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The Perfect Storm of Retirement Insecurity: Fixing the Three-Legged Stool of Social Security, Pensions, and Personal Savings

Stephen F. Befort†

Sebastian Junger authored a highly acclaimed book in 1997 entitled *The Perfect Storm*. He tells the story of a fishing boat based out of Gloucester, Massachusetts, that was lost at sea near Newfoundland during a 1991 Halloween nor'easter. *The Perfect Storm* chronicles the unique mix of meteorological forces that coalesced to create a once-in-a-century maelstrom of devastating proportions.

Another potential perfect storm threatens the financial well being of future retirees in the United States. As with the Halloween nor'easter, this storm has the potential to cause exceptional damage due to the confluence of a unique set of circumstances. This time, however, the forces at work are actuarial rather than meteorological.

Two factors are principally responsible for the looming retirement insecurity storm. First, the coming generation of retirees will be large and long-lived. The retirement of the baby boom generation will create a retiree cohort historically un-equalled in size. Continued increases in life expectancies prompt many analysts to anticipate that this cohort will have a retire-

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2. *Id.* at 5, 90–92, 166–67.
3. *Id.* at 107–16.
ment span that also is beyond that experienced by any prior generation. The financial burden on the smaller contingent of working taxpayers to support this retiree group will be immense.4

Second, a growing proportion of American workers are financially unprepared for retirement. The components of a financially secure retirement are often analogized to a three-legged stool.5 The financial platform of the stool is supported by three legs representing three sources of retirement income: (1) Social Security, (2) private pension plans, and (3) individual savings and assets. Observers have rightly focused considerable attention on the impending depletion of the Social Security Trust Funds. But less well known, yet also vitally important, are the precarious deficiencies in projected retirement assets in the form of employer-sponsored pensions and personal savings for a large segment of current workers. Shortfalls are forecast for all three legs of the retirement stool, making the financial prospects for many future retirees more shaky than secure.

Fortunately, actuarial forces are less immutable than meteorological forces. Although the retirement insecurity problems are significant, there is still time to avoid the perfect storm by taking the steps necessary to shore up the retirement safety net. Until recently, however, Congress lacked the political will to take meaningful action. While both political parties championed certain reforms, neither party was willing to engage in the give-and-take necessary to craft what by necessity will be a package of likely unpopular reforms.

The recently enacted Pension Protection Act of 2006 (PPA),6 however, offers a glimmer of hope. This highly complicated piece of legislation was forged in the give and take of a conference committee during the summer of 2006. Although the Act is far from perfect, it contains a number of largely beneficial changes to the U.S. pension system. Perhaps more importantly, it represents the type of bipartisan effort that will be needed to produce a full-blown package of reforms addressing all three legs of the retirement stool.

4. See infra notes 27–37 and accompanying text.
With the potential storm of retirement insecurity intensifying and drawing nearer with each passing year, the time has come for Congress to build upon its experience with the PPA and to acknowledge the difficult reality that a restoration of retirement security will require a combination of higher taxes, reduced benefits, and enhanced regulatory oversight. Fortunately, the pain associated with embracing these solutions is far less serious than the pain associated with continuing inaction. As this Article illustrates, the retirement safety net can be secured without systemic upheaval or considerable hardship, but through a practical agenda of modest reforms.

Toward that end, this Article recommends a three-step reform agenda: (1) adopting a mix of tax increases and benefit reductions, including a slight rise in the retirement age, that would eliminate the projected Social Security Trust Fund deficit while still preserving the integrity of Social Security’s critical social insurance function; (2) making changes in the default settings for defined contribution pension plans that would both encourage plan participation and improve plan security; and (3) enacting a modest refundable tax credit that would encourage low- and middle-income wage earners to save for retirement, whether in a defined contribution plan or in a personal savings account. While these steps would not stave off the oncoming demographic changes in the retirement population, they would significantly enhance the United States’ ability to meet that challenge with a sturdy retirement security platform.

This Article proceeds in two parts. Part I reviews the current status of retirement security in the United States. More particularly, this part identifies the underlying problems with each of the three legs of the retirement stool that threaten the financial security of future retirees. Part II then turns toward a discussion of the possible responses for avoiding the perfect storm scenario. After exploring various alternatives and reviewing the principal changes wrought by the PPA, the Article lays out a three-step reform plan designed to reinvigorate Social Security, private pensions, and personal savings so as to provide shelter from the impending storm.

I. THE CURRENT STATUS OF RETIREMENT INSECURITY

Most American retirees rely on three principal income streams in order to finance their retirement years. These three income streams are Social Security benefits, pension plan bene-
fits, and accumulated private savings and assets. As demonstrated below, each of these income streams is projected to provide substantially less than optimal resources for the next generation of retirees.

A. SOCIAL SECURITY

Social Security is a government-sponsored defined benefit program that provides approximately 40% of the total income that current retirees receive. From a budgetary standpoint, Social Security is the single largest program of the federal government with an annual outlay in excess of $500 billion or approximately 23% of total federal spending. First adopted in 1935 as a tool to alleviate poverty among the elderly, Social Security is a hybrid program that includes both an income maintenance objective and an earned insurance-based entitlement objective.

Social Security is a near-universal program; more than 90% of all Americans over the age of sixty-five receive benefits, either directly by virtue of having paid payroll taxes on at least ten years of earnings, or indirectly by virtue of being disabled or having an eligible spouse. As of 2004, about forty-eight million Americans received Social Security benefits, while 159 million American families paid taxes into the system. The average Social Security benefit amount payable to retirees as of December 2004 was $955 per month. The actual payment de-
pends upon the beneficiary's past earnings; the calculation is based on a progressive formula designed to replace a larger share of earnings for low income as compared to high income earners.¹⁴

The benefit amount also varies according to a worker's age at retirement. While people traditionally view age sixty-five as the normal retirement age at which full benefits are payable, a 1983 amendment is gradually increasing the full benefit age over time so that it will rise to age sixty-seven by 2022.¹⁵ Workers may retire as early as age sixty-two and receive an actuarially reduced benefit (currently 22% below that of full benefit age), while workers who retire later than the full benefit age receive an annual 8% boost for each year of deferred retirement until they reach the age of seventy.¹⁶

Social Security benefits are financed primarily through a tax on earnings that is credited to the Social Security Trust Funds. Employees and employers each pay a payroll tax of 6.2% of earnings up to a maximum taxable earnings base which is adjusted annually to reflect the growth in average wages.¹⁷ The base was set at $90,000 for 2005, meaning that contributors did not pay payroll taxes on individual earnings above that amount.¹⁸ In addition to the payroll tax, a far smaller revenue stream is provided by the partial taxation of Social Security benefits received by higher income retirees.¹⁹

Notably, the Social Security Trust Funds are not active investment accounts, but primarily serve as an accounting mechanism that tracks Social Security revenues and expenditures. The Trust Funds hold no actual funds and do not refund future Social Security benefits. Instead, Social Security is a pay-as-you-go system that funds benefits out of current tax revenues.²⁰

¹⁸. SOC. SEC. ADMIN., supra note 11, at 11, 14.
¹⁹. Id. at 20.
²⁰. CONG. BUDGET OFFICE, supra note 10, at 26–28; June E. O'Neill, Why
The good news from an accounting standpoint is that the Social Security Trust Funds are currently maintaining a positive $1.5 trillion balance.\(^{21}\) The bad news is that a budgetary train wreck is looming on the horizon. The 2005 Annual Report of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds Board of Trustees provides a snapshot of the problem.\(^{22}\) Beginning in 2017, total Social Security benefit outlays will exceed projected tax revenues.\(^{23}\) This negative balance will worsen over time; the result will be that the combined Social Security Trust Fund will be fully exhausted by 2041.\(^{24}\) By then, only current tax revenues will pay Social Security benefits, and these revenues will finance just 74\% of scheduled payments.\(^{25}\) Over the course of the seventy-five-year projection period, Social Security will fall $4 trillion short of the funding necessary to maintain current benefit levels.\(^{26}\)

Much of this shortfall has to do with projected demographic changes affecting the size of the benefit-receiving cohort as compared with the size of the taxpayer, wage-earning cohort. Two principal factors are affecting this equation. The first is increasing life spans. When the government set the retirement age at sixty-five in 1937, the average American life expectancy was only sixty-three years.\(^{27}\) Today, life expectancy in the United States is about seventy-seven years.\(^{28}\) Life expectancy at age sixty-five has increased by four years for men and five years for women since Social Security first paid monthly benefits in 1940, and experts expect it to continue to rise.\(^{29}\)

Second, the coming retirement of the post-World War II baby boom generation will further exacerbate this growth in the number of future benefit recipients.\(^{30}\) As the large group of baby boomers exits the workforce, the proportion of the popula-
tion over the age of sixty-five will swell from 12% in 2005 to approximately 20% in 2030.31 In contrast, the number of future wage earners is projected to grow at a much slower pace, reflecting a relative decline in both fertility and immigration rates.32 This decline, in particular, is fueled by a significant drop in the birth rate from over three children per woman during the baby boom era to approximately two children per woman in subsequent years.33 Social Security actuaries predict that the fertility rate will stabilize at 1.95 children per woman.34 Finally, a continuing decline in retirement age affects the relative size of the two cohorts. Although the normal retirement age at which a worker becomes eligible for full Social Security retirement benefits is sixty-five, more than one-half of all American workers choose to retire at the early eligibility age of sixty-two.35

The combined effect of these demographic factors is startling. While the number of retirees is projected to grow by 90% between now and 2030, the number of wage-earning taxpayers is projected to grow by only 15%.36 As a result, the number of workers per beneficiary will drop from 3.3 to 2.2 by 2030.37

The bottom line is that unless Congress adopts a solution, retirees will receive only 74% of scheduled benefits in 2041, and this percentage will continue to decrease for the remainder of the seventy-five-year projection period.38 This decline would have a severe, if not devastating, impact on the many Americans who depend on Social Security benefits as their principal

31. SOC. SEC. ADVISORY BD., supra note 17, at 10.
32. DIAMOND & ORSZAG, supra note 16, at 74–77; SOC. SEC. ADVISORY BD., supra note 17, at 12.
33. SOC. SEC. ADVISORY BD., supra note 17, at 12.
34. Id.
35. DIAMOND & ORSZAG, supra note 16, at 21–22; JONATHAN GRUBER & DAVID A. WISE, SOCIAL SECURITY AND RETIREMENT AROUND THE WORLD 16–18 (1999). Other factors contributing to the looming Social Security deficit include growing income inequality, which leaves a larger portion of high-end earnings exempt from the payroll tax, and the legacy debt burden resulting from the fact that the first generation of Social Security benefit recipients received far more in benefits than it paid in contributions. DIAMOND & ORSZAG, supra note 16, at 64–74.
36. CONG. BUDGET OFFICE, supra note 10, at 1–2.
37. See 2005 TRUST FUNDS ANN. REP., supra note 12, at 9; GOV'T ACCOUNTABILITY OFFICE, supra note 8, at 21–22; CONG. BUDGET OFFICE, supra note 10, at 31–33.
38. 2005 TRUST FUNDS ANN. REP., supra note 12, at 8 (projecting a decline to 68% of scheduled benefits by 2079).
or only source of retirement income. At present, the Social Security program provides more than one-half of all income for 65% of retirees and more than 90% of all income for one-third of retirees; it constitutes the sole source of income for 21% of current beneficiaries.\textsuperscript{39}

But the benefit gap is only part of the problem. The growth of the retiree cohort also means that projected Social Security outlays—even without any increase in taxes—will climb by approximately 50% from a current 4.2% of GDP to 6.5% of GDP by 2030.\textsuperscript{40} Increasing age and health care pressures in the Medicaid and Medicare programs will compound this burden on the federal budget.\textsuperscript{41} Taken together, these three federal entitlement programs, which now consume approximately 8% of GDP, will grow to about 15% of GDP by 2030 in the absence of any major policy changes.\textsuperscript{42}

The result is a projected combination of declining benefits and increasing taxes. Any long-term solution inevitably will require more of either or both. So far, elected representatives have demonstrated a lack of political will to support either of these painful paths.

