TESTIMONY BEFORE THE

HOUSE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON SELECT REVENUE MEASURE

ON

THE ROLE OF INDIVIDUAL RETIREMENT ACCOUNTS IN OUR RETIREMENT SYSTEM

June 26, 2008

WASHINGTON, D.C.

WITNESS: Dr. Leobardo Estrada
Member, AARP Board of Directors

For further information
Contact: Frank Toohey
Government Relations and Advocacy
(202) 434-3764

Mr. Chairman and members of the Subcommittee, My name is Leobardo Estrada, I am a member of the AARP Board of Directors. I am here today to testify on behalf of our more than 39 million members, AARP is the largest organization representing the interests of Americans age 50 and older and their families. About half of AARP members are working either full-time or part-time.

Thank you for convening this hearing on the role of individual retirement accounts in our retirement system. We appreciate this opportunity to urge support for legislation that would significantly expand the use of the Individual Retirement Accounts (IRA) by extending payroll deduction coverage to the millions of workers currently unable to save for retirement through the workplace.

AARP thanks you Mr. Chairman and the ranking minority member of the Subcommittee, Mr. English, for introducing H.R. 2167, the Automatic IRA Act of 2007. We also appreciate the support of the other members of the Subcommittee on Select Revenue Measures who have cosponsored the Automatic IRA Act of 2007, including Reps. Blumenauer, Emanuel, Schwartz, Larson, and McDermott.

Auto IRA and Its Importance

The Automatic IRA is an innovative, bipartisan, common sense idea that can help the millions of workers who do not have an employer sponsored retirement income vehicle to save for retirement. The Automatic IRA Act of 2007 proposes a simple but practical mechanism to expand dramatically retirement savings for workers who are not currently offered an employer-provided retirement plan. The bill would require employers to offer employees the opportunity to save for retirement through the payroll process.

The automatic IRA would feature direct payroll deposits to a low-cost, diversified individual retirement account. Most employees not covered by an employer-sponsored retirement plan would be offered the opportunity to save through the powerful mechanism of regular payroll deposits that continue automatically (an opportunity now limited mostly to 401(k) plan eligible workers). Employees would choose whether or not to take advantage of this simple effective savings vehicle.

Employers with 10 or more employees that have been in business for at least two years but that do not sponsor any plan for their employees would be called upon to offer employees this payroll-deduction saving option. These employers would receive a temporary tax credit for simply serving as a conduit for saving, by making regular payroll deposit available to their employees.

Employers making direct deposit or payroll deduction available would be protected from potential fiduciary liability and from having to choose an IRA or arranging default investments. Instead, diversified default investments and a handful of standard, low-cost investment alternatives would be specified by statute and regulation. Payroll deduction contributions would be transferred, at the employer's option, to a central repository, which would remit them to IRAs designated by employees or, absent employee designation, to a default collective retirement account.

This approach involves no employer contributions, no employer compliance with qualified plan or ERISA requirements, and, as noted, no employer liability or responsibility for selecting investments or an IRA provider, or for opening IRAs for employees. By capitalizing on the existing IRA system, the legislation also steers clear of any adverse impact on employer-sponsored plans or on the incentives designed to encourage firms to adopt new plans. In fact, this proposal could draw some small employers into the private pension system.

Auto IRAs appeal to workers and employers alike
According to research and surveys conducted by AARP, 84 percent of AARP members and 76 percent of Americans age 50 and over would like to have a workplace IRA as an option to help people save for retirement. AARP has been reaching out to small business owners and asking them how they view this legislation. The response has been very positive. Small business owners recognize the need to help their employees save for retirement. Mr. Gary Kousan of Allentown, PA, reflects the views of many small business owners. When AARP asked him to comment on why it was important to help his 15 employees save and plan for a secure retirement, he said:

"Because I didn't do it myself. My son works for me now and if I had started saving when I was his age, I would be in a much better position now. I understand how important it is. The Auto IRA is so convenient. As long as my employees can opt out, it's a great system. It's difficult in a business this size to offer any significant perks. Health insurance is so expensive, gas is almost $5 a gallon. Auto IRA allows me to offer my employees something."

