*Source: International Society of Certified Employee Benefit Specialists

Retirement Plan Sponsorship by Small Employers

by Patrick J. Purcell
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►**This article analyzes recent data on the sponsorship of pensions and retirement savings plans by small employers.** *It describes the characteristics of small firms and their employees that account in part for the lower rate of retirement plan sponsorship among small employers, and it summarizes the various retirement plans that Congress has authorized to encourage more small employers to sponsor retirement plans.*◄

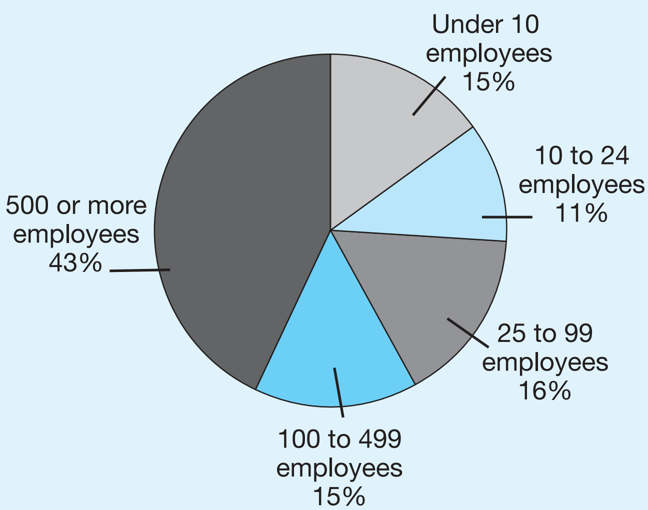
Federal tax law allows employers to deduct certain pension expenses from income and permits employees to defer taxes on contributions and investment earnings that accrue to retirement plans. The deductions and deferrals for employer-sponsored retirement plans represent the largest tax expenditure in the federal budget, greater than either the deduction for interest on home mortgages or the deduction for employer-sponsored health insurance.[1] The congressional Joint Committee on Taxation has estimated that the tax deductions and deferrals associated with employer-sponsored retirement plans will result in more than $420 billion in forgone tax revenue during the five years from 2001 through 2005.[2] That such a substantial amount of tax revenue is forgone through these deductions and deferrals is an indication of the importance that Congress has assigned to the policy of encouraging employers to sponsor retirement plans and employees to participate in these plans.

Private employers offer retirement plans voluntarily, and many of them—especially large firms with 500 or more employees—have responded to the tax incentives that Congress has provided by sponsoring retirement plans for their employees. Among small employers, however, the rate of sponsorship of pension plans remains comparatively low. The low rate of retirement plan sponsorship in small firms has been a topic of ongoing concern to Congress, in part because some 63 million workers—more than half of the private sector labor force—are employed by firms with fewer than 500 employees.[3] (See Figure 1.) On several occasions over the past quarter century, and most recently in the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16), Congress has sought to provide small employers with additional incentives to sponsor retirement plans. For example, Congress has authorized special retirement plans for small employers that are exempt from some of the regulations and administrative procedures that apply to the retirement plans of larger employers. P.L. 107-16 authorizes a refundable tax credit for small employers to offset some of the administrative costs of establishing a new retirement plan.

FIGURE 1

Employment by Size of Employer in 1999

Private Sector Wage and Salary Workers, by Employment Size of Firm



Total = 111.5 million workers.

Source: Authors' analysis of the March 2000 *Current Population Survey.*

PREVIOUS RESEARCH

Research based on surveys of both households and businesses has established that employees of small firms are less likely to have the opportunity to participate in an employer-sponsored retirement plan than are employees of large firms (U.S. Department of Labor 1999b; U.S. General Accounting Office 2000; Employee Benefit Research Institute (EBRI) 2001a; Purcell forthcoming 2002). Some analysts have attributed the lower rates of retirement plan sponsorship among small employers mainly to the legal and regulatory framework in which retirement plans must operate (Pearce 1999), while other research points to the variability in revenues and profits and high labor turnover experienced by many small businesses as more important factors in dissuading these employers from establishing retirement plans for their employees (EBRI 2001b). Several authors have described the plans authorized by Congress for small employers in efforts to simplify the process of establishing and maintaining a retirement plan (Shanney-Saborsky 1997; Philhours 1999; Kilgour 2001). This article combines an analysis of recent data on the sponsorship of pensions and retirement savings plans by small employers with a summary of the various retirement plans that Congress has authorized to encourage more small employers to sponsor retirement plans.

RECENT DATA ON RETIREMENT PLAN SPONSORSHIP

Each month, the Census Bureau conducts the *Current Population Survey (CPS)* among a random sample of approximately 50,000 households, mainly to collect information about labor force participation needed to estimate the unemployment rate. Every year in March, supplemental questions are asked about income and employment during the previous year. The survey includes two questions about retirement plan sponsorship and participation at the worker's place of employment. Survey respondents are asked whether any employer for whom they worked in the previous year sponsored a retirement plan for any of its employees. Those who answer "yes" to this question are asked whether they were included in the plan. The *CPS* does not ask whether the plan was of the defined benefit or defined contribution type. Consequently, in this article the term *retirement plan* refers to any plan that an employer sponsors, regardless of whether it is a defined benefit plan or a defined contribution plan.

