Article

The Defined Contribution Paradigm

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CONTENTS

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INTRODUCTION

Pension cognoscenti have frequently remarked on the stagnation of defined benefit pensions and the concomitant rise of defined contribution plans. I suggest that, over the last generation, something even more fundamental has occurred, something that can justly be called a paradigm shift. Americans today primarily conceive of and implement retirement savings in the form of individual accounts. Such accounts have become primary instruments of public policy, not just for retirement savings, but increasingly for health care and education as well.

To some, President Bush's proposals to introduce personal accounts to the Social Security system and to revise the individual account provisions of the Internal Revenue Code[1] appear to be radical departures from the status quo. In fact, those proposals continue the process of the last three decades by which the defined contribution plan has become the primary framework for retirement savings and, more broadly, a fundamental tenet of tax and social policy.

Pension mavens (myself included) have framed the choice between the defined benefit and the defined contribution formats as a matter of risk allocation in the design of retirement savings programs.[2] The defined benefit configuration principally assigns risk to the employer because the employer guarantees the employee a specified benefit, while the more privatized defined contribution approach apportions risk to the employee, because the adequacy vel non of the employee's retirement resources in her individual account is the employee's problem. This remains an important truth as far as it goes.

However, the defined contribution society as it has emerged today entails more considerations than this and constitutes a fundamental transformation of the way Americans think about and implement tax and social policy. In a defined contribution society, the policies more likely to be adopted are those that channel government subsidies through individual accounts controlled by the taxpayer herself. In contrast, defined benefit

1. *See, e.g.*, Edmund L. Andrews, *Bush Promotes Earlier Proposals for Tax-Advantaged Savings Accounts*, N.Y. TIMES, Jan. 21, 2004, at A16; Arleen Jacobius & Vineeta Anand, *Huge Implications*, PENSIONS & INVESTMENTS, Feb. 17, 2003, at 1; Richard W. Stevenson, *Bush Prepares for Changes in Programs and Cabinet*, N.Y. TIMES, Nov. 7, 2004, at A34. The Bush proposals would enlarge, simplify, and combine the existing forms of individual accounts. These proposals would thereby increase quantitative limits on the amounts that can be saved on a tax-deferred basis and weaken the link between tax deferral and particular purposes for saving.

2. *See, e.g.*, David Millon, *Worker Ownership Through 401(k) Retirement Plans: Enron's Cautionary Tale*, 76 ST. JOHN'S L. REV. 835, 838 (2002) ("This development is important because defined-benefit and defined-contribution plans differ in how they allocate investment risk.").

arrangements—as exemplified by the traditional pension plan and the federal Social Security system—are less likely to be proposed, adopted, or expanded. As a result of the increasing prevalence of defined-contribution-type programs, upper-middle-class taxpayers can in practice undertake all of their financial savings for retirement, education, and health outlays through tax-favored individual account devices. If Congress ever formally transformed the Internal Revenue Code into a federal consumption tax, the defined contribution paradigm would have paved the way for that transformation, by acclimating the public to tax-favored accounts for savings.

While the emergence of the defined contribution society has been a quiet, largely unheralded revolution, a revolution it has been, incrementally but fundamentally changing the manner in which Americans think about tax and social policy and in which their governments formulate such policy. Like any other paradigm shift, the emergence of the defined contribution society has both opened opportunities and foreclosed possibilities. As the members of the Baby Boom generation provide for their retirements, educate their offspring, and prepare for the medical costs of their older years, the defined contribution paradigm will be the framework governing their choices.

The initial Part of this Article describes the differences between defined benefit and defined contribution plans as retirement savings devices. In this Part, I emphasize the characteristics of the traditional defined benefit pension, which pays a deferred retirement annuity based on the participant's salary and work history, and the contemporary defined contribution plan, largely self-funded by the participant's salary reduction contributions to his or her own account. Part II discusses these differences as a matter of retirement plan design: Defined benefit arrangements principally allocate risk and reward to the sponsoring employer, while defined contribution devices assign such risk and reward to the participant. In the third Part, I sketch the major features of the contemporary defined contribution paradigm and its development to date. This sketch highlights, inter alia, the extent to which the paradigm today determines how middle-class individuals and households undertake their medical and educational savings, making the defined contribution format the norm for such savings. The fourth Part places the defined contribution paradigm in the context of the possible futures of the Internal Revenue Code and emphasizes the extent to which the paradigm has effectively converted the Code into a consumption tax for middle-class taxpayers. Finally, I label the choices presented to us by the defined contribution paradigm and identify those that I think are best.

I. HOW ARE THEY DIFFERENT? THE DEFINED BENEFIT AND DEFINED CONTRIBUTION FORMATS CONTRASTED

In the often opaque morass of pension terminology, the distinction between defined benefit and defined contribution plans is surprisingly clear. A defined benefit pension, as its name implies, specifies an output for the participant. Traditionally, such plans defined benefits for particular employees based on the employees' respective salary histories and their periods of employment.[3] Thus, for example, a prototypical defined benefit formula specifies that a participant is entitled at retirement to an annual income equal to a percentage of her average salary times the number of years of her employment with the sponsoring employer.[4]

In contrast, a defined contribution arrangement, as its equally apt moniker indicates, specifies an input for the participant. Commonly, the plan defines the employer's contribution for each participant as a percentage of the participant's salary for that year. Having made that contribution, the employer's obligation to fund is over because the employee is not guaranteed a particular benefit, just a specified input. In a defined contribution context, the participant's ultimate economic entitlement is the amount to which the defined contributions for her, plus earnings, grow or shrink.

Defined contribution plans classically took the form of employer-sponsored pensions (often denoted "money purchase pensions") and of employment-based profit-sharing arrangements. In the pension incarnation, the employer sponsoring a defined contribution arrangement has a fixed annual obligation to contribute, typically a percentage of the participant's salary. The profit-sharing alternative, on the other hand, gives the employer flexibility in determining its contribution. Most obviously, the sponsoring employer need not contribute anything in a year without profits, unlike a pension obligation, which is a fixed cost unrelated to profitability.[5] Profit-

3. Union-sponsored plans often use only service in determining the participant's retirement benefits, e.g., twenty dollars of monthly retirement income for each year of covered employment. *See, e.g.*, Schweizer Aircraft Corp. v. Local 1752, UAW, 29 F.3d 83, 84 (2d Cir. 1994) (describing such a plan).

4. *See* JOHN H. LANGBEIN & BRUCE A. WOLK, PENSION AND EMPLOYEE BENEFIT LAW 45 (3d ed. 2000); Edward A. Zelinsky, *The Cash Balance Controversy*, 19 VA. TAX REV. 683, 687-91 (2000).

5. Defined benefit plans are, by definition, pensions, because the employer is obligated to fund the benefit promised to its employees. *See* Treas. Reg. § 1.401-1(b)(1)(i) (as amended in 1976) ("A pension plan within the meaning of section 401(a) is a plan established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to his employees over a period of years, usually for life, after retirement."); *cf. id.* § 1.401-1(b)(1)(ii) ("A profit-sharing plan is a plan established and maintained by an employer to provide for the participation in his profits by his employees or their beneficiaries.").

sharing plans can also be designed to permit the employer to decide annually how much of its profits it wants to contribute. The great flexibility of profit-sharing plans explains their increasing popularity in recent years, particularly when that flexibility is contrasted with the regulatory rigidities surrounding defined benefit pensions.

Traditionally, defined benefit arrangements have promised participants benefits at retirement in the form of periodic (typically monthly) payments for the duration of the retired participant's life. Amounts to fund these benefits (paid by the employer, sometimes augmented by employee contributions) are invested in a trust fund supervised by trustees. At retirement, the fund pays the now-retired employee her defined benefit or purchases an annuity contract for her to provide such periodic benefit.

Thus, for purposes of this discussion, traditional defined benefit pensions have four major characteristics as a matter of plan design. First, they provide income on a deferred basis at retirement and not before then.[6] Second, traditional defined benefit plans provide such retirement income as periodic, annuity-type payments rather than as single lump sums. Third, traditional defined benefit plans are funded collectively, the employer's contributions being pooled in a common trust fund from which all participants receive their benefits. Finally, the defined benefit format places on the employer rather than the employee the obligation to fund the benefit promised to the participating employee. If the funds in the trust are inadequate to pay promised benefits, the employer is obligated to make up the shortfall. Thus, as I shall discuss in the next Part, the risks associated with funding a defined benefit pension fall principally on the employer.[7]

In all four respects, today's prototypical defined contribution plan differs. The contemporary defined contribution arrangement distributes to an employee when she leaves employment, even if she is well short of retirement age.[8] Typically the distribution from a defined contribution plan today takes the form of a single lump sum payout of the employee's

6. Defined benefit plans often pay a death benefit to the employee's spouse if the employee dies while working and pay a disability payment if the employee becomes disabled while working. However, as to a living, healthy employee, the typical traditional defined benefit plan starts payments only at retirement.

7. If an employer fails financially with an underfunded defined benefit plan, the funding shortfall may be the responsibility of the Pension Benefit Guaranty Corporation (PBGC), the federal corporation that provides FDIC-type insurance to defined benefit plans. If the employer is insolvent and the employee's benefit exceeds the level insured by the PBGC, the employee may be out of luck. On balance, however, the observation in the text is correct: The sponsor of a defined benefit plan undertakes to guarantee a specified output at retirement and thus bears the principal risk of a funding shortfall.

8. *See* PATRICK J. PURCELL, CONG. RESEARCH SERV., ORDER CODE RL30496, PENSION ISSUES: LUMP-SUM DISTRIBUTIONS AND RETIREMENT INCOME SECURITY, at Summary (2003) ("Thus, most recipients of lump sums were more than 20 years away from retirement.").

account balance rather than an annuity or other periodic distribution spread over time.[9] By its nature, a defined contribution plan does not pool resources like a defined benefit pension but rather establishes for each participant his own individual account. Allocated to that account are the employer's contributions for the employee, the employee's own contributions (if any), and the earnings or losses generated by the investment of all those contributions. For this reason, defined contribution plans are synonymously known as individual account plans.[10]

Since the employee's entitlement under the plan is the balance of her individual account, good investment performance redounds to the employee's benefit (because her account balance is larger), while, symmetrically, poor investment performance hurts the employee (because her account balance is smaller and the employer has no obligation to fund a defined benefit). Thus, as I emphasize in the next Part, defined contribution plans, in contradistinction to defined benefit arrangements, shift investment risk and reward from the employer to the employee.

Increasingly, defined contribution assets, while formally held in trust funds, are invested by each employee herself. Under such self-directed arrangements,[11] the employee chooses the investments for the amounts in her individual account.

In short, the label "defined benefit," standing by itself, is in important ways incomplete. The traditional defined benefit plan specified a quite particular kind of benefit: a deferred annuity, starting at retirement, typically measured by the employee's work and salary history. Similarly, today the moniker "defined contribution" predominantly refers to a profit-sharing plan with a salary reduction (401(k)[12]) arrangement and participant-directed investing, a plan that distributes to a participant as a lump sum upon the severance of employment[13] (which, in a world of employee mobility,[14] often takes place before retirement age). The shift from the defined benefit modality to the defined contribution one has altered in a

9. *See id*. at 6.

10. *See* Employee Retirement Income Security Act (ERISA) of 1974 § 3(34), 29 U.S.C. § 1002(34) (2000). In this Article, I shall use the terms "defined contribution plan" and "individual account plan" interchangeably.

11. Such self-directed accounts are authorized under ERISA section 404(c). *See infra* notes 108-110 and accompanying text.

12. CBO, UTILIZATION OF TAX INCENTIVES FOR RETIREMENT SAVING 5 (2003) ("All of the growth in participation in defined-contribution plans between 1975 and 1997 can be attributed to 401(k) plans.").

13. Sometimes a defined contribution distribution may occur even before the participant's separation from service. *See* Treas. Reg. § 1.401-1(b)(1)(ii) (as amended in 1976) (permitting in-service profit-sharing distributions as long as "the funds accumulated under the plan" for "a fixed number of years").

14. *See* PURCELL, *supra* note 8, at Summary ("A typical 25-year-old today will work for seven or more employers before reaching age 65 . . . .").

fundamental manner the way in which Americans experience and think about retirement savings; simultaneously it has transformed our approach to other areas of tax and social policy.

II. WHY DOES IT MATTER? ALLOCATING RISK AND REWARD

In this Part, I probe the basic features of defined benefit and defined contribution plans in terms of the allocation of risk and reward in the design of retirement arrangements. In terms of retirement planning, there are a variety of risks that the defined benefit arrangement assigns to the employer and that a defined contribution plan allocates to the employee. As an initial matter, it is useful to divide these risks into three broad categories—investment risk, funding risk, and longevity risk—although, as we shall soon see, within these categories there are important subclasses that could themselves plausibly be treated as separate categories of risk. We shall also see that the assignment of risk and reward to the individual account holder is a critical feature of the defined contribution paradigm as that paradigm has spread from the arena of retirement savings to encompass savings for health and medical outlays.

A. *Investment Risk*

Consider initially investment risk, the risk that retirement resources will earn an inadequate rate of return. Defined benefit arrangements impose investment risk upon the sponsoring employer because the employer, having promised specified retirement benefits, must provide the additional contributions to fund those promised benefits even if the plan's assets earn disappointing returns. In contrast, defined contribution arrangements shift the risk of poor (and the rewards of better) investment performance to the employee, because her entitlement under the plan is her account balance, however low (or high) that balance might be.

For several reasons, it is often advantageous for the employer to absorb investment risk via a defined benefit arrangement.[15] An employer investing a single large pool of pension assets through a trust holding defined benefit assets can obtain economies of scale unavailable to the employees each investing for herself, particularly because the employees are often investing relatively small amounts. By spreading transaction costs over a single large

15. *See* Daniel Halperin, *Employer-Based Retirement Income—the Ideal, the Possible, and the Reality*, 11 ELDER L.J. 37, 61 (2003) ("Employers have much greater capacity than employees to absorb the risks associated with investment performance. Besides benefiting from economies of scale, the employer can average out investment results among cohorts of retirees, so it need not worry about a temporary market downturn.").

pool of capital, the employer sponsoring a defined benefit arrangement can achieve a higher net rate of return than can the employees, each investing on her own.

In theory, economies of scale can be achieved when investing defined contribution assets because these assets too can be controlled on a centralized basis by the plan's trustees. In that case also, the costs of commissions and investment advice can be spread over a larger pool of employer-managed capital with resulting economies of scale. In practice, however, today's defined contribution plans typically take the form of self-directed 401(k) plans under which the employee invests her own resources,[16] even if her investment choice is simply to leave her funds in the plan's default investment option.[17] Thus, the realistic choice today is between defined benefit plans, with the economies of scale they can achieve through centralized investment of a single pooled fund, and self-directed defined contribution plans that, in contrast, entail proportionately higher transaction costs because retirement resources are managed on a dispersed basis by individual employees in their own separate accounts.[18] There is, moreover, a substantial consensus that many (perhaps most) employees in self-directed defined contribution arrangements are poor investors, regardless of how much is spent educating and advising them.[19]

16. LAWRENCE A. FROLIK & KATHRYN L. MOORE, LAW OF EMPLOYEE PENSION AND WELFARE BENEFITS 45 (2004) ("[A]lmost 90 percent of 401(k) plans permit the participants to control the investment of their accounts subject to the options provided by the plan.").

17. *See, e.g.*, JAMES J. CHOI ET AL., DEFINED CONTRIBUTION PENSIONS: PLAN RULES, PARTICIPANT DECISIONS, AND THE PATH OF LEAST RESISTANCE 4 (Nat'l Bureau of Econ. Research, Working Paper No. 8655, 2001) ("[E]mployer choices of default savings rates and default investment funds strongly influence employee savings levels. Even though employees have the opportunity to opt out of such defaults, few actually do so."); JAMES J. CHOI ET AL., FOR BETTER OR FOR WORSE: DEFAULT EFFECTS AND 401(K) SAVINGS BEHAVIOR 5 (Nat'l Bureau of Econ. Research, Working Paper No. 8651, 2001) ("Under automatic enrollment, 65-87% of new plan participants save at the default contribution rate and invest exclusively in the default fund."); Cass R. Sunstein & Richard H. Thaler, *Libertarian Paternalism Is Not an Oxymoron*, 70 U. CHI. L. REV. 1159, 1172-73 (2003).

18. *See* Colleen E. Medill, *Challenging the Four "Truths" of Personal Social Security Accounts: Evidence from the World of 401(k) Plans*, 81 N.C. L. REV. 901, 907-08, 937-46 (2003) (discussing the impact of mutual fund fees on the worker's account balance at retirement); *see also* Alicia H. Munnell, *Comment*, *in* HENRY J. AARON & JOHN B. SHOVEN, SHOULD THE UNITED STATES PRIVATIZE SOCIAL SECURITY? 133, 137 (Benjamin M. Friedman ed., 1999) (noting that "IRA-type account[s] would be extremely costly" because of "transaction costs").

19. *See* David M. Cutler, *Comment*, *in* AARON & SHOVEN, *supra* note 18, at 123, 129 ("[M]any people (particularly the poor) may not be good investors."); Richard L. Kaplan, *Enron, Pension Policy, and Social Security Privatization*, 46 ARIZ. L. REV. 53, 83 (2004) ("[M]ost employees have neither the training, the interest, nor the desire to become competent money managers. . . . It is hardly surprising, therefore, that individually managed retirement accounts perform more poorly than professionally managed accounts, often by significant margins."); Norman Stein, *Three and Possibly Four Lessons About ERISA That We Should, but Probably Will Not, Learn from Enron*, 76 ST. JOHN'S L. REV. 855, 861, 861-68 (2002) (claiming that the argument that "investor education can mitigate the problem of employees allocating excessive amounts of their investments in plans to employer stock. . . . is problematic").

A component of investment risk stems from employers' longer time horizons, which permit employers (or to be precise, plan trustees engaged by employers) to invest in riskier, but ultimately more profitable, investments than can many employees, particularly older persons with shorter time horizons to retirement and thus less ability to make riskier investments. The basic considerations are now well known under the rubric of portfolio theory:[20] An older 401(k) participant's choice of a riskier investment with a higher long-run return is potentially problematic because she may not have the time to wait for the investment's rebound—assuming that rebound will occur.[21] In contrast, with a longer time horizon, a defined benefit plan can more comfortably make this riskier but more profitable investment. This subcategory of investment risk can be denoted as "temporal risk," the time-based danger associated with riskier investments because such investments' variability may strike on the downside at an inopportune time in the individual's life span, i.e., when she needs her retirement resources to live.

The self-investing participant can respond to this temporal risk by eschewing riskier investments, but a more conservative strategy reduces her long-term rate of return as she limits herself to less aggressive possibilities. Alternatively, a defined contribution participant concerned about the temporal risk of aggressive investments but sensitive to the lower returns earned by more conservative deployments of her capital can use her individual account resources to purchase an annuity contract. The insurer issuing that annuity contract (like a defined benefit plan) has a longer (arguably infinite) time horizon that permits the insurer to invest more aggressively; the insurer's consequently superior long-run investment return will be reflected in the terms of the annuity contract purchased by the participant.

However, this private response to temporal risk carries with it the shortcomings inherent in participant-directed investing: There are diseconomies of scale when myriad defined contribution retirees purchase annuities individually. Many of those retirees may be unsophisticated investors who are ignorant either of temporal risk or of their ability to contract out of it by purchasing annuity policies from companies with

20. For a technical presentation of these ideas, see ZVI BODIE & ROBERT C. MERTON, FINANCE 255-57, 272-77, 299-303, 318-37 (2000). For a presentation aimed at a general audience, see M. JOHN STERBA, JR., FUNDAMENTALS OF PERSONAL INVESTING: A GUIDE FOR LAWYERS AND OTHER PROFESSIONALS 8-43 (1997).

21. If a seventy-year-old conceives of his retirement resources as testamentary in nature, his perspective may be different, because, in that case, he may think in terms of the longer life expectancies of his younger heirs, intended to be the ultimate recipients of those resources. However, insofar as retirement resources are for financing retirement, a seventy-year-old has a far shorter time horizon than does a thirty-year-old.

longer time horizons; paying to educate these investors costs money and is not always successful. Here, then, is another investment-based argument for the defined benefit plan, which facilitates better long-term investment performance by imposing temporal risk on the employer.

B. *Funding Risk*

A second major category of risk allocated to the employer by the defined benefit format can be denoted "funding risk,"[22] i.e., the danger that the funds necessary to finance adequate retirement benefits will not be contributed to the plan. By definition, a defined benefit plan places primary responsibility upon the employer for financing the benefits promised by the plan.[23] Indeed, as I will discuss below,[24] ERISA imposed complex and opaque funding obligations on defined benefit sponsors to ensure that that responsibility is executed properly. In similar fashion, a money purchase pension, though it is a defined contribution device, is a pension plan and thus imposes upon the employer the legal responsibility to fund the contributions required under the plan. While the employee is not guaranteed that those contributions will grow to any particular level (investment risk and reward fall on the employee), the employee covered by a money purchase arrangement is assured that the employer will, as an initial matter, make the promised inputs to the plan.

In practice, however, defined contribution plans today come not in the pension variant but in forms that place the principal funding risk on the employee. Most prominently, 401(k) plans usually require the employee to elect reduced salary for funds to be contributed to the plan on the employee's behalf.[25] If an employee does not so elect, the failure to fund her 401(k) account is the employee's problem, not the employer's responsibility.[26] By shifting funding risk to employees, i.e., by requiring 401(k) participants to make affirmative decisions to save from current

22. FROLIK & MOORE, *supra* note 16, at 34-35.

23. Some defined benefit plans have a contributory feature under which each participant makes an explicit contribution to the plan. Today, such contributory plans are less common than they once were. Most economists believe that employers' payments to qualified plans ultimately result in reduced current compensation and thus an implicit contribution by the covered employee.

24. *See infra* notes 68-75 and accompanying text.

25. Regina T. Jefferson, *Post-Enron Pension Reform: Where Do We Go from Here?, in* NEW YORK UNIVERSITY REVIEW OF EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION § 10.01, at 10-1, § 10.02[3], at 10-10 (Alvin D. Lurie ed., 2003). I discuss 401(k) plans in detail *infra* Section III.B.

26. The same is also true under 403(b) plans.

salary, the defined contribution paradigm may be pushing some (perhaps many) employees down the path of inadequate retirement savings.[27]

Or consider conventional profit-sharing plans under which the employer, in its discretion, may or may not contribute to the plan in any given year. Because the employer has no obligation to make discretionary profit-sharing contributions in any particular year,[28] the employer's failure to make such contributions causes the employee's account to be unfunded. While the employee has no legal obligation to fund in this context, the economic risk of no or inadequate funding falls upon the employee, because the employer's failure to make adequate contributions to its profit-sharing plan results in a deficient account for the employee at retirement.

C. *Longevity Risk*

Consider finally longevity risk, i.e., the danger that a retiree will outlive her retirement resources.[29] The traditional, annuity-paying defined benefit plan provides at least partial protection against longevity risk because such a traditional pension disburses retirement payments periodically (typically monthly) and continues such annuity-type payments until the participant's death—often with payments continuing at a reduced level to the surviving spouse. With such a lifetime annuity it is by definition impossible for the retiree to outlive her pension income, though that income may decline in real value if it is not increased to reflect increments in the cost of living.

The defined contribution participant can eliminate her longevity risk on her own by annuitizing her account balance.[30] In particular, a retiree can use her account balance from a 401(k) or another kind of profit-sharing plan, a money purchase plan, an IRA, or a 403(b) account to buy an individual commercial annuity policy for herself (and, perhaps, her spouse). That annuity policy will replicate the periodic, lifetime payout from a defined benefit arrangement.

27. The insights of behavioral economics may supply a remedy to this problem of employee undersaving, namely default rules that affirmatively require employees to opt out if they wish to refrain from saving. *See infra* notes 258-260 and accompanying text.

28. An employer cannot avoid profit-sharing contributions indefinitely. To qualify as a profit-sharing plan, there must, over the years, "be recurring and substantial contributions out of profits for the employees." Treas. Reg. § 1.401-1(b)(2) (as amended in 1976).

29. *See* RICHARD A. IPPOLITO, PENSIONS, ECONOMICS AND PUBLIC POLICY 30-32 (1986); DAN M. MCGILL ET AL., FUNDAMENTALS OF PRIVATE PENSIONS 444 (7th ed. 1996); Peter Orszag & Norman Stein, *Cross-Tested Defined Contribution Plans: A Response to Professor Zelinsky*, 49 BUFF. L. REV. 629, 654-55 (2001).

30. William G. Gale & Peter R. Orszag, *Whither Pensions? A Brief Analysis of Portman-Cardin III*, 99 TAX NOTES 573, 574 (2003) ("[A]nnuitization is crucial to ensuring that retirees will not outlive their savings."). As noted earlier, annuity contracts can also be used to mitigate temporal risk because the issuer has a longer horizon for investments than does the individual annuity purchaser.

However, such individualized solutions to the problem of longevity risk entail adverse selection[31] for insurers selling individual annuity policies, namely the danger that those most concerned about longevity risk and purchasing protection against it will indeed be the persons who live longest. The retirees buying commercial annuities for themselves because they are concerned about longevity risk tend to be people who perceive (often accurately) that they are healthier than their peers and thus likely to live beyond their actuarial life expectancies. Consequently, commercial insurers charge a premium for the individual annuity policies they sell because the purchasers of such policies tend to be more long lived than their peers who do not purchase such annuities.[32] The premium from the insurers' perspective is a penalty from the retirees'. This penalty/premium leads many experts to prefer the defined benefit arrangement as a superior device for mitigating longevity risk.[33]

In theory, defined contribution plans can be designed in a fashion that ameliorates longevity risk in the same way as defined benefit arrangements. In particular, if a defined contribution plan provides for only the annuitization of distributions and furnishes no other distribution option (e.g., no lump sum payments), the plan will purchase annuity contracts that do not reflect a premium for adverse selection, because the group of covered employees will have a normal distribution of life expectancies. In practice, however, this option rarely exists; today, virtually all defined contribution plans distribute participants' account balances to them as lump sums rather than as annuities. This leaves each retiree concerned about

31. MICHAEL J. GRAETZ & JERRY L. MASHAW, TRUE SECURITY: RETHINKING AMERICAN SOCIAL INSURANCE 16 (1999) (defining adverse selection as "the tendency of those at high risk to be overrepresented in the insurance pool."). Professor Schuck has recently defined adverse selection as a "diversity-related impediment to market efficiency." PETER H. SCHUCK, DIVERSITY IN AMERICA: KEEPING GOVERNMENT AT A SAFE DISTANCE 58 (2003). According to Schuck,

> Where participants in an insurance pool are diverse in ways that pose significantly different risks of loss but their premiums are based on average risk rather than on their own risk, people who pose lower-than-average risks will want to avoid or abandon this pool in favor of insurance for which they can pay a premium reflecting their own, lower risk.

