Automatic Escalation

One potential problem with automatic enrollment, highlighted by recent research, is that it can induce some employees to passively maintain the default contribution rate over time, when they might otherwise have elected to contribute at a higher rate.[14] This adverse effect can be mitigated through automatic escalation, whereby contributions rise gradually and automatically over time (for example, from 4 percent of the worker's pay in the first year to 5 percent in the second, 6 percent in the third, and so on). For example, in the "Save More Tomorrow" program proposed by Richard Thaler and Shlomo Benartzi, workers would agree (or not) at the outset that future pay increases will generate additional contributions. In one trial, "Save More Tomorrow" was shown to lead to a substantial increase in contribution rates over time for those who participated, relative to other 401(k) participants at the same company. Alternatively, workers could agree to future contribution increases even in the absence of pay raises. Automatic escalation plans have been explicitly approved by the IRS in a general information letter obtained by one of the authors.[15]

Automatic Investment

A third key feature of the automatic 401(k) is automatic investment. In the accumulation phase of 401(k) retirement savings, too many employees find themselves confronted by a confusing array of investment options and lack the expertise, time, or interest to become expert investors. As a result, many 401(k)-type accounts fail basic standards of diversification and sound asset allocation: millions of workers are overconcentrated in their employer's stock or overinvested in safe but low-yielding money market funds.

Policies that encourage employers to provide sound default investments should increase retirement savings by improving investment performance. A key step to improving asset allocation choices would be to grant employers relief from selected fiduciary liabilities if they offer employees alternatives to mandatory self-direction, through either standardized investments, such as low-cost diversified balanced funds, or professionally managed accounts. Such a strategy would improve asset allocation and investment choices in 401(k) plans while protecting employers and preserving employees' rights to self-direct their accounts if they so choose.

Asset allocation choices could be improved by granting employers relief from selected fiduciary liabilities if they offer alternatives to mandatory self-direction, through either standardized investments or professionally managed accounts.

Two changes in legislation would greatly encourage automatic investment. First, Congress could designate certain standardized types of investments, the inclusion of which in a 401(k) would assure the employer a measure of fiduciary safe harbor treatment. That is, the employer would be immune from certain challenges for imprudence or lack of diversification to which they might otherwise be subject under ERISA. The definition of qualifying investments would remain broad: in addition to certain recognized stable-value investments, they would include balanced, prudently diversified, low-cost funds with a range of permissible allocations between equities and bonds. Plan sponsors would not be required to offer such investments, but they would be permitted to impose standard investments on all participants who make no other choice, or to include standard investments among participants' investment options.

Employers would have an incentive to use standard investments to the extent that doing so would provide fiduciary safe harbor protection. Indeed, the market might come to view investments that receive such favorable treatment as, in effect, enjoying a presumption of prudence. Use of presumptively prudent balanced or life-cycle funds as the default investment, in lieu of money market or stable-value funds or employer stock, seems likely, in turn, to improve investment returns for participants.

Second, Congress could make it clear that plan sponsors seeking protection from fiduciary liability may designate an independent professional investment manager to invest participants' accounts. This would free participants from having to manage their own accounts, although they could retain the option to do so. The plan sponsor and trustee would be exempt from fiduciary responsibility for investments appropriately delegated to an independent investment manager, except for the continuing responsibility to prudently select and monitor the manager (for example, to ensure reasonable fees). Such guidance from policymakers would likely accelerate the expansion of professional account management services, already an emerging trend. Like standard investments, professionally managed accounts would tend to ensure reasonable asset allocation and adequate diversification (including reduced exposure to employer stock), two key factors in raising expected returns and reducing risks.

Automatic Rollover

A similar automatic or default-based approach has already been applied to plan payouts before retirement, to limit leakage of assets from the retirement system. Currently, most people who receive distributions from 401(k) and similar plans take one-time cash payments. In general, the smaller this lump-sum distribution, the less likely it is to be saved by being transferred ("rolled over") to another employer plan or to an IRA. In fact, data suggest that, as of 1996, the median lump-sum distribution was $5,000, and a sizable majority of defined contribution plan participants who receive a lump-sum distribution of $5,000 or less do not roll it over to a qualified plan or IRA.[16]

For years, account balances of up to $5,000 could be involuntarily "cashed out," that is, paid to departing employees without their consent, and these payments were the least likely to be preserved for retirement. In 2000, however, a Treasury-IRS ruling permitted retirement plan sponsors to transfer such

Most defined contribution plan participants who receive a lump-sum distribution of $5,000 or less fail to roll it over to a qualified plan or IRA. Automatic rollover would ensure that more of those funds are saved.

