

## **“Progressivity and Government Incentives to Save”**

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### **Introduction**

As the baby boomer generation nears retirement, policy-makers seem to be increasingly focusing on the nation’s system of tax-preferred retirement savings. The bulk of the policy changes that have been enacted in recent years, however, move the pension system in the wrong direction: They provide disproportionate tax benefits to high-income households who would save adequately for retirement even in the absence of additional tax breaks, while doing little to encourage lower- and moderate-income households to save more. This fundamentally flawed approach should be replaced with a progressive set of pension reforms, which would be more likely to raise national saving and to reduce elderly poverty.

The paper proceeds as follows. First we summarize the shortcomings in the current pension system.<sup>3</sup> Then we discuss the benefits of progressivity in pension reform, explain why recent pension legislation has moved the system in the wrong direction, and examine a progressive set of policy changes to raise pension coverage and accumulation rates for lower- and moderate-income workers. A brief concluding section summarizes our findings.

### **I. Overview of shortcomings in current pension system**

Data from the Current Population Survey suggest that the percentage of full-time private-sector wage and salary workers covered by a pension has fluctuated only narrowly over the past three decades, between 48 and 51 percent (see Table 1). Over this period, coverage has

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<sup>3</sup> We focus here only on pensions and Individual Retirement Accounts; we do not examine Social Security. Diamond and Orszag (2004) propose a balanced reform to restore long-term solvency to Social Security in a progressive manner.

shifted from defined benefit to defined contribution plans, but the overall coverage rate has changed little.<sup>4</sup>

Table 1: Retirement plan coverage rates for full-time, private-sector workers

Year	All	Male	Female
1972	48%	54%	38%
1979	50%	55%	40%
1983	48%	52%	42%
1988	48%	51%	44%
1993	50%	51%	48%
1995	48%	49%	48%
1997	50%	51%	48%
1999	51%	52%	49%

Sources: U.S. Department of Labor, *Report on the American Workforce 1997*, Table 3-1, for 1972-1993, and U.S. Department of Labor, Pension and Welfare Benefits Administration, "Coverage Status of Workers under Employer Provided Plans," 2000, available at <http://www.dol.gov/dol/pwba/public/programs/opr/CWS-Survey/hilites.html>, for 1995-1999.

The figures displayed in Table 1 obscure substantial differences in pension coverage and participation rates by income. Table 2 shows data from the Internal Revenue Service compiled by the Congressional Budget Office (CBO). Only about one-fifth of workers in households with income of below \$20,000 participated in some form of tax-preferred savings plan (including an employer-provided plan or an Individual Retirement Account) in 1997. As a result, such lower-income workers represented 34 percent of all workers, but just 15 percent of workers who participated in tax-preferred savings plans — and 55 percent of total *non*-participants in such saving plans. The number of workers in households with less than \$20,000 in income was more than 2.5 times as large as the number of workers in households with over \$80,000 in income, but the absolute number of tax-preferred savings participants was significant *lower* in the lower-income category (10.0 million) than in the higher-income category (13.8 million).

Table 2: Participation rates by income, 1997

Adjusted gross income	Number of workers (in thousands)	Share of workers	Percent participating in employer plan or IRA	Share of total participants	Share of total non-participants
Under \$20,000	45,790	34%	22%	15%	55%
\$20,000 to \$40,000	32,867	25%	56%	27%	22%
\$40,000 to \$80,000	37,145	28%	70%	38%	17%
\$80,000 to \$120,000	10,812	8%	79%	13%	3%
\$120,000 to \$160,000	3,097	2%	78%	4%	1%
\$160,000 and Over	3,686	3%	76%	4%	1%
All Income Groups	133,397	100%	51%	100%	100%

Source: Authors' calculations based on Congressional Budget Office, "Utilization of Tax Incentives for Retirement Saving," August 2003, Table 2.

<sup>4</sup> See Gale, Papke, and VanDerhei (1999) for a discussion of the causes of the shift from defined benefit to defined contribution plans.

In addition to participation rates, contribution rates (contributions as a percentage of income) in defined contribution plans also vary significantly across workers, resulting in another source of inequality. Low-income workers typically contribute a smaller percentage of their pay to 401(k)-type pension plans than higher-income workers. Among workers aged 18 to 64 with a 401(k) plan in 1992, for example, the average employee contribution rate (excluding employer matches) was 3.7 percent of pay for those with household income less than \$25,000 and 7.9 percent of pay for those with household income exceeding \$75,000.<sup>5</sup>

The inequality in pension contributions manifests itself in various indicators. For example, since higher-income workers enjoy more access to pension coverage than lower-income workers do, since covered higher-income workers also make larger contributions to pensions than lower-income covered workers, and since higher-income workers pay taxes at higher marginal tax rates, the tax subsidies provided to pensions and IRAs are heavily skewed toward higher earners. Unpublished Treasury Department data on the distribution of tax benefits from current pension and IRA provisions suggest that two-thirds of the tax benefits of current tax preferences for pensions accrue to those whose family incomes place them in the top fifth of the income scale.<sup>6</sup>

The inequality in pension contributions is also reflected in inequality in pension wealth (the accumulated value in a pension). Table 3 shows the value of defined contribution and IRA assets by income for households headed by someone aged 55 to 59 (and thus on the verge of retirement years) from the 2001 Survey of Consumer Finances. The table demonstrates two crucial points: First, most households have relatively low levels of defined contribution/IRA assets; the median value of such assets even for households nearing retirement age was only \$10,400. Second, lower-income households have particularly low levels of such assets. The bottom 40 percent of the income distribution accounts for only 5 percent of total defined contribution/IRA assets among households aged 55-59. The top 10 percent of the income distribution accounts for more than 50 percent of total defined contribution/IRA assets.

