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IRA'S, 401(k) PLANS, AND OTHER SAVINGS PROPOSALS

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

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FIRST SESSION

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IRA'S, 401(k) PLANS, AND OTHER SAVINGS PROPOSALS

THURSDAY, FEBRUARY 9, 1995

U.S.SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to recess, at 9:30 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Bob Packwood (chairman of the committee) presiding.*

Also present: Senators Roth, Chafee, Grassley, D'Amato, Moynihan, Baucus, Bradley, Breaux, and Moseley-Braun.

OPENING STATEMENT OF HON. BOB PACKWOOD, A U.S. SENATOR FROM OREGON, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The committee will come to order. I indicated to Mr. Fink, who represents the mutual fund industry, that this committee had started hearings this year with the question: "does our Tax Code tilt toward consumption?" Most people say, yes; it does.

Should it? Most people say "no," although there are some industries that say "yes;" they are mainly consumption industries. But the bulk of the testimony we have had so far has been, "yes, we should save more and save for investment."

Then the question becomes, "how?" Through IRAs, and 401(k)s, or capital gains, or a flat tax, or a value added tax, or a national sales tax, or Nunn-Domenici? These are all forms of savings incentives.

And, if we do not do VAT, or Nunn-Domenici, or flat, or sales, or something like that, then the question becomes using the present Tax Code and building into it incentives for savings.

Of course, then the difficulty that comes is that every industry is convinced it is the lynch pin for savings; it does not matter what the industry is, that without them being included, the plan will fail.

So we are now at the stage where we are hearing testimony from different people as to what should be added to encourage savings.

Senator Hutchison has long been an advocate of homemaker IRAs, and has been the staunchest supporter of it in the Senate, and we have her with us today.

Senator Moynihan?

*The Joint Committee on Taxation prepared a committee print entitled "Description and Analysis of Tax Proposals Relating to Individual Saving," (JCS–3–95), February 8, 1995.

OPENING STATEMENT OF HON. DANIEL PATRICK MOYNIHAN, A U.S. SENATOR FROM NEW YORK

Senator MOYNIHAN. Thank you, Mr. Chairman. Welcome, Senator Hutchison. You have kept us at this subject now for a month, which means I am finally going to think about it—it takes about a month at my age to do that—and also in the context of the Balanced Budget Amendment on the floor, which I think is a hugely wrong-headed idea. But where did it come from? After long, careful consideration, I find it is not entirely the fault of the Republican party.

The CHAIRMAN. No.

Senator MOYNIHAN. Well, not entirely. And that is to say, what are the long cultural swings involved here? as I mentioned earlier, if you go through a long period of capital accumulation you will come to a point where you want a return on that capital, and that means consumption.

But also in our economic thinking, by the beginning of the 1920's and then with the Keynesian revolution, there was a big settlement. Nobody quite noticed it at the time.

The argument from the Progressives, the New Deal, was that we had a real problem of massive accumulation of capital, trusts, economic power, finance, on Wall Street. People ran up against Wall Street and they always lost. But then came the Great Depression, and the Keynesian theory emerged: the problem was underconsumption.

We settled the issue for leaving the institutions of capital in place. Laissez-faire is still there, Morgan Bank is still there. But we adopted an economic doctrine, and it has gone through every administration until at least the 1980's, following the Employment Act of 1946, that the principal problem of the Depression was underconsumption and the market could stabilize at levels of underconsumption. You had to stimulate consumption, and that is what Keynesian economics is about. Two generations of that kind of thinking, and you have a lot of consumption. [Laughter.]

Senator MOYNIHAN. That is as far as I have gotten. I have to leave off right there.

The CHAIRMAN. I believe one of the previous Presidents that you served said we are all Keynesians now.

Senator MOYNIHAN. We are all Keynesians now, said President Nixon.

The CHAIRMAN. Senator Baucus?

Senator BAUCUS. Thank you, Mr. Chairman. I do not know if I can follow that statement. I welcome Senator Hutchison and the other witnesses and look forward to their statements. Thank you.

The CHAIRMAN. Senator Moseley-Braun?

Senator MOSELEY-BRAUN. Well, I am kind of at a loss also, Mr. Chairman, but to say that I would welcome Senator Hutchison here and I just want to congratulate her and commend her on all the fine work she has done on this proposal. I absolutely support it.

Having spent a little time as a homemaker myself, I know that equal work ought to be allowed to be eligible for IRA contributions and it would increase savings. I think that her bill is a commendable step in the right direction, and I am delighted to have co-sponsored it again this year. I would encourage the rest of the members

of the committee to be mindful of the need for us to pass this legislation.

The CHAIRMAN. Thank you.

Senator Hutchison?

STATEMENT OF HON. KAY BAILEY HUTCHISON, A U.S. SENATOR FROM TEXAS

Senator HUTCHISON. Thank you very much, Mr. Chairman. I just want to ask Senator Moynihan if I can construe his statement as support for my bill.

Senator MOYNIHAN. A tendency toward, yes.

Senator HUTCHISON. I want to say that this is a bill that I introduced, along with Senator Barbara Mikulski, Senator Moseley-Braun, Senator Feinstein, Senator Kassebaum. Last time we did have the distinguished two Senators, the Chairman and the Ranking Member as well, as co-sponsors last year, and it is a very bipartisan effort.

I want to thank Senator Mikulski for her hard work on this bill and ask the Chairman if her statement could also be put in the record today since she was not able to be with us.

The CHAIRMAN. Without objection.

[The prepared statement of Senator Mikulski appears in the appendix.]

Senator HUTCHISON. Mr. Chairman, this is an issue of equity and good economic policy. Right now, if you are working outside the home you can set aside $2,000 in IRAs to help with your retirement security. But, if you work inside the home, you can only set aside $250 a year.

This discriminates against the one-income earner family and it discriminates against the homemakers of this country whose work is as important, if not more important, than the work done by those of us who work outside the home.

Over a lifetime, by conservative estimates, under the current law a single income family could set aside $188,554. But if we add the ability for the homemaker to set aside money, they would have $335,207, which is an increase of $150,000. Now, for a middle income or lower middle income family, that $335,000 could really be a nest egg to help with retirement security.

The bill that we are introducing today does not change the phase-out of deductibility, so it really is targeted toward the person or family that makes under $50,000 a year. Now, I understand that Secretary Rubin was asked the question at yesterday's hearing whether this proposal would primarily benefit higher income taxpayers. And I want to answer very forcefully that this is for all people, but it does target people who make under $50,000 a year.

One thing that I think must be brought to the table here, that must be considered in light of that question, is that so often it is the homemaker who does not have the retirement security, regardless of the total family income, because the homemaker may lose her husband——

Now, this applies to men as well, but I am going to use women because the vast majority of the people who stay home to raise children are women, but my bill does apply to men as well.

But what we have seen in the real world is that after 25 years of marriage, and then in a divorce, it is the homemaker who was never out in the work force who does not have the work experience necessary to provide for retirement security who is really left without that ability to retire with some security in her own right.

I want to make sure that the homemaker's work is valued and that the homemaker, who will probably go in and out of the work force, if she goes into the work force at all, is going to have the same opportunity for her retirement security through IRAs that those of us who work outside the home will have.

According to the Bureau of Labor Statistics, 23 percent of all women over the age of 16 are married homemakers, so you can see that this is something that will apply to a large number of people in this country. Sixteen million single income married couples are eligible for IRAs.

So, I think it is very important that we say, as a matter of equity, as a matter of good economic policy, the time has come for us to bring the people who stay home and raise children and give a great contribution to our society by doing that have the same ability to provide for retirement security as those who work outside the home have.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much. I have no questions.

Senator Moynihan?

Senator MOYNIHAN. Well, I should record that I had the honor in the last Congress to support Senator Hutchison's bill, and I mean to do the same in this Congress.

Senator HUTCHISON. Thank you.

Senator MOYNIHAN. Thank you for your testimony.

Senator HUTCHISON. Thank you.

The CHAIRMAN. Senator Moseley-Braun?

Senator MOSELEY-BRAUN. You know, I thought this passed last year. What happened to it?

Senator HUTCHISON. Well, Senator Moynihan and I worked on trying to pass it last year, but we never had a vehicle. If you remember, there were not very many eligible bills. A bill has to originate in the House to be able to have a tax amendment.

Senator MOSELEY-BRAUN. Right.

Senator HUTCHISON. So that is why I am hoping very much that we will be able to do it this year. I would really like for our homemakers of this country to be able to start this year, or next at the latest.

Senator MOSELEY-BRAUN. Oh, absolutely. Absolutely.

Senator HUTCHISON. And also, I did testify before the House Ways and Means Committee, got a very favorable response there, and I am cautiously optimistic that we will be able to see that in an early bill out of the House.

The CHAIRMAN. I will tell you one practical problem, and I can see it coming down the road toward us now, everyone I know on this committee supports trying to extend the 25 percent health insurance deductibility for the self-employed.

The House Ways and Means Committee sent out a bill yesterday achieving that with a couple of tax provisions. They would like to know if there would be any possibility that this bill could go clean,

with no other amendments, and I said, not likely on the Senate floor because you face the same problem.

We are only going to have one or two tax bills, and if you do not tie onto the tax bill that is, there may not be any other tax bill. So I could not give them any great assurance that it could go all by itself.

Senator Breaux?

Senator BREAUX. I would just like to thank Senator Hutchison for her involvement in this issue and to congratulate her on the legislation. I think we have included provisions similar to Senator Hutchison's legislation in the Roth-Breaux IRA bill. I am a co-sponsor of your bill as well. I think it is the right thing to do. Congratulations.

Senator HUTCHISON. Thank you, Senator Breaux. I know that my part is in your bill and, of course, I am supporting your bill as well because I think anything we can do to encourage savings in this country should be done. So, either through your bill or through the major bill that will come through from the House this year, in one of those I hope we will take care of this inequity in our law.

The CHAIRMAN. Kay, thank you very much for coming. We appreciate it.

Senator HUTCHISON. Thank you, Mr. Chairman. I appreciate your courtesies and look forward to working with you to include this in the first thing that can come through. I certainly would not want to hurt the chances of the 25 percent deduction because I certainly support that, but if other things go on, I will be the first in line to make sure that this is also added.

The CHAIRMAN. Thank you.

Senator HUTCHISON. Thank you very much.

The CHAIRMAN. Now, we have a panel of Dr. Paul Yakoboski from the Employee Benefit Research Institute, a group that has given us excellent information over the years; Professor Daniel Halperin from Georgetown University; Matthew Fink, representing the Investment Company Institute, which is the mutual funds; and then John Motley, the Vice President for Federal Government relations of the National Federation of Independent Business, who has also testified a number of times before this committee.

I am told that John Motley is delayed, but we are going to go in the order that you appear on the witness list and he appears last anyway. So, I assume by the time that the three of you finish we will have gotten to him.

And we will start, therefore, with Dr. Yakoboski. Doctor?

STATEMENT OF DR. PAUL YAKOBOSKI, RESEARCH ASSOCIATE, EMPLOYEE BENEFIT RESEARCH INSTITUTE *

Dr. YAKOBOSKI. Thank you, and good morning. I am pleased to appear before you this morning to discuss issues of IRAs, 401(k) plans, and individual saving.

My name is Paul Yakoboski. I am a research associate at the Employee Benefit Research Institute, a non-profit, non-partisan public policy research organization based here in Washington.

*The tables referred to in Dr. Yakoboski's statement appear with his prepared statement in the appendix.

EBRI has been committed since its founding in 1978 to the accurate statistical analysis of economic security issues. Through our research we strive to contribute to the formulation of effective and responsible health and retirement policies. Consistent with our mission, we do not lobby or advocate specific policy solutions.

The original objective in establishing IRAs was to provide a tax-deferred retirement saving vehicle for those workers who did not have an employment-based retirement plan. The fact is that today the vast majority of workers eligible to make a tax-deductible IRA contribution do not contribute. In 1993, for example, there were 54 million workers not participating in any type of employment-based retirement plan. As Table I here demonstrates, only 6 percent——

Senator MOYNIHAN. That would be about half?

Dr. YAKOBOSKI. Pardon?

Senator MOYNIHAN. About half.

Dr. YAKOBOSKI. About half.

Senator MOYNIHAN. Half do not, but half do.

Dr. YAKOBOSKI. Correct.

Senator MOYNIHAN. All right.

Dr. YAKOBOSKI. Among those not participating in any employment-based retirement plan, we see from this table that only 6 percent reported having contributed to an IRA. Therefore——

The CHAIRMAN. I am confused about this chart. Wait a minute.

Dr. YAKOBOSKI. Certainly.

The CHAIRMAN. Where is the 6 percent, or is that an average of everything? I do not understand it.

Dr. YAKOBOSKI. I am sorry. That was taken off the chart.

The CHAIRMAN. Oh. All right.

Dr. YAKOBOSKI. The 6 percent would be an average of these numbers.

The CHAIRMAN. All right.

Dr. YAKOBOSKI. In the aggregate, 6 percent of all workers eligible do not make an IRA contribution. What this chart then shows is those workers eligible, broken down by firm size, and we see that under every firm size, less than 10 percent of eligible workers contribute to an IRA.

The participation rate is actually higher at the smaller entities. This is probably the result of participation in salary reduction simplified employee pensions, which very small plans can offer. Employers of under 25 employee can offer that type of simplified employee pension, but larger employers cannot.

We also see from the chart that the average amount contributed tends to be smaller among workers in smaller firms. That is likely due to the fact that these workers also tend to have lower earnings.

Moving on to 401(k) type plans, 401(k) type plans continue to grow as an important element of the employment-based retirement income system. The percentage of civilian non-agricultural wage and salary workers with an employer who sponsors such a plan increased from 27 percent in 1988 to 37 percent in 1993.

What Table II shows is the increase in the fraction of workers with a plan available across firm size. And, as you can see, between the years 1988 and 1993, employees with all sized employers experienced an increase in the offer rate of 401(k) type plans. They oc-

curred across the spectrum from employees in the smallest firms to those in the largest firms.

Would you put up Table II, please? The other point I would like to make from Table II, is if you look down underneath the 1993 column you will notice that the likelihood of having a plan available is much greater for workers with larger employers than smaller employers.

Essentially, at the various smallest plan level, under 10 employees, compared to the highest group I have broken out here, 250 or more, workers are 10 times less likely of having a plan available.

Could you put up Table III, please? Next, I would like to look at the fraction of workers actually participating in a plan when it is available. Between the years 1988 and 1993, this percentage rose from 57 percent to 65 percent in the aggregate.

Again, Table III breaks these changes out by employer size. There are a couple of things of note here. The participation rate did not increase in this time period among workers with smaller employers—here, 25 or less than 25 employees—however, there was a sizeable increase in the participation rate among workers at larger entities, here—everywhere from 25 employees and up—experienced an increase in the participation rate of roughly 15 percent.

The other thing to note, again, going down the 1993 column, is that the participation rate does not vary greatly, with the employer size. In fact, the highest participation rate is still under the employer size category of less than 10 employees.

Table IV, please. The final table I have brought with me today looks at the average contribution amount in 401(k) type plans. Among all participants, the average amount contributed was $2,700 in 1993. This was well below the maximum tax-deductible amount allowed by law, which at that time was almost $9,000.

Contribution amounts were noticeably lower among participants from the smallest firms—again, those with under 10 employees—but otherwise they did not vary systematically with firm size.

There are a couple of conclusions to be drawn from these tables. As can be seen, participation rates among eligibles is much higher for employment-based 401(k) type plans than for IRAs.

A relevant question then for policy purposes is, simply, why? Probably the single most important reason is the availability of employer matching contributions to 401(k) type plans. Also, such plans tend to be heavily marketed to employees by the sponsoring employer.

Finally, the other point of note is that, despite the rapid growth in the number of defined contribution plans—primarily 401(k) arrangements it is still at the small plan level where a noticeable gap in sponsorship of plans remains.

The question then—and this is not an easy question with a simple answer—is what, if anything, can be done to fill this void? That is something everyone is still struggling with.

Thank you.

The CHAIRMAN. Thank you.

[The prepared statement and tables of Dr. Yakoboski appear in the appendix.]

The CHAIRMAN. Professor Halperin?

STATEMENT OF DANIEL HALPERIN, PROFESSOR OF LAW, GEORGETOWN UNIVERSITY LAW CENTER

Mr. HALPERIN. Thank you, Mr. Chairman. I would like to summarize my statement, and I apologize for not always following its order.

I think it is important to distinguish between two objectives that this committee and the Congress might have. One, is increasing the overall rate of savings, and two, is improving retirement security for middle and lower income individuals.

I think changes in IRAs and qualified plans should be considered only with the second goal in mind. In my view, reduction of tax on investment income is not likely enough to significantly increase savings to risk the threat to the equitable distribution of the tax burden that is involved in exempting income from savings, while fully taxing income from wages.

I think, as Dr. Yakoboski has indicated, if we are to have tax subsidies for retirement savings, employer-sponsored plans with strong anti-discrimination tests are much more effective than IRAs in reaching lower income people, in particular. I think what distinguishes 401(k) is, in part, at least, the non-discrimination test.

The non-discrimination test, again, as Dr. Yakoboski suggests, gives the employers an incentive to encourage participation by the non-highly compensated employees so that the highly compensated employees can make the desired contributions.

There have been efforts to eliminate the non-discrimination test; some say it is too complex. But, without these restrictions we have no assurance that the goal of the tax incentive would be satisfied.

The whole idea behind 401(k) was that it was not important who contributed, who made the choice to contribute. We could, like in an IRA, give the employee the choice rather than giving the employer the choice, which had been traditional up until then.

But the idea was that, as long as we got participation across the board, it did not matter who chose. If we just go to design-based testing and say, if you have a particular match, for example, then you are all right and we do not have to see who actually participated, we are violating that original goal behind 401(k). In fact, we eliminate the employer incentive.

I think right now there are substantial education efforts, substantial outreach efforts, by employers on the 401(k) plans, and that explains the large participation rate we get there compared to the smaller participation rate in an IRA.

Once you go to a design-based test, the employer no longer has that incentive. In fact, it has the opposite incentive because if it does not want to make matching contributions for particular employee groups, the way to do that is to try to discourage people from participating in plans.

Turning to IRAs, there are a number of proposals before you for enhancements of IRAs and they differ in what they propose. I believe most of these changes are unwise. I think it is sensible to limit IRAs, as we have, to individuals at lower income levels, and I would not remove the income limits on those who can make deductible contributions.

The higher the income one is, the more likely that we do not generate new savings and that all people are doing when they set up

IRAs is moving savings that already existed in other forms. I would not, as some bills do, allow IRA accumulations to be retained for generations. Only the very rich can afford to do that. Most of us would have to use it in retirement.

I would not eliminate penalties on early withdrawals, except perhaps for unseen emergencies. I definitely would not do—as many of these bills—allow withdrawals for any reasons without penalties once the amount has been aged in the plan for 5 years.

This turns an IRA account into a regular savings account, which has to substantially increase the likelihood that it is merely a substitute for savings that otherwise would take place and not new savings dedicated for retirement. Nevertheless, if you believe these changes or some other changes to be sound policy, they certainly can be implemented in the existing IRA format.

With all respect, I really do not understand at all the attractiveness of the so called "back-end" IRAs, which are supported by bills that have been in roduced in this body, and also in the Contract With America, and also by the administration, why many of the enhancements, particularly the participant's freedom to withdraw for any purpose, depend upon the adoption of this new format and are not available to those who stay with an existing IRA.

If tax rates do not change, as many people who have done the math have shown, there is no difference between the deduction for contributions, as under present law, and tax-free withdrawals under the proposed, so called "back-end" IRA. Both provide tax exemption for investment income.

Why two formats? Two formats will be confusing, they will be complex. People are definitely going to misunderstand the rules that would apply to their particular investment, so why are we doing it?

The message it sends to me, at least, is that we are trying to hide the cost of a tax subsidy. The revenue loss from not taxing withdrawals comes much later than the revenue loss from a reduction and, therefore, it is not an up-front loss and, therefore, does not have the same impact on the budget.

Beyond that, by making the new back-end IRA more attractive, in particular with respect to freedom to withdraw, we will entice a number of people to switch which will accelerate their tax payments to the next few years.

The new IRA proposals show, in fact, the revenue gain. Since these people would be paying on the current value of their account as opposed to the value that they would have on withdrawals, it does not increase the tax burden to pay now rather than later.

In fact, by spreading the tax burden over 4 years, which most of these proposals will do, we actually reduce the tax burden on those who elect to make the switch. Essentially, what we are doing is giving a greater than market discount for early payment. That is something that people are likely to respond to and it will increase short-term revenues, but it can hardly improve the long-term deficit picture.

I think, by providing a tax reduction which raises money, we claim not only to not have to raise other taxes to pay for it, but we can spend some of this money on additional breaks. To me, this

gives the message that we are not serious about budget cutting. I would go on to say that the back-end approach also disguises an enhancement in the value of the IRA, which enhancement is increased the higher one's tax bracket. The point is difficult to describe——

The CHAIRMAN. Can I ask you to abbreviate and summarize?

Mr. HALPERIN. All right. The point is difficult to describe, but essentially a $2,000 contribution is really not a $2,000, but really the tax-free build-up goes to the after-tax amount. So, current IRAs allow basically people in the highest bracket to set aside $1,200 a year, and people in the lowest bracket $1,700 a year.

What we would do in the back-end IRA is to increase it to $2,000 for everybody, actually a much bigger increase for people in the highest tax bracket. When the real problem is savings by low- and moderate-income people, this seems to be not a sensible way to set up a tax subsidy.

Thank you.

The CHAIRMAN. Thank you.

[The prepared statement of Mr. Halperin appears in the appendix.]

The CHAIRMAN. Mr. Fink, good to have you with us again.

STATEMENT OF MATTHEW P. FINK, PRESIDENT, INVESTMENT COMPANY INSTITUTE

Mr. FINK. Thank you, Mr. Chairman. I am Matthew Fink, President of the Investment Company Institute, which is the national association of the mutual fund industry.

Senator MOSELEY-BRAUN. Mr. Fink, would you hold, please, just for one second?

Mr. Chairman?

The CHAIRMAN. Yes.

Senator MOSELEY-BRAUN. Are we not going to have questions for Mr. Halperin following?

The CHAIRMAN. No. We have been going through the panel and then we will have the questions at the end.

Senator MOSELEY-BRAUN. You are going to go through the entire panel.

The CHAIRMAN. Right.

Senator MOSELEY-BRAUN. All right. Thank you, sir.

Mr. FINK. Our membership consists of over 5,000 mutual funds who have more than 38 million shareholders and represent about one-third of all U.S. households. By and large, mutual fund shareholders are middle class Americans. Their median income last year was approximately $50,000.

Mutual funds are a major investment medium for both IRAs and employer-sponsored plans. For example, as of the end of last year we held over $636 billion in retirement plan assets, of which some $341 billion were IRA assets. Mutual funds represent almost one-third of all IRA assets, and almost one-quarter of all 401(k) plan assets.

As a member of the Savings Coalition, which includes not only financial service firms, but also educational groups, housing groups, and others who are interested in savings and long-term investment, we are confronted in the marketplace that we serve by

a very sobering fact: most American citizens are not confident today that their current savings will be sufficient for retirement, and they have grave doubts that Social Security will ever fill the gap.

We think part of the message that the voters sent this November was a call for more personal responsibility and less government bureaucracy. We think that in the retirement plan area Congress can respond in two ways. First, by restoring full accessibility to Individual Retirement Accounts, and, second, by improving pension coverage in the small employer market.

Now, let me address each of these points in turn. First, I think restoring all American families' access to IRAs is probably the most responsible form of middle class tax relief among all the different proposals that the Congress is now considering.

Therefore, we support the legislation recently introduced by Senators Roth and Breaux. Their bill would reestablish universal access to the fully-deductible IRA, and also create the new type of back-end IRA that Mr. Halperin referred to.

In addition, that legislation and the legislation introduced by Senators Hutchison and Mikulski would, as the Senator said earlier this morning, permit homemakers, non-wage-earning spouses, to contribute to IRAs, and we support that.

There is one thing we have learned in the 20 years or so that IRAs have been around, and that is for saving incentives like IRAs to work, the key rules must be straightforward, they must be simple, they must be universal, they must be permanent.

Our experience in the IRA market—and we are the biggest funder of IRAs—has told us that in order for a plan like the IRA to work it must be simple and easy to market if it is to succeed. If only tax accountants can understand the IRA rules, only tax accountants will use IRAs.