Id.; *see also* PETER A. DIAMOND & PETER R. ORSZAG, SAVING SOCIAL SECURITY: A BALANCED APPROACH 73 (2004) ("Adverse selection stems from the fact that those who expect to benefit more from insurance are more likely to buy it . . . .").

32. *See* GAO, NO. GAO-03-309, SOCIAL SECURITY REFORM: INFORMATION ON USING A VOLUNTARY APPROACH TO INDIVIDUAL ACCOUNTS 18 (2003) ("As a result [of adverse selection], annuity prices can be as much as 14 percent higher than they would be if every retiree purchased an annuity, according to one study."); Medill, *supra* note 18, at 958 ("The traditional explanation given by economists for the low demand for traditional annuities is the problem of adverse selection."); *id*. at 959 ("Annuity providers will price the traditional annuity at a higher cost to account for this systemic increased risk of longevity among purchasers of traditional annuities.").

33. *See, e.g.*, Medill, *supra* note 18, at 960 (discussing how adverse selection "can be easily avoided" with "defined benefit plans sponsored by private employers").

longevity risk to purchase her own annuity contract; that, in turn, leads to an adverse selection problem, as the retirees who purchase such contracts tend, as a group, to be more long lived than those who do not.

While the universal, compulsory nature of Social Security is often justified in redistributive terms (Social Security provides proportionately more retirement income for lower-paid workers)[34] and in paternalistic terms (Social Security compensates for workers' short-sighted failure to save),[35] longevity risk is, in important respects, the most compelling defense of a mandatory, annuity-providing public pension program like Social Security. By definition, there can be no adverse selection when no one can opt out of a compulsory, universal pension pool.

Even if there were no adverse selection problem in the market for individually purchased annuities, there is substantial market-based risk for the 401(k) or IRA holder who purchases an individual annuity upon her retirement. If that retiree is lucky enough to terminate employment during a bull market, her lump sum distribution will be large and the resulting gains will be locked in when she converts her substantial lump sum into an annuity contract. On the other hand, if a 401(k) participant or IRA holder retires and purchases an annuity during a bear market, her smaller lump sum distribution will translate into a permanently smaller annuity. True, that retiree could try to wait out the bear market and purchase an annuity later. However, that wait entails its own risks: For example, the market might go even lower.

Moreover, the defined contribution participant purchasing her own annuity upon retirement bears the risk associated with the purchase rates of annuity contracts. If the participant buys her annuity contract when insurers are assuming higher returns, her lump sum will purchase a more generous annual income than if she retires when annuity contracts are less favorable.

Thus, even absent adverse selection in the market for privately purchased annuities, the ability of an individual account retiree to shift longevity risk to the issuer of an individually purchased annuity contract entails market risk (and possible reward) for that retiree. The historic evidence indicates that, because of varying market conditions including the fluctuating interest rate assumptions used by annuity issuers, returns to retirees can "vary enormously and over relatively short periods of time."[36]

34. *See, e.g.*, John B. Shoven, *Social Security Reform: Two Tiers Are Better than One*, *in* AARON & SHOVEN, *supra* note 18, at 1, 15 (arguing that Social Security's "redistribution from those with higher lifetime earnings to those with lower earnings is entirely appropriate and worth preserving").

35. *See, e.g.*, DIAMOND & ORSZAG, *supra* note 31, at 73; Munnell, *supra* note 18, at 144.

36. Henry J. Aaron, *Social Security: Tune It Up, Don't Trade It In*, *in* AARON & SHOVEN, *supra* note 18, at 55, 64.

In contrast, a traditional defined benefit plan can self-annuitize, providing annual payments to retirees from its common pool of funds. Alternatively, the traditional defined benefit pension can purchase annuity contracts throughout the retiree's career and thereby avoid the need to buy an annuity at a single (potentially unfavorable) moment. While a well-informed individual account holder might similarly purchase annuity policies throughout her career, there is to date no evidence that this investment pattern is in fact widespread. Even if it were, myriad purchases of individual annuities would entail diseconomies of scale, such as fees and administrative costs, that are avoided by pension trusts' centralized purchases of annuities for groups of employees.

D. *Qualifications*

None of this is to say that defined benefit plans are risk free for their participants; no financial arrangement can be devoid of risk for the parties.[37] For example, a defined benefit participant whose annuity entitlement is specified in nominal rather than real dollars bears the risk that inflation will erode the purchasing power of her retirement distribution. In this sense, the defined benefit participant is the holder of a fixed claim like a bondholder and, as such, is exposed to the dangers of inflation or the possible benefits of deflation.

Even if a defined benefit plan provides cost-of-living increases for retirees, inflation represents an important risk for the defined benefit participant who terminates employment prior to retirement and is entitled to an annuity fixed in nominal terms. In such instances, even if a cost-of-living adjustment kicks in at age sixty-five, there is no compensation for inflation before then.

Similarly, in the event of catastrophic default, i.e., the insolvency of both the plan and its sponsoring employer, the participant, to the extent her benefits exceed the level insured by the Pension Benefit Guaranty Corporation (PBGC),[38] bears the loss.[39] Again, in this context, analogizing a

37. Even U.S. Treasury debt, universally considered the benchmark for risk-free investment, carries with it the (remote) possibility that the federal government could suspend its debt payments.

38. See *infra* notes 77-82 and accompanying text for a discussion of the PBGC.

39. Some pension analysts use the term "default risk" more broadly than I do in this Article. *See, e.g.*, BODIE & MERTON, *supra* note 20, at 36; JAMES A. WOOTEN, THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974: A POLITICAL HISTORY (forthcoming 2005) (manuscript at 53, on file with author). While a more expansive concept of default risk is useful in certain settings, for purposes of my analysis it is helpful to distinguish the circumstances that can cause an employer to default on its pension promise, e.g., pension assets earn an inadequate rate of return, the employer funds inadequately, or the employer goes out of business before financing promised benefits. The first possibility is subsumed within the concept of investment risk, while

defined benefit participant to a bondholder is instructive. Insofar as the participant's pension claim is insured by the PBGC, the participant (like the owner of an insured debenture) has recourse to the PBGC if the employer-issuer becomes insolvent and the collateral (i.e., the pension trust assets) becomes inadequate. However, to the extent a defined benefit participant's claim exceeds the amount covered by the PBGC, employer default is a risk that falls on the participant, as pension trust assets may be insufficient to pay promised benefits after the employer's insolvency. For such a participant, employer default represents undiversifiable risk because her job and her pension (to the extent it is noninsured and inadequately funded) both depend upon the employer's continued viability.

There is an important intergenerational element to the defined benefit risk of employer default: Such risk is concentrated most heavily upon younger plan participants who are neither withdrawing funds from the plan nor close to starting such withdrawals. As current retirees receive their payments and thus extract the funds of the pension trust ahead of younger active participants, the risk of employer default diminishes for these retirees, because they have their retirement resources in hand and, to that extent, are protected against default. If the plan terminates, these current retirees, by statute, have a higher claim on the assets of the defined benefit pension trust than do younger participants.[40] These younger participants are the ones who will be left holding the proverbial bag if the plan and the employer both become insolvent.

To the extent the PBGC insures pension payments in the face of plan and employer default, the risk for younger participants shifts from the solvency of the plan and the employer to the solvency of the PBGC. And here there are reasonable bases for worry, given the deficits the PBGC itself confronts.[41] Younger participants, from one perspective, are the greatest beneficiaries of PBGC coverage (because they are furthest away from

the second scenario goes to funding risk. I think it makes sense to limit the concept of "default risk" to the situation in which the employer goes out of business, leaving behind an inadequately funded pension.

40. ERISA § 4044(a)(3)-(4), 29 U.S.C. § 1344(a)(3)-(4) (2000).

41. *America's Pensions: The Next Savings and Loan Crisis?: Hearing Before the Senate Special Comm. on Aging*, 108th Cong. 51, 49-53 (2003) [hereinafter *America's Pensions*] (statement of Steven A. Kandarian, Executive Dir., PBGC) ("During FY 2002, PBGC's single-employer insurance program went from a surplus of $7.7 billion to a deficit of $3.6 billion—a loss of $11.3 billion in just one year. The $11.3 billion loss is more than five times larger than any previous one-year loss in the agency's 29-year history."); GAO, NO. GAO-04-90, PENSION BENEFIT GUARANTY CORPORATION: SINGLE-EMPLOYER PENSION INSURANCE PROGRAM FACES SIGNIFICANT LONG-TERM RISKS 1 (2003) (stating that "the long-term viability of the program is at risk" as to PBGC single-employer insurance program); Mary Williams Walsh, *U.S. Insurer of Pensions Says Its Deficit Has Soared*, N.Y. TIMES, Jan. 16, 2004, at C1.

claiming pension trust assets) and are consequently at greatest risk if the PBGC itself is ultimately incapable of meeting its obligations.

The "back-loaded" nature of defined benefit plans[42] creates another kind of risk for the participant: She may lose her employment and thus her plan coverage just as she is about to earn the most valuable benefits under the plan. Because older employees tend to be more highly paid, their salary-based pension entitlements escalate late in their careers. An employee may work for an employer sponsoring a defined benefit plan in anticipation of earning significant pension benefits toward the end of her career and then be fired on the cusp of those high-pay years. Even for an employee whose compensation does not increase in her later years, the pension accruals of those years will have increased present value because the employee is closer to retirement than before and a pension dollar to be received shortly has greater present value than does a pension dollar to be received far in the future.

The Code and ERISA preclude certain types of back-loading by proscribing plan formulas that delay pension accruals until the end of the employee's work life.[43] However, even with these statutory safeguards, as a matter of economics the most valuable pension accruals under traditional[44] defined benefit formulas occur late in the employee's career when her salary is higher and she is closer to retirement.[45] The defined benefit participant thus bears the risk that she will be fired on the eve of those more valuable accruals.

A variation of this risk is the danger that the employee, while retaining her job, will lose defined benefit coverage as she is about to enter her most valuable years of employment. In this scenario, the employer terminates its defined benefit plan just as the employee embarks upon her years of high pay and therefore of valuable pension accruals. Even if the employer replaces the terminated defined benefit pension with an individual account plan, the employee will have lost the particularly lucrative late-career years of defined benefit coverage.

At its core, this is the source of the controversy surrounding cash balance plans, which I discuss below. Employees who work in anticipation that they will earn valuable pension benefits late in their careers instead find themselves covered by cash balance arrangements. It is an understatement

42. *See* Zelinsky, *supra* note 4, at 688-91.
43. I.R.C. § 411(b)(1) (2000); ERISA § 204(b)(1), 29 U.S.C. § 1054(b)(1).
44. Note that even union-sponsored plans tend to be back-loaded because twenty dollars of monthly pension income earned by a sixty-year-old will, in present value terms, be more valuable than that same twenty dollars of monthly pension income earned by a thirty-year-old.
45. *See* Zelinsky, *supra* note 4, at 688-91.

to say that this has disappointed these employees' expectations of significant pension accruals in their later years.

In light of all of this, I think it fair to criticize some defined benefit advocates (myself included) for tending to ignore or understate the financial risks of defined benefit arrangements for their participants. However, the fundamental point remains valid: Defined benefit pensions, in the main, impose upon the employer the predominant risks of providing adequate retirement income—funding, investment, and longevity risk. While the risks to the defined benefit participant are not de minimis, they are not as large as the risks assumed by the employer sponsoring a defined benefit plan nor as substantial as the risks assigned to the employee under individual account arrangements.

E. *Summary*

A strong case can be made that it is efficient to place various risks associated with retirement planning upon the employer, as defined benefit plans do. Investment risk, funding risk, and longevity risk all present challenges for the individual investor. And, in the final analysis, today's prototypical defined contribution participant, who finances her retirement savings through salary reduction and self-directs the investment of her individual account, is an individual investor.

In contrast, when a workforce and its retirement resources are pooled and invested collectively, as in the case of the classic defined benefit arrangement, economies of scale and other efficiencies are achieved by investing a single common pool. When the onus is placed on employers to provide defined benefits to their respective employees, investment risk (including temporal risk) and funding risk fall on employers, who will likely handle those risks better than the average employee. Similarly, an annuity-paying defined benefit plan, because it covers a more representative swath of the workforce, is a better answer to the challenge of longevity risk than is the individual purchase of annuity policies, subject to the problems of adverse selection and diseconomies of scale.

Offsetting these considerations is the reality that the allocation of risk carries with it the allocation of reward. If, in the defined benefit context, investment performance is good, the employer, having absorbed the risk, reaps the profit. The employer sponsoring a defined benefit has promised its employees an output, assuming a particular rate of return on the plan's assets. Better-than-assumed investment performance means the employer need contribute less (perhaps even nothing) to fund the promised benefits. Similarly, the benefits promised by the plan are premised on certain mortality assumptions. If employees and their beneficiaries are less long lived than has been assumed, the employer need put less into the plan.

Conversely, in the defined contribution context, the reward to the employee for absorbing risk is the potential profit of superior investment gain in her own account. In a prolonged bull market, the allocation of risk and reward to the participant looks attractive as she sees her account balance climb with seeming inevitability. When the bears return and individual account balances stagnate or decline, the employer's promise to pay a defined benefit acquires new appeal—ironically, at the same time that the cost of providing that benefit increases for the employer because declining or stagnant values of plan assets require the employer to contribute more to remedy the shortfall and thereby pay promised benefits.[46]

In light of these considerations, retirement savings specialists (myself included) have tended to view the choice between the defined benefit and the defined contribution configurations as a matter of allocating risk and reward among employers and employees and have been concerned that allocating risk and reward to employees, while appropriate for many of them, might ultimately prove problematic for a significant percentage of plan participants. However, this story of risk/reward allocation increasingly appears to be only part of the truth, a large—indeed the predominant—part of the truth but not the totality. At its core, the defined contribution paradigm reflects an individualized conception of retirement savings, a conception that carries tremendous appeal in a culture that, like ours, places a high value on private property and individual autonomy.

III. HOW DID IT HAPPEN?

In this Part, I review the major steps by which the defined contribution paradigm became entrenched in American retirement, tax, and social policy. As a preliminary matter, it is important not to overstate the decline of defined benefit plans. Many such plans remain in existence, holding roughly $1.6 trillion in assets and covering approximately one-fifth of all full-time private-sector employees.[47] Almost three-quarters of the

46. *See, e.g.*, *America's Pensions*, *supra* note 41, at 50 ("[A]s of December 31, 2002, . . . the total underfunding in single-employer plans exceeded $400 billion, the largest number ever recorded. Even with recent rises in the stock market and interest rates, PBGC projects that underfunding still exceeds $350 billion today."); Cassell Bryan-Low & Robin Sidel, *The Pension-Plan Pit: Major Companies Face Shortfall of Billions of Dollars*, WALL ST. J., Oct. 11, 2002, at C1 ("The contributions holiday of the late 1990s that many companies enjoyed as a result of the long bull market is now grinding to a halt.").

47. STAFF OF JOINT COMM. ON TAXATION, 108TH CONG., PRESENT LAW AND BACKGROUND RELATING TO THE FUNDING RULES FOR EMPLOYER-SPONSORED DEFINED BENEFIT PLANS AND

companies listed in the S&P 500 sponsor defined benefit plans.[48] Nevertheless, the defined benefit system today stagnates; both the number of such plans and the number of participants in them have declined.[49] "Since 1986, 97,000 [defined benefit] plans with 7 million participants have terminated."[50] Events during the summer and fall of 2004 suggest that the airline industry, one of the last private-sector bastions of defined benefit pensions, may be moving to shed such pensions.[51] In contrast, defined contribution devices, most prominently 401(k) plans and IRAs, have by all indicators grown. Today, significantly more private-sector employees participate in defined contribution retirement arrangements than in defined benefit plans. Indeed, the percentage of full-time, private-sector employees participating in defined contribution plans, forty percent, is roughly double the percentage of private-sector employees covered by defined benefit arrangements.[52] The assets held by employer-sponsored defined contribution plans (roughly $2.1 trillion) exceed by a wide margin the

THE FINANCIAL POSITION OF THE PENSION BENEFIT GUARANTY CORPORATION ("PBGC") 44, 48 (Comm. Print 2003), *available at* http://www.house.gov/jct/x-39-03.pdf. Different estimates vary in detail but not in substance. For example, Federal Reserve data indicate that "[a]t the end of 2002, there was $2.1 trillion in corporate defined contribution plans, compared with $1.59 trillion in corporate defined benefit plans." Arleen Jacobius, *Rollover Money To Eclipse DB and DC Plans' Assets*, PENSIONS & INVESTMENTS, Mar. 31, 2003, at 3. Data developed by the Society of Professional Administrators and Record Keepers paints a similar picture of the size of defined benefit plans. *Id*.

48. *Administration Drafting Proposals To Preserve Pension Plans*, N.Y. TIMES, Mar. 12, 2003, at C17. The numbers in the text underestimate the relative strength of the defined contribution paradigm because many surviving defined benefit plans have adopted the cash balance format, which mimics in important respects defined contribution arrangements. On cash balance plans, see *infra* Section III.F.

49. STAFF OF JOINT COMM. ON TAXATION, 108TH CONG., *supra* note 47, at 46-48.

50. *Funding Challenge: Keeping Defined Benefit Pension Plans Afloat*: *Hearing Before the Senate Comm. on Fin*., 108th Cong. 57 (2003) (prepared statement of Steven A. Kandarian, Executive Dir., PBGC); *see also id*. at 37-38 (prepared statement of Henry Eickelberg, Staff Vice President, Gen. Dynamics, representative of the Am. Benefits Council) ("The total number of defined benefit plans has decreased from a high of 170,000 in 1985 to 56,405 in 1998 (the most recent year for which official Department of Labor statistics exist), and most analysts believe there are fewer than 50,000 plans in the U.S. today. There has been a corresponding decline in the percentage of American workers with a defined benefit plan as their primary retirement plan from 38 percent in 1980 to 21 percent in 1997." (footnote omitted)).

51. *See* Joel Chernoff & Nicholas Braude, *Airline Industry Ponders UAL Move*, PENSIONS & INVESTMENTS, Aug. 9, 2004, at 1; Mary Williams Walsh, *Bailout Feared if Airlines Shed Their Pensions*, N.Y. TIMES, Aug. 1, 2004, at A1.

52. Press Release, House Committee on Education and the Workforce, Witnesses Cite Burdensome Rules and Regulations as Causes for Decline in Defined Benefit Pension Plans (June 4, 2003), *available at* http://edworkforce.house.gov/press/press108/06jun/pensionhrg060403.htm ("According to the Pension Benefit Guaranty Corporation (PBGC), there were 32,321 defined benefit plans insured by the agency last year, down from 114,000 in 1985. Furthermore, the percentage of active workers covered by these plans is down from 38 percent in 1985 to 23 percent today."); *see also* CBO, *supra* note 12, at 4 ("[From 1975 to 1997,] the percentage participating in defined-contribution plans increased from less than 15 percent to 40 percent."); Patrick Purcell, *Retirement Savings and Household Wealth in 2000: Analysis of Census Bureau Data*, J. PENSION PLAN. & COMPLIANCE, Summer 2003, at 48, 53.

assets of defined benefit arrangements. If amounts held in IRAs are added to the amounts in defined contribution plans, the size difference between defined contribution assets and defined benefit assets grows even larger.[53] All of this represents a significant reversal of historic patterns under which the traditional defined benefit plan was the dominant paradigm for the provision of retirement income.[54]

A. *The Role of ERISA*

How did the defined benefit plan go from the behemoth of the private retirement system to a secondary player? The story starts with the adoption of ERISA in 1974.[55] Of course, defined contribution plans existed before ERISA. In the pre-ERISA era, many employers maintained profit-sharing or money purchase pension plans, though these typically supplemented defined benefit pensions. Among nonprofit employers, particularly colleges and universities, the normal retirement savings arrangement was (and still is) a 403(b) annuity, an individual account funded by employee contributions, often matched by the employer's contributions. Nevertheless, in the years before ERISA, the traditional defined benefit plan was the dominant device for retirement savings.

In four ways, ERISA, without anyone planning it that way, started the trend toward the defined contribution society as we know it today. First, ERISA created the individual retirement account (IRA), a device that played a critical role in acclimating Americans to the notion of tax-advantaged[56] individual accounts. Second, ERISA placed regulatory

53. *See* Allen Kenney, *IRS Announces Release of Spring 2004* SOI Bulletin, 104 TAX NOTES 601, 601 (2004) ("By the end of 2000, the report says, 46 million taxpayers held a total of $2.6 trillion in IRAs."); Jacobius, *supra* note 47.

54. And these numbers do not reflect the assets held in individual accounts for educational and medical purposes.

55. The origins of ERISA are well explored in WOOTEN, *supra* note 39.

56. It is important to distinguish between the tax advantages under current law of qualified plans and the view that current law constitutes a tax subsidy or, to use the more conventional term, tax expenditure. The Code's treatment of qualified plan earnings (i.e., the deferral of tax until the distribution of such earnings to the plan participants) is undoubtedly more advantageous than current law's approach to investment earnings arising outside qualified plans (i.e., immediate taxation as earned). This advantage is commonly labeled a tax subsidy or a tax expenditure. For two reasons, I am skeptical of these labels as applied to qualified plans. First, current law's treatment of qualified plans falls within the range of plausible choices for a normative income tax. A rational legislator, seeking not to subsidize retirement plans but to tax them properly, could plausibly have made the choices embodied in current law considering such criteria as administrability, popular acceptance, and taxpayer liquidity. Second, current law's treatment of qualified plans is normatively correct if one favors cash flow consumption taxation, i.e., deferring taxation of savings until savings are used for consumption. From either vantage, it is misleading to call the Code's treatment of qualified plans a tax expenditure, because that treatment implements tax norms rather than subsidizing qualified plans.

burdens upon defined benefit plans in a way that made the more flexible defined contribution devices, particularly profit-sharing plans, more attractive to employers than traditional defined benefit arrangements. Third, ERISA's fiduciary rules incented employers to shift to self-directed defined contribution arrangements under which participants control the investment of their own retirement resources. Finally, ERISA permitted defined contribution plans to hold more stock of sponsoring employers than defined benefit arrangements. Cumulatively but inadvertently, these regulatory choices embodied in ERISA started America down the path to the contemporary defined contribution society.

1. *The Creation of the Individual Retirement Account*

Among the many issues confronted by the drafters of ERISA, none were knottier than the two topics labeled "portability" and "coverage"[57] for those not participating in employer-sponsored plans. Under the rubric of portability, those who crafted ERISA addressed the situation of the vested but younger participant who leaves employment prior to his retirement age. Under pre-ERISA practice, it was common (particularly under traditional defined benefit plans) for the (now-terminated) employee to receive nothing at the time he severed employment. Rather, he remained entitled to a deferred benefit, payable on a delayed basis upon the subsequent attainment of retirement age. For both administrative and economic reasons, this delay was often problematic, particularly as to relatively young employees. As an administrative matter, the plan and the terminated participant had to stay in touch with one another for the participant to receive information about the plan and his benefit and, ultimately, for the participant to get paid. Such participant tracking could be (and still is) resource consuming.[58]

For elaboration of the argument that the current tax treatment of qualified plans is not a tax subsidy but rather is consistent with choices that can be properly be made in designing a normative income tax, see Edward A. Zelinsky, *Qualified Plans and Identifying Tax Expenditures: A Rejoinder to Professor Stein*, 9 AM. J. TAX POL'Y 257 (1991); Edward A. Zelinsky, *Tax Policy v. Revenue Policy: Qualified Plans, Tax Expenditures, and the Flat, Plan Level Tax*, 13 VA. TAX REV. 591 (1994); and Edward A. Zelinsky, *The Tax Treatment of Qualified Plans: A Classic Defense of the Status Quo*, 66 N.C. L. REV. 315 (1988). Professor Wooten, analyzing the historic origins of the tax treatment of qualified plans, concludes that those who crafted that treatment in fact did not intend to subsidize but rather sought to tax such plans properly. James A. Wooten, *The 'Original Intent' of the Federal Tax Treatment of Private Pension Plans*, 85 TAX NOTES 1305 (1999). That conclusion reinforces my skepticism about the application of the tax expenditure label to the current tax treatment of qualified plans. *See also infra* text accompanying notes 264-265.

57. The term "coverage" is also used to address situations where an employer maintains a plan and the issue is how much of the workforce must be included within the plan. I.R.C. § 410(b) (2000).

58. *See* Halperin, *supra* note 15, at 60 (discussing the "difficulties in requiring employers and employees to keep track of each other").

Even more seriously, there was (and still is) no requirement for defined benefit plans to adjust a terminated participant's benefit to reflect inflation or the time value of money between his termination of employment and his eventual retirement from the workforce, when he finally starts to receive that benefit. Suppose, for example, that a forty-five-year-old participant quit his job in 1950 entitled to a defined benefit of $100 per month at his retirement two decades hence. Twenty years later, then ready to retire, he was entitled to this payout of $100 per month. While in nominal terms his benefit had remained steady for two decades, in economic terms his entitlement had eroded.

