The Cost of “Choice” in a Voluntary Pension System

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The Cost of “Choice” in a Voluntary Pension System

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Regulation of Benefit Plans:
The Most Consequential Subject to Which No One Pays Enough Attention

(to be held at the University of Michigan on March 22, 2013)

by

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Jonathan Barry Forman** & G. A. (Sandy) Mackenzie♣

ABSTRACT

Unlike our mandatory universal Social Security system, America’s private pension system is replete with choice: choices about the type of pension plan, choices about the amount and timing of contributions, choices about investments, and choices about the timing and nature of distributions. It takes time to make all these choices, and sometimes employers and workers just throw up their hands and don’t make any choices at all. This “choice overload” or “analysis paralysis” imposes significant costs on employers, workers, and government; and this article recommends a variety of ways to reduce those costs.

I. INTRODUCTION

The United States and most other industrialized nations have multi-pillar retirement systems that fit within the World Bank’s multi-pillar model for retirement savings consisting of a first-tier public system, a second-tier employment-based pension system, and a third-tier of supplemental voluntary savings. While in many countries, the second-tier occupational pension

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1 WORLD BANK, AVERTING THE OLD AGE CRISIS: POLICIES TO PROTECT THE OLD AND PROMOTE GROWTH (Oxford University Press, 1994) xiv; see also ROBERT HOLZMANN AND RICHARD HINZ, OLD-AGE INCOME SUPPORT IN THE 21ST CENTURY: AN INTERNATIONAL PERSPECTIVE ON PENSION SYSTEMS AND REFORM (World Bank, 2005), http://www.egm.org.tr/kutuphane/Old_Age_Income_Support_Complete.pdf (suggesting an additional pillar for informal intrafamily or intergenerational sources of both financial and nonfinancial support to the elderly, including access to health care and housing); Lans Bovenberg & Casper van Ewijk, The Future of Multi-Pillar Pension
is mandatory or quasi-mandatory, in the United States, both the second and third-tier retirement savings systems are voluntary. That is, employers are not required to offer pensions, and when they do, they have considerable choice over the type of pension plan to have and over many of that plan’s features. Moreover, when employers do offer a pension plan, it is probably a 401(k)-type plan that offers employees considerable choice about whether to participate, about how much to contribute, about how to invest those contributions (and prior accumulations), and about the timing and nature of distributions. In short, unlike our first-tier, mandatory Social Security system, America’s second-tier, private pension system is replete with choice: choices about the type of pension plan, choices about the amount and timing of contributions, choices about investments, and choices about the timing and nature of distributions.

To be sure, the availability of pension choices may be of value to employers and individuals, but, on the whole, the costs of choice almost certainly exceed the benefits. Pertinent here, one of the major problems with the current pension system is its incredible complexity. That complexity imposes significant costs on individuals, employers, and government, especially when compared to the relatively rigid, but straightforward, Social Security system. As more fully discussed below, the administrative costs for Social Security’s retirement system are well under 1% of benefits paid. Meanwhile, other than the cost for a payroll withholding service, employers

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3 Outside of the public sector, 401(k)-type plans are the most common type of pension plan. See infra Part II.B.

4 See infra Part III.A.
incur almost no costs because of Social Security; and almost the only choice that workers face is the choice about *when* to take their benefits, at which point in time, a costless and simple application\(^5\) leads to a lifetime of inflation-adjusted retirement income.\(^6\)

On the other hand, employers, individuals, and government all incur significant costs in connection with the current pension system.\(^7\) Employers incur significant costs in choosing, designing, administering, or even outsourcing their pensions; individuals incur significant costs in connection with the management, investment, and distribution of their contributions and benefits; and the government incurs significant costs in regulating thousands of disparate pension plans and millions of Individual Retirement Accounts (IRAs). Also, because of the voluntary nature of our second-tier, private pension system, coverage and participation rates are low, and retirement savings may be inadequate for many retirees.\(^8\)

All in all, this Article focuses on the costs of choice in America’s voluntary private pension system. At the outset, Part II of this Article provides an overview of the current U.S. retirement system—both Social Security and private pensions. Next, Part III of this Article looks at the costs associated with the current Social Security and private pension systems. Finally, Part IV of this Article outlines some ways to reduce the costs associated with the private pension system. In particular, Part IV discusses how to reduce costs by moving to a universal, second-tier pension system; and Part IV also discusses some more modest approaches for reducing the costs associated with the current private pension system.

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6 See infra Part II.A.
7 See infra Part III.C.
II. AN OVERVIEW OF THE UNITED STATES RETIREMENT SYSTEM

The United States retirement system consists of a universal Social Security system, a voluntary, employment-based pension system, and supplemental voluntary savings. These are discussed in turn.

A. SOCIAL SECURITY AND SUPPLEMENTAL SECURITY INCOME (SSI)

The current Social Security system includes two programs that provide monthly cash benefits to workers and their families. The Old-Age and Survivors Insurance (OASI) program provides monthly cash benefits to retired workers and their dependents and to survivors of insured workers; and the Disability Insurance (DI) program provides monthly cash benefits for disabled workers under full retirement age and their dependents. A worker builds protection under these programs by working in employment covered by Social Security and paying the applicable payroll taxes. At retirement, disability, or death, monthly Social Security benefits are paid to insured workers and to their eligible dependents and survivors.

The Old-Age and Survivors Insurance program is by far the larger of these two programs, and it is usually what people mean when they talk about Social Security. Consequently, for the remainder of this Article, “Social Security retirement taxes” will refer to OASI taxes, and “Social Security retirement benefits” will refer to OASI benefits. Historically, “full retirement age” was age 65, but it is currently age 66, and it is gradually increasing to age 67 for workers born after 1959 (who reach that age in or after 2027). In January of 2013, OASI paid benefits to almost 37

8 See infra Part II.B.5.
9 See, e.g., FORMAN, supra note 2, at 184-190.
million retired workers, and the average monthly benefit paid to a retired worker was $1,264.03.\(^{11}\)

Social Security retirement benefits are financed primarily through payroll taxes imposed on individuals working in employment or self-employment that is covered by the Social Security system. For 2013, employees and employers each pay a Social Security retirement tax of 5.3% on up to $113,700 of wages, for a combined OASI rate of 10.6%—the lion’s share of the total 15.3% collected for OASI, DI, and Medicare.\(^{12}\) Self-employed workers pay an equivalent OASI tax of 10.6% on up to $113,700 of net earnings.\(^{13}\)

Workers over the age of 62 generally are entitled to Social Security retirement benefits if they have worked in covered employment for at least 10 years.\(^{14}\) Benefits are based on a measure of the worker’s earnings history in covered employment. Of note, however, the benefit formula is highly progressive,\(^{15}\) and, as a result, the Social Security retirement system favors workers with


\(^{13}\) Id.

\(^{14}\) 42 U.S.C. §§ 402(a), 414(a)(2).

\(^{15}\) For example, benefits for retired workers are based on a measure of the worker’s earnings history in covered employment known as the average indexed monthly earnings (AIME). The starting point for determining the worker’s AIME is to determine how much the worker earned each year through age 60. Once those “benefit computation years” and covered earnings for those years have been identified, the worker’s earnings are indexed for wage inflation, using the year the worker turns 60 to index the earnings of prior years. The highest 35 years of earnings are then selected, and the other years are dropped out. The AIME is then computed as the average earnings for the remaining 35 years (420 months). The AIME is then linked by a progressive formula to the monthly retirement benefit payable to the worker at full retirement age, a benefit known as the “primary insurance amount” (PIA). For a worker turning 62 in 2013, the PIA equals 90 percent of the first $791 of the worker’s AIME, plus 32 percent of the AIME over $791 and through $4,768 (if any), plus 15 percent of the AIME over $4,768 (if any).
low lifetime earnings relative to workers with higher lifetime earnings. For example, Figure 1 shows how a worker’s initial retirement benefits compare to her final pre-retirement earnings. Of particular note, these redistributive Social Security benefits play an important role in reducing poverty among the elderly. Without Social Security benefits 43.6% of elderly Americans would fall below the poverty level, but with Social Security benefits, just 8.7% are poor.


Also, because high-earners are more likely to be married than low-earners, high-earners receive a disproportionate share of the Social Security system’s rather generous spousal benefits. In 2010 for example, 78.4% of households in the top 20% of households income were married-couple families, but only 17.0% of households in the bottom 20% were married-couple families. See, e.g., Mark J. Perry, Income inequality can be explained by household demographics (American Enterprise Institute, AEIdeas blog, 2011), http://www.aei-ideas.org/2011/10/income-inequality-can-be-explained-by-household-demographics/#print.


Similarly, Figure 2 shows the initial Social Security retirement benefits that workers born in the 1970s are scheduled to receive when they get to age 65 (in and after 2035). All in all, Social Security’s replacement rate is high when incomes are low, but may not be high enough to keep recipients above the poverty line, and it drops off substantially as incomes rise.

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Benefits may be increased or decreased for several reasons. Most importantly, the real (inflation-adjusted) value of retiree benefits is kept constant by an annual adjustment of nominal benefits to compensate for consumer price inflation.\textsuperscript{20} Also, the “retirement earnings test” can

reduce the monthly benefits of individuals who have not yet reached full retirement age but who continue to work after starting to draw Social Security retirement benefits.\(^{21}\)

In addition, workers who retire before their full retirement age have their benefits actuarially reduced.\(^{22}\) On the other hand, benefits payable to workers who choose to retire after their full retirement age are actuarially increased (but only up to age 70).\(^{23}\) In effect, beneficiaries can buy additional annuity protection by delaying retirement.\(^{24}\) For example, consider a worker who reached age 62 in January of 2013 and earned the maximum taxable amount under Social Security for every year of her working life. If she claims her Social Security benefits at 62, she will get $1,923 per month.\(^{25}\) If she instead waits until she is 65, she will get $2,414 per month, and if she waits until age 70, she will get $3,350 per month—and any additional years of work may boost the measure of lifetime earnings that is used to determine monthly benefits.\(^{26}\)

\(^{21}\) 42 U.S.C. § 403(f).

\(^{22}\) 42 U.S.C. § 402(q).

\(^{23}\) 42 U.S.C. § 402(q).


Spouses, dependents, and survivors of the worker may also receive additional monthly benefits which are based on the worker’s benefits. For example, a retirement-age wife or husband of a retired worker is typically entitled to a monthly spousal benefit equal to 50% of the worker’s benefit. Also, a retirement-age widow or widower of the worker is entitled to a monthly surviving spouse benefit equal to 100% of the worker’s benefit.

In addition, a means-tested Supplemental Security Income (SSI) program provides monthly cash benefits to certain low-income elderly, disabled, or blind Americans. In 2013, the maximum federal benefit for a single individual is $710 per month, and the maximum for a couple is $1,066 per month. In January of 2013, over two million elderly Americans received SSI benefits from the federal government, and the average monthly benefit was $422.17.

B. THE PRIVATE PENSION SYSTEM

As already mentioned, the United States has a voluntary pension system, and employers have considerable choice about whether and how to provide pension benefits to their employees. However, when employers decide to provide a pension, those pensions are typically subject to regulation under the Employee Retirement Income Security Act of 1974 (ERISA).

