

The Administration's Savings Accounts Proposals: A Critique

Peter Orszag and Gene Sperling
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Five Flaws of the Current Pension System

1. Few People Participate in the Current System

Limited Participation in 401(k)s and Employer-Provided Pensions

- Only about half the workforce is enrolled in tax-preferred retirement savings plan

AGI	Number of workers	Share of workers	Percent participating in employer plan or IRA
Under \$40,000	78,657	59.0%	36%
More than \$120,000	6,783	5.1%	77%
All Income Groups	133,397	100%	51%

IRA Participation Is Particularly Low

- Only 6% of workers made *any* contribution to an IRA in 1997
- For the third of workers with incomes below \$20,000, only 2.4% made any contribution to an IRA in 1997
- IRA participation (accounts outside employer system) is much lower than 401(k) participation

Source: Calculations based on Congressional Budget Office, "Utilization of Tax Incentives for Retirement Saving," August 2003

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2. Far Fewer Benefit From Full Incentives By "Maxing Out" Their Accounts

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- Only 4% of eligible taxpayers contribute the maximum to an IRA
- Only 6% contribute maximum to 401(k) plan

Source: Craig Copeland, "IRA Assets and Characteristics of IRA owners," *EBRI Notes*, December 2002, and calculations based on CBO, "Utilization of Tax Incentives for Retirement Saving," August 2003.

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Pension Contribution, by Income Group

Household income (AGI)	Number contributing (thous.)	% of total contributors	% in income class contributing maximum	Number at maximum (thous.)*	% of total contributing maximum
Under \$20,000	2,695	7.6%	1%	27	1.2%
\$20,000 to \$40,000	8,914	25.0%	1%	89	3.9%
\$40,000 to \$80,000	15,020	42.1%	4%	601	26.1%
\$80,000 to \$120,000	5,739	16.1%	10%	574	24.9%
\$120,000 to \$160,000	1,624	4.6%	21%	341	14.8%
\$160,000 and Over	1,673	4.7%	40%	669	29.1%
	35,666	100.0%	6%	2,301	100.0%

Source: Calculations based on CBO, "Utilization of Tax Incentives for Retirement Saving," August 2003, Table 2.

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Many Households Approaching Retirement with Little Pension Savings Beyond Social Security

Ownership of defined contribution or IRA assets, for households aged 55-59, 2001

Percentiles of income	Number of households	Percent of households with DC/IRA retirement assets	Median DC/IRA assets	Median DC/IRA assets among those with an account	Share of aggregate DC/IRA assets
Less than 20	1,664,508	25.0%	\$0	\$8,000	1.1%
20-39.9	1,559,689	49.6%	\$0	\$12,000	4.2%
40-59.9	1,660,767	61.6%	\$7,200	\$28,000	8.6%
60-79.9	1,506,983	91.0%	\$50,000	\$54,000	16.7%
80-89.9	825,049	95.4%	\$148,000	\$190,000	18.8%
90-100	769,096	92.1%	\$215,000	\$299,000	50.6%
Total	7,986,092	63.6%	\$10,400	\$50,000	100%

Source: Peter Diamond and Peter Orszag, *Saving Social Security: A Balanced Approach*, Brookings Institution Press, forthcoming, Table 8-2 ⁹

3. An Upside-Down Savings System

System Based Solely on Tax Deductibility
Implies the Following Principle:

“The easier it is for you to save, the more we help you; the harder time you have saving, the less we help you”

- Family who makes \$500,000 and is in the 35% tax bracket gets immediate 35¢ tax break for every dollar it saves
- Family who makes \$50,000 and is in the 15% bracket gets immediate tax break of only 15¢ on every dollar it saves
- Family of four making \$25,000 (one of 33 million tax filers who do not make enough to owe income taxes) gets no incentive to save

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The Result

- Bottom 40% get 2% of the tax subsidies
- Top 10% get 43% of the tax subsidies.

4. Does not leverage enough additional private savings

The Upside-Down System And National Saving

- National saving = public + private saving
- Present value of tax subsidies given in 2002 was about \$190 billion.
- These subsidies raise national saving only if private saving rises by more than the cost to the government of providing the subsidies.

The Upside-Down System And National Saving Cont.