\section*{B. PENSION PLANS}

\subsection*{1. Types of Plans}

The American pension system is, in many respects, a reverse image of the Social Security system. Pensions in the United States are wholly voluntary and exist independent of any government mandate. Also, unlike Social Security, virtually all pensions in the United States are sponsored by employers rather than by the government.\textsuperscript{43} The only governmental

\begin{footnotesize}
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\item \textsuperscript{39} SOC. SEC. ADMIN., \textit{supra} note 11, at 11; SOC. SEC. ADVISORY BD., \textit{supra} note 17, at 25.
\item \textsuperscript{40} CONG. BUDGET OFFICE, \textit{supra} note 10, at 29, 42.
\item \textsuperscript{41} GOV'T ACCOUNTABILITY OFFICE, \textit{supra} note 8, at 27 (stating that the rapid expected growth rates in these two programs "reflect not only a burgeoning beneficiary population but also the escalation of health care costs at rates well exceeding general rates of inflation"). Health care costs currently are skyrocketing at double-digit annual rates, four times as fast as the annual rise in wages. David S. Broder, Op-Ed, \textit{To Save U.S. Health Care System from Certain Disaster, Drastic Surgery Is Needed}, ST. PAUL PIONEER PRESS, July 15, 2004, at A12.
\item \textsuperscript{42} CONG. BUDGET OFFICE, \textit{supra} note 10, at 42; GOV'T ACCOUNTABILITY OFFICE, \textit{supra} note 8, at 29.
\item \textsuperscript{43} \textit{PRIVATE PENSION SYSTEMS AND POLICY ISSUES} 25 (William G. Gale et
role in the U.S. pension scheme is the provision of tax incentives for plan contributions and the regulatory safety net imposed by the Employee Retirement Income Security Act (ERISA).  

Pensions in the United States fall into two broad categories: defined benefit plans and defined contribution plans. Traditional defined benefit plans provide a predetermined, specified retirement benefit, usually in the form of a life annuity, linked to pre-retirement earnings. Employers must provide universal coverage to qualified employees, but employees generally are not required to contribute. Defined benefit plans typically are funded solely by the sponsoring employer, and plan contributions are held in a single trust on behalf of all participants.

Defined contribution plans, such as employer-sponsored 401(k) plans, in contrast, promise only a contribution rate to an employee’s individual account, and both employers and employees typically contribute to such plans. Individual workers must make a number of key decisions concerning defined contribution plans, such as whether to participate, how much to contribute, how to allocate investments, and when and how to withdraw funds.

al. eds., 2000).


46. MUNNELL & SUNDET, supra note 45, at 16; Copeland, supra note 45, at 5.

47. Copeland, supra note 45, at 5.

48. A 401(k) plan is named after the Internal Revenue Code requirements that such a plan must meet to be a qualified plan entitled to special tax treatment. See I.R.C. § 401(k) (2000 & West Supp. 2003). While 401(k) plans are the most prevalent type of defined contribution plan, other defined contribution formats include individual retirement accounts, profit-sharing plans, and employee stock ownership plans. See Sharon Reece, Enron: The Final Straw & How to Build Pensions of Brick, 41 DUQ. L. REV. 69, 78 (2002).

A crucial distinction between the two plan types concerns which party bears the investment risk associated with plan assets. In defined benefit plans, the employer bears the risk of investment shortfalls, while in defined contribution plans, individual employees bear this risk.\(^{50}\)

Two historical trends illustrate the prevalence of pension coverage in the United States. First, pensions are a twentieth-century phenomenon; comparatively few private pension plans existed prior to World War II.\(^{51}\) Tax policy and managerial desires to attract skilled, long-term workers spurred the growth of pensions and other fringe benefits during the war and the years immediately following.\(^{52}\) This growth continued over the next few decades as the number of American workers covered by pension plans more than doubled between 1950 and 1979.\(^{53}\) By that latter year, approximately 50% of all private-sector workers were covered by a pension.\(^{54}\) However, this upward trend stagnated in the 1980s, and following a modest uptick during the strong economy of the 1990s, overall pension coverage has declined since the turn of the century.\(^{55}\) While estimates vary by methodology, most studies agree that fewer than half of all U.S. workers currently participate in an employer-sponsored pension plan.\(^{56}\) The non-covered group includes a disproportionately large number of female, Hispanic, and low-

\(^{50}\) Private Pension Systems and Policy Issues, supra note 43, at 26; Clark & Schieber, supra note 49, at 12-14; Copeland, supra note 45, at 5.


\(^{54}\) Id.


wage workers. Employees of smaller firms and part-time workers also are more likely to lack pension coverage.

The second major trend concerns the relative decline in defined benefit pension plans and the concomitant increase in defined contribution plans. Through the 1970s, traditional defined benefit plans predominated. In 1975, for example, 87% of all workers covered by a pension plan participated in a defined benefit plan. Since 1980, however, there has been a significant shift toward defined contribution plans. While the number of employees covered by a defined benefit plan fell 25% between 1980 and 2000, the number participating in a defined contribution plan jumped 250%. As of 2005, twice as many American workers were covered by defined contribution plans as compared to defined benefit plans. Of those with pension coverage, only 19% of U.S. households are currently covered by a defined benefit plan, while 58% are covered solely by a defined contribution plan, and 23% participate in both types of plans.

The movement away from defined benefit plans becomes even more pronounced when hybrid plans, such as cash balance plans, are added to the mix. Such plans combine the various attributes of the defined benefit and defined contribution regimes. A cash balance plan, for example, defines a worker's retirement account based on an annual contribution rate plus a guaranteed rate of accumulating interest on the account balance. Although technically funded and regulated as a type of defined benefit plan, cash balance plans resemble defined contribution plans in that the plan sponsor may peg the annual rate of return to an index that reflects actual economic or investment performance. Many employers that switch to cash

57. PRIVATE PENSION SYSTEMS AND POLICY ISSUES, supra note 43, at 29–30; Copeland, supra note 45, at 7–12.
59. Id. at 27.
60. Copeland, supra note 45, at 5.
61. BUREAU OF LABOR STATISTICS, supra note 56, at 6.
62. MUNNELL & SUNDPN, supra note 45, at 3.
64. See Clark & Schieber, supra note 49, at 15; Elliott & Moore, supra note 63, at 4.
balance plans also reduce their overall level of plan contributions.\footnote{65} As a result, when a typical defined benefit plan is converted to a typical cash balance plan, a majority of workers receive lower overall benefits.\footnote{66} As of 2004, approximately 11% of all Fortune 1000 firms had frozen or terminated their defined benefit plans while instituting or maintaining cash balance or defined contribution plans for future purposes.\footnote{67}

What is driving this fundamental restructuring of the pension landscape? A recent survey of American employers identified two principal motivating factors: (1) reducing cost and funding volatility, and (2) achieving long-term cost savings.\footnote{68} Because defined benefit plans guarantee a specific benefit payout regardless of economic circumstances, employers bear a substantial risk of potential liability in the event of a fund’s substandard investment performance. The 2000–03 recession, during which many fund balances plummeted in value, vividly illustrates this risk.\footnote{69} A switch toward defined contribution or cash balance plans also enables employers to reduce costs while requiring employees to share funding responsibilities (defined contribution plans) or, at least, a greater share of the plan’s investment risk (cash balance plans).\footnote{70} In short, a move away from defined benefit plans enables employers to shift some of their risks and costs to workers.\footnote{71} Substituting a cash balance plan for an existing defined benefit plan also enables employers to avoid the high excise taxes required of an employer that

\footnote{66. GOV’T ACCOUNTABILITY OFFICE, PRIVATE PENSIONS: INFORMATION ON CASH BALANCE PLANS 6 (2005).}
\footnote{70. Clark & Schieber, \textit{supra} note 49, at 12–15, 24–25.}
\footnote{71. \textit{Id.; see also} VanDerhei, \textit{supra} note 67, at 6 (noting that employers gave reduced costs and shifting investment risk as reasons for freezing defined benefit plans).}
seeks to recapture excess assets upon the termination of a defined benefit plan.\textsuperscript{72}

2. Three Pension Problem Areas

a. Overall Coverage

The most over-arching problem with the current pension regime in the United States is the lack of overall coverage. As noted above, fewer than half of all U.S. workers currently participate in an employer-sponsored pension plan of any type.\textsuperscript{73} Put another way, approximately seventy million American workers today face the prospect of retirement with no pension leg on their already shaky retirement stool.\textsuperscript{74} In addition, more specific shortcomings exist with respect to both defined benefit and defined contribution plans.

b. Defined Benefit Plans

i. Inadequate Funding

An increasing number of defined benefit plan sponsors fail to fulfill their pension promises. One factor contributing to this phenomenon is the fact that many traditional defined benefit plans are dangerously underfunded. Between 1999 and 2004 the level of overall pension funding fell from 130\% of liabilities to 90\% of liabilities in current-value terms.\textsuperscript{75} Presently, more than one-half of all defined benefit plans are underfunded, facing a cumulative shortfall of $450 billion.\textsuperscript{76} The result is a seri-
ous disconnect between promises made by pension plan sponsors and the funding available to fulfill those promises.

For two reasons the shortfall is likely even worse than these numbers suggest. First, the Pension Benefit Guarantee Corporation (PBGC) has assumed responsibility for a number of the most seriously underfunded defined benefit plans. The PBGC is a federal agency, funded by premiums charged to covered defined benefit plans, that assumes responsibility for a portion of a sponsor's pension obligations in the event of a plan default. In 2000, the PBGC was maintaining a $9.7 billion surplus. By 2004, the agency reported a $23.3 billion deficit following its takeover of several large terminating plans. With financially distressed firms currently responsible for a combined underfunding of almost $100 billion dollars in their sponsored plans, a sizeable bailout of the PBGC program soon may be necessary.

