

PROGRESSIVITY AND SAVING: FIXING THE NATION'S UPSIDE-DOWN INCENTIVES FOR SAVING

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As the baby boomer generation nears retirement, the shortcomings in the nation's upside-down system of incentives for retirement saving are becoming increasingly apparent.² The existing structure is upside down for two reasons:

- First, it gives the strongest incentives to participate to higher-income households who least need to save more to achieve an adequate retirement living standard and who are the most likely to use pensions as a tax shelter, rather than as a vehicle to raise saving.
- Second, the subsidies are worth the least to households who most need to save more for retirement and who, if they do contribute, are most likely to use the accounts to raise net saving.³

In part reflecting this upside-down set of incentives, the nation's broader pension system betrays several serious shortcomings:

- Only about half of workers participate in an employer-based pension plan in any given year, and participation rates in Individual Retirement Accounts (IRAs) are substantially lower.
- Even those workers who participate in tax-preferred retirement saving plans rarely make the maximum allowable contributions. Only about 5 percent of 401(k) participants make the

¹ The views expressed are mine alone and should not be attributed to the trustees, officers, or staff of the Brookings Institution or the Tax Policy Center. They also do not necessarily represent the views of, and should not be attributed to, the Retirement Security Project or the Pew Charitable Trusts. Much of this testimony draws directly upon joint work with William Gale and Mark Iwry of Brookings, Robert Greenstein of the Center on Budget and Policy Priorities, and Gene Sperling of the Center for American Progress. My co-authors should not be held responsible for the views expressed in this testimony, however. I thank Jennifer Derstine and Emil Apostolov for excellent research assistance.

² For a broader discussion of these issues, see William G. Gale and Peter R. Orszag, "Private Pensions: Issues and Options," in H. Aaron et. al., eds., *Agenda for the Nation* (Brookings: 2003).

³ Evidence indicates that (a) high-income households are the least likely, and low- and moderate-income households are the most likely, to need additional saving to have adequate living standards in retirement (see Eric M. Engen, William G. Gale, and Cori E. Uccello, "The Adequacy of Household Saving," *Brookings Papers on Economic Activity* 1999(2), pp. 65–165) and (b) high-income households are the most likely to shift assets from other accounts into tax-preferred form, and hence not raise private or national saving, while low- and moderate-income households, when they do participate, tend to raise their net private saving (see Eric M Engen and William G. Gale, "The Effects of 401(k) Plans on Household Wealth: Differences Across Earnings Groups," The Brookings Institution, August 2000, and Daniel Benjamin, "Does 401(k) Eligibility Increase Saving? Evidence from Propensity Score Subclassification" Mimeo, London School of Economics, 2001).

maximum contribution allowed by law, and only about 5 percent of those eligible for IRAs make the maximum allowable contribution.

- Despite the shift from defined benefit to defined contribution plans, many households approach retirement with meager defined contribution balances. The median defined contribution balance among all households aged 55 to 59 in 2001 was only about \$10,000.

The bulk of the policy changes that have been enacted in recent years, moreover, move the pension and broader saving system further 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.

The Administration's new savings proposals would exacerbate this flawed approach. The Retirement Saving Account proposal and Lifetime Saving Account proposal would induce substantial asset shifting by high-income households, do little to boost saving among moderate income households, and significantly reduce revenue over the long term. Over the next 75 years, the revenue cost of the proposals would amount to a third or more of the actuarial deficit in Social Security.

A better strategy would encourage expanded pension coverage and participation among low- and middle-income households by:

- Expanding the income eligibility range for the saver's credit and making the credit refundable;
- Reducing the implicit taxes on saving done by moderate income households through the asset tests under certain government programs;
- Encouraging financial education provided by disinterested parties; and
- Promoting automatic saving, including through changes to the default choices in 401(k) plans and through the "split refund" proposal included in the Administration's budget.

I would also like to note that a new Retirement Security Project at Brookings and George Washington University, funded by the Pew Charitable Trusts, is studying ways of bolstering financial security for America's aging population by raising retirement savings and improving long-term care insurance products.⁴ It brings together pension researchers and health care experts to examine areas such as the opportunities and challenges involved in using home equity to purchase long-term care insurance; reforming the existing saver's credit to strengthen its incentives for moderate-income households to save; and removing the disincentive for pension saving implicit in the existing asset tests under various means-tested government programs.

