STRENGTHENING RETIREMENT SECURITY

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Mr. Chairman, my testimony this morning addresses two aspects of strengthening retirement security: why it is critical to preserve Social Security's core insurance features while reforming the program to eliminate its long-term deficit; and how we can expand retirement saving on top of Social Security.

Saving Social Security without destroying it

Social Security is one of America's most successful government programs.[2] It has helped millions of Americans avoid poverty in old age, upon becoming disabled, or after the death of a family wage earner.

Social Security's success as a social insurance program is attributable to several basic features of the system. It provides participants with a well-defined, assured basic income that is protected against inflation, the risk of outliving one's assets, and financial market fluctuations. It is progressive, providing larger annual benefits (relative to previous wages) for lower earners than for higher earners. And it provides families with insurance against the disability or death of a wage earner, in addition to retirement benefits.

Although we can and should boost retirement saving on top of Social Security, we must not forget that for the majority of the population, Social Security provides the key layer of financial security during particular times of need. One-fifth of elderly beneficiaries receive *all* their income from Social Security, and nearly two-thirds receive the majority of their income from Social Security. The average Social Security benefit amounts to slightly more than $10,000 a year, and 20 percent of beneficiaries receive $7,000 a year or less.

Social Security faces a long-term deficit. Restoring long-term financial balance to Social Security is therefore necessary, but it is not necessary to destroy the program in order to save it. One particularly contentious issue involves whether part of Social Security should be replaced with individual accounts. In my view, such an approach would be unwise both because of the

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[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 Peter Diamond of MIT, 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] Much of the discussion on Social Security in this testimony is drawn from Peter A. Diamond and Peter R. Orszag, *Saving Social Security: A Balanced Approach* (Brookings: 2004).

financing issues it entails and because individual accounts are not likely to provide an adequate replacement for the crucial protections offered by the current system:

- Diverting Social Security revenue into individual accounts creates a substantial financing problem. The revenue diversion by itself worsens Social Security's financial standing. To avoid this, individual accounts must be linked in some way to a reduction in traditional benefits sufficient to offset the cost of the diverted revenue. Even then, however, the flow of revenue into the individual accounts would precede by many years (if not decades) the offsetting reductions in traditional benefits.

- Despite whatever ivory-tower proponents might like to believe, it is unlikely that real-world individual accounts would require that benefits keep pace with inflation, last as long as the beneficiaries are alive, or protect surviving spouses as well as the current system. There would also likely be intense political pressure to allow withdrawals prior to retirement, which would undermine the role of the accounts in providing retirement security. Furthermore, the assets in the accounts are subject to financial market risks. As a result, individual accounts are simply inappropriate for the basic tier of income during retirement, disability, and other times of need. Especially as the private retirement system on top of Social Security shifts from a defined benefit to a defined contribution one, it makes little sense to engineer a shift to individual accounts within the core layer of financial security provided by Social Security.

A final issue regarding Social Security involves the relative magnitudes of the actuarial deficit in Social Security and the cost of the recent tax cuts. Over the next 75 years, the Social Security actuarial deficit amounts to 0.7 percent of GDP. Over the same period, the tax cuts (if they are extended and protected from being erased by the Alternative Minimum Tax) amount to more than 2 percent of GDP. In other words, the tax cuts cost more than three times the actuarial deficit in Social Security.

The relative size of the tax cuts and the Social Security deficit underscores two points:

- First, the tax cuts dissipate revenue that could have instead been used for more constructive purposes, including to shore up the Social Security system. Since the tax cuts sunset in 2010 or before, we still face a choice. Assuming an Alternative Minimum Tax reform, the cost of *extending* the tax cuts (that is, ignoring the costs that arise before the enacted tax cuts sunset) is 1.8 percent of GDP over the next 75 years. That is more than 2.5 times as large as the actuarial deficit in Social Security over the same period.

- Second, even if it were sensible to finance regressive tax cuts through reductions in progressive benefit programs, it is not realistic to "pay for" the tax cuts through reduced Social Security benefits. The relative magnitudes mean that the math doesn't even come close to working (assuming that one is not willing to enact benefit reductions that are even more severe than the extreme of eliminating the entire Social Security deficit on the benefit side).

Expanding retirement saving on top of Social Security

Various types of savings incentives already exist for households to supplement the key protections offered by Social Security. These savings incentives, however, are upside-down:[3]

- First, they give 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.

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. Participation is particularly low among lower earners: Only about one-fifth of workers in households with income of less than $20,000 participated in some form of tax-preferred savings plan in 1997.

- 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 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. Many households thus appear to have substantial difficulty in saving significant amounts for retirement.

