UPSIDE DOWN

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Upside Down: Retirement Tax Programs

Ezra Levin, Federal Affairs Manager, elevin@cfed.org

All Americans deserve a fair shot at retirement security

Just half of working-age Americans are confident that they will have enough money to retire.[1] They have good reason to worry. Traditional pensions are fading out of existence, and only about half of workers have access to any sort of employer-sponsored plan. Half of households have no retirement savings at all.[2] Even among households with savings, the median balance is $40,000, still far less than many workers will need to maintain their standard of living in retirement.[3] And while Social Security provides critical support for millions of retired Americans, it's expected to make up a smaller proportion of the income needed to maintain their standard of living in the future.[4]

In short, America is facing a retirement security crisis.

Yet the federal government spends nearly $130 billion annually on retirement tax programs (also known as "tax expenditures") to encourage Americans to save for retirement. With so much being spent on these federal tax programs, why do so many Americans still lack adequate retirement savings? A large part of the answer is that the vast majority of spending on retirement tax programs does little for the millions of working Americans who need the most help building a nest egg. Every year, top-income workers can expect to receive thousands of dollars in tax support for retirement savings. A low- or moderate-income worker can expect to receive little or nothing at all.

This is Upside Down.

The problem with retirement tax programs is one of both savings support and adequate account access. If we expect low- and moderate-income workers to save for retirement, we should at least provide them with the same level support provided to high-income households. Ensuring that all workers can take advantage of this support requires automatic enrollment in affordable, simple, safe retirement savings accounts.

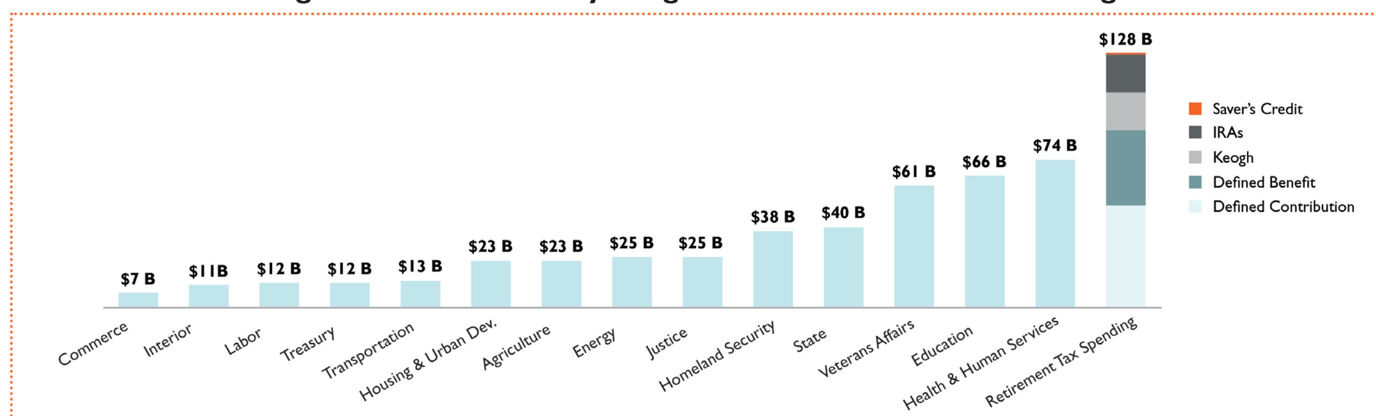
The remainder of the paper is organized as follows:

1. The size of retirement tax programs
2. The distribution of retirement tax benefits
3. The three reasons why retirement tax programs are upside down
4. Federal policy reforms to turn these programs right-side up

I The federal government spends billions of dollars on retirement tax programs

Tax programs are the main source of retirement savings support in the country. In the last ten years, the federal government has spent over $1 *trillion* on these retirement tax programs.[5] To put this number in perspective, the current annual spending—$128 billion—is larger than the discretionary budgets of fourteen U.S. cabinet-level agencies—more than all but the Department of Defense.