How many workers are employed by firms that sponsor retirement plans? According to information reported on the *CPS*, approximately 56% of all wage and salary workers age 16 and older in the private sector were employed by firms that sponsored a retirement plan in 1999. (See Figure 2.) The Employee Retirement Income Security Act of 1974 (ERISA) allows plan sponsors to exclude part-time employees and those under 21 from employer-sponsored retirement plans, so many studies of pension coverage focus on workers who are 21 or older and who work full time. Among private sector wage and salary workers between the ages of 21 and 64 who worked full time in 1999, 67% worked for employers that sponsored retirement plans for at least some of their employees.

How many workers participate in employer-sponsored retirement plans? Not all workers whose employer sponsors a retirement plan are eligible to participate, and some choose not to participate.[4] As a result, fewer than half of all wage and salary workers actually participate in an employer-sponsored retirement plan. According to the *CPS,* 42% of the 111 million wage and salary workers in the private sector in 1999 participated in an employer-sponsored retirement plan.[5] Among wage and salary workers who worked year round, full time and who were between the ages of 21 and 64, an estimated 57% participated in an employer-sponsored retirement plan in 1999. The U.S. Department of Labor has estimated that slightly more than half of these participants were enrolled only in defined contribution plans, while about a third participated in only defined benefit plans.[6] About one in seven (14%) participated in both a defined benefit plan and a defined contribution plan.

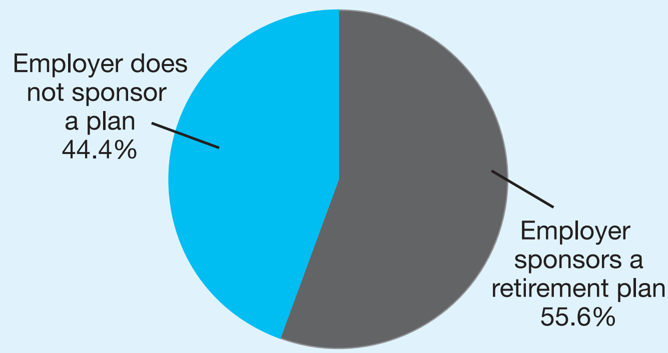
Sponsorship of retirement plans by small employers. Small employers are less likely to sponsor a retirement plan than larger employers. According to data reported on the *CPS,* only 20% of workers in firms with fewer than ten employees were employed by firms that sponsored a retirement plan in 1999. Among workers in firms with ten to 24 employees, only 32% worked for an employer that sponsored a retirement plan. (See Figure 3.) In firms with 100 or more employees, however, more than half of all workers were employed by firms that sponsored retirement plans for at least some of their employees. Of the wage and salary workers employed by firms with 100 to 499 employees, 63% worked for an employer that sponsored a retirement plan. Among employees of firms with 500 employees, 74% worked for employers that sponsored one or more retirement plans.

Even among workers employed year round, full time, the proportion whose employer sponsors a retirement plan is much lower among employees of small firms than among those who work for large firms. In 1999, only 27% of year-round, full-time workers in firms with fewer than ten employees, and 42% of such workers in firms with ten to 24 employees, were employed by firms that sponsored a retirement plan for at least some of their employees. In contrast, 71% of year-round, full-time workers in firms with 100 to 499 employees, and 83% of those employed by firms with 500 or more em-

FIGURE 2

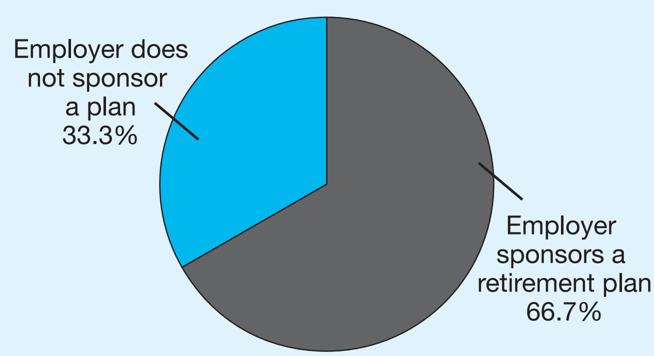
Employer Sponsorship of Retirement Plans in 199

All Private Sector Wage and Salary Workers



Total = 111.5 million workers.

