Improving Retirement Security

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Mr. Chairman and other members of the Committee, thank you for inviting me to testify before the Committee this morning. The past 25 years have seen a dramatic shift in our nation's pension system away from defined benefit plans and toward defined contribution accounts such as 401(k)s and IRAs. Our public policies, however, have largely not been updated to reflect the increased responsibility that has been placed on workers to prepare for their own retirements. To this end, my testimony makes two central points.

First, retirement security can be substantially improved and strengthened through a series of common sense reforms that would make the defined contribution pension system easier to navigate and more rewarding for American families. A growing body of empirical evidence, including a path-breaking new study conducted by The Retirement Security Project in conjunction with H&R Block, suggests significant benefits if we make it easier for middle- and lower-income households to save for retirement and increase their incentives to do so.

My testimony highlights four key policy changes to improve retirement security for middle- and lower-income households: (a) automating 401(k) plans to reduce the decision-making burden on workers, (b) implementing split tax refunds so that workers could deposit part of their tax refund into a retirement account, (c) revamping the existing Saver's Credit so that it provides a more effective and transparent matching incentive for retirement contributions, and (d) reducing the steep and confusing implicit taxes on retirement saving often imposed through means-tested benefit programs such as Food Stamps, Medicaid, and Supplemental Security Income. Both sides of the Social Security debate can embrace these common sense reforms to make the individual accounts we already have, in the form of 401(k)s and IRAs, work better.

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[1] The views expressed here are those of the author alone. Much of this testimony is based upon joint work with Len Burman, Peter Diamond, Esther Duflo, William Gale, Robert Greenstein, Mark Iwry, Jeffrey Liebman, and Emmanuel Saez. I also thank the staff of The Retirement Security Project and Tax Policy Center for their contributions and assistance, Bernie Wilson and other officials at H&R Block for their work on the matched savings experiment described below, and The Pew Charitable Trusts for its support of The Retirement Security Project.

Second, too much of our existing tax preferences for retirement saving simply subsidize asset shifting into tax-preferred accounts by households who are already well-prepared for retirement, undermining the public policy benefit from the tax incentives. Contributions to tax-advantaged retirement accounts that are financed by shifting other assets into the accounts do not increase private saving, and the empirical evidence suggests that is often what occurs, especially among higher-income households.[2] Such households, furthermore, tend to be better prepared for retirement in any case. Policy changes to bolster retirement saving should instead be focused on middle- and lower-income households who typically have few other assets that could be shifted into tax-preferred saving and who are not fully taking advantage of existing opportunities to save.

Expanded income tax deductions, higher contribution limits, and higher income limits are all inconsistent with the objective of encouraging saving among middle- and low-income households, and would therefore only exacerbate the serious flaws in the existing system. The vast majority of middle- and low-income households are in low marginal income tax brackets, so that policies based on expanded tax deductions (as opposed to credits or matching contributions) do little to help them. Similarly, expanding income or contribution limits on tax-preferred retirement accounts would do little to help these households, since the vast majority are not contributing the maximum amounts already allowed and are also not affected by existing income limits. Instead, expanded deductions, higher income limits, and increased contribution limits are likely to result mostly in substantial asset shifting, as high-income households move saving from other forms into the tax-preferred one. In other words, such proposals are likely to represent an expensive tax subsidy for saving that high-income households would have done in any case. Since the nation's fiscal outlook is already dismal, reducing tax revenue to provide further subsidies for asset shifting among households already well-prepared for retirement seems misguided from a public policy perspective.

In addition to these two core points, my testimony highlights two others. First, ill-advised policies that result in yet more subsidized asset shifting should not be the "price" of enacting sound policies to help middle- and lower-income families. Second, any new preferences for retirement saving, whatever their merit, should be fully offset both over the short term and the long term. The proliferation of back-loaded tax preferences for saving, in which budgetary costs are disguised in the short run, underscores the need for extending the time horizon over which proposals should be offset beyond the traditional 10-year period.

[2] Early research on 401(k)s found that the saving plans raised saving at all levels of income. Subsequent research, which has improved upon the statistical techniques of earlier work, has tended to find that 401(k) plans have not increased saving among relatively high-income households, but may have raised saving of low-income households. See, for example, Eric M. Engen and William G. Gale, "The Effects of 401(k) Plans on Household Wealth: Differences Across Earnings Groups," Working Paper 8032 (Cambridge, Mass.: National Bureau of Economic Research, December 2000), and Daniel Benjamin, "Does 401(k) Eligibility Increase Saving? Evidence from Propensity Score Subclassification," Journal of Public Economics 87, no. 5-6 (2003): 1259-90.

I. Increasing Retirement Security for Middle- and Low-Income Households

The trend over the past two decades away from traditional, employer-managed plans and toward saving arrangements directed and managed largely by employees themselves, such as 401(k)s and IRAs, is in many ways a good thing. Workers enjoy more freedom of choice and more control over their own retirement planning. But for too many households, the 401(k) and IRA revolution has fallen short.

The most vivid manifestation of the shortcomings of today's private pension arrangements is the simple fact that many families approaching retirement age have meager retirement saving, if any.[3] In 2001, half of all households headed by adults aged 55 to 59 had $10,000 or less in an employer-based 401(k)-type plan or tax-preferred savings plan account. These households clearly have the option to save: Most workers have accounts available to them in which they could save money on a tax-preferred basis for retirement, and almost all households lacking such an option could contribute to an IRA. The problems lie elsewhere and are essentially twofold.

The first problem is that the system is too complicated. My colleague, William Gale, has remarked that you don't have to be a mechanic to drive a car and you shouldn't need a Ph.D. in financial economics to navigate the pension system. In the face of the difficult choices presented by the current system, many people simply procrastinate making any decision, which dramatically raises the likelihood that they will not save enough for retirement within the current system.

