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

THE BROOKINGS INSTITUTION

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

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Abstract

Many middle- and low-income Americans retire without having accumulated sufficient savings to enjoy a comfortable retirement. Low retirement saving is not primarily due to a lack of eligibility for tax-favored retirement accounts, but rather to a lack of take-up. The low take-up, in turn, can be explained primarily by inertia and incentives. People do not enroll in a 401(k) or an individual retirement account (IRA) because such plans typically require specific actions to join and present a confusing array of investment and contribution choices. Under current rules, not making a decision usually means not enrolling. Furthermore, the financial incentive to enroll in an IRA or 401(k) plan is often weak or nonexistent because the value of contributing money, and thus excluding it from taxation, depends on a taxpayer's tax bracket—and the majority of households face a 15 percent or lower marginal tax rate.

We offer proposals to address both impediments to saving. First, we would require every firm (with possible exceptions for the smallest businesses) to enroll its new workers automatically in at least one plan: a traditional defined benefit plan, a 401(k), or an IRA. Businesses also would be required to set various features of the plans in a "pro-saving" manner, although workers always would have the option to override those "pro-saving" defaults. Second, our proposal would replace current tax deductions for contributions to tax-preferred retirement accounts with a new program providing universal matching contributions from the government for household deposits to 401(k)s and IRAs. Unlike the current system under which low-income households enjoy much weaker immediate incentives to contribute than high-income households, all households making a qualified contribution to a 401(k) or IRA would receive the same 30 percent match from the government. We also propose other changes to the retirement system to promote lifetime annuities.

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I. The Challenge of Increasing Retirement Savings

Most Americans expect a substantial period of retirement. Workers tend to leave the labor force as they approach their midsixties. For example, the share of men participating in the labor force falls from more than two-thirds among those ages fifty-five to sixty-four to under one-fifth for those sixty-five and older; for women, labor force participation declines from over half in the fifty-five-to-sixty-four age bracket to just slightly more than 10 percent for those sixty-five or older. Yet in their midsixties, most people still have a significant life expectancy. A sixty-five-year-old man now has an average life expectancy of 17.0 more years; a sixty-five-year-old woman has a life expectancy of 19.7 additional years (Social Security Administration 2005, table V.A4). In recent decades, furthermore, life expectancies have steadily crept higher, while retirement ages have moved relatively little—with the result that the expected number of years in retirement has risen.

What resources will elderly Americans be able to draw upon during this substantial period of retirement? Most middle- and lower-income Americans enter their retirement years having accumulated relatively little financial wealth. Social Security, the primary government program that provides income for the elderly, was never intended to provide a full retirement income by itself. Nonetheless, two-thirds of retirees depend on Social Security for half or more of their retirement income, and one-fifth depend on the program for all their income (Diamond and Orszag 2005).

Some retirees will be able to draw upon a private pension plan. But the traditional pension plans that offered lifelong benefits paid by an employer are becoming increasingly rare. An enormous shift has occurred in recent decades away from employers providing "defined benefit" pensions, in which a certain predefined level of benefits was saved by the firm in a pension fund and then paid out after retirement, and toward employers helping employees to set up personal retirement savings accounts like 401(k) plans. (We will use the broad term "401[k] plan" to refer to a retirement savings plan offered by any employer, regardless of whether the employer is a for-profit corporation, governmental entity, or nonprofit, in which employees can choose to have some of their paychecks automatically deposited in a retirement account.) Many other individuals have set up individual retirement accounts on their own, without the direct assistance of an employer. These 401(k) plans and IRAs have typically offered workers a tax advantage: contributions to the accounts are untaxed at the time they are made, and returns on the savings are also untaxed when they are earned, although taxes are eventually imposed when money is withdrawn from the retirement accounts, presumably after retirement.

Retirement savings accounts like 401(k)s have been increasingly dominant over the past twenty-five years. Between 1975 and 1998, the number of 401(k)-type plans more than tripled, and the number of active participants more than quadrupled. During the same period, the number of traditional defined benefit plans fell by almost half, and the number of active participants fell by one-quarter. Retirement savings plans like 401(k)s accounted for more than 80 percent of contributions to pensions in 1998, compared with just over one-third in 1975 (Gale and Orszag 2003). By 2004, 401(k) plans and IRAs held more than $6.7 trillion in assets (Investment Company Institute 2005, authors' calculations based on figure 2). These aggregate amounts, however, mostly reflect large balances among high-income households. Indeed, most families approaching retirement age have meager retirement saving, if any.[1] In 2001, for example, half of all

1. Significant controversy surrounds the question of how well households are preparing for retirement. However, most studies suggest that households with moderate- and low-income are among the most vulnerable. Researchers have taken a wide variety of approaches to examine the adequacy of retirement savings: measuring changes in household consumption at the time of retirement, calculating accumulated wealth at retirement, comparing wealth across generations, and comparing models of optimal wealth accumulation to households' actual saving behavior. For recent overviews of this literature, see

households headed by adults aged fifty-five to fifty-nine had $10,000 or less in an employer-based 401(k)-type plan or tax-preferred savings plan account like an individual retirement account (Diamond and Orszag 2005).

Low retirement saving is not due to a significant lack of *eligibility* for tax-favored retirement accounts. Instead, about half of workers are eligible for 401(k) accounts through their employers, and almost all households lacking such an option through their employers could contribute to an individual retirement account. The problem is instead primarily a lack of take-up—too many people fail to take adequate advantage of the tax-preferred retirement savings opportunities they have. The inadequate take-up, in turn, reflects two key factors, and our proposed policies to encourage private saving, especially among low- and middle-income households, address these two problems directly.

One reason that people do not enroll in a 401(k) plan or an IRA is that such plans typically require specific actions to join. Furthermore, the plans sometimes present a difficult and confusing array of choices regarding investment allocations and contribution levels. As a result, many people who recognize that they should be saving more end up procrastinating and avoiding any decision. Under current rules, not making a decision means not enrolling. Thus, inertia tends to keep workers out of 401(k) plans and IRAs, since participating in a 401(k) plan or IRA usually requires an affirmative action by the worker. Thus, in practice, saving often becomes a "residual decision" for households; that is, saving is what is left over after consumption choices have been made.

In response to this problem, our first theme is that public policy should make retirement saving more of an automatic, or default, choice for households. We suggest that public policies capture the power of inertia to promote, rather than to hinder, participation in retirement plans. To accomplish this, we propose that every employer in the United States (with the exception of the smallest businesses) be required to ensure that all its new workers are automatically enrolled in a traditional defined benefit employer pension plan, a 401(k)-type plan through the employer, or an IRA. Defined benefit plans typically already have automatic enrollment and typically do not involve employee contributions. The automatic 401(k) and IRA plans would have a specified share of paychecks automatically contributed to such accounts. The funds would be automatically invested in broad-based stock and bond mutual funds. The proposal, though, respects the autonomy of individuals by letting any individual choose to override these default options if he or she wishes to do so. After all, even if many people are saving too little for retirement, some households will find themselves in situations in which they don't need or want to save more. For example, someone who is working her way through law school may reasonably expect to have a much higher income in the future and thus may not wish to save in the present. These and other individuals should be permitted to opt out of the automatic savings vehicle.

