THE HAMILTON PROJECT

Advancing Opportunity, Prosperity and Growth

POLICY BRIEF NO. 2006-02

APRIL 2006

Many Americans leave the workforce in their midsixties facing extended retirement, but with few financial resources. Social Security—the primary federal income support program for the elderly—was never intended to provide full retirement income, and traditional pension plans that offer lifetime benefits are increasingly rare, largely replaced by retirement savings plans like 401(k)s and individual retirement accounts (IRAs) that depend on workers' voluntary contributions.

Improving Opportunities and Incentives for Saving by Middle- And Low-Income Households

The trend toward such retirement savings plans has important benefits, including the opportunity for workers to exercise greater freedom of choice and more control over their own retirement planning. In practice, however, too few eligible households take advantage of these new saving vehicles. In 2001, for example, half of all households headed by adults ages fifty-five to fifty-nine either had no IRA or employer-based 401(k)-type plan or had put no more than $10,000 in one of those saving vehicles.

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THE CHALLENGE

Two key factors account for the low participation rates in retirement savings plans. The first is inertia. Establishing IRA and 401(k) accounts usually requires specific actions and presents a confusing array of investment and contribution options. Under current practice, not making a decision usually means not enrolling in an IRA or 401(k). By contrast, in traditional defined-benefit plans, workers are enrolled automatically and earn benefits even if they take no specific actions regarding their pensions.

The second factor, which applies to middle- and low-income households, is that there is little or no immediate financial incentive to enroll. Contributions to traditional IRAs and 401(k) plans are tax deductible, and the value of deducting these contributions depends on the household's tax bracket. For a majority of households (those with a 15 percent or lower marginal tax rate), the immediate saving incentive provided by this exclusion is weak. In contrast, the immediate saving provided by this exclusion is largest for high-income families, who are more likely simply to shift other savings into these tax-preferred accounts to obtain the tax advantage rather than increase their overall saving.

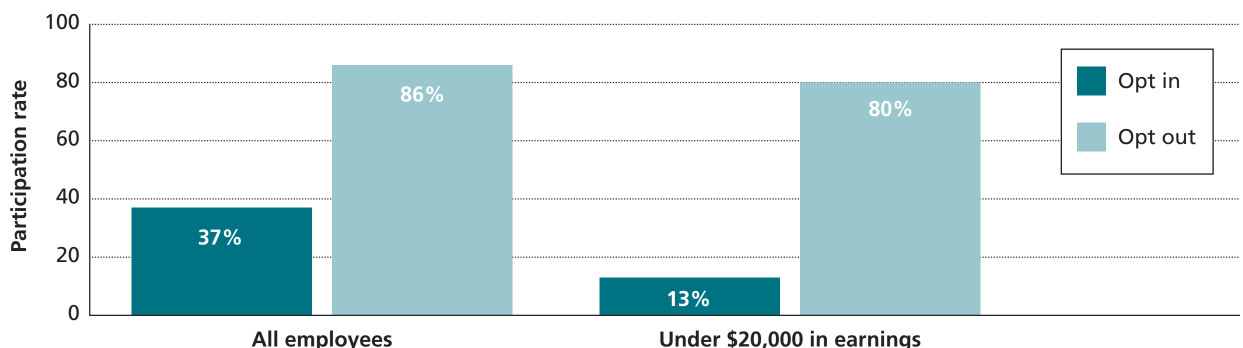
In a new Hamilton Project white paper, William G. Gale, Jonathan Gruber, and Peter R. Orszag propose two policy approaches to reduce these impediments to retirement saving:

- First, employers should generally be required to automatically enroll new workers in 401(k)s, IRAs, or traditional defined-benefit plans. These automatic 401(k)s and IRAs would be designed to increase workers' contributions over time, invest contributions prudently, and preserve or roll over accounts when employees change jobs. Workers could opt out of the plan or any of these default choices.

- Second, the current income tax deductions for 401(k) and IRA contributions should be eliminated and replaced by a new government program providing 30 percent matching contributions for all qualifying deposits to these accounts.

