OPPORTUNITY 08
Independent Ideas For Our Next President

Promoting Retirement Security
Make Saving Easier & More Rewarding

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Summary

The past 25 years have brought 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 Individual Retirement Accounts (IRAs). But many of our public policies have not been updated to reflect the increased responsibility placed on workers to prepare for their own retirement. The next President can improve and strengthen retirement security substantially through a series of common-sense reforms that would make the defined contribution pension system easier to navigate and more rewarding for American families. Specifically,

- The most important change would be to ***make saving easier*** and less complicated. One way would be through automatic 401(k)s for workers at firms offering pensions and automatic IRAs for other workers.
- Another important move would be to ***restructure tax incentives*** for retirement saving. Existing incentives mostly subsidize asset-shifting by higher-income households, rather than encourage new saving by middle- and lower-income households. A simple 30 percent match for everyone would give moderate and lower-income households—some 80 percent of households—a stronger incentive to save.
- Finally, ***implicit taxes on retirement saving should be reduced***. These steep and confusing taxes are often imposed through means-tested benefit

[1] This brief is a result of joint work with Len Burman, Esther Duflo, Mark Iwry, Jeffrey Liebman, Peter Orszag and Emmanuel Saez. Thanks are due to the staff of the Retirement Security Project and the Tax Policy Center (TCP), a project of the Urban Institute and the Brookings Institution, for their contributions and assistance, and to the Pew Charitable Trusts for its support of the Retirement Security Project.

programs, such as food stamps, Medicaid, Supplemental Security Income, and cash welfare assistance.

This set of policies is much more promising than the alternative of simply raising contribution amounts or income limits on tax-preferred retirement saving. Such strategies merely perpetuate tax preferences for households already well-prepared for retirement and undermine the public policy benefit from these tax incentives.

Context

Increasing Retirement Security for Middle- and Low-Income Households

The trend away from traditional, employer-managed retirement 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 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 little or no retirement savings.[2] In 2004, according to data from the Federal Reserve's Survey of Consumer Finances, half of all households headed by adults age 55 to 59 had $15,000 or less in an employer-based 401(k)-type plan or tax-preferred savings plan account. Although the savings option is there, Americans don't take advantage of it for two principal reasons:

- the system is too complicated
- incentives to save for retirement are weak or nonexistent

[2] For a broader discussion of these issues, see William G. Gale and Peter. R. Orszag. "Private Pensions: Issues and Options." Pp. 183-216 in *Agenda for the Nation,* Henry J. Aaron, James M. Lindsay, and Pietro S. Nivola, eds., Washington, D.C.: Brookings Institution Press, 2003; 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 Web site (www.retirementsecurityproject.org).

In the face of the difficult choices and limited encouragement presented by the current system, many people simply procrastinate and never save enough for retirement.

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 the taxpayer's income tax bracket. For example, a 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.[3] Thus this approach provides the smallest benefits to the middle- and lower-income families who most need to save more in order to meet their basic needs in retirement. Furthermore, as a strategy for promoting national saving, the subsidies are poorly targeted. Higher-bracket households are disproportionately likely to respond 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. By contrast, middle- and lower-income households that participate in pensions are most likely to use the accounts to *increase* net saving.

Making It Easier to Save

To make it easier for households to save, policymakers should encourage greater adoption of automatic 401(k)s and create an automatic IRA.

Automating the 401(k)

401(k)-type plans typically leave it to the employee to choose whether to participate, how much to contribute, which investment vehicle 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 complex 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 choose poorly.

