Public Policy and Saving for Retirement: The "Autosave" Features of the Pension Protection Act of 2006

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On August 17, 2006, President Bush signed the Pension Protection Act of 2006 (PPA) into law, following its passage by both houses of Congress in a strong showing of bipartisan support.[1] This law, heralded by some as the most sweeping piece of pension reform legislation since the Employee Retirement Income and Security Act of 1974 (ERISA), contains many different pension reform provisions.[2] In this paper, we focus on a subset of measures within the PPA adopted specifically to promote better savings outcomes in defined contribution savings plans.

In particular, the Pension Protection Act encourages employers to structure their defined contribution savings plans to include the following features:

- Automatic enrollment—employees are automatically enrolled in the savings plan unless they explicitly choose to opt out.
- Employer contribution—the employer makes reasonably generous contributions to employee accounts, either on a non-contingent basis (independent of whether employees contribute anything themselves) or as a match on contributions made by employees.[3]
- Contribution escalation—participant contributions to the savings plan automatically increase over time for those who are enrolled.[4]
- Qualified default investment alternative (QDIA)—contributions are defaulted into a diversified portfolio that includes exposure to both equity and fixed income assets.[5]

The encouragement for employers to adopt these features comes in two forms. First, plans that adopt automatic enrollment with automatic contribution escalation and a sufficiently generous employer contribution are granted a safe harbor from annual non-discrimination testing. The non-discrimination tests are a set of regulations designed to ensure that the tax benefits of savings plan participation do not accrue disproportionately to employees deemed "highly compensated." To pass the non-discrimination tests, firms must demonstrate that the participation and savings rates of employees with compensation below the "highly compensated" income limit are sufficiently high relative to employees whose incomes are above the threshold.[6] Demonstrating compliance with the non-discrimination tests is costly to employers, and there are additional costs associated with restructuring savings plans to achieve compliance in the likely

[1] The bill was passed by the Senate in a 93-5 vote and by the House of Representatives in a 279-131 vote.
[2] See the U.S. Department of Labor's pension reform website for more details on all of the provisions contained in the Pension Protection Act (including the complete text of the 393-page act): http://www.dol.gov/EBSA/pensionreform.html.
[3] More specifically, employers can choose either a non-contingent contribution of 3% of pay for all of their employees (regardless of whether the employees choose to contribute themselves) or an employer match of 100% on the first 1% of pay contributed to the plan and 50% on further contributions to the plan up to 6% of pay (for a total matching contribution of 3.5% of pay if employees contribute at least 6% to the plan). A more generous non-contingent contribution or employer match would also qualify.
[4] The contribution rate begins at 3% or higher, and it then escalates by 1% each year until reaching a rate of at least 6% and no more than 10%. Contribution escalation could presumably continue beyond the 10% level with an explicit affirmative election on the part of employees.
[5] The regulations for qualified default investment alternatives specifically bless three different long-term investment options: life cycle or target retirement date funds, balanced funds, and professionally managed accounts (see http://www.dol.gov/ebsa/pdf/fsQDIA.pdf and http://www.dol.gov/ebsa/regs/fedreg/final/07-5147.pdf).
[6] The income threshold for classification as a "highly compensated employee" has increased over time, and is currently set at $105,000 for 2008.

event that a firm would not otherwise pass. The PPA safe harbor exempts employers from having to demonstrate compliance. More generally, the safe harbor sends a signal to firms about what the Internal Revenue Service (IRS) and the Department of Labor (DOL), which jointly regulate employee benefit plans, deem to be acceptable, and encouraged, plan design features.

The encouragement to adopt default investments that have exposure to both fixed income assets and equities comes in an entirely different form. Section 404(c) of ERISA affords employers relief from legal liability for losses resulting when participants in employer-sponsored savings plans direct the asset allocation of their investments (Putnam Investments). PPA extends 404(c) protection to default investments under automatic enrollment (and in other circumstances when participants fail to make an explicit asset allocation election) if these defaults satisfy certain requirements, including exposure to more than one asset class.[7]

Understanding the significance of these provisions of the Pension Protection Act requires some historical context. Up until the 1970s, most employers who provided retirement income benefits for their workers did so using traditional defined benefit pension plans. In 1975, there were 2.4 participants in defined benefit pension plans for every one participant in a defined contribution plan (Department of Labor, 2007). In the 1980s, however, the pension landscape began to change, precipitated by a series of new laws and regulations starting with the 1974 passage of ERISA. This act made it more costly and restrictive for employers to offer traditional defined benefit pension plans to their workers. ERISA was followed by the addition of section 401(k) to the Internal Revenue Code in 1978, and in 1981 an IRS clarification concerning the definition of taxable income allowed employers to exempt 401(k) contributions from taxable income.