⁴ See www.brookings.edu/retirementsecurity

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 shifted from defined benefit to defined contribution plans, but the overall coverage rate has changed little.

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%
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.

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

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). In addition to

participation rates, contribution rates (contributions as a percentage of income) in defined contribution plans also vary 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.

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.

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

Percentiles of income	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	25.0%	\$0	\$8,000	1.1%
20-39.9	49.6%	\$0	\$12,000	4.2%
40-59.9	61.6%	\$7,200	\$28,000	8.6%
60-79.9	91.0%	\$50,000	\$54,000	16.7%
80-89.9	95.4%	\$148,000	\$190,000	18.8%
90-100	92.1%	\$215,000	\$299,000	50.6%
Total	63.6%	\$10,400	\$50,000	100%

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

Table 3 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. (The median balance is \$50,000 among those with accounts. But when the 36 percent of the population without an account is included the median declines to \$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.

II. Benefits of progressivity in pension policy

Given the gaps in the current system, 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 both to raise national saving and to minimize the likelihood 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 only 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.⁵) 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.⁶ The empirical evidence suggests that tax-preferred retirement 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 higher-income workers are less likely to be in danger of living in poverty in older age. Focusing attention on lower-income workers in fashioning new tax-favored pension initiatives is a more efficient anti-poverty tool.

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 and proposals

Recent legislative changes and proposals have exacerbated rather than attenuated the regressivity of the pension system and thus have moved (or would move) the pension system in the wrong direction. These proposals include the pension component of the 2001 tax legislation and the Bush Administration's Retirement Saving Account and Lifetime Savings Account proposal.

(A) 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 top 20 percent of the income distribution.

⁵ 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.

⁶ 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.

To be sure, the legislation included 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, involved 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.⁷ 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.”⁸ 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.⁹

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 EGTRRA was very small.¹⁰ 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 allowed by law. 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%
TOTAL	35,666	100.0%	6%	2,301	100.0%

Source: Author’s 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.

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

⁷ Robert Carroll, “IRAs and the Tax Reform Act of 1997,” unpublished mimeo, Office of Tax Analysis, Department of the Treasury, January 2000. See also Craig Copeland, “IRA Assets and Characteristics of IRA Owners,” EBRI Notes, December 2002.

⁸ Robert Carroll, “IRAs and the Tax Reform Act of 1997,” unpublished mimeo, Office of Tax Analysis, Department of the Treasury, January 2000.

⁹ General Accounting Office, “Private Pensions: Issues of Coverage and Increasing Contribution Limits for Defined Contribution Plans,” GAO-01-846, September 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.)

¹⁰ See, for example, David Joulfaian and David Richardson, “Who Takes Advantage of Tax-Deferred Saving Programs? Evidence from Federal Income Tax Data,” Office of Tax Analysis, US Treasury Department, 2001.

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.

(B) Bush Administration's Lifetime Saving Account and Retirement Saving Account proposal

In this year's budget, the Bush Administration reintroduced, in slightly modified form, its proposal to create a new set of tax-preferred accounts that would expand opportunities for tax-advantaged saving. The proposal 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).¹¹ 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 Administration's 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 (\$5,000 per account per year) for any purpose, with no 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 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.

A particular shortcoming of the RSA and LSA proposals is that they may diminish interest in employer-provided pension plans, although the size of the effect is unknown. Any such adverse effect on employer plans is particularly disturbing given the relatively low level of participation in non-employer-based plans like IRAs, compared to the conditional participation rate in employer-based plans like 401(k)s. That differential may highlight several important factors in encouraging saving, including 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 RSA/LSA proposal would also result in growing revenue losses over time; estimates based on Burman, Gale, and Orszag (2003) suggest an annual revenue loss exceeding 0.3 percent of GDP after 25 years. An analysis by the Congressional Research Service reached similar conclusions.¹² The Burman-Gale-Orszag figures suggest that over the next 75 years, the revenue loss amounts to a third or more of the actuarial deficit in Social Security.

¹¹ Much of this section draws upon Leonard Burman, William G. Gale, and Peter R. Orszag, "The Administration's Saving Proposals: A Preliminary Analysis," *Tax Notes*, March 3, 2003.