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<sup>5</sup> General Accounting Office (1996), Table II.4

<sup>6</sup> Department of the Treasury, Office of Tax Analysis, March 30, 1999

Table 3: Ownership of defined contribution or IRA assets, for households aged 55-59, 2001

Percentiles of income	Number of households	Percent of households with DC/IRA retirement assets	Median DC/IRA assets	Median DC/IRA assets among those with an account	Share of aggregate DC/IRA assets
Less than 20	1,664,508	25.0%	\$0	\$8,000	1.1%
20-39.9	1,559,689	49.6%	\$0	\$12,000	4.2%
40-59.9	1,660,767	61.6%	\$7,200	\$28,000	8.6%
60-79.9	1,506,983	91.0%	\$50,000	\$54,000	16.7%
80-89.9	825,049	95.4%	\$148,000	\$190,000	18.8%
90-100	769,096	92.1%	\$215,000	\$299,000	50.6%
Total	7,986,092	63.6%	\$10,400	\$50,000	100%

Source: Authors' calculations using the 2001 Survey of Consumer Finances.

## II. Benefits of Progressivity in Pension Policy

Given the gaps in the current system, our thesis is that sound pension reform entails encouraging more participation by middle- and lower-income workers who currently are saving little, if anything, for retirement. This emphasis on workers with low pension coverage is warranted for several reasons, including national saving and the avoidance of poverty in old age.

One of the nation's economic imperatives is to raise the national saving rate to prepare for the retirement of the baby boom generation. Tax incentives intended to boost pension saving will raise national saving if they increase private saving by more than the cost to the government of providing the incentive. (National saving is the sum of public saving and private saving. All else being equal, every dollar of lost tax revenue reduces public saving by one dollar. Consequently, for national saving to increase, private saving must increase by more than one dollar in response to each dollar in lost revenue.<sup>7</sup>) To raise private saving, the incentives must not simply cause individuals to shift assets into the tax-preferred pensions but must generate *additional* contributions.

Since those with modest or low incomes are less likely to have other assets to shift into tax-preferred pensions, focusing pension tax preferences on moderate- and lower-income workers increases the likelihood that lost tax revenue will reflect additional contributions rather than shifts in assets.<sup>8</sup> Indeed, Engen and Gale (2000) suggest that tax-preferred retirement

<sup>7</sup> If the revenue loss is fully offset through other fiscal measures, then the net impact on national saving is simply the change in private saving. In this case, public saving would be unchanged.

<sup>8</sup> Economists continue to debate the impact on private saving from existing pension incentives. Most economists agree, however, that whatever the overall effect, focusing incentives on those with fewer opportunities to shift assets from taxable to non-taxable forms is likely to produce a larger increase in private saving for any given reduction in government revenue. For a discussion of the impact of existing tax preferences, see Engen, Gale, and Scholz (1996), and Poterba, Venti, and Wise (1995).

saving undertaken by lower-income workers is much more likely to represent new saving (rather than asset shifting) than tax-preferred retirement saving undertaken by higher-income workers

A second motivation for progressive reforms is that one of the reasons that we as a society are willing to provide such large tax preferences to pension contributions is the belief that they are an important leg of the three-legged stool of providing retirement security and reducing elderly poverty. The three legs of that stool include Social Security, tax-preferred pensions, and personal saving. Yet higher-income workers are less likely to be in danger of living in poverty in older age. This is another reason it makes sense to focus attention on lower-income workers in fashioning new tax-favored pension initiatives.

In summary, higher-income households are generally saving adequately for retirement and are most likely to have pensions, but their pension contributions represent less new saving and more asset shifting (and, hence, tax avoidance) than do the pension accumulations of lower earners. Conversely, lower-income households are less likely to be saving adequately for retirement and are less likely to have pensions than are higher earners, but their pension contributions are more likely to represent net additions to saving.

These findings indicate problems with the current pension system as well as opportunities for reform. The problem is that pension benefits accrue disproportionately to high-income households with little improvement in the adequacy of saving for retirement and little increase in national saving. By contrast, lower- and middle-income households gain less from the pension system, but these benefits — where they exist — appear both to increase saving and to help households who would otherwise save inadequately for retirement. The goal of reform should be to encourage expanded pension coverage and participation among low- and middle-income households, a step that would boost national saving and build wealth for households, many of whom are currently saving too little.

### **III. Recent legislation**

Recent legislative changes have exacerbated rather than attenuated the regressivity of the pension system and thus move the pension system in the wrong direction. We examine the pension component of the 2001 tax legislation, a new set of proposals from leading pension policy-makers, and the Bush Administration's Retirement Saving Account and Lifetime Savings Account proposal.

#### 2001 tax legislation

The Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 included a series of important changes to the pension and IRA laws. Unfortunately, most of the changes did not represent sound pension reform. For example, the retirement saving provisions in EGTRRA are disproportionately aimed at higher earners; they are therefore unlikely to raise national saving and will exacerbate the inequities in the distribution of tax subsidies for retirement saving. Analysis by the Institute for Taxation and Economic Policy found that roughly 75 percent of the pension and IRA tax reductions would accrue to the 20 percent of Americans with the highest incomes.