While these latter actions were not intended to transform the pension landscape in the U.S., this in fact is what ensued. Section 401(k) gave firms a tax-favored option for providing retirement income benefits at a lower regulatory cost than the traditional defined benefit pension in the post-ERISA environment. What was originally intended as a supplemental savings vehicle instead resulted in a complete upheaval of the system of employer-provided pension plans. By the mid-1980s, both the number of defined benefit pension plans and the number of participants in these plans had started a decline that continues to this day. Picking up the slack, and then some, were defined contribution savings plans, headed by the 401(k). In 2004, the latest year for which data are available, defined contribution participants outnumbered defined benefit participants by a ratio of 2.5 to one, a striking reversal from the situation just 30 years earlier (Department of Labor, 2007).

Employers initially adopted a “Field of Dreams” approach to defined contribution savings plans in this new era—if we offer it, they will save. The premise behind this laissez-faire attitude is that individuals know what savings outcomes are in their best interest and will achieve these outcomes through their savings plan choices. Indeed, the hallmark of most defined contribution savings plans is choice—individuals choose whether or not to participate, how much to save, and how to allocate their assets.

[7] See http://www.dol.gov/ebsa/pdf/fsQDIA.pdf and http://www.dol.gov/ebsa/regs/fedreg/final/07-5147.pdf.

But the foundations underlying this presumption began to crumble as research slowly uncovered how well employees were actually utilizing defined contribution savings plans. In a series of surveys conducted periodically from 1991 to 2004, John Hancock Financial Services documented a striking lack of financial knowledge among defined contribution plan participants. In the most recent published version of the survey, 38% of respondents claimed that they had little or no investment knowledge, and two-thirds reported that they would be better off working with a financial advisor than managing their retirement investments on their own (John Hancock Financial Services, 2002). This self-perceived lack of expertise is corroborated by more objective measures of financial knowledge (Choi, Laibson and Madrian, 2007; Lusardi and Mitchell, 2006).

Of course, a lack of financial expertise need not be a problem if individuals can obtain advice from those who are more knowledgeable. But historically, the role of "retirement savings expert" was filled for many individuals by their employers through the provision of a defined benefit pension plan. Employers made the complicated calculations required to determine the level of income needed to maintain consumption in retirement; they determined how much money to set aside today to meet those needs in the future; and they were responsible for managing those assets that had been put aside to fund future pension benefits. All of these tasks were done with the help of highly trained financial professionals. But in the transition from defined benefit to defined contribution savings plans, many employers stepped out of this implicit role as financial advisor, leaving individuals to navigate the financial waters on their own with little in the way of guidance.

The implications of a widespread lack of financial expertise among defined contribution plan participants are clearly evident when examining the savings outcomes of individuals eligible to participate in such savings plans. Participation, contribution rates, and asset allocation outcomes are all heavily influenced by seemingly small changes in plan design in ways that are hard to rationalize with the transaction costs of making changes within the plan, especially given the importance of these outcomes for consumption in retirement.

Some of the strongest evidence on this front, and the rationale for both the encouragement of automatic enrollment and the QDIA regulations under PPA, comes from research on savings outcomes under automatic enrollment (Madrian and Shea, 2001; Choi, Laibson, Madrian and Metrick, 2002, 2004 and 2006; Beshears, Choi, Laibson and Madrian, 2008). The majority of defined contribution savings plans have historically required employees to proactively enroll in order to initiate participation. As part of the enrollment process, employees choose a contribution rate and an asset allocation. In contrast, under automatic enrollment employees are enrolled in the plan at a contribution rate and asset allocation pre-specified by the employer unless they either explicitly opt out of participation or proactively choose a different contribution rate and/or asset allocation. Note that automatic enrollment in and of itself does not alter the set of options available to employees. Employees have the choice to participate or not, and they retain the ability to select their own contribution rate and asset allocation. Automatic enrollment simply replaces one default (non-participation) with another (participation), but this seemingly small procedural change generates quite significant differences in savings outcomes.

Figure 1 shows the relationship between tenure (on the x-axis) and savings plan participation (on the y-axis) at a single large chemicals firm for three groups of employees: those hired before automatic enrollment was introduced, those hired under automatic enrollment with a default contribution rate of 3%, and those hired under automatic enrollment with a default contribution rate of 6%. There is a striking difference in participation rates between those hired before and those hired after automatic enrollment. At this firm, participation rates prior to automatic enrollment start out below 50% for newly hired employees and gradually increase to about 75% for those with more than two years of tenure. In contrast, participation rates for employees hired after automatic enrollment consistently exceed 90% once those employees who do not opt out have been swept into the savings plan in the third month of employment. Interestingly, the participation rate under automatic enrollment does not appear to depend on whether the default contribution rate is 3% or 6%.

