

Should They Stay or Should They Go?

Panelists share their thoughts in a blog series on retirement tax incentives

A Conversation with Monique Morrissey on the State of American Retirement and Tax Incentives

By *Monique Morrissey, Economist, Economic Policy Institute*

You authored a detailed report last year on retirement in the US. What did you find?

We're moving toward a retirement system that magnifies inequality rather than reducing or simply reflecting it. Social Security's progressive benefit structure reduces inequality—this is not news to most people. What's more surprising is that before the 401(k) revolution, black workers were almost as likely to participate in pensions as white workers, and high-school-educated workers were almost as likely to participate as college-educated workers. The charts in "The State of American Retirement" show that this isn't true with 401(k)s. While 401(k)s have failed most Americans, at-risk groups have fared the worst. The typical lower-income, black, Hispanic, high-school-educated, or single household has no savings at all in a retirement account.

Why do tax incentives play such a big role in our current retirement system?

In the United States, government subsidies for employer pensions and retirement savings take the form of deferred income taxes on investment earnings. Meanwhile, Social Security is primarily funded through a dedicated payroll tax on workers, and these benefits are largely exempt from income tax. The government's involvement is based on the assumption that people do not save enough on their own for retirement, and, in the case of traditional pensions and Social Security, that group plans are more efficient due to economies of scale and risk pooling.

However, there's no rule that says government incentives to sponsor or participate in a voluntary plan must take the form of tax breaks on investment earnings, nor that mandatory social insurance must be funded through a tax on labor income. There are advantages and disadvantages to these approaches that are worth discussing, though personally I favor maintaining a strong link between worker contributions and social insurance benefits.

In your view, are tax incentives an effective way to boost retirement savings? Why or why not?

I think we should expand Social Security and rely much less on trying to incentivize saving in tax-favored accounts. First, I think do-it-yourself retirement accounts are inherently inefficient. Second, I think current tax subsidies are poorly designed. Third, I think that even better incentives in the form of refundable credits have limitations in the context of retirement saving.

Incentives work best when actors are rational and responsive, when the market failure is an externality such as pollution, and when redistributive and other side effects are benign or can be ameliorated through other policies. An example of a well-structured incentive is a carbon tax or cap-and-trade scheme. With either, the tax rate or the emissions reduction is knowable in advance; the revenues raised, if any, are known after the fact; businesses are assumed to be rational and responsive; and firms with the lowest opportunity cost reduce emissions the most. Conversely, an example of a poorly-designed incentive is a sin tax on an addictive substance or behavior, such as tobacco or gambling, if the response is inelastic and the "incentive" is really a politically expedient way to avoid raising broader tax rates. Such taxes violate the principle of horizontal equity, and, to the extent that low-income people

spend the same or a higher share of their income on the taxed good or service, are regressive or make the tax system less progressive. On the plus side, at least the revenues are quantifiable and can in theory be earmarked for harm reduction, such as treatment for gambling or tobacco addiction.

As a general rule, an inelastic response is desirable when the goal is to raise revenue with the least economic distortion, and the reverse is true when a tax or subsidy is intended as an incentive. In the case of a subsidy, the worst-case scenario is when the response to the supposed incentive is inelastic because many people already engage in the desired behavior *and* the subsidy is regressive—that is, exacerbates inequality. This is the case with incentives for retirement saving, since *wealthy people by definition have funds they can shift to tax-favored accounts and so are given a tax break just for being wealthy*. To make matters worse, there's a lack of transparency because untaxed investment returns aren't reported and so the amount of the giveaway can only be estimated.

Unlike the high-income households who make the lion's share of contributions to tax-favored accounts, some lower-income households increase their saving in response to tax incentives. This isn't necessarily a point in their favor, since households in lower tax brackets get little or no benefit from the incentives but may believe that they do. Salience is usually viewed as a positive attribute of incentives, but the "first do no harm" rule should apply when people are misled, even supposedly for their own good. Many low-income households who are induced to save more for retirement at least benefit from an employer match. But other cash-strapped families get no benefit at all from saving in these accounts yet end up paying an excise tax to access their funds before retirement. Since by definition these families are more likely to need to access funds before retirement, it is counterproductive to nudge them to save in these accounts. If these seem like abstract concerns, the impact of the housing bubble collapse on minority households is a reminder that significant harm can flow from poorly-designed incentives that appear to further motherhood-and-apple-pie goals like homeownership or retirement saving.

401(k)s are an accident of history—Congress never intended them to replace employer-provided pensions for ordinary workers. But after they caught on with employers eager to shift pension costs and risks onto workers, proponents began arguing that individuals were savvy investors and would choose investments tailored to their needs. This claim has been effectively disproven, but advocates still cite a weaker version—that tax incentives help individuals optimize the *amount* they save.