The bulk of the policy changes that have been enacted in recent years, moreover, move the tax-preferred pension 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.

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[3] 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).

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.

Retirement Security Project

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.

I. Saving Social Security

For the majority of the population, Social Security benefits provide the key layer of financial security during particular times of the need. Social Security benefits are particularly valuable for several reasons:

- First, Social Security benefits are indexed for inflation and last for as long as the beneficiary is alive. Beneficiaries therefore do not have to worry that they will exhaust the income flow from their assets before they die, nor do they have to worry that inflation will rob them of the standard of living supported by Social Security.
- Second, Social Security benefits are progressive: they replace a larger share of previous wages for those whose earnings were low during their working life than for those whose earnings were high. This progressivity provides a form of lifetime earnings insurance that is not available in the private market.
- Third, Social Security retirement benefits do not depend on what happens in financial markets. Concern about market risk is greatly heightened by the evidence of how poorly many workers manage their 401(k) investments. Far too many workers do not diversify

[4] See www.brookings.edu/retirementsecurity

properly, over-invest in their employer's stock, choose short-term bonds for a long-term investment, and do not make adjustments in their portfolios as their circumstances change.

- Finally, Social Security provides benefits for surviving spouses, mostly widows, for young children losing a parent, and for disabled workers and their families. The image of Social Security solely as a retirement program is inaccurate: almost 15 percent of beneficiaries are younger than 62.

In any reform to Social Security, it is critically important that these key features of the program be retained. Restoring long-term financial balance to Social Security is necessary, but it is not necessary to destroy the program in order to save it. To be sure, some analysts reject the view that Social Security's projected financial problems are serious enough to warrant any changes right now. Others exaggerate the difficulty of saving Social Security to justify proposals that would undermine the most valuable features of the program. My view is that Social Security's projected financial difficulties are real and that addressing those difficulties sooner rather than later would make sensible reforms easier and more likely. The prospects are not so dire, however, as to require undercutting the basic structure of the system.

Causes of long-term deficit

In exploring reforms to Social Security, it may be helpful to explain the causes of the long-term deficit. Many factors contribute to that deficit. As Peter Diamond and I explain in *Saving Social Security: A Balanced Approach* (Brookings, 2004), three important contributing factors include improvements in life expectancy, increases in earnings inequality, and the burden of the legacy debt resulting from Social Security's history.

Life expectancy at age 65 has risen by four years for men and five years for women since 1940, and it is expected to continue rising in the future. Increasing life expectancy raises the value of Social Security benefits to workers, because benefits last as long as the recipient is alive. By the same token, however, improving life expectancy adversely affects Social Security's financial condition, because beneficiaries then collect benefits over a longer period.

A second factor affecting Social Security's financing is earnings inequality. Over the past two decades, earnings have risen most rapidly among workers who already have the highest earnings. This affects Social Security's financing because the Social Security payroll tax is imposed only up to a maximum taxable level ($87,900 in 2004). Between 1983 and 2002, the share of aggregate earnings above the maximum taxable level increased from 10 to 15 percent. Furthermore, the extent to which people with higher earnings and more education tend to live longer than those with lower earnings and less education has also increased. This increasing gap in life expectancy exacerbates Social Security's financing shortfall and makes the system less progressive on a lifetime basis, since higher earners will collect benefits for an increasingly larger number of years, and thus enjoy larger lifetime benefits, relative to lower earners.

A third important influence on the future finances of Social Security reflects the past. The benefits paid to almost all current and past cohorts of beneficiaries exceeded what could have been financed with the revenue they contributed, including interest. This history imposes a "legacy debt" on the Social Security system. That is, if earlier cohorts had received only the benefits that

could be financed by their contributions plus interest, the Trust Fund's assets would be much greater today. If those assets were present, they would be earning interest that could contribute to paying for benefits.

Social Security's legacy debt is similar in many ways to the explicit public debt. The public debt reflects the accumulated difference between spending and revenue from the beginning of the nation to the present; because spending has exceeded revenue in the past, we are left with a public debt. The cost of financing that public debt requires some combination of higher taxes and lower spending in the future than would have been necessary in the absence of the public debt. So, too, the legacy debt within Social Security reflects the accumulated difference between benefits and revenue for previous and current beneficiaries; the cost of financing that debt will require some combination of higher taxes and lower benefits than the system could otherwise afford for future generations.

Social Security reforms, unless they reduce benefits for current retirees (which no one today is seriously proposing), will have only modest effects on the size of the legacy debt. With the size of the legacy debt thus largely already determined, the type of reform enacted will instead determine how the resultant legacy cost is spread across generations. In other words, how actuarial balance is restored will determine how the costs of the program's legacy debt are shared.

