THE HAMILTON PROJECT

Advancing Opportunity, Prosperity, and Growth

POLICY BRIEF 2015-05

Building on What Works: A Proposal to Modernize Retirement Savings

JUNE 2015

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Our strategy calls for combining public investment, a secure social safety net, and fiscal discipline. In that framework, the Project puts forward innovative proposals from leading economic thinkers — based on credible evidence and experience, not ideology or doctrine — to introduce new and effective policy options into the national debate.

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Building on What Works: A Proposal to Modernize Retirement Savings

Millions of Americans face the challenge of saving adequately for retirement. As fewer employers provide traditional pensions and individuals live longer, the challenge of accumulating sufficient wealth to maintain an ideal standard of living in retirement—and to be protected from financial and health cost shocks—is an increasingly daunting proposition. Furthermore, saving for retirement often requires navigating a complex patchwork of tax-preferred retirement accounts accessed through employers. Mounting evidence suggests that reform of both the current structure and tax-code treatment of retirement accounts could stimulate greater savings for many Americans.

In a new Hamilton Project discussion paper, John N. Friedman of Brown University proposes two related reforms to the current system of retirement savings accounts with the goal of increasing individual rates of saving and getting a bigger bang for the buck from federal tax breaks. First, Friedman calls for replacing the current multitude of retirement savings accounts—401(k)s, IRAs, and so on—with a single plan, the Universal Retirement Savings Account (URSA). All of workers' retirement savings contributions would flow into unique, individual accounts that would stay with them permanently, following them as they change jobs. This reform would both rationalize the confusing proliferation of different accounts and reduce retirement savings leakage by limiting the early withdrawals that sometimes occur—for example, when workers change jobs and exercise the opportunity to cash out their employer-based plans.

Second, Friedman proposes redirecting part of the tax incentive aimed at individuals toward large tax credits for employers who help workers save through auto-enrollment and payroll-deductible contributions. The author contends that firms are both more knowledgeable about and more responsive to tax incentives than individuals are, and this shift would increase the effectiveness and progressivity of such targeted tax incentives. Together, these two reforms would substantially increase retirement savings and financial security for a broad range of Americans without additional direct costs to the government.

The Challenge

The need for private saving to ensure financial well-being in retirement is rising. Americans are living longer but not retiring later, out-of-pocket health-care costs for seniors remain high, Social Security is expected to provide lower benefits relative to income in the years ahead, and the offer of defined-benefit, lifelong pensions from private sector employers is increasingly rare. At the same time, the U.S. personal savings rate hovers around 5 percent, less than half its rate in the early 1980s. Several studies suggest that a sizable share of Americans—between one-third and one-half—are not saving adequately for retirement, and that the problem is worse for black and Hispanic households and households of moderate incomes.

Friedman argues that the centrality of employers in the existing retirement system is both the main cause of and the most logical solution for limited retirement savings. In particular, he maintains that the two primary mechanisms for private retirement savings—employer-sponsored plans and tax subsidies—are currently structured inefficiently for promoting savings and reach few moderate-income earners. He contends that congressional reform of both mechanisms could remedy these shortcomings.

Historically, employer-sponsored plans consisted of defined-benefit pensions that provided fixed, lifelong monthly benefits for employees at retirement. Employer-sponsored plans today, however, much more commonly consist of defined-contribution accounts. In defined-contribution plans, such as 401(k)s, employees and sometimes employers regularly contribute a share of the worker's earnings to investments that serve as a pool of resources for the employee during retirement. For workers to benefit from these plans their employers must offer them, but according to a recent government survey, just half of private sector employees aged 21 to 64 reported that their employer sponsored such a retirement plan. This share is much lower among part-time workers, those working multiple jobs, and employees of small firms.

Although all workers can open individual retirement accounts (IRAs) separate from their employers, these accounts are neither as generous nor as convenient as employer-sponsored plans, with lower limits on annual contributions, little to no guidance on what investments to make, and often the need for individuals to make contributions separately and manually. In contrast, employer-sponsored plans usually provide for automatic payroll deductions, which are far more effective, especially for workers who may face the temptation to skip payments in favor of increased current consumption. Moreover, employers bear fiduciary responsibility to select sound investment options for their workers. This legal burden is one reason why smaller employers are less likely to offer employer-sponsored plans.