To be sure, the legislation includes several helpful reforms in the pension laws. For example, it simplified the rules on rolling over account balances from one type of retirement account to another, which may increase pension portability for some workers. The legislation also included a progressive matched savings tax credit, which is described further below.

The major pension and IRA provisions, however, involve various changes that allow larger contributions by high-income workers and do little to simplify the system. The theory behind this approach is that liberalizing the rules for higher-income executives will lead more businesses to adopt pension plans and thereby help their middle- and lower-income employees. The theory, however, lacks any significant empirical support.

Among the most expensive retirement saving provisions in EGTRRA were:

- **Increased Dollar Limits for Employee Contributions to 401(k) Plans.** In 2001, workers were allowed to deposit a maximum of \$10,500 in a 401(k) account. EGTRRA raised the maximum to \$15,000 by 2006 (and by an additional \$5,000 for those age 50 or over).
- **Increased Maximum Employer-Employee Contributions.** The aforementioned limit on deposits to a 401(k) account applies to *employee* contributions. There also is a limit on combined employee-employer contributions. Previous tax law required that combined employee-employer contributions to 401(k)s and other defined contribution pension plans not exceed \$30,000, or 25 percent of pay, whichever is lower. EGTRRA raised the maximum combined employer-employee contribution to \$40,000, and also eliminated the requirement that such contributions not exceed 25 percent of pay.
- **Expansions of Individual Retirement Accounts.** EGTRRA more than doubles the amount that a taxpayer and spouse can contribute each year to an IRA. Under prior law, a taxpayer and spouse could each contribute \$2,000; EGTRRA raises the maximum contribution to \$5,000 by 2008.
- **Increased Maximum Considered Compensation.** Prior to EGTRRA, tax-favored pension benefits were based on compensation up to a maximum compensation level of \$170,000. For example, if a firm contributed five percent of wages to a defined contribution pension plan, the maximum contribution was \$8,500 (five percent of \$170,000). EGTRRA raised the maximum compensation level from \$170,000 to \$200,000.
- **Increase in Benefit Payable under a Defined Benefit Pension Plan.** Under prior law, the maximum allowable annual payment from a defined benefit pension plan was \$135,000. EGTRRA increased the \$135,000 limit to \$160,000. In addition, EGTRRA raised the amounts that can be paid from a defined benefit pension plan for early retirees by an even larger proportion, which allows plans to incorporate even larger early retirement subsidies than were allowable under prior law.

A common theme in many of these provisions is that they increase the maximum amount that can be saved on a tax-preferred basis. Such increases are unlikely to have much effect on the vast majority of families and individuals who had not previously been making the maximum

allowable contribution. For example, an unpublished study by a Treasury economist found that only four percent of all taxpayers who were eligible for conventional IRAs in 1995 made the maximum allowable \$2,000 contribution.<sup>9</sup> The paper concluded: “Taxpayers who do not contribute at the \$2,000 maximum would be unlikely to increase their IRA contributions if the contribution limits were increased whether directly or indirectly through a backloaded [Roth] IRA.”<sup>10</sup> Similarly, the General Accounting Office has found that the increase in the statutory contribution limit for 401(k)s would directly benefit *fewer than three percent* of participants.<sup>11</sup> Other recent studies have reached similar conclusions, finding that the fraction of individuals constrained by the limits that were in place prior to enactment of the 2001 tax-cut legislation was very small.<sup>12</sup>

Table 4 presents information from the Congressional Budget Office on workers constrained by the previous 401(k) limits in 1997. Only 6 percent of all 401(k) participants made the maximum contribution. Only 1 percent of participants in households with incomes below \$40,000 made the maximum contribution. Among participants in households with more than \$160,000 in income, by contrast, 40 percent made the maximum contribution.

Table 4: 401(k) participants making the maximum contribution in 1997

Household income (AGI)	Number of total contributors (thous.)	% of total contributors	% in income class contributing maximum	Number at maximum (thous.)*	% of total contributing maximum
Under \$20,000	2,695	7.6%	1%	27	1.2%
\$20,000 to \$40,000	8,914	25.0%	1%	89	3.9%
\$40,000 to \$80,000	15,020	42.1%	4%	601	26.1%
\$80,000 to \$120,000	5,739	16.1%	10%	574	24.9%
\$120,000 to \$160,000	1,624	4.6%	21%	341	14.8%
\$160,000 and Over	1,673	4.7%	40%	669	29.1%
	35,666	100.0%	6%	2,301	100.0%

Source: Authors’ calculations based on Congressional Budget Office, “Utilization of Tax Incentives for Retirement Saving,” August 2003, Table 2.

\* Number may be imprecise because of rounding in official estimates.

<sup>9</sup> Carroll (2000). See also Copeland (2002) for similar figures.

<sup>10</sup> Carroll (2000), page 7. It is only the very small minority of eligible taxpayers contributing the maximum \$2,000 to an IRA who are likely to benefit from raising the maximum contribution amount on Roth IRAs above \$2,000. A large share of such taxpayers are likely to be higher earners who are not covered by an employer-provided pension and therefore are eligible to make contributions to conventional IRAs regardless of their income. (The income limits on eligibility do not apply to those who are not covered by an employer-provided pension.) In addition, an increase in the IRA contribution limits to \$5,000 is likely to work to the detriment of some low- and middle-income workers by inducing some small businesses not to offer an employer-sponsored pension plan.

