COST AND IMPACT OF FEDERAL REGULATION ON SMALL VERSUS LARGE BUSINESS RETIREMENT PLANS

EXECUTIVE SUMMARY

June 1990

Submitted To:
Office of the Chief Counsel for Advocacy
Small Business Administration
Contract No. SBA-3058-OA-88

Submitted By:
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Introduction

Since the passage of the Employee Retirement Income Security Act (ERISA) in 1974, there have been eleven major legislative initiatives that substantially changed the regulatory requirements for retirement plans. The effects of these recent changes in regulatory requirements on plan formation, termination, administration and costs in small businesses have yet to be assessed.

The purpose of this study is to examine the administrative burden and costs of retirement plan regulation on plans sponsored by small versus large businesses. Key evaluation questions and issues that this study addresses include the following:

- How do plan administrative costs as a percentage of total pension contributions and per employee compare between small and large firms? What factors are most responsible for high administrative costs in small plans?

- What are the administrative costs of complying with various regulatory requirements for small businesses (compared to large businesses)?

- How have regulatory requirements affected the rate of formation of new retirement plans and rate of termination of existing plans in small businesses?

- What regulatory requirements and provisions have small businesses found to be most burdensome and most beneficial?

- What regulatory or policy alternatives could (1) ease regulatory burdens, (2) reduce complexity and costs of administering plans and (3) expand retirement plan coverage for small businesses?

To address these questions, data were collected on the actual costs of (1) plan formation, (2) on-going administration, and (3) compliance with regulatory change from
over 50 pension plan service providers. These data provide estimates of administrative costs as a percentage of total pension contributions and average cost per employee. At the same time, information was also collected about what service providers felt were the most burdensome and costly aspects of plan administration and pension plan regulations. Case studies of eleven small and two large businesses were also conducted, which were intended to provide the practical experience and detail necessary to conduct in-depth analyses of major aspects of administering plans. These interviews, which were typically with the owner-operator and/or benefits administrator of the firm, also provided detail on the ways in which plans have been (and will be) affected by changes in pension plan regulations. Finally, existing data sources were used to analyze recent trends in plan formation and terminations.

Recent Trends in Pension Plan Formation and Termination

Since 1982, there has been a substantial decrease in the number of plans formed, accompanied by a substantial increase in the number of plan terminations.\(^1\) Internal Revenue Service (IRS) data indicate that since the peak of 85,400 new plan establishments (letters filed) in 1982, overall pension plan formations have declined by 71.1 percent to an estimated 24,700 in 1989. This trend is even more pronounced for defined benefit plans whose formations dropped by 84.0 percent to 4,500 in 1989. In part, these trends reflect the increasing costs of establishing, administering, and revising plans.

\(^1\)An estimate of plan formations and terminations was made from IRS determination letter data. However, determination letter data may reflect an underestimate of the number of new plans formed and terminations because some plan sponsors will not request a determination letter. This may occur because they are confident of their plan's tax favored status or they are filing a standardized plan upon which the IRS has already favorably ruled.
Table ES-1: IRS Qualified Applications and Terminations of Employer-Sponsored Pension Plans (Plans in '000)

<table>
<thead>
<tr>
<th>Year</th>
<th>Defined Contribution</th>
<th>Defined Benefit</th>
<th>Total</th>
<th>Defined Contribution</th>
<th>Defined Benefit</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1976</td>
<td>18.9</td>
<td>2.6</td>
<td>21.5</td>
<td>0.3</td>
<td>0.1</td>
<td>0.4</td>
</tr>
<tr>
<td>1978</td>
<td>56.0</td>
<td>9.7</td>
<td>65.7</td>
<td>10.7</td>
<td>4.6</td>
<td>15.3</td>
</tr>
<tr>
<td>1980</td>
<td>50.5</td>
<td>18.8</td>
<td>69.3</td>
<td>9.0</td>
<td>4.3</td>
<td>13.3</td>
</tr>
<tr>
<td>1982</td>
<td>57.2</td>
<td>28.2</td>
<td>85.4</td>
<td>10.1</td>
<td>5.0</td>
<td>15.2</td>
</tr>
<tr>
<td>1984</td>
<td>28.3</td>
<td>12.8</td>
<td>41.1</td>
<td>11.0</td>
<td>9.2</td>
<td>20.2</td>
</tr>
<tr>
<td>1986</td>
<td>45.1</td>
<td>22.1</td>
<td>67.1</td>
<td>14.6</td>
<td>10.7</td>
<td>25.3</td>
</tr>
<tr>
<td>1988</td>
<td>41.2</td>
<td>13.6</td>
<td>54.8</td>
<td>13.8</td>
<td>14.1</td>
<td>28.0</td>
</tr>
<tr>
<td>1989 est.</td>
<td>20.2</td>
<td>4.5</td>
<td>24.7</td>
<td>12.4</td>
<td>14.5</td>
<td>26.9</td>
</tr>
</tbody>
</table>