Furthermore, since employer-sponsored plans are specific to each employer, individuals—especially if they change jobs—often must manage a large number of retirement accounts with varying rules for contributions, withdrawals, and asset management. The federal tax code currently provides for no fewer than thirteen different types of individually directed retirement savings accounts. This complexity, Friedman asserts, generates needless administrative burden and confusion for both employees and employers, resulting in lower-quality choices of savings and asset allocation. The administrative transition from one retirement plan to another that occurs when workers switch jobs also contributes to the large amount of early withdrawals from retirement accounts. When workers transition from one job to another and seek to close down 401(k) plans with the employer they are leaving, they are often presented with the option to withdraw the funds in cash. By one estimate this leakage amounts to nearly 50 cents for each dollar in annual contributions. Moreover, workers who have taken out loans from these accounts are required to immediately repay them when switching jobs, increasing the risk of default and converting a temporary withdrawal into a permanent one.

The ostensible purpose of the tax subsidies for retirement accounts, especially employer-sponsored plans, is to encourage workers to save more by making it less costly for them to do so. Individually directed retirement accounts, including both employer-sponsored plans and IRAs, are tax-preferred, meaning that individuals do not pay taxes on interest or capital gains on balances in these accounts. Individuals are also exempt from paying income taxes on either contributions to the accounts (called pre-tax treatment under traditional 401(k)s or IRAs) or withdrawals from them (called post-tax treatment under Roth 401(k) or Roth IRAs). In other words, under pre-tax treatment, contributions are tax-free and withdrawals are taxed; under post-

tax treatment, contributions are taxed and withdrawals are tax-free. When combined across all tax-preferred retirement plans, these individual tax breaks—also called government tax expenditures—total approximately $100 billion annually and are growing rapidly.

Despite the preponderance of tax-preferred retirement plans, which continue to grow rapidly in dollar terms, Friedman cites scholarly evidence suggesting that incentives based on income tax breaks are not effective at raising savings rates, especially among those who are most in need of additional saving. First, research shows that roughly 80–85 percent of savers are unaware of or inattentive to the tax incentives and thus do not change their savings behavior. Second, savers who do respond to the incentives do not save more overall but instead shift money they would have saved anyway to tax-preferred retirement accounts. Third, the savers who respond the most to tax incentives tend to be wealthier individuals who are already saving enough for retirement; furthermore, two-thirds of the current tax break goes to households in the top 20 percent of the income distribution, and one-third goes to those in the top 5 percent. These inefficiencies suggest the current system can be reformed successfully to encourage more Americans to save more for retirement.

A New Approach

Friedman offers two strategies to encourage individuals to address weaknesses in the current system. First, the author calls for consolidating all existing tax-preferred retirement savings plans into a single Universal Retirement Savings Account (URSA). Second, Friedman proposes tax credits to employers that automatically enroll their employees in an employer-sponsored plan (including URSAs) and whose workers regularly contribute to this plan via payroll deduction. The two prongs of this proposal complement each other in a comprehensive reform, but they would also be effective if undertaken separately.

Universal Retirement Savings Accounts

Friedman proposes that Congress replace all existing tax-preferred retirement savings plans with a single URSA that a worker would keep through retirement. Contributions could be made to this account either through payroll deduction set up by their employer or by workers directly (as with IRAs); employers themselves would also be able to make contributions to their workers' retirement accounts. Any firm offering direct deposit of paychecks would be required to allow contributions through payroll deduction, a step that has been shown to be highly effective at increasing plan participation.

