



**Tax Policy Center**  
Urban Institute and Brookings Institution

## THE TAX POLICY

### BRIEFING BOOK

*A Citizens' Guide for the  
2008 Election and Beyond*

## SAVINGS AND RETIREMENT

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## Savings and Retirement: What kinds of tax-favored accounts are there?

Taxpayers have a variety of options for receiving tax benefits for retirement saving. Tax-favored accounts fall into two broad categories: those offered through an employer and those established by an individual. Accounts offered through an employer in turn are of two types. Defined-benefit plans generally distribute funds during retirement according to a formula that accounts for a worker's years of service at a firm and earnings. In defined-contribution plans, of which the 401(k) plan is the most common, distributions depend on the size of past employee and employer contributions and on the investment returns on those contributions over time. Accounts established by an individual include two types of Individual Retirement Accounts (IRAs): traditional IRAs and Roth IRAs. Traditional IRAs and 401(k)s allow taxpayers to deduct the value of contributions, up to a limit, from taxable income, but tax the value of the distributions made during retirement. Contributions to Roth IRAs and Roth 401(k)s generate no immediate tax deductions but allow distributions to be received tax-free after the worker has reached retirement age. In all of these arrangements the accumulation of interest, dividends, and capital gains inside the account is not taxed.

- Employers are not required to offer their employees retirement benefits, and only about half of all workers do receive retirement benefits through their employer. Employees of large companies are more likely to receive employer-sponsored retirement benefits than employees of small firms. About two-thirds of workers at medium-size and large firms receive retirement benefits, compared with just one-third of workers at small firms. Almost all government employees receive retirement benefits.
- Worker participation in IRAs is less common. In any given year about one worker in twelve contributes to an IRA, although a higher percentage of workers own IRAs. Participation in IRAs is approximately evenly split between traditional and Roth IRAs.

### See Also

Retirement Saving: What are defined-benefit retirement plans?

Retirement Saving: What are defined-contribution retirement plans?

Retirement Saving: What types of non-employer-sponsored accounts are available?

Authors: William Gale and Benjamin Harris  
Last Updated: December 14, 2007

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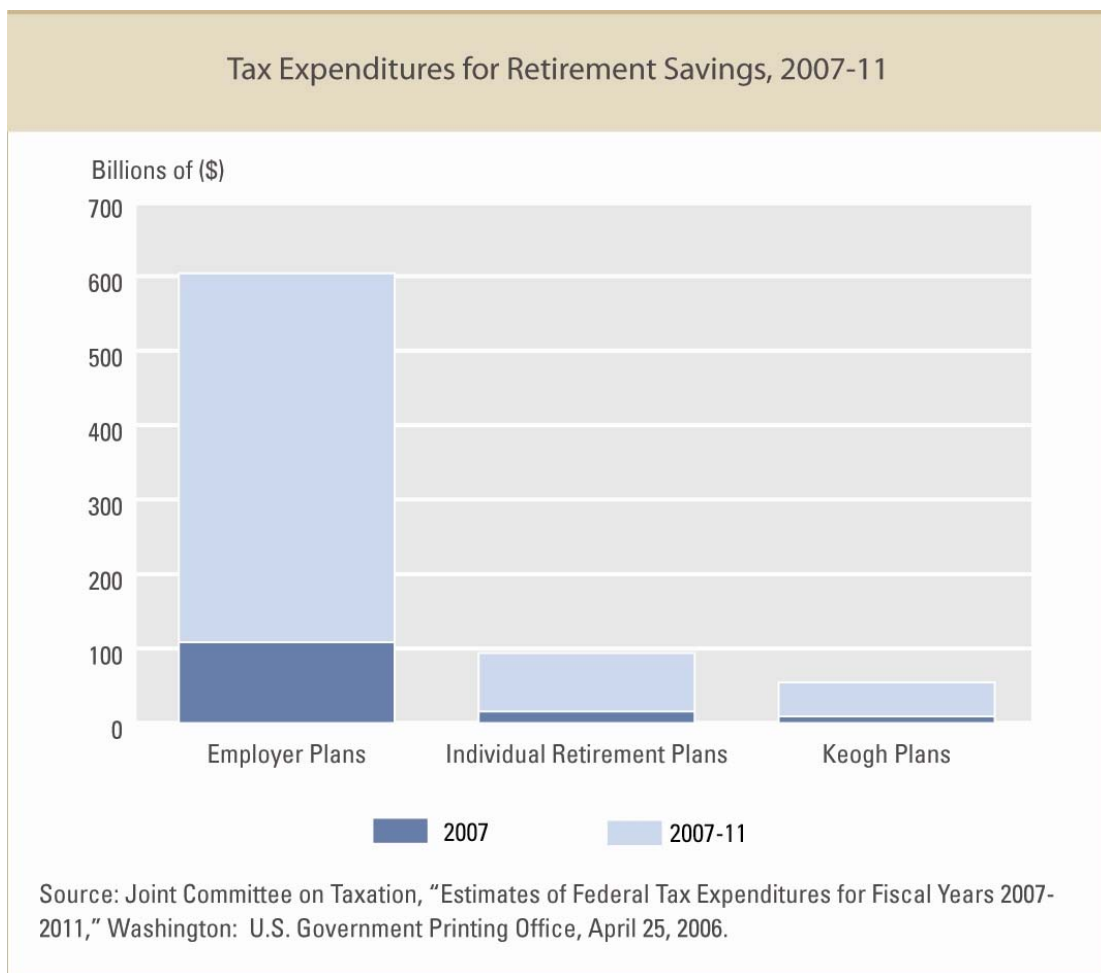
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## Savings and Retirement: How large are the tax expenditures for retirement saving?