A second reason that many people do not enroll in an IRA or a 401(k) plan is that the financial incentive to do so is weak or nonexistent for the vast majority of middle- and low-income households. The primary way in which the government encourages participation in employer-based 401(k) retirement plans and IRAs is that the contributions to such plans are not counted as part of the income on which federal taxes are owed. The value of excluding the contributions from taxation depends, however, on the income tax bracket into which that taxpayer would fall. For example, consider two taxpaying couples who contribute $6,000 each to a 401(k). By doing so, each couple reduces the income subject to taxation by $6,000. However, one couple has a high income and faces a marginal tax rate of 35 percent, so reduces its taxes owed by $2,100 (35 percent of the $6,000 contribution). The other couple has a relatively low income and is in the

Engen, Gale, and Uccello (1999) and Congressional Budget Office (2003a). For recent work in this area, see Scholz, Seshadri, and Khitatrakun (2004). For evidence on the particular problems of middle- and lower-income households, see, for example, Banks, Blundell, and Tanner (1998); Bernheim (1993); Bernheim and Scholz (1993); Engen, Gale, and Uccello (1999); Engen, Gale, and Uccello (2004); Kotlikoff, Spivak, and Summers (1982); Mitchell, Moore, and Phillips (1998); Moore and Mitchell (1997); Robb and Burbidge (1989); and Warshawsky and Ameriks (1998). For a broader discussion of the resources available to those on the verge of retirement, see Gale and Orszag (2003), Orszag (2004), and Iwry (2003). A variety of publications related to these are available on the Retirement Security Project Web site, http://www.retirementsecurityproject.org.

10 percent tax bracket, so this couple reduces its taxes owed by only $600. The current system thus provides the smallest immediate benefits to middle- and lower-income families, who are generally in the lowest marginal tax brackets and who are often the ones most in need of saving more to meet basic needs in retirement.

The existing tax rules not only provide less benefit to those from low- and middle-income households, but also are relatively ineffective at inducing new saving rather than simply shifting other saving into tax-preferred accounts. The reason is that the contributions by high-income households to tax-subsidized retirement accounts are more likely to represent funds that are reshuffled from existing savings to take advantage of the tax benefit and thus do not represent a net new addition to saving (Engen and Gale 2000; Benjamin 2003). In other words, too much of our existing tax incentives for saving has relatively low "bang for the buck" because it merely subsidizes shifting the form of saving among higher-income households, rather than raising the total amount of saving in the economy.

The tax preferences for new contributions to 401(k) plans and IRAs will reduce U.S. government tax revenues by roughly $60 billion in 2005, according to estimates from the Tax Policy Center.[2] Instead of providing this incentive for saving in a manner that benefits those with high incomes proportionally more than those with lower incomes and generates little new saving to boot, we propose replacing the current deduction for contributions to these accounts with a new government program that matches households' retirement saving at a 30 percent rate up to 10 percent of their income. This matching program would significantly increase the share of the government's subsidies for savings incentives that accrue to middle- and low-income households; 80 percent of households would enjoy a stronger incentive to save under the proposal than under current law. This proposal is likely to generate both more net new saving and a more equitable distribution of retirement saving than the current system.

Making retirement saving automatic and restructuring the incentive to contribute are the key elements of our reforms. Thus, the next section of this paper will explore in some detail what automatic retirement accounts would look like and why we expect them to increase savings even if people are allowed to opt out. The following section will explore in more detail our proposal for altering the financial incentives for saving. After that, we briefly explore the challenges facing middle- and low-income households in the withdrawal stage from retirement accounts. Finally, we contrast our reforms with alternative proposals to provide greater incentives for saving by expanding the current deductions or exemptions for tax-preferred savings accounts. These alternative proposals would not target new saving among middle- and low-income households and, instead, are more likely to offer high-income households a greater opportunity to shift their assets from other forms into tax-preferred vehicles.

2. This figure should not be confused with a tax-expenditure estimate, such as those provided by the Office of Management and Budget (2005). The tax-expenditure estimate of the present value of the revenue loss due to current 401(k) and IRA contributions consists of several factors: the revenue losses due to tax-deductible contributions and the nontaxation of accruing account earnings and the revenue gains from taxation of withdrawals and any early-withdrawal penalties. The estimate in the text refers only to the first of these factors, namely, the revenue loss due to tax-deductible contributions. This, rather than the tax-expenditure estimate, is the appropriate cost measure for comparison with our proposal since our proposal would not significantly alter the rules regarding the taxation of accruing earnings, the taxation of withdrawals, or any penalties on early withdrawals.

II. The Importance of Default Choices in Saving Decisions

This section explores policies designed to promote savings opportunities by making it easier for households to save. We first document the striking empirical evidence that something as simple as changing default options can be a powerful tool for increasing participation rates and contributions. We then offer a detailed description of two major elements of our proposal: the automatic 401(k) and the automatic IRA.

The Importance of the Default Option in Saving Decisions

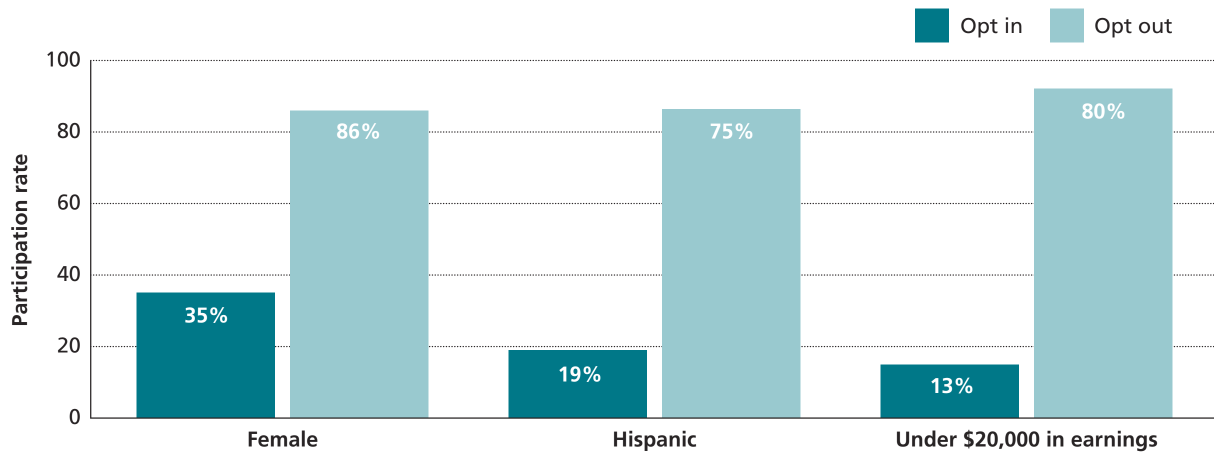
A growing body of empirical evidence highlights that it makes a considerable difference whether people must choose to *enter* a retirement savings program or whether they must choose to *opt out* of an otherwise automatic program. Currently, 401(k)-type plans typically leave it up to the employee to 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 and therefore do not participate in retirement savings plans. Those who do choose often make poor choices.