Even before ERISA there was, if the plan elected, an alternative approach: Pay the employee his benefit as a lump sum on his termination of employment rather than wait to commence payment upon his future attainment of retirement age. Even prior to ERISA, such pre-retirement distributions were common from defined contribution plans. However, this approach was not without its drawbacks. In particular, under pre-ERISA law, an employee had to pay tax on his pre-retirement distribution and on the subsequent earnings generated by this distribution.[59] While this early taxation often occurred at relatively favorable rates,[60] such early taxation was (often correctly) viewed as diminishing the ultimate resources available for the participant's retirement.[61]

In light of these considerations, the drafters of ERISA, under the rubric of "portability," sought a device that enabled the employee to carry his benefit with him from job to job on a tax-advantaged basis and that allowed him to earn additional income on that benefit as he moved toward retirement. The mechanism ultimately devised to achieve such portability was the individual retirement account.[62] In particular, under ERISA, the employee receiving a pre-retirement distribution from a qualified plan is given the "rollover" option, i.e., the right to transfer his distribution tax free

59. The recipient of a pre-retirement distribution could have invested the proceeds of such distribution in tax-favored investments, like municipal bonds. However, that kind of investment choice typically entails an implicit tax in the form of a lower rate of return. *E.g.*, WILLIAM A. KLEIN ET AL., FEDERAL INCOME TAXATION 184-86 (13th ed. 2003).

60. Before the adoption of ERISA, I.R.C. § 402(a)(2), § 402(a)(3)(C), and § 402(a)(5) provided capital gain treatment to certain lump sum distributions. I.R.C. § 402(a)(2)-(3), (5) (1970) (repealed 1974).

61. Much has been written on the consequences of tax deferral. Suffice it for these purposes to observe that the deferral of income taxation until retirement typically generates two benefits for the retiree: a higher after-tax return on investment earnings because these earnings are untaxed prior to retirement and a lower tax bracket on distribution because the retiree is then no longer working. *See* LANGBEIN & WOLK, *supra* note 4, at 229-34; Daniel I. Halperin, *Interest in Disguise: Taxing the "Time Value of Money,"* 95 YALE L.J. 506 (1986).

62. *See* I.R.C. § 408 (2000).

to an IRA.[63] Once in the IRA, those funds grow tax free; income tax is not payable until the participant finally withdraws his funds from the IRA to which those funds were previously transferred without tax.[64]

The architects of ERISA also used the IRA to address the problem of workers not covered by pensions at their workplaces. In particular, ERISA's drafters envisioned the IRA as a mini-pension plan under which workers without employer-provided pension coverage could make tax-deductible contributions from their own earnings for their own retirements. Such tax-deductible contributions were initially limited to $1500 per year[65] and were permitted only if the taxpayer was not an "active participant" in an employer-based qualified plan.[66]

With the benefit of hindsight, we can see that the IRA was destined to play a more critical role in American life than its crafters had anticipated. In four respects, the IRA proved to be a crucial, albeit unintended, step toward the defined contribution society. First, in a world of employee mobility, the rollover process stimulated a long-term shift of retirement savings from employer plans to IRAs. The availability of the IRA as a rollover device encouraged plans to eschew annuity-style payouts and instead to distribute lump sums, transferable tax free to departing participants' IRAs. The existence of the IRA and its rollover feature similarly prompted employees to accept such lump sums and to convey them tax free to their IRAs. Thus, over time, pension-based wealth was destined to migrate from employer-sponsored plans to the IRAs of former employees. Second, as I discuss below, the emergence of the IRA as a central feature of the finances of middle- and upper-middle-class families was accelerated during the early years of the Reagan Administration by the use of the IRA as a nearly universal vehicle for tax-deductible savings. Third, as I also discuss below, the IRA model, embraced initially for retirement savings, proved adaptable to medical and educational savings. Finally, the often successful

63. *Id*. § 402(c). The rollover provisions of the Code have undergone many changes since the original version enacted by ERISA, including the authorization of trustee-to-trustee rollovers under I.R.C. § 401(a)(31)(A). These changes do not affect the basic point in the text: the decision by ERISA's drafters to use the IRA to address the issue of portability.

64. *Id*. § 408(d)(1), (e)(1).

65. The original ERISA limit on IRA contributions was the lesser of $1500 or fifteen percent of the participant's compensation. I.R.C. § 219(b)(1) (Supp. V 1975) (amended 1981). As discussed below, the Economic Recovery Tax Act (ERTA) of 1981 increased the $1500 limit to $2000. The $2000 limit on IRA contributions then remained in effect until the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 provided for scheduled increases in that limit through 2008, cost-of-living increases thereafter, and additional "catch up" contributions for persons fifty years of age and older. In 2004, the basic IRA deduction is $3000 annually and catch-up contributions are permitted for an additional $500. I.R.C. § 219(b) (2000), *as amended by* Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 § 601(a), Pub. L. No. 107-16, 2001 U.S.C.C.A.N. (115 Stat.) 38, 94 (2001).

66. *See* I.R.C. § 219(b)(2) (Supp. V 1975) (amended 1981).

experiences of Americans with IRAs reinforced an individual account culture that, by molding the expectations of employees, bolstered the transformation of employer-based pension and fringe benefit plans to the individual account format.

As we have seen, employers had their own incentives to move from the defined benefit to the defined contribution motif: to shift investment, funding, and longevity risk to their employees; to avoid ERISA's heavier regulation of defined benefit pensions; and to embrace greater flexibility for their qualified plans. The emergence of the IRA acclimated employees to individual accounts so that the switch from employer-sponsored defined benefit pensions to employer-sponsored individual account plans (a switch that employees might otherwise have resisted) seemed normal, indeed inevitable. The IRA thus proved critical on the path toward the defined contribution paradigm by acclimating Americans to the individual account format.

2. *ERISA's Regulatory Burdens on Defined Benefit Plans*

Another way in which ERISA proved critical on the path toward the defined contribution society was the heavier regulatory burdens it imposed on defined benefit arrangements, burdens that discouraged the creation and continuation of such arrangements. Much of ERISA applies equally to individual account and defined benefit plans—for example, its minimum vesting rules.[67] These rules require that employees' interests in their accrued benefits become nonforfeitable upon the completion of specific periods of employment. Such rules, by increasing employee vesting and thus employer costs, may lead some employers to eschew qualified plans altogether. However, ERISA's vesting rules do not affect the choice between the defined contribution and the defined benefit formats since the rules apply equally to both.

On the other hand, parts of ERISA burden defined benefit plans more heavily than defined contribution ones.[68] Most prominently, ERISA imposes complex minimum funding requirements on defined benefit plans.[69] These often opaque rules limit (and frequently eliminate) any employer flexibility in the financing of defined benefit plans. Consequently, in a bad year the employer sponsoring a defined benefit plan may find itself

67. I.R.C. § 411 (2000); ERISA § 203, 29 U.S.C. § 1053 (2000).

68. ALICIA H. MUNNELL & ANNIKA SUNDÉN, COMING UP SHORT: THE CHALLENGE OF 401(K) PLANS 9 (2004) ("Technically, ERISA's provisions applied to both defined benefit and defined contribution plans. But the main thrust of the legislation was on the defined benefit side.").

69. I.R.C. § 412; ERISA §§ 301-308, 29 U.S.C. §§ 1081-1086.

locked into a pension-funding obligation it would rationally prefer to defer to better times.[70]

The minimum funding rules are not without plausible justifications: Employees covered by defined benefit plans reasonably rely on the promise of future benefits and the implicit assurance that those benefits are being funded properly. The sound financing of projected pension benefits is actuarially complex, leading to complicated calculations and, thus, a complicated statute.[71] Because promised benefits are payable in the future, it is tempting to promise those benefits now and leave to one's successor the task of financing them; hence the need for legislation to assure that promised benefits are funded currently.[72] Whatever the merits of these arguments, the minimum funding rules deprive the employer of much (perhaps any) flexibility in the financing of defined benefit pensions. In contrast, the employer sponsoring a profit-sharing plan retains far greater flexibility[73] to contribute (or not) in any year and to decide how much to contribute.[74] Moreover, the employer's obligations in the profit-sharing context are simpler to understand.

Compliance with ERISA's minimum funding rules also entails significant administrative costs for defined benefit arrangements,[75] i.e., actuarial, accounting, and legal fees, costs to which many employers, particularly smaller ones, are quite sensitive.

In short, the inflexibility, impenetrability, and administrative costs associated with ERISA's defined benefit minimum funding rules are, for

70. JACK VANDERHEI & CRAIG COPELAND, ERISA AT 30: THE DECLINE OF PRIVATE-SECTOR DEFINED BENEFIT PROMISES AND ANNUITY PAYMENTS? WHAT WILL IT MEAN? 8 (Employee Benefit Research Inst., Issue Brief No. 269, 2004) ("[D]efined benefit plans may not allow plan sponsors to reduce or even eliminate contributions in a specific year.").

71. Between the often complex formulas for determining a participant's benefit and the equally complex actuarial formulas for funding, it is in some ways appropriate to think of defined benefit pension plans as the original complex financial instruments.

72. Ironically, concerns about systematic underfunding were, and still are today, most compelling as to governmental defined benefit plans—which are exempted from ERISA's minimum funding rules. *See infra* note 180 and accompanying text.

73. For the long run, the employer's discretion to contribute to its profit-sharing plan is not unbridled.

74. As I discuss *infra*, a common design today is for 401(k) plans to include an employer match of the employees' salary reduction contributions. Unlike defined benefit funding requirements, employers can suspend or reduce this match in difficult economic times—as many employers do. *See, e.g.*, *Firms Cutting Contributions to 401(k)s*, NEW HAVEN REG., Apr. 4, 2003, at E4; Arleen Jacobius, *More Plan Sponsors Do Away with 401(k) Match*, PENSIONS & INVESTMENTS, Aug. 18, 2003, at 4; *Tightening the Belt*, WALL ST. J., May 20, 2003, at B1 ("At least a dozen major companies have temporarily reduced or suspended matching contributions to 401(k) plans since January 2002."). This flexibility stands in sharp contrast to the defined benefit funding rules.

75. Norman P. Stein, *An Alphabet Soup Agenda for Reform of the Internal Revenue Code and ERISA Provisions Applicable to Qualified Deferred Compensation Plans*, 56 SMU L. REV. 627, 641 (2003) ("Defined benefit plans are generally more costly to administer, in large part because of the need to engage the services of an actuary.").

many employers, a significant deterrent to establishing or continuing defined benefit plans, particularly when those rules are contrasted with the greater flexibility, transparency, and simplicity of the rules governing profit-sharing plans, including 401(k) plans.[76]

Another cost ERISA imposes on only defined benefit plans is premium payments to the PBGC, the government-operated insurance entity, which resembles the FDIC and which insures basic pension benefits.[77] Here, again, plausible arguments can be mounted to defend the PBGC, as can a serious critique.[78] My purpose is not to evaluate the pros and cons of the PBGC but rather to observe the impact of PBGC premiums on an employer's choice between a defined benefit plan and a defined contribution arrangement. Because the PBGC covers only the former and not the latter, PBGC premiums impose an additional cost on the defined benefit option in contradistinction to an uninsured individual account plan.

To the extent employers must absorb these extra costs, those costs deter the creation and continuation of defined benefit plans. Even if these costs can be passed on to employees in the form of reduced wages, they are likely to give employers pause. Insofar as employees appreciate the advantages of an insured benefit, they might accept lower cash wages as a reasonable price to pay for insured defined benefit coverage. However, insofar as employees do not presently value either their participation in a defined benefit plan or PBGC insurance coverage, lower cash wages put the employer at a competitive disadvantage in the labor market.[79] Moreover, to the extent the employer maintaining a defined benefit plan attracts employees who value defined benefit coverage, the employer is likely to lure older employees and the longevity risks associated with a self-selected workforce attracted to a classic defined benefit annuity by the expectation of long life spans.[80]

76. As Patrick Purcell has pointed out, in the years immediately after the enactment of ERISA, the number of defined benefit pensions actually increased. Purcell, *supra* note 52, at 54 ("Between 1975 and 1983, the number of [defined benefit] plans increased from 103,346 to 172,642."). By some measures, the decline of the defined benefit system commenced in earnest after the adoption of § 401(k) in 1978. I find it plausible, as indicated in the text, to conclude that the subsequent adoption of § 401(k) had a synergistic effect, compounding ERISA's regulatory impact on defined benefit plans by creating an attractive alternative (the 401(k) plan) for employers. However, it seems likely that, in the long run, ERISA's regulation of defined benefit plans discouraged the maintenance and creation of defined benefit plans, independently of the existence of the 401(k) alternative.

77. ERISA §§ 4001-4071, 29 U.S.C. §§ 1301-1371 (2000); *see also* Daniel Keating, *Chapter 11's New Ten-Ton Monster: The PBGC and Bankruptcy*, 77 MINN. L. REV. 803, 806 (1993).

78. *See, e.g.*, IPPOLITO, *supra* note 29, at 14-15.

79. *See* Halperin, *supra* note 15, at 41.

80. *See supra* Section II.C.

While PBGC premiums may not be large in absolute dollar terms,[81] they nevertheless have a disproportionate impact on smaller employers that are particularly sensitive to professional fees and other administrative costs[82] and consequently are discouraged from establishing or maintaining defined benefit pensions by such expenses. The resulting tendency of small employers to abandon the defined benefit format is significant, both because most American workers are employed by small employers and because some small employers become large employers.

Many employers, particularly smaller firms, responded to the regulatory burdens imposed by ERISA by abandoning qualified plans altogether. Others responded to the heavier burdens placed on defined benefit plans by shifting to less heavily regulated defined contribution devices. This shift gave an important impetus to the defined contribution paradigm as employers and employees came to experience and thus conceive of retirement savings in individual account terms.

3. *ERISA's Fiduciary Rules and Participant-Directed Accounts*

ERISA's third step down the road toward a defined contribution society was the decision embraced in the statute to permit sponsors of defined contribution plans to authorize employees to direct the investment of their own accounts.[83] Such self-directed investment largely relieves the employer (or, to be precise, the trustee the employer has designated) of the otherwise substantial fiduciary obligations stemming from the responsibility for investing the plan's assets.[84]

A central feature of ERISA was the imposition upon trustees managing plan assets of federal fiduciary standards based on the traditional obligations of trustees: the duties of loyalty, prudence, and diversification.[85] In some states, state law, even without ERISA, imposed upon pension trustees the traditional duties of trustees and the time-honored sanctions for

81. For a fully funded defined benefit plan, the premium is $19 per participant per year. 29 U.S.C. § 1306(a)(3)(A). For an underfunded plan, there is an additional premium of $9 per $1000 of unfunded vested benefits. *Id.* § 1306(a)(3)(E).

82. *See* Stein, *supra* note 75, at 641.

83. ERISA § 404(c), 29 U.S.C. § 1104(c).

84. Under the Department of Labor's interpretation, ERISA section 404(c) relieves a plan fiduciary of liability for a participant's investment decisions only if the plan satisfies certain regulatory requirements designed to ensure that each participant has a meaningful "opportunity . . . to exercise control over assets in his individual account." 29 C.F.R. § 2550.404c-1(b)(1)(i) (2004). Additionally, the regulatory requirements mandate "an opportunity to choose, from a broad range of investment alternatives, the manner in which some or all of the assets in his account are invested." *Id.* § 2550.404c-1(b)(1)(ii).

85. ERISA § 404(a)(1), 29 U.S.C. § 1104(a)(1); *see also* LANGBEIN & WOLK, *supra* note 4, at 678-82; John H. Langbein, *What ERISA Means by "Equitable": The Supreme Court's Trail of Error in* Russell*,* Mertens*, and* Great-West, 103 COLUM. L. REV. 1317, 1321-38 (2003).

violating those duties.[86] However, even in those states, ERISA's federalization of the fiduciary obligations of pension trustees gave those obligations a new salience. And, as to those states in which the fiduciary responsibilities of pension trustees were less well articulated, ERISA was reasonably perceived as imposing new burdens on such trustees.

There is, however, an important safety valve: Under ERISA section 404(c), if a defined contribution plan permits each employee to direct the investment of the funds in his own account, the plan's trustee bears no liability to the employee for investments,[87] on the apparent assumption that the employee is deciding for himself. Such participant direction of plan investments is not feasible in the defined benefit context because the defined benefit participant has no discrete subset of assets earmarked to him that he can manage for himself. Rather, the defined benefit participant has a claim for future benefits against the totality of a common fund.

Consider in this context the owner of a closely held corporation who, before ERISA, acted as trustee of his company's defined benefit pension plan. With ERISA heightening the salience and perhaps the substance of his fiduciary obligations, this owner had three alternatives: continuing to serve as trustee with those obligations, hiring a professional trustee for the plan, or terminating the defined benefit plan and replacing it with a self-directed defined contribution plan. For at least some employers, the self-directed defined contribution plan proved the best choice, because it shifted the investment function to the plan participants and consequently shifted fiduciary liability away from the owner-trustee.

4. *The Ten Percent Limit on Employer Stock*

Finally, ERISA established a strict numerical limit on the amount of the sponsoring employer's stock that may be held for a defined benefit plan, capping such stock holdings at ten percent of total plan assets.[88] In contrast, ERISA enacted no such numerical limit on the employer stock held for individual account plans.[89] As *l'affaire* Enron demonstrated, many

86. *See, e.g.*, Bd. of Trs. v. Mayor of Balt., 562 A.2d 720, 734 (Md. 1989) (noting that "the pension contracts incorporate the Trustees' common-law duties of prudence and loyalty" for governmental pension plan not regulated by ERISA).

87. Subject to compliance with the regulatory requirements to insure the participant a meaningful opportunity to make his investment choices. *See supra* note 84.

88. ERISA § 407(a)(2), 29 U.S.C. § 1107(a)(2).

89. ERISA § 407(b)(1), 29 U.S.C. § 1107(b)(1). In the wake of the Enron affair, Congress adopted ERISA section 407(b)(2), which applies the ten percent limit in cases where employees' salary reduction contributions must be invested in the employer's stock. ERISA § 407(b)(2), 29 U.S.C. § 1107(b)(2). These are relatively rare cases. More typically, the employer contributes its stock and the employees also voluntarily direct their own contributions to employer stock. Consequently, ERISA section 407(b)(2) will have little practical effect.

employers grasped this difference, established defined contribution plans, and loaded them with quantities of employer stock that would not have been permitted for defined benefit plans.[90]

5. *Demographic and Economic Changes Reinforcing ERISA's Effects*

Demographic trends reinforced ERISA's negative impact on defined benefit plans. Unions have been important advocates of the traditional defined benefit plan. Indeed, a good predictor of whether a firm sponsors a defined benefit plan is whether it has a collective bargaining agreement.[91] Another good predictor of defined benefit sponsorship (often overlapping with union membership) is whether the firm is engaged in traditional manufacturing or extractive activity.[92] As union membership stagnated and

90. *See* Millon, *supra* note 2, at 839; Sharon Reece, *Enron: The Final Straw & How To Build Pensions of Brick*, 41 DUQ. L. REV. 69, 116 (2002) ("Other companies have 401k assets similarly invested in a high percentage of company stock."); Susan J. Stabile, *Enron, Global Crossing, and Beyond: Implications for Workers*, 76 ST. JOHN'S L. REV. 815, 820 (2002) ("In addition, we have reached a point where the 401(k) plan accounts of a significant number of employees are bloated with company stock.").

The question of why employers contribute their stock to qualified plans is not as simple as first appears because the economic effect of contributing newly issued stock directly to the plan is identical to the impact of contributing cash to the plan and then having the plan itself purchase new stock from the corporation with that contributed cash. The employer derives no additional monetary savings from a direct stock contribution as opposed to a cash contribution followed by the plan's purchase of newly issued stock from the corporation with that cash.

Why, then, do corporations contribute their stock to their 401(k) plans rather than contribute cash for stock purchases? I believe that such contributions are primarily intended to encourage employees to invest their salary reduction contributions in the employer's stock. The employer's direct contribution effectively endorses its stock as an investment. That endorsement, in turn, influences employees to put their salary reduction contributions in the same investment. In short, the corporate contribution of stock signals to the employees that they should direct their funds into stock purchases.

There are three reasons why corporate management wants employees to invest their salary reduction amounts in the employer's stock. First, when employees purchase newly issued stock, they in effect rebate part of their compensation back to the employer. Suppose an employee is paid $10 and elects salary reduction for $1. If that $1 is returned to the corporation for newly issued stock, the corporation has, in practice, paid the employee $9 and has the other $1 back to spend for corporate purposes. Second, if the employees' salary reduction amounts are used to purchase stock in the open market, those purchases increase demand for the employer's stock and hence elevate the price of that stock. It is attractive to corporate management, particularly managers with stock options, to increase the employer's stock price in this fashion. Third, corporate management perceives (often with good reason) that stock owned by employees is in friendlier hands than if that stock were in the hands of third parties.

91. Pension scholars have frequently noted the role of unions in the establishment and maintenance of defined benefit plans. *See, e.g.*, STEVEN A. SASS, THE PROMISE OF PRIVATE PENSIONS: THE FIRST HUNDRED YEARS 230 (1997).

92. *See America's Pensions*, *supra* note 41, at 55 ("Many defined benefit plans are in our oldest and most capital intensive industries."); *see also* Lee A. Sheppard, *Pension Benefit Obligations: Twilight of the Household Names*, TAX NOTES TODAY, Oct. 13, 2004, 2003 TNT 198-5 (LEXIS) (discussing the financial problems of defined benefit plans maintained by "the steel companies, the automobile and parts companies, and the airlines").

as old-style manufacturing and mining declined in economic importance (the two trends were intertwined), the defined benefit plan ebbed accordingly. Conversely, as service industries, with no strong history of unionization or of defined benefit sponsorship, grew in relative importance, ERISA pushed the firms in those industries toward defined contribution plans for their employees.[93]

Also diminishing the appeal of the traditional defined benefit pension was the perception of greater employee mobility among firms. The traditional defined benefit arrangement is particularly attractive for an employee who spends his entire career with a single firm. In that instance, the employee's salary and service history typically elevate the size of the retirement annuity to which he is entitled. As previously observed, pension experts frequently label traditional defined benefit plans "back-loaded," meaning that an employee must spend most of his career with one employer to earn the particularly valuable benefits that accrue in his later years.[94]

In contrast, a job-hopping employee rarely accumulates the kind of earnings and work history with a single employer necessary to earn a substantial annuity under a traditional defined benefit plan. Consequently, a job-hopping employee is better off with a series of defined contribution plans, because, every time he changes employers, he can roll over the amount in his individual account to an IRA or to the next plan if the plan so permits.

Whether employee mobility has actually increased is a matter of controversy.[95] However, undoubtedly real is the perception of greater employee mobility and of the loss of stigma attached to frequent job changes. Hence, defined contribution devices came to be favored by many employers and employees as better adapted to a world of greater (or at least more acceptable) employee mobility.

The upshot of these legislative and demographic forces was, after the adoption of ERISA, the termination of defined benefit pension plans as employers reassessed such plans in the new legal environment created by the statute. In many instances, employers created defined contribution plans to replace their terminated defined benefit arrangements. Moreover, employers seeking to establish new qualified plans from scratch eschewed

93. MUNNELL & SUNDÉN, *supra* note 68, at 26 ("Employment was declining in large, unionized, manufacturing firms, which typically offered defined benefit plans, and was growing in high-tech firms and small, nonunionized companies in the services and trade sectors, which typically did not.").

94. *See* Zelinsky, *supra* note 4, at 688-91; *supra* notes 42-45 and accompanying text.

95. MUNNELL & SUNDÉN, *supra* note 68, at 43 ("Economists who have studied trends in mobility have split into two camps, one that supports the popular view of increased mobility and another that disputes it.").

the defined benefit configuration and instead opted for individual account arrangements, particularly profit-sharing plans.

Many of the defined benefit plans terminated in the wake of ERISA were maintained by small and professional employers. Some observers dismissed these defined benefit pensions as tax shelters for high-income earners and consequently viewed the demise of these plans with equanimity.[96] However, for two reasons, the death of the small-employer defined benefit plan had important long-term consequences. First, small firms, in the aggregate, employ much of the workforce.[97] Second, some small employers become large employers; when firms establish money purchase pension and profit-sharing plans in their early years, they tend to stay with such plans later.

In short, ERISA, without anyone intending it that way, laid the grounding for the defined contribution society, both by authorizing the IRA and by placing burdens on defined benefit plans that discouraged the creation and maintenance of such plans. ERISA thereby shifted employers toward the defined contribution model.[98]

B. *Section 401(k)*

The next critical event for the emergence of the defined contribution paradigm was the adoption of I.R.C. § 401(k) and the regulations implementing that section. Today, we are so used to thinking of the now-ubiquitous 401(k) account as a retirement savings device that it is easy to forget § 401(k)'s origins in the tax problem of constructive receipt. An endemic problem of the federal income tax is taxpayers' manipulation of the cash method of accounting.[99] In its classic incarnation, that

96. This attitude persists among influential commentators today. *See, e.g.*, Stein, *supra* note 75, at 654 (noting that small-employer defined benefit "plans are inconsistent with the justification for the tax subsidy, since they operate to weight benefits toward highly compensated employees and away from the lower and middle-income employees, who are the primary target of the tax expenditures").

97. PATRICK J. PURCELL, CONG. RESEARCH SERV., ORDER CODE RL30122, PENSIONS AND RETIREMENT SAVINGS PLANS: SPONSORSHIP AND PARTICIPATION 4 (2003) ("Encouraging sponsorship of retirement plans by small firms is an important issue to the Congress in part because of the large number of people employed by small businesses. In 2002, for example, more than 34 million people worked for firms with fewer than 25 employees.").

98. Professor Kaplan's analysis is similar. Kaplan, *supra* note 19, at 63 ("There are several reasons for this shift from defined benefit plans to defined contribution plans, including (1) absence of PBGC premiums, (2) no actuarial expenses, (3) fewer compliance costs due to less burdensome regulations, and (4) the structural transformation of the American economy from unionized manufacturing companies to service sector operations and high technology enterprises." (footnote omitted)).

