ARTICLE

RETHINKING 401(k)S

JEFF SCHWARTZ*

In this Article, I argue that 401(k) plans make for bad public policy. The substantial tax subsidy upon which these plans are founded is allocated inefficiently and inequitably; many who could benefit from 401(k)s lack access to them; and those fortunate enough to participate are left ill-positioned to make wise financial decisions and withstand stock-market turbulence. To cure these ills, I recommend a replacement. This alternative would be similar to the 401(k) setup in that each investor would have a private investment account. But it would differ in three fundamental respects. First, unlike 401(k)s, everyone would have the opportunity to participate. Some individuals would be enrolled in the program by default but would be free to opt out. Second, rather than provide a tax subsidy, the government would match a certain portion of the savings of low- and middle-income earners. Third, this plan would include a default investment alternative that would provide participants with the potential for reasonable returns along with significant protection from down-side risk. By broadening access, reconfiguring the government's financial support, and providing a thoughtful default investment, this reform proposal promises to remedy much of what ails our current approach.

I. INTRODUCTION

The rise of 401(k) plans happened swiftly and dramatically. Since their introduction in the early 1980s, 401(k)s have accumulated an impressive $2.8 trillion in retirement savings and, as a result, have become a central component of United States pension policy.[1] Their startling ascendancy, however, was not the realization of a farsighted policy agenda. Rather, the rapid spread of these savings devices, in which employees receive favorable tax treatment for investing in employer-sponsored retirement vehicles, was an unintended consequence of a seemingly mundane tax-code revision enacted to resolve a simmering debate about the taxation of deferred compensation.[2]

Unintended consequences are often the bane of regulation, but perhaps in this case, the opposite is true. The ascension of 401(k)s could be seen as a

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* Associate Professor of Law, California Western School of Law; J.D., University of California at Berkeley School of Law (Boalt Hall). I wish to thank Edward Dauer, Andrea Freeman, Julie Hill, Colin P. Marks, Joanna K. Sax, Matthew P. Schaefer, and Paul M. Secunda for their valuable comments on earlier drafts of this Article. I also received helpful comments at the Law and Society Annual Meeting in San Francisco, California, and the Junior Law Faculty Workshop at the Arizona State University Sandra Day O'Connor College of Law. Jeff Faillers provided excellent research assistance.

[1] *See* INV. CO. INST., 2010 INVESTMENT COMPANY FACT BOOK 102 (50th ed. 2010) [hereinafter ICI FACT BOOK].

[2] *See* EDWARD A. ZELINSKY, THE ORIGINS OF THE OWNERSHIP SOCIETY: HOW THE DEFINED CONTRIBUTION PARADIGM CHANGED AMERICA 93–97 (2007).

happy accident, their success a reflection of public-interest merit that regulators failed to foresee. Indeed, many influential voices have lauded the contribution that 401(k)s have made to retirement savings.[3] In this Article, however, I take a less sanguine position. I argue that while the 401(k) system may be of help to some, it also wastes billions of dollars a year, exacerbates economic inequality, and leaves 401(k) participants overly exposed to the Janus-faced nature of financial markets. Given all of this, I argue that rather than continue to rationalize policy inertia, we should think about reform.

To that end, I propose a replacement to the 401(k) that responds to the ills just listed. The core of this new savings program is that low- and middle-income earners would, by default, have a portion of their earnings diverted into a carefully-chosen default investment, where a portion of their savings would be matched by the government and guaranteed against losses. These individuals would be free to opt out of the program before they are enrolled or at any time thereafter and, assuming they remain, they would be free to choose from a wide array of investments other than the default plan. This pension program is specifically designed to cure the deficiencies in the 401(k) system: (1) it saves governmental and individual resources by shrinking the employer's role in retirement savings and by providing retirement savers with a sound default investment alternative; (2) it reduces economic inequality by targeting the program at those at the more modest end of the wage scale; and (3) it better insulates individuals from market turbulence by providing savers in the default investment with protection against severe losses.

I present my argument for reform in three parts. First, I briefly describe 401(k) plans and how they fit into pension policy. Second, I flesh out the problems with 401(k)s. In doing so, rather than present a laundry list of issues, I organize my critique according to the key underpinnings of social policy—efficiency and fairness. I argue that the waste, inequity, and excessive exposure to risk in our current system offend both of these regulatory goals. Third, I present my proposed substitute, which is a significant departure from today's accidental status quo.

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[3] *See, e.g.*, Editorial, *The Government and Your Pension*, WASH. TIMES, Feb. 8, 2002, at A22; Martin Feldstein, *Board of Contributors: Don't Waste the Budget Surplus*, WALL ST. J., Nov. 4, 1997, at A22; Stephen Moore, *The Wages of Prosperity*, WALL ST. J., Aug. 29, 2005, at A9; Robert L. Reynolds, *The Next Generation*, WALL ST. J., Nov. 28, 2005, at A17; President George W. Bush, Radio Address by the President to the Nation: President Acts to Protect Pensions and Retirement Security (Oct. 19, 2002) (transcript available at http://georgewbush-whitehouse.archives.gov/news/releases/2002/10/20021019.html) (lauding 401(k)s as a way to "build economic security over a lifetime," an "opportunity to build wealth and independence," and a "chance to invest in the long-term growth of the American economy"). As discussed *infra* Part II, 401(k)s are the centerpiece of the defined contribution paradigm. This paradigm served as the ideological foundation for George W. Bush's vision of an "ownership society." *See* ZELINSKY, *supra* note 2, at xiii.

II. 401(k)s and Pension Policy

Retirement policy is often described as a three-legged stool consisting of Social Security, private pensions, and personal savings.[4] Social Security provides workers with an annuity in retirement scaled to reflect their preretirement earnings; private pensions are government- and employer-subsidized savings schemes; and personal savings are simply what individuals manage to put away for retirement on their own.[5]

Private pensions, the category to which 401(k)s belong, play an essential role, particularly given the stress on the other two legs of the stool. On the one hand, Social Security faces continuous questions about its solvency[6] and, even if the program makes good on its promises, the annuity stream it provides is insufficient to meet people's needs in retirement.[7] At the same time, personal savings in the United States is meager.[8]

The traditional private pension is the defined benefit plan. In these plans, employers promise to provide their employees with a portion of their preretirement income in retirement.[9] Such plans, however, are on the decline and now cover only a small portion of the population.[10] So-called defined contribution plans have taken their place. In defined contribution plans, employers facilitate retirement savings by their employees and may make contributions to their employees' retirement accounts.[11] Unlike providers of traditional pensions, in this type of plan, employers do not promise their employees a set amount post-retirement.

401(k)s are a type of defined contribution plan—and they are by far the most important. 401(k)s already hold the vast majority of defined contribu-

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[4] *See* Alicia H. Munnell & Annika Sundén, Ctr. for Ret. Research at Boston College, Issue in Brief No. 43, 401(k) Plans are Still Coming Up Short 1 & fig.1 (2006).

[5] *See* Teresa Ghilarducci, When I'm Sixty-Four: The Plot Against Pensions and the Plan to Save Them 139–43 (2008) (describing Social Security); Alicia H. Munnell et al., Ctr. for Ret. Research at Boston College, Issue in Brief No. 8, How Important Are Private Pensions 1–2 (2002) (discussing private pensions); Munnell & Sundén, *supra* note 4, at 2 (discussing personal savings).

[6] *See* Ghilarducci, *supra* note 5, at 145–53.

[7] *See* Munnell et al., *supra* note 5, at 9. For an adequate retirement, retirees require enough savings to replace roughly 80% of preretirement income. *Id.* For the median earner, however, Social Security replaces 41% and this figure is forecast to fall. *See* Alicia H. Munnell, Ctr. for Ret. Research at Boston College, Just the Facts No. 6, The Declining Role of Social Security 1 (2003).

[8] *See* Munnell & Sundén, *supra* note 4, at 2.

[9] *See* Ghilarducci, *supra* note 5, at 333.

[10] *See* Dave Carpenter, *Baby Boomers Near 65 with Retirements in Jeopardy*, Associated Press, Dec. 27, 2010, *available at* http://finance.yahoo.com/news/Baby-boomers-near-65-with-apf-654311409.html (reporting that only 15% of private-sector workers have defined benefit plans).

[11] *See* Ghilarducci, *supra* note 5, at 333.

tion plan assets and their numbers swell each year.[12] As defined benefit plans fade, questions about Social Security linger, and personal savings stagnate, 401(k)s have assumed a central role in the pension-policy edifice.

These plans have several key features. The first is favorable tax treatment.[13] Employees make plan contributions with pre-tax dollars. The contributions and investment returns are not taxed until they are withdrawn.[14] The benefit here is two-fold. Taxpayers always prefer to delay paying taxes because of the time value of money. Additionally, the expectation is that when money is eventually withdrawn from 401(k) plans, the saver will have retired and will therefore be in a lower tax bracket than when the money was earned. Thus, tax liability is not only deferred, but also theoretically decreased. These benefits do, however, come with a couple of key caveats. There are set limits each year with respect to how much an employee may contribute[15] and withdrawals before the age of 59½ are penalized.[16]

Employers are not required to set up these plans. Frequently, when employers do offer this benefit, they also match a certain portion of their employees' contributions.[17] In a typical setup, an employer agrees to match 50% of an employee's contribution for a total of up to 3% of that employee's salary.[18] Employee and employer contributions are then invested through the 401(k) plan.

Where to invest the money is up to employees, but employers dictate what options are available. All employers who sponsor 401(k)s end up serving as intermediaries between their employees and the marketplace for mutual funds and other potential investment vehicles. To help them fulfill this role, employers hire third parties, typically mutual-fund companies, to administer their 401(k) plans. Employees then have access to some subset of the investments offered by the chosen provider, typically different types of

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[12] *See* ICI FACT BOOK, *supra* note 1, at 102 fig.7.6. 401(k)s and their close relatives, the 403(b) plan and the 457 plan, which are essentially 401(k)s for nonprofit and government employees respectively, together hold nearly 90% of defined contribution plan assets. *See id.*

[13] *See* ALICIA H. MUNNELL & ANNIKA SUNDÉN, COMING UP SHORT: THE CHALLENGE OF 401(K) PLANS 6–7 (2004).

[14] This paper is focused on traditional 401(k)s, although Roth 401(k)s also exist. In a Roth 401(k), employees contribute post-tax dollars. The benefit in this case is that the earnings on contributions go untaxed. *See* William G. Gale et al., *An Analysis of the Roth 401(k)*, TAX NOTES, Jan. 9, 2006, at 163.

[15] *See* I.R.C. § 402(g) (2006 & Supp. II 2008) (limiting the amount of pre-tax contributions); I.R.C. § 415(c) (2006 & Supp. II 2008) (limiting the amount of annual contributions to defined contribution plans).

[16] *See* I.R.C. § 72(t)(1) (2006 & Supp. IV 2010); I.R.C. § 72(t)(2)(A)(i) (2006 & Supp. IV 2010); GHILARDUCCI, *supra* note 5, at 331.

[17] *See* TRANSAMERICA CENTER FOR RETIREMENT STUDIES, THE EMPLOYERS' PERSPECTIVE ON RETIREMENT BENEFITS AND PLANNING: 11TH ANNUAL TRANSAMERICA RETIREMENT SURVEY 62 (2010) [hereinafter TRANSAMERICA EMPLOYERS STUDY], *available at* http://www.transamericacenter.org/resources/TCRS%2011th%20Annual%20Employer%20Report_FINAL.pdf.

