THE CENTURY FOUNDATION
Issue Brief

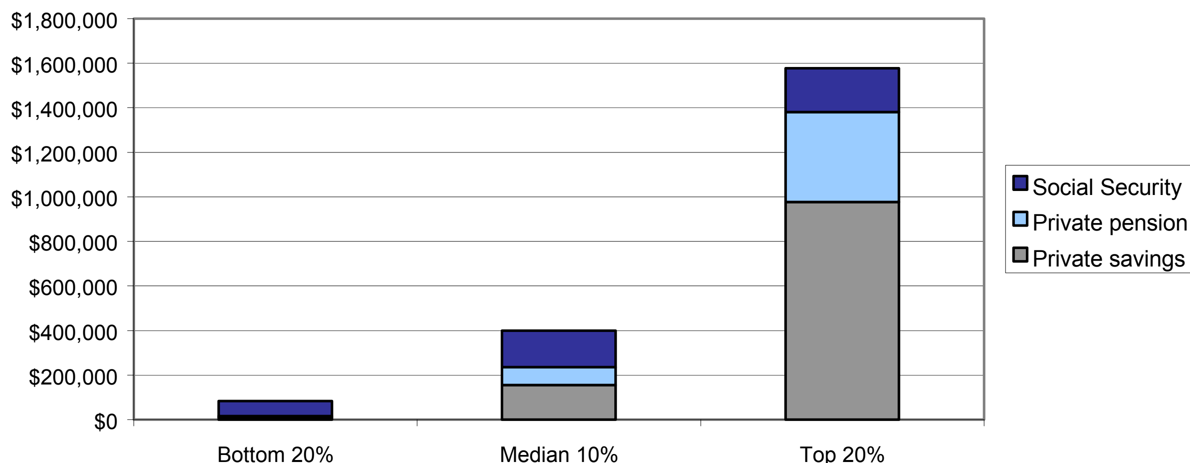
PROMOTING RETIREMENT SAVINGS: THE BUSH PLAN VS. A BETTER WAY

The Bush administration's proposals to restructure tax breaks for private saving, which are included in the 2005 budget plan, tackle a problem that desperately needs to be fixed. Today's tax code is riddled with overlapping, complicated savings incentives that badly require simplification. At the same time, the low- and middle-income families who are most likely to find themselves short of funds in retirement receive the least help from the current jumble of tax breaks. Unfortunately, the administration appears to be using the legitimate need for reforms as a subterfuge for pursuing a policy that will drain the federal treasury, transfer money to the rich, and leave the fundamental problems unsolved.

THE PROBLEMS

Alongside Social Security, private pensions and savings are essential parts of the American system of retirement. Figure 1 shows how private pensions and savings compare to Social Security wealth for families at the top and the bottom of the wealth distribution as they reach retirement age.[1] Notice that the bottom 20 percent of families have almost no private pensions or private savings. These are the families most likely to have inadequate resources for a decent retirement. The top 20 percent, in contrast, have plenty of resources in addition to their Social Security. They hardly need additional saving incentives.

Figure 1. Average Wealth at Retirement



Source: James Moore and Olivia Mitchell, *Projected Retirement Wealth and Savings Adequacy in the Health and Retirement Study*, NBER Working Paper 6240, 1997; wealth figures adjusted to 2000 prices.

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[1] Social Security wealth is the present value of expected benefits.

In spite of the obvious need for incentives that induce low- and middle-income families to save more for retirement, our current system of tax breaks delivers most of its rewards to families who already have high incomes and substantial savings.

To illustrate today's perverse retirement saving incentives, take as an example three families, each with two children: the low-income family earns $30,000, the middle-class family earns $60,000, and the high-income family earns $300,000. Every $1,000 that any of these families puts into a tax-favored saving account is sheltered from income tax. But since the marginal tax rates these families face are zero for the poor family, 15 percent for the middle-class family, and 35 percent for the high-income family, that $1,000 of saving will generate extra take-home income of $350 for the high-income family, $150 for the middle-income family, and *nothing at all* for the low-income family. Deductions from taxable income deliver their greatest rewards to those who face the highest tax rates—the well-off.

Another problem with the existing system is its sheer complexity. Saving subsidies come in more varieties than Campbell soup. There are standard 401(k) plans and SIMPLE 401(k) plans; traditional IRAs, SIMPLE IRAs, Roth IRAs, and SEP IRAs; 403(b) plans and 457(b) plans. Every year the menu grows, with the cooks in Congress aiming not to make the offerings simpler and more rational, but only to add more concoctions to the list (see Figure 2).