A series of studies has demonstrated that automatic enrollment boosts the rate of plan participation substantially, as shown in figure 1 (Madrian and Shea 2001; Choi et al. 2002). As the figure shows, automatic enrollment is particularly effective in boosting participation among those who often face the most difficulty in saving.

One potential problem with automatic enrollment, highlighted by recent research, is that it can induce some employees to maintain the original default contribution rate passively over time, when they might otherwise have elected to contribute at a higher rate (Choi et al. 2004). This adverse effect can be mitigated through changing the defaults on contribution rates, so that contributions rise gradually and automatically over time (for example, from 4 percent of the worker's pay in the first year to 5 percent in the second, 6 percent in the third, and so on). For example, under the Save More Tomorrow program proposed by Thaler and Benartzi (2004), workers would agree (or not) at the outset that future pay increases will generate additional contributions. In one trial, Save More Tomorrow was shown to lead to a substantial increase in contribution rates over time for those who participated, relative to other 401(k) participants at the same company. Alternatively, workers could agree to future contribution increases even in the absence of future pay raises.

The evidence on defaults underscores that even minor impediments, such as the requirement to cash a paycheck and then deposit it into another account for retirement, can have substantial effects on behavior. The payroll deduction system obviates the need for such inconveniences and thus makes saving much easier. In particular, the payroll deduction mechanism delivers contributions to a worker's account in a "frictionless" manner; the worker does not need to receive the funds and then deposit them in the 401(k) account. The participation rate in 401(k)s, which use payroll deductions, is substantially higher than in IRAs, which typically do not use payroll deduction. For example, among those offered a 401(k), roughly three-quarters typically participate (Munnell and Sundén 2004). The participation rate in IRAs is substantially lower: less than a tenth of eligible taxpayers make a contribution to an IRA in any given year (Carroll 2000; Copeland 2002). The relatively low level of participation in IRAs, relative to 401(k)s, may reflect a variety of factors associated with the 401(k), but we strongly suspect that the higher participation rates in 401(k) plans as compared with IRAs also reflect how a payroll-deduction system encourages automatic saving, and we believe that payroll deductions represent an auspicious way of promoting saving.

Figure 1. Effects of Automatic Enrollment on Participation Rates among New Employees



Source: Madrian and Shea (2001).

Our proposal combines the benefits of setting "pro-saving" defaults and exploiting the benefits of payroll deductions. Specifically, we propose that firms (except for the smallest) be required to automatically enroll all new workers in some automatic plan: either a traditional defined benefit plan, an automatic 401(k), or an automatic IRA, where the latter two terms are defined below.

Automatic 401(k)

To make saving easier, we propose an "automatic 401(k)" under which each of the key events in the 401(k) process would be programmed to make contributing and investing easier and more effective (Gale, Iwry, and Orszag 2005).

Our automatic 401(k) plan would begin with *automatic enrollment*. Employees would automatically become participants in their company's 401(k) plan, although they would preserve the option of declining to participate. In other words, workers would be included in the 401(k) retirement plan unless they opted out, rather than being excluded unless they opt in.

The next step would be *automatic escalation*. Employee contributions would automatically increase in a prescribed manner over time—for example, raising the share of earnings contributed to the account whenever a worker experiences a pay increase, again with an option of declining to increase contributions in this fashion.

The 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 entire stock market or the entire bond market, again 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.

Finally, these accounts would have *automatic rollover*. When an employee switches jobs, the funds in his or her account would be either retained in the previous employer's plan or automatically rolled over into an IRA or 401(k) plan offered by the new employer. At present, many employees receive their accumulated balances as a cash payment upon leaving an employer, and most of them spend part or all of it. For example, Poterba, Venti, and Wise (1998) report that fewer than half of distributions are rolled over, although more than half of dollars are rolled over. 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.

At each step—enrollment, escalation, investment, and rollover—workers could always choose to override the defaults and opt out of the automatic design. Automatic 401(k) plans thus do not dictate ultimate choices any more than does the current set of default options, which

exclude workers from the plan unless they opt to participate. Instead, automatic 401(k) plans merely point workers in a pro-saving direction when workers decline to make explicit choices of their own.

Some retirement savings plans already include at least some of these automatic features. According to a recent survey, for example, 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 (Profit Sharing/401(k) Council of America 2004). We would mandate that all 401(k) plans move to these opt-out arrangements for new employees, unless the firm is a small business, already offers a defined benefit plan, or is willing to offer an automatic IRA (defined below).[3] We limit the mandate to new employees to avoid unnecessary disruption and to reflect the evidence that automatic enrollment in particular has caused a substantially smaller gain in participation for long-tenured employees than for new employees (for example, Choi et al. 2004). Firms would be allowed to apply the automatic features to existing employees if they so choose. Over time, as workers switch jobs or enter the labor force and become new workers at firms, a growing share of the overall workforce will be covered by the new system. We would *not* require that firms offering a traditional defined benefit pension plan—that is, where the firm promises to pay pension benefits based on income earned during the worker's time at the firm—also have automatic 401(k) plans for the workers covered by the traditional pension, although rules might need to be tightened to ensure that such defined benefit plans provide at least a minimum level of benefits to workers with certain levels of experience.

Several additional policy interventions would be beneficial to address various concerns firms may have about automatic 401(k) plans. First, the laws governing automatic enrollment could be clarified. In some states (such as New York and California), some employers see their state labor laws as potentially restricting their ability to adopt automatic enrollment; the laws are written broadly to protect workers against "coercive" measures. Although many experts believe that federal pension law preempts such state laws as they relate to 401(k) plans, additional federal legislation to confirm explicitly 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. Such withdrawals could prove costly under current law because restrictions on 401(k) withdrawals 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, if workers are automatically enrolled, their contributions have to be invested in something—and some firms are worried about legal liability for these default investments. Congress could give plan sponsors a measure of protection from fiduciary liability for sensibly designed default investments—like the broad index funds that mimic the overall performance of the stock or bond markets.