Provisions in the tax code designed to encourage retirement saving cost the U.S. Treasury billions of dollars in forgone revenue each year. Provisions of this type, which reduce tax revenue for the sake of promoting other public goals, are called tax expenditures. Of all the tax expenditures in the tax code, the one allowing tax-free employer contributions to employee pension plans is the second largest, costing \$108.6 billion in 2007 according to estimates by the congressional Joint Committee on Taxation. All of the retirement saving incentives in the tax code together amounted to \$133.8 billion in tax expenditure in that year and \$760.3 billion over five years.

- The second-largest tax expenditure for retirement saving is the exclusion of contributions to and earnings in Individual Retirement Accounts, both Roth IRAs and traditional IRAs. This tax expenditure is an estimated \$15.5 billion in 2007 and \$94.1 billion over five years, significantly less than the cost of employer-sponsored pensions. The retirement saving expenditure for Keogh plans, which cover self-employed workers, amounted to \$8.8 billion in 2007 and \$54.5 billion over five years.



**See Also**

Retirement Saving: What kinds of tax-favored accounts are there?

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Retirement Saving: What are defined-contribution retirement plans?

Retirement Saving: What types of non-employer-sponsored accounts are available?

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## Savings and Retirement: What are defined-benefit retirement plans?

Defined-benefit plans provide pension income to retired employees on the basis of a formula that accounts for a worker's years of service at a firm and earnings. Distributions are typically made for the remainder of the employee's life, making the plan similar to an annuity. Contributions are generally made by the employer only, who is responsible for determining what level of contributions is necessary to provide the promised benefits to all current and future employees. Contributions to defined-benefits plans are tax-deferred, meaning that neither the employer nor the employee pays tax on the initial contributions or accumulated earnings.

- Compared with other types of retirement accounts, the risk in a defined-benefit plan is borne mostly by the employer. If employees live longer in retirement than anticipated, or if the investments financing the employees' pensions fail to meet expectations, it is the employer's responsibility to increase contributions so as to make good on the promised benefits.
- Defined-benefit plans are more likely to be offered by large employers, who are better suited to bear the risk involved.
- Defined-benefit plans have been decreasing in popularity over the past few decades. From 1991 to 2003 the share of full-time employees at medium-size and large establishments participating in defined-benefit plans fell from 59 percent to 33 percent. Defined-benefit plans, however, are still the most common type of plan for government employees.
- Defined-benefit plans are insured by the Pension Benefit Guarantee Corporation, a federal entity whose responsibility is to ensure that employees receive a minimum pension benefit in the event that their employer is unable to pay the promised benefits in full.

