Analysis of the Pension Protection Act of 2006: Increasing Participation Through the Automatic 401(k) and Saver's Credit

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Automatic 401(k) - Policy Objectives	Pension Protection Act of 2006	RSP Evaluation
Promote auto enrollment and auto investment by --		
Affirming State laws do not preclude or restrict auto enrollment. Background: These "anti-garnishment" laws are designed to prevent employers or others from making inappropriate/involuntary deductions from employees' pay.	Yes The new law provides that federal law (ERISA) preempts such State laws to allow employers in all States to automatically deduct 401(k) contributions from employees' paychecks.	The law removes a concern that made some private sector employers nervous about adopting auto enrollment. Congress, however, should make sure the law also applies to nonprofit employers with non-ERISA 403(b) (tax deferred annuity) plans as well as State and local government plans.
Allowing retroactive "unwind" of auto enrollment for auto enrolled employees who request it within a short time. Background: 401(k) withdrawal restrictions will commonly prevent the return of automatic contributions; and if contributions could be returned, they could trigger a 10% early withdrawal tax.	Yes The legislation allows plans to return automatic contributions to employees without withdrawal restrictions or a 10% early withdrawal tax if an employee so requests within 90 days of joining the plan.	The new law removes another concern that had made some employers hesitant to adopt auto enrollment: what to do if automatically enrolled employees say they didn't realize they were being automatically enrolled and ask for their money back.
Giving plan sponsors greater comfort re fiduciary liability for asset-allocated default investments as well as independent professionally managed accounts Background: 401(k) sponsors get partial protection from potential fiduciary liability for investment decisions that employees affirmatively direct. Some employers have been concerned about auto enrollment jeopardizing this protection where auto enrolled employees accept the employer-designated default investment (i.e., without taking affirmative action).	Yes The legislation directs DoL to issue regulations specifying certain default investments that won't deprive employers of the fiduciary protection for employee-elected investments. These would be "default investments that include a mix of asset classes consistent with capital preservation or long term capital appreciation." These are generally understood to include balanced funds, life cycle funds and managed accounts).	This is an important step forward. Employers will now have comfort that if they follow these investment guidelines they will have no more fiduciary liability than they currently have with employees choosing their own investments. DoL has already written the proposed regulation, currently pending at OMB, reportedly covering balanced and life cycle (target maturity) funds and managed accounts. As regulations are developed and refined they should include provisions that encourage low cost highly diversified revisions of the default investments.

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Maintain employers' financial incentives to encourage the majority of employees to save. Background: Current 401(k) nondiscrimination standards seek to align management's interests with the interests of the majority of employees and of U.S. taxpayers who tax-subsidize 401(k) plans. The nondiscrimination standards link executives' ability to enjoy larger tax-preferred benefits to the employer's success in encouraging or providing greater benefits for the majority of employees. Auto enrollment powerfully enhances this win-win 401(k) feature by improving participation by average and lower-paid workers and thereby permitting executives to contribute more on a tax-preferred basis.	No The new exemption from nondiscrimination standards breaks the usual linkage between the amount of tax-preferred saving allowed for executives and the amount saved by most workers. Executives' 401(k) benefits would no longer depend on how much most workers save. The new exemption from the nondiscrimination standards is conditioned on auto enrollment at 3% of pay (at least), escalating 1% a year up to 6%, and an employer offer of matching contributions conditioned on employee contributions (100% of first 1% of pay, 50% of next 5% of pay, vesting after 2 years). Under the new exemption, even if most employees don't participate or save very little, that will not affect how much executives can put away on a tax-favored basis.	This exemption is unnecessary and could be counterproductive. It could take away an employer's financial incentive to encourage low-income workers to save. Under the new exemption, (i) employees lose the benefit of the nondiscrimination linkage, (ii) the employer matching obligation could actually make employers discourage participation because the more employees save, the more the employers must spend to match their savings, and (iii) there is no evidence that auto enrollment would work to encourage participation where greater participation would cost the employer more without at the same time improving nondiscrimination results and thereby enabling executives to save more. The legislation would have been better without this exemption.
Encourage auto enrollment for existing employees who are not participating (in addition to new hires) Background: The House bill would have replaced nondiscrimination safeguards for all employees with auto enrollment of newly hired employees only, while the Senate bill, in the same context, would have required auto enrollment of all employees.	Yes The nondiscrimination exemption is conditioned on auto enrollment of not only new hires but also existing employees, except those existing employees who were eligible to participate before the employer adopted the automatic contribution arrangement and who made an affirmative/explicit election (either to participate or to refrain from participating).	It is best to encourage participation by extending automatic enrollment to existing employees who are not participating – at least those who did not previously make an affirmative/explicit election to opt out – and that is what the legislation requires of employers that use the nondiscrimination exemption.
Encourage automatic escalation of contributions Background: Increasing the automatic contribution percentage over time helps prevent inertia from keeping employees at the initial automatic contribution rate even though they might have saved more but for automatic enrollment	Yes The new nondiscrimination exemption is conditioned on automatic annual 1% increases in the rate of employee contributions up to 6% of pay.	For plans that use the nondiscrimination exemption, automatic escalation up to 6% of pay will be required. For plans that do not use the exemption, the exemption provision provides a reminder that auto escalation of contributions is permitted. However, In either case, auto escalation should go above 6%, which is slightly below the average 401(k) contribution.