[18] *See* John Beshears et al., *The Impact of Employer Matching on Savings Plan Participation Under Automatic Enrollment*, *in* RESEARCH FINDINGS IN THE ECONOMICS OF AGING 311, 312 (David A. Wise ed., 2010). To get the full match under this scenario, employees must contribute 6% of their salaries.

mutual funds. Depending on the structure of the plan, they may also be able to invest their money in their employers' stock or may even have access to a so-called brokerage window, which gives them the opportunity to participate in an even broader array of investments.[19]

The Employee Retirement Income Security Act of 1974 ("ERISA") codifies the employer's obligations in fulfilling its intermediary role.[20] The law provides that employers are fiduciaries in this capacity and, that being the case, imposes extensive fiduciary duties upon them.[21] Like all fiduciary obligations, the employer's duties in this regard are a bit amorphous. Most important in the 401(k) context, however, is that employers must prudently select and monitor the chosen provider and the investment alternatives it offers.[22] Also important in this context is that employers can avoid potential fiduciary liability for employee losses arising out of their own investment decisions if employers comply with Section 404(c) of the code.[23] The rule and its accompanying regulations have a number of detailed requirements, but in brief, compliance with 404(c) requires that employers provide employees with a broad range of investment options and sufficient information to make a reasonably-informed choice among them.[24] Overall, the fiduciary duties are less aimed at casting the employer as a paternalistic overseer of employee investing than they are at preventing employees from being given inadequate options and information as a result of their employers' self-interest or negligence.

III. Problems with the 401(k) Paradigm

A look back at the above description reveals that the 401(k) paradigm rests on three key traits: (1) individuals are free to allocate their portfolios largely on their own and, commensurately, bear portfolio risk alone; (2) employers are cast as pension intermediaries; and (3) 401(k) investing is afforded favorable tax treatment. In this section, I discuss the fairness and efficiency concerns associated with each of these traits.

[19] *See* Sarah Holden et al., *The Economics of Providing 401(k) Plans: Services, Fees, and Expenses, 2010*, ICI Res. Persp., June 2011, at 9; *see also* Hecker v. Deere and Co., 556 F.3d 575, 578 (7th Cir. 2009) (describing plan at issue in this recent case concerning 401(k) fees). A brokerage window allows a 401(k) account to be treated like a brokerage account, which gives employees the option of buying and selling a wide array of securities. *See* Ron Lieber, *Seeking Investment Flexibility in a 401(k)*, N.Y. Times, July 9, 2011, at B1.

[20] *See* 29 U.S.C. §§ 1001–1461 (2006).

[21] *See* 29 U.S.C. § 1104(a)(1)(B) (2006).

[22] *See* 29 C.F.R. § 2550.404a-5(a), (f) (2011).

[23] *See* 29 C.F.R. § 2550.404c-1 (2006).

[24] *See id.*

A. *Individual Sovereignty*

1. *Individual Portfolio Management*

Current pension policy leaves investors largely to their own devices when it comes to deciding how to allocate their retirement savings among 401(k) investment alternatives.[25] As discussed above, although employees have peripheral fiduciary protection, at the end of the day, how they invest their money is up to them. While this light-touch approach comports with traditional liberal ideals, it is also a source of inefficiency.

a. *Efficiency Concerns*

Government should strive to maximize social welfare;[26] its success in this regard can be characterized in terms of "efficiency."[27] An efficient government policy is one that closely fits this goal.[28] Inefficient policies, in contrast, fail to directly and coherently respond to social-welfare concerns (i.e., inefficiency in society).[29]

401(k)s are inefficient because they allow for a great deal of waste. Because waste undermines welfare, government should favor policies that seek to minimize the wasteful expenditure of personal and governmental resources. Sometimes government restraint is the best way to do this. Staying out of the way is good public policy in situations where we can expect individuals to pick out products that best fit their needs.[30] In these cases, there are no wasteful expenditures to combat. Where decisionmaking is suspect, however, well-reasoned and narrowly targeted government intervention aimed at aiding decisionmaking offers the potential to improve the status

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[25] The Department of Labor has conducted modest retirement-savings outreach as called for by the SAVERS Act of 1997. *See* H.R. 1377, 105th Cong. (1997). Previous to 2006, ERISA rules discouraged employers from providing their employees with investment advice. Advice, however, is now permitted under the Pension Protection Act of 2006. *See* Jon O. Shimabukuro, Cong. Research Serv., RS22514, Investment Advice and the Pension Protection Act of 2006 1 (2008).

[26] This is a key tenet of welfare economics. *See* Louis Kaplow & Steven Shavell, *Fairness Versus Welfare*, 114 Harv. L. Rev. 961, 977 (2001). This goal has also been embraced by the federal government. *See* Office of Mgmt. & Budget, Circular A-4: Regulatory Analysis 1–3 (Sept. 17, 2003) [hereinafter Circular A-4], *available at* http://www.whitehouse.gov/sites/default/files/omb/assets/regulatory_matters_pdf/a-4.pdf.

[27] *See* Kaplow & Shavell, *supra* note 26, at 997 & n.71.

[28] *See id.*; Circular A-4, *supra* note 26, at 1–3.

[29] *See* Circular A-4, *supra* note 26, at 10–14; Kaplow & Shavell, *supra* note 26, at 997 & n.71.

[30] Good choices should lead to competitive markets for goods and services, which generate societal progress as rivals continuously compete to offer better and cheaper offerings. One caveat, which is not relevant in the 401(k) context, is that intervention may be warranted even if market actors are making good decisions from their own perspectives if such decisions have deleterious third-party consequences (so-called negative externalities).

quo.[31] Failure to intervene in these cases allows for costly mistakes. The formulation of efficient policy, therefore, depends on an assessment of how individuals perform in particular contexts. Because investing is an area where individuals struggle mightily, our current noninterventionist approach is questionable.

One problem is a knowledge gap. Study after study shows that Americans possess little financial acumen, both generally and when it comes to investing.[32] Moreover, with respect to 401(k) investors, there is particular reason for concern. In a recent survey, about 50% rated themselves as "not very experienced" or "not at all experienced" in investing.[33] Perhaps this is because 401(k) participants do not relish the opportunity to invest. The same survey labeled 62% of 401(k) participants as "accidental investors," because they "typically invest only [in their 401(k)s], they don't enjoy investing, and they don't pay much attention to what they invest in."[34]

Once investors do reluctantly turn to their portfolios, their decisions are likely marred by various behavioral biases. The list of biases that potentially undermine investing is diverse and lengthy,[35] but the following appear particularly relevant: (1) people are overconfident; and (2) they are bad at probabilities.[36] While it is difficult to establish a causal link between particular biases and particular behaviors, I mention these because, at least as a matter of inferential reasoning, they appear linked to the cursory nature of the typical investor's financial analysis. As we might expect from investors who are overconfident and statistically naïve, rather than engage in a thoughtful comparison of competing alternatives, most rely on intuition, ad-

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[31] This is a key tenet of market-failure analysis. *See* Jeff Schwartz, *Reconceptualizing Investment Management Regulation*, 16 GEO. MASON L. REV. 521, 524–30 (2009) (discussing market-failure analysis in the mutual-fund context).

[32] *See* OFFICE OF INVESTOR EDUC. & ASSISTANCE, SEC, THE FACTS ON SAVING AND INVESTING 14–19 (1999) [hereinafter FACTS ON SAVING AND INVESTING] (compiling research showing the public's lack of comfort with basic financial concepts and ignorance of investing basics); FINRA INVESTOR EDUC. FOUND., FINANCIAL CAPABILITY IN THE UNITED STATES: NATIONAL SURVEY—EXECUTIVE SUMMARY 17–20 (2009) [hereinafter FINRA STUDY], *available at* http://www.finrafoundation.org/web/groups/foundation/@foundation/documents/foundation/p120535.pdf; Annamaria Lusardi, *Household Saving Behavior: The Role of Financial Literacy, Information and Financial Education Programs* 13–17 (Nat'l Bureau of Econ. Research, Working Paper No. 13824, 2008); Annamaria Lusardi & Olivia S. Mitchell, *Financial Literacy and Retirement Preparedness: Evidence and Implications for Financial Education* 1–6 (Univ. of Mich. Ret. Research Ctr., Working Paper No. 2006-144, 2006).

[33] *See* ALLIANCEBERNSTEIN, INSIDE THE MINDS OF PLAN PARTICIPANTS 5 (2009) (author's calculation based on statistics on page 5).

[34] *Id.* at 2. Perhaps as a result of their distaste for investing, most individuals devote much more time to picking out a television or a refrigerator than they do to choosing a 401(k) investment alternative. *See* Jeff Sommer, *Chilly Reception for Savings*, N.Y. TIMES, June 8, 2003, http://www.nytimes.com/2003/06/08/business/investing-diary-chilly-reception-for-savings.html (referencing a Putnam Investments study).

[35] For a survey of these biases, *see* Nicholas Barberis & Richard Thaler, *A Survey of Behavioral Finance*, *in* 2 ADVANCES IN BEHAV. FIN. 1, 12–22 (Richard H. Thaler ed., 2005).

[36] *See* Jeff Schwartz, *Fairness, Utility, and Market Risk*, 89 OR. L. REV. 175, 205–06 (2010).

vice from friends, and recent market performance to guide their investments.[37]

Combine these tendencies with a lack of financial savvy and the result is faulty decisions and costly mistakes. One error is that investors consistently mistime their investments in the stock market.[38] They buy after the market has had a good run and sell after it has swooned. By doing so, investors deprive themselves of the opportunity to earn the market return. From 2000 to 2010, for example, the stock-market return was about zero.[39] This is not good, but many investors likely earned significantly less during that time. A remarkable study found that during that period investors in S&P 500 index funds lost about 20% of their money (about $39 billion in total), because they bought when the market was high and sold when it was low.[40] During the last several years, this aspect of investor behavior has been on full display. Many investors pulled their money out as the market fell in 2008 and early 2009.[41] This was poor timing considering the market has significantly rebounded since.[42]

While 401(k) investors are often seen as passive,[43] just like other investors, they too time the market to their detriment.[44] 401(k) allocations to stock funds fell approximately 20% in the wake of the recent financial collapse.[45] More generally, new entrants tend to allocate a greater percentage of their portfolios to equity after the market has had a good run.[46] If the market has been falling, meanwhile, they are more reticent.[47] Similarly, 401(k) investors have been shown to chase returns in hot sectors of the market.[48] All of these activities needlessly erode returns over time.

401(k) participants also fail to properly diversify. A touchstone of modern finance is that equity investors are best served by spreading their invest-

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[37] *See id.* at 206 & nn.147–50.

[38] *See* Brett Arends, *You Should Have Timed the Market*, WALL ST. J., Sept. 29, 2010, http://online.wsj.com/article/SB10001424052748704791004575520261460993110.html; Schwartz, *supra* note 36, at 232 n.278.

[39] *See* Arends, *supra* note 38.

[40] *Id.* An index fund is a type of mutual fund that tracks a particular list of securities. An S&P 500 index fund tracks 500 specific securities chosen to be representative of the US economy. *See* Standard and Poor's, Summary of S&P 500 Index, http://www.standardandpoors.com/indices/sp-500/en/us/?indexId=spusa-500-usduf—p-us-l— (last visited Oct. 5, 2011).

[41] Overall, investors pulled $151.4 billion out of stock-market mutual funds in 2008. Graham Bowley, *In Striking Shift, Small Investors Flee Stock Market*, N.Y. TIMES, Aug. 21, 2010, http://www.nytimes.com/2010/08/22/business/22invest.html; *see also* Sam Mamudi, *Mutual-Fund Assets Fall 21% in 5 Months*, WALL ST. J., Nov. 26, 2008, at C15.

[42] By mid-February 2011, the stock market had risen 95% from its post-crisis nadir. Adam Shell, *Investors Push Money Back into Mutual Funds*, U.S.A. TODAY, Feb. 11, 2011, http://www.usatoday.com/money/perfi/funds/2011-02-11-1Aassetshift11_ST_N.htm.

[43] *See* MUNNELL & SUNDÉN, *supra* note 13, at 90–91.

[44] *See* Shlomo Benartzi & Richard Thaler, *Heuristics and Biases in Retirement Savings Behavior*, 21 J. ECON. PERSP. 81, 92 (2007).