99. That manipulation and the doctrines developed to combat it (including constructive receipt) are important topics in virtually all introductory casebooks on the federal income tax. *See, e.g.*, KLEIN ET AL., *supra* note 59, at 251-78.

manipulation takes the form of a high-bracket cash method taxpayer ignoring income available to him in the current year to shift that income into subsequent years in which his marginal rate will be lower. To combat perceived abuses along these lines, the doctrine of constructive receipt taxes this cash method taxpayer in his high-bracket year when the income was constructively received, i.e., when he could have taken it had he not manipulated the cash method.[100]

In the context of qualified retirement plans, consider an employer who establishes a plan with what is sometimes called a "cash or deferred" provision, sometimes also called a salary reduction arrangement. Under such a provision, the employer's plan gives the employee an election between full salary (all currently taxable to the employee as current compensation) and reduced salary with the difference contributed by the employer to the qualified plan. If the tax system respects the employee's election to receive reduced salary and for the employer to make a corresponding plan contribution, the employee shifts a portion of her otherwise available income from the current year to the future, when she receives her plan distribution and is likely to be in a lower tax bracket—precisely the harm at which the doctrine of constructive receipt is aimed.

Not surprisingly, the IRS and the Treasury had serious misgivings about these elective salary reduction arrangements, while employers defended them. The issue proved so contentious that the drafters of ERISA postponed it for future resolution.[101] Finally, in 1978, Congress acted in a way that inadvertently but decisively accelerated the trend toward the defined contribution culture.[102]

Congress's decision—embodied in § 401(k) of the Code—condoned salary reduction arrangements and the tax deferral they entail. Specifically, § 401(k) permits elective cash-or-deferred arrangements in profit-sharing plans if the higher-paid portion of the employer's workforce participates in such arrangements at levels roughly proportional to the participation rates of rank-and-file employees. For these purposes, § 401(k) originally divided the sponsoring employer's covered employees into the highest-paid one-third and the rest. For each member of both groups, § 401(k) requires the

100. *See, e.g.*, Treas. Reg. § 1.451-2(a) (as amended in 1979) ("Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given.").

101. *See* ERISA, Pub. L. No. 93-406, § 2006, 1974 U.S.C.C.A.N. (88 Stat. 829, 992-93) 935, 1136-38.

102. *See* Revenue Act of 1978, Pub. L. No. 95-600, § 135, 1978 U.S.C.C.A.N. (92 Stat.) 2763, 2785-87 (codified at I.R.C. § 401(k) (2000)); *see also* Stein, *supra* note 75, at 659 (discussing the events leading to "the 401(k) revolution").

calculation of an "actual deferral percentage," that is, the percentage of the employee's compensation electively converted into an employer contribution to the plan. As long as the average actual deferral percentage of the highest-paid third of the workforce does not exceed the actual deferral percentage of the remaining employees by more than the statutorily permitted limits,[103] the plan and its cash-or-deferred arrangement are respected for tax purposes.[104]

Section 401(k) was effective for 1980 and, once implemented through Treasury regulations,[105] resulted in the rapid growth of what, quite sensibly, became known as 401(k) plans, i.e., profit-sharing plans with qualified cash-or-deferred arrangements. Two features of typical 401(k) plans enhanced their popularity. First, employers often augment their cash-or-deferred arrangements with matching formulas.[106] Under such formulas, if the employee converts one dollar of otherwise taxable salary into one dollar of plan contribution, the employer matches that contribution with additional funds.[107]

Second, 401(k) plans typically provide for self-directed investments, with the participant allocating the funds in his own account among the available alternatives. An important feature of participant-directed accounts, we have seen,[108] is that, per ERISA section 404(c), fiduciary liability largely abates for the plan trustee because the self-directing participant is investing for himself.[109] For the financial services industry, self-directed plans have proven an attractive product, with the industry providing a panoply of services such as plan documents, investment advice to employees, and the actual investments themselves, including the means for employees to switch their allocations, often quite frequently. The 401(k) plan and its self-directed accounts have accordingly become an important (perhaps the important) retail product of the financial services industry.[110]

103. I.R.C. § 401(k)(3)(A) (2000).

104. Congress later amended § 401(k) to define the group of higher-paid employees as those employees who are highly compensated within the meaning of I.R.C. § 414(q). Congress also gave § 401(k) plans the alternative of complying with so-called "safe harbor" rules. I.R.C. § 401(k)(12).

105. The regulations today appear at Treas. Reg. §§ 1.401(k)-0 to -1 (as amended in 1994, 1995).

106. *See, e.g.*, Kaplan, *supra* note 19, at 67 ("[M]any employers with 401(k) plans provide 'matching' funds; i.e., they supplement the employee's 401(k) deferral with employer funds.").

107. Congress subsequently imposed upon such matching contributions rules similar to those of § 401(k). I.R.C. § 401(m).

108. *See supra* Subsection III.A.3.

109. To receive the protection of ERISA section 404(c), the plan's fiduciaries must comply with regulatory requirements designed to guarantee that the participants' right to invest is meaningful, both substantively and procedurally. *See supra* notes 84-87.

110. *See* Lawrence A. Cunningham, *Behavioral Finance and Investor Governance*, 59 WASH. & LEE L. REV. 767, 789 (2002) ("As the Baby Boomer generation has become poised to pressure the Social Security system, self-directed retirement plans have increased in size and

The insurance industry played a critical role in the early stages of the private pension system, encouraging firms to establish plans and to fund such plans with the industry's insurance and annuity products.[111] Banks have long served as trustees and financial advisors for corporate pension and profit-sharing plans.[112] Thus, at one level, the role of the financial services industry in promoting 401(k) arrangements merely extended a historic pattern. At another level, however, the role of that industry hastened the shift toward the defined contribution paradigm as the financial services industry became a major advocate of and advertiser for 401(k) plans and IRAs.

One way of describing the services provided to 401(k) plans and their participants is that these services are the diseconomies of scale that result from decentralized investing, the diseconomies avoided under the defined benefit format with its centralized investment of a common pool of capital. That, needless to say, has not been the perspective advanced by the financial services industry, which has instead emphasized the investment autonomy of the individual 401(k) participant and IRA holder.

C. *ERTA and TRA86: Expanded Availability of IRAs and the Financial Services Industry*

As § 401(k) accelerated the shift to the defined contribution paradigm, the Economic Recovery Tax Act (ERTA) of 1981,[113] championed by President Reagan, further reinforced that shift by converting the IRA into something approximating a universal savings vehicle. Reagan was committed, depending upon one's perspective, to the encouragement of tax-favored savings or to the elimination of the income tax bias against savings. Reflecting these concerns, ERTA liberalized ERISA's rules for tax-deductible IRA contributions by permitting any person with earned income (even if covered by a qualified plan at work) to establish an IRA and to make tax-deductible contributions to that IRA up to $2000 per person.[114]

availability. People now want to take individual responsibility for their financial needs, particularly in retirement. The market for investment services eagerly meets the demand."); *see also* FAREED ZAKARIA, THE FUTURE OF FREEDOM 200-01 (2003) ("Anyone with a pension account knows that the entire financial business now revolves around selling products to people like him or her.").

111. *See* SASS, *supra* note 91, at 154 ("[T]he insurance companies were the most active providers of pension services through the years of depression and war . . . .").

112. *See id*. at 155.

113. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 1981 U.S.C.C.A.N. (95 Stat.) 172 (codified in scattered sections of 26 and 42 U.S.C.).

114. ERTA limited IRA contributions to the amount of the individual's compensation for the year. Thus, IRA contributions were only available to taxpayers with earned income. I.R.C. § 219(b) (2000).

ERTA thus transformed the IRA from a response to the coverage and portability problems to a virtually[115] universal savings vehicle, even as the IRA continued to address the portability issue via the rollover rules.

It is interesting to speculate in what form ERTA would have passed Congress had ERISA not created the IRA seven years earlier. Perhaps, in deference to President Reagan's views, something like the IRA would have been created from scratch in 1981 to serve as a general, tax-favored savings vehicle. Alternatively, in a world without the IRA, perhaps Reagan would not have succeeded in extending taxpayers' ability to save on a tax-deductible basis. From this vantage, that the IRA both existed and was easily adaptable to Reagan's vision may have facilitated an otherwise unobtainable alteration of the tax law; what would have seemed an abrupt change instead appeared incremental given the preexistence of the IRA. In any event, the IRA was at hand and became the vehicle for Reagan's goal of a more savings-friendly tax code.

Even without the enactment of ERTA, the amounts held in IRAs would, with the passage of time, have increased as more individuals received plan distributions and rolled them over into IRAs. However, ERTA, by permitting anyone with earned income to contribute to an IRA on a tax-deductible basis, caused an immediate and explosive growth in the number of IRAs and in the amounts they held—which, of course, is what President Reagan and those who supported this aspect of ERTA intended.

Between the adoption of ERISA in the mid-1970s and the effective date of ERTA (January 1, 1982), relatively few individuals had established IRAs for coverage purposes, i.e., to make tax-deductible contributions in the absence of pension participation at the workplace. This is not surprising given the correlation among higher incomes, pension coverage, and ability to save. Those covered by qualified plans tend to be the better-paid participants in the workforce; correspondingly, those without employment-based pension coverage tend to be lower-paid workers who, by virtue of their lesser incomes, are poorly positioned to save via IRA contributions or otherwise.[116] Moreover, the IRA was a novel device and initially lacked Treasury regulations to clarify the inevitable concerns that arise under a new and complex statute. The upshot was that, in the period immediately after ERISA's adoption, relatively few persons availed themselves of the opportunity to make deductible contributions to IRAs, because persons without work-based pension coverage (before ERTA, the only persons

115. As noted above, the taxpayer needed earned income to make deductible IRA contributions.

116. *See* PURCELL, *supra* note 97, at Summary ("Workers who earned less than $20,000 in 2002 were just one-third as likely as those who earned $60,000 or more to have participated in a retirement plan at work."); Medill, *supra* note 18, at 919.

permitted tax-deductible IRA contributions) tend to be low-income individuals who find it difficult to save, even with a tax incentive, and because the novelty and uncertainties of the IRA initially deterred some, perhaps many, individuals who might otherwise have established such accounts.

ERTA radically changed the dynamic of the IRA, making tax-deductible contributions available to middle- and upper-income taxpayers even if they had employment-based pension coverage. This caused a quantum growth in the number of persons with IRAs and in the amounts held in those accounts. In 1981, the last year before ERTA became effective, slightly more than 3 million taxpayers had IRAs. In 1982, the first year ERTA was in force, the number of taxpayers with IRAs almost quadrupled, to 12 million.[117] The corresponding increase in total IRA assets was even more dramatic, from slightly less than $5 billion in 1981 to more than $28 billion in 1982.[118]

Much ink has been spilled arguing whether this growth in IRA assets reflected new, additional savings or, rather, the diversion to IRAs of existing savings or of savings that would have occurred anyway.[119] For purposes of this Article, however, this dispute is irrelevant: Whether the ERTA-stimulated growth of IRA assets in the early 1980s reflected new net savings or not, that growth turned the IRA from a device of limited utility into a national institution, widely used by middle- and upper-income taxpayers. As a result, millions of Americans for the first time experienced retirement savings as individual accounts rather than as employer-guaranteed defined benefits. This spread and reinforced the defined contribution paradigm.

Moreover, the ERTA-based growth of the IRA further ensconced the financial services industry as a key supporter of the defined contribution paradigm as it exists today.[120] With ERTA's embrace of near-universal IRA availability and the simultaneous emergence of the self-directed 401(k) account, the financial services industry aggressively promoted the retirement savings business on a retail basis, serving individuals as IRA owners as well as 401(k) participants. As Fareed Zakaria has observed,

117. Edward A. Zelinsky, *ERISA and the Emergence of the Defined Contribution Society, in* NEW YORK UNIVERSITY—PROCEEDINGS OF THE FIFTY-SEVENTH INSTITUTE ON FEDERAL TAXATION: EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION § 6.01, at 6-1, § 6.03, at 6-12 n.33 (Alvin D. Lurie ed., 1999).

118. *Id.*

119. *See, e.g.*, JAMES M. POTERBA ET AL., THE TRANSITION TO PERSONAL ACCOUNTS AND INCREASING RETIREMENT WEALTH: MACRO AND MICRO EVIDENCE (Nat'l Bureau of Econ. Research, Working Paper No. 8610, 2001).

120. *See* Cunningham, *supra* note 110, at 789; *see also* ZAKARIA, *supra* note 110, at 199-205 (describing the rise of financial services for the masses).

"Introduced only twenty-five years ago, IRAs and 401(k) plans are now the mechanisms through which most Americans participate in the stock and bond markets."[121]

The promotion of IRAs by the financial services industry did not diminish when Congress, in the Tax Reform Act of 1986 (TRA86), severely curtailed ERTA's expansion of taxpayers' ability to make tax-deductible IRA contributions.[122] The central policy of TRA86, also Reagan-inspired, was a significant reduction of federal income tax rates in return for a broadening of the tax base. As part of that policy, TRA86 restricted, on the basis of income, the ability of taxpayers covered by employment-based qualified plans to make tax-deductible IRA contributions.[123]

TRA86 thus restored the IRA to a role closer to that originally embodied in ERISA: Taxpayers without employment-based qualified plan coverage could, regardless of income, use the IRA on a tax-deductible basis as a substitute for workplace pension coverage. The IRA's rollover function continued unimpaired. However, nondeductible IRA contributions did not prove particularly attractive, while lower-income families generally could not afford the supplemental savings of deductible IRA contributions.

For the emergence of the defined contribution paradigm, TRA86's restoration of the IRA to something closer to its original role was less important than might have been predicted. During the five-year period (1982 through 1986) during which ERTA expanded to near universality the availability of deductible IRA contributions, enormous sums were placed into IRAs. These sums had to be managed even if no further amounts were being contributed. Even when IRA owners were precluded from further tax-deductible contributions (as many were by TRA86), they continued to hold and manage those accounts. Between Congress' decision to condone cash-or-deferred arrangements under § 401(k) and ERTA's five-year expansion of the IRA, the defined contribution genie was out of the bottle.

By the 1980s, the defined benefit system was stagnating. Virtually no new defined benefit plans were being created.[124] Many had been (and were being) terminated. Simultaneously, less heavily regulated defined contribution devices—in particular, 401(k) arrangements and IRAs—were thriving. For many individuals, the individual account format worked well. A paradigm shift was underway that, by the end of the century, would

121. ZAKARIA, *supra* note 110, at 204.

122. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1101, 1986 U.S.C.C.A.N. (100 Stat.) 2085, 2411-14 (codified as amended at I.R.C. § 219(e), (g) (2000)).

123. *Id.*

124. According to the Employee Benefit Research Institute, there were over 128,000 defined benefit plans in 1978. By 2003, the number of defined benefit plans had declined to 26,000. Employee Benefit Research Inst., Historical Statistics, http://www.ebri.org/policyforums/may2004/hbstats.pdf (last visited Nov. 23, 2004).

transform the way in which Americans save for retirement. As Patrick Purcell has observed, "Considering that IRAs were first authorized by Congress in 1974, and that the first 401(k) plan was established just 22 years ago in 1981, some might find it quite astonishing that by 2000 more than 47 million Americans owned one or more of these retirement savings accounts."[125]

In some ways, the most interesting manifestation of the growing grip of the defined contribution paradigm was the legislative response to employers' increasingly vociferous complaints that Congress, by its cumulative regulation of qualified plans, had made such plans too complex for many (particularly smaller) employers. Rather than embracing the most straightforward response to the problem of overregulation, i.e., deregulating, Congress instead added to the Code provisions for "simplified employee pensions"[126] and "simple retirement accounts."[127] These devices authorized employer contributions to employees' IRAs as a substitute for regular pension contributions—and thereby further extended employers' and employees' experiences with such accounts.

D. *Flexible Spending Accounts and Medical Savings Accounts*

Given the shift to the individual account paradigm for retirement savings, it was perhaps inevitable that Congress would extend this paradigm to other areas of tax and social policy. An initial step in that direction occurred in the early 1980s with the institutionalization of the "flexible spending account" (FSA). Like the 401(k) plan, the origins of the FSA can be traced to the question of employment-based constructive receipt: If an employer offers an employee a choice of either a tax-free fringe benefit or taxable cash compensation, does the employee electing the fringe benefit constructively receive taxable income because he had the option to take taxable cash? As a statutory matter, Congress answered with a qualified "no," decreeing in I.R.C. § 125 that, pursuant to a nondiscriminatory "cafeteria plan," an employer can offer employees the choice between cash compensation and certain fringe benefits with the fringe benefits retaining their tax-free status.

Thus was born the FSA, an individual account by which the employee can elect to divert a portion of his compensation to certain fringe benefit programs on a tax-favored basis. Notwithstanding the Treasury's efforts to

125. Purcell, *supra* note 52, at 66.
126. I.R.C. § 408(k) (2000).
127. *Id.* § 408(p).

restrain FSAs,[128] these have become popular with employers, particularly as a way of permitting employees to defray their copayments for medical coverage on a pretax basis.[129] The FSA thus further acclimated working Americans to the individual account experience, broadening that experience beyond retirement savings.

In 1996 and 1997, Congress took further, indeed decisive, steps in the expansion of individual accounts. Again, no one heralded these steps as furthering a significant transformation of tax and social policy. Each step was taken as a discrete response to a particular problem. Cumulatively, however, the result was, first, the extension of the defined contribution configuration to the funding of education and of medical care and, second, adaptation of the individual account design to provide for tax-free withdrawals coupled with nondeductible contributions. Among these devices that extended and reinforced the defined contribution format was the "medical savings account" (MSA).

Congress added the MSA to the Code as part of the Health Insurance Portability and Accountability Act of 1996.[130] The MSA adapts the IRA model to medical care. An employee or self-employed person establishes an MSA by making tax-deductible contributions to an MSA, subject to dollar limits; those contributions grow tax free; and amounts are withdrawn from the MSA to defray the medical expenses of the employee and his family.

However, the MSA differs from the IRA in ways that reflect, inter alia, the vagaries of tax policy, interest group influence, and ideological concerns. Withdrawals from MSAs for medical expenses are (unlike distributions from conventional IRAs) tax free. In this way, MSAs mimic the highly favorable tax treatment of employer-provided medical care under

128. Long-pending Treasury regulations under § 125 embody the so-called "use it or lose it" principle: The holder of an FSA must use the balance in her account by the end of the year for the fringe benefit she selects or must forfeit any remaining funds in the account. *See, e.g.*, Prop. Treas. Reg. § 1.125-1, Q&A 7, 49 Fed. Reg. 19,321 (May 7, 1984) ("For example, a plan that offers participants the opportunity to purchase vacation days (or to receive cash or other benefits under the plan in lieu of vacation days) will not be a cafeteria plan if participants who purchase the vacation days for a plan year are allowed to use any unused days in a subsequent plan year.").

Technically, these proposed regulations have been pending since 1984. De facto, these regulations today serve as part of the legal framework governing FSAs. *See* Julie A. Roin, *United They Stand, Divided They Fall: Public Choice Theory and the Tax Code*, 74 CORNELL L. REV. 62, 101-08 (1988); Letter from Charles E. Grassley, Chairman, Senate Fin. Comm., to John W. Snow, Sec'y of the Treasury (Aug. 23, 2004), *reprinted in Grassley Urges Treasury To Rewrite FSA "Use It or Lose It" Rule*, TAX NOTES TODAY, Aug. 24, 2004, 2004 TNT 164-21 (LEXIS).

129. *See, e.g.*, Eileen Alt Powell, *Flexible Spending Accounts Help Consumers Cover Health, Child Care Costs*, NEW HAVEN REG., Oct. 20, 2003, at A6.

130. Health Insurance Portability and Accountability Act of 1996, Pub. L. No. 104-191, § 301, 1996 U.S.C.C.A.N. (110 Stat.) 1936, 2037 (codified at I.R.C. § 220 (2000)). Congress subsequently renamed these accounts "Archer Medical Savings Accounts." Consolidated Appropriations Act, 2001, Pub. L. No. 106-554, app. G, § 202, 2000 U.S.C.C.A.N. (114 Stat.) 2763, 2763A-628 to -629 (2000).

which premiums are tax deductible to the employer[131] and tax free to the employee[132] while the payments received by the employee for medical outlays are also tax free.[133] In addition, MSAs are available only to self-employed persons who purchase "high deductible" medical insurance to cover large, nonroutine medical outlays and to persons whose employers purchase such insurance for them.[134] Thus, in the final analysis, the MSA is a device for defraying day-to-day medical expenses with insurance coverage triggered for larger expenditures. An employee can establish an MSA only if he works for a small employer, generally defined as a firm with fifty or fewer employees. The total number of MSAs that can be established nationwide is capped at 750,000; after reaching that number, no more MSAs will be established.[135]

This network of limitations in part reflects the clash of interest groups and, more interestingly, ideological tensions between the individualized vision underlying the defined contribution paradigm and the preference for group risk pooling embodied in the defined benefit format. Opponents of MSAs often decry the political influence of insurers offering high-deductible insurance coverage.[136] MSAs, permitted only if the insured has such coverage, obviously stimulate such insurers' business. On the other hand, full-service insurance companies must consider the MSA a threat to both their routine claims-processing business and to the standard, low-deductible policies they sell. Since the MSA shifts responsibility for paying claims to the account holder who withdraws from the MSA what he needs to pay, there is, as to those claims, no longer a need for the claims-processing services of the full-service insurer. Moreover, those insurers' standard policies cannot be purchased by MSA holders, who can purchase only high-deductible policies. One need not be a devotee of public choice theory to see that, just as the establishment in the Code of the MSA

131. I.R.C. § 162(a).

132. *Id.* § 106.

133. *Id.* § 105(b).

134. *Id.* § 220(c)(1)(A)(iii). An individual can establish an MSA if her spouse is employed by a small employer maintaining a high-deductible policy or if her spouse is self-employed.

135. For a more detailed review of the rules governing MSAs, see Danshera Cords, Comment, *The Medical Savings Account Provision of the HIPAA: Is It Sound Health and Tax Policy?*, 21 SEATTLE U. L. REV. 1217 (1998).

136. *See* EDWIN PARK & IRIS J. LAV, CTR. ON BUDGET & POLICY PRIORITIES, PROPOSED EXPANSION OF MEDICAL SAVINGS ACCOUNTS COULD DRIVE UP INSURANCE COSTS AND INCREASE THE NUMBER OF UNINSURED 2 (2003), *available at* http://www.cbpp.org/4-30-03health.pdf ("These MSA expansions have long been pushed by insurance companies that sell MSA policies and conservative policy institutions."); *see also* Martin A. Sullivan, *Economic Analysis: The Side Effects of Health Savings Accounts*, TAX NOTES TODAY, July 21, 2003, 2003 TNT 140-8 (LEXIS) ("To this day, Rooney and the Golden Rule Insurance Co. are the leading supporters of efforts to expand medical saving accounts. The company has spent millions of dollars on lobbying expenses and campaign contributions—mostly to Republicans.").

reflected in important part the political heft of the insurers that sell high-deductible coverage, the statutory limits on MSAs similarly protect other insurers' claims-processing and standard policy-selling businesses, by limiting both the size of MSAs and the number of MSAs that can be established.

These statutory limits on MSAs also reflect the ideological fault lines of the defined contribution society. Medical insurance (whether of the indemnity or managed care variety) is the health care analogue to a defined benefit pension. Just as defined benefit plans pool employees and their claims and assign risk and reward to the sponsoring employer, medical insurance pools insureds into a covered group and allocates risk and reward to the insurer.[137] If those covered by medical insurance in the aggregate spend less on medical care than had been predicted, the difference inures to the insurer; conversely, greater-than-expected outlays for the insured group are the insurer's problem. Similarly, if the insurer generates more income than anticipated from the investment of premiums, that profit accrues to the insurer—as does poorer-than-expected investment experience. Within the group of insureds, insurance pools the risks of unexpectedly bad health much as defined benefit plans pool longevity risk for members of the covered workforce.

Just as defined contribution retirement devices (i.e., self-directed 401(k) accounts and IRAs) privatize decisions about retirement savings, MSAs assign to the individual account holder responsibility for her routine medical outlays and for investing the assets in her MSA account. Such responsibility is crucial for MSA advocates who contend that that responsibility makes consumers of health care more sensitive to the cost of such care, leading them to economize their use of medical resources and to shop for less expensive medical services.

In light of these similarities, it is not surprising that debates about MSAs track the arguments in the retirement context about the relative merits of the defined benefit and defined contribution formats. Opponents of MSAs argue that such accounts will be utilized by relatively healthy persons who feel that they can, via the MSA, handle their routine medical issues alone. Thus, in a world of MSAs, conventional, full-service medical insurance will be subject to an adverse selection process: Less healthy persons will pursue conventional insurance to pool risk with others. The premiums for such insurance will rise as the insurance pool reflects the

137. This is true whether medical insurance takes the form of traditional indemnity insurance or HMO and other managed care arrangements. That HMOs and similar managed care devices spread risk, like classic indemnity insurance, has proved to be a critical factor in the Supreme Court's evolving jurisprudence of ERISA preemption. *See* Edward A. Zelinsky, *Against a Federal Patients' Bill of Rights*, 21 YALE L. & POL'Y REV. 443, 450-51 (2003).

poorer health of the remaining participants in the pool. A vicious cycle will ensue as relatively healthy persons respond to higher premiums by shifting to the MSA format that, in turn, further isolates those less healthy in the conventional insurance system and increases the costs to those who remain in that system.[138]

The critique advanced by MSA opponents and their defense of conventional medical insurance is analogous to the justification of the defined benefit plan as a risk-pooling device and its alleged superiority to the defined contribution alternative. Just as individual accounts shift the financing of retirement from a common pool to the employee himself, the MSA privatizes the financing of routine medical care. Just as the defined benefit plan is a superior device for reducing longevity risk because it pools a broad cross section of the workforce, conventional medical insurance pools risk by covering a broad swath of the workforce, rather than a self-selected group that is sensitive to its health needs and is thus likely less healthy than a random cross section of workers.

On the other hand, MSA proponents, emulating the arguments of defined contribution advocates, tout the personal autonomy of MSA holders, the price sensitivity engendered by MSAs, and the more efficient consumption of medical services said to result from such autonomy and sensitivity.

