

TOWARDS A SENSIBLE SYSTEM FOR SAVING

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Executive Summary

Today millions of Americans contribute to 401(k) and other savings plans that enable them to save on a tax-preferred basis. The history of savings plans is short but Congress has created more plans in the last ten years than in any prior period. There are now eight plans for retirement saving: 401(k)s, SIMPLE 401(k)s, 403(b)s, 457(b)s, the Thrift Savings Plan, SIMPLE IRAs, traditional IRAs, and Roth IRAs. Congress recently added savings plans for education, 529 plans and Coverdell IRAs, and its latest initiative is a savings plan for healthcare, health savings accounts or HSAs.

Savings plans fall into two broad categories. “Intermediary” plans include 401(k)s, 403(b)s, 457(b)s, the Thrift Savings Plan, SIMPLE 401(k)s, SIMPLE IRAs, 529 plans, and work-based HSAs. Usually only available through employers (or states, in the case of 529 plans), these plans provide important support services such as payroll deduction and/or pre-selected investment menus; permit the highest level of contributions; offer additional legal protections to investments; and often restrict the timing and amount of withdrawals. “Open access” plans include traditional IRAs, Roth IRAs, Coverdell IRAs, and individual HSAs. Widely available through the financial services industry, they provide little or no savings support services; permit lower levels of contributions; offer no additional legal protections to investments; and allow withdrawals at any time, subject to tax penalties.

Although Congress has recently focused on creating new open access plans, the plans most successful in attracting savings are intermediary plans. By the end of 2004, savings plans held over \$6 trillion in assets. This statistic reflects contributions by individual savers and, in some cases, employer contributions as well as investment earnings. Intermediary

plans (401(k)s, 403(b)s, 457(b)s, the Thrift Savings Plan, SIMPLE IRAs, and 529 plans) held about \$3 trillion in assets, primarily in retirement savings plans. While open access plans held about \$3.2 trillion, the bulk of those assets originated in rollovers from intermediary retirement plans.

In 2004, some 20% of Americans had a 401(k) account, while 33% of households had at least one traditional IRA and an additional 13% had at least one Roth IRA. In addition, there were over 5 million 529 plan accounts for children. The profile of savings plan contributors is remarkably consistent across all plans: most are employed, earning in the top-half of the income distribution, middle-aged, married, and educated. Account sizes vary widely with an average size in a 529 plan of \$9,700, about \$57,000 in a 401(k) plan, and \$45,000 in the Thrift Savings Plan. Median account sizes in 401(k) plans were about \$20,000, traditional IRAs held \$24,000, and Roth IRAs held less than \$9,000.

By some measures, savings plans are a success. They now dominate the private pension system, are highly valued by employees, and have introduced millions to equity investing. Yet, savings plans also exhibit notable flaws and weaknesses:

- Work-based intermediary plans induce saving but many Americans have no savings plan at work.
- Low-income workers are often excluded from work-based plans.
- Most saving occurs in work-based intermediary plans. Few workers use open access plans as a substitute.
- The best predictor of participation in a savings plan is income.

- Savings rates vary widely but average savings rates are low among both lower and higher income savers.
- Increasing contribution limits does not induce more saving.
- Account accumulations are low. Whether current plan designs can induce adequate saving is debatable.
- Matching contributions are a puzzle. Thought to induce more saving, they often don't.
- Complex investment menus deter participation and result in investment paralysis.
- The economics of plan investment and administration are poorly understood by both savers and employers.

To make these plans a universal success, we must build a more sensible system for saving. Step one in that process means striving for simplification. The current system has too many over-lapping plans with overly complex and idiosyncratic rules. Because existing plans permit general purpose saving, there is little need for new plans unless they represent a net improvement by reaching out to new savers or fill an unmet need. A more sensible system for saving would enable savers to find and fund a savings plan easily. It is important, however, to take a cautious approach to consolidating today's plans. Thirty years of experience has demonstrated the ability of intermediary plans to induce saving. A more sensible system for saving would not, as Congress seems inclined to do, spin-off more and more open access plans for special purpose saving.

Instead, it would make the successful features of intermediary plans available to more savers.

Step two means building better plans. A more sensible system for saving would move beyond the “build it and they will come” philosophy underlying today's plans. The next generation of savings plans requires a better science of plan design and greater understanding of the psychology of saving and savers. In addition, today's savings plans have been constructed around their tax incentives, but those only reward higher-income Americans. Expanding saving requires financial incentives independent of tax benefits that work for all savers, especially those with low and moderate incomes. A more sensible system for saving would be based on incentives for those savers who need them, not those who don't.

Step three means recognizing that what really matters the most for saving in the long run are outcomes. Traditionally, savings plan design has focused almost entirely on the first stage of saving—contributions and their tax incentives. But contributions alone do not make savings plans effective. A more sensible system for saving would set specific savings objectives and design plans capable of achieving them. This requires focusing more on the second stage of saving—investments—and emphasizing their critical importance to adequate saving. Outcome-structured plans could also help reduce the difficult choices and uncertainties confronting today's savers. An outcome-centered system for saving is likely to be not only a more sensible system for saving but a more successful one, too.

Introduction and Background

Introduction

Benjamin Franklin was the first promoter of American saving through his maxim, “a penny saved is a penny earned.” If Ben were alive today, he would be surprised, and no doubt amused, by the American system for saving in the twenty-first century. Not too many years ago, saving meant walking down to the corner bank, opening up an account, and earning interest at a rate set by law. But no longer.

Today, American savers are confronted with a dazzling array of savings choices. They can save through their employer, the government, or a financial service institution. They can choose to save for general purposes or through one or more special purpose plans. They can also choose to invest their savings in a wide variety of products from certificates of deposit, to individual stocks and bonds, to mutual funds, to variable annuities, to exotic derivatives.

Yet even as the savings marketplace has flourished, the American appetite for saving has not. According to standard measures, the rate of real personal saving in the U.S. has been falling since the early 1980s and actually became negative in 2005, which is the first time it dipped below zero since the Depression (Munnell et al. 2005; U.S. Department of Commerce 2006).¹

In response, Congress has become an active promoter of saving. It is continually retooling the federal income tax system to create financial incentives and special savings plans to encourage more people to save and to save more. In 2005, the federal government will have foregone some \$725 billion in current revenue due to such preferential tax

benefits; incentives for saving account for a very large proportion of that amount (EBRI 2004; Joint Committee on Taxation 2005).²

This brief examines the American system for saving by focusing on one incentive for saving now highly favored by Congress: the special “plans” for saving now found throughout the tax code. It first charts their development since the 1920s and expansion in the past ten years. It then describes current plans and the savers who use them. It next describes the lessons learned in the past twenty years about savers and saving. Finally, it discusses some proposals to improve the current system as well as an agenda for building the next generation of savings plans.

Background

Definition of a Savings Plan

Congress uses the federal tax code to offer special credits, deductions, grants, and programs to encourage behavior it views as desirable. Because saving is now viewed as particularly worthwhile behavior, Congress has created many incentives to promote it. Most people are familiar with one very prominent incentive: special “plans” for saving such as individual retirement accounts (IRAs) and the popular 401(k) plan.

Not all tax incentives for saving are savings plans. For example, taxpayers can save for education through EE savings bonds that are exempt from state and local tax as well as from federal tax when used for college expenses. Annuities purchased from an insurance company also offer tax-deferred benefits for retirement saving.

1. Personal saving for this purpose means personal outlays (i.e., spending) that exceed disposable personal income.

2. Estimates differ but it appears that 401(k)-type plans will cost the government about \$59 billion, IRAs \$20 billion, state education plans (including 529 savings plans) \$320 million, Coverdell IRAs \$100 million, and HSAs \$400 million in revenue in 2005 (EBRI 2004; Joint Committee on Taxation 2005).

Savings bonds, annuities and similar products have tax advantages that make them attractive for an individual investment plan. But they are not true savings plans.

Table 1. Savings Plan Basics

- Individuals decide how much to contribute each year up to any limit set by law.
- Special tax incentives and subsidies apply to contributions, investment, and withdrawals.
- Contributions are held in individual trust or custodial accounts at an authorized financial services company or employer-based plan.
- Savers choose investments from retail options such as mutual funds, insurance products, and bonds.
- Withdrawals may be limited by time or purpose.

A savings plan is instead a set of legal rules that sit like an umbrella over an account holding multiple investments. The purpose of the rules is to qualify the account, and its investments, for special tax benefits. These benefits can apply to contributions made to the account, investments held in it, and distributions made from it. A savings plan can consist of a single account for a single saver or individual accounts for many savers. Savings plans have the basic characteristics described in Table 1. In a savings plan, individuals decide how much they will save each year and how their savings will be invested among multiple investments. Each saver has a separate account containing contributions and investments (and earnings). Plan rules

determine when and for what purpose savers may take withdrawals from their accounts.

Special Tax Treatments for Saving

The engine driving saving in these plans is their special tax rules. Table 2 describes four basic types of tax treatments.³ The traditional rule of taxation is that income is taxed either when earned or at a future time when earnings in the interim are also taxed. In the basic case of saving without a plan, savers invest with dollars remaining after all taxes have been paid. Each year, interest earned and dividends received are taxed. In addition, when an investment is sold, its appreciation (increase in value) is also taxed, although at tax rates lower than those applied to wage income.

Currently, savings plans are designed to qualify for one of the following exceptions to general tax rules:

Pre-tax treatment • These rules apply to the popular 401(k)-type plans offered through employers as well as traditional IRAs. Savers pay no tax on contributions or earnings until they make withdrawals from the plan. But they pay tax at ordinary income tax rates on the full amount of the withdrawal. These plans work best for savers who will be in a lower income tax bracket when retired than when working. As compared to saving without a plan, savings benefit from tax deferral on investment earnings (i.e., no annual tax while investments remain in the plan), and savers typically pay less tax than they otherwise would.⁴

Roth treatment • In the late 1990s, Congress created a new type of tax treatment for IRAs named after former Senator William Roth of

3. This section considers only federal income tax rules. Depending on the type of plan, Social Security, estate, state, or other taxes may or may not apply. These taxes are not discussed in this brief.

4. For many years, savings plans only offered after-tax treatment. This treatment is very similar to saving without a plan but savings do get the benefit of tax deferral. This means earnings accumulate tax-free while held in the plan. Withdrawals are taxed only on their increase in value in the plan. But this increase is taxed at ordinary income tax rates rather than the preferential capital gains rates applied to saving outside a plan. Today, savers typically make after-tax contributions to a plan only after contributing the maximum pre-tax amount in order to get the benefit of tax deferral on these extra savings.

Table 2. Tax Rules for Saving

	Non-Plan Treatment	Pre-Tax Treatment	Roth Treatment	No-Tax Treatment
Initial dollars	After-tax dollars	Pre-tax dollars	After-tax dollars	Pre-tax dollars
Dividends (if a stock)	Taxed annually at special low rates through 2010	No annual tax		
Interest (if a bond)	Taxed annually as ordinary income			
When sold or withdrawn	Capital appreciation (sale price - purchase price) taxed at special low rates through 2010	Amount withdrawn fully taxed as ordinary income	No tax if for qualified purposes	No tax if for qualified purposes

Delaware. Savers with a Roth IRA pay tax upfront. They contribute after tax dollars and are never taxed again, if withdrawals satisfy plan rules. The rationale for Roth treatment is that it is economically identical to pre-tax treatment, provided tax rates don't change between the time of contribution and withdrawal. These rules work best for savers who will be in a higher income tax bracket when retired than when working. They also provide a hedge against increases in income tax rates in the future. Roth treatment is available through

an IRA as well as those employer-based plans offering Roth contributions, beginning in 2006.