Last week, an article in the Wall Street Journal called the current IRA eligibility rules seemingly "insurmountable." I have passed around a copy of a chart from the current IRS publication on IRAs dealing with eligibility. When you look at the complexity in that chart, it is no wonder that mass marketing of IRAs has ground to a halt and that IRA contributions by all income classes have plummeted since 1986.*

In contrast, the effective marketing of a simple, easy-to-understand IRA can lead to the development of a savings habit. I would not be here testifying today if the experience of our industry had not convinced us that an expanded IRA can increase long-term savings. If an expanded IRA simply only provided shifting, we would have no interest in being here today.

Second, as Dr. Yakoboski just stated this morning, pension coverage in the small employer market also requires attention. As of the end of last year, only 29 percent of employees who worked for small business were covered by retirement plans versus 83 percent in larger companies. There are many reasons for this, but one reason is the current complex and burdensome rules on retirement plans.

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*The item referred to appears in the appendix with Mr. Fink's prepared statement.

I personally recently experienced this very problem. My wife works for a non-profit organization here in Washington. Ironically, it is the Concord Coalition, which is a deficit cutting group. They established a 403(b) salary reduction plan. This was last year.

It took two lawyers in my office and an accountant to try to determine her eligibility, how much she could contribute, for calendar year 1994. I can tell you that even those experts could not calculate the contribution level with any certainty. Saying it today, I am probably setting myself up for an audit. [Laughter.]

Mr. FINK. But four of us with a lot of experience in this area could not make that determination. So, I personally share the problem that small employers have when they try to apply these rules.

I think probably the best way to address the small employer problem is to concentrate on salary reduction plans. In addition to allowing employer contributions, these plans allow individuals to save for their own retirement and they also satisfy the smaller employer's desire that the employees share some of the burden. We support simplification proposals of both 401(k) plans and simplified employee pension plans, or SARSEPs.

Just to enumerate some of them, we would advocate adoption of an alternative safe harbor non-discrimination rule. Not as some apparently have suggested, as Mr. Halperin said, getting rid of non-discrimination rules, but trying to put a simple test in for SARSEPs and 401(k)s as an alternative to the current fairly complicated rules.

Second, we would advocate expanding SARSEP availability. Currently they are only available to employers with 25 or fewer employees; we would urge that be expanded to 100. I think there are other administrative tests that could be changed.

We are committed to addressing the problem with the small employer market. As I said in the beginning of my testimony, we fund both IRAs and small employer plans and we think both need addressing. The time has come to try to develop a better plan and improve existing plans for small employers, and we look forward to working with this committee and the Congress to do that.

Thank you.

The CHAIRMAN. Mr. Fink, thank you.

[The prepared statement of Mr. Fink appears in the appendix.]

The CHAIRMAN. We will conclude with Mr. Motley.

STATEMENT OF JOHN MOTLEY, VICE PRESIDENT FOR FEDERAL GOVERNMENT RELATIONS, NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. MOTLEY. Thank you, Mr. Chairman. I am John Motley, Vice President of Government Affairs for NFIB. On behalf of our more than 600,000 members across the country, I want to thank you for the opportunity to testify on small business and pension policy and, Mr. Chairman, on your bill, the Prime Retirement Incentive Match by Employers, or PRIME account, which we have a great deal of interest in.

In the pension area, NFIB believes that public policy should encourage the greatest number of small business owners or business owners to offer pension opportunities to the greatest number of employees.

If this happens, it will help better prepare those employees for their retirement, it will reduce the pressures on the Social Security system, and it will increase savings and investment in the country.

Only 15 percent of small business owners, according to the Small Business Administration and EBRI, offer pension plans to their employees today, therefore, we believe that current public policy in this area is a failure.

Small employers do not offer pension policies because they cannot afford to offer them. They are too expensive to start, and they are even more expensive to maintain.

As costs rise—and costs have risen at least 11 times over the last two decades as Congress has passed new requirements for business pension plans—more and more small business owners refuse to set them up and, even more tragically, others terminate them.

Let us take a closer look for a second of why small business owners do not offer pension plans. First of all, as I have mentioned previously, is cost. The set-up cost for small firms is four times higher than it is for larger firms, and the administrative costs are three times higher per employee.

To administer a 401(k) plan, it costs a firm with 25 employees included about $71 per employee. For a firm with 200 employees, it costs about $25 per employee. And, when the law changes, as it has done, a plan has to be re-qualified.

I have a letter from an NFIB member which came in just a couple of weeks ago which said that for his 401(k) plan, which was about $60,000, it cost him $9,000 in annual administrative costs. He considers that to be too much and is seriously thinking about eliminating the plan.

The second reason, is the type of person who works in a small business. There is a high turnover rate in a great many small businesses because they employ a lot of younger people and a lot of older people and people who are in their first and second jobs and have not settled on a career yet. It is very expensive to administer a plan where you have a high turnover rate.

Second, as a just mentioned, there is a disproportionate number of older people, younger people, and part-time people who work for smaller businesses in this country.

The third reason that small firms do not set up pension plans, in our opinion, is that pensions are really fairly low in the order of preferred fringe benefits by employees. The big issue that we discussed last year, health insurance for employees, is much higher in the list of priorities, both for employers and for employees. Until we find some way to deal with the health care problem and reduce the cost of health insurance to small employers, pension plans are going to be much more difficult to set up.

Last, there is a heavy disproportionate impact of the regulatory and administrative burden associated with pension plans on smaller firms. The NFIB Education Foundation found out that one-third of our members who terminate their plans terminate them because of administrative and regulatory costs.

Obviously, to NFIB the thing that we have to do is to try and find some way to get more small businesses to offer pension plans to their employees. If we are going to do this we have to find a way

to make it less costly for them and much simpler for them to administer.

Many small businesses in this country today do not have human resource managers, they do not even have accountants or bookkeepers. The owner wears three or four different hats and it is very difficult for him to deal with pension laws.

Mr. Chairman, NFIB believes that your PRIME bill, which you introduced in the 102nd Congress, is a very good place to start if we are going to look for ways to simplify and to reduce costs for small businesses.

PRIME is simple for small business owners. It has simple participation rules and no non-discrimination rules or testing. It is administered by banks and security firms, or those who offer the PRIME account.

And PRIME is, therefore, less costly because of the reduced record-keeping requirements, reporting requirements, and no requalification costs which are associated when you change the law.

We would have two suggestions as to your PRIME, at least immediately, but we would be more than happy to work with you in taking a look at how it could be restructured. First of all, to allow employers to put more away for themselves than they put away for their employees.

There is a simple reason for this: most employers tend to be older. They start their businesses later in life after they have held another career. It takes a number of years for the business to become stable and to make a profit and, therefore, they think of setting up pension plans later in the business.

Last, frankly, we have the basis of all human motives, and that is self-interest. If an employer is able to take care of his needs and to put money away more quickly he is more likely to set up a pension plan that his employees can participate in.

A second suggestion would be to allow employers to decide on what amount they want to match each year. One of the biggest problems small firms have is cash flow. In fact, many of them do not live on profits, they live on cash flow.

So, if they are committed to an amount every single year, it may make it very difficult for them to make the decision. If, on the other hand, you allow them to decide what amount they are going to match each year and notify their employees, it may be an incentive to make them set up a plan.

In conclusion, Mr. Chairman, we believe that public policy should encourage small business owners to set up and to participate in funding pension plans. Currently, it does not. In fact, it does just the opposite, it discourages them from doing that. This needs to be changed, and NFIB believes that your PRIME bill is the place to start.

Thank you.

[The prepared statement of Mr. Motley appears in the appendix.]

The CHAIRMAN. Thank you, Mr. Motley.

Let me ask each of the witnesses the same question I have asked other witnesses here. One, in your judgment, does the present Tax Code tilt toward consumption? And, two, if it does, could we change it to tilt it toward saving and investment?

I will start with Dr. Yakoboski.

Dr. YAKOBOSKI. Well, the standard answer is, the Tax Code taxes income.

The CHAIRMAN. Speak a little louder.

Dr. YAKOBOSKI. I am sorry. Essentially, the way the Tax Code is set up, it has features that do promote savings through special exemption—IRAs and employment-based pension plans—but otherwise the general structure of the Tax Code does not promote savings.

The CHAIRMAN. Should it?

Dr. YAKOBOSKI. Given the nature of EBRI's organization, we do not take positions on whether it should or should not. [Laughter.]

The CHAIRMAN. I do not think Mr. Fink is so constrained.

Dr. YAKOBOSKI. I am sure he is not.

Mr. FINK. Not as much, no. I think the Code generally tilts toward consumption. I just came home from vacation last week and my mailbox was filled with credit card solicitations and home equity solicitations, but no saving solicitations. We have these incentives in the tax law.

I do not think you have to tilt it all the way and abandon Keynesian economics, as Senator Moynihan stated, but I think the tilt should be changed a little bit toward savings.

The CHAIRMAN. Professor Halperin?

Mr. HALPERIN. Well, Senator, I remain a supporter of income tax and would not favor a change to a consumption tax system. I think there are a number of reasons for that. I think, for one——

The CHAIRMAN. But that was not my question. My question is, "Does our present Tax Code tilt toward consumption, and should it, or should it not?"

Mr. HALPERIN. Well, I think the question really is whether a tax on income from savings tends to reduce savings, and that is an issue that economists have been arguing about for a long time, and I know that you have heard conflicting testimony on that issue. But it seems to me, on balance, the testimony suggests that the impact on savings from the present tax system is relatively small.

The CHAIRMAN. Yes. But that still is not my question. We have a relatively low savings rate. Should we try to encourage a relatively higher savings rate? Although I will quote what Senator Moynihan said the other day from a professor who he has not yet got the name of, or do you, the founder of what was it, that state ways cannot change folk ways. Maybe anything we pass will not make any difference in savings.

Senator MOYNIHAN. William Graham Sumner, Yale, 1872, first Professor of Sociology in the United States, author of The Conquest of the United States by Spain.

The CHAIRMAN. The Conquest of the United States by Spain?

Senator MOYNIHAN. Yes. In 39 steps, you can shut me up by shooting me, otherwise I am going to tell you——[Laughter.]

The CHAIRMAN. Anybody have a pistol? [Laughter.]

Mr. HALPERIN. I do not believe that the solution to our savings problem is going to be through changes in the Tax Code.

The CHAIRMAN. All right.

Mr. MOTLEY?

Mr. MOTLEY. I am not sure I am qualified to answer the question, as much qualified as these gentlemen, but let me take a crack at it.

I think, from a small business standpoint, from NFIB's standpoint, the Code does not do enough to encourage savings, which is important to small businesses because they always have difficult times financing themselves—start-ups, growth—and they tend to be at the end of the line for credit and they are the ones that get bumped out quickest, so a larger pool of savings for investment would be beneficial for smaller firms.

There is, though, another very interesting, I think, plus for small business if you move towards changing the Code dramatically like that, and that is complexity. Complexity is still the bane of small business owners, and if we could find some way to encourage savings and to make the Code a great deal simpler, then small business would end up being a big winner.

The CHAIRMAN. Well, let me ask you this. You can make it simpler. A flat tax is simple. If you do not have any exemptions for even the poor, you can get the rate down pretty low. The widow with two kids with $10,000 income who now pays no tax on a 15 percent flat tax would pay $1,500. I am not sure we want to do that.

But if you mean simple, we can get it relatively simple at a relatively low percentage, but it does mean then we are not going to build into it any incentives for saving. There are not going to be any IRA deductions, and there are not going to be any 401(k) deductions, or mortgage interest deductions, but it would be simple. Is that what you are talking about?

Mr. MOTLEY. Well, we are on the horns of a dilemma there. There is no doubt about it. If you take a look at consumption taxes that are in place around the world, many of them are extremely complex and small businesses suffer under them, and we have done studies of what has happened to small business in Europe. So, that type of a complex consumption tax is not something that we would find——

The CHAIRMAN. But a flat tax is a simple tax.

Mr. MOTLEY. Flat tax. In a vacuum, about 70 percent of our membership would like to see that come about.

The CHAIRMAN. Do they understand what it means when you ask them in the vacuum?

Mr. MOTLEY. No.

The CHAIRMAN. Oh.

Mr. MOTLEY. They do not, and we have not, as of yet, done the research needed to answer the question that you just raised.

The CHAIRMAN. All right.

Mr. Halperin, although you basically not only like the income tax, but I sense tilt toward consumption, unless I misstate you.

Mr. HALPERIN. No. I share your concern that we do not have a high enough savings level, but I do not think we can solve it through the income tax.

The CHAIRMAN. How do we get there, out of curiosity? If we have a low savings rate and tax incentives will not work, how do we get there?

Mr. HALPERIN. Well, I think the first step to increasing our savings rate is obviously deficit reduction. The other issues, I think, are really beyond my expertise. I do not know what causes our decline in savings rate. There are people who have given lots of reasons, and I am not sure I know how to solve them any more than anybody else does. I think one of the problems with the flat tax, as you said earlier, Mr. Chairman, is every industry thinks they are the solution to the problem.

And, if we went to more of a consumption tax system, which would be basically a zero tax on all forms of investment income, which would mean, as you says, no incentives for IRAs, no incentives for pension plans, no incentives for the real estate industry, no incentives for state and local bonds, I think that just does not last. I think everybody will say zero is not the limit; if everybody else has zero, I want negative, and I think we are back with all the preferences.

The CHAIRMAN. I once had a witness who was testifying in favor of capital gains who was convinced that the capital gains rate had to be one-half of whatever the regular rate was.

In fact, Senator Chafee was here at the time, and he would ask each of the witnesses, how did we ever get people to invest before we had the income tax? How did the Rockefellers, and the Hills, and the Harrimans ever manage to build any railroads or found oil companies when they did not have any deductions? [Laughter.]

The CHAIRMAN. Anyway, I pursued with this fellow and he said, yes, it had to be half. Twenty percent had to be 10, if we had a 10 percent rate it had to be five. I asked him, if we had no income tax would he need a subsidy? And he had not thought about that. He was not sure.

Senator MOYNIHAN. He probably was not against it.

The CHAIRMAN. No, he did not dismiss the possibility.

Senator Moynihan?

Senator MOYNIHAN. Yes. Thank you, Mr. Chairman. I much appreciated Dr. Yakoboski's remarks. Could I just ask the panel for their response? Thinking of this subject, and we have been doing it a long time under the leadership of Senator Packwood, since 1986, in the Tax Reform Act, we eliminated the deduction of interest paid on credit cards.

Now, I do not know what more direct statement that could be because that is not 3 percent, it is 20 percent. Your wife consistently does not believe it, but there it is. You cannot take it off. Mr. Fink's mailbox was filled with solicitations for more.

Professor Halperin, you seem to have some response to this. But could we hear the panel? Because we tried in a very emphatic way.

Mr. HALPERIN. Well, we did, though, keep the exceptions for home equity loans, and I think a lot of people have been able to switch their consumer borrowing to home equity loans. So I think if we wanted to carry through on that, probably that is the next step, though that is certainly not going to be an easy step for you to take.

Senator MOYNIHAN. But the panel would perhaps agree that a rather direct effort to reduce a certain kind of indebtedness did not have any evident effect.

Mr. FINK. We do not know the statistics. The marketers may be lagging. We do not know.

Senator MOYNIHAN. Yes. Dr. Yakoboski?

Dr. YAKOBOSKI. The other possibility is that there would have been even more use of credit——

Senator MOYNIHAN. We could have had more had we not done this.

Dr. YAKOBOSKI. Yes.

Senator MOYNIHAN. That is where a lot of inquiry comes out. But I just want to speak to Mr. Motley for a second. I would suggest, sir, because we are dealing with movements in the way we behave, that we do not respond very well to incentives.

It may be that the U.S. Government has to decide to increase the savings rate by having a surplus in its operating budget that automatically produces an increase in savings in the amount of the surplus. Is that not right, Mr. Halperin? I see you agreeing.

Mr. HALPERIN. That is correct.

Senator MOYNIHAN. That is an interesting thought. Think about that.

Now, I have to ask Mr. Motley. Prepare to resist temptation. If we could get you a government grant, would you be willing to study the manner in which the flat tax has destroyed small business in western Europe? [Laughter.]

Senator MOYNIHAN. Mr. Motley, it is a grant, free.

Mr. MOTLEY. NFIB does not accept government grants of any kind, Senator Moynihan. [Laughter.]

Mr. MOTLEY. The way the flat tax has destroyed, you mean?

Senator MOYNIHAN. You were telling us——

The CHAIRMAN. He means the VAT tax.

Mr. MOTLEY. The VAT tax.

Senator MOYNIHAN. Well, that is a consumption tax. Yes.

Mr. MOTLEY. A consumption tax.

Senator MOYNIHAN. Right.

Mr. MOTLEY. But we have done that already, and through private funding. I do not know where we could study a flat tax. Myself, I do not know where one is in place today.

Senator MOYNIHAN. But consumption tax is anti-small business. I have some friends on Wall Street who would be interested to know that.

Mr. MOTLEY. Oh, yes. Definitely. If you want to see small business owners absolutely come off the wall, try to impose a European type of consumption tax.

Senator MOYNIHAN. I see. But I thought that was——

Mr. MOTLEY. I would be more than happy to provide you with multiple copies of the study. It was done by an economist in this country and an economist in Great Britain.

Senator MOYNIHAN. If Mr. Halperin or Dr. Yakoboski, who are, I think, free to accept research grants, would be interested in these matters, we would be happy to try to oblige.

I would make the point that we are dealing with something that does not respond quickly to changes, and may be something much more cultural than it is economic.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Moseley-Braun.

Senator MOSELEY-BRAUN. Thank you very much, Mr. Chairman.

Dr. Halperin, in your testimony you said that you thought that the proposed changes with regard to IRAs were unwise. I am a little confused about that, particularly as we started off this hearing with Senator Hutchison's proposal—one, frankly, to show my bias, I very much support—which is simply a matter of equity for people, primarily women, who work inside the home.

My question to you is, do you think it is unwise to value homemakers' contributions the same as workers outside the home? I got the impression you do not like IRAs overall, but, assuming for a moment that IRAs are a fact of life, is it not only fair that women and people who work inside the home should be entitled to an IRA contribution as well?

Mr. HALPERIN. Sorry, Senator. was not focusing on that proposal in my statement. It seems to me, you are correct, that as long as we keep the current income limits it would be fair to say that a married couple can make a $4,000 contribution if a single person can make a $2,000, and it seems to me to make sense to say that that can be done whether you have one worker or two workers.

Senator MOSELEY-BRAUN. Thank you for clarifying the record on that. I was a little taken aback.

My second question is, one of the other panelists—I think it was Mr. Fink—talked about his support for universal access to deductible IRAs. Maybe I am wrong, but if I kind of put all the pieces together of what that means, that kind of sounds to me like just a tax subsidy for the old-fashioned passbook accounts.

I mean, if you think it through, when you are talking about universal access to a deductible IRA you are talking about a tax subsidy for the IRA contribution. If you have universal access to it, that is the same thing as the old passbooks that we used to have when you went in and withdrew your $5 from your bank deposits.

It seems to me that, are we not just talking about a whole passel of subsidies that will impact, not just on private savings, but the kinds of objectives that we are talking about trying to achieve?

Mr. FINK. By access I meant allowing everyone to establish a deductible or back-end IRA.

Senator MOSELEY-BRAUN. All right.

Mr. FINK. By access I meant, universality. I did not mean you could take money out whenever you want.

Senator MOSELEY-BRAUN. Because there are a number of proposals that you can take it out for. I am glad you clarified that.

I just wanted to ask some clarifying questions, Mr. Chairman. I have one final question for, again, Mr. Halperin.

This gets to the whole issue of the flat tax. We are looking at a number of tax proposals. I think the real driving force here is not so much the form of the tax as much as it is simplification.

I mean, people just really have gotten to the point they are just fed up; as Mr. Motley talked about, the poor small businesses trying to struggle under the weight of the regulations. The Tax Code is just really incomprehensible, even when you hire a passel of lawyers and accounts. So, there is a lot of interest in simplification.

My question to you is, assuming for a moment that you believe the distributive effects of an income tax are better, I can assume then some of the flat tax proposals that are around. How then

would you address the issue of simplification within the context of an income tax?

Mr. HALPERIN. Well, that is a tough question, Senator. But I think we made a lot of strides toward simplification in the 1986 act. I think we did a lot of base broadening. I think we were much more neutral between various types of income. I think if we had continued along that line many more improvements would have been possible.

I think, unfortunately, in the last eight or 9 years we have turned it around and moved back in the other direction. I think the most complicating thing we have done is introduced a special provision for capital gains. I think that that is the most complicating thing in the law and I would oppose it for that reason, among many others.

So, I think simplification is possible in the context of an income tax. I think what most of the flat tax proposals do, is essentially they are consumption taxes, they are taxes on wage income alone.

The most complicated part of income tax is trying to tax income from property, and it is obviously simplifying if we give up on it. I think it is unfair to give up on it, and I think we have to continue to try.

I think there are things we can do within the context of an income, but people want special provisions and it is a very tough battle. I think everybody says they want simplification until you tell them that you want to take away their deduction and they are against it. I think that is the struggle that you have.

The CHAIRMAN. Thank you. I have not looked at the statistics recently. After we passed the 1986 act and it was in effect a couple of years, the number of filers using 1040 or 1040-EZ went from about 60 to 70 percent, so we made it easier for some. The remaining 30 percent, there are still complications in it, although I have discovered after years of experience that no one complains about complication if it favors them.

Mr. HALPERIN. Right.

The CHAIRMAN. It is only if it disadvantages them do they then raise the issue of complication.

Senator Chafee?

Senator CHAFEE. Thank you, Mr. Chairman.

Mr. Halperin, you made a statement and I wrote it down; I hope I got it accurately. "The first thing to do to increase savings rate is to reduce the deficit." Could you explain that a little bit?

Mr. HALPERIN. Well, I am certainly going to get myself in trouble quickly because I am not an economist. But I think that the savings rate is basically the net difference between savings and borrowing, and the government is, in effect, borrowing money, so that the government borrowing offsets the savings being done by individuals. So, the smaller the government deficit, the greater the overall savings rate would be.

Senator CHAFEE. So you were not referring to incentives for an individual to make greater savings, you are talking about, I believe the term they are using now is dissaving, which the Federal Government is doing.

Mr. HALPERIN. Right. If the Federal Government did less dissaving, there would be net more savings in the economy.

Senator CHAFEE. So you were addressing the net rather than the effect on an individual.

Mr. HALPERIN. Yes.

Senator CHAFEE. Thank you very much.

I listened, Mr. Motley, with considerable interest to the proposal in your statement because my State is filled with small businesses. I think we have, percentage-wise, as many employees employed by small businesses as any State.

It seemed to me that what you are seeking is simplicity, which is what we all seek. You would like to have the maximum contribution go up to $30,000 a year. Was that being set aside for a pension plan?

Mr. MOTLEY. That is the amount that is allowed to be put away under a 401(k) or a SEP, I believe. I do not think the exact amount is important. I think the principle that self-interest is a great motivator for people who run businesses to set up pension plans that will help not only themselves but their employees, is something that should be recognized. It is one of the motivating factors that makes them do it.

Senator CHAFEE. But to have the self-interest be effective for setting up a plan for the employees, then there would have to be some mandates that the employees be covered.

Mr. MOTLEY. Well, in the Chairman's bill, what he does is say that all employees would have to be offered the opportunity to have the plan set up, and then if they chose they would pick the amount of money that they could put away and the employer would match it.

The opportunity, I think, is something that needs to be offered to all employees, and not necessarily coverage. If you are going to focus in on coverage of 100 percent of the employees, you are simply not going to have businesses setting up pension plans.

And I think that what has happened since the 1970's, since the enactment of ERISA on, is ample proof. I can remember testifying on this issue before the House Small Business Committee in the mid-1970's after ERISA was put in place. The problem emerged then and it has continued and gotten worse. Now we are down to, 85 percent of all of the small businesses in the United States do not offer pension plans for their employees.

Senator CHAFEE. So what you would suggest is that the employer be able to set aside a substantial amount—what seems to me like a substantial amount, $30,000—for a pension fund for himself. At the same time, he would have to offer to his employees an equal opportunity. Are you saying that he would also have to match the contribution that each of them made?

Mr. MOTLEY. Yes.

Senator CHAFEE. Match it dollar for dollar?

Mr. MOTLEY. Dollar for dollar. That is, again, the bill that the Chairman introduced in the 102nd Congress. We liked it then, we like it now. We think that employers would take advantage of it.

They would save substantially on the administrative and record-keeping costs under the Chairman's proposal. And, because of that, it would simply be a matter of writing a check out to the PRIME account, which would be held by banks, or securities firms, investment firms, and we believe that they would do it.

Senator CHAFEE. Yes. I understand that. It just seems to me—and you know more about this than I do—that if the employer had to match dollar for dollar what the employees are putting in, that he is signing himself up for a pretty big expenditure, is he not?