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27 42 U.S.C. §§ 402(b) (wife), (c) (husband), (d) (child), (e) (widow), (f) (widower), (g) (mother and father), and (h) (parents).
29 42 U.S.C. §§ 402(e), (f).
31 Social Security Administration, supra note 11.
1. Retirement Savings are Tax-Favored

Most pension plans qualify for favorable tax treatment. Basically, an employer’s contributions to a tax-qualified retirement plan on behalf of an employee are not taxable to the employee.\(^3^3\) Moreover, the pension fund’s earnings on those contributions are tax-exempt.\(^3^4\) Workers pay tax only when they receive distributions of their pension benefits.\(^3^5\) Nevertheless, the employer is allowed a current deduction for its contributions (within limits).\(^3^6\)

Favorable tax rules are also available for individual retirement accounts (IRAs).\(^3^7\) Almost any worker can set up an IRA with a bank or other financial institution. In 2013, individuals without pension plans can contribute and deduct up to $5,500 to an IRA, although individuals over age 50 can contribute and deduct another $1,000 (for a total of up to $6,500); and spouses can contribute and deduct similar amounts.\(^3^8\) If a worker is covered by another retirement plan,
however, the deduction may be reduced or eliminated if the worker’s income exceeds $59,000 for a single individual or $95,000 for a married couple.\textsuperscript{39} Like private pensions, IRA earnings are tax-exempt, and distributions are taxable.\textsuperscript{40}

Also, since 1998, individuals have been permitted to set up Roth IRAs.\textsuperscript{41} Unlike regular IRAs, contributions to Roth IRAs are not deductible. Instead, withdrawals are tax-free. Like regular IRAs, however, Roth IRA earnings are tax-exempt.

Also, since 2002, certain low- and moderate-income individuals have been able to claim a tax credit of up to $1,000 for certain qualified retirement savings contributions.\textsuperscript{42} Finally, qualified small firms may claim a nonrefundable tax credit of up to $500 for a certain costs incurred in setting up a new retirement plan for employees.\textsuperscript{43}

\section*{2. Types of Pension Plans}

Pension plans generally fall into two broad categories based on the nature of the benefits provided: defined benefit plans and defined contribution plans.

\begin{footnotes}
\item[39] Id.
\item[40] Also, so-called “Keogh plans” give self-employed workers an ability to save for retirement that is similar to plans that employers sponsor, and Keogh plans allow self-employed workers to contribute more than they could otherwise contribute to a regular IRA. Internal Revenue Service, \textit{Retirement Plans for Small Business (SEP, Simple, and Qualified Plans)} 2, 12 (Publication No. 560, 2012), \url{http://www.irs.gov/pub/irs-pdf/p560.pdf}.
\item[41] I.R.C. § 408A.
\item[42] I.R.C. § 25B. The credit equals a percentage (50\%, 20\%, or 10\%) of up to $2,000 of contributions. In effect, the credit acts like an employer match: the government matches a portion of the employee’s contributions. Employer matches encourage workers to contribute, at least up to the match level, and the saver’s tax credit seems to have similar pro-savings effects. \textit{See, e.g.}, Lisa Southwirth & John Gist, \textit{The Saver’s Credit: What Does It Do For Saving?} (AARP Public Policy Institute Insight on the Issues Paper, 2008) \url{http://assets.aarp.org/rgcenter/econ/11_credit.pdf}.
\item[43] I.R.C. § 45E. The credit is equal to 50\% of up to $1,000 in eligible costs incurred in each of the first three years of the plan’s existence. \textit{See, e.g.}, Gary Guenther, \textit{Small Business Tax Benefits: Overview and Economic Rationales} 17 (Congressional Research Service, Paper No. RL32254, 2008), \url{http://royce.house.gov/uploadedfiles/small%20business%20tax%20benefits.pdf}.
\end{footnotes}
a. Defined Benefit Plans

In a defined benefit plan, an employer promises employees a specific benefit at retirement. To provide that benefit, the employer typically makes payments into a trust fund, contributed funds grow with investment returns, and eventually the employer withdraws funds from the trust fund to pay the promised benefits. Employer contributions are based on actuarial valuations, and the employer bears all of the investment risks and responsibilities.

Defined benefit plans often provide each worker with a specific annual retirement benefit tied to the worker’s final average compensation and number of years of service. For example, a plan might provide that a worker’s annual retirement benefit ($B$) is equal to 2% times the number of years of service ($yos$) times final average compensation ($fac$) ($B = 2\% \times yos \times fac$). Under this final-average-pay formula, a worker who retires after 30 years of service with final average compensation of $50,000 would receive a pension of $30,000 a year for life ($30,000 = 2\% \times 30 yos \times $50,000 fac$). Final average compensation is often computed by averaging the worker’s salary over the last three or five years prior to retirement. While many defined benefit plans allow for lump sum distributions, the default benefit for defined benefit plans is a retirement income stream in the form of an annuity for life.

b. Defined contribution plans

Under a typical defined contribution plan, the employer simply withholds a specified percentage of the worker’s compensation which it contributes to an individual investment account for the worker. For example, contributions might be set at 10% of annual compensation.

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44 Alternatively, some plans use career-average compensation instead of final-average compensation. Under a career earnings formula, benefits are based on a percentage of an average of career earnings for every year of service by the employee.
Under such a plan, a worker who earned $50,000 in a given year would have $5,000 contributed to an individual investment account for her ($5,000 = 10% \times $50,000). Her benefit at retirement would be based on all such contributions plus investment earnings.\textsuperscript{46}

Unlike traditional defined benefit plans, defined contribution plans usually make distributions in the form of lump sum or periodic distributions rather than life annuities. Indeed, relatively few defined contribution plans even offer annuity options, and, in any event, relatively few participants elect those annuity options.\textsuperscript{47}

In the United States, there are a variety of different types of defined contribution plans, including money purchase pension plans, target benefit plans, profit-sharing plans, stock bonus plans, and employee stock ownership plans (“ESOPs”).\textsuperscript{48} Of particular note, profit-sharing and stock bonus plans often include a feature that allows workers to choose between receiving cash

\textsuperscript{45}In the United States, defined benefit plans are generally designed to provide annuities, i.e., “definitely determinable benefits . . . . over a period of years, usually for life after retirement.” Treas. Reg. § 1.401-1(b)(1).

\textsuperscript{46}Defined contribution plans are also known as “individual account” plans because each worker has her own account, as opposed to defined benefit plans, where the plan’s assets are pooled for the benefit of all of the employees.

\textsuperscript{47}See, e.g., Beverly I. Orth, \textit{Approaches for Promoting Voluntary Annuitization}, \textsc{Society of Actuaries, 2008 Retirement 20/20 Conference} (Monograph No. M-RS08-1, 2009), http://www.soa.org/library/monographs/retirement-systems/retirement2020/2008/november/mono-2008-m-rs08-01-orth.pdf; Paul Yakoboski, \textit{Retirees, Annuitization and Defined Contribution Plans} 3, 5 (TIAA-CREF Institute Trends and Issues, April 2010), http://www.tiaa-crefinstitute.org/ucm/groups/content/@ap_ucm_p_tcp_docs/documents/document/tiaa02029462.pdf (finding that only around 19% of retirees with significant defined contribution plan assets but little defined benefit pension income annuitized a portion of their retirement savings); David L. Wray, \textit{Testimony before the ERISA Advisory Council Working Group on Spend Down of Defined Contribution Assets as Retirement} 5 (July 16, 2008), http://www.psca.org/psca-president-testified-july-16-2008-before-the-erisa-advisory-council-on-the-spend-down-of-defined-contribution-assets-at-retirement (noting that only about 20% of defined contribution plans offer annuities, and these are hardly ever utilized). All in all, people rarely choose to buy annuities voluntarily, even though purchasing annuities could rationally help maximize their expected retirement incomes. That is, the demand for annuities is lower than expected, and this shortfall has come to be known as the “annuity puzzle.” See, e.g., Manahem E. Yaari, \textit{Uncertain Lifetime, Life Insurance, and the Theory of the Consumer}, 32(2) \textsc{Review of Economic Studies} 137 (1965); Franco Modigliani, \textit{Life Cycle, Individual Thrift, and the Wealth of Nations}, 76(3) \textsc{American Economic Review} 297 (1986); Shlomo Benartzi, Alessandro Previtero & Richard H. Thaler, \textit{Annuitization Puzzles}, 25(4) \textsc{Journal of Economic Perspectives} 143 (Fall 2011).
currently or deferring taxation by placing the money in a retirement account according to Internal Revenue Code section 401(k). Consequently, these plans are often called “401(k) plans,” and they are the most popular type of retirement plan in the United States.\(^{49}\) The maximum annual amount of such elective deferrals that can be made by an individual in 2013 is $17,500, although workers over the age of 50 can contribute another $5,500 (for a total of up to $23,000).\(^{50}\) Also, since 2006, employers have been permitted to set up Roth 401(k) plans that operate in a similar fashion.\(^{51}\)

c. **Hybrid retirement plans**

So-called “hybrid” retirement plans mix the features of defined benefit and defined contribution plans. For example, a cash balance plan is a defined benefit plan that looks like a defined contribution plan.\(^{52}\) Like other defined benefit plans, employer contributions are based on actuarial valuations, and the employer bears all of the investment risks and responsibilities. Like defined contribution plans, however, cash balance plans provide workers with individual accounts (albeit hypothetical).\(^{53}\) A simple cash balance plan might allocate 10% of salary to each worker’s account each year and credit the account with 5% interest on the balance in the account. Under such a plan, a worker who earned $50,000 in a given year would get an annual cash balance credit of $5,000 ($5,000 = 10% \times $50,000), plus an interest credit equal to 5% of the


\(^{50}\) Internal Revenue Service, *supra* note 38.

\(^{51}\) I.R.C. § 402A.

balance in her hypothetical account as of the beginning of the year. The interest credit on a cash balance plan may also be tied to a market rate, like the long-term interest rate, in which case the plan member bears some interest risk.

d. Other Voluntary Savings Mechanisms

In addition to voluntary saving through 401(k) elections and IRAs, individuals can also save money outside of the retirement system. Investment income is generally subject to personal federal income tax rates of up to 39.6% in 2013;\(^{54}\) however, dividend income and capital gains are generally taxed at no more than a 20%.\(^{55}\) Also, there are various tax advantages associated with investments in homes,\(^{56}\) state and local bonds,\(^{57}\) annuities,\(^{58}\) and life insurance.\(^{59}\)

3. The Regulation of Employment-based Plans

In the almost 40 years since it was enacted, the Employee Retirement Income Security Act has been amended numerous times, and a whole regulatory system has grown up to enforce its provisions. The key agencies charged with the administration of ERISA are the U.S. Department of Labor, the Internal Revenue Service (IRS), and the Pension Benefit Guaranty

\(^{53}\) Sometimes, these hypothetical accounts are referred to as “notional accounts.”
\(^{55}\) I.R.C. § 1(h).
\(^{56}\) For example, home mortgage interest is generally deductible, and gains from the sale of a personal residence are often excludable. I.R.C. §§ 163(a), 121.
\(^{57}\) I.R.C. § 103 (interest exclusion).
\(^{58}\) Under I.R.C. § 72, the individual can exclude a fraction of each annuity payment from income. That fraction (the “exclusion ratio”) is based on the amount of premiums or other after-tax contributions made by the individual. The exclusion ratio enables the individual to recover her own after-tax contributions tax free and to pay tax only on the remaining portion of benefits which represents income. The net effect is a deferral of taxation. See also note 35 supra.
\(^{59}\) I.R.C. § 101(a) (exclusion for insurance proceeds paid by reason of the death of the insured).
Corporation (PBGC). The IRS and the Department of Labor also have significant responsibilities with respect to IRAs and Roth IRAs.

Pension plans must be operated for the exclusive benefit of employees or their beneficiaries, and plan assets generally must be held in a trust. To protect the interests of plan participants, ERISA requires significant reporting and disclosure in the administration and operation of employee benefit plans. ERISA also imposes extensive fiduciary responsibilities on employers and administrators of employee benefit plans. In addition, prohibited transaction rules prevent parties in interest from engaging in certain transactions with the plan. For example, an employer usually cannot sell, exchange, or lease any property to the plan.

