Plan Distributions

Improving Retirement Readiness: Is the Answer SIMPLE?

This column discusses preparing for retirement through SIMPLE IRAs.

BY TERRY DUNNE

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More and more experts contend that we face a retirement crisis in the United States. Yet others believe many Americans are reasonably well prepared for retirement. Both groups rely on a variety of statistics and surveys to support their positions. Regardless, the reality is that assessing the retirement readiness of Americans is quite difficult.

The workplace retirement system in the United States is a decentralized assemblage encompassing 694,000 private-sector plans, comprised primarily of defined-contribution plans. [Employee Benefits Security Administration. US Department of Labor, "Private Pension Plan Bulletin Historical Tables and Graphs 1975-2015," p.1, *https://www.dol.gov/sites/default/files/ebsa/researchers/statistics/retirement-bulletins/private-pension-plan-bulletin-historical-tables-and-graphs.pdf* (Feb. 2018)] Individual retirement accounts (IRAs) also are a critical component of the system as well, accounting for about one-third of US retirement assets. (See Exhibit 1.) [Sarah Holden, Daniel Schrass, "The Role of IRAs in US Household's Saving for Retirement, 2016," ICI Research Perspective, Vol. 23, No. 1, p.3, Fig. 1, *https://www.ici.org/pdf/per23-01.pdf*, (January 2017)]

Challenges associated with assessing our retirement system are compounded by the fact that some US households have multiple retirement accounts. Morningstar estimated, "The average working household nearing retirement age has three retirement accounts, and nearly 30 percent of households nearing retirement have four or more." [John Rekenthaler, Jake Spiegel, Aron Szapiro, "Small Employers, Big Responsibilities. How Policymakers Can Address the Small Retirement Plan Problem," Morningstar, *http://www.morningstar.com/content/dam/morningstar-corporate/pdfs/policy/SmallEmployersBigResponsibilities.pdf* (November 2017)] Also lurking among the statistics is the reality that too many US households have very small or no retirement accounts.

By many measures, the US retirement system is a resounding success. It has helped 80 million workers save more than $7 trillion in workplace retirement accounts and amass an additional $8 trillion in IRAs. [Robert Reynolds, From Here to Security: How Workplace Savings Can Keep America's Promise, p.xii (Sept. 2017)] While these amounts are impressive, there is more that should be done to help the 40 percent of Americans who do not have access to

Exhibit 1. IRA Ownership in US Households, 2016

	Number of US households with type of IRA[1]	Percentage of US households with type of IRA[1]
Traditional IRA	32.1 million	25.5 percent
SEP IRA[2] SAR-SEP IRA[2] SIMPLE IRA[2]	7.2 million	5.7 percent
Roth IRA	21.9 million	17.4 percent
Any IRA[1]	42.5 million	33.8 percent

1. Households may own more than one type of IRA.
2. SEP, SAR-SEP, and SIMPLE IRAs are employer-sponsored IRAs.

Source: Sarah Holden, Daniel Schrass, "The Role of IRAs in US Household's Saving for Retirement, 2016." ICI Research Perspective, Vol. 23, No. 1, p.3, Fig. 1, *https://www.ici.org/pdf/per23-01.pdf* (Jan. 2017).

workplace retirement plans prepare for retirement. {Ken Willis, "Small Business Views on Retirement Savings Plans," The Pew Charitable Trusts, p.3, Fig. 2, *http://www.pewtrusts.org/~/media/assets/2017/01/small-business-survey-retirement-savings_f.pdf* (2017)}

A Focus on Small Businesses

The Brookings Institute estimates that 55 million US workers do not have the option to save through payroll deduction in an employer-sponsored plan. {Mark Muro, "Failure to adjust: The case of auto-IRA," Brookings, *https://www.brookings.edu/blog/the-avenue/2017/05/08/failure-to-adjust-the-case-of-auto-ira/* (May 8, 2017)} In many cases, these individuals work for smaller businesses that do not offer retirement plans. Upwards of 43 million US workers, composing 36 percent of our workforce, are employed by small businesses. Educating small business owners about plan adoption and encouraging plan adoption is imperative to the success of the US retirement system. {US Bureau of Labor Statistics, Table F, Distribution of private sector employment by firm size class: 1993/Q1 through 2017/Q1, not seasonally adjusted, *https://www.bls.gov/web/cewbd/table_f.txt* (2017)}