The second problem is that for the vast majority of middle- and low-income households, existing incentives to save for retirement are weak or non-existent. (Indeed, in some cases described further below, federal policy actually *penalizes* those who save for retirement in a 401(k) or IRA.) The primary policy tool used to encourage participation in employer-based retirement plans and IRAs is a set of deductions and exclusions from federal income tax. The immediate value of any tax deduction or exclusion, though, depends directly on one's income tax bracket. For example, a taxpaying couple with $6,000 in deductible IRA contributions saves $1,500 in tax if they are in the 25 percent marginal tax bracket, but only $600 if they are in the 10 percent bracket.[4] The income tax incentive approach thus provides the smallest benefits to the middle- and lower-income families in the lower marginal tax brackets, who are the ones most in need of saving more for basic needs in retirement. Furthermore, as a strategy for

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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 Agenda for the Nation, edited by Henry J. Aaron, James M. Lindsay, and Pietro S. Nivola (Brookings, 2003), pp. 183-216; Peter R. Orszag, "Progressivity and Saving: Fixing the Nation's Upside-Down Incentives for Saving," Testimony before the House Committee on Education and the Workforce, February 25, 2004; and J. Mark Iwry, "Defined Benefit Pension Plans," Testimony before the House Committee on Education and the Workforce, Subcommittee on Employer-Employee Relations, June 4, 2003. These and other related publications are available on The Retirement Security Project website (www.retirementsecurityproject.org).

[4] Some of this difference may be recouped when the contributions are withdrawn and taxed, if families who are in lower tax brackets during their working years are also in lower tax brackets during their retirement.

promoting national saving, the subsidies are poorly targeted. Higher-bracket households are disproportionately likely to respond to the incentives by shifting existing assets from taxable to tax-preferred accounts. To the extent such shifting occurs, the net result is that the pensions serve as a tax shelter, rather than as a vehicle to increase saving. In contrast, middle- and lower-income households, if they participate in pensions, are most likely to use the accounts to raise net saving.

To address these two key problems with 401(k)s and IRAs, policy-makers should make saving for retirement easier and increase the incentives for middle- and lower-income households to save for retirement. Let me give two specific examples of how saving can be made easier, and two specific examples of how incentives could be bolstered for middle- and lower-income families.[5]

A. Making It Easier to Save

To make it easier for households to save, policy-makers should encourage greater adoption of automatic 401(k)s and allow part of income tax refunds to be deposited directly into a retirement account.

Automating the 401(k)

A 401(k)-type plan typically leaves it up to the employee to choose whether to participate, how much to contribute, which of the investment vehicles offered by the employer to select, and when to pull the funds out of the plan and in what form. Workers are thus confronted with a series of financial decisions, each of which involves risk and a certain degree of financial expertise. Many workers shy away from these decisions and simply do not choose. Those who do choose often make poor choices.

To improve the design of the 401(k), we should recognize the power of inertia in human behavior and enlist it to promote rather than hinder saving.[6] Under an automatic 401(k), each of the key events in the process would be programmed to make contributing and investing easier and more effective.

- **Automatic enrollment**: Employees who fail to sign up for their company's 401(k) plan -- whether because of simple inertia or procrastination, or perhaps because they are not sufficiently well organized or are daunted by the choices confronting them -- would become participants automatically, although they would preserve the option of declining to participate. In other words, workers would be included unless they opted out, instead of being excluded unless they opt in.

[5] For further information on these and other common sense reforms to bolster retirement security, see www.retirementsecurityproject.org.

[6] William G. Gale, J. Mark Iwry, and Peter R. Orszag, "The Automatic 401(k): A Simple Way to Strengthen Retirement Savings," Retirement Security Project Policy Brief No. 2005-1, March 2005.

- **Automatic escalation**: Employee contributions would automatically increase in a prescribed manner over time, for example raising the contribution rate as a share of earnings whenever a worker experiences a pay increase, again with an option of declining to increase contributions in this fashion.

- **Automatic investment**: Funds would be automatically invested in balanced, prudently diversified, low-cost vehicles, such as broad index funds, life-cycle funds, or professionally managed funds, unless the employee makes other choices. Such a strategy would improve asset allocation and investment choices while giving employers reasonable protection from potential fiduciary liabilities associated with these default choices.

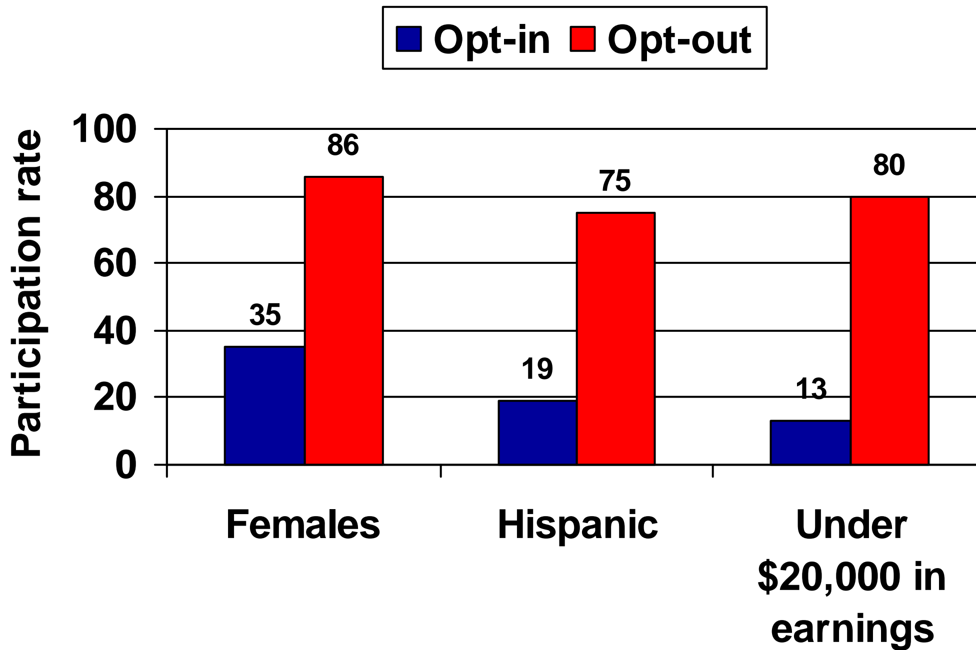
- **Automatic rollover**: When an employee switches jobs, the funds in his or her account would be automatically rolled over into an IRA, 401(k) or other plan offered by the new employer. At present, many employees receive their accumulated balances as a cash payment upon leaving an employer, and many of them spend part or all of it. Automatic rollovers would reduce such leakage from the tax-preferred retirement saving system. At this stage, too, the employee would retain the right to override the default option and place the funds elsewhere or take the cash payment.