Full-Time Private Sector Wage and Salary Workers, Ages 21 to 64

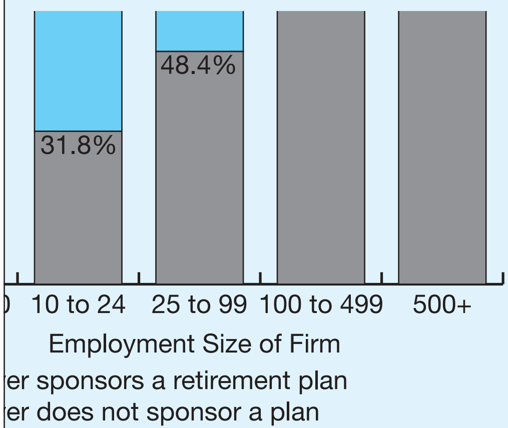


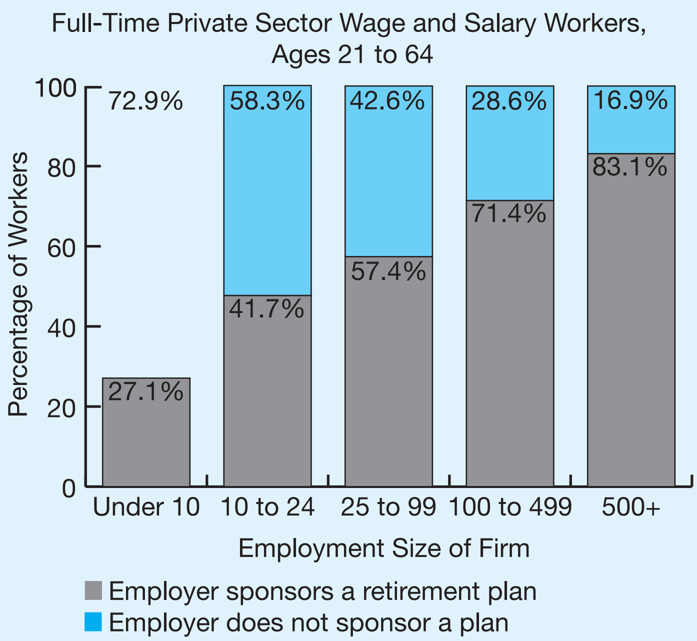
Total = 70 million workers.

Source: Authors' analysis of the March 2000 *Current Population Survey.*

FIGURE 3

Sponsorship of Retirement Plans by Employer Size





Source: Authors' analysis of the March 2000 *Current Population Survey.*

ployees, worked for firms that sponsored one or more retirement plans in 1999.

Why don't more small employers sponsor retirement plans? The most direct way to find out why employers do or do not choose to offer a retirement plan to their employees is to ask them. To that end, EBRI, in association with the American Savings Education Council (ASEC) and the market research firm of Mathew Greenwald & Associates, has conducted the *Small Employer Retirement Survey* each year since 1998.[7] The survey is conducted annually among representatives of approximately 600 firms with five to 100 employees. Roughly half of the firms sponsor retirement plans, and half do not. In each of the four surveys conducted since 1998, employers that do not sponsor a retirement plan have been asked to choose from a list of reasons those that were important in their decision.

Major reasons for not sponsoring a retirement plan. Among the smallest employers (those with five to 20 employees), 50% cited uncertain revenues among the major reasons for not offering a retirement plan. This was the most commonly cited major reason for not offering a retirement plan among employers of this size. The second most-cited reason for not offering a retirement plan among very small employers was that the required contributions are too expensive, mentioned by 46% of very small employers. Forty-three percent said that their workers prefer higher wages or other benefits to a retirement plan. One-third of very small employers cited the cost of setting up and administering a retirement plan, while 30% mentioned the number of seasonal or part-time employees as reasons for not sponsoring a retirement plan. Thus, among very small employers, three of the five most frequently cited reasons for not sponsoring a retirement plan are directly attributable to the *expense* involved. The other two most frequently cited reasons can be classified as *characteristics of the small employer workforce.*

Among employers with 21 to 100 employees, uncertain revenue (30%) and the cost of required contributions (39%) also were frequently given as major reasons for not offering a retirement plan, but the two reasons most often cited by employers in this size category were the number of seasonal or part-time employees (46%)

and the cost to set up and administer a plan (42%). A substantial percentage (37%) also cited the preference of their employees for higher wages or other benefits. Employers with 21 to 100 employees were more likely than very small employers to cite vesting requirements that result in benefits going to relatively short-term employees as a major reason for not sponsoring a retirement plan (41% vs. 29%). In this regard, it is interesting to note that firms with 21 to 100 employees also were more likely than very small employers to cite the number of seasonal and part-time workers as a major reason for not sponsoring a retirement plan (46% vs. 30%). Together, these two statistics suggest that very small employers and their slightly larger counterparts may differ with respect to workforce tenure and turnover. The only other major reasons given by at least 20% of small employers for not offering a retirement plan were too many regulations and that the business is too new.

Small firms are more likely to employ part-time and part-year workers. Many firms that do not sponsor retirement plans cited *the number of part-time or seasonal workers* that they employ as a reason for not sponsoring a retirement plan. Statistics gathered by the Census Bureau indicate that workers in small firms are more likely to be employed on a part-time or part-year basis than workers in larger firms. In 1999, 41% of workers in firms with fewer than ten employees were employed on a part-time or part-year basis, as were 33% of workers in firms with ten to 24 employees. (See Table I.) In contrast, only 24% of workers in firms with 500 or more employees were employed part time or for less than the full year. Because part-time and part-year workers often are not eligible to participate in an employer's retirement plan, it is not surprising that there is a positive correlation between the proportion of a firm's employees who are part-year or part-time workers and the preference of those employees for higher wages over retirement benefits.[8] Even if permitted to participate, part-time or seasonal workers are less likely to remain employed long enough to vest in the plan's benefits or to earn wages high enough to accrue a substantial retirement benefit.

Distinguishing Between "Establishments" and "Firms"

The *Current Population Survey* asks people to estimate the number of people who work for their employer at all locations where the employer operates. This represents the number of employees of the *firm* by which they are employed rather than the number of workers at the *establishment* to which they go to work each day. This distinction is important, because some small establishments are units of large firms.

An *establishment* is a single place of business at a particular location or all branches of a business located in a specific metropolitan area or county. A *firm* consists of all the establishments that together comprise a particular corporation, partnership or other business enterprise. Many firms consist of a single establishment, but other firms have establishments in several locations.