Billions in Perspective: **federal retirement tax spending in 2013 outweighed the discretionary budgets of 14 federal cabinet-level agencies**



Author's calculations based on data from the Office of Management and Budget (2014)

In 2013, the largest retirement tax programs were:[6]

***$50.7 billion* – Defined Contribution (DC) Employer Plans.** Workers can claim an exclusion for contributions to these employer-provided retirement savings accounts. Workers must wait until age 59½ to make withdrawals or face penalties. Traditionally, DC plan benefits function as "tax deferrals" because the income deposited into these accounts and accrued gains are taxed when withdrawn rather than when earned. In constrast to traditional DC plans, workers get no immediate tax benefit for contributions to Roth-style DC plans, but the accounts grow tax free and are not taxed when withdrawn.

The most common DC plan is the 401(k), but this category also includes the 403(b), the Federal Thrift Savings Plan, and other similarly structured plans. For 2014, annual exclusions are limited to $17,500 for the employee, and a total of $52,000 from both the employer and employee.[7]

Traditional vs Roth Plans

Traditional 401(k), 403(b), 457, and IRA plans each have Roth counterparts. The key difference is tax treatment of contributions. Contributions to traditional plans are deductible, but future withdrawals are taxed as income. For Roth plans, workers use their after-tax income to make contributions, but future withdrawals are tax free.

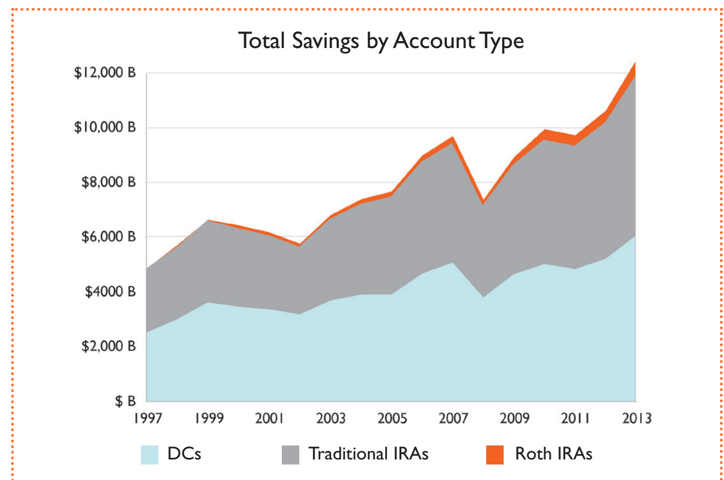
***$37.9 billion* – Defined Benefit (DB) Employer Plans**, often referred to as "traditional pensions," guarantee workers a steady stream of benefits as long as they live. Similar to DC plans, workers don't pay taxes on DB benefits until they are withdrawn, at which point these benefits are taxed as income. DB plans face maximum annual benefit limits ($210,000 in 2014) rather than maximum annual contribution limits.[8] But particularly high-income workers can build up more tax-supported retirement savings by combining a DB plan with an additional DC or IRA plan.

***$19.4 billion* – Keogh Retirement Plans** were created for sole-proprietors and other small business owners, and they can be structured as either DB or DC plans. While these plans are considerably more complex than alternative options, they are favored by high-income business owners and self-employed entrepreneurs who can take advantage of the higher contribution limits.

***$19.3 billion* – Individual Retirement Accounts (IRAs)** function similarly to DC plans but are usually set up by workers themselves rather than employers. IRAs also offer greater early withdrawal flexibility to pay for a home, education, and medical expenses. In addition to making normal contributions to IRA plans, workers are allowed to transfer (or "rollover") savings from a DC plan into an IRA. This is in fact the largest source of IRA contributions.[9]

There are four types of IRAs that offer tax benefits directly to workers, each of which differ by contribution limit and level of tax benefit:

Retirement savings in DCs & IRAs has grown rapidly



Author's calculations based on ICI data. Note traditional IRAs include standard IRAs, SIMPLE, and SEP. DC plans include 401(k), 403(b), 457, and other DC plans. All figures inflation-adjusted to 2013 dollars.