Mr. MOTLEY. He is, and that is the reason for one of the suggestions that we made. Now, there is a limitation in the Chairman's bill, and it was $3,000 or 3 percent of salary.

What we are suggesting is that the employer be given the option of sort of electing the amount that he felt the firm could match during that year. Again, cash flow is a big problem, and one of the things we see as a problem with the bill is, indeed, locking them in, particularly in a small firm, which needs the flexibility.

So, an improvement would be to give them that flexibility at the beginning of the year. The employer might say, this year I think the firm can only afford to match up to $750 per employee.

Senator CHAFEE. And what about the boss, what would be the restrictions on him? Let us take the case you gave. He said, we can only match it up to $750.

Mr. MOTLEY. I think you would have to tie that together in some way as a percentage of what the total would be. Let us say, if $3,000 was the cap for employees and $30,000 was the cap for the boss, then if he only decided to match $1,000, then he could only do $1,000 for himself. You would have to tie it together in order to prevent the employer from scamming the system.

Senator CHAFEE. I would think so. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Grassley.

Senator GRASSLEY. Thank you, Mr. Chairman.

Before I ask a question, I just want to state a short view about the fact that people are promoting the idea of encouraging savings. I think it is a very important issue, so, obviously, I appreciate the Chairman very much getting involved in this.

Obviously, there is going to be great pressure, public and private, particularly because of the baby boom generation coming on when they retire.

So, we, as a country, and most importantly, they, as retirees are not going to be prepared for their retirement unless we begin to do something, either privately or through public policy, that is going to reverse this trend.

I think my first question would be to you, Dr. Yakoboski, and that is, I want to emphasize published research, the extent to which you would know about the public research.

There still appears to be what we have been discussing here all morning, the question of whether or not increasing the income limits at which IRA savings can be tax-deductible results then in new savings or just a shifting.

Could you summarize for us shortly the published resource, if there is one, and the analysis on that question?

Dr. YAKOBOSKI. I could summarize it very quickly by saying the findings are mixed.

Senator GRASSLEY. They are mixed.

Dr. YAKOBOSKI. To elaborate, there is honest disagreement among people who have done various studies regarding the degree

to which targeted savings vehicles such as IRAs, even 401(k) plans, actually add to savings.

Senator GRASSLEY. Well, since it is mixed, then is it your judgment that we have had qualified outstanding experts on both sides of the question, or is the quality of the research on one point of view better than the quality of the research on the other point of view?

Dr. YAKOBOSKI. There are very competent and very good people on each side of the answer.

Senator GRASSLEY. All right.

Dr. YAKOBOSKI. I would say if I was to draw a conclusion from my reading of the research, I would come down on the side that they do result in some addition to savings than otherwise would have occurred.

The real question is the magnitude, and it is far from clear whether it is a slightly marginal effect or a larger effect, and the other question is the timing, the length of time it takes to materialize.

Senator GRASSLEY. All right.

Well, then coming at it from a different point of view, I have a couple of questions from Mr. Halperin. When you spoke, I think you made clear that you are opposed to the easier withdrawal, for other reasons, from IRAs. I presume that would be whether it is for home purchase, educational investment, catastrophic medical expenses, or long-term unemployment.

You did note that such options could increase IRA savings because individuals might be more inclined to save in IRAs if they had easier access to their money. So, my first question is—but I immediately want to state my second one—how strong would this added incentive to save be, in your view?

Second, how would you respond to the point that withdrawals for home purchase could increase the net wealth of individuals, perhaps more than IRA savings accounts would, or that spending for education would increase the earning power of the individual? Are investments like these which could increase the financial security of those involved a good idea, in your point of view?

Mr. HALPERIN. Well, Senator, I think the most problematic is the full freedom to withdraw for any purpose, which is in some of the bills, particularly with respect to the back-end IRA.

I think the easier case is unforeseen emergencies. I think withdrawals for medical, or withdrawals in the case of unexpected unemployment, people can make a good case for.

The difficulty is when you start talking about, basically, withdrawals for home purchases or education which, of course, people would expect to have from the beginning, so that turns the IRA into basically a savings account.

As I say, I think if we are going to have tax incentives for savings, I think I would concentrate them on qualified plans because I think that is where we are going to get the savings for the people who are unlikely to do it on their own, and that is where it is going to be most cost effective to increase the overall savings rate.

With the IRAs, we have the question which no one has the answer to: how much additional savings are we getting from IRAs? But, if we can get more money into qualified plans for lower and

middle income people, I think we have got a much greater assurance that that is something that they otherwise would not have.

Now, the issue that you asked me about, if people do not go into IRAs today because they are afraid they are not going to be able to get it out, if you tell them they can get it out relatively easily, will they then put it in and, in fact, the problem will not arise so they will leave it there and when they retire they will actually have more money than they otherwise would have?

Logically, there is no way to answer that. It would have to be an empirical matter, and I think the research probably would be incomplete at this moment. So, at the moment we can just both guess at it. I think the more freedom, though, you give to the withdrawal, the least likely it is going to actually end up for retirement.

Senator GRASSLEY. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Roth?

OPENING STATEMENT OF HON. WILLIAM V. ROTH, JR., A U.S. SENATOR FROM DELAWARE

Senator ROTH. Thank you, Mr. Chairman. I regret that an auto accident—not mine, but someone else's—prevented me from being here on time, because I think these are a very important series of hearings. I do have an opening statement which I would ask be included as if read.

The CHAIRMAN. Without objection.

[The prepared statement of Senator Roth appears in the appendix.]

Senator ROTH. I would like to make a couple of observations; one, partially in response to Chuck Grassley's statement. There certainly are a number of pre-eminent economists and scholars, including the former Chairman of the Council of Economic Advisors, Martin Feldstein; Lawrence Summers, who is now on leave, as Under Secretary of Treasury for International Affairs; Professor Wise of Harvard; Steven Venti of Dartmouth; Skinner of the University of Virginia, just to mention a few, that do find IRAs result in new savings.

And, I think, as we discuss the question of savings, it is important to look at the problem, not only from the standpoint of the importance of savings to the Nation, but also from the standpoint of family.

Alan Greenspan, of course, recently said the most important thing in this country economically is to do something about our National savings rate, so I think we can all agree with that.

But I think it is also important to look at the problem from the standpoint of the average family. Now, it is my understanding that the average family headed by persons 45–54 years old only have savings of $2,300, the baby boomers. If you go up to 54–64, it is something like $7,000.

So, families are not preparing for retirement. I think it is estimated that families, the baby boomers, will have one-third of the income they need to maintain their pre-retirement standard of living, so I think it is a critical problem and one that needs to be addressed. Of course, I think that is the advantage of IRAs; it is good for the family and it is good for the Nation.

Let me address this question to Mr. Fink. I would like you to address Dr. Yakoboski's point that a vast majority of workers eligible for tax-deductible IRAs do not contribute. I believe there has been other evidence that, had we kept the pre-1986 law, we could have expected half of all Americans to have an IRA.

At its peak in 1986, some 29 percent of all families with heads of households under age 65 had positive IRA balances; 75 percent of these contributions came from families with less than $50,000 of income.

I think the evidence just makes it clear that you have to sell savings. Would you care to comment?

Mr. FINK. I think that is what the evidence indicates, because from 1982 to 1986 when you had an IRA available to everyone, the banks, insurance companies, mutual funds, stockbrokers advertised IRAs, and each year we had an increasing participation rate, and it was reaching down to lower income levels.

As I remember it, 75 percent of new contributors in 1986 had incomes below $50,000, and the median was dropping each year. I think in 1982 the median was $41,000, and by 1986 it had dropped to $29,000.

As the IRA lasted, more people participated and their income levels went down, so you can see the importance of marketing during the 1982–1986 period. Conversely, you can see what happened when the IRA was changed in 1986.

Before you came in, Senator, I handed around the IRS booklet which shows you the current rules. It looks like a Chinese menu, it is so complicated. Marketing has stopped.

I think Congress was trying to stop the top 25 percent of the population from having tax-deductible IRAs, but, as I remember the numbers, because marketing has stopped, you have not had just a 25 percent reduction, you have had a 75 percent reduction. It was because the marketing stopped. Lower income people who are still qualified do not contribute because they are not being marketed to.

Another example: of the people who are currently eligible, the participation rate of that cohort has dropped, 40 percent from 1986 through last year because of the lack of marketing. To make these programs work you need simplicity so marketers can market.

There is no way a bank, insurance company, broker, or mutual fund can market the current IRA, because of the complexity of the ad you would have to run. This exemplifies the problem. You need marketing, constancy, universality to make it work. If you make it complicated, it will not be marketed and it will not work.

Senator ROTH. Does the experience with credit card marketing not underscore what you are saying? I mean, everybody has been talking about, every time you go home and pick up your mail you have got new proposals, new efforts to get you to get another credit card. So, there are tremendous marketing efforts on the credit side, but on the savings side we really do not have much today.

Mr. FINK. Sir, our experience is that if everybody had perfect knowledge and acted as the perfect economic man or woman it might be different, but that is not the way society works.

Senator ROTH. I have one other brief question, Mr. Chairman, if I could ask.

The CHAIRMAN. Sure. Go ahead.

Senator ROTH. Dr. Yakoboski, could you tell me how many two-earner couples are eligible for a full IRA deduction under current law, and how that will change in the next few years? Can you give us any information on whether these are young, middle-aged, or older Americans that are more adversely hurt by this?

Dr. YAKOBOSKI. In the numbers that I presented this morning, I did not break eligibles out by trying to match workers with spouses. We could do that. I think I have numbers back at the office which I would be more than happy to send up.

[The following was subsequently received by the committee:]

IRA PARTICIPATION AND ELIGIBILITY

	Number (thousands)	Percentage Eligible for Deductible IRA Contribution	Number Eligible for Deductible IRA Contribution (thousands)	Percentage of Eligibles Contributing in 1992
Single Workers				
Total	40,151	88.9	35,684	4.7
Annual Earnings (1993):				
less than $10,000	10,655	100.0	10,655	1.4
$10,000–$24,999	17,974	100.0	17,974	4.7
$25,000–$34,999	5,879	100.0	5,879	8.4
$35,000–$49,999	3,547	21.6	766	12.1
$50,000 or more	2,097	19.6	411	27.2
Married Couples, Two Earners				
Total Households	19,389	56.4	10,934	10.0
Annual Earnings (1993):				
less than $10,000	61	100.0	61	0.0
$10,000–$24,999	1,584	100.0	1,584	5.7
$25–$49,999	8,398	100.0	8,398	9.5
$50,000 or more	9,345	9.5	890	23.1
Married Couples, One Earner				
Total Households	14,212	72.4	10,288	8.5
Annual Earnings (1993):				
less than $10,000	1,653	100.0	1,653	5.5
$10,000–$24,999	5,331	100.0	5,331	6.3
$25,000–$34,999	2,383	100.0	2,383	11.5
$35,000–$49,999	2,443	22.2	542	17.3
$50,000 or more	2,402	15.8	380	21.9

Source: EBRI tabulations of the April 1993 Current Population Survey employee benefit supplement.

Dr. YAKOBOSKI. I think that the interesting point is, the lack of participation spans across the earnings bracket, that the typical reason hypothesized, almost knee-jerk, is it is a lack of money.

But, when you look at those without an employment-based plan and, therefore, who could put money in an IRA and deduct it, even among the higher earners, those making, let us say, $50,000 or above, it is still 75 percent do not.

So it is just not an issue of having the money available to put in, I think it is also an issue of, as has been discussed, not being able to access the money once it is in there without a significant tax penalty.

And I think there is a lot to be said for the changes that have been made in the rules over time which has resulted in confusion, and a lack of marketing that has grown over time.

Senator ROTH. Thank you, Mr. Chairman.

The CHAIRMAN. Senator D'Amato.

Senator D'AMATO. Thank you, Mr. Chairman. I would ask that I be permitted to put in a statement as if read in its entirety.

The CHAIRMAN. Without objection.

[The prepared statement of Senator D'Amato appears in the appendix.]

Senator D'AMATO. Mr. Chairman, I think that it was Mr. Fink who spoke to the advertising. I think he is absolutely right. After the 1986 law changed it got so complex to try to figure out under what circumstances you could participate that marketing just did not take place, and we went from a situation where almost 30 percent of the heads of households were participating to people just dropping off and losing interest.

I am wondering if you think, if we were to lift the restrictions, let everyone be able to participate in an IRA, marketing and sales would then again take place as it did previously?

Mr. FINK. I have no doubt that it would, Senator.

Senator D'AMATO. All right. Let me ask you this. Because it has often been said that the cost of this plan—and, by the way, I think it is somewhat simplistic, as many of my arguments might be, to say that the best plan is a qualified plan to encourage savings because, obviously, that is not open to many, many Americans; their employers just simply do not have a 401(k) or a qualified plan.

So, I mean, it is simplistic to just simply say, that is the best. Sure, that is the best if everyone has it, but they do not have it, and particularly small businesses. They just find more and more small businesses that do not have the ability to enter into that kind of plan.

Having said that, what do you think the impact would be in an attempt to reduce the cost, the tax loss, if you were to say that 50 percent of whatever you contributed to your IRA would be deducted as opposed to 100 percent?

Would you still get the same kind of savings rate and increase that we experienced between 1981 and 1986 where you saw this growth and it just began picking up as people began to learn more and more about it, and there is more and more advertising?

Mr. FINK. I think you might not get the exact dollar total, but you would get something approximating that. Again, it is a matter of marketing. The two things we have learned make a difference are marketing and giving people immediate gratification. So it may not be a full deduction, it may be half a deduction, but that can be sold and marketed. I cannot tell you, I am not an economist, if it is going to get to the same exact dollar amount——

Senator D'AMATO. Sure.

Mr. FINK [continuing]. But I bet it would come to that amount or very close to it.

Senator D'AMATO. Well, I suspect that it would because, again, the evidence is anecdotal and very personal, my own. When I had that deduction and I could deduct the full amount of the contribution that my wife and I put in, we put in $4,000, $2,000 of mine and $2,000 of hers. It absolutely made sense. It was silly not to.

Now, if we were to reduce that to 50 percent, that is still such a tremendous incentive that I certainly would have made sure that I put that away, and I am sure that my wife would do the same thing, even if it were 50 percent.

Now we cut the burden down. If it was $25 billion—I do not know what the estimate was as it related; it just seems to me that was the number that was vaunted around—you would be cutting

it by 50 percent and still bringing about great savings and helping both the savings rate and people's retirement later on, their accounts for retirement.

So, again, I think we do great damage if we are for limiting, for example, tax breaks as it relates to, let us say, the area of capital gains tax cuts. There are some who say we should target them or only give them to certain incomes, or certain transaction sizes. I reject that.

I think if it is good for the economy, we should do it. It also seems—and I just throw this out—that we should not get into the business of allowing IRAs for people with incomes that reach a certain amount. That is arbitrary. I do not understand it.

The CHAIRMAN. Should or should not?

Senator D'AMATO. We should not.

The CHAIRMAN. Should not have a cut-off?

Senator D'AMATO. No, we should not. It gets into class warfare. If it is good and if it makes sense, we should encourage it, we should do it. And I think that rich people, wealthy people, are going to change their investment patterns.

And, by the way, if they are really, truly wealthy, putting $2,000 in at a 50 percent reduction is not going to be a great thing. They are still going to be saving well above and beyond.

It is ridiculous for us to engage in that kind of activity because when we do it, we are going to do it with IRAs, we are going to do it with capital gains tax cuts, and that is a philosophy that this administration oftentimes advances. I just think it is wrong and we should not be playing part of that. I just put that out for my own suggestion, my own point of view.

The CHAIRMAN. Maybe Mr. Fink can answer. As I recall, when we did the IRA studies in 1986, once you got above a certain income level they fell off. It was not a big enough contribution. People who were making $150,000 or $200,000, they might have bought an IRA, but it was not their principal method of saving.

Mr. FINK. My recollection is dim, but I think that rings a bell.

The CHAIRMAN. It was small enough. They might do it, they might not. It just was not enough for what they regarded as——

Senator D'AMATO. And that underscores my point, Mr. Chairman. Some people would say that the wealthy are going to take advantage of it. It just did not seem that that was the case.

The CHAIRMAN. I want to ask Mr. Motley a question, following up on what Senator Chafee said, because I want to make sure I heard right, John.

You have no objection to a saving plan which will, if the employer wants to be involved in it, compel him to match something that the employees are putting up. Did I hear right?

Mr. MOTLEY. You heard right, Mr. Chairman.

The CHAIRMAN. You do not need to answer any more.

Mr. MOTLEY. I think you need to provide some flexibility, though, because I think Senator Chafee raised a very important point and one that we raised in the testimony. And that is, for a lot of small firms, cash flow is a significant problem. To lock themselves into a specific amount forever when they may have down years would be very difficult and probably would make many of them think twice, and in the end not do it.

The CHAIRMAN. That I understand. And I understand in a bad year you cut everybody 20 percent, or 50 percent, or it is proportionate for everybody. But you state that you would not necessarily object to a compulsory match. I find that very interesting.

Bill?

Senator ROTH. Thank you, Mr. Chairman.

I would just like to add a comment to what my friend from New York was saying. One of the problems I see with a cut-off is, you have small businessman, you have farmers who may have a good year and exceed whatever that ceiling is, but it seems to me what we are trying to do is establish a pattern of annual savings among the American people.

And, if you are going to have rules of, this year they are in, or that year they are not—you have got a lot of young sports figures that make big money for a few years, but not necessarily for a lifetime—it seems to me we lose sight of what we are trying to do, and that is to help the family as well as the Nation.

People will have some good years. A lot of people will exceed, maybe, the limit as they reach retirement. But, if you want people to plan ahead, I do not think you can constantly change the rules on them. That is the reason I strongly oppose it.

One question I would like to ask you, Mr. Motley. Maybe you commented on this before, but are you supportive of the concept of IRAs for small business?

Mr. MOTLEY. Yes. Yes, Senator. We have polled the concept. We supported it in the beginning, we opposed it when it was restricted, and our membership still favors it. It is something that is very important to self-employed business owners who may not have the ability to set up a pension plan for their employees. It is another option.

The Chairman's plan that we primarily testified on today is not a panacea. I think a small business owner needs to have a number of options and an IRA is certainly an option that our membership has found very valuable.

Senator ROTH. I mentioned the importance to the family of promoting savings through IRAs. Would anybody disagree that it is fine to increase savings through reducing the deficit, but that has very little significance as far as the family is concerned? Is that not a paramount problem in this country today, the lack of adequate savings on the part of the family?

I mean, when you look at these figures the typical 45-to 54-year-old only has $2,300. Should that not be a matter of concern? To me it is impressive that Professor Summers has shown that Canadian savings incentives increased savings there at the same time our reduced incentives lowered savings in America. It seems to me that that is very significant. Anyone disagree with that?

Mr. HALPERIN. Well, Senator, I think obviously that is a problem. The question is, whether these people that you are most concerned with are going to respond to the IRA incentive.

Even after 5 years in 1986 we had less than 15 percent participation of people earning less than $50,000 a year. So, I think people who are reaching age 55 with total savings of $2,300 are not likely to be people who will respond to the IRA incentive.

Those people, I think, if they are going to be protected in retirement, are going to have to be protected through Social Security or other means in which they have no choice whether to save or not, because I think, given the choice, evidence shows that they do not do it. I think that is the problem, it is whether or not options will work.

When you offer people the advantage of tax-free treatment, it may be psychological, and maybe people respond to the tax deductions, but essentially what you are saying is, rather than paying 15 percent of tax on savings income you are going to pay zero.

And that difference does not seem to me to be significant enough to somebody who, up till now, has found such an obstacle to savings that he has almost none available when he is 10 or 15 years from retirement. I think that is the dilemma.

Senator ROTH. Go ahead, Mr. Fink.

Mr. FINK. I would disagree with Mr. Halperin. In 1986, of the new IRA participants, 75 percent made less than $50,000. And, as I said, each year the program went on the median income of the new IRA contributors was dropping substantially.

Now, it was not 100 percent of the people who participated, or even 50 percent of the people, but the program was only in effect for 4 years. These other countries have had savings programs in effect for decades.

The treasurers of different countries write a letter to every taxpayer every year that says, remember, you ought to contribute. If we want to ingrain the savings habit we have to leave it in place long enough, and the evidence shows it will bite more and more. It is not a universal panacea, but it is better for lower income people, it has been shown, than doing nothing.

Senator ROTH. Well, thank you, Mr. Chairman.

The CHAIRMAN. Thank you. I have no more questions. Very, very helpful. We appreciate it.

[Whereupon, at 11:30 a.m. the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED

PREPARED STATEMENT OF SENATOR ALFONSE D'AMATO

Mr. Chairman, I would like to welcome Senator Kay Bailey Hutchison before this Committee today to discuss the Individual Retirement Plans and other legislative proposals which address the savings rate in this country. I am proud to be a cosponsor of her bill.

Mr. Chairman, the savings rate in this country is directly tied to the growth of the economy and the prosperity of all Americans. Whether we put money away for a rainy day or plan for retirement, savings are essential to maintaining a high quality of life. Many of the proposals which this Committee will consider increase the expected after-tax return on savings, thereby making saving relatively more attractive than current consumption. As a result of these incentives, taxpayers choose to save more of their discretionary income.

I am confident that this Committee will look at all the many options before it that relate to promoting and rewarding savings. I look forward to hearing from Senator Hutchison today.

PREPARED STATEMENT OF MATTHEW P. FINK

Good morning, I am Matthew P. Fink, President of the Investment Company Institute, the national association of America's mutual fund industry. The Institute's membership consists of over 5,000 mutual funds. Institute member funds serve more than 38 million shareholders and almost one-in-three American households. I am appreciative of the opportunity to testify today about an issue of great importance to our nation's future.

A. INTRODUCTION

Mutual funds permit millions of individuals to pool their savings in a fund professionally managed by an adviser who invests on their behalf in a wide variety of securities. Today, America's mutual funds serve an important financial management role for countless middle-income families. Median household income of mutual fund shareholders is approximately $50,000 a year.[1] Increasingly, mutual funds also serve as the investment medium for retirement programs, including employer-sponsored retirement plans and IRAs. As of December 1993, mutual funds held over $636 billion in retirement plan assets, of which $341 billion were IRA investments.[2]

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[1] Profiles of Mutual Fund Shareholders, Investment Company Institute (Fall 1992).

[2] Annual Mutual Fund Pension Statistics, Investment Company Institute (August 1994).

Our industry's primary focus is on saving and long-term investment. For this reason, we are confronted daily with the sobering fact that America's personal saving rate is far too low. Most Americans realize this fact—they are not confident their savings will be sufficient to meet their retirement needs, and they doubt Social Security benefits will be able to fill the gap. Their dilemma is finding ways to save more in the face of stagnating household incomes, increasing costs and bigger tax bites.

One part of the message sent in November by middle-class voters all across America was a demand that Congress give them a fighting chance to provide for their own long-term financial security. In effect, voters were saying: "We're willing to take our share of responsibility for our personal futures, but we want some relief from tax burdens to help us do that."

The Savings and Investment Incentive Act of 1995, S.12, introduced by Senators Roth and Breaux responds directly to this need by reestablishing universal access to a fully deductible individual retirement account (IRA) and establishing a new type of non-deductible, tax free IRA designed to meet retirement needs and increase personal saving. By expanding the IRA options available to middle-class Americans, S. 12 will provide direct, tangible tax relief by letting Americans save more and plan for retirement.

There are other simple actions that would promote retirement security of American workers, however, and other aspects of the retirement saving problem need to be addressed now. Specifically, pension plan coverage in the small employer market is woefully inadequate. The Institute endorses simplifying the complex and burdensome operational requirements applicable to employee retirement plans, especially targeted retirement saving vehicles, like 401(k) plans and salary reduction simplified employee pensions (SARSEPs), that allow individuals to save on their own behalf for the specific purpose of financing their retirement. The complexity of these rules has contributed significantly to the burden of plan administration, thereby discouraging small employers from installing 401(k) and SARSEP plans. Easing these burdens will promote greater retirement plan coverage and result in increased retirement saving.

These recommendations have broad-based support. The Institute is a member of the Savings Coalition, which includes education and housing groups, financial service organizations and many others. The Savings Coalition has strongly endorsed expanding incentives to increase personal saving rates.