¹² Congressional Research Service, "Effects of LSAs/RSAs Proposal on the Economy and the Budget," January 6, 2004. CRS estimated that the long-term costs of last year's proposal could reach the equivalent today of \$300 billion to \$500 billion over ten years. Due to changes made in this year's proposal, which reduced the maximum contribution limit from \$7,500 to \$5,000 — a one-third reduction — the long-term cost of the new proposal would be lower, although not substantially lower. For those who would have contributed the full \$7,500, the change would reduce their benefit by one-third. For all others, the benefit reduction would be smaller, and those contributing \$5,000 or less would see no change. Preliminary estimates by CRS indicate that the total impact of the lower contribution limits may be to reduce the ultimate cost of the proposal by as little as one-sixth, to about \$250 billion to \$420 billion over ten years. Even if the cost of the proposal were reduced by one-third — which is the maximum possible reduction — the ultimate cost would still be large.

The RSA proposal, income limits, and the “advertising effect”

A key issue with regard to the RSAs is the absence of an income limit. Indeed, RSAs are basically Roth IRAs without an income limit. In commenting on a similar proposal in the late 1990s, then-Treasury Secretary Robert Rubin explained, “...if you don’t have income limits, then you’re going to be creating a great deal of benefit for people who would have saved anyway, and all of that benefit will get you no or very little additional savings.” That perspective is consistent with the evidence cited above about the effect of saving incentives on asset shifting as one moves up the income distribution.

Preliminary analysis using the retirement savings module from the Urban-Brookings Tax Policy Center (TPC) model suggests that more than 90 percent of the tax subsidies (in present value) from removing the income limit on Roth IRAs would accrue to the 2 percent of households with Adjusted Gross Income of more than \$200,000. Almost 40 percent of the benefits would accrue to the 0.4 percent of households with income of more than \$500,000.¹³

The implied long-term revenue loss and likelihood of substantial asset shifting in response to removing the income limit on Roth IRAs both suggest the lack of wisdom in pursuing such a course. A counter-argument is that eliminating income limits could allow financial services firms to advertise more aggressively and thereby encourage more saving by moderate-income households. Three points are worth noting about this “advertising effect” argument:

- First, it is extremely unlikely that the overall result would be progressive, especially given the types of advertising that are likely, since that would require not only that the advertising “trickle down” the income distribution but that the effect actually grow relatively stronger as it moved down the income ladder (which could perhaps be referred to as an “avalanche” version of the trickle-down effect).
- Second, advocates of the substantial benefits from advertising point to the experience with IRAs after 1981, when access was expanded to include all wage earners, and before the Tax Reform Act of 1986, when income limits were imposed on deductible IRAs. It is true that participation rates in IRAs declined after the 1986 reform, even among those below the new income limits. But the declines were somewhat modest in an absolute sense, especially given the rise in 401(k) availability and changes in income tax rates, both of which may well have diminished interest in IRAs. For example, data from the IRS Statistics of Income suggest that 5.0 percent of those with Adjusted Gross Income of \$20,000 or less in 1984 contributed to an IRA; in 1988, 2.4 percent of those with Adjusted Gross Income of \$20,000 or less contributed to an IRA. (The declines in contribution rates to IRAs were larger, in absolute terms, between \$20,000 and \$40,000 in AGI.) More broadly, with respect to the

¹³ The TPC estimates also suggest that reducing the contribution limit to approximately \$3,000 while removing the income limit on Roth IRAs would result in no net change in aggregate contributions to Roth IRAs, which is one proxy for no revenue effect in present value. In other words, the present-value revenue losses from removing the income cap on Roth IRAs could be approximately offset by reducing the contribution limit from its scheduled level of \$5,000 to about \$3,000.

pre-1986 era without any income limits, the Congressional Research Service concludes that “There was no overall increase in the savings rate...despite large contributions to IRAs.”¹⁴

- Finally, the advertisements used prior to 1986 suggest that much of the advertising was designed to induce asset shifting among higher earners rather than new saving among lower earners. For example, one advertisement that ran in the *New York Times* in 1984 stated explicitly: “Were you to shift \$2,000 from your right pants pocket into your left pants pocket, you wouldn't make a nickel on the transaction. However, if those different ‘pockets’ were accounts at The Bowery, you'd profit by hundreds of dollarsSetting up an Individual Retirement Account is a means of giving money to yourself. The magic of an IRA is that your contributions are tax-deductible.”¹⁵ This type of advertising is extremely unlikely to generate new saving among moderate-income households.