Finally, moving to automatic enrollment could be associated with a reform of the rules governing "nondiscrimination" in 401(k) plans. These nondiscrimination standards have nothing do with discrimination by ethnicity, gender, or age. Instead, they are designed to prevent discrimination by executives and high-paid employees against others in the firm. Specifically, these rules specify that the amount of tax-favored contributions permitted for executives and other higher-paid employees depends on the contributions made by other employees. These nondiscrimination rules have become extremely complicated, and we would embrace a broad reform in this arena (for a proposed simplification, see Orszag and Stein 2001).

3. The number of employees would presumably determine the threshold for the small business exemption. The precise level for that threshold could be set as part of the legislative process for implementing this proposal.

Automatic IRA

Since only about half of the workforce is offered an employer-based pension in each year, it is important to make it easier for workers to save even if their employers don't offer a 401(k) or other pension plan. We propose an "automatic IRA" to address this challenge.[4] As in the case of 401(k) plans, the automatic nature of the IRA would apply at each relevant step—enrollment, escalation, and investment. In the case of the IRA, automatic rollover is not an issue because these accounts would be held on an individual basis, rather than through the firm. As with the automatic 401(k), workers could choose to override the IRA defaults at any stage.

Firms that do not offer qualified pension plans, of either the 401(k) or the standard defined benefit variety, would be required to set up automatic payroll-deduction IRAs as a default for their workers. Firms that do offer 401(k) or other qualified plans could also set up these IRAs, but would not be required to do so. Workers who did not opt out would have part of their paychecks every period flow into the "automatic IRA." The share of the paycheck flowing to the account would automatically escalate over time, unless the worker opted out of such increases. Legislators could provide a modest tax credit for start-up administrative costs at firms mandated to offer an automatic IRA under this plan that currently do not offer a pension plan. The funds in the IRA would be automatically invested in a limited number of diversified funds available. The specific default option could be chosen by the financial institution holding the IRA, but we envision the default investment being similar or identical to those allowed under the default investment option for the automatic 401(k).

The automatic IRA could also receive part of a household's tax refund each year. For many households, and particularly those with low or moderate income, the refund is the largest single payment they 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 refunds in designated accounts at financial institutions. The direct deposit, however, can be made to only one account and must be for the entire refund. This all-or-nothing approach discourages many households from saving any of their refunds. Some of the refund is often needed for immediate expenses, so depositing the entire amount in an illiquid retirement savings account is not a feasible option. Yet directly depositing only *part* of the refund in such an account is not currently possible. Allowing taxpayers to split their refunds could make saving simpler and, thus, more likely. (The Bush administration has committed to allowing split refunds by 2007.) The deposits could increase the amounts accumulated in automatic IRAs. Families might also 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 a rising share of each year's tax refund was deposited into the automatic IRA over time.

Individuals could also make additional voluntary contributions to the automatic IRA, to the extent that their payroll deduction contributions and refund-based contribution do not exceed the allowable limits discussed in the next major section of the paper.

Summary

The creation of the automatic 401(k) and automatic IRA, coupled with the requirement that firms enroll all workers in an automatic retirement plan of some sort, would make saving much easier for households. All workers would have the opportunity to save for retirement in a diversified manner without having to take affirmative steps. Those workers who wanted to opt out of participating, contributing at the specified levels, or the default investment choices could always do so. The two accounts, furthermore, would work together, since the automatic 401(k) could be rolled automatically into the automatic IRA if workers switch jobs. At any point in time, people would thus have a maximum of two defined contribution retirement accounts: the employer-based automatic 401(k) and the individual automatic IRA.

4. For details on how a related proposal for automatic IRAs would be implemented, see Iwry and John (2006).

III. Restructuring Incentives for Savings

The fact that savings decisions are so heavily influenced by behavioral factors such as defaults does not mean that economic incentives are necessarily irrelevant. Indeed, recent evidence suggests that the rate at which the government matches retirement savings contributions can have a significant effect on contributions. In a recent study, households were at random offered different matching rates for making contributions to an IRA at the time they were preparing their taxes. The experiment showed that households made significantly higher contributions when offered a higher match rate (Duflo et al. 2005).

Increasing retirement account *contributions*, though, is not necessarily the same thing as raising overall household savings. It could be that the higher rates of contributions to retirement accounts due to automatic enrollment or higher match rates result from a simultaneous decrease in other savings outside of 401(k)s and IRAs. Alternatively, people might borrow more, perhaps in the form of home equity loans, while they increase their retirement contributions by a counterbalancing amount, leaving their overall net level of personal saving unchanged. We noted earlier that evidence suggests that, for many high-income households, contributions to existing retirement savings accounts largely represented a reshuffling from other assets to take advantage of the tax savings in the retirement accounts. However, this is less likely to be true for those with low and middle incomes because they have less money in other assets and thus less ability to reshuffle assets; so it is more plausible that government savings incentives will increase total household saving for these households.

This argument suggests that the current system of tax incentives for retirement savings is flawed. By providing incentives for contributions through tax provisions that are linked to the marginal tax rates that people owe, current incentives deliver their largest immediate benefits to higher-income individuals in the highest tax brackets. These high-income individuals are precisely the ones who can respond to such tax incentives by reshuffling their existing assets into these accounts to take advantage of the tax breaks, rather than by increasing their overall level of saving. As a result, the tens of billions of dollars in tax expenditures associated each year with 401(k) and IRA contributions could be targeted more effectively to increasing overall saving.

Replace the Deduction for Retirement Savings Contributions with a Government Matching Contribution

We propose a new incentive structure for contributions to retirement savings accounts, which would cost roughly the same as the current tax incentives. Our plan would replace the existing tax deductions for contributions to retirement savings accounts with a government matching contribution into the account. Unlike the current system, workers' contributions to employer-based 401(k) accounts would no longer be excluded from income subject to 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). However, all qualified employer and employee contributions would be eligible for the 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.

The qualifying government matching contribution would be 30 percent for all contributions up to the minimum of either: a) 10 percent of adjusted gross income, which is the measure of income on which federal income taxes are imposed; or b) $20,000 for 401(k) accounts and $5,000 for IRAs. Thus, the maximum contribution eligible for a match would be $20,000 per person under a 401(k) account and $5,000 per person under an IRA. Each spouse of a married couple could make these contributions, so each spouse would be allowed to contribute 10 percent

of the household's income, and the maximum contribution for a couple could amount to $40,000 to 401(k)s and $10,000 to IRAs. These limits would be indexed for inflation.