A reasonable estimate of the program's legacy that needs to be financed by those younger than 55 years old is $11.5 trillion. Relative to a world in which the legacy debt didn't exist, future generations will have to bear some combination of higher taxes and lower benefits. The key question is how those higher taxes and lower benefits are spread across different generations in the future, and different people within each generation. Any plan that restores actuarial balance spreads this cost in some way. The challenge is to select a way that seems fair.

As one extreme example, imagine that benefits in the years after 2042 (when the trust fund is projected to be exhausted) are reduced so that they just equal incoming payroll revenue at the existing tax rate. Such an approach would pass most of the legacy debt along to distant generations. The reduction in benefits for those distant generations would have to be substantial, because little of the legacy debt would have been paid down in the meanwhile. At the other extreme, imagine that taxes are raised on current workers by enough to eliminate the entire legacy debt within a generation. Such an approach would transform Social Security into a fully funded system. It would leave generations in the distant future with no legacy debt, but it would impose a substantial burden on the transition generation.

Social Security reform should reflect a balance in the financing of the system's legacy debt between these two extremes of paying off the entire debt immediately and shifting all of it to future generations. The "appropriate" balance between them is clearly a subjective matter.

Individual accounts

Individual accounts within Social Security have two problems: They raise a substantial financing challenge, and they are unlikely to be a particularly effective mechanism for delivering the core layer of financial security during times of need.

If Social Security revenue were diverted into individual accounts without any

corresponding reduction in benefits, Social Security's financial standing would clearly be worsened. To avoid this, individual accounts financed by such revenue diversion must be linked in some way to a reduction in traditional benefits sufficient to offset the cost of the diverted revenue. Even if the traditional benefits that would otherwise be paid to the individual accountholder are reduced in such a way that traditional Social Security finances are unaffected over the accountholder's lifetime, however, the bulk of the flow of revenue into the individual accounts would precede by many years the offsetting reductions in traditional benefits.[5] The benefit offset for, say, a worker age 25 would occur over a period of several decades that does not begin until about four decades hence. Revenue would thus be diverted from the trust fund over many years before the corresponding "debt" would be repaid. For example, if 2 percent of payroll were diverted to individual accounts, with an offsetting reduction in traditional benefits for accountholders upon retirement, the individual accounts have no effect on Social Security in present value terms—the program would eventually be paid back in full for the diverted revenue. However, the cash flow from the individual accounts would be negative over a period of more than forty-five years, because the diverted revenue would exceed the benefit offsets until almost 2050.

The delay between the revenue flow and the corresponding benefit reductions poses a significant problem for the Social Security system. The net cash outflow would cause the Trust Fund to be exhausted more than a decade earlier than in the absence of the generic accounts. To offset this negative cash flow, it would be necessary either to phase in benefit reductions more rapidly, to provide additional revenue to Social Security, or to allow Social Security to borrow from the rest of the budget. The "magic asterisk" approach of simply assuming that trillions of dollars will be provided from the rest of the budget to fill this hole, despite the nation's substantial fiscal gap, is fiscally irresponsible. (This concern is even more pronounced if the traditional benefit reductions linked to individual accounts do not ultimately occur, or do not occur to the extent originally envisioned, because of political pressure to reduce the offset rate.)

Even if it were not for these financing issues, individual accounts would not make sense *within* Social Security. Although tax-favored individual accounts such as 401(k)s and IRAs already provide a useful supplement to Social Security, they are simply inappropriate for the basic tier of income during retirement, disability, and other times of need. Those nearing retirement need a reliable source of income that offsets inflation and lasts as long as they live. This is particularly important for the one-third of the elderly who get at least 90 percent of their income from Social Security. Individual accounts do not provide this type of security. The assets in the accounts are subject to financial market risks.

Furthermore, despite whatever ivory-tower proponents might like to believe, it is unlikely that real-world individual accounts would require that benefits keep pace with inflation, last as long as the beneficiaries are alive, or protect surviving spouses as well as the current system. The result would be that an individual account system would not provide retirement security for the core layer of income as effectively as the current benefit structure.

[5] It is worth noting that many recent Social Security reform plans, including both Model 2 and Model 3 put forward by the President's Commission to Strengthen Social Security, would *not* hold Social Security harmless over the life of worker who chooses to divert funds to an individual accounts. Instead, these proposals entail lifetime subsidies to the accounts, and corresponding permanent costs to the government.