In each case – automatic enrollment, escalation, investment, and rollover – workers can always choose to override the defaults and opt out of the automatic design. Automatic retirement plans thus do not dictate choices any more than does the current set of default options, which exclude workers from the plan unless they opt to participate. Instead, automatic retirement plans merely point workers in a pro-saving direction when they decline to make explicit choices of their own.

These steps have been shown to be remarkably effective, as research by Richard Thaler and others has demonstrated. For example, one of the strongest empirical findings from behavioral economics is that automatic enrollment boosts the rate of plan participation substantially (Figure 1).[7] As the figure shows, automatic enrollment is particularly effective in boosting participation among those who often face the most difficulty in saving.

[7] Brigitte Madrian and Dennis Shea, "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior," Quarterly Journal of Economics 116, no. 4 (November 2001): 1149-87; and James Choi and others, "Defined Contribution Pensions: Plan Rules, Participant Decisions, and the Path of Least Resistance," in Tax Policy and the Economy, Vol. 16, edited by James Poterba (MIT Press, 2002), pp. 67-113.

Figure 1: Effects of automatic enrollment on participation rates



Source: Madrian and Shea

Despite its demonstrated effectiveness in boosting participation, automatic enrollment is relatively new – and a small but growing share of 401(k) plans today include this feature. According to a recent survey, about one-tenth of 401(k) plans (and one-quarter of plans with at least 5,000 participants) have switched from the traditional "opt-in" to an "opt-out" arrangement.[8] Since automatic enrollment is a recent development, it may become more widely adopted over time even with no further policy changes. But policy-makers could accelerate its adoption through several measures. Some of these policy measures would be appropriate only if automatic enrollment were adopted in conjunction with other features of the automatic 401(k), especially automatic escalation:

- First, the laws governing automatic enrollment could be better clarified. In some states, some employers see their state labor laws as potentially restricting their ability to adopt automatic enrollment. Although many experts believe that federal pension law preempts such state laws as they relate to 401(k) plans, additional federal legislation to explicitly confirm that employers in all states may adopt this option would be helpful.

- Second, some plan administrators have expressed the concern that some new, automatically enrolled participants might demand a refund of their contributions, claiming that they never read or did not understand the automatic enrollment notice. This could prove costly, because restrictions on 401(k) withdrawals

[8] Profit Sharing/401(k) Council of America, 47th Annual Survey of Profit Sharing and 401(k) Plans (2004).

typically require demonstration of financial hardship, and even then the withdrawals are normally subject to a 10 percent early withdrawal tax. One solution would be to pass legislation permitting a short "unwind" period in which an employee's automatic enrollment could be reversed without paying the normal early withdrawal tax.

- Third, Congress could give plan sponsors a measure of protection from fiduciary liability for sensibly designed, low-cost default investments. If workers are automatically enrolled, their contributions have to be invested in something – and some firms are worried about fiduciary liability for these default investments. A targeted exemption from fiduciary liability given a prudent default would provide meaningful protection under the Employee Retirement Income Security Act of 1974 (ERISA), thus encouraging more employers to consider automatic enrollment. Defining a range of prudent defaults would enhance this safe harbor.

- Fourth, Congress could establish the federal government as a standard-setter in this arena by incorporating automatic enrollment and automatic escalation into the Thrift Savings Plan, the defined contribution retirement saving plan covering federal employees. The Thrift Savings Plan already has a high participation rate, but if automatic enrollment increased participation by even a few percentage points, that would draw in tens of thousands of eligible employees who are not currently contributing. The Thrift Savings Plan's adoption of automatic enrollment, along with automatic escalation, would also serve as an example and model for other employers.

- Finally, broader adoption of automatic enrollment and the other key pieces of the automatic 401(k) could be encouraged by reforming the regulations governing nondiscrimination in 401(k) plans. Many firms are attracted to automatic enrollment because they care for their employees and want them to have a secure retirement, while others may also be further motivated by the associated financial incentives, which stem in large part from the 401(k) nondiscrimination standards. These standards were designed to condition the amount of tax-favored contributions permitted to executives and other higher-paid employees on the level of contributions made by other employees. In recent years, however, employers have had the option to satisfy the nondiscrimination standards merely by adopting a 401(k) "matching safe harbor" design. The matching safe harbor provision exempts an employer from the nondiscrimination standards that would otherwise apply as long as the firm merely *offers* a specified employer matching contribution. It does not matter whether employees actually take up the match offer -- all that matters is that the offer was made. Firms using this safe harbor may have less interest in widespread employee participation in 401(k)s than other firms, thus posing an obstacle to wider adoption of automatic enrollment. Policy-makers should consider various ways of addressing this obstacle.[9]

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[9] One possibility is to change the existing rules so as to allow the matching safe harbor only for plans that feature automatic enrollment and the other key parts of the automatic 401(k). Plan sponsors currently using the matching safe harbor could be given a transition period to meet the new requirements. Another

In sum, a growing body of evidence suggests that the judicious use of default arrangements -- arrangements that apply when employees do not make an explicit choice on their own, and that could be overridden by employees at each decision point -- holds substantial promise for expanding retirement saving. Retooling America's voluntary, tax-subsidized 401(k) plans to make sound saving and investment decisions more automatic, while protecting freedom of choice for those participating, would require only a relatively modest set of policy changes -- and the steps taken thus far are already producing good results. Expanding these efforts will make it easier for millions of American workers to save, thereby promising greater retirement security.