At one level, the opponents of the MSA have, so far, won this debate. Relatively few MSAs have been established, nowhere near the number triggering the statutory cap.[139] Moreover, it is unlikely that many new MSAs will be established in the future.[140] However, at another level, as we shall see, the introduction of the MSA model has had greater influence than the numbers would indicate, both by forcing many insurers to develop comparable individual account devices in the form of health reimbursement arrangements (HRAs) and by presaging Congress's recent authorization of

138. *See* PARK & LAV, *supra* note 136, at 7 (discussing "spiraling premium costs due to adverse selection" caused by MSAs). Professor Roin raises the possibility that fundamental tax reform in the form of a value-added tax could trigger a similar process for group health insurance in general as healthy persons opt for cash wages rather than insurance coverage. *See* Julie Roin, *The Consequences of Undoing the Federal Income Tax*, 70 U. CHI. L. REV. 319, 326 (2003) ("A vicious cycle may ensue that in the end virtually eliminates the insurance function of group health insurance . . . ."). Similar observations are often made about proposals to expand health accounts along the MSA model. *See, e.g.*, ROBERT GREENSTEIN & EDWIN PARK, CTR. ON BUDGET & POLICY PRIORITIES, HEALTH TAX PROVISION BEING PUSHED IN MEDICARE CONFERENCE POSES THREATS BOTH TO LONG-TERM FISCAL POLICY AND TO THE EMPLOYER-BASED HEALTH INSURANCE SYSTEM 3 (2003), *available at* http://www.cbpp.org/10-27-03health.pdf.

139. *See* Sullivan, *supra* note 136 (reporting that "[t]here are fewer than 100,000 Archer MSAs now in existence" out of a total of 750,000 authorized).

140. After December 31, 2005, new MSAs may only be established by employees of "MSA-participating employer[s]." I.R.C. § 220(i) (West Supp. 2004). Moreover, as discussed *infra*, health savings accounts can be established without many of the limitations applicable to MSAs.

health savings accounts (HSAs).[141] HRAs and HSAs have firmly planted the defined contribution paradigm in the health care arena.

E. *Section 529, Educational Savings Accounts, and Roth IRAs*

At roughly the same time Congress added the MSA to the Code, it also added § 529 to the federal tax law. The background of § 529 is particularly revealing, as the state-sponsored prepaid tuition programs that gave rise to it were originally structured as defined benefit arrangements. That § 529 plans have evolved into predominantly defined contribution devices testifies to both the strength of the defined contribution paradigm and to the role of the financial services industry in promoting that paradigm.

Many states, grappling with the fact that even public colleges and universities have become expensive for large segments of their populations, have established prepaid tuition programs. Under these programs, a purchaser (such as a parent or grandparent) pays a sum of money as prepaid tuition for a prospective college student (such as a child or grandchild). In return for that prepaid tuition payment, the program guarantees the student's tuition at one of the state's institutions of higher education when the student reaches college age. Thus, the risk of future tuition increases is shifted to the state's program, which plans, through superior investment performance and actuarial funding techniques, to use the prepaid tuition funds entrusted to it to cover future tuition increases.[142] These prepaid tuition programs are a defined-benefit-style device, pooling resources (the prepaid tuition payments from families concerned about increasing education costs), shifting the risk associated with such costs to the program, and guaranteeing an output in the form of in-state tuition (whatever that might be when a child is ready for higher education).

After the Sixth Circuit Court of Appeals held that the Michigan prepaid tuition program is exempt from the federal corporate tax,[143] Congress in § 529 not only confirmed the tax-exempt status of prepaid tuition institutions but expanded the compass of such institutions, converting what had been a defined-benefit-type guarantee of future tuition into a defined

141. *See infra* Sections III.H-I.

142. It has not turned out that way. *See, e.g.*, Christopher Swope, *Catch-22 for College Savings*, GOVERNING, March 2003, at 40, 40 ("[T]he combination of skyrocketing tuition rates and a swooning stock market are forcing states to raise their prices and rethink their promises."); *see also* Peter Schmidt, *Prepaid-Tuition Plans Feel the Pinch*, CHRON. HIGHER EDUC., Sept. 12, 2003, at A19 ("What has left many state prepaid-tuition plans financially vulnerable is their basic structure."); Robert Tomsho, *Prepaid College-Tuition Plans Are Falling Short*, WALL ST. J., Dec. 16, 2002, at B1 ("[M]any prepaid plans are projecting actuarial deficits for the first time.").

143. Michigan v. United States, 40 F.3d 817 (6th Cir. 1994). *See generally* Jeffrey S. Lehman, *Social Irresponsibility, Actuarial Assumptions, and Wealth Redistribution: Lessons About Public Policy from a Prepaid Tuition Program*, 88 MICH. L. REV. 1035 (1990).

contribution arrangement. Specifically, § 529 created a new statutory category, the "qualified tuition program,"[144] and declared such programs to be federally tax exempt.[145]

Under § 529, a qualified tuition program can come in either of two forms. Such a program can permit the "purchase [of] tuition credits or certificates on behalf of a designated beneficiary which entitle the beneficiary to the waiver or payment of qualified higher education expenses of the beneficiary."[146] In this incarnation, the § 529 program takes a defined benefit configuration in which the program, in return for a current payment, grants a future output as an in-kind "credit" or "certificate," e.g., one year of tuition at any of State *X*'s state-sponsored colleges in 2010.

A qualified tuition program may also take the form of "an account which is established for the purpose of meeting the qualified higher education expenses of the designated beneficiary of the account."[147] In this version, the § 529 program uses the defined contribution format: An individual account is established for a particular beneficiary to pay his higher education expenses. Here, the qualified tuition program does not promise a guaranteed future output, e.g., one year of tuition in 2010, but rather generates an account balance available for educational expenses. Thus, risk (both investment risk and the possibility of escalating tuition costs) remains with the prospective student and his family, as does reward if, for example, funds in the § 529 account grow at a faster pace than future tuition increases.

As originally passed by Congress in 1996,[148] benefits under a qualified tuition program, whether in-kind tuition or actual cash for educational expenses, were taxable to the beneficiary. In 2001, Congress, refining § 529, excused from all federal income tax both the in-kind benefits of a qualified tuition program and cash payments from § 529 accounts to the extent of qualified higher education costs. Hence, today, neither the college student nor her parent pays any federal income tax upon the child's receipt of credits for the tuition prepaid for her or upon the use of cash in a § 529 account to defray her qualified education expenses.

On the face of the statute, the financial services industry has no particular role under § 529. The reality has been otherwise; indeed, § 529 has been a boon to the financial services industry, providing that industry

144. The original name was "qualified state tuition program."

145. A qualified tuition program may nevertheless trigger the tax on unrelated business income. I.R.C. § 529(a) (2000).

146. *Id.* § 529(b)(1)(A)(i).

147. *Id.* § 529(b)(1)(A)(ii).

148. For a description and critique of § 529 as originally enacted, see Eric A. Lustig, *Taxation of Prepaid Tuition Plans and the 1997 Tax Provisions—Middle Class Panacea or Placebo? Continuing Problems and Variations on a Theme*, 31 AKRON L. REV. 229 (1997).

with another tax-favored account to promote.[149] States have essentially subcontracted their qualified tuition programs to particular firms that have aggressively marketed § 529 in its defined contribution form, often on a nationwide basis.

Merrill Lynch, for example, manages Maine's § 529 program.[150] A Merrill Lynch customer in California, who has no interest in a defined-benefit-style arrangement guaranteeing future tuition at Maine's public colleges, can open a § 529 account with his local Merrill Lynch office. Maine's sponsorship of the account is of no import to the Merrill Lynch customer,[151] who is simply offered the program as an opportunity to save for college through a tax-favored account. From the customer's perspective, Maine's involvement is nominal; it is Merrill Lynch that offers him an opportunity to open a tax-favored account for the accumulation of college funding.[152]

This defined contribution product flows incrementally from the experience of this customer who, via 401(k) participation or IRA participation or both, has come to see tax-favored individual accounts as a standard way of saving and investing for the future. From this perspective, the § 529 account is a natural extension of his familiarity with retirement savings in similar accounts.

In short, § 529 has come full circle from the original conception of prepaid state tuition programs that, in defined benefit fashion, pooled funds from state residents; shifted to the state instrumentality both investment risk and the risk of future tuition increases; and guaranteed a specified, projected output in the form of eventual tuition coverage. Today, the typical

149. *See* Swope, *supra* note 142, at 40 ("[P]rivate money-management firms that run the state plans are marketing them aggressively."); *see also* William Baldwin, *Section 529 Crime Wave*, FORBES, Dec. 8, 2003, at 24, 24 ("Section 529 lets states team up with fund outfits to offer college savings plans."); John Kimelman, *Fund Scandal Puts College Saving Plans on Alert*, N.Y. TIMES, Nov. 23, 2003, § 3 (Money & Business), at 6 ("Many fund companies, including Fidelity Investments, the Vanguard Group and Franklin Templeton Investments, have formed partnerships with state governments to offer 529 plans."); Lynn O'Shaughnessy, *Avoiding Fee Pitfalls as College Savings Climb*, N.Y. TIMES, July 13, 2003, § 3 (Money & Business), at 8 ("More states have been embracing broker-sold savings plans, partly because of pressure from the financial industry, which wants to participate more in this growing area.").

150. My discussion in the text of Merrill Lynch is illustrative. I could as easily have discussed another state's program managed by a comparable firm. For example, Franklin Templeton manages the New Jersey § 529 program. *See* Cecily Patterson, Special Advertising Section, *Tuition Planning*, FORBES, June 23, 2003.

151. With the qualification that, as noted *infra*, some states provide deductions against their income taxes for contributions to their own respective § 529 programs.

152. *See, e.g.*, Fin. Auth. of Me., FAME Education—NextGen, http://www.famemaine.com/html/education/nextgen.htm (last visited Nov. 15, 2004) (noting management of state program by Merrill Lynch). Another increasingly common format has been the intermediate firm that arranges for the rebate to § 529 accounts of a portion of consumer purchases. *See, e.g.*, Baby Mint, http://www.babymint.com (last visted Nov. 23, 2004); Upromise, http://www.upromise.com (last visited Nov. 23, 2004).

§ 529 account, as promoted by the financial services industry, is an individual account for higher education outlays. Given the aggressiveness with which the industry has promoted these individual account arrangements, it is not surprising that, just as the assets held by defined contribution retirement plans have outstripped those of defined benefit pensions, the amounts invested in defined-contribution-style § 529 accounts now exceed the amounts held by defined-benefit-style prepaid tuition plans.[153]

Besides this shift to the defined contribution format, two other aspects of § 529 are noteworthy. First, the tax treatment today incorporated in § 529 (no deduction on contribution, investment earnings grow tax free, no income taxation on distribution) finds increasing favor with Congress and the President in contradistinction to the traditional tax treatment of qualified plans and conventional IRAs (deductible contributions, investment earnings grow tax free, income taxation on distribution).[154] From the taxpayer's perspective, the alternative regime, assuming stable tax rates, is equivalent economically to the traditional tax pattern.[155] However, the political appeal of the newer formula is undeniable, because that formula, under existing budgetary accounting rules, moves perceived revenue losses from the present, because there is no current deduction on contribution, to the future when funds are paid out tax free.

A second noteworthy feature of § 529 is the absence of income-based limits on participation. Since TRA86, if a taxpayer is covered by a qualified plan, his ability to make deductible IRA contributions is limited (and eventually eliminated) as his income rises. As we shall see, this type of income-based restriction has been extended to other Code provisions

153. Swope, *supra* note 142, at 40; *see also* O'Shaughnessy, *supra* note 149 ("In a short time, the state-sponsored 529 savings plan has become one of the nation's most popular ways to invest for college. About $30 billion is now spread among more than three million accounts, and the flood of cash is rising exponentially.").

154. Some states provide income tax deductions for contributions made to their own § 529 programs. *See, e.g.*, IOWA CODE § 12D.3(1)(a) (2004) (providing Iowa income tax deduction up to $2000 per beneficiary for contribution to Iowa Educational Savings Plan Trust); N.M. STAT. ANN. § 7-2-32 (Michie 2001) (providing deduction for contributions to the New Mexico education trust fund).

155. If tax rates remain stable, the participant ends up with the same after-tax amount under either tax regime. As Professor Halperin has recently noted, the economic equivalence of the two tax patterns has received considerable attention in comparisons of Roth and conventional IRAs. *See* Daniel Halperin, *A Fairer and More Effective Approach to Deferred Compensation*, 103 TAX NOTES 1187, 1187 (2004); *see also* PAUL BURNHAM, CBO, TAX-DEFERRED RETIREMENT SAVINGS IN LONG-TERM REVENUE PROJECTIONS 6 (2004), *available at* http://www.cbo.gov/ftpdocs/54xx/doc5418/05-10-RetirementSavings.pdf ("As long as tax rates remain constant over the cycle of contributions and withdrawals, the ultimate tax benefits of Roth IRAs relative to regular savings are exactly the same as those of deductible IRAs.").

regulating defined contribution devices.[156] But not to § 529. Thus, § 529 accounts can be marketed to affluent families,[157] a feature undoubtedly of interest to the financial services industry.

Unlike § 529 programs, Congress constrained the educational savings account with income-based restrictions. As originally enacted in 1997, these accounts bore the oxymoronic label "educational IRAs."[158] As a political matter, that label reflected the same strategy as ERTA's use of the IRA to create a universal savings vehicle: An arguably radical innovation instead appeared to be incremental, the modest extension of the IRA status quo.[159]

As originally passed by Congress in 1997, the educational IRA was indeed modest in scope. In addition to the income-based limitations Congress imposed on contributions to such accounts, Congress also initially capped contributions to educational IRAs at $500 per year and made those contributions nondeductible. Like the funds placed in § 529 plans, the funds given to educational IRAs in their initial incarnation could be used only for higher education expenses. To the extent so used, withdrawals from educational IRAs were (and are) tax free, thus subjecting such devices to the alternative tax pattern: nondeductible contributions, tax-free income, and tax-free withdrawals.

In 2001, the educational IRA was retooled in important respects.[160] The $500 annual contribution limit was raised to $2000. The income-based limitations on contributions were liberalized.[161] Most importantly, Congress permitted funds in educational IRAs to be used for "qualified elementary and secondary education expenses," which include costs connected with "public, private, or religious" schooling.[162] Finally, in 2002, these accounts were given a more apt moniker, "Coverdell education savings accounts," in memory of a prime advocate of these devices.[163]

156. *See infra* notes 165-166 and accompanying text (discussing Roth IRAs and educational accounts).

157. SUSAN DYNARSKI, TAX POLICY AND EDUCATION POLICY: COLLISION OR COORDINATION? A CASE STUDY OF THE 529 AND COVERDELL SAVINGS VEHICLES 16 (Nat'l Bureau of Econ. Research, Working Paper No. 10,357, 2004) ("[S]ince the 529 has no eligibility requirements, it provides the first opportunity for tax-advantaged saving for those families ineligible for the IRA or [the Coverdell education saving account] due to their incomes or their access to a pension program at work.").

158. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 213(a), 1997 U.S.C.C.A.N. (111 Stat.) 788, 813 (codified as amended at I.R.C. § 530 (2000)).

159. *See supra* notes 116-121 and accompanying text.

160. *See* EGTRRA, Pub. L. No. 107-16, §§ 401, 402(a)(4), 2001 U.S.C.C.A.N. (115 Stat.) 38, 57-61 (amending I.R.C. § 530 (2000)).

161. *See* DYNARSKI, *supra* note 157, at 10-11 (contrasting the income and contribution limits applicable to the Coverdell education savings account with the more liberal rules for § 529 plans).

162. *See* I.R.C. § 530(b)(4)(A)(1) (2000).

163. I.R.C. § 530 (West 2002). The accounts are named for the late Senator Paul Coverdell.

It remains to be seen whether education savings accounts will become as ubiquitous as IRA and 401(k) plans.[164] What cannot be gainsaid is that, between § 529 plans and educational savings accounts, Congress has firmly implanted tax-favored individual accounts for education into federal tax and social policy.

The other defined contribution device introduced by Congress in 1997 was the Roth IRA. The critical difference between the Roth IRA and the traditional IRA that it adapts is the sequence of taxation. Instead of the tax pattern of a conventional IRA (deduction on contribution, tax-free earnings, taxation on distribution), a Roth IRA uses the alternative sequence (no deduction on contribution, tax-free income during the accumulation phase, tax-free distribution). While that alternative tax sequence has plausible justifications, undoubtedly the driving force behind Congress's decision to embrace that sequence for the Roth IRA (as well as for § 529 and education savings accounts) is the budgetary accounting convention[165] that allocates revenue losses to the future when amounts will be withdrawn tax free from these accounts.[166] Hence, via the Roth IRA, Congress added one more device to the defined contribution paradigm on politically attractive terms: The budgetary costs of the Roth alternative will fall on future Congresses.

F. *Cash Balance, New Comparability, and Age-Weighted Plans*

While Congress was, during the 1990s, reinforcing and expanding the defined contribution paradigm by establishing these new statutory devices, other developments were confirming and accelerating the emergence of that paradigm. To the general public, the best known of these developments was the cash balance pension plan, a defined benefit arrangement designed to look like an individual account plan.[167] Under a cash balance plan, the employer guarantees a benefit that emulates a 401(k) or other individual account balance. The employer sponsoring a cash balance pension thus assumes funding and investment risk by guaranteeing a specified output, which guaranteed output mimics the lump sum account balance that predominates in a defined contribution society.

164. For a discussion and critique of the Coverdell educational savings account, see George Salimbas, *Educational Opportunities for Taxpayers*, 18 AKRON TAX J. 1, 29-32 (2003).

165. *See* Elizabeth Garrett, *Accounting for the Federal Budget and Its Reform*, 41 HARV. J. ON LEGIS. 187, 190 (2004) ("Tax provisions can be drafted so that most of the revenue loss occurs in the future, outside the budget window of one, five or ten years. . . . An example of a back-loaded tax provision is the Roth IRA . . . .").

166. Indeed, the pattern of after-tax contributions, tax-free earnings, and tax-free distribution has proved so appealing to Congress that in 2001 it extended the option of such treatment to both 401(k) and 403(b) plans. *See* I.R.C. § 402A (establishing "qualified Roth contribution program[s]").

167. *See* Zelinsky, *supra* note 4, at 687.

As we have seen, the traditional defined benefit plan promises a deferred annuity at retirement age and typically determines the amount of that annuity based upon the participant's salary and service history with the sponsoring employer. This tends to favor older, long-term workers who accumulate substantial employment history with the sponsoring employer.

In contrast, a cash balance plan guarantees a benefit but specifies that benefit in terms of a theoretical account balance. This theoretical account balance is nominally credited with a portion of the participant's salary, thus mimicking the employer contributions under a true defined contribution arrangement. This theoretical account balance is also credited with a notional interest factor, again to look like an individual account arrangement. However, in the cash balance context, no separate account for the participant actually exists. Rather, the defined benefit trustee holds a common pool of funds financing the cumulative total of all participants' theoretical account balances.

Suppose, for example, that a cash balance pension credits each participant's notional account with ten percent of her salary and augments each such account with a nominal interest factor of five percent. Suppose further that a hypothetical cash balance participant earns a salary of $50,000 in the current year. Under this cash balance plan, the participant's theoretical account is credited with $5000 as a pay credit and with a notional interest credit of $250. Thus, she has a fixed claim against the plan for a lump sum of $5250.[168]

If, to continue the example, the trustee garners a seven percent return on the plan's assets, the cash balance participant is not entitled to any more than $5250, because the plan is a defined benefit arrangement. Superior investment performance inures to the sponsoring employer, not to the participating employee, who receives a guaranteed, defined benefit in the form of an ersatz account balance. Conversely, if the trustee earns only a three percent return on the plan's assets, the participant is not harmed, because she is assured of $5250, based on notional interest earnings of $250. Any shortfall in actual investment earnings is the employer's liability because the employer has promised a benefit based on a five percent return. On the other hand, if this were a true defined contribution plan, the employer, once it conveyed the $5000 to a genuine separate account for the employee, would have no further obligation. The participant would be entitled to whatever amount the account rose or fell to without any guarantee from the employer or the plan.

168. Subject to the satisfaction of the minimum vesting rules of I.R.C. § 411(a) and ERISA section 203, 29 U.S.C. § 1053 (2000).

If the participant terminates her employment with the firm sponsoring this cash balance plan, she usually receives (in defined contribution style) an immediate lump sum distribution of her notional account balance rather than the deferred annuity of the traditional defined benefit arrangement.[169]

In short, the cash balance plan is a defined benefit pension: The plan and the employer guarantee a benefit; the risk and reward of investment performance accrue to the plan and the employer, not to the employee; and funds are invested by the plan trustee as a common pool from which benefits are paid. However, the benefit of a cash balance plan is defined and typically paid as an individual-account-style lump sum. This mixture of features shifts longevity risk to the employee (because the employee receives her distribution as a lump sum) while the employer incurs the funding and investment risk of a defined benefit arrangement (because the employer promises a benefit, albeit one formulated as an ersatz account balance rather than a traditional deferred annuity). Given this mix, it is not surprising that cash balance pensions are often denoted “hybrid” plans.[170]

Much controversy has surrounded cash balance plans.[171] For purposes of this Article, one aspect of that controversy is revealing: employers’ justifications for switching their defined benefit plans to the cash balance format.

Those firms that have shifted their defined benefit plans from the traditional format to the cash balance motif justify that shift via the norms of the defined contribution paradigm: Workers, particularly younger workers, today neither appreciate nor understand traditional defined benefit plans with their deferred annuity payments and benefit formulas based on salary and work history.[172] Few expect to remain with an employer long enough to accrue significant benefits under the back-loaded, service-based formulas of traditional defined benefit plans.[173] To adapt to the expectations of a younger, more mobile workforce, expectations molded by 401(k) plans and similar individual account devices, the defined benefit pension must conform to those expectations.

Hence, the cash balance plan formulates its benefits in terms of theoretical account balances and pays immediate distributions upon the

169. Again, subject to vesting rules. *See* PURCELL, *supra* note 8, at 6 (“Virtually all cash balance plans offer a lump-sum distribution option to departing employees who are vested in their benefits.”).

170. *See, e.g.*, *id.*; Nicholas G. Apostolou et al., *Illusionary Pension Fund Returns*, 99 TAX NOTES 565, 567 (2003).

171. *See, e.g.*, Mary Williams Walsh, *What if a Pension Shift Hit Lawmakers, Too?*, N.Y. TIMES, Mar. 9, 2003, § 3 (Money & Business), at 1.

172. For one commentator who agrees, see Jane Bryant Quinn, *Oh, No—More Pension Blues*, NEWSWEEK, Jan. 20, 2003, at 35, 35 (“[Traditional] pensions are going the way of the dodo. They bore young workers and multiply the cost of maintaining an aging work force.”).

173. PURCELL, *supra* note 8, at Summary.

employee's termination of employment because these are the expectations workers have developed from their experiences with 401(k) plans and other individual account arrangements. The hybrid features of a cash balance plan represent the best of both worlds, as those features achieve the superior investment performance of a commonly managed pool and shift investment risk to the employer. At the same time, the cash balance plan defines and pays benefits in a fashion that mimics the individual account format that has become the norm for American workers.

Even if this is not the entire story,[174] this defense of cash balance plans is instructive in that it reveals how far we have traveled down the defined contribution road. A generation ago, it would have been anomalous to suggest that defined benefit plans must jettison some of their traditional features (i.e., deferred annuity payments based on salary and service formulas) to emulate defined contribution arrangements. Today, it is a compelling, if not totally complete, explanation for the popularity of cash balance plans that, to survive in the defined contribution culture, defined benefit plans must be restyled to emulate individual account plans.

Equally instructive in confirming the emergence of the defined contribution culture are the hybrid plans that have earned the monikers "age weighted" and "new comparability."[175] While cash balance pensions are

174. I believe it is not. Traditional pensions are more expensive to fund for older employees because these employees are closer to retirement, leaving fewer years for the pension's trust funds to earn investment returns. Older employees also tend to be more highly paid than their younger coworkers. Consequently, shifting to the cash balance format reduces the sponsoring employer's costs as to older employees by eliminating the expensive pension benefits these employees would earn under the traditional, back-loaded defined benefit format. *See* Zelinsky, *supra* note 4, at 704-15. Employers shifting to the cash balance format may also (with good reason) be concerned that they will attract older workers if such employers retain their traditional defined benefit pensions. As the Baby Boom cohort enters its "empty nester" phase, employers maintaining traditional annuity-paying defined benefit plans may fear that those plans will attract older, more expensive participants, now free to relocate, because their child-rearing responsibilities are over. Hence the shift to the cash balance motif to avoid attracting older Baby Boomers, now interested in traditional, annuity-paying pensions.

Moreover, some sponsors of well-funded traditional defined benefit plans shift to the cash balance format (rather than establish true defined contribution plans) to avoid the excise tax on plan reversions under § 4980. *See id*. at 713. IBM has, in recent litigation, been commendably candid on this score. Cooper v. IBM Pers. Pension Plan, 274 F. Supp. 2d 1010, 1022 (S.D. Ill. 2003) ("According to IBM, [moving to a defined contribution plan] was impractical as the Plan surplus could not have been 'tax effectively' withdrawn . . . .").

Finally, an important factor is the perception that sponsors of cash balance pensions can obtain more favorable accounting treatment of plan-based liabilities than can the sponsors of traditional, annuity-based defined benefit plans. *See, e.g.*, Mary Williams Walsh, *Changes Discussed in Accounting for Some Pension Fund Obligations*, N.Y. TIMES, Sept. 25, 2003, at C1.