<sup>11</sup> General Accounting Office (2001). The GAO also found that 85 percent of those who would benefit from an increase in the 401(k) contribution limit earn more than \$75,000. (These figures reflect the effects of other changes included in EGTRRA that have already taken effect, such as the elimination of the previous percentage cap on the amount of combined employer-employee contributions that can be made to defined contribution plans.)

<sup>12</sup> See, for example, Richardson and Joulfaian (2001).

Participants in that high-income category represented fewer than 5 percent of total participants but almost 30 percent of participants making the maximum contribution. Participants with household income of more than \$120,000 represented 44 percent of those making the maximum contribution. Table 4 underscores the point that increasing the maximum contribution limit is beneficial primarily to higher-income households; for the vast majority of lower- and moderate-income families, such an increase is of no direct benefit.

Most of the pension-related provisions in EGTRRA were drawn from earlier pension legislation sponsored by Representatives Rob Portman and Ben Cardin. In analyzing the effects of that legislation, Stein (1999) concluded, “Although there are good things in the Portman-Cardin bill, some of its major provisions would not contribute enough to good retirement policy to justify their substantial price tags, and other of its provisions would harm more people than they would help. It would be ironic and deeply unfortunate if this well-intentioned but flawed legislation is enacted, for it may well be remembered as the Retirement Insecurity and Pension Reduction Act of 1999. I fear that this possibility, an illustration of the law of unintended consequence, is all too real.”

### Portman-Cardin III

Congress is currently considering new Portman-Cardin legislation, informally referred to as “Portman-Cardin III.” The House Ways and Means Committee approved this legislation in late July.

According to the Joint Committee on Taxation, the new Portman-Cardin legislation would cost \$48 billion over ten years. This cost is artificially low, however, because some provisions in the bill sunset artificially before the end of the ten-year budget window. In 2010 alone, the legislation would cost \$8.6 billion. This indicates that the cost of the legislation would likely exceed \$100 billion in the second decade it was in effect.

Some of the most costly provisions in the Ways and Means Committee legislation would set a particularly dangerous precedent, because they effectively reduce taxes owed on *withdrawals* from current 401(k) and Individual Retirement Account (IRA) balances. Contributions to 401(k)s and traditional IRAs are tax-deductible, and accumulations within the accounts occur on a tax-free basis.<sup>13</sup> The funds are then taxed when they are withdrawn. Trillions of dollars in revenue are expected to be collected on the withdrawals from these accounts in future decades.<sup>14</sup> The fact that this expected future revenue is so substantial means that proposals to reduce the taxation of withdrawals from retirement accounts could significantly worsen a long-term fiscal outlook that is already quite bleak.

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<sup>13</sup> The tax treatment of Roth IRAs and Roth 401(k)s is reversed: Contributions are included in taxable income, but withdrawals are tax-free.

<sup>14</sup> Despite recent media reports to the contrary, most of this revenue is assumed in long-term budget projections. Policy-makers and others looking for a previously hidden pot of gold are likely to be disappointed. For further details, see Auerbach, Gale, and Orszag (2003).



The single most expensive provision in the bill — costing \$24 billion over the next 10 years and more than \$4 billion in 2013 alone — represents an unwise step in the direction of reducing taxes on withdrawals. It would relax the “minimum distribution” rules that are intended to ensure that tax-advantaged retirement accounts are used primarily to finance retirement needs, rather than for other purposes such as estate planning by wealthy individuals.

To ensure that retirement plan assets are used primarily to finance retirement needs, current law requires that workers generally begin to draw down their accumulated pensions by age 70½, or when they retire, whichever is later.<sup>15</sup> This rule ensures that pension accumulations are used at least in part during retirement. In the absence of such a rule, high-income individuals could use the tax benefits associated with pensions and IRAs as tax shelters, making contributions to tax-preferred pension and IRA accounts that they never intend to use for retirement needs. (Without some form of minimum distribution rule, high-income individuals could use tax-preferred pension and IRA accounts to accumulate substantial estates rather than to provide income during retirement, and the tax preferences associated with pensions and IRAs would not serve their basic purpose of bolstering retirement security. As Professor Jay Soled of Rutgers University and Bruce Wolk of the University of California at Davis have written, “There seems little justification for a system that, on one hand, allows the highly compensated to amass significant tax-favored wealth on the theory that it was needed for retirement, but, on the other hand, permits them to perpetuate their own financial dynasties as this wealth moves across multiple generations, retaining its tax-favored status.”<sup>16</sup>)

Weakening the minimum distribution rules in a way that enables affluent individuals to use tax-favored retirement accounts to a greater degree as estate planning devices is thus unsound. And in light of the nation’s grim fiscal outlook, such a tax subsidy to wealthy households would be particularly unwarranted.

To be sure, the current minimum distribution rules are complicated, but that is not justification for the type of change in the rules that the Ways and Means legislation would make. Furthermore, efforts to simplify these rules already are underway, including important simplifications contained in recent IRS regulations.<sup>17</sup> If further steps are required, a different approach — exempting a moderate level of assets from the minimum distribution rules — would be far preferable to the Ways and Means bill provision. Such a step would limit the application of the minimum distribution rules to relatively affluent retirees.