B AMERICA IS NOT ADEQUATELY PREPARING FOR RETIREMENT

There is a clear need for Congress to establish more powerful incentives to increase retirement saving. Future retirees will have a longer life expectancy and, therefore, a longer retirement period than prior generations. It is also well known that the increasing cost of maintaining Social Security benefits must be funded by a shrinking work force. When the so-called "baby boom" generation (born between 1946 and 1964) reaches retirement, there will be more retirees supported by fewer workers than ever before. Today, for each person 65 and older there are almost 5 persons between 20 and 64; when today's younger workers reach retirement in 2040, there will be only an estimated 2.7 persons between 20 and 64 for each person 65 and older.[3] In fact, the Social Security Administration reports that the program is insufficiently funded in the long run, and that it is projected to have a negative cash flow by approximately the year 2013.[4]

[3] Board of Trustees, Federal Old-Age and Survivors Insurance and Disability Insurance Trust Fund, 1994 Annual Report (U.S. Government Printing Office, 1994); Bipartisan Commission on Entitlement and Tax Reform, "Interim Report to the President" (August 1994).

[4] Ibid.

Recent studies indicate that even if our current mix of entitlement obligations and taxes remains unchanged, today's low saving rates could leave 46 million members of the "baby boom" generation with retirement living standards lower than today's median for 65 year-olds.[5] Even under that scenario, described as "an optimistic extreme," they conclude that future generations will need more private saving to provide them with as much purchasing power as current retirees.

This is not going unnoticed by the American people. A survey released in December 1994 by the Employee Benefit Research Institute reports that roughly two-thirds of Americans age 26 and over are not confident that Social Security will continue to provide benefits of equal value to the benefits received by retirees today.[6]

What are Americans doing in the face of this increased need for personal retirement saving? Unfortunately, they are saving less than ever before.

Government statistics show that personal saving as a percent of disposable personal income has tumbled over the last decade -- from a high of 8.0% in 1984, to a low of 4.0% in 1993.[7] If government deficits are factored in, the situation appears even more bleak: since the 1960s, "net national saving" has dropped from more than 8% to less than 2% today.[8]

The Institute has been concerned about the falling saving rate for some time. An Institute study released three years ago confirmed that, compared to other generations, the Baby Boom generation seems much less prepared financially for their retirement years. Despite a higher number of two-income families and a considerably higher per capita income than previous generations, their saving rates are lower than the two generations that preceded them. The study found that more than 6 out of every 10 Baby Boomers state that they are not saving for retirement, even though more than half expressed worry about meeting their financial needs during retirement.[9] Subsequent research only confirms these alarming trends.[10]

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[5] See "Saving the American Dream," An Economic and Public Opinion Study Sponsored by Merrill, Lynch & Co., Inc. (1994); Auerback, Alan J. and Kotlikoff, Laurence J., "U.S. Fiscal and Saving Crisis and Their Impact for Baby Boomers" (May 1994), printed in Employee Benefit Research Institute, " Retirement In The 21st Century -- Ready Or Not," EBRI Policy Forum (1994).

[6] Employee Benefit Research Institute, "Retirement Confidence In America: Getting Ready For Tomorrow," EBRI Special Report SR-27/Issue Brief No. 156 (December 1994).

[7] Economic Report of the President, Transmitted to the Congress February 1994 (United States Government Printing Office), Table B-27.

[8] Bipartisan Commission on Entitlement and Tax Reform, "Interim Report to the President" (August 1994).

[9] "The Baby Boom Generation, A Financial Portrait," Investment Company Institute (Spring 1991).

[10] According to research performed for Merrill Lynch, half of American families currently only have approximately $1,000 in net financial assets. Anderson, Joseph M., "The Wealth of U.S. Families In 1991 and 1993," Capital Research Associates (December 1994). "Net financial assets" as used in the study include checking, savings and money market deposit accounts, Cds, stocks, bonds, mutual fund shares, IRA and Keogh accounts, 401(k) accounts, and other financial instruments, less unsecured debt (such as unpaid bills, bank debt and credit card balances) and debt secured by financial assets. Employer pension fund accruals are not included in net financial assets. See also, Employee Benefit Research Institute, " Retirement In The 21st Century -- Ready Or Not," EBRI Policy Forum (1994) and Employee Benefit Research Institute, "Public Attitudes on Retirement Income," EBRI Report G-55 (1994).

The evidence is overwhelming. Saving by America's middle class is simply not keeping pace with future needs. The prospects looking forward are unsettling. A policy response by government is imperative.

C. EXPANDING IRA OPTIONS IS A VERY EFFECTIVE POLICY RESPONSE

While the debate over more comprehensive responses to our overall national saving problem is, of course, important, immediate steps like expanding IRA options can help alleviate this coming national crisis; they should be treated as a legislative priority and they should be implemented now.

1. Expanded IRA Options Will Increase Saving

Strong academic evidence supports the conclusion that IRAs do increase saving and do result in new saving.[11] A stable program, consistently maintained, will produce increased saving, not just a shifting of assets into tax-favored retirement programs. A saving habit can be developed through the use of an effective marketing campaign that reinforces the benefits of regular saving.

The psychological impact of an IRA on saving behavior should not be underestimated.[12] Common sense dictates that an IRA is more likely to produce long-term retirement saving than short-term saving vehicles. Money in your wallet is more tempting to spend than money in the checking account, which, in turn, is more tempting than a saving account. Even less tempting are funds set aside for retirement, such as money in an IRA. **We believe that money in an IRA is less likely to be spent than money in a savings account, so IRAs will increase long term saving even if all the money put into IRAs would have been put into some other shorter term saving account.**

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[11] See, e.g., Hubbard, R. Glenn and Skinner, Jonathan, "The Effectiveness of Saving Incentives: A Review of the Evidence" (January 1995)(includes a discussion of the major research papers); Venti, Steven F., "Promoting Saving For Retirement Security," Testimony before the Senate Finance Subcommittee on Deficits, Debt Management, and Long Term Growth (December 7, 1994); Thaler, Richard H., "Self-Control, Psychology, and Savings Policies," Testimony before the Senate Finance Subcommittee on Deficits, Debt Management, and Long Term Growth (December 7, 1994); Skinner, Jonathan, "Individual Retirement Accounts: A Review of the Evidence," printed at 54 Tax Notes 201 (January 1992)(includes collection of citations to relevant research studies by Professor Skinner and others); Venti, Steven F. and Wise, David A., "The Evidence On IRAs," printed at 38 Tax Notes 411 (January 1988)(includes discussion and collection of citations to earlier series of papers by Professors Venti and Wise).

[12] Thaler, Richard H., "Self-Control, Psychology, and Savings Policies," Testimony before the Senate Finance Subcommittee on Deficits, Debt Management, and Long Term Growth (December 7, 1994).

In the end, of course, all the statistics, scholarly research and academic studies in this area must give way to basic instinct and business judgment. The Institute and its members have made expanding the IRA our highest legislative priority, and we expect that the banking and brokerage industries share a similar objective.

From our perspective, the conclusion that IRAs increase saving is quite clear. And to those who suggest that IRAs result in only a shifting of assets, let me say that financial institutions would not be so strongly supportive of an expanded IRA if it led to a mere shifting of money from one account to another. The experience of the mutual fund industry, like that of securities brokers and banks, indicates that the IRA does in fact result in increased accumulations not simply shareholders transferring assets from one account balance to another.

2. Expanding IRA Options Would Benefit Middle-Income Families

Most contributions to IRAs are made by middle-income families. They are not a "tax break for the rich." At the IRA program's peak in 1986, 75 percent of all IRA contributions were accounted for by families with annual incomes of less than $50,000.[13] Moreover, it has been shown that, **before its discontinuance, the universal IRA was increasingly attracting contributions from lower income brackets.** In the period of 1982-1986, the median income of new contributors (expressed in 1984 dollars) dropped an average of 24 percent, i.e., from $41,277 in 1982 to $28,677 in 1986.[14]

Precisely because of the saving opportunity they provide to millions of individual working Americans, expanding IRA options is undeniably viewed as important by America's middle-class voters. Frank Luntz, a prominent national pollster, has reported that a recent poll of the American public on budget, deficit and Social Security issues found that 65 percent of respondents felt strongly that Congress should restore tax deductible IRAs for all income levels. In fact, enhancing IRAs was the single most popular of all the tax proposals in the poll.[15]

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[13] Venti, Steven F., "Promoting Saving For Retirement Security," Testimony before the Senate Finance Subcommittee on Deficits, Debt Management, and Long Term Growth (December 7, 1994). IRA participation is also closely related to age. Nearly 50 percent of all families in the 55-65 age group had an IRA account. Thus, even though less than one-third of all families have an IRA at any single point in time, Professor Venti concluded that over their lifetimes, at least half of all families could be expected to participate in an IRA program.

[14] J. Skinner, "Individual Retirement Accounts: A Review of the Evidence," 54 Tax Notes 201 (January 1992).

[15] Luntz Research Companies, "Budget and Contract Post-Election Survey" (1994).

The Congress should not, however, judge IRA expansion proposals solely on the basis of their popularity. All tax cuts are popular. America needs responsible tax cuts -- ones that increase saving, spur investment and do so without overstraining fiscal policy. Fortunately, we don't have to reinvent the wheel to find such a tax cut. Expanding taxpayers' opportunity to contribute to IRAs meets all of these sensible criteria.

3. Enacting IRA Legislation Now Is An Essential Step Toward Curing Our Personal Saving Shortfall

Proposals to expand the IRA have gained strong and well-deserved bipartisan support, and they include a number of thoughtful approaches.

The Senate is, once again, active in this area. As noted above, Senators Roth and Breaux have introduced a bill which would restore a fully deductible front-end IRA and establish a nondeductible, tax-free back-end IRA.[16] For individuals covered by another retirement plan, the existing income limits on eligibility for a full IRA deduction would be phased out beginning in 1995 and eliminated altogether in 1999. Total annual contributions to front-end and back-end IRAs cannot exceed $2,000 per individual or $4,000 for a married couple filing jointly. The bill would also allow pre-retirement withdrawals to be used for higher education expenses, first time home purchases, catastrophic medical expenses or for long-term unemployment.

Both the Roth-Breaux bill and legislation introduced by Senators Hutchison and Mikulski permit non-wage earning spouses to contribute to IRAs. We strongly support spousal eligibility as an issue of fundamental fairness vital to any IRA measure that Congress adopts.

The House Republican "Contract With America" offers a new "American Dream Savings Account" that allows a non-deductible annual contribution of up to $4,000 for a married couple ($2,000 for an individual). If the account is held for five years, the taxpayer could withdraw funds tax-free and without penalty for retirement, first time home purchases, higher education or medical expenses.[17]

The Administration's proposal would expand tax-deductible IRAs and would permit the use of pre-retirement withdrawals to pay for first home purchases, higher education expenses, catastrophic health care expenses, long-term unemployment, or the care of an elderly parent. The Administration proposes to raise the current tax deductible IRA income limit for couples from $40,000 (phasing out at $50,000) to $80,000 (phasing out at $100,000).

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[16] See, S. 12, The Savings and Investment Incentive Act of 1995.

[17] H.R.6, The American Dream Restoration Act.

The Administration also would allow individuals the option of the "back-end IRA" for non-deductible contributions to an IRA, with the earnings exempt from tax when withdrawn.[18]

Congressmen Thomas and Neal recently introduced H.R. 682 in the House as a companion measure to the Roth-Breaux bill.

The current IRA proposals allow to varying degrees pre-retirement withdrawals from IRAs for purposes such as first-time home purchases, higher education and others. The mutual fund industry's focus is on long-term saving. We believe that is the right focus, and that retirement income is the area for which saving is most needed. Our experience has shown us, however, that many Americans are reluctant to lock up their savings for the long term without some assurance that they will be able to get access to those funds in the event of a family crisis or need. Accordingly, some pre-retirement withdrawal rights may be necessary to encourage people to put their money into saving vehicles like IRAs.

In the final analysis, **all of these IRA options respond directly to the need to increase personal saving. But a bill like that offered by Senators Roth and Breaux is the most effective answer available to Congress.** It gives Americans a choice of IRA vehicles. That way individuals can choose to structure an IRA investment program that best suits their particular needs. Some may want the tax-free distribution option of the back-end IRA, while others may find the immediate tax deduction of the front-end IRA is the incentive they need to save. Still others may want to divide their IRA contribution into front- and back-end IRAs.

While IRA choices are the best answer, the mutual fund industry's substantial **experience in the IRA market has taught us an important lesson: a saving program which is not amenable to a simple marketing campaign is not likely to be as effective as Congress would like.** Economic studies on IRAs and saving have concluded that marketing plays a role in IRA purchases.[19] An IRA saving program that is easy to understand is most likely to be successful.

To doubt the importance of "marketing" and "marketability" to a successful saving initiative is to ignore the realities of the marketplace. We all can attest to the barrage of advertisements that pervade television, radio, newspapers, magazines, and billboards urging us to buy, spend, and consume. To promote saving you also need an effective "message" that encourages people to save and invest for their and their family's future. The saving record

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[18] See U.S. Department of the Treasury, Treasury News, "Tax Cut Proposals In President Clinton's Middle Class Bill of Rights" (December 16, 1994).

[19] See, e.g., J. Skinner, "Individual Retirement Accounts: A Review of the Evidence," 54 Tax Notes 201 (January 1992). Skinner also reported that a large fraction of IRA households contributed exactly $2,000 even when each spouse was eligible to contribute $2,000. He cited the IRA marketing campaign's focus on the $2,000 contribution limit for individuals as a possible explanation. Ibid.; Feenberg, D. and Skinner, J. "Sources of IRA Saving," Tax Policy and the Economy (3d ed. L Summers) (1989).

compiled between 1982 and 1986 proves the point. **When virtually all Americans enjoyed access to a simple, universally deductible IRA, financial institutions across the country actively promoted and marketed them as saving programs. As a result, millions of families invested approximately $250 billion in those years.** The IRA experience since 1986 is just the opposite and some studies have suggested the post-1986 drop off in IRA saving could be attributable to the greater difficulty financial institutions faced in trying to market the more complicated post-1986 IRA.[20] IRA legislation with multiple limits, set offs, exceptions, exclusions, rules and other technicalities cannot be effectively marketed, because the IRA it produces cannot be effectively explained to most Americans. We cannot emphasize enough, if an IRA is too complicated, it will not work! If only tax accountants can understand it, they will be the only ones to use it.

Moreover, for saving incentives to work, the rules that govern them need to be stable and predictable. Frequent changes in the law create uncertainty and reduce contributions. Such changes do not just confuse individual savers. They also undercut the willingness of financial institutions to make costly, long-term investments in marketing these saving programs to the public. **Our recommendation: make the IRA available as broadly as possible; keep it simple; make it permanent.**

D. STRENGTHENING OTHER RETIREMENT SAVING PROGRAMS CAN FURTHER ENHANCE SAVING

There are other simple actions that would promote retirement security of American workers, and other aspects of the retirement saving problem that need to be addressed now. Pension plan coverage in the small employer market requires urgent attention. One of the major distinctions between the small employer (i.e., one with 100 or fewer employees) and larger employers is in the retirement plan area. As of 1993, only 29 percent of the employees who worked for a small employer worked for a company that offered a retirement plan, as compared with 83 percent in the larger companies.[21] Improving pension coverage among

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[20] In a recent article discussing the role of tax policy in shaping middle class tax cuts, Gene Steuerle, a Senior Fellow at the Urban Institute, said: "There is a fair amount of evidence that the current system adds enough complexity to deter saving in these [individual retirement] accounts. Thus, when IRA deductions were limited by income class, even those who did not face those new income limitations cut back on their IRA saving. One reason, perhaps, was that banks, mutual funds, and other institutions found it much more difficult to advertise these accounts in any simple way. If the simplification goal is important, then one would need to be careful not to add too many bells and whistles onto bills expanding IRA account availability." Steuerle, G., "Middle-Class Tax Cuts and Principles of Tax Policy," Tax Notes p. 1722 (December 26, 1994). See also Summers, Lawrence H., "How Best to Give Tax Incentives for Saving and Investment?" Testimony Before the Senate Finance Committee (September 29, 1989); J. Skinner, "Individual Retirement Accounts: "A Review of the Evidence," 54 Tax Notes 201 (January 1992).

[21] See Employee Benefit Research Institute, "Employment-Based Retirement Benefits: Analysis of the April 1993 Current Population Survey," EBRI Issue Brief No. 153 (September 1994).

small employers would address a major problem area contributing to our personal saving shortfall.

The Institute endorses simplifying the complex and burdensome operational requirements applicable to employee retirement plans, especially targeted individual retirement saving vehicles, like 401(k) plans and salary reduction simplified employee pensions (SARSEPs).[22] In addition to allowing employer contributions, those plans allow individuals to save on their own behalf through salary reduction contributions for the specific purpose of financing their retirement. The complexity of these requirements has contributed significantly to the burden of plan administration, thereby discouraging small employers from establishing 401(k) and SARSEP plans. Easing these burdens will promote greater retirement plan coverage and result in greater personal retirement saving.

Salary reduction plans respond directly to the desire of American families for more personal responsibility and control over their own long-term financial security. They also satisfy the small employer's belief that his or her employees should share the burden of funding retirement savings. Section 401(k) plans are one of the most popular types of employer sponsored retirement plans.[23] The salary reduction SEP, or SARSEP, is an alternative to the 401(k) plan for very small employers (those with 25 employees or less).[24] Modest changes in the current legal restrictions on salary reduction SEPs and 401(k) plans would make them more attractive to small employers, and should increase coverage substantially. For example, simplifying both the 401(k) and the salary reduction SEP nondiscrimination rules would ease the burdens on small employers, promote greater retirement plan coverage and increase retirement saving. In lieu of these often complex and

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[22] Under a simplified employee pension (SEP), the employer makes contributions on a non-discriminatory basis to all covered employees. The contributions are made to IRAs maintained for the individual employees and are immediately 100% vested. All employees who have (1) performed service for the employer during at least three of the immediately five preceding calendar years, (2) attained age 21, and (3) receive at least $300, adjusted for inflation ($396 in 1994), in compensation from the employer for the year, must be covered by the SEP. The employer's deduction for its contribution cannot exceed 15% of employee compensation. The maximum contribution to any single participant's IRA is $30,000. Minimal reporting and disclosure obligations are imposed.

Employers maintaining a SEP who have 25 or fewer employees eligible to participate can utilize a special cash or deferred arrangement. Under this salary reduction SEP or SARSEP, employees are permitted to elect to defer receipt of a portion of their compensation and have it contributed on their behalf to the SEP. At least 50% of the employees eligible to participate must elect to have amounts contributed to the SEP, rather than distributed in cash. The total amount deferred by any employee cannot exceed $7,000 a year, adjusted for inflation ($9,240 in 1994). Plans must comply with complex nondiscrimination rules similar to those applicable to 401(k) plans.

[23] "401(k) Plans: How Plan Sponsors See The Marketplace," Investment Company Institute (Winter 1995).

[24] 26 U.S.C. section 408(k).

cumbersome calculations, we support providing alternative non-discrimination safe harbors similar to those in last year's Pension Simplification bill.[25]

There are other flaws in addition to the nondiscrimination rules that continue to make the SARSEP an under-utilized retirement plan vehicle in the small employer market. For example, the class of employers that can take advantage of the salary reduction SEP should be expanded beyond the current "25 or fewer employees" size limit, and Congress should eliminate the requirement that at least 50% of the employees of the employer eligible to participate must elect to have salary reduction contributions made to the SEP. Each of these changes can be simply implemented.

These changes are just a starting point. We know that Chairman Packwood, and others on this Committee, have been forceful advocates for improvement in this area. We have worked in the past on these issues and will continue to do so in the future. Indeed, the time has come for the SARSEP to be made into a truly simple, easy-to-administer retirement plan ideally suited for the entire small employer market. With access to such a retirement plan, the vast number of small employers not currently maintaining retirement plans could be encouraged to provide a source of retirement income for their employees. The Institute is committed to working with this Committee in accomplishing that result.

E. CONCLUSION

Today's targeted individual retirement savings are helping millions of families secure their future retirements through investments that help create saving, jobs and economic growth now. By working together to expand IRA options, restore full IRA eligibility to the middle class, and expand pension coverage in the small employer market we can empower millions more families to realize their own long-term financial security.

Thank you again for permitting me to testify.

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[25] See Title II - Pension Simplification - of H.R. 3419 and S. 762., "Tax Simplification and Technical Correction Act of 1993."

APPENDIX

INVESTMENT COMPANY INSTITUTE

SYNOPSIS OF ACADEMIC STUDIES ON THE IRA'S EFFECTIVENESS AS A SAVING INCENTIVE

The Institute has long supported legislative efforts to enhance individual retirement saving. A great deal of research has been done in recent years on the effectiveness of IRAs as incentives designed to increase personal saving. The primary issue on which many of these studies focus is whether the IRA tax incentive produces new saving or a windfall to typically higher income groups. Would IRA contributors have saved the money anyway, such that their contributions are simply assets shuffled from taxable to tax-favored accounts that do not increase overall personal saving? The mutual fund industry's experience has convinced us that IRA saving options that are easy to understand and consistently maintained can and do increase personal saving. This appendix is a synopsis of the work of a number of prominent scholars who have concluded that IRAs do result in new saving.

In a January, 1995 study, Professor R. Glenn Hubbard of Columbia University and Professor Jonathan Skinner of the University of Virginia published several important conclusions.[1] They focused on whether savings incentives like the IRA are likely to improve households' financial resources in retirement. They found evidence that IRAs and 401(k) plans account for between one-fifth and one-half of financial wealth among lower-middle-income households. They also found that most researchers studying saving incentives agree that in the long run, 401(k)s and IRAs have an important positive impact on saving behavior. For example, they cited recent calculations by economists suggesting that increasing the limit on IRA contributions will increase net national saving by $4 for every $1 reduction in tax revenue. They conclude that a long-term saving strategy for the U.S. Government should include saving incentives such as IRAs and 401(k) plans, and that since saving incentives appear most effective in the long term, policies introduced to encourage saving should remain in place.

In an earlier study, Professor Skinner studied IRS tax return tapes containing a sample of more than 5,000 tax returns filed for the years 1982-1986, to reexamine the evidence on the effectiveness of the IRA program.[2] He found that the IRS data "suggests a strong persistence in IRA purchases, with the probability of contributing to an IRA -- given enrollment in the prior year -- remaining over 80 percent during the entire period 1982-1986." In other words, he concluded that IRAs are a good way for individuals to contribute to their saving -- they do create new saving -- by ingraining the saving habit. Professor Skinner's

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[1] J. Skinner & R.G. Hubbard, "The Effectiveness of Saving Incentives: A Review of the Evidence" (January 19, 1995).

[2] J. Skinner, "Individual Retirement Accounts: A Review of the Evidence," 54 Tax Notes 201 (January 1992) (study also reviews earlier research done by Professor Skinner and others).

study also cited data showing that, before its discontinuation, the universal IRA was increasingly attracting contributions from lower income brackets. Again using the IRS tapes of tax returns, Skinner found differences between those who first contributed in 1982, and subsequent new contributors. In the period of 1982-1986, the median income of new contributors (expressed in 1984 dollars) dropped an average of 24 percent, i.e., from $41,277 in 1982 to only $28,677 in 1986, although the fraction of new enrollees was low in that final year.

Dartmouth Professor Steven Venti has spent nearly a decade studying the saving effectiveness of what he calls "targeted retirement saving programs," such as IRAs, that allow individuals to save on their own behalf for the specific purpose of financing consumption in retirement. In recent testimony before a Senate Finance Subcommittee, he examined saving data from the Survey of Income and Program Participation for three different age groups (families reaching age 60 to 64 in 1984, 1987 and 1991).[3] Dr. Venti found an "astounding" increase in asset balances the longer the family has been exposed to targeted retirement programs. The typical family with the longest exposure to targeted retirement savings programs -- those with nine years of exposure -- had nearly three times the targeted retirement assets of the typical family with only two years of exposure. He noted a comparable increase in total assets as well. Dr. Venti concluded that since total financial assets, including balances in IRAs, are much larger for the younger cohort than for the older cohort, that suggested that targeted retirement saving programs did stimulate new saving over the period, not just a shifting of saving from taxable accounts into tax deferred retirement accounts. He went on to conclude that "the weight of the evidence shows that these targeted retirement saving programs do increase saving."

Further according to Professor Venti, at the IRA program's peak in 1986, about 16 percent of tax filers contributed to an IRA, and about 29 percent of all families with heads of households under age 65 had positive IRA balances. While the likelihood of households having an IRA increased with income and age, at the peak of the program, 75 percent of all IRA contributions were accounted for by families with annual incomes less than $50,000.[4]

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[3] Venti, Steven F., "Promoting Saving For Retirement Security," Testimony before the Senate Finance Subcommittee on Deficits, Debt Management, and Long Term Growth (December 7, 1994).

