Bolstering Retirement Security

Remarks to the Stable Value Investment Association

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October 13, 2004

Thank you. The topic of my talk this morning is how we can encourage increased retirement saving on top of Social Security. I'd also be happy to answer questions about how we can shore up Social Security's own long-term finances, which was the focus of a recent book I co-authored with Professor Peter Diamond of MIT.

The bottom line is that too many Americans have little if any additional financial assets on top of Social Security:

- For example, half of households nearing retirement age have $10,000 or less in a 401(k) or IRA.
- Roughly a quarter of those offered the opportunity to participate in a 401(k) do not do so, and only about 5 percent of participants contribute the maximum allowable amount.
- Furthermore, workers often do not adequately diversify their investments.
- And when they change jobs, many cash out their retirement savings rather than transfer them to their new employer's plan or to an IRA.

Problems in the current retirement saving system

These failures largely result from two fundamental problems within the existing pension system. The first is that we impose obstacles on saving, rather than imposing obstacles on not saving. In other words, the defaults are generally backwards. In the defined benefit world, this didn't matter much, since workers didn't really have any decisions to make. But in the defined contribution world in which we increasingly find ourselves, it matters a lot.

[1] The views expressed are mine alone and should not be attributed to the trustees, officers, or staff of the Brookings Institution. 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, and Robert Greenstein of the Center on Budget and Policy Priorities. My co-authors should not be held responsible for the views expressed in this talk, however.

The second problem is that the financial incentives for saving provided through the tax code are also backwards. They give the strongest incentives to participate to higher-income households who least need to save more to live comfortably in retirement -- and who are the most likely to use pensions as a vehicle simply to shift assets from other accounts rather than to raise saving. At the same time, 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.

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 the additional tax breaks, while doing little to encourage lower- and moderate-income households to save more. And they fail to change the defaults in a meaningful way.

For example, the 2001 tax legislation 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 suggests that only 6 percent of all 401(k) participants made the maximum contribution allowed by law in 1997. 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 (or LSAs) and individual Retirement Saving Accounts (or RSAs). The Administration's proposal follows the basic thrust of recent policy changes in substantially expanding opportunities for tax-sheltered saving by high-income households.[2] The RSA/LSA proposal would also result in growing revenue losses over time.[3]

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[2] 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.

[3] Estimates from the Tax Policy Center, of which I am a co-director, suggest an annual revenue loss exceeding 0.3 percent of GDP after 25 years. An analysis by the Congressional Research Service reached similar conclusions. The TPC 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. As Robert Rubin has explained with regard to a similar proposal, "…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." And he should know. In any case, 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

A change in direction is necessary. I am directing a new Retirement Security Project, funded by the Pew Charitable Trusts, which is intended to chart a new course and focus attention on improving retirement security for moderate and low-income households.

The most exciting aspect of work in this area is that we know from growing research that substantial improvements are possible. Let me talk about two of the most important changes: making it easier for lower and moderate-income households to save, and increasing the financial incentive for them to do so.

Changing defaults and making it easier to save

First, a new body of empirical evidence highlights the importance of using the power of inertia to improve retirement security. 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.

Simply changing the default in this manner has a substantial effect on participation rates: Participation rates jump to between 85 and 95 percent once automatic enrollment takes effect. Empirical evidence also shows that savings rates are positively affected by 401(k)s that commit workers to saving part of their future pay raises, rather than trying to encourage workers to save at a higher rate immediately. The IRS has recently clarified that such plans can qualify as automatic enrollment plans.

Despite such encouraging evidence, automatic enrollment plans are still unfortunately the exception rather than the rule. To encourage the expanded use of these effective plans, we should remove the obstacles and provide stronger incentives for their adoption.

- For example, some firms are worried that automatic enrollment and related plans could violate state labor laws. Clarifying the preemption of state laws to the extent necessary to accommodate the plans would make sense.

- Some firms are also concerned that workers may change their minds soon after being enrolled; allowing firms to disburse small account balances to an employee

who decides to opt out soon after the automatic enrollment begins without a penalty would address this address.

- Finally, it is worth considering preferential treatment under the non-discrimination rules of plans that feature automatic enrollment, an adequate minimum contribution rate, and escalating contribution rates, as well as default investments in broadly diversified equity and bond index funds.

Another way of making it easier to save would allow tax refunds to be deposited into more than one account. This "split refund" proposal would allow taxpayers to split their tax refunds and direct portions of their refund into different accounts. This 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 $2,000, or about 5 percent of median income.

- 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. Many families are reluctant to have their entire refund deposited to a tax-preferred savings account, like an IRA.

- The split refund proposal would increase 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, along with evidence from a recent pilot project, suggests considerable opportunities for gains from allowing taxpayers simply to check a box on their tax return to save part of their refund.

Despite the promise of this split refund approach, implementation is stalled. The IRS should begin implementation immediately.

<u>Increasing financial incentives for saving</u>

Another key step in bolstering retirement income security among lower- and moderate-income workers is increasing their financial incentives to save. The most promising mechanism to achieve this objective involves a progressive government matching formula – one that provides relatively larger matches for saving done by lower-income workers than higher-income workers. This would help to level the incentives for saving, which are currently upside-down.

One component of the 2001 tax 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. Married couples with income of $30,000 or less are eligible for a maximum 50 percent tax credit – so if you save $2,000, you get a $1,000 tax credit. A smaller credit rate applies up to $50,000 in income for married couples. In 2002, the first year that the credit existed, more than 5 million households benefited from it.

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. First, since the tax credit is not refundable, it provides *no* additional saving incentive to families who otherwise qualify on paper based on their income. These people are excluded because they have no income tax liability against which the credit could be applied. In particular, more than 60 million households have incomes low enough to qualify for the 50 percent credit. Since the credit is non-refundable, however, only about one-sixth of these tax filers could actually receive any benefit from the credit if they contributed to an IRA or 401(k).

2. Second, 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 and therefore provides little incentive to participate.

3. Third, 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. Finally, the credit officially sunsets in 2006.

To address these shortcomings, policy-makers could 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. Strengthening the saver's credit in this manner offers the most auspicious approach to bolstering the financial incentives for lower- and moderate-income households to save for retirement.

Another way to increase such incentives involves asset tests. To be eligible for

many means-tested benefits, such as Food Stamps or Medicaid, applicants generally must meet an asset test as well as an income test. Some resources, including defined benefit pensions, are excluded from these asset tests. Other assets count, including in many cases 401(k) assets and IRAs. Thus, moderate- and lower-income workers who participate in 401(k) plans or IRAs often must withdraw most or all 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 means-tested programs. These rules discourage workers from saving in the accounts in the first place and need to be rethought. It makes little sense to impose a steep implicit tax on saving in this manner.

Conclusion

Let me conclude merely by noting that we should not despair at the relatively meager retirement accounts of many Americans. A growing body of evidence suggests that through relatively simple changes, we can accomplish a great deal. The four specific steps I have highlighted today – encouraging automatic enrollment plans, creating split refunds, strengthening the saver's credit, and reducing the implicit tax on saving imposed under means-tested benefit programs – are not particularly complicated. But by helping to remove the obstacles to saving and to increase the financial incentives to do so, they would move public policy in a much more promising direction than the path we have been on.

Thank you again for the opportunity to speak with you this morning, and I look forward to your questions both about these ideas and about Social Security.