For example, the minimum distribution rules could be modified so each person could exempt up to \$50,000 of pension and retirement account assets from the minimum distribution requirements. Data from the 2001 Survey of Consumer Finances suggest that more than 70 percent of households aged 55-64 possess defined contribution and IRA assets of less than \$50,000. If the minimum distribution rules did not apply to assets of less than \$50,000, these

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<sup>15</sup> The rules for distributions from traditional IRAs are slightly different. Distributions from IRAs are required to begin by age 70½ regardless of whether the owner is retired. No minimum distribution rules apply to Roth IRAs until the death of the owner.

<sup>16</sup> Soled and Wolk (2000), page 616.

<sup>17</sup> See Internal Revenue Bulletin (2001-11, page 865), March 12, 2001.

rules would cease to affect approximately two-thirds or more of retirees. The impact of the rules also would be greatly reduced on retirees who have pension and retirement assets of modestly more than \$50,000. This approach could eliminate the need for most retirees to be concerned about the minimum distribution rules and would do so without creating powerful incentives for the very well-off to use retirement tax preferences primarily as estate-building mechanisms.

This is not the approach the Ways and Means legislation takes; that legislation delays from 70½ to 75 the age at which mandatory distributions must begin if a worker already is retired. Such a change is quite problematic, for a number of reasons.<sup>18</sup>

- Such a delay in the age at which distributions from pension plans must begin to be made would provide a significant tax benefit to those high-income individuals who have sufficient assets or income to enable them to delay withdrawals from pensions and IRAs past age 70½.<sup>19</sup> The vast majority of American workers retire before age 70½ and need to begin withdrawing funds from their pensions before then.<sup>20</sup> For the vast majority of workers, the minimum distribution rules are not generally relevant, either because these workers lack retirement assets or because they will already have begun to take regular distributions from their pensions well before the age by which the distributions must start.
- Raising the required age thus would affect primarily high-income retiree households that have such ample income and assets that they can delay withdrawals from their tax-preferred pension accounts despite the fact they are no longer working. This would significantly expand the potential for these households to use their tax-preferred retirement accounts as estate planning devices.
- Raising the required age for minimum distributions also could *discourage work* among high-income elderly individuals. Currently, for example, an affluent individual between age 70½ and 75 needs to continue working if he or she is intent on *not* withdrawing any funds from a 401(k), since the rules requiring distributions to start at age 70½ do not apply if the individual remains employed. The Ways and Means bill would enable such individuals to retire without having to make any withdrawals from their 401(k)s until age 75.

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<sup>18</sup> The legislation would raise the age for mandatory withdrawals from 70 ½ to 72 for 2004 through 2007, and to 75 thereafter. It would also loosen the rules applying to non-spouse beneficiaries and ease other aspects of the minimum distribution rules. In part because of the phase-in in the age for mandatory withdrawals, the long-term cost of the provision is much larger than the Joint Tax Committee's 10-year total cost figure might suggest. The cost in 2013 alone is \$4.1 billion.

<sup>19</sup> In addition to allowing deferral of tax while the account owner is alive, the change may substantially defer income tax after the owner has died. In particular, if distributions from the account have not begun before the death of the owner, the designated beneficiary on the account is generally allowed to spread the withdrawals for income tax purposes over his or her entire lifetime. A delay in the mandatory beginning age will expand the pool of assets that have not begun to be distributed before the death of the owner, thereby substantially deferring the income tax owed and reducing the effective tax rate on the accounts.

<sup>20</sup> The typical retirement age — that is, the age at which half of men are no longer in the labor force — is approximately 63. See Burtless and Quinn (2000).

- Finally, and perhaps most important, loosening the minimum distribution rules would represent a dangerous step toward effectively reducing taxes on withdrawals from 401(k)s and IRAs. Relaxing the minimum distribution rules would allow account holders to enjoy more years of tax-advantaged accumulation within the accounts, which reduces the effective tax rate on the accounts.<sup>21</sup> As emphasized above, large deficits are projected in the future (even after the trillions of dollars in revenue expected to come from 401(k) and IRA withdrawals are taken into account). Reducing taxes on those withdrawals would exacerbate an already bleak fiscal outlook.

The Ways and Means legislation also would accelerate EGTRRA's scheduled increases in the amounts that can be contributed to 401(k)s and IRAs. These proposals would accelerate tax subsidies to upper-income households who least need additional help in preparing for retirement, while providing little or no benefit to the majority of families struggling to save for retirement.

#### Bush Administration's Lifetime Saving Account and Retirement Saving Account and Proposal

In its Fiscal Year 2004 budget, the Bush Administration proposed to create a new set of tax-preferred accounts that would expand opportunities for tax-advantaged saving. There are increasing signs that the Administration will re-introduce some version of this proposal in late 2003 or early 2004.

The proposal contained in the FY 2004 budget would dramatically alter the tax treatment of saving, via the creation of Lifetime Saving Accounts (LSAs), individual Retirement Saving Accounts (RSAs) and Employer Retirement Saving Accounts (ERSAs).<sup>22</sup> Some elements of the proposal — in particular, some of the simplifications — could form the basis of a useful pension reform package. Other elements are troubling because they would be regressive, could reduce saving among the most vulnerable populations, and would exacerbate the already bleak long-term budget outlook.