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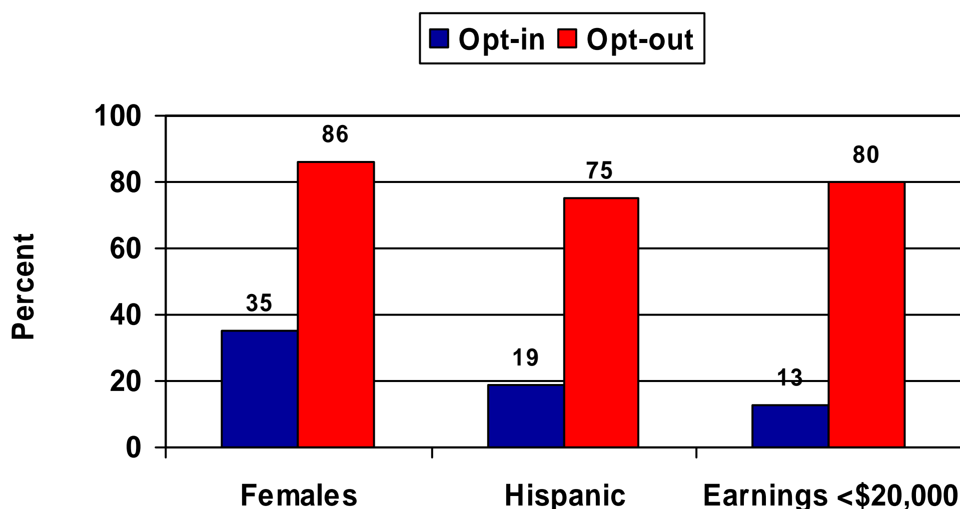
[3] Some of this difference may be recouped when the contributions are withdrawn and taxed, if families who are in lower tax brackets during their working years are also in lower tax brackets during retirement.

To improve 401(k) participation, we should recognize the power of inertia in human behavior and enlist it to promote rather than hinder saving. Under an automatic 401(k), each of the key events in the process—enrollment, escalation, investment, and rollover—would be programmed to make contributing and investing easier and more effective. In each case, workers could always choose to override the defaults and opt out of the automatic design. Automatic retirement plans thus do not dictate choices any more than do conventional default options, which exclude workers unless they opt to participate. Instead, automatic retirement plans merely point workers in a pro-saving direction when they decline to make explicit choices on their own.

Research shows that these steps can be remarkably effective. For example, one of the strongest empirical findings from behavioral economics is that *automatic enrollment boosts the rate of plan participation substantially*.[4] Further, as the Figure shows, automatic enrollment is particularly effective in boosting participation among groups that face the most difficulty in saving.

[4] Brigitte Madrian and Dennis Shea. "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior." *Quarterly Journal of Economics 116*: 1149-1187, November 2001; and James Choi, *et al*. "Defined Contribution Pensions: Plan Rules, Participant Decisions, and the Path of Least Resistance." Pp. 67–113 in *Tax Policy and the Economy, vol. 16*, James Poterba, ed., Cambridge, Mass.: MIT Press, 2002.

Figure: Effects of automatic enrollment on 401(k) participation



Source: Brigitte Madrian and Dennis Shea. "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior." *Quarterly Journal of Economics 116*: 1160, November 2001.

Automatic enrollment is a relatively new strategy, but a small and growing share of 401(k) plans today include this feature. According to a recent survey, about 12 percent of 401(k) plans (and 30 percent of plans with at least 5,000 participants) have switched from the traditional "opt-in" to an "opt-out" arrangement.[5] In August 2006, President Bush signed pension legislation that goes a long way toward taking down the barriers to corporate adoption of the Automatic 401(k). Now corporate America has the opportunity to automate more of their 401(k) plans.

Creating an Automatic IRA

Since, at any one time, only about half the U.S. workforce is offered an employer-based pension, we also must make it easier for other workers to save. An "automatic IRA" would address this challenge.[6] As in the case of 401(k) plans, the automatic IRA's

[5] Profit Sharing/401(k) Council of America, *48th Annual Survey of Profit Sharing and 401(k) Plans*. Chicago: PSCA, 2005.

[6] J. Mark Iwry and David John. "Pursuing Universal Retirement Security Through Automatic IRAs." Washington, D.C.: Retirement Security Project, February 2006.

features would apply at each relevant step: enrollment, escalation, and investment. In the case of the IRA, rollover is not an issue, because these accounts would be held by the individual, rather than linked to an employer. As with the automatic 401(k), workers could choose to override the IRA defaults at any stage.

Under this proposal, firms that do not offer any type of automatic pension plan would be required to set up automatic payroll-deduction IRAs for their workers. Firms that do offer 401(k) or other qualified plans also could set up these IRAs, but would not be required to do so. Workers who did not opt out would have part of their paychecks flow into the "automatic IRA." The share of the paycheck flowing to the account would automatically escalate over time, unless the worker declined such increases. Legislators could provide a modest tax credit for start-up administrative costs at firms required to offer an automatic IRA. The IRA's funds would be automatically invested in a limited number of diversified funds.

