Improving Opportunities and Incentives for Saving by Middle- and Low-Income Households

William Gale, Brookings Institution
Jonathan Gruber, MIT
Peter Orszag, Brookings Institution
The Problem

- Americans are leaving work earlier but living longer
- Social Security was not designed to be full income replacement and is under financing pressure
- Employer-provided pensions are disappearing
- Enormous rise in health care costs for the elderly that will continue and place Medicare in jeopardy
Current Solution

• Employer-provided 401(k) accounts, and Individual Retirement Accounts (IRA)
• But half of all households headed by adults ages 55 to 59 either have either no IRA/401(k) or small amount invested
• Why? Two reasons
Inertia

• Establishing IRA and 401(k) account requires specific actions and presents a confusing array of investment and contribution options.
• Not making a decision means not enrolling in an IRA or 401(k).
• By contrast, in traditional defined-benefit plans, workers were enrolled by default.
• Default shouldn’t matter for a decision of this magnitude, but it clearly does.
Evidence on Importance of Inertia

• Exciting new evidence shows enormous effects of defaulting workers into 401(k)
• Defaulting workers into 401(k) raises participation enormously
• For disadvantaged groups, increase in participation from less than 20% to more than 80%
Upside-Down Incentives

• Value of tax-deductible IRAs or 401(k) plans depends on the household’s tax bracket.
• For a majority of households (those with a 15 percent or lower marginal tax rate), the immediate saving incentive provided by this exclusion is weak.
• In contrast, the immediate saving provided by this exclusion is largest for high-income families.
• This has the obvious problem of being regressive.
• But it has another problem as well.
Incentives Minimize New Savings

- Savings incentives have very different effects along the income distribution
- For low-income groups, generate new savings
- For higher-income groups, simply subsidize existing savings
- So tax deductibility targets largest incentives on the groups which are least likely to be doing new savings
Our Solution

• Our proposed initiative addresses these issues in two steps

• First, we *make savings the default option*, so that savings takes a higher priority in the budgets of U.S. consumers
  – “Putting Savings First”

• Second, reform savings incentives to target new savings in a progressive fashion that encourages new savings
Putting Savings First: Automatic 401(k) Plans

• Begin with **Automatic 401(k) plan**
  • *Automatic enrollment*: Default participation in company’s 401(k) plan at the commencement of employment
  • *Automatic escalation*: contributions would by default increase in a prescribed manner over time.
  • *Automatic Investment* in prudently diversified, low-cost investment vehicles
  • *Automatic roll over* to retirement plans when employees change jobs
  • At each step, employees could override the defaults and opt out of the automatic provisions.
Putting Savings First: Automatic IRA

- Employers without 401(k) would be required to set up automatic payroll-deduction IRAs for their workers.
- IRA funds would be placed in a limited number of diversified investments.
- The share of a worker’s paycheck flowing into the account would automatically escalate over time.
- Once again, employees would be eligible to opt out of these plans
Turning Savings Incentives Right Side Up

• Replace the current tax deduction for contributions to retirement accounts with a more effective incentive to save – a government matching contribution that would be the same for all households

• Workers’ 401(k) and IRA contributions would no longer be tax-deductible, and employers’ 401(k) contributions would be treated as taxable income.

• All qualified employer and employee contributions would be eligible for government matching contribution: 30 percent of all qualifying contributions up to either
  – 10 percent of Adjusted Gross Income OR
  – $20,000 for 401(k) accounts and $5,000 for IRAs
Turning Savings Incentives Right Side Up

• Our proposal is budget neutral vis-à-vis the current system
• But it would be much more progressive: raise return to savings if marginal rate below 23%, fall for those with higher marginal rates
• Ties savings incentives to % of income
• And would substantially raise savings
  – Biggest incentives for new savings
  – Match deposited directly into account, so automatically saved – appeals to defaults
What About Post-Retirement?

• Strange anomaly in current system: we want to ensure enough savings at 60, but not when it is really needed
  – Poverty in elderly is concentrated in oldest old
  – This is when uncovered medical expenditure risk is highest

• Can protect against these risks by converting plan balances into annuity that guarantees periodic payments for life.

• Private annuities, however, are generally unattractive to most middle- and low-income families - unprotected by inflation and suffer from “adverse selection”
Annuities Market Reform

- We propose that the government matching contributions automatically be turned into an annuity when people retire.
- Annuities could be government-provided or government-intermediated.
- Annuities would represent a relatively small share of final plan balances, but underscores the usefulness of annuities as a sensible way to manage retirement income.
- Once again, individuals could opt out of the default annuitization if they wished.
Bottom Line

• Two Fundamental Reforms:

• **Putting Savings First**: Make retirement savings the default at all workplaces through Automatic 401(k) and IRA

• **Turning Savings Incentives Right Side Up**: Replace regressive and inefficient tax deductions with government match that is progressive and promotes new savings