TABLE I

Employment Status by Size of Firm, 1999

	Private Sector Employment, in Thousands				
	Year Round, Full Time		Part Year or Part Time		Total
Size of Firm	**Number**	**Percent**	**Number**	**Percent**	**Number**
1 to 10 employees	8,070	59.5	5,501	40.5	13,571
10 to 24 employees	6,855	67.1	3,358	32.9	10,213
25 to 99 employees	10,697	70.9	4,392	29.1	15,089
100 to 499 employees	11,915	75.7	3,823	24.3	15,738
500 or more employees	32,472	76.4	10,011	23.6	42,483
Total	70,009	72.1	27,085	27.9	97,094

Source: Authors' analysis of the March 2000 *Current Population Survey.*

TABLE II

Business Survival Rates by Employment Size of Firm

Firm Size	Percentage of Firms *in Business* in 1976 That Survived Until: 1978	1980	1982	1984	1986
1 to 4 employees	66.2	47.5	43.3	35.8	30.9
5 to 9 employees	81.0	69.2	63.9	57.0	51.2
10 to 19 employees	85.8	76.3	70.7	64.4	58.6
20 to 49 employees	88.0	79.4	73.2	67.0	61.0
50 or more employees	89.2	81.0	74.9	68.9	62.8

Source: Business Survival Rates by Age Cohort of Business, prepared for the U.S. Small Business Administration, by Joel Popkin & Co., 1991.

TABLE III

Survival Rates of New Firms, by Industry

Employer Firms *Established* Between 1989 and 1992

Still Open After	All New Firms	Manufacturing	Retail Trade	Services
1 year	81.7%	84.2%	83.2%	84.9%
2 years	66.0	69.4	67.2	71.5
3 years	56.5	59.5	56.7	62.6
4 years	49.6	52.5	49.0	55.7

Note: Results for firms in unidentified industries are not shown separately.

Source: Office of Advocacy, U.S. Small Business Administration.

Small firms have lower survival rates than large firms. Small employers often cite the *uncertainty of revenue* as a major reason for not sponsoring a retirement plan. Data compiled by the Small Business Administration show that small firms—many of which are new businesses—face a high risk of termination. The relatively high risk of termination among small firms may dissuade some business owners from offering retirement benefits. The uncertainty of survival faced by small firms and by new firms is demonstrated by the data presented in Table II and Table III. The data in Table II show the percentage of firms that were *in business* in 1976 that were still operating in 1978, 1980, 1982, 1984 and 1986. The firms that were in business in 1976 were not necessarily *new* firms that began operating that year; in fact, most were not new firms when the survey began. Nevertheless, the smaller the firm, the more likely it was that it had ceased operation in any succeeding year. Among the smallest firms, only two-thirds were still in business two years later in 1978, and just 31% survived ten years until 1986. Survival rates were higher for firms in each of the larger employment-size categories, but even among firms with 50 or more employees, 25% had closed by 1982, six years after the survey began.[9]

The Office of Advocacy of the Small Business Administration has undertaken a project to develop the Business Information Tracking System (BITS), a database that represents the universe of private sector employers in all industries, except for farms, railroads and household employees. This universe comprised almost 5.1 million employers in 1992. The BITS includes information on the firm's location, industry, number of employees, amount of payroll and the year that the business was started. This last piece of information can be used to ascertain the survival rate of new businesses. (See Table III.)

The data displayed in Table III show that only about half of new firms established between 1989 and 1992 were still in business after four years. Comparing the four-year survival rates in Table III with the percentages in the column in Table II labeled "1980" indicates that, as one might expect, the survival rate of firms in their first four years of existence is substantially lower than the four-year survival rate for a group of firms not composed exclusively of new businesses. While the four-year survival rate of the newly established firms in Table III averaged about 50%, the four-year survival rate of the firms in Table II (including both new and established firms) ranged from 48% for those with fewer than five employees to 81% for firms with 50 or more employees.

As evidenced by the fact that nearly 50% of all new firms close within four years, small firms face considerable uncertainty about their continued existence from year to year. Moreover, considering the high proportion of their workforce that is employed part time or part year, many small employers might reasonably conclude that their employees would place a greater value on a dollar paid as wages than as a contribution to a retirement plan. Together, the economic uncertainty faced by small firms and the unique characteristics of their workforce may dissuade many of these employers from incurring the expenses inherent in sponsoring a retirement plan.

CONGRESS AND EMPLOYER-SPONSORED RETIREMENT PLANS

The decision to offer a retirement plan is up to the employer, but those who do must comply with the Employee Retirement Income Security Act of 1974 (P.L. 93-406), commonly called ERISA. To be eligible for the tax deductions and deferrals that Congress has granted to retirement plans, that is, to be "tax qualified," a plan also must comply with the relevant sections of the Internal Revenue Code (IRC). Responsibility for enforcing these laws is shared between the Departments of Labor and Treasury. Together, ERISA and the IRC set standards that plans must meet with respect to:

- Reporting information about the plan to the appropriate government agencies
- Disclosing information about the plan to plan participants
- Minimum participation standards and maximum vesting periods
- Minimum funding requirements
- Fiduciary responsibilities of the plan sponsor and plan administrator.