Automatic rollover thus has the potential to help achieve a far broader expansion of retirement plan coverage for middle- and lower-income households.

amounts to an IRA established for a departing employee who did not affirmatively elect any other disposition of the funds. A year later Congress mandated such automatic rollover for distributions between $1,000 and $5,000. Under this legislation, scheduled to take effect in March 2005, plan sponsors may no longer force cash-out distributions of more than $1,000 on departing employees. Instead they are required to follow the employee's instructions either to transfer the funds to another plan or an IRA, pay the funds directly to the employee, or keep the funds in the plan if the plan permits that option. The individual thus has the choice to preserve or consume the retirement savings, but, if the individual makes no other choice, the default is preservation—either in the employer's plan, if the employer so chooses, or in an IRA that the employer opens for the employee. The employee must also be notified that, if the payout is automatically rolled over to an IRA, he or she may then roll it over to another IRA of his or her choice.

Automatic rollover was designed to have a potentially valuable byproduct, namely, the broader utilization of IRAs. Currently, fewer than 10 percent of those eligible to open and contribute to an IRA on a tax-preferred basis actually do so. Like enrolling in a 401(k), opening an IRA requires individuals to overcome inertia and to navigate their way through a number of decisions (in this case, choosing among a vast number of financial institutions and investments). Automatic rollover instead calls upon the employer to take the initiative to set up an IRA and choose investments on the employee's behalf, again unless the employee chooses to do so. The intended result is not only to preserve the assets within the tax-favored retirement plan universe, but also to create an expanding infrastructure of portable, low-cost individual accounts for the millions of workers who have no IRAs but who are covered at some point by an employer-sponsored retirement plan. Automatic rollover thus has the potential to help achieve a far broader expansion of retirement plan coverage for middle- and lower-income households. Indeed, this broader agenda is explicitly reflected in the automatic rollover legislation, which directs the Treasury and Labor Departments to consider providing special relief for the use of low-cost IRAs.

Eventually, leakage might be further limited by expanding automatic rollover to a wider array of distributions. However, for various reasons, any such expansion would need to be examined carefully. For one thing, in most cases, benefits in excess of $5,000 currently remain in the employer plan as the default arrangement that applies if the employee makes no explicit election regarding disposition of the funds.

Other Potential Components of the Automatic 401(k)

Alternative default options could also be considered for other aspects of retirement savings, including the form in which funds are paid out upon retirement. Current law reflects some preference for encouraging payouts to take the form of a lifetime annuity, which guarantees periodic payments for life (as opposed to a single cash payment, for example). Lifetime annuities are a sensible way to reduce the risk of retirees outliving their assets, yet few people purchase them. In defined benefit and money purchase pension plans, a lifetime annuity is generally the default mode of distribution. In contrast, 401(k) and most other defined contribution plans have been able for the most part to exempt themselves from such default requirements. Proposals to extend to 401(k) default arrangements (including spousal protection) similar to those of defined benefit and money purchase plans have been advanced and have generated lively debate.

Conclusion

A growing body of evidence suggests that the judicious use of default arrangements—arrangements that apply when employees do not make an explicit choice on their own—holds substantial promise for expanding retirement savings. The effects appear to be particularly promising for middle- and lower-income households, who have the greatest need to increase their savings. Retooling America's voluntary, tax-subsidized 401(k) plans to make sound saving and investment decisions more automatic, while protecting freedom of choice for those participating, would require only a relatively modest set of policy changes—and the steps taken thus far are already producing good results. Expanding these efforts will make it easier for millions of American workers to save, thereby promising greater retirement security for millions of American families.

About The Retirement Security Project

The Retirement Security Project is dedicated to promoting common sense solutions to improve the retirement income prospects of millions of American workers. The goal of The Retirement Security Project is to work on a nonpartisan basis to make it easier and increase incentives for middle- and lower-income Americans to save for a financially secure retirement.

The Retirement Security Project is supported by The Pew Charitable Trusts in partnership with Georgetown University's Public Policy Institute and the Brookings Institution.