175. *See* Edward A. Zelinsky, *Is Cross-Testing a Mistake? Cash Balance Plans, New Comparability Formulas, and the Incoherence of the Nondiscrimination Norm*, 49 BUFF. L. REV. 575, 587, 598 (2001) [hereinafter Zelinksy, *Is Cross-Testing a Mistake?*] (defining new comparability and age-weighted plans); *see also* Edward A. Zelinsky, *Cross-Testing, Nondiscrimination, and New Comparability: A Rejoinder to Mr. Orszag and Professor Stein*, 49 BUFF. L. REV. 675 (2001) [hereinafter Zelinsky, *Rejoinder*].

defined benefit plans that mimic individual account arrangements, age-weighted and new comparability plans are individual account plans that mimic defined benefit pensions. In particular, under an age-weighted or new comparability plan, the employer allocates contributions among employees, not in the typical way as a percentage of each employee's salary, but rather in a fashion that emulates the employer's contributions as if the plan were a defined benefit device. Such an allocation formula skews contributions toward older, higher-paid employees because, in the defined benefit context, more must be contributed to fund projected benefits that are based on higher salaries and are scheduled to begin sooner. Because older employees are closer to retirement, there is less time for the pension's trust fund to accumulate investment earnings before such employees retire. Moreover, older employees are typically higher paid than their younger colleagues and are thus entitled to higher salary-based defined benefits. Accordingly, more must be funded by the employer to finance the benefits starting upon such employees' retirements.

This is another manifestation of the back-loading phenomenon discussed earlier:[176] Under defined benefit plans, late-career accruals tend to be particularly valuable for employees (and commensurately expensive for employers) both because older employees are generally better paid than their younger coworkers and because older workers are closer to retirement, when benefits must be paid.

These observations prompt the inquiry, If new comparability and age-weighted plans are defined contribution arrangements under which the employer's contributions are allocated among employees like a defined benefit pension, why don't employers instead establish defined benefit plans? The answer harkens back to the burdens ERISA imposed on defined benefit arrangements, in particular, the minimum funding requirements of § 412 and PBGC premiums.[177]

Those who decide about plan design are generally older and better-paid employees, typically the owners or managers of the firm. New comparability and age-weighted formulas give these decisionmakers the advantages of defined benefit funding patterns weighted in their favor while sparing the firm the inflexibility and the costs of the minimum funding rules and PBGC premiums. In addition, new comparability and age-weighted plans, because they are defined contribution devices, can permit employees to self-direct their own investments. This abates trustee liability for such investing while granting to the employees something they may view as

176. *See supra* notes 42-45 and accompanying text.

177. Smaller professional plans are not covered by the PBGC. *See* ERISA § 4021(b)(13), 29 U.S.C. § 1321(b)(13) (2000).

valuable: the right to direct the allocation of their own funds, with the resulting sense of ownership and control.

In short, the new comparability and age-weighted designs reflect the regulatory burdens placed on defined benefit plans and constitute yet other defined contribution alternatives for firms that, a generation ago, would have used defined benefit pensions to skew contributions toward their older, better-paid employees. These designs also reflect the extent to which the defined contribution paradigm and the individual account that are the hallmarks of the paradigm have become central to contemporary understanding and implementation of retirement savings.

G. *Public Employee Pensions and § 457 Plans*

The discussion so far has documented the extent to which the traditional defined benefit plan has stagnated in the private-sector economy, while individual account arrangements have, in their various incarnations, become predominant in the private retirement system and increasingly common for educational savings and medical outlays. Reflecting further the shift toward the defined contribution paradigm is states' and municipalities' embrace of that paradigm for public employee pensions. As recently as five years ago, the movement to convert public employee pensions to the individual account format was nascent. It has now accelerated to the point where defined contribution plans often serve as replacements for or as alternatives to many states' and municipalities' traditional defined benefit pensions.[178] Other states are contemplating a transition to the defined contribution format.[179]

This change has a variety of causes: the American culture of private ownership, the influence of the financial services industry and conservative ideological groups, the concern that defined benefit plans tempt politicians to reap the political advantages of promising benefits while leaving the problem of funding to their successors,[180] and the self-reinforcing

178. *See* Phyllis Feinberg, *Brighter Skies in Forecast for Florida's 401(a) Plan*, PENSIONS & INVESTMENTS, May 3, 2004, at 4; Phyllis Feinberg, *Other States Might Follow Oregon's DC Trail*, PENSIONS & INVESTMENTS, Apr. 5, 2004, at 19; *Profiles of the Top Public Defined Contribution Plans*, PENSIONS & INVESTMENTS, Mar. 31, 2003, at 16; *see also* GAO, *supra* note 32, at 20 (discussing Florida's recent adoption of an optional individual account plan for its employees).

179. *See, e.g.*, Dave Kovaleski, *State Eyes DC Plan That Is Mandatory for New Workers*, PENSIONS & INVESTMENTS, Mar. 17, 2003, at 4 (discussing Massachusetts). However, one commentator believes that the shift to public defined contribution plans has peaked. Anya Sostek, *Pension Pendulum*, GOVERNING, Mar. 2004, at 28.

180. A concern not without a basis in fact. *See, e.g.*, John E. Petersen, *In an Era of Uncertainty, States and Localities Are Looking to Some Unusual Options*, GOVERNING, June

expectations of workers and taxpayers molded by the norms of the defined contribution culture. Taxpayers who experience retirement savings as 401(k) plans are likely to agree that public employees should provide for their retirements in similar fashion. For now, the important point is that this last bastion of the defined benefit plan, state and municipal employee pensions, is under assault.

Even state and local governments that maintain traditional defined benefit pensions for their employees often provide a supplementary defined contribution program, known as a § 457 plan. Congress adopted I.R.C. § 457 in response to the perception that tax-exempt employers can offer their employees unique tax benefits via nonqualified deferred compensation.

When an individual employed by a taxable employer defers compensation outside of a qualified plan, the employer's deduction for that compensation is delayed until the employee ultimately reports the deferred compensation as income.[181] Moreover, if, prior to distribution to the employee, the deferred compensation is retained and invested by the taxable employer, the annual earnings generated by that compensation are themselves taxable because these earnings are attributable to a taxable person, the employer. The deferred compensation bargain between a taxable employer and its employee will reflect the employer's tax burden stemming from that deferral of compensation.

In contrast, when an individual employed by a tax-exempt entity (such as a state or local government) defers otherwise taxable compensation, there is no tax cost to the employer in terms of a delayed deduction for the deferred compensation because the exempt employer pays no tax anyway and is thus indifferent as to when the employee recognizes income. Similarly, if an exempt employer retains deferred income for ultimate distribution to the employee, the earnings of those deferred amounts are free of tax because the employer itself is free of tax. Consequently, the concern animating § 457 is that tax-exempt employers and their employees can negotiate favorable deferred compensation arrangements at the expense of the federal fisc because there is no tax cost to exempt employers to participating in such arrangements.[182]

2004, at 54, 56 (claiming that states and localities are "skipping or reducing contributions" to their pension plans); Janice Revell, *The $366 Billion Outrage*, FORTUNE, May 31, 2004, at 130.

181. I.R.C. § 83(h) (2000) (delaying the employer deduction until "the taxable year in which such amount is included in the gross income" of the employee).

182. For a recent colloquy between two prominent members of the tax community debating the logic of § 457, see Peter L. Faber, *It's Time To Repeal Section 457*, 100 TAX NOTES 416 (2003); Daniel Halperin, *Section 457 Should Be Replaced by a Special Tax on Investment Income*, 100 TAX NOTES 730 (2003); Peter L. Faber, *Arguments Against Section 457 Repeal Don't Stand*

Consequently, § 457 was adopted to constrain the ability of tax-exempt employers and their employees to engage in deferred compensation arrangements. Section 457 is similar to § 401(k) and § 403(b); like those provisions, § 457 both permits and limits employees' ability to defer compensation and thereby postpone income taxation until actual receipt of that deferred compensation. Under § 457, employees of tax-exempt employers[183] can defer compensation subject to an annual ceiling in 2004 of $13,000.[184] The amounts deferred pursuant to § 457, including earnings, are subsequently taxable to the participant or his beneficiary upon eventual distribution.[185]

Just as § 401(k) triggered an explosive growth in profit-sharing plans with cash-or-deferred features, § 457 has catalyzed the establishment of deferred compensation programs. Over forty billion dollars are now held by § 457 plans.[186] Particularly noteworthy has been Congress's recent decision to incorporate governmental § 457 plans into the network of rules governing rollovers, a decision that firmly plants § 457 within the statutory structure of the defined contribution paradigm.[187]

H. *Health Reimbursement Arrangements*

Among recent developments, the "health reimbursement arrangement" (HRA) represents the insurance industry's response to the defined contribution paradigm. As approved by the IRS in 2002,[188] the HRA is an individual account for health care controlled by the covered employee.

Up, 100 TAX NOTES 969 (2003); and Daniel Halperin, *Section 457 Repeal Debate Continues*, 100 TAX NOTES 1455 (2003).

183. Originally, § 457 applied only to employees of state and local governments. I.R.C. § 457 (1982). Today, it applies to such public employees and all employees of tax-exempt entities. I.R.C. § 457(e)(1) (2000).

184. I.R.C. § 457(e)(15)(A) (West 2002). Under no circumstances can the employee defer more than the amount of his income. The $13,000 annual limit is scheduled to increase to $14,000 in 2005 and $15,000 in 2006. *Id*. Thereafter, the yearly limit will be increased by a cost-of-living adjustment. The employee may also make additional catch-up deferrals at the end of his career. I.R.C. § 457(e)(18) (West Supp. 2004).

185. I.R.C. § 457(a) (2000). In the case of nongovernmental, nonprofit employers, amounts are also taxable when "made available to the participant" or to the participant's beneficiary. *Id*.

186. Arleen Jacobius, *457 Plans Win Top Spot in Popularity with Government*, PENSIONS & INVESTMENTS, Mar. 31, 2003, at 14.

187. *See, e.g.*, I.R.C. § 402(c)(8)(B)(v) (West Supp. 2004) (permitting rollover from governmental § 457 plan into IRA).

188. I.R.S. Notice 2002-45, 2002-28 I.R.B. 93; Rev. Rul. 2002-41, 2002-28 I.R.B. 75. In Revenue Ruling 2003-43, 2003-21 I.R.B. 935, the IRS condoned HRAs using debit and credit cards and other forms of electronic payment. For a comprehensive discussion of these rulings and the Code sections that they implement, see Dianne Bennett, *Health Reimbursement Arrangements: Boon or Bane for Employers?*, *in* NEW YORK UNIVERSITY REVIEW OF EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION, *supra* note 25, § 2.01, at 2-1, § 2.02. *See also* Zelinsky, *supra* note 137, at 465-68.

After the employee (or her dependent) incurs a health care outlay, the HRA defrays that cost. Typically, the employee covered by an HRA issues the equivalent of a check to the medical service provider, pays the provider with a special credit card, or pays the provider from her own funds, then applies for HRA reimbursement. In any event, the employer is the ultimate source of payment, which payment depletes the employee's balance for future medical expenses. The employer can administer the HRA itself or can hire an insurer or other agency to implement the HRA for it. Unlike the MSA, the HRA does not entail segregated, funded investments that the employee controls for herself.

An employer that completely self-funds medical coverage for its employees can provide all such coverage through HRAs.[189] More typical (so far, at least) are HRAs that cover employees' routine health costs up to an amount specified by the employer.[190] Above that base level, conventional insurance is triggered when the HRA is exhausted.[191] The insurance industry is now actively promoting packages along these lines—the HRA for basic, routine medical costs coupled with insurance for larger health outlays.[192]

When linked to conventional insurance coverage, the HRA adapts the MSA model just as the MSA adapted the IRA model. Indeed, when coupled with conventional insurance, the resemblance of the HRA to the MSA (combined with high-deductible insurance) is striking. It is most reasonable to view the HRA as the insurance industry's cooptation of the MSA model, a recognition that, in a defined contribution society, the insurance industry must offer an individual account product.

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189. *See, e.g.*, Zina Moukheiber, *Give Them a Stake,* FORBES, May 13, 2002, at 171, 171-72 (discussing Definity Health, an administrator of HRAs for self-funded employers).

190. Note that an HRA is not an FSA under which the employee chooses between taxable compensation and nontaxable fringe benefits. Rather, under an HRA, the employer specifies the level of coverage for all participating employees, who have no right to elect another form of benefit or cash compensation instead. *See* Brian L. Shiker & Emily C. Vitan, *Defined Contribution Health Plans: A Tool To Help Control Rising Health Care Costs*, J. PENSION PLAN. & COMPLIANCE, Spring 2003, at 53, 57.

191. Under some HRA arrangements, the employee, after exhausting her account, must herself pay some additional medical expenses before triggering insurance coverage. *See, e.g.*, Beth Kobliner, *A New Health Plan Works, at Least for the Healthy*, N.Y. TIMES, Mar. 2, 2003, § 3 (Money & Business), at 8 (describing the HRA of CompuCom Systems).

192. *See, e.g.*, *Health Insurance: Defined Contribution Product for Employers Announced by Wisconsin Blue Cross Plan*, BNA PENSION & BENEFITS DAILY, Apr. 11, 2002; Elizabeth White, *Defined Contribution Health Plans Emerge as Employers Face Double-Digit Cost Hikes*, BNA PENSION & BENEFITS DAILY, Feb. 25, 2002 ("[A]n increasing number of big-name health insurers are rolling out defined contribution products.").

I. *Health Savings Accounts*

If the MSA represents a defined contribution toehold in the financing of health care, the "health savings account" (HSA) authorized by Congress in 2003[193] institutionalizes the individual account approach to medicine. Unlike MSAs, HSAs are neither limited to a fixed number of taxpayers nor restricted to those employees who work for small employers. In practical terms, the HSA, Congress' most recent embrace of the defined contribution paradigm, further extends the MSA model just as the MSA extends the IRA model.

Any individual who is covered by a high-deductible health plan and who is generally not covered by any other insurance or health plan may establish and make tax-deductible contributions to an HSA.[194] For these purposes, a high-deductible health plan is a health plan with a minimum annual deductible of at least $1000 for an unmarried individual ($2000 for a family) and a maximum annual deductible of $5000 for an unmarried individual ($10,000 for a family).[195]

If an individual establishing an HSA is the only person covered by a high-deductible health plan, he may annually contribute and deduct for income tax purposes the lesser of $2250 or the amount of the annual deductible under the plan.[196] An individual who establishes an HSA and who maintains high-deductible coverage for his family may contribute and deduct yearly the lesser of $4500 or the annual deductible under that family plan.[197] HSAs receive the same income tax treatment as MSAs: Contributions (subject to these limits) are deductible for income tax purposes;[198] earnings of HSAs grow tax free;[199] and distributions from HSAs are tax free as long as such distributions are used for medical expenses.[200]

It is obviously too early to know whether (as HSA proponents hope) large employers, forbidden from utilizing MSAs in the design of their

193. I.R.C. § 223 (West Supp. 2004), *added by* Medicare Prescription Drug, Improvement, and Modernization Act of 2003, Pub. L. No. 108-173, § 1201, 2003 U.S.C.C.A.N. (117 Stat.) 2066, 2469; *see also* I.R.S. Notice 2004-2, 2004-2 I.R.B. 269.

194. An individual may be covered by certain kinds of health plans and still maintain an HSA, provided that he is also covered by a high-deductible plan. These permitted forms of coverage include long-term-care insurance, accident and disability coverage, dental and vision care plans, and workers' compensation insurance. I.R.C. § 223(c)(1)(B), (c)(3). For an application of these rules, see Rev. Rul. 2004-45, 2004-22 I.R.B. 971.

195. I.R.C. § 223(c)(2). These limits will be adjusted for inflation. *Id.* § 223(g).

196. *Id.* § 223(b)(2)(A). These limits will be adjusted for inflation. *Id.* § 223(g).

197. *Id.* § 223(b)(2)(B). Again, these limits will be adjusted for inflation. *Id.* § 223(g).

198. *Id.* § 223(a).

199. *Id.* § 223(e)(1).

200. *Id.* § 223(f)(1).

health care arrangements, will find attractive the combination of HSAs and high-deductible coverage. At a minimum, the enactment of the HSA guarantees that traditional insurers will continue to offer insurance coordinated with HRAs as an alternative for persons who might otherwise be tempted by the HSA model. The more robust possibility (sought by HSA supporters[201] and feared by HSA detractors[202]) is that HSAs, freed of the limitations and restrictions applicable to MSAs, will find broad acceptance in the medical insurance marketplace. In either event, the defined contribution paradigm will have been ensconced in the funding of health care.

J. *Proposals*

The strength of the defined contribution paradigm is further confirmed by the many individual account proposals receiving serious attention today from policymakers and analysts. These proposals (as well as those possibilities beyond the bounds of current debate) demonstrate the extent to which the individual account model defines the parameters of contemporary public discussion of tax and social policy.

Chief among the proposals manifesting the power of the defined contribution format is the much-discussed suggestion that the federal Social Security program be modified to include individual accounts.[203] A generation ago, such a proposal (like the cash balance plan) would have been inconceivable. Today, proposals for such accounts bear the imprimatur of the President of the United States, a reflection of the way in which the norms of the defined contribution paradigm have come to set the

201. *See, e.g.*, TOM MILLER, JOINT ECON. COMM., HOW THE TAX EXCLUSION SHAPED TODAY'S PRIVATE HEALTH INSURANCE MARKET 6 (2003), *available at* http://jec.senate.gov/_files/HealthTaxExclusion.pdf ("Consumer-driven health vehicles would reacquaint individuals with the cost and quality of the choices they can manage on their own."); Steve Forbes, *Big Good in a Bad Bill*, FORBES, Dec. 22, 2003, at 35 (stating that HSAs will "put patients in charge of their own health care dollars"); Newt Gingrich, Op-Ed, *Bill Sets Foundation for Revitalizing Medicare*, NEW HAVEN REG., Dec. 3, 2003, at A6 ("Health Savings Accounts are the single most important change in health-care policy in 60 years.").

202. HSA opponents raise the same concerns as MSA opponents: that HSAs, if they become widespread, will result in adverse selection, with relatively healthy persons using HSAs and sicker individuals relegated to conventional insurance. Given the close similarity of the HSA and the MSA, it is unsurprising that those who criticize these accounts raise the same arguments—and tend to be the same people. *See, e.g.*, GREENSTEIN & PARK, *supra* note 138, at 3 ("As HSA use becomes more widespread, the health policy consequences are likely to become increasingly serious, especially for older and sicker workers.").

203. *See, e.g.*, AARON & SHOVEN, *supra* note 18; GAO, *supra* note 32; PRIVATIZING SOCIAL SECURITY (Martin Feldstein ed., 1998); JAMES R. STOREY, CONG. RESEARCH SERV., ORDER CODE RL30397, SOCIAL SECURITY REFORM: INDIVIDUAL ACCOUNT PROPOSALS (2002); Medill, *supra* note 18.

parameters for contemporary debate.[204] One can no more imagine President Nixon discussing individual accounts for Social Security than one can imagine him discussing the Internet.

In other ways also, President Bush has been a proponent of the defined contribution model. His budget for 2004 proposed a major expansion of MSAs.[205] That proposal undoubtedly boosted the movement resulting in the authorization of HSAs. Bush also advocates IRA-style "re-employment" accounts.[206] Such accounts would replace conventional unemployment compensation and retraining programs with a lump sum controlled by the unemployed worker. When the worker obtains reemployment, any unexpended balance in the account would be the worker's to keep on a taxable basis.

President Bush has also proposed a radical modification and expansion of other defined contribution programs today embodied in the Code.[207] In addition, he has endorsed "individual development accounts," the proceeds of which would be available for higher education expenses, first-time home purchases, or small-business creation.[208] Such individual development accounts are now widely used by the states to encourage self-reliance and entrepreneurial efforts among the poor.[209]

Proposals to expand the defined contribution network have been advanced by Democrats as well. President Clinton, for example, advocated

204. *See President Bush's Acceptance Speech of Sept. 3, 2004*, N.Y. TIMES, Sept. 4, 2004, at P4 ("We must strengthen Social Security by allowing younger workers to save more of their taxes in a personal account.").

205. MSAs and President Bush's proposal to expand them are described (and criticized) in PARK & LAV, *supra* note 136. *See also* EDWIN PARK & IRIS J. LAV, CTR. ON BUDGET & POLICY PRIORITIES, WHAT'S IN A NAME? HOUSE BILL WOULD CHANGE NAME BUT NOT THE SUBSTANCE OF A PROPOSED EXPANSION OF MEDICAL SAVINGS ACCOUNTS 1 (2003), *available at* http://www.cbpp.org/6-26-03tax.pdf (making similar criticisms of the Health Savings Account Availability Act, H.R. 2351, 108th Cong. (2003), as "essentially identical to the proposal to greatly expand MSAs included in the Administration's fiscal year 2004 budget"); Sullivan, *supra* note 136 (discussing the Bush proposal for "an extension and expansion of Archer MSAs").

206. *See, e.g.*, Press Release, White House, Fact Sheet: Providing Job Opportunities for America's Workers (June 17, 2003), *available at* http://www.whitehouse.gov/news/releases/2003/06/20030617.html; *see also* Steve Lohr, *Debate over Exporting Jobs Raises Questions on Policies*, N.Y. TIMES, Feb. 23, 2004, at C1 (describing the Bush proposal for "personal re-employment accounts"); George F. Will, *Once More, The Bullhorn*, NEWSWEEK, Jan. 20, 2003, at 84, 84 (same).

207. For excellent descriptions of those proposals, see PATRICK J. PURCELL, CONG. RESEARCH SERV., ORDER CODE RS21451, RETIREMENT SAVINGS ACCOUNTS: PRESIDENT'S BUDGET PROPOSAL FOR FY2005 (2004); and David A. Pratt, *Pension Reform Proposals*, *in* NEW YORK UNIVERSITY REVIEW OF EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION, *supra* note 25, § 3.01, at 3-1, §§ 3.03-.07. For a critique of those proposals, see Gene Steuerle, *The Latest 'ZITCOM' and My New Tax Shelter Bank*, 99 TAX NOTES 739 (2003).

208. *See* Robert F. Manning, *Cuttings on the Conference Room Floor: Will the Grafts Take?*, 100 TAX NOTES 217, 225 (2003).

209. *See, e.g.*, Individual Development Account Act, COLO. REV. STAT. §§ 26-2-1001 to -1005 (2002).

the creation of "Universal Savings Accounts," with particular emphasis on helping low-income families save for retirement.[210] Representative Gephardt has proffered a comparable proposal to expand the defined contribution participation of lower-income workers.[211]

For present purposes, it does not matter whether any of these proposals will ultimately become law. Rather, the relevant observation is that today these proposals define the parameters of debate. Indeed, the extent to which the defined contribution paradigm shapes contemporary thinking about tax and policy issues becomes clear when we consider the kinds of proposals that fall outside those parameters and consequently command little political support or academic interest.

Even those concerned about the decline of the private defined benefit format are, at best, proposing minor reforms to resuscitate that format. One can envision proposals designed to stimulate the private retirement system back toward the traditional defined benefit pension. For example, Congress could deny tax-advantaged treatment to individual account plans, thereby requiring firms in search of tax savings to establish defined benefit pensions. To articulate such a possibility is to indicate its impossibility in the contemporary defined contribution society. No member of Congress today would vote to deny his constituents the tax savings associated with their IRA and 401(k) accounts. But, absent such fundamental change, it is difficult to envision any reversal of the stagnation of the defined benefit system.

Similarly, no one today proposes expansion of Social Security benefits.[212] Those opposed to incorporating individual accounts into the Social Security system are fighting a defensive battle for the defined benefit status quo, not suggesting an enlargement of the payments promised by that system. Indeed, thoughtful proponents of the current defined benefit configuration for Social Security generally advocate benefit reductions rather than individual accounts to restore the long-term solvency of Social Security.[213] If advocates of the defined benefit status quo did suggest an enlargement of Social Security payments, it is unlikely they would be taken seriously.

210. Halperin, *supra* note 15, at 72; *see also* Martin A. Sullivan, *Pols Maneuver To Protect and Increase Pensions*, 95 TAX NOTES 822, 826 (2002).

211. *See* Universal and Portable Pension Act of 2002, H.R. 4482, 107th Cong. (2002); *see also* Pratt, *supra* note 207, § 3.13[4]-[5]; Sullivan, *supra* note 210, at 825-26.

212. *Cf.* Halperin, *supra* note 15, at 39 ("[I]t is unlikely that future Social Security benefits will achieve full income replacement. Because payroll tax revenues dedicated to Social Security are in the long run insufficient to provide for promised benefits, it is more likely that future benefits will be less than the level of benefits currently promised by the program." (footnote omitted)).

213. *See, e.g.*, Aaron, *supra* note 36, at 89-95.

K. *Conclusion: The Significance of Enron*

In light of the foregoing, consider the collapse of Enron, an event that provoked Congress to quickly pass securities law and accounting reforms. If any event were going to stimulate a serious effort to revive the defined benefit paradigm, it would have been *l'affaire* Enron, as thousands of Enron employees, their 401(k) accounts stuffed with Enron stock, saw their retirement savings evaporate.[214] Here, in a very visible nutshell, were the dangers of the defined contribution paradigm, under which employees have no guaranteed benefits prefunded in accordance with actuarial standards and are subject to the vagaries of investment, funding, and longevity risk.

The plight of Enron's employees was a subject of intense national attention.[215] However, this attention has resulted in no action to halt the decline of the defined benefit system. Instead, after Enron, the movement toward the defined contribution society continues. It was after Enron that President Bush advanced his proposals for reemployment accounts, for the consolidation and expansion of existing defined contribution devices, and for legislation legitimating cash balance plans. Similarly, post-Enron, the Treasury proposed regulations widely understood as giving a green light to the conversion of traditional defined benefit plans to cash balance arrangements. The often heated opposition to the proposed cash balance regulations, now apparently superseded by the President's legislative proposal, focused upon issues of transition and age discrimination, i.e., whether the transformation of traditional defined benefit plans to the cash balance motif is fair to older workers caught up in that transformation. Virtually no one opposes cash balance plans per se, a sure sign that the defined contribution format, which the cash balance arrangement emulates, has been accepted as the prevailing norm.

Some members of Congress do pursue legislation to help resuscitate the defined benefit paradigm, but their efforts, even if enacted into law, seem likely to have minor effects at best. The typical post-Enron reform proposal

214. *See* Millon, *supra* note 2, at 853 ("Enron graphically illustrates the risks workers face when they over-invest their pension savings in their company's stock."); Reece, *supra* note 90, at 82 ("Most of the sensation concerning the unfortunate employees at Enron revolves around the losses they have experienced in their 401(k) plans."); Stabile, *supra* note 90, at 824 ("As a result, many [Enron] participants lost between seventy and ninety percent of their retirement funds.").