Minimum participation requirement. ERISA and the IRC set minimum requirements on who must be allowed to participate in an employer-sponsored retirement plan. For example, an employee cannot be excluded from participating on account of age or years of service if he or she is at least 21 years of age and has worked for the employer for a year or more. An employee cannot be excluded on the basis of part-time employment if he or she works more than 1,000 hours in a year.[10]

Prohibition on discrimination. For a plan to be tax qualified, it must benefit "rank and file" employees. To that end, the IRC prohibits tax-qualified retirement plans from discriminating in favor of "highly compensated employees" in terms of eligibility, contributions or benefits.[11] With respect to eligibility, for example, the IRC requires a qualified plan to benefit at least 70% of the employees of a firm who are not in the "highly compensated" group.[12] For Section 401(k) plans and 403(b) plans, there is a further requirement that contributions on behalf of highly compensated employees cannot exceed

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TABLE IV

Maximum Average 401(k) Contributions for Highly Compensated Employees

Nonhighly Compensated Employees (NHCEs)	Highly Compensated Employees (HCEs)
Maximum average deferral and match:	Maximum average deferral and match:
2% of pay or less	NHCE percentage × 2
2% to 8% of pay	NHCE percentage + 2%
8% of pay or more	NHCE percentage × 1.25

Note: "Deferral and match" is the sum of contributions from employers and employees as a percent of salary.

Source: Internal Revenue Code Section 401(k)(3) and Kilgour (2001).

contributions on behalf of rank and file employees by more than specific amounts or ratios. (See Table IV.) Plans are subject to annual testing to see that they do not discriminate in favor of highly compensated employees, a process referred to as "nondiscrimination testing." Plans that violate the standards on nondiscrimination risk losing their tax-qualified status.

Help for small employers. To encourage small employers to sponsor retirement plans, Congress has authorized several types of plans that relieve small employers of some of the administrative expenses and regulatory burdens that they otherwise would have to meet in order to comply with ERISA and the IRC. To date, all of the small employer retirement plans authorized by Congress have been *defined contribution* plans. In previous Congresses, bills have been introduced that would have authorized defined benefit plans specifically designed for small employers; however, none of those bills have been enacted into law.[13]

Simplified employee pensions (SEPs). In the Revenue Act of 1978 (P.L. 95-600), Congress authorized a defined contribution plan called the *simplified employee pension (SEP)* for firms that do not already sponsor a retirement plan. Only the employer can make contributions to a SEP, and contributions must be made on behalf of *all eligible employees.* Participants are fully and immediately vested in the employer's contributions to the plan. Only employees who are under age 21, have not worked in at least three of the last five years, or have earned less than $450 in the past year can be excluded from the plan. The contribution must be a uniform percentage of pay for all eligible employees, and it cannot exceed an amount equal to 15% of pay up to a maximum of $25,500 (indexed to inflation).

In the Tax Reform Act of 1986 (P.L. 99-514), Congress authorized a salary reduction SEP (SARSEP) for firms with 25 or fewer employees. A SARSEP is funded entirely by contributions from the employee and allows the employee to defer up to 15% of pay to a maximum of $10,500 (indexed to inflation).[14] At least half of all eligible employees must participate for the plan to be qualified. In all other significant respects—such as eligibility, vesting and testing for discrimination in favor of highly compensated employees—a SARSEP is subject to the same laws and regulations as other defined contribution plans. Congress prohibited the adoption of new SARSEPs in the Small Business Job Protection Act of 1996 (P.L. 104-188), but plans already existing at that time can continue to enroll new participants.

SIMPLEs. The Small Business Job Protection Act of 1996 authorized the Savings Incentive Match Plan for Employees (SIMPLE). A SIMPLE relieves the employer from the annual nondiscrimination test, in exchange for providing a required employer contribution, in which the employee is immediately 100% vested. A SIMPLE can be established by any employer with fewer than 100 employees that does not already have a retirement plan. If the firm later exceeds the 100-employee limit, it can continue the plan for two years. The plan must be open to any employee who earned $5,000 or more in either of the previous two years and whose earnings are expected to be at least $5,000 in the current year. The maximum allowable employee contribution to a SIMPLE is $6,500 in 2001. The Economic Growth and

TABLE V

Retirement Plan Sponsorship and Participation, 1991-1999

(Workers 25 to 64 Years Old, Employed Year-Round Full Time, in Thousands)

Employment Size of Firm	Number of Workers	Employer-Sponsors Plan		Employee Participates	
		Number	Percent	Number	Percent
Under 25					
1991	11,705	3,160	27.0	2,740	23.4
1993	12,555	3,134	25.0	2,688	21.4
1995	14,627	3,715	25.4	3,109	21.3
1997	14,732	4,356	29.6	3,722	25.3
1999	15,582	5,259	33.4	4,522	29.0
25 to 99					
1991	8,010	3,972	49.6	3,383	42.2
1993	8,217	3,967	48.3	3,374	41.1
1995	9,108	4,923	54.1	4,188	46.0
1997	9,691	5,416	55.9	4,602	47.5
1999	9,974	5,881	59.0	4,933	49.5

Source: Authors' analysis of the March *Current Population Survey,* various years.

Tax Relief Reconciliation Act of 2001 (P.L. 107-16) will raise the maximum employee contribution to a SIMPLE to $7,000 in 2002, $8,000 in 2003, $9,000 in 2004 and $10,000 in 2005, after which it will be indexed to inflation in $500 increments.

There are two kinds of SIMPLEs: a SIMPLE 401(k) and a SIMPLE IRA. An employer that sponsors either of these plans must either (1) match 100% of the first 3% of each *participating* employee's contributions up to a maximum of $5,100 or (2) contribute an amount equal to 2% of pay on behalf of every *eligible* employee up to a maximum of $3,400.[15] Under the SIMPLE IRA, however, the employer can reduce its contribution to 1% of pay in two years out of any five. Reduced contributions are not permissible in a SIMPLE 401(k).