Finally, this complex array of ineffective saving incentives costs the U.S. Treasury a great deal. In 1999, the Joint Committee on Taxation estimated that the total cost of tax expenditures to encourage retirement saving would reach $560 billion over the 2000 to 2004 period, about a sixth of the combined value of all personal and corporate income tax breaks.[2]

- With the leading edge of the baby boom generation only a decade away from retirement, the priority should be to reform the incentives in order to increase private saving by low- and middle-income workers. We also need to simplify the rules without endangering the existing private pension system. Unfortunately, the administration's saving incentive plans are grossly inadequate

The Bush Proposals

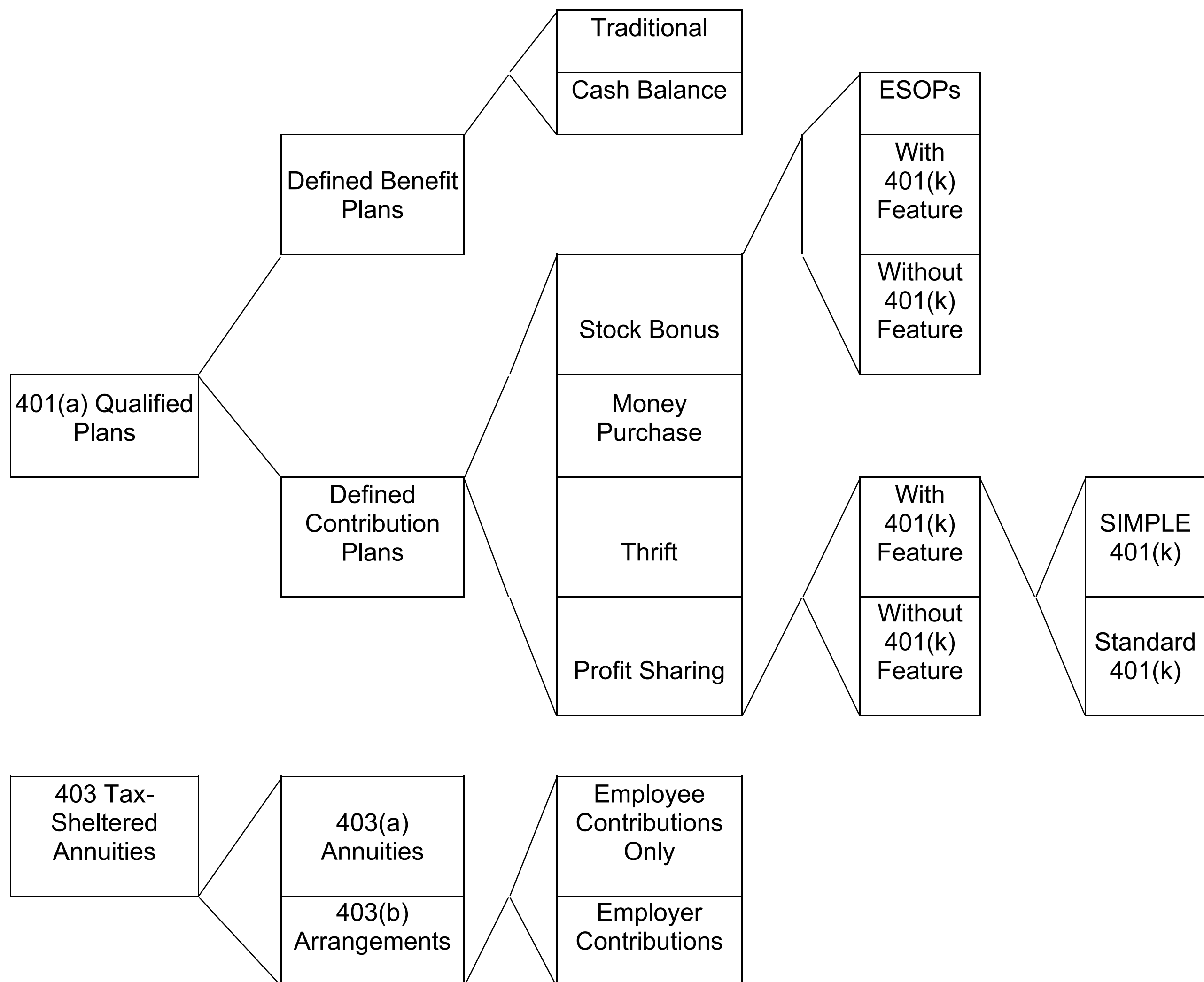
President Bush has proposed creating two new kinds of individual savings accounts. The "Retirement Saving Account" (RSA)—essentially a Roth IRA with a contribution limit of $5,000—would become the main tax-favored individual retirement vehicle. All returns would be permanently sheltered from taxes, and the funds could be withdrawn, penalty free, after age fifty-eight. Unlike Roth IRAs, however, RSA rules would place no restrictions on age or income of the saver and eliminate minimum distribution rules.