Second, the fact that the pension plan funding rules in existence prior to the PPA permitted plan sponsors to maintain funding at less than socially desirable levels exacerbated the funding problem. Valuation rules, for example, gave plans wide latitude in adopting assumptions for measuring the current value of assets and liabilities, and many plan sponsors chose assumptions that overstated funding levels. Further, while

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77. EMPLOYEE BENEFIT RESEARCH INST., FACTS FROM EBRI: BASICS OF THE PENSION BENEFIT GUARANTEE CORPORATION 1 (2005), http://www.ebri.org/pdf/publications/facts/0705fact.pdf. The PBGC guarantees payment of basic pension benefits for approximately forty-four million workers and retirees participating in more than thirty-one thousand private-sector defined benefit pension plans. Id. The PBGC guarantees retirement benefits under a defined benefit plan up to a maximum monthly amount. As of 2005, the maximum payment for a single life annuity at age sixty-five was $3,801.14 per month. Id. at 2.

78. Ford et al., supra note 76, at 351.


ERISA nominally assessed an additional funding charge (AFC) when the actuarial value of a plan’s assets fell below 90% of liabilities, accounting credits and other exceptions caused the AFC to be assessed in practice only if a plan fell to a 75–80% funding level.82

The termination of Bethlehem Steel’s defined benefit plan in 2002, which resulted in the then-largest PBGC claim in history,83 provides a vivid illustration of these regulatory shortcomings. In 2002, Bethlehem Steel’s Form 5500 filing reported that its plan was 85% funded on a current liability basis.84 Later that same year, the plan terminated with actual assets of less than one-half the current value of promised benefits.85 Yet, from 2000 to 2002, Bethlehem Steel was not required to make an AFC contribution.86 Following plan termination, the PBGC assumed a $3.7 billion charge to defray the plan’s $4.3 billion shortfall.87 In short, Bethlehem Steel effectively shifted its funding shortfall to its employees and the federal government.

ii. Cash Balance Conversions

Many employers also abandon defined benefit promises in the context of converting to cash balance plans. These conversions fundamentally alter the methods of benefit accumulation. Benefit accruals in defined benefit plans typically are back-loaded such that they increase significantly the closer a long-term worker gets to retirement.88 Cash balance plans, on the other hand, generally employ a more level pattern of accrual throughout a worker’s career.89 A conversion of a defined bene-

82. Ford et al., supra note 76, at 362–74. To prevent funding levels from falling too low, plan sponsors generally are required to make additional funding contributions to underfunded plans in the amount of a percentage of the unfunded liability. Id. at 356.

83. Pension Plan Hearing, supra note 79, at 6.

84. Ford et al., supra note 76, at 362. Form 5500 is a disclosure form that private sector employers with defined benefit plans are required to file annually with the Internal Revenue Service and the PBGC. Id. at 352 n.5.

85. Id. at 362.

86. Pension Plan Hearing, supra note 79, at 8; Ford et al., supra note 76, at 368.

87. Pension Plan Hearing, supra note 79, at 6, 9; Ford et al., supra note 76, at 362.


89. Elliott & Moore, supra note 63, at 4; Forman & Nixon, supra note 88, at 392–93, 399.
fit plan to a cash balance plan, as a result, bolsters the accrual rates for younger workers, but diminishes the accrual rates for long-term workers.  

Many employers voluntarily cushion the impact of a plan conversion on older workers by providing transitional benefits such as a monetary bonus or the option to continue coverage under the prior defined benefit formula. Other employers, however, compound the negative impact on older workers by implementing a "wear-away" period. Under ERISA, an employer is free to set the new cash balance benefit value at whatever level it desires so long as the employer maintains, at a minimum, the employee's previous level of benefit accrual for payout purposes. If an employer, upon a cash balance conversion, sets the new benefit level below the previous defined benefit accrual level, the employer may freeze the older worker's benefit accrual under the new plan until the excess defined benefit level is "worn away" and matches the rising cash benefit account. In such circumstances, the older worker suffers a double whammy: (1) the loss of expected defined benefit backloading, and (2) a wear-away period during which the worker receives no benefit for the new cash balance plan.

c. Defined Contribution Plans

i. Lack of Employee Participation

Problems also exist in the increasingly important realm of defined contribution plans. The most significant issue here concerns the relatively low level of employee participation even when an employer sponsors a 401(k) plan. While employees

covered by defined benefit plans are automatic participants in those plans, employees covered by a defined contribution plan have the option to choose or reject participation. Recent studies show that roughly one-fourth to one-third of all employees covered by a defined contribution plan opt not to participate. Since participation in a defined contribution plan occurs only when a covered employee affirmatively elects to contribute to the plan, this negative choice typically reflects either inertia, an inability to pay, or a conscious choice to prefer current disposable income over deferred retirement benefits, even when enhanced by an employer’s promise of a matching contribution. Not surprisingly, young and low-income workers are the most likely not to participate. The problem of non-participation often is compounded by frequent job turnover. More than one-half of all workers covered by a 401(k) plan take cash out of their plans when they change jobs. Although one of the principal advantages of defined contribution plans is the potential for roll-overs and other devices to create a mobile retirement savings plan, the lure of a new boat or the pressure of mounting debt too often takes precedence over the accumulation of retirement assets. Studies

95. MUNNELL & SUNDÉN, supra note 45, at 55.


97. See MUNNELL & SUNDÉN, supra note 45, at 55–67; James F. Moore & Olivia S. Mitchell, Projected Retirement Wealth and Savings Adequacy, in FORECASTING RETIREMENT NEEDS AND RETIREMENT WEALTH 68, 87 (Olivia S. Mitchell et al. eds., 2000) (hypothesizing that the need to spend current income, misinformation regarding life expectancy, and a general discounting of the future may contribute to shortfalls in savings).


100. See Hinz, supra note 7, at 29 (explaining that needs and interests may be better met by defined contribution plans due to, inter alia, the high mobility of some workers); Munnell et al., supra note 96, at 65 (“[401(k) plans are] more appealing to a younger, more mobile workforce.”).
indicate that the $37,000 median 401(k) balance of workers between the ages of forty-five and fifty-four is less than one quarter of the amount that would be expected for a similarly situated worker who had not prematurely withdrawn funds from his or her account.\footnote{101}

ii. Over-Concentration in Company Stock

A second problem with respect to defined contribution plans concerns the substantial amount of fund assets invested in the company stock of participants’ employers. This investment concentration is at odds with the consensus view that the preferable allocation of fund assets is in a diversified portfolio.\footnote{102} When all of a worker’s retirement eggs are concentrated in one basket, the risk of financial retirement insecurity increases exponentially.\footnote{103}

The Enron debacle provides the most vivid illustration of the dangers flowing from an over-concentration in company stock. At the end of 2000, employees of the energy trading firm that was then the seventh-largest U.S. corporation\footnote{104} held $2.1 billion in the firm’s sponsored 401(k) plan. Sixty-two percent, or $1.3 billion, of those assets were invested in Enron stock which, at the time, was trading at more than $80 per share.\footnote{105} As disguised operating losses and accounting manipulations came to light in 2001, the value of Enron stock plunged. By December 2001, Enron declared bankruptcy, and its stock became worth-
less. As a result, thousands of current and retired Enron employees lost the bulk of their retirement savings.

The Enron story is not an isolated incident. Similar fates have befallen participants in several other large corporate pension plans during the past decade, including plans sponsored by Lucent, Polaroid, and Global Crossing. In each instance, workers who were overly dependent on the financial fortunes of their employers suffered the double loss of both a current job and future retirement security.

The pertinent data concerning 401(k) company stock holdings brings the extent of this problem into better focus. As of 2000, company stock represented approximately 19% of all 401(k) assets. These company stock assets primarily are concentrated in plans sponsored by larger firms. Only about 10% of plan sponsors include company stock in their portfolios, but those plans cover 42% of all defined contribution plan participants. Within this subset of plan sponsors, approximately

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106. CHOI ET AL., supra note 105, at 3; Reece, supra note 48, at 97–98.
109. Iwry, supra note 102, at 2 (noting that heavy pension plan investment in company stock is particularly risky because "[i]f the employer falls on hard times, the worker stands to lose not only a job but also his or her retirement savings").
111. CHOI ET AL., supra note 105, at 7; William E. Even & David Macpherson, Company Stock in Pension Funds, 57 NAT'L TAX J. 299, 306 tbl.2 (2004). In 2001, 51.9% of firms with 5000 or more employees offered company stock in their 401(k) plans, while only 4.9% of firms with fewer than fifty employees did so. MUNNELL & SUNDÉN, supra note 45, at 100.
30% of plan assets take the form of company stock,113 and 45% of plan participants have concentrated company stock positions in excess of 20% of their portfolios.114 Over five million plan participants, or about one in ten Americans with 401(k) holdings, have invested more than 60% of their account balances in company stock.115

Company stock can end up in a plan in either of two ways. First, a plan sponsor can offer company stock as one of the investment options available to plan participants.116 Second, a plan sponsor can direct its own matching contribution in the form of company stock.117 About 45% of all firms offering company stock as an option also make matching contributions exclusively in company stock;118 this was the case with Enron.119 Where this combination occurs, individual holdings in company stock become substantially more concentrated. While employees with a company stock option invest 22% of their contributions in company stock, those employed in firms that also have a directed company stock match end up with 53% of their assets invested in company stock.120 Interestingly, about one-third of this greater concentration is attributable to increases in the voluntary employee selection of company stock.121

The over-concentration problem is further exacerbated by the policy of many firms to restrict the ability of participants to diversify their company stock match. According to a survey published in 2001, 85% of plans using a company stock match

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115. See Mitchell & Utkus, supra note 112, at 34–42.


117. Id.

118. Id.

119. See Reece, supra note 48, at 91–92. Enron offered its own company stock as an investment choice and also matched employee contributions with shares of Enron stock. As is common with many 401(k) plans, Enron provided a 50% match on employee contributions up to 6% of base pay. Id.

120. Holden & VanDerhei, supra note 110, at 11 tbl.6.

121. Id. While employees with a company stock option make 22% of their 401(k) investments in company stock, those with both a company stock option and a directed match make 33% of their elective investments in company stock. Id.
placed some restriction on employee diversification, although there is some evidence that this percentage is now declining.\textsuperscript{122} Once again, the Enron scenario provides a typical example. Enron restricted plan participants from selling any of the matched Enron company stock prior to reaching age fifty.\textsuperscript{123} As a result, many Enron employees could only watch helplessly as a significant chunk of their 401(k) assets crashed and burned.\textsuperscript{124}

With diversification widely lauded as an investment strategy, why are so many 401(k) portfolios so heavily laden with company stock? Three factors appear to be at work.