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## Savings and Retirement: Who uses tax-favored retirement savings accounts?

Almost all workers are eligible to participate in at least one type of tax-favored retirement savings account, yet only about half do. Older workers and workers with higher incomes are more likely to participate than other workers. Married earners also have higher rates of participation than unmarried earners.

Participation in Tax-Favored Retirement Plans, 2003				
Category	Percentage actively participating in any plan	Percentage participating in IRAs	Percentage participating 401(k) type plans	Percentage participating in non-contributionary plans
<b>Age</b>				
Under 30	32	4	14	16
30 - 44	56	7	34	18
45 - 59	63	10	38	19
60 and over	44	9	22	15
All ages	50	7	29	17
<b>Income (1997 dollars)</b>				
Under \$20,000	20	2	6	12
\$ 20,000 - \$40,000	52	6	26	22
\$ 40,000 - \$80,000	68	10	42	21
\$ 80,000 - \$120,000	80	14	57	17
\$120,000 - \$160,000	82	15	60	14
\$160,000 and over	79	12	54	12
All incomes	50	7	29	17
<b>Marital status of earner</b>				
Unmarried earners	40	5	21	16
<b>Married earners</b>				
Sole	52	8	30	17
Primary	72	10	47	20
Secondary	57	10	31	19
All earners	50	7	29	17

Source: Congressional Budget Office Background Paper, Utilization of Tax Incentives for Retirement Savings: Update to 2003, March 2007.

- The likelihood of participation in a tax-favored retirement savings account varies by age. In recent years fewer than one-third of workers under age thirty participated in an account, compared with almost two-thirds of workers aged forty-five to fifty-nine (see table).
- Workers with higher incomes are also more likely to participate in a tax-favored savings account. In recent years, about four out of five high-income workers did so, but only one out of five low-income workers.
- Middle-income workers have higher rates of participation in defined-benefit plans than higher-income workers, who in turn are more likely to participate in defined-contribution plans. In re-

cent years the participation rate of higher-income workers in 401(k)-type plans was over twice that for lower-income workers.

- Participation rates in traditional and Roth Individual Retirement Accounts (IRAs) tend to increase with income. The wealthiest workers, who are ineligible to participate in Roth IRAs, are more likely to participate in traditional IRAs compared to middle-income taxpayers.
- Among those workers participating in a plan, contributions to 401(k)-type plans are highly correlated with income. The average contribution to a 401(k)-type account was \$3,700 in 2003, but high-income workers earning over \$160,000 contributed an average of about three times that amount (\$9,503), while workers earning between \$20,000 and \$40,000 contributed, on average, just \$726.
- IRA contribution limits are more restrictive than those for 401(k)s, and partly as a consequence, average taxpayer contributions vary less with income for IRAs than for 401(k)-type plans. In 2003 the average contribution to an IRA was \$2,197. The average contribution varied somewhat by income, with those in the \$20,000 to \$40,000 range contributing an average of \$1,962 and those earning more than \$160,000 contributing an average of \$2,941. As workers approach retirement, the average contribution increases. There is little difference in contribution levels to IRAs for married and unmarried workers.
- About half of all IRA participants contribute the maximum amount allowed. Among those with traditional IRAs, 55 percent contributed the maximum deductible amount in 2003, and a significantly higher proportion of high-income taxpayers did so than of lower-income taxpayers. Among those with Roth IRAs, 44 percent contributed the maximum amount, with higher-income taxpayers again doing so more frequently. This contribution pattern illustrates one reason why proposals to increase the maximum IRA contribution would benefit wealthy taxpayers more than low- and middle-income taxpayers.