No-tax treatment • Pre-tax and Roth treatments are variations of the traditional tax rule. Congress, however, has recently made a far more generous tax system available to savings plans. In this system called no-tax treatment, savers contribute pre-tax dollars, and earnings are not taxed while held in the plan. If a withdrawal is taken for permitted purposes under the plan, it is made from income that is never taxed.

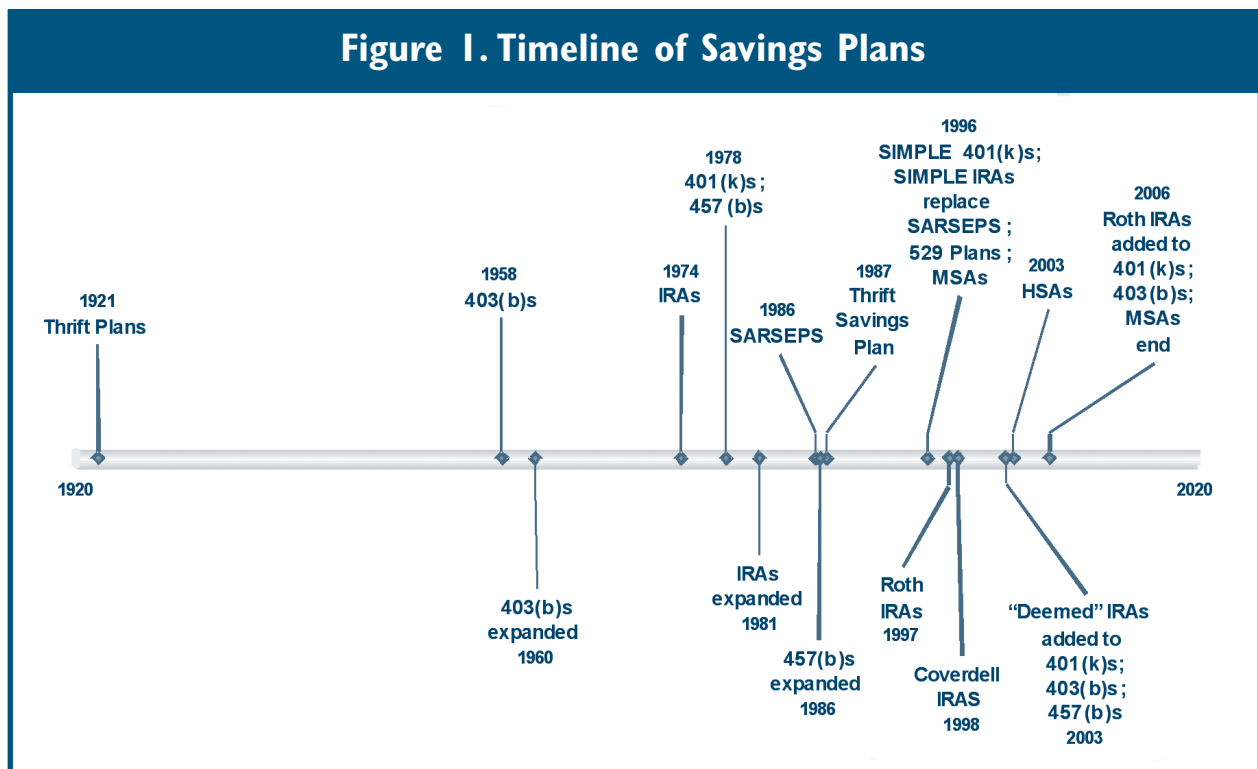
The American System of Savings Plans

The Evolution of Savings Plans

Savings plans are common today but this is a relatively new phenomenon. For most of the twentieth century, employer-funded defined benefit plans provided retirement income for most workers. Savings plans were secondary, offered by employers as supplemental work-based plans or available to workers without an employer plan. Today, employee savings plans outnumber defined benefit plans by a wide margin in the private pension system. Beyond the retirement arena, Congress is creating new types of savings plans at a rapid rate. The U.S.

system of saving now includes separate systems for retirement, education, and healthcare savings plans, and more plans for more purposes are proposed every year.

As an aid in understanding the current system, Figure 1 traces the evolution of savings plans since the early 1920s. Figure 1 depicts only savings plans, not the many other plans found in the private pension system such as defined benefit plans or defined contribution plans with just employer contributions. In addition, Figure 1 illustrates only the most significant events in the history of savings plans.⁵



5. The rules that govern savings plans change often but, because this brief is intended to describe how the savings system of 2006 came to be, Figure 1 does not chart the major changes to savings plan rules historically.

The first savings plans: work-based retirement plans • In the beginning, there was just one savings plan and it was in the private pension system. In the 1920s, Congress began to grant special tax benefits to retirement plans offered by corporate employers.⁶ Among them was the original savings plan: the “thrift” plan that enabled workers to save after-tax dollars. The thrift plan is a “qualified” plan.⁷ Employers typically offered thrift plans as plans that supplemented the defined benefit plans then dominating the private pension system.

In the late 1970s, the profile of savings plans began to increase after Congress ratified the 401(k) plan, which offered pre-tax treatment for savings. Almost 30 years later, 401(k) plans have become the dominant form of defined contribution plans (Copeland 2005a, b) in the corporate world. Today, only about 10% of private-sector workers have a defined benefit plan (Buessing and DeSoto 2006) as compared to about 90% of state and local government workers that represent just a small fraction, roughly 12%, of the U.S. workforce (Anderson and Brainard, 2004; Nationwide 2006: 14). By design, 401(k) plans contain complex rules to encourage participation by lower-paid workers. In the belief, however, that those rules discouraged small employers from offering plans, Congress introduced the SIMPLE 401(k) some 20 years later. The SIMPLE 401(k) offers reduced regulation in exchange for minimum employer contributions and broad employee coverage.

About 30 years after corporate workers had thrift plans, Congress recognized similar tax treatment for a plan known as a “403(b)” or “TSA” (tax-sheltered annuity) found in non-profit organizations.⁸

The first 403(b)s were available only to workers in tax-exempt organizations, but Congress expanded them in 1961 to include public school workers. In 1978, Congress established a similar pre-tax plan, called “deferred compensation” plans or “457(b)s,” for state and local governmental workers.⁹ These plans initially set savings limits only for government workers but were extended to non-profit workers in 1986. Also in 1986, Congress created a special 401(k)-type plan for federal workers known as the “Thrift Savings Plan” or “TSP.”¹⁰

Individual retirement savings plans • To save through a 401(k), 403(b) or 457(b) plan, workers must work for an employer that offers one. But not all employers, particularly small business employers, wish to take on this responsibility. In 1974, Congress introduced a new pre-tax savings plan, known as an “individual retirement account” or “IRA.”¹¹ Originally, only workers without an employer plan could have an IRA, but in 1981 they were opened to all workers. These traditional IRAs reserve pre-tax treatment for lower- and middle-income contributors and those without an employer plan. Others may still contribute on an after-tax basis. In 1997, Congress created a new type of IRA called the Roth IRA.¹² Contributions to either type of IRAs are subject to a single, combined limit each year. In 2006 that limit is \$4,000; contributions to traditional IRAs are made from pre-tax dollars and to Roth IRAs from after-tax dollars.

The convergence of individual and work-based retirement plans • In some respects, IRAs have long been the stepsisters of the U.S. retirement system. Savers can always save more through

6. Different tax rules apply to different types of employers—corporate, nonprofit, and government employers—so Congress has typically created separate families of savings plans in an attempt to match plan rules with employer tax rules.

7. Qualified plans are a family of plans primarily intended for corporate employers whose rules are found in IRC § 401(a) and related statutes.

8. Although similar to a qualified plan such as a 401(k) plan, it has its own special rules found in IRC § 403(b).

9. These plans are similar to 401(k)s and 403(b)s in operation but are governed by IRC § 457(b).

10. The governing statute for the TSP can be found at Title 5, Part III, Subpart G, Chapter 84 of the United States Code.

11. The rules for IRAs are found in IRC § 408.

12. The rules for Roth IRAs are found in IRC § 408A.

an employer-based plan. In other respects, IRAs have had enormous influence. Their simple design presents an attractive alternative to the highly regulated work-based plan.

In 1986, Congress used the IRA model to create a new family of work-based retirement savings plans.¹³ These plans, originally known as SARSEPs, were replaced by SIMPLE IRAs in 1996 and are intended to encourage small business employers to offer plans. In exchange for less regulation and a smaller compliance burden, these plans require employers to make contributions. SIMPLE IRAs are very similar to the qualified SIMPLE 401(k) plan.

The invention of IRA-based plans was also an important first step toward merging individually based and work-based retirement savings plans. Some seven years later, Congress again expanded the use of IRAs. This time, rather than creating new plans, it simply inserted IRAs directly into work-based plans. In 2003, employers could opt to include “deemed IRAs” in their 401(k), 403(b), and 457(b) plans, and in 2006, employers may also offer Roth IRAs in their 401(k) and 403(b) plans but not their 457(b) plans. This will enable savers to make IRA contributions without having to maintain a separate savings vehicle.

Saving for education • In the 1990s, Congress turned its attention to saving for education. Although the tax code included many special tax breaks for education at that time, it had no formal

savings plan for education.¹⁴ Many states, however, had created education savings plans for their residents in the 1980s. These plans had generous treatment under state tax law but their federal tax status was unclear (Ma 2005). In 1996, Congress recognized state-sponsored (and now eligible education institution-sponsored) savings plans for higher education now known as “529” plans.¹⁵ In 2002, Congress expanded their tax benefits by exempting withdrawals used to pay higher education expenses from all federal tax.

In 1998, Congress created its own education saving program based on the IRA model, called “Coverdell” IRAs.¹⁶ Unlike 529 plans, Coverdell IRAs can pay for primary and secondary education as well as higher education expenses. Coverdell IRAs are only available to lower-and middle-income savers and contributions are limited to \$2,000 per child per year.

Saving for healthcare • In 2003, Congress turned its attention to saving for healthcare and created “Healthcare Savings Accounts” or “HSAs.”¹⁷ Although HSAs are savings plans, saving is not their primary purpose. HSAs are really about spending.¹⁸ They represent an alternative approach to traditional health insurance intended to change how Americans spend their healthcare dollars.

HSAs are the successor to “MSAs” or “Archer Medical Savings Accounts” which Congress created in 1997 as a pilot program.¹⁹ In Congress’s view,

13. The rules for SARSEPs and SIMPLE IRAs are found in IRC § 408(k).

14. These include an exclusion from income for scholarships, fellowships, grants and tuition reductions for degree candidates under IRC § 117, funding received from employers’ educational assistance programs under IRC § 125, and interest earned on education savings bonds (Series EE or I bonds) under IRC § 135. In addition, students may often deduct their education expenses to improve their skills under IRC § 162, their student loan expenses under IRC § 221, and tuition and fees under IRC § 222. Finally there are also tax credits for education expenses such as the Hope Credit under IRC § 25A(b) for the first two years of post-secondary education and the Lifetime Learning Credit under IRC § 25A(c). These special tax benefits each have complicated rules that are not reviewed in this paper.