The proposal follows the basic thrust of policy changes delineated above in substantially expanding opportunities for tax-sheltered saving by high-income households. LSAs would allow significant amounts of tax-free saving (\$7,500 per account per year) for any purpose, with no

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<sup>21</sup> All other things being equal, the additional years of deferral of taxes that would be permitted under the relaxed minimum distribution rules do not reduce the present value of the revenue on the withdrawals, since the additional deferral of taxes should just offset the higher level of taxes on the accumulated balances upon withdrawal. Allowing longer deferral of taxes, however, reduces the present value of the revenue that would be collected on the assets if they had been withdrawn from the tax-advantaged account earlier and deposited in a taxable account. In other words, allowing longer deferral of taxes on a tax-preferred account provides a benefit to the account owner and a cost to the government, assuming the alternative to the tax-preferred account is saving in a taxable account. In addition, if the assets are not exhausted before the death of the owner, they are taxed at the marginal rate of the beneficiary, which may be lower than the marginal rate of the owner. To the extent that an older mandatory beginning age raises the likelihood that the assets will not be exhausted before the death of the owner, and to the extent that the marginal tax rate of the beneficiary is lower than the owner, deferral further reduces the effective tax rate on the account.

<sup>22</sup> Much of this section draws upon Burman, Gale, and Orszag (2003).

restrictions on age or income. RSAs would be designed similarly, but tax-free withdrawals could only be made after age 58 or the death or disability of the account holder. RSAs would significantly expand annual contribution limits for retirement saving outside of work; would remove all eligibility rules related to age, pension coverage, or maximum income; eliminate minimum distribution rules while the account owner is alive; and allow conversions of traditional and nondeductible IRAs into the new back-loaded saving vehicles without regard to income.

The proposal would also result in growing revenue losses over time; Burman, Gale, and Orszag (2003) estimate an annual revenue loss exceeding 0.5 percent of GDP after 25 years (the equivalent today of more than \$50 billion a year, given the current size of the economy).

#### **IV. A Better Direction**

As the previous section argued, the current thrust of pension policy is fundamentally flawed. A change in direction is necessary. A progressive set of reforms should center on three factors that have generally been shown to boost pension participation, especially among lower- and moderate-income workers: (a) some sort of progressive government matching contribution for employee contributions; (b) ease of savings and (c) financial education in the workplace about the benefits of saving.

##### Progressive Government Matching Contribution

One propitious approach to bolstering retirement income security among lower- and moderate income workers would involve a progressive government matching formula – one that provides relatively larger matches to lower-income workers than higher-income workers. Data on participation rates in 401(k) plans among lower- and moderate-income workers suggest that such a progressive matching approach may be highly beneficial. In particular, a surprisingly large share of lower- and moderate-income workers participate in a 401(k) plan if offered the chance.

In other words, the *conditional participation rate* (that is, the participation rate among those workers who are offered the opportunity to save through a 401(k) plan) is surprisingly high, even for lower-income workers. To be sure, the workers who are offered the opportunity to participate in a 401(k) plan may differ somewhat, in terms of their propensity to save, from the rest of the population.<sup>23</sup> But our interpretation of the evidence is, nevertheless, that offering low- and moderate-income workers the opportunity to participate in a matched saving program may be particularly important to encourage a significant share of them to save.<sup>24</sup> Moreover, the

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<sup>23</sup> This issue is the subject of heated debate. See, for example, Poterba, Venti, and Wise (1995). For an opposing view, see Engen, Gale, and Scholz (1996).

<sup>24</sup> The relatively low level of participation in IRAs, relative to the conditional 401(k) participation rate, may highlight four important factors in encouraging saving: a positive matching rate; financial education in the workplace; peer effects; and the role of the non-discrimination rules (which tie maximum contribution rates for higher-income workers to those undertaken by lower-income workers). The evidence on the impact of higher

evidence from 401(k) plans suggests that once someone starts to save, he or she generally continues to do so: Participation is persistent.<sup>25</sup>

A progressive government matching formula could thus be particularly beneficial for at least two (potentially related) reasons:

- i) The tax treatment of pension contributions naturally creates an implicit *regressive* government matching formula. For every \$1 that a taxpayer in the 35 percent marginal tax bracket contributes to a tax-preferred pension, for example, the taxpayer receive a 35 cent tax benefit. A taxpayer in the 15 percent marginal tax bracket, however, receives only a 15 cent tax benefit for the same \$1 contribution. To offset the regressivity of the implicit match provided by the tax code, the explicit government match should be *progressive*.
- ii) Although the conditional participation rate for lower-income workers offered 401(k) plans is higher than many analysts may have suspected, it is substantially lower than that for higher-income workers. Encouraging participation at higher rates may require a more aggressive matching formula for the lower-income workers.

One component of the EGTRRA legislation — the saver’s credit — reflects the logic of such a progressive matched savings program. The saver’s credit provides a matching tax credit for contributions made to IRAs and 401(k) plans. The eligible contributions are limited to \$2,000. Joint filers with income of \$30,000 or less, and single filers with income of \$15,000 or less, are eligible for a maximum 50 percent tax credit. (A 50 percent tax credit is the equivalent of a 100 percent match on an after-tax basis: A \$2,000 contribution generates a \$1,000 credit on the individual’s tax return, so that the after-tax contribution by the individual is \$1,000, and the government’s contribution is \$1,000.)

