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

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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 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