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Laying the Groundwork for More Efficient Retirement Savings Incentives

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Introduction and summary

Americans want to be financially secure throughout their retirement years. While Social Security offers a basic income to almost everybody, most people need to save a lot of money on their own to be able to enjoy the retirement they envision.

However, people often encounter substantial obstacles to saving more money, such as low income, lack of retirement benefits from their current employers, and limited help from existing savings incentives in the tax code. Hence, fewer and fewer working-age households can expect to maintain their standard of living in retirement. One widely cited 2013 estimate from the Center on Retirement Research showed that a little more than half—52 percent—of all working-age households were at risk of having to cut back their consumption in retirement, up from 31 percent in 1983.[1] As a result, a growing number of people are more likely to retire in poverty, to experience economic hardships such as not being able to afford necessary medication, and to have to rely on public assistance and family members for financial support.[2] This retirement crisis is real and is only getting worse.

The U.S. tax code offers financial incentives—such as contributions to certain retirement plans not being subject to federal income taxes—to encourage people to save more money than they would otherwise. These savings incentives exist under different rules in a wide variety of retirement savings accounts, including 401(k) plans and individual retirement accounts, or IRAs. The rules for these types of plans vary by how much people can contribute each year, the role employers play in offering these plans, and when people need to pay taxes.

Current savings incentives, though, are inefficient. People who need the most help to save more for retirement often get little or no help. Better designed savings incentives that target lower-income workers—for instance, those who do not work for an employer that offers retirement benefits—would make a real difference in workers' retirement preparedness. Economic research shows that low-income people do save for their futures when offered substantial financial incentives.[3] An often-cited 2005 experiment that researchers conducted with

H&R Block in predominantly lower- and middle-income neighborhoods showed that offering a 50 percent match—people received 50 cents for each dollar they saved—increased the likelihood that people participated in an IRA from 3 percent without matches to 14 percent with a match, an increase of almost 400 percent.[4] And in the same experiment, the amount that people who participated in an IRA saved increased sevenfold when they were offered a 50 percent match.[5]

These are examples of the potentially large benefits of well-targeted savings incentives. It is worth remembering, however, that more efficient savings incentives and greater access to these incentives are not the only fixes necessary to address the looming retirement crisis for many low- and middle-income people. But they would be important steps in the right direction.

What exactly are the problems with the existing incentives? The federal government and states forego revenue of more than $100 billion annually to help people save, but the effect on increasing savings is often small or negligible.[6] A recent estimate suggests that each $100 in savings incentives offered under the current structure increases savings by only $1—a low payoff for a big investment.[7] The reason for this small effect is that incentives are skewed toward high-income earners, frequently not reaching the Americans who need the most help with saving. And savings incentives are overly complex, possibly slowing savings for people who are unaware of these benefits or do not fully understand them. Moreover, how much people can possibly benefit from savings incentives depends to a large degree on whether or not they work for an employer that offers retirement benefits; employers that do can make it easier for their employees to qualify for savings incentives. Put differently, people who do not get retirement benefits at work likely also receive fewer savings incentives. The result is a well-intentioned—but dysfunctional—tax benefit system that is in need of reform to change the way that people save for retirement.

Because the current system only works for the lucky few, it does not offer much assistance to the vast majority of Americans who are trying to build a better future. Only households in the top fifth of the income distribution tend to have resources, receive substantial tax incentives, and have significant access to employer and nonemployer retirement plans to benefit from current savings incentives. It is, for example, only among households in the top fifth of the income distribution that a substantial majority of households have one or more tax-advantaged form of savings, while the majority of households in the rest of the income distribution—the bottom 80 percent—have no tax-advantaged savings.[8]

Reforming the tax code to make it more efficient should prioritize refundable tax credits over new tax deductions; emphasize progressive savings matches that offer relatively higher benefits to lower-income households; create savings incentives that are simple to use; and establish new savings options, such that gaining access to savings incentives depends less on employers offering retirement plans. Federal and state policymakers should consider five important steps that could make savings incentives more attainable and efficient. The benefits of these steps would largely go to the Americans who need the most help saving more, including lower-income workers and people who work for employers that do not offer retirement benefits. The five policy recommendations include:

1. Make the Saver's Credit fully available to lower-income households
2. Establish and expand progressive savings matches
3. Simplify retirement savings incentives by streamlining rules
4. Limit the automatic increases of tax deductions
5. Create simple, low-cost, and low-risk options for people to save for retirement outside of employer plans

Policymakers should pursue these steps to ensure that more middle-class Americans enjoy greater benefits from existing retirement savings incentives. All five recommendations would benefit lower-income earners, especially those who work for employers that do not offer retirement benefits.

Since a single report cannot possibly address all potential tax reforms, this report begins by highlighting a few basic reform principles that would make savings incentives more efficient to guide the subsequent recommendations. The report then summarizes the main problems that underlie the inefficiencies of current savings incentives,[9] followed by recommendations to address these problems.

A better network of targeted savings incentives and supporting policies would go a long way toward addressing the looming retirement crisis.

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