SOURCE: Internal Revenue Service determination letter statistics: for 1976 through 1986, data obtained from various IRS News Releases; for 1988 and 1989, IRS data files were utilized.

Since the low point of 13,300 plan terminations (letters filed) in 1980, plan terminations have increased by more than 100 percent to 26,900 in 1989. Defined benefit plan terminations rose continuously and most dramatically, increasing from 4,300 in 1980 to 14,500 by 1989 or by 237 percent. In fact, by 1988 the number of defined benefit plan terminations exceeded the number of defined contribution plan terminations even though, at the time, there were only a third as many plans. In 1989, the estimated number of plan terminations exceeded the number of plan formations (by 9 percent) for the first time. It is notable that in 1989, there were 10,000 more terminations than establishments of defined benefit plans; said another way, terminations exceeded
formations by more than three times for such plans. These trends are displayed in Table ES-1.

Initiation and On-Going Administration of Pension Plans in Small Firms

The cost and burden of initiating a plan depends upon the type of plan selected (for example, defined benefit plans are generally more costly and difficult to establish) and whether the plan is a prototype plan or individually-designed plan. Regardless of whether the small employer chooses a prototype plan or an individually-designed plan, some level of expert assistance will almost certainly be required to select the most advantageous plan and properly complete all the steps needed to establish a plan.

In recent years, the cost, complexity and burden of initiating pension plans in small businesses has been reduced substantially with the introduction of a wide variety of prototype plans. For example, one major investment firm will prepare all of the documents necessary for establishing a plan and provide a guide to administration for $300. This has represented a major breakthrough for small businesses, many of whom were unwilling to absorb the costs (and the efforts) of developing an individually-designed plan. Prototype plans, which previously had been offered only through insurance companies, banks, investment companies, and other financial institutions, now may be offered by employee benefit consultants through the IRS's new regional prototype program. Many benefit plan consultants felt that the IRS's regional prototype program is the most positive development in the pension area in recent years.

Some small employers hire an actuary, attorney, or employee benefits consultant to individually design a plan for the firm. As might be expected, the costs of setting up this type of plan are considerably higher than those for prototype plans. The key
advantage is that the firm is able to structure the plan in a way that is most advantageous to the firm and its employees (particularly key employees, such as the owner-operator).

On-going administration of pension plans involves two major types of activities: (1) administrative activities related to the plan as a whole, and (2) administrative activities related to plan participants. Small plan sponsors approach the administration of plans in several different ways, depending upon the particular expertise within the firm, type of plan that is administered and the size of the pension fund. Some small firms (primarily those with relatively straightforward defined contribution plans) conduct nearly all administrative tasks in-house. Other firms choose to delegate responsibility for plan administration and asset management to other firms that specialize in plan administration (e.g., an accounting or investment firm). Finally, some firms contract with an outside firm to do some of the more difficult aspects of plan administration, but retain an active role in other aspects of administration and investment.

Effects of Regulation on Plan Formation, Termination and Administration

Changes in the regulations governing pension plans during the past decade -- particularly during the past five years -- have had a significant effect upon formation, termination and on-going administration of pension plans in small firms. In-depth interviews with pension plan service providers, as well as the case studies with small firms, revealed the extent to which pension plan regulation has affected the actions of small plan sponsors, including the following:

- Frequency and Complexity of Regulatory Changes Cited as the Most Important Problem. The frequency of changes in the law and the complexity of those changes were cited by nearly all of those that were
interviewed -- both small employers and pension plan service providers -- as the "number one" problem with pension regulation. Small employers could simply not stay up with or understand the many changes that have occurred. They viewed these changes as not only increasing the burden and costs of plan administration, but also creating great uncertainty about what the plans will cost in the future.