In January 2008, Prudential released a report, "Saving for Retirement At Work: Employee and Business Reactions to an Automatic IRA Concept," that surveyed 214 businesses (with 10 or more employees, in business 2 or more years, with no current retirement plan) and found that 8 out of 10 businesses surveyed support the adoption of the Auto-IRA concept. Specifically, businesses perceive strong program value to both themselves and to their employees:

- 80% of the employers appreciate the lower level of administration and believe the proposal is well-positioned to overcome prior barriers of excessive administration cost
- 89% of employers believe the Auto-IRA proposal will help their employees save. 77% think it's affordable for their employees and 77% say it will be easy for employees to understand

The Uncovered
AARP believes that it is important for this committee and others to understand more about the uncovered population. According to the Internal Revenue Service, an estimated 79 million U.S. workers are not participating in a retirement plan in their workplace.[1] Many of these workers are employed by businesses that do not offer a retirement plan. For those who work for an employer with a retirement plan, many may not be eligible to participate in that plan.

[1] Calculations based on data found in Bryant, Victoria, "Accumulation and Distribution of Individual Retirement Arrangements, 2004," *Statistics of Income Bulletin*, Spring 2008, 90-101. The IRS estimates that 145 million workers file a tax return, but only 66 million make contributions to qualified workplace retirement plans, as reported on their Forms W-2. The 145 million workers includes only those eligible to contribute to an IRA; i.e., those under age 70 and a half with earned income, and older taxpayers with earned income and modified AGI under the Roth IRA limit.

The lack of access to a workplace-based retirement savings plan is particularly acute for employees of small businesses. Only 45 percent of employees of small employers (those with less than 100 employees) have access to an employer retirement plan.[2]

While Individual Retirement Accounts are generally available to these workers as an alternative to a workplace-based retirement savings program, the data show that a very small percentage (about 10 percent) of people eligible to contribute to an IRA actually make contributions in any given year[3]. As a result, a significant segment of the U.S. workforce does not save systematically for retirement.

Research indicates that most employees favor saving automatically through regular payroll deductions -- this is especially true for more moderate income persons. Studies have also shown that automatic enrollment programs provide a way of improving retirement savings by using the so-called "power of inertia" to change non-savers into savers. Automatic enrollment requires workers to elect "not" to participate in a retirement savings program, rather than requiring them to take specific action to participate. Participation rates in employer retirement savings plans are significantly higher when automatic enrollment is utilized.

Automatic IRAs are designed to fill the void for private sector workers who do not have access to a workplace-based retirement savings program.[4] Automatic IRAs would make payroll deduction IRAs available to all workers who do not have access to an employer retirement plan. In addition, Automatic IRAs would utilize automatic enrollment to ensure that a greater number of workers actually participate in the program.

The Workers Most Likely to Participate in Automatic IRAS

Since the 1980s, the percentage of private sector workers participating in employer-sponsored retirement plans has remained fairly stable, hovering around 50 percent.[6] Internal Revenue Service (IRS) tabulations of tax return data suggest that an estimated 79 million U.S. workers out of 145 million workers are not participating in a retirement plan in their workplace. Many of these workers do not participate because they do not have access to a plan in their workplace. Other workers may have access, but are either ineligible to participate in the plan or choose not to participate.

---

[2] "National Compensation Survey: Employee Benefits in Private Industry in the United States, 2007." U.S. Department of Labor, U.S. Bureau of Labor Statistics. Summary 07-05, August 2007.

[3] Bryant, supra.

[4] Employers currently can make payroll deduction IRAs available to their workers. The Congressional Budget Office estimates that approximately 7 percent of workers have access to this feature. See Congressional Budget Office, "Utilization of Tax Incentives for Retirement Saving: Update to 2003," *Background Paper* (Washington, D.C., March 2007).

[5] *National Compensation Survey: Employee Benefits in Private Industry in the United States, March 2007.* Summary 07-05. U.S. Department of Labor, U.S. Bureau of Labor Statistics, August 2007. Paid employment consists of full and part-time employees, including salaried officers and executives of corporations, who were on the payroll in the pay period including March 12. Included are employees on sick leave, holidays, and vacations; not included are proprietors, self-employed, unpaid family or volunteer workers, farm workers, and domestic workers. http://www.bls.gov/ncs/ebs/sp/ebsm0006.pdf . This survey is a survey of establishments. The survey data represents approximately 108 million private industry workers, 83 million of whom are full-time workers. For purposes of this survey, agriculture, private households, aircraft manufacturing, State and local governments, and the Federal government are excluded.