- **Traditional IRAs** are the most common IRA and function similarly to DC plans. Typically, workers can deduct contributions of up to $5,500 every year. Depending on filing status and access to other employer-sponsored retirement plans, income limits may apply.
- **Roth IRAs** face the same $5,500 contribution limit as traditional IRAs but deposits are taxed as normal income and withdrawals are tax-free. All Roth IRAs also face income limits.
- **Savings Incentive Match Plan for Employees** (SIMPLE) IRAs, are targeted to small businesses and the self-employed. The accounts provide the same tax benefits as traditional IRAs, but are established by the employer.
- **Simplified Employee Pension** (SEP) function very similarly to SIMPLE IRAs but feature higher contribution limits in some cases. Unlike SIMPLE IRAs, only the employer may contribute to a SEP IRA.

***$1.2 billion* – The Saver's Credit**, unlike each of the tax programs described above, is not a type of account, but rather a tax benefit for making deposits into qualified DC and IRA plans. Depending on level of annual income, a saver can receive between 10 and 50 cents for every dollar saved, up to a maximum non-refundable credit of $1,000. The credit is geared toward low- and moderate-income savers, with an income eligibility cutoff of $30,000 ($60,000 for couples filing jointly). Because the credit is non-refundable, individuals with income tax liability of less than $1,000 (common among the credit's target population) can't receive the maximum credit.

2 Most retirement tax spending goes to the highest-income households

A large majority of the nearly $130 billion spent every year on retirement savings programs goes to the highest-income households. The Urban Institute recently analyzed spending on DB and DC plans (including Keogh plans), IRAs, and the Saver's Credit.[10] This new data reveals that the primary impact of retirement tax programs is to help the wealthy build more wealth through retirement savings.

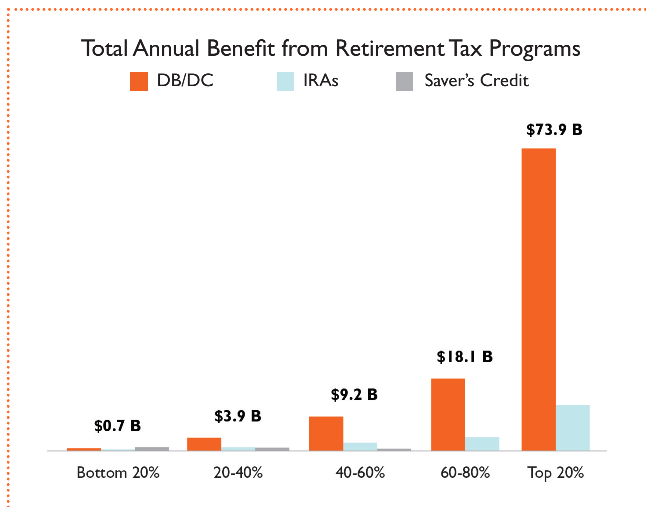
The less income you have, the less the federal government spends to help you build retirement savings. In 2013, an average taxpayer with income less than about $60,000 (in the bottom 60%) received $200 or less from federal tax spending on DC plans, DB plans, IRAs and the Saver's Credit. By comparison, the average taxpayer in the top 1%, who had income of $1.6 million, received more than $13,000 from these programs. The unequal distribution of retirement tax support continues all the way up the income spectrum. A typical top 0.1% household received even more—$16,115.