[4] Professor Venti also found that IRA participation is also closely related to age. Nearly 50 percent of all families in the 55-65 age group had an IRA account. Professor Venit concluded that "even though less than one-third of all families have an IRA at any single point in time, over their lifetimes at least half of all families could be expected to participate in an IRA program." Venti, Steven F., "Promoting Saving For Retirement Security," Testimony for the Senate Finance Subcommittee on Deficits, Debt Management, and Long Term Growth (December 7, 1994).

Professor Venti also has done a series of papers with Professor David A. Wise of Harvard University in which they examined saving.[5] In their 1991 paper, they estimate that fully 66% of the increase in IRA contributions comes at the expense of current consumption; 31% comes from the tax subsidy, and only 3% comes from a reshuffling of existing saving. That is, that IRA contributions do represent new saving.

Professor Richard Thaler of Cornell agrees that, over time, the households that contribute to IRAs and 401(k) accounts accumulate assets in those accounts rapidly, rarely draw them down before retirement, and show no signs of reducing assets in other accounts.[6] He further argues that recent experience with the IRA suggests that saving is as much a psychological as an economic decision. Specifically, Professor Thaler explains that households allocate funds, implicitly or explicitly into categories, or "mental accounts." "Some funds, e.g., those in cash or checking accounts, are designed for current consumption. Others, e.g., those in savings accounts, are for 'rainy days' or 'special occasions'." The various accounts differ in how "tempting they are to invade. Money in your wallet is more tempting to spend than money in the checking account, which in turn is more tempting than a savings account. Even less tempting are funds explicitly set aside for retirement, such as money in an IRA or 401(k) plan." Professor Thaler notes that while some economists have argued that IRAs simply shifted assets from taxable savings accounts into a tax sheltered IRA, those "studies fail to take into consideration that money in an IRA is less likely to be spent than money in a savings account." He argues that once this concept is acknowledged, IRAs can increase long-term saving even if all the money put into IRAs would have been put into some other shorter term saving account.

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[5] See, e.g., S. Venti & D. Wise, "The Evidence On IRAs," 38 Tax Notes 411 (January 1988) and J. Skinner & R.G. Hubbard, "The Effectiveness of Saving Incentives: A Review of the Evidence" (January 19, 1995) (including citation and discussion of the Venti & Wise 1991 paper).

[6] Thaler, Richard H., "Self-Control, Psychology, and Savings Policies," Testimony before the Senate Finance Subcommittee on Deficits, Debt Management, and Long Term Growth (December 7, 1994).

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Individual Retirement Arrangements (IRAs)

For use in preparing
1994 Returns

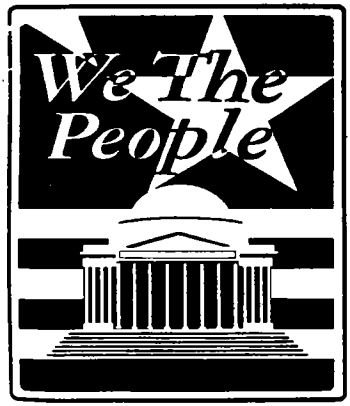

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Table 4.1 **Can You Take An IRA Deduction?** This chart sums up whether you can take a full deduction, a partial deduction, or no deduction as discussed in Chapter 4.

If Your Modified AGI* is:		If You Are Covered by a Retirement Plan at Work and Your Filing Status is:			If You Are Not Covered by a Retirement Plan at Work and Your Filing Status is:			
		• Single • Head of Household	• Married Filing Jointly (even if your spouse is not covered by a plan at work) • Qualifying Widow(er)	Married Filing Separately**	Married Filing Jointly (and your spouse is covered by a plan at work)	• Single • Head of Household	• Married Filing Jointly or Separately (and your spouse is not covered by a plan at work) • Qualifying Widow(er)	Married Filing Separately (even if your spouse is covered by a plan at work)***
At Least	But Less Than	You Can Take	You Can Take	You Can Take	You Can Take	You Can Take	You Can Take	You Can Take
$0.01	$10,000.00	Full deduction	Full deduction	Partial deduction	Full deduction	Full Deduction	Full Deduction	Full Deduction
$10,000.00	$25,000.01	Full deduction	Full deduction	No deduction	Full deduction			
$25,000.01	$35,000.00	Partial deduction	Full deduction	No deduction	Full deduction			
$35,000.00	$40,000.01	No deduction	Full deduction	No deduction	Full deduction			
$40,000.01	$50,000.00	No deduction	Partial deduction	No deduction	Partial deduction			
$50,000.00 or over		No deduction	No deduction	No deduction	No deduction			

*Modified AGI (adjusted gross income) is: (1) for Form 1040A—the amount on line 14 increased by any excluded series EE bond interest shown on Form 8815. *Exclusion of Interest from Series EE U.S. Savings Bonds Issued after 1989*, or (2) for Form 1040—the amount on line 31, figured without taking into account any IRA deduction or any foreign earned income exclusion and foreign housing exclusion (deduction), or any series EE bond interest exclusion from Form 8815.

**If you did not live with your spouse at any time during the year, your filing status is considered, for this purpose, as Single (therefore your IRA deduction is determined under the "Single" column).

***You are entitled to the full deduction only if you did not live with your spouse at any time during the year. If you did live with your spouse during the year, you are, for this purpose, treated as though you are covered by a retirement plan at work (therefore, your IRA deduction is determined under the "Married Filing Separately" column in the "If You Are Covered by a Retirement Plan..." section of the chart).

- A simplified employee pension (SEP) plan, or
- A 501(c)(18) trust (a certain type of tax-exempt trust created before June 25, 1959, that is funded only by employee contributions), if you made deductible contributions during the year.

When Are You Covered?

Special rules apply to determine whether you are considered to be covered by (an active participant in) a plan for a tax year. These rules differ depending on whether the plan is a defined contribution or defined benefit plan. They also differ because of your marital status.

Defined contribution plan. Generally, you are considered covered by a defined contribution plan if amounts are contributed or allocated to your account for the plan year that ends within your tax year.

A defined contribution plan is a plan that provides for a separate account for each person covered by the plan. Benefits are based only on amounts contributed to or allocated to each account. Types of defined contribution plans include profit-sharing plans, stock bonus plans, and money purchase pension plans.

Example. Company A has a money purchase pension plan. Its plan year is from July 1 to June 30. The plan provides that contributions must be allocated as of June 30. Bob, an employee, leaves Company A on December 30, 1993. The contribution for the plan year ending on June 30, 1994, is not made until February 15, 1995 (when Company A files its corporate income tax return). In this case, Bob is considered covered by the plan for his 1994 tax year.

Defined benefit plan. If you are eligible (meet minimum age and years of service requirements) to participate in your employer's defined benefit plan for the plan year that ends within your tax year, you are considered covered by the plan. This rule applies even if you declined to be covered by the plan, you did not make a required contribution, or you did not perform the minimum service required to accrue a benefit for the year.

A defined benefit plan is any plan that is not a defined contribution plan. Contributions to a defined benefit plan are based on a computation of what contributions are necessary to provide definite benefits to plan participants. Defined benefit plans include pension plans and annuity plans.

PREPARED STATEMENT OF DANIEL HALPERIN

Mr. Chairman and Members of the Committee: My name is Daniel Halperin. I am a Professor of Law at Georgetown University Law Center. I am pleased to have the opportunity to discuss how effectively IRAs, 401k plans and similar retirement arrangements increase long term savings. I am also pleased to comment on proposals for "back-end" IRAs and those designed to encourage small business to offer retirement plans for their employees.

It is important to distinguish between two different objectives; on the one hand increasing the overall rate of savings; on the other hand, improving retirement security, particularly, for low and moderate earners. As to the former question, I would agree with those who say that the most effective means of increasing savings is to reduce the long-term budget deficit. The reduction of tax on investment income is not an effective method of increasing savings and threatens the equitable distribution of the tax burden. I would not, therefore, tinker with IRAs or qualified retirement plans for the purpose of attempting to increase overall savings. I would do so only if my goal was to enhance retirement security.

Ideally we should attempt to foster "full replacement[1] of pre-retirement earnings up to moderate levels of income. At these income levels individuals often have difficulty saving. Therefore, the only fully effective way to accomplish this goal is to require additional savings through Social Security or the employer. Since requiring savings is unlikely, at least for the present, the most likely option is to provide a tax incentive either for employer sponsored plans or individual savings through IRAs or otherwise. It seems to me to be clear that if tax subsidies for retirement savings are to exist, the focus should be on employer sponsored plans, with strong anti-discrimination requirements, and not on individual savings.

The Internal Revenue Code provides for favorable treatment of savings in the form of employer-sponsored qualified pension plans or IRAs. If there is no change in the employee's tax rates over time, this can be described as eliminating the tax on investment income (a consumption tax as opposed to an income tax for savings in this form). The problem is that the subsidy is upside down in that it provides the most benefit to those at the highest tax rates,[2] who are most likely to save even without the tax subsidy, and the least benefit to those otherwise unlikely to save. How much after all is a tax free return worth if you would only pay taxes at a 15% rate?

We respond to this difficulty by allowing only relatively minimal contributions to Individual Retirement Accounts, and by limiting the more generous tax benefits[3] to plans that are said not to discriminate in favor of highly compensated employees, that is plans in which the benefit for non-highly compensated employees is not "too much"[4] less than the benefit for the highly compensated. In addition, deductible contributions to IRAs, by those who participate in qualified plans, are limited to individuals with income below $50,000.

It must be assumed that the goal of the non-discrimination requirements is to achieve coverage for at least some people who would not choose it on their own, even if tax-favored. If this were not the case, the tax incentive could be provided for individual retirement savings. In essence, high income individuals generally cannot take advantage of the tax savings unless some lower income do so as well.

INDIVIDUAL RETIREMENT ACCOUNTS

A number of proposals have been presented for the enhancement of IRAs. These include raising the applicable limits on contributions, increasing or eliminating income limits on (effectively) tax deductible contributions, expansion of the oppor-

[1] The meaning of full replacement is complicated. In particular in deciding how much the employee should be expected to save and therefore how much of the replacement could come from savings.

[2] It has been asserted that the tax expenditure is not unfair in that it provides most of its benefits to middle income workers. Obviously, this has to be true since this group comprises most of the work force. On the other hand, the benefit per return is five times as high for the income class over $200,000 as it is for the class between $30,000 and $50,000. I am not sure that a comparison which shows that the tax expenditure is more "progressive" than an across the board rate cut is very meaningful since the latter is not a likely response to the availability of funds for a tax cut or as a means of enhancing retirement security.

[3] Contrast IRC §219(b) (maximum $2000 contribution to an Individual Retirement Account (IRA)) with IRC §415(c) ($30,000 contribution allowed to a qualified defined contribution plan. Under §415(b), even higher contributions would be allowed to the extent necessary to provide a "defined benefit" of up to $120,000.

[4] The non-discrimination test permits benefits to be compared as a percentage of pay and also allows a fair amount of disparity between the benefit percentage provided to the highly compensated and that provided to employees who are not in that group. See IRC §410(b).

tunity for early withdrawal without penalty, and the elimination of the requirement that IRA accumulations be distributed beginning at age 70 and be completed within a short time after the death of the creator. In many cases these enhanced benefits depend upon the creation of the new back-end IRAs. I believe almost all of this is unwise, particularly the back-end IRA, which in my opinion, cannot be justified since it signals an absence of seriousness as to deficit reduction.

I am skeptical of the efficacy of removing or significantly raising the income limits on deductible IRAs. Obviously this will provide additional benefits for those at higher income levels, who will undoubtedly participate in large numbers. Whether, it will provide additional savings is much more in dispute, but it is obvious that the higher up the income scale one goes, the more likely it is that individuals will have existing savings or would have saved additional amounts and, therefore, the IRA contribution is merely shifting savings rather than generating new savings.

It is also unwise to eliminate all requirements for distributions from IRAs. IRAs are designed as savings for retirement. Only the very wealthy would not need them for this purpose and could continue to let funds accumulate tax-free to pass on in the way of bequests to the next generation or beyond. This problem is substantially aggravated if the advantage would be extended to rollovers into IRAs from qualified plans.

I would also not increase the opportunity for penalty-free withdrawals prior to retirement except, perhaps, for unforeseeable emergencies. In particular, I would oppose provisions which would allow back-end IRA balances to be distributed penalty-free for any purpose once they have been accumulated for 5 years.[5] I recognize that providing greater access to the accumulation might encourage more individuals to contribute to IRAs and that these additional contributions might be left untouched until retirement. Thus, the effect on retirement savings of easing withdrawal restrictions is uncertain. Still, it seems likely that total freedom to withdraw, particularly if extended to rollovers from qualified plans, will have a negative impact on retirement savings.

Much in the way of pension savings is now consumed prior to retirement. In fact, it has become increasingly common to distribute benefits from employer plans in the form of a lump sum, upon termination of service, and a substantial portion of lump sum distributions are not preserved for retirement. This occurs even in the face of substantial penalties. I would urge that distributions from qualified plans, not in the form of an annuity, should be required to be made directly to an IRA and that loans and hardship distributions be limited to unforeseen

In any event, my misgivings aside, to the extent that the Congress believes that some of these changes to be sound policy, all of it could be accomplished in the existing IRA format. How therefore do we explain the support from the Administration, the Contract with America and in S. 12. for a so-called "back-end" IRA which would create a new method of providing a tax subsidy—tax free withdrawal in lieu of tax deductible contributions. Those who have done the math recognize that both IRA formats basically provide tax-free treatment of investment income. The back-load IRAs enhance these benefits by effectively increasing the contribution limits, but to a much greater extent for those in the highest bracket, nearly three times as much of an increase as compared to the increase for those paying tax at a 15% rate. This proposal will favor the richest Americans, will substantially increase the budget deficit, while appearing not to do so, and may be at least as likely to reduce savings as it is to increase them.

In light of all this can we really take seriously the Administration's suggestion that what they are trying to do is to provide an alternative savings vehicle that some middle- income taxpayers may find more suitable for their savings needs. Who are these people? Most of us would prefer a tax deduction "in hand" to potential tax free treatment "in the bush." Relatively few would rely on an expectation to be in a higher tax bracket in the future to prefer the latter. It seems to me that without all the additional bells and whistles, which could just as easily be attached to the current "front-end" IRA, almost no one would opt for the new format.

However, by making the new back-end IRA more attractive, in particular with respect to withdrawals, we will entice a number of people to switch, which will accelerate their tax payments to the next five years,[6] while at the same time postponing

[5] The complexity involved in tracing distributions to determine if they relate to contributions which have been aged for five years is daunting and certain to create problems. events. Allowing such rollovers to be distributed without penalty after five years is a step in the wrong direction.

[6] Spreading the tax, in these circumstances, over 4 years, without increasing the base by investment income in this period, effectively reduces the overall tax burden, even if the marginal

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the revenue loss, from the back-end exclusion from income, to the time of withdrawal from the new IRA, which would take place mostly outside of the budget window. By providing a tax reduction which "raises money," we not only do not have to raise other taxes to pay for it, we can spend some of this money on additional breaks. It is hard to believe that a Congress or Administration serious about budget cutting would make such a proposal.

If this is not troubling enough, the back-end approach also disguises an enhancement in the value of the IRA, which enhancement is increased the higher one's tax bracket. This point is difficult to describe but, assuming tax brackets do not change, the traditional IRA is equivalent to receiving the benefit of a tax free return, not on the $2000 nominal investment, but rather on the amount that the taxpayer would have retained after tax if there were no up front deduction to offset ordinarily taxable compensation. This would be $1700 in the 15% bracket and about $1200 at the highest rates.

To get a comparable result from the back-end IRA which explicitly provides a tax-free return, the investment ought to be this after-tax amount and not $2000. In effect, the benefits from a $2000 investment in a back-end IRA exceed the benefit from investing that amount in a front end vehicle. The greater the tax bracket, the greater the additional advantage. Since the problem with IRAs is that they do not provide enough incentive for lower income people to respond it would seem odd to enhance benefits to a greater extent to those who are already responding.

Evidence that, among those with income under $50,000, less than 15% of those eligible contributed in 1985, and that more than 90% of all persons now eligible fail to contribute, indicates that Individual Retirement Accounts will not be more than marginal contributors to retirement security for low and moderate earners. Thus it seems to me that we ought to concentrate on enhancing the viability of qualified plans particularly for small business.

INCREASING COVERAGE IN QUALIFIED PLANS

At the present time, only approximately 50% of the work force is covered by employee plans at any one time.[7] While more than 50% will have coverage at some point in their career, it seems likely that, even a number of years from now, as many as one-third of retirees will not receive a pension,[8] and for many the amount of the benefit will be relatively insubstantial. Given the confluence of lower tax rates, tighter limits on benefits per individual and increased restrictions as to coverage, there has to be at least some risk of a decline in coverage.

This level of coverage is troubling in that it suggests the failure of the private pension system to supplement Social Security for a substantial portion of the workforce. There are two reasons for this result. First, the failure of companies, which have plans, to cover 100% of their work force or to provide the same level of benefits for all employees.[9] Secondly, and more important, many employers, particularly small employers, have not established qualified plans.

A factor which might discourage plan formation by small business is the costs of administration.[10] Ways of minimizing such costs should be sought, for example, by establishing an account for each employee, perhaps under Social Security, to which employers could contribute on a non-discriminatory basis.

Employers resist covering some lower income workers since they often believe they will be unable to reduce wages to offset the cost of contributions to qualified plans on behalf of this group, which would not choose coverage if left to their own devices. Thus, employers might prefer section 401k plans where the employees

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tax rate remains constant. A greater than market discount for early payment would likely increase short-term revenues but it can hardly improve the long-term deficit picture.

[7] Estimates of pens ion coverage differ depending upon the data source and the definition used. For a collection of studies, see Pension and Welfare Benefits Administration, U.S. Dep't of Labor, Pension Coverage Issues for the '90s (Richard P. Hinz et. al. eds 1994).

[8] See Sylvester J. Schieber & Gordon P. Goodfellow, Pension Coverage in America: A Glass Two-Thirds Full or One-Third Empty? in Pension Coverage Issues for the '90s 125, 135–6.

[9] In 1988, 20% of men and 25% of women not covered by a pension plan worked for an employer who already maintained a qualified plan. Sophie M. Korczyk, Gender Issues in Employer Pensions Policy, in Pensions in a Changing Economy (Richard v. Burkhauser and Dallas L. Salisbury eds. 1993) at 65.

[10] See Donald O. Parsons, Recent Trends in Pension Coverage Rates in Pension Coverage Issues for the '90s 39 at 42–5. In any event, there is an obvious dilemma. No employer is required to have a plan. Thus, while favorable tax treatment can encourage the adoption of a plan, the more restrictive the rules, in particular rules which force coverage of employees, who would not save given the choice, the less likely employers will respond to the incentive. On the other hand, if there were fewer restrictions, such plans that do exist would be less likely to provide coverage to low and moderate earners.

choose whether to participate or not and effectively reduce their current pay by the amount contributed. But, in order to qualify under section 401k, it is necessary to demonstrate that the level of contributions by highly compensated employees is no more than a specified percentage greater than contributions by non-highly compensated employees. It is said that this test is cumbersome and creates uncertainty among the highly compensated as to the amount that they will be able to contribute. Thus, the Congress has been considering so-called design based tests which would not require a showing of non-discrimination in actual participation.

In my view, this approach is dangerous and a perversion of the original idea behind section 401k. The idea was that we could allow employee choice as long as in fact non discrimination in participation was actually achieved. Without such a requirement, section 401k would not have been approved.

To the extent, it leaves the option to contribute up to the employee rather than the employer, section 401k is just like a bigger IRA, which has been shown not to entice large numbers of low and moderate earners to contribute. In fact a switch by an employer to a section 401k plan may reduce participation. Section 401k only increase overall coverage to the extent it plays a role in encouraging the adoption of retirement plans by employers, particularly small employers, who would otherwise not put any plan into effect. Importantly, the only thing that distinguishes section 401k from an IRA is the non-discrimination test. Since it is essential to achieve significant levels of participation by the lower income if the highly compensated is to benefit, the employer has a strong incentive to encourage lower income employees to participate.

For a design based test to be successful, it must maintain this incentive. Employers will argue that a requirement that the employer match employee contributions will mean that the cost of not contributing will be so high that the employee will not fail to participate. First, if this were always so, employees could offer a match and count on such a level of low income employee participation so as to reduce the anxiety among the highly compensated as to the amount they will be able to contribute. Second, experience suggests that not everyone responds to an employer match by participating in either a retirement or health insurance program. Finally, and most important, as compared to current law the employer has the opposite incentive. Now employers must make efforts through education and outreach to encourage participation among the lower paid. If plans qualify automatically merely because they provide matching contributions to the required extent, employers have every incentive to discourage participation by those groups for whom they feel the matching contribution cannot be recovered in reduced wages. Certainly employers may have little reason to engage in extensive outreach to encourage participation.

A designed based test which requires a significant minimum level of contributions for all employees has more justification. This could allow additional contributions to be made by selected employees but, in order to maintain the incentive for coverage, the allowable amount of such additional contributions has to be tied to contributions on behalf of non-highly compensated employees.

Thus, while simplicity is clearly worthwhile, simplicity through eliminating nondiscrimination testing is not the way to go—it is inconsistent with the whole basis for the tax subsidy. If simplicity is the goal, we can properly achieve it by requiring qualified plans to cover all employees (who have completed a minimal period of service and have attained age 21), whose earnings are below that of any covered employee.[11]

A requirement that all employees be included in the same plan would result in greater coverage, or an increase in benefits for some who are now covered under less generous plans, only if it could be accomplished without causing a significant decline in the number of plans. Note that a decline in plans is a risk even though the suggested rule is undoubtedly simpler than the current non-discrimination tests. While it is often stated that complexity, which increases the costs of compliance, discourages plans, this is not always true. Thus, employers might object to the additional coverage required under the simpler rule. They would prefer the flexibility, and, therefore, the complexity of current law, under which employers are given wide latitude to demonstrate that the plan does not discriminate in favor of higher income employees.

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[11] Such a rule could be flexible enough to "grandfather" plans in existence at the time the rule were adopted and plans of an acquired business which differed from the plan of the acquiring company. It should also be possible to accommodate preferences by different groups of employees for defined benefit or defined contribution plans. Integration with Social Security could continue to be permissible as long as the (indexed?)

DEFINED BENEFIT PLANS

I believe steps can be taken to reduce the disincentives for defined benefit plans, particularly by phasing in the benefit guarantee to be more consistent with the expected funding cycle (and not necessarily by accelerating funding as is now being done). We should also liberalize the funding rules to allow employers to anticipate increases in both the maximum limits and considered compensation and by eliminating the restriction on accumulation above 150% of the amount needed if the plan terminated. In return we could require benefits payable from a defined benefit plan on separation from service or termination of replacement rate was at least 70–80% including Social Security. the plan to reflect future inflation up to the point of retirement.

Since the latter is not required under current law, when a plan terminates, benefits are based upon earnings at that time. Thus, an increase in defined contribution as opposed to defined benefit plans would enhance the benefits of short service as opposed to long service workers. Nevertheless, the growth of defined contribution plans may not have substantially enhanced retirement security if the bulk of preretirement distributions are lost through lump sum benefits which are consumed.

PREPARED STATEMENT OF SENATOR KAY BAILEY HUTCHISON

Mr. Chairman, thank you very much for allowing me to appear here today. In January, Senator Mikulski and I introduced a bill that will allow the homemakers of this country to make fair, fully deductible Individual Retirement Account contributions of $2,000. 58 of our Senate colleagues have joined us in support of this legislation. Identical legislation has been introduced in the House by Ways & Means Members Johnson, Kennelly, and Dunn.

Senator Mikulski and I have worked closely together on this bi-partisan initiative. A broad coalition of citizen's groups has joined us to push for its enactment. Groups as diverse as the American Association of University Women, the Concerned Women for America, the Family Research Council, the National Women's Political Caucus, and the Older Women's League have endorsed this bill.

Unfortunately, Senator Mikulski's schedule prevents her from being here today. She has asked me to speak on her behalf in support of our legislation and, with your permission, Mr. Chairman, to submit her statement for the record.

The bill will allow equal IRA contributions by Americans that work at home—women, and a growing number of men, who have suffered unfairly under an out-of-date section of the tax code.

Under the current IRA rules, single-income married couples are limited to a deductible IRA contribution of $2,250 each year; $2,000 for the working spouse, and $250 for the homemaker. But if both spouses in a household work outside the home, each is permitted to contribute up to $2,000 annually to an IRA—that's a combined contribution of $4,000. The bill does not change the current pension limitation of section 219(g), which phases-out the deductibility of IRA contributions for married taxpayers who are active participants in retirement plans and earn more than $40,000 a year.