[45] *See* Bowley, *supra* note 41.

[46] *See* Benartzi & Thaler, *supra* note 44, at 92.

[47] *See id.*

[48] *See id.*

ments across a wide swath of the market rather than concentrating their money in a single stock.[49] But many 401(k) investors fail to heed this advice. Instead, they invest too heavily in their employers' securities.[50] A recent study showed that, in 2009, 19% of 401(k) assets were in employer stock and that 13% of employees had the majority of their holdings in their employer.[51] This lack of diversification costs investors greatly. One article estimated that a dollar invested by a long-term employee in his or her employer is worth less than one-half as much as a dollar placed in a diversified portfolio.[52]

Diversification across asset classes is equally important and equally ignored. By spreading their holdings among various asset classes, investors can choose how much risk to bear in their retirement savings accounts. For example, they can protect themselves from the severe swings that come with the stock market by including a mix of safer assets, like government and certain corporate bonds, in their portfolios. But 401(k) investors fail to understand or take advantage of this financial tool.

When asked about diversification, few correctly identify its purpose.[53] In practice, many ignore it. For instance, though diversification counsels a mixture of financial assets, one-half of 401(k) participants have either essentially all of their money in equities or none at all in this asset class.[54] Still more troubling is that a significant number of older investors—those who can least stand exposure to stock-market volatility—have their money solely in equities.[55] By mistiming the market, investors undermine their returns, and by failing to diversify, they leave themselves with inappropriate exposure to risk. The latter can be just as damaging as the former. Too little risk means a significant forgone opportunity for asset growth and too much, particularly later in life, can lead to financial ruin.

Another concern is that many 401(k) participants flock to actively-managed mutual funds.[56] These are funds in which the manager attempts to earn market-beating returns by timing the market. The finance industry promotes

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[49] *See* MUNNELL & SUNDÉN, *supra* note 13, at 78–80 (discussing modern portfolio theory).

[50] *See id.* at 95–114.

[51] *See* Joe Mont, *The Dangers of Investing in Your Company Stock*, NEWSWEEK, July 9, 2010, http://www.newsweek.com/blogs/jobbed/2010/07/09/the-dangers-of-investing-in-your-company-stock.html.

[52] *See* Shlomo Benartzi et al., *The Law and Economics of Company Stock in 401(k) Plans*, 50 J. L. & ECON. 45, 50 (2007). Enron's collapse most vividly illustrates the potential downside that accompanies investing in employer stock. 60% of employee 401(k) assets were in Enron stock, meaning that when the company's stock price collapsed, so did the employees' retirement accounts. *See* MUNNELL & SUNDÉN, *supra* note 13, at 113–14 & fig.5-2.

[53] *See* FACTS ON SAVING AND INVESTING, *supra* note 32, at 18.

[54] *See* ALICIA H. MUNNELL ET AL., CTR. FOR RET. RESEARCH AT BOSTON COLLEGE, ISSUE IN BRIEF NO. 52, INVESTMENT RETURNS: DEFINED BENEFIT VS. 401(K) PLANS 5 (2006).

[55] Doug Waggle & Basil Englis, *Asset Allocations in Retirement Accounts: An All or Nothing Proposition*, 9 FIN. SERV. REV. 79, 90 (2000).

[56] According to a recent article, 64% of assets in 401(k)s and other defined contribution plans are in actively-managed funds. *See* Kenneth R. French, *Presidential Address: The Cost of Active Investing*, 63 J. FIN. 1537, 1546 tbl.3 (2008).

actively-managed funds as a way for investors to earn returns in excess of the stock-market average. In reality, however, investors who choose to participate in such funds almost always come out behind.

The first thing to note is that it is mathematically impossible for active investors, as a group, to outperform the market. As the Nobel Laureate William Sharpe pointed out, the market return is the weighted average of the returns that accrue to active investors and passive investors.[57] In contrast to active investors, passive investors do not attempt to time the market. They are satisfied with investing in index funds that track the market as a whole.[58] Given that the market return is merely an average of passive and active investor returns, and that, by definition, passive investors earn the market return, active investors must also earn the market return on average.[59] On the whole, this arithmetic illustrates that active investing does nothing to improve performance.

This is only an aggregate figure, however. It leaves open the possibility that actively-managed mutual funds do well, while other active investors, like day-traders and hedge-fund managers, end up pulling down the average. While it is worthwhile to parse the market in this way, doing so does not support this theory. It turns out that actively-managed mutual funds do not rise above their peers; on average, they perform no better or worse than the market as a whole.[60]

This alone is unflattering for active managers, but the story worsens significantly when we take fees into account. Active managers charge a hefty premium for their services (in 2006, for example, mutual-fund investors paid about $13 billion in fees for active management).[61] Numerous studies show, however, that a small minority of active managers generate high

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[57] *See* William F. Sharpe, *The Arithmetic of Active Management*, 47 FIN. ANALYSTS J. 7, 7 (1991).

[58] In particular, Professor Sharpe describes passive investors as follows: "A passive investor always holds every security in the market, with each represented in the same manner as the market. Thus if security X represents 3 percent of the value of the securities in the market, a passive investor's portfolio will have 3 percent of its value invested in X." *See id.*

[59] *See id.* at 8. *See also* Eugene F. Fama & Kenneth R. French, *Luck Versus Skill in the Cross Section of Mutual Fund Returns*, 65 J. FIN. 1915, 1915 (2010); Eugene F. Fama & Kenneth R. French, *Why Active Investing Is a Negative Sum Game*, FAMA/FRENCH FORUM (June 3, 2009), http://www.dimensional.com/famafrench/2009/06/why-active-investing-is-a-negative-sum-gain.html. A simplified illustration may be useful to flesh out this concept. Consider a passive investor. This person invests in an index fund that tracks the entire stock market. This investor's return will mirror the market's return. Indeed, that is what a broadly-based index fund promises to do. Thus, we know that the return from passive investing is equal to that of the market. Not everyone invests this way, however. Active investors buy and sell shares in an attempt to profit off of short term rises and falls. What will their return be in the aggregate? Their return must equal the market return. Since the market is made up of passive investors and active investors, and we know that the return to passive investors mirrors the market return, the return to active investors must also do so.

[60] *See* Fama & French, *supra* note 59, at 1921.

[61] Author's calculation based on data from French, *supra* note 56, at 1554 tbl.VI, 1558 tbl.VII.

enough returns to justify their costs.[62] This means that 401(k) investors who participate in actively-managed funds by and large end up with lower after-cost returns than those who simply put their money in passively-managed index funds. The money paid in fees to active managers is largely wasted.[63]

On top of this, although there are a few actively-managed funds that are worthwhile, it is almost impossible for average investors to identify them ex ante. While it is tempting for investors to think that they are sharp enough to uncover the top funds, the reality is that selecting a successful active manager almost all boils down to luck. A recent study by Eugene Fama and Kenneth French showed that the vast majority of fund managers who beat the market in any given year owe their success to chance.[64] Since investors cannot hope to skillfully select the luckiest managers, the success some investors enjoy with lucky managers cannot be attributed to astute fund selection.

But some investors will end up in funds run by skillful managers. While it is possible these investors outsmarted the crowd, it is unlikely. Fama and French used complex statistics to separate the skillful managers from the lucky ones, whereas ordinary investors must rely mainly on past returns, which are a dubious measure of skill due to their problematic entanglement with luck. Because ordinary investors only have limited tools to aid in fund selection, the choice of a skillful manager is largely guesswork. The reality, therefore, is that investing in an actively-managed fund is essentially a gamble with very poor odds. Failure to appreciate this rather bleak conclusion is likely a big reason why retirement savers pay active managers billions in unnecessary fees.

The discussion above shows that, when left to their own devices, investors make significant and costly investing mistakes. Because individuals are failing to make the most of their savings, and because this waste goes unaddressed, these mistakes are a source of both social and policy inefficiency. But these mistakes are not the only source of inefficiency that current policy ignores. Another is the duplicative efforts investors expend in the investment process.

401(k) savers have broadly similar goals. For the most part, they want their money to be safe and grow at a reasonable rate. Financial professionals generally agree that the best way to make this happen is for investors to

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[62] *See, e.g.,* Fama & French, *supra* note 59, at 1916; Burton G. Malkiel, *Reflections on the Efficient Market Hypothesis: 30 Years Later,* 40 Fin. Rev. 1, 1–9 (2005); Scott Burns, *Mutual Funds Beset by Costs*, San Antonio Express-News, Oct. 5, 1997, at 1H.

[63] Interestingly, although active investing does not, on the whole, benefit those who partake in it, the activity is necessary for the market to function. A robust stock exchange is, in essence, a positive externality that stems from active investing. A thriving stock market can still exist, however, if 401(k) investors save their money by investing in passively-managed funds. This would serve society's interest in maximizing retirement savings without sacrificing its interest in a successful stock exchange.

[64] *See* Fama & French, *supra* note 59, at 1931–33.

diversify their money mainly among stocks and bonds.[65] If this investing formula works for most people, then rather than forcing every individual to toil away at their homes on Saturday afternoons attempting to figure this out, it makes sense to set a broadly diversified portfolio as a default investment. Setting up such a default would render society more efficient, saving investors from the self-inflicted wounds of poor investment decisions and saving them time.

There is an interesting analogy here to business law. The law generally grants people tremendous flexibility in setting up the governance structure of their businesses.[66] At the same time, legal rules provide a default structure designed to meet the needs of most coventurers.[67] The rationale is that it is inefficient to force each entrepreneur to reinvent the wheel.[68] The same logic applies to investing. If there is broad agreement about an investment portfolio that works well for most people, it makes sense to set people up with it as the default. The 401(k) regulations, however, do nothing of the sort.

To be fair, even though regulators have been wary of intervening in investment decisions, the industry itself has evolved rapidly in the last few years and now offers investors some valuable structure. Most importantly, the mutual-fund industry introduced so-called life-cycle funds (also referred to as target-date funds). These funds invest in a diversified portfolio of other funds and embrace an asset mix that grows more conservative over time.[69] By taking part in these instruments, individuals are reasonably diversified without having to do the work themselves. On top of that, a portion of employers automatically default new hires into these plans.[70] Some employees, therefore, benefit from life-cycle funds without even having to appreciate why they are a good alternative.

It is encouraging to see industry innovate in a way that aligns with the public interest. But depending on industry only takes us so far. The arrival of

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[65] *See* Munnell & Sundén, *supra* note 13, at 86 tbl.4-11 (showing asset allocation recommendations from top mutual-fund firms).

[66] *See* Henry Hansmann, *Corporation and Contract*, 8 Am. L. & Econ. Rev. 1, 2–4 (2006).

[67] *See* Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law 34 (1991).

[68] *See id.*

[69] Fidelity's Freedom 2040 Fund, which invests in a number of other Fidelity funds, is a good example. *See* Fidelity, Fidelity Freedom 2040 Fund, http://fundresearch.fidelity.com/mutual-funds/composition/315792101 (last visited Mar. 3, 2011).