Allowing part of a tax refund to be deposited into an IRA

Most American households receive an income tax refund every year. For many, the refund is the largest single payment they can expect to receive all year. Accordingly, the more than $200 billion issued annually in individual income tax refunds presents a unique opportunity to increase personal saving.

Currently, taxpayers may instruct the Internal Revenue Service to deposit their refund in a designated account at a financial institution. The direct deposit, however, can be made to only one account. This all-or-nothing approach discourages many households from saving any of their refund. Some of the refund is often needed for immediate expenses, so depositing the entire amount in a saving account is not a feasible option. Yet directly depositing only *part* of the refund in such an account is not possible.

Allowing taxpayers to split their refund could make saving simpler and, thus, more likely -- especially if combined with the stronger incentives to save discussed below. The Administration has supported divisible refunds in each of its last two budget documents, but the necessary administrative changes have not yet been implemented. The Internal Revenue Service could provide a split refund option by administrative action without the need for legislation. Although implementation does raise a variety of administrative issues, none of these administrative issues presents an insuperable obstacle, and implementation should move ahead more aggressively than currently planned.

Once refund splitting was implemented, a key obstacle that might limit participation, is the need for the tax filer to have an IRA to receive the refund. If a household does not already have an IRA, an IRA would have to be set up, which may be a significant impediment in some cases. One possibility would be to allow taxpayers who do not already have an IRA, to direct on their tax return that the government open an IRA in their name at a designated "default" financial institution that has contracted with the government to provide low-cost IRAs for this and related purposes. Another possibility, suggested by Professor Peter Tufano of Harvard Business School, is to allow

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possibility is to explore a much broader reform of the nondiscrimination rules, under which automatic 401(k) plans would be given preferential treatment relative to other plans.

tax filers to elect part of their refund to be invested in a government savings bond, which would not require an IRA to be created in their name.

In summary, allowing households to split their tax refunds and deposit part of them directly into an IRA would make saving easier. Since federal individual income tax refunds total some $228 billion a year, even a modest increase in the proportion of refunds saved could represent a significant increase in saving.

B. Increasing the incentive to save

In addition to making it easier to save, policy-makers should significantly expand the incentives for middle- and lower-income households to do so.

A new study conducted by The Retirement Security Project in conjunction with H&R Block underscores the significant effect that incentives have on retirement contributions, even among middle- and low-income households.[10] The study reports evidence from the first large-scale, randomized field experiment ever conducted regarding the effects of matching rates on the willingness of low- and middle-income families to contribute to IRAs.

Since the study may prove useful to policy-makers struggling with how to encourage contributions by middle- and lower-income households, I will briefly describe both the experimental design and the results. The experiment was run in 60 H&R Block tax preparation offices in the St. Louis metro area from March 5th to April 5th, 2005. It was built around the Express IRA (X-IRA) product offered by H&R Block, which allows clients to make IRA contributions at the time of tax preparation and to fund those contributions with part or all of their federal income tax refunds or from other sources. In effect, through its X-IRA, H&R Block allows clients to split their anticipated refund between contributions to a retirement account and other uses.

Each client preparing a tax return in one of the 60 H&R Block offices during the period was randomly assigned to one of three match rates for X-IRA contributions: zero (the control group), 20 percent, or 50 percent.[11] By randomizing the matching rate across tax filers, the study was able to identify not only the impact of the presence of a match, but also how variations in the matching rate affect both take-up and contribution levels.

Figure 2 shows the effect of the match rate on participation rates, and Figure 3 shows the effect on average contributions, among those in the different match groups.

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[10] Esther Duflo, William Gale, Jeffrey Liebman, Peter Orszag, and Emmanuel Saez, “Saving Incentives for Low- and Middle-Income Families: Evidence from a Field Experiment with H&R Block,” Retirement Security Project Policy Brief No 2005-5, May 2005.

[11] Contributions were matched up to $1,000, a limit that applied separately for each spouse for married tax filers. Each client, including those in the control group, received a waiver of the $15 set-up fee for opening an X-IRA. The minimum X-IRA contribution is $300.

Figure 2 shows that the match had a significant effect on participation rates; participation rose from 3 percent to 17 percent as the match rate increased from zero to 50 percent.