This proposal would be roughly revenue neutral for the federal government, according to estimates from the Tax Policy Center microsimulation model. Calculations based on the model show that replacing the current tax incentives with a government matching contribution, without making any change to the definition of eligible contributions, would allow a matching rate of 28 percent. Our proposal, though, restricts eligible contributions to no more than 10 percent of income up to a maximum income threshold of $200,000, which modestly restrains eligible contributions compared with current law and thus facilitates close to a 30 percent match rate on a revenue-neutral basis.[5]

Our proposal has major advantages over the existing system of savings incentives. For any given dollar deposited into an account, the match rate would depend solely on saving relative to income (up to the contribution limits), not on the level of income itself. As a result, our system provides the same proportional benefit for saving defined as a share of income (at least up to the contribution limits), unlike the existing set of tax incentives for saving. Many investment advisers counsel people to save a certain percentage of their income—advice that is in turn based on the insight that saving a certain proportion of income now will avoid sharp declines in living standards after retirement. Providing a savings incentive with a government match based on the share of income saved promotes this consistent approach to saving.

5. Contributions currently amount to $281 billion, and eligible contributions under our proposal amount to $273 billion. The weighted average marginal tax rate on contributions is approximately 22 percent. We assume after-tax contributions would remain constant, so our match would apply to after-tax contributions of $273 billion x (1-0.22), or $213 billion. With a match rate of 30 percent, the cost is $63.9 billion. The cost of the 22 percent average marginal tax rate applied to $281 billion in contributions is $62 billion, suggesting the proposal is roughly revenue neutral. The precise match rate could be adjusted to make the proposal precisely revenue neutral based on official estimates from the Joint Committee on Taxation.

As noted above, the government matching payment would be directly deposited into the account, rather than providing a reduction in tax. The government match is thus similar to a tax break that is required to be deposited into the account. It seems likely that this requirement would make the matching contribution itself more likely to be saved than is the tax deduction under current law. This form of the incentive may even induce more household saving (even apart from having the incentive itself saved): although we have no direct evidence on this point in the context of retirement savings, some evidence suggests that direct matches are more effective than equivalent tax rebates at inducing people to contribute to charities (Eckel and Grossman 2003). Also, the match is a replacement for the up-front tax deduction as a method of providing a government subsidy for contributions; when the matching funds are withdrawn from the account, they are therefore subject to taxation just as under an existing 401(k) or traditional IRA.

Comparison with Current Incentives

For an individual with a hypothetical marginal income tax rate of 23 percent, our proposed incentive system is very similar to the existing incentives provided under the tax code. Under the current system, for every dollar saved by that individual, the individual would receive a tax deduction worth twenty-three cents. Thus for every dollar in an account, the individual's after-tax cost is seventy-seven cents. Under our system, instead, the individual gets a matching contribution of 30 percent of the contribution, and the matching contribution is deposited into the account. If the individual makes a contribution of seventy-seven cents, the government would provide a matching contribution of twenty-three cents, so the individual would have one dollar in his or her account. Again, as with the current tax system, the individual would have one dollar in the account in exchange for an after-tax cost of seventy-seven cents. Depositing the matching contribution directly into the retirement savings account, rather than delivering it as a tax break, seems likely to significantly raise the chance that the tax break is saved, rather than consumed.

Compared with the current system, our proposed incentives for saving reduce the tax subsidy to savings for

Table 1. Illustrative Existing and Proposed Incentives

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
$40,000	$3,000	10%	$2,700	30%	$300	$810
$60,000	$5,000	15%	$4,250	30%	$750	$1,275
$150,000	$10,000	25%	$7,500	30%	$2,500	$2,250
$250,000	$15,000	28%	$10,800	30%	$4,200	$3,240
$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.

high-income households—more precisely, for those with marginal tax rates higher than 23 percent, while raising it for lower-income individuals, those with marginal tax rates below 23 percent. Consider households at different incomes illustrated in table 1, with different assumed levels of savings. The final two columns of the table show, given our assumed pattern of saving, that our proposal generally shifts the government's incentives for saving so that higher benefits flow to those with low and middle levels of income. The family with $30,000 in income, for example, receives no benefit under the existing system of tax deductions and exclusions (since the family does not have positive income tax liability), but would receive $600 under the proposal as a match for saving $2,000.

The incentive to save additional funds is determined by how much of a financial incentive is provided for an additional dollar of saving. Table 1 also illustrates how the proposed system creates stronger *marginal* incentives for most families to save that additional dollar. The family at $30,000 in income with savings of $2,000, for example, would receive a 30 percent match, rather than nothing, for saving an extra dollar. It would also receive a $600 benefit, rather than nothing, for its $2,000 contribution. By contrast, a family with $500,000 of income and $20,000 of contributions sees a reduction in its overall benefit from $7,000 to $3,900. Its marginal incentive to contribute declines, which is warranted for the reasons we discuss above. These calculations ignore the role of state taxation—for residents of most states, there will also be a loss of state tax savings from existing retirement savings vehicles—but we will discuss state taxation issues in more detail below.

Table 1 is helpful for illustrating the mechanics of the proposal. As the table suggests, the proposal generates benefits for most middle- and low- households, while imposing costs on higher-income households.

Table 2 shows the distribution of potential winners and losers under the proposal. As emphasized above, households facing a marginal tax rate of less than 23 percent have a stronger incentive to contribute under the proposal than under current law; households with a marginal tax rate of more than 23 percent have a weaker incentive. Table 2 shows that 80 percent of all households would enjoy a stronger saving incentive under the 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. (In this table, "income" is defined as adjusted gross income, the concept of income defined in the tax code. The table shows the results for tax units, which are typically similar but not identical to households.)

One concern with our proposal is the potential to erode the employer-based retirement savings structure. We agree that the available evidence suggests that individuals will respond much more to savings incentives through the workplace than they do to savings incentives outside the workplace. The reason that we have a much tighter limit on the income to which the matching credit can be applied for IRAs than for 401(k) plans is to ensure the attractiveness of workplace-based savings plans. Indeed, our proposal may modestly encourage defined benefit plans, which would continue to enjoy the same tax treatment as under current law. For high-income workers,

Table 2. Share of Tax Units with Marginal Tax Rate below 23 Percent Threshold for Gaining under Proposal[1]

Adjusted gross income class (thousands of 2005 dollars)[2]	Tax units[3]			
	Number (thousands)	Percent of total	Number with marginal tax rate below 23 percent (thousands)	Percent with tax rate below 23 percent as share of total within income class
Less than 10	34,644	24.0	34,642	100.0
10–19	21,895	15.1	21,895	100.0
20–29	18,053	12.5	18,053	100.0
30–39	14,232	9.8	13,498	94.8
40–49	10,888	7.5	7,473	68.6
50–74	18,946	13.1	12,990	68.6
75–99	10,596	7.3	4,373	41.3
100–199	10,788	7.5	596	5.5
200–499	2,619	1.8	62	2.4
500–1,000	454	0.3	5	1.0
More than 1,000	257	0.2	5	1.9
ALL	**144,575**	**100.0**	**114,788**	**79.4**

1. Baseline is current law.
2. Tax units with negative AGI are excluded from the lowest income class but are included in the totals.
3. Includes both filing and nonfiling units. Tax units that are dependents of other taxpayers are excluded from the analysis
Source: Urban–Brookings Tax Policy Center Microsimulation Model.
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a defined benefit plan would provide a tax break linked to the 35 percent marginal tax rate. By contrast, as suggested by table 1, high-income workers would enjoy a smaller benefit under a 401(k) plan or IRA. To the extent that high-income workers influence choices made by firms about pension plans, the difference in tax treatment for such workers could encourage some defined benefit plans (which would then cover middle- and low-income workers also).