ERISA and the Internal Revenue Code also impose many other requirements on retirement plans, including rules governing participation, coverage, vesting, benefit accrual, contribution and benefits, nondiscrimination, and funding.

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61 I.R.C. § 401(a); ERISA §§ 403(a), 404(a)(1)(A).
62 See, e.g., ERISA §§ 101(a) et seq.
63 I.R.C. § 401(a); ERISA § 404.
64 I.R.C. § 4975; ERISA § 406.
65 I.R.C. § 410(a); ERISA § 202.
66 I.R.C. § 410(b).
67 I.R.C. § 411(a); ERISA § 203.
68 I.R.C. § 411(b); ERISA § 204.
69 I.R.C. § 415.
70 I.R.C. § 401(a)(4).
71 I.R.C. § 412; ERISA § 302.
4. The Dominance of Defined Contribution Plans

In recent years, defined contribution plans have come to dominate the pension landscape. For example, 50% of full-time private industry workers in the United States participated in defined contribution plans in 2011, up from 40% in 1989-90; meanwhile, participation in defined benefit plans fell from 42% in 1989-90 to just 22% in 2011.²² Also of note, a recent study estimated that 92% of the new pension plans formed from 2003-2007 were defined contribution plans, as opposed to defined benefit plans.²³ Pertinent here, employers may be responding to the relatively higher costs of providing a defined benefit plan as opposed to a defined contribution plan. For example, according to the Bureau of Labor Statistics, in March 2012, it cost an average of $2.53 an hour to provide each participating worker with a defined benefit plan, compared with just $1.46 per hour for defined contribution plan participants.²⁴ That said, defined benefit plans incur investment fees and other


charges that DC plans do not incur or can pass on to their participants. All in all, however, the era of the traditional defined benefit plan is largely behind us.\textsuperscript{75}

5. Coverage and Retirement Income Adequacy

To encourage Americans to save for retirement in our voluntary pension system, the government relies on two major approaches. First, most pension plans qualify for favorable tax treatment. Second, employers and workers are given great flexibility in designing their pension plans, in making contributions, and in making (or taking) distributions. Despite those incentives, coverage and participation are low, and retirement savings may be inadequate for many retirees.

Indeed, at any point in time, only about one out of two American workers have pension plans, and few can be confident they will have enough income to meet their economic needs throughout retirement. For example, of the 153.7 million Americans workers in 2011, just 75.2 million (48.9\%) worked for an employer (or union) that sponsored a retirement plan, and just 61.0 million (39.7\%) participated in that plan.\textsuperscript{76} Table 1 provides more details about employer


sponsorship of retirement plans in 2011 and worker participation in those plans. Pertinent here, the probability of pension coverage is greater for older workers, for whites, for highly educated workers, for full-time workers, for higher-income workers, and for workers at larger firms. Participation rates increased through age 55 and then declined. But even among older workers age 55 to 64, only 49.9% participated in a pension plan.

Table 1. Share of Workers with an Employer that Sponsored a Retirement Plan and Share Participating in the Plan, by Various Characteristics, 2011 (percent)

<table>
<thead>
<tr>
<th>Worker characteristic</th>
<th>Sponsorship rate</th>
<th>Percentage participating</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Age</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>20 or younger</td>
<td>20.4</td>
<td>3.9</td>
</tr>
<tr>
<td>21–24</td>
<td>34.2</td>
<td>16.2</td>
</tr>
<tr>
<td>25–34</td>
<td>47.7</td>
<td>36.4</td>
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<tr>
<td>35–44</td>
<td>52.8</td>
<td>45.3</td>
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<td>45–54</td>
<td>55.3</td>
<td>49.0</td>
</tr>
<tr>
<td>55–64</td>
<td>56.2</td>
<td>49.9</td>
</tr>
<tr>
<td>65 and older</td>
<td>40.8</td>
<td>31.4</td>
</tr>
<tr>
<td><strong>Gender</strong></td>
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</tr>
<tr>
<td>Male</td>
<td>48.3</td>
<td>39.9</td>
</tr>
<tr>
<td>Female</td>
<td>49.6</td>
<td>39.4</td>
</tr>
<tr>
<td><strong>Race/Ethnicity</strong></td>
<td></td>
<td></td>
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<tr>
<td>White</td>
<td>52.7</td>
<td>43.6</td>
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<tr>
<td>Black</td>
<td>49.6</td>
<td>38.1</td>
</tr>
<tr>
<td>Hispanic</td>
<td>32.5</td>
<td>24.2</td>
</tr>
<tr>
<td>Other</td>
<td>47.1</td>
<td>37.4</td>
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<tr>
<td><strong>Education</strong></td>
<td></td>
<td></td>
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<tr>
<td>No high school diploma</td>
<td>22.4</td>
<td>13.6</td>
</tr>
<tr>
<td>High school diploma</td>
<td>42.7</td>
<td>33.1</td>
</tr>
<tr>
<td>Some college</td>
<td>49.0</td>
<td>37.9</td>
</tr>
<tr>
<td>Bachelor’s degree</td>
<td>58.7</td>
<td>50.6</td>
</tr>
<tr>
<td>Graduate/professional degree</td>
<td>68.1</td>
<td>61.6</td>
</tr>
<tr>
<td><strong>Work status</strong></td>
<td></td>
<td></td>
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<tr>
<td>Full-time, full-year</td>
<td>57.5</td>
<td>50.6</td>
</tr>
</tbody>
</table>


Copeland, supra note 76, at 10-11 fig. 2.
As already mentioned, 401(k)-type plans are the most popular type of retirement plan in the United States today. Membership in a 401(k) plan does not, however, guarantee that retirement saving will be adequate: the median balance of these plans is only around $77,000.
enough at 2013 interest rates to finance a stream of before-tax annual income of about $5,000 a year for life (although, to be sure, 401(k) plans are not even required to offer annuities).\(^\text{80}\)

Participation in individual retirement accounts plans is even lower than participation in pension plans. For example, only 28.0% of American families had an IRA or Keogh in 2010.\(^\text{81}\)

As with employment-based plans, participation in IRAs and Keoghs tends to be highest among those families where the head of the family is older, has attained a higher educational level, or has a higher income level.\(^\text{82}\)

To be sure, over their lifetimes, most households will accumulate some retirement savings through current or past work. In that regard, according to the Survey of Consumer Finances, in 2010, 55.1% of families had rights to some retirement plan other than Social Security through current or past work of the family head or that person’s spouse or partner.\(^\text{83}\)

Moreover, as households get closer to retirement age, they are even more likely to have accumulated some retirement assets, and recent cohorts of retirees tend to have more retirement assets than previous cohorts.\(^\text{84}\)

Households headed by a working individual aged 55 to 64 are doing especially well: while these near-retiree households are less likely to be covered by a

\(^{80}\) For a 65-year-old man who purchased a $100,000 immediate, level-payment annuity without inflation protection in 2012, the average annual payout was $6,336 per year [12 × $528 per month] or 6.336% of the annuity’s purchase price); and $4,897.73 = 6.336% × $77,300 average 401(k) balance. *Immediate Annuities Update*, 28(1) ANNUITY SHOPPER 23, 28 tbl. 5. (Winter 2013), [http://www.annuityshopper.com/archives/2013-Jan-Annuity-Shopper.pdf](http://www.annuityshopper.com/archives/2013-Jan-Annuity-Shopper.pdf).  
\(^{82}\) *Id.*, at 18-19 figs. 12a & 12b.  
defined benefit plan than previous cohorts, about 70% of them had defined contribution plans
and/or IRAs; and the median amount of their total retirement accumulations was $101,350 in
2010, up from just $63,719 in 2001 (in 2010 dollars).\textsuperscript{85}

Still, low participation rates in pension plans, in general, and low contributions rates to
401(k) plans, in particular, have led many analysts to wonder whether current and future
generations of retirees will have adequate retirement incomes.\textsuperscript{86} For example, according to recent
research by the Employee Benefit Research Institute, 44\% of Baby Boom and Gen-Xer
households are at risk of running short of money in retirement, and about 1 in 5 (19.4\%) are
projected to have less than 80\% of what they will need.\textsuperscript{87} The bottom line is that many
Americans are just not saving enough in retirement plans or otherwise. In that regard, for
example, a recent study by the Life Insurance and Market Research Association showed that two-

\begin{itemize}

\item \textsuperscript{85} Id.

\item \textsuperscript{86} See, e.g., Pension Savings: Are Workers Saving Enough for Retirement?: Hearing Before the Senate Committee on Health, Education, Labor & Pensions, 113\textsuperscript{th} Cong. (January 31, 2013),
\url{http://www.help.senate.gov/hearings/hearing/?id=4cd69c00-5056-a032-52b4-2693a6672740}; Jack VanDerhei, The
Importance of Defined Benefit Plans for Retirement Income Adequacy, 32(8) EMPLOYEE BENEFIT RESEARCH
INSTITUTE NOTES 7 (2011) (showing that having a defined benefit plan at age 65 significantly reduces the risk that
retirement income will be inadequate); Melissa M. Favreau, Richard W. Johnson, Karen E. Smith & Sheila R.
Zedlewski, Boomers’ Retirement Income Prospects (Urban Institute Brief No. 34, 2012),
\url{http://www.urban.org/uploadedpdf/412490-boomers-retirement-income-prospects.pdf} (4 out of 10 late baby-
boomers will lack sufficient income at age 79 to replace 75\% of what they earned between ages 50 and 54); Munnell
et al., supra note 19 (half of households will not have enough retirement income to maintain their preretirement
living standards); Jack VanDerhei, Retirement Income Adequacy for Boomers and Gen Xers: Evidence from the
2012 EBRI Retirement Security Projection Model\textregistered, 33(5) EMPLOYEE BENEFIT RESEARCH INSTITUTE NOTES 2
(2012), \url{http://www.ebri.org/pdf/notespdf/EBRI_Notes_05_May-12_RSPM-ER_Cvg1.pdf}.

\item \textsuperscript{87} Jack VanDerhei, All or Nothing? An Expanded Perspective on Retirement Readiness, 33(11) EMPLOYEE BENEFIT
RESEARCH INSTITUTE NOTES 1, 11 (2012),
\url{http://www.ebri.org/publications/notes/index.cfm?fa=notesDisp&content_id=5131}; see also Alicia H. Munnell,
Anthony Webb & Francesca Golub-Sass, The National Retirement Risk Index: An Update (Boston College Center
(estimating that some 53\% of households will have replacement rates that fall more than 10\% below the target).

\end{itemize}
thirds of middle-income ($40,000-$99,999) American workers were saving less than 5% of their annual income for retirement, and nearly a quarter were saving nothing at all.\textsuperscript{88}

Even the most optimistic analysts see problems for people who retire earlier than expected because of poor health, for people with limited work histories, and for unmarried people (never married, divorced, or widowed).\textsuperscript{89} Finally, even more retirees could be put at risk if Social Security and Medicare benefits are curtailed in connection with the federal government’s efforts to get its deficits under control\textsuperscript{90} or if medical breakthroughs result in significant increases in longevity.\textsuperscript{91}

III. THE COSTS OF THE CURRENT RETIREMENT SYSTEM

A. THE COSTS OF SOCIAL SECURITY

The costs of running the Social Security retirement system are remarkably low.\textsuperscript{92} For example, Table 2 shows that, in Fiscal Year 2013, the Social Security Administration expects to spend just 0.3\% of benefit payments on administrative expenses for its Old Age and Survivors

\textsuperscript{88} Life Insurance and Market Research Association (LIMRA), \textit{Most Middle-Income Workers Saving Less Than Five Percent of Their Income for Retirement} (accessed February 27, 2013, 2012), \url{http://www.limra.com/newscenter/NewsArchive/ArchiveDetails.aspx?prid=269}; see also HSBC Insurance Holdings Limited, \textit{The Future of Retirement: A new reality} fig. 11 (2013), (finding that 31\% of Americans surveyed have never saved for retirement).