Many small business owners participating in Pew Charitable Trusts focus groups in Philadelphia, Chicago, Dallas, and Los Angeles agreed that, when it comes to attracting and retaining employees, offering retirement plans was a top priority, although it came second after providing health insurance. Workplace plans help differentiate businesses, and have the potential to make them more competitive. Also, retirement plans "project an image of a stable and enduring company to their workers and other businesses." {John Scott, "Business Owners' Persepectives on Workplace Retirement Plans and State Proposals to Boost Savings," The Pew Charitable Trusts, *http://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2016/09/business-owners-perspectives-on-workplace-retirement-plans-and-state-proposals-to-boost-savings* (Sept. 7, 2016)}

However, many focus group participants were reluctant to introduce retirement plans, as some did not see how retirement plans would directly benefit their companies. These companies tended to hire younger individuals, part-time employees, and seasonal workers, all of whom were thought unlikely to participate in the plans. In addition, these participants often reported high rates of employee turnover. Focus group participants also cited the financial costs of plan sponsorship with plan administration challenges as obstacles to participation. In addition, many were reluctant to learn more about retirement plans, which they perceived to be complex and difficult to understand. Pew wrote:

> Most participants did not have a full understanding of how 401(k) plans work, and few were familiar with plans or incentives designed for small businesses, such as the Simplified Employee Pension Plan (SEP), the Savings Incentive Match Plan for Employees (SIMPLE), or the small employer tax credit for retirement plan startup costs. At the same time, several suggested that a tax credit would make them more likely to offer a plan.

{John Scott, "Business Owners' Persepectives on Workplace Retirement Plans and State Proposals to Boost Savings," The Pew Charitable Trusts, *http://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2016/09/business-owners-perspectives-on-workplace-retirement-plans-and-state-proposals-to-boost-savings* (Sept. 7, 2016)}

Is It As Simple—and As Challenging—As Educating Small Business Qwners?

In their book, *Nudge*, Richard Thaler and Cass Sunstein explained that human beings are susceptible to biases that may result in blunders. Poor decisionmaking can affect personal finance, health care, retirement preparations, and many other aspects of our lives. They also described how nudging—making small changes that can significantly alter individual behavior—can help produce more desirable outcomes.

Pew uncovered misconceptions that may cause small business owners to make poor decisions regarding workplace retirement plans. Business owners are unfamiliar with existing plan options that were created specifically to meet the needs of small businesses. One example, the SIMPLE IRA, a low-cost payroll deducted plan, overcomes almost every objection business owners expressed.

The SIMPLE IRA:

- Limits participation to employees who have earned at least $5,000 during any two preceding years, which should appeal to companies that have high turnover or hire young, part-time, and seasonal workers.
- Minimizes plan administration because of simplified reporting requirements and no required nondiscrimination testing.
- Offers tax incentives for business owners and participants.

To qualify, companies cannot offer other retirement plans and must have 100 or fewer employees. The plan structure allows each participant to elect how much to contribute to his or her IRA via payroll deduction and to elect investments according to his or her risk tolerance and desired asset mix.

Unlike a 401(k) or a state-sponsored plan, the employer must contribute to the SIMPLE IRA, either through dollar-for-dollar matching up to 3 percent of the employee's compensation or through a 2 percent nonelective contribution for all eligible employees. In return, the plan sponsor receives a tax deduction for the employer contributions made to employees' accounts, and also may claim a tax credit of up to $500 for each of the first three years to cover startup and employee education costs.