Of the 79 million taxpayers who do not have access or choose not to participate in an employer retirement plan, not all will be eligible to participate in Automatic IRAs. Very small employers, new employers, government employers and churches would not be required to offer an Automatic IRA. In addition, employers could elect to exclude employees under age 18, nonresident aliens, and certain other employees from eligibility for Automatic IRAs. Thus, it is estimated that approximately 50.2 million workers would be *eligible* to participate in an Automatic IRA program through their employers, in 2009.[6] In addition, the total number of workers who are eligible for Automatic IRAs at some point during their working career is likely to be much higher because of job mobility.

Demographic Characteristics of Eligible Automatic IRA Savers

Because the percentage of private sector workers covered by an employer-sponsored retirement plans has remained around 50 percent since the 1980s, this suggests that the converse – the percentage of workers ***not covered*** by an employer-sponsored retirement plan – also has remained stable. The characteristics of the uncovered workforce have also remained fairly stable, as well.

The Government Accountability Office (GAO) released one of the few studies to focus on workers not covered by an employer-sponsored retirement plan.[7] They identified the most common characteristics of these workers during the ten-year period from 1988 to 1998. GAO found that about 85 percent of uncovered workers shared one or more characteristics. Generally, they were more likely to have lower incomes (81 percent); worked part-time or part-year (79 percent); worked for a small employer (82 percent); or were younger than 30 years of age (76 percent).

The characteristics identified by the GAO remain prevalent today among the uncovered workforce as documented by the Federal Reserve Board Survey of Consumer Finance (SCF) and Bureau of Labor Statistics, National Compensation Survey (NCS). Analysis of the 2004 SCF by the Congressional Research Service and the AARP Public Policy Institute confirms the GAO finding that lower income, part-time work status, employer size, and age were important determinants of workplace retirement savings coverage.[8] The 2004 data also indicate that white workers were more likely than others to have coverage. For example, 56 percent of white workers but only 30 percent of Hispanic and Latino workers had coverage at their current or a previous job, and 68 percent of white workers but only 33 percent of Hispanic and Latino workers had either pension coverage though employment or an IRA or Keogh account. In addition, the SCF suggests that full-time workers were 2.5 times more likely than their part-time counterparts to have workplace retirement coverage.

The approximately 50.2 million workers who will be *eligible* to participate in an Automatic IRA program (shown in Table 1 and Graph 1, below) are likely to share the characteristics of

[6] See Schmitt, Mary M. and Judy A. Xanthopoulos, supra. for derivation of estimate for 2007. Current estimates updated using most recently published SOI tables for tax year 2005. As the number of workers increases over time, the number of eligible participants will also increase.
[7] U.S. General Accountability Office, GAO/HEHS-00-131, "Characteristics of Person in the Labor Force Without Pension Coverage," Report to Congressional Requesters, August 2000.
[8] Patrick Purcell, "Retirement Savings and Household Wealth: Trends from 2001 to 2004." CRS Report for Congress, RL30922, updated may 22, 2006.

the workforce described in these studies. The Automatic IRA proposal will encourage many of those not covered by an employer-sponsored retirement plan to begin saving for their retirement. The importance of introducing so many workers to retirement savings cannot be underestimated, since both the GAO and SCF studies indicate that individuals without retirement assets are less likely to have other forms of financial assets.[9]

Estimating Eligible Automatic IRA Savers by Income Class

Automatic IRAs will likely become the primary source of retirement savings for many lower-income workers. Estimates indicate that 50 percent of workers eligible for Automatic IRAs will have adjusted gross income of no more than $20,000 per year. The estimated income distribution and estimated average annual contribution by income level of individual taxpayers eligible for Automatic IRAs are presented in Table 1 and Graph 1, below.