The automatic IRA also could receive part of a household's income tax refund each year. For many households, and particularly for those with low or moderate incomes, the refund is the largest single payment received all year. Accordingly, the more than $200 billion in refunds issued annually presents a unique opportunity to increase personal saving. The IRS has announced that, beginning in January 2007, taxpayers will be allowed to split their refunds between designated accounts, which could include their automatic IRA. Allowing taxpayers to split their refunds could make saving simpler and, thus, more likely. Families also might be able to commit to depositing an increasing share of their *future* tax refunds to the automatic IRA. Families could always override this decision when the time came, but the default would be that, over time, a rising share of each year's tax refund would be deposited into the automatic IRA.

Increasing the Incentive to Save

Even though savings decisions can be heavily influenced by behavioral factors such as defaults, economic incentives are nonetheless important. In fact, the rate at which the

government matches retirement savings contributions can have a significant effect. For example, a recent well designed study found that households selected significantly higher IRA contributions when offered a higher match rate.[7]

Unfortunately, current tax incentives for retirement saving do not promote new saving among those most at risk of inadequate retirement security. To better target incentives to save, we should replace the existing tax deductions for contributions to retirement saving accounts with a government matching contribution into the account.[8] Unlike the current system, workers' contributions to employer-based 401(k) accounts would no longer be excluded from taxation, and contributions to IRAs would no longer be tax deductible. Furthermore, any employer contributions to a 401(k) plan would be treated as taxable income to the employee (just as current wages are). These increases in taxable income would be offset by making all qualified employer and employee contributions eligible for a government matching contribution. Earnings in 401(k)s and IRAs would continue to accrue tax-free, and withdrawals from the accounts would continue to be taxed at regular income rates, as under current law. This proposal would be roughly revenue neutral for the federal government, according to estimates from the Tax Policy Center microsimulation model.

Advantages of this approach over the existing system are numerous. For any given dollar deposited into an account, the match rate would depend solely on savings relative to income (up to the contribution limits), not on the level of income itself. As a result, the matching system would provide every family the same proportional benefit for saving (at least up to the contribution limits). Many investment advisers counsel people to save a certain percentage of their income, in order avoid a sharp decline in living standard after retirement. Providing a government match based on the share of income saved promotes this consistent approach to saving.

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[7] 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." *Quarterly Journal of Economics 121*: 1311-1146, November, 2006.

[8] William Gale, Jonathan Gruber, and Peter Orszag. "Improving Opportunities and Incentives for Saving by Middle- and Low-Income Households." Washington, D.C.: The Hamilton Project, April 2006.

As noted above, the government matching payment would be directly deposited into the retirement account. This strategy would make the matching funds more likely to be saved than are the funds represented by the current tax deduction. This form of the incentive may even induce additional household saving, since, possibly analogously, direct matches appear more effective than equivalent tax rebates at inducing people to contribute to charities, for example. A further incentive for keeping the matching funds in savings arises, because when they are withdrawn from the account, they are subject to taxation just as under an existing 401(k) or traditional IRA.

Compared with the current system, these proposed incentives would reduce the tax subsidy for saving by high-income households, while raising it for lower- and middle-income individuals: A family with $30,000 in income receives no benefit under the existing system of tax deductions and exclusions (since the family does not have positive income tax liability), but, under this proposal, would receive $600 as a match for saving $2,000; by contrast, the overall benefit for a family with $500,000 in income and $20,000 of retirement contributions would decline from $7,000 to $3,900. Still, roughly 80 percent of all households would enjoy a stronger saving incentive under this proposal than under current law, including all households with incomes below $30,000 and more than 40 percent of households with incomes between $75,000 and $100,000.