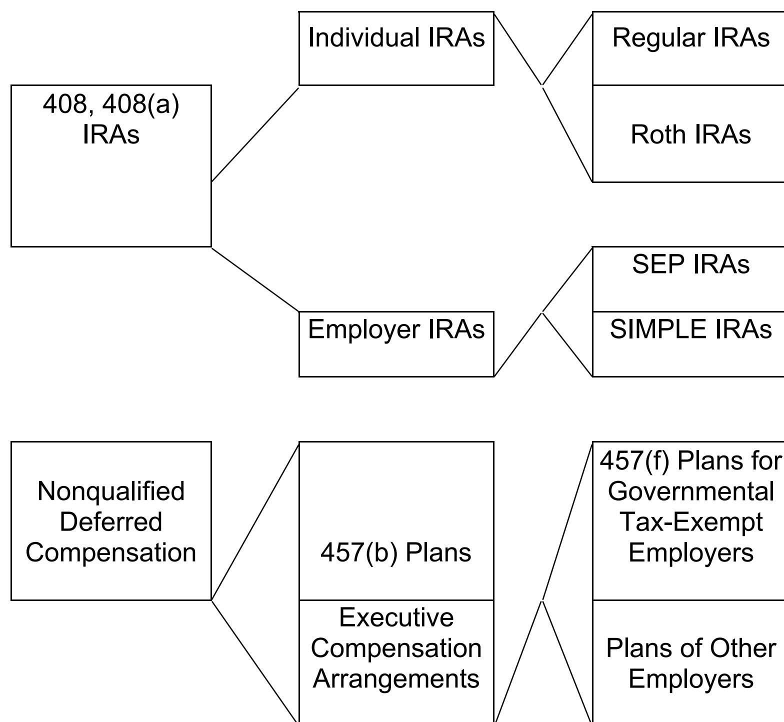
"Lifetime Saving Accounts" (LSAs) similarly would allow accumulation at the rate of up to $5,000 per year per household member, but for any purpose, with no penalty for withdrawal at any age. Parents would be able to establish trustee accounts for their minor children. Thus a

[2] Cited in Michael P. Ettlinger, "Our Bucket Is Leaking: Tax Expenditures and Loopholes in the Federal Budget," in *Bad Breaks All Around: The Report of The Century Foundation Working Group on Tax Expenditures* (New York: The Century Foundation Press, 2002).

family of four, which today can contribute $6,000 to an IRA, could contribute $10,000 per adult (to RSA and LSA accounts) as well as $5,000 per child into LSA trustee accounts for a total of $30,000 per year in new assets, the returns from which would be tax free. Although contributions to these plans would be after taxes, all income (interest, dividends, capital gains) on these savings would be shielded permanently from taxation. Even a family that saved nothing in a given year could shift its past accumulations into these new tax-sheltered accounts.

FIGURE 2: PRIVATE RETIREMENT SAVINGS VEHICLES REGULATED UNDER ERISA





Source: Pamela Perun and Eugene Steuerle, *ERISA at 50: A New Model for the Private Pension System*, The Urban Institute Retirement Project, Occasional Paper #4, March 2000, Figure 2.

What's Wrong with the Bush Proposals

We need a system that is simple, fair, targeted to those who save too little (low income workers) and that does not cost too much in foregone revenues. Instead, the Bush proposals

- add saving vehicles that interact in complex ways with the existing array of tax-favored accounts;
- offer no improvement in the incentives facing low-income families;
- raise ceilings, thereby steadily removing capital income from the tax base and delivering a tremendous boon to high-income families who already save a lot;
- undermine existing employer-sponsored pension system; and
- severely exacerbate already huge future budget deficits.

In spite of creation of the RSA and LSA accounts, many existing tax-favored saving vehicles would be retained under the Bush proposals, for example Archer Medical Saving Accounts and Section 529 college saving plans. Some retirement saving vehicles, for example traditional (as opposed to Roth)

IRAs, would continue to exist as well. The problems of understanding multiple savings options therefore would not be solved under the Bush proposals.