Participants receive the benefits of tax-deferred contributions, which may lower current income taxes; tax-deferred growth on any earnings, which may result in a more substantive retirement nest egg; and overall improved retirement security. Some participants, depending on income, also may be eligible to receive a saver's tax credit. The amount of the credit is equal to 50 percent, 20 percent or 10 percent of their retirement plan or IRA contributions up to $2,000 for a single filer and $4,000 for a joint filer. [IRS, Retirement Savings Contributions Credit (Saver's Credit), *https://www.irs.gov/retirement-plans/plan-participant-employee/retirement-savings-contributions-savers-credit* (2017)]

Understanding What It Means to Nudge for Good

During his Nobel interview, Richard Thaler said his favorite example of a successful nudge was "…the use of what we call automatic enrollment in [retirement] plans. Meaning the default is to join rather than not to join." [Adam Smith, "Richard H. Thaler—Interview," Nobelprize.org, *https://www.nobelprize.org/nobel_prizes/economic-sciences/laureates/2017/thaler-interview.html* (2017)]

Not everyone agrees with his point of view. The majority of business owners who participated in Pew focus groups were uncomfortable with automatic features and some believed the features were an unethical way to place and keep employees in retirement plans. One commented, "It's like you've been forced. You've been tricked. You know, you haven't been treated as an adult that's able to make their own decision." [John Scott, "Business Owners' Persepectives on Workplace Retirement Plans and State Proposals to Boost Savings," The Pew Charitable Trusts, *http://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2016/09/business-owners-perspectives-on-workplace-retirement-plans-and-state-proposals-to-boost-savings* (Sept. 7, 2016)]

Thaler makes no bones about the need to nudge for good. He has set forth principles that should guide nudging, such as:

- Nudging should be transparent,
- Nudging should never be misleading,
- Opting out of a nudge should be easy, preferably a single mouse-click away, and
- The behavior encouraged by nudging should improve the welfare of the nudged.

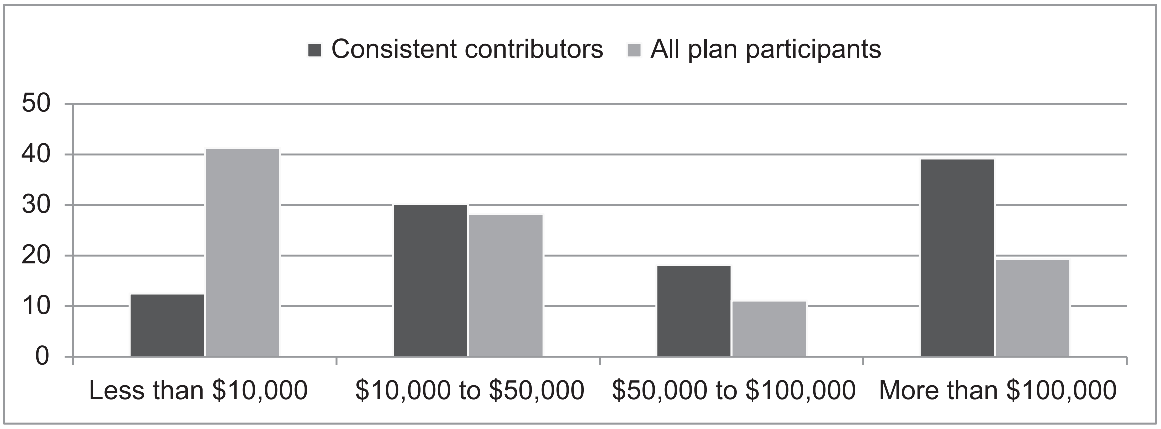
[Richard H. Thaler, "The Power of Nudges, for Good and Bad." *The New York Times*, *https://www.nytimes.com/2015/11/01/upshot/the-power-of-nudges-for-good-and-bad.html* (Oct. 31, 2015)]

Automatic enrollment (often in tandem with automatic deferral escalation) is responsible for many positive retirement savings outcomes and has improved the retirement readiness of many Americans. Today, many professionals in the retirement plan industry consider the adoption of automatic features to be a plan design best practice.