[70] Estimates of how many employers actually default their employees into such funds vary. *Compare* Transamerica Employers Study, *supra* note 17, at 47, 51 (reporting that 27% of employers automatically enroll their employees in 401(k)s and that 40% of those employers use life-cycle funds as their default, which suggests that about one in ten 401(k) sponsors automatically default their employees into such funds), *with* AllianceBernstein, *A New Paradigm: Making DC a Sustainable and Effective Retirement System*, Research Perspectives at 3 (2010), *available at* https://www.alliancebernstein.com/Instrumentation/Research-Articles/Future-Plans-Of-DC-Inst_LTR.pdf (reporting that 45% of employers automatically enroll their employees into defined contribution plans and that almost 60% of them default their employees into life-cycle funds).

life-cycle funds is a positive step, but they come with significant, and at least partially unnecessary, costs. These funds are frequently actively managed and, partly for this reason, have higher fees.[71] On average, life-cycle funds cost investors 10% to 25% more than other funds.[72] In addition, these funds frequently allocate a large proportion of their portfolios to equities even as investors age. This practice exposes their customers to a great deal of risk.[73] Thus, even though these funds are a welcome innovation, there is room for improvement. As I discuss later, regulators can build on the idea of default enrollment in life-cycle funds to create an investing framework that is more in line with the public's interest.[74]

b. Fairness Concerns

Fairness should be the government's other central policy goal.[75] While the concept of efficiency concerns the maximization of social welfare, the concept of fairness is centered on the minimization of social-welfare inequality.[76]

In considering fairness in the 401(k) context, it helps to focus on one aspect of social welfare—economic well-being. Economic well-being is particularly relevant here because this is the aspect of social welfare that is at stake in pension policy. After all, the interest in improving people's economic lot, particularly later in life, provides the normative justification for retirement programs.

If we focus on economic well-being, we can judge the fairness of 401(k) policy by looking at its effect on economic inequality. Although progressive thinkers might argue that, in order to be fair, 401(k)s must seek to lessen pre-existing economic inequality, we need not go so far in order to condemn 401(k)s on fairness grounds. At a minimum, in order to pass muster under a fairness analysis, 401(k)s must not contribute to economic ine-

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[71] *See* MARK BRUNO, SAVE NOW OR DIE TRYING 108 (2007); Christine Dugas, *Efforts to Raise 401(k) Participation Hit Snags*, USA TODAY, Jan. 10, 2010, http://www.usatoday.com/money/perfi/retirement/2010-01-10-401k-retirement-fix_N.htm?csp=obinsite; Morningstar Funds 200: Investor Classroom, http://www.morningstar.com/news-classroom-course-13/2949/4.shtml (last visited Dec. 27, 2010).

[72] Dugas, *supra* note 71.

[73] *See* M.P. Dunleavey, *Some Target-Date Funds Adjusting After Criticism,* N.Y. TIMES, Apr. 11, 2010, at BU20.

[74] *See infra* Part IV.

[75] The OMB recognizes that government intervention may be called upon to promote what it refers to as "distributional fairness" and what I refer to simply as fairness. *See* Circular A-4, *supra* note 26, at 4.

[76] Fairness is a concept that can be defined in different ways. This definition captures its substantial overlap with the notion of distributive justice, which can be defined as concern for "the distribution of benefits and burdens to individuals." GERALD ALLAN COHEN, RESCUING JUSTICE AND EQUALITY 126 (2008); *see also* Michael B. Dorff, *Why Welfare Depends on Fairness: A Reply to Kaplow and Shavell*, 75 SO. CAL. L. REV. 847, 856–57 (2002) (describing a common understanding of fairness as including a commitment to "distributive equality.").

quality.[77] Today's pension policy, however, centered as it is around each individual's ability to make wise investing decisions, exacerbates preexisting wealth and income inequality, and therefore fails even this modest criterion.

Lack of financial savvy is a ubiquitous problem,[78] but it is more pronounced among women, African Americans, Latinos, those with less education, and those with lower incomes. These segments of society tend to perform worse on tests of basic finance and are more likely to construct inferior portfolios.[79] At the same time, it is these individuals who tend to fall at the lower end of the economic ladder.[80] This combination raises fairness concerns. Because those who are already economically behind struggle the most under our current laissez-faire regulatory system, this approach exacerbates preexisting economic inequality. The existing hands-off approach, therefore, is inefficient because it turns a blind eye to the billions wasted through poor investment choices. It is unfair because it widens economic disparity.[81]

2. *Individual Risk Management*

The current framework's individualist leitmotif extends to risk management. Under the 401(k) system, individuals not only make their own finan-

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[77] This principle applies *ceteris paribus*. In the right circumstances, a policy that increases social welfare may be advisable even if it increases economic inequality. *See* John Rawls, Justice as Fairness: A Restatement 122–23 (2001). This is only a theoretical point with respect to the application of fairness in the 401(k) context. The unfairness I critique cannot be defended on social-welfare grounds.

[78] *See supra* note 32 and accompanying text.

[79] *See* FINRA Study, *supra* note 32, at 18–19; John Y. Campbell, *Household Finance*, 61 J. Fin. 1553, 1575–77 (2006); Lusardi, *supra* note 32, at 14–15 & nn.10, 19; Lusardi & Mitchell, *supra* note 32, at 14; Gary R. Mottola & Stephen P. Utkus, *Red, Yellow, and Green: Measuring the Quality of 401(k) Portfolio Choices*, *in* Overcoming the Saving Slump 122, 127–133 (Annamaria Lusardi, ed. 2008); Transamerica Center for Retirement Studies, Full-time and Part-time Workers: 11th Annual Transamerica Retirement Survey 130–31 (2010) [hereinafter Transamerica Workers Study], *available at* http://www.transamericacenter.org/resources/WorkerReport.pdf; David C. John, Deputy Director, Retirement Security Project, Brookings Institution, Disparities for Women and Minorities in Retirement Saving, Testimony Before the Advisory Council on Employee Welfare and Pension Benefit Plans, Dep't of Labor (Sept. 1, 2010) (transcript available at http://www.brookings.edu/testimony/2010/0901_retirement_saving_john.aspx).

[80] *See* Barbara A. Butrica & Richard W. Johnson, Racial, Ethnic, and Gender Differentials in Employer-Sponsored Pensions, Statement Before the ERISA Advisory Council, Dep't of Labor 1–2, 8 (June 30, 2010) (transcript available at http://www.urban.org/UploadedPDF/901357-racial-ethnic-gender-differentials.pdf); John, *supra* note 79.

[81] The fairness issue could also be approached from a race and gender perspective. One could reasonably argue that 401(k)s are unfair because, while facially neutral, they have a disparate impact on women and certain racial groups. In the 401(k) context, however, such an approach is less useful than the economic-inequality analysis I employ. The latter approach is broader, and is therefore able to capture the deleterious impact that 401(k)s have on social groups not defined by race or gender, such as those with lower education. The breadth of the economic analysis also captures the unfairness I describe *infra* Part II.A.2, which is not amenable to this alternative analysis.

cial decisions, they also bear market risk alone. This too raises fairness and efficiency concerns.

Because 401(k) participants are left to fend for themselves, what they take out of their accounts when they retire depends not only on what they put in but also on how the financial assets they purchased have performed. The performance of financial assets, however, is largely a matter of chance. Some retirement savers will benefit from chance market swings while others will be victims.

To see the role that chance plays, consider the stock market. As home to two-thirds of 401(k) contributions, the stock market is the centerpiece of retirement savings.[82] But the market is extremely volatile. It can have tremendous bull markets, as it did throughout the 80s and 90s, and vertiginous crashes, as it did in 2002 and 2008.[83] This volatility means that different investors will have different returns based solely on when they participate. Investors of different generations, in fact, can have widely disparate results purely based on these chance swings. A striking Brookings Institution study compared hypothetical equity investors of different generations and found that they had vastly different savings as a result of chance market moves.[84] The luckiest individuals accumulated seven times more than the unluckiest.[85]

Such arbitrariness is troublesome from a fairness perspective because it contributes to economic inequality. Just as government policy should not exacerbate preexisting wealth and income inequality, so too it should avoid policies that create economic inequality where none existed before. A retirement policy centered on the performance of volatile financial assets, however, does just that. Different investors can start with the same amount of money but end with vastly different sums, all because of the chance market moves that take place while they happen to be accumulating assets for retirement. The current system, in relying on the stock market to fund retirement accounts, creates a savings lottery, which in turn, increases economic disparity.[86]

A concern for fairness is not the only thing that militates against the current approach. The stock market's arbitrariness means that investors can

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[82] *See* Sarah Holden et al., *401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2007*, ICI Res. Persp. at 1 (Dec. 2008), *available at* http://www.ici.org/pdf/per14-03.pdf; *see also* Alicia H. Munnell & Dan Muldoon, Ctr. for Ret. Research at Boston College, Issue in Brief No. 8-16, Are Retirement Savings Too Exposed to Market Risk? 2 tbl.1 (2008) (estimating that as of October 2008, individuals held $2.7 trillion in equities as part of their retirement savings accounts).

[83] *See* Ibbotson, SBBI, 2010 Classic Yearbook: Market Results for Stocks, Bonds, Bills, and Inflation 1926–2008, 20, 22 tbl.1-2 (2010).

[84] *See* Gary Burtless, The Brookings Inst., Stock Market Fluctuations and Retiree Incomes: An Update 3–5 (2008), *available at* http://www.brookings.edu/papers/2008/1031_market_burtless.aspx.

[85] *Id.* at 5.

[86] The idea that the arbitrary distribution of wealth is unfair is grounded in John Rawls's political philosophy. In his conception of a just society, the most fortunate agree to share with the least. *See* Rawls, *supra* note 77, at 74–75; *see also* Schwartz, *supra* note 36, at 190–92.

only guess at how much to save for retirement in order to meet their goals. Uncertainty like this breeds inefficiency. On the one hand, fearing a future of meager stock-market returns, some individuals may save too much, needlessly avoiding current consumption. On the other, some may be overly optimistic about the market and therefore save too little. A system that provides more certainty would allow individuals to more efficiently spread consumption over their lifetimes.

Thus, the volatility of the stock market, while it provides high rewards to some, is also a cause for concern because it creates inequality and makes retirement planning more uncertain. The market's fluctuations can be tamed, however, through risk sharing and diversification (which, as discussed above, is underutilized by investors).[87] Later in this Article, I assess regulatory changes that would take advantage of these financial tools.

B. *The Employer's Role*

The employer's role in 401(k)s likely stems from inertia more than anything else. The traditional pension, the defined benefit plan, calls on employers to guarantee a post-retirement annuity.[88] The very nature of the plan structure, therefore, requires that employers play an integral role. As mentioned previously, however, these plans are fading away.[89] Although they have not completely disappeared, defined benefit plans have been largely replaced by 401(k)s in the private sector.[90] Employers need not be involved in these; their participation, in fact, is likely counterproductive.

From a fairness perspective, the employer's involvement is problematic because it expands economic inequality. Our reliance on employers as 401(k) sponsors ends up disfavoring essentially the same economically disadvantaged social groups who are disproportionately hurt by the current regime's focus on individual sovereignty. 401(k)s are traditionally offered to those with long-term employment with a company.[91] But women, African Americans, Latinos, and those with lower incomes tend to work for shorter durations and are more likely to move from job to job.[92] This makes it much more difficult for them to gain a foothold in a company's plan. And, in order to take advantage of an employer-sponsored retirement plan, one has to be

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[87] *See supra* notes 54–55 and accompanying text.

[88] *See supra* note 9 and accompanying text.

[89] *See supra* note 10 and accompanying text.

[90] *See* Munnell & Sundén, *supra* note 13, at 15–28 (describing the growth of 401(k)s at the expense of defined benefit plans); Carpenter, *supra* note 10.

[91] Patrick Purcell & Peter Orszag, *Summary of the Employment Retirement Income Security Act (ERISA)*, *in* Underfunded Pensions, Pension Dumping, & Retirement Security 1, 10–11 (2009).