- To raise private saving, the incentives must not simply cause individuals to shift assets into the tax-preferred pensions but must generate *additional* contributions.
- Studies confirm that offering incentives to upper-income households leads them *not* to save more but simply *shift existing savings* (Engen and Gale, 2000; Gravelle, 2000; Gale and Scholz, 1994)
 - “in general ... neither conventional economic theory nor the empirical evidence on savings effects tends to support an expectation that increased IRA contributions are primarily new savings.” Jane Gravelle, CRS 2000.
- Upside-down system does little to increase savings among lower and middle-income households, which would make the largest positive contribution to private savings ¹⁵

5. Not enough employers offering plans

- Particularly low coverage rates for part-time and small business employees
 - Only 17% of employees in firms with less than 25 employees and 23% of employees in firms with less than 100 employees have employer-provided plans
 - Only 14% of part-time workers have employer provided plans
- Potential importance of employer-based plans in encouraging participation
 - Non-discrimination rules
 - Water-cooler effects
 - Employer match

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The Administration's Proposal: Background and Critique

The Proposal in Last Year's Budget

- Two new individual accounts
 - Lifetime Savings Accounts (LSAs)
 - Retirement Savings Accounts (RSAs)
 - Roth-type tax treatment: Backloaded tax break
 - No income or age limits
- Employer Retirement Savings Accounts (ERSAs)
 - Consolidate different types of DC plans
 - Simplify nondiscrimination rules
- Press reports suggest proposal will be pushed next year
- Focus on RSA/LSA component

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LSAs

- Contribution limit \$7,500/year
- No income limits
- Contributions not deductible, earnings and withdrawals not taxable
- No withdrawal restrictions

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RSAs

- New name for Roth IRAs
- Traditional and nondeductible IRAs could not accept new contributions
 - Except rollovers from pensions into traditional IRAs
- Contribution limit \$7,500/year
- No income limits
- Contributions not deductible, earnings and withdrawals not taxable

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RSAs, continued

- Income limits on rollovers eliminated
 - Rollover amount minus basis taxable
- Income attributed to rollovers in 2003 could be spread over 4 tax years
- Rollovers from pensions also allowed, subject to tax as for IRA rollovers
- Contributions may be made at any age
- Withdrawals before age 59 subject to penalty and tax on untaxed earnings
- No withdrawal requirement during life

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The Administration's Proposal Moves in the Wrong Direction on Each and Every Issue

1. Only helps the 4-6% who already contribute the max
 - Raising amounts does virtually nothing for the 95% of Americans who currently do not save enough to max out accounts

1. Only helps the 4-6% who already contribute the max, cont.

Maximum Annual Contributions to Tax-Sheltered Savings Accounts for a Family of Four			
	IRA/RSA	LSA	Total
<u>Today</u>			
Husband	\$3,000	-----	\$3,000
Wife	\$3,000	-----	\$3,000
2 Kids	-----	-----	-----
Total	<u>\$6,000</u>	-----	\$6,000
<u>Under Full Bush Plan</u>			
Husband	\$7,500	\$7,500	\$15,000
Wife	\$7,500	\$7,500	\$15,000
2 Kids	-----	\$15,000	\$15,000
Total	<u>\$15,000</u>	<u>\$30,000</u>	\$45,000

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2. Insufficient Incentives for Those Who Don't Benefit from the Current Upside-Down System

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RSA Benefits Dramatically Skewed

- Less than 4 percent of IRA contributors contributed max
- About same percentage contributed max to 401(k)
- Virtually all of benefit of RSAs goes to people with incomes over \$100,000
 - And value of tax benefit grows with tax rate (and thus income)

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LSAs Skewed as Well

- Over a 25-year period, bottom 60% would get 11% of the benefits from the LSAs, while the top 10% get 52%
- By 2028, the bottom 60% would be receiving only 4% of the benefits, versus 66% -- a full 2/3 -- for the top 10%

Distributional Effects of LSAs

	2003	2010		2028	
Percentile	Share of Tax Cut	Share of Tax Cut	Share in last year	Share of Tax Cut	Share in last year
0-59	17	14	11	11	4
60-79	23	22	21	20	16
80-89	21	20	18	18	15
90-94	15	15	15	15	16
95-98	18	22	25	24	29
99	6	8	11	13	21

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Source: Burman, Gale, Orszag (2003)

3. Will leverage little additional private saving

- Subsidizes saving that high-income households would have done anyway
- **CBO on Bush Plan:** "Most taxpayers would simply save the same amount in one of the new accounts as they would have saved in one of their current tax-free accounts. Moreover, people who currently have assets in taxable accounts could reduce their tax liability by selling those assets and putting the cash from the sale into the tax-preferred accounts--an action that would have no effect on private saving. Most new saving would be done in small amounts by taxpayers with few taxable assets to shift."