215. *See, e.g.*, *Hearing on Retirement Security and Defined Benefit Pension Plans Before the House Comm. on Ways and Means*, 107th Cong. 66 (2002) (statement of Jonathan Skinner, Professor, Dartmouth Coll. and Med. Sch.), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=107_house_hearings&docid=f:86581.pdf ("[T]he Enron debacle has focused attention on what is the most serious charge against 401(k) plans, that they are just too risky for use in retirement planning.").

has been to tweak the 401(k) framework, not to resurrect defined benefit plans.[216]

In short, while Enron elicited an immediate congressional response in some areas,[217] it has not resulted in any serious reconsideration of the now-sustained trend toward the defined contribution paradigm. Enron was a watershed event for that paradigm, confirming the permanence and preeminence of the defined contribution format. If no serious effort to resuscitate defined benefit plans and to deemphasize individual account arrangements is forthcoming after Enron, none is likely to be forthcoming.

IV. WHAT DOES IT MEAN?: CONSUMPTION TAXATION, TAX EXPENDITURES, AND THE POSSIBLE FUTURES OF THE INTERNAL REVENUE CODE

In this Part, I place the defined contribution paradigm in the context of contemporary debate about consumption taxation and tax expenditures and discuss the prospects of the paradigm in light of the possible futures of the Internal Revenue Code. Among tax commentators and policy analysts, no topic is more hotly debated today than the advisability of shifting the federal tax base from income to consumption.[218] Prominent voices argue that converting the Internal Revenue Code to a consumption base would enhance efficiency and equity while simplifying the tax law.[219] Under what is commonly denoted a cash flow consumption tax, there would no longer be separate accounts for savings for particular purposes, such as retirement, health, or education. Rather, every taxpayer (with earned income or not) would undertake all of her savings through either or both of two kinds of accounts: those subject to the conventional tax-deferral regime (deduction on contribution, tax-free accumulation of earnings, taxation upon withdrawal from the account), or the alternative, economically equivalent pattern reflected in the treatment of Roth, § 529, and educational savings accounts (post tax contributions, tax-free accumulation of earnings, tax-free

216. *See, e.g.*, Pension Security Act of 2003, H.R. 1000, 108th Cong. (2003); Jefferson, *supra* note 25, § 10.05; Reece, *supra* note 90.

217. Most prominently, the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 2002 U.S.C.C.A.N. (116 Stat.) 745 (to be codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

218. The literature on cash flow consumption taxation is now voluminous. Among seminal contributions to that literature are William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974); Michael J. Graetz, *Implementing a Progressive Consumption Tax*, 92 HARV. L. REV. 1575 (1979); and Alvin Warren, *Would a Consumption Tax Be Fairer than an Income Tax?*, 89 YALE L.J. 1081 (1980).

219. *See, e.g.*, Bruce Bartlett, *Explaining the Bush Tax Cuts*, COMMENTARY, June 2004, at 23, 27; *see also* Alvin C. Warren, Jr., *Three Versions of Tax Reform*, 39 WM. & MARY L. REV. 157, 166 (1997).

withdrawals). Thus, under the cash flow consumption tax, there would no longer be distinctions, in theory or in practice, among savings for particular purposes because all savings would receive one of these tax treatments. Likewise, under a cash flow consumption tax, there would be no limits on the amount that any taxpayer could save through such accounts, because tax would be deferred[220] on all saved income until such saved income was consumed.[221]

Equally prominent voices opposing a consumption tax base contend that, as a matter of distributional fairness, the federal fisc should tax all income when earned or received, including saved income.[222] Because it is more affluent taxpayers who save, exempting saved income from the tax base potentially skews the effective tax burden away from these more prosperous taxpayers toward lower-income nonsavers. Yet other important voices characterize the existing tax code as a hybrid tax, in some respects an income tax that taxes saved income, in other respects a consumption tax that defers the taxation of saved income until such saved income is subsequently used for consumption.[223]

My survey of the defined contribution paradigm suggests a fourth perspective: For middle- and upper-middle-class households, the federal government levies a de facto consumption tax today because these households can effectively conduct all their financial savings on a tax-deferred (or equivalent) basis via the individual account devices of the defined contribution paradigm. In terms of financial savings,[224] middle-class families save principally for retirement and to educate their offspring. This saving today occurs largely through tax-deferred devices such as 401(k) accounts, 403(b) accounts, § 529 plans, IRAs, and cash balance pensions. Under these devices, the taxpayer's saving receives either the traditional tax-deferred treatment of qualified plans and IRAs or the economically equivalent alternative. Either way, these families receive consumption tax treatment for their savings. For these families, little would in practice change if the Code were transformed into a true consumption tax; they effectively live under a federal consumption tax regime today.

220. The alternative treatment is equivalent to deferral, assuming stable tax rates.

221. *See* Mitchell L. Engler & Michael S. Knoll, *Simplifying the Transition to a (Progressive) Consumption Tax*, 56 SMU L. REV. 53, 62 (2003) ("The principal change required to the existing tax base is the expansion of the current tax treatment of qualified accounts—such as IRAs, 401(k)s, etc.—to all investments, in effect providing an unlimited deduction for new savings." (footnote omitted)).

222. Warren, *supra* note 219, at 166 ("Income tax proponents have responded that the consumption tax would be regressive and therefore unfair, because higher income individuals save more.").

223. *See, e.g.*, Edward J. McCaffery, *Tax Policy Under a Hybrid Income-Consumption Tax*, 70 TEX. L. REV. 1145 (1992).

224. As opposed to savings in the form of housing appreciation and mortgage amortization.

Because the families in the bottom half of the income spectrum generally do not undertake financial savings, and because middle- and upper-middle-income households can save on a consumption tax basis through the tax-deferring mechanisms of the defined contribution paradigm, only the wealthiest taxpayers, who save in excess of the amounts permitted under these individual account mechanisms, are subject to current income taxation on saved income.[225]

A cash flow consumption tax[226] would represent the ultimate extension, indeed the triumph, of the defined contribution paradigm, because all savings would occur through individual accounts. It is precisely because of their experience with that paradigm that taxpayers might view a federal consumption tax as an incremental extension of their encounters with IRAs, 401(k) arrangements, and other individual accounts such as § 529 and 403(b) accounts.

Consider in this context President Bush's proposals to consolidate and expand the various individual accounts authorized under federal tax law, proposals that have been characterized as radical innovations.[227] In fact, the Bush proposals are quite incremental in nature. While they would enlarge, simplify, and combine the extant forms of individual accounts, the resulting changes would expand existing patterns of tax-deferred savings, not initiate new patterns. The Bush proposals thus institutionalize and reinforce the consumption tax features of the Code rather than break sharply from current law.

Despite their incremental nature, the Bush proposals are noteworthy insofar as they would weaken the link between the individual account devices of the defined contribution paradigm and savings for particular purposes. The Bush proposals would thereby move the Code closer to a pattern of generalized deferral for savings as such.[228] As we have seen, in

225. Even this statement must be qualified. Much investment income takes the form of dividends and capital gains, taxed at preference rates. I.R.C. § 1(h) (2000). The effective tax rates on some investment earnings can be lowered by deferring tax by avoiding realizations. *See* Edward A. Zelinsky, *For Realization: Income Taxation, Sectoral Accretionism, and the Virtue of Attainable Virtues*, 19 CARDOZO L. REV. 861 (1997). Yet other investment income, most prominently municipal bond interest, is excluded from gross income. I.R.C. § 103(a).

226. As opposed to a value-added tax, a retail sales tax, or any similar consumption levy.

227. *E.g.*, Heather Bennett, *Bush To Renew Call for Savings Accounts but Details Await Budget Release*, TAX NOTES TODAY, Feb. 2, 2004, 2004 TNT 21-6 (LEXIS) (quoting Assistant Secretary of the Treasury for Tax Policy Pamela F. Olson on the "radical change" sought by the Bush Administration through its savings account proposals).

228. This is not the only significant issue raised by the Bush proposals. For example, by increasing the ability of entrepreneurs to save on a tax-deferred basis on their own, the Bush proposals, if enacted, would discourage some business owners from establishing qualified plans at the workplace, because these owners would themselves no longer need work-based plans to defer tax on saved income. *See* Martin A. Sullivan, *Budget Preview: Are LSAs Coming to Town?*, 101 TAX NOTES 1255, 1259 (2003) ("So because RSAs and LSAs would give small employers

their current incarnation, each form of individual account implements savings for a specific end: Section 529 accounts effect savings for the costs of higher education, 401(k) and 403(b) accounts implement savings for retirement, MSAs and HSAs are used to save for health costs, and so on. The Bush proposals, in contrast, would to a large degree decouple savings from particular purposes, permitting tax-deferred savings per se.[229] Such decoupling would move the Code closer to consumption tax norms by extending tax deferral to savings as such rather than conditioning such tax deferral on the future purpose for which savings are to be used.

But even here the Bush proposals are more incremental in nature than first appears. In important respects, Congress has already moved toward consumption tax norms by attenuating the links between tax deferral and the particular purposes animating tax-deferred savings, thereby pointing toward generalized tax deferral for savings as such. Congress, for example, has chipped away at the notion that retirement savings are just for retirement. In I.R.C. § 72(t), Congress has exempted from the ten percent penalty tax on premature distributions those qualified plan and IRA distributions used for tax-deductible medical expenses.[230] Congress has also exempted from this penalty tax IRA withdrawals used for certain higher education expenses,[231] for limited down payments for first-time home buyers,[232] and for health insurance premiums for certain unemployed persons.[233] The message that emerges from § 72(t) is that "pension" savings are properly used prior to retirement for other pressing needs.

Less explicit, but equally revealing, is the extent to which Congress has condoned the use of qualified plan and IRA resources for testamentary transmissions of wealth. To a degree, the minimum required distribution (MRD) rules of I.R.C. § 401(a)(9)(A) discourage individuals from hoarding their qualified plan and IRA resources for transfer at death to their children. In particular, the MRD rules require that payment of retirement amounts must commence after the participant has attained her "required beginning date," the later of age seventy and one-half or the participant's actual retirement date.[234] Thus, an employee, unless she works until she dies,

significantly greater capacity to save for retirement outside of a pension plan, many pension experts believe the enactment of RSAs and LSAs would reduce pension coverage.").

229. *Id.* at 1256-57.

230. I.R.C. § 72(t)(2)(B). Distributions are exempted from tax to the extent they are allowable as a deduction under I.R.C. § 213. *Id.*

231. *Id.* § 72(t)(2)(E).

232. *Id.* § 72(t)(2)(F).

233. *Id.* § 72(t)(2)(D).

234. *Id.* § 401(a)(9)(C)(i). The precise statutory requirement is that distributions must commence by April 1 of the calendar year of the participant's required beginning date. *Id.* If the participant owns five percent or more of the employer sponsoring the qualified plan, his required

cannot simply hold intact her individual account[235] to convey it on death, but must begin withdrawals (and pay income tax on such withdrawals) while alive.

In practice, however, the MRD rules are a minimal impediment to the testamentary transmission of individual account wealth. Most obviously, the MRD mandate that distributions must commence after the account holder's required beginning date does not apply to Roth IRAs.[236] Consequently, an individual who views her Roth IRA as a device for transmitting wealth to her offspring can hold that account intact (generating income-tax-deferred earnings) until her death and then leave that Roth account to her descendants.

Moreover, in the early years after the required beginning date, the MRD rules permit a testamentarily inclined account holder to withdraw quite small amounts based on her life expectancy[237] and thereby preserve the balance of the account for her heirs.[238] Thus, even when the MRD rules apply, the individual account of the defined contribution paradigm is a potentially potent device for transmitting wealth at death.

At the most fundamental level, Congress's willingness to condone lump sum distributions in lieu of annuities implicitly countenances the testamentary transmission of individual account wealth. So far, I have emphasized the longevity risk created by lump sums, i.e., the possibility that individuals will outlive their retirement resources. But congressionally condoned lump sums also create the possibility that retirement resources

beginning date is age seventy and one-half, with no option to extend that date by delaying retirement. *Id*. § 401(a)(9)(C)(ii).

235. The MRD rules apply to conventional IRAs by virtue of I.R.C. § 408(a)(6). The MRD rules do not apply to Roth IRAs. They do apply to 403(b) annuities and § 457 plans. *Id*. §§ 403(b)(10), 457(d)(2).

236. *Id*. § 408A(c)(5).

237. *Id*. § 401(a)(9)(B), *implemented by* Treas. Reg. § 1.401(a)(9)-5 (2002).

238. Consider, for example, a widowed IRA holder who has an IRA balance of $100,000 at age seventy-one. The MRD rules require this widow in the current year to withdraw from the IRA and pay federal income tax on $3774 (because *$100,000/26.5 = $3774*, *see* Treas. Reg. § 1.401(a)(9)-9 (as amended 2002)). Thus, if the account earns a return in that year of four percent, the account balance actually increases, because the mandated distribution is less than the year's earnings. True, the account will not grow as much as it would have absent the required distribution. On the other hand, that required distribution does not impair the amount available for testamentary transmission. Moreover, after this widow's death, the IRA balance transferred to her child can, under the MRD regime, be distributed and taxed to that child on a favorable basis. If, for example, the widowed IRA holder dies survived by a forty-year-old child, he may inherit the IRA and may spread withdrawals from the inherited IRA (and thus defer income taxes) over a period of 43.6 years, reflecting his life expectancy. In this fashion, the child may continue favorable tax treatment of the inherited IRA for the remainder of his lifetime. If the inherited IRA balance is still $100,000 when received by the child, the child, given his life expectancy of over forty years, must, in the first year after his mother's death, withdraw from his inherited IRA only $2294 (because *$100,000/43.6 = $2294*). If the IRA earns on its investments a minimum rate of two-and-one-half percent during that year, the IRA balance will actually increase, despite the required withdrawal based on the child's life expectancy.

will outlive the individual. Annuities terminate on the death of the participant (or of the participant's spouse), leaving nothing for the participant's children. In contrast, lump sums create the possibility (in some cases, the likelihood)[239] that, on the demise of the participant (or of the participant's spouse), a lump sum balance will remain for the participant's heirs. Thus, the congressionally approved movement from annuities to lump sums has increased the utility of individual account devices for testamentary purposes, because lump sums carry the possibility of balances transmittable at the participant's death, unlike annuities that terminate at the participant's death.[240]

To summarize: Proponents of a federal cash flow consumption tax can plausibly characterize the individual account devices of the defined contribution paradigm as the harbinger of such a tax. For most middle- and upper-middle-class families, individual accounts already create a de facto consumption tax because those families can undertake nearly all of their financial savings on a tax-deferred basis via these accounts. Congress's willingness to condone the use of pension and IRA resources for purposes other than retirement—medical care, education, first-time home buying, testamentary transfers—can plausibly be viewed as steps toward a true consumption tax under which all savings, regardless of purpose, receive tax deferral or equivalent treatment. President Bush's proposals would move the Code further toward consumption tax norms, both by increasing quantitative limits on the amounts that can be saved on a tax-deferred basis and by weakening the link between tax deferral and particular purposes for saving.

The debate about the propriety of consumption taxation has paralleled the simultaneous controversy about tax expenditure analysis.[241] Tax expenditure analysis starts from the premise that the Code does and should

239. Consider, for example, a two-earner couple who have amassed substantial resources in their respective 401(k) accounts, who defer withdrawals until their required beginning dates, and who withdraw at the minimum rate based on life expectancy. There is a substantial possibility that one member of this couple will leave a significant 401(k) balance on his or her death.

240. MUNNELL & SUNDÉN, *supra* note 68, at 154 ("Bequests are likely to increase as retirees receive more of their pension benefits as lump sums rather than as annuity payments.").

241. For a small sample of the now-voluminous literature on tax expenditure analysis, see STANLEY S. SURREY & PAUL R. MCDANIEL, TAX EXPENDITURES (1985); Boris I. Bittker, *Accounting for Federal "Tax Subsidies" in the National Budget*, 22 NAT'L TAX J. 244 (1969); David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 YALE L.J. 955 (2004); Edward A. Zelinsky, *Are Tax "Benefits" Constitutionally Equivalent to Direct Expenditures?*, 112 HARV. L. REV. 379 (1998); and Edward A. Zelinsky, *James Madison and Public Choice at Gucci Gulch: A Procedural Defense of Tax Expenditures and Tax Institutions*, 102 YALE L.J. 1165 (1993).

tax income[242] and further contends that deductions, exemptions, and exclusions constitute "tax expenditures" when these provisions are intended not to measure the taxpayer's income but to pursue policies extraneous to such income measurement. Proponents of this perspective typically cite the Code provisions concerning qualified plans as a quintessential tax expenditure, a subsidy for retirement savings rather than an appropriate part of a normative income tax.

There are those who dispute in general the utility of the tax expenditure label[243] and those who question in particular the application of that label to the Code provisions governing qualified plans.[244] What cannot be gainsaid is that tax expenditure analysis is now deeply embedded in the federal[245] and state[246] budgetary processes and in the academic understanding of the tax law,[247] and that tax expenditure budgets classify the qualified plan provisions of current law as among the largest subsidies administered through the federal tax law.[248]

From this perspective, the defined contribution paradigm is an elaborate subsidy mechanism, delivering tax expenditures through the income tax to those who contribute to and retain assets in tax-favored individual accounts. The costs and benefits of such tax-based subsidies have been much debated. For purposes of the present discussion, the most salient fact is the distributional implication of those subsidies. Professor Surrey, the founder of tax expenditure analysis, denoted the distributional consequences of tax expenditures in a powerful sound bite as "upside-down":[249] Tax deductions, exclusions, and exemptions provide the greatest subsidies to high-bracket taxpayers who, absent such deductions, exclusions, and exemptions, pay tax at the highest rates. If the defined contribution paradigm represents a tax expenditure, Surrey's distributional concerns carry force, because the prime beneficiaries of the paradigm are families and individuals who can afford to

242. The key premise of tax expenditure analysis—the division of tax provisions into the normative and the subsidizing—can be applied to any tax. In practice, Stanley Surrey and his followers have devoted the bulk of their attention to income taxation.

243. The most prominent of these opponents is Boris Bittker. *See, e.g.*, Bittker, *supra* note 241.

244. *See supra* note 56.

245. *See, e.g.*, 2 U.S.C. § 639(c)(3) (2000).

246. One commentator indicates that thirty-three states today prepare tax expenditure budgets. Herman P. Ayayo, *Tax Expenditures: Useful Economic Concept or Budgetary Dinosaur?*, 93 TAX NOTES 1152, 1153 (2001).

247. *See, e.g.*, WILLIAM D. ANDREWS, BASIC FEDERAL INCOME TAXATION 401-14 (5th ed. 1999).

248. *See, e.g.*, *Hearing on Oversight of Various Pension Issues Before the House Comm. on Ways and Means Subcomm. on Oversight*, 105th Cong. 160 (1998) (statement of David Wray, President, Profit Sharing/401(k) Council of Am.) (characterizing "the exclusion of employer contributions to a qualified plan and the earnings on plan assets" as "the largest tax expenditure figure in the tables").

249. SURREY & MCDANIEL, *supra* note 241, at 71.

save, the same affluent high-bracket beneficiaries of tax preferences like the mortgage interest deduction.[250]

From either the consumption tax or the tax expenditure perspective, the prospects of the defined contribution paradigm are intimately tied to the future of the Code of which the paradigm is now a central feature. The most likely future of the Code is the continuation of the status quo, whether that status quo is considered to be a proto-consumption tax or an imperfect income tax laden with tax preferences. Under either characterization, the defined contribution paradigm is an important contributor to and product of the status quo. It is unlikely that Congress will upset that status quo by jettisoning the individual account devices of the defined contribution paradigm, as this would defeat the expectations and raise the taxes of Congress's middle-class constituents. As mechanisms that (depending on your premise) afford consumption tax treatment to middle-income taxpayers or give such taxpayers expenditure-type subsidies for savings, those mechanisms are now deeply embedded in the tax law and American society.

If the most likely possibility for the Code is the continuation of the status quo, the next most probable possibility is the formal conversion of the Code to a cash flow consumption tax providing generalized tax deferral (or its equivalent) for all savings. The conversion of the Code to a formal cash flow consumption tax would constitute the ultimate triumph of the defined contribution paradigm because all savings would be conducted through individual accounts. Indeed, if the public does acquiesce to the formal conversion of the Code to a thoroughgoing consumption tax, that acquiescence would flow from the public's experience with the defined contribution paradigm, an experience that has acclimated the public to the notion of tax-deferred savings accounts. As we have seen, an important dynamic in the evolution of the paradigm has been the incremental expansion of individual accounts. That expansion has, step by step, made feasible policies that would otherwise have seemed to have been sharp breaks from the status quo. Thus, for example, the IRA begat the MSA,[251] which gave rise to the HSA.[252] The conversion of the Code to a formal consumption tax would be the ultimate step in this incremental process, a step for which the public was prepared for a generation by its experience with individual accounts such as IRAs, 401(k) and 403(b) accounts, and § 529 programs.

250. *See* I.R.C. § 163(h)(5) (2000).
251. *See supra* notes 130-141 and accompanying text.
252. *See supra* Section III.I.

If the Code were changed to a true cash flow consumption tax, employer-sponsored plans would largely become a thing of the past, because any taxpayer could, without limit, replicate for herself the tax results of such plans.[253] There would, accordingly, be no tax-based attraction to such plans. Here a paradox arises: Under a cash flow consumption tax, the employer-sponsored plan with the greatest utility, and thus the highest chance of survival, would be the traditional defined benefit pension that, by shifting investment, funding, and longevity risk to the employer, performs a unique economic function, desired by some (particularly older) employees. This niche function, attractive to employers seeking older workers, might keep some traditional defined benefit plans alive under a cash flow consumption tax.

If the two most likely futures for the Internal Revenue Code are the status quo and the formal conversion of the Code to a true consumption tax, two less likely possibilities are the conversion of the Code to an accretionist income tax, which taxes unrealized appreciation,[254] and the substitution for the current Code of a national value-added tax (VAT).

The impact of an accretionist tax on the defined contribution paradigm would depend critically upon the scope of the accretionist regime, i.e., whether that regime would apply to qualified plans and individual account devices or whether unrealized gains would be taxed only outside such plans and accounts. In the latter case, qualified plans and other individual accounts would stand out as tax-favored vehicles, refuges from the rigors of accretionist taxation. This would reinforce the defined contribution framework. On the other hand, if qualified plans and individual accounts were subject to immediate taxation on their (realized and unrealized) earnings and if participants were taxed on accrued but as-yet-unpaid benefits, we could expect that, unless directly subsidized, qualified plans and individual accounts would (except for some niche defined benefit plans designed to attract older workers) likely atrophy and die when stripped of tax advantage.

Of all the possibilities for the future, a federal VAT is the scenario that poses the most dire threat to the defined contribution paradigm. I agree with Professors Roin and Forman that, in this scenario, most employer plans would be likely to disappear, as the abolition of the income tax would strip

253. Professor Forman agrees that a cash flow consumption tax would likely lead to the demise of most employer-sponsored pension plans. Jonathan B. Forman, *The Impact of Shifting to a Personal Consumption Tax on Pension Plans and Their Beneficiaries*, *in* TAX REFORM: IMPLICATIONS FOR ECONOMIC SECURITY AND EMPLOYEE BENEFITS 51, 51-53 (Dallas L. Salisbury ed., 1997).

254. I discuss this possibility in Zelinsky, *supra* note 225.

such plans of any tax advantage.[255] Again, the ironic exception would be a relatively small number of traditional defined benefit plans likely to persist under a VAT as niche devices for attracting older workers particularly attuned to such plans.

As to other kinds of individual accounts, unless Congress elected to provide direct subsidies to such accounts, these too would likely disappear under a VAT, though the insurance industry might still find it desirable to market HRAs. Thus, of the possibilities for the future, the stand-alone VAT regime is the greatest threat to the defined contribution paradigm in its current form.

A final observation about the defined contribution system going forward—that system is an important cause of complexity in the current tax law; there is, in light of the foregoing, little chance of simplifying this area. Under the likely possibilities—continuation of the status quo or movement toward an explicit cash flow consumption tax—the network of individual accounts will, in one form or another, continue indefinitely. There are good reasons to be skeptical of the feasibility or desirability of tax simplification.[256] The existence and popularity of the defined contribution paradigm is one more reason for such skepticism.

V. WHAT SHOULD WE DO?

A. *Clarifying Premises*

In this last Part, I explore our choices for molding the defined contribution paradigm for the future and identify which of those choices I think are best. Since those choices necessarily rest on premises about the defined contribution paradigm and the persons affected by that paradigm, let me try to make my premises as explicit as I can.

First, the defined contribution paradigm has its advantages, not least that it exists, that it corresponds to Americans' cultural norms about individual ownership and control, and that it works well for many Americans. Despite my misgivings about the paradigm's shifting of risk to employees poorly suited to handle those risks, there is little chance—today, for the foreseeable future, probably indefinitely—of revitalizing the defined benefit model. Indeed, after Enron, the absence of any serious effort to

255. *See* Forman, *supra* note 253, at 51-53; Roin, *supra* note 138, at 328 ("Given that employer pension plans are expensive to administer, employers and employees may both decide they are better off letting workers save for their own retirement independent of the workplace.").

256. It is a commonplace in discussion of tax simplification that there is no constituency for simplification because most everyone has higher priorities, priorities which often make for greater complexity. For a recent discussion, see Zelinsky, *supra* note 4.

revive traditional defined benefit plans is the Holmesian[257] dog that did not bark. Any program for the future must start with the acknowledgment that the private retirement system going forward will predominantly reflect the defined contribution paradigm.