15. IRC § 529 contains the rules for 529 plans.

16. The rules for Coverdell IRAs are found in IRC § 530.

17. HSAs were created as part of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 and their rules can be found in IRC § 223.

18. Before HSAs, savings for healthcare was limited to flexible spending accounts (“FSAs”), which enable workers to contribute pre-tax dollars to an account in their employer’s health plan to pay for out-of-pocket expenses. FSAs are not vehicles for long-term accumulations because they have a “use it or lose it” rule where workers forfeit unused funds each year.

19. The rules for MSAs can be found in IRC § 220.

such accounts were needed because

Americans ... have few incentives to lower their health costs or benefit from staying well ... One approach to providing incentives for Americans to be more cost conscious purchasers of medical services is to make available ... medical savings accounts ... Because MSAs afford people the opportunity to save unspent MSA funds for future health and long-term care needs, the Congress believed that people will be more prudent in their purchase of health care services.²⁰

As a pilot program, MSAs were made available only to those believed to be underserved by conventional health plans, that is, small business employers (generally, no more than 50 employees) and self-employed individuals. In addition, Congress limited participation to 750,000 individuals. But a market for MSAs never really developed; by 2003, only about 10% of the number of accounts authorized had been opened.

Nevertheless, Congress expanded the MSA concept through HSAs, which first became available in 2004.²¹ MSAs and HSAs couple a savings account for out-of-pocket expenses with a high-deductible insurance policy. To entice participation, Congress gave MSAs and HSAs an extremely generous tax treatment previously reserved for work-based healthcare plans. Contributions are made from pre-tax dollars, while distributions are free of tax if made for qualified medical expenses. Unlike MSAs, HSAs are available to almost all individuals and

through health plans sponsored by any employer who chooses to offer them.

Observation • It is easy to see that the American system of savings plans has many not-so-sensible features. First, there are already too many plans but more may be coming. Congress has created more new plans in the past ten years than in any prior period and the system threatens to expand further. Bills introduced into the current session of Congress would add savings plans for Social Security, for homeownership accounts, for children's accounts, for new medical savings accounts, and for individual development accounts, among other worthy purposes.²² Second, there are too many duplicate plans. For example, there are multiple plans for retirement saving, depending on the type and size of employer, as well as two plans for education saving. Third, the primary savings plans historically have been work-based. In the 1990s, however, Congress began to favor new, individually based plans. Whether that is a sensible step remains to be seen.

Today's Savings Plans

In 2006, as illustrated in Figure 2, there are eleven savings plans available through the tax code:

- **Saving for retirement at work: 401(k)s, SIMPLE 401(k)s, 403(b)s, 457(b)s, the Thrift Savings Plan, and SIMPLE IRAs.**²³
- **Other retirement saving: traditional IRAs and Roth IRAs.**

20. Staff of Joint Comm. on Tax'n, 104th Cong., 2d Sess., General Explanation of Tax Legislation Enacted in the 104th Congress at 321–322 (Comm. Print 1996).

21. HSAs are intended to replace MSAs; no new MSAs may be created after 2005.

22. Examples include: the “Social Security Personal Savings Guarantee and Prosperity Act of 2005” (S. 857 and H.R. 1776); the “Saving Social Security Act of 2005” (S. 540) and the “Growing Real Ownership for Workers Act of 2005” (H.R. 3304) to create private savings accounts in Social Security; the “ASPIRE Act” (S. 868 and H.R. 1767) to establish a new federal savings account program for children including federal matching contributions for low-income children; the “Savings for Working Families Act of 2005” (S. 922) to establish individual development accounts for low-income individuals to save for education, homeownership, and business investment; the “Individual Investment Act of 2005” (H.R. 339) to provide for deductible individual investment accounts and tax-free distributions for first time homebuyers; and, the “Medicaid Health Opportunity Act of 2005” (S. 1833 and H.R. 1357) to create state demonstration projects providing health opportunity accounts.

23. There actually are two versions of 403(b) and 457(b) plans, depending on whether the particular plan covers tax-exempt or government workers. For simplification purposes, this report will describe the form of 403(b) plan that applies to tax-exempt workers and the form of 457(b) plan that applies to government workers. Some rules for the Thrift Savings Plan are different for employees hired before 1984. This report describes the rules for those hired in or after 1984. This report also focuses only on state-run 529 plans, not those established by eligible educational institutions, and those that feature individual savings accounts, not pre-paid tuition programs.

**Figure 2.
U.S. Savings Plans
Circa 2006**

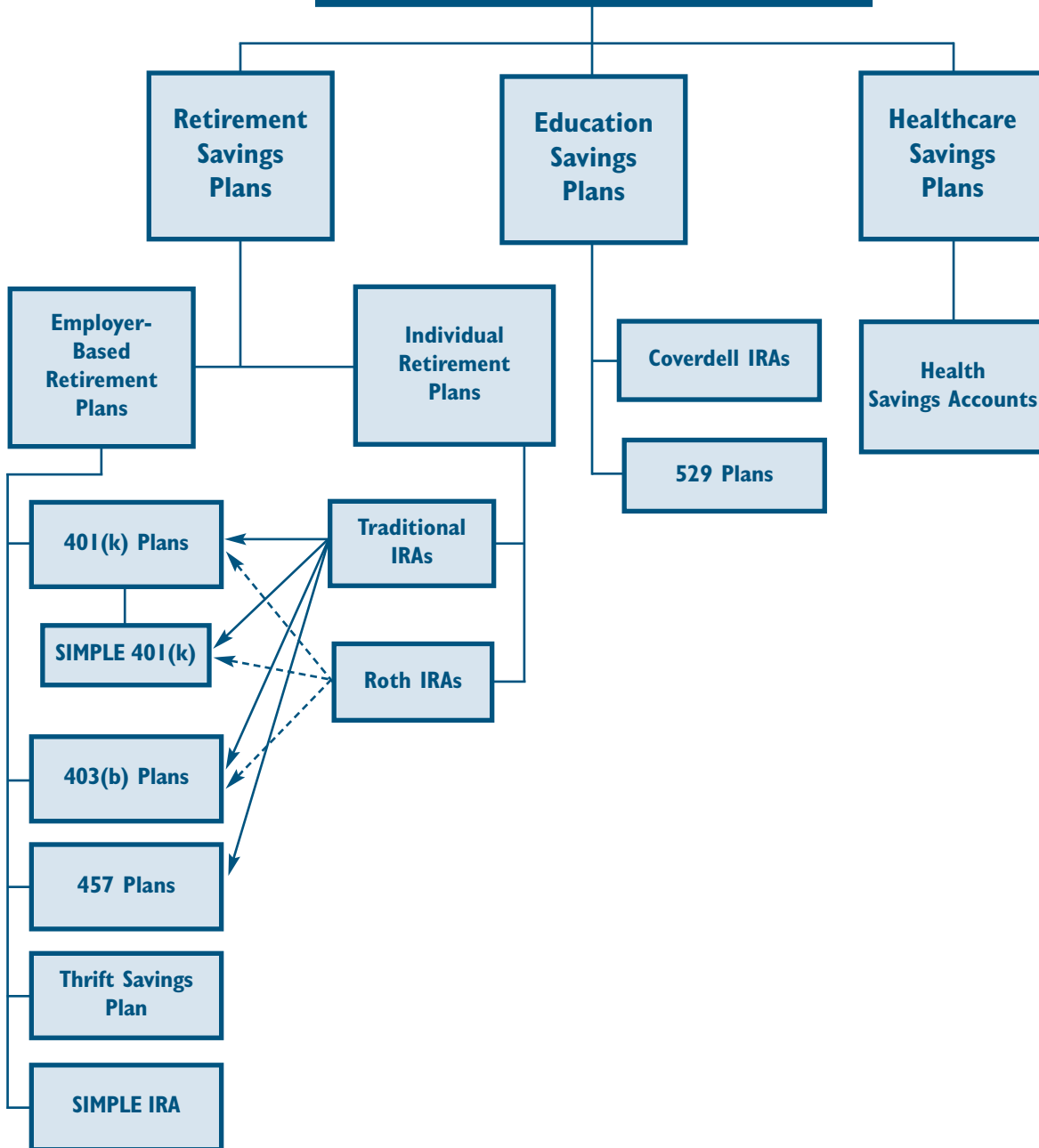


Table 3. Basic Features of Today's Savings Plans

	Plan Eligibility	Plan Access	Saving Decisions	Savings Vesting	Investment Decisions	Investor Protection	Complex Rules
401(k)	Only workers; employer chooses; subject to discrimination rules	Only available through employers; employers not required to offer a plan	Must sign up; decide/change amount of contributions; payroll deductions	Worker savings fully-vested; over time vesting for employer	Employer chooses menu; employees choose account investments and allocations	Employers may be responsible for a poor investments menu	Most complex rules for both employers and employees
SIMPLE 401(k)	All Workers			Fully-vested			
403(b)			Same as 401(k) but often must choose among employer-authorized providers	Same as 401(k)	Employers choose providers; employees choose among providers, investments and allocations	None	Much less than 401(k)
457(b)	Workers; service providers; employer chooses						
Thrift Savings Plan	All Workers		Automatically in plan but must sign up to contribute, otherwise same as 401(k)	3-year vesting for 1% agency contributions; employee and matching fully-vested	Same as 401(k)	Only through federal oversight of investments	
SIMPLE IRA							
Traditional IRA	Anyone under age 70 ½, some income limits	Sold by financial service companies or available in an employer's plan	Must choose provider, decide if eligible to contribute, decide how much to contribute, contributions usually made annually	Fully-vested	Account owners choose among provider options	None	Rules far less complex than in any employer plan but tax rules are tricky
Roth IRA	Income limits						
529 Plans	Any child, some state limit contributions to residents	Sold by state-approved financial service companies			States select investments providers; contributions or parents choose investments	Possibly through state oversight of investments	
Coverdell IRA	Child under age 18, income limits on contributions	Sold by financial service companies			Contributors, parents choose investments	None	
HSA	Anyone with a high deductible health plan, not on Medicare or a dependent	Sold by financial service companies or available from an employer	Must find a high deductible health plan, decide when and how much to contribute		Same as IRA		

Table 4. Financial Features of Savings Plans in 2006

	Tax Benefits	Annual Limits	Income Limits	Leveraged Contributions	Loans	Withdrawals	Hardship Categories		
401(k)	Pre-tax	\$15,000; Catch-ups	Can be, if low-paid workers save too little	Optional by employer; Saver's Credit	Lesser of \$50,000 or 50% of the account	At age 59 ½ or as a hardship; extra 10% tax before age 59 ½	Medical expenses home purchase, prevent foreclosure, casualty loss, education		
SIMPLE 401(k)		\$10,000; Catch-ups	No	Required; Saver's Credit					
403(b)		\$15,000; Catch-ups		Optional but not common; Saver's Credit	Same as 401(k) but worker savings only	After age 70 ½ or as a hardship	Medical expenses, prevent foreclosure, casualty loss		
457(b)				Required; Saver's Credit					
Thrift Savings Plan				Required; Saver's Credit	Same as 401(k)	Once after age 59 ½; hardship; extra 10% tax before 59 ½	Medical expenses, cash crunch, personal casualty loss, divorce		
SIMPLE IRA				\$10,000; Catch-ups	Required; Saver's Credit	No	Any time; extra 25% tax in 1st 2 years; extra 10% tax before 59 ½	Not relevant	
Traditional IRA	Pre-tax or after-tax	\$4,000 Combined; Catch-Ups		If not the only plan, deduction limits begin at \$45,000/\$75,000 Contribution limits begin at \$95,000/\$150,000	None except Saver's Credit				
Roth IRA	Roth	After age 59 ½ and 5-year waiting period							
529 Plans	Roth	Varies by State	No	Minority of states have matches/other enhancements	No				Anytime but extra tax if not for qualified purposes
Coverdell IRA	Roth	\$2,000 (until child is 18), per account/per contributor	Contribution limits begin at \$95,000/\$190,000	No					
HSA	No-tax	\$2,700/\$5,450; Catch-ups	No	Optional by employer; Saver's Credit		Anytime but tax + penalty before 65 and tax after 65 if not for qualified purposes			

- Saving for education: 529 plans and Coverdell IRAs.
- Saving for healthcare: HSAs.