These differences are particularly striking given the relatively low costs of effecting a change in participation status. In surveys, employees who have signed up for their employer's savings plan report that doing so took a little over an hour; similarly, employees who have not signed up estimate that it would take them a little over an hour to do so (Choi, Laibson and Madrian, 2007). This modest time cost is hard to reconcile with the rather substantial financial benefits from participation, the largest of which is the employer match (for example, the company in Figure 1 has a dollar-for-dollar match on contributions up to 6% of pay). There are other financial benefits as well, including the favorable tax treatment of contributions and the future benefits of consumption smoothing (of course, this latter must be weighed again the cost of decreased current consumption).

From Figure 1 it is not clear which, if any, of the tenure-participation profiles is closest to reflecting the true savings preferences of employees. Nothing in this graph rules out the possibility that many employees have very flat indifference curves when it comes to the tradeoff between current and future consumption and that they are roughly indifferent to saving 6% of their income (plus an additional 6% from the employer match) and saving nothing at all. Other evidence, however, leads us to the conclusion that most employees prefer automatic enrollment. First, the opt-out rate under automatic enrollment is low, both before and after automatic enrollment takes effect (Madrian and Shea, 2001; Choi, Laibson, Madrian and Metrick, 2002 and 2006). Moreover, most of those who opt out do so almost immediately—employees who are automatically enrolled do not appear to be deciding after the fact that they would rather not be contributing to their employer's savings plan. In contrast, when the default is non-participation, the rate at which employees opt in and begin participating is high, and this rate does not decrease dramatically after the first few months of tenure. Second, when employees are required to make an active decision within a relatively short time frame about whether or not to participate in their employer's savings plan (even when this choice is reversible in the future), participation rates are much higher than when employees do not face an arbitrary decision deadline and have the option to delay making a choice (Carroll et al., 2007). Finally, when asked, most employees state a preference to save more than they currently are (Choi, Laibson, Madrian and Metrick, 2002 and 2006; Thaler and Benartzi, 2004; Bernheim, 1995; Farkas and Johnson, 1997). Taken together, these various pieces of evidence suggest that most employees would in fact prefer to be participating in their employer-sponsored savings plan and that automatic enrollment is a useful mechanism for reducing the transaction costs of enrollment. This collection of research findings

provided the strong rationale to encourage employer adoption of automatic enrollment as part of the Pension Protection Act.

Automatic enrollment not only impacts participation status, but also contribution rates and asset allocations. Figure 2 shows the distribution of contribution rates for participants at a large food company both before automatic enrollment and under automatic enrollment when the default contribution rate was 3% and later when it was increased to 4%. Like the company shown in Figure 1, this company also provides a much on employee contributions up to 6% of pay. Before automatic enrollment, most participants (84%) elected to save at or above the 6% match threshold, and very few had a contribution rate of either 3% or 4%. The distribution of contribution rates under automatic enrollment is strikingly different. When the default contribution rate is 3%, 47% of participants have a 3% contribution rate; when the default contribution rate is 4%, a similar 49% have a 4% contribution rate. Under both automatic enrollment regimes, the fraction of participants saving at or above the match threshold is substantially lower, less than half of all participants, relative to the 85% observed savings at that level before automatic enrollment.

Just as employees tend to persist with the employer-chosen default participation status and default contribution rate under automatic enrollment, so too do they persist with the default asset allocation. Figure 3 shows the relationship between tenure and retention of the default asset allocation and default contribution rate for 4 different companies that have automatic enrollment. There are two things to note about Figure 3. First, the fraction of participants at these defaults is initially very high but declines with tenure as participants begin to elect their own contribution rates and asset allocations. Second, although the persistence of the default declines with tenure, there is still a high fraction of participants at the employer-chosen default even at relatively high levels of tenure (e.g. over three years). Although not shown in Figure 3, the default asset allocation tends to be slightly more persistent than the default contribution rate.

Figure 3 understates the persistence of the default asset allocation in one important dimension. Even when automatically enrolled participants choose to diversify out of the default fund, their movement away from the default tends to be incomplete relative to the asset allocation chosen by participants who were hired before automatic enrollment (Madrian and Shea, 2001; Choi, Laibson, Madrian and Metrick, 2004; Beshears, Choi, Laibson and Madrian, 2008). The presumed rationale for this persistence, even among those who choose to diversify, is that the default retains salience for participants because it has been implicitly endorsed by the employer. This endorsement effect also shows up in higher elective allocations to the default fund after a company adopts automatic enrollment, even among participants who were not themselves subject to automatic enrollment.[8]

Of course, the outcome that matters most at the end of the day is actual asset accumulation, which depends on all of the outcomes discussed so far: participation, contribution rates, and asset allocation. On this front, automatic enrollment has the potential to be a two-edged sword. Automatic enrollment clearly increases asset accumulation (at least within the

[8] A similar endorsement effect may influence employee allocations to employer stock, which are higher in firms that direct the employer match into employer stock relative to firms where employer stock is simply available as an investment option (Benartzi, 2001; Brown, Liang and Weisbenner, forthcoming).

savings plan) for employees who would not have participated otherwise—these employees are saving something instead of saving nothing. But how does it impact asset accumulation for employees who would have participated anyway? The answer to this question is less clear, and it hinges critically on how the default compares to what employees would have chosen in the absence of automatic enrollment.