Reducing Implicit Taxes on Retirement Saving Imposed by Asset Tests

Another way to increase incentives for middle- and low-income households to save is by removing *penalties* imposed on such saving.[9] In particular, the asset rules in means-tested benefit programs often penalize moderate- and low-income families who have saved for retirement in 401(k)s or IRAs. 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, as does the

[9] Zoe Neuberger, Robert Greenstein, and Eileen P. Sweeney. "Protecting Low Income Families' Retirement Savings: How Retirement Accounts Are Treated in Means-Tested Programs And Steps to Remove Barriers to Retirement Saving." Washington, D.C.: Retirement Security Project, June 2005.

Supplemental Security Income (SSI) program for the elderly and people with disabilities. Asset tests can force households that rely on these benefits—or might rely on them in the future—to deplete retirement savings in order to qualify, even when doing so involves a financial penalty. As a result, the asset tests represent a substantial implicit tax on retirement saving.

These asset tests are one of the most glaring examples of how our laws and regulations have failed to keep pace with the evolution in the nation's pension system. Defined employer-sponsored benefit plans were the norm when the rules were developed, and these plans generally were not considered in asset tests. But at that time, defined contribution accounts like 401(k)s and IRAs were not exempted, because they were not viewed as primary pension vehicles. The failure to update these rules means that many means-tested programs still exempt defined benefit plans while counting 401(k)s and IRAs. Excluding these plans when applying asset tests would be much more equitable and would remove a significant barrier to increasing retirement saving among low-income working households.

Furthermore, the rules governing the means-tested benefit programs are complex, confusing, and often seemingly arbitrary, as they apply to 401(k)s and IRAs. As just one example, 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.

Not counting saving in retirement accounts when applying the asset 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.

Avoiding Further Tax Subsidies for Asset Shifting

The common sense reforms described above could significantly bolster retirement security for millions of Americans. However, some policymakers seem inclined to couple these proposals with a number of other provisions that would expand income

and contribution limits on tax-preferred retirement accounts. Such proposals would have fundamentally different effects: rather than bolstering retirement security among middle- and lower-earners, proposals to increase income and contribution limits would generate significant asset shifting and primarily benefit households already disproportionately well-prepared for retirement. Policymakers should not be tempted to create substantial new tax subsidies for this type of asset shifting at the expense of sensible policies to bolster retirement security among middle- and lower-income households.

One 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). But only a small fraction of households would be affected.[10] The table shows that in 1997, only 6 percent of all 401(k) participants made the maximum allowed contribution, but that the percentage who did so rose sharply with income. Similarly, the Government Accountability Office has found that an increase in the statutory contribution limit for 401(k)s would directly benefit *less than 3 percent* of participants.[11] In short, the expanded tax preference would mostly translate into subsidizing saving that would have occurred anyway, rather than encouraging new saving, and provide windfall gains to a few well-resourced households.

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[10] See, for example, David Joulfaian and David Richardson. "Who Takes Advantage of Tax-Deferred Saving Programs? Evidence from Federal Income Tax Data," Office of Tax Analysis, U.S. Treasury Department, 2001, and Janette Kawachi, Karen E. Smith, and Eric J. Toder. "Making Maximum Use of Tax-Deferred Retirement Accounts." *Working Paper*. Washington, D.C.: Urban Institute, May 2006.

[11] U.S. Government Accountability Office. "Private Pensions: Issues of Coverage and Increasing Contribution Limits for Defined Contribution Plans." GAO-01-846, September 2001. The Government Accountability Office 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 the Economic Growth and Tax Relief Reconciliation Act of 2001 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.)

Table: 401(k) participants making the maximum contribution in 1997

Household income (AGI)	Total contributors (in thousands)	% of total contributors	% 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.

Concluding Observations

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 have changed, shifting more responsibility to workers, and our fiscal policies need to catch up. Given the known shortfalls in retirement saving among millions of American households, policies that improve retirement security are urgently needed. But these should not be accompanied by policies that merely encourage government-subsidized asset shifting among households already tending to be adequately prepared for retirement. Instead, policymakers should focus on the groups most in need, making saving easier and increasing the incentive to save for middle- and low-income workers.

About the Author and the Project

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William G. Gale is a Brookings vice president and director of the Economic Studies Program. He also is co-director of the Urban-Brookings Tax Policy Center and director of the Retirement Security Project. Gale is an expert on tax policy, budget and fiscal policy; and public and private pensions. He served as a senior staff economist for the Council of Economic Advisers under President George H.W. Bush.

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