- **Rules Relating to Changes in Pension Regulation Are Not Issued in a Timely Fashion and Are Difficult to Understand.** The frequency and complexity of the changes are further exacerbated by the fact that the issuance of specific rules by the IRS and other regulatory agencies governing the changes in pension laws is often untimely. In fact, in some cases the specific rules are not even published prior to the date that the change is to go into effect.

- **Regulatory Changes Have Substantially Affected Formation and Termination of Defined Benefit Plans.** There is little doubt that changes in regulation over the past decade -- particularly the Tax Reform Act of 1986 (TRA) and Omnibus Budget Reconciliation Act of 1987 (OBRA'87) -- have had a serious impact on the formation, termination and on-going expense of administering defined benefit plans. Those interviewed for this study provided a number of explanations -- all related to changes in regulations -- for the precipitous decline in defined benefit plans in small firms:
  - the stringency of OBRA'87 full funding limitations;
  - recent increases in the Pension Benefit Guaranty Corporation (PBGC) premium;
  - overall complexity and expense of administering plans; and
  - the need to make almost continual and costly revisions to plan documents.

- **Changes in Statutory Requirements Have Significantly Reduced the Benefit of Pension Plans to Key Personnel.** In recent years, Congress has introduced a series of statutory requirements that have been intended to curb abuses in plans and to limit the ability of key individuals to shelter income within plans. The combined effect of these changes -- while increasing the fairness of plans to workers -- has reduced some of the motivation for owners of small firms to establish plans. In particular, the following have been identified as having an effect upon plan formation and termination in small plans:
  - limitations on plan contributions and benefits (Section 415 Limits),
• Social Security integration rules,
• Top-heavy rules, and
• lower (overall) tax rates.

• **Other Regulatory Concerns.** There were numerous other areas of regulatory concern cited by small firms and pension plan service providers, including:
  
  • discrimination testing for 401(k) plans,
  • Age Discrimination in Employment Act (ADEA) accruals, and
  • IRS user fees for plan formation and amendments.

**Costs of Pension Plans to Small Businesses**

In order to assess the relative **fixed** and **variable costs** of small and intermediate size employers, informal interviews of over 50 geographically-dispersed pension plan service providers throughout the U.S. were undertaken. Service providers were asked to assume that two different employers came to them wishing to establish a new pension plan. One employer was assumed to own a small business with 25 employees and the other an "intermediate" size business with 200 employees. The service providers were also asked to assume that each employer wishes to decide between establishing a relatively simple defined contribution plan (either a money purchase or profit sharing plan) or a relatively straightforward defined benefit plan. Service providers were then asked what the "full service" administrative costs would be for administering each of the plans exclusive of any revisions and compliance costs related to legislative or regulatory

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²The Small Business Administration defines a "small business" for research purposes as a firm with less than 500 employees. For purposes of this study, we have compared the costs of providing pension coverage for a "small" firm of 50 employees, with those of (what we have termed) an "intermediate" size firm of 200 employees.
changes. Finally, service providers were asked what the cost of revising each plan for each employer would be to bring it into compliance with the Tax Reform Act of 1986.

Table ES-2 provides a summary of the findings on the costs of plan formation, administration and plan revisions. As this table shows, the set-up costs for defined contribution plans increase from $2,018 on average per plan for a small plan to $4,278 on average for an intermediate size plan. In other words, average set-up costs for defined contribution plans only slightly more than double as the number of plan participants increases by 700 percent. This indicates a substantial per participant cost difference for small versus intermediate size employers. This is reflected in the fact that the per participant costs are $81 in the small plan versus $21 in the intermediate plan -- nearly a four-fold cost disadvantage per participant for small plans. It should be noted that these per participant cost disadvantages would be even more pronounced if we had examined businesses with plan participation significantly larger than 200.