Another concern is that the matches provided through the government may displace employer matches to 401(k) plans. One motivation for these employer matches is the nondiscrimination requirements described earlier: to meet the nondiscrimination test, pension plans must ensure sufficient participation by low-income employees, and the match is an incentive to encourage such participation by low-income workers. Under this theory, to the extent that our automatic 401(k) raises participation by low-income employees, it could erode the use of matching contributions by employers (since such matches would no longer be necessary to satisfy the nondiscrimination standards). This chain of events could lead to an overall lowering of the incentive to save through employer-based retirement plans. On the other hand, many other potential motivations exist for employer matching. For example, the match may be offered as a way of furthering tax-free compensation for the highly paid employees most likely to participate in 401(k) plans; such a motivation would still exist under our proposal. Moreover, even if employer match rates decline substantially (which we do not expect to occur), the overall effects of the reform may still be beneficial. If lower-income individuals participate more in 401(k) plans through defaults, but higher income individuals receive smaller matches, the net result may still be an increase in net saving.

Withdrawal Rules

Individuals will sometimes wish to withdraw funds prior to retirement. The rules for preretirement withdrawal are important for any savings vehicle. In the extreme, individuals could be penalized for any withdrawal before an appointed retirement age. Yet, over time, U.S. policy has evolved to allow more generous preretirement access to funds in both IRAs and 401(k)s

(National Academy of Social Insurance 2005). The argument against allowing a wide range of circumstances for early withdrawals is that preretirement withdrawals tend to harm the retirement security that is the goal of such savings. The argument for some preretirement withdrawals is that they may finance alternative forms of (physical or human) capital accumulation and that, by making access to the account balances less restrictive, such rules can raise the appeal of these accounts as savings vehicles and thus possibly increase voluntary contributions in the first place. Indeed, some argue that existing approved uses do not go far enough. Most Americans have no savings other than home equity and their retirement accounts. Thus, if they suffer adverse events, such as unemployment, restricting their access to the account denies them liquidity that they could use to avoid severe drops in their living standards. It seems unfair, under that view, to induce individuals to store away their savings in a mechanism that is not available should they face unfortunate life circumstances.

We propose a middle ground between these views. We would allow qualified withdrawals for capital accumulation like existing IRAs: that is, for first-time home purchases or college education. We would, though, disqualify other existing exceptions to early-withdrawal penalties. At the same time, we would allow loans from IRAs. Already, 401(k) plans allow loans of up to $50,000 or one-half of the employee's account balance, whichever is less.[6] Under our proposal, individuals would similarly be allowed to take loans from their IRAs for up to the lesser of $50,000 or half the accumulated balance due to their contributions (excluding the funds from the match). The loans would have to be repaid within five years, at the interest rate that the government pays when it issues five-year bonds. If individuals did not repay these loans, they would be treated as unqualified withdrawals from a retirement account, and penalties would be imposed accordingly.

Transition and Gaming Issues

This proposal represents a major change in the tax treatment of retirement savings. As such, it raises concerns about the transition from current policy to the proposed alternative. We propose that all existing 401(k) and IRA retirement savings accounts be left unchanged under this proposal, but that no new savings are allowed to flow into those accounts. Ending new contributions would apply both to conventional 401(k) and IRA accounts and also to Roth 401(k)s and Roth IRAs. In Roth savings vehicles, retirement savings are taxed up-front but accumulation inside the account is not taxed, and the funds are not taxed when withdrawn.

Individuals would be encouraged to roll their existing accounts into the two remaining retirement savings vehicles, the 401(k) and IRA. Balances in existing 401(k) and IRA accounts could be directly rolled into the new 401(k) and IRA. Balances in Roth IRA accounts could also be given the match and then rolled into the new IRA. For administrative simplicity, such rollovers should be eligible for the match under our proposal and then taxed upon withdrawal, which would obviate the need for separate accounting.

The large matching payments also raise the possibility of gaming: individuals might invest the money, trigger the match, and then quickly withdraw the contribution. In the current context, imposing a penalty of 10 percent on early withdrawals that do not meet permissible purposes discourages gaming. The traditional IRA withdrawal rules would not be potent enough in the context of our proposed incentives, since the match rate is much higher than 10 percent.[7] As a result, gaming in which people

6. Some 401(k) accounts accumulate balances but also require that the employee spend a certain amount of time before those balances belong to, or "vest," with the employee. The rule here refers to "vested" amounts. If half the vested account balance is less than $10,000, the employee may borrow up to $10,000. The loan must be repaid within five years, unless it is used to purchase a home. To limit employees' ability to maintain outstanding loan balances of up to $50,000 for an indefinite time, a special rule reduces the $50,000 amount by the excess of the highest outstanding loan balance during the preceding year over the current outstanding balance. For further information, see National Academy of Social Insurance (2005).

7. Gaming possibilities do exist under the current Saver's Credit. This tax credit is worth between 10 and 50 percent of an individual's eligible contribution of up to $2,000 to an account like a 401(k) or an IRA. Thus, a taxpayer could deposit the fund in an IRA, receive the tax credit, and then immediately withdraw the funds. As long as the tax credit reduces taxes by more than the 10 percent penalty for early withdrawal from the account, the taxpayer will come out ahead. However, the Saver's Credit is available to a limited number of tax filers

contribute money to a retirement account, receive the match of 30 percent, and then withdraw their contribution and pay the 10 percent penalty could become a problem. One possibility is to increase the penalty rate for early withdrawal. Alternatively, we would prefer that individuals would forfeit their government matching payments by an unqualified early withdrawal. As an example, consider an individual who contributes $1 to an account and receives $0.30 in matching contributions. The individual then withdraws the $1 before retirement. If the $1 withdrawal does not meet one of the specified exceptions to the early-withdrawal penalties, the government would impose a penalty to reclaim the $0.30 match.[8]

State Tax Implications

This proposed reform also has important implications for state income taxation.[9] Almost all states follow the federal tax treatment of retirement savings in 401(k) accounts and IRAs: that is, income contributed to a 401(k) account is excluded from taxation, and income contributed to an IRA is deductible from income. Eliminating these tax provisions could mean that many taxpayers would face higher state income tax bills unless states took explicit actions to offer state-specific savings incentives. It seems unlikely that many states would want to take such actions, since tax deferral of retirement savings makes less sense when individuals are mobile. That is, if the state of Michigan gives an up-front match to a savings retirement plan, but the taxpayer then retires to Arizona, the state tax on the withdrawals would be paid there. (If the person retires to Florida, which doesn't have an income tax, the match on the contribution would never actually be offset by a state tax bill after retirement.) Admittedly, this perspective suggests that states should not currently exclude retirement contributions from taxable income at the state level, but it may be easier for state governments not to offer a matching incentive than to include an item in taxable income that is excluded at the federal level. In other words, many state governments may view this plan as a fiscal windfall.