"Safe harbor" 401(k) plans. In 1999, 46 million workers were employed by firms with fewer than 100 employees; however, only about a third of these workers were employed by firms that sponsored a retirement plan. Thus, the large majority of workers in small firms did not have access to an employer-sponsored retirement plan. To encourage more employers—of all sizes—to sponsor Section 401(k) plans, Congress in 1996 authorized a "safe harbor" 401(k) plan that is exempt from nondiscrimination testing if the employer agrees either to contribute an amount equal to 3% of pay on behalf of each *eligible* employee (regardless of whether the employee defers any of his or her own salary into the plan) or to match the first 3% of salary deferrals of each *participating* employee on a dollar-for-dollar basis and to match the next 2% of employee deferrals at 50 cents per dollar. In either case, an employer that adopts this safe harbor 401(k) design is relieved from the annual testing for excess contributions on behalf of highly compensated employees described in Table IV.

In each of these plans—the SEP, the SIMPLE and the safe harbor 401(k)—Congress has offered small employers some relief from regulatory and administrative burdens in exchange for minimum eligibility standards and mandatory employer contributions. Because relatively few small employers adopted SEPs and SARSEPs, which were authorized in 1978 and 1986, respectively, Congress in 1996 authorized safe harbor 401(k) plans for employers of all sizes and SIMPLE plans for firms with fewer than 100 employees. The effect that these changes to the federal pension laws have had on retirement plan sponsorship among small employers cannot be determined exactly, but recent data from the Census Bureau show an

The Two Kinds of Individual Retirement Account (IRA)

Any worker can contribute up to $2,000 (in 2001) to a *traditional IRA.* A married couple filing jointly can contribute up to $4,000 if at least one of them works. Contributions to a traditional IRA are tax deductible if the worker is not covered by an employer-sponsored retirement plan *or* has income below amounts specified in law.[17] Investment earnings on a traditional IRA accrue on a tax-deferred basis. Withdrawals can begin without penalty at age 59½ and must begin no later than April of the year after the individual turns 70½. Withdrawals before age 59½ are subject to a 10% excise tax in addition to regular income taxes.[18] Workers who are covered under a retirement plan where they work, or whose income is over the thresholds specified by law still may contribute up to $2,000 to a traditional IRA. These contributions are not tax deductible, but taxes are deferred on all investment earnings until retirement, and only the portion of a withdrawal that is attributable to investment earnings is taxed.

Roth IRAs accept only *aftertax* contributions; however, withdrawals from a Roth IRA after age 59½ are *tax free,* provided that the account has been held for at least five years. The maximum allowable contribution to a Roth IRA also is $2,000 (in 2001); however, only single persons with adjusted gross income (AGI) of less than $95,000 and married couples with AGI of less than $150,000 are eligible to contribute that amount. Single persons with AGI between $95,000 and $110,000 and married couples with AGI between $150,000 and $160,000 are eligible to make a partial contribution (less than $2,000) to a Roth IRA. Withdrawals from a Roth IRA before age 59½ are subject to regular income tax as well as a 10% excise tax on the portion of the withdrawal that is attributable to investment earnings; however, the amounts withdrawn are not considered to be attributable to investment earnings until all of the individual's contributions have been withdrawn from the account.

If an individual chooses to contribute to both a traditional IRA and a Roth IRA, the combined contributions cannot exceed $2,000 (in 2001). Congress set the maximum contribution to an IRA at $2,000 per year in 1981, and it remained unchanged until enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16). Under this law, the maximum annual contribution to either a traditional IRA or a Roth IRA will increase to $3,000 in 2002, to $4,000 in 2005, and to $5,000 in 2008. In calendar years after 2008, the limit will be indexed to the Consumer Price Index in $500 increments. Individuals age 50 and older will be allowed to contribute an additional $500 to an IRA in each year from 2002 through 2005 and an additional $1,000 in each year thereafter.

encouraging trend in retirement plan participation among workers in small firms. (See Table V.)

Individual retirement accounts (IRAs). Most people with earned income are eligible to contribute to an individual retirement account (IRA). There are two types of IRA: the "traditional" IRA, in which eligible contributions and all investment earnings are *tax deferred,* and the "Roth" IRA, which accepts only aftertax contributions but allows *tax-free* distributions.[16] The traditional IRA was originally authorized by ERISA in 1974, while the Roth IRA was authorized by the Taxpayer Relief Act of 1997 (P.L. 105-34). While the two kinds of IRA differ in the way that they treat contributions and distributions, they *both* provide more generous treatment for contributions made by low-income workers and workers whose employer does not offer a retirement plan than they do for higher-income workers and those who have a retirement plan at work. Unfortunately, rates of participation in IRAs among workers who do not have an employer-sponsored retirement plan remain disappointingly low. According to the Bureau of the Census, in 1999 only 17% of workers between the ages of 21 and 64 who were not enrolled in an employer-sponsored retirement plan owned an IRA. (See Figure 4.)

Some policy analysts have suggested that the increase in the maximum allowable contribution to an IRA authorized by the Economic Growth and Tax Relief Reconciliation Act of 2001 might slow the growth of retirement plan sponsorship by small employers. The allowable contributions to an IRA will be lower than the maximum contribution permissible under a 401(k) plan, SEP or SIMPLE, even with the increases in IRA contribution limits authorized by the recent tax law. Nevertheless, a small business owner who would like to provide for his or her own retirement might consider an IRA a more attractive option than previously, since a married couple will be able to contribute up to $6,000 to an IRA in 2002 and up to $10,000 by 2008, with none of the regulatory compliance and reporting requirements that an employer-sponsored retirement plan can involve. How individual employers respond will depend on the specific circumstances of their businesses. For instance, will they believe that offering retirement benefits will help them attract and retain employees with valuable skills, or will their main concern be to set aside funds for themselves and their families?