Figure 2: Effect of match rate on participation

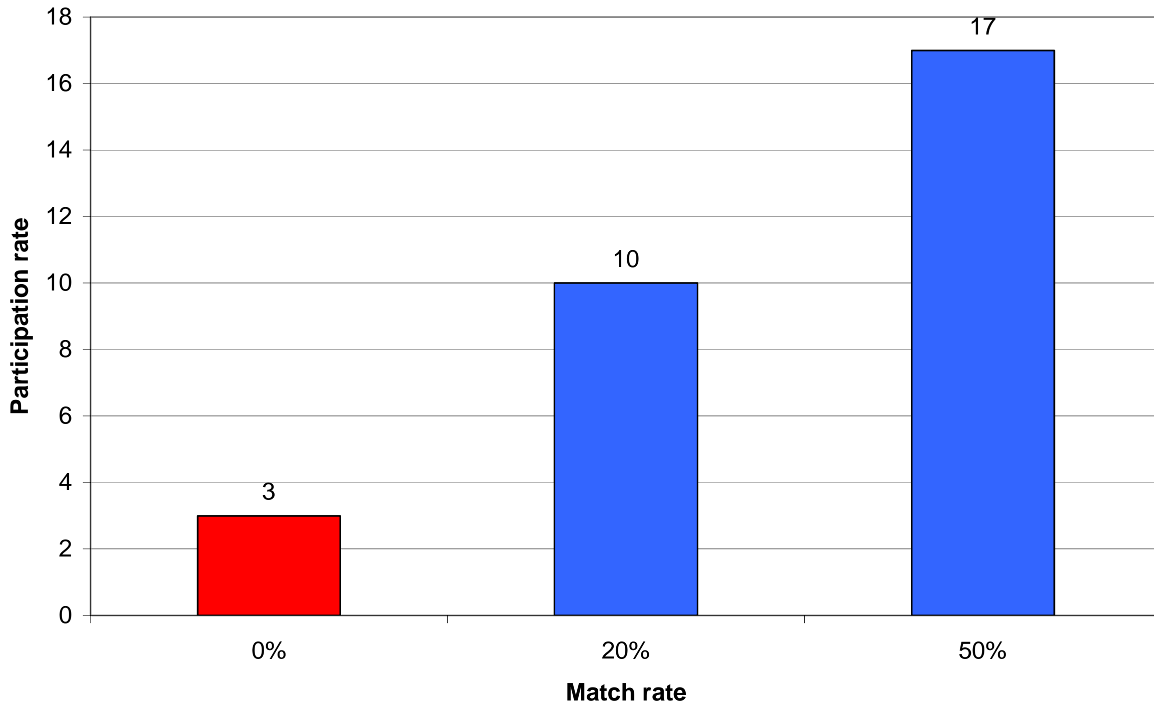


Figure 3 shows that the effects on overall amounts contributed were even stronger. Deposits made by individuals (i.e., excluding the match from H&R Block) in the match groups were between four and eight times higher than with no match.

The positive effect of incentives on participation and contributions was stronger among married filers than among singles, and stronger among higher-income households than lower-income households. Nonetheless, the effects remained striking and significant even among low-income households. Figure 4, for example, splits the sample into EITC recipients and non-EITC recipients and shows the effects of the match rate on participation; the 50 percent match generated a substantial increase in participation rates even among EITC recipients.

Interestingly, the study found more modest effects on take-up and amounts contributed from the existing Saver's Credit, which is described below and provides an effective match for retirement saving contributions through the tax code. We suspect that the differences reflect the way in which the implicit match from the Saver's Credit is presented, the complexity associated with the variation in credit rates under the Saver's Credit and its non-refundability, and the fact that the match in the experiment was highlighted and explained to clients by H&R Block's tax professionals.

Figure 3: Effect of match rate on average contributions

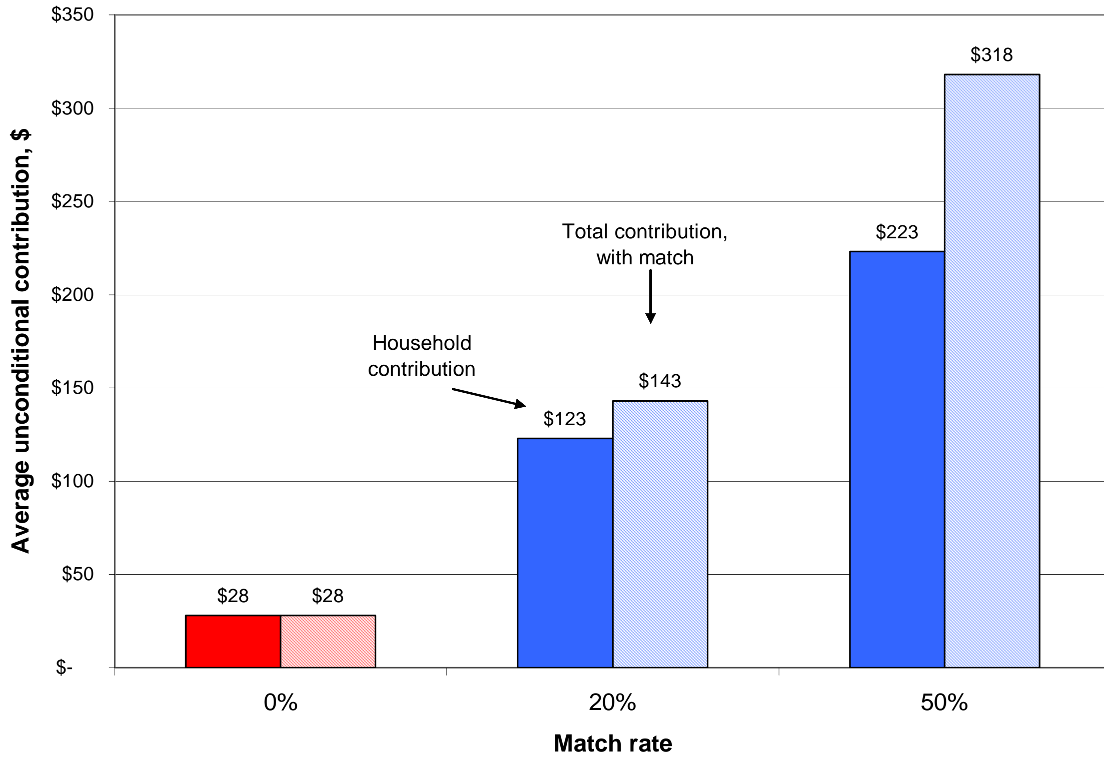
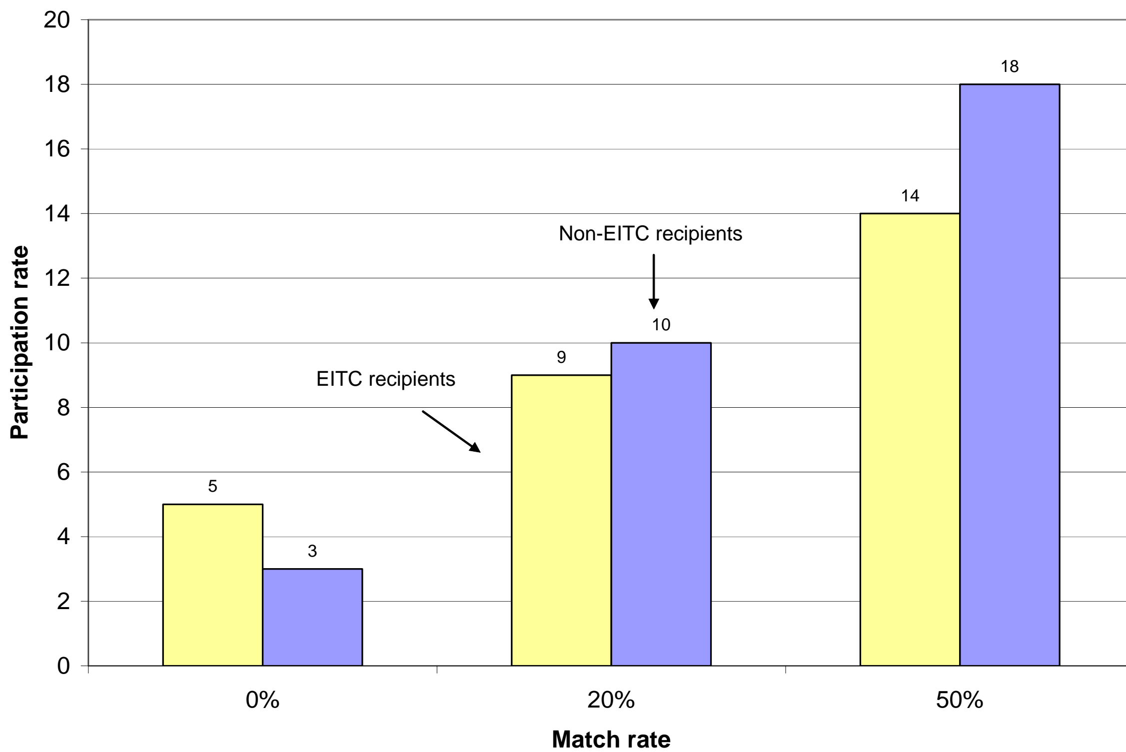