Several crucial details of the credit, however, result in its being of very limited value. It provides little or no benefit to the vast majority of lower-income workers and only a very small benefit to others:

1. Since the tax credit is not refundable, it provides *no* additional saving incentive to the vast numbers of families who otherwise qualify on paper for the 50 percent credit rate based on their income (under \$30,000 for married couples and \$15,000 for singles with no children). These people are excluded from the credit because they have no income tax liability against which the credit could be applied. Table 5 shows that 57 million returns have incomes low enough to qualify for the 50 percent credit. Because the credit is non-refundable, however, only one-fifth of these tax-filers could actually benefit from the credit if they contributed to an IRA or 401(k). Furthermore, only 64,000 — or slightly more than one out of every 1,000 — of the returns that qualify based on income could

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matching contributions in 401(k) plans is actually somewhat mixed, although the presence of a match does appear to raise contributions.

<sup>25</sup> See, for example, Papke, Petersen and Poterba (1996).

receive the maximum possible credit (\$1,000 per person) if they made the maximum eligible contribution.

Table 5: Returns that May Benefit from the 50 Percent Saver's Credit by Filing Status  
Current Law, Tax Year 2003

	Returns by Filing Status (thousands) <sup>1</sup>				Total
	Single	Married Filing Jointly	Head of Household	Other	
(A) Total Returns	59,108	56,083	21,242	2,526	138,959
(B) Returns Eligible for 50 Percent Credit Based on Income <sup>2</sup>	27,402	15,938	13,121	567	57,029
(C) Returns that Would Receive <i>Any</i> Benefit from 50 Percent Credit <sup>3</sup>	6,757	3,238	1,187	232	11,414
<i>As share of those eligible based on income (=C/B)</i>	24.7%	20.3%	9.0%	41.0%	20.0%
(D) Returns that Would Benefit in Full from 50 Percent Credit for Maximum Allowed Contribution <sup>4</sup>	2	3	60	0	64
<i>As share of those eligible based on income (=D/B)</i>	0.0%	0.0%	0.5%	0.0%	0.1%

Source: Urban-Brookings Tax Policy Center Microsimulation model (version 0503-1).

(1) Includes both filing and non-filing units. Returns of individuals who are dependents of other taxpayers are excluded from the analysis.

(2) Eligible returns exclude filing units above the relevant AGI threshold and those claimed as dependents on other tax returns.

(3) Returns that would receive any benefit from the saver's credit are eligible and would see some reduction in taxes as a result of the credit if a contribution were made to an approved retirement account.

(4) Returns that would benefit in full from the 50 percent saver's credit for the maximum allowable contribution are both eligible and would see a reduction in taxes equal to the size of the credit if the maximum contribution were made to an approved retirement account.

- For families with somewhat higher incomes, the fact that the credit is not refundable poses much less of a problem. But for these families, the credit provides such a small incentive for saving as to be of little value. For example, a married couple earning \$45,000 a year receives only a \$200 tax credit for depositing \$2,000 into a retirement account. This small credit represents a very low matching rate and therefore provides little incentive to participate.

Despite the apparent generosity of the 50 percent credit rate, it thus does not result in any additional incentive to save for many of the tax filing units in the relevant income range. In addition, the steep declines in the credit rate as income rises can result in very high marginal tax rates for those savers who use the credit.

The existing credit for lower- and middle-income savers thus could be substantially improved. The credit ostensibly sunsets in 2006. A better-designed credit is essential to evaluating the benefits of the general approach proposed here.

### Ease of Savings

Evidence suggests that participation rates are significantly higher if workers are automatically enrolled (unless they object), rather than if a worker has to make an affirmative indication of his or her desire to participate. In other words, participation rates are significantly higher if workers are enrolled in a savings plan unless they specifically opt out of the plan, relative to the participation rate if workers are *not* enrolled in the plan unless they specifically opt in.

One recent study examined 401(k) savings behavior of employees in a large U.S. corporation before and after changes to the 401(k) plan. Before the plan change, the employees had to elect to participate in the 401(k); after the change, employees were automatically enrolled unless they specifically requested to opt out. Given that none of the economic features of the plan changed, the purely “rational” model of economic behavior would suggest that the change would have no effect on 401(k) savings behavior. Contrary to the predictions of the model, however, the study found that 401(k) participation increased dramatically once automatic enrollment went into effect. It also found that the change affected not only participation, but also the amount people chose to contribute. The authors conclude that their results suggest that “changes in savings behavior can be motivated simply by the ‘power of suggestion.’”<sup>26</sup>

### Financial Education

Enhancing financial education appears to be extremely effective in bolstering private retirement saving and elective pension contributions. As one example of the “education gap,” a 1998 EBRI survey concluded that only 45 percent of workers have even attempted to figure out how much they will need to save for their retirement. Other surveys have also found a lack of financial knowledge.<sup>27</sup>

The evidence suggests that the impact of employer-provided financial education on lower-income workers is greater than on higher-income workers. Higher-income workers tend to be more financially sophisticated to begin with, and employer-provided education consequently does not benefit them as much as lower-income workers.<sup>28</sup> Expanded financial education campaigns and more encouragement to firms to provide financial education in the workplace may prove to be beneficial in raising retirement security for lower- and moderate-income workers.

### Defined contribution pension plans and the asset tests in means-tested benefit programs

Another area related to pension policy that warrants examination is the treatment of pensions under the asset tests used in means-tested government benefit programs. The basic rules governing the treatment of pensions under the asset tests used in programs such as Medicaid, the food stamp program, and the Supplemental Security Income program were established in the 1970s. Federal policymakers have given them little attention since, and significant problems have arisen.