Regulatory Structure of Universal Retirement Savings Accounts

Individuals would hold URSAs with any regulated account provider of their choice, including major financial management firms (e.g., Vanguard, Fidelity, BlackRock, etc.) or with a potential new class of dedicated account providers that could arise to serve this market without offering investment products of their own. To guarantee the financial integrity of the accounts, Friedman suggests URSA providers operate under regulations mirroring current rules for employer-sponsored retirement accounts, an investment environment conceptually similar to that of 401(k)-type plans, except that the provider would face the fiduciary standard rather than the employer. The author posits, however, that some additional regulation governing allowable assets and fee structures would be required.

In particular, URSAs would exclude highly speculative or risky assets such as derivatives or employer stock grants, and ideally would be restricted to low-fee index funds—which track broad stock market indexes such as the S&P 500 or Wilshire 5000—and to lifecycle funds—which automatically adjust the mix of assets as account holders approach retirement age. Friedman notes that this arrangement could be achieved without a blanket restriction on allowable assets if account managers were presumed to have satisfied their fiduciary duty for savers who invested only in these preferred assets. Account managers would have to justify other asset allocations, but such allocations would still be possible.

Account providers would also be free to offer services and sell additional products to savers, though they would be required to institute a clear firewall between the fiduciary and the sales divisions of the business. As an inducement for bearing fiduciary responsibility, account providers would be allowed to charge an additional one basis point (0.01 percent) fee on assets annually, which Friedman estimates would generate approximately $1.25 billion in additional revenue for them.

Friedman calls for regulatory authority of URSA providers to fall jointly on the U.S. Department of the Treasury and the Consumer Financial Protection Bureau, with the former ensuring that account managers satisfy standard obligations of financial institutions, and the latter taking the lead in delineating which assets would be URSA-eligible. However, as much of the regulatory responsibility and expertise for existing retirement plans lies with the Employee Benefits Security Administration (EBSA) within the U.S. Department of Labor, the transition to the new system should draw substantially on EBSA's expertise.

Contributions and Withdrawals

Friedman is agnostic as to whether URSAs should be subject to pre-tax treatment (with contributions tax-free and withdrawals taxed, as with traditional 401(k) plans) or post-tax treatment (with contributions taxed and withdrawals tax-free, as with Roth IRAs). If Congress designates URSAs as pre-tax accounts, Friedman proposes an annual contribution limit of $35,000 each year (from worker and employer combined), with all contributions deductible at a rate limited to 25 percent instead of the actual marginal tax rate. If Congress designates URSAs as post-tax accounts, the contribution limit would be set to $25,000 each year, and aggregate capital gains in the account would be taxed at half the normal capital gains rate upon withdrawal instead of being tax-free. These proposed contribution limits are higher than the limits for IRAs (currently $5,500) but lower than the limits for 401(k)s (currently $18,000 from workers, and $53,000 from workers and employers combined). Other rules on withdrawals, under either tax status, would be similar to those currently governing the 401(k) system.

These limits and rules would represent a reduction in the individual tax advantages of retirement savings accounts, especially for higher-income taxpayers. According to Friedman, roughly 1 percent of current savers (and 0.5 percent of the working-age population) currently contributes above the new limits described above, and these individuals are almost exclusively from the top 5 percent of the income distribution. Friedman cites research that tax incentives to promote greater savings are highly inefficient for this group, leading to little additional saving at high federal expense. Instead, he proposes redirecting the additional tax revenue from the reduced contribution limits to pay for employer incentives as in the second prong of his proposal, described below.

Transition

Many workers currently hold retirement savings across different accounts that often include both pre-tax and post-tax contributions.

Friedman proposes that workers designate one of these existing accounts—in most cases, the account associated with the plan sponsored by their current employer—as their URSA, as long as the account is held with a qualified URSA provider. Current firms would help in this transition as their final fiduciary act. Workers would roll savings from any other accounts they have into the URSA. Accounts that have different tax treatment from what Congress authorizes for URSAs—e.g., Roth IRAs if URSAs are pre-tax accounts—would have balances rolled into a special URSA subaccount for separate tracking. If Congress sets up URSAs as post-tax accounts, there would also be an option for a one-time conversion of assets from pre-tax accounts to the post-tax URSA at current income tax rates; workers who did not exercise this option would continue to hold savings within a pre-tax subaccount until withdrawal, as under current rules.