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**Data Sources**

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**Further Reading**

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Steuerle C. Eugene, "The Role of Employer-Sponsored Retirement Plans and National Saving," Testimony before the Senate Committee on Aging (April 2005).

## Savings and Retirement: What are defined-contribution retirement plans?

A defined-contribution plan is a plan in which an employee's benefits during retirement depend on the contributions made to and the investment performance of the assets in his or her account, rather than on the employee's years of service or earnings history. Like a typical savings account, a defined-contribution account contains a specific balance at any given time, which is equal to the market value of the assets accumulated in the account. Unlike with a defined-benefit plan, employees have substantial control over how the contributions to their plan are invested and may generally choose from an assortment of stocks (often including company stock), bonds, mutual funds, and other investment vehicles. Examples of defined-contribution plans include 401(k) plans, 403(b) plans, and 457 plans, all of which share similar characteristics.

- The proportion of employees participating in defined-contribution plans has gradually increased over the past several decades, and today stands at about half of all workers nationwide. However, within the defined-contribution universe, savings and thrift-type plans have grown in popularity at the expense of profit-sharing plans.
- Compared with defined-benefit plans, which offer employees an annuity at retirement, defined-contribution plans are riskier for employees, because the employee bears the risk of underperforming assets and extended longevity. This risk can be muted if employees use the assets in their defined-contribution plan to purchase annuities at retirement.
- Contributions to defined-contribution plans are tax-deferred, meaning that neither the employer nor the employee pays tax on the initial contributions or accumulated earnings. However, the employee does pay tax when funds are withdrawn. Exceptions to this rule are Roth 401(k) plans, which tax contributions when they are made rather than when the contributions are withdrawn.
- Withdrawals from defined-contribution accounts are generally not permitted before age 59 except in certain circumstances, such as the purchase of a first home or the payment of certain educational or medical expenses. In these circumstances, tax penalties may reduce the value of the account.

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## **Savings and Retirement: What types of non-employer-sponsored accounts are available?**

Workers can receive tax-favored benefits for retirement saving through arrangements that do not involve their employer. The Individual Retirement Account (IRA) comes in two forms, traditional IRAs and Roth IRAs. (Other types of IRAs are available to workers through their employer, including SIMPLE and SEP plans.) The primary difference between traditional and Roth IRAs is in the timing of the tax on contributions. Qualified contributions to traditional IRAs are excluded from tax and allowed to grow tax-free, but withdrawals during retirement are taxed. Contributions to Roth IRAs, conversely, are taxed in the year they are made but are allowed to grow tax-free, and withdrawals during retirement are not taxed. About 45 million households own at least one IRA.

- Traditional IRAs and Roth IRAs also differ in the amount of funds that can be sheltered from taxation, with Roth IRAs shielding a higher level of funds from taxation than traditional IRAs. This is due to the Roth IRA characteristic that allows contributions to grow tax-free and never be taxed after the initial contribution, which is generally more favorable than the tax treatment of contributions with a traditional account.
- The tax code limits the extent to which individuals may take advantage of the tax benefits associated with traditional and Roth IRAs. Taxpayers with income beyond a certain level, which varies with filing status, may not contribute to a Roth IRA and may not deduct contributions to a traditional IRA; taxpayers who participate, or whose spouse participates, in an employer-provided pension also may not deduct traditional IRA contributions if their income exceeds a certain amount.
- Since traditional IRAs were originally designed to be a parallel tax benefit for employees lacking access to an employer-sponsored saving plan such as a 401(k), taxpayers participating in such a plan face stricter criteria for traditional IRA eligibility.
- For single taxpayers without access to an employer-sponsored pension, and for married couples where neither spouse participates in such a pension, there are no income restrictions on the deductibility of traditional IRA contributions. A married taxpayer who does not participate in an employer-sponsored plan but whose a spouse does participate may contribute the maximum statutory amount to an IRA, provided the couple's joint income does not exceed \$156,000.