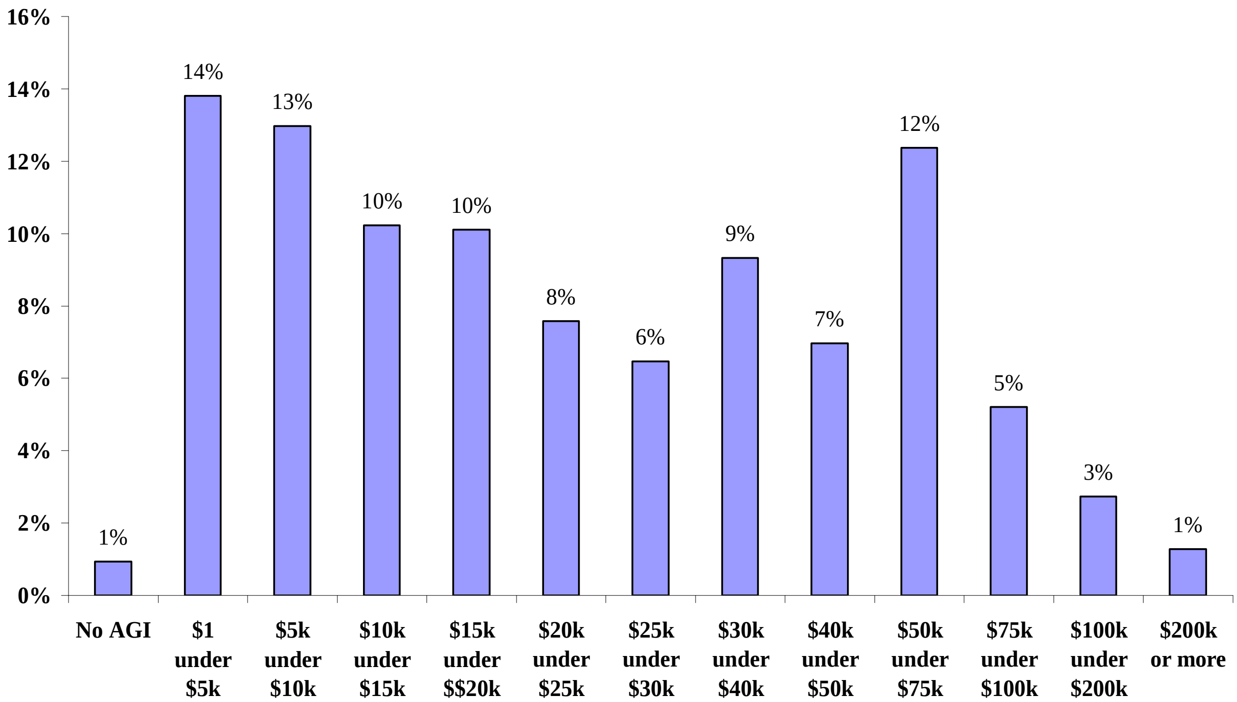
The estimated average Automatic IRA contribution reflects an assumed default contribution rate of 3 percent of the average wages for an individual in a given income class. This estimate assumes that most employers would provide the default deferral rate, at least in the short run after Automatic IRAs are first enacted. This rate is consistent with the default deferral rate for automatic enrollment in 401(k) plans.

[9] Brian K. Bucks, Arthur B. Kennickell and Kevin B. Moore, “Recent Changes in U.S. Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finance,” Federal Reserve Board, Survey of Consumer Finance, 2006.

Table 1 – Estimated Distribution of Taxpayers *Eligible* for Automatic IRAs in 2009 and Estimated Average Contributions **Source: Estimates based on published IRS SOI Tables**		
Adjusted Gross Income	**Estimated Number of Taxpayers** ***(in thousands)***	**Estimated Annual Contribution to Automatic IRA for an individual** ***(average dollars, per person, per year)***
No AGI	470	$ - 0 -
$1 under $5,000	6,940	$ 75
$5,000 under $10,000	6,520	$ 225
$10,000 under $15,000	5,140	$ 375
$15,000 under $20,000	5,080	$ 525
$20,000 under $25,000	3,810	$ 675
$25,000 under $30,000	3,250	$ 825
$30,000 under $40,000	4,690	$ 1,050
$40,000 under $50,000	3,500	$ 1,350
$50,000 under $75,000	6,210	$ 1,875
$75,000 under $100,000	2,620	$ 2,625
$100,000 under $200,000	1,370	$ 3,000
$200,000 under $500,000	450	$ 3,000
$500,000 under $1,000,000	120	$ 3,000
$1,000,000 or more	80	$ 3,000
Total Eligible for Automatic IRAs (Not Participants)	50,250	

The average contributions to Automatic IRAs are likely to increase as employers utilize automatic increases in the contribution rates to increase retirement savings. Studies have shown that employer 401(k) plans with automatic increases in contribution rates improve the rate of retirement savings over time.

Graph 1 Automatic IRA, Estimated Eligible Taxpayers by Adjusted Gross Income



Source: Schmitt and Xanthopoulos, supra.