Figure 4: Effect of match rate on EITC and non-EITC recipients



Taken together, the results suggest that the combination of a clear and understandable match for saving, easily accessible saving vehicles, the opportunity to use part of an income tax refund to save, and professional presentation and explanation of the match and its advantages could generate a significant increase in retirement saving participation and contributions, even among middle- and low-income households. Below I suggest ways in which the fundamental insights provided by this new research could be implemented.

Revamping the Saver's Credit

The Saver's Credit, enacted in 2001, in effect provides a government matching contribution, in the form of a nonrefundable tax credit, for voluntary individual contributions to 401(k) plans, IRAs, and similar retirement saving arrangements.[12] The Saver's Credit applies to contributions of up to $2,000 per year per individual. As Table 1 shows, the credit rate is 50 percent for married taxpayers filing jointly with adjusted gross income (AGI) up to $30,000, 20 percent for joint filers with AGI between $30,001 and $32,500, and 10 percent for joint filers with AGI between $32,501 and $50,000. The same credit rates apply for other filing statuses, but at lower income levels: the AGI thresholds are 50 percent lower for single filers and 25 percent lower for heads of households.

Table 1: Saver's Credit

AGI range for:					
Joint filers	Singles	Credit rate	Tax credit for $2,000 contribution	After-tax cost incurred by individual to create $2,000 account balance	Effective after-tax matching rate
0-$30,000	0-$15,000	50%	$1,000	$1,000	100%
$30,001-$32,500	$15,001-$16,250	20%	$400	$1,600	25%
$32,501-$50,000	$16,251-$25,000	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 the effects of tax deductions or exclusions that might be associated with the contributions or any employer matching contributions.

The credit represents an implicit government matching contribution for eligible retirement saving contributions. The implicit matching rate generated by the credit, though, is significantly higher than the credit rate itself. The 50 percent *credit* rate for gross contributions, for example, is equivalent to having the government *match* after-tax contributions on a 100 percent basis. Consider a couple earning $30,000 who contributes $2,000 to a 401(k) plan or IRA. The Saver's Credit reduces that couple's federal income tax liability by $1,000 (50 percent of $2,000). The net result is a $2,000 account balance that cost the couple only $1,000 after taxes (the $2,000 contribution

[12] For more detail on the Saver's Credit, see William G. Gale, J. Mark Iwry, and Peter R. Orszag, "The Saver's Credit: Expanding Retirement Savings for Middle-and Lower-Income Americans," Retirement Security Project Policy Brief, No. 2005-2, March 2005.

minus the $1,000 tax credit). This is the same result that would occur if the net after-tax contribution of $1,000 were matched at a 100 percent rate: the couple and the government each effectively contribute $1,000 to the account. Similarly, the 20 percent and 10 percent credit rates are equivalent to a 25 percent and an 11 percent match, respectively (Table 1).

The results of the recent randomized experiment suggest that the presence of an easily understandable and transparent 50 percent match significantly raises participation in and contributions to IRAs. The results confirm the basic idea behind the existing Saver's Credit: offering a stronger incentive to save to low- and moderate-income households can encourage them to contribute significantly more to retirement accounts. The study also suggests, however, that the existing Saver's Credit could be made more effective in encouraging additional contributions. Some options to do so are already under active discussion among policy-makers.

First, it is possible that the credit would be more salient and effective if it were redesigned as a matching contribution that goes into the account, rather than a tax credit. As the table on the previous page shows, the current design results in a substantially higher implicit match rate than the credit rate. Instead of the current design in which a tax credit generates cash for a worker, it may be desirable to have matching contributions made directly to a worker's account.

Second, the non-refundability of the current credit complicates its presentation and substantially reduces the number of people eligible for it. In 2005, 59 million tax filers will have incomes low enough to qualify for the 50 percent credit.[13] Since the existing credit is non-refundable, however, only about one-seventh of them actually would benefit from the credit *at all* by contributing to an IRA or 401(k). Furthermore, only 43,000 -- or fewer than one out of every 1,000 -- filers who qualify based on income could receive the maximum credit ($1,000 per person) if they made the maximum contribution. These are the households who have sufficient tax liability to benefit in full from the Saver's Credit but sufficiently low income to qualify for the highest match rate. The incentives provided by a matching program for retirement contributions should be extended to lower-income working families.

