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PORTION – JONATHAN GRUBER

View PowerPoint Presentation

MR. GRUBER: Thank you, Peter.

I am going to be talking today about a proposal that I have developed together with Peter Orszag and Bill Gale. They really deserve most of the credit. This is really an outgrowth of the Retirement Security Project they have worked so closely with, and this is sort of using the lessons that that project has provided to make sensible policy.

What is the problem? Americans are leaving work earlier but living longer. Social security was not designed to be a full income replacement. It never was. It is under, as we know, enormous financing pressure. Employer-provided pensions are disappearing. And most importantly, probably, the enormous rise in health care costs for the elderly are going to continue and place Medicare in jeopardy.

What is the solution to these problems currently? Currently, the main solution we have for these retirement security problems is employer-provided 401(k) accounts and Individual Retirement Accounts or IRAs. But half of all households headed by adults aged 55 to 59 either have neither of these accounts or have very small amounts in them, less than $10,000.

Why is this? Well, it is for two reasons. The first is inertia, something economists feel uncomfortable talking about, which undoubtedly matters. Basically, establishing IRA and 401(k) accounts requires specific actions and presents a confusing array of investments and contribution options. Basically, the default is you don't save in your 401(k). By contrast, you take a traditional defined benefit pension, the kind that workers used to be covered under, you were enrolled by default.

Now, clearly, this shouldn't matter. It shouldn't matter whether we enroll some by default or they have to choose. They should do what is best for them. That is what you learn in Econ 101. It is not true. Basically, there is exciting new evidence from Brigitte Madrian and David Laibson and others, showing enormous effects of defaulting workers into 401(k) plans. Basically, if you take disadvantaged groups of workers in particular, fewer than 20 percent of them participate when they have to make the active decision to enroll. If instead you enroll them and allow them to opt out, which should be the same thing, 80 percent participate—an enormous effect from something that should have no effect, suggesting inertia really matters, and we need to think about using that in a policy context.

The second reason that there is low participation is what we call upside-down tax incentives. Basically, if you take any tax-deductible benefit like an IRA or a 401(k), the value of that benefit depends on your tax bracket. For the majority of households who have a 15 percent or lower tax rate, there is a very small incentive to save through these deferred savings plans. You get 10 or 15 cents back on the dollar. In contrast, for high income people, you can get 35 or more cents back on the dollar from saving through these retirement plans. This has the obvious problem of being regressive.

More interestingly, there is another problem as well, which is it minimizes the incentives for new savings. For low income groups, we know that these retirement plans, especially 401(k)s, generate new savings, savings they otherwise would not have done. But for higher income groups, what these plans are doing is largely subsidizing savings they would have done anyway. It is 35 cents back on a dollar you would have saved anyway. For many high income groups, they have savings rules. They save more money than they can spend, and they are going to be saving this money either way. We are just giving them 35 cents back. For low income groups, these are the people who would really save anew, and we are not targeting them. We are targeting the wrong group.

What is our solution? We are going to have a proposal in two steps. First, we want to make savings the default option. To borrow from President Clinton, we will call it Putting Savings First. Basically, let us not make consumption the default anymore in America; let us make savings the default. Second, let us reform savings incentives to target new savings in a progressive fashion.

Now Putting Savings First, what does that mean? We begin with what we call the automatic 401(k) plan. This is a plan where any firm that offers a 401(k), we would mandate has to offer four features: automatic enrollment, automatic escalation where contributions increase over time as workers' pay increases, automatic investment defaulting into a prudent and yet economically sensible set of default investments, and automatic rollover of savings to retirement plans when workers leave their jobs. Critically, at each step, these are not mandates but rather defaults. At any step of these four, an employee can say: No thanks, I am not interested in, say, your automatic investment or your automatic escalation.

But nonetheless, the evidence shows that simply by changing the default, we can have an enormous effect on how much is saved in these plans.

The second feature is the automatic IRA in which we would actually mandate that all employers that do not provide a 401(k) have to offer their employees a payroll deduction savings device that would once again follow the same kind of automatic default rules.

The key thing that this research tells us about savings incentives is if you take the money out of people's payroll before they have a chance to spend it, they will save it. It is really about putting savings first, about making that the default. That is the first part of our plan.

The second part of our plan is turning savings incentives right side up. Let us replace the current tax deduction for contributions into 401(k)s and IRAs with a much more effective incentive to save, a government matching contribution that will be the same for all households.

So here is how it would work. First of all, 401(k) contributions and IRA contributions would no longer be tax-deductible. There would be no more tax deductibility. Instead, any contribution to these accounts, once placed in, would be eligible for a government matching payment which would be 30 percent of all qualifying contributions up to either 10 percent of income or an income limit of $20,000 for 401(k) accounts and $5,000 for IRAs.

Two key points about this feature: First of all, we chose the 30 percent rate to be budget-neutral vis-à-vis the current system, a point raised earlier. This costs no additional money. We are simply redistributing the existing tax incentives, but this is much more progressive. Essentially, if you take people whose marginal tax rates are below 23 percent, this dramatically raises the savings incentives for them; it lowers the savings incentives for those with marginal rates above 23 percent. We think this would substantially raise savings because it is targeted to the groups that do the most new savings in response to these incentives. It is targeted away from the richest people, who are saving anyway and just reshuffling their assets into 401(k)s, towards poorer people who aren't saving, who will now have a strong incentive to save.

Moreover, continuing this principle of thinking about how to use the psychology of savings, unlike a tax deduction for an IRA contribution which comes to you in the form of a check in April that you may or may not save, this is a match that will be deposited directly in your account. So, when someone puts a dollar in, 30 more cents is deposited directly in. Once again, the default becomes to save it. You would have to actively go in and try to get it out as opposed to the default being that it would be saved.

One last point we discuss in our paper is: What about post-retirement? There is this strange anomaly in our current system which I don't think is appreciated enough, which is we want to sure everyone has enough money at 60, but if they want to party like crazy at 60, that is their business. They can spend it all by the time they are 61, and we don't care. This is really a problem because poverty in the elderly is concentrated among the oldest old. That is where the real problem of poverty remains. This is also where uncovered medical expenditures are the highest.

As a result, what we argue is that we need to help individuals protect against these risks by converting a part of plan balances into an annuity that guarantees periodic payments for life. Private annuities are typically unattractive for many families, which is why the private annuity market is so small. So we propose that the government matching contributions automatically be turned into an annuity when people retire, that will be government-provided or at a minimum government-intermediated. You could have an FEHBP-like institution, a preferred annuity provision instead of health insurance provision. This would provide a relatively small share—it would just be the match that annuitizes—but it would set the notion in place that individuals need to increase the resources they have for their oldest ages, not just what they have at age 60.

What is the bottom line? The bottom line is we propose two fundamental reforms.

First, let us put savings first. Let us make retirement savings the default at all work places through automatic 401(k)s and IRAs, where individuals default in, they are defaulted to invest prudently, they are defaulted to have their investments increased, and it is defaulted to roll over. The key thing is individuals can opt out at any stage. But this exciting new evidence suggests that this alone, what we call benign paternalism, can have an enormous effect on people's savings behavior.

Second of all, let us turn the savings incentive right side up by replacing the regressive and inefficient tax deductions with a government match that is progressive and promotes new savings by being targeted to the lowest income groups and by being deposited directly into savings accounts.

That is what our proposal is. Thank you very much.

(Applause)