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## **Savings and Retirement: How does tax-favored retirement saving affect national saving?**

One of the most important and controversial aspects of the taxation of retirement saving is its effect on private saving, wealth accumulation, and retirement preparedness. Although traditional pensions and other tax-deferred vehicles such as 401(k) plans and Individual Retirement Accounts (IRAs) clearly make up a sizable share of households' wealth, both in their preretirement years and during retirement, it is less clear how much of that wealth represents incremental balances, that is, wealth that would not have existed in some other form in the absence of favored tax treatment of retirement saving.

- The accounts raise private saving to the extent that they induce households to finance their own contributions through either reductions in consumption or increases in labor supply. Saving incentives do not raise private saving to the extent that households finance their contributions by shifting their existing assets into a tax-favored account, or by shifting current-period saving that would have occurred even in the absence of the incentive, or by increasing their debt. Likewise, there is no increase in private saving to the extent that households respond to employer-provided pensions or contributions by reducing their other saving or increasing their borrowing.
- The earliest research on both traditional defined-benefit pensions and defined-contribution plans appeared to demonstrate very strong effects on private wealth and saving. These efforts, however, were marred by a series of econometric and statistical problems. More recent research, using improved methods, has found significantly smaller impacts of tax-preferred saving vehicles on private saving and wealth, and in some cases has found no net effects on private wealth at all.

**See Also**

Savings and Retirement: Where does the tax saving come from?

Savings and Retirement: How might saving be encouraged for low- and middle-income households?

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## Savings and Retirement: Where does the tax saving come from?

The tax saving in tax-favored retirement saving accounts primarily comes from the favored tax treatment of the returns on assets held within the account. Some types of tax-favored accounts tax assets when withdrawn from an account, whereas others do not, but all such accounts share the characteristic that saved assets are permitted to grow untaxed. Over time, this benefit can become substantial.

- Broadly speaking, there are two classes of subsidized retirement saving accounts: front-loaded accounts, such as traditional IRAs and 401(k)s, and back-loaded accounts, such as Roth IRAs. In front-loaded accounts, contributions are tax-deductible and withdrawals are taxed. In back-loaded accounts, contributions are not tax-deductible but withdrawals are not taxed. In both types of accounts the investment returns on assets kept within the account are untaxed.
- Whether taxpayers benefit more from a front-loaded or a back-loaded account depends on the difference in tax rates during their working years and in retirement. Someone with a high tax rate during his or her working years and a lower tax rate in retirement would benefit more from a front-loaded account, since the original contribution is deducted against a high tax rate and the withdrawal is taxed at a lower rate. Someone whose tax rate is expected to be higher in retirement would benefit more from the back-loaded account.
- An additional consideration is that one can effectively shelter more saving in a back-loaded account than in a front-loaded account if the two accounts have the same contribution limit. For example, if an individual facing a 25 percent marginal income tax rate contributes \$1,000 to a front-loaded account, she is really contributing \$750, or  $(1.00 - 0.25) \times \$1,000$  of her own funds, and \$250 of government funds because of the tax deduction. When the funds are withdrawn, the government reclaims its share of the amount withdrawn. In contrast, in a back-loaded account, the entire amount grows tax-free and can be withdrawn tax-free.