\textsuperscript{89} Brady et al., supra note 84, at 39; see also John Karl Scholz, Ananth Seshadri & Suurachai Khitatrakun, \textit{Are Americans Saving ‘Optimally’ for Retirement?}, 114(4) \textit{Journal of Political Economy} 607 (2006) (optimistically predicting that less than 20\% of households will have less retirement wealth than optimal); Austin Nichols, \textit{Do Financial Planners Advise Us to Save Too Much for Retirement?} (Urban Institute, Program on Retirement Policy Paper, 2012), \url{http://www.urban.org/UploadedPDF/412510-Do-Financial-Planners-Advise-Us-to-Save-Too-Much-for-Retirement.pdf} (Americans are not necessarily saving too little for retirement).


Insurance program. In Fiscal Year 2012, the Social Security Administration had 64,545 full-time-equivalent employees and a total budget authority limitation on administrative expenses of $11.4 billion. To be sure, the Social Security Administration spends almost nothing on investment and money management functions as the trust funds are by law required to be invested in special-issue Treasury bills.

Table 2. Administrative Outlays as a Percent of Trust Fund Income and Benefit Payments, FY 2013

<table>
<thead>
<tr>
<th></th>
<th>Percent of Income</th>
<th>Percent of Benefit Payments</th>
</tr>
</thead>
<tbody>
<tr>
<td>OASI</td>
<td>0.3%</td>
<td>0.4%</td>
</tr>
<tr>
<td>DI</td>
<td>2.7%</td>
<td>2.1%</td>
</tr>
<tr>
<td>OASDI (combined)</td>
<td>0.7%</td>
<td>0.7%</td>
</tr>
<tr>
<td>SSI (Federal and State)</td>
<td>n/a</td>
<td>0.7%</td>
</tr>
<tr>
<td>TOTAL SSA</td>
<td></td>
<td>1.4%</td>
</tr>
</tbody>
</table>


B. THE COSTS OF GOVERNMENT PLANS

The costs associated with the pension plans run by large government employers are also quite low. For example, at the federal level, the Thrift Savings Plan for U.S. Government employees manages to keep fees so low that it reported an expense ratio of just .027% of assets in 2012 (27 cents per each $1,000 of investment or 27 basis points [100 basis points equals

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95 Mitchell, supra note 92, at 415; Social Security Administration, Trust Fund FAQs (March 20, 2012), http://www.ssa.gov/oact/progdata/fundFAQ.html#n2.
96 These administrative costs typically do not include investment fees.
The federal government’s defined benefit plans (Civil Service Retirement System for most older workers and the newer Federal Employees Retirement System) also have low administrative expenses. For example, a study of federal pensions in 2006 found that administrative expenses were around 0.02% of assets and 0.28% of contributions.\textsuperscript{98}

Large state-wide public defined benefit pension plans also have relatively low administrative expenses. For example, the administrative expenses of the Oklahoma Public Employees Retirement System were under \textit{.07}\% of assets in 2011 and just over 1.47\% of contributions.\textsuperscript{99} Similarly, according to a recent study of seven other states, administrative expenses as a percentage of assets ranged from 0.01\% for Florida’s two state-wide defined benefit pension plans in 2007 (0.53\% of contributions) to 0.10\% of assets for the West Virginia defined benefit plan for teachers (0.19\% of contributions).\textsuperscript{100} Ohio’s defined benefit plan for public employees was in the middle with administrative expenses equal to 0.07\% of assets and 2.07\% of contributions.\textsuperscript{101}

Newer, state-run defined contribution plans have higher administrative costs so far; for example, the administrative expenses as a percentage of assets for Colorado’s

\footnotesize
\begin{itemize}
\item \textsuperscript{97} Thrift Savings Plan, \textit{Administrative Expenses} (accessed March 4, 2013), \url{https://www.tsp.gov/planparticipation/administrative/administrativeExpenses.shtml} (noting that “[t]he expense ratio for a fund is comprised of the total administrative expenses charged to that fund during a specific period, divided by that fund’s average balance for that period.”); see also Edwin C. Hustead, \textit{Administrative Costs of State Defined Benefit and Defined Contribution Systems, in The Future of Public Employee Retirement Systems} 97, 101 tbl. 7-2 (Olivia S. Mitchell & Gary Anderson, eds., 2009) (reporting Federal Thrift Savings Plan administrative expenses of 0.41\% of contributions and 0.04\% of assets for 2006).
\item \textsuperscript{98} Hustead, \textit{supra} note 97 (estimates are for 2006).
\item \textsuperscript{99} Authors’ computations from \textit{Oklahoma Public Employees Retirement System, Connections} 13 (2011), \url{http://www.opers.ok.gov/Websites/opers/images/pdfs/CAFR2011OPERS.pdf} (0.000687 = \$4.7 million administrative expenses ÷ \$6,841 million of assets; 0.0147196 = \$4.7 million administrative expenses ÷ [\$66.4 million member contributions + \$252.9 million state and local agency contributions]).
\item \textsuperscript{100} Hustead, \textit{supra} note 97, at 98-99.
\item \textsuperscript{101} \textit{Id.}
\end{itemize}
defined contribution plan were 0.34% of assets in 2007.\textsuperscript{102} In general, large state plans can expect to have administrative costs of around 0.1% of assets whether they have a defined benefit plan or a defined contribution plan.\textsuperscript{103} Note that these estimates of the administrative cost of public employee plans do not include the administrative expenses incurred by the employing agencies (i.e., the costs of collecting and forwarding contributions),\textsuperscript{104} and these estimates may not include investment expenses and certain fees for professional and consultant services.\textsuperscript{105}

\textit{C. The Costs of Private Pensions}

Private pension plans and their participants incur significant costs in connection with their retirement savings. At the outset, there are significant costs because of the plethora of choices that employers and employees must make about private pension plans. In addition, private pension plans have relatively high administrative and compliance costs. Private pension plans also result in significant opportunity costs for participants, including for example, many lost opportunities to save and to annuitize these savings.

\textit{1. The Cost of Choice}

Choosing a private pension plan in the United States is a daunting prospect. There are a plethora of retirement plans including traditional defined benefit plans, cash balance plans, money purchase pension plans, target benefit plans, profit-sharing plans, stock bonus plans,

\textsuperscript{102} Id.
\textsuperscript{103} Id., at 103.
\textsuperscript{104} Id., at 100-101.
\textsuperscript{105} See, e.g., OKLAHOMA PUBLIC EMPLOYEES RETIREMENT SYSTEM, supra note 99, at 40-42 (noting that in addition to its $4,680,679 in administrative expenses for 2011, OPERS also incurred $7,466,011 in investment expenses and $313,529 in professional/consultant fees).
employee stock ownership plans (“ESOPs”), SIMPLE plans, SEPs, IRAs, and Roth IRAs. Every one of these plans has a different set of rules and regulations, limits on contributions, vesting rules, and tax advantages. The net result is bewildering complexity, for plan sponsors.

Then, because so many private employers have chosen to offer 401(k) plans, most individual participants also have numerous choices to make. They must decide whether or not to participate in the plan, how much to contribute, and how to invest those contributions. Later, they must decide whether to increase their contributions, when to retire, when to take their distributions, and what form of distribution to take. Here, too, most individuals face bewildering complexity as they are called upon to make decisions that even financial economists and actuaries cannot make with confidence.

It takes time to make all these choices, and sometimes people just throw up their hands and don’t make any choices at all. This is sometimes called “choice overload” or “analysis paralysis.” Behavioral economics suggests that limiting the number of choice to a manageable few is best. In addition, numerous behavioral economics studies have shown that automatically enrolling people into 401(k) plans can achieve higher levels of participation, and automatically

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106 See *supra* Part II.B.2. Of note, in the public sector, in addition to a variety of traditional I.R.C. § 401(a) plans, there are also see a variety of I.R.C. §§ 403(b) and 457 arrangements.
escalating the levels of their contributions can dramatically increase their level of savings.\textsuperscript{109} Automatic reenrollment can also increase participation and savings.\textsuperscript{110} The bottom line is that employees want, and need, plan sponsors to help them make better financial decisions.\textsuperscript{111}

\textit{2. Administrative and Compliance Costs}

In addition to, and, in part, because of, so many choices, private pension plans in the United States face many other one-time and ongoing costs.\textsuperscript{112} One-time costs include the fees incurred to set up a plan, the fees to convert a plan from one provider to another, and the fees


associated with the addition or termination of services (e.g., adding or removing an investment option or a brokerage window).

In addition, private pension plans incur ongoing fees for plan administration, for investment options, and for each participant.\textsuperscript{113} Ongoing \textit{plan administration} fees may be paid by the plan sponsor or passed on to the plan participants. These fees include: the costs associated with keeping a record of participant accounts (recordkeeping costs); the costs associated with safekeeping plan assets (custodial costs); the expenses related to enhanced participant services including brokerage windows and with communication and education programs (enhanced service platform); the expenses associated with getting independent advice about plan investments and structure (investment consulting costs); and the periodic costs associated with legal counsel, audits and compliance (intermittent/cyclical service costs).

Ongoing \textit{investment fees} are usually paid by the plan participants as a percentage of total assets.\textsuperscript{114} These fees include: the fees associated with managing a mutual fund (the expense ratio); the portion of the expense ratio that mutual funds use to cover sales, promotion, and marketing expenses (12(b)-1 fees); the extra fees that are sometimes assessed when funds are bought or sold (front- and back-end loads); investment management fees for investments in assets other mutual funds (privately managed/collective fund fees); and the fees associated with managing a variable annuity (wrap fees).

\textsuperscript{113} The Standard, \textit{supra} note 112.
\textsuperscript{114} \textit{Id.}
Investment fees are the majority of fees in 401(k)-type plans, and these fees are typically borne by participants. Pertinent here, expenses can vary greatly for different types of investments. In that regard, one study estimated that in the aggregate, investors spend 0.67% of the aggregate value of the market in pursuing active versus passive investment strategies. Asset class also matters. For example, stocks are generally more expensive to manage than bonds, small and mid-cap funds. Of course, fees can be reduced by moving from actively managed funds to low-cost index funds.