Savers are not restricted to just one savings plan. Savers with a work-based plan may have a separate traditional IRA, but not always on a pre-tax basis, or a Roth IRA, if they meet income limits. If an employer chooses, as Figure 2 illustrates, savers may also contribute to a traditional or Roth IRA through their work-based plan. Savers may make such contributions to their 401(k), 403(b), or 457(b) plan, but Roth IRA contributions may only be made to 401(k) and 403(b) plans. Savers might also have an HSA at work or, if without work-based health coverage, could buy one individually. They can also contribute to a 529 plan and/or Coverdell IRA for their children and grandchildren.

Savers can often save for multiple purposes in a single plan. Work-based plans for retirement usually permit withdrawals for education, homeownership and healthcare expenses. IRA and Roth permit withdrawals for any purpose at any time, although additional tax penalties may apply. Other plans such as 529 plans, Coverdell IRAs, and HSAs appear to be single purpose savings vehicles but they are not. Like IRAs, savers can take withdrawals for any purpose at any time, if they don't mind losing the special tax benefits available through these plans.

From a design perspective, savings plans seem very simple—one saver, one account. Although savings plans have three stages—contribution, investment, and distribution—none is inherently complicated. But, as Tables 3 and 4 illustrate, today's savings plans have very complex rules. Tax law is primarily responsible for this complexity. Plan rules are intended to protect the integrity of special tax benefits, so they include detailed rules regulating the flow of money through the plan and imposing penalties for rule violations. A second contributor is the “build it and they will come” philosophy underlying the American system of savings plans. In real-

ity, the psychology of saving and savers is poorly understood. It is not clear which tax incentives work and which don't, and which plan features induce saving and which impede it. Plans are created based on the best beliefs of the time but uninformed by any science of plan design. Individual plans differ widely on their rules. Plans for the same purpose can look very dissimilar while plans for dissimilar purposes can look very much alike.

It is easy to get lost in all the different rules in today's savings plan system. By focusing on plan similarities instead, it is possible to see that there are two basic plan designs. The first, “open access” plans, consists of plans generally available to all savers. The second, “intermediary” plans, consists of plans in which one party, usually an employer, acts as a gatekeeper by controlling access or facilitating services. Although all plans have many similar features, they characteristically diverge on the five important dimensions described later in Table 5 (see page 16): ease of access; savings support services; level of contributions; investments and protection for investors; and control over withdrawals.

Plan access • As a general rule, individually based plans such as traditional, Roth, and Coverdell IRAs and HSAs (when not part of a work-based plan) are open access plans. They are available to all savers. Some open access plans such as Roth and Coverdell IRAs have, as Table 4 illustrates, income limits but those limits are high. In addition, in order to participate in an HSA, a saver must have purchased a high-deductible insurance plan.

Intermediary plans are primarily work-based plans, although 529 plans are a new and interesting variation on this theme. Employers control access to work-based plans, first by deciding whether or not to offer a plan, and second by choosing which workers may participate. Employers need not include all workers, as long as

their plans satisfy rules against favoritism towards highly paid workers. These rules are most stringent for 401(k) plans, while 403(b) plans are less heavily regulated and 457(b) plans are not regulated at all. Employers who choose a SIMPLE plan, however, are required to cover almost all workers in their plans. Similar, even simpler, rules apply to HSAs included in a work-based health plan. Although not a work-based plan, state-designed 529 plans exhibit many characteristics of intermediary plans, including eligibility requirements set by state law.

Savings support services • Intermediary plans provide many important savings support services. As Table 3 illustrates, employers facilitate saving by educating workers about saving and encouraging plan participation. Intermediary plans also make saving easy by providing plan information materials, payroll deduction contributions, a menu of investment choices, and web-based or telephone services for plan and investment actions. Employers also simplify the savings decision for workers by offering just one 401(k) or SIMPLE plan. This is often not true for 403(b) and 457(b) plans, where employers typically offer workers several choices of plan providers. Other employer services such as payroll deduction are available, however, and 403(b) and 457(b) providers offer services comparable to those found in a 401(k) plan. Although 529 plans do not provide payroll deduction services, they generally simplify the savings process by offering just one plan and limited investment options.

In open access plans, savers are generally on their own. Although financial service companies market these plans widely, savers must take the initiative to find a plan. After choosing from among the many available, they then must decide on contributions and investments. Plan providers do offer financial education and investment advice as well as assistance in calculating contributions and other tax-related services. While open access plans cannot duplicate the convenience of work-based sav-

ings support services, their administrative costs are often lower, making them an attractive option for self-employed workers.

Plan contributions • As Table 4 illustrates, there are significant differences in the level of savings available through open access and intermediary plans. The rationale for this distinction is unclear but Congress has historically viewed the work-based plan system as primary. As a result, Congress provides more generous contribution levels to maintain the attractiveness of the work-based system for employers and workers as follows:

- The most generous plans are intermediary plans: 401(k), 403(b), 457(b) plans, and the Thrift Savings Plan.²⁴ In 2006, savers can contribute up to \$15,000. A saver with both a 401(k) and a 403(b) is limited to \$15,000 in total, but a saver with both a 403(b) and a 457(b) can contribute \$15,000 to each. Special “catch-up” contributions permit savers over 50 to contribute an additional \$5,000 in 2006.
- Moderately generous plans are also intermediary plans: SIMPLE plans permit \$10,000 in contributions in 2006, while catch-up contributions are limited to \$2,500.
- The least generous plans are open access plans: combined contributions to a Roth or a traditional IRA are limited to \$4,000 (increased to \$5,000 in 2008) with catch-up contributions limited to \$1,000. Savers with a work-based plan may also contribute to an IRA on a pre-tax or Roth basis if they satisfy income limits. Coverdell IRA accounts are limited to \$2,000 in annual contributions, and, unlike most other plans, this limit is not adjusted for inflation.
- Anomalies: state-based 529 plans and HSAs. Federal law does not impose any contribution

24. How much highly paid workers can contribute to a 401(k) plan, however, depends on how much low-paid workers as a group contribute.

limit to 529 plans because contributions do not receive special tax benefits.²⁵ Most states give tax deductions for contributions but deduction ceilings can range from \$1,000 to \$110,000. State lifetime contribution limits to individual accounts range from a low of around \$180,000 to a high of over \$300,000.²⁶ Whether as part of an intermediary or open access plan, HSA contributions are limited to \$2,700 for singles and \$5,450 for family coverage in 2006, with catch-up contributions limited to an extra \$700.

Intermediary plans can also leverage worker savings through matching contributions or, in the case of some work-based plans, across-the-board contributions. Savers are usually required to have worked for a designated number of years (no more than six years for matching contributions and no more than seven years for across-the-board contributions in work-based plans) to earn the contribution.²⁷ On a per-person basis, tax law limits annual account allocations as follows:

- Intermediary plans: Employers can make matching or across-the-board contributions to 401(k)s, 403(b)s, and 457(b) plans.²⁸ Total account contributions (including worker savings) are capped at \$44,000 for 401(k)s and 403(b)s, and \$15,000 for 457(b)s. SIMPLE plans require employer contributions of either a 100% match (up to 3% of pay) or a 2% across-the-board contribution. The federal Thrift Savings Plan contributes 1% of pay across-the-board and a 100% match on the first 3% of pay contributed and a 50% match on the next 2%. Employers may contribute to work-based HSAs provided their contributions meet a “comparability” standard. Some states offer additional education benefits as part of their 529 plans, and eight states offer matching contributions, sometimes limited to low-income contributors, in 2006.²⁹

Table 5. Two Savings Plan Models

	Open Access Plans	Intermediary Plans
Plans	Traditional IRAs, Roth IRAs, Coverdell IRAs, individual HSAs	Generally work-based plans, including HSAs, 529 plans
Ease of access	Usually available to all, unless income limits apply	Employer controls; tax rules limit favoritism towards highly paid workers
Savings support services	Little or none	Usually many
Level of contributions	Lowest	Highest
Protection for investors	Standard	Additional
Control over withdrawals	None; tax law penalties	Yes; tax law penalties

25. Because federal gift tax rules have an annual \$11,000 per person exemption, many contributors limit their contributions to \$11,000 per child annually. Federal tax law, however, allows them to advance fund these accounts by contributing up to 5-year’s worth of contributions (\$55,000) in a single year without having to pay gift taxes.

26. Information obtained from <http://www.401kid.com/529-plan-statebystate.asp>.

27. Savers always own their contributions, whether made to an intermediary or open access plan.

28. Matching contributions for highly paid workers in 401(k) plans must be kept in proportion to those for high-paid employees.

29. States offering matching contributions in 2006 are Utah, Colorado, Louisiana, Maine, Michigan, Minnesota, Pennsylvania and Rhode Island. Information obtained at: http://www.savingforcollege.com/compare_529_plans/?plan_question_ids%5B%5D=438&page=compare_plan_questions.

- **Open access plans:** Except in the case of spouses, traditional IRAs and Roth IRAs only permit contributions by individual savers. But other plans, such as Coverdell IRAs and HSAs (not part of a work-based plan) are designed to encourage contributions by multiple parties, up to annual account limits.

For some low-income savers, the federal government provides some savings leverage through a special program called the Saver's Credit, designed to encourage saving by subsidizing contributions.³⁰ The Saver's Credit provides a tax credit of 10-50%, up to \$2,000, for contributions to the plans indicated in Table 4. In order to qualify for the 50% credit, the taxpayer must have an income of \$30,000 or less if married and \$15,000 if single. The Saver's Credit is non-refundable so savers must have some income tax liability to qualify. Because many low-income savers are below tax thresholds, they are often unable to take advantage of the Saver's Credit.