When considering defined benefit plans, total set-up costs are 37 percent to 43 percent higher in comparison to similar sized defined contribution plans because of their complexity and the need for actuarial consultation. Set-up costs increase from $2,755 on average per plan for small defined benefit plans to $6,117 on average for an intermediate size defined benefit plan. This implies average costs of $110 per participant for small plans and $31 per participant for intermediate size plans -- a three and one-half fold per participant cost disadvantage.

Similar to set-up costs, per participant on-going annual administrative costs were considerably higher for small firms compared to intermediate size firms. As shown in Table ES-2, average annual administrative costs for defined contribution plans increase by 183 percent from $1,767 for small plans to $4,997 for intermediate plans; this is in
Table ES-2: Summary of Pension Plan Set-up and Administrative Costs for Small And Intermediate Size Plans

<table>
<thead>
<tr>
<th></th>
<th>Defined Contribution Plans</th>
<th></th>
<th>Defined Benefit Plans</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>25 Participants</td>
<td>200 Participants</td>
<td>25 Participants</td>
<td>200 Participants</td>
</tr>
<tr>
<td><strong>Set Up Costs</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average Cost Per Plan</td>
<td>$2,018</td>
<td>$4,278</td>
<td>$2,755</td>
<td>$6,117</td>
</tr>
<tr>
<td>Cost Per Participant</td>
<td>$81</td>
<td>$21</td>
<td>$110</td>
<td>$31</td>
</tr>
<tr>
<td><strong>Annual Administrative Cost</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average Cost Per Plan</td>
<td>$1,767</td>
<td>$4,997</td>
<td>$2,651</td>
<td>$7,747</td>
</tr>
<tr>
<td>Cost Per Participant</td>
<td>$71</td>
<td>$25</td>
<td>$106</td>
<td>$39</td>
</tr>
<tr>
<td><strong>Revisions and Compliance Cost</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average Cost Per Plan</td>
<td>$1,060</td>
<td>$1,755</td>
<td>$1,482</td>
<td>$2,626</td>
</tr>
<tr>
<td>Cost Per Participant</td>
<td>$42</td>
<td>$9</td>
<td>$59</td>
<td>$13</td>
</tr>
<tr>
<td><strong>SOURCE:</strong> Lewin/ICF interviews of pension plan service providers, December 1989.</td>
<td></td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>

contrast to a smaller 112 percent increase in costs for average plan set-up costs. The increase in administrative costs is greater in comparison to set-up costs because administrative charges are more closely linked to the number of plan participants. However, on a per participant basis, small plans are still faced with a significant per participant cost disadvantage of almost three times: the annual cost per participant is $71 for small plans and $25 for intermediate plans. In perspective, this $71 per participant charge for small plans represents about four percent of annual average total
employer and employee contributions for defined contribution pension plans in 1987.\(^3\)

Average annual administrative costs per plan are 192 percent higher for intermediate size defined benefit plans, at $7,747 versus $2,651 for small plans. This translates into per participant costs of $106 for small plans and $39 for intermediate plans. For small defined benefit plans, this annual administrative cost represents 12 percent of average annual total employer and employee contributions for defined benefit pension plans in 1987.\(^4\)

Small employers face significant additional per participant administrative costs in order to keep up and comply with the plethora of changing laws and regulations affecting private pension plans. For small employers, the additional administrative costs of complying with the Tax Reform Act of 1986 represent on average more than 50 percent of annual administrative charges and more than 50 percent of pension plan set-up costs for both defined contribution and defined benefit plans. For example, the additional costs of complying with TRA'86 for a small employer defined contribution plan were estimated to be $1060 (see Table ES-2), representing 53 percent of annual administrative charges and 60 percent of pension plan set-up costs. On a per participant basis, costs are about four and one-half times higher for the small employer ($42 per participant) versus the intermediate size employer ($9 per participant). The compliance costs for defined benefit plans, on a per participant basis, are also about four and one-half times higher.

\(^3\)According to Department of Labor analysis of Form 5500 data, annual average total employer and employee contributions for defined contribution pension plans in 1987 was $1,683 per participant.