IV. A better direction

As the previous section of my testimony argued, the current thrust of pension policy is fundamentally flawed. A change in direction is necessary. A progressive set of reforms should center on factors that would boost participation, especially among lower- and moderate-income workers: (a) expanding the income eligibility range for the saver's credit and making the credit refundable; (b) reducing the implicit taxes on saving done by moderate income households through the asset tests under certain government programs; (c) encouraging financial education; and (d) making it easier to save, including through changes to the default choices in 401(k) plans and the “split refund” proposal included in the Administration’s budget.

(A) Improving the saver’s credit

One promising 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. A progressive government matching formula could be beneficial for at least two (potentially related) reasons.

First, the tax treatment of pension contributions naturally creates an implicit *regressive* government matching formula. To offset the regressivity of the implicit match provided by the tax code, the explicit government match should be progressive. Second, 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 more participation 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.

¹⁴ Congressional Research Service, “Effects of LSAs/RSAs Proposal on the Economy and the Budget,” January 6, 2004.

¹⁵ William G. Gale, “Saving and Investment Incentives in the President’s Budget: The Effects of Expanding IRAs, Testimony before the Committee on Ways and Means, March 19, 1997.

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. As Table 5 shows, a smaller credit rate applies up to \$50,000 in income for joint filers. The table also shows that 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 net after-tax contribution by the individual is \$1,000, and the government’s implicit contribution is \$1,000.

Table 5: Saver’s credit for married couples

AGI above	AGI not above	Credit rate	Tax credit for \$2,000 contribution	After-tax contribution for \$2,000 account balance	Effective after-tax matching rate
0	\$30,000	50%	\$1,000	\$1,000	100%
\$30,000	\$32,500	20%	\$400	\$1,600	25%
\$32,500	\$50,000	10%	\$200	\$1,800	11%

Note: Figures in table assume that couple has sufficient income tax liability to benefit from the nonrefundable income tax credit shown, and do not take into account any employer matching contributions or the effects of tax deductions or exclusions that might be associated with the contributions.

IRS data indicate that 3.7 million tax filing units claimed the credit in 2002, the first year it was in effect.¹⁶ This figure likely reflects more than 3.7 million qualifying individual savers, however, as a significant portion of these returns represent married couples filing jointly, where both spouses may have made a separate qualifying contribution.¹⁷ Preliminary estimates of the distributional effects of the saver’s credit using the Urban-Brookings Tax Policy Center micro-simulation model suggest that roughly 60 percent of the benefits accrue to filers with AGI of \$30,000 or under.¹⁸

Despite the promise of the saver’s credit in helping to address the upside-down nature of the nation’s savings incentives, several crucial details of the credit as enacted result in its being of limited value:

1. Since the tax credit is not refundable, it provides *no* additional saving incentive to 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

¹⁶ IRS Taxpayer Usage Study.

¹⁷ The IRS data are based on the number of tax returns that claimed the saver’s credit by entering an amount on line 49 of Form 1040 (“retirement savings contributions credit”) and filing Form 8880 (“Credit for Qualified Retirement Savings Contributions”). The data do not show a breakdown of contributions by type of plan (employer plan versus IRA, for example) or size of contribution. However, partial data that shed some light on these issues are available from other sources because a significant portion of the returns claiming a saver’s credit were filed with the aid of tax preparers.

¹⁸ The model is based on data from the 1999 public-use file produced by the Statistics of Income (SOI) Division of the Internal Revenue Service (IRS). The model contains additional information on demographics and sources of income that are not reported on tax returns through a constrained statistical match of the public-use file with the March 2000 Current Population Survey (CPS) of the U.S. Census Bureau. The retirement savings module also uses data from the Survey of Consumer Finances (SCF) and the Survey of Income and Program Participation (SIPP). For more detail about the model, see www.taxpolicycenter.org.