Footnotes

[1] Particularly notable contributions have been made by Brigitte Madrian, Dennis Shea, James Choi, David Laibson, and Andrew Metrick; by Richard Thaler and Shlomo Benartzi; and by Alicia Munnell and Annika Sundén. See the citations of their work elsewhere in this policy brief.

[2] In this sense, traditional private pensions may be characterized less by their defined benefit structure—in fact, many were defined contribution profit-sharing and money purchase plans—than by the fact that employers took the initiative to fund and manage the plans, bearing most of the risk and making most of the decisions for their employees. For a discussion of these developments, including the shift from defined benefit to defined contribution plans, see J. Mark Iwry, "Defined Benefit Pension Plans," Testimony before the House Committee on Education and the Workforce, Subcommittee on Employer-Employee Relations, June 4, 2003.

[3] For a broader discussion of these issues, see William G. Gale and Peter R. Orszag, "Private Pensions: Issues and Options," in *Agenda for the Nation*, edited by Henry J. Aaron, James M. Lindsay, and Pietro S. Nivola (Brookings, 2003), pp. 183-216; Peter R. Orszag, "Progressivity and Saving: Fixing the Nation's Upside-Down Incentives for Saving," Testimony before the House Committee on Education and the Workforce, February 25, 2004; and J. Mark Iwry, "Defined Benefit Pension Plans," Testimony before the House Committee on Education and the Workforce, Subcommittee on Employer-Employee Relations, June 4, 2003. These and other related publications are available on The Retirement Security Project website (www.retirementsecurityproject.org).

[4] Some of this difference may be recouped when the contributions are withdrawn and taxed, if families who are in lower tax brackets during their working years are also in lower tax brackets during their retirement.

[5] William G. Gale, J. Mark Iwry, and Peter R. Orszag, "The Saver's Credit" (The Retirement Security Project, March 2005; available at www.retirementsecurityproject.org).

[6] See Alicia Munnell and Annika Sundén, *Coming Up Short: The Challenge of 401(k) Plans* (Brookings, 2004).

[7] In other words, automatic 401(k)s are an example of what Cass Sunstein and Richard Thaler have called "libertarian paternalism." See Cass R. Sunstein and Richard H. Thaler, "Libertarian Paternalism is Not an Oxymoron," *University of Chicago Law Review* 70, no. 4 (2003): 1159-1202; and Richard H. Thaler and Cass R. Sunstein, "Libertarian Paternalism," *American Economic Review (Papers and Proceedings)* 93, no. 2 (2003): 175-79.

[8] Brigitte Madrian and Dennis Shea, "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior," *Quarterly Journal of Economics* 116, no. 4 (November 2001): 1149-87; and James Choi and others, "Defined Contribution Pensions: Plan Rules, Participant Decisions, and the Path of Least Resistance," in *Tax Policy and the Economy*, Vol. 16, edited by James Poterba (MIT Press, 2002), pp. 67-113.

[9] Madrian and Shea, "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior," table 5.

[10] James Choi and others, "Active Decisions: A Natural Experiment in Savings," Working Paper, Harvard University, August 2003.

[11] Profit Sharing/401(k) Council of America, *47th Annual Survey of Profit Sharing and 401(k) Plans* (2004).

[12] Although some have raised the question of whether automatic enrollment should be a *required* feature of 401(k) and similar types of plans, the pros and cons of such a proposal are beyond the scope of this brief.

[13] Richard Thaler and Shlomo Benartzi, "Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving," *Journal of Political Economy* 112, no. 1, pt. 2 (2004), S164-S187.

[14] James Choi and others, "For Better or For Worse: Default Effects and 401(k) Savings Behavior," in *Perspectives in the Economics of Aging*, edited by D. Wise (University of Chicago Press, 2003), pp. 81-121.

[15] General information letter from Internal Revenue Service to J. Mark Iwry, March 17, 2004.

[16] J. Mark Iwry and Jack VanDerhei, "Lump Sum Distributions," Testimony before the House Committee on Education and the Workforce, Subcommittee on Employer-Employee Relations, July 1, 2003.

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Mission Statement

The Retirement Security Project is dedicated to promoting common sense solutions to improve the retirement income prospects of millions of American workers.

The goal of The Retirement Security Project is to work on a nonpartisan basis to make it easier and increase incentives for middle- and lower-income Americans to save for a financially secure retirement.

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