Given the inducements of an URSA-specific management fee (mentioned above) and the potential volume of new accounts, Friedman expects that most current providers of various retirement accounts would also become URSA providers, minimizing the volume of asset transfers between firms. Individuals with IRA accounts holding assets not permitted within URSAs (such as derivatives) would have the option to grandfather those assets into the new system, though the right to hold the asset would be lost once it is sold.

Tax Credits for Employers That Help Workers Save

Friedman proposes federal tax credits to employers that promote regular, payroll-deductible savings contributions among their workers. Specifically, employers would be eligible for a refundable tax credit for each worker that contributes at least 3 percent of earnings to a retirement savings plan each pay period. This credit would count against the employer share of payroll taxes (although the Department of the Treasury would reimburse Social Security for any reduction in receipts), thus allowing the self-employed and nonprofits to participate and automatically adjusting for part-year and part-time workers. The credit would be available to private firms of all sizes with no time limit. The credit per worker would also be larger for firms with fewer workers (scaled on a full-time full-year basis) to reflect the larger per-person costs of setting up and administering a plan—but even for larger firms it would provide a potential credit that would, in most cases, be too large to ignore.

Credit Design

As shown in table 1, as economies of scale kick in and the per-employee costs of administering URSA decline, the proposed credit for each additional worker drops to progressively lower levels. The higher per-worker credit for smaller firms is also designed to provide a larger incentive to smaller firms, a low fraction of which currently offer access to retirement savings accounts.

TABLE 1.

Credit Design

Employees (FTEs)	Size of Credit
1–10	$1,000 per FTE
11–25	$10,000 + $500 for each FTE above 10
26–100	$17,500 + $100 for each FTE above 25
101 +	$25,000 + $25 for each FTE above 100

Note: FTE = full-time equivalent worker.

Roadmap

- Congress will replace the multitude of tax-preferred retirement savings accounts with a single tax-preferred Universal Retirement Savings Account (URSA), which could function under either pre-tax (e.g., 401(k)) or post-tax (e.g., Roth IRA) treatment.
    - Existing retirement accounts will be rolled into the URSA as subaccounts, and account holders will have the option to convert assets into the main URSA account at any time.
- Workers will hold their URSAs at account providers regulated under a framework similar to that currently governing 401(k)s.
    - Eligible assets will exclude speculative and overly risky investments and will ideally be restricted to low-cost index funds and lifecycle funds.
    - Fiduciary duty would shift from employers, who often lack financial expertise, to account providers; for bearing this responsibility, account providers would be allowed to levy an annual 0.01 percent fiduciary fee on account balances.
- By auto-enrolling their employees into low-risk, low-fee URSAs, at a set savings rate of at least 3 percent, employers will receive refundable tax credits against the employer share of the payroll tax.
    - The savings rate will increase for workers by one percentage point annually, eventually stabilizing at 8 percent.
    - The size of the tax credit will increase with the number of employees at a slowing rate.
- The federal government will offset these employer tax credits by instituting new limits on tax-deductible contributions to employer-sponsored savings accounts, including URSAs.
    - If Congress sets up URSAs as pre-tax accounts (like today's 401(k)s), the cap will be set at $35,000 and the share of income that can be deducted for tax purposes will be limited to 25 percent instead of the worker's marginal tax rate.
    - If Congress sets up URSAs as post-tax accounts (like today's Roth IRAs), the cap will be set at $25,000 and withdrawals will no longer be tax-free but subject to capital gains tax of half the normal rate.