It is my understanding that a question was raised with Secretary Rubin in yesterday's hearing about whether this proposal would primarily benefit higher-income taxpayers. Under the assumption that most higher-income taxpayers already participate in pension plans through their employment, the phase-out of the deductibility of IRA contributions for higher-income taxpayers with pension plans ensures that the primary benefit of this bill will flow to lower and middle-income taxpayers. They are the taxpayers who have the greatest need for the increased retirement savings opportunity provided by this bill.

Under current law, a single-income married couple saving $2,250 each year for thirty years will have $188,554 for retirement, at six percent interest. If that couple is permitted to save $4,000 a year, after 30 years they will have $335,207—an increase in savings of almost $150,000.

According to the Bureau of Labor Statistics, 23% of all women over the age of sixteen are married homemakers. It's obvious that their family's retirement income needs are the same as a two-income couple's. In fact, their needs may be even greater—because the homemaker stayed home to raise the children, a single-income couple may have earned less money to set aside for the future. We can help them meet that need by giving them the incentive and opportunity to save.

Women have longer life expectancies than men and make less money for the same work. They leave work to have children and care for their families, and then return to find that they have fallen behind on their retirement savings. With lower pension

and social security benefits, homemakers have much less for retirement. We must not deny them their best opportunity to save.

I support many of the tax policy changes that have been proposed this year, including expanding IRAs. But before we expand IRAs or make other changes, we need to make IRAs fair. We must permit homemakers to save for their retirement like all other Americans.

It is time the Congress recognizes that work done inside the home is as important as work done outside the home, if not more so. I know that Senator Roth has supported making this change for many years. In fact, twelve members of this Committee have co-sponsored my bill. I hope that all of you will support it after today. I urge the Committee to include this legislation in the first tax bill it reports this year so that American homemakers can begin saving for retirement now.

Thank you, Mr. Chairman.

PREPARED STATEMENT OF SENATOR BARBARA A. MIKULSKI

I am delighted to work on a bi-partisan basis with Senator Hutchison again to pass IRA Equity legislation.

Work is work, whether it is done inside the home or outside the home. And we should reward work. With this legislation we do.

I like this legislation because it reflects our values; it gives help to those who practice self-help.

It acknowledges the value of motherhood and it acknowledges that work done in the home is important to American society. Not all work is done in the marketplace. A substantial amount of the most important work of America goes on in the home.

This legislation will provide the same IRA tax deduction to stay-at-home moms and dads as is available now to those who earn an income.

Current law allows workers to set aside up to $2000 a year in an IRA—but only if they get an income. So two-income couples can contribute $4000.

But one-earner couples, where one spouse stays home to raise the kids, well, the best they can contribute to their IRA each year is $2250.

Our IRA Equity bill says every couple gets the full $4000 contribution. Period.

Motherhood has always been important. Today we're seeing it's absolutely important.

I believe that when we say honor your father and your mother it should not only be a commandment, but a public policy. The law should be clear that mom and dad will not only be rewarded now, but in the future, in their retirement years.

For someone whose work is as a full-time mom, it's not only an occupation, it's a pre-occupation.

When we're talking about productivity in the workplace we need to remember that the work of mothers today is preparing America's workers and leaders of tomorrow.

Often in our society we don't count what counts. We look at the Gross Domestic Product, we look at what is done in the marketplace, but what is not counted is what is done in the home or what is done as volunteer work.

I happen to believe that one of the most important areas of productivity is the work that goes on in the home.

The current rules of government do not support this. We see this in the rules governing pension plans. And we continue to see inequity for women in the workplace in many ways, like bringing home smaller paychecks.

This is important pro-family legislation. It truly acknowledges the value of the family. It gives help to those who practice self-help. And it builds strong communities.

It also acknowledges the pattern of women as they work in and out of the marketplace. Many women do not have linear careers, with glittering resumes, tickets being punched and revolving rolodexes that take them on the path to glory.

Most women do the ordinary with enthusiasm, whether its raising their family or raising the productivity of the private sector in the marketplace. But because they work, and have their children, and return to the marketplace, often their pension plans are spotty, erratic, and most often, skimpy.

That is not a recipe for a relaxing retirement, but a plan for poverty.

Passing this legislation not only offers a measure of fairness and hope, it just makes good sense. It—

—boosts our national savings,

—helps women have the opportunity for a comfortable retirement, and

—strengthens our commitment to family values.

I support this legislation because I want to put our values into pragmatic public policy, and I am pleased to join with my colleagues on a bipartisan basis to reward hard-working Americans.

I will continue to fight for passage of IRA Equity because it's time Congress puts the law where our values are.

PREPARED STATEMENT OF JOHN J. MOTLEY III

Mr. Chairman, my name is John Motley, and I am the Vice President for Federal Governmental Relations for the National Federation of Independent Business. NFIB is the nation's largest small business advocacy organization, representing more than 600,000 small and independent business owners nationwide. For more than half a century, NFIB has served the needs of small business on a broad spectrum of issues. The typical NFIB member employs five workers and reports gross sales of approximately $250,000 per year. On behalf of the entrepreneurs who are members of NFIB, I appreciate the opportunity to testify this morning.

SMALL BUSINESS: AMERICA'S PATH TO JOBS AND INDEPENDENCE

Evidence continues to clearly suggest that small business plays a unique and rather remarkable role as a job creator and provider of personal opportunity, security and independence for million of Americans. Consider the following:

Jobs. Since the early 1970s, small firms have created two of every three net new jobs Bin this country (created jobs minus lost jobs). A substantial majority of that job growth came in the very smallest firms—those with fewer than five employees. The nation's small business job machine has shown a capacity to produce in either good or tough times. From 1989 to 1991, a period of minimal economic growth, firms with fewer than 20 employees created all net new jobs in the country. Firms of all other sizes lost employment during that period.

Demographics. Almost all businesses are small businesses. There are approximately five million employers in the United States. About 99% of them are small employers. And almost all small businesses are very small—so-called Mom-and-Pop, Main Street, family enterprises. More than half of businesses with employees employ fewer than five people. Almost 90% of employers employ fewer than 20. Small business as a whole employs more than half of the private sector workforce. Most small firms are not set up as C corps, but as proprietorships, partnerships, and subchapter S corporations.

Values. Small business holds out to our citizens great hope. Small business offers a road map to the American dream that allows any American with a good idea and talent to follow it to economic freedom and security by starting their own business and working hard to make it a success.

It is this culture, these values, that primarily drive people to start a business—not because they have money or want to make a lot of it. In a 1991 NFIB Education Foundation study entitled New Business in America, new business owners were asked why they went into business. Answers such as "Use my skills," "Control over my own life," and "Build for the family" were all cited twice as frequently by respondents than was "Earn Lots of Money." And having money to start with is not a distinguishing factor in wanting or being able to start a business and pursue the American dream. More than half of all businesses begin with less than $20,000 in capital. One in four of Inc. magazine's 500 fastest growing companies in 1992 started with less than $5,000.

None of this should lead you to believe that surviving as a small employer is easy. To the contrary, it is difficult. About half of all businesses do not survive the first five years.

There are numerous reasons why businesses fail. One of them is government—government taxes, government red tape, government regulations, and government paperwork. You have a unique challenge and opportunity—an opportunity to free small business owners and entrepreneurs from the drag of government so they can do what they do best, create opportunity and wealth for the American people.

SMALL BUSINESS AND RETIREMENT PLANS

NFIB believes that simplification of the regulations and reduction in the costs associated with retirement plans are of vital importance to American small business.

Employee benefit decisions are based on two principles:

—What can the business afford, and

—What do the employees want.

Small firms, as a group offer, employee benefits in a clearly defined sequence and frequency. First offered and most common are paid vacations. Next comes health insurance, which I will discuss at greater length later in my testimony because it comes with its own list of problems and concerns. Then a cluster of benefits show up together—paid sick leave, life insurance and employee discounts, and then retirement plans.

The point is simple. Employee benefits do not grow on trees, just like the money to pay for them does not.

Since small firms represent the majority of the businesses in the U.S., the majority of workers without pension coverage are in small businesses. Data from the Small Business Administration (SBA) reveals that approximately 85 percent of firms in this country do not sponsor retirement plans. The SBA also reports that in 1990, only 14.9 percent of firms with fewer than 500 employees had a retirement plan.

Few small businesses are currently able to afford pension plans for their employees. In the past decade, small employers have repeatedly stated that the costs and regulations affiliated with running a retirement plan have deterred them from starting up plans and caused them to terminate existing ones.

WHY MORE SMALL BUSINESSES DO NOT OFFER PENSION COVERAGE

1. Cost. The cost of starting and maintaining a pension plan is the primary reason small employers give for not having one, according to the Small Business Employee Benefits survey taken by the NFIB Education Foundation.

The administrative and start-up costs of a retirement plan are disproportionately higher for small businesses than for large corporations. Set-up costs for retirement plans are approximately four times higher for small firms, and administrative costs are three times higher for small firms than for large ones, according to James Bell Associates.

For example, the administrative costs, per-participant, under a defined contribution plan (like a 401(k) plan) averages $71 for 25 participants and $25 for 200 participants. Small businesses are rarely profitable enough to afford these sort of costs in setting up and running a pension plan under current law. In fact, every time Congress changes our pension laws—which have numbered 11 in a little over 20 years—additional administrative costs to bring the plans into compliance with the law are incurred.

2. Types of Employees. Employee turnover, ages and whether the employees are full- or part-time dramatically affect a small employer's decision to implement a retirement plan.

Small employers generally cannot afford the administrative costs of implementing and maintaining a retirement plan for employees who will not stay with the business long enough to be vested. Workers in small firms are much more likely to have higher turnover rates than workers in large firms: 27 percent of workers in small firms move every year compared with only 15 percent of those in large firms (Berkeley Planning Associates, 1988). Because small businesses have such high numbers of new employees due to turnover, the employers have little incentive to offer a pension plan for which many of the employees are ineligible.

Small businesses also employ a disproportionately large number of older workers, who are too old to qualify, or younger workers, who are not yet interested in retirement plans. Small businesses are the primary employers of older workers. In 1988, 80 percent of workers 65 years old and over were employed in small firms with fewer than 500 workers. Additionally, many young, low-wage workers would prefer to have a higher salary than to set aside money for retirement. If a small business owner has $2,000 a year that can be used either to start a pension plan or to increase salaries, invariably the younger, lower-paid employees of that business prefer higher pay to benefits they may not see for 40 years.

Part-time workers (working fewer than 35—hours per week) also represent a larger proportion of small business employment than of large business employment—19.6 percent and 12.9 percent respectively, according to the 1990 State of Small Business report. Part-time workers generally do not qualify for and are not interested in a retirement plan through their employer.

3. Preference for health benefits. Many small businesses do not provide pension benefits for their employees because there is another benefit they are struggling to provide first: health insurance. Because small firms are so labor intensive, employee compensation must be acutely sensitive to employee demand in order to be competitive. Nearly every firm offers health insurance, regardless of firm size or age, before they offer a retirement plan. While both benefits are important to employees, having health insurance to be able to pay one's medical bills constitutes a

more immediate need than does savings for retirement. A 1991 EBRI/Gallup poll found that 65 percent of the respondents regard health insurance as their most important benefit.

In addition, 60 percent of respondents said they would be willing to accept a reduction in employer contributions to a pension plan in exchange for increased health benefits.

NFIB surveys show that small employers respond to this high employee demand for health insurance. An extensive 1990 NFIB Education Foundation study indicated that by two to one, small business owners agree that health insurance benefits should be one of the first benefits that employers provide, and that about 60 percent of small employers who provide health insurance do so because "employees need it." And two-thirds of small business owners who do not provide health benefits do not do so because of cost, not because of a lack of desire.

All of this explains why the cost of health insurance has been the number one problem for small business owners for most of the last decade. The reason this is relevant to this testimony is that many small firms will not consider creating pension plans until health insurance is more accessible and affordable.

4. Regulatory burden. The regulatory burden imposed by retirement benefit plans has had a direct impact on the decrease in pension plans in small firms. Since ERISA (The Employee Retirement Income Security Act, known to many small business owners as Every Ridiculous Idea Since Adam,) Congress has passed at least eleven pieces of legislation increasing pension regulations. Studies conducted during the 1980s showed that four out of seven small employers claimed legal complexities and paperwork burdens as deterrents to starting a pension plan.

An NFIB Education Foundation study revealed that one-third of small businesses which recently terminated their plans, did so because of changing and complex regulations. Enabling small employers to implement a retirement plan without complex participation and non-discrimination rules will provide them with incentives to do so.

WHY SMALL BUSINESSES OFFER PENSIONS

In order to increase the number of small businesses that set up and maintain pension plans, it is important to explore why a small business owner would want to set up one in the first place. Small business owners are motivated by a number of factors when deciding whether or not to establish a retirement program.

The primary threshold that must be crossed is whether or not the business can afford the administrative and benefit costs of a plan. If the business can afford the expense of a plan, studies have found that small business owners have a variety of objectives when they start a plan:

1. to take advantage of the tax deductions pension plans offer,
2. to provide their employees with an opportunity to save for retirement,
3. to attract better quality employees,
4. to reward good employees, and,
5. to instill worker loyalty and encouragement to remain with the business.

Obviously, to the extent pension law permits employers to accomplish these objectives, more small employers will offer pensions.

HOW TO INCREASE SMALL BUSINESS PARTICIPATION

As this Committee is by now aware, current pension plans are too expensive and too complicated for the majority of small employers. The prevalence of 401(k), or defined contribution, retirement plans has increased significantly in the past decade. Yet, these plans are generally too costly for many small employers to afford. Additionally, 401(k) plans contain complex non-discrimination rules which successfully prevent small business owners from implementing these plans.

The Private Retirement Incentive Matched by Employers (PRIME) Account legislation introduced by Chairman Packwood in the 102nd Congress presents an excellent starting point for current pension simplification efforts for small employers.

This bill allows firms with less than 100 employees and no other retirement plan to set up accounts for each interested employee in which both employee and employer could make contributions. The PRIME account plan is not subject to any participation or non-discrimination rules, which greatly reduces the employer's regulatory burden. In addition, banks, mutual funds and other financial institutions would maintain the accounts, thus eliminating the employer's recordkeeping burden.

The PRIME plan also gives favorable tax treatment to contributions from both employers and employees. It allows employees to make pre-tax contributions to the PRIME account of up to $3,000 annually, an amount we hope this Committee will seriously consider increasing.

By the time a business is profitable enough to afford a retirement plan, the owners and top managers will typically be older and are going to need to set aside considerable amounts of money. They need to catch-up for the years when any extra cash the business generated was immediately reinvested to expand and grow. Both 401(k) and SEP plans allow business owners to contribute up to $30,000 a year, and we would encourage a similar figure for PRIME.

However, the PRIME plan requires that employers match employee contributions dollar-for-dollar up to three percent of compensation. While small business owners understand the importance of employer contributions in a retirement plan, they prefer that these contributions not be a mandatory requirement. We would recommend allowing the employer to decide at the beginning of the year how much of the employee's retirement savings the employer will guarantee to match. Small businesses need the increased flexibility in their benefit plans to match their ever-wavering profit margin. Employers should be able to increase their contribution during times of business upswing or decrease their contribution when there is little cash on hand. By the nature of their size, small businesses live by cash flow. Small business owners will shy away from pension plans with mandatory contributions at mandatory times for fear of pinching their cash flow, the most important component of a successful business.

Overall, there are many aspects of the PRIME account plan make it a very attractive solution for small businesses that want to provide pension plans but cannot afford to do so. Small business owners purchase pension coverage the same way they purchase any other employee benefit. The lower the cost, the more likely employers will buy it.

IRAs

NFIB members support using Individual Retirement Accounts (IRAs) as a way to increase overall savings for individuals. In a survey, 78 percent of NFIB members supported giving all taxpayers a full $2,000 tax deduction for their contributions to individual retirement accounts.

IRAs are a low-cost, effective method of increasing retirement savings for self-employed individuals who have no other pension options. IRAs will reduce our heavy reliance on foreign investment and increase the low rate of U.S. personal savings, something Federal Reserve Chairman Greenspan has characterized as "the key domestic economic policy problem of this country."

IRAs should be expanded, in line with what Senators Roth and Breaux have put forward in S. 12. The Roth-Breaux bill allows for penalty-free withdrawals for first home purchases, extended unemployment, educational and catastrophic medical expenses. Since most small firms start with funds from personal savings, the Committee may also want to consider early IRA withdrawals to start a small business and become an entrepreneur.

While IRAs are an important step, small employers need retirement plan simplification that goes beyond the IRA.

SEPs

While simplified employee pensions (SEPs) were established to help increase retirement plan sponsorship among small firms, the available evidence indicates they have not been very successful. Only four percent of all workers (with or without a retirement plan available) in the smallest firms (fewer than 25 workers) had SEPs available, according to the SBA.

SEP rules require employers to contribute (up to $30,000 or 15 percent of salary) to the account of every employee who is as least 21 years old, performed services for the employer in at least three of the preceding five years, and received at least $300 in compensation. SEP non-discrimination rules are relatively simple. Employer contribution will be discriminatory unless they bear a uniform relationship to the first $200,000 each employee earns. In other words, if the employer contributes 10 percent of the CEO's salary, the employer has to contribute at least 10 percent of other employees' salaries.

Why aren't SEPs more popular? They do not allow employees to make pre-tax contributions to their own plans. Only employer's contributions receive favorable tax treatment. Additional provisions, like requiring all employees to be covered and immediate vesting add burdens and take away incentive for plan sponsorship. Additionally, financial institutions and advisors have little incentive to market SEPs because there is little profit in it for them, further contributing to low utilization.

Salary Reduction SEPs (SARSEPs) are SEPs that permit employee contributions in pre-tax dollars up to $8,500 or 15 percent of compensation, whichever is less. Only businesses with fewer than 25 employees are eligible for SARSEPs. They have at least two major drawbacks: One, employees can only contribute to a SARSEP,

if at least 50 percent of the business's employees also contribute. And two, SARSEP contributions are subject to complex non-discrimination rules similar to 401(k) plans.

HIGHLY-COMPENSATED EMPLOYEES

One of the primary contributors to the complexity of pension plans is non-discrimination testing, and the definition of a highly-compensated employee is a major cause of that complexity. The problem with the current definition of a highly-compensated employee is that *it includes all business owners,* regardless of how much they earn. Forty percent of NFIB members earn less than $40,000 a year. These business owners are in no position to abuse the system by socking away tens of thousands of dollars a year in pre-tax income. Pension law should encourage small business owners to create plans for themselves and their employees. Declaring up front that every small business owner is highly compensated is not a good way to start.

Rules governing highly-compensated employees, or "top heavy" plans were enacted in the Tax Equity and Fiscal Responsibility Act of 1982 in an attempt to ensure that all employees receive an equitable share of benefits. Under these rules, there are stricter limits on allowable benefits for "key" employees and large minimum benefits for all employees if more than 60 percent of accumulated benefits are given to key employees.

These rules have a tremendous impact on small firms. The highly-compensated rules may prevent owners of small businesses from accruing pension benefits as generous as those of the top management of large corporations who earn the same salaries because small firms have a higher ratio of owners to workers than larger firms. Legislative limits on benefits to employers have contributed to low levels of coverage in small firms by reducing a firm's flexibility to design a plan according to its needs.

Conclusion

To increase pension coverage, Congress should focus on making plans available and affordable for all employers to offer his or her employees. Three out of every four small businesses do not have pension plans. Until small employers offer pension plans to their employees, most American workers will not be covered outside of individual savings and Social Security.

Small employers currently do not offer pension plans because they cannot afford them. Unless the cost of starting and maintaining retirement plans are lowered, small businesses will be discouraged from offering them.

NFIB members urge Congress to enact legislation that will provide a workable small business pension plan, similar to Chairman Packwood's PRIME account; one that will greatly increase the chances that small employers will use the plan, thus enabling them to help their employees provide for a secure retirement.

PREPARED STATEMENT OF SENATOR WILLIAM V. ROTH, JR.

Mr. Chairman, I want to thank you for holding this hearing today, as well as for holding the past two hearings regarding savings—I have been unavoidably absent. The debate on the issue of savings incentives in the tax code has often boiled down to the question of whether they improve the overall savings rate, or result in more forgone revenue for the government than increased private savings. I have looked at the evidence and believe strongly that taxpayers do increase their savings as a result of IRA, 401(k)s and other tax incentives. With an average family burden of 40% in overall taxes, according to the well-respected *Tax Foundation,* how could they *not* encourage savings?

In fact, *recent* studies show that the IRA during the first half of the 1960's dramatically increased *new* savings. In fact, up to 80 percent or more of IRA savings has proven to be new savings, and not merely shifted savings. IRA contributions accounted for more than one-quarter of all personal saving in 1966.

Prominent public financial economists and scholars, including former Council of Economic Advisers Chairman Martin Feldstein, Harvard Professor Lawrence Summers, now on leave as U.S. Treasury Under Secretary for International Affairs, and Professors David A. Wise of Harvard University, James M. Poterba of Massachusetts Institute of Technology, Steven F. Venti of Dartmouth College, Jonathan Skinner of the University of Virginia, and Richard A. Thaler of Cornell University, have concluded that IRAs—especially tax deductible IRAs do result in new saving.

Nearly a dozen scholarly studies, using a variety of data sources and employing several different statistical approaches, have examined whether targeted saving ve-

hicles such as IRAs and 401(k)s impact saving. For example, Professor Venti's testimony examined saving data from a Survey of Income and Program Participation for three different age groups (families reaching age 60 to 64 in 1984, 1987 and 1991). Professor Venti found a striking increase in saving the longer the family has been exposed to the targeted retirement programs—IRAs, 401(k)s and Keoghs. And Professor Summers has shown that Canadian savings incentives increased savings there at the same time our reduced incentives lowered savings in America.

The average family headed by persons 45–54 years old had financial assets of only $2,300 in 1987. For those 55–64 median assets were only about $7,000. Now with those kind of statistics, its impossible for me to see how the average American family can shift savings year after year into an IRA. I would also add that studies show that nearly two-thirds of IRA contributors do not make the maximum possible contribution, suggesting that they cannot effortlessly move money in order to contribute. And, at the peak of the IRA program, 75 percent of all IRA contributions were accounted for by families with annual incomes less than $50,000—not the kind of people who can easily shift assets around.

Finally, just let me point out that IRA opponents in the past have pointed to the saving rates in the early 1980's as an indication that IRAs did not encourage savings. Well, the numbers have been revised. Although I know a lot of things can affect these savings rates, it is clear that savings jumped from 7.0% in 1979 to over 8.0% after the IRA was enacted in 1981. Then in 1987, after they were cut back, the savings rate dropped from 6% to about 4.3%. It's been pretty much declining ever since.

There are a lot of other reasons to enact IRAs. For example, simple fairness to millions of Americans that do not have access to more generous 401(k) plans through their employers is an excellent reason. And, as we are about to hear, fairness to women in particular is important. I look forward to the testimony.

PREPARED STATEMENT OF PAUL L. YAKOBOSKI

I am pleased to appear before you this morning to discuss issues of individual retirement accounts (IRAs), 401(k) plans, and individual saving. My name is Paul Yakoboski. I am a research associate at the Employee Benefit Research Institute (EBRI), a nonprofit, nonpartisan, public policy research organization based in Washington, DC.

EBRI has been committed, since its founding in 1978, to the accurate statistical analysis of economic security issues. Through our research we strive to contribute to the formulation of effective and responsible health and retirement policies. Consistent with our mission, we do not lobby or advocate specific policy solutions.

IRA Usage

Through enactment of the Employee Retirement Income Security Act of 1974 (ERISA), Congress established IRAs to provide workers who did not participate in employment-based retirement plans an opportunity to save for retirement on a tax-deferred basis. U.S. tax law has substantially changed the eligibility and deduction rules for IRAs since then. The Economic Recovery Tax Act of 1981 extended the availability of IRAs to all workers, including those with pension coverage. The Tax Reform Act of 1986 (TRA '86) retained tax-deductible IRAs for those not covered by an employment-based retirement plan but restricted the tax deduction among those with a retirement plan to individuals with incomes below specified levels. In addition, TRA '86 added two new categories of IRA contributions: nondeductible contributions, which accumulate tax free until distributed, and partially deductible contributions, which are deductible up to a maximum amount less than the $2,000 maximum otherwise allowable.[1]

According to EBRI tabulations of the April 1993 Current Population Survey employee benefits supplement (CPS-ebs), in 1993, among the 54 million civilian workers not participating in any type of employment-based retirement plan, *only* 6 percent reported having contributed to an IRA in the previous year (table 1). Therefore, over 90 percent of those eligible to make a tax-deductible IRA contribution chose not to do so. It is often speculated that this is due to a lack of money on the part of lower income workers, but these results hold across different income levels. Only 2 percent of those eligible for a tax-deductible contribution in the lowest earning bracket (under $5,000 annually) contributed to an IRA. While the contribution rate among eligible higher earners is greater, the vast majority still do not participate. Three-quarters of those with earnings of $50,000 or more and not participating in an employment-based plan did not contribute to an IRA (table 1). An additional reason hypothesized for low participation rates among those eligible is that individuals, especially lower income individuals, are reluctant to put their saving in a vehicle where it is beyond their reach (without significant tax penalty) should they need it before retirement age.[2]

Workers eligible for a tax-deductible IRA contribution in small firms were more likely than eligibles in large firms to contribute; however, their participation rates were still under 10 percent. The IRA participation rate among workers without a retirement plan in very small firms (with fewer than 10 employees) was 9 percent. This dropped to 5 percent for those in firms with 1,000 or more employees. This may be at least partially explained by the availability of simplified employee pensions with a salary reduction option (SARSEPs) at firms with fewer than 25 employees.[3]

Among those without an employment-based plan who did contribute to an IRA, the average contribution was $1,845 in 1992 (or slightly under the deductible limit of $2,000 for single filers). While those in smaller firms were more likely to contribute to an IRA, they also tended to make smaller contributions relative to contributors from large firms. The average contribution rate of participants in firms with fewer than 10 employees was $1,792, compared with $1,992 for those in firms of 1,000 or more employees.