[92] Vanguard, How America Saves 2010 at 40 (2010), *available at* https://institutional.vanguard.com/iam/pdf/HAS.pdf; Transamerica Workers Study, *supra* note 79, at 116, 203; Butrica & Johnson, *supra* note 80, at 7–8; John, *supra* note 79.

employed. But women, African Americans, and Latinos are more likely to be unemployed.[93]

Even employment, however, does not assure participation. Once employed, one has to be fortunate enough to work for an employer that offers a 401(k) plan. But low-income earners, African Americans, and Latinos are less likely to work for employers that do so.[94] A study by Boston College notes that "only about one-third of individuals in the bottom third [of earnings] work for an employer that sponsors a plan, compared with over 70 percent for the highest earning group."[95] Similarly, according to researchers at the Urban Institute, "[i]n 2009, 64.6 percent of white wage and salary workers were offered employer-sponsored retirement plans. . . . In contrast, only 55.7 percent of black wage and salary workers and 38.4 percent of [Latino] wage and salary workers worked for employers with retirement plans."[96]

As the above statistic illustrates, the inequity of employer intermediation is perhaps the most acute for Latino workers. Latinos tend to work for smaller employers.[97] But these employers are less likely to offer 401(k) plans.[98] Similarly, as noted earlier, a fair number of employers match a portion of their employees' contributions;[99] however, it is large employers that are more likely to do so.[100] Finally, larger employers are more likely to help their employees by offering investment advice and by defaulting the inattentive into their plans.[101] The current system forces Latinos who work for smaller employers to forfeit these benefits. Placing the employer at the center of retirement savings thus continues the pattern of favoring the economically advantaged while leaving others behind.

Finally, while it is true that IRAs (which offer tax benefits analogous to 401(k)s) are available to everyone,[102] this dampens the inequity only slightly. There is a significant difference between being offered a 401(k) plan by your employer and seeking out an IRA on your own. The former is much more likely to encourage saving because it is simpler and more immediately tangible. Moreover, in practice, IRAs have done little to expand pension cover-

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[93] *See* Butrica & Johnson, *supra* note 80, at 2–3; John, *supra* note 79.

[94] *See* Nada Karamcheva & Geoffrey Sanzenbacher, Ctr. for Ret. Research at Boston College, Issue in Brief No. 10-1, Is Pension Inequality Growing? 2 (2010); Alicia H. Munnell & Christopher Sullivan, Ctr. for Ret. Research at Boston College, Issue in Brief No. 9-24, 401(k) Plans and Race 5 (2009); Butrica & Johnson, *supra* note 80, at 2; John, *supra* note 79.

[95] Karamcheva & Sanzenbacher, *supra* note 94, at 2.

[96] Butrica & Johnson, *supra* note 80, at 2.

[97] *Id.* at 4–5.

[98] *See* Transamerica Employers Study, *supra* note 17, at 15, 31.

[99] *See supra* note 17 and accompanying text.

[100] *See* Transamerica Employers Study, *supra* note 17, at 62.

[101] *See id.* at 48, 64.

[102] For the current IRA rules, see generally I.R.S. Publication 590 (2010), Individual Retirement Arrangements (IRAs), *available at* http://www.irs.gov/publications/p590/index.html.

age. For example, less than 2.1% of those with incomes below $40,000 contributed to IRAs in 2004.[103] More generally, IRA participation among the economically disadvantaged is tiny and lags behind other demographic groups.[104] Thus, while IRAs technically make 401(k)-like investing available to all, they do little in reality to plug the 401(k) participation gap arising out of employer intermediation.

The exclusionary effects of the employer's involvement are the most troubling. But even those fortunate enough to participate are set back by their employers' intervention, which can pose an awkward and inefficient constraint on their investment decisionmaking. After employers select a plan provider, they frequently limit the investments available to their employees to those offered by that provider.[105] But employers have no particular expertise in choosing an apt company to fill this role. The result is that employees may end up with investment choices that do not fit their preferences. One study, in fact, found that 53% of plans offered inadequate choices.[106] More generally, only 14% of plans offer a brokerage window, a feature which provides employees with a truly broad range of alternatives.[107]

An employer-centric system also poses unnecessary transaction costs on employees, and these costs end up having a significant deleterious impact on retirement savings. People generally do not stick with one employer throughout their working careers. In fact, the average 25-year-old will work for seven or more employers over the course of a career.[108] Because 401(k) plans are unique to each employer, when people move jobs, they frequently face the unenviable task of rolling over their 401(k) balances into IRAs or their new employers' plans.[109]

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[103] EMMANUEL SAEZ, THE BROOKINGS INST., SAVING INCENTIVES FOR LOW- AND MIDDLE-INCOME FAMILIES: EVIDENCE FROM A FIELD EXPERIMENT WITH H&R BLOCK 30 n.1 (2005) (quoting Leonard E. Burman et al., *Distributional Effects of Defined Contribution Plans and Individual Retirement Arrangements*, 57 NAT'L TAX J. 671 (2004)), *available at* http://www.brookings.edu/views/papers/20050509galeorszag.pdf.

[104] *See* PATRICK PURCELL, CONG. RESEARCH SERV., RL 30922, RETIREMENT SAVINGS AND HOUSEHOLD WEALTH: A SUMMARY OF RECENT DATA 8–10 & tbl.4 (2003).

[105] *See supra* note 19 and accompanying text.

[106] Edwin J. Elton et al., *The Adequacy of Investment Choices Offered by 401K Plans*, 90 J. PUBLIC ECON. 1299, 1299 (2006). *But see* Ning Tang et al., *The Efficiency of Pension Menus and Individual Portfolio Choice in 401(k) Pensions* 6 (Univ. of Mich. Ret. Research Ctr., Working Paper No. 2009-203, 2009) (finding that 94% of plans studied were "efficient compared to market benchmarks"). This is not to say that employees are commonly faced with options that are wholly deficient. In order to comply with Section 404(c) of ERISA, employers must provide at least three diversified alternative investments across a range of asset classes. *See* 29 C.F.R. § 2550.404c-1(b)(3)(i)(B)1-4 (2006).

[107] Ashlea Ebeling, *The Great 401(k) Escape*, FORBES, Feb. 25, 2008, *available at* http://www.forbes.com/forbes/2008/0225/046.html. Brokerage windows are described *supra* note 19.

[108] PATRICK PURCELL, CONG. RESEARCH SERV., RL 30496, PENSION ISSUES: LUMP-SUM DISTRIBUTIONS AND RETIREMENT INCOME SECURITY 1 (2009).

[109] Employees with smaller balances are usually forced to exit their old employers' plan, while those with bigger balances are permitted to stay. *See* Carolyn T. Geer, *Time to Quit Your Old 401(k)s?*, WALL ST. J., Aug. 2, 2010, http://online.wsj.com/article/SB10001424052748704913304575371022207053604.html.

This annoyance takes a toll. Rather than deal with this administrative task, many investors, especially those with smaller accounts, simply cash out whatever they had accumulated with a former employer when they change jobs.[110] In 2004, for instance, about 45% of employees cashed out when they switched employers.[111] Cashing out early, however, substantially erodes retirement savings.[112] No doubt some who opt to take their money are rationally diverting it toward other accounts or immediate expenses. They are probably in the minority, however. Given the tax penalty for early withdrawals, using the money in this way would rarely be a wise long-term decision.[113] Rather, many individuals are likely irrationally and inefficiently undermining their retirement savings. A more efficient system would not put individuals in a position where their actions so frequently contravene their own long-term interests.

On top of this, putting so much on the employer's shoulders creates a needless layer of complexity. Abstruse ERISA regulations are in place to protect employees from abuse.[114] If the employer were not involved with the selection and monitoring of plan administrators, these rules (and the compliance costs associated with them) could disappear. Because the employer's extensive involvement creates manifold issues of inefficiency and unfairness, it may be time to relegate them to a background role.

C. 401(k) Tax Treatment

While the regime is relatively laissez-faire with respect to the investing decision, it is decidedly paternalistic when it comes to the saving decision. The paternalism comes in the form of the aforementioned tax subsidy, which can be seen as a nudge to encourage employees to set money aside in their 401(k)s. In general, subsidizing retirement savings is likely defensible. Though everyone stands to collect Social Security, questions about its future remain unresolved and, even in the best case, it was never meant to serve as the sole source of savings during old age.[115] Meanwhile, study after study shows that, when left to their own devices, many people fail to set enough aside for the long-term.[116] This combination means there is a crucial gap, which left unfilled, could mean an austere retirement for many or even pov-

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[110] *See id. passim*; MUNNELL & SUNDÉN, *supra* note 13, at 132–36;

[111] *See* MUNNELL & SUNDÉN, *supra* note 4, at 5 & fig.9.

[112] *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-715, 401(K) PLANS: POLICY CHANGES COULD REDUCE THE LONG-TERM EFFECTS OF LEAKAGE ON WORKERS' RETIREMENT SAVINGS 17–19 (2009); MUNNELL & SUNDÉN, *supra* note 13, at 135–36.

[113] *See* PURCELL, *supra* note 108, at 4 (discussing the tax penalty as well as other measures currently in place in order to encourage 401(k) rollovers).

[114] *See, e.g.*, 29 C.F.R. § 2550.404c-1 (2006) (detailing requirements for compliance with ERISA Section 404(c)).

[115] *See* Butrica & Johnson, *supra* note 80, at 1.

[116] *See* David I. Laibson, et al., *Self-Control and Saving for Retirement*, 1998 BROOKINGS PAPERS ON ECON. ACTIVITY 91, 91–95 (1998).

erty for some.[117] A subsidy that incentivizes and bolsters savings, therefore, seems like a reasonable government undertaking.

The trouble with the tax subsidy, however, is that it favors high-income earners. Higher earners are in higher tax brackets. Because they are in higher tax brackets, they save a greater amount in taxes when they are permitted to invest in their retirement accounts tax free. Along these lines, research has shown that 70% of the tax subsidy—a subsidy worth $113 billion in 2009[118]—goes to the top 20% of earners and that 50% of the subsidy goes to the top 10%.[119] Favoring high-income earners with pension policy is unfair, because, like other aspects of 401(k) policy, it exacerbates economic inequality.

It is also an inefficient use of society's resources. High-income earners are not the ones in danger. Multiple studies have shown that high-income earners save at a greater rate than those with lower incomes.[120] For instance, a much-cited study found that, according to one metric, the top quintile of earners saves 24% of its income, while the lowest quintile saves a mere 1%.[121] Moreover, it does not appear that 401(k)s have anything to do with this increased savings. In fact, one study found that 401(k)s lead to no additional savings for the top earning groups.[122] What seems to be happening is that higher earners are participating in 401(k)s, but rather than saving more in order to take part, they are shifting savings from bank accounts and other investments into 401(k)s in order to take advantage of the tax benefits.[123] The dismal implication from these findings is that, rather than serving as a nudge to save, the 401(k) subsidy is for the most part merely a tax shelter for those who would have saved their money in any case.

In contrast to our current system, an efficient use of government resources would target those of lesser means. Unlike the wealthy, there is reason to believe low-income individuals would benefit from the nudge to

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[117] *See Social Security Found to Save Third of Elderly From Poverty*, N.Y. Times, Apr. 9, 1999, at A16.

[118] Office of Mgmt. & Budget, Analytical Perspectives, Budget of the United States Government, Fiscal Year 2011 223 tbl.16-4 (2010).

[119] Ghilarducci, *supra* note 5, at 275; Leonard E. Burman et al., Urban-Brookings Tax Policy Center, Discussion Paper No. 16, Distributional Effects of Defined Contribution Plans and Individual Retirement Accounts 2 (2004).

[120] *See e.g.*, Karen E. Dynan et al., *Do the Rich Save More?*, 112 J. Pol. Econ. 397, 397, 399–400 (2004).

[121] *Id.* at 417.

[122] *See* Eric M. Engen & William G. Gale, *The Effects of 401(k) Plans on Household Wealth: Differences Across Earnings Groups*, 21–22 (Nat'l Bureau of Econ. Research, Working Paper No. 8032, 2000). *See also* Daniel J. Benjamin, *Does 401(k) Eligibility Increase Saving? Evidence from Propensity Score Subclassification*, 87 J. Pub. Econ. 1259, 1285–87 (2003) (reporting that certain financially savvy individuals do not increase savings in response to the 401(k) tax incentive).