The Likely Savings Behavior of Automatic IRA Participants

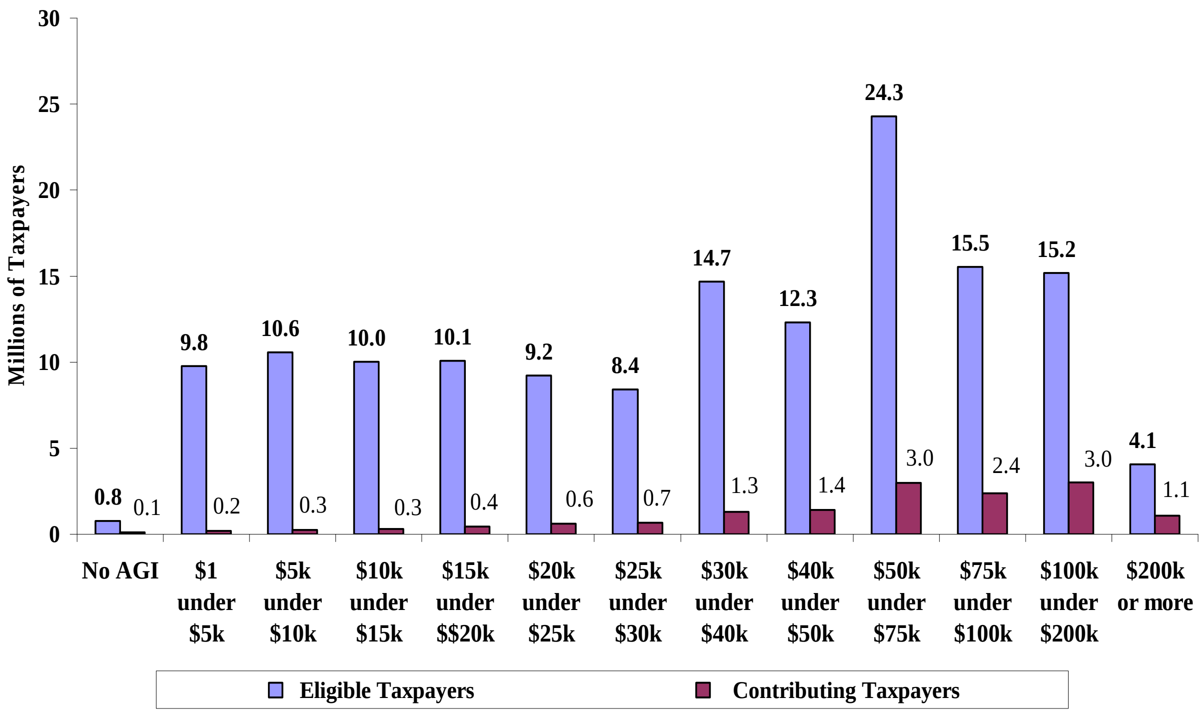
It is difficult to estimate with any certainty what the response to Automatic IRAs might be. Unlike existing IRAs that have particularly low levels of participation among lower-income taxpayers, Automatic IRAs may be structured more like a 401(k) plan with automatic enrollment. If employers embrace the automatic enrollment structure for Automatic IRAs and utilize scheduled automatic increases in contribution rates, Automatic IRAs have the potential to create significant increases in retirement savings among the low and moderate income workers who are least likely to be saving for retirement now.

While IRA participation under current law hovers around 10 percent of those eligible, typically around 85 percent of workers eligible for any employer-sponsored retirement plan participate.[10] This suggests workplace-based access to Automatic IRAs would increase participation substantially, filling an important gap in retirement savings coverage. The low participation in current law IRAs suggests that many individuals have difficulty saving on their own. The Automatic IRA would overcome this difficulty by creating a small regular contribution with every pay period.

[10] US Department of Labor, Bureau of Labor Statistics, National Compensation Survey: Employee Benefits in Private Industry in the United States, March 2006, page 1.

Graph 2 Eligible Taxpayers and Taxpayers Contributing to All IRAs, by AGI, Tax Year 2004

Source: IRS SOI, Accumulation and Distribution of IRAs, 2004



Accumulated Benefits

As Automatic IRA savings participation increases for uncovered workers, the potential for greater accumulated balances grows. Automatic IRAs would help to provide a bridge in retirement plan coverage for mobile workers who move from job to job and would make it more likely that workers will accumulate retirement savings over their full working career. Table 2 shows how dramatically total savings can increase over a working career.

If an individual has only five years until retirement, that person might expect to accumulate approximately $4,500 if they defer $750 per year (or 3 percent of salary for a worker earning $25,000). However, deferring the same amount, a younger person might expect to accumulate approximately $62,900 saving continuously for 30 years.

Increasing contributions with consistent, continuous savings would produce significantly greater savings balances. If an individual has only five years until retirement, that person might expect to accumulate approximately $18,000 if they defer $3,000 per year. However, deferring the same amount, a younger person might expect to accumulate approximately $251,500 saving continuously for 30 years.