In addition, when workers retire, the government's matching contributions and their accumulated earnings should be defaulted into a lifetime annuity to encourage retirees not to exhaust their savings too quickly. This set of proposals would make it easier—and more likely—for

Figure 1. Changing Default Enrollment Policies Dramatically Affects New Employees' Participation in Retirement Savings Plans



Source: Brigitte Madrian and Dennis Shea, "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior," Quarterly Journal of Economics 116 (4): 1149-87.

all Americans to save, enhance financial incentives for them to do so, and stabilize and increase many retirees' annual income.

Improving Americans' Retirement Saving

A NEW APPROACH

Change Current Default Choices

Currently, most 401(k) plans let employees decide whether to participate, how much to contribute, and which investment vehicles to select. For many people, this creates a series of confusing financial decisions that they simply avoid. A growing body of empirical evidence shows that many more people participate in plans when the default is to participate, and they can choose to opt out, than when the default is not to participate, and they can choose to opt in (see figure 1). Participation would significantly increase, therefore, if enrollment were automatic for more plans.

Recent research also has shown that, even after they are in a plan, most people passively maintain their initial contribution rates. The result is often inadequate saving for retirement. Changing the defaults on contribution rates, so that they rise gradually and automatically, can mitigate this tendency.

Create Automatic 401(k)s

About 10 percent of 401(k) plans (and a quarter of plans with at least five thousand participants) have switched from traditional "opt-in" to "opt-out" defaults. Gale, Gruber, and Orszag propose that all 401(k) plans move to opt-out arrangements for all new employees, with some exceptions detailed below. This "automatic 401(k)" program could promote saving in four ways:

- Through *automatic enrollment*, employees would by default become participants in their company's 401(k) plan at the commencement of employment.
- Through *automatic escalation*, their contributions would by default increase in a prescribed manner over time.
- Funds in the retirement account would be *automatically invested* in prudently diversified, low-cost investment vehicles, such as index funds that mimic the performance of the market, and be rebalanced as necessary.
- Finally, accounts would *automatically roll over*, so that when an employee changes jobs, the money in his or her accounts would either be rolled into a plan offered by the new employer or retained in the previous employer's plan.

At each step—enrollment, escalation, investment, and rollover—employees could override the defaults and opt out of the automatic provisions. Firms that are very small, or that offer either a traditional defined benefit pension plan or an automatic IRA, would be exempt from having to provide an automatic 401(k). By limiting this requirement to new employees, disruption to existing employees would be minimized, while in the coming years a growing share of the workforce would be incorporated into the new, automatic system.

> Automatic 401(k) plans do not dictate ultimate choices any more than does the current set of default options. They merely point workers in a pro-saving direction when they do not make explicit choices of their own.

Create Automatic IRAs

"Automatic IRAs" would promote saving by employees whose employers do not offer a 401(k) plan (about half the nation's workforce) or defined-benefit pensions plan. These employers would be required to set up automatic payroll-deduction IRAs for their workers. These IRA funds would be placed in a limited number of diversified investments. The share of a worker's paycheck flowing into the account would automatically escalate over time. (Legislators could provide a modest tax credit for start-up administrative costs at affected firms.)

These IRAs also could receive part of a household's income tax refund—the largest single payment many households receive all year. In fact, the more than $200 billion in annual tax refunds present a substantial opportunity to increase personal saving. Currently, taxpayers may instruct the IRS to deposit only the entire refund in a designated account at a financial institution. Since some of the refund may be needed for expenses, this all-or-nothing approach discourages many households from saving any of it. Allowing taxpayers to split their refunds could make saving easier and more likely. (The Bush administration has committed to allowing split refunds by 2007.) Individuals also could make additional voluntary contributions to their automatic IRA, to the extent that total contributions did not exceed proposed allowable limits discussed below.

Automatic 401(k)s and automatic IRAs would work together, since the 401(k) could roll automatically into the IRA when workers switch jobs. At any point, workers would therefore have a maximum of two defined-contribution retirement accounts: the employer-based automatic 401(k) and the individual automatic IRA.