[123] *See* Benjamin, *supra* note 122, at 1287; William G. Gale, *Improving Opportunities and Incentives for Savings by Middle- and Low-Income Households*, *in* Path to Prosperity 93, 97 (Jason Furman & Jason Bordoff eds., 2008); William G. Gale et al., The Brookings Inst., The Saver's Credit: Issues and Options 3–4 & n.4 (2004).

invest. As discussed above, low-income individuals save at a much lower rate than their wealthier counterparts.[124] Therefore, if we are seeking to increase savings, this is where a government subsidy should be targeted. Moreover, it has been shown that, unlike higher earners, those with lower incomes have actually increased their savings in response to the 401(k) tax subsidy.[125] This finding means that this is a group that government 401(k) policy actually impacts. The combination of a lower savings rate and a greater responsiveness to the current savings incentive means that government money aimed at this group is better spent than subsidization skewed towards the higher end of the wage scale.

A retargeted structure also would make sense because it would focus on adding higher-value dollars. Like anything, money has diminishing marginal value. This means that each additional dollar is worth less than the one before it. While early dollars buy necessities like food and shelter, later dollars buy niceties like flat-screen TVs and iPads. If we focus on retirement savings, this means that foundational savings have a higher marginal value than later savings. To maximize the value of pension subsidies, the government should, therefore, focus its efforts on those with the least savings. Since, as the above discussion noted, low-income earners have less savings than others,[126] the government can generate the most value per government dollar by seeking to bolster this group's skimpy retirement accounts. In focusing tax relief on the opposite end of the wage scale, our current system represents an inefficient mismatch of government outlays and policy goals.

The foregoing analysis of the 401(k) structure suggests that this pension system falls short on both efficiency and fairness grounds. It is inefficient because it allows for a great deal of waste. The system fails to help individuals make portfolio-allocation decisions. As a result, 401(k) investors make poor choices that lead to billions of dollars in losses. At the same time, the system includes a generous tax subsidy;[127] but much of this money is likely squandered on people that would have saved anyway. The program also performs poorly under a fairness analysis. Economically disadvantaged groups are the least likely to be offered a 401(k) by their employers, benefit the least from the program's tax subsidy, and are the most likely to make poor investment decisions. This means that the current paradigm operates as a wedge, bestowing further advantages on those who are already fortunate while allowing others to fall further behind. As such, it contributes to the gross economic stratification that marks society today.[128] All of this means that there is much room for improvement.

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[124] *See supra* note 120 and accompanying text.
[125] *See* Engen & Gale, *supra* note 122, at 22.
[126] *See supra* note 121 and accompanying text.
[127] *See supra* note 118 and accompanying text.
[128] *See* Chang-Keun Han et al., *Assets Beyond Saving in Individual Development Accounts*, 83 Soc. Serv. Rev. 221, 221 (2009); Robert H. Frank, *Income Inequality: Too Big To Ignore*, N.Y. Times, Oct. 17, 2010, at BU5.

IV. A New Retirement Savings Template

My rethink of the 401(k) paradigm revolves around three key changes: (1) the employer's role would be significantly contracted; (2) the tax deduction would be replaced by a government savings match, which would be phased out as income increases; and (3) low- and middle-income wage earners would be defaulted into a passively-managed mutual fund, which would include an investment in inflation protected treasury bonds as a form of guarantee. The end result would be a universal pension system that is focused on the more modest end of the wage scale. Individuals in this group would be free to opt out of the program, but if they do not do so, they would be automatically invested in retirement accounts featuring a government match and an investment portfolio that offers the potential for reasonable returns while providing reasonable safety. This template, while not a cure-all, promises great improvement over our current approach.

A. *Employer Disintermediation*

Currently, employers stand between employees and those managing their retirement accounts. As discussed above, their role in this regard is an impediment to sound policy.[129] Therefore, under my proposed replacement to 401(k)s, the employer's role would be significantly reduced. Employers would no longer have a role in selecting and monitoring plan administrators. Rather, the employee and the entity managing that employee's account—for example, a mutual-fund company—would have a direct contractual relationship. Once an employee has an account, the employer's only responsibility would be to divert a portion of that employee's paycheck to the account as instructed by the employee.

In addition, although high-income workers would be free to set up their own accounts, the government (in coordination with employers) would set up retirement accounts on an opt-out basis for low- and middle-income workers.[130] This means that, unless these individuals expressly decline to participate, accounts will be automatically set up on their behalf. Once enrolled, employers would be responsible for directing a default portion of these employees' salaries into these accounts (the employees would be free to change this amount at any time).[131] The government savings match, which

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[129] *See supra* Part III.B.

[130] This automatic enrollment would not take place when employers already provide employees with a defined benefit plan. In these cases, enrolling employees in another plan seems redundant.

[131] In practice, this would likely work by an employer having two new-hire packets: one for high-income earners, the other for middle- and low-income earners. The former would provide information about the savings plan and notify employees that they are free to participate. The latter would also describe the savings plan, but would notify employees that they will be enrolled by default in the default investment, as further described *infra* Part IV.C, unless they choose differently. If employees do not opt out, then the government and the employer

is further described below, would determine who is automatically enrolled and the amount of the default contribution. Only those eligible for the match, i.e., low- and middle-income earners, would be automatically enrolled. The default salary contribution would be the amount which maximizes the available government match for each particular employee.[132]

Automating the process in this way builds on our experience with 401(k) plans. Today, some employers automatically set up 401(k) accounts and default contribution amounts for their employees.[133] Research shows that this practice dramatically increases participation, particularly among low-income groups.[134] For instance, one study showed that participation among those earning between $20,000 and $29,999 per year shot up from 32% to 83%.[135] Including a default savings feature in the new scheme, therefore, would likely do much to encourage widespread participation.[136]

Finally, employees would not be the only ones eligible to contribute to these plans. Though the vast majority of deposits would likely come through people's employers, the opportunity to invest in these plans, and therefore benefit from the government match, would be available to everyone. Thus, those who are unemployed but still wish to set money aside would be able to do so directly without any employer involvement. This is imperfect. The unemployed, particularly those who are unemployed for an extended period of time, are likely to struggle in old age. Because many likely need their money for current expenses, however, it is difficult to picture a sizable number taking advantage of this savings scheme. But this is an inherent limitation of any earnings-based pension arrangement. Closing this lacuna would demand a broader reassessment of our pension and welfare policy and is therefore beyond the scope of this piece.

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would coordinate enrollment. The easiest way to do this would likely be to have a government-supported website where the employer can register the new hire for the default investment. If an employee already has a plan, the website should have a record, and the employer can divert the employee's saving to that plan.

[132] One downside of default enrollment is that employees tend to save at the default rate even though, if left to their own devices, they may have saved more. *See* Richard H. Thaler & Shlomo Benartzi, *Save More Tomorrow™: Using Behavioral Economics to Increase Employee Saving*, 112 J. POL. ECON. 164, 169 (2004). To combat this, employees should also be given the option to pre-commit themselves to increased contributions every time they receive an increase in salary. This is the heart of Professor Thaler and Professor Benartzi's Save More Tomorrow Program. *See id.* at 170.

[133] *See* TRANSAMERICA EMPLOYERS STUDY, *supra* note 17, at 48.

[134] *See* MUNNELL & SUNDÉN, *supra* note 13, at 64.

[135] *Id.*

[136] To broaden access to 401(k)-type savings opportunities, President Obama has proposed "universal savings accounts," which similarly involves automatic enrollment of employees. *See* Ron Lieber, *Savings Accounts for All: Simple, but Not Easy*, N.Y. TIMES, Mar. 7, 2009, at B1. The president's plan, while similar in concept to that proposed herein, is less comprehensive: it leaves the tax subsidy in place, whereas I suggest eliminating it (*see infra* Part IV.B); it leaves employers to intermediate the relationship between employees and mutual-fund companies, whereas I would take them out of this role; and the president's default option remains ambiguous, whereas I set out a specific template (*see infra* Part IV.C). *See* Lieber, *supra*.

The structure of this proposal also potentially gives rise to misgivings related to paternalism. On the one hand, defaulting particular segments of society into a savings account may seem overly paternalistic. This concern, while it cannot be disregarded, is mitigated by the program's non-mandatory structure. While there is certainly an element of paternalism in the proposal, given the success of previous default savings programs and the importance of retirement savings, it seems that the extent of the interference in this instance is defensible. On the other hand, it may seem inequitable to leave high-income earners out of the automatic enrollment program. This concern is answerable, as well. While it would be possible to default everyone into the program, it seems unnecessary given that high-income earners tend to save anyway and will not be eligible for the savings match. They are free to participate if they think well of the investment alternatives available or other aspects of the program, but automatic enrollment appears unneeded.

An additional concern may be the threat this approach could potentially pose to the employer match. Currently, employers are incentivized to provide the match because doing so is one way to satisfy 401(k) non-discrimination rules (a set of requirements designed to ensure that employers do not restrict pension-plan participation to highly-compensated employees).[137] Because the proposed scheme I set out would be available to everyone, these rules would no longer be necessary. The problem is that absent this regulatory push, employers might be tempted to withdraw this benefit. While it is true that some employers may choose such a course, this should not be a great concern.

First, many employers may choose to keep the match. Matching contributions are generally popular among employees,[138] so employers may choose to continue the practice even though it no longer provides a regulatory benefit. Second, even if some employers drop the match, this should not lead to a change in their employees' total compensation. This figure should remain stable because a change in pension regulation would have no effect on the market forces that determine it. That being the case, the money that went toward the match should, in theory, simply be redirected toward salary or other benefits. It may be reasonable to fear that, in practice, the result may not be as rosy. In a weak labor market, some employers may abandon the match as a way to subtly lower pay. But this may not even be a bad thing. If total compensation is artificially high, then lowering it may lead to higher employment. Moreover, if there is broader concern about the bargaining power of employees vis-à-vis employers, then this is an argument for labor-law reform rather than against pension-plan reform.

A related worry is that losing the employer match would decrease pension participation. But even if the employer match were to completely disap-

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[137] *See* Keenan Dworak-Fisher, *Encouraging Participation in 401(k) Plans: Reconsidering the Employer Match* 2 n.5 (U.S. Bureau of Labor Statistics, Working Paper No. 420, 2008).

[138] *See* Transamerica Workers Study, *supra* note 79, at 35.

pear, such an occurrence appears highly unlikely. In this case, we would essentially be swapping out one mechanism to encourage participation, the employer match, with another, automatic enrollment. Making this trade is sensible because automatic enrollment has proven to be more effective at encouraging participation.[139] Thus, if the employer match were to disappear, there would likely be no decrease in overall participation.[140] In fact, because this template would expand access to all employees, and, as discussed in the following section, would include a government match for which many employees would be eligible, total participation would almost certainly increase.[141]

This relates to the major benefit of peeling back the employer's role, which is that it levels the playing field and broadens access. Under this revised scheme, individuals would have the same opportunity to participate in private pensions regardless of their employer. There are other benefits as well. The change would free employers from significant ERISA compliance burdens and free employees from any investing constraints that employers may impose. Finally, these new accounts, since they would be linked to each employee rather than each employer, would remain with employees automatically as they switch employers throughout their careers. Employees would therefore no longer bear the burden of moving their retirement accounts with them—a step which, as discussed earlier, has proved problematic in the past.[142] For all of these reasons, a rollback of the employer's involvement would prove valuable.

B. Government Savings Match

Our current system incentivizes savings through tax subsidies. This structure, however, disproportionately favors those who are already economically advantaged and likely already predisposed to save.[143] A more effectual and equitable way to incentivize retirement savings would be to have the

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[139] *See generally* DWORAK-FISHER, *supra* note 137.

[140] For those employers with both an employer match and automatic enrollment, taking away the match (without any other changes) would likely lead to lower participation. John Beshears et al. found that if employers in this position abandoned the employer match, there would be a 5–11% drop. John Beshears et al., *supra* note 18, at 312. Under my proposal, however, such a drop would likely be more than offset by increased participation among low- and middle-income earners, who would have greater access to these retirement plans and would be spurred to participate by the government match (discussed *infra* Part IV.B).