Table 2 – Sample Account Balances for Selected Annual Contribution Amounts and Selected Years of Participation
(Rate of Return = 6 percent, Amounts rounded up to the nearest $100)

	$750	$1,000	$2,000	$3,000
5 years	$ 4,500	$ 6,000	$ 12,000	$ 18,000
10 years	$ 10,500	$ 14,000	$ 28,000	$ 42,000
15 years	$ 18,600	$ 24,700	$ 49,400	$ 74,100
20 years	$ 29,300	$ 39,000	$ 78,000	$ 117,000
25 years	$ 43,700	$ 58,200	$ 116,400	$ 174,500
30 years	$ 62,900	$ 83,900	$ 167,700	$ 251,500

The Saver's Credit

The Saver's Credit will interact with Automatic IRAs by providing an additional incentive for low- and moderate-income workers to save. The current law Saver's Credit increases the incentives for low and moderate-income individuals to make retirement savings contributions by providing an annual income tax credit of up to 50 percent of $2,000 of contributions to qualified retirement savings plans. As such, the Saver's Credit could provide a boost to retirement savings participation by the lower income taxpayers targeted to benefit from Automatic IRAs. However, nonrefundability and the rapid phase-out of the current-law credit tend to reduce its effectiveness.

Nonrefundability of the credit – Nonrefundability of the Saver's Credit significantly limits the benefit of the credit for the low-income taxpayers who could most use it. In a recent analysis of the Saver's Credit, Gary Koenig and Robert Harvey found that many taxpayers are ineligible for the full 50-percent Saver's Credit rate because of nonrefundability of the credit.[11] They found that 43 percent of taxpayers claiming the Saver's Credit in 2002 had the amount of their credit limited by nonrefundability. Further, they estimated that 89 percent of taxpayers who made retirement savings contributions eligible for the Saver's Credit would have had their credit limited by nonrefundability if they had made the maximum contribution permitted.[12]

Income levels of the credit – The 50 percent credit rate is reduced to 20 percent, 10 percent, and zero as income rises. The income levels at which the Saver's Credit is available limits the effectiveness of the credit for many taxpayers. For 2008, the 50 percent credit rate is available for married couples filing a joint return with adjusted gross income of not more than $32,000 ($16,000 in the case of a single individual); the income levels at which the 20-percent and 10-percent credit rates are reduced are $34,500 and $53,000, respectively, for married couples filing jointly ($17,250 and $26,500, respectively, for single individuals). Expansion of the

[11] Koenig, Gary and Harvey, Robert. *Utilization of the Saver's Credit: An Analysis of the First Year.* National Tax Journal, Vol. LVIII, No. 4, December 2005.
[12] According to Koenig and Harvey's calculations, taxpayers claimed $1.058 billion in Saver's Credits for 2002, but were eligible to claim $1.752 billion. This translates to a claimed rate of 60 percent.

income levels would encourage more middle-income taxpayers to utilize the Saver's Credit and would provide a more meaningful savings incentive for lower-income taxpayers.

Cliff effects of the Saver's Credit – There is no income phase-out for the Saver's Credit rates; rather, the credit rate falls from 50 to 20 percent (or from 20 to 10 percent, or from 10 percent to zero) with the addition of just one more dollar of income earned. These income cliffs have the effect of imposing a high marginal tax rate on taxpayers who have income just above the cliff level. Cliffs also make it difficult for taxpayers to know whether they will be eligible for a credit, and if so, at what rate, before filing their tax return. Changing the income cliffs to a gradual income phase-out would do much to smooth the effects of these high marginal tax rates and eliminate uncertainty, and would make the Saver's Credit more consistent with most other tax incentives that phase out for higher income levels.

Improvements to the Saver's Credit to correct these drawbacks would make the Automatic IRA even more effective in increasing retirement savings among low and moderate-income workers.

Conclusion

Automatic IRAs create the potential help for finally filling the gaps in retirement savings coverage in the United States. Automatic IRAs will be particularly beneficial to many low-wage workers who do not currently have access to an employer-sponsored retirement plan.

While it is difficult to predict how successful Automatic IRAs might be in bridging the gap in retirement plan coverage faced by half of the U.S. workforce, evidence suggests that design features that encourage automatic enrollment could lead to substantial rates of participation even among lower-income workers. Enhancements to the Saver's Credit might further improve the chances that these lower-income workers will have both the means and the incentive to contribute toward their retirement savings.