\(^4\)According to Department of Labor analysis of Form 5500 data, annual average total employer and employee contributions for defined benefit pension plans in 1987 was $880 per participant or nearly half the level for defined contribution plans.
Implications and Conclusions

Small employers lag substantially behind large employers in offering pension benefits to their employees. If pension coverage in the United States is to expand, much of the growth must come through expanded coverage in small firms because most large firms already have plans. However, this study (and others before it) has pointed to a variety of barriers that small firms face in establishing and maintaining pension benefits for their employees.

The final chapter of this report focuses on two major questions: (1) Are there ways to reduce the burden and costs of administering pension plans in small firms? and (2) Would a reduction in administrative burden and cost lead to an increase in pension coverage in small businesses? A series of alternatives are presented. These alternatives are based upon our interviews with pension plan service providers, small businesses and other experts in the field of pension plan policy.

The alternatives are primarily intended to reduce the burden and/or costs of administering plans in small businesses. It is likely that some of these alternatives would also expand the level of coverage of pension benefits in small businesses. However, expansion of coverage does not come without costs. Many of the recent legislative and regulatory changes that Congress enacted were implemented to address perceived abuses and/or to reduce the federal budget deficit. Attempting to change these laws for the sake of increasing pension coverage must be done carefully, with political and economic tradeoffs fully considered.
1. Reduce the Need to Constantly Modify Plans

Many small businesses complain about the frequent shifts in regulations and the resulting need to make almost constant revisions to plans. For example, small plan sponsors often have a difficult time understanding the changes in regulations. In addition, modifying plans, particularly defined benefit plans, can be costly and time-consuming. There are several possible alternatives that would reduce the need to constantly modify plans:

- **Alternative #1: Slow the Pace of Regulatory Changes.** Several options emerged for slowing the change of regulations, including: (1) exempting existing plans from rule changes, (2) delaying the period of compliance to rule changes for existing plans, (3) establishing a "moratorium" of rule changes for a period of five years, and (4) allowing firms to revise plans to comply with new laws only once every five years.

- **Alternative #2: Mandate that the IRS and other Regulators Publish New Regulatory Requirements Prior to the Effective Date of New Laws.** The IRS should be required to issue final rules and regulations well before the effective date of the change in the law. The effective date of laws should be sufficiently deferred after the date of law passage so that IRS and other regulators have adequate time to write well-considered and easily understood regulations.

2. Reduce the Cost of Plan Establishment and Administration

Some of the reluctance of small businesses to form plans appears to be associated with the generally higher per participant costs of setting up and administering plans. Alternatives for reducing administration costs to small firms include:

- **Alternative #3: Provide a Tax Credit toward Plan Administration.** A tax credit or a "negative income tax" for small employers would reduce administrative costs, thereby encouraging plan formation. A tax credit, for example, might enable plans with fewer than 100 participants to credit (against taxes) up to some specified amount (e.g., $1,000) per year of administrative costs.

- **Alternative #4: Reduce IRS User Fee Schedule.** The IRS user fee could be based on the number of plan participants. Another alternative would
be for the fee to be waived for plans with fewer than 100 employees.

- **Alternative #5: Reduce PBGC Premiums for Fully Funded Plans.** The premium for fully funded plans could be reduced or eliminated (to reflect the risk that fully funded plans have of terminating with an unfunded liability). In addition, employers could have the option of buying fully insured deferred annuities for these former employees and no longer having to pay PBGC premiums.

- **Alternative #6: Reduce Filing Requirements.** The administrative costs of filing reporting forms could be reduced if plans were required to file only once every five years. This change would be particularly appropriate if plans were required to update their plan provisions to meet regulatory changes once every five years as discussed above.

3. **Simplify Pension Plan Regulations and Increase Benefit of Offering Pension Benefits for Small Firms**

A frequent complaint from small businesses and pension plan service providers is that the pension plan laws and regulations are excessively complicated. In addition, many of the recent changes in regulations are costly to comply with and have reduced some of the incentives for owners to offer retirement benefit plans. Several alternatives for reducing the complexity or increasing the incentives for offering pension benefits include the following:

- **Alternative #7: Modify the OBRA'87 Full Funding Limitation.** There are several ways in which it would be possible to reduce the adverse impact of the full funding limitation: (1) the limit could be based on the interest rates used by the PBGC for plan terminations; (2) the added margins and lower interest assumptions needed by small plans could be recognized by using a 200 percent limit for small plans; (3) funding after a plan comes out of full funding could be simplified by letting the same rules be followed as for the old full funding limit; and (4) funding flexibility could be preserved by maintaining the old credit balance plus interest or by increasing the old credit balance by waived contributions and interest at the plan's funding rate.