[141] Also worth noting at this point is that, while societal participation would likely rise, this new template would likely lead to a significant decrease in participation by wealthier individuals. They may no longer have the benefit of the employer match, and, as discussed *infra* Part IV.B, they would have no tax incentive either.

[142] *See supra* note 111 and accompanying text. This simplicity would be of particular benefit to those social groups that more frequently switch jobs, including low-income workers and others. *See supra* note 91 and accompanying text.

[143] *See supra* note 121 and accompanying text.

government match retirement contributions for those who inhabit more modest sections of the wage spectrum.

As mentioned above, the value of the current 401(k) tax subsidy is $113 billion.[144] Rather than implicitly giving this money away through the tax code, the money could be expressly credited to people's retirement accounts. Instead of providing favorable tax treatment, the government could match a certain percentage of an employee's contribution up to a certain amount. The amount of the match would decrease as an individual's salary increased, eventually disappearing for those earning more than moderate incomes.[145] Finally, the matched funds should only vest once the employee reaches retirement age. This would encourage savers to leave their money invested for the long-term.

There are several reasons for this progressive structure, all of which relate back to issues discussed earlier in the paper. The first is that by targeting those with modest or moderate incomes, the program incentivizes those most likely to benefit from the nudge to invest.[146] The second is that, as mentioned above, money allocated to the less well-off has a higher marginal value: it buys items necessary for subsistence in retirement rather than things people may be able to do without.[147] Finally, the progressive structure serves as a small response to economic inequality.[148]

One trade-off with this policy change would be that high-income earners would no longer have a government nudge to save. This raises the possibility that well-off individuals would save less under the proposal than they do today. But this risk is relatively minor. As discussed earlier, by and large, the well-off save anyway.[149] Statistics suggests that for high-income earners, 401(k)s serve merely as a tax shelter rather than as an incentive to save more.[150] That being the case, the absence of the subsidy should have little aggregate effect on the savings of the wealthy.[151]

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[144] *See supra* note 118 and accompanying text.

[145] Unemployed individuals would be eligible for the highest match rate. By the same token, in designing the program, we would wish to avoid subsidizing wealthy individuals who have quit working and unemployed spouses in well-off single-income households. *See infra* note 151 and accompanying text. The way to do this is to provide a wealth-based cut-off for participation by the unemployed. Those seeking to take part in the plan would need to certify that they fall below this threshold.

[146] *See supra* note 125 and accompanying text.

[147] *See supra* text accompanying note 126.

[148] The legitimacy of government intervention to ameliorate inequality finds philosophical support in John Rawls's work. *See* RAWLS, *supra* note 77, at 130–31.

[149] *See supra* note 121 and accompanying text.

[150] *See supra* note 123 and accompanying text.

[151] While it may be true that some well-off individuals would save less if their 401(k) tax subsidy was withdrawn, it would be inefficient to expend government resources in an attempt to target this group. Since we cannot tell ex ante who would be influenced, this effort would require that the government subsidize all high-income earners, which would entail a great deal of waste given the general propensity of the wealthy to save independent of any subsidy. In light of this phenomenon, public money would be better spent matching the savings of the less fortunate, where it would have a broader impact.

Ideally, the government match would simply replace the current tax deduction and therefore require no increase in government expenditures. Further analysis is necessary to calculate actual dollar amounts for the match that would accomplish this goal.[152] At this time, however, we can at least conclude that a program that follows the progressive matching structure set out above would better align government expenditures with public-policy goals.

C. Investment Alternatives

By taking a largely agnostic stance with respect to 401(k) investing, the current system allows policymakers to avoid tough questions about the proper way for people to invest and the correct form of intervention to steer people in that direction.[153] But this avoidance has left investors twisting in the wind. Rather than dodge these issues, this new scheme would seek to improve upon how investors allocate their money by (1) setting a sound default investment and (2) lightly guiding individuals toward good choices when they opt for a different alternative.

When low- and middle-income earners are enrolled by default in the new savings scheme, their money must be directed into a default investment. This default must be chosen with great care. Though a simple default may not seem like much, behavioral-economics research has shown that people stick to defaults in overwhelming numbers.[154] Thus, many would undoubtedly "choose" this investment through inaction. Therefore, even though a carefully-set default would not improve decisionmaking per se, it would do much to improve how money is actually invested, which, after all, is the ultimate goal.

In designing this default, the government must make a fundamental decision at the outset. Two different investment paradigms are available: one is

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[152] The exact structure of the match and the rules that support it also require further analysis. One issue is that the match distorts compensation incentives. Employers may attempt to game the system by devising alternative forms of compensation that would not reduce their employees' match. For example, employers could choose to compensate employees through greater perquisites rather than salary. To the greatest extent possible, rules should be designed to ensure that such alternative forms of compensation are captured when calculating a particular employee's match. Along the same lines, in designing how the match phases out over time, care should be taken to ensure that an increase in pay does not trigger a loss in the match that is greater than the pay increase. This result would distort an employee's decision about whether to take the raise. It would also encourage employers and employees to design the alternate compensation schemes just discussed. Although an exact analysis based on the dollar figures involved must wait, it seems that this scenario can likely be avoided by phasing out the match in small increments as salary increases rather than in large amounts tied to broad salary ranges.

[153] The Department of Labor, however, implicitly takes the position that life-cycle funds and other similar investments are preferable by giving employers fiduciary protection for defaulting their employees into such alternatives. *See* 29 C.F.R. § 2550.404c-5(e)(4)(i) (2010) (providing that protection under ERISA § 404(c), discussed supra note 23 and accompanying text, is available for employers defaulting their employees into these funds).

[154] *See* RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE 83–87 (2008).

collective, the other individualistic. In the first, although individuals would have their own accounts, their money would be invested alongside others in a pooled vehicle, where investors share market risk via a conduit such as an insurance company or the government. In the second, each individual account would be an island where the investor bears market risk alone. Although the former is tremendously appealing on an abstract level, the latter is likely the better alternative on a practical level.

The risk-sharing approach is appealing because, at least theoretically, this structure would allow investors to achieve the average return of the most risky asset class, without the risk. For instance, if investors could share the risk of the stock market through a mechanism whereby those who earned above the average return shared with those who earned below, then everyone could be assured the market's average—historically around 7.6%.[155] On the other hand, if individuals wish to shield themselves from market risk on their own, they would have to do so through diversification. But diversification does not offer such certainty at such high returns.

Unfortunately, however, moving from the abstract to the practical dampens the appeal of risk-sharing schemes. A pure risk-sharing scheme is impossible. Future market returns are unknown and the market has a potentially infinite lifespan over which its returns are shaped. Because the market's return is constantly changing and investors are of different generations, those who earn above the market return cannot simply share with those who earn below. In practice, therefore, risk sharing is a bit more awkward and rigid. In one version, an entity guarantees a certain level of returns to stock-market participants at retirement. To fund the guarantee, this entity may charge a fee or require that participants agree to forfeit returns above a certain amount.[156] The other mechanism is a defined benefit plan. In these plans, a post-retirement annuity is promised irrespective of market returns. In both schemes, the retirement savers are insulated from market swings by intermediaries who bear market risk by taking it on themselves and by spreading it among all of their participants.

This is a lot of responsibility for the intermediary. To bear the risk, this entity must have a long life span; this allows it to spread risk among different generations. The intermediary also needs voluminous resources, so it can foot the bill if it has over-promised. These concerns make it difficult to find an appropriate body to fill this role. In sponsoring defined benefit plans, employers, perhaps shortsightedly, took on this load, but they have now largely seen fit to shed that obligation. Because of their limited resources and potentially limited lifespans they were never the ideal conduit anyway. What about insurance companies? Insurance companies make a living by

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[155] This figure is the stock market's return after inflation from 1883–2008. *See* Alicia H. Munnell et al., Ctr. for Ret. Research at Boston College, Issue in Brief No. 9-4, What Does it Cost to Guarantee Returns? 3 (2009).

[156] *See id.* at 5–7.

pooling risks, but there are a couple of special concerns in this context. One is solvency risk. Investors would be forced to rely on the solvency of the insurance company to fund retirement, which for some individuals may lie far in the future. But not all insurance companies last forever and nobody wants their retirement savings tied up in a bankrupt insurer. The second concern is that, at least in part because market returns are uncertain, the insurance products that the private sector offers tend to be highly complex and therefore unappealing.[157] A default investment, which depends on risk sharing through an insurer, therefore, would likely be unsatisfactory.

This leaves the government. This is a task for which government may be uniquely well-suited because it has the ability to borrow money cheaply if needed to fund its obligations and it has an unlimited lifespan.[158] Indeed, a study done by the Center for Retirement Research at Boston College showed that in retrospect the government could have guaranteed retirees stock-market returns of 6% (in exchange, investors would forfeit any returns above this amount).[159] Looking prospectively, the study concludes that a 4% return guarantee with a 6% cap is feasible, given certain assumptions.[160]

Such a government-sponsored risk-sharing fund certainly sounds like a promising default investment. But this is only in the abstract; in practice, the scheme would be problematic. A move in this direction would swap market risk for political risk. Rather than face market volatility alone, investors would face the risk that government would renege on its guarantee obligations. And this is a real possibility. Who knows what market returns will be in the future? If they are not as forecast, our government would find itself in a quandary. A politically attractive way out might be to alter pension obligations.

The central problem is that a return guarantee imposes a long-term static obligation in connection with something that is dynamic, namely market returns. As the divergence between expectations and reality inevitably builds, political and economic concerns may take precedence over earlier commitments.

Unfortunately, the risk of elected officials changing course dampens the appeal of all long-term government-based risk-sharing schemes. Consider Social Security, which can be viewed as a national defined benefit plan. In 1977, Congress cut benefits to one age group by 19% and to another by 30%.[161] The future likely holds more of the same.[162] Such political risk rivals, if not surpasses, the market risk posed by the stock market. This precedent

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[157] *See* Schwartz, *supra* note 36, at 253.

[158] *See* Munnell et al., *supra* note 155, at 6–7.

[159] *See id.* at 4. This is based on several key assumptions, one of which is that employees keep their money in the stock market for their entire working careers. *Id.* at 3.

[160] *See id.* at 6–7. Among other things, the projection assumes a certain mean market return, a certain standard deviation of returns, and that returns will be normally distributed. *See id.* at 12.

[161] Salvador Valdes-Prieto, *Market Innovations to Better Allocate Generational Risk*, *in* Restructuring Retirement Risks 226, 227 (David Blitzstein et al. eds., 2006); *see also*

suggests that it would be unwise to rely directly on government when it comes to this second tier of retirement savings. Indeed, since individuals are already exposed to the political risk associated with Social Security, it makes sense from a diversification perspective to steer clear of this risk when it comes to other forms of saving.

Ultimately, the design problems and political risk associated with government intermediation of pension returns means that we are likely better off seeking to improve, rather than abandon, the current paradigm, where risk is shouldered individually. Such a scheme falls short of egalitarian ideals, but perhaps it is the best among imperfect alternatives.

With the investment paradigm decided, the question then becomes how to structure the default investment so as to maximize its potential without seeking to take advantage of risk sharing. The life-cycle funds that mutual-fund companies currently offer provide a good starting point. Today's life-cycle funds focus on stocks and bonds.[163] The default investment should also invest in these asset classes, but within some specific parameters. First, let us consider the stock portion of the portfolio. The life-cycle funds of today consist of either actively- or passively-managed funds.[164] It would be better, however, for retirement savers to participate solely in passively-managed funds.

As discussed earlier, active management involves a largely unnecessary transfer of wealth from retirement savers to the finance industry.[165] That being the case, there is no reason for policymakers to default individuals into actively-managed funds. Thus, the portion of the default investment that is in equities should be in an index fund. This index fund should cover a broad swath of the market so as to provide investors with ample diversification.