Social Security, the tax cuts, and the long-term deficit

A final point worth noting about Social Security reform is that the Social Security deficit plays some role, but a relatively modest one, in explaining our long-term fiscal problems. Perhaps the most vivid demonstration of this point is the chart below, taken from this year's *Economic Report of the President.* It shows the path of the deficit with and without one of the Social Security reform plans proposed by the President's Commission to Strengthen Social Security. The striking feature of the chart is that the long-term budget outlook does not change that much even if the type of reform favored by the Administration for addressing the long-term Social Security deficit were enacted.

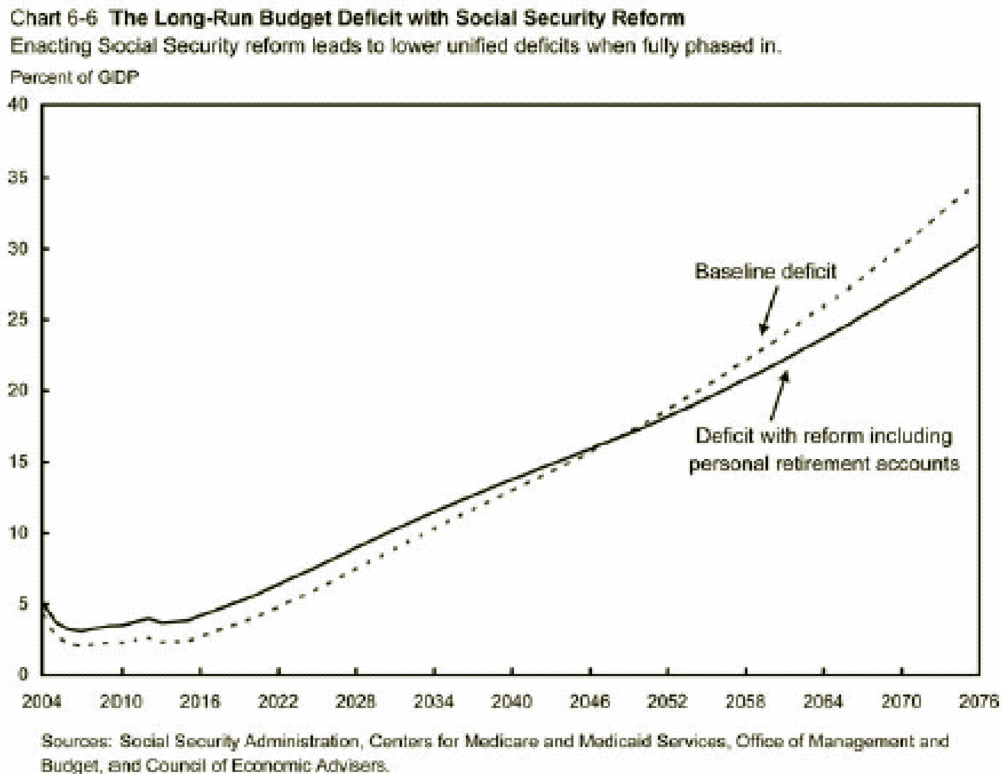
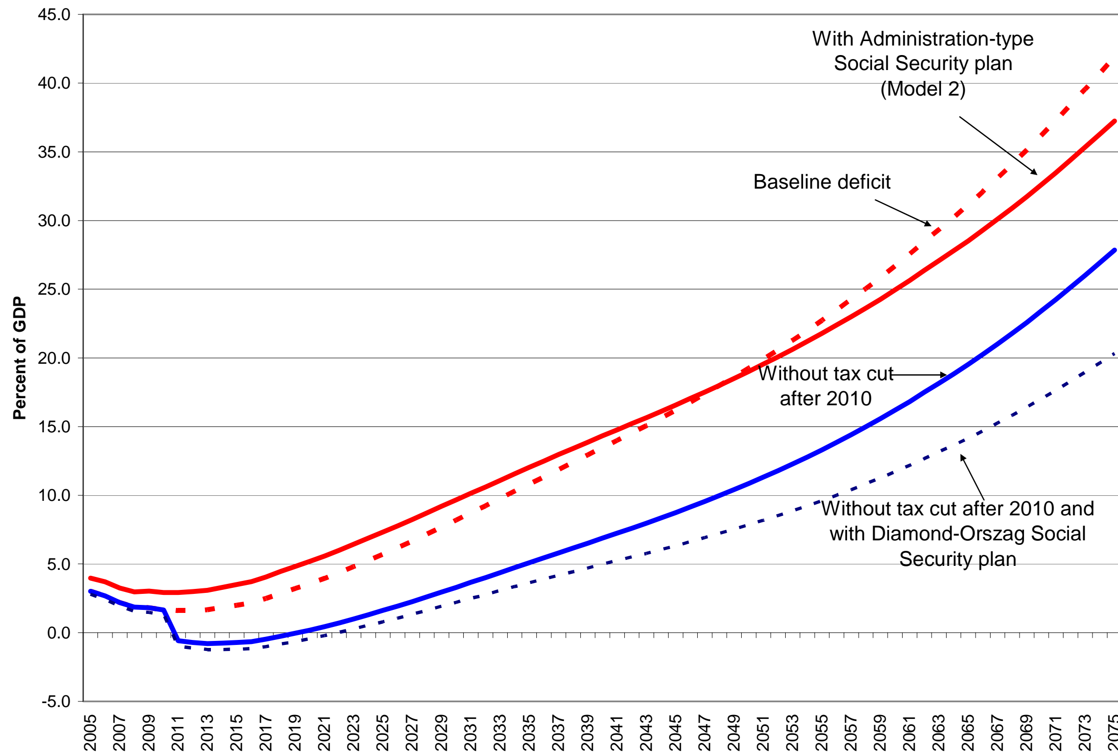