Investments and investor protections • Although tax incentives for contributions are important, in the end a savings plan is only as good as the investment options it offers. However, Congress has adopted a hands-off approach to this stage of savings plan design. There is no list of required or, with a few minor exceptions, prohibited investment options. Plan providers are largely free to offer any number or type of investments, and savers are free to choose how their accounts will be invested.

In open access plans, savers are responsible for their own investment decisions. If they violate the prohibited investment rules or misuse their account assets, their plan loses its special tax benefits. They are protected by the standard securities laws if they are the victims of fraud or market manipulation and abuse, the same legal protections available to investors who save outside a plan. But if their investments lose value due to poor investment selection, they have no additional protection.

Congress has given savers in some intermedi-

ary plans additional protection by making plan officials fiduciaries. These plans have an obligation to offer a good menu of investment choices or a good list of plan providers to savers. This benefits savers in two ways. First, a pre-qualified menu or provider simplifies the investment process for savers. Second, savers may have some additional recourse when things go wrong beyond that available to ordinary savers. Savers who suffer investment losses can attempt to recoup them from plan fiduciaries that may be held personally responsible when a plan offers poor investment options. These rules apply to most 401(k) plans and to a lesser degree to 403(b) and SIMPLE plans. State law may provide similar protection to 457(b) savers. In 529 plans, states provide similar pre-qualification services by choosing plan providers and selecting investment options.

Access to withdrawals • Distributions are the third stage of plan design, and savings plans are full of complex rules about when and for what purpose savers may withdraw from their accounts. Congress regulates withdrawals to protect the special tax benefits it confers on a particular plan. It also restricts savers' ability to access their funds in order to promote long-term saving. In addition, it takes away tax benefits or imposes tax penalties when withdrawals would defeat the intended purpose of the plan.

As a general rule, withdrawals are freely available in open access plans but loans are not. Savers may withdraw from their IRAs and HSAs at any time. However, tax law imposes extra penalties on withdrawals made before specified ages or for reasons not approved by the plan.

In intermediary plans, employers play more of a role in withdrawal options. First, they decide which withdrawal options their plans will offer. Second, if they are plan fiduciaries, they are responsible for making sure their plans comply with the law. This means that they must monitor withdrawals to

30. Rules for the Saver's Credit are found in IRC § 25B.

ensure they satisfy plan rules and tax law. Many plans offer loans as the first option for savers (PSCA 2005). Loan programs are fairly generous, offering savers access to loans up to the lesser of \$50,000, or 50% of their account balance. Generally, loans are repaid through payroll deduction and must be repaid within five years. Loans are not available in SIMPLE IRAs because they belong to the IRA family of plans that prohibits loans. Intermediary plans are less liberal about withdrawals than open access plans. By law, savers may not withdraw their own contributions before age 59½ (or 70½ in the case of 457(b)s), although employer contributions are often available earlier.³¹ Many employers allow savers access to their funds by offering a “hardship” withdrawal for emergency or short-term needs. These include medical, educational, or housing expenses, and tax penalties for early withdrawal often apply.

In both types of plans, savers must begin withdrawing from their retirement plan accounts at age 70. Similar rules apply to traditional IRAs but not Roth IRAs or HSAs. Education plans have different age limits. Account assets must be distributed from Coverdell IRAs when the beneficiary reaches age 30, unless they are rolled over to an account for another eligible child. Although federal law does not apply an age limit, similar rules often apply to 529 plans.

Observation • The single most not-so-sensible feature of the American system of savings plans is its complexity. The system is a labyrinth of plans and rules that even experts find difficult to navigate. Rationalizing the current array of plans is long overdue. Congress has achieved some simplification recently by making 401(k)s, 457(b)s, and 403(b)s more similar, but then they added IRAs, which require a new layer of complex rules and regulations.

By continually adding more plans and failing to rationalize plan rules, Congress is contributing to the complexity problem rather than solving it.

The Significance of Savings Plans

Statistics about plans • Measuring the effectiveness of savings plans is difficult because there is no standard, comprehensive source of data on their use. Infrequently, the federal government reports information obtained from income tax data on contributions to savings plans. Although the data are comprehensive, the information is usually years out of date.³² Financial service industry sources as well as consulting firms also provide information from time to time. But their data, while more timely, are proprietary and not often made public. One respected source, however, the Investment Company Institute (ICI), compiles extensive statistics on saving and investing. Many of their findings are presented below along with some additional information from other resources.³³

As a starting point, it is useful to turn to statistics from the retirement market. Industry statistics indicate that financial assets held for retirement totaled nearly \$13 trillion in 2004 (ICI, 2005e: 1). This represents about 36% of total household financial assets at year-end 2004.³⁴ It is not clear, however, what proportion of this \$13 trillion has been generated by retirement savings plans. This figure includes assets held both inside and outside savings plans. It also includes assets held in savings plans as well as non-savings plans (such as defined benefit plans). It does not indicate what proportion is attributable to contributions by workers and/or employers and what proportion is attributable to earnings.³⁵

31. Savers who quit their jobs are not bound by these restrictions and can close out their accounts or roll the assets over to an IRA.

32. The most recent report includes data on plan contributions in 2000 (CBO 2006).

33. The ICI is the national trade association for over 9,000 U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds, and unit investment trusts.

34. Personal communication, Sarah Holden, Investment Company Institute, January 24, 2006.

35. The \$13 trillion total includes \$1.2 trillion in annuities, both fixed and variable, not held in a savings plan. It also includes assets held in employer-based plans, such as defined benefit plans and defined contribution plans with only employer contributions, which produce retirement income but are not savings plans.

Table 6. Assets Held In Savings Plans, 2004

Plans	Assets	Individuals (I) or Households (H) Holding Accounts	Account Size - Average (A) or Median (M)
401(k)/SIMPLE 401(k)	\$2.1 trillion	43 million (I)	\$56,876(A) \$19,926(M)
403(b)	\$585 billion	NA	NA
457(b)	\$130 billion	NA	\$29,900(A)
Thrift Savings Plan	\$152 billion	3.4 million (I)	About \$45,000(A)
SIMPLE IRA	\$33 billion	2.2 million (est.) (I)	NA
Traditional IRA	\$3.15 trillion	36.7 million (H)	\$24,000(M)
Roth IRA	\$120 billion	14.3 million (H)	\$8,600(M)
529 Plans	\$52.2 billion	5.4 million (I)	\$9,700(A)
Coverdell IRA	\$3 billion (only mutual funds)	NA	NA
HSA	NA	NA	NA

Turning to just savings plans, Table 6 presents three different indicators of comparative plan size: the assets held in each type of plan; the number of individuals or households holding accounts in each type of plan; and the average or median account size.³⁶ Because households may have more than one account and individuals may participate in more than one plan, the individual and household numbers cannot be added to find the total number of households or individuals with a savings plan. These data generally reflect year-end numbers in 2004, except that 457(b) plan account size data are as of June 30, 2005. Again, these are aggregate numbers and do not distinguish contributions from earnings or contributions attributable to savers from those of employers or others. Table 6 also does not include data on HSAs, which effectively became available only in 2005.

According to Table 6, at the end of 2004, savings plans held over \$6 trillion in assets. Intermediary plans (401(k)s, 403(b)s, 457(b)s, the Thrift Savings

Plans, SIMPLE IRAs, and 529 plans) held about \$3 trillion in assets in total. All but a small proportion of these assets were held in retirement savings plans, indicating that these plans account for more than 20% of all financial assets held for retirement. Open access plans (IRAs) held about \$3.2 trillion in assets. Most of these assets, however, actually originated in intermediary retirement plans. For example, ICI data indicate that the majority of assets held in traditional IRAs are rolled over from employer plans (including employer contributions). In 2002, for example, new contributions accounted for only about 1% of IRA assets (ICI, 2005a: 7).

Table 6 thus indicates that intermediary plans have, to date, been more successful in generating assets than open access plans. Many open access plans, such as Roth IRAs and Coverdell IRAs, are relatively new plans so their assets may increase substantially in the future. Table 6 also indicates that it is the work-based plans that are flourishing,

36. In Table 6, data on Coverdell assets come from ICI (2005f: 38). Information on 401(k) and SIMPLE 401(k) assets are from ICI (2005e) and Holden and VanDerhei (2005a:3). Information on traditional and Roth IRA account holders and account sizes comes from ICI (2005f: 42-43) and on asset size from ICI (2005a:8). Information on 529 plans comes from ICI (2005f: 47) and ICI (2005c). Information on assets held in SIMPLE IRAs comes from ICI (2005a:9), and estimates of the number of account holders are from the author's calculations based on 5-year trends reported in Holden et al. (2005:9). Information on asset size and number of accounts for the Thrift Savings Plan come from Deloitte & Touche (2005) and average asset size is based on the author's calculations based on these data. Information about assets held in 403(b)s come from ICI (2005e: 5). Data on 457(b) plans come from ICI (2005e: 5) and Nationwide (2006: 18).

with 401(k) plans accounting for almost two-thirds of their assets (ICI, 2005f: 40). Among other plans, 403(b)s account for about 20% of the remaining assets while the Thrift Savings Plan accounts for about 5% and 457(b) plans slightly less. SIMPLE IRAs have less than 1% of work-based plan assets. First available in 1997, they are a relatively new savings plan alternative but are growing fast, with an average annual increase in assets of 50% since 1998. This compares to an average annual increase of 14% for Roth IRA assets (which probably include assets originating in work-based plans) during the same period. The ICI data also indicate that 529 plans (intermediary plans) have been more successful in generating assets for education than Coverdell IRAs (open access plans). In 2005, 529 plans held over \$52 billion in assets while Coverdell IRA assets held in mutual funds accounted for only \$3 billion in assets.

Statistics about savers • Table 6 also provides some aggregate data on savers. In 2004, there were roughly 220 million Americans over age 18 and 112 million American households.³⁷ About 20% of Americans had a 401(k) savings account, while 33% of households had at least one traditional IRA and an additional 13% had at least one Roth IRA. In addition, there are over 5 million 529 plan accounts for children.

Table 6 indicates that account sizes vary widely. The average account size in a 529 plan was \$9,700, about \$57,000 in a 401(k) plan, \$30,000 in a 457(b) plan, and \$45,000 in the Thrift Savings Plan. Averages, however, can be distorted in plans with

many small accounts or several very large ones. Median account sizes, which reflect the midpoint or 50th percentile, provide a better indication of typical account size. Table 6 also indicates that in 2004 the median 401(k) account size was about \$20,000, traditional IRAs held \$24,000, and Roth IRAs held less than \$9,000.³⁸

Table 7 provides more background information on plan participation using 2003 data on 401(k) and education savers, 2004 data on IRA savers, and January through June 30, 2005, data on HSA purchasers.³⁹ The HSA data should be viewed with caution because HSAs are not yet widely represented in the employer market. The education plan data should also be viewed as preliminary because they come from a single survey whose sample and results are likely biased toward higher-income households.