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

2. 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 a relatively modest incentive for saving. 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 low implicit matching rate (see Table 5) and therefore provides little incentive to participate.
3. 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. For example, consider a married couple contributing \$2,000 to an IRA. If the couple's AGI increases from \$30,000 to \$30,001, the tax credit for that contribution declines from \$1,000 to \$400 — a \$600 increase in tax liability triggered by a \$1 increase in income.
4. The credit officially sunsets in 2006.

To address these shortcomings, policy-makers should make the saver's credit refundable, extend the 50 percent credit rate up the income distribution, address the current "cliffs" by phasing the credit rate down more smoothly, and extend the credit beyond its 2006 sunset. Estimates from the TPC model suggest that making the credit refundable would add about \$5 billion per year to its cost. The current credit costs about \$2 billion a year; making the credit refundable would raise this cost to about \$7 billion per year. Expanding the 50 percent credit rate to \$50,000 for joint filers, and phasing the credit down over the next \$10,000, would add about \$4 to \$5 billion a year in cost. Each \$10,000 increment in the availability of the 50 percent credit rate above \$50,000 in income for joint filers then adds another \$4 to \$5 billion or so a year in revenue cost.

Combining improvements to the saver's credit and the RSA proposal

Some policy-makers are apparently exploring the possibility of combining a refundable, expanded saver's credit with the RSA proposal. Although the details of such proposals remain unclear, some insight into their potential effects may be obtained by examining the impact of (a) eliminating the income limit on Roth IRAs while making the existing saver's credit refundable; or (b) eliminating the income limit on Roth IRAs, expanding the 50 percent credit rate under the existing saver's credit up to \$50,000 for joint filers (phased out by \$60,000), and making the credit refundable.

Preliminary TPC estimates suggest that under option (a), more than a third of the tax benefit in present value would accrue to households with incomes above \$100,000, and roughly a quarter would accrue to the top 2 percent of the income distribution. Under option (b), about a fifth of the aggregate benefit in present value would accrue to households with incomes above \$100,000, and about 15 percent would accrue to the top 2 percent of the income distribution. For many purposes, however, it is better to examine the percentage change in after-tax income than the share of tax cuts

by income class. Under both option (a) and option (b), the percentage change in after-tax income first declines as income increases, then increases. In other words, the proposals deliver tax benefits both at the bottom and at the top of the income distribution, with almost no effect on households with income between \$50,000 and \$100,000.

My own view, given the evidence on the degree to which subsidies for saving merely induce asset shifting among high-income households, is that eliminating the income limit on Roth IRAs would carry an excessively high price in terms of national saving -- and that price would likely be too high to pay even in exchange for other measures that improve retirement policy, such as substantially strengthening the saver's credit, and for any marginal beneficial effect from increased advertising effort by financial services firms.

(B) Reducing implicit taxes on saving

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.

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. Research suggests that the stringent asset tests that means-tested programs employ have some effect in reducing saving among low-income households.¹⁹

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.

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.²⁰ 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,

¹⁹ See Peter R. Orszag, "Asset Tests and Low Saving Rates Among Lower-Income Families," Center on Budget and Policy Priorities, April 2001.

²⁰ 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.

benefits that a worker or retiree has accrued in a defined benefit pension plan are not considered an asset for these tests. The monthly income that the defined benefit plan provides is, however, counted as part of an individual's income when the individual retires and begins receiving this income. (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.)

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 accounts are counted as assets. 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.

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 consider excluding 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.

(C) Improving financial education provided by disinterested parties

A new book by Alicia Munnell and Annika Sunden (*Coming Up Short: The Challenge of 401(k) Plans*, Brookings 2004) documents the multiple mistakes that workers make in saving on their own for retirement. One clear explanation for such poor decision-making is a lack of financial education. As an 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.

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. 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.

Employers generally avoid giving specific investment advice to workers because doing so could expose them to potential fiduciary liability with respect to investment decisions. Unfortunately, the general financial education that may be provided under the Employee Retirement Income Security Act (ERISA) without triggering possible fiduciary exposure is too abstract to be of much use for many workers. As a result, Congress has considered measures to relax ERISA’s constraints on investment advice. A measure considered by the Senate after the Enron debacle would allow independent third-party financial advisors to provide such advice under certain circumstances. An earlier bill, passed by the House, would permit investment advice to be

provided by the firms that provide financial products to the plan; this approach is problematic, since it creates a conflict of interest that is subject to abuse. The experience in the United Kingdom with financial advice clearly underscores the critical importance of fully disinterested parties providing the advice.