Not surprisingly, the average IRA contribution (among those without an employment-based retirement plan) tended to increase with the worker's annual earnings. The average contribution was $1,410 for those earning less than $5,000 annually, compared with $2,121 for those earning $50,000 or more annually.

The original objective of establishing IRAs was to provide a tax-deferred retirement saving vehicle for those workers who did not have an employment-based retirement plan. The fact is that today the vast majority of workers eligible for a tax-deductible IRA contribution do not contribute.

Salary Reduction Plans

Salary reduction plans include 401(k) plans, 457 plans, and 403(b) plans. The Revenue Act of 1978 permitted employers to establish 401(k) arrangements, named after the Internal Revenue Code (IRC) section authorizing them. In 1981, the Internal Revenue Service (IRS) issued the first set of proposed regulations covering such plans. These proposed regulations provided some interpretive guidelines for sec. 401(k) and specifically sanctioned "salary reduction" plans. Through 401(k) arrangements, participants may contribute a portion of compensation (otherwise payable in cash) to a tax-qualified employment-based plan. Typically, the contribution is made as a pretax reduction in (or deferral of) salary that is paid into the plan by the employer on the employee's behalf.[4] In many cases, an employer provides a "matching" contribution that is some portion of the amount contributed by the employee, generally up to a specified maximum. The employee pays no federal income tax on the contributions or on the investment earnings that accumulate until withdrawal. Some plans also permit employee after-tax contributions; the earnings on these contributions are also not taxed until withdrawal.

Public-sector employers can establish similar plans under IRC sec. 457; charitable organizations qualified under IRC sec. 501(c)(3) (for example, a tax-exempt hospital, church, school, or other such organization or foundation), and public school systems and public colleges and universities can establish tax-deferred annuity plans under sec. 403(b). The 1983 Social Security Amendments required that a new civil service retirement system be established to cover federal employees hired after December 31, 1983. The Federal Employees Retirement System (FERS), which Congress adopted in 1986 and which went into effect in January 1987, combines Social Security, a defined benefit pension, and an optional tax-deferred thrift plan similar to a private-sector 401(k) arrangement. Employees hired before the end of 1983 were given the option of joining the new system or remaining in the old Civil Service Retirement System (CSRS) during a six-month period ending in December 1987.[5]

Such plans, while providing for many workers who may not otherwise have had an employment-based retirement plan, do involve explicit decision making on the part of individuals that will directly impact their retirement income security. These decisions start with whether or not to participate in the plan. If workers do decide to participate, they must then decide how much to contribute to the plan and usually how that money is to be allocated among the various investment options offered by the plan. They may also have to decide how employer matching contributions are to be allocated. Decisions do not end there. When plan participants change jobs, they receive lump-sum distributions of their vested account balances and must decide whether to roll the money over and preserve it on a tax-deferred basis or spend it and in the process incur federal income and, if under age 59 1/2, penalty taxes.

The following discussion refers to these arrangements generically as salary reduction plans. A worker's benefit from such plans consists of employee contributions, any employer matching contributions, forfeitures of nonvested benefits by former participants, plus any investment gains and less any investment losses.[6]

Salary reduction plans continue to grow as an important element of the employment-based retirement income system. According to EBRI tabulations of the April 1993 CPS-ebs, the percentage of civilian nonagricultural wage and salary workers with an employer who sponsors a salary reduction plan (the sponsorship rate) increased from 27 percent (27 million workers) in 1988 to 37 percent (39 million workers) in 1993 (table 2). Over the same time period, the fraction of all workers participating in such plans (the participation rate) rose from 15 percent (16 million workers) to 24 percent (25 million workers).

The fraction of participating workers among those where a salary reduction plan was sponsored (the sponsored participation rate) also increased, rising from 57 percent to 65 percent (table 2). The growth in salary reduction plan sponsorship and participation has occurred across almost all worker and job-related characteristics, including firm size.

The likelihood of salary reduction plan sponsorship and participation increased with firm size (table 2). In 1993, 5 percent of those employed by a firm with fewer than 10 employees reported that their employer sponsored a salary reduction plan, compared with 54 percent of those employed by firms with 1,000 or more employees. Note that when a plan was sponsored, the participation rate did not vary systematically with firm size. In all but the smallest employer category, the participation rate among workers where a plan was sponsored was about two-thirds. In the smallest firms (with fewer than 10 employees), almost three-quarters of workers where a plan was sponsored chose to participate. Therefore, the positive relationship between firm size and overall participation rates was solely a function of the positive relationship between firm size and sponsorship rates.

Among all salary reduction plan participants, the average amount contributed to the plan was $2,700 in 1993 (well below the maximum tax-deductible amount allowed by law of $8,994 at that time). This was up slightly from $2,400 in 1988 (1993 $) (table 3). Except for workers in the smallest firm size category (fewer than 10 employees), the average amount contributed did not vary greatly with firm size. It ranged from a low of $2,400 for participants in firms with 25-49 employees to a high of $2,800 for participants in firms with 1,000 or more employees. The average contribution among those participants with an employer with fewer than 10 employees was $1,700 in 1993, down dramatically from $3,100 (1993 $) in 1988.

Discussion

As seen above, participation rates among eligibles is much higher for employment-based salary reduction plans than for IRAs. A relevant question for policy purposes in considering how best to increase retirement savings is why?

Probably the single most important reason is the availability of employer matching contributions with salary reduction plans. Among workers whose employer sponsored a salary reduction plan in 1993, 51.3 percent reported that their employer provided matching contributions to the plan. The actual percentage was likely higher, as 30.2 percent did not know if their employer matched contributions. Among those responding that their employer did provide a matching contribution, the average reported match rate was 65 percent (i.e., for every $1 the employee contributed, the employer contributed 65 cents). Such employer matching contributions are not available with IRAs.

While workers reporting an employer match available were more likely to participate in the plan than those reporting no match, the difference was not as great as might be expected, according to EBRI tabulations of the April 1993 CPS-ebs. The participation rate among those reporting an employer match was 77.8 percent, compared with a rate of 71.8 percent among those reporting no match. The true difference in participation rates between those with a match available and those without a match available may have been understated by these tabulations to the extent that those who did not know whether a match was available were more likely, in actuality, not to have had a match than to have had a match. Other studies have found evidence that the availability of an employer match does have a more significant effect on participation. For example, a 1993 Hewitt Associates' study of 401(k) plans found an average participation rate of 77 percent in plans with an employer match as opposed to an average of 59 percent in plans with no employer match.[7]

In addition, participation in a salary reduction plan is generally more convenient since it is offered through the workplace and involves automatic contributions from a worker's paycheck before he or she even sees it. Plan sponsors will also market the plan to their employees and typically educate them as to the importance for their retirement income security of participating in the plan. With IRAs, on the other hand, an individual must make a conscious decision to seek out such information on his or her own. Furthermore, it has been speculated that some workers who are eligible for a tax-deducible IRA contribution may not be aware of their eligibility.

Finally, the other point of note from the data presented above is that, despite the rapid growth in the number of defined contribution plans—primarily 401(k) arrangements—in small firms over recent years, it is at the small plan level where a noticeable gap in plan sponsorship remains. The question naturally arises as to what if anything can be done to fill this void?

There is no easy answer to this question. SEPs and SARSEPs do exist and were created specifically to appeal to small employers, but they simply are not utilized to any significant degree. To the extent that we are dealing with businesses that have marginal profits and whose workers are relatively young and have relatively low earnings, there may not be great interest on either side for an employment-based retirement plan. The firm cannot afford such a plan, nor are the workers willing to sacrifice earnings for a plan at this point in their careers. Of course, this generalization does not cover all small employers, and therefore it may be possible to create some vehicle that will appeal to them and that financial companies will find worthwhile to market to small employers and their employees.

Endnotes

[1]Under current law, individuals who are not active participants in a qualified employment-based retirement plan can make fully tax-deductible contributions up to a $2,000 maximum per year to an individual retirement account (IRA). Individuals who are active participants or whose spouse is an active participant in a qualified employment-based plan and whose adjusted gross income (AGI) does not exceed $25,000 (single taxpayers) or $40,000 (married taxpayers filing jointly) may make a fully deductible IRA contribution. Individuals who are active participants or whose spouse is an active participant in a qualified employment-based plan and whose AGI falls between $25,000 and $35,000 (single taxpayers) and between $40,000 and $50,000 (married taxpayers filing jointly) may make a fully deductible IRA contribution of less than $2,000 and a nondeductible IRA contribution for the balance, as follows. The $2,000 maximum deductible deduction is reduced by $1 for each $5 of income between the AGI limits. Individuals who are active participants or whose spouse is an active participant in a qualified

employment-based plan and whose AGI is at least $35,000 (single taxpayers) or at least $50,000 (married taxpayers filing jointly) may only make nondeductible IRA contributions of up to $2,000; earnings on the nondeductible contribution are tax deferred until distributed to the IRA holder. IRAs can also be established as rollover vehicles for lump-sum distributions from employment-based retirement plans or other IRAs.

[2]Distributions from IRAs are taxed as ordinary income in the year received, except for the portion of the total IRA distribution that is attributable to nondeductible contributions, which are excludable from gross income. Taxable distributions prior to age 59 1/2 are subject to a 10 percent penalty tax, unless they are taken as part of a series of equal payments made for the life (or life expectancy) of such employee and his or her beneficiary, or the IRA owner dies or becomes disabled.

[3]The Revenue Act of 1978 established a new tax-favored retirement plan aimed primarily at small employers—the simplified employee pension (SEP). SEPs are arrangements under which an individual retirement account (IRA) is established for each eligible employee. These arrangements are sometimes called SEP-IRAs. The Tax Reform Act of 1986 (TRA '86) added a salary reduction feature under which employees in small firms (25 or fewer employees) may elect to have a portion of their pretax salary contributed to a SEP. Such arrangements are sometimes referred to as SARSEPs. An employer may offer both an employer-funded SEP and a salary reduction SEP as long as the total amount contributed per employee does not exceed certain limits.

[4]TRA '86 placed a $7,000 limit on pretax employee contributions to private-sector 401(k) plans. This limit was indexed to the consumer price index beginning in 1988. The 1995 limit is $9,240.

[5]The thrift plan is available to workers covered by either the Federal Employees Retirement System (FERS) or the Civil Service Retirement System (CSRS), but different rules apply to the two groups. FERS employees are automatically covered under the thrift plan, and the government contributes the equivalent of 1 percent of pay for each employee whether or not the individual contributes. Employees may make further contributions of up to 10 percent of base salary (up to the same maximum as 401(k) plans). The government will then match, dollar for dollar, the first 3 percent of employee contributions and 50 percent of the next 2 percent, with no match beyond 5 percent. CSRS participants may contribute up to 5 percent of their salaries to the thrift plan but are not entitled to government contributions.

[6]Workers are immediately vested (that is, entitled to receive nonforfeitable and nonrevocable benefit payments from the plan) in their own contributions and any investment gains on those contributions. Workers are also immediately vested in employer contributions counted for ADP (actual deferral percentage) testing and earnings on those contributions; otherwise, only after having worked for the sponsoring employer for a minimum number of years do they become vested in any employer matching contributions and investment gains on those contributions.

[7]See Hewitt Associates, *401(k) Plan Hot Topics, 1993* (Lincolnshire, IL: Hewitt Associates, 1993).

Table 1
Individual Retirement Account (IRA) Participation by Workers Not Participating in Any Employment-Based Retirement Plan (Includes Salary Reduction Plans) Among Civilian Nonagricultural Wage and Salary Workers, Aged 16 and Over, by Firm Size and Earnings, 1993

	Total (thousands)	Percentage Contributing to an IRA in 1992	Average Contribution (1993 $)
Total	53,636	6.3%	$1,845
Firm Size			
Fewer than 10	12,505	9.0	1,792
10–24	6,537	8.0	1,832
25–49	4,700	6.2	1,782
50–99	3,553	6.6	1,729
100–249	3,614	4.8	2,400
250–499	2,037	2.7	1,670
500–999	2,090	5.4	1,763
1,000 or more	13,361	4.8	1,992
Annual Earnings, 1993 $			
Less than $5,000	7,007	2.1	1,410
$5,000–$9,999	8,943	3.3	1,962
$10,000–$14,999	10,385	3.2	1,485
$15,000–$19,999	7,478	4.6	1,481
$20,000–$24,999	4,572	7.4	1,503
$25,000–$29,999	3,179	8.1	1,601
$30,000–$49,999	4,392	13.1	2,078
$50,000 or more	1,463	24.1	2,121

Source: Employee Benefit Research Institute tabulations of the April 1993 Current Population Survey employee benefit supplement.

Table 2
Civilian Nonagricultural Wage and Salary Workers, Aged 16 and Over, by Salary Reduction Plan Sponsorship and Participation, by Firm Size, 1988 and 1993

	Total Workers		Sponsorship Rate[a]		Participation Rate[b]		Sponsored Participation Rate[c]	
	1988	1993	1988	1993	1988	1993	1988	1993
	(thousands)				(percentage)			
Total	101,745	105,815	26.9%	36.8%	15.3%	23.8%	57.0%	64.6%
Firm Size								
Fewer than 10	13,561	14,032	3.0	5.1	2.2	3.8	74.3	74.3
10–24	8,164	8,466	8.0	12.1	5.7	8.4	70.9	69.5
25–49	6,781	6,716	14.2	20.1	7.8	12.7	55.2	62.9
50–99	5,563	6,185	18.0	29.9	11.0	20.9	61.2	69.8
100–249	7,497	7,775	22.8	39.0	13.3	25.0	58.4	64.2
250 or more	51,274	54,709	41.5	53.2	23.4	34.5	56.2	64.9
250–499	d	5,471	d	49.9	d	32.5	d	65.2
500–999	d	5,485	d	47.8	d	30.5	d	63.7
1,000 or more	d	43,753	d	54.3	d	35.3	d	65.0

Source: Employee Benefit Research Institute tabulations of the May 1988 and April 1993 Current Population Survey employee benefit supplements.
[a]The fraction of workers whose employer sponsors a salary reduction plan for any of the employees at the worker's place of employment.
[b]The fraction of all workers participating in a salary reduction plan.
[c]The fraction of workers participating in a salary reduction plan among those whose employer sponsors a plan for any of the employees at the worker's place of employment.
[d]Data not available.

Table 3
Average Annual Dollar Contributions Among Civilian Nonagricultural Wage and Salary Workers, Aged 16 and Over, Who Participate in a Salary Reduction Plan, by Firm Size 1988 and 1993

	Total Participants (thousands)		Average Contribution (1993 $)	
	1988	1993	1988	1993
Total	15,586	25,148	$2,443	$2,681
Firm Size				
Less than 10	303	536	3,147	1,667
10–24	462	714	2,406	2,608
25–49	530	850	2,311	2,368
50–99	613	1,292	2,157	2,480
100–249	999	1,944	2,177	2,461
250 or more	11,973	18,889	2,501	2,780
250–499	a	1,780	a	2,609
500–999	a	1,671	a	2,615
1,000 or more	a	15,438	a	2,816

Source: Employee Benefit Research Institute tabulations of the May 1988 and April 1993 Current Population Survey employee benefit supplements.
[a]Data not available.

COMMUNICATIONS

STATEMENT OF THE AMERICAN SOCIETY OF ASSOCIATION EXECUTIVES

The American Society of Association Executives (ASAE) is pleased to have the opportunity to present a written statement for the February 9, 1995 hearing of the Senate Finance Committee, regarding the extension of Internal Revenue Code ("Code") section 401(k) plans to tax-exempt employers.

ASAE strongly supports permitting all tax-exempt employers to maintain qualified cash or deferred arrangements (CODAS), also known as 401(k) plans. ASAE believes that employees of trade associations and other tax-exempt employers are entitled to the same opportunity to save for their retirement on a tax-favored basis as employees of charitable and educational organizations, federal, state and local government and the private sector. It is unfair and discriminatory to prevent one type of employer from being able to offer to its employees a particular type of employee benefit that is available in one form or another to employers in every other sector of the economy. It is ultimately the employees of those employers whose ability to save for retirement is being restricted.

The American Society of Association Executives is headquartered at 1575 Eye Street, N.W., Washington, DC 20005 (202/626–2703) and is the professional society for executives who manage trade and professional associations as well as other not-for-profit voluntary organizations in the United States and abroad. Founded in 1920 as the American Trade Association Executives with 67 charter members, ASAE now has a membership of over 22,500 individuals representing more than 10,500 national, state, and local associations. In turn, these business, professional, educational, technical and industrial associations represent an underlying force of hundreds of millions of people throughout the world. Many of ASAE's members work for associations which employ less than 10 employees. Approximately two-thirds of ASAE's members represent trade associations exempt from taxation under Code section 501(c)(6). Many of ASAE's member associations either sponsor or are contemplating sponsoring some form of qualified retirement plan, including 401(k) plans if they would be permitted by law.

BACKGROUND

It has long been recognized that an individual's retirement income should be derived from three sources: (1) Social Security benefit payments, (2) employer-sponsored retirement plan benefits and (3) individual savings. It also has been recognized that individuals in this country have not been saving in sufficient amounts for their long-term needs, including retirement. ASAE believes that the policy of providing tax-favored savings through employer-sponsored plans is an appropriate and efficient means of encouraging Americans to save.

As this Committee is aware, most employers may establish programs that allow their employees to save for retirement on a tax-favored basis. For-profit employers may offer their employees the opportunity to participate in 401(k) plans and, if employing less than 25 employees, salary reduction simplified employee pensions ("SEPs"). Organizations exempt under Code section 501(c)(3) and certain educational organizations may offer their employees tax-sheltered annuities under Code section 403(b). Employees of state and local governments may participate in an eligible deferred compensation plan under Code section 457 (457 Plan). And within the past few years, even the Federal government has provided its employees with a tax deductible salary reduction retirement savings program.

Only tax-exempt organizations, other than those described in Code section 501(c)(3), are unable to provide all of their employees with an opportunity to save for their retirement on a tax-favored basis. To further compound the problem, many

individuals may no longer make tax-deductible contributions to individual retirement accounts after the passage of Tax Reform Act of 1986.

Prior to the Tax Reform Act of 1986, all tax-exempt organizations could sponsor 401(k) plans. In 1985, the President's Tax Proposals to the Congress for Fairness, Growth and Simplicity (President's Proposal) proposed that private sector tax-exempt organizations and public sector employers no longer be permitted to establish and maintain CODAs. The President also proposed to establish rules for deferred compensation arrangements of private sector tax-exempt organizations similar to those found in Code section 457. In its explanation of reasons for change, the President's Proposal stated that private sector tax-exempt organizations may offer their employees tax-sheltered annuities under Code Section 403(b). This, of course, was and is not true for the vast majority of employees of tax-exempt organizations. As the Committee knows, and as stated above, tax-sheltered annuities are available only to employees of Code section 501(c)(3) organizations and certain educational organizations.

Perhaps as a result of this misconception, Congress, in the Tax Reform Act of 1986, acted to prohibit all tax-exempt organizations from adopting 401(k) plans after July 1, 1986. ASAE was active in the unsuccessful attempt to preserve new 401(k) plans for non-governmental tax-exempt organizations during the development and passage of the Tax Reform Act of 1986. Congress also brought under Code section 457 unfunded salary reduction arrangements offered by private sector tax-exempt organizations to a select group of management or highly compensated employees. Accordingly, the only retirement savings plan now available to employees of tax-exempt organizations other than those described in Code section 501(c)(3) is the 457 plan which, as discussed below, is not an adequate replacement vehicle for the 401(k) plan.

Certain members of Congress were quick to perceive the inequity of this situation, and sought to rectify it. In 1987, Senator David Pryor introduced the Small Business Retirement and Benefit Extension Act (S. 1426), which would have extended the availability of Code section 403(b) tax-sheltered annuities to all tax-exempt organizations. Hearings were held before the Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service of the Committee on Finance at which the particular inequities faced by employees of tax-exempt organizations, including trade associations, were thoroughly aired. ASAE presented oral testimony before the Subcommittee at a hearing held on October 23, 1987. ASAE strongly supported this legislation, which unfortunately was not enacted.

The Ways and Means Committee, and later the full House of Representatives adopted H.R. 3545, the Omnibus Budget Reconciliation Act of 1987, which contained a provision that would have permitted tax-exempt organizations not eligible to offer Code section 403(b) tax sheltered annuities to establish 401(k) plans. Unfortunately, this provision as well as many others were removed as the result of the deficit reduction agreement between Congress and the administration. The Code was ultimately amended by the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) to reinstate 401(k) plans for rural telephone cooperatives. More recently, in October, 1989, the Senate version of H.R. 3299, the Revenue Reconciliation Act of 1989, contained a provision to permit all tax-exempt organizations to again be able to sponsor a 401(k) plan. Although this provision was approved by the Senate Finance Committee, the version of H.R. 3299 submitted to the full Senate for a vote did not contain a provision to extend 401(k) plans to tax exempt organizations because most matters not germane to the budget were dropped from the bill. ASAE believes that these legislative actions evidence continuing Congressional interest in fairness in tax policy and in the soundness of public policy regarding tax-favored savings programs.

Many members of Congress continue to fight against the inequity of this situation, and have sought to rectify it during the 102nd and 103rd Congresses. Senator Pryor had included language in the Employee Benefits Simplification and Expansion Act of 1991, S. 1364, that would reinstate 401(k) plans. In May 1991, Representatives Sander Levin and Bill Archer introduced H.R. 2327 which, if enacted, would have allowed all tax—exempt organizations to have access to 401(k) tax deferred retirement plans. This bill had strong bipartisan support with 98 co-sponsors, including 10 from the Ways and Means Committee.

In February 1991, Senator Steve Symms introduced a similar bill which also had strong bipartisan support with 25 co-sponsors, including 9 members of the Senate Finance Committee. In addition, the language from H.R. 2327 was included in two of the major pension simplification bills: former House Ways and Means Committee Chairman Dan Rostenkowski's bill—H.R. 2730, and Representative Ben Cardin's bill—H.R. 2742.

At the close of the 102nd Congress, when Congress and the President began work in earnest on a tax bill, members of the 401(k)s for 501(c)s Coalition, headed by

ASAE, worked to ensure that 401(k) reinstatement would be included in any tax legislation passed by Congress. ASAE was successful when the tax measure which passed the House and Senate (H.R. 11) included 401(k) reinstatement. Unfortunately, due to other provisions in the bill, President Bush vetoed the measure.

In the 103rd Congress, ASAE once again lobbied to restore 401(k) eligibility to all exempt organizations. As Congress convened in the first week of January, one of the first bills introduced, the Tax Simplification and Technical Corrections Act of 1993 (H.R. 3419), included the reinstatement of 401(k) plans for all 501(c) organizations. In addition, 401(k) reinstatement was included in the Pension Simplification Act of 1993 (S. 862), introduced by Sen. David Pryor (D-AR).

In May 1994, the U.S. House of Representatives passed by a voice vote the Tax Simplification and Technical Corrections Act of 1994, H.R. 3419. This bill included reinstatement of Section 401(k) plans for all 501(c) organizations. Although passed by the House, the Act died a quiet death by inaction in the U.S. Senate.

REASONS TO PERMIT TAX-EXEMPT EMPLOYERS TO SPONSOR 401(K) PLANS

The reasons why Congress should extend 401(k) plans to tax-exempt employers are rooted in the principle that employees of tax-exempt organizations should have the same opportunity to save on a tax-favored basis as employees who work in the private sector or for federal, state or local governments. ASAE believes that eliminating this inequitable treatment between taxpayers would result in a more equitable tax policy. It also would foster the objective of increased private retirement savings. ASAE's members support the extension of 401(k) plans to tax-exempt organizations primarily because it would benefit their employees and, by virtue of being able to hire the most qualified employees, the public which they serve.