The picture that emerges from Table 7 is that savings plans attract participants who seem very similar across most plans: employed, earning in the top-half of the income distribution, middle-aged, married, and educated.⁴⁰ They take full advantage of the tax incentives offered through savings plans. Their employer provides them with retirement plans, to which they contribute, and then they save more for retirement through an IRA and for their children's education through a 529 plan or Coverdell IRA. The preliminary data on HSAs suggest that HSA purchasers might be significantly different: less likely to be married, less affluent, less likely to be

37. Statistics (as of July 1, 2004) on the over-age 18 U.S. population come from the U.S. Census Bureau and can be found at: <http://www.census.gov/popest/national/asrh/NC-EST2004-sa.html>. The estimate of U.S. households can be found at ICI (2005d: figure 1, footnote 1).

38. The ICI data on average and median account size balances are quite consistent with those reported by various mutual fund companies. For the end of 2003, Vanguard reported average balances at about \$58,000 and median balances at about \$21,000 (Vanguard 2004), while Fidelity reported \$55,000 in average account balances and \$20,000 median account balances in the defined contribution plans they manage (Fidelity 2004). A consulting group survey of over 400 plan sponsors in 2004 also reported average account balances of about \$55,000 in 401(k) plans (Deloitte Consulting 2005).

39. The 401(k) data come from a 2003 Fidelity Investments' study of over 10,000 defined contribution plans with over 8 million participants (Fidelity 2004) and from research reported in Smith et al. (2004). IRA data come from mid-2004 data reported by the Investment Company Institute (Holden et al. 2005). Education savings data come from a 2003 survey of about 900 households with children under age 18 by the ICI (ICI 2003). Data on HSA purchases in 2004 and the first 6 months of 2005 come from statistics kept by eHealth Insurance Services, Inc., a privately-held online marketing company of individual and small group health policies to the public (eHealth 2005a, b).

40. To set the data in Table 7 in context, in 2004, median household income was \$44,389, and the median income of men who worked full-time was \$40,798 and \$31,223 for women (DeNavas-Walt, 2005: 3, 8).

employed. HSAs, however, are a very new product and these data reflect individual purchasers. It may be several years before good data on HSA utilization become available. Once employers start offering HSAs, the demographics of HSA savers may look much like the other plans. On the other hand, it is possible they will be popular for their tax benefits among high-income purchasers but also prevalent among employees of small businesses as part of a work-based plan.

Observation • In order to make the American system of savings plans more sensible, it is necessary to understand which plans and which features are most effective in inducing saving. Unfortunately, that is not possible today. It is not even clear how much is contributed to these plans each year, although actual contributions are reported to the federal government through the income tax system. Instead, information about savings plans comes largely from proprietary industry data

Table 7. Some Demographics of Savings Plan Participants

Retirement Plan Savers			Education Plan Savers		HSA Savers
401(k) Plans	457(b) Plans	IRAs	529 Plans	Coverdell IRAs	HSAs
Median age: 44	Average age: 48	Median age: 49	Median age: 40	Median age: 40	Average age: 38 (62% male)
Median account balance by age: 40-49 \$27,000 50-59 \$37,000 60-64 \$41,000	Average account balance: \$29,900	Median IRA assets: \$24,000	Median 529 assets: \$5,000	Median Coverdell assets: \$4,000	
Median income (employees): \$53,000 (25% earn between \$50,000-75,000)	Average salary: \$48,100	Median household income: \$62,500	Median household income: \$100,000	Median household income: \$93,500	58% had incomes > than \$50,000
Participation and contribution rates increase with age, education, and earnings		More likely to be married, college educated, employed full-time, with employer retirement plan	More likely to be married, college educated, employed full-time with IRAs (75%), employer retirement plans (89%), and other financial assets	More likely to be married, college educated, employed full-time with IRAs (78%), employer retirement plans (89%), and other financial assets	57% single, 30% couples with children, 12% couples without children
25% of all workers do not contribute; 11% contribute the maximum; average contribution rate is between 6-7% of pay	Average participation rate: 34%; 3% contribute the maximum; average contribution rate is 7.9% of pay; average contribution: \$3,800	Roth owners are younger (44 v. 52), wealthier (\$70,000 v. \$63,800), but have smaller IRAs (\$21,800 v. \$30,000).			31% were previously uninsured for 6 months (in 2004, 66% in this group had incomes below \$50,000)

and from studies that differ widely by sample, time-frame, and method. Although this information is valuable, there is much that could be learned from more comprehensive and systematic data.

Top 10 Lessons Learned

By one measure, savings plans have been an enormous success. They now dominate the private pension system. 401(k)-type plans now represent 70% of all defined contribution plans, 75% of all defined contribution plan assets, more than 85% of all defined contribution plan participants, and 40% of all private sector retirement assets (defined benefit and defined contribution plan assets combined) (Vanguard, 2004: 16). Among workers, savings plans are very popular. According to one recent survey, they are viewed as an essential employee benefit, out-ranked only by health care. Some 93% of workers viewed them as “important,” while 75% considered them “very important” (Transamerica, 2005: 10).

Savings plans have not only transformed the American workplace; they have also transformed American capital markets. As the ICI notes, “America has become a society of equity investors. The number of households owning equities has increased more than three-fold since the early 1980s. ... The growth in equity ownership has been largely fueled by the increased availability of defined contribution retirement plans, particularly 401(k) plans” (ICI, 2005b: 1). And it is worker savings behind this trend as “employee contributions have ... become the main source of funding [for defined contribution plans]” (Vanguard, 2004: 14).

Table 7 indicates, however, that savings plans are not a universal success story. But it is important they become one. Americans are being asked to rely more on their own resources to pay for healthcare, education, and retirement. Savings plans are key to helping Americans save more. After roughly thirty years of experience on a wide scale, it is appropriate to step back and review what has been learned about savings plans. The discussion below summarizes the current

state of knowledge about savings plans and describes their known trouble spots and weaknesses. The evidence comes primarily from the private pension system’s experience with the 401(k) plan. The 401(k) is this nation’s largest experiment with savings plans, and much can be learned from its successes and failures. The data cited below tend to reflect the experience of large corporate savings plans. These are the elite plans and typically represent the most innovative designs and best practices for contemporary savings plans.

Lesson 1: Work-based plans induce saving but many Americans have no savings plan at work. One undisputable issue is that the American system of savings plans has a coverage problem. As Table 6 indicates, most Americans save through 401(k) and other work-based plans that have pioneered a turn-key opportunity to save. Because these are intermediary plans, however, workers have no savings plan unless their employer decides to offer one. Congress has created new plan types and lessened the regulatory burden to attract more employers, particularly small business employers, without much success.

- For decades, a consistent finding has been that only about 50% of the private sector workforce has access to a work-based retirement plan, including savings plans (Munnell et al. 2002; Smith et al. 2004; Orszag 2005).
- Data for 2003 indicate that retirement plans were available to only about 44% of private-sector workers. Most (70%) but not all of those plans were 401(k)-type plans (Vanguard, 2004: 13-14).
- Large employers are most likely to offer a plan, but coverage rates shrink with the size of the employer (VanDerhei 2003).

The American system of work-based savings plans does not require employers to provide workers with a plan. Instead, it hopes to encour-

age employers to do so by providing special tax incentives for plans and designing plans that fit their business needs. The persistent coverage problem in the private pension system indicates that its incentives and plans are not attractive to many employers, especially small business employers.

Lesson 2: Low-income workers are often excluded from work-based plans. Under current law, work-based plans are usually not required to cover an entire workforce or include short-service workers. Low-income workers are often ineligible under plan rules to save at work.

- Workers with less education, lower earnings, or working for small businesses are substantially less likely to have a work-based plan (Purcell, 2005: 5).⁴¹
- Workers earning below \$20,000 in 1997 represented just 15% of workers in work-based retirement plans, even though they represented 34% of all workers (Orszag, 2005: 3).

If a corporate employer offers a plan, the plan must satisfy rules about worker participation that were first drafted over 30 years ago. At that time, the goal was to increase participation by employees who worked at least half-time. Because many low-income workers have sporadic employment or work schedules that don't satisfy these rules, they often fail to qualify for participation even if their employer offers a plan.

Lesson 3: Most saving occurs in work-based plans. Few workers use open access plans as a substitute. As Tables 6 and 7 illustrate, saving primarily takes place in a work-based intermediary plan. Open access plans, such as IRAs, are not effective substitutes. Most workers without a work-based plan do not contribute to an IRA. IRAs are used primarily to hold assets generated by work-based plans rather than for additional saving.

- Industry statistics report participation rates in work-based retirement savings plans to be in the mid-70% to low-80% range (Vanguard, 2004: 30).
- In contrast, according to ICI data, only 41% of U.S. households own IRAs and less than 20% contributed to IRAs in 2004 (ICI, 2006: 1).
- Only 10% of households in 2003 without an employer plan have an IRA, while 29% had neither an employer plan nor an IRA (ICI, 2006: 2).
- Low-income savers may not find open access plans accessible as many lack a meaningful connection to the financial services industry. About 10% of American families, predominantly Hispanic and African-American, those under 35 or over 65, or with incomes below \$20,000, have no bank account of any kind (NASI, 2004: 40).

IRAs were created about thirty years ago as a simple, alternative savings plan for workers without a work-based plan. Early in their history, they were popular but, much like work-based plans, they have become increasingly complicated. It is not clear if that is the basis for their lack of popularity but it is clear that IRAs have not grown into the strong, supplemental saving system they were intended to become.

Lesson 4: The best predictor of participation in a savings plan is income. As Table 7 illustrates, current savings plan designs have been most successful in attracting more affluent savers. Their success among lower-income savers has been limited.

- Savings plan participation rates increase with income, education, and age (Smith et al. 2004: 4).

41. From February through May of 2003, the Bureau of the Census collected information on participation in employer-sponsored retirement plans among individuals in more than 29,000 U.S. households through the Survey of Income and Program Participation (SIPP). These data represent the most comprehensive source of information available on workers' participation in employer-sponsored retirement plans from a nationally representative sample of American households.

- On average, a \$10,000 increase in compensation is associated with a 3.7% higher probability of plan participation (Huberman et al., 2003: 1).
- Among active savers, 7% have mean incomes below \$19,999 while 55% earn more than \$50,000 (Fidelity, 2004: 34).⁴²
- Vanguard reports that in 2003 only about 40% of eligible employees earning under \$30,000 contributed to a savings plan as compared to about 90% of those earning more than \$100,000 (Vanguard, 2004: 29).⁴³

It is not surprising that higher-income savers take more advantage of savings plans than lower-income savers. The chief attraction of savings plans is their special tax benefits and those are certainly of more value to savers in the higher-income tax brackets.

Lesson 5: Savings rates vary widely but average savings rates are low among both lower-and higher-income savers. Savings plans such as 401(k) plans have become widely available in the last fifteen years but not universally popular among savers. Large numbers of potential savers fail to contribute or contribute less than they could.

- Data from major financial service companies in the retirement plan market reveal that about one-third of eligible workers save nothing (Hewitt, 2005a: 2; Vanguard 2005: 11).
- In 2004, about 25% of savers contributed 10% of pay or more while 25% contributed below 4% (Vanguard, 2005: 14).
- According to one trade association study, participants earning less than about \$90,000

in 2004 contributed on average about 5.4% of pay while those earning more contributed about 6.7% of pay (PSCA 2005).⁴⁴

- In 2003, statistics from several studies report average savings rates of between 5% and 7%, rates substantially unchanged since 2000 and very similar to 2003 Census data reporting mean contributions of 7.3% of pay (Vanguard, 2004: 30; Purcell, 2005: Summary).