First, many employers view a strong 401(k) stock posture as a favorable business strategy. Some of the reasons frequently cited in support of this viewpoint are the following:

- a plan participant stake in company stock increases productivity by aligning the financial interests of employers and employees;
- employer contributions in the form of newly issued stock preserve employer cash reserves; and
- 401(k) holdings of company stock helps to deter hostile takeovers by keeping a sizeable chunk of company stock in friendly hands.\textsuperscript{125}

More concretely, employers can benefit financially through plan holdings of company stock in that dividend payments, which normally are not tax deductible by companies, may be deducted if paid to shareholders holding company stock in a defined contribution plan structured as either an employee stock ownership plan (ESOP) or a hybrid KSOP plan.\textsuperscript{126} About one-half of all defined contribution plans holding company stock are structured in such a fashion.\textsuperscript{127}

Second, many employee plan participants also perceive advantages in electing to hold company stock in their plan portfo-

\textsuperscript{122} MUNNELL & SUNDÉN, supra note 45, at 102.
\textsuperscript{123} Reece, supra note 48, at 92.
\textsuperscript{124} See supra notes 105–07 and accompanying text.
\textsuperscript{125} See, e.g., MUNNELL & SUNDÉN, supra note 45, at 106–10; Even & Macpherson, supra note 111, at 300–01; Mitchell & Utkus, supra note 112, at 46–50.
\textsuperscript{126} See I.R.C. § 404(k) (2000); Iwry, supra note 102, at 3; Reece, supra note 48, at 88. An ESOP is a defined contribution plan designed to be invested primarily in the employer's stock. Iwry, supra note 102, at 2. A KSOP is created when "a company marries its 401(k) to its ESOP." Reece, supra note 48, at 88.
\textsuperscript{127} Even & Macpherson, supra note 111, at 307 tbl.2.
lios. Here, the evidence points to a mixture of loyalty and greed as motivating factors. With regard to the former, some employees see an ownership stake in their employing entity as an expression of loyalty and support. As to the latter, in spite of the conventional wisdom supporting a diversified investment strategy, many unsophisticated employee investors hope to "strike it rich" by replicating in diminutive form the stock option holdings of their executive counterparts. Indeed, these two motivations tend to coalesce in what is commonly described as the "endorsement" effect. When employers direct their contribution match in the form of company stock, studies show a correlative boost in participant company stock elections, presumably owing to the employer's perceived endorsement or recommendation of company stock as a desirable investment choice.

A third factor contributing to the high incidence of company stock in defined contribution plans is the lack of legal constraints on the practice. While ERISA forbids defined benefit plans from investing more than 10% of plan assets in company stock or real estate, no similar limitation applies to defined contribution plans. In addition, ERISA exempts defined contribution plans from its fiduciary diversification requirements with respect to participant-directed investment decisions.

128. CHOI ET AL., supra note 105, at 8–9.
129. See MUNNELL & SUNDÉN, supra note 45, at 102–06. Research indicates that many employees myopically underestimate the risks associated with investments in company stock. See id.; Mitchell & Utkus, supra note 112, at 51.
131. Compare 29 U.S.C. § 1107(a)(2) (2000) (providing an ERISA prohibition on defined benefit plans investing more than 10% of plan assets in company stock or real estate), with 29 U.S.C. § 1107(b)(1) (excluding defined contribution plans from ERISA's 10% prohibition). In part, this distinction is a historical accident. At the time of ERISA's enactment, defined benefit plans were the dominant pension form, and 401(k) plans did not yet exist. Mitchell & Utkus, supra note 112, at 35–36. Congress adopted legislation authorizing 401(k) plans in 1978. Id. at 36. The principal types of defined contribution retirement plans in existence in 1974 were ESOP and profit-sharing plans, both of which were premised on, or at least compatible with, company stock ownership and not surprisingly exempted from the 10% limitation. Even & Macpherson, supra note 111, at 305; Mitchell & Utkus, supra note 112, at 35–36.
132. 29 U.S.C. § 1104(c). See generally Andrew S. Hartley, Making the Case for Mandatory Removal of Imprudent Investment Vehicles: Inside Information Can Make Employer Securities a Bad 401(k) Option, 5 APPALACHIAN J.L. 99,
In sum, current regulations permit both employers and employees to overload defined contribution plans with company stock. The result, as demonstrated by Enron and other examples, is a particularly dangerous threat to retirement security.

C. PERSONAL SAVINGS

The third leg of the retirement stool also is in trouble. While personal savings represent an important potential cushion against the declining fortunes of retirement programs sponsored by the government and employers, the current reality is that this leg is as wobbly as the other two.

The Bureau of Economic Analysis (BEA), a division of the U.S. Commerce Department, has been tracking personal savings data since 1929. The annual personal savings rate depicts the amount of disposable income that individuals do not expend in personal outlays over the course of a year. For most of the period from 1945 to 1985, the personal savings rate hovered in the range of 7 to 11%. But the rate has been falling precipitously over the past twenty years. The personal savings rate was 10.8% in 1984, 4.8% in 1994, and 1.8% in 2004. For the first time since the Great Depression the rate declined to negative territory in 2005 (-0.5%) and 2006 (-1.0%).

How does a society manage to spend more than it makes? The short answer is by borrowing. During the first five years of the twenty-first century, consumer debt grew approximately twice as fast as personal income. In other words, savings ac-

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136. Personal Income, supra note 134; BEA, Personal Income and Outlays, supra note 133, at 1–4.

137. See Pender, supra note 135; BEA, Personal Income and Outlays, supra note 133, at 4.

138. Pender, supra note 135.
count credits are giving way to credit card and home equity loan debits.

The decline in personal savings is troubling for a number of reasons. First, and most obvious, the lack of assets accumulated from personal savings exacerbates the impact of looming shortfalls in Social Security and in employer-sponsored pension programs.\textsuperscript{139} Second, from a macroeconomic view, a decline in personal savings decreases the amount of capital available for business growth.\textsuperscript{140} And, as a corollary matter, the savings deficit means that the U.S. economy increasingly depends on foreign sources to provide necessary capital investment.\textsuperscript{141}

Some critics take issue with the validity of the BEA data. They point out that the BEA's measurement of personal savings does not include capital gains obtained through the ownership of real estate or stock equity holdings.\textsuperscript{142} According to these critics, sizeable capital gains over the past decade have made personal savings less necessary as a source of retirement funding.\textsuperscript{143}

This argument, however, is valid only to a point. Even if the more volatile and less predictable prospect of capital gains is added to the personal resource reservoir,\textsuperscript{144} that mix of assets still falls far short of providing a desirable retirement safety net. Experts suggest that combined savings rates of 15% or higher are needed to augment other sources of retirement income.\textsuperscript{145} But capital gains, even in the above average range of recent years, only bump up the overall savings rate by somewhere between 2 and 6%.\textsuperscript{146} And these gains tend to accrue

\textsuperscript{139} Jonathan Barry Forman, \textit{Universal Pensions}, 2 CHAP. L. REV. 95, 95-96 (1999); Moore & Mitchell, \textit{supra} note 97, at 68.

\textsuperscript{140} See Pender, \textit{supra} note 135.

\textsuperscript{141} Frank Shostak, \textit{Should We Worry About Falling Savings?}, MI\textsc{S}E\textsc{S} DAILY ARTICLE (Ludwig von Mises Inst., Auburn, Ala.), Feb. 2006, available at http://www.mises.org/story/2067 ("Many experts are of the view that the falling savings rate points to a growing dependence on the inflow of foreign capital to keep the economy going.").


\textsuperscript{143} Pender, \textit{supra} note 135.

\textsuperscript{144} See id. (discussing how retirement security may be negatively affected if the "perfect scenario" of rising home and stock prices does not continue).

\textsuperscript{145} See Clements, \textit{supra} note 142; Mary Beth Franklin, \textit{How Much Is ENOUGH?}, KIPLINGER'S PERS. FIN., Feb. 2006, at 69, 70.

\textsuperscript{146} Satyendra Verma & Jules Lichtenstein, \textit{The Declining Personal Sav-
primarily to top earners rather than to future retirees as a class. As BEA research economist Marshall Reinsdorf concludes, the decline in the savings rate is “too big to explain away. . . . The overall conclusion, that people are saving less than they used to, doesn’t change.”

D. SUMMARY

Each of the three legs of the retirement stool either currently falls short of contributing adequate financial resources for future retirees or threatens to do so in the foreseeable future. Current trends presage that about 45% of all future baby boom retirees will fail to achieve the desired target of having enough post-retirement income to replace 75% of pre-retirement earnings, and that figure has the potential to worsen significantly if scheduled Social Security benefits are not maintained. More disturbingly, the combination of increased longevity and asset shortfalls suggests that more than half of all current workers will run out of retirement assets before they run out of retirement years. In short, the retirement stool is an increasingly wobbly platform that threatens too many American workers with an insecure post-work financial future.

II. STRENGTHENING THE RETIREMENT SAFETY NET

Because all three components of the retirement safety net are in trouble, Congress needs to take significant reform measures to provide broad-based financial security for the coming

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147. WELLER & WOLFF, supra note 7, at 28.
148. Clements, supra note 142.
149. Barbara A. Butrica et al., The Changing Impact of Social Security on Retirement Income in the United States, SOC. SEC. BULL., Jan. 2005, at 1, 6; see also Alicia H. Munnell et al., A New National Retirement Risk Index, AN ISSUE IN BRIEF (Ctr. for Ret. Research, Chestnut Hill, Mass.), June 2006, at 1, 3–4, http://www.bc.edu/centers/crrr/issues/ib_48.pdf (finding that 43% of American households are at risk of having insufficient retirement income and projecting that income will fall 10% or more below target income replacement rates).
wave of retirees. This Part reviews the current array of reform proposals as well as some of the major provisions of the PPA. It then goes on to recommend an agenda for averting the potential perfect storm of retirement insecurity.