Ongoing participant fees are often paid by the plan participants but are sometimes paid by the plan sponsor. These fees include the fees charged when a fund is sold prematurely (redemption fees); the annual or per transaction fees charged for the use of a brokerage window (brokerage window fees); the annual or usage fees for online or one-on-one advice (advice-related fees); the fees charged for buying and selling company stock (company stock fund fees);

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115 U.S. GOVERNMENT ACCOUNTABILITY OFFICE, GAO-08-222T, PRIVATE PENSIONS: INFORMATION THAT SPONSORS AND PARTICIPANTS NEED TO UNDERSTAND 401(K) PLAN FEES 13 (2007)
119 The Standard, supra note 112.
and the fees associated with withdrawing funds, borrowing from the plan, or securing a qualified domestic relations order (other fees).\(^\text{120}\)

a. **All-in Cost Estimates**

Plans use a wide variety of arrangements to pay all these fees and to allocate these fees between the plan, plan sponsor, and the participants. A good place to start is with an estimate of the total fees associated with private pension plans. For example, a recent study for the Investment Company Institute (ICI) used survey responses from 520 defined contribution/401(k) plan sponsors to estimate an “all-in fee” for the core expenses of incurred by a private pension plan.\(^\text{121}\) The study’s “all-in fee” includes nearly all of the relevant administrative, recordkeeping, and investment fees, whether they are paid by the plan, plan sponsor, or the participants; but it excludes those fees that only apply to particular participants, such as the fees associated with brokerage windows, distributions, loans, and qualified domestic relations orders. The study found that the median participant’s all-in fee was 0.78%, of assets (78 basis points) or approximately $248 per participant per year.\(^\text{122}\)

Because there are fixed costs to start-up and run any defined contribution plan, larger plans (i.e., those with a higher number of participants and higher average participant account

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122 Id., at 6; see also *Retirement plan fees declining*, February 26, 2013, [http://www.plansponsor.com/401k_Plan_Fees_Declining.aspx](http://www.plansponsor.com/401k_Plan_Fees_Declining.aspx) (citing the 13th edition of the 401k AVERAGES BOOK, and finding that the average total plan cost for a small retirement plan [50 participants/$2,500,000 assets] was 1.46% of assets in 2012, and the average large retirement plans [1,000 participants/$50,000,000 assets] was 1.03%).
balances) tended to have lower all-in fees.\textsuperscript{123} Also, because equity investment options tend to have higher expense ratios than fixed income investments, plans with a higher percentage of assets invested in equities tended to have higher all-in fees.\textsuperscript{124} Plans with higher participant contribution rates also tended to have lower all-in fees, as did plans with automatic enrollment. On the other hand, plans with more investment options tended to have higher all in fees. Other variables related to plan complexity, such as the number of payrolls and the number of business locations, were not significant drivers of the all-in fee.\textsuperscript{125}

Pertinent here, according to a 2011 survey of employers with defined contribution plans, 63% are “very” or “somewhat” concerned about fees.\textsuperscript{126} That survey also found that 72% of employers calculated total plan cost that year; and, regarding administrative fees, 73% of plans report that participants pay all recordkeeping fees, either directly or indirectly, 22% share the fees with participants, and just 5% of employers pay all the fees directly.

b. Form 5500 Annual Reports

ERISA-covered pension plans annually report their administrative costs to the U.S. Department of Labor on their Form 5500 Annual Reports.\textsuperscript{127} For example, Table 3 shows the employer administrative expenses that plan sponsors reported to the U.S. Department of Labor

\begin{itemize}
\item \textsuperscript{123} Deloitte Consulting LLP, \textit{supra} note 121, at 8.
\item \textsuperscript{124} \textit{Id.}, at 7.
\item \textsuperscript{125} \textit{Id.} at 32.
\item \textsuperscript{126} Aon Hewitt, 2011 Trends \& Experience in Defined Contribution Plans: Paving the Road to Retirement 10 (2011), \url{http://www.aon.com/attachments/thought-leadership/2011_Trends_Experience_Executive_Summary_v5.pdf}.
\item \textsuperscript{127} See, e.g., 2012 Form 5500, Schedule H (Financial Information), line 2i (accessed March 5, 2013), \url{http://www.dol.gov/ebsa/pdf/2012-5500-Schedule-H.pdf}. Administrative expenses include professional fees, contract administrator fees, investment advisory and management fees, and other. \textit{Id.;} 2012 Instructions for Form 5500 36 (accessed March 5, 2013), \url{http://www.dol.gov/ebsa/pdf/2012-5500inst.pdf}.
\end{itemize}
on their Form 5500 Annual Reports for 2010. Based on those figures, the administrative expenses for defined benefit plans averaged 7.5% of contributions, 2.4% of total income, and 5.8% of total benefit payments, and the administrative expenses for defined contribution plans averaged 1.3% of contributions, 0.6% of total income, and 1.4% of total benefit payments.

Also, using additional data, it can be shown that the administrative expenses averaged 0.4% of assets for defined benefit plans and 0.1% of assets for defined contribution plans.

| Table 3. Income Statement of Pension Plans by type of plan, 2010 (amounts in millions) |
|---------------------------------------------|----------------|----------------|----------------|
| Income and Expenses                        | Total          | Defined Benefit| Defined Contribution|
| Employer contributions                     | $245,499       | $127,443       | $118,056        |
| Participant contributions                  | 176,546        | 760            | 175,787         |
| Contributions from others (including rollovers) | 19,300         | 326            | 18,975          |
| Noncash contributions                      | 3,978          | 2,527          | 1,452           |
| All other income                           | 693,596        | 283,576        | 410,020         |
| **Total Income**                           | **1,138,921**  | **414,631**    | **724,290**     |

<table>
<thead>
<tr>
<th>Expenses</th>
<th></th>
<th></th>
<th></th>
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<tbody>
<tr>
<td>Total benefit payments</td>
<td>456,927</td>
<td>169,645</td>
<td>287,282</td>
</tr>
<tr>
<td>Certain deemed and/or corrective distributions</td>
<td>1,728</td>
<td>24</td>
<td>1,704</td>
</tr>
<tr>
<td>Administrative expenses</td>
<td>13,780</td>
<td>9,769</td>
<td>4,011</td>
</tr>
<tr>
<td>Other expenses</td>
<td>1,540</td>
<td>107</td>
<td>1,433</td>
</tr>
<tr>
<td><strong>Total Expenses</strong></td>
<td><strong>473,975</strong></td>
<td><strong>179,545</strong></td>
<td><strong>294,430</strong></td>
</tr>
</tbody>
</table>

128 U.S. Department of Labor, Employee Benefits Administration, supra note 72, at 8 tbl. A4 (the data excludes plans covering only one participant); see also Id., at 32 tbl. C9 (showing similar information just for pension plans with 100 or more participants).
129 \(0.0745406 = \frac{9,769 \text{ million}}{(127,443 \text{ million} + 760 \text{ million} + 326 \text{ million} + 2,527 \text{ million})}; 0.0235607 = \frac{9,769 \text{ million}}{414,631 \text{ million}}\) and \(0.0575849 = \frac{9,769 \text{ million}}{169,645 \text{ million}}\).
130 \(0.0127629 = \frac{4,011 \text{ million}}{(118,056 \text{ million} + 175,787 \text{ million} + 18,975 \text{ million} + 1,452 \text{ million})}; 0.0055378 = \frac{4,011 \text{ million}}{724,290 \text{ million}}\) and \(0.0139618 = \frac{4,011 \text{ million}}{287,282 \text{ million}}\).
131 That year defined benefit plans reported having $2,448,361 million assets, and defined contribution plans reported having $3,833,388 million in assets. U.S. Department of Labor, Employee Benefits Administration, supra note 72, at 3 tbl. A1 (these data also exclude plans covering only one participant). \(0.00399 = \frac{9,769 \text{ million}}{3,833,388 \text{ million}}\); \(0.0010463 = \frac{4,011 \text{ million}}{3,833,388 \text{ million}}\).
c. International Comparisons

The Organization for Economic Co-operation and Development (OECD) regularly reports on the total operating costs of private pension systems around the world in relation to the assets managed. For example, in 2009, operating costs ranged from 0.1% of assets under management (in Denmark, Iceland, and Luxembourg) to 1.2% in Mexico.\(^\text{132}\) See Figure 3. Fee structures can be fairly complex, even in countries that have mandatory defined contribution systems. For example, in Australia, the fees on contributions as a percentage of salary ranged from 0 to 4.5% in 2009, while the fees on assets as a percentage of individual account balances ranged from 0.7 to 2.53%.\(^\text{133}\) On the other hand, some countries with mandatory defined contribution systems have fixed fees. The main conclusion to draw from the international experience is that countries with defined-contribution systems and those with large numbers of small funds tended to have higher operating costs than those countries with only a few funds offering defined-benefit, hybrid, or collective defined-contribution pension arrangements.\(^\text{134}\)


\(^\text{133}\) OECD, supra note 132, at 185 tbl; see also Hazel Bateman & Olivia S. Mitchell, New evidence on pension plan design and administrative expenses: the Australian experience, 3(1) JOURNAL OF PENSION ECONOMICS AND FINANCE 63, 74 (2004) (finding that employer-sponsored defined contribution plans in Australia had the lowest costs and that defined benefit and retail pensions available to the general public were 30 to 70% more costly).

\(^\text{134}\) Id.
d. Government Costs

The federal government also incurs significant costs in connection with the private pension system. As mentioned, the key agencies charged with the administration of ERISA are the U.S. Department of Labor, the Internal Revenue Service (IRS), and the Pension Benefit Guaranty Corporation (PBGC).\textsuperscript{135} These agencies promulgate regulations and issue other guidance, monitor and enforce plan compliance, and educate workers, employers, and plan providers about retirement plans.\textsuperscript{136}

\textsuperscript{135} See supra note 60.

\textsuperscript{136} See, e.g., U.S. Department of Labor, Employee Benefits Security Administration, Organizational Chart (accessed February 8, 2013), http://www.dol.gov/ebsa/aboutbsa/org_chart.html#mission (noting that “The mission of the Employee Benefits Security Administration is to assure the security of the retirement, health and other workplace related benefits of America’s workers and their families. We will accomplish this mission by developing effective regulations; assisting and educating workers, plan sponsors, fiduciaries and service providers; and vigorously enforcing the law.”)
Pertinent here, for example, in Fiscal Year 2012, the Internal Revenue Service as a whole had 92,513 full-time equivalent employees and a $13.1 billion total program operating level.\footnote{U.S, Department of Treasury, FY 2013 Budget-in-Brief (last updated February 13, 2012), at Internal Revenue Service, \texttt{http://www.treasury.gov/about/budget-performance/budget-in-brief/Documents/11.2013%20passed.pdf}.} More specifically, within the Internal Revenue Service, the Employee Plans portion of the Tax Exempt and Government Entities Division had 829 full-time equivalent employees and a $104.4 million budget for Fiscal Year 2012, and the Employee Benefits portion of the Office of Chief Counsel had 38.4 full-time equivalent employees and a budget of $6.3 million.\footnote{Personal communication from Dennis Ferrara, Associate Chief Counsel (Finance & Management), Internal Revenue Service Office of Chief Counsel, November 7, 2012 (in possession of Jonathan Barry Forman).} Among its many retirement plan activities in Fiscal Year 2011, the IRS completed 54 guidance projects (regulations, revenue rulings, etc.), and it completed 2,224 technical projects, 6,102 voluntary compliance agreements, and 28,544 determination letters.\footnote{\textit{Internal Revenue Service}, 2011 DATA BOOK 53 tbl. 22, 55 tbl. 23 (2012), \texttt{http://www.irs.gov/pub/irs-soi/11databk.pdf}. The Office of Chief Counsel’s Tax Exempt and Government Entities Division closed 999 guidance and assistance “cases” that year, 2,152 cases involving tax law enforcement, and 403 cases of other legal services to the IRS. \textit{Id.}, at 59 tbl. 26. Many of these projects also involved the Treasury’s Office of Tax Policy. In that regard, in Fiscal Year 2013, the Department of the Treasury’s Offices of Domestic Finance and Tax Policy had 172 full-time equivalent employees and, a budget of $71 million. U.S, Department of Treasury, \textit{supra} note 137, at Departmental Offices.} 

Also in Fiscal Year 2012, the U.S. Department of Labor’s Employee Benefits Security Administration had 1,003 full-time-equivalent employees and a total budget authority of $183 million.\footnote{U.S. Department of Labor, \textit{FY 2013 Department of Labor Budget in Brief} 84 tbl. (2012) (i.e., full-time equivalent employees), \texttt{http://www.dol.gov/dol/budget/2013/PDF/FY2013BIB.pdf}.} Among its many activities, the Employee Benefits Security Administration estimated that for Fiscal Year 2012, it would conduct 3,611 civil investigations, respond to 300,000
participant inquiries, secure 93 indictments by conducting 310 criminal investigations, and complete 4,330 reporting compliance reviews.\(^\text{141}\)

The PBGC had 999 employees and a total budget authority of $477 million (not counting another $6.03 billion for single employer benefit payments and multi-employer financial assistance).\(^\text{142}\) Among other activities in Fiscal Year 2012, the PBGC paid $5.5 billion benefits to nearly 887,000 retirees in more than 4,500 failed pension plans, including assuming responsibility for 47,000 people in 155 newly-failed, single-employer plans.\(^\text{143}\) Pertinent here, the PBGC is not funded out of general tax revenues; instead it relies on the insurance premiums that it collects from employers that sponsor insured pension plans and on the money that it earns from the investments of the pension plans that it has taken over.\(^\text{144}\)

As for federal civilian employees, the Office of Personnel Management budgeted $61.5 million on retirement services in Fiscal Year 2012,\(^\text{145}\) and the Federal Retirement Thrift Investment Board budget for Fiscal Year 2012 was $141 million.\(^\text{146}\) The federal government

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\(^{142}\) U.S. Department of Labor, *supra* note 140.