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, many means-tested benefit programs such as Food Stamps, health insurance through Medicaid, and cash welfare under Temporary Assistance to Needy Families have rules that moderate- and low-income families who have saved for retirement in 401(k)s or IRAs are disqualified from receiving benefits under the program. Such asset tests can be viewed as an implicit tax on retirement saving, in the sense that retirement saving reduces government benefits that would otherwise have been available (Neuberger, Greenstein, and Sweeney 2005).

These asset tests represent one of the most glaring examples of how laws and regulations have failed to keep pace with the evolution of the U.S. pension system. At the time the asset test rules were developed, most pension plans took the form of defined benefit plans, where the employer promised to pay a future pension and in effect held the retirement assets in a pension fund on behalf of the employee. However, many firms have now shifted to providing pensions in the form of 401(k) accounts and IRAs, in which the employee holds the assets directly. Yet the asset test rules have largely not been updated, so many programs still do not treat defined benefit plans as a personal asset, while counting 401(k)s and IRAs as such. 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.

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

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because it is available only to filers with incomes below $50,000, and it can only reduce taxes to zero. The gaming possibilities do not appear to be well known.

8. We thank Emmanuel Saez and Esther Duflo for suggesting this antigaming rule. The details of the antigaming provisions for people fifty-nine and one-half or older, the stacking order of withdrawals of matched principal amount and other funds (including earnings on the matched principal amount) from the account, and the tax treatment of the match itself and its withdrawal would need to be decided.
9. We are grateful to Iris Lav of the Center on Budget and Policy Priorities for laying out these issues for us.

401(k)s over into IRAs when they switch jobs, as many financial planners suggest they should, could disqualify themselves from the Food Stamp Program.

Disregarding amounts 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. Congress could alter the law so that retirement accounts that receive preferential tax treatment, such as 401(k) plan and IRAs, are disregarded for purposes of eligibility and benefit determinations in federal means-tested programs. Less dramatic steps to avoid the disincentives of asset tests include simply raising the amounts allowed in retirement accounts without disqualification. Any resulting increase in state government expenditures could be offset, in part or whole, by the additional revenue that states would collect from ending the deductions and exclusions associated with 401(k) and IRA plans.

IV. Retirement Withdrawals and Annuitization

The proposals delineated in this paper would help households accumulate more funds in their retirement accounts. But the proposals would not address a major challenge for those who have accumulated such funds: how do they make sure that whatever funds they have saved in a 401(k) or IRA are not exhausted too soon during their retirement?[10] Consider an actuarially average woman aged sixty-five. She has a life expectancy of twenty more years, according to the Social Security Administration. However, the same projections suggest that she faces more than a 30 percent probability of living past age ninety, and almost a 15 percent chance of living past age ninety-five (National Academy of Social Insurance 2005). The standard way that she could protect herself against running out of retirement funds if she lives past her average life expectancy is to convert the funds in her 401(k)-type plan or IRA into a lifetime annuity, which guarantees periodic payments for life.

We recommend that the government set as a default that the matching contributions in each person's account be annuitized. This amount would represent only a modest portion of final account balances, but it would set the precedent for individuals that annuities are a sensible use of retirement resources. Moreover, this choice would only be a default; individuals could opt out of the annuitization if they choose, allowing those with extenuating circumstances (like a family history of short life expectancies) or alternative preferences to avoid annuitization altogether.

A problem with this recommendation, however, is that for most middle- and low-income families, lifetime annuities purchased on the individual market as it currently exists may be financially unattractive, for several reasons.

10. Some of the ideas in this section are drawn from National Academy of Social Insurance (2005). Responsibility for the specific form of the ideas presented here, however, rests solely with the authors.

First, current lifetime annuity products are typically not protected against the risks of inflation. Although inflation has been low in recent years, even a low steady inflation rate can significantly erode the real value of income from an annuity over time: $100 today will have a buying power (expressed in current dollars) of less than $75 after ten years of 3 percent inflation and less than $50 after twenty-five years of 3 percent inflation. Unexpectedly higher increases in inflation could be even more devastating to the real buying power of fixed retirement income.

A second problem is that for the average purchaser, annuities are not a good deal. (Brown, Mitchell, and Poterba 2000). When an individual converts a retirement account to a lifetime annuity, the value of the savings in the account is likely to be reduced by roughly 3 to 5 percent to cover the annuity company's marketing expenses, commissions to agents, other administrative costs, and profits. Moreover, those who buy annuities tend to have longer life expectancies than the population as a whole, because those are the people who are most concerned about outliving their wealth. Because those who purchase annuities tend to have longer-than-average life expectancies, and firms that sell annuities must price the annuities to reflect that reality, the payments from an annuity are about 10 percent less than the amount that would reflect an average life expectancy. This penalty for the average person would be reduced if the market expanded, but it would likely still exist to some degree even with significant increases in market participation.

The bottom line, then, is that lifetime annuities available to individuals through private markets do not provide an attractive way for average families to protect themselves against outliving their assets. The policy question is how to facilitate better products for middle- and low-income households who want to ensure that their retirement assets are not dissipated too soon.

One option would be for the federal government to act as an intermediary between potential middle- and low-

income annuitants and the private market. Under the Thrift Savings Plan, for example, the federal government acts as an intermediary between federal employees and insurance companies in providing annuities. The government selects a range of annuity products that are presented to retirees. Employees may select annuities with payments that rise by 3 percent a year or annuities that provide the same benefits to the primary annuitant as well as his or her spouse. The government then contracts with companies that will offer the annuities, making selections through a competitive bidding process. Once employees buy an annuity, they deal directly with the insurance company. It is possible that this approach could be replicated on a broader scale.

The approach we prefer, however, is for the federal government itself to provide the annuities. For example, the government could allow any household with income under a certain threshold (perhaps $100,000) to purchase an annuity of up to some amount per year (perhaps $15,000) using funds accumulated in a 401(k) or IRA. Projected life expectancy and the value of the annuity would be determined using mortality tables such as those currently employed in projecting Social Security benefit payments, and the annuity would be provided in an inflation-protected form. The Social Security Administration could process the annuities, obviating the need for a new government agency.