One possible revamping of the credit would thus take the following form:

- **Eligibility**: Tax filers would be eligible if they have made IRA or 401(k)-type contributions and have Adjusted Gross Income below the qualifying thresholds.[14]

- **Match rate**: The government would match 50 percent of first $2,000 in contributions made by eligible tax filers to an IRA or 401(k)-type plan. Each

[13] These estimates are generated by the Urban-Brookings Tax Policy Center microsimulation model.

[14] In addition, eligibility would be restricted to filers age 18 or over who are not full-time students and are not claimed as dependents on another return. These eligibility conditions are the same as the existing Saver's Credit.

spouse in a couple filing a joint return would be eligible for a match on up to $2,000. The match would be made regardless of the tax filer's income tax liability.

- **Phase-out**: The maximum eligible contribution would fall from $2,000 to $0 linearly between $30,000 and $50,000 in Adjusted Gross Income for joint filers (the phase-out would occur from $15,000 to $25,000 for singles and married filing separately; and from $30,000 to $40,000 for heads of households).

- **Matching contribution deposited to account**: The matches would be deposited directly to the IRA and 401(k) accounts of eligible taxpayers after the tax return has been processed.

- **Anti-gaming rules**: A variety of protections could be enacted to ensure that tax filers did not "game" the system.

A matching contribution of this type offers significant potential to help correct the nation's upside-down tax incentives for retirement.

Reducing the implicit taxes on retirement saving imposed by asset tests

Another way of increasing the incentives for middle- and low-income households to save is by removing *penalties* imposed on such saving. In particular, the asset rules in means-tested benefit programs often penalize any moderate- and low-income families who do save for retirement in 401(k)s or IRAs by disqualifying them from the means-tested benefit program. The asset tests thus represent a substantial implicit tax on retirement saving.

The major means-tested benefit programs, including Food Stamps, cash welfare assistance, and Medicaid either require or allow states to apply asset tests when determining eligibility. Similarly, the Supplemental Security Income (SSI) program applies such an asset test. The asset tests may force households that rely on these benefits -- or might rely on them in the future -- to deplete retirement saving before qualifying for benefits, even when doing so would involve a financial penalty. As a result, the asset tests penalize low-income savers.

The asset tests represent one of the most glaring examples of how our laws and regulations have failed to keep pace with the evolution from a pension system based on defined benefit plans to one in which defined contribution accounts play a much larger role. At the time the rules were developed, defined benefit plans were the norm and were generally disregarded in applying the asset tests. In part because they were not viewed as a primary pension vehicle when the rules were written, defined contribution accounts like 401(k)s and IRAs were not exempted. Since then, the pension system has shifted away from defined benefit plans, and defined contribution accounts have become more dominant. Yet the rules have largely not been updated since, so many programs still exempt defined benefit plans while counting 401(k)s and IRAs. (As one example within

the jurisdiction of this Committee, the asset test within SSI generally counts all resources "deemed accessible" to an individual. As a result, both IRAs and 401(k)s are generally counted toward the SSI asset limit, but defined benefit plans do *not* count as assets for current employees.) Treating defined benefit and defined contribution plans similarly would be much more equitable and would remove a significant barrier to increasing retirement saving by low-income working households.

The effect of counting 401(k)s or IRAs within the asset tests is not only unfair, it also likely discourages saving for retirement. Furthermore, the rules applied under the means-tested benefit programs are confusing and often treat 401(k) accounts and IRAs in a seemingly arbitrary manner. As just one example of the complexity, workers who roll their 401(k) over into an IRA when they switch jobs, as many financial planners suggest they should, could disqualify themselves from the Food Stamp program.

Asset tests in means-tested programs, as currently applied, thus constitute a barrier to the development of retirement saving among the low-income population. Disregarding saving in retirement accounts when applying the tests would allow low-income families to build retirement saving without having to forgo means-tested benefits at times when their incomes are low during their working years.[15]

II. Avoiding Further Tax Subsidies for Asset Shifting

The four common sense reforms described above could significantly bolster retirement security for millions of Americans. However, some policy-makers seem inclined to couple these proposals with a number of other provisions that would expand income and contribution limits on tax-preferred retirement accounts. Although they may initially sound similar to those above, such proposals are fundamentally different: Rather than bolstering retirement security among middle- and lower-earners, proposals to increase income and contribution limits would generate significant asset shifting and be of primary benefit to households who are already disproportionately well-prepared for retirement. Policy-makers should not be tempted by a "deal" under which substantial new tax subsidies for this type of asset shifting would be created in exchange for sensible policies to bolster retirement security among middle- and lower-income households.

The problems with the Retirement Savings Account proposal

The Retirement Savings Account (RSA) proposed by the Administration is basically a Roth IRA with no income limit. (The proposal may be presented as "creating a Retirement Savings Account" rather than eliminating the income limit on Roth IRAs. The RSA, however, is virtually identical to the Roth IRA except that, unlike the Roth, the RSA has no income limit.) Simply removing the income limit on the existing Roth IRA,

[15] A forthcoming paper from The Retirement Security Project will examine these changes in more detail. Policy-makers considering introducing accounts within Social Security should also be careful to ensure that such accounts would not be counted under the asset tests included in various means-tested benefit programs.

though, would have no direct benefit for the vast majority of American households who are already under the current income limit.

Since access to Roth IRAs currently begins to be curtailed at $150,000 for couples and $95,000 for singles, the only people who would directly benefit from eliminating the cap are married couples with incomes above $150,000 or singles with incomes above $95,000.[16] Analysis using the retirement saving module from the Urban-Brookings Tax Policy Center (TPC) model suggests that three-quarters of the tax subsidies (in present value) from removing the income limit would accrue to the three percent of households with cash income of more than $200,000. More than 25 percent of the benefits would accrue to the 0.6 percent of households with cash income of more than $500,000. More than 40 percent of households with cash income of above $1 million would receive a tax benefit, averaging $1,500 per year in present value. As noted below, it is very unlikely that such households would respond to this tax break by increasing their saving (rather than asset shifting).