Numerous other agencies may also play minor roles in the pension world. For example, the Bureau of Labor Statistics, the Federal Reserve Board, and even the Small Business Administration issue reports that discuss pensions; and pensions can also come up in the routine work of the Securities and Exchange Commission and the National Labor Relations Board.\footnote{See, \textit{e.g.}, United States Department of Labor, Bureau of Labor Statistics, \textit{Employee Benefits Survey} (accessed February 8, 2013), \url{http://www.bls.gov/ncs/ebs}; Federal Reeserve Board, \textit{Federal Reserve Statistical Release, Flow of Funds Accounts of the United States: Third Quarter 2012} 32 tbl. F.116 (2012), \url{http://www.federalreserve.gov/releases/z1/current/z1.pdf}; Jules H. Lichtenstein, \textit{Saving for Retirement: A Look at Small Business Owners} (Small Business Administration, Office of Advocacy, Working Paper, 2010), \url{http://www.sba.gov/sites/default/files/rs362tot_2.pdf}.} Congressional committees and legislative branch organizations like the Congressional Budget Office, the Government Accountability Office, and the Congressional Research Service also devote resources to pension law and policy.\footnote{See, \textit{e.g.}, Joint Committee on Taxation, \textit{supra} note 32; CONGRESSIONAL BUDGET OFFICE, \textit{supra} note 73; U.S. GOVERNMENT ACCOUNTABILITY OFFICE, \textit{supra} note 73.}

\textbf{e. Cost Trends}

The cost of administering pension plans has generally increased since ERISA was enacted in 1974.\footnote{Edwin C. Hustead, \textit{Trends in Retirement Income Plan Administrative Expenses, in Living with Defined Contribution Pensions: Remaking Responsibility for Retirement} 166, 175 (Olivia S. Mitchell & Sylvester J. Schieber, eds., 1998).} Moreover, administrative costs and regulatory burdens can discourage small
businesses from establishing a pension plan. Pertinent here, voluntary systems tend to be more expensive to administer than mandatory systems.

As already mentioned, larger plans generally cost more to administer that smaller plans. There are large economies of scale in pension plan administration and asset management; and, in particular, collective arrangements are certainly cheaper than individual ones. Also, newer plans tend to cost more to administer than older plans.

Finally, it generally costs more to administer defined benefit plans than defined contribution plans, for example, because of the need to hire actuaries and pay guaranteed annuities. For example, one study found that, in 1996, the costs for administering defined benefit plans ranged from 3.10% of pay for the smallest plan in the study to 0.23% of pay for the largest plan, while costs for defined contribution plans ranged from 1.44% of pay for the smallest plan.

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151 See, e.g., OECD, supra note 2, at 122.
152 Hernandez & Stewart, supra note 132, at 3, 15.
154 See, e.g., Jacob A. Bikker & Jan De Dreu, Operating costs of pension funds: the impact of scale, governance, and plan design, 8(1) JOURNAL OF PENSION ECONOMICS 63, 83 (2009) (finding that industry-wide pension funds in the Netherlands were significantly more efficient than company funds and other funds).
155 See supra note 102 and accompanying text; see also Hernandez & Stewart, supra note 132, at 3, 16-19.
156 See, e.g., Bateman & Mitchell, supra note 133, at 68; Sean Collins, The Expenses of Defined Benefit Plans and Mutual Funds 9(6) INVESTMENT COMPANY INSTITUTE PERSPECTIVE (2003), http://www.iciglobal.org/pdf/per09-06.pdf. In the public sector, it also tends to cost more to administer defined benefit plans than defined contribution plans. See supra Part III.B.
plan to 0.16% of pay for the largest plan.\footnote{Hustead, \textit{supra} note 150, at 170. Administrative costs included all in-house administrative costs and PBGC premiums but did not include investment expenses. \textit{Id.} Pertinent here, however, the National Institute on Retirement Security estimates that the cost to deliver the same level of retirement income to a group of employees is 46% lower in a defined benefit plan than it is in a defined contribution plan, largely because of the higher fees and lower investment returns of 401(k) plans and the longevity risk pooling that is available in defined benefit plans. \textit{Beth Almeida & William B. Fornia, A Better Bang for the Buck: The Economic Efficiencies of Defined Benefit Pension Plans} 1, 6 (2008), \url{http://www.nirsonline.org/storage/nirs/documents/Bang%20for%20the%20Buck%20Report.pdf}} Administrative costs are also higher for plans that offer annuities.\footnote{Mitchell, \textit{supra} note 92, at 436.}

\subsection*{f. The Costs of Service Providers and Supporting Organizations}

In passing, it is worth noting that providing services for pension plans has become a cottage industry in the United States. While the cost of these service providers (i.e., lawyers and actuaries) should already be reflected in the private pension plan estimates described above,\footnote{See \textit{supra} Part IV.C.2a, b.} it is worth considering the plethora of pension experts that have their fingers in America’s private pension pie. While an exact count of employee benefits professionals would be impossible, the following discussion is suggestive.

For example, the American Society of Pension Professionals & Actuaries is one of the largest national organizations for career retirement plan professionals, and it has more than 11,000 members.\footnote{ASPPA, \textit{About Us} (accessed December 14, 2012), \url{http://www.asppa.org/home-page/about-asppa.aspx}.} So-called enrolled actuaries are actuaries who have been licensed by the Joint Board for the Enrollment of Actuaries to perform actuarial services for pension plans covered by ERISA,\footnote{Internal Revenue Service, \textit{Enrolled Actuary - Frequently Asked Questions} (October 11, 2012), \url{http://www.irs.gov/Tax-Professionals/Enrolled-Actuaries/Enrolled-Actuary---Frequently-Asked-Questions}.} and as of October 2012, there were some 4,180 enrolled actuaries.\footnote{Active Enrolled Actuary Listing As of October 18, 2012 (2012), \url{http://www.irs.gov/PUP/taxpros/Active%20EA%20Roster.pdf}. There were some 4,600 enrolled actuaries in 2007.  
Department of the Treasury Internal Revenue Service, \textit{User Fees Relating to Enrollment to Perform Actuarial Services}, 72 Federal Register 72,606 (2007).}
There are also thousands of pension lawyers. In that regard, the American Bar Association Section of Taxation’s Employee Benefits Committee alone has 837 members.\textsuperscript{163} Other sections of the American Bar Association also have employee benefits committees, including the Business Law Section,\textsuperscript{164} the Section on Labor and Employment Law,\textsuperscript{165} the Section of Real Property, Trust and Estate Law,\textsuperscript{166} and the Section on Tort Trial & Insurance Practice;\textsuperscript{167} and the American Bar Association also has a Joint Committee on Employee Benefits that coordinates the efforts of the various section.\textsuperscript{168} Also, the American College of Employee Benefits Counsel has 400 members.\textsuperscript{169}


\textsuperscript{165} American Bar Association Section of Labor and Employment Law, Employee Benefits Committee home page, \url{http://www.americanbar.org/groups/labor_law/committees/ebcom.html} (accessed February 12, 2013).


\textsuperscript{167} American Bar Association Section of Tort Trial & Insurance Practice, Employee Benefits Committee home page, \url{http://apps.americanbar.org/dch/committee.cfm?com=IL208000} (accessed February 12, 2013).


\textsuperscript{169} American College of Employee Benefits Counsel, \textit{Who We Are}, \url{http://www.acebc.com/who-we-are} (accessed February 12, 2013).
There are also thousands of accountants who work in the pension area. For example, the American Institute of CPAs (AICPA) has an Employee Benefit Plan Audit Quality Center. In addition, thousands of accountants and tax preparers are involved in preparing tax returns for individuals and employers who have pension plans and IRAs. In that regard, for example, 26.6 million individual income tax returns for 2010 reported taxable pensions and annuities, 2.6 million claimed a deduction for IRA payments, and 6.1 million claimed the retirement savings contribution credit. Also, more than 701,000 Form 5500 reports were filed by pension plans for 2010.

Pension plans also benefit from the services of national trade groups, lobbyists, and activists. A number of think tanks and educational institutions also devote considerable effort to retirement issues. In addition, numerous academic journals and trade journals focus their reporting on pensions.

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172 U.S. DEPARTMENT OF LABOR, EMPLOYEE BENEFITS ADMINISTRATION, supra note 72.
3. Opportunity Costs

a. Lost Investment Returns

It is well understood that fees reduce the rate of return on pension investments, and over the course of a lifetime, fees can reduce retirement savings significantly. In that regard, for example, the Government Accountability Office has noted that a one percentage point increase in fees can reduce retirement savings by 17% over a 20-year period.
Pertinent here, traditional defined benefit plans generally outperform 401(k) plans.\textsuperscript{178} Indeed, one study of U.S. pensions found that traditional defined benefit plans managed by investment professionals tend to get annual returns 1.9 percentage points higher than defined contribution plans where individuals tend to choose their own investments.\textsuperscript{179} There are numerous economies of scale associated with traditional pension plans. In particular, those large plans can negotiate much lower fees for most services. All in all, traditional pensions pay lower fees, have better portfolio allocations, and have professional investment advisors that generally pick better investment products.

On the other hand, individual plan participants tend to be pretty poor investors. Individual participants tend to invest too heavily in bonds and guaranteed investment contracts, and they invest too little in stocks.\textsuperscript{180} Moreover, even when participants invest in stocks, they tend to invest too heavily in the stock of their employers, as the Enron scandal in the U.S. showed.\textsuperscript{181} Individual participants also tend to invest too heavily in stocks of their home country (as opposed


\textsuperscript{179} Retirement Planning: Do We Have a Crisis in America?: Hearing Before the Senate Special Committee on Aging, 108\textsuperscript{th} Cong. (2004) (statement of John C. Goodman, President, National Center for Policy Analysis) 5-6, \url{http://aging.senate.gov/events/hr115jg.pdf}.