4. May Encourage Employers to Drop Coverage for Their Employees

- Would increase from \$6,000 to \$45,000 the amount that small business owners could save on their own before having to provide 401(k)-type plans to their employees.
 - “By increasing the IRA limits to create LSAs and RSAs, there would be little incentive for a small business owner to establish the new ERSA plan...[It] would gut the small business retirement plan system.” Al Martin, President, Small Business Council of America, February 5, 2003
- Would also change the “non-discrimination rules” governing 401(k)s for all employers, potentially altering the “bribe” that helps ensure that lower-income employees are covered.

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Simplification issue

- What happens to existing accounts?
 - In last year’s proposal, 529 accounts etc. still existed – and provided opportunities for double-dipping
- Complexities with savers credit and with college financial aid (LSA/RSA/IRA)

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The Larger Picture:

1. Bush's Tax Work not Wealth Agenda
2. Increasing the Debt Burden on the Next Generation

1. Bush's Tax Work not Wealth Agenda

President Bush's Broad Vision: Tax Work With Both Income and Payroll Taxes; Do Not Tax the Passive Income of the Wealthy

- Goal: Zero dividend taxation
- Goal: Zero capital gains taxation
- Goal: No estate tax
- Goal: Lifetime Savings Accounts and Retirement Savings Accounts to allow \$45,000 a year to go into tax-free accounts (family of four)

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Warren Buffett on the Proposal for Zero Dividend Taxation

“Our receptionist? She’d still be paying about 30 percent, which means she would be contributing about 10 times the proportion of her income that I would to such government pursuits as fighting terrorism, waging wars, and supporting the elderly.”

“Supporters of making dividends tax-free like to paint critics as promoters of class warfare. The fact is, however, that their proposal promotes class welfare. For my class.”

“Dividend Voodoo,” *Washington Post*, May 20, 2003.

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Administration tax agenda vs. a consumption tax

- Consumption tax rhetoric does not match Administration's actions
 - Dividend and capital gains tax breaks provided windfall gains to "old capital," thereby moving toward a wage tax rather than a consumption tax
 - Retaining partial deductibility of interest
- Theoretical benefits of consumption tax arise in a revenue-neutral setting, not a revenue-reducing one
 - Tax changes are *reducing* national saving; goal of consumption tax is to raise national saving

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2. Increases the Debt Burden on the Next Generation

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Fiscal Outlook

- CBPP/Concord/CED: \$5 trillion deficit over next decade
- Goldman Sachs: \$5.5 trillion
- *After* the next decade, problem becomes worse
 - First baby boomers eligible for Social Security in 2008
 - Eligible for Medicare in 2011

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\$6 Trillion Higher Debt Now Projected for 2008 – When the First Baby Boomers Will Retire – Than Was Projected in January 2001

	Net Indebtedness 2008
CBO January 2001	0.036 trillion
CBPP/Concord/CED September 2003	6.239 trillion

Revenue Effects

- Treasury: negligible effects on budget over decade

	2004-2008	2009-2013	2004-2012
LSA+RSA	14.8	-12.8	2.0
ERSA	-1.3	-1.7	-3.0
Total	13.6	-14.6	-1.0

- But ...

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Creating Another Hole 1/2 As Large as the Social Security Gap

- Risk of greater revenue losses in short run
- Certainty of much bigger revenue losses in long run, when baby boomers will be putting pressure on federal budget
- Burman, Gale, Orszag (2003) estimate revenue loss of 0.5 percent of GDP *per year* after 25 years.
- 75-year revenue loss, in present value, is about half the actuarial deficit in Social Security (and perhaps more)
- Claims that proposal “helps the deficit” are disingenuous – very expensive borrowing from the future

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Progressive Alternatives

- Universal 401k/USA Accounts
 - Generous ‘right-side-up’ incentives:
 - 2-to-1 matches for the working poor
 - 1-to-1 matches for middle-income savers
 - Under Clinton USA Account plan, low-income family that contributed \$700 a year would accumulate a nest egg of nearly \$250,000 after 40 years, assuming a 5% rate of return

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Savers Credit: Positive Step, but Far Outweighed by RSA/LSA Negatives

- Current non-refundable credit matches up to 50% of first \$2,000 saved by low-income earners (and smaller match rates for moderate-income earners)
- Making savers credit refundable (and paying for it), *without rest of Administration proposal*, would begin to move the pension system in the right direction
 - Incentives for lower earners
 - Raise private saving more than incentives for higher earners
- If made refundable, would thus represent a positive step, but far outweighed by harm from LSAs and RSAs.
- Cost of refundability is about .05 percent of GDP; a *tenth* of ultimate cost of RSA/LSA program
- We could do this without paying the high cost of subsidies for high-income saving

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