Lower-income households get almost no benefit from retirement tax programs. Compared to the average bottom 20% taxpayer, the average top 20% taxpayer receives 150 times as much support from retirement tax programs. The wealthiest taxpayers receive astronomical sums. The typical top 0.1% taxpayer received more from retirement tax programs ($16,115) than the entire annual income of a typical bottom 20% taxpayer ($13,607). ***This is Upside Down.***

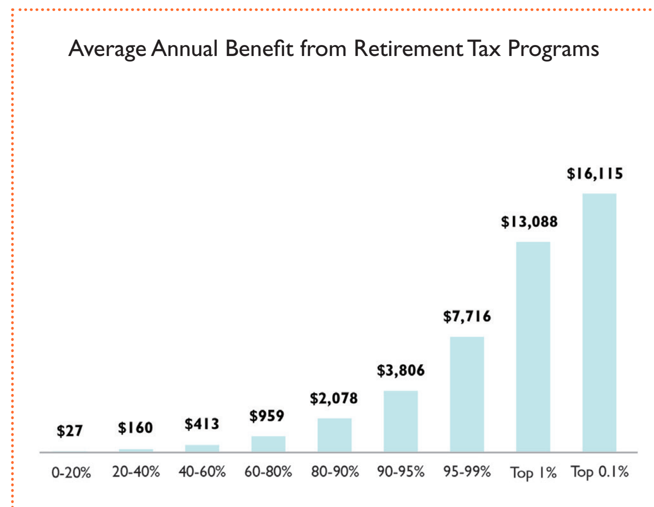
The Top 1% Get More From Retirement Tax Programs than the Bottom 60%

Author's calculations based on data from Urban Institute (2014). Includes tax benefits for DB plans, DC plans, IRAs, and the Saver's Credit.

Upside Down Retirement Tax Programs
Top 20% get $74 billion
Bottom 20% get $0.7 billion

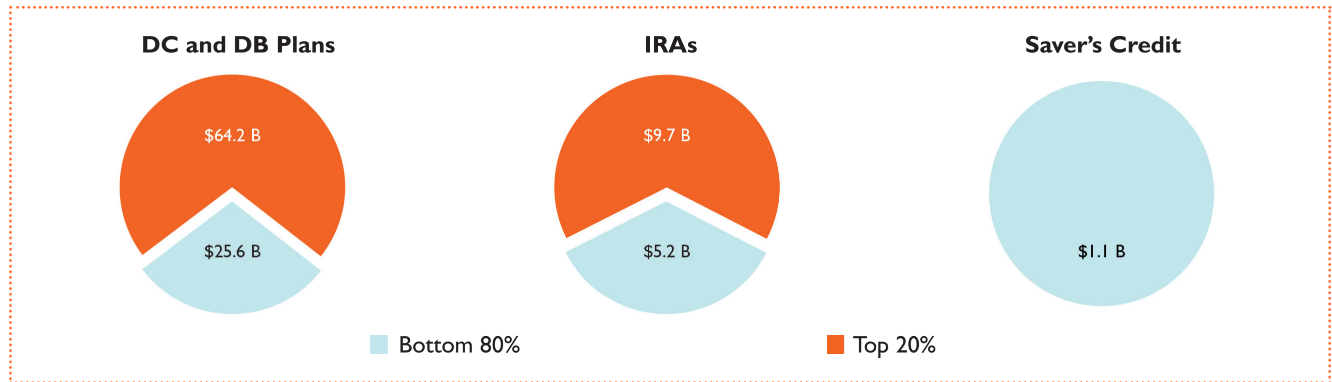


Upside Down Retirement Tax Programs
Average Top 0.1% household gets $16,115
Average Bottom 20% household gets $27



Author's calculations based on data from Urban Institute (2014). Analysis includes tax benefits that all tax filers receive from DB plans, DC plans, IRAs, and the Saver's Credit.

Retirement tax spending on DB plans, DC plans, and IRA plans mostly goes to high-income households, but the Saver's Credit goes entirely to low and moderate-income households



Author's calculations based on data from Urban Institute (2014). Analysis includes tax benefits that all tax filers receive from DB plans, DC plans, IRAs, and the Saver's Credit.

Most retirement tax programs are upside down, but the Saver's Credit is largely right-side up. The highest-income 1% receives more support from DC plans, DB plans, and IRA tax benefits ($15.9 billion) than the entire bottom 60% of the population combined ($12.7 billion). The Saver's Credit, however, does not fit this upside down picture. Every dollar of support from the Saver's Credit goes to a household in the bottom 60%. A majority of Saver's Credit support ($730 million) went to families in the bottom 40%. The Saver's Credit is proof that federal retirement tax programs can indeed focus support on moderate-income and even very low-income households.