A. SOCIAL SECURITY

Social Security reform has been the subject of a long-running and contentious debate. In his 2005 State of the Union address, President Bush declared that the Social Security system was in crisis and proposed a systemic overhaul centered on the creation of personal retirement accounts.\footnote{151} Under this plan, workers under the age of fifty-five would have the option to divert up to four percentage points of their payroll taxes (approximately one-third of the current combined employer and employee 12.4% assessment) to individual accounts that would pay benefits in exchange for accepting a reduced amount of traditionally funded Social Security benefits.\footnote{152} President Bush suggested that workers could invest the retirement accounts in a limited mix of stock and bond funds and that those accounts could be centrally administered in a manner similar to the Thrift Savings Plan currently in place for federal employees.\footnote{153} According to a prepared summary of the President’s proposal, “[p]ersonal retirement accounts [would] give younger workers the chance to receive a higher rate of return from sound, long-term investing of a portion of their payroll taxes than they receive under the current system.”\footnote{154} The President’s proposal favors a curb on future benefit increases by tying such adjustments to changes in prices rather than by continuing the more generous practice of wage-indexing.\footnote{155}

Democrats generally have reacted negatively to the President’s proposal. Many Democrats deny both the existence of a crisis as well as the need for a systemic restructuring of the current Social Security system.\footnote{156} Former representative Mar-
tin Sabo (D-Minn.), for instance, critiqued the Bush plan as follows: "I am frustrated by the talk of 'crisis.' I believe it is an effort to deceive the American public into accepting massive changes that would destroy the life-long, guaranteed Social Security benefits that retirees have earned."157

Each political viewpoint contains a germ of truth. President Bush accurately depicts the looming depletion of the Social Security trust accounts as a crisis. Unless Congress undertakes remedial action, the Social Security system will be unable to pay out scheduled benefits, and a large segment of the retired workforce will slip into poverty.158 This problem becomes more severe with each passing year that Congress fails to find a solution.159

But, the President’s Democratic opponents also are correct in arguing that the proposal for personal retirement accounts fails to address the problem at hand—namely, that the Social Security system eventually will run out of funds to pay benefits.160 Personal accounts would change how funds are held and invested, but by themselves would not increase revenue or decrease program costs.161 Further, even if the claim that equity holdings would generate more investment gains is accurate, that same effect could be captured by investing a portion of the combined trust funds in such holdings. Such a system-wide approach would avoid exposing individual retirees to dangerous investment volatility risks and increased administrative account-handling costs.162

There is, however, a more fundamental problem with the proposal for private retirement accounts. Such accounts would worsen the financial posture of the Social Security system because the President’s individual account initiative would re-

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158. See supra notes 38–39 and accompanying text.
159. SOC. SEC. ADVISORY BD., supra note 17, at 20–21.
160. See supra notes 25–26 and accompanying text.
161. DIAMOND & ORSZAG, supra note 16, at 133–34.
quire the Social Security system to finance two programs simultaneou-
sely for a lengthy transitional period. First, the trust funds would con-

continue to pay benefits under the present pay-as-you-go retirement system.163 Second, the Social Security system would pre-fund individual accounts for future benefit payments.164 While some analysts suggest that up to two trillion dollars in borrowing would be necessary to fund the private account plan,165 even the official summary of the President’s plan acknowledges a potential shortfall of $754 billion, or one-half of the current trust fund surplus, during the plan’s first decade of existence.166 Although the Social Security Trust Funds would recoup the overall outflow of funds in the subsequent seventy-five years as account holders retire, the ensuing transitional deficit would hasten the Trust Funds’ exhaustion by about a decade.167

If private retirement accounts are not the answer, what is the best solution for avoiding Social Security’s impending meltdown? The good news is that a wide variety of options are available to correct Social Security’s imbalance without the need to resort to radical structural changes. The shortfall in Social Security finances over the next seventy-five years (the usual durational yardstick for measuring program solvency) amounts to 1.92% of payroll.168 Put simply, that means that a 1.92% reduction in benefits or a corresponding increase in payroll taxes (i.e., from 12.4% to 14.32%) would “solve” the Social Security crisis. A combination of benefit reductions and tax increases that eliminate the 1.92% gap would have a similar effect.

Analysts have suggested proposals for closing this gap. Among the more frequently mentioned options are the follow-

• Increasing the payroll tax;
• Increasing the portion of benefits subject to the income tax;
• Raising the payroll tax ceiling for employees;

163. SOC. SEC. ADVISORY BD., supra note 17, at 25.
164. Id.
165. See GOV'T ACCOUNTABILITY OFFICE, supra note 8, at 45; Bernstein et al., supra note 162, at 54.
166. THE WHITE HOUSE, supra note 151, at 8.
168. 2005 TRUST FUNDS ANN. REP., supra note 12, at 3.
Raising the retirement age; Reducing benefit amounts; Modifying the rules for indexing initial benefit amounts; Reducing the size of the annual cost-of-living adjustment for benefits; Investing a portion of the Trust Funds in the stock market; and Creating a system of private accounts.\textsuperscript{169}

Although a myriad of solutions is possible, a combination of benefit and tax adjustments optimally should fill the gap. Structuring the solution solely through benefit reductions would unduly undercut Social Security's critical social insurance function at a time when retirement resources in general are challenged in all directions. On the other hand, a tax-only solution would further exacerbate the budgetary burden generated by escalating mandatory social welfare expenditures.\textsuperscript{170}

With these principles in mind, this Article recommends three reform proposals to eliminate the 1.92% deficit. While other possible approaches are worth considering, this combination of modifications would best preserve the integrity and viability of the current Social Security system.

1. Raise the Retirement Age

When Congress enacted the Social Security Act in the 1930s, the average American life expectancy was sixty-three years.\textsuperscript{171} By 2002, that figure had increased to an average of seventy-seven years.\textsuperscript{172} Meanwhile, the average retirement age has dropped; a majority of American workers now file for retirement benefits at age sixty-two.\textsuperscript{173} Taken together, these trends have transformed Social Security from a system that pays benefits to a minority of former workers for a relatively short span of a few years to a system that pays benefits to a majority of former workers for a period of one to several dec-

\textsuperscript{169} See SOC. SEC. ADVISORY BD., supra note 17, at 27–37 (describing various proposed options for reducing the projected Social Security actuarial imbalance as well as the fiscal impact of these various options).


\textsuperscript{171} Wyss, supra note 27.

\textsuperscript{172} Infoplease, supra note 28.

In this context, a modest future increase in the Social Security retirement age would generate sizable cost savings without undermining Social Security's fundamental retirement insurance objectives.

A recommendation of the Social Security Advisory Council (1994–96) provides the outline of such a proposal. A majority of the Council favored accelerating the increase of the full retirement age to sixty-seven and then raising the retirement age in future years to keep pace with further increases in life expectancy.\textsuperscript{174} Present law provides for phasing in an increase in the normal retirement age from sixty-five to sixty-seven for workers born in 1960 or later.\textsuperscript{175} The Council's recommendation to accelerate that increase, so as to be fully effective in 2011, for those workers born in 1949 or later, would eliminate 7% of the seventy-five-year deficit.\textsuperscript{176} The Council also recommended indexing both the normal and initial retirement ages thereafter to coincide with future increases in life expectancy.\textsuperscript{177} These two modifications would eliminate 43% of the deficit (or .83% of the payroll tax shortfall) over the seventy-five-year measuring period,\textsuperscript{178} and could complement measures to increase the retirement age to sixty-seven.

2. Implement After-Tax Indexing

The Social Security program calculates benefit levels on the basis of an individual worker's past earnings.\textsuperscript{179} Under current practice, "wage-indexing" adjusts these earnings to reflect the value of past earnings in terms of present wage levels.\textsuperscript{180} Since wages tend to rise faster than the rate of inflation, some critics view wage-indexing as an overly generous practice.\textsuperscript{181}

Indexing benefits to changes in prices, which generally increase at a slower rate than wages, is a frequently discussed al-

\textsuperscript{176} Soc. Sec. Advisory Bd., supra note 17, at 29.
\textsuperscript{177} Soc. Sec. Advisory Bd., supra note 17, at 29–30.
\textsuperscript{178} See id. at 8 ("The portion of a worker's earnings that are replaced by Social Security varies according to the worker's wage level.").
\textsuperscript{181} Pozen, supra note 155 (discussing the merits of alternative progressive indexing).
ternative. The Bush reform agenda includes a call for "progressive price indexing" by which the Social Security program would continue to index the benefits of the lowest 30% of wage earners on the basis of wages, while the program would index the benefits to prices for high earners or to a mix of prices and wages for middle earners. 182 While this proposal would be consistent with the traditionally progressive nature of Social Security benefits, many commentators have strongly criticized it as making too deep a cut in benefits. 183 A middle wage earner at retirement age would receive an immediate 9% reduction in benefits under the progressive price indexing formula. 184 These reductions would compound over time, amounting to a 22% reduction in benefits by 2055, 185 and an approximate 50% drop by 2080. 186

Indexing benefit levels to after-tax wages is a preferable approach. Most economists expect the tax burden on workers to rise in future years as the baby boom generation retires and budgetary pressures increase. 187 Some studies predict that the increase in after-tax wages will be roughly 0.2 to 0.3 percentage points per year less than the increase in pretax wages. 188 After-tax wages also more accurately reflect the true purchasing power of workers than do pre-tax wages. 189 A shift to after-tax indexing would provide a gentler curb on future benefit growth while positively affecting the seventy-five-year trust fund deficit. 190

182. Id.


186. Bernstein et al., supra note 162, at 56.

187. Id.

188. Id.

189. Id.

190. SOC. SEC. ADVISORY BD., supra note 17, at 29, 35; Bernstein et al., supra note 162, at 56 ("As a result, initial retiree benefits, which today are
3. Raise the Payroll Tax Ceiling

The final proposed Social Security reform implicates the revenue side of the ledger. Raising the payroll tax would be the most direct way to raise additional revenue. A boost of the current 12.4% tax to 13.2%, which would entail an additional 0.4% contribution by both employers and employees, would eliminate the remainder of the seventy-five-year shortfall.\textsuperscript{191}

Nonetheless, a different approach is preferable. In 1983, the Greenspan Commission set the maximum taxable earnings base for the Social Security payroll tax at a figure that covered 90% of national income from work-related earnings.\textsuperscript{192} The current ceiling is $90,000, meaning that individual earnings that exceed that amount are not subject to the payroll tax.\textsuperscript{193} This ceiling also is wage-indexed and increases each year.\textsuperscript{194} Over time, however, the percentage of earnings captured by the ceiling has dropped to around 85% of national earnings and is projected to fall to 83% by 2014.\textsuperscript{195} Phasing in increases in the ceiling to restore the 90% benchmark would generate enough revenue to reduce the seventy-five-year period deficit by approximately 40%.\textsuperscript{196} This solution is preferable to the 0.8% across-the-board option because it avoids an overall increase in the payroll tax and responds to growing income inequality by extending a previously determined contribution arrangement for taxpayers with the greatest ability to pay.