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<sup>26</sup> Madrian and Shea (2000).

<sup>27</sup> Levitt (1998).

<sup>28</sup> Bernheim and Garrett (1996) find that the effect of firm-provided education on raising total saving is stronger at the 25<sup>th</sup> percentile of workers than at the 75<sup>th</sup> percentile. They also find that education has a smaller absolute effect, but a larger proportional effect, on 401(k) balances for those at the 25<sup>th</sup> percentile of workers than those higher in the income distribution. They conclude that “the effects of education are particularly pronounced among those least inclined to save...” Bayer, Bernheim, and Scholz (1996) also find that firm-provided seminars stimulate 401(k) participation, and that the effect is larger for non-highly compensated employees than for highly compensated employees.

To be eligible for means-tested benefits, applicants generally must meet an asset test as well as an income test. The asset tests are stringent. For example, in SSI, the asset limits are \$2,000 for a single individual and \$3,000 for a couple. In food stamps, the limit is \$2,000 unless a household contains an elderly or disabled member, in which case the limit is \$3,000. These limits are not indexed to inflation. In both SSI and food stamps, the limits have not been adjusted since the 1980s.

Some resources are typically excluded from these asset tests, including an individual's home, household goods, and some or all of the value of an automobile, as well as assets that are not accessible. Other assets generally count, including retirement accounts that can be cashed in prior to retirement, even if there is a penalty for early withdrawal. In Medicaid, states have the ability to alter these rules and to eliminate the asset test altogether or to exempt more items from it.

Because defined benefit pension funds are *not* accessible, while withdrawals can be made from many defined contribution plans, low-income workers whose employers offer a defined contribution plan are often disadvantaged relative to those whose employer provides a defined benefit plan. In about half of the states, low-income workers who participate in defined contribution plans generally must withdraw most of the balance in their accounts (regardless of early withdrawal penalties or other tax consequences) and spend those assets down before they can qualify for Medicaid.<sup>29</sup> Similarly, poor elderly and disabled people who otherwise would qualify for SSI are required to consume upfront most of the funds they have accumulated in a defined contribution plan, leaving little for their remaining years, before they can receive SSI benefits. By contrast, benefits that a worker or retiree has accrued in a defined benefit pension plan are not considered an asset; the monthly income that the defined benefit plan provides is counted as part of an individual's income when the individual retires and begins receiving this income, but the pension does not count against the program's asset limits. (Note: In the food stamp program, the treatment accorded defined benefit plans is extended to 401(k) plans and similar employer-sponsored defined contribution plans as well, but not to IRAs or Keoghs. Balances in IRAs and Keoghs count against the food stamp asset limits.)

When these features of federal law and regulations were crafted in the 1970s, far fewer employers offered defined contribution retirement plans than do today. Employer-based pension coverage has shifted markedly from defined benefit to defined contribution plans, a shift that continues today.

As the number of low-income workers with defined contribution plans continues to grow, an increasing number stand to lose various means-tested benefits if the balances in these

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<sup>29</sup> Technically, in Medicaid, states can address this problem by excluding amounts in defined contribution accounts, using the authority of sections 1902(r) and 1931 of the Medicaid statute to do so. These authorities are not well understood by states. We are not aware of a state that has an asset test in its Medicaid program that has acted specifically to exclude defined contribution plans.



accounts are counted as assets.<sup>30</sup> In addition, workers with defined contribution pensions who experience temporary periods of need, such as during a recession, can be forced to liquidate their accounts (and also to pay early withdrawal penalties) before they can qualify for certain forms of means-tested assistance. This is particularly unwise policy; workers who are hard-pressed during an economic downturn and withdraw most of the accumulated funds in their retirement accounts to qualify for means-tested assistance can reach retirement with little left in their accounts.

On a related front, some research also suggests that the stringent asset tests that means-tested programs employ have some effect in reducing saving among low-income households.<sup>31</sup>

Reforms in this area merit consideration. Under current law, if an individual (whether working or retired) withdraws funds from a tax-deferred retirement account, the amounts withdrawn are counted as income. That is as it should be. But policymakers should exclude amounts in a pension account from the asset tests used in means-tested programs, regardless of whether the pension is a defined benefit plan or a defined contribution plan. Whether a worker is entitled to a means-tested benefit should not depend on whether the worker has a defined benefit or defined contribution pension.

## **V. Conclusion**

The nation's pension system is not living up to the task we have set for it. At any point in time, it covers only half the work force. Despite its substantial revenue costs, it may do substantially less to bolster retirement security than is commonly assumed, since it provides the largest tax incentives to households that would save sufficiently for retirement even in the absence of such incentives.

Recent policy shifts have exacerbated these shortcomings. A change of course is necessary to enlarge the number of workers who reach retirement with sufficient assets to sustain their living standards. Major reforms may be desirable, but they require a measure of political consensus that is as scarce in pension policy today as it is elsewhere in American political life. Incremental reforms — from improving the default options under 401(k) plans to expanding the low-income saver's credit and making it refundable to exempting defined contribution plan assets from the asset tests in means-tested programs — would be important steps in the right direction.

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30 Between 1984 and 1991, for example, the share of families with earnings between \$10,000 and \$20,000 (in 1991 dollars) who participated in a 401(k) rose from 3.3 percent to 13.9 percent. See Engen and Gale (2000), Table 1.

<sup>31</sup> See Orszag (2001).

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