My colleague, Mark Iwry, has proposed a different approach: plan sponsors could obtain relief from fiduciary liability if they include a prudently diversified, balanced portfolio in the plan's investment options. An employer could obtain a higher degree of fiduciary protection if it chose to make the standard balanced portfolio option the default -- the automatic investment for employees who do not affirmatively choose another option.²¹ As discussed below, defaults exert a substantial influence on saving behavior.

(D) Promoting automatic saving

A final prong of sound retirement saving reform should dramatically expand the force of inertia to be enlisted in favor of saving, not against it. Evidence suggests that participation rates are significantly higher if workers are automatically enrolled in savings plans (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.'"²²

To encourage the use of these effective plans, policy-makers could remove obstacles that prevent some plan sponsors from adopting them by steps such as clarifying the preemption of state laws to the minimum extent necessary to accommodate automatic enrollment; granting fiduciary

²¹ Iwry argues that this approach, while still allowing employees the freedom to choose among any other plan options, "would steer employees away from not only excessive investment in employer stock but also investments that fail to reflect reasonable asset allocation and diversification, including frequent investment changes, attempts at market timing, failure to rebalance, and excessive reliance on money market funds. Ultimately, such an approach could help move the defined contribution system back from investing on a "retail" basis to investing on more of a collective, wholesale basis, with the associated economies of scale and professional management. J. Mark Iwry, "Promoting 401(k) Security," Urban-Brookings Tax Policy Center Issues and Options Paper No. 7, September 2003.

²² Brigitte C. Madrian and Dennis F. Shea, "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior," *Quarterly Journal of Economics*, February 2002; 116(4): 1149-87. See also Richard H. Thaler and Shlomo Benartzi, "Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving," *Journal of Political Economy*, forthcoming.

safe harbor treatment for selected default investments; allowing a plan to disburse small account balances to an employee who decides to opt out soon after the automatic enrollment begins without a penalty; and reforming the matching safe-harbor contribution requirements (which allow employers to avoid non-discrimination testing under 401(k)s and SIMPLE plans) by requiring automatic enrollment of all eligible rank-and-file employees if the employer chooses to use the safe harbors.

Another way of making it easier to save was included in the Administration's Fiscal Year 2005 budget: allowing tax refunds to be deposited into more than one account. This "split refund" proposal, which reflects work by Lily Batchelder and Fred Goldberg of Skadden Arps along with others, would allow taxpayers to split their tax refunds and direct portions of their refund into different accounts. As Batchelder and Goldberg note, the proposal is highly promising as a mechanism for raising saving because:

- Refunds are a significant potential source of savings for many families. The average taxpayer's refund is approximately \$2,100 per year, or 5 percent of median income. In addition, many lower-income families receive sizable refunds as a result of the Earned Income Tax Credit, and those refunds are often their only realistic opportunity to save during the year.
- The current IRS practice of only permitting taxpayers to direct their refund to one account significantly reduces the portion of tax refunds that are saved for two reasons. First, many families are reluctant to have their entire refund deposited to a tax-preferred savings account, like an IRA, because such accounts are intended for retirement saving and therefore cannot be used for every-day transactions. Second, while taxpayers can have their entire refund deposited into a checking account, and then transfer a portion of the deposit to a savings vehicle, it is likely that this additional step significantly reduces the extent to which refunds are saved.
- The split refund proposal would increase refund saving because it would make the process of saving refunds much simpler. It would also provide tax preparers with a natural opportunity to suggest that clients save a portion of their refund, educate clients about the tax and non-tax benefits of saving, and open new savings vehicles for clients who do not already have one. Some tax preparation firms already offer a service in which they serve as intermediaries for clients who want to split their refunds between a taxable account and a tax-preferred account. The interest in these services suggests substantial opportunities for gains from an IRS program of splitting refunds, which would be simpler and more universal than the services offered by tax preparation firms.
- The proposal is particularly attractive because it would not require additional legislation, and could be implemented under current law.

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, and the Administration's Retirement Saving Account proposal would continue to move in the wrong direction. 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 allowing split refunds, expanding the low-income saver's credit and making it refundable, and exempting defined contribution plan assets from the asset tests in means-tested programs -- would be important steps in the right direction.