As indicated above, it is unfair and discriminatory to single out one employer group and, thereby, one group of employees who may not sponsor 401(k) plans. Because the employers do not derive a direct economic benefit from sponsoring a 401(k) plan, it is their employees who are being penalized. This unfair and discriminatory treatment is especially inappropriate when the inequity results from incorrect assumptions regarding the availability of alternative tax-favored savings plans.

The first incorrect assumption is that Code section 403(b) tax-sheltered annuities are available to all tax-exempt organizations. They are not. They are available only to Code section 501(c)(3) charitable organizations and certain educational organizations. Trade associations and other Code section 501(c) organizations may not sponsor such plans for their employees. The other incorrect assumption is that 457 plans are comparable to 401(k) plans for retirement savings purposes. This assumption is incorrect for two reasons.

First, 457 plans do not provide the same level of retirement income security as a 401(k) plan. Qualified plan contributions and earnings, including those in a 401(k) plan, are held in trust for the exclusive benefit of participants and their beneficiaries. In contrast, a 457 plan must be unfunded, and amounts held under that plan are subject to the general creditors of the employer. This greatly reduces the retirement security of an employee who participates in a 457 plan because of the uncertainty of whether the employer will ultimately be able to provide the promised retirement income. In this regard, it would be wrong to assume that private sector tax-exempt organizations have the same ability to generate revenue as public sector tax-exempt organizations, since private sector tax-exempt organizations do not have the power to levy taxes to raise revenue.

Second, as a result of the interplay between the Code and the Employee Retirement Income Security Act of 1974 (ERISA), as amended, 457 plans of private sector tax-exempt organizations may not be offered to all employees, as is the case with public sector organizations such as state and local governments. Again, Code section 457 requires the plan to be unfunded. However, ERISA does not permit a plan of deferred compensation sponsored by a non-governmental private sector organization to be unfunded unless it is maintained primarily for a select group of management or highly compensated employees. This interplay results in the exclusion from a 457 plan of virtually all rank and file employees.

This is clearly inconsistent with the Underlying purposes of the amendments to Code section 401(k) by the Tax Reform Act of 1986; namely, to broaden coverage to non-highly compensated employees and to limit the benefits of highly compensated employees, especially relative to non-highly compensated employees. By limiting the availability of broad-based tax-favored savings to highly compensated and management employees, current law limiting the availability of broad-based tax-favored savings plans for tax-exempt organizations runs counter to both sound tax policy and the objectives of the Tax Reform Act of 1986. ASAE is not suggesting that an exemption from the funding rules be granted. ASAE does not want un-

funded plans to be extended to all employees because deferred amounts would be subject to creditors of the employer.

Another reason that tax-exempt organizations should be able to sponsor 401(k) plans is competitiveness. ASAE's members are particularly sensitive to the tax incentives for employee benefits, like 401(k) plans, because these incentives' affect the ability of the ASAE members, who are employers, to attract and retain well-qualified personnel. Trade associations frequently compete within the same labor pool for employees as private industries that have 401(k) plans or organizations that have Code section 403(b) tax-sheltered annuities available to them. Not only must trade associations be competitive in relation to these employers, but they must also compete with the Federal Government which now provides a funded salary reduction plan for Federal employees. Furthermore, it appears that 457 plans offered by public sector employers work reasonably well because they are available to a broad cross-section of employees, and because public entities generally have the power to tax to secure the promise. Because most of our members work for associations that are small tax-exempt employers, they are concerned about tax incentives that favor for-profit employers or other segments of tax-exempt organizations, or that create tax disadvantages for small tax-exempt employers. The change in the law to prohibit tax-exempts from establishing 401(k) plans has had a significant impact as evidenced by the fact that in 1992 only 13% of ASAE members currently maintained a 401(k) plan. It is estimated that 49% of employers in the population at large offer a 401(k) plan to their employees. These disparities create an often insurmountable handicap to attracting and keeping qualified employees. It is also unfair that our members, the employees of associations, have to do their savings for retirement on a different basis than the employees of virtually every other type of employer.

CONCLUSION

ASAE strongly urges Congress to extend the availability of 401(k) plans to tax-exempt employers.

This would allow all tax-exempt employers the opportunity to offer salary reduction programs to all of their employees. It also would eliminate the disparate treatment between employees of private sector tax-exempt organizations and all other employers. Most importantly, it would help these employees save for their retirement.

Alternatively, ASAE would support extending the availability of tax-sheltered annuities to all tax-exempt organizations. ASAE stands ready to provide any assistance to the Committee that it can in order to achieve this fair and equitable result.

STATEMENT OF THE INDEPENDENT BANKERS ASSOCIATION OF AMERICA

Mr. Chairman, Members of the Committee: The Independent Bankers Association of America (IBAA) appreciates the opportunity to express its views on savings incentives, a matter of long-standing interest to our membership and our customers.

IBAA is the only national trade association that exclusively represents the interests of the nation's community banks.

IBAA SUPPORTS ENHANCED SAVINGS INCENTIVES

For the past several years, IBAA has expressed its support of tax incentives for savings in resolutions approved by our entire membership. These resolutions specifically endorse expanding existing Individual Retirement Accounts (IRAs), as well as the establishment of other tax-advantaged savings products.

IBAA very much appreciates the opportunity to present its views to the Finance Committee at this time, because the subject is of special significance to community banks. IBAA commends the Chairman Packwood and the Committee on the prompt scheduling of these hearings. IBAA also commends the new Congressional Leadership for making the encouragement of savings a national priority issue in 1995. We also commend the Administration for taking the initiative to propose doubling of the income eligibility limits on existing IRA accounts.

Our statement addresses the several important issues we believe are involved.

NEED FOR SAVINGS INCENTIVES

IBAA feels it is not an exaggeration to say that the U.S. is experiencing a "quiet crisis" of inadequate savings and investment.

Federal Reserve Chairman Greenspan said as much to the Ways and Means Committee in a 1991 hearing on tax policy: "the national balance sheet has been severely stretched" by large accumulations of debt in the 1980s by corporations (for

mergers and buyouts), by real estate firms (for development of offices and other commercial space), and by consumers (for motor vehicles and other durables). The aftermath, Greenspan said, "is a considerable degree of financial stress. . ." (Testimony by Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, December 18, 1991).

The Chairman's principal recommendation was as follows:

> "I and others have long argued before this Committee that the essential shortcoming of this economy is the lack of savings and investment. It's here that our major policy focus should rest. Investment is the key to enhanced productivity and higher living standards. . . Bolstering the supply of savings available to support productive investment must be a priority for fiscal policy (Loc. cit., pages 6–7).

From the standpoint of both national and personal saving, the situation seems to have gone from bad to worse since Chairman Greenspan's appearance.

The nation's largest securities firm reported that, during 1992, America's net national savings rate—the sum of savings by governments, businesses and individuals—fell to 1.7 percent, the lowest level since World War II ("National Saving: Key to Investing in the Future," Merrill Lynch Pierce Fenner & Smith, Inc., 1993, page 1). This 1.7 percent figure is consistent with a tabulation by the Organization for European Development and Cooperation, showing U.S. net national savings, as a percentage of Gross Domestic Product, was even lower in 1993—1.2 percent ("OECD IN FIGURES," Statistics on the Member Countries, Supplement to the OECD Observer No. 188, June/July 1994).

The U.S. net national savings rate is thus smaller than all but five of the 24 industrialized members of the OECD. By comparison, the 1993 savings rates for other countries with which the U.S. must compete, were: Belgium 11. 5%, France 6. 5%, Germany 9.8%, Japan 19.5%, Switzerland 19. 3%, Turkey 10. 2% and the United Kingdom 2.0% (OECD, loc. cit., pages 24–25).

For personal savings, the story is similarly dismal. From the 1960s to the mid-1980s, personal savings in the U.S. cycled between 6 and 9 percent. However, in the seven years between 1987 and 1993, the average personal savings rate declined to 4.6 percent. Then, in the 12 month period ending in August, 1994, the rate fell to 3.8 percent, the lowest level in U.S. history (see "Americans Run Out of Options to Boost Their Spending," by John Berry, Washington Post, October 20, 1994, page B13). A table comparing U.S. personal savings rates with those of other OECD nations since 1977 is attached as Exhibit 1.

As an economist, before becoming Treasury Undersecretary for International Affairs, Lawrence H. Summers concluded that reductions in U.S. personal savings during the 1980s accounted for more than twice the decrease in national savings than did the increase in government deficits ("Savings: The Hidden National Crisis," Merrill Lynch, Inc., 1992, page 5).

Because our savings and investments are lagging, productivity has only been growing at about 1 percent a year, and median family in this country in 1994 was somewhat lower than it was in 1974, despite the fact that many spouses joined the workforce and were contributing to family income ("Increasing US Saving is Critical to Securing Our Prosperity," C. Fred Bergsten, Chairman, Competitiveness Policy Council, Feb. 2, 1995).

The U.S. Competitiveness Policy Council concluded that maintaining American competitiveness and living standards can only be accomplished "thought sharp increases in both public and private savings" (Bergsten, Feb. 2, 1995, loc. cit., page 2).

This shortage in savings also means there is less money available for investment in long-term municipal and other bonds to fund improvements in the U.S. infrastructure.

The deterioration of or national infrastructure has been a matter of increasing concern for more than a decade (See "Infrastructure in Ruins," P. Choate, 1982). As to just one segment, the 3.9 million mile U.S. highway system: the Department of Transportation (DOT) estimates that half the nation's roads are substandard and, of the 573,660 bridges more than 20 feet long, 1/3 are in substandard condition and about 1/5 are functionally obsolete.

The DOT Road Information Program estimates the cost of added fuel and vehicle wear and tear resulting from these conditions is about $17.5 billion annually (White Paper, American Road and Transportation Builders Association, Dec. 16, 1994). DOT's report on "The Status of the Nation's Highways, Bridges and Transit" estimates a $290 billion backlog of needed but unfunded road and bridge projects. Increased savings would thus make it possible to address vital road, transit, air and water travel problems.

One experienced observer estimated that half of U.S. domestic investment in the 1980s was financed with foreign capital ("Savings: The Hidden National Crisis," Merrill Lynch etc., loc. cit., page 2). This is not a healthy situation.

A growing literature documents the inadequacy of household savings, especially for retirement. According to Merrill Lynch, the ratio of household assets to household debt has dropped from 20:1 in the 1940s to about 5:1 in 1993 ("National Saving: Key to Investment in the Future," Merrill Lynch, loc. cit., 1993, page 3).

Another study, commissioned by Merrill Lynch, found that families headed by individuals less than 45 years old had median net financial assets of only $700, while families headed by individuals in the 55–64 age bracket (e.g. approaching retirement), had median net financial assets of $6,880, and families headed by individuals aged 65–74 had median net assets of $10,000. Merrill Lynch states that the results of this current study, based from the period 1991–93, is "virtually unchanged" from a similar analysis of 1987 data ("New Data Shows Wealth of American Families at 'Woeful Low'," Merrill Lynch & Co., Inc. press release, December 21, 1994). A table from this study is attached as Exhibit 2.

Merrill Lynch also commissioned a study of the savings habits of 2,015 households representative of the 76 million "baby boomers," who will live longer than their parents. The Savings Coalition, a group of 50 associations and companies, has observed that persons reaching the normal retirement age of 65 can now expect to live another 16.7 years. The Merrill Lynch survey found, that under current fiscal assumptions, these households are saving at a rate of 35.9 percent of what would be required to enjoy a retirement "consistent" with their current lifestyles ("The Merrill Lynch Baby Boom Retirement Index," 1994, page 1).

IBAA's conclusion from this information is that there would be manifold benefits from encouraging personal savings. Initially, increased personal savings prepare families better for major expenditures, such as home and car buying, college and retirement, as well as medical and other emergencies.

Such savings increase the capacity of financial institutions to fund the debt of governments and corporations through domestic resources, rather than foreign capital, to upgrade America's infrastructure through investment in municipal bonds, to build productive capacity of corporations through investment in corporate bonds and stocks, and to enhance job creation and innovation through loans to small enterprise.

This combination of these results would enhance the performance and competitiveness of the U.S. economy all along the line.

BENEFITS TO COMMUNITY BANKS OF SAVINGS INCENTIVES

Smaller, independent community banks have a real stake in the possible enhancement of savings incentives, because community banks rely for their funding almost exclusively upon domestic deposits (96.5 percent). Larger banks, with multiple sources of funds, rely far less on domestic deposits (68.4 percent), as shown in the following table:

RELATIVE IMPORTANCE OF DOMESTIC DEPOSITS TO U.S. BANKS OF DIFFERENT SIZES

	Less than $100 million	$100 million to $1 billion	$1–10 billion	Greater than $10 billion
Total assets	$320.3	$687.7	$1,087.6	$1,836.7
Deposits	278.3	569.7	776.6	1,168.6
Assets less equity (Liabilities)	288.3	620.0	997.5	7,707.8
Deposits as percentage of Liabilities	96.53	91.89	77.85	68.43

Accordingly, increased savings incentives could be even more valuable to smaller banks and their customers than to larger banks.

This value of dedicated savings to independent banks is confirmed by the following figures on the distribution of IRA and Keogh Plans, which indicates that the value of these savings plans in community banks (about 10.7 percent) is slightly higher than their share of overall deposits (about 9.96 percent).

IRA & KEOGH PLANS

	No. of Banks	Totals for IRAs & Keogh	Average per Bank	Median Amount
<100M	7,412	15,519,659,000	2,093.855	1,647
100M–1B	2,791	35,002,962,000	12,541.369	
	9,284			
1B–10B	335	46,060,219,000	137,493.191	121.185
>10B	57	47,863,851,000	839,716.684	911.258

Data as of 9/30/94, One-Source, Sheshunoff Information Service, 1st quarter 1995.

BENEFITS TO SMALL BUSINESSES

Small enterprise is one of the most important elements of U.S. economic life. According to the Small Business Administration (SBA), small businesses account for 53–55 percent of U.S. sales and 52–53 percent of U.S. jobs.

However, of great significance in an era of large-corporate downsizing and large-bank consolidations, is the SBA finding that, between 1976 and 1990, small businesses (500 employees or less) accounted for nearly 2/3 of the net new jobs in our economy (65 percent). Small independent businesses are often the anchors of towns and communities across the country, and are therefore a tangible factor in the quality of American life. And, small business lending is the bread and butter of community banking.

A study of the 1993 Federal Reserve Call Report data by Robert Morris and Associates illustrates how strongly small banks support small businesses. Banks with less than $100 million in assets, which would have up to 50 employees, rank, generally, as community banks. These institutions appear to make more than a quarter of all small business loans of less than $100,000 (28.17 percent, or $21.8 billion out of a total of $77.4 billion). The $21.8 billion amount of these loans by the smallest banks exceeds the total amount of such loans by any category of banks. ("Credit Availability for Small Businesses," *The Journal of Commercial Lending*, April, 1994, page 51).

Banks with under $100 million in assets thus concentrate on small business lending. Almost 3/4 of all their commercial and industrial loans (73.65) are of less than $100,000. Banks with assets of $100 million to $300 million make about half of their loans in amounts of less than $100,000 ($17.7 billion out of $34.2 billion, or 51.75 percent). The largest banks (over $5 billion in assets) made $17.6 billion or 6.73 percent of their loans in amounts of under $100,000.

There is also evidence to suggest that megabanks, that intensely compete with other megabanks, are increasingly shying away from small business lending, where margins are slimmer, or resorting to formula-based decision on small business loans which inhibits the diversity and creativity of small business enterprise ("Is it Banking Without Boundaries or Megabanks Without Constraints? by Kenneth A. Guenther, Executive Vice President, IBAA, Washington Post, January 17, 1995).

Thus, an increased flow of funds into IRA-type retirement vehicles, or similarly structured savings accounts, is very likely to generate a significant additional economic "bang for the buck" because more credits should flow through to for job-creating, innovative, taxpaying small independent businesses.

LEGISLATIVE ISSUES INVOLVED WITH SAVINGS INCENTIVES

The legislative history of IRAs indicates that there have been a variety of policy approaches to savings tax incentives over the years.

When IRAs were created in 1974, as a part of the Employment Retirement Income Security Act (ERISA), they were designed as a retirement savings vehicle for employees not otherwise covered by a pension plan. The Tax Reform Act of 1981 made all workers eligible for IRA deductions of up to $2,000 per year (a so-called "universal" approach). The Tax Reform of 1986 than restricted IRA eligibility to single taxpayers with incomes of less than $25,000 and married taxpayer couples with incomes of less than $40,000, on condition that these taxpayers were not covered by pension plans.

In recent Congresses, Senator Lloyd Bentsen, prior to his tenure as Treasury Secretary, collaborated with Senator William Roth to introduce a "Super-IRA" bill, which proposed to restore universal eligibility and provide opt ions of either the tax deductible contribution of existing IRAs or a "back loaded" alternative that would be funded with after-tax money, but could be removed tax free after age 59½. Another proposal by Senator Kay Bailey Hutchison, was to permit a full $2,000 tax-

deductible contribution by a non-working spouse (S. 1669 of the 103rd Congress; reintroduced as S. 287 this year). IBAA supported these proposals.

The Contract With America proposed:

- to restore universal eligibility,
- to permit a $2,000 (single taxpayer) or $4,000 (joint return) contribution,
- to have this contribution non-deductible, but to allow withdrawal for retirement and, after a prescribed period, for other specified purposes such purchase of a first home (owner occupied), education (college or above), or medical expenses, including insurance for long-term care. The Contract measure was introduced in the 104th Congress as the American Dream Savings Act on January 4, 1995 (H.R. 6).

In the Senate, also on January 4, 1995, Senators Roth and Breaux introduced S. 12, the Savings and Investment Incentives Act of 1995. This bill proposes "front-loaded" deductions that index the current $2000/$4000 limits to the rate of inflation after 1995. The income eligibility would be expanded from the present $25,000 for single taxpayers, to $125,000 by 1998; and for joint return taxpayers, from the present $80,000 to $140,000 by 1998. This measure would also permit a "homemakers" deduction of up to $2,000, but limited to the amount of compensation earned by a spouse.

Consistent with past years, the Senate bill also provides an option of an "IRA-Plus" Account that would be subject to the same contribution and eligibility limits. These sums would not be tax deductible at the outset, but the earnings would be tax free and the proceeds could be withdrawn after five years penalty free to purchase a first home, pay higher education expenses, or defray catastrophic medical expenses.

A detailed bill paralleling the Senate proposal was introduced on January 25, 1995 by Representatives Bill Thomas of California and Richard Neal of Mass. (H.R. 682).

Also part of the picture is the President's proposal to double the income limitations of the existing IRS program, to $50,000 for single taxpayers and $80,000 for joint return taxpayers.

EVALUATION OF PROPOSALS

After its preliminary review of the various proposals, IBAA has several comments. However, the association also wants its pertinent banker committees to review these matters, so that we provide detailed comments based on banker experience.

On the basis of its on-going study of these issues, IBAA can observe that tax incentives for saving are a "going concern." IRA contributions rose from $28.3 billion in 1982 to a peak of $38.3 billion in 1986, and have since dropped to an annual level of between $10 and $11 billion ("IRA Reporter, August, 1994).

This vehicle is thus familiar to many Americans and most financial institutions. IRA accounts are currently found at 10,595 commercial banks, 7,412 of which (or 69.6 percent) are community banks with assets of less than $100 million. These numbers testify to the fact that IRA-type saving is well established in this country, and that expanding such a program would be accomplished safely, speedily and with few administrative problems.

IRAs at banks are insured, up to $100,000 by the federal government, so there is no question of safety and soundness of future IRA-type investments in a banking environment.

Thus, an expansion of tax incentives for saving, particularly bank based savings, is a matter of utilizing an existing, proven system. The additional savings that flow into that system will help those who save, the institutions that receive the funds (especially community banks), the customers of those institutions (including prominently, in the case of banks, small business enterprise), and the national economy.

At present there is considerable debate on how much of funds devoted to tax-advantaged accounts is new savings and how much is transferred from elsewhere. For example, see "The Coming Changes in IRA's Will Be Popular, But They Won't Make American's Save More" Barron's Magazine, January 16, 1995. Barrons' conclusion is based on the work of a National Bureau of Economic Research study by Attanasio and DeLeire. However, the NBER study has been criticized as incorrect on the law, facts, and interpretation by a study performed for the Securities Industry Association by Hubbard and Skinner. The SIA study concludes that raising the IRA contribution limit would increase the nation's capital stock by $4 for each dollar lost in government tax revenue ("The Effectiveness of Savings Incentives: A Review of the Evidence," Hubbard and Skinner, January 19, 1995, Executive Summary).

IBAA finds desirable features in all of the current proposals, and believes any tax incentive legislation passed by this Congress could provide that questions of effec-

tiveness and the structure of the tax-advantaged savings be studied with care, so future decisions would be informed by such analysis. Because savings tend to be a long-term matter, savings incentive policy seems to be susceptible to such a studied approach.

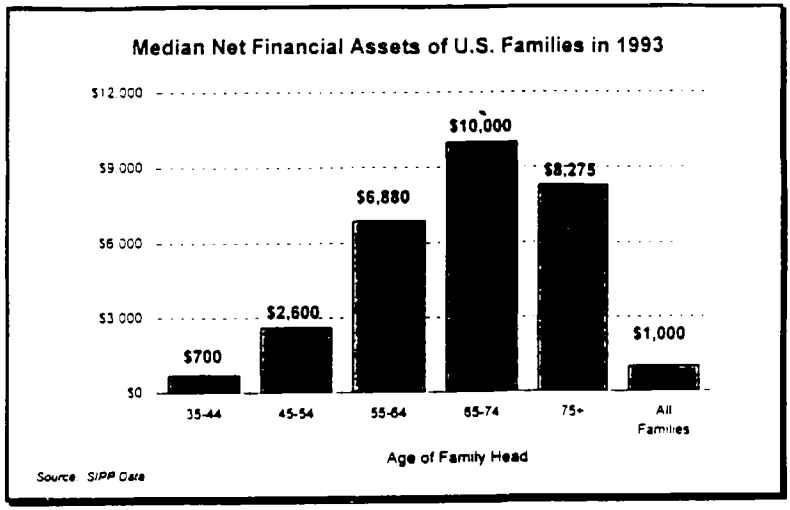
IBAA thus has no hesitation in urging that the Finance Committee and the Congress move forward with the maximum limits and flexibility for savers that is consistent with budget constraints.

IBAA will be delighted to work with this Committee to resolve outstanding issues as the American Dream Savings and related proposals work their way through the legislative process.

Thank you again for this opportunity to express to the Committee our views on these important matters.

EXHIBIT 2

Median Net Financial Assets of U.S. Families in 1993



Source: "New Data Shows Wealth of American Families at 'Woeful Low.'" Press Release. MLPFS, December 21, 1994.

EXHIBIT 1

Household Savings Rates of OCED Countries 1977 to 1996 (estimated)

	1977	1993	Estimates and projections 1994	1995	1996
United States	6.5	4.6	3.9	4.1	4.4
Japan	21.8	15.0	16.0	15.3	15.0
Germany	12.2	12.3	11.4	11.4	11.6
France*	18.7	14.1	13.3	13.1	12.6
Italy*	25.5	16.8	15.2	14.3	14.1
United Kingdom*	9.2	12.2	10.0	9.2	9.2
Canada	11.4	9.2	8.4	8.3	8.2
Australia	11.7	5.0	6.7	5.3	4.4
Austria	8.0	11.5	11.9	11.4	11.0
Belgium	18.8	22.9	22.2	21.6	21.4
Denmark	6.1	14.4	11.8	9.5	7.6
Finland	2.4	6.6	4.0	7.1	4.2
Greece	..	..	..	..	..
Iceland	..	..	..	..	..
Ireland	15.0	14.2	13.1	12.5	12.5
Luxembourg	..	..	..	..	..
Mexico	..	..	..	..	..
Netherlands	3.8	1.3	0.6	1.3	1.3
New Zealand	..	..	..	..	..
Norway	4.7	4.8	4.0	4.3	4.3
Portugal	20.0	18.3	18.2	17.5	16.9
Spain	12.6	12.5	11.7	11.4	11.4
Sweden	4.1	7.2	8.2	7.3	6.8
Switzerland	3.9	13.0	12.1	11.9	11.6
Turkey	..	..	..	..	..

a) Gross saving

Source: "OECD Outlook." Organization for European Cooperation and Development December 1994, page A28.