POLICY IMPLICATIONS

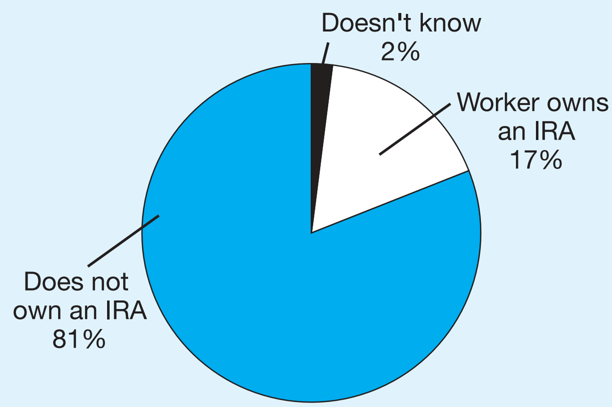
Although the percentage of employees in small firms who participate in employer-sponsored retirement plans has risen in recent years, employees of small firms still are much less likely to work for an employer that sponsors a retirement plan than are employees of large firms. (See Figure 3.) Sponsorship of retirement plans is unlikely ever to be as widespread among small employers as it is among larger firms, because of both the characteristics of the small employer workforce and the uncertainty of revenue, profits and survival that the typical small business faces from year to year. These are not necessarily reasons that Congress ought to forego efforts to promote sponsorship of retirement plans by small employers, but they are factors that should be taken into account when assessing their potential for success.

Employers need more information about plans they can offer. Among the findings of the EBRI/ASEC/Mathew Greenwald *Small Employer Retirement Survey (SERS)* is that many small employers are not aware of the various retirement plans such as SEP, SIMPLE and the safe harbor 401(k) that they can offer to their employees. In the 2001 SERS, for example, only 33% of small employers said that they were either "very familiar" or "somewhat familiar" with the SEP. More than half—52%—said that they had never heard of the SEP. A larger percentage of small employers (45%) said that they were "very" or "somewhat" familiar with the SIMPLE, but they still represented a minority of small employers. While the vast majority of small employers (92%) said that they were familiar with 401(k) plans, the survey did not determine whether they were familiar with the safe harbor provisions enacted in 1996 to make these plans less administratively cumbersome. Future outreach efforts by federal agencies—mainly the Departments of Labor and Treasury and the Small Business Administration—could make more small employers aware of the options available for offering retirement plans to their employees.[19]

FIGURE 4

IRA Ownership Among Workers With No Employer-Sponsored Retirement Plan

Private Sector Wage and Salary Workers, Ages 21 to 64



Total = 35.6 million workers with no employer-sponsored plan.

Source: Authors' analysis of the February 1999 *Current Population Survey.*

Employees need education about the importance of saving. Education about the importance of saving for retirement may be especially important for workers whose employers do *not* sponsor retirement plans. Data from the *Current Population Survey* indicate that when a small employer offers a retirement plan, its employees are as likely to participate as employees of larger firms. In 1999, 81% of workers in firms with 100 or more employees worked for firms that sponsored at least one retirement plan, and 71% of workers in these firms were included in their employers' plans. This means that 87.7% of employees whose employer offered a plan participated in the plan (.71/.81 = .877). Among workers in firms with *fewer* than 100 employees, 43.6% worked for firms that offered retirement plans, and 37% were included in such plans. Thus, 84.9% of workers in small firms that offered a retirement plan participated in the plan (.370/.436 = .849).[20]

The workers who may most need additional education about the importance of saving for retirement—or perhaps additional incentives to save—are those whose employers do not sponsor retirement plans. This group consists disproportionately of those who work for small employers. As seen in Figure 4, only 17%—about one in six—workers whose employer did not sponsor a retirement plan in 1999 owned an IRA. Because not everyone who owns an IRA makes a contribution every year, the percentage of these workers who contributed to their IRAs in 1999 was even smaller. Workers who do not have access to an employer-sponsored retirement plan and who do not have an IRA may have other assets, such as equity in their homes, on which they will be able to draw during retirement, but many are—either wittingly or unwittingly—putting all of their retirement eggs in one basket, namely Social Security. The average Social Security benefit for a retired worker in October 2000 was $815 per month, equivalent to $9,780 per year. Future retirees might receive Social Security benefits smaller than those promised under current law. According to the Social Security Board of Trustees, by 2038 revenue from Social Security payroll taxes will be sufficient to pay only 73% of the program's promised benefits.[21] Clearly, relying only on Social Security for one's retirement income is a gamble that might not pay off.

Congress recognized both the importance of educating workers about the need to save for retirement and the unique role that government can play in this effort when it passed the Savings Are Vital to Everyone's Retirement (SAVER) Act of 1997 (P.L. 105-92). This act requires the Department of Labor to hold periodic national summits on retirement saving issues and to maintain an ongoing public education campaign to help people understand the importance of providing for their future financial security. The first national summit on retirement saving was held in 1998, and the second will be held early in 2002. The General Accounting Office (GAO) recently reported that while the 1998 summit may have increased public awareness about the need to save for retirement, it "did not develop recommendations addressing retirement savings issues and coordinating government education programs, as called for in the [SAVER] act."[22] GAO noted that the development of specific policy recommendations to promote retirement saving is likely to be on the agenda of the next SAVER summit.