Choi, Laibson, Madrian and Metrick (2004) show that for some of these employees who would have participated in the absence of automatic enrollment, there is no effect on asset accumulation—these employees opt out of the automatic enrollment defaults early on and choose the same contribution rate and asset allocation that they would have chosen without automatic enrollment. But other employees are heavily influenced by the automatic enrollment defaults. In the absence of automatic enrollment they would have eventually enrolled, and in all likelihood they would have chosen a contribution rate that equals or exceeds the match threshold and an asset allocation that contains substantial equity exposure. If the automatic enrollment default contribution rate is below what employees would have chosen without automatic enrollment, and if the default asset allocation has a much lower expected rate of return than the asset allocation that employees would have chosen on their own, the rate of asset accumulation will be much lower (in expectation) under automatic enrollment. Thus, automatic enrollment may lead some employees to participate earlier, but it may also reduce the rate at which their balances grow due to both lower incremental contributions and lower expected asset returns.[9] Over a long enough time horizon, these employees may actually be worse off as a result of automatic enrollment.

Whether it is likely that automatic enrollment will reduce asset accumulation for some employees depends on the nature of the automatic enrollment defaults adopted by employers. Many employers have historically chosen defaults—low contribution rates and conservative default funds—that could work against long-run asset accumulation. This possibility provides the rationale for two of the key components of PPA: the adoption of contribution escalation as a qualification for the PPA safe harbor, and the qualified default investment alternative (QDIA) guidelines.

The discussion of automatic enrollment so far has focused on companies that have adopted automatic enrollment with a static default contribution rate. While the PPA safe harbor allows for a fixed default contribution rate of 6% or higher, the baseline safe harbor plan design is automatic enrollment with a lower initial default contribution rate of 3% in conjunction with contribution escalation, specifically automatic annual contribution rate increases of 1% continuing until participants have reached at least a 6% contribution rate and not to exceed a 10% contribution rate.

Benartzi and Thaler (2004) document the effectiveness of contribution escalation at increasing employee savings rates. At the firm they study, employees who opted into an automatic annual 3% increase in their contribution rate saw their average contribution rate increase almost four-fold, from 3.5% of pay to 13.5% of pay, over the course of four years. In

[9] Of course, lower expected asset returns may be acceptable or even desirable to the extent they are associated with less risk. However, standard economic theory suggests that individuals should be willing to take on at least some stock market risk, so it seems that some exposure to the higher expected returns of equities is attractive from a normative standpoint.

contrast, employees who did not elect contribution escalation saw their average contribution rate increase by much less over the same time period, from 5.3% to 7.5%. Interestingly, this latter group started out saving much more than those who opted into contribution escalation, but the relative positions were reversed four years later. As might be expected given the evidence on automatic enrollment, contribution escalation is much more prevalent when combined with automatic enrollment than when participants must opt in. In firms where contribution escalation is an option but is not automatic, about 25% of savings plan participants sign up; in contrast, when contribution escalation is combined with automatic enrollment, only 15% of participants opt out, so that 85% of participants are subject to future automatic contribution increases (Benartzi, Peleg and Thaler, 2007).

The combination of automatic enrollment with contribution escalation works to mitigate the potential drag on long-term asset accumulation that results under automatic enrollment when employers choose a low default contribution rate, from which many participants will not deviate by taking action to choose something higher. This approach takes the participant inertia that makes automatic enrollment so successful at increasing participation rates and makes it work to increase their contribution rates over time as well. As noted above, however, picking a higher initial contribution rate is also an option (either with or without contribution escalation). Relative to the PPA benchmark (3% initial contribution rate with contribution escalation), picking a higher initial contribution rate also with contribution escalation will clearly lead to the greatest level of asset accumulation in both the short and the long term, provided that it does not result in significantly higher opt-out rates. Picking a higher initial contribution rate without contribution escalation will lead to higher asset accumulation than the PPA baseline in the short run, but may result in lower asset accumulation in the long run (because contributions do not automatically increase).