\textsuperscript{180} See, e.g., Marco Angrisani, Michael D. Hurd & Erik Meijer, Investment Decisions in Retirement: The Role of Subjective Expectations (University of Michigan Retirement Research Center, Working Paper No. WP 2012-274, 2012), \url{http://www.mrrc.isr.umich.edu/publications/papers/pdf/wp274.pdf}. Moreover, individuals tend to reduce their equity holdings as they get older, while large defined benefit plans typically continue to collect the equity premium in perpetuity.

to foreign stocks).\textsuperscript{182} Even when their employers offer efficient investment menus, individual participants often construct inefficient portfolios. For example, one recent study of participant portfolio elections estimated that poor choices by participants reduced their retirement wealth by about one-fifth.\textsuperscript{183}

Individuals investing in retail IRAs are doing even worse than those in 401(k) plans. Pertinent here, the expenses associated with retail IRAs tend to be higher than those associated with 401(k)s.\textsuperscript{184} Another problem is that individuals can use self-directed IRAs for speculation or for business start-ups.\textsuperscript{185}

The bottom line is that instead of having a single plan hiring a handful of experts to manage millions of dollars of assets, today, most employers have plans in which thousands of individual participants each make dozens of decisions about how to invest their much smaller individual accounts, and those participants are not doing very well.

b. Lost Savings Opportunities

(1) The Lost Opportunity to Save


\textsuperscript{183} Ning Tang, Olivia S. Mitchell, Gary Mottola & Steve Utkus, \textit{The efficiency of sponsor and participant portfolio choices in 401(k) plans}, 94 (11-12) JOURNAL OF PUBLIC ECONOMICS 1073 (December 2010), http://ac.els-cdn.com/S00472727110000812/1-s2.0-S00472727100000812-main.pdf?_tid=b4568984-449b-11e2-8b38-00000aab0f6b&acdnat=1355348111_573ad22256e7dd9d995be8a4a2b2cead5; see also James J. Choi, David Laibson & Brigitte C. Madrian, \textit{$100 \text{Bills on the Sidewalk: Suboptimal Investment in 401(k) Plans}, 93(3), THE REVIEW OF ECONOMICS AND STATISTICS 748 (August 2011), http://www.mitpressjournals.org/doi/pdf/10.1162/REST_a_00100; Vanguard Strategic Retirement Consulting, \textit{Improving plan diversification through reenrollment in a QDIA} 2 (August 2012), https://institutional.vanguard.com/iam/pdf/RENPPR.pdf (noting that nearly one out of six defined contribution plan participants makes significant portfolio construction errors, holding either a zero-equity portfolio or concentrating their holdings in their employer’s stock).

\textsuperscript{184} Karen Blumenthal, \textit{How Much Does Your 401(k) Cost You?}, WALL STREET JOURNAL, September 10, 2008, http://online.wsj.com/article/SB121200978601116727.html (citing a Hewitt Associates study that found that a 35-year-old saver who chose a retail IRA could end up with (9% to 18% less in her retirement account at age 70).

Perhaps the biggest cost of the current pension system is the lost opportunity to save. Workers who are not covered by a pension plan simply miss the chance to save. To be sure, most of these uncovered individuals could set up, and save in, individual retirement accounts (IRAs), but few individuals do.  

(2) The Lost Opportunity to Buy a Longevity Insurance

Traditional pensions also paid out benefits in the form of an annuity. In effect, pension plans bought group annuities and benefited from the reduced transaction costs. To be sure, individuals can seek to convert their 401(k), IRA, or free-standing savings into annuities, but few do. Moreover, individuals seeking to buy individual annuities will face significantly higher costs than if they could buy into group annuities.

(3) The Cost of Leakage

Another major problem is that today’s pensions can be leaky. While traditional defined benefit plans typically provided lifetime annuities for retirees and their spouses, today’s defined contribution plans, and even many defined benefit plans, allow participants to choose to withdraw all or a portion of their retirement savings in a lump sum (and many plans allow participants to choose to borrow against their savings). Unfortunately, a significant portion of

186 See *supra* notes 81-82 and accompanying text.

187 Moreover, because of adverse selection (i.e., those that voluntarily purchase annuities tend live longer than those that do not), annuities may not be priced very well for those with normal life expectancies.

these premature distributions (and loans) will be dissipated before retirement. To be sure, Section 72(t) generally imposes a 10% tax on distributions made before an individual reaches age 59½, but there are numerous exceptions. Moreover, even if a participant wanted to re-contribute funds to her account, statutory and plan rules may make that impossible. All in all, the lost retirement savings and the lost returns on those savings are yet another cost of the current pension system. Accordingly, it could make sense to prohibit cash-outs, distributions, or loans from pension plans and IRAs. That said, these kinds of prohibitions could reduce participation in a voluntary system.

IV. REDUCING COSTS

A. REDUCING COSTS WITH A UNIVERSAL, SECOND-TIER PENSION SYSTEM

This Section considers what a model, second-tier pension system could look like, and its potential superiority to the current second-tier system. It begins by exploring how much workers will need in retirement. Next, this part considers the two principal approaches for enhancing retirement income security: expanding Social Security or strengthening the private pension system. These two approaches are not necessarily all that different from each other. Indeed, many analysts believe that a model second-tier pension system would simply piggyback individual

189 See, e.g., Lucas, supra note 188; Timothy (Jun) Lu, Olivia S. Mitchell & Steven Utkus, An Empirical Analysis of 401(k) Loan Defaults (Financial Literacy Center, Working Paper WR-799-SSA, 2010), http://www.rand.org/content/dam/rand/pubs/working_papers/2010/RAND_WR799.pdf (finding that about 20% of 401(k) plan participants had loans, about one in ten loans resulted in a default; and of those employees who terminated employment, the loan default rate was nearly 80%); Matt Fellowes & Katy Willemin, The Retirement Breach in Defined Contribution Plans: Size, Causes, and Solutions (HelloWallet, January 2013), http://op.bna.com/pen.nsf/id/dbrh-93zk3d/$File/HelloWalletretirementbreach-final2.original.pdf (finding that over 25% of households that use a DC plan for retirement have withdrawn, or breached, their DC balances for non-retirement spending needs, amounting to over $70 billion in annual withdrawals).

190 For example, there are exceptions for distributions on account of disability or to cover high medical expenses. Internal Revenue Service, Topic 558 – Additional Tax on Early Distributions from Retirement Plans, Other Than IRAs (December 20, 2012), http://www.irs.gov/taxtopics/tc558.html.

191 See, e.g., Forman, supra note 2, at 233.
retirement savings accounts (IRSAs) onto the current Social Security withholding system. Such add-on “Social Security” accounts should be less costly to administer than the current pension system, and these accounts could easily be designed to provide secure and significant asset growth and to pay benefits in a way that significantly enhances lifetime retirement incomes.

1. How Much Will Workers Need in Retirement?

A successful reform needs to be based on a reliable estimate of the amount of income that retirees will need.

a. Sources of Income in Retirement

Social Security is the most common source of income for households aged 65 or older. For example, in 2010, 86.3% of households aged 65 or older received Social Security benefits.\(^{192}\) Moreover, Social Security provided more than half of total income for 53.1% of aged beneficiary couples and 74.1% of aged single beneficiaries.\(^{193}\) Just 39.7% of households received retirement benefits from sources other than Social Security, and 51.9% received income from other assets.\(^{194}\)

All in all, Social Security provides the largest share of aggregate income for the elderly, 36.7% in 2010.\(^{195}\) Earnings accounted for another 30.2% that year, pensions for 18.6%, and asset income for 11.4%.\(^{196}\) Pertinent here, the shares of aggregate income from each source differ greatly by income level. For example, in 2010, households in the bottom 20% of household income got 84.3% of their income from Social Security benefits and just 2.9% from pensions and


\(^{193}\) Id., at 9.

\(^{194}\) Id., at 8.

\(^{195}\) Id., at 16.
just 2.4% from earnings.\textsuperscript{197} See Figure 4. Meanwhile, earnings accounted for 44.9% of the income of households in the top 20%, while Social Security provided just 17.3% and pensions provided just 19.1%.\textsuperscript{198}

Figure 4. Shares of aggregate income for the lowest and highest income quintiles, by source, 2010

Lowest quintile

- Social Security: 2.4%
- Earnings: 1.8%
- Asset income: 44.9%
- Cash public assistance: 7.0%
- Other: 16.1%

Highest quintile

- Social Security: 17.3%
- Pensions: 19.1%
- Earnings: 0.1%
- Asset income: 2.4%
- Cash public assistance: 19.1%
- Other: 16.1%


Notes: The quintile limits for aged units for 2010 are $12,554, $20,145, $32,602, and $57,957. Totals do not necessarily equal the sum of the rounded components.

\textsuperscript{196} Id.
\textsuperscript{197} Id., at 17.
\textsuperscript{198} Id.
b. Replacement Ratios

As a rule of thumb, after retirement individuals will need to replace around 80% of their preretirement income.\(^\text{199}\) People will generally need less income after retiring because income taxes are lower after retirement, Social Security payroll taxes end, and savings for retirement are no longer needed.\(^\text{200}\) Social Security (and SSI) will provide a large portion of that replacement income, but the private pension system (and personal savings) will need to provide the rest. For example, Table 4 shows Aon Consulting’s recent estimates of the replacement rates that would be needed by married couples with various levels of pre-retirement income.\(^\text{201}\)

<table>
<thead>
<tr>
<th>Pre-retirement income</th>
<th>From Social Security</th>
<th>From private and employer sources</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>$20,000</td>
<td>69%</td>
<td>25%</td>
<td>94%</td>
</tr>
<tr>
<td>$30,000</td>
<td>59%</td>
<td>31%</td>
<td>90%</td>
</tr>
<tr>
<td>$40,000</td>
<td>54%</td>
<td>31%</td>
<td>85%</td>
</tr>
<tr>
<td>$50,000</td>
<td>51%</td>
<td>30%</td>
<td>81%</td>
</tr>
<tr>
<td>$60,000</td>
<td>46%</td>
<td>32%</td>
<td>78%</td>
</tr>
</tbody>
</table>


200 See, e.g., Aon Consulting, supra note 199, at 1-2.

$70,000 42% 35% 77%
$80,000 39% 38% 77%
$90,000 36% 42% 78%


Table 5, also from that 2008 Aon study, shows estimates of how large a lump-sum is needed from private and employer sources to provide an adequate retirement.\textsuperscript{202}

<table>
<thead>
<tr>
<th>Pre-retirement income</th>
<th>Baseline replacement rate needed (% of final pay)</th>
<th>Equivalent Lump Sum Needed (as a multiple of final pay)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$20,000</td>
<td>25%</td>
<td>4.4 Male 4.5 Female</td>
</tr>
<tr>
<td>$30,000</td>
<td>31%</td>
<td>5.0 Male 5.5 Female</td>
</tr>
<tr>
<td>$40,000</td>
<td>31%</td>
<td>5.0 Male 5.5 Female</td>
</tr>
<tr>
<td>$50,000</td>
<td>30%</td>
<td>4.8 Male 5.4 Female</td>
</tr>
<tr>
<td>$60,000</td>
<td>32%</td>
<td>5.2 Male 5.7 Female</td>
</tr>
<tr>
<td>$70,000</td>
<td>35%</td>
<td>5.6 Male 6.3 Female</td>
</tr>
<tr>
<td>$80,000</td>
<td>38%</td>
<td>6.1 Male 6.8 Female</td>
</tr>
<tr>
<td>$90,000</td>
<td>42%</td>
<td>6.8 Male 7.5 Female</td>
</tr>
</tbody>
</table>


2. Enhancing Retirement Income Security

The retirement income security of American workers can be enhanced by expanding the current Social Security system and/or strengthening the private pension system.

a. Expand the Social Security System

One way to enhance the retirement security of American workers would be to increase Social Security benefits. For example, one could imagine tweaking the benefit formula so that the Social Security system replaced 80\% of preretirement earnings, at least for workers with low lifetime earnings. As Social Security already replaces around 70\% of the preretirement earnings

\textsuperscript{202} Id., at 16 tbl.
for those workers in the lowest quintile of lifetime household earnings, increasing replacement rates for those households to 80% would not cost that much. The cost would be even lower if Congress targeted the benefit increases to those with the lowest lifetime earnings, rather than increasing Social Security benefits for all retirees. Pertinent here, a recent survey found that 75% of Americans believe that we should consider increasing Social Security benefits to provide a more secure retirement for working Americans. Also, by increasing the generosity of Supplemental Security Income (SSI) benefits, Congress could ensure that all elderly Americans would escape poverty, regardless of how low their lifetime earnings might be.