As savings plans mature, contribution rates may increase as workers become more familiar with them. There is also some evidence that many workers increase their contributions as they age. If so, younger generations of workers who will have a full career's exposure to work-based savings plans may exhibit greater rates of saving than those common today.

Lesson 6: Increasing contribution limits does not induce more saving. In 2001, Congress greatly increased the amount savers could contribute on the theory that this would increase saving across-the-board. For example, savers can now contribute 100% of pay up to \$15,000 in 2006 to a 401(k), 403(b), or 457(b) plan. So far, results are disappointing. Most savers contribute well below the maximum permitted.

- The increase in contribution limits has not increased the number of families owning IRAs (Copeland, 2006: 3).
- In 2003, only 3% of private sector workers contributed the maximum permitted, while 85% contributed less than \$500 per month (Purcell, 2005: Summary).⁴⁵

42. These 2003 data are compiled from more than 10,000 corporate defined contribution plans covering over 8 million participants for which Fidelity serves as record keeper. These statistics represent workers aged 20 and over.

43. Because 401(k) plans are designed to encourage participation by lower-paid workers, these statistics are especially discouraging. In a 401(k) plan, the amount high-income workers can contribute depends on how much low-income workers contribute. So many plans offer matching contributions and provide education about the value of savings to raise participation rates by low-income workers. Other plans such as 403(b)s and 457(b)s do not have such rules.

44. The survey covered about 1,000 401(k) plans sponsored by member companies, representing \$500 billion in plan assets and more than 9 million participants.

45. These data come from a U.S. Census Bureau survey of more than 29,000 households through its Survey of Income and Program Participation (SIPP). The figures reported here focus on workers at least 18 years old with a paid job in the private sector.

- In 2004, while almost 90% of Vanguard plans offered catch-up contributions to older workers, only 13%, largely those with household incomes over \$50,000, contributed but, on average, not the maximum permitted (Utkus and Mottola, 2005: 1).

The evidence to date suggests that raising contribution limits is not a particularly effective tool for increasing saving, even among older workers close to retirement. Inducing greater saving appears to be a complicated set of behaviors requiring more than a simple stimulus such as increased contribution limits.

Lesson 7: Account accumulations are low.

Whether current plan designs can induce adequate saving is debatable. According to one recent study, workers with a full career's exposure to a 401(k) plan could accumulate substantial assets. Through consistent saving, a median retiree in the bottom 25% of earners could replace slightly over 50% of pre-retirement income, while one in the top 25% of earners could replace about 66% through their 401(k) accumulations (Holden and VanDerhei, 2005b: 4). Average account balances are expected to grow substantially as the work-based savings plan system matures. But the statistics below as well as those reported in Table 7 suggest that savings adequacy is a real concern.

- In 2003, about 50% of Fidelity 401(k) participants had balances under \$20,000, and nearly half of them (24% of all participants) had balances under \$5,000. About 70% of all participants had balances under \$50,000 (Fidelity, 2004: 27).
- In 2004, about 33% of Vanguard plan participants had account balances of \$10,000 or less, while 18% had balances greater than

\$100,000 (Vanguard, 2005: 27).

- Hewitt reports that at the end of 2004 nearly one in four 401(k) participants had an account balance, including employer contributions, of less than \$5,000 (Hewitt, 2005a: 2).⁴⁶

As yet, there is no consensus on what constitutes adequate saving. But many savers today have account balances that are obviously inadequate for providing substantial income in retirement.

Lesson 8: Matching contributions are a puzzle.

Thought to induce more saving, they often don't. Savings behavior is a complex phenomenon that is as yet poorly understood. Many employers offer matching contributions to increase plan participation and individual savings levels but academic researchers studying their incentive effects have reported puzzling results from matching programs. Many programs, even those with strong marginal incentives, fail to produce the additional savings predicted by economic theory (Mitchell et al. 2005a, 2005b; Choi et al. 2006b).

- Almost 75% of workers say they view matching contributions as a very important plan feature (Transamerica, 2005: 19) but workers do not necessarily respond to these incentives.
- About 80% of Vanguard plans offer matches, with a typical formula of a 50% match on the first 6% of pay contributed (Utkus, 2005: 3).⁴⁷ Consulting firm studies report similar results (Deloitte Consulting, 2005:13; Hewitt, 2005c: 2; and PSCA 2005).⁴⁸
- Vanguard data indicate that some 60% of lower-income workers (earning less than \$85,000) save independent of a match, only

46. Statistics reported by Hewitt are based on a biennial survey conducted in early 2005. About 450 employers participated, including 19% of Fortune 500 companies, providing information on plans with 2.5 million participants and \$264 billion in assets.

47. This study examined over 500 plans with an average plan size of about 1,500 employees using data from 2001.

48. The Deloitte Consulting study included 462 plans with an average plan size of 12,000 employees using data collected in 2004.

about 10% of workers respond to a match by saving, while 30% do not respond at all (Mitchell et al., 2005b: 2).

- Increasing match rates appears to induce more workers to save but does not encourage existing savers to save more (Mitchell et al., 2005a: 22).
- Hewitt survey data reveal that about one in five savers failed to save enough to qualify for a match and about 30% more saved just enough to earn a full match (Hewitt, 2005a: 2).
- On the other hand, a recent field experiment found that for an IRA matching contribution of 50%, low- and moderate-income savers increased participation by 17% and contributions eight-fold. Those offered a 20% match increased participation by 10% and contributions four-fold (Duflo et al. 2005).⁴⁹

Matching contributions are believed to be one important tool for inducing saving but are clearly not the sole determinant of savings behavior. Other factors, such as simplicity and universality, may also be key elements of plan design that, in combination with matching contributions, promote savings behavior.

Lesson 9: Complex investment menus deter participation and result in investment paralysis. Congress has imposed few restrictions on the investment menus of savings plans. Today's savings plans offer an enormous variety of investment options that enable savers to structure their own portfolios as they wish. Savers have instant access to account information through web-based or telephone services, enabling them to track their investment performance. Most plans also offer trading services that permit savers to change their investment allocation at will. Research suggests, however,

that savers might benefit from more investment guidance and simpler menus than current plans provide (Holden and VanDerhei 2005a).

- Many plans offer double-digit numbers of investment options: an average of fourteen (Hewitt, 2005c: 2), fifteen (Deloitte Consulting, 2005: 18) and eighteen (Fidelity 2004: 3; PSCA 2005; Vanguard, 2005: 30).
- Participation is higher in plans offering a handful of funds than in those offering ten or more (Iyengar et al. 2003).
- On average, adding ten additional investment choices reduces predicted participation rates by 2% (Mottola and Utkus, 2003: 1).
- In Vanguard plans, almost all participants (80%) initiate no trades, and an additional 11% make only a single trade in a two-year period (Mitchell et al. 2005c).⁵⁰
- Inertia and procrastination are widespread and trading infrequent. Only about 10-20% change their investment allocations each year (Fidelity, 2004: 3; Vanguard, 2005: 36; Hewitt, 2005a: 3).
- About 25% invest in only one fund (Fidelity, 2004: 3). Where offered, company stock is the most popular option and comprises 50% or more of account balances for over 25% of participants (Hewitt, 2005a: 2).

Although more rather than less choice is generally viewed as desirable, many savings plans today exhibit choice overload. In an attempt to induce saving by reducing the complexity of savings decisions, many employers are now simplifying investment menus and other features in their savings plans.

49. The H&R Block study was a large scale, randomized field study covering about 14,000 H&R Block clients, across 60 offices in predominantly low- and middle-income neighborhoods in St. Louis.

50. These data come from a two-year extract of 401(k) plans and participants drawn from the recordkeeping systems of Vanguard from 2003 to 2004. The same encompasses 1,530 defined contribution retirement plans and includes asset allocation and trading patterns for nearly 1.2 million active participants in those plans.

Lesson 10: The economics of plan investment and administration are poorly understood by both savers and plan sponsors. Congress has not restricted fees in savings plans or their investments. Instead, under the securities laws, it requires their disclosure to help savers make informed investment decisions. It also requires fiduciaries in many intermediary plans to monitor and minimize plan fees and expenses. Despite efforts by the Department of Labor and the SEC, the information provided about fees, expenses, and revenue sharing arrangements in savings plans is still an issue (DOL 1998; Anderson 2004; McHenry Consulting Group 2004a, b; Faucher 2005; SEC 2005).

- Plan sponsors don't understand the total costs incurred by plans and participants don't understand the fees being charged (DOL 1998).
- Large plan sponsors believe they have sufficient information to understand the total fees charged to their plan as well as the normal

operating expenses of its investment options (Deloitte Consulting, 2005: 22).

- In that same survey, however, only 57% felt they clearly understood the revenue sharing arrangements between plan service providers and only 52% understood the costs of administering their plan (Deloitte Consulting, 2005: 22).
- Concerns about fees and expenses have also been an issue with 529 plans (Clancy et al. 2004; Tergesen 2004; Todorovna 2004).

If they don't understand their plan's finances, savers who contribute adequately and invest appropriately may still fail to achieve their savings objectives. Fees, service charges, and expenses deducted from their accounts can reduce their rate of return and ultimately their account balances significantly (Hewitt, 2005b: 45). Improving transparency in this area is important for the long-term health of the American system of savings plans.

Building the Next Generation of Savings Plans

Although reasonable people might differ, most would agree that the American system of savings plans earns a passing grade but also needs major improvement. The wish list for improvements includes more savers with plans, increased contributions, better investment performance, and a simpler system for saving.

Building the next generation of savings plans will not be easy. As a first step, it is important to recognize that what is needed is not more plans but better plans. Creating more and more open access plans, as Congress is continually being asked to do, is counterproductive. After thirty years of experience on a large scale, there is sufficient evidence that the “build it and they will come” approach just doesn’t work. At the same time, constantly retooling the rules for existing plans and adding more features doesn’t make them better plans, just more complicated plans.

Building the next generation of savings plans requires returning to basics. First, what plans are actually needed for a successful savings society? Before creating more plans, it is important to ask whether they would represent a net improvement by reaching out to new savers or filling an unmet need. If not, then it makes little sense to add them to a system already cluttered with too many plans that have duplicate features and idiosyncratic rules. Returning to basics suggests subtracting rather than adding plans. Recently, two proposals have been advanced to do just that. These proposals advocate a major pruning of the American system of savings plans. They are described below.

Returning to basics also involves plan designs. What do effective savings plans look like? Recent research has found that “savings outcomes are not

simply determined by individual worker characteristics such as their propensity to save or their tax exposure ... accumulations are also influenced by how employers design their ... plans” (Mitchell et al. 2005a: 26). Plan design is increasingly seen as the key to successful saving, and researchers are beginning to create a science of plan design that looks very promising.

Current designs do well by many Americans. These tend to be wealthier Americans who benefit the most from the tax incentives on which these plans are built. And, as researchers have recently noted, it is the interests of these Americans that drive current savings plan designs.

401(k) plan design is highly-motivated by a desire to satisfy higher-paid employees’ demand for tax-advantaged compensation ... 401(k) plans appear to be mainly a complex form of tax-advantaged compensation (Mitchell et al., 2005a: 26).