Figure 1 shows the projected deficit under a somewhat broader array of policy scenarios. The baseline deficits are very close to those presented by the Administration in the figure above; the baseline deficit in 2075 is about 40 percent of GDP, relative to about 35 percent under the Administration projections. As in the figure above, the path of the deficit is little affected by enacting the type of Social Security reform favored by the Administration (Model 2 proposed by the President's Commission to Strengthen Social Security, which was also the basis for the figures presented in the *Economic Report of the President*).

As Figure 1 shows, the tax cuts after 2010 exert a more significant influence on the projected deficit: Not extending the 2001 tax cut raises revenue, which then reduces accumulated

debt service costs. By 2075, the reduction in the unified deficit amounts to 13 percent of GDP – almost three times the reduction from the Administration's type of Social Security reform. (The figure assumes an AMT reform; in the absence of such a reform, the tax cuts would gradually be erased by the AMT even if they were officially extended.) If combined with the type of Social Security reform plan that I have proposed with Peter Diamond, the unified deficit in 2075 could be roughly cut in half relative to the baseline.

Figure 1: Unified deficits under different policy scenarios



II. Expanding retirement saving on top of Social Security

Social Security was always designed as a foundation upon which to build financial security during retirement and disability. The evidence suggests that many households, however, have little additional saving on top of Social Security. For example, 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 IRA) 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 inequality in pension contributions is also reflected in inequality in pension wealth (the accumulated value in a pension). Table 1 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 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.

Table 1: 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.

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.) 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

[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

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.

The flaws in recent legislation and proposed legislation

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.

A common theme in many recent policy proposals is that they increase the maximum amount that can be saved on a tax-preferred basis. For example, the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 raised the maximum amounts that can be contributed to IRAs and employer-based pension plans. 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. Information from the Congressional Budget Office on workers constrained by the previous 401(k) limits in 1997 suggests that only 6 percent of all 401(k) participants made the maximum contribution allowed by law.[7] 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. 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.

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). The Administration's proposal follows the basic

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from taxable to non-taxable forms is likely to produce a larger increase in private saving for any given reduction in government revenue.

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

thrust of policy changes delineated above in substantially expanding opportunities for tax-sheltered saving by high-income households.[8] 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.[9] An analysis by the Congressional Research Service reached similar conclusions.[10] 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.

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." 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.[11] 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 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

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[8] 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.

[9] Leonard Burman, William G. Gale, and Peter R. Orszag, "The Administration's Saving Proposals: A Preliminary Analysis," *Tax Notes*, March 3, 2003.

[10] 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.

[11] 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 of 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.

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.

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. 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 smaller credit rate applies up to $50,000 in income for joint filers.

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 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.

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.[12]

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

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

qualify for Medicaid.[13] 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 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.

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.

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[13] 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.

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.[14] As discussed below, defaults exert a substantial influence on saving behavior.

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.[15] Most recent studies underscore the importance of encouraging increased saving over time as the default.[16] *These types of plans are likely the most effective way of expanding retirement saving on top of Social Security.*

The challenge for policy-makers is to find ways to encourage more firms to adopt these automatic enrollment approaches. As some examples of helpful steps, policy-makers could clarify the preemption of state laws to the minimum extent necessary to accommodate automatic enrollment; grant fiduciary safe harbor treatment for selected default investments; allow a plan to disburse small account balances to an employee who decides to opt out soon after the automatic

[14] 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.
[15] 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.
[16] Richard H. Thaler and Shlomo Benartzi, "Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving," *Journal of Political Economy*, forthcoming.

enrollment begins without a penalty; and reform 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 Bush 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.