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Discourage use of employer stock (and employer real estate) as default investments for employee contributions. Background: Too many 401(k) accounts are overly concentrated in employer stock, subjecting workers' retirement security and job security to the same risk.	No	Employer stock generally should be discouraged as a default investment for employee contributions, subject to appropriate transition/grandfathering of existing balances (for example, where an employee's account is turned over to a professional investment manager) and exceptions for modest percentages.

Saver's Credit - Policy Objectives	Pension Protection Act of 2006	RSP Evaluation
Make Saver's Credit permanent	Yes The Saver's Credit was scheduled to sunset after 2006, but the legislation makes it permanent together with all of the other EGTRRA pension provisions.	The Saver's Credit levels the playing field for moderate- and lower-income households in lower tax brackets by basing the incentive on the amount saved (a credit) rather than giving larger tax benefits to those in higher tax brackets (the deductions and exclusions that comprise other pension tax preferences).
Make Saver's Credit refundable and thereby available to an additional 50 million lower-income households	No	The Saver's Credit was originally designed to be refundable -- so as to be available to workers who pay payroll taxes but have no income tax liability -- and to be deposited to the IRA or 401(k) account. But it was enacted in 2001 without refundability and not as a savings deposit. Instead it offsets the taxpayer's income tax liability. It needs to be made refundable, preferably in the form of a deposit to the IRA or 401(k).
Eliminate multiple credit rates and "cliffs" (sharp drops in the credit rate as income exceeds a given level)	No The Saver's Credit has 10%, 20% and 50% credit rates. Eligibility for each rate depends on income, but without a gradual transition between rates.	The Saver's Credit was originally designed with a single 50% credit rate. Congress cut it to save money by introducing 10% and 20% rates for most eligible households, reducing the incentive and complicating the credit. The credit should be restored to its original design: a single, simple 50% credit, phased out smoothly above the income eligibility limit.

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Extend eligibility to additional middle-income households	No	The Saver's Credit was originally designed for households with joint income up to about $70,000, roughly those in the 15% or lower tax brackets, because they get little incentive from the traditional deductions or exclusions whose value depends on one's tax bracket. Congress in 2001 cut the Saver's Credit to save money by limiting it to those with incomes below $50,000, but that limit should be increased.
Index income (adjusted gross income or "AGI") eligibility limits for inflation	Yes The 10% credit is available for those with AGI below $50,000; the 20% credit for those with AGI below $32,500, and the 50% credit for those with AGI below $30,000 (figures for married filing jointly). All 3 dollar limits will be indexed.	This was a necessary change to prevent inflation from shrinking the group of households eligible for the credit.

Expand Coverage - Policy Objectives	Pension Protection Act of 2006	RSP Evaluation
Expand retirement savings coverage to the half of the work force - some 71 million workers - who have no access to an employer plan	No Except for the Saver's Credit provisions, the Act generally does little to expand coverage to the half of the work force who have no access to an employer plan.	This is the next step: the RSP-Heritage Foundation Automatic IRA proposal would build on the success of the automatic 401(k) and employer plans to extend payroll deposit savings to most of the 71 million. See www.retirementsecurityproject.org for Mark Iwry and David John testimony to the Senate Finance Committee describing the proposal.

For further information on the Retirement Security Project's policy proposals, see www.retirementsecurityproject.org

The Retirement Security Project is supported by The Pew Charitable Trusts in partnership with Georgetown University's Public Policy Institute and the Brookings Institution. It is led by Peter R. Orszag, J. Mark Iwry, and William G. Gale. RSP works on a nonpartisan basis to promote common sense solutions to improve the retirement income prospects of middle- and lower-income Americans.