One risk from this approach is that healthier individuals would be more likely to purchase the annuity from the government than those with shorter life expectancies would. After all, individuals know from their personal and family health history more about their life expectancy than overall government actuarial tables will ever reveal. The limits on how much annuity protection can be purchased may help to limit these selection effects. Any residual losses from attracting a larger-than-expected share of healthier individuals may be a necessary price to pay to offer an actuarially fair product to middle-income households and to offer a much more attractive product to low-income households.

V. Contrasts with 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, could significantly bolster retirement security for millions of Americans. However, some policymakers seem more inclined to pursue provisions that would expand income and contribution limits on the existing tax-preferred retirement accounts. Such proposals are fundamentally different than those advocated in this paper. Proposals to increase income and contribution limits on existing retirement savings plans would primarily benefit households who are already disproportionately well prepared for retirement. Moreover, those high-income households would probably benefit mainly from being able to place a greater share of their already-existing assets into a tax-preferred account, rather than by increasing their overall level of saving.

The Retirement Savings Account Proposal

As one example of a competing proposal, the retirement savings account (RSA) proposed by the Bush administration is basically a Roth IRA with no income limit. A Roth IRA, as mentioned earlier, is a specific kind of IRA plan in which the original contribution to the account is not deductible from the income on which taxes are owed. However, returns on saving that build up inside such accounts are untaxed, and no taxes are imposed on income withdrawn from a Roth after retirement. Under current law, access to Roth IRAs begins to be curtailed at $150,000 for couples and $95,000 for singles.

Removing the income limit on the existing Roth IRA would have no direct benefit for the vast majority of American households who are already under the current income limit. 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.[11] Analysis using the retirement saving module from the Urban–Brookings Tax Policy Center model suggests that three-quarters of the tax subsidies from removing the income limit would accrue to the 3 percent of households with cash income of more than $200,000. It is very unlikely that such households would respond to this tax break by increasing their saving—rather than shifting existing assets to take advantage of expanded access to the tax-preferred accounts. The Congressional Research Service has estimated that eliminating the income limit on Roth IRAs will, after two decades or so, reduce revenue by $9 billion a year (Gravelle 2004b).

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 5 percent of participants in retirement savings plans make the maximum contribution allowed by law, so increasing the maximum contribution amounts would thus be unlikely to have much effect on most families. 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.

The 2001 tax legislation raised the allowable contribution to Roth IRA from $2,000 to $5,000. Because of the income limits, the benefits do not accrue to those

11. Advocates of removing the Roth IRA income limits claim that eliminating the limits could allow financial services firms to advertise more aggressively and thereby encourage more saving by middle-income households. However, advertisements used in the past suggest that much 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."

Table 3. 401(k) Participants Making the Maximum Contribution in 1997

Household income (adjusted gross income)	Number of total contributors (thousands)	Percent of total contributors	Percent in income class contributing maximum
Under $20,000	2,695	7.6%	1%
$20,000 to $39,999	8,914	25.0%	1%
$40,000 to $79,999	15,020	42.1%	4%
$80,000 to $119,999	5,739	16.1%	10%
$120,000 to $159,999	1,624	4.6%	21%
$160,000 and over	1,673	4.7%	40%
TOTAL	**35,666**	**100.0%**	**6%**

Source: Authors' calculations based on Congressional Budget Office (2003b, table 2).

with the very highest incomes. However, the benefits all accrue to those who can save more than $2,000. In addition, this change is costly. The Congressional Research Service has estimated that perpetuating the $5,000 contribution limit on the Roth IRA, rather than allowing it to revert to the $2,000 limit, would reduce revenue in the long term by $20 billion per year (Gravelle 2004b).

An unpublished study by a Treasury economist found that only 4 percent of all taxpayers who were eligible for conventional IRAs in 1995 made the maximum allowable $2,000 contribution at that time (Carroll 2000; see also Copeland 2002). The paper concludes: "Taxpayers who do not contribute at the $2,000 maximum would be unlikely to increase their IRA contributions if the contribution limits were increased . . . ." Similarly, the General Accounting Office (2001) found that the increase in the statutory contribution limit for 401(k)s would directly benefit fewer than 3 percent of participants.

The findings for raising contribution limits for 401(k) accounts are similar (for example, Joulfaian and Richardson 2001). Table 3 presents information from the Congressional Budget Office on workers constrained by the previous 401(k) limits in 1997. Only 6 percent of all 401(k) participants made the maximum contribution allowed by law. Only 1 percent of participants in households with incomes below $40,000 made the maximum contribution. Among participants in households with more than $160,000 in income, by contrast, 40 percent made the maximum contribution.

This expected and common pattern—in which those with the highest incomes are most likely to make the maximum allowable contributions to existing retirement accounts—helps to explain why the subsidized retirement savings largely induces asset shifting for higher income households. These high-income households already have levels of assets above the limits in the existing programs, so that most of the funds that they hold in current retirement accounts are probably shifted from other assets, and their response to increasing the contribution limits is likely to be additional shifting of assets from other accounts. Thus, expansions of current tax preferences would mostly translate into subsidizing saving that would have occurred anyway, rather than encouraging new saving.

Furthermore, increasing IRA contribution limits could reduce the incentives for small- and medium-sized businesses to offer employment-based payroll deduction savings plans. When the IRA limit is raised, a larger number of business owners and managers may find that they can meet all their personal 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" (Gravelle 2004a). Since payroll deduction is such an important piece of encouraging savings, 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 through 401(k) plans.

VI. Conclusion

A growing body of empirical evidence raises fundamental questions about the way in which the U.S. government seeks to encourage personal saving. The evidence suggests it makes a substantial difference whether the default choice is not to participate in a retirement savings plan, with an option to participate, or whether the default choice is to participate in a retirement savings plan, with an option not to participate. However, in most cases, the default is currently set to spending, rather than saving. The evidence also suggests that those with high incomes tend to respond to incentives for contributions by shifting existing assets into tax-preferred accounts, rather than by carrying out net new saving. Current incentives for saving—which are overwhelmingly devoted to encouraging contributions to retirement accounts by high-income households, rather than contributions by households with low and middle incomes—are thus upside down.

In this paper, we have proposed a dramatic set of reforms. We would put saving first, rather than treating it as the residual left over after spending decisions have been made, by creating an automatic 401(k) and automatic IRA. Inertia would allow families to be saving in sensible ways, rather than missing their opportunity to save. We would also eliminate the existing system of tax deductions for 401(k)s and IRAs and replace them with a universal government matching program that would better target new saving by middle- and low-income households. This shift would be accomplished without any significant change in the government's budget position, since the reduction in government revenue that currently arises because of tax incentives to encourage saving would be replaced by our system of government matching payments to encourage saving. We would also improve retirement security by having the federal government provide an actuarially fair and inflation-protected lifetime annuity. The net result of this set of policies would be a dramatic rise in the retirement income security of middle- and low-income Americans.

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