More drastic change may be appropriate for the bond portion of the portfolio. In a recent paper, Martin Feldstein, former president of the National Bureau of Economic Research, now at Harvard, showed how treasury-inflation protected securities ("TIPS") can offer one form of a return guarantee.[166] Using TIPS is particularly attractive because this type of guarantee comes with significantly less political risk than the sort of direct government backing discussed above.

ZELINSKY, *supra* note 2, at 114 n.46 (discussing the fact that individuals do not have a property right to Social Security benefits).

[162] For a description and analysis of a recent proposal, see Peter Orszag, *Safer Social Security*, N.Y. TIMES, Nov. 15, 2010, at A29.

[163] The Fidelity Freedom Fund 2040, for instance, is invested in approximately 80% equity and 20% bonds. *See supra* note 69; *see also* John Ydstie, *Partner in Time: Retirement Funds You Can Age with*, NPR, Mar. 3, 2010, at tbl. "Anatomy of a Lifecycle Fund," http://www.npr.org/templates/story/story.php?storyId=124245298.

[164] *See* BRUNO, *supra* note 71, at 108. For example, the Fidelity Freedom Fund 2040, described *supra* note 69, invests in a variety of actively-managed funds.

[165] *See supra* notes 56–64 and accompanying text.

[166] *See generally* Martin Feldstein, *Reducing the Risk of Investment-Based Social Security Reform, in* SOCIAL SECURITY POLICY IN A CHANGING ENVIRONMENT 201 (Jeffrey R. Brown et al. eds., 2009).

TIPS are U.S. government bonds that pay a fixed real interest rate.[167] This is in contrast to a typical treasury bond, which pays a fixed nominal interest rate. If the interest rate on TIPS is 2%, for instance, an investor will earn 2% above inflation, whatever that turns out to be. TIPS do not offer a high return, but they are one of the safest investments. Unlike pension obligations, the federal government historically has treated U.S. debt obligations with the utmost seriousness. Therefore, the likelihood that it would default on its debt is low.[168] In addition, there is no inflation risk, the bane of most super-safe investments. Currently, investors can buy TIPS directly from the U.S. government or buy them indirectly by purchasing shares in mutual funds holding these instruments.[169] Despite the appeal of TIPS, however, they claim only a small portion of 401(k) contributions.[170]

Because TIPS are so secure, investors can use them to guarantee returns. Feldstein uses the example of a 21-year-old with $1000 to invest, who expects to retire at age 66.[171] If we assume TIPS have a real return of 2%, then, if this individual puts in $410 out of the original $1000 into TIPS, this person will be guaranteed to get the $1000 in real terms at retirement. This result owes to the TIPS's steady 2% real return year after year. Thus, by allocating about 40% of the portfolio to this conservative investment, even if the rest of the portfolio collapses, the return of principal in real terms is guaranteed.

This neat result means that it would be possible to guarantee retirement accounts without the government making any specific promises regarding pension returns. The default investment could be made up of an index fund consisting of U.S. equities, with the remainder invested in the amount of TIPS necessary to guarantee return of principal in real terms at retirement.[172] As retirement nears, a larger percentage of contributions would need to go into TIPS to ensure return of principal. Thus, as with today's life-cycle funds, investor portfolios would grow more conservative as individuals age.

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[167] *See TIPS in Depth,* TreasuryDirect, http://www.treasurydirect.gov/indiv/research/indepth/tips/res_tips.htm (last updated May 11, 2011); Feldstein, *supra* note 166, at 205.

[168] Even during the debt ceiling crisis in the summer of 2011, yields on treasury bonds remained low, indicating that the market never expected a default. Perhaps this is because, even had Congress failed to reach a compromise, investors expected that the Treasury Department would continue to pay bondholders, even if it meant defaulting on other obligations. *See* Catherine Clifford, *Bond Investors Still Hungry for U.S. Debt*, CNNMoney, July 20, 2011, http://money.cnn.com/2011/07/20/markets/bondcenter/treasuries/index.htm.

[169] Annelena Lobb, *Investors Seek Inflation Haven in TIPS Funds, But Treasury Securities Tied to Consumer Prices Carry Their Own Risks*, Wall St. J., Sept. 23, 2009, at D1, *available at* http://online.wsj.com/article/SB10001424052970203278404574414772435247710.html.

[170] *See* Mottola & Utkus, *supra* note 79, at 125–26 & tbl.4-3.

[171] Feldstein, *supra* note 166, at 205.

[172] Other return guarantees could be produced by altering the mix of TIPS and equities. Feldstein, for instance, discusses the potential for a 1% real return guarantee. *Id.* at 206. While neither guarantee is clearly superior from a finance perspective, *see id.* at 207–10, the principal guarantee is more appealing from a social and political perspective, because it is more concrete.

This paradigm walks a middle road. It is designed to tame the arbitrariness of the market, and the deleterious social-welfare impacts that come with it, without completely sacrificing investor returns. While this plan fails to live up to the ideal of risk sharing, where arbitrary inequality is eliminated, it manages to provide a modest guarantee while essentially eliminating the political risk posed by more robust risk-sharing schemes.[173] This compromise solution should serve the interests of many investors.

There may be some hesitancy about this proposal because it commits the government to issue new debt, in particular debt it cannot inflate away. While this is a valid concern, it should not be overstated. First, the government already issues a significant amount of TIPS.[174] Rather than increasing the amount it is already prepared to issue, future issuances can be redirected into the retirement market. Second, the plan need not result in any new debt. The government could purchase existing treasuries and issue TIPS to retirement savers. In fact, the Government Accountability Office recently highlighted the government's need to roll over existing short-term debt into longer-term obligations and recommended TIPS as the solution.[175] Finally, the government would not be promising to issue TIPS as part of a retirement default forever. If, in the future, it is uneconomical to do so, the government would still need to honor its existing obligations, but the default investment could be changed for new contributions.

Indeed, given the long-term nature of retirement savings, there is a need for flexibility. Though TIPS may represent a good balance today, society will change in the future and there will be advances in financial engineering that may make this system seem antiquated. A big benefit of using TIPS to guarantee returns is that, since the government makes no promises about granting them in the future, this dynamism can be easily accommodated. In light of their potential fiscal impact, further study by the appropriate government agencies is appropriate, but the advantages of TIPS suggest that this would be a worthwhile next step.[176]

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[173] Nevertheless, even this guarantee is subject to two risks, which should be made clear to investors: (1) the potential for the U.S. government to default on its treasury obligations, which as discussed *supra* note 168 and accompanying text, remains low; and (2) the potential inability of the investment fund to purchase TIPS with nonnegative real returns. In rare circumstances, market forces can lead to TIPS returns that are negative (i.e., less than inflation). Investors in funds forced to purchase TIPS with such returns would experience some erosion of principal in real terms.

[174] *See* S. Gowri Shankar, *A New Strategy to Guarantee Retirement Income Using TIPS and Longevity Insurance*, 18 FIN. SERV. REV. 53, 58 (2009) ("In March 2008, the total value of TIPS outstanding was $474 billion or about 10% of all the U.S. Treasury securities held by the public.").

[175] *See generally* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-932, DEBT MANAGEMENT: TREASURY INFLATION PROTECTED SECURITIES SHOULD PLAY A HEIGHTENED ROLE IN ADDRESSING DEBT MANAGEMENT CHALLENGES (2009).

[176] It is also worth considering whether a special class of TIPS should be created for the purpose envisioned herein. Doing so would avoid overly disrupting the existing TIPS marketplace. We could also create an instrument that is more narrowly tailored to the needs of retirement savers. TIPS as currently constructed are a good fit, but it is worth conducting a detailed

Once the default portfolio is set, the next question is how to choose the default fund manager. The best option seems to be to choose through a competitive bidding process. Like other public contracts, the government could select the private-sector company that it deems best.[177] This is somewhat worrisome because it raises capture concerns. Since the management of the default fund would result in a lot of business, industry players might inappropriately curry favor with government decisionmakers.

There are several ways to address this concern. The first is to give the agency in charge of the decision, perhaps the new Consumer Financial Protection Bureau, clear guidelines on how to select a fund manager. For instance, the government should instruct the agency to give management fees great weight in its analysis. Indeed, since managing these funds should be fairly straightforward and administrative, price should be the key distinguishing feature. The second is to subject the initial decision to review by another agency or even an external party. This secondary reviewer would have to affirm the decision.[178] Third, the decision and the decisionmaking process must be transparent. The government should make different proposals and counterproposals from the bidding entities available for public inspection. Finally, whatever fee the default fund ends up charging must be clearly disclosed. If it is not the cheapest, individuals will be able to tell, and will have the ability to switch to a competing fund, even one offering the same portfolio. These steps, while not a panacea, should make capture less likely and less damaging if it does occur.

The final consideration is whether there should be any limitations on or guidance for those who open these accounts on their own and for those who wish to choose investments other than the default. Limiting choice is probably regulatory overkill in this context. There may be worthwhile innovations and, if so, individuals should have access to them. To lay the groundwork for informed decisions, however, the government should make information about the pros of diversification and the cons of active management available. In addition, regulations should be put in place along the lines of the newly adopted Department of Labor 401(k) disclosure rules to ensure that investors have access to user-friendly and clear information with respect to fees and other important aspects of their investment alternatives.[179] A nudge may also be in order. To incentivize passive investing, the government could reduce its match when individuals direct their money to actively-managed

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analysis as to whether all of their existing features are appropriate for use in the manner proposed.

[177] Because the choice of a default fund manager would not implicate the expenditure of public funds, the decision probably would not be subject to the extensive regulatory framework regarding government procurement. *See* Steven W. Feldman, 1 Government Contract Awards: Negotiation and Sealed Bidding § 1:6 & nn.6, 7 (2010).

[178] Nor should any decision last forever. The performance of the default fund should be reviewed annually, and there should be open competition for the position every few years.

[179] *See generally* 29 C.F.R. 2550.404a-5 (2011); *cf.* Schwartz, *supra* note 31, at 568–73 (discussing ways to improve mutual fund disclosure).

funds. This would help to counterbalance the investor naïveté and industry marketing efforts that tug in this direction.

In sum, this new retirement-savings landscape would include a default investment with an allocation to an equities index fund and TIPS. The investments available to those who choose to opt out of the default would not be limited. But the marketplace should be transparent and the government match should be limited in cases where it is applied to actively-managed investments. This framework should provide investors with guidance and safety without foreclosing innovation or choice.[180]

V. Conclusion

The current 401(k) template raises significant efficiency and fairness concerns. Most glaringly, its noninterventionist stance with respect to investment decisionmaking turns a blind eye to enormously costly mistakes, while its interventionist tax subsidy, by and large, subsidizes the wrong people.

The proposal outlined above realigns pension policy with the public interest. The new template would be centered around low- and middle-income earners. Each would be defaulted into a retirement fund structured to provide the investor with the potential for reasonable investing returns, and, at a minimum, the return, in real terms, of every dollar put in. Individuals automatically enrolled in the default fund would have the option of remaining, choosing another alternative, or opting out completely. While nobody would be forced to stay in the savings program, individuals would be incentivized to do so by a government savings match that declines as salary increases. The creation of the 401(k) paradigm was a regulatory accident, the result of which is a pension policy marred by inefficiency and inequality. The adoption of this proposed framework, however, would make great strides in remedying these ills.

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[180] This Article focuses on the accumulation phase of retirement savings. There is also concern about what happens when individuals retire. Many take a lump-sum distribution, when in fact a life-time annuity may be the better option. Resolution of this issue is outside the scope of this Article, but for further discussion, see Munnell & Sundén, *supra* note 13, at 143–71 and Paul M. Secunda, *401K Follies: A Proposal to Reinvigorate the United States Annuity Market*, 30 ABA Sec. of Tax'n Newsquarterly, 13, 14–15 (2010).