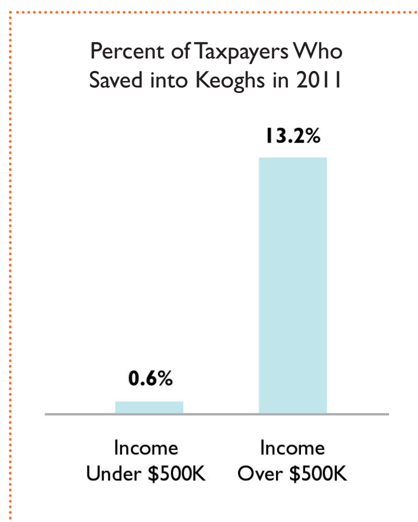
Positive though the Saver's Credit is, it is not without its flaws. Because the credit is non-refundable, it fails to help low-income workers who have little or no tax liability. For instance, if a worker qualified for $100 in credit but only had a tax liability of $80, they would only receive $80 of the credit. A worker with no tax liability receives no support.

And the Saver's Credit is minuscule compared to the other tax benefit programs. For every dollar the federal government spends on the Saver's Credit to help a household in the bottom 60% build retirement savings, it spends more than $67 to help a household in the top 20% build wealth through DC plans, DB plans, and IRAs. In fact, the federal government spends more than 15 times as much on retirement tax deductions for the top 1% as it spends on the Saver's Credit for the bottom 60%.

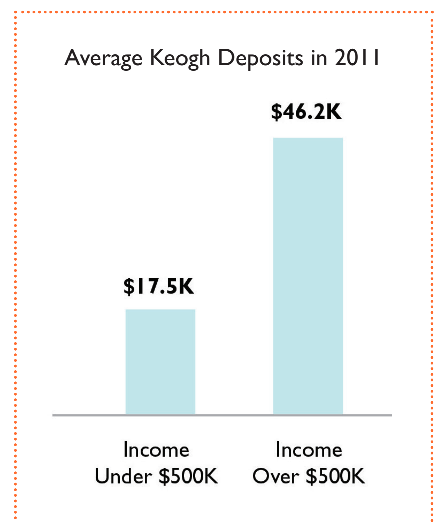
Keogh plans are particularly tilted toward high-income households. Public IRS data sheds light on who is making contributions to these plans, and the data reveals a program that is even more upside down than other retirement tax programs.[11]

Keogh plans are upside down in two ways. First, high-income households are much more likely than low-and moderate-income households to make deposits into these plans. Only a vanishingly small proportion of low- and moderate-income, and upper-middle income households use Keoghs, which are administratively burdensome compared with other retirement savings options. In 2011 only 0.6% of tax filers with income less than $500,000 reported deposits in Keogh plans. Households with income over $500,000 were twenty times more likely to use these plans than households with income below $500,000.

Who saves into Keoghs? *High income taxpayers.*



How much do they save? *A lot.*



Author's calculations based on data from IRS Statistics of Income (2013).

Second, the high-income households who use Keoghs deposit very large amounts of wealth into these tax-supported accounts. Taxpayers with income below $500,000 reported saving an average of about $17,500 in Keogh plans in 2011. A hefty sum to be sure, but higher-income workers make even more out of Keogh's generous deposit limits. The average Keogh deposit for filers with income of $500,000 or more was just over $46,000. This level of savings is not random—it is strikingly close to the 2011 maximum Keogh deduction, $49,000. These households are maximizing their federal tax benefit by maxing out their deposits into these accounts.