As with contribution escalation, the qualified default investment alternative (QDIA) guidelines also work to mitigate the potential drag on long-term asset accumulation that can occur under automatic enrollment. In this case, the pertinent issue is the lower expected investment returns that accompany the adoption of conservative default funds. The rationale that many employers have given in the past for their selection of these conservative defaults is a desire to forestall potential 401(k) participant lawsuits should the default fund decline in value; by choosing a default fund designed to preserve principal, this risk is minimized (if not eliminated). PPA diminishes this rationale for selecting a conservative default by shielding plan sponsors from legal liability if the default fund they choose satisfies certain conditions. These conditions include a requirement for diversification (which precludes using a single asset, such as employer stock, as a QDIA default) and exposure to both equity and fixed income assets. The QDIA regulations describe three specific long-term investment options that satisfy these requirements: life cycle or target retirement date funds, balanced funds, and professionally managed accounts. Funds designed to preserve principal are only allowed as a QDIA default during the first 90 days of an individual's employment. This exception to the more general regulations is included because PPA gives employees 90 days to retroactively opt out of automatic enrollment without a tax penalty, and some plan sponsors argued that it would be less costly to allow employees to retroactively opt out of automatic enrollment with a conservative default than with the long-term defaults that qualify under the regulations.

The discussion above describes the evidence behind and rationale for the autosave and QDIA regulations that are part of PPA. Another important part of the story, however, is how the provisions came to be actually incorporated into law.

McDonald's is commonly cited as the first company to have adopted automatic enrollment in its 401(k) plan, in 1984.[10] By the mid-1990s, a handful of other companies had also adopted automatic enrollment. The oft-cited motivation for doing so was to increase participation rates sufficiently among lower-paid employees that the firm would pass the non-discrimination tests and maintain its tax-qualified status. There were some questions, however, as to the permissibility of automatic enrollment—could employers legally withhold employee contributions to an employer-sponsored savings plan without the affirmative consent of employees, and could the absence of a "negative election" (that is, opting out) under automatic enrollment be construed as approval to do so?

In 1997, a Treasury Department staffer requested an IRS decision on the permissibility of 401(k) automatic enrollment. The staffer's request was initially denied—the investment of scarce resources for the legal comfort of a small number of companies that had not formally requested such a decision did not appear warranted. But further reflection led some at the Treasury Department to recognize that automatic enrollment held the potential to increase savings and improve retirement security for millions of Americans. An affirmative ruling on the permissibility of automatic enrollment might lead to more widespread adoption. And so, in 1998, Treasury/IRS issued Revenue Ruling 98-30, which set out a permissible scenario for 401(k) automatic enrollment.

In contrast to private rulings, which are issued in response to a directed question by a private party, revenue rulings are more generic. The scenario in Ruling 98-30 involved a hypothetical company using automatic enrollment with a 3% default contribution rate invested in a balanced fund and an employer match that was not directed into employer stock. These seemingly ancillary details about the employer match were chosen quite purposefully. The staff at Treasury had two concerns about automatic enrollment. First, they were worried that firms that had adopted an employer match as an encouragement for broad-based savings plan participation in order to satisfy the non-discrimination rules would see automatic enrollment as a substitute for offering an employer match, a move that could nullify or even reverse the savings increases that might otherwise occur under automatic enrollment. Second, they were worried that automatic enrollment could be manipulated by employers to funnel employee and employer contributions into employer stock in order to inflate stock prices. For firms interested in implementing a 401(k) automatic enrollment scheme with the blessing of the IRS, the safest course of action would be to emulate the ruling's example precisely—that is, with the provision of an employer match that was not directed into employer stock.

This initial ruling was followed by a June 1998 speech by President Clinton in which he endorsed automatic enrollment as a mechanism for increasing savings. Despite a belief within Treasury that automatic enrollment should be heavily endorsed, there were concerns that moving too quickly could backfire politically. Automatic enrollment could be perceived as being too

[10] Interestingly, McDonald's abandoned automatic enrollment in 2002, just as it was gaining in popularity among other employers.

overtly paternalistic, or its promotion could be viewed as yet another burdensome employer obligation. Either of these outcomes could result in Congressional action to block 401(k) automatic enrollment programs.

Advancing an agenda of 401(k) automatic enrollment adoption beyond the initial ruling became a strategic matter about how best to nudge employers toward automatic enrollment schemes with desirable features without stirring up too much political controversy. And so Treasury/IRS began issuing a series of successively more expansive rulings meant to illustrate the different types of plans and different types of automatic enrollment deemed acceptable.