Employers offer retirement plans voluntarily, and a large and growing proportion of the retirement plans that employers sponsor require the employee to defer some of his or her current salary. Consequently, to the extent that Congress deems it to be in the public interest for employers to offer retirement plans and for employees to save for retirement, pursuing that goal will require *educating* employers and employees about the benefits of saving for retirement and the consequences of failing to do so. This educational role will become even more imperative if at some point in the future the Social Security system is modified to incorporate individual accounts. Fortunately, as has been demonstrated by the cooperative efforts of the Department of Labor and the American Savings Education Council, this endeavor is one in which private interests can help promote a public good. Successfully expanding the effort to educate the public about the need to save for retirement will likely require more such cooperative efforts in the future.

Editor's note: The conclusions and opinions expressed in this paper are those of the authors and do not represent policy recommendations of the Congressional Research Service or the Library of Congress. ◀

Endnotes

1. The U.S. General Accounting Office defines a *tax expenditure* as a revenue loss attributable to a provision of law that (1) allows a special exclusion, exemption or deduction from gross income, or (2) provides a special credit, preferential tax rate or deferral of tax liability.
2. Bureau of National Affairs, *Daily Tax Report* no. 69, April 10, 2001.
3. The designation of firms as "large" or "small" is necessarily arbitrary. The average size of firms varies from one industry to another. The Small Business Administration generally classifies firms with fewer than 500 employees as small firms.
4. In February 1999, the *CPS* asked workers who did not participate in their employer's retirement plan why they did not participate. About half said they were not eligible, and about 30% said they chose not to participate. The remainder either did not respond or did not know why they were excluded.
5. Private sector wage and salary employment excludes an estimated 14 million people who were self-employed and 21.6 million who worked in the public sector.
6. U.S. Department of Labor, Pension and Welfare

Benefits Administration, *Private Pension Plan Bulletin: Abstract of 1997 Form 5500 Annual Reports* no. 10, Winter 2001, page 2.

7. Results of the 2001 *Small Employer Retirement Survey* presented here are summarized from EBRI *Issue Brief* no. 234, June 2001. For more information, see www.ebri.org/sers.

8. Economic theory suggests that each dollar that an employer contributes to a retirement plan represents a dollar that otherwise would have been paid as wages or other benefits.

9. Not all firms that close have "failed." According to the SBA, about one-third of business owners consider their business to be successful at the time of closure. A successful firm might close, for example, if the owner accepts employment with another firm, decides to enter another line of business or closes a firm because of illness or retirement. Regardless of the reasons that small firms close, the prospect is a deterrent to offering a retirement plan.

10. 26 U.S.C. Section 410(a).

11. A highly compensated employee (HCE) is defined at 26 U.S.C. Section 414(q) as anyone who is at least a 5% owner of a company or an employee earning at least $85,000 (in 2001). The employer can choose to limit the designation of HCEs to those who earn $85,000 or more and are among the top 20% of salary earners in the firm (but cannot exclude 5% owners).

12. 26 U.S.C. §410(b). Alternatively, the plan may benefit a percentage of nonhighly compensated employees that is at least 70% of the percentage of HCEs covered by the plan.

13. The Secure Assets for Employees (SAFE) plan was introduced in the 106th Congress as HR 2190 by Rep. Nancy Johnson. The Secure Money Annuity or Retirement Trust (SMART) was included in HR 1213 (106th Congress), introduced by Rep. Richard Neal.

14. An employer can offer both a SEP and a SARSEP, in which case the maximum permissible combined annual contribution cannot exceed the lesser of 15% of pay or $25,500.

15. Amounts are based on a maximum of $170,000 in countable compensation. The ceiling will increase to $200,000 in 2002 as a result of P.L. 107-16. The 3% and 2% maximum employer contributions under a SIMPLE will therefore increase to $6,000 and $4,000, respectively.

16. Taxpayers ineligible to make tax-deductible contributions to a traditional IRA can make nondeductible contributions. Interest, dividends and capital gains on these contributions accrue on a tax-deferred basis until withdrawal.

17. In 2001, contributions to a traditional IRA are fully deductible for workers with adjusted gross income (AGI) up to $33,000 and are partially deductible for those with AGI up to $43,000. Contributions are fully deductible for couples filing jointly if their AGI is under $53,000. Contributions are partially deductible for couples with AGI up to $63,000.

18. A withdrawal before age 59½ is not subject to the 10% excise tax if it is applied toward the purchase of a first home (up to a maximum of $10,000); to pay for educational expenses; to pay medical expenses in excess of 7.5% of AGI; to pay health insurance premiums while unemployed; or is transferred as the result of divorce settlement.

19. The Small Business Administration does not regulate or administer employer-sponsored retirement plans; however, the SBA cooperates with the Department of Labor to provide information about retirement plans to small employers.

20. Moreover, employees of large firms are more likely to work for firms that sponsor *defined benefit* plans, in which enrollment of eligible employees is usually automatic. Employees of small firms are more likely to have access only to a defined contribution plan, which usually requires the employee to authorize the employer to begin making payroll deductions.

21. Social Security and Medicare Board of Trustees, *Status of the Social Security and Medicare Programs: A Summary of the 2001 Annual Reports,* Washington DC, March 2001.

22. U.S. General Accounting Office, *Retirement Savings: Opportunities to Improve DOL's SAVER Act Campaign,* GAO-01-634, June 2001.

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