Yale Finance Professor James Choi thinks the most important effect of automatic enrollment is the increase in defined contribution plan savings for US workers who otherwise might not have participated in workplace plans. [James Choi, "Three Questions: Prof. James Choi on the Future of the 401(k)," Yale Insights, *http://insights.som.yale.edu/insights/three-questions-prof-james-choi-on-the-future-of-the-401k* (Nov. 1, 2017)] He quantified the results, saying automatic enrollment is the reason "the overall employee participation rate has risen from 68 percent in 2007 to 79 percent in 2016."

Recent research from the Employee Benefit Research Institute (EBRI), explored the importance of making consistent contributions to 401(k) plans over time. (See Exhibit 2.) The account balances of participants who consistently contributed to plan accounts from year-end 2010 through year-end 2015, nearly doubled. "Overall, the average account balance increased at a compound annual average growth rate of 13.9 percent … to $143,436 at year-end 2015." [Sarah Holden, Jack VanDerhei, Luis Alonso, Steven Bass, "What Does Consistent Participation in 401(k) Plans Generate? Changes in 401(k) Plan Account

Exhibit 2. Consistent Participation in 401(k) Plans Helps Participants Accumulate More Savings for Retirement (Account balances at year end 2015)



Source: Tabulations from EBRI/ICI Participant-Directed Retirement Plan Data Collection Project. The year-end 2015 EBRI/ICI 401(k) database represents 26.1 million 401(k) plan participants. The consistent sample is 7.3 million 401(k) plan participants with account balances at the end of each year from 2010 through 2015. Note: Retirement savings held in plans at previous employers or rolled over into IRAs are not included. Components may not add to 100 percent because of rounding. *https://www.ebri.org/pdf/EBRI_IB_439_Long-K.24Oct17.pdf*.

Balances, 2010-2015," Employee Benefit Research Institute, Issue Brief No. 439, *https://www.ebri.org/pdf/EBRI_IB_439_Long-K.24Oct17.pdf* (Oct. 24, 2017)} The return calculations included participant and employer contributions plus any return on investment less loans and distributions repayment of loans.

The nudge approach is taken further by Morningstar, which suggested that we take a page from the United Kingdom's playbook and "… legislate automatic IRA enrollment for companies with electronic payroll systems that lack a 401(k). Such a regulation would place millions of additional Americans into an employer-sponsored retirement plan, with minimal cost and effort required of the employer." {John Rekenthaler, Jake Spiegel, Aron Szapiro, "Small Employers, Big Responsibilities: How Policymakers Can Address the Small Retirement Plan Problem," Morningstar, *http://www.morningstar.com/content/dam/morningstar-corporate/pdfs/policy/SmallEmployersBigResponsibilities.pdf* (November 2017)}

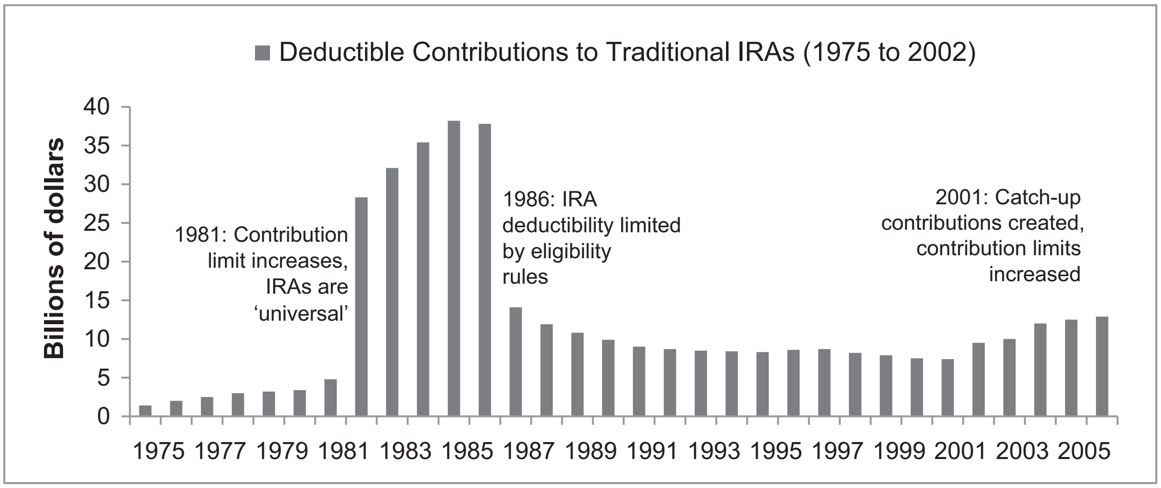
When small business owners are ready to give employees a nudge for good and embrace payroll-deducted IRA plans with automatic features, they will find that options with best practice features are already available from several private sector providers. In addition, many state governments have explored new payroll deduction plan options.