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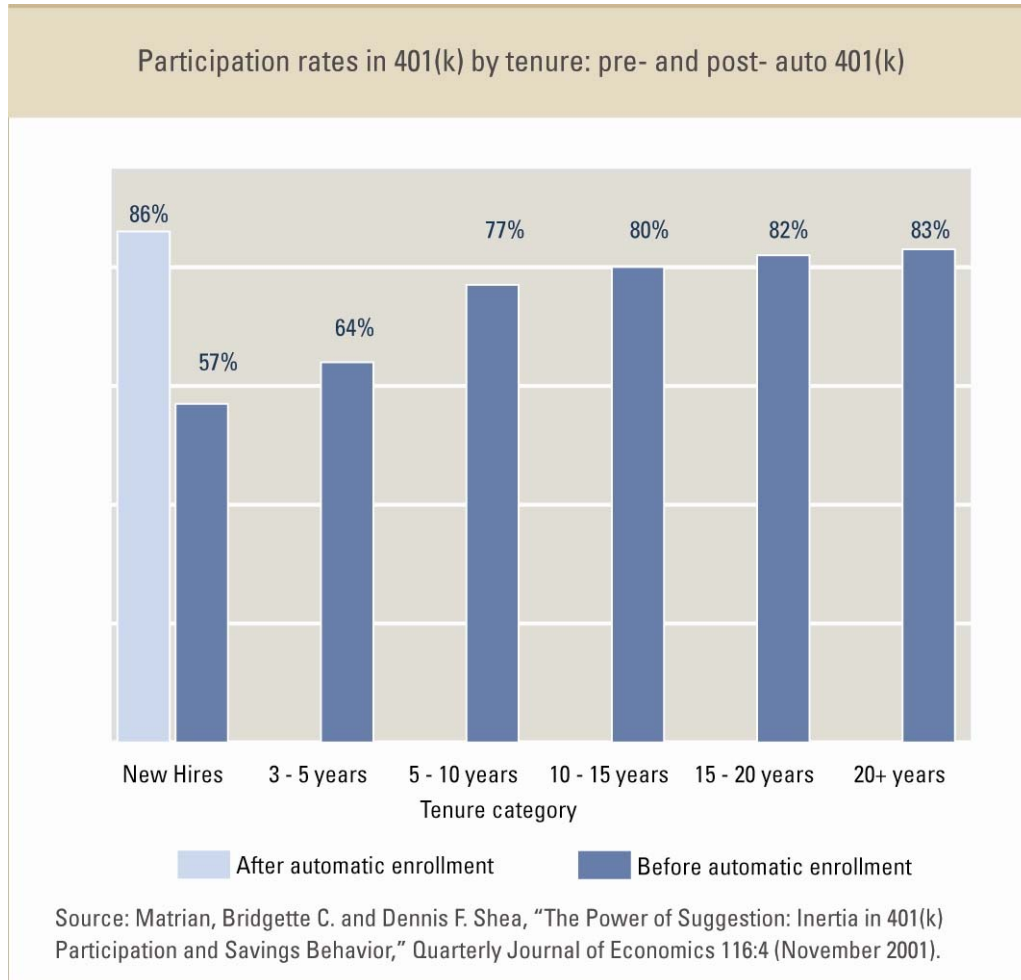
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## Savings and Retirement: What is an automatic 401(k)?

An automatic 401(k) is simply a 401(k) plan that automatically enrolls workers in the plan, rather than requiring workers to decide on their own to sign up. Eligible workers are assigned a default contribution rate, usually 3 percent or less of wages, and a default allocation of funds contributed to the retirement account. As with a traditional 401(k), workers still have a choice about whether to participate and how much to contribute: they can opt out of automatic enrollment or change the default contribution rate. The difference is that, under an automatic 401(k) plan, inaction on the worker's part will automatically result in the worker saving for retirement.



- In traditional 401(k) plans, workers must make numerous choices, including whether to sign up, how much to contribute, how to allocate their investment funds, how often to rebalance their portfolios, what to do with the accumulated funds when they change jobs, and when and in what form to withdraw the funds during retirement. These decisions can be difficult, and many workers, daunted by the complexity, either make poor choices or never sign up at all. Thus they remain outside of the retirement savings system and are deprived of the tax-advantaged saving opportunities that 401(k)s provide.
- With an automatic 401(k)-sometimes called an opt-out plan-workers are automatically enrolled unless they actively choose not to participate; they are assigned a reasonable contribution level,

which rises over time, and a reasonable allocation of investments across stocks and bonds. That is, each stage of the process is automatically set at a pro-saving default. Workers can choose to override any of these choices, but the same inertia that leads them not to make decisions in a traditional 401(k) is likely to make them stay at the defaults in an automatic 401(k).