Treasury/IRS Rulings and Announcements on Automatic Enrollment	
Revenue Ruling 98-30	Automatic enrollment permitted in 401(k) plans for new hires
Revenue Ruling 2000-8	Automatic enrollment permitted in 401(k) plans for current employees and new hires
Revenue Ruling 2000-35	Automatic enrollment permitted in 403(b) plans for employees of public schools, other educational and charitable organizations
Revenue Ruling 2000-33	Automatic enrollment permitted in 457(b) plans for state and local government employees
Announcement 2000-60	Automatic enrollment permitted in IRS-approved prototype 401(k) plans (standardized plans used largely by small businesses)
Source: U.S. Treasury Department, 2000	

This strategizing on the part of Treasury coincided with the emergence of the first research findings on how automatic enrollment and contribution escalation impact savings outcomes. Although Treasury officials had worried about both the potential impact of automatic enrollment on the continued provision of an employer match and its potential for abuse as a way to direct savings plan assets into employer stock, neither of these fears seemed to have been realized in practice. The biggest drawback to automatic enrollment was one that had not been anticipated—the persistence of the default options chosen by employers. As discussed above, if an employer adopted a default contribution rate below that which employees tended to choose on their own, individuals who might have saved at a high level in the absence of automatic enrollment might instead start out saving at a lower contribution rate by default under automatic enrollment and then, by inertia, remain there. If such an effect were prevalent, 401(k) automatic enrollment could have a neutral, or even a negative, net effect on retirement savings in the long term. Similarly, if employers adopted conservative default funds with an expected rate of return below that of the assets employees would otherwise choose for themselves, account balances might not grow as quickly with automatic enrollment as without it.

Although the revenue rulings issued by IRS/Treasury all used a balanced fund as the default investment option, most early adopters of automatic enrollment opted for much more conservative money market or stable value funds as their defaults. As discussed previously, the reluctance of employers to choose somewhat riskier default funds with higher expected rates of return was largely due to an abundance of precaution—employers were concerned that a default

fund which declined in value could give rise to a 401(k) participant class-action lawsuit. There was little more that Treasury could do on this front given that its existing revenue rulings already specified higher-yielding defaults (balanced funds). But Treasury could encourage both higher initial default contribution rates and contribution escalation. Revenue ruling 2000-35 specified a 4% default contribution rate, in contrast to the 3% default rate specified in the earlier rulings (98-30 and 2000-8). This was followed in 2004 by an IRS general information letter[11] which clarified that employers have substantial leeway in structuring default contributions under automatic enrollment, including default contribution rates that are higher (or lower) than those used in previous revenue rulings, default contribution rates that are higher (or lower) than the employer match threshold, and default contribution rates that increase over time, that is, automatic contribution escalation.

As the results of the academic research cited earlier began to diffuse, both automatic enrollment and contribution escalation started to gain traction with employers, savings plan administrators, and benefits consultants. The staunchest opponents were those who felt that automatic enrollment and automatic contribution escalation smacked of paternalism. But these concerns were largely allayed with the argument that with or without automatic enrollment and contribution escalation, a company savings plan has a default; the question is simply what that default should be.

The discomfort some employers felt in adopting automatic enrollment was not entirely philosophical—there were several legal issues that made many employers reluctant to adopt so-called autopilot 401(k)s. Some companies did not feel adequately shielded from state laws that prohibit employers from withholding money from an employee's paycheck without consent. Other companies were concerned about the potential legal liability associated with choosing a default fund that would likely be the repository of a significant fraction of the plan's assets going forward. And still others were concerned about the tax implications of automatic enrollment for employees who did not want to participate in the savings plan but who did not opt out of participation before the enrollment deadline—these employees would incur a 10% tax penalty if they tried to recover the contributions they had inadvertently made. Congressional action was required to address these concerns.

Peter Orszag and Mark Iwry of The Retirement Security Project took the lead in incorporating into the Pension Protection Act provisions that would encourage employers to adopt automatic enrollment and contribution escalation (including clearing out the legal underbrush mentioned above) and in pushing the legislation through Congress. The sell was not a difficult one—most of the key political constituencies were quickly convinced that automatic enrollment was aligned with their own interests. Employee support for automatic enrollment was widespread, leading to the backing of labor unions.[12] Employers were generally in favor—the proposed legislation would grant relief from non-discrimination testing to employers that adopted sufficiently generous forms of automatic enrollment, but employers would not be required to adopt automatic enrollment if they did not want to. The financial sector recognized that automatic enrollment and contribution escalation would increase assets that they would

[11] A general information letter is a device used by the IRS when a ruling does not seem necessary because a point is sufficiently obvious but may require clarification.
[12] See Harris Interactive (2007) for evidence on widespread employee support of automatic enrollment.

manage. The failure of Social Security reform spurred an interest in promoting increased private savings among both conservatives and liberals, and although liberals were generally more inclined to support strengthening traditional defined benefit pension schemes, they came around based on the evidence that automatic enrollment had the largest beneficial impact on the savings outcomes of lower-income individuals and minority groups. In the words of Peter Orszag, automatic enrollment "had become like apple pie on Capitol Hill—everyone was for it."[13]

Orszag attributes the success of the autosave features in the Pension Protection Act to three factors.[14] First, there was clear and compelling evidence that automatic enrollment was an effective means of increasing savings and improving economic wellbeing, particularly of minorities and of the poor. The evidence and the theory behind automatic enrollment and contribution escalation were transparent and convincing. Second, the results of the economic research on the isolated adoption of automatic enrollment and contribution escalation were clearly scalable and conformed to intuition and to experience. Third, as noted above, the effects of automatic enrollment appealed to both sides of the political aisle.