3 The three reasons retirement tax programs are upside down

As the above analysis shows, retirement tax programs mainly operate to help wealthy workers save for retirement. This is no accident. Each of these programs is structured to focus benefits on the highest-income households. In particular, there are three structural defects that make retirement tax programs upside down:

1. **The higher a household's tax bracket, the larger the retirement tax benefit.** A household's tax bracket is their "marginal tax rate"—the amount of tax they owe for every additional dollar of income earned. There are currently seven tax brackets ranging from 10% to 39.6%. As a household's income increases, their marginal tax rate increases as well—this is what makes our income tax system progressive. But this also means that tax deductions are worth more to higher-income households.

   How does this work in practice? As an example, imagine two families in two different tax brackets, the Hendersons and Hiltons. The Hendersons have an annual income of $70,000, which places them in the 15% tax bracket. The Hiltons have an annual income of over $500,000, which places them in the 39.6% bracket. Now let's assume that both families coincidentally decided to save $5,000 into a traditional IRA or DC plan. As a result of this savings, the Hendersons' tax refund check next year will be $750 bigger—$5,000 times their tax rate, 15%. But the Hiltons' benefit will be even bigger, $1,980—$5,000 times 39.6%. Both families chose to save for retirement. Both saved into the same type of account. Both qualified for a tax benefit. But the Hiltons received more than 2.5 times the support from the retirement tax program, simply because they had more income.

   The lower your income, the less these retirement tax programs help. If the Hendersons had a marginal tax rate of only 10%, their benefit from $5,000 of retirement savings would be only $500. If they had no income tax liability at all, then they would receive no tax support for having saved for retirement.

High-income households get more support for every dollar they save

	LOW INCOME		MODERATE INCOME	HIGH INCOME	
Example Tax Bracket	No Tax Liability	10%	15%	39.6%	39.6%
Example Retirement Savings	$5,000	$5,000	$5,000	$5,000	$52,000
Retirement Tax Benefit	**$0**	**$500**	**$750**	**$1,980**	**$20,592**

2. **Retirement tax programs subsidize very high levels of annual savings.** At a time when roughly half of American households have no retirement savings at all, the federal tax code is spending billions of dollars on retirement tax programs to subsidize annual retirement savings of $50,000 or more for the highest-income earners.

   Let's return to the Hiltons and the Hendersons. It's actually unrealistic to assume that the Hiltons would only save the same amount as the Hendersons, because we know that households at the very top save much more for retirement than most families. While the annual $52,000 contribution limit for a Keogh and other plans is astronomical compared to what many families can save, high-income households are able to circumvent this limit and save even more into tax-preferred accounts. A 2013 article in Forbes Magazine described how a worker with income of $300,000 can combine various tax-preferred plans to shelter nearly $170,000 of income from taxes.[12] The scheme costs a few thousand dollars in accountant fees, but the taxpayer stands to gain tens of thousands of dollars in retirement tax benefits. In short, not only do the highest income households benefit more from every dollar saved; they're also saving more dollars with the help of pricey accountants, high contribution limits, and federal subsidies.

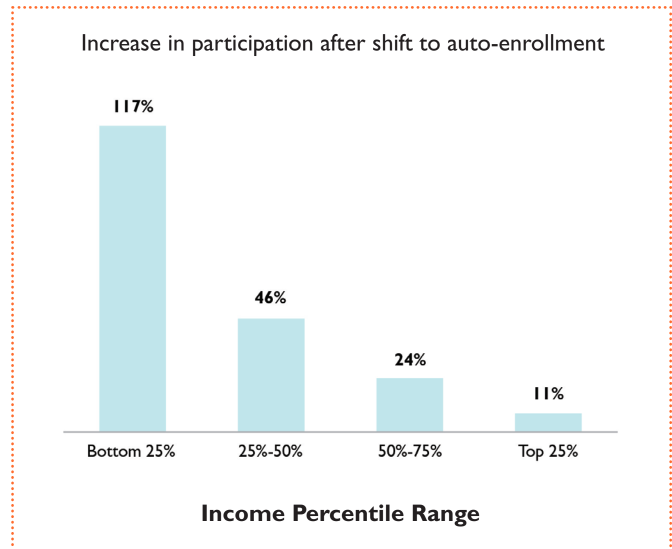
3. **Most low- and moderate-income workers lack access to an adequate retirement savings account.** A household can't benefit from retirement tax programs if they don't save; and they can't save without access to an account. While Keoghs, 401(k)s and other tax-supported retirement plans cater to the wealthiest households, millions of workers lack access to a safe, simple, and affordable retirement savings account. Only about half of working Americans have access to a workplace retirement plan.[13] Employees of color are even less likely to have access to these employer-sponsored plans.[14] For employees with access to an employer-sponsored plan, saving for retirement