4. Summary

The three reform proposals described above close the 1.92% gap and avert Social Security's oncoming fiscal crisis. The following chart\textsuperscript{197} depicts the relative contributions of each proposal:

\textsuperscript{191.} See SOC. SEC. ADVISORY BD., supra note 17, at 31, 36.
\textsuperscript{193.} See SOC. SEC. ADMIN., supra note 11, at 11, 14.
\textsuperscript{194.} Id. at 14.
\textsuperscript{195.} SOC. SEC. ADVISORY BD., supra note 17, at 31.
\textsuperscript{196.} Bethell, supra note 183; Baker & Rosnick, supra note 192, at 6.
\textsuperscript{197.} See supra notes 171–96 and accompanying text.
Table 1: Three Social Security Proposals

<table>
<thead>
<tr>
<th>Proposals</th>
<th>As Percent of Taxable Payroll</th>
<th>As Percent of 1.92% Deficit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Raise Retirement Age</td>
<td>0.83</td>
<td>43</td>
</tr>
<tr>
<td>After-Tax Indexing</td>
<td>0.47</td>
<td>21</td>
</tr>
<tr>
<td>Raise Payroll Tax Ceiling</td>
<td>0.83</td>
<td>43</td>
</tr>
<tr>
<td><strong>Totals:</strong></td>
<td><strong>2.13</strong></td>
<td><strong>107</strong></td>
</tr>
</tbody>
</table>

Although perhaps less important than the bottom line, another aspect of this analysis bears mention. A striking attribute of these proposals is their relative modesty. They do not entail a systemic modification to the structure of the Social Security system. They require, instead, only very minor adjustments to existing obligations and benefits. In short, the Social Security financial crisis, although real, would not be difficult to remedy if only we could find the political will to accomplish the task.

B. PENSIONS

Fixing the pension leg of the retirement stool presents a more difficult task. The problems plaguing the highly technical realm of pension plans are more diverse and more nuanced than the actuarial issues at play with respect to Social Security. In addition, the voluntary nature of pensions is less amenable to reform through command and control regulation. Finally, any examination of the U.S. pension system must include a look at the complex provisions of the new PPA.

This section will first identify the necessary ingredients of a pension reform agenda in the contexts of defined benefit and defined contributions plans, respectively. Within these two subsections, the analysis will then review and critique how the PPA addresses this agenda and offer some additional recommendations for reform.

1. Fulfilling Defined Benefit Plan Promises

The past twenty-five years have not been kind to defined benefit pension plans and their beneficiaries. As plans have been weakened by under-funding and buffeted by volatile markets, a growing number of plan sponsors have defaulted on their defined benefit obligations.\(^\text{198}\) Other plan sponsors have frozen their defined benefit plans and substituted less generous

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\(^{198}\) See supra notes 75–87 and accompanying text.
cash balance plan arrangements.\textsuperscript{199} Too often, these conver-
sions have been crafted with a substantial "wearaway" of bene-
fit expectations for workers with long tenure.\textsuperscript{200} Reform meas-
ures are needed to better ensure that employers carry out the
retirement security promises made to their employees.

\textit{a. Require Adequate Funding}

Plan terminations often correlate with inadequately funded plans.\textsuperscript{201} Even when that correlation is lacking, the ter-
mination of inadequately funded plans results in a frustration of retirement benefit expectations. Defined benefit plans in the
United States are currently underfunded by approximately $450 billion;\textsuperscript{202} significant steps are needed to ensure that plan
sponsors make sufficient contributions to satisfy future liabili-
ties.

To shore up the current funding deficit, policy-makers
must address three primary issues. First, an accurate actuarial
measure of a fund's assets and liabilities is a necessary precon-
dition to gauging funding adequacy.\textsuperscript{203} One way to enhance the
accuracy of this measurement is to reduce the degree of discre-
tion that plan sponsors can exercise in making interest rate as-
sumptions. Under current regulations, plan sponsors have an
incentive to assume rates that maximize projected asset accu-
mulations.\textsuperscript{204} Such projections are prone to overstate the
amount of available assets and thereby mask likely funding
shortfalls.\textsuperscript{205}

As a second funding issue, defined benefit plan sponsors
should be required to meet a more stringent minimum funding
obligation. Sponsors at present generally are required to meet a
90\% funding level benchmark.\textsuperscript{206} This standard, along with
various accounting exceptions, too often enables plan sponsors

\begin{footnotes}
\footnotetext{199}{See supra notes 60–67 and accompanying text.}
\footnotetext{200}{See supra notes 88–94 and accompanying text.}
\footnotetext{202}{Ford et al., supra note 76, at 357; Simon, supra note 76, at 86.}
\footnotetext{203}{See Ford et al., supra note 76, at 385; Fabozzi & Ryan, supra note 81, at 57–58.}
\footnotetext{204}{See supra notes 81–82 and accompanying text.}
\footnotetext{205}{Ford et al., supra note 76, at 360–74; Fabozzi & Ryan, supra note 81, at 54–55.}
\footnotetext{206}{See Kerstein, supra note 69, at 5.}
\end{footnotes}
to withhold contributions, even to seriously underfunded plans. 207

Finally, the current credit balance rules contribute to plan underfunding. These rules enable plan sponsors to replace cash contributions with credit balances accrued in previous years, even if the plan in question is significantly underfunded. 208 Congress should prevent the Bethlehem Steel type of pension plan collapse by restricting the use of accounting credit balances for underfunded plans.

For the most part, the PPA does a good job of addressing these benchmark funding concerns. The PPA is the successor to various legislative proposals that have kicked around Congress since 2002. While members of both political parties introduced a considerable amount of pension legislation during this period, sharp partisan divisions in Congress stymied any decisive action. 209 In 2006, however, the prospect of several major airlines terminating their pension plans made some type of pension legislation a “must-pass” objective. 210 In this climate, a conference committee hammered out a complicated 907-page bill that incorporated a series of practical and largely beneficial reforms. 211

The PPA implements three major changes with respect to the funding issue:

- Requiring employers to make sufficient contributions to defined benefit plans in order to meet a 100% funding target over a seven year period;
- Requiring employers to use a segmented interest rate

207. See supra note 82 and accompanying text.
208. See supra notes 83–87 and accompanying text.
yield curve based upon long-term investment-grade corporate bonds and the retirement age dispersion of a fund's beneficiaries in order to measure future pension liabilities; and

- Prohibiting employers from using credit balances in lieu of contributions for plans funded at less than 80% of full funding status.  

These three measures, in short, address each of the three benchmark issues identified above. Of course, the devil may be in the details of these highly technical provisions. Further, the bar restricting the use of accounting credit balances in lieu of actual contributions may be better set at a 90% rather than at an 80% funding level. Such an approach would more strongly redress the chronic problem of sponsors skirting the AFC requirements for underfunded plans. Nonetheless, these three amendments demonstrate a practical and generally positive response to the problem of pension plan underfunding.

b. Preserving Benefits in Plan Conversions

A second crucial goal is to ensure that workers' expectations in defined benefit plans are not unduly trammeled in conversions to cash balance plans. The proper legal status of cash balance conversions has been a subject of considerable debate. Some scholars find most cash balance conversions to be illegal under ERISA's age discrimination prohibition because their uniform accrual methodology generally results in a retirement age annuity value that declines with age. Other scholars view cash balance plans as lawful so long as the plans do not decrease present accrual levels on the basis of age. The federal courts similarly are split on this issue.


213. See supra note 82 and accompanying text.


Numerous legislative proposals have been advanced to address this uncertain landscape. Some of these proposals essentially would prohibit or significantly penalize cash balance conversions. The American Association of Retired Persons (AARP), for example, supported legislation that would require an employer to permit a worker who is at least forty years old or has ten years of service to choose continued defined benefit coverage following an attempted conversion. Representative Bernard Sanders, as an alternative, introduced a bill calling for a 50% excise tax on any asset surplus in a converting defined benefit plan. Proposals such as these go too far because they are premised on the assumption that cash balance plans are inherently bad. They are not. Although officially a variant of a defined benefit plan, a cash balance plan essentially operates in a fashion similar to a defined contribution plan by periodically accumulating benefits in a hypothetical retirement account. Studies show that a majority of workers accrue equal or greater benefits under a cash balance plan as compared to a defined benefit plan if those plans are funded at an equivalent level. And, like defined contribution plans, cash balance plans are relatively portable and arguably more in tune with today's mobile workforce. Moreover, cash balance plans provide greater retirement security than defined contribution plans because sponsoring employers (rather than employees) bear the risk of investment loss and because the PBGC provides partial replacement coverage in the event of plan termination.

219. See supra notes 63–67 and accompanying text.
220. Forman & Nixon, supra note 88, at 387; Elliott & Moore, supra note 63, at 1–2.
221. GOV'T ACCOUNTABILITY OFFICE, supra note 66, at 7; Clark & Schieber, supra note 49, at 16–19. Many employers, however, fund cash balance conversion plans at a lower level than the predecessor defined benefit plan. See supra notes 88–94 and accompanying text. A study conducted by the Government Accountability Office reported that a "comparison of a typical [defined benefit] FAP plan that is converted to a typical CB [cash benefit] plan finds that, regardless of a worker's age, more workers would have received greater benefits under the FAP than under the typical CB plan." GOV'T ACCOUNTABILITY OFFICE, supra note 66, at 6.
222. Zelinsky, supra note 65, at 731–32.
223. Elliott & Moore, supra note 63, at 4.
The crucial problem is not with cash balance conversions per se, but with those conversions that use wear-away periods that unduly undercut the legitimate reliance expectations of long-term employees. These workers not only lose the anticipated defined benefit backloading effect of increased benefit accruals during the last few years preceding retirement, but they also experience a period in which they, unlike their junior colleagues, enjoy no benefit accrual at all under the new cash balance plan. Accordingly, proposals at the opposite extreme, such as the 2005 version of the PPA which would have provided a safe harbor to the wear-away practice in cash balance conversions, also are objectionable.

The PPA adopts a middling approach to the cash balance conversion issue by enacting two principal reforms. First, the Act removes the legal uncertainty surrounding cash balance plans by deeming such plans prospectively nondiscriminatory as to age if older workers earn current benefits at least equal to younger workers (even though younger workers may receive such amounts over a longer period of time). Second, the Act prohibits the practice of imposing a wear-away period following a plan conversion. Thus, the 2006 measure strikes a balance by permitting employers to switch to a cash balance formula, while prohibiting them from denying benefit accruals to older workers pursuant to that formula following plan conversion. Put another way, the 2006 Act permits a cash balance conversion to be accompanied with a maximum of "one whammy."

Although some groups have criticized the 2006 Act for not including additional transition assistance for workers hurt by cash balance conversions, the Pension Protection Act strikes

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224. See supra notes 91–94 and accompanying text.
225. See supra note 94 and accompanying text.
228. Id.
229. See supra note 94 and accompanying text (discussing the “double whammy” previously associated with cash balance plans).
an acceptable compromise by means of the wear-away ban. The bigger concern is that the combination of more rigorous defined benefit funding rules along with loosened cash balance conversion standards will further hasten the demise of traditional defined benefit plans. These two changes will likely act as twin incentives for still more employers to terminate or freeze their defined benefit plans.  