> Expanding current tax deductions would mostly translate into a government subsidy for saving that has already occurred.

Government Matching Contributions

Stronger, better targeted, and more equitable incentives for saving are critical, even with automatic 401(k) plans and IRAs. Recent evidence suggests that people contribute more to retirement savings accounts when their contributions are matched at higher rates; even better, well-designed matching strategies can increase net saving much more effectively than do current tax incentives.

Increasing employees' retirement contributions doesn't raise overall household saving if other savings decrease by the same amount. Currently, many high-income households simply reshuffle other assets to take advantage of the tax savings in retirement accounts. (This is less true for low- and middle-income households, where contributions to 401[k]s and IRAs are more likely to increase total saving for the simple reason that these households have fewer assets to reshuffle.) As a result, the tens of billions of dollars in tax incentives for 401(k)s and IRAs are not very effective at boosting overall saving.

Gale, Gruber, and Orszag propose replacing the current tax deduction for contributions to retirement accounts with a more effective incentive to save—a government matching contribution that would be the same for all households. Under this plan, earnings in 401(k)s and IRAs would continue to accrue tax free, and withdrawals would be taxed at regular income rates, as under current law. However, workers' 401(k) and IRA contributions would no longer be tax deductible, and employers' 401(k) contributions would be treated as taxable income.

At the same time, all qualified employer and employee contributions, instead of being deductible, would be

How Current and Proposed Incentives Work

Adjusted gross income	Pretax retirement contributions (401[k] plus IRA)	Marginal tax bracket	After-tax retirement contribution[1]	Match rate under proposal	Immediate benefit under current system	Immediate benefit under proposed system
$30,000	$2,000	0%	$2,000	30%	$0	$600
$60,000	$5,000	15%	$4,250	30%	$750	$1,275
$500,000	$20,000	35%	$13,000	30%	$7,000	$3,900

1. Table assumes that after the reform, households maintain after-tax cost of contributions.

eligible for a significant government matching contribution—30 percent of all qualifying contributions up to either 10 percent of adjusted gross income or $20,000 for 401(k) accounts and $5,000 for IRAs, whichever is less. Each spouse in a married couple could make these contributions, so that a couple could receive a 30 percent match on $40,000 for their 401(k)s and $10,000 for their IRAs. These limits would be indexed for inflation. According to estimates from the Urban Institute-Brookings Tax Policy Center, the cost to the government of the matching contributions would be almost equal to its gains from eliminating the tax deduction, so this strategy would not greatly affect the federal budget deficit.

Compared with the current system, matching contributions would increase the immediate financial benefit of saving for middle- and low-income households whose marginal tax rates are below 23 percent, while reducing the immediate financial benefit for households with marginal tax rates above 23 percent. A family with $30,000 in income, for example, receives no benefit under the existing system of tax deductions and exclusions, but would receive a $600 match if it saved $2,000.

This proposal would allow qualified withdrawals for first-time home purchases or college education and allow individuals to take loans against their IRAs up to certain specified amounts. To prevent gaming—investing the money, triggering the government match, and then quickly withdrawing the contribution—people would forfeit their matching payments if they make an unqualified early withdrawal.

The proposal also has implications for state taxation, because most states follow the federal tax treatment of retirement savings in 401(k)s and IRAs; eliminating tax deductions for contributions would thus lead to higher revenue from state income tax.

Create Lifetime Annuities to Stabilize Retirees' Income

Even if they have savings in 401(k) or IRA plans, retirees still need to avoid exhausting those funds too soon. Retirees can protect against this risk by converting some or all plan balances into an annuity that guarantees periodic payments for life. Commercially available annuities, however, are generally unattractive to most middle- and low-income families because they are not protected against inflation and because they are not a good financial value (since firms must sell them at a price high enough to cover both administrative costs and the longer-than-average life expectancies of the people who tend to purchase them). To address this need, Gale, Gruber, and Orszag propose that the government matching contributions automatically be turned into an annuity when people retire. Under their proposal, lifetime annuities would be administered by the Social Security Administration, eliminating the need to create a new government agency. Although these annuities would represent a relatively small share of final

Key Provisions

Automatic 401(k)s and IRAs

- All new workers are enrolled in a 401(k)-type plan, IRA, or traditional pension plan.
- IRA and 401(k) contribution rates rise gradually over time.
- IRA and 401(k) contributions are placed in diversified investments (e.g., index funds).
- If a worker changes jobs, the account balance rolls over into the new employer's plan.
- Workers may choose to opt out of participation or any specific aspect of the automatic plan.