can still be burdensome. Employment may be short-term, and enrollment procedures are often complex. IRAs are an option for those without access to an employer-sponsored plan, but this option is not working well. Among Americans who have access solely to private IRAs, only a small percentage open and regularly contribute to these plans.[15]

A key feature of an adequate retirement savings plan is automatic enrollment. Auto-enrollment programs switch the default from "opt-in" to "opt-out." Strong empirical evidence shows that automatic enrollment in retirement savings plans has a very large impact on participation, especially for low- and moderate-income workers. The results are astounding. The bottom half of workers are ***81% more likely*** to participate in an auto-enrollment plan compared to an opt-in plan.[16]

Interestingly, workers at the top of the income distribution are only slightly more likely to participate in auto-enrollment plans than in opt out plans. For these high-income households, there is simply too much money on the table to *not* traverse the barriers to save for retirement.

Auto-enrollment dramatically increases retirement savings rates for low- and moderate-income workers



Based on simulation by EBRI (2005)

4 Federal reforms must turn retirement tax programs right-side up

The model for retirement tax programs shouldn't be accounts with large barriers to entry, but rather targeted support for working families who need help the most. In other words, the model should be the Saver's Credit rather than the 401(k) or Keogh. But simply providing incentives will never be enough—workers also need access to simple, safe, and affordable retirement accounts in order to save at all. With these two goals in mind, there are several options for reforming the existing retirement savings system to make it work for all Americans:

Turn existing retirement tax programs right-side up. As currently structured, the deductions, exclusions, and deferrals for retirement savings exacerbate wealth inequality and do little to combat retirement insecurity for millions of working Americans. Without adding a dime to the deficit, replacing these programs with a more equitable refundable credit would shift the system from spending billions on the wealthy to boosting retirement security for all working Americans.

The Urban Institute analyzed one such proposal to replace the current retirement savings incentives with a 25% refundable credit.[17] Returning to the example of the Hendersons and the Hiltons, if they both chose to save $1,000 for retirement, they would both receive $250 in support—25% of the $1,000 saved. Under this plan, the entire bottom 80% of taxpayers would see an increase in after-tax income, while gaining federal support for retirement savings. Former Chair of the National Economic Council, Gene Sperling, has made a similar proposal to replace existing retirement tax programs with a 28% credit.[18]

Expand and reform the Saver's Credit. The Saver's Credit proves that many low- and moderate-income workers can and will take advantage of tax support to build retirement savings. But the credit is far too complicated in structure and limited in size, currently accounting for less than 1% of spending on retirement tax programs. Positive reforms would:

- Make the credit fully refundable to provide additional support to low-income workers
- Expand the income thresholds so that the credit reaches further up the income spectrum
- Replace benefit cliffs with a gradual benefit phase-out, similar to the Earned Income Tax Credit

There are several strategies for accomplishing these three goals. The Urban Institute analyzed one new configuration of the Saver's Credit that would create a refundable $1,000 credit for incomes up to $36,400, and that would gradually phase out as income increases above that level. This reform would expand support for the entire bottom 80% of earners.[19]

Reduce contribution limits for retirement savings. While the median level of retirement savings in the U.S. is only $3,000,[20] the *annual* contribution limit for tax-preferred retirement plans is as high $52,000. Who benefits from these astronomical contribution limits? Those at the very top of the income spectrum. Not only are the highest-income households saving more into Keoghs and other retirement savings products due to these high limits, they're getting more federal support for each dollar they deposit.