2. Encouraging and Protecting Defined Contribution Plan Participation

a. Altering the Default Options for Participation

Defined contribution plans, most notably employer-sponsored 401(k) plans, implicate a different set of problems. Here, the issue is not one of funding since defined contribution plans, by definition, are fully funded on an ongoing basis. The most significant problem, instead, is the low rate of employee participation, with approximately one-fourth to one-third of all those employees offered a defined contribution plan failing to participate.

As the prevalence of defined contribution plans has increased in the United States, so too has the degree of personal responsibility for employees to manage their own retirement resources. But individual financial planning is not a simple task. Many employees, faced with application forms and a dizzying array of investment options, simply procrastinate and do nothing. The complexity of the financial planning task, in other words, results in “bounded rationality” and a sub-optimal process of retirement planning.  

231. See Sheila R. Cherry, Pension Reform Administration, Industry Reacts to H.R. 4 as Provisions Head for Vote in Senate, PENSION & BENEFITS DAILY, Aug. 3, 2006 (reporting on an interview with Professor Teresa Ghilarducci, who criticized the PPA by calling it “a disguise for a further exit out of the defined benefit system”); Jane Bryant Quinn, A Requiem for Pensions, NEWSWEEK, July 3, 2006, at 53, 53 (describing the 2006 Act as a strange reform that will “push many more companies into freezing or dropping their plans”).

232. Reece, supra note 48, at 80.

233. See supra note 96 and accompanying text.


235. MUNNELL & SUNDÉN, supra note 45, at 172–74; Madrian & Shea, supra note 96, at 1176–84; Gale et al., supra note 234, at 3.
Since the problem here essentially is a matter of inertia, reversing the pull of inertia offers an intriguing possible solution. Rather than putting the onus on individual employees to undertake the steps necessary to opt into an offered 401(k) plan, why not provide for the automatic enrollment of a covered employee unless he or she opts out of the plan?

Several studies support the efficacy of an automatic enrollment strategy. In 1998, the Treasury Department issued a revenue ruling authorizing an employer's voluntary adoption of an automatic enrollment policy.\(^2^{36}\) Three years later, Brigette Madrian and Dennis Shea published a paper analyzing the impact of a large corporation's implementation of an automatic enrollment policy.\(^2^{37}\) Before the plan change, employees participated in the company's 401(k) plan only if they affirmatively elected to do so. Following the plan change, the company automatically enrolled new employees in the plan unless they made a negative election to opt out of the plan. Although none of the economic features of the plan changed, the switch to automatic enrollment increased plan participation by 25%.\(^2^{38}\) Other studies similarly indicate that automatic enrollment can boost the rate of plan participation from a national average of around 75% to between 85 and 95%.\(^2^{39}\) Automatic enrollment is particularly effective in raising the participation rates of previously under-participating groups such as younger workers and low-wage workers.\(^2^{40}\)

The PPA embraces this strategy by encouraging employers to enroll employees automatically in defined contribution plans subject to the right of employees to opt out of such participation.\(^2^{41}\) The PPA also encourages employees strongly by provid-


\(^{237}\) Madrian & Shea, supra note 96, at 1149–50.

\(^{238}\) Id. at 1173; see also John Beshears et al., The Importance of Default Options for Retirement Savings Outcomes: Evidence from the United States 6–7 (Nat'l Bureau of Econ. Research, Working Paper No. 12009, 2006), available at http://www.nber.org/papers/w1209 (reporting on another study showing a similar 25% participation gain).


\(^{240}\) Madrian & Shea, supra note 96, at 1176–79.

ing a safe harbor from nondiscrimination and fiduciary requirements for employers that adopt the reverse default option practice.242

While the Act removes potential obstacles to default enrollment, it remains to be seen how many employers will voluntarily embrace this option. Some employers that make matching contributions on behalf of participating employees may decide against the automatic enrollment option because of its greater cost. Ultimately, Congress should monitor employer participation rates to determine whether an automatic enrollment mandate would be preferable.

Congress should consider adopting default options for some other 401(k) decisions as well. Madrian and Shea's study found that, even with automatic enrollment, inertia tended to stagnate contribution levels and investment allocations in accordance with the initial enrollment default parameters.243 Further, a majority of employees with smaller account balances cash in their plans when changing jobs rather than rolling them over into a new or ongoing plan.244 These tendencies, of course, depress the overall accumulation of retirement savings.245 Like initial enrollment, there is reason to believe that these negative inclinations could be dampened if plans provided automatically for periodic increases in contributions, default investment allocations (such as life-cycle funds), and the default rollover of plan funds upon job change.246 While employees should have the right to override each of these settings, these new default options would harness the powerful force of inertia for greater retirement savings.


243. Madrian & Shea, supra note 96, at 1171-76; see also Beshears et al., supra note 238, at 8-12.

244. Walczak & Dunham, supra note 99, at 32.

245. See MUNNELL & SUNDÉN, supra note 45, at 28-40, 125-42 (estimating that employees amass assets in defined contribution plans at only about one-fourth the rate that would be anticipated, primarily due to asset "leakages" attributable to job change distributions and non-repaid loans).

246. Id. at 174-76; Gale et al., supra note 234, at 4-5, 8-10; see also Beshears et al., supra note 238, at 16-26 (describing in general the significant impact that default options have on retirement savings outcomes).
b. Diversifying Defined Contribution Plan Investments

Following the 2001 Enron collapse, legislators have introduced numerous bills in Congress to address the issue of company stock concentrations in defined contribution plans. But, until the passage of the PPA, Congress was unable to forge a consensus solution.

The most far-reaching of these reform proposals was the proposed Pension Protection and Diversification Act sponsored by Senators Boxer (D-Cal.) and Corzine (D-N.J.). This bill would have capped company stock holdings at 20% of an individual's 401(k) holdings and enabled employees to sell company matching stock ninety days after receipt.\textsuperscript{247} The bill also would have limited the tax deduction available to employers who make matching contributions in company stock to 50% of the value of that stock.\textsuperscript{248}

But many critics, including President Bush, oppose placing limits of this type on an employer's ability to make matching contributions in the form of company stock.\textsuperscript{249} A principal objection is one of deterrence. As the argument goes, employers who are precluded from making company stock matching contributions will respond by not making any matching contributions or by not sponsoring any pension plan at all.\textsuperscript{250}

Most congressional proposals have steered clear of an explicit limitation on company stock holdings in favor of alternatives that would encourage education and enable employee diversification.\textsuperscript{251} The most prominent of these proposals was the Pension Security Act of 2003 sponsored by Representative Boehner (R-Ohio).\textsuperscript{252} This bill would have permitted plan participants to diversify out of company stock matching contributions after three years and would have permitted "fiduciary advisors" to offer investment advice to participants.\textsuperscript{253} These advisors would have included interested pension managers and investors, so long as conflicts of interest were disclosed.\textsuperscript{254}

\textsuperscript{248}. \textit{Id}.
\textsuperscript{249}. See Lawrence, supra note 104, at 42, 48–49; Stabile, supra note 113, at 557–58.
\textsuperscript{250}. Lawrence, supra note 104, at 48–49.
\textsuperscript{251}. See Iwry, supra note 102, at 3–4.
\textsuperscript{253}. \textit{Id}., §§ 104(j)(3)(A), 105(g).
Congressional Democrats also have moved away from the explicit cap approach of the Boxer/Corzine bill. Those sponsors withdrew their bill in 2003 in favor of one introduced by Senator Kennedy (D-Mass.).\footnote{255} Kennedy’s bill created an “either/or” option, permitting employers to contribute stock to 401(k) plans or to offer stock as an investment option to plan participants, but not both.\footnote{256} The bill also would have enabled employees to sell company matching stock after a maximum three-year holding period.\footnote{257}

These legislative proposals reflect a difficult set of competing policy choices. On the one hand, over-concentration of company stock in pension portfolios poses significant dangers to retirement security. On the other hand, a prohibition on an employee’s voluntary choice to invest in his or her employer’s stock smacks of paternalism.\footnote{258}

The anti-paternalism concern won out in Congress. The PPA, also sponsored by Representative Boehner, essentially carries forward the diversification and education components of the earlier Pension Security Act proposal. The PPA enables plan participants to sell any employer-directed company stock match at any time beyond three years of receipt.\footnote{259} It also provides a safe harbor for fiduciary advisors, including interested financial service firms, who give advice to participants on portfolio management, so long as they disclose conflicts and base advice upon an independently approved computer model.\footnote{260}

The PPA’s response to the problem of company stock over-concentration warrants lower marks. Considerable research suggests that participant education and empowerment are unlikely to lead to diversification.\footnote{261} Many participants are less-than-savvy investors who tend to think that company stock


\footnote{257} Id. § 102(a)(2)(A)(iii).

\footnote{258} See generally CHOI ET AL., supra note 105, at 23–24 (discussing how these competing policies create a “policymaking muddle”).


\footnote{261} See Stabile, supra note 113, at 552–57; Iwry, supra note 102, at 3–4.
concentrations are a problem for others, but not themselves.\textsuperscript{262} As an example, the widespread media attention given to the Enron collapse, coupled with a voluntary loosening of diversification restrictions by some employers, has had a negligible impact on the prevalence of company stock concentrations.\textsuperscript{263}

The provision authorizing investment advice by interested advisors also is problematic. This safe harbor measure runs counter to ERISA's general prohibited transaction rules that bar parties with conflicts of interest from exercising fiduciary responsibilities.\textsuperscript{264} The provision of investment advice by entities that may gain from an employee's continued investment in company stock is a puzzling way to foster diversification. As Professor Stabile commented with respect to the proposed Pension Security Act, "[i]f the only advice available is conflicted advice, participants will either take that conflicted advice or be no better off than they are now."\textsuperscript{265}

Here again, a change in default options may provide a better solution. Some commentators have suggested requiring plans to structure default employee investment options in a diverse portfolio that does not contain company stock.\textsuperscript{266} Employees could override the default option and change the investment mix to include company stock if it is offered by the plan as an investment option.\textsuperscript{267} Under this approach, employees could consciously choose to invest in company stock, but the impact of inertia, a definite force in determining investment allocations, would work in favor of diversification.\textsuperscript{268} Meanwhile, employers

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\item \textsuperscript{262} See also \textit{John Hancock Fin. Servs., Eighth Defined Contribution Plan Survey: Insight into Participant Investment Knowledge \& Behavior} 10 (2002), available at http://www.reig.jhancock.com/gsfp/survey2002.pdf (reporting on survey results showing that 401(k) plan participants on average rate company stock as a less risky investment than a diversified equity mutual fund).
\item \textsuperscript{263} \textit{Choi et al.}, supra note 105, at 23–24 (estimating that the media publicity surrounding the bankruptcy of Enron and other firms "reduced the fraction of 401(k) assets held in employer stock by at most 2 percentage points"); see also Press Release, Hewitt Associates, Hewitt Research Shows U.S. Employees Not Interacting with 401(k) Plan for Optimal Benefit (July 8, 2002) (on file with author) (reporting on a study showing that in 2001, the year of Enron's collapse, "only 19.5\% of active 401(k) participants made any form of trade" in their account).
\item \textsuperscript{264} See Lawrence, supra note 104, at 66–67.
\item \textsuperscript{265} Stabile, supra note 113, at 557.
\item \textsuperscript{266} \textit{Choi et al.}, supra note 105, at 24–25; Iwry, supra note 102, at 5.
\item \textsuperscript{267} Iwry, supra note 102, at 5.
\item \textsuperscript{268} Id.; see also Stabile, supra note 113, at 554 ("[Sixty percent] of participants in 401(k) plans never make any changes to their initial contribution and
could still choose to make matching contributions in company stock, but participants would have the ability to diversify the match within a relatively short time.