Expanding the tax subsidies from Roth IRAs to high-income households would also significantly reduce revenue over the long term. The full cost, however, is not obvious during the 10-year budget window: The revenue loss on a Roth IRA does not occur when the funds are contributed (as under a traditional IRA), but rather when they are withdrawn free of tax. Therefore, the full revenue effect does not manifest itself for several decades -- when the budget will already be under severe pressure from the retirement of the baby boomers.

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[16] A frequent claim by advocates of removing the Roth IRA income limits is that eliminating the limits could allow financial services firms to advertise more aggressively and thereby encourage more saving by middle-income households. Two points are worth noting about this "advertising effect" argument. First, the advertisements used in the past (for example, prior to 1986, when there were no income limits on deductible IRAs) 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 dollars ....Setting 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." Second, advocates of 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. After all, some decline in IRAs may have been expected given the rise in 401(k) availability (which could substitute for IRAs) and the reductions in marginal income tax rates (which reduces the advantage to saving in an IRA). 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. In other words, the decline amounted to only about 2.5 percent of that income group – and some decline would have been expected for the reasons just mentioned. More broadly, with respect to the 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." This suggests that any contributions to IRAs were mostly asset shifting from other accounts, rather than new saving.

It is thus crucially important not to be misled by the revenue changes over the first few years. Instead, the changes should be examined in terms of their ultimate effect, or their effect in present value (which transforms the future revenue losses into their equivalent amount, with interest, today). The Congressional Research Service (CRS) has estimated that eliminating the income limit on Roth IRAs will, after two decades or so, reduce revenue by $8.7 billion a year. The Tax Policy Center estimates suggest a cost by 2010 of roughly $5 billion a year in present value.[17] To avoid fiscal gimmicks, policy-makers should offset the cost of backloaded new tax preferences over periods longer than the traditional 10-year budget window.

The revenue loss from removing the income cap on Roth IRAs might be worth the cost if it were likely to trigger significant increases in private saving. Instead, the result would likely be substantial shifting of assets from taxable accounts into the tax-advantaged IRAs by households with incomes above $150,000. 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."[18]

The problems with raising the contribution limits to IRAs and 401(k)s

Another common proposal would increase the maximum amount that can be saved on a tax-preferred basis, such as by raising the *amount* that can be contributed to an IRA or 401(k). Yet only about five percent of 401(k) participants make the maximum contribution allowed by law, and only about five percent of those eligible to contribute to IRAs make the maximum contribution. Increasing the maximum contribution amounts would thus be unlikely to have much effect on the vast majority of families and individuals, since they are not currently making the maximum allowable contribution. Instead, raising the contribution limits would largely provide windfall gains to households already making the maximum contributions to tax-preferred accounts *and* saving more on top of those contributions in other accounts.

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 at that time.[19] The paper concluded: "Taxpayers who do

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[17] In addition to the revenue costs associated with removing the income limit on Roth IRAs, policy-makers should recognize that perpetuating a $5,000 maximum contribution to IRAs is expensive. The CRS has estimated that perpetuating the $5,000 contribution limit on the Roth IRA, rather than allowing it to revert to the $2,000 limit that was in effect prior to the enactment of the 2001 tax legislation, would reduce revenue in the long term by $20 billion per year.

[18] Press briefing by Secretary of Treasury Robert Rubin, National Economic Advisor Gene Sperling, OMB Director Franklin Raines, and Chair of Council of Economic Advisers Janet Yellen, June 30, 1997.

[19] 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.

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." 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.[20]

Table 2: 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
Under $20,000	2,695	7.6%	1%
$20,000 to $40,000	8,914	25.0%	1%
$40,000 to $80,000	15,020	42.1%	4%
$80,000 to $120,000	5,739	16.1%	10%
$120,000 to $160,000	1,624	4.6%	21%
$160,000 and over	1,673	4.7%	40%
TOTAL	35,666	100.0%	6%

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

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.[21] Table 2 presents information from the Congressional Budget Office on workers constrained by the previous 401(k) limits in 1997. Only six percent of all 401(k) participants made the maximum contribution allowed by law. Only one 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.

Again, the problem is that most of the response to increasing the contribution limits is likely to be shifting of assets from other accounts. The expanded tax preference thus would mostly translate into subsidizing saving that would have occurred anyway, rather than encouraging new saving.

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[20] 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.)

[21] 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.

Furthermore, at least with regard to increasing IRA contribution limits, the increase in the amount of tax-free saving that taxpayers would be able to do outside of retirement plans could reduce the incentives for small and medium-sized businesses to offer qualified plans, which could *reduce* opportunities for middle- and lower-earners to save in a convenient way. With a higher IRA limit, many business owners and managers may find that they can meet all of their demands for tax-free saving without the hassle and expense of maintaining an employer-sponsored plan. According to an analysis by the Congressional Research Service, "some employers, particularly small employers, might drop their plans given the benefits of private savings accounts."[22] Higher IRA limits may thus actually reduce retirement security for middle- and lower-earners by making it less likely that they would have a convenient and easy way to save.

Conclusion

In conclusion, bolstering retirement security on top of Social Security need not be contentious and divisive. Over the past 25 years, the ways in which Americans save for retirement has changed and more responsibility has been shifted to workers, but our policies have failed to keep pace. We should make it easier for middle- and lower-income households to save for retirement and increase the incentives for them to do so, and my testimony highlights four specific ways in which this could be done. Especially in light of the nation's dire long-term fiscal gap, however, policies that disproportionately result in yet more government-subsidized asset shifting among households who already tend to be adequately prepared for retirement should not be the price of enacting proposals to improve the retirement security of millions of Americans.

[22] Jane G. Gravelle, Congressional Research Service, "Effects of LSAs/RSAs Proposal on the Economy and the Budget," January 6, 2004.