The U.S. is not the only country to recognize the potential impact that automatic enrollment can have on savings outcomes. In New Zealand, the KiwiSaver Act adopted in 2006 creates a new national program based on automatic enrollment to supplement the existing superannuation scheme. On the other side of the Atlantic, the United Kingdom's Pensions Act of 2007 also incorporates automatic enrollment as part of its pension system reforms. While it is too early to determine the efficacy of these programs, widespread take-up of 401(k) automatic enrollment in the United States is encouraging, inspiring Orszag to declare the autosave features of the Pension Protection Act "a stunning example of the success of behavioral economics in effecting public policy."[15]

[13] Interview with Peter Orszag, July 3, 2007.
[14] Ibid.
[15] Ibid.

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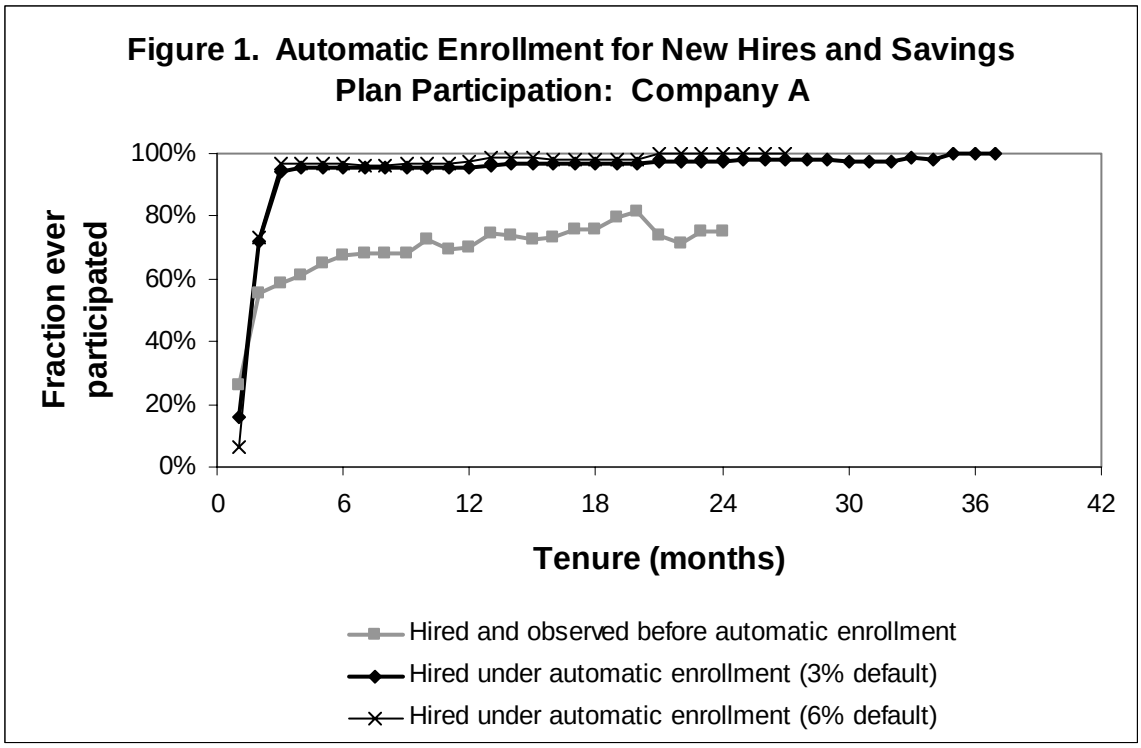