Needed: A Solution for Part-Time Workers and Workers in the Gig Economy

While SIMPLE IRAs may meet the needs of small business owners and sole proprietors, they may not be a solution for all. Part-time workers and workers in the expanding gig economy need suitable solutions as well. From 2005 through 2015, the number of people employed through alternative work arrangements (such as help agency workers, on-call workers, contract workers, and independent contractors or freelancers) increased by 56 percent. {Lawrence F. Katz, Alan B. Krueger, "The Rise and Nature of Alternative Work Arrangements in the United States, 1995-2015," *https://krueger.princeton.edu/sites/default/files/akrueger/files/katz_krueger_cws_-_march_29_20165.pdf* (Mar. 29, 2016)} Evidence suggests that although these individuals may be permitted to save in IRAs, they are not doing so in the numbers they once were. (See Exhibit 3.)

A 2005 report from the Investment Company Institute (ICI) suggests that IRAs fell prey to investor inertia in the late 1980s. Rules changed eligibility requirements and contribution limits in 1986, and as a result contributions declined precipitously. Prior to that time, IRAs were universal, and all workers younger than age 70½ were allowed to make tax-deductible contributions. {Sarah Holden, Kathy Ireland, Vicky Leonard-Chambers, Michael Bogdan, "The Individual Retirement Account at Age 30: A Retrospective," Investment Company Institute

Exhibit 3. IRA Contributions Over Time



Source: Sarah Holden, Daniel Schrass, "The Role of IRAs in US Household's Saving for Retirement, 2016," ICI Research Perspective, Vol. 23, No. 1, p.3, Fig. 1, *https://www.ici.org/pdf/per23-01.pdf* (January 2017).

Perspective, Vol. 11. No. 1. p.4. Fig. 3, *https://www.ici.org/pdf/per11-01.pdf* (February 2005)}

IRAs have the flexibility to meet the needs of this group, if individuals can be educated and incentivized to participate. It is possible that simplifying eligibility and increasing contribution levels would make saving in IRAs an attractive solution for this alternative work arrangement population left out of the traditional employer-sponsored plan system.

Crisis or Not, Retirement Readiness Is a City, State, and National Priority

The launch of OregonSaves, a pilot phase of Oregon's auto-IRA program, marked the beginning of a new era in US retirement savings. While the Oregon effort currently involves only a handful of employers, it is scheduled to take effect for all of the state's businesses in 2020. Illinois, California, Connecticut, and Maryland are following the trend and developing similar programs that will be implemented during the next few years. Washington and New Jersey are focusing on online marketplaces where small-business owners can shop for plans that suit their needs. It remains to be seen whether smaller businesses and their employees are better off with a state-run plan or one of the other options available in the private sector.

No matter how we get there, cultivating the retirement security of US workers has the potential to improve our country's economic well-being. Segal Consulting conducted an analysis earlier this year and found that if all full-time workers had access to retirement plans, states could save a collective $5 billion on future Medicaid costs—and that's just in the first decade. {Cathie Eitelberg, Wendy Carter, Rocky Joyner, "State-Run Retirement Savings Plans Are a Win-Win," Segal Consulting, *https://www.segalco.com/media/3139/medicaid-savings-infographic.pdf* (2017)} As more US workers become better prepared for life after work, our country may realize other economic benefits, as well. ■