Government Matching Contributions

- Qualifying contributions to 401(k)s and IRAs are matched at a 30 percent rate up to 10 percent of income or $20,000 for 401(k) accounts and $5,000 for IRAs, whichever is less.
- The government match is deposited directly into the relevant accounts.
- Tax deductions for retirement account contributions are eliminated.
- Early withdrawals are permitted for first-time home purchases or college education.
- Early withdrawals for other reasons forfeit the government match.

plan balances, this proposal underscores the usefulness of annuities as a sensible way to manage retirement income. Once again, individuals could choose to opt out of the default annuitization if they wished.

Comparisons to Existing Policy Proposals

Making a retirement savings account the default option for all American workers, together with improved incentives for retirement saving by those with low and middle incomes, would do more to bolster retirement security for millions of Americans than would other policy changes currently being considered. Most other proposals focus on expanding income and contribution limits on existing tax-preferred retirement accounts, which would benefit only those people already well prepared for retirement.

For example, the retirement savings account (RSA) plan recently proposed by the Bush administration is basically a Roth IRA with no income limit on eligibility. (With Roth IRAs, withdrawals are tax free, but contributions are not tax deductible.) The removal of income limits would benefit only couples earning more than $150,000 and single individuals earning more than $95,000. (Lower-income Americans already are eligible to contribute to Roth IRAs.) Indeed, three-fourths of the tax benefit of this plan would accrue to the 3 percent of households with cash income of more than $200,000.

Another common proposal would increase the maximum annual amount that can be contributed to an IRA or 401(k). That proposal would benefit only the roughly 5 percent of plan participants who already make the maximum allowable contribution. Further, it is very costly: just keeping the Roth IRA contribution limit at $5,000, as amended in the 2001 tax legislation, rather than allowing it to revert to the prior $2,000 limit, will in the long run cost the government $20 billion per year in forgone taxes—revenue unlikely to wind up as additional savings, since people tend to switch funds from other saving to take advantage of favorable tax treatment.

CONCLUSION

Recent empirical research raises fundamental questions about the effectiveness of federal government efforts to encourage retirement saving because the "default choices" in most current retirement savings plans favor spending rather than saving and because the bulk of the tax incentives and benefits are directed toward households that do not need to save more for retirement and who tend to use the subsidies to shelter existing assets rather than increase total saving. This proposal addresses these problems with two key reforms.

- It would put saving first, by creating "automatic" 401(k)s and IRAs, making sensible saving the easiest choice for families. (Workers would always be free to opt out of these default options.)

- It would eliminate tax deductions for 401(k)s and IRAs and replace them with a universal government matching program that would encourage new saving by low- and moderate-income households. (This shift would be accomplished without any significant change in the government's budget position, since the cost of the new government matching payments would be offset by the increased revenue, achieved by eliminating the tax deduction.)

In addition, it would improve retirement security by giving retirees a federally administered and inflation-protected lifetime annuity. (Individuals could also opt out of the default annuitization if they wished.) The net result would be greater retirement income security for the majority of American households.

The Hamilton Project white paper discussed in this policy brief, *Improving Opportunities and Incentives for Saving by Middle- and Low-Income Households* can be found at www.hamiltonproject.org. The paper was authored by:

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The Project is named after Alexander Hamilton, the nation's first treasury secretary, who laid the foundation for the modern American economy. Consistent with the guiding principles of the Project, Hamilton stood for sound fiscal policy, believed that broad-based opportunity for advancement would drive American economic growth, and recognized that "prudent aids and encouragements on the part of government" are necessary to enhance and guide market forces.

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