Learn More about This Proposal

This policy brief is based on The Hamilton Project discussion paper, "Building on What Works: A Proposal to Modernize Retirement Savings," which was authored by

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Default Settings

Drawing on insights from the behavioral economics literature, Friedman proposes that credit eligibility hinges on employers automatically defaulting employees into retirement accounts at a minimum 3 percent contribution rate (from the worker's earnings), which would escalate by one percentage point each year for five years. Employees would be free to explicitly opt out, and each firm could increase any part of the contribution schedule if desired, though rates should not be set above 10 percent. Firms could add their own contribution if they wish. Because lower-income workers are likely to benefit more from greater levels of current consumption than they would from greater saving, Friedman suggests that all workers earning less than $20,000 (on a full-time annualized basis) be exempt from being defaulted into a retirement account. He further suggests that workers earning between $20,000 and $30,000 be defaulted into a contribution schedule of one-half the standard rate. The default asset allocation for workers opening an account for the first time would be a lifecycle index fund with a target maturation date of the year in which the worker turns 65.

With two modest legal changes, these default settings would qualify the plans for a provision of the Department of Labor's safe harbor rules, which are designed to reduce compliance costs for firms if they meet certain guidelines when enrolling their workers in retirement plans. First, the safe harbor rules would need to allow the full (partial) exclusion of workers making less than $20,000 ($30,000) annually. Second, employer contributions would be optional instead of mandatory.

Cost and Rationale

Friedman estimates that implementing these tax credits would cost $22.5 billion annually. As described in the previous section, this expense would be fully offset by reducing the individual tax deductions for savings among high-income workers. At current saving levels, this proposal would be revenue neutral as compared to the status quo, so that total tax expenditures would initially remain about $100 billion per year. Since the proposal would significantly increase contributions over time, total tax expenditures would also rise in future years.

However, this proposal would also increase the efficiency of the system by adjusting the role played by firms. Because firms play such a large role in the defined contribution retirement system—being more knowledgeable about the tax code than individual workers, being more informed of worker circumstances, and best able to encourage contributions automatically through the payroll process—Friedman contends that shifting some of the tax incentives from individuals to firms would be both more efficient in increasing rates of saving and more equitable in reaching additional workers. But this proposal takes away from firms the burden of fiduciary liability, placing it instead on account providers who are much more likely to possess the necessary expertise.

Conclusion

The decline of defined-benefit plans and the diminished expectations of replacement income from Social Security mean that, more than ever, workers are dependent on their own savings to support themselves in retirement. However, the savings rate has been falling, not rising, in recent years. Our current system of retirement accounts consists of a confusing array of different savings accounts with different rules, a lack of access to employer-sponsored accounts and the advantages they carry, and an inefficient incentive structure that does little to increase savings among the workers who most need to save.

Against this backdrop, Friedman offers a two-pronged approach to modernize retirement savings. First, he proposes that the multitude of retirement plans be replaced by a single Universal Retirement Savings Account (URSA) that workers would keep until retirement. Contributions could be made directly through payroll deduction at annual limits higher than those on current IRAs but lower than those on current 401(k)s. Account providers would face a regulatory environment similar to that for 401(k)s today, but eligible assets would be restricted to low-fee index funds and lifecycle funds to meet fiduciary compliance, and the fiduciary duty would shift from employers to financial firms that are account providers.

Second, Friedman proposes tax credits to businesses that (1) auto-enroll their employees in retirement savings accounts, (2) set the savings rate to at least 3 percent of worker earnings, and (3) auto-escalate the savings rate by one percentage point of salary each year for five years (reaching a maximum of 8 percent of earnings). These tax credits would be proportionately larger for smaller firms to cover the costs of setting up and overseeing retirement plans for their workers. The credits would not require additional spending; instead, they would be paid for through new limits on tax deductions for contributions (or withdrawals) for high-income workers.

Although they are separable proposals, Friedman estimates these reforms if enacted together would have a large impact on the country's private retirement savings. Under conservative projections, the share of workers participating in an employer-enabled retirement plan would increase from 41 to 65 percent, and aggregate annual savings would increase by $45 billion. For a family in the middle of the income distribution, Friedman estimates savings at retirement would rise to $400,000; this compares with just $100,000 for the typical household at retirement today. These savings would both increase available capital in the economy and lead to higher standards of living for millions of middle-income workers during their retirement.