C. ENCOURAGING SAVINGS BY LOW- AND MIDDLE-INCOME EARNERS

As a final matter, U.S. workers should be encouraged to increase savings for retirement. Because defined benefit plans are crumbling and Social Security's future is increasingly uncertain, it is more important than ever for workers to supplement these external sources with individually financed retirement investments. Many vehicles are available to assist in this endeavor, including employer-sponsored 401(k) plans, Individual Retirement Accounts, and personal savings accounts. Yet current data depict a widespread pattern of sub-optimal investment in each of these various forms.

U.S. policy currently encourages savings through a variety of tax preferences. Employees, for example, may defer income tax liability on contributions of up to $15,000 per year made to a qualifying 401(k) plan. These contributions, as well as employer contributions to the plan, are excluded from the employee’s current taxable income until the employee subsequently withdraws them as retirement income. Employers also may deduct their contributions as ordinary business expenses. In a similar vein, individuals may reduce current taxable income by up to $5000 per year by the year 2008 for each dollar contributed to an Individual Retirement Account. Alternatively, individuals may use a Roth IRA from which they may withdraw investment growth at retirement without tax li-

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269. See supra notes 36–42, 59–62 and accompanying text.
270. See supra notes 125–36 and accompanying text.
271. I.R.C. § 402(g)(1)(B) (West 2006); see also MUNNELL & SUNDÉN, supra note 45, at 183–89 (summarizing the regulatory framework and tax treatment of contributions made to 401(k), IRA, and other defined contribution pension plan arrangements); PETER ORSZAG & ROBERT GREENSTEIN, TOWARD PROGRESSIVE PENSIONS: A SUMMARY OF THE U.S. PENSION SYSTEM AND PROPOSALS FOR REFORM 14–17 (2001), http://www.sbgp.com/Papers/csconf.pdf (discussing the benefits of progressive pension policy as it relates to tax incentives and preferences).
273. Id. § 404(a).
274. Id. §§ 219, 408.
Altogether, these various tax preferences reduce the present value of tax revenues by approximately $150 billion each year.276

This preferential tax treatment, however, is problematic on grounds of both equity and efficacy. In terms of equity, a disproportionate share of tax savings flows to high-income earners even though it is low- and middle-income earners who are most in danger of having inadequate funds available upon retirement.277 This fact is illustrated by comparing the tax consequences to a high-income earner and a low-income earner making a 401(k) contribution of the same amount. A $100 contribution by a high-income earner in the 35% marginal federal income tax bracket receives a $35 exclusion, resulting in a $65 after-tax cost to the taxpayer. The same contribution by a low-income earner in the 15% marginal tax bracket, in contrast, receives only a $15 exclusion, resulting in an $85 after-tax cost. The deduction, accordingly, is worth more than twice as much to the high-income earner.278 In total, two-thirds of the existing savings tax preferences currently go to the highest 20% of income earners.279

In terms of efficacy, tax subsidies are poorly targeted as a strategy for boosting overall savings. High-income households have a higher propensity (and ability) to save, meaning that they are disproportionately likely to respond to a tax incentive by shifting assets from a taxable investment account to a tax-preferred investment account.280 To that extent, the tax preference provides a tax shelter that does not translate into a net increase in overall savings.281 In contrast, lower- and middle-income households are less likely to have other assets on hand,
and their contributions to tax-preferred accounts are more likely to represent a net increase in overall savings.\textsuperscript{282} The Bush Administration has adopted an expansion of tax incentives as the centerpiece of its savings agenda. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) substantially raised tax preference caps through 2010,\textsuperscript{283} and the PPA makes those increases permanent.\textsuperscript{284} The Administration also is on record in support of additional future tax breaks.\textsuperscript{285}

Put simply, this agenda is misguided. Since only 5 or 6% of all taxpayers make the maximum tax-free contributions currently permitted, expanded tax preferences would principally benefit only a small segment of high-income earners.\textsuperscript{286} Sound pension policy reform, instead, should focus on directing incentives to low- and middle-income workers. This focus would assist those workers with the least retirement security and would also have the salutary effect of increasing overall net savings.\textsuperscript{287}

The Saver's Credit, enacted in 2001 as part of EGTRRA, takes an important first step in this direction.\textsuperscript{288} The Saver's Credit, which Congress also extended in the PPA,\textsuperscript{289} provides a government matching contribution in the form of a tax credit for voluntary individual contributions to 401(k) plans, IRAs, and similar retirement savings arrangements.\textsuperscript{290} The legislation adopts a progressive structure; the rate of government

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\textsuperscript{282} Gale et al., \textit{supra} note 278, at 1, 8.
\textsuperscript{287} Gale et al., \textit{supra} note 278, at 1, 7–8; ORSZAG & GREENSTEIN, \textit{supra} note 271, at 14–17.
\textsuperscript{288} I.R.C. § 25B (West 2006).
\end{footnotesize}
subsidy falls as household income rises. The credit rate is 50% for an unmarried taxpayer with an adjusted gross income of up to $15,000, 20% for taxpayers with an adjusted gross income between $15,001 and $16,250, and 10% for taxpayers with an adjusted gross income between $16,251 and $25,000. The same credit rates apply to married couples filing jointly with the adjusted gross income bounds multiplied by a factor of two. By using this progressive structure, the Saver’s Credit works to level the playing field by correcting for the inherent bias of tax exclusions that favor taxpayers with higher marginal rates.

The Saver’s Credit, however, like other pure tax credit measures, only confers a benefit on taxpayers who have a federal income tax liability against which to apply the credit. Because many low-income individuals owe little or no federal tax, more than 80% of the fifty-nine million tax filers who otherwise would qualify for the maximum 50% credit are excluded from participation, while many others are eligible for only a fraction of what theoretically is available on paper. As a result, the Saver’s Credit fails to encourage savings among a large group of low-income earners who are at the greatest risk of a financially insecure retirement.

In order to reach this low-earner group, some type of affirmative contribution or refundable tax credit is needed. Policy analysts have proposed a variety of solutions in this vein. Former President Jimmy Carter’s Commission on Pension Policy, for example, proposed a mandatory minimum employer contribution of 3% of payroll for every employee over the age of twenty-five who works more than 1000 hours per year. More common are proposals that call for leveraged government funding, such as former President William Clinton’s proposal for a system of universal savings accounts financed by a combination of direct and matching contributions. Whatever the details,
some form of program targeted at low and moderate earners as a supplement to Social Security is needed in order to prime the pump for additional savings by workers who need it most. Studies show that these incentives can be effective, even among workers with relatively few resources at hand.297

The easiest path to take at this point would be to expand the Saver's Credit program by making the credit refundable. Under this approach, the government would substitute a monetary payment in lieu of an income tax credit for those individuals who make a matching contribution to a qualifying pension or savings program, but who do not have a sufficient tax liability to make use of the tax credit. The monetary payment, in other words, would mirror the credit in terms of income limitations, benefit amounts, and progressivity.298 It should be underscored that this reform would not result in a direct transfer payment to any individual, but only to a retirement or savings account to which the individual also is required to contribute.299

This refundability expansion would add approximately $2 billion to $3 billion per year in cost to the existing Saver’s Credit program.300 This additional expenditure could be financed by rolling back the tax preferences primarily benefiting high-income earners to pre-EGTRRA levels.301 Alternatively, we could borrow a page from the new Massachusetts health insurance plan and require employers to contribute an extra 1% of payroll for those employees with more than a year of service who are not offered any form of pension plan.302 In either event, it would be money well spent in terms of enhancing overall retirement security.

298. Gale et al., supra note 278, at 10–11.
299. Id. at 11.
300. Id.
301. See Weller, supra note 63, at 13–14.
302. See MD. CODE ANN. HEALTH-GEN. § 118G-18B (West 2006); Pam Belluck, Massachusetts Sets Health Plan for Nearly All, N.Y. TIMES, Apr. 5, 2006, at A1 (summarizing 2006 Massachusetts health care legislation that requires employers who do not sponsor an employee health plan to contribute to a state-sponsored health care program).
Problems abound in the realm of retirement finance. The Social Security system is on a collision course with financial insolvency. Over one-half of all Americans lack a private pension to supplement Social Security benefits. The shrinking minority who are covered by a defined benefit pension plan are seeing their employers increasingly renege on pension plan commitments. The growing minority offered an employer-sponsored defined contribution plan are seeing their potential nest eggs diluted by inertia, job-change leakages, and an over-concentration in company stock. Meanwhile, personal savings have plunged into negative territory. If all three legs of the retirement stool continue on this course, a perfect storm of retirement insecurity will wreak havoc with the burgeoning baby-boom generation of retirees.

This perfect storm is not inevitable, however. As this Article illustrates, a wide variety of options exists to improve retirement security. The problem is not a lack of possible solutions, but a lack of political will. So far, neither political party has been willing to take responsibility—or blame—for the necessary agenda of increasing taxes, trimming benefits, and enhancing regulatory oversight. Both parties, instead, primarily have treated the matter of retirement security as a wedge issue, with each party pointing to the other as obstructionist.

But the PPA illustrates that meaningful reform is possible when Congress sets political bickering aside and engages in a practical, bipartisan mode of problem-solving. That same approach should now be directed at devising a broad-based package of measures that will shore up all three legs of the retirement stool.

This Article provides one possible set of proposals for such a reform agenda. The ingredients of that agenda consist of three practical and not particularly painful steps. First, the Social Security system could be saved from insolvency through a mix of relatively small payroll tax hikes and benefit reductions, including a slight rise in the retirement age. Second, with defined contribution plans becoming the new pension norm, changes in setting account default options could encourage both greater plan participation and improved plan security. Third, Congress could implement a modest refundable tax credit to encourage low- and middle-income earners to build their own supplemental nest eggs.
The recommendations set out in this Article underscore a crucial aspect of the policy debate: the reforms needed to restore retirement security are not paradigm-shifting or unbearably painful. In the end, what is needed to avoid the looming perfect storm of retirement insecurity is not some systemic overhaul, but a common sense program of shared responsibility.