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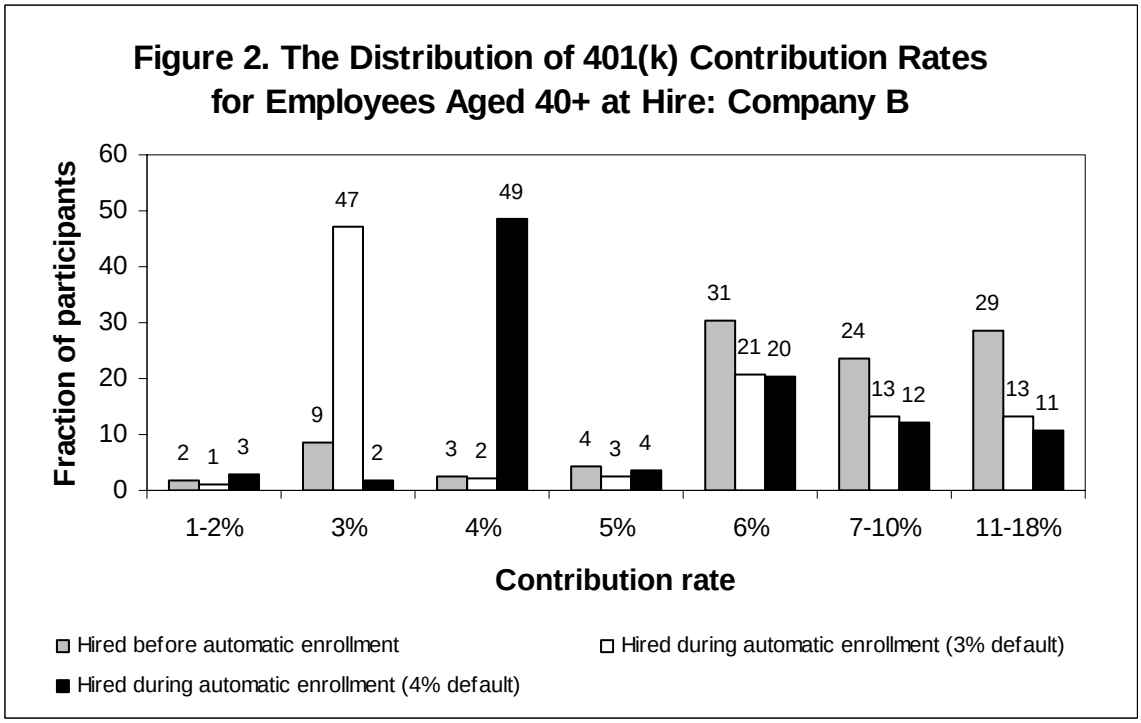

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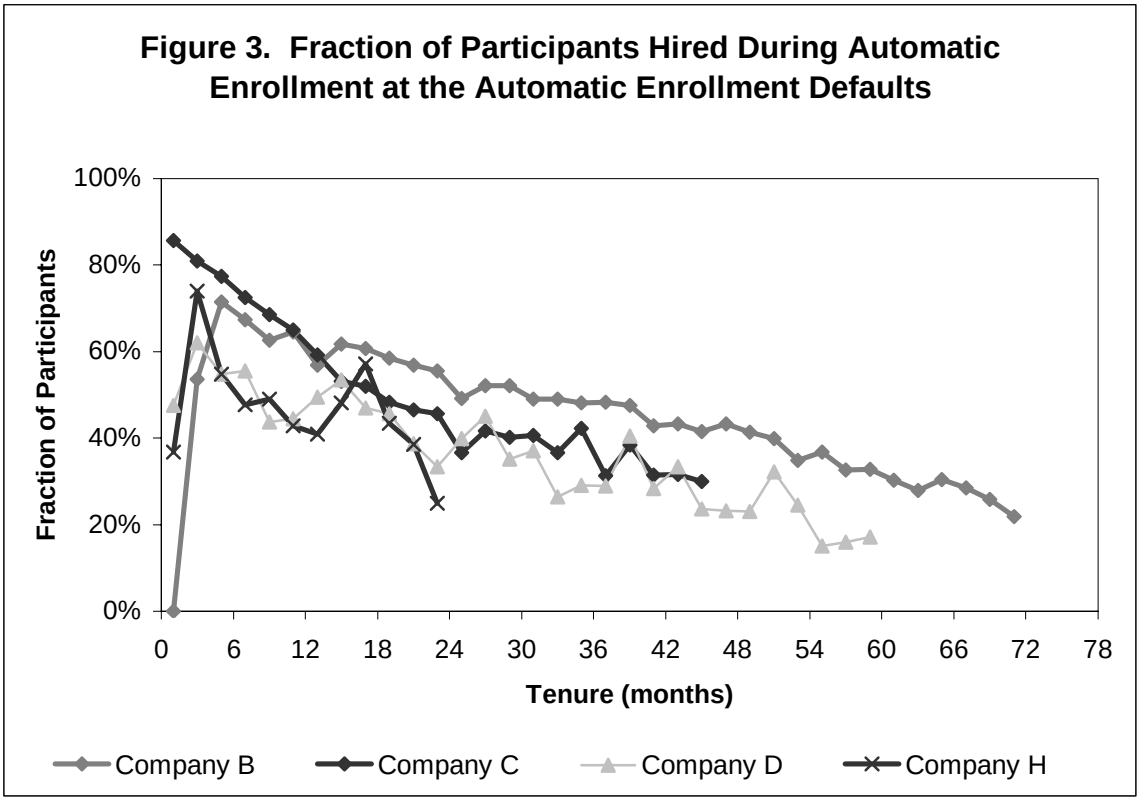

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