Questions and Concerns

1. Why not impose a mandate on employers to offer retirement savings accounts?

An alternative approach to broadening retirement access would be to mandate that employers offer access to retirement accounts. According to economic theory, it would be possible to set the penalties for noncompliance (i.e., the stick) such that employers would face the same incentive to participate as under the proposal outlined above (i.e., the carrot). Furthermore, loss-aversion and social norms suggest that a mandate plus penalty could generate even higher take-up rates than an economically equivalent tax credit.

There are important drawbacks to mandates, however. A key issue is that some employers might correctly choose to not default their employees into contributions if they judge that it would create employee financial hardship. Under a mandate system, these firms and their workers would be made worse off. In contrast, this proposal would not affect firms that chose not to take up the tax credit.

Nevertheless, the proposal could be strengthened with the addition of a mandate that would require employers to default workers into payroll-deductible contributions to their URSAs. A mandate that applied to all firms—similar to the tax credit—would avoid the potentially harmful effects on business growth of other mandates that apply only to firms above a certain size threshold. Similarly, a mandate that applied to all workers (rather than only to full-time workers) would avoid distortions to the nature of employment. Notably, most current retirement savings account mandate proposals revolve around retirement access through IRAs, which, due to their lower contribution limit and lack of guidance on optimal asset allocation, provide a less attractive account structure than URSAs.

2. How does the proposal deal with part-time workers, part-year workers, or other workers with variable incomes for the purposes of claiming the employer tax credit?

Employers would be eligible to claim the tax credit on a pro rata basis for any workers employed less than full-time full-year. For instance, a small firm (with fewer than ten full-time equivalent workers [FTEs] on average during a year) could claim $1,000 per full-time full-year worker, $500 per half-time full-year worker, and $500 per full-time worker who worked only half of the year. Minimum required contributions would be the same 3 percent of income. Because contributions would be made on an ongoing basis as a deduction from each paycheck, income fluctuations would not affect claiming of the credit, nor would individuals or employers have to estimate future annual incomes, as they must for the health insurance premium tax credit under the Affordable Care Act.

Employers would claim the tax credit on a rolling basis against payroll tax withholding, a system that automatically adjusts credit rates for part-year workers. For instance, a small firm (i.e., fewer than ten FTE employees) with a monthly pay schedule would claim a tax credit worth $83.33 each month (one-twelfth of $1,000) for each employee contributing the minimum amount of 3 percent of earnings. If an employee left the firm for three months of the year, the firm would be unable to claim the credit for that worker during those three pay cycles, so that the effective credit per month would be $83.33 less than it was before the employee left.

Highlights

John N. Friedman of Brown University proposes a two-pronged approach to encourage workers to save more for retirement. Intended to help middle-class workers who do not save enough for retirement and who are thus at risk of hardship, these proposals would increase the number of workers participating in an employer-sponsored retirement plan from 41 percent to at least 65 percent and raise annual retirement savings by $45 billion.

The Proposal

Establish Universal Retirement Savings Accounts. These accounts, or URSAs, would replace the multitude of currently available retirement plans and remain with workers over their lifetimes. URSAs would be low-fee accounts managed by established account providers that are regulated by the U.S. Department of the Treasury and other federal agencies. Employers would support the transition from the many accounts available today to the URSA framework.

Institute Large Tax Credits for Businesses that Encourage Workers to Save. The federal government would offer businesses tax credits when their workers contribute to retirement savings accounts. In order to be eligible for the credits, firms would need to auto-enroll their workers at a 3 percent savings rate and auto-escalate the savings rate by one percentage point each year (stabilizing at 8 percent). The size of the tax credit would be tied to the size of the business, with the total credit increasing with the number of employees enrolled. At any point, workers could choose to opt out of their plans, or to adjust them to better suit their personal circumstances.

Benefits

Together, these reforms would substantially increase retirement savings for workers, reduce the burden on employers of offering and managing retirement plans, and more efficiently and equitably use federal tax dollars to promote retirement preparation. The two prongs of this proposal complement each other in a comprehensive reform, but they would also be effective if undertaken separately.

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