What is more, the Bush proposals provide no new incentives for low-income families while greatly expanding the opportunities to earn tax-free income for high-income families. The increase in the amount of saving a couple can protect from taxes each year, from $6,000 under current law to $10,000 under the Bush proposals, will do nothing for the family that earns, say, $30,000 per year and manages to save almost nothing. This is the couple that can be expected to arrive at retirement age with no private pension or savings. Even middle-class families that save today will gain nothing unless they are finding today's maximum saving limits a constraint; fewer than 3 percent of all households save at the maximum permissible level today. After all, a family that saves $6,000 each year for forty years, earning a modest 5 percent yield, will retire with more than $700,000 in accumulated savings. This is not the family we should be worrying about. We need provisions that raise saving rates among those who save less than $6,000 per year.

The increase in saving ceilings for households also threatens the employer-sponsored pension system of small businesses. Today, the owner of a small business who wants to provide a pension to management (including himself and his family) must set up a retirement plan for all his employees. By allowing the owner of small business with two children to save up to $30,000 on his own, the Bush plan will reduce severely the incentive to set up a pension plan that also covers employees. Under the legislation in force today, fewer than half the workforce has any pension coverage at a given time; we hardly need new measures that discourage employers from setting up pension plans.

Rich families already save a lot, and the Bush proposals would allow them to protect much more of this saving from taxation. As a result, the main consequence of the proposals would be to reduce taxes for the rich, reducing government revenue correspondingly. As more and more of the nation's accumulated wealth is transferred into tax-sheltered accounts, less and less of the income of capital will be taxed. The Brookings Institute–Urban Institute Tax Policy Center estimated that the loss of revenue from an earlier, slightly more generous version of the Bush proposal would reach 0.3 percent of GDP by 2013 and 0.5 percent by 2028. A loss of 0.5 percent of revenues would exceed $500 billion over ten years, at today' income.

The Reforms We Really Need

Saving Incentives Should Be Fair to Low-Income Families

A pair of changes to today's tax breaks would ameliorate the bias against low-income savers. First, a tax *credit* could be substituted for a deduction from taxable income. A fixed percentage of eligible saving—say 28 percent—could be subtracted from income-tax liabilities. A family that saves $2,000 would have its taxes reduced by $560 (28 percent of $2,000) regardless of its income level. Second, the credit could be made *refundable.* If a family's income is too low to produce a tax liability greater than the tax credit, then the unused credit would be refunded to the family. So a low-income family that succeeds in adding $2,000 to a tax favored account but owes no income taxes would receive its tax credit of $560 in the mail as a tax refund. There are already refundable tax credits in our tax codes, such as the earned income tax credit (EITC).

The incentive to those with low income to save would be even stronger if the refundable tax credit on saving provided a higher credit for the first increment of saving than for the last. For

example, if the saving tax credit were set at a rate of 40 percent for the first $1,000 of eligible saving, 20 percent for the next $5000, and 10 percent for additional eligible saving, the results would be more favorable to poor households.[3]

Saving Incentives Should Not Sacrifice Revenue for What Families Would Do Anyway

It probably would be impossible to enforce a rule that required additions to a tax-favored retirement saving account to represent truly additional saving rather than financial reshuffling. Therefore, we must try to target incentives to specific populations who need additional saving and to place restrictions on the tax favored accounts that make it difficult to draw on them indirectly (for example by using them as collateral for a loan). Current law already places a number of restrictions on tax-favored balances. Today, most carry a penalty for early withdrawal and for other uses not approved by legislation. But the Bush Lifetime Saving Accounts carry practically no restrictions. There is no reason to expect the introduction of LSA to lead to anything by tax avoidance.

The households most likely to increase their retirement saving in response to tax breaks, as opposed to simply shifting money from taxable to tax sheltered accounts, are exactly those that save little or nothing today—low- and middle-income families. So benefits that target low-income families are both more fair and more likely to increase total saving than incentives such as those in President Bush's plan, which essentially would shelter more of high-income families' saving from taxation. The same reforms that would increase fairness also would increase effectiveness.

Conclusion

President Bush's proposals to reform tax incentives to encourage saving do little to solve the real problems of the current system: unnecessary complexity, unfairness, and ineffectiveness due to poor targeting. Instead, the Bush proposals would do little more, once again, than cut taxes for those with the highest incomes. Our alternative proposals, which feature a refundable progressive tax credit would be more effective, fairer, and less costly.

Written by Bernard Wasow, Senior Fellow at The Century Foundation.

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[3] This is exactly analogous to a progressive income tax, which is levied at a lower rate for the first dollar earned than for the last dollar earned. A progressive tax generally has marginal rates that *rise* as income rises; a progressive subsidy generally has marginal rates that *fall* as income rises.

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