Designing better plans means recognizing that plans must be attractive to savers less motivated by tax considerations. Current designs do not do well by low- and moderate-income Americans for whom tax incentives are of limited value. There is substantial evidence that these Americans can and do save (Maki and Palumbo 2001; Duflo et al. 2005; Sherraden and Barr 2005), but today’s plans have failed to attract and retain many of these potential savers. Some innovative proposals for new plan features, however, may soon be enacted, and their potential for improving plan design is explored below.

Simplifying the Savings Plan System

Although recent changes have standardized many of the rules for 401(k)s, 403(b)s, and 457(b)s, tax law still maintains separate savings plans for different types of employers. In addition, many plans originally created for specific types of saving have evolved into more general purpose saving plans. Two proposals have recently recommended drastically restructuring the current system by consolidating plans. For several years, the Bush administration has advocated reducing the number of savings plans and simplifying their rules (Treasury 2006). More recently, the President’s Advisory Panel on Federal Tax Reform has pro-

posed similar changes (President’s Advisory Panel 2005). Both envision three basic plans for saving: work-based retirement savings accounts; individual retirement savings accounts; and individual all-purpose savings accounts.

As Table 8 illustrates, most (in the administration proposal), or all (in the Tax Reform Panel Proposal) work-based retirement plans would be collapsed into a single plan type called “Employer Retirement Savings Accounts” or “Save at Work Accounts,” respectively. These accounts would maintain current tax treatments for contributions—pre-tax, after-tax, and Roth taxation treatment—as well as current contribution limits

Table 8. Simplification Proposals for Savings Plans

	Administration	Tax Reform Panel
Combines 401(k), 403(b), 457(b) plans, SIMPLE 401(k)s, SIMPLE IRAs + Thrift Savings Plan (Tax Reform Panel proposal only) into:	Employer Retirement Savings Accounts \$15,000 annual contributions	Save at Work Accounts \$15,000 annual contributions
Combines traditional IRAs and Roth IRAs into:	Retirement Savings Accounts \$5,000 annual contributions	Save for Retirement Accounts \$10,000 annual contributions
Combines HSAs, 529 Plans, Coverdell IRAs into:	Lifetime Savings Accounts \$5,000 annual contributions	Save for Family Accounts \$10,000 annual contributions
Introduces:	Individual Development Accounts Tax credit to financial service companies that offer accounts to low-income savers with a 100% match up to \$500	No
Revises Saver’s Credit:	No	Refundable tax credit to low-income savers with a maximum 25% match on up to \$2,000 in contributions

(\$15,000 in 2006) based on earnings. In the administration's proposal, separate rules would continue to apply to corporate, non-profit, and governmental employers. Corporate plans would still be required to balance contributions by high-paid workers against those made by lower-paid workers but under simplified rules. The Tax Reform Panel also promises simplified rules but it is not clear whether they would apply to all Save at Work accounts, or just those in corporate plans.

Both proposals would consolidate IRAs into Retirement Savings Accounts or Save for Retirement Accounts. In a change from current law, these accounts would only offer Roth treatment. No new contributions could be made to traditional IRAs that are not converted. Save for Retirement Accounts differ from Retirement Savings Accounts in two important ways. Both offer more generous contributions than current IRAs (\$4,000 in 2006), but Save for Retirement Accounts are twice as generous (\$10,000) as Retirement Savings Accounts (\$5,000). These accounts would allow all savers, regardless of earnings, to contribute, but contributions would be limited to annual earnings. Both would permit distributions at any time but Save for Retirement Accounts are designed to discourage withdrawals. These accounts would not include the existing IRA exemptions from the penalty tax for withdrawals made before age 58.

These proposals also consolidate all of today's special purpose savings plans for healthcare and education into a single account called either Lifetime Savings Accounts or Save for Family Accounts. These accounts would offer only Roth treatment, and Save for Family Accounts would permit \$10,000 in annual contributions, while Lifetime Savings Accounts would permit \$5,000. Contributions would not be based on earnings, so, for example, a family of four could contribute \$10,000 to an account for each family member, for an annual total of \$40,000.

In addition, the proposals offer some incentives to low-income savers. The administration's proposal would provide indirect incentives through tax credits to financial service institutions that sponsor savings accounts called Individual Development Accounts with matching contributions. These would be Roth accounts enabling low-income savers to accumulate assets for homeownership, education, or business development. The Tax Reform Panel instead provides direct incentives through a Saver's Credit. Unlike the current credit, this credit is refundable so that more low-income savers would qualify, but it is less generous.

Reaction to the proposals has been mixed (Burman et al. 2004; Greenstein and Friedman 2005; Perun and Steuerle 2005; Esenwein 2006; Perun and Chavez 2006). Commentators have viewed them as a welcome alternative to the continued proliferation of savings plans. They have also applauded their efforts to simplify both the structure and rules of the current system. But the proposals have also been criticized for offering overly generous individual savings vehicles. Employers might prefer to save through these vehicles rather than sponsoring a work-based plan. If so, this could exacerbate the current coverage problem in the private pension system as well as undermine the intermediary plans that have been so successful in inducing saving.

Simplifying the Saving Process

As Tables 3 and 4 indicate, today's savings plans have very complicated rules. One approach to improving their effectiveness involves making them simpler for savers. Studies indicate that potential savers may be inhibited by the many decisions and choices required in today's savings plans (Beshears et al. 2006; Mitchell et al. 2005a; Choi et al. 2006a,b; Gale and Iwry 2005; Goodman and Orszag 2005; Utkus and Young 2005). Research suggests that there are three critical decision points where savers may stumble: 1)

deciding to save; 2) deciding how much to save; and 3) deciding how to invest amounts saved. Changing plan designs by adding “default” or “autopilot” features at each of these decision points may make saving simpler. In effect, such features could make inertia work for saving instead of against it.

Plans with these features are typically called “auto-enrollment” or “autopilot” plans. In these plans, workers are automatically enrolled in a plan once they become eligible. They can choose to opt-out, but if they don’t, they contribute a default percentage of pay set by the plan every payroll period. They can lower or raise their rate of contribution at any time, but if they don’t, they continue to contribute the default percentage. Some plans also provide default investment options. Workers can decide how their accounts will be invested among the investment options available through their plans, but again, if they don’t, their accounts are invested in a default option.

Employers have been experimenting with such features, although not on a large scale, for the past decade. Recent statistics indicate that about 10% of 401(k) plans, typically large plans, offer automatic enrollment. The default contribution rate found in

over 50% of these plans is 3% of pay (PSCA 2005). A study of fifteen automatic enrollment plans found auto-enrollment features boosted participation by new workers from 75% to 84%, while those that enrolled all eligible workers saw participation jump from 74% to 90%. These plan sponsors typically choose 3% of pay as the default contribution rate, although about 25% chose a default rate of 4% or higher (Vanguard 2001a,b).

The Pension Protection Act of 2006, recently passed by Congress, authorizes employers to add “automatic contribution arrangements” with automatic contribution, automatic contribution increases, and default investment options to 401(k) and 403(b) plans. Incentives for employers to adopt these features include some relief from the standard non-discrimination rules that apply to such plans and fiduciary liability for default investment options. Table 9 illustrates the new rules for automatic contribution arrangements.

These features represent major improvements in savings plan design, if employers add them to their plans. The real test is whether employers will adopt them and workers will accept them. Because

Table 9. The Pension Protection Act of 2006

Automatic contributions	At least 3% of pay the 1st year
Automatic contribution increases	At least 4% the 2nd year, 5% the 3rd year and 6% the 4th year and thereafter, up to a maximum of 10%
Required employer contributions	For all low-paid workers, either a 100% match on the 1st 1% of pay contributed + a 50% match on contributions between 1%-6% of pay OR an across-the-board contribution of 3% of pay
Opt-out opportunity	On both participation and amount of contributions
Default investment options	Gives employers offering them protection from fiduciary liability
Other rules:	2 year maximum vesting period for employer contributions; applies only to new participants after plan adopts default options; rules effective as of 1/1/08

they require employers to contribute, it is not clear whether they will be attractive to small business employers. Auto contribution features will be attractive to corporate employers because they simplify contribution rules for 401(k) plans, but there are no incentives for employers to add them to 403(b)s or 457(b)s. They also have the potential to get workers into the habit of saving and educated about investing over time. But default savings rates are initially too low to accumulate sufficient assets for long-term needs such as retirement. If these features are popular, however, higher contributions will phase-in over time as these plans mature. On the other hand, workers may be unwilling to contribute at these higher levels and may decide to reduce their contributions to just the amount required to earn the matching employer contribution.

Future Agenda

Boosting savings for everyone requires building a more sensible American system of savings plans. Step one means striving for simplification. The current system has too many overlapping plans with overly complex and idiosyncratic rules. Because existing plans permit general purpose saving, there is little need for new plans unless they represent a net improvement by reaching out to new savers or fill an unmet need. A more sensible system for saving would enable savers to find and fund a savings plan easily.

It is important, however, to take a cautious approach to consolidating today's plans. Thirty years of experience have demonstrated the ability of intermediary plans to induce saving. A more sensible system for saving would not, as Congress seems inclined to do, spin-off more and more open access plans for special purpose saving. Intermediary plans have an advantage over open access plans through the savings support services they provide to workers and other savers. It is probably unrealistic, however, to expect the work-based plan system to expand significantly. Coverage in work-based

plans has been stagnant for decades, and it has probably reached its natural limit. So one sensible strategy for the future could be to embed saving in the workplace, but not necessarily through an employer-sponsored plan. One recent proposal argues for harnessing the payroll deduction facilities of employers for IRA contributions. These "automatic IRAs" would provide workers without an employer-sponsored plan with facilitated savings opportunities through work (Iwry and John 2006). This is just one proposal, but it provides a practical starting point for making connections between the workplace and saving where they don't exist today.

Step two means building better plans. A more sensible system for saving would move beyond the "build it and they will come" philosophy underlying today's plans. The next generation of savings plans requires a better science of plan design and greater understanding of the psychology of saving and savers. In addition, today's savings plans have been constructed around their tax incentives, but those only reward higher-income Americans. Expanding saving requires financial incentives independent of tax benefits that work for all savers, especially those with low- and moderate-incomes. A more sensible system for saving would be based on incentives for those savers who need them, not those who don't. It would include financial incentives that work for all, whether in the form of employer matching contributions, government subsidies, or some other strategy to increase the return to saving.

Step three means making saving more effective. That means recognizing that what really matters the most in the long run are savings outcomes. Historically, savings plan design has focused almost entirely on the first stage of saving—contributions and their tax incentives. But contributions alone do not make savings plans effective. A more sensible system for saving would set specific savings objectives and design plans

capable of achieving them. This requires focusing more on the second stage of saving—investments—and emphasizing their critical importance to adequate saving. Outcome-structured plans could also help reduce the difficult choices and uncertainties confronting today's savers.

This requires turning our usual thinking about designing savings plans upside down. It forces us to

start at the end and think of outcomes instead of just starting at the beginning and thinking only of inputs. This will require more sophisticated design techniques, tools, and strategies than are currently available. An outcome-centered system of saving holds promise as an innovative approach towards building the next generation of savings plans for a more sensible American system of saving.

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