There are several proposals to limit contributions to tax-preferred retirement accounts. In his 2014 budget, President Obama proposed limiting total savings into these accounts to $3.4 million, a massive sum compared to what most Americans have saved or would be able to save.[21] This proposal would raise $9 billion in revenue over ten years.

The Urban Institute analyzed another proposal that would limit annual contributions to the lesser of $20,000 or 20% of the worker's earnings.[22] This would reduce federal spending on the top 1% and top 0.1% of households, and it would have little or no impact on those in the bottom 80%.

Creating reasonable contribution limits for tax-supported retirement accounts will not itself expand retirement security, but the tax dollars saved from this reform could be redeployed to fund retirement tax programs that support all working families.

Create a universal, simple, safe, and affordable retirement savings account for all Americans. We know that low- and moderate-income workers are less likely to have access to an employer-sponsored retirement plan. And as important as federal savings incentives are, they are of little use to workers who have no access to a retirement savings account.

A partial solution to this reality is the myRA program, a proposal developed out of the work of the Retirement Security Project, which was a joint effort by the Heritage Foundation and the Brookings Institute. Now sponsored by the U.S. Department of Treasury, the myRA program is launching as a pilot program to help working families build retirement savings even if they lack access to an employer-sponsored retirement plan.[23] The myRA was designed by Treasury with three features:

- **SIMPLICITY:** Workers make contributions to their myRA through after-tax payroll deductions. Like a Roth program, contributions can be withdrawn at any time without penalty (although withdrawn interest earnings may be subject to penalties), providing a level of flexibility that is crucial for low- and moderate-income working families who often have little or no emergency savings.[2]
- **SAFETY:** Because myRA account balances are invested in U.S.-backed securities, the principle is guaranteed and savings will grow with little risk.
- **AFFORDABILITY:** A worker can start saving through myRA with as little as $25 and can save as little as $5 through each payroll deduction. The accounts are also fee-free for the consumer—every dollar saved is a truly a full dollar saved for the future.

Ensure automatic enrollment in retirement savings programs to boost participation. We know that auto-enrollment greatly increases retirement savings of low- and moderate-income workers. Based on this knowledge, the Retirement Security Project proposed automatically enrolling workers into an IRA, an "Auto-IRA." Automatically enrolling workers in a workplace retirement savings plan eliminates a key barrier to savings—complexity. Although opting out is always possible, examples from the private sector indicate that few workers choose to do so. Research shows that moving to automatic enrollment could boost participation rates above 90%.[25]

Automatic enrollment proposals are already being considered in 17 states.[26] At the federal level, the Obama Administration and members of the House and Senate have advanced various versions of Auto-IRA legislation. These proposals would require or encourage all but the smallest firms to automatically enroll employees in retirement savings plans with a low minimum contribution. Paired with an affordable, simple starter account like myRA, Auto-IRA can ensure that all employers comply without undue administrative or financial burden. These employer-friendly and employee-supportive Auto-IRA proposals have garnered support on both sides of the aisle.

Conclusion

Americans believe that a lifetime of hard work should guarantee workers the dignity of a financially secure retirement. The federal government's annual $130 billion investment in retirement tax programs reflects how fundamental this belief really is.

But this enormous investment is poorly structured to promote retirement security for most working Americans. At a time when half of working Americans rightfully fear that they do not have enough savings to retire, the federal government is sending multi-thousand dollar tax refund checks to millionaires in support of their retirement savings every year.

The problem with our upside down retirement tax programs is one of both access and support. Millions of working Americans lack access to a safe, simple, and affordable retirement savings account. But even those workers that do participate in employer-provided or private retirement plans receive little benefit from our existing retirement tax programs.

At the very least, our retirement tax programs should provide low- and moderate-income families the same level of support offered to high-income families. Reforms built on this principle need not devote billions of dollars of new federal resources to the goal. We can expand retirement security for millions of working Americans simply by turning our existing upside down retirement tax programs right-side up.

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