To be sure, raising revenue to pay for more Social Security benefits would be a challenge. Historically, to raise money for more Social Security benefits, the federal government has raised the Social Security payroll tax—at least 20 times since the program began in 1937. While the government could, perhaps, raise payroll taxes again, if additional revenue is needed to enhance retirement income security for low-income workers, it might be fairer to raise those revenues from our progressive income tax system. In any event, simply raising the payroll tax rate would not adequately target the benefit increases to workers with low lifetime earnings. For example, because the current Social Security system has generous spousal and dependent benefits, benefit increases tends to favor married couples over single individuals, one-earner couples over two-earner couples, and larger families over smaller families. In short, while Congress could raise payroll taxes and increase Social Security benefits, that approach might not be the most efficient

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203 See supra Figure 2.  
205 FORMAN, supra note 9, at 199.
way to enhance the retirement incomes of workers, least of all those with low life-time earnings. In any event, given the present federal budget deficits, Congress seems more likely to cut Social Security benefits than to increase them.\footnote{207}{See, e.g., Congressional Budget Office, Choices for Deficit Reduction 12, 14-15 tbl. 3 (2012), \url{http://www.cbo.gov/sites/default/files/cbofiles/attachments/43692-DeficitReduction_print.pdf}.}

b. Strengthening the Private Pension System

Another approach for enhancing the retirement income security of American workers would be to strengthen and expand the second-tier private pension system. With the near disappearance of traditional defined benefit plans, a comprehensive approach to expanding the private pension system probably means encouraging or mandating individual retirement accounts on top of the current Social Security system. These accounts could be held by the Social Security Administration, invested in a broadly diversified portfolio of stocks, bonds, and government notes, and annuitized on retirement. Alternatively, these accounts could be held and invested by large private pension funds, as is the case Australia and Chile.\footnote{208}{See, e.g., David C. John & Ruth Levine, National Retirement Savings Systems in Australia, Chile, New Zealand and the United Kingdom: Lessons for the United States (Retirement Security Project Paper No. 2009-1, 2009), \url{http://www.brookings.edu/papers/2009/07_retirement_savings_john.aspx}; Australian Taxation Office, APRA-regulated funds - home (accessed February 20, 2013), \url{http://www.ato.gov.au/superfunds/pathway.aspx?sid=42&pc=001/149/031&mfp=001/149&mnu=52002#001_149_031}; Barbara E. Kritzer, Chile’s Next Generation Pension Reform, 68(2) SOCIAL SECURITY BULLETIN 69 (2008), \url{http://199.173.225.108/policy/docs/ssb/v68n2/v68n2p69.pdf}.}

Of note, in 1981, the President’s Commission on Pension Policy recommended adoption of a Minimum Universal Pension System that would have required all employers to contribute at least 3% of wages to private pensions for their workers.\footnote{209}{President’s Commission on Pension Policy, Coming of Age: Toward a National Retirement Income Policy (1981).} That proposal attracted little interest at
the time, but there has recently been renewed interest in such mandatory pensions. For example, one study estimates that, in the long run, 3% add-on individual accounts could provide an annual retirement benefit equal to 14.5% of final wages for men, 13.3% of final wages for women, 14.5% of final wages for one-earner couples, and 13.9% of final wages for two earner couples.

Shy of mandating individual accounts, the government may simply want to require that every employer have a pension plan or at least offer their employees a 401(k) plan or a payroll-deduction IRA coupled with automatic enrollment and automatic escalation features. As already mentioned, studies have shown that such auto-enrollment features can have a dramatic effect on participation and retirement savings. Pertinent here, a recent survey found that most Americans would like to see a universal, privately-run, individual-account pension system with auto-enrollment features, portability from job to job, and the opportunity for monthly checks throughout retirement.


\[213\] See supra note 109 and accompanying text.

\[214\] Diane Oakley & Kelly Kenneally, PENSIONS AND RETIREMENT SECURITY 2013: A ROADMAP FOR POLICY MAKERS 13 (National Institute on Retirement Security, 2013),
3. A Model Second-Tier Pension System

A model second-tier, universal pension system could simply piggyback individual retirement savings accounts (IRSAs) onto the current Social Security withholding system. Such a system of add-on accounts would increase retirement savings for most Americans, and it would be less costly to administer than the current pension system.

a. A Simple System of Add-on Individual Accounts

The simplest design for a mandatory pension system would be to piggyback a system of individual retirement savings accounts (IRSAs) onto the existing Social Security withholding system. For example, employers and employees could both be required to contribute 1.5% of payroll to these IRSAs (and the self-employed could be required to contribute 3% of their earnings). These accounts could be held by the government and invested in secure equity funds and annuitized on retirement. Alternatively, these individual accounts could be held by financial institutions and their investment could be directed by individual workers. All in all, this type of mandatory universal pension system could help ensure that all American workers and their families have adequate retirement incomes. Pertinent here, such a mandatory universal pension system would have much lower costs than the current system.

b. The Cost of a Simple System of Add-on Individual Accounts

The costs of having a universal system of individual retirement savings accounts (IRSAs) would depend on how those accounts are designed. See, e.g., Individual Social Security Accounts: Administrative Issues 37 (Employee Benefit Research Institute, Issue Brief No. 236, 2001).
certainly be higher than the cost of administering the current Social Security system, but the costs will largely depend on how the system is designed.\textsuperscript{216} The best estimates range from 0.1\% of assets (10 basis points) for a system with limited investment choices and customer service up to 2\% of assets (200 basis points) or more for a system with broad investment choices and extensive and flexible customer service.\textsuperscript{217} With a universal system of individual retirement savings accounts, every worker would have the opportunity to save, and these accounts could even be designed to allow workers to save even more than the mandatory minimum.\textsuperscript{218}

Of particular importance, investment fees would almost certainly be lower in a universal system with limited choice than under the current system where so many individuals must make their own choices in the retail market. In that regard, one study found that while annualized fees in the retail market ranged between 0.8 and 1.5\% of assets, use of the institutional markets in individual account systems could reduce annualized fees and costs to less than 0.6\% and in some cases to less than 0.2\% of assets.\textsuperscript{219}

Of course, high administrative costs would have a detrimental impact on individual account accumulations. For example, the GAO estimated that for a man who had average annual earnings every year for 45 years, a change in administrative cost from 0.1\% to 2\% of assets would reduce his account accumulation by almost 40\%. Id., at 3, 22-25.
\textsuperscript{218} That option might be especially attractive to workers with higher incomes who have a relatively smaller share of their income replaced by Social Security benefits. See Figure 2 supra.
In a universal system of individual accounts, participants could also be provided with the opportunity to buy group annuities. The fees associated with offering those group annuities would almost certainly be lower than they are in the current individual retail market.\(^{220}\)

Short of having mandatory individual retirement savings accounts, the government could simply require employers to at least offer their employees a 401(k) plan or a payroll-deduction IRA coupled with automatic enrollment and automatic escalation features. Even these semi-universal accounts should result in significantly lower costs than America’s current second-tier private pension system.

**B. SOME MORE MODEST WAYS TO REDUCE THE COSTS ASSOCIATED WITH AMERICA’S SECOND-TIER SYSTEM**

Because of the incredible complexity of the current private pension system, many analysts have called for simplification,\(^{221}\) and some have even argued for creating one single consistent pension system with one set of rules, limits, and regulations.\(^{222}\) To be sure, that’s where a universal system of individual accounts would make sense, and in that regard, countries like Australia and Chile have come close to that approach. Rather than moving to a universal system of individual accounts, however, the government might want to make some more incremental changes to the current system.

\(^{220}\) U.S. GOVERNMENT ACCOUNTABILITY OFFICE, supra note 217, at 3, 25-26, citing James M. Poterba & Mark J. Warshawsky, *The Cost of Annuitizing Retirement Payouts from Individual Accounts* (National Bureau of Economic Research, Working Paper No. 6918, 1999) (finding that the average administrative cost of purchasing an annuity is around 5% of the amount being converted into the annuity, not counting the additional cost of adverse selection).


1. **Encouraging Default Investments**

As we have seen, when investment choice is left up to individuals, they tend to make suboptimal decisions, but behavioral economics and choice architecture can help. For example, defaulting individuals into target-date funds should lead to better investment returns than defaulting them into government bond funds. Similarly, it would make sense to encourage individuals to choose low-cost stock index funds rather than high-fee, actively-managed funds. All in all, the case for offering individuals lots of choices about how to invest their basic retirement savings is extremely weak.

2. **Employer Retirement Savings Account (ERSAs)**

One approach would be to narrow the range of pension plan and participant choices. In that regard, for example, President George W. Bush’s Budget proposals for fiscal years 2004 through 2009 called for: 1) consolidating traditional and Roth IRAs into Retirement Savings Accounts (RSAs); and 2) consolidating the various types of employer-sponsored defined contribution plans into new Employer Retirement Savings Account (ERSAs). The proposal would make it easier for employers to decide whether to adopt a plan and what type of plan to

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223 See supra Part III.C.3.a.
have, and the proposal would also make it easier for employees to understand their plans. So far, however, consolidation proposals such as these have not made any headway in Congress.

3. **Multiple Employer Plans**

Another approach would be to take advantage of the economies of scale that can come from large plans, and encourage the creation of more multiple employer plans. Along the same lines, individual employers could be encouraged to pool the funds in their 401(k) plans to achieve economies of scale. Pertinent here, the Swedish and Bolivian systems have gained significant costs advantages by forcing providers to compete for business through a central agency (a “clearing house”).

4. **State Funds**

Another approach that could achieve significant cost savings would be to make it easier for State governments to offer pension plans for workers whose employers do not. In that regard, for example, California recently enacted legislation that will require employers above a certain

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227 Joint Committee on Taxation, *supra* note 32, at 61.


229 See, e.g., Janet Novak, *How to Fix Your Lousy 401(k) Retirement Plan: Pool It, Like a Pension Fund*, FORBES.COM, October 11, 2012, [http://www.forbes.com/sites/janetnovack/2012/10/11/how-to-fix-your-lousy-401k-retirement-plan-pool-it-like-a-pension-fund/](http://www.forbes.com/sites/janetnovack/2012/10/11/how-to-fix-your-lousy-401k-retirement-plan-pool-it-like-a-pension-fund/) (finding that our $3.4 trillion in 401(k) savings is spread among millions of small, inefficient, individual accounts . . . that “are bleeding us to death.”); see also Bikker & De Dreu, *supra* note 154, at 84 (suggesting that “[p]ublic policy could be used to promote the transparency of pension plan operating costs and to increase the incentives for small to medium-sized pension funds to merge.”)


5. \textit{Other Options}


V. \textit{Conclusion}

America’s second-tier, private pension system is replete with choice: choices about the type of pension plan, choices about the amount and timing of contributions, choices about investments, and choices about the timing and nature of distributions. All in all, the costs of these choices seem to exceed their benefits, and reform of the private pension system is desperately needed. The best approach would be to move to a universal system of individual retirement...
savings accounts on top of the current Social Security system. Shy of mandating that all employers provide such individual accounts, the government might just require that every employer have a pension plan or at least offer their employees a 401(k) plan or a payroll-deduction IRA, coupled with automatic enrollment and automatic escalation of contribution levels. Under such a system, employers and workers could achieve significant economies of scale, and the country could achieve a boom in retirement savings.