Second, I think heavy-handed paternalism in matters of private retirement savings is unwarranted and generally counterproductive, but that there is room to improve individuals' decisions about retirement savings if done in a reasonably careful and subtle way. There is today in the legal academy no more heated debate than whether man is the rational, competent utility maximizer of traditional economic theory, capable of pursuing his own interests, or the cognitively impaired being of behavioral economics, potentially benefiting from a heavy dollop of paternalism.[258] For my analysis people are both rational utility maximizers and the cognitively impaired beings of behavioral economics. Standard economic theory is a powerful predictor of human behavior because, in many settings, people are rational self-maximizers, responding to incentives and disincentives in methodical, consistent, and sensible ways. The power of the emerging behavioralist perspective is to demonstrate that irrationality, when it occurs, often occurs in systematic and predictable (if not sensible) ways—although, even when most people are behaving illogically, many are not.

On balance, I conclude that, in the context of the private retirement system, the strongest forms of paternalism are not warranted (many people do behave rationally),[259] nor is heavy-handed paternalism likely to succeed (people can opt out of the system if its restrictions chafe too much). Most obviously, if 401(k) plans are perceived as overly restrictive, employees can decline to participate in them.

On the other hand, there is room for improving the retirement choices of many people if the rules are formulated and implemented with reasonable care and subtlety. Retirement is a complex topic—individuals who can make rational decisions about simpler aspects of their lives are less than optimal decisionmakers in this complicated area. Feedback from retirement savings decisions is often long delayed—the value of retirement savings undertaken when an individual is in her thirties will not be manifest for most of her working career. Aging is the ultimate nonrepeat game—the sixty-five-year-old who suddenly realizes that she did not save enough

257. Sherlock, not Oliver Wendell. *See* ARTHUR CONAN DOYLE, *Silver Blaze*, *in* THE ADVENTURES AND THE MEMOIRS OF SHERLOCK HOLMES 277, 296 (Penguin Books 2001) (1894) ("That was the curious incident . . . ." (internal quotation marks omitted)).

258. *See, e.g.*, Jeffrey J. Rachlinski, *The Uncertain Psychological Case for Paternalism*, 97 NW. U. L. REV. 1165 (2003).

259. *See, e.g.*, William G. Gale, *Comment*, *in* BEHAVIORAL DIMENSIONS OF RETIREMENT ECONOMICS 116, 116-20 (Henry J. Aaron ed., 1999).

when younger does not get a second chance. And, as this example suggests, individuals' preferences may be time inconsistent—current consumption can look more valuable when one is younger than it does with the benefit of hindsight.[260] In short, we must search for essentially noncoercive ways of guiding individuals' retirement decisions, nudging them over any cognitive hurdles without succumbing to the temptation of overbearing paternalism.[261]

Third, in this area, there is a need for greater sensitivity to the costs of regulation than has occurred in the past. The dilemma retirement policymakers face, reflective of a broader problem of regulation generally, is that each particular act of regulation can be justified as responding to a compelling concern. Cumulatively, however, the aggregation of regulations (each plausible on its own) makes for a legal framework of daunting complexity that deters the creation and maintenance of the plans being regulated. Well-meaning mandates, each arguably justifiable individually, can cumulatively overburden the plans those mandates are designed to improve. In the final analysis, employers' decisions to maintain and establish defined contribution plans are voluntary; if the costs of such plans outweigh the perceived benefits, employers will abandon such plans or will not establish them in the first place. The same is true of accounts maintained by individuals. If the rules are too onerous, some (perhaps many) will eschew them.

Finally, I believe it confuses, rather than helps, to label current law vis-à-vis qualified plans as a tax expenditure. Under the provisions of current law, tax-deferred saving within qualified plans is typically more attractive than is taxable saving outside such plans. This advantage to accumulating within qualified plans underpins the conventional characterization of the Code as creating a qualified plan tax expenditure. However, the provisions of current law can be understood not as an effort to subsidize pension and profit-sharing arrangements, but as a plausible (perhaps the best) selection from among the range of practical alternatives for taxing such arrangements.[262] Indeed, those who crafted the existing income tax treatment of qualified plans did not seek to subsidize such plans, but rather sought to tax such plans and their participants in a fair and administrable fashion.[263]

260. On procrastination and time-inconsistent preferences for retirement savings, see Ted O'Donoghue & Matthew Rabin, *Procrastination in Preparing for Retirement*, *in* BEHAVIORAL DIMENSIONS OF RETIREMENT ECONOMICS, *supra* note 259, at 125.

261. Professors Sunstein and Thaler come to similar conclusions. Sunstein & Thaler, *supra* note 17, at 1201.

262. *See supra* note 56.

263. *See* WOOTEN, *supra* note 39.

Moreover, in the years since Surrey first propounded the tax expenditure label, there has been a noted shift in political and academic opinion toward the ideal of consumption taxation.[264] In a world characterized by a strong consensus that income is the desired tax base, those labeling current law as a tax expenditure for qualified plans plausibly invoke an idealized version of that base. Under that idealized income tax base, all savings would be taxed currently as they accrue—a theoretical treatment far from the reality of current law, under which the taxation of qualified plan savings is delayed (perhaps for a long time) until the participant actually receives his plan distribution.

However, starting from the premise that consumption should be taxed, the Code's treatment of qualified plans looks not like a subsidizing departure from the theoretical income tax norm that all savings should be taxed immediately, but rather like a harbinger of a consumption tax under which all saving would be treated as are qualified plans today. In short, placing the label "tax expenditure" on the present tax treatment of qualified plans is conclusory and problematic.

Perhaps most seriously, that label obscures the nature of the decisions that are embedded in current law and that we confront for the future. The tax expenditure label allows paternalistic pension regulation to be defended without confronting its paternalistic nature. Rather, subsidy rhetoric allows such regulation to be characterized merely as the government guaranteeing that it receives something for its tax-based assistance.[265] In contrast, I think that, if we choose to be paternalistic, we should be open and explicit about that choice, not obscuring such paternalism with subsidy rhetoric.

B. *The Program*

From these premises, I propose the following program:

(1) *Do no harm*. The most important imperative for the future is to do no harm. That leads me to skepticism about numerous suggestions that are plausible (indeed, anodyne) at first blush but that, upon further reflection, appear problematic. Consider, for example, the now-widespread consensus that, in a world of individual accounts, 401(k) and IRA holders need investment education.[266] From this consensus, it is a short step to mandating that employers provide such education.

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264. *See supra* notes 218-221 and accompanying text.

265. *See* Orszag & Stein, *supra* note 29, at 650 ("[M]ost analysts and policy-makers agree that qualified pension plans generate tax expenditures. As such, non-discrimination rules and other forms of regulation are warranted.").

266. *See* Janice Kay Lawrence, *Pension Reform in the Aftermath of Enron: Congress' Failure To Deliver the Promise of Secure Retirement to 401(k) Plan Participants*, 92 KY. L.J. 1,

But not so fast. Education is not costless. Someone must pay for it. Either employers will absorb the costs of investor education for their employees or those costs will be passed onto employees via lower wages or lower employer contributions. And there is, as yet, no hard evidence that such mass education will in practice accomplish enough to justify its not inconsiderable costs. Before mandating such education, we need rigorous proof that the results are likely to justify the costs. Without such data, a mandate for employer-provided investor education looks suspiciously like a windfall for the providers of that mandated education.

Similar observations are to be made about proposals for mandatory annuitization, i.e., for requiring that, in lieu of lump sum distributions, participants must purchase annuity contracts with her qualified plan or IRA balance. Again, at first blush, such proposals are a plausible response to the problems of longevity risk and adverse selection. If everyone is required to purchase an annuity with their respective individual account balances, the adverse selection problem disappears, because everyone (whether likely to be long lived or not) must buy an annuity.[267]

But there is a potential flaw in this happy scenario, and it is a big one: Mandatory annuitization may deter some, perhaps many, employees from participating in defined contribution plans or individual retirement accounts by imposing a restriction they consider onerous. In its simplest incarnation, mandatory annuitization would eliminate the possibility of accessing retirement resources early by permitting withdrawals only on retirement and only in annuity form.

In response to these concerns, one can envision less stringent proposals for mandatory annuitization, like requiring such annuitization only after age fifty. But under that regime many participants would take distributions in their late forties to avoid forced annuitization, even though they would have left their retirement savings untouched in the absence of the annuitization requirement. Under this scenario, mandatory annuitization might actually cause greater pre-retirement consumption of plan distributions than would otherwise be the case. This, of course, would not be the first instance of qualified plan regulation generating unintended consequences.

Likewise, proposals for PBGC-type insurance for defined contribution plans are attractive when considered in isolation and without weighing their

13 (2003); Jayne Elizabeth Zanglein, *Investment Without Education: The Disparate Impact on Women and Minorities in Self-Directed Defined Contribution Plans*, 5 EMPLOYEE RTS. & EMP. POL'Y J. 223, 268 (2001).

267. Furthermore, if everyone were forced to buy an annuity, it is probable that, in at least some contexts (e.g., large 401(k) plans), plans would negotiate for annuity contracts on a centralized basis, thereby minimizing administrative costs and sales fees. Or perhaps, as the market for annuities expanded, competitive pressures would force the insurance industry to pass on to purchasers the resulting economies of scale.

possible secondary effects.[268] But someone will be required to pay for this insurance. If we charge employers or their 401(k) plans for those costs, as well as the expenses of investment education and the burden of mandatory annuitization rules, we change the cost-benefit calculation of such plans for employers and participants, perhaps to the detriment of maintaining such plans or participating in them.

If, on the other hand, government-sponsored insurance for defined contribution plans is a voluntary program, we must confront the failure of the private sector to provide such insurance. That the commercial insurance market has not generated such coverage suggests that publicly provided defined contribution insurance also is likely to flunk the test of the market and will eventually require subsidization either from the public treasury or from the universe of defined contribution plans. Neither alternative seems attractive.

In short, "do no harm" is not a bromide but a caution to avoid repeating the overregulation that made departure from the defined benefit format so attractive. The pathway to overregulation is paved with good intentions. We should be reluctant to replicate this experience with defined contribution arrangements.

(2) *Amend § 401(k) to require elections out*. While I would eschew many well-meaning but potentially counterproductive changes to the rules governing defined contribution plans, I would amend § 401(k) in one important respect: to require employees to opt out of 401(k) participation. Under current law, most 401(k) plans require the employee to elect plan coverage; absent such an election, the default rule for most plans is nonparticipation.

There is now substantial evidence that the opposite approach, making participation the default rule,[269] increases employees' coverage under 401(k) arrangements.[270] Employees who procrastinate about opting in also procrastinate about electing out. Hence, there is much to be gained by defining a 401(k) plan as an arrangement from which the employee must affirmatively withdraw by electing current cash salary rather than an equivalent plan contribution on her behalf.

Unlike the reforms I reject as potentially imposing significant burdens on employers and participants, defining the § 401(k) default rule as participation does not constitute overbearing paternalism. Under such a

268. *See, e.g.*, Regina T. Jefferson, *Rethinking the Risk of Defined Contribution Plans*, 4 FLA. TAX REV. 607 (2000) (proposing voluntary insurance coverage for defined contribution plans).

269. The IRS has specifically approved automatic enrollment 401(k) plans under which participation is the default rule if the employee makes no election. *See* Rev. Rul. 2000-8, 2000-1 C.B. 617; Prop. Treas. Reg. § 1.401(k)-1(a)(3)(ii), 68 Fed. Reg. 42,476, 42,489-90 (July 17, 2003).

270. *See supra* notes 25-28 and accompanying text.

rule, the employee can choose to depart from the plan and thereby take current cash compensation in lieu of a plan contribution on her behalf. Moreover, a 401(k) default rule that puts employees in the plan unless they affirmatively elect out might be as easy or easier for employers to administer than the default rule that requires employees to opt in. This suggests that many, perhaps most, 401(k) sponsors will eventually, on their own, gravitate toward the rule under which plan participation is presumed unless the employee elects out.

On balance, however, I favor legislating such a default rule, thereby accelerating the trend to such a rule. An interesting analogy is the Code's current withholding treatment of lump sum distributions. Today, federal income taxes are generally withheld from a qualified plan distribution[271] unless the distributee elects a trustee-to-trustee rollover, i.e., a direct payment of her distribution to an IRA or a qualified plan.[272] Substantively, this withholding rule does not affect the ultimate tax consequences of the distributee's choices. If the employee undertakes a traditional rollover, tax is withheld from the distribution. If the rollover is properly completed, the previously withheld taxes are subsequently refunded on the employee's federal income tax return for the rollover year. Under the no-withholding rule, the employee making a trustee-to-trustee rollover instead pays no tax on her rolled-over lump sum and thus receives no refund. Except for liquidity[273] and time-value-of-money concerns, there is no substantive difference between paying tax and receiving a refund or avoiding withholding ab initio. Either way, there is ultimately no tax due.

But, as behavioralists tell us, there may be a difference in how these two possibilities are perceived by many individuals. Even one skeptical of the vocabulary of framing effects might agree that a rule that suspends withholding on trustee-to-trustee rollovers highlights the tax benefits of rollovers and therefore might incline more distributees in that direction—as opposed to the delayed reward of a refund at filing time. Similarly, there is now enough experience and study to indicate that putting participants into 401(k) plans, unless they affirmatively elect current cash compensation instead, overcomes some of the cognitive barriers (or, perhaps, uses those barriers) to increase employees' participation in such plans.[274]

271. I.R.C. § 3405 (2000).

272. *Id.* § 401(a)(31).

273. If the employee making a traditional rollover desires to transfer the full amount of his distribution to an IRA or a qualified plan, he must transfer from his own or borrowed resources an amount equal to the taxes withheld.

274. Sunstein and Thaler come to a similar conclusion. Sunstein & Thaler, *supra* note 17, at 1195.

(3) *Legitimate cash balance plans*. The current status of cash balance plans is anomalous. As a statutory matter, these plans violate the rules for age discrimination because those rules require that all defined benefit pensions (including cash balance arrangements) test for age discrimination on the basis of projected annuities and because, converting cash balance contributions to annuity equivalents, the same contribution declines in value with the age of the participant.[275]

On the other hand, as a matter of retirement policy, there is much to commend cash balance plans. Under such plans, employers assume funding and investment risk, as they are obligated to pay whatever is necessary to finance the participants' notional account balances.[276] As a practical matter, if cash balance plans are outlawed, many (perhaps most) sponsors of such plans will terminate their defined benefit arrangements and replace them with defined contribution plans, under which funding and investment risk shift to the employees.

To bring the statutory age discrimination rules into compliance with the dictates of sound pension policy, I would amend the relevant statutes to authorize cross-testing for pension age discrimination.[277] This would permit cash balance plans to test for age discrimination, not on the basis of annuity equivalents but on the basis of theoretical contributions.[278] On that basis, most cash balance pensions will be deemed nondiscriminatory as to age. President Bush has now proposed legislation roughly along these lines.[279]

There is no doubt that the conversion of traditional pensions to the cash balance format upsets the sincerely held expectations of many older workers. These older workers, on the verge of earning significant pension

275. *See* I.R.C. § 411(b)(1)(H)(i) (prohibiting the reduction of "the rate of an employee's benefit accrual . . . because of the attainment of any age"); 29 U.S.C. § 623(i)(1)(A) (2000); ERISA § 204(b)(1)(H)(i), 29 U.S.C. § 1054(b)(1)(H)(i).

276. Cash balance plans generally allocate longevity risk to the participants because such plans' standard distribution mode is a lump sum with which the participants can (but need not and typically do not) purchase an individual annuity contract.

277. Zelinsky, *supra* note 4, at 759. Under current law, defined benefit plans cannot reduce "the rate of an employee's benefit accrual" "because of the attainment of any age." I.R.C. § 411(b)(1)(H)(i); *accord* 29 U.S.C. § 623(i)(1)(A); ERISA § 204(b)(1)(H)(i), 29 U.S.C. § 1054(b)(1)(H)(i). If the notional contributions under cash balance plans are translated into the annual annuity benefits those contributions purchase at retirement, the rate at which such benefits are earned declines with age, because the same contribution for an older person has fewer years to accumulate interest before an annuity must be provided at retirement. Hence the age discrimination problem with cash balance plans.

278. Zelinsky, *Rejoinder*, *supra* note 175; Zelinsky, *Is Cross-Testing a Mistake?*, *supra* note 175.

279. *See* STAFF OF SENATE BUDGET COMM., 108TH CONG., PRESIDENT BUSH'S 2005 BUDGET 23 (2004), *available at* http://www.senate.gov/~budget/republican/analysis/2004/Instant/2005Instant.pdf ("[The President's proposal aims to] clarify that a cash balance plan satisfies age-discrimination rules if the plan provides pay credits for older workers that are not less than the pay credits for younger workers.").

accruals under traditional, back-loaded annuity-based formulas, instead find themselves earning less (perhaps much less) under cash balance arrangements. If I were the director of a company considering the conversion of a traditional defined benefit plan to the cash balance format, I would attempt to respond to those expectations either by giving employees the option of remaining in the traditional plan[280] or by giving older employees extra credits under the cash balance formula to compensate for the accruals they anticipated under the traditional format but will not receive.

However, I would not mandate these approaches legislatively.[281] If Congress requires either of these courses, some (perhaps many) employers will simply terminate their traditional defined benefit plans rather than convert those plans to the cash balance format, and will replace those defined benefit pensions with individual account arrangements. That would entail a net loss of retirement security (funding and investment risk will shift from employer to employee) while accomplishing nothing for older employees.

(4) *Reduce scheduled Social Security benefit levels*. Under the defined contribution paradigm, there is a de facto division of responsibility between private retirement plans and the Social Security system. In effect, we have delegated to the federal government the task of providing, via Social Security, traditional defined benefit coverage, particularly to low-income individuals. In contrast, the private retirement regime predominantly places risk and reward upon the individual account holder. Proposals to introduce individual accounts to Social Security would alter this division of responsibility by installing individual accounts in that system, thereby diluting its defined benefit quality.

I am skeptical of such proposals. In the main, the half of the workforce covered by private retirement plans already has opportunities for employer-sponsored individual accounts. For them, accounts under the Social Security system would be duplicative, if not redundant. Moreover, I am doubtful about the wisdom of diminishing the defined benefit nature of Social Security for the other half of the population that lacks private plan coverage. In my judgment, the risks thereby imposed outweigh the potential rewards.[282]

280. The best-known example of a company giving its employees this option is CSX, which was under the leadership of John Snow before he became Secretary of the Treasury. *See* Walsh, *supra* note 171.

281. The legislation proposed by President Bush would. *See supra* note 279 and accompanying text.

282. I prefer to encourage the participation of lower-income individuals in the defined contribution paradigm by expanding the scope of the § 25B credit and by making that credit permanent. *See infra* note 289 and accompanying text.

However, the current benefit levels scheduled to be paid by Social Security are not actuarially sustainable at prevailing FICA tax rates. Because I see no prospect of increasing those tax rates (and, in any event, am unenthusiastic about increasing those rates given their regressive impact),[283] the only way to restore actuarial balance to the Social Security system is to reduce its projected benefit payments. Indeed, it should be (and often is) the advocates of the defined benefit nature of Social Security who, to preserve it, would bring the current Social Security system into actuarial balance by reducing its benefit commitments.[284]

Here, again, the behavioralist perspective has useful lessons: Economically equivalent benefit reductions may be perceived differently when achieved through different formulas. For example, delaying Social Security benefits (while keeping nominal annual payments the same) is economically equivalent to starting a lower level of benefits earlier. As Peter Diamond observes, "[C]hanging the age for full benefits is a benefit cut, plain and simple . . . ."[285] Nevertheless, pushing back the age at which individuals may collect Social Security benefits seems more politically palatable than an economically equivalent reduction of annual payments commencing earlier. After all, who can deny the reality that ages like sixty-two,[286] sixty-five,[287] and sixty-seven[288] carry different connotations for the Woodstock generation than they did for that generation's parents?

(5) *Make permanent and expand the § 25B credit*. The advocates of incorporating individual accounts within Social Security raise an important

283. It is true that, considering Social Security benefits and taxes together, the overall package is somewhat progressive in incidence. That, however, does not allay my qualms about increasing FICA taxes, an increase which imposes its heaviest burden on low-income persons and deters their work efforts.

284. *See, e.g.*, Aaron, *supra* note 36, at 89-94. Peter Diamond and Peter Orszag argue that scheduled Social Security benefit increases can be scaled back in a fashion that simultaneously helps to restore the actuarial balance of the Social Security system, maintains current benefits for existing retirees and near retirees, and authorizes benefit increases for future retirees (just not as great as the benefit increases scheduled for them under current law). DIAMOND & ORSZAG, *supra* note 31, at 28, 83, 87-88, 93, 167-70, 183. In their particulars, my conclusions are somewhat different from those underpinning the Diamond-Orszag proposal. Specifically (and contrary to that proposal), I believe that at least some near retirees should be forsaking some Social Security benefits we are scheduled to receive and that the politically palatable way to do this is to push back normal retirement age for us while that age is still a decade or more away. However, in its broad outlines, the Diamond-Orszag proposal demonstrates that reducing scheduled Social Security payments is critical to the maintenance and continuation of Social Security as a solvent defined benefit plan.

285. PETER A. DIAMOND, TAXATION, INCOMPLETE MARKETS, AND SOCIAL SECURITY 127 (2003).

286. The early retirement age for Social Security old-age benefits. 42 U.S.C. § 416(*l*)(2) (2000).

287. The Social Security normal retirement age for most individuals who were sixty-two years old before January 1, 2000. *Id.* § 416(*l*)(1)(A).

288. The age to which Social Security normal retirement is scheduled to be changed over time. *Id.* § 416(*l*)(1)(E).

issue: the nonparticipation in the defined contribution paradigm by the half of the population (largely lower-income individuals) who lack qualified plan coverage. The federal government's principal device for encouraging low-income individuals' IRA and 401(k) contributions, the tax credit of § 25B, suffers from two deficiencies.

First, the credit is set to expire at the end of 2006.[289] Second, the credit applies only to retirement contributions. If, however, saving for medical or educational outlays is a higher priority for a particular low-income taxpayer, the Code should respect that choice. Accordingly, I recommend that the § 25B credit be made permanent and that its coverage be expanded, not just to subsidize IRA and 401(k) contributions but to reward contributions to MSAs, HSAs, educational IRAs, and § 529 programs if the eligible taxpayer prefers any of these instead.

(6) *Apply the ten percent limit on employer stock to defined contribution plans*. Diversification of retirement savings is good. ERISA reflects the value of such diversification both by imposing upon plan fiduciaries a general obligation to diversify the plan assets under their control[290] and by preventing defined benefit pension trusts from investing more than ten percent of their total assets in employer stock.[291]

In terms of diversification, it is particularly troubling for an employer or for the employee herself to invest a significant portion of the employee's retirement assets in her employer's stock because the employee's job, and thus her current compensation, is already tied to her employer's economic fate. Concentrating her retirement investments in the employer (whether that concentration is imposed upon her or represents her voluntary choice) creates an economic form of double jeopardy, further entwining her finances with the employer's future performance. Some employees can win from this kind of undiversified approach, just as some people can win the lottery. But, as a matter of retirement policy, diversification is the more sensible course.[292]

It is thus today anomalous that the ten percent limit on employer stock does not apply to defined contribution plans. This exemption from the ten percent ceiling can best be understood historically. When ERISA was adopted, defined benefit plans predominated. The typical money purchase pension or profit-sharing plan supplemented a defined benefit arrangement.

289. I.R.C. § 25B(h) (West 2004).

290. ERISA § 404(a)(1)(C), 29 U.S.C. § 1104(a)(1)(C) (2000).

291. ERISA §§ 407, 408(e), 29 U.S.C. §§ 1107, 1108(e); *see also* I.R.C. § 4975(d)(13).

292. *See* Gretchen Morgenson, *Lopsided 401(k)'s, All Too Common*, N.Y. TIMES, Oct. 5, 2003, § 3 (Money & Business), at 1 ("After Enron collapsed, Congress discussed limits on the amount of company stock that can be in a 401(k), but the issue died. Now, almost two years later, investors in many 401(k) plans remain dangerously overexposed to their companies' stock.").

Even if the defined contribution plan was loaded with employer stock, that concentration was expected to be balanced by the diversified assets held in the employer's defined benefit plan. Today, in contrast, with defined contribution plans the main (often sole) retirement savings vehicles for many employees, there frequently is no diversified pool of defined benefit assets to offset heavy concentrations of employer stock in 401(k) or other individual account arrangements.

With an appropriate transition period so that plans can sell their excess employer stock holdings in an orderly fashion, the ten percent limit on employer stock should apply to all defined contribution plans.[293] Employers would still be free to grant employees stock as current compensation and to award stock options. However, the undiversified individual account plan, bloated with employer stock, should, in the post-Enron era, become a thing of the past. Given employers' evident determination, even after Enron, to permit unlimited concentrations of employer stock in 401(k) accounts,[294] ERISA's ten percent cap should be extended to defined contribution arrangements also.

CONCLUSION

Pension experts have frequently remarked on the stagnation of the defined benefit system and the corresponding rise of defined contribution plans. I suggest that, over the last generation, something even more fundamental has occurred, something that can justly be called a paradigm shift. Americans today experience and conceive of retirement savings in the form of individual accounts. Such accounts are primary instruments of public policy, not just for retirement savings, but increasingly for health care and education as well. Many of the surviving defined benefit pensions will, through the cash balance format, mimic defined contribution arrangements. For middle-class Americans, the defined contribution paradigm effectively transforms the Internal Revenue Code into a consumption tax.

The decline of the traditional defined benefit plan and the parallel emergence of contemporary individual account arrangements has worked well for many. However, the movement from the defined benefit framework to the defined contribution paradigm will, in the long run, prove problematic for some, perhaps many, employees by shifting from their employers to them the investment, funding, and longevity risks associated

293. This would entail the phaseout of employee stock ownership plans (ESOPs).

294. *See, e.g.*, Fred Williams, *More Employers Allow Unlimited Company Stock*, PENSIONS & INVESTMENTS, Oct. 27, 2003, at 1 ("87% of plan sponsors allow unlimited allocation of participant assets in company stock, compared to 59% in last year's survey.").

with retirement savings. Nevertheless, there is today no realistic chance of resuscitating the classic annuity-paying defined benefit plan. We are simply too far down the defined contribution road. Our task now is to make the defined contribution paradigm work.