- **Alternative #8: Simplify or Eliminate Top-Heavy Requirements for Small Plans.** Three changes could be made to simplify top heavy rules reducing the burden on top-heavy plans, but not changing the spirit of the law: (1) delete the top-heavy vesting schedule now that TRA'86 has essentially required all plans to have a schedule that is almost as demanding; (2) clear
up the administrative burden placed on career average defined benefit plans by permitting the use of the career average definition of compensation for top-heavy accruals in career average plans; and (3) reduce the excessive impact of top-heavy rules on modest plans where the increase from the plan formula to top-heavy accruals is far greater than a plan that may already accrue at a rate of 2 percent of pay per year (the top-heavy minimum). Other changes could be made to lessen the severity of the top-heavy definition.

- **Alternative #9: Modify Section 415 Limits on Plan Contributions and Benefits.** To reduce the stringency of the Section 415 limits, consideration could be given to reverting back to prior law, under which the dollar limit reduction began for retirement prior to age 65. In addition, the compensation considered for benefit calculations could be increased from its current limit of $200,000.

- **Alternative #10: Modify Social Security Integration Rules.** One option would be to eliminate the 35-year limit on the three-quarter percent integrated portion of benefits in defined benefit plans, as specified in Section 401(i)(4) of the Internal Revenue Code. The regulations on the reduction of excess benefits for early retirement could also be simplified.

- **Alternative #11: Modify OBRA'86 Age Discrimination in Employment Act (ADEA) Accruals.** Employers could be permitted to either actuarially increase benefits or add five percent of compensation to the lump sum value of benefits. The benefit purchased by the five percent of pay could be added to the previously accrued benefit. The amount purchased by the five percent of pay could be calculated based on PBGC equivalence assumptions.

4. **Increase Knowledge of Small Businesses About Pension Plans and Expand the Availability of Simplified Plan Options**

Many small businesses are unaware of the many choices that are available at a relatively low cost. Hence, there is a need for added emphasis on disseminating information to small firms about the many choices that are available in establishing plans. Because of the constant formation of new small businesses, it is important that information about pension plan alternatives be regularly disseminated to the small business community. In addition, there is still much more that could be done to enhance and simplify the types of plans that are available to small firms. There are several
alternatives for increasing knowledge of small businesses and enhancing the pension plan offerings available to small firms:

- **Alternative #12: Conduct Joint Department of Labor/Small Business Administration (DOL/SBA) Outreach to Inform Small Employers About Pension Plan Alternatives.** DOL and SBA could expand their efforts in providing information to small businesses about various options. This information could be provided directly to small employers and/or through pension plan service providers. Recent publications by DOL (e.g., "What You Should Know About the Pension Law") and SBA (e.g., "Simplified Employee Pensions: What Small Businesses Need to Know") are examples of the type of outreach that is needed.

- **Alternative #13: Increase Flexibility and Encourage Use of Simplified Employee Pensions (SEPs).** The utility of SEPs to small businesses could be enhanced by: (1) removing some of the restrictions on such plans; (2) further streamlining reporting and disclosure requirements; or (3) requiring businesses that do not have pensions to establish SEPs at the request of the employee.

- **Alternative #14: Establish a Voluntary Federal Retirement Plan for Smaller Firms.** The federal government could create a voluntary national retirement plan for small businesses that do not elect to set up a plan on their own. Such a plan might operate much like Social Security currently does, with the employer making additional deductions from those employees that choose to join the plan.

Given the variety of factors that go into the decision of whether to offer pension benefits, it is not certain that any of the alternatives discussed above would substantially change the level of coverage in small businesses. However, given the slow growth in plan formations in recent years and the acceleration in the rate of plan terminations, it is unlikely that in the absence of some change in pension plan regulations that there will be a major increase in the level of pension plan coverage in small firms.