- Automatic enrollment has been shown to raise 401(k) participation rates dramatically when applied to new hires, especially those who are female, members of minority groups, or low earners.
- The automatic escalation of contributions over time raises overall contributions to 401(k)s relatively painlessly, as employees become accustomed to deferring receipt of a portion of their pay. Escalation also helps ensure that inertia does not keep some employees at a default contribution rate lower than the rate they would have chosen absent the default.
- Under reasonable assumptions about the effect of the automatic 401(k) on overall saving behavior, it is estimated that this simple proposal, applied nationwide, would raise national saving by 0.06 percent of GDP. Private saving would rise by 0.07 percent of GDP, but because 401(k) contributions are tax-favored, government saving would fall by 0.01 percent of GDP.

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## **Savings and Retirement: How might saving be encouraged for low- and middle-income households?**

In 2007 the tax code contained \$108.6 billion in tax expenditures that subsidized retirement saving, but only a small fraction is aimed at low- and middle-income households. Several reforms would help to encourage saving among these households. One would be a reform of the savers' credit. A second would be to encourage automatic enrollment in 401(k) plans and Individual Retirement Accounts (IRAs). Taken together, these two changes would make saving easier and more rewarding.

- Current retirement saving incentives are inefficient and poorly targeted. They are worth the least to lower-income families and thus provide minimal encouragement to those households who most need to save more to provide for basic needs in retirement. Also, as a strategy for promoting aggregate national saving, the subsidies are poorly targeted. Higher-income households are disproportionately likely to respond to the incentives by shifting existing assets from taxable to tax-preferred accounts. Because low- and middle-income households are much less likely to have other assets to shift in this way, any deposits they make to tax-preferred accounts are more likely to represent new saving.
- The saver's credit is a credit to low- and middle-income households for contributions to retirement savings plans. The credit rate is not fixed but declines as income rises. For married couples filing jointly, the credit rate is 50 percent for adjusted gross incomes (AGI) below \$31,000, 20 percent for AGI between \$31,000 and \$34,000, and 10 percent for AGI between \$34,000 and \$52,000. For single filers, the credit rate is 50 percent for AGI below \$15,500, 20 percent for AGI between \$15,500 and \$17,000, and 10 percent for AGI between \$17,000 and \$26,000.
- The saver's credit could be improved in several ways. First, if it were made refundable, it would benefit the millions of low-income families who face no net federal income tax liability but do pay other taxes. Second, if it were simplified by setting a fixed credit rate, with the contribution limit phasing down as income rises, it would be easier for taxpayers to understand. Third, if the credit were converted to a match (a 50 percent credit is equivalent to a 100 percent match) and deposited directly into the account rather than refunded as a tax reduction, it would make the credit operate more like a standard 401(k) match and help improve account balances.
- Reform of the saver's credit would make saving more rewarding; other options would make saving easier. The automatic 401(k) proposal would automatically enroll eligible workers in their employer's 401(k) or other retirement savings plan, if the employer has one. Saving for retirement would thus become the default option: employees taking no action would automatically be on the path to better saving for retirement; employees not wishing to participate could still opt out. Similarly, the automatic IRA proposal would automatically enroll employees in an IRA if their employer does not offer a retirement plan. When automatic enrollment has been instituted on a company level, it has shown to be an effective method of raising the participation rates of low- and middle-income workers in company retirement plans.
- These incentives to make saving more rewarding and efforts to make saving easier could be mutually reinforcing: the saver's credit will reach more people if automatic enrollment is expanded, and the value of automatic enrollment is enhanced if the saver's credit is reformed.

- Some provisions of current policy actually discourage retirement saving. For example, outdated asset tests in means-tested public assistance programs penalize low- and moderate-income households that respond by saving. Applicants for public assistance programs generally must meet both an asset test and an income test, and any retirement savings they hold in defined-contribution plans are often counted in their assets. This has the effect of a steep implicit tax on 401(k) and IRA saving, producing a disincentive for these families to save. Changing the rules of asset tests to exclude the value of retirement savings accounts would generate stronger incentives for low-income families to save.

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### Further Reading

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