But if under-saving is due to irrational or ill-informed behavior and an inefficient individual account system, tax incentives are unlikely to address the problem. In this case, it's better to focus on expanding an efficient mandatory system like Social Security and find other ways to promote saving. For example, we could require employers who offer 401(k) plans to contribute to these accounts and require employers who don't offer 401(k) plans or traditional pensions to facilitate payroll deductions to low-cost state-sponsored IRAs.

What ideas for reforming these tax subsidies do you think are the most promising?

Tax incentives for retirement saving are famously upside down. They're worth more if you're in a high tax bracket and have high investment returns—in other words, they help those who need the least help saving. As mentioned, they are also ineffective, serving as tax shelters more than saving incentives.

While little attention is paid to the high cost of these ineffective subsidies, social insurance programs vital to seniors' wellbeing are under attack. Left to my own devices, therefore, I might scrap tax

subsidies altogether and use the savings to pay off some of the legacy costs of Social Security. Social Security has one of the lowest income replacement rates among “first tier” pensions in OECD countries, and shoring up Social Security’s finances is a necessary first step toward expanding benefits.

In short, with such a meager first tier system, we probably should not be using taxpayer funds to subsidize voluntary saving even if this could be done effectively. Of course, this assumes that revenues from eliminating these subsidies would instead be used to promote retirement security, rather than, say, lowering top tax rates. In the real world, it’s easier to reform a system than start from scratch. Realistically, then, limiting the size of all tax expenditures and converting them to refundable credits is a good start.

How do you see the prospects for the best ideas moving forward in our current political moment?

Reform of tax incentives pits narrow interests—in this case, the financial industry lobby, avid investors, and the wealthy—against diffuse interests. Meanwhile, Congress is controlled by a party that opposes tax increases, wants to shrink government, and doesn’t consistently equate tax expenditures with government spending. Given these political realities, probably the best that can be hoped for in the short run is mildly progressive base broadening—revenue-neutral tax reform that limits and better targets tax incentives in exchange for slightly lower tax rates.

Looking beyond the 115th Congress, advocates need to start building the case for reforming these and other tax incentives by educating voters about tradeoffs. While tax experts tend to be jaded about reform prospects, the issue is ripe for a populist campaign showing who benefits from our complicated tax code. People may like tax incentives for retirement saving yet still accept the need to lower contribution limits and cap the benefit for taxpayers in upper tax brackets, especially if the savings are used for something they like even more, such as strengthening Social Security.

While President Obama fell short in his attempt to limit and target tax expenditures, he and his allies in Congress did not make this a legislative priority and their efforts should be seen as laying the groundwork for reform rather than hitting a dead end. Tax reform is difficult, but so is cutting popular programs or raising tax rates, if these are the choices.

How will you be evaluating proposals that may be introduced in the new Congress? Against a certain metric or set of principles?

First, as a general rule, policies should be judged by their stated purpose, not theoretical rationales that policymakers are unaware of or would be loath to cite publicly. If no elected official is willing to say that regressive tax subsidies for retirement saving serve as a corrective to overly progressive Social Security benefits or income tax rates, experts shouldn’t pay lip service to these ideas.

Likewise, it is sometimes suggested that the goal of savings incentives is to increase aggregate savings in the household sector rather than advancing retirement security. (A variation on this argument, popular among tax policy wonks, is that we should replace our income tax with a consumption tax, so savings and investment returns should not be taxed in the first place.) While these experts might prefer that savings were more equitably distributed, they see expanding aggregate household savings as a desirable goal based on the assumption that it leads to increased investment and faster economic growth. Meanwhile, the same experts pay little attention to the fact that expanding savings in tax-favored

accounts increases the government deficit and may have little or no effect on national saving given the weak incentive effect. In fact, it's even conceivable that the net effect on national saving is negative since much of the wealth in these accounts is shifted from non-tax-favored accounts.

Leaving aside the fact that tax-incentivized saving is partly or wholly offset by government dissaving, it's not at all clear that increasing aggregate saving increases investment and productivity growth. While this would be true in a supply-constrained closed economy, we live in what appears to be a demand-constrained open economy with a global savings glut. Moreover, the distributional effects are likely a drag on growth since the wealthy have a lower propensity to consume. A related issue is what we assume about government spending—whether tax expenditures increase the deficit (a plus, in a demand-constrained economy) or put pressure on government programs.

In short, while some experts welcome any increase in private saving while ignoring the effect on public revenue, I would argue that an increase in household saving, especially among the wealthy, has negative macroeconomic implications while contributing to snowballing inequality since wealth begets wealth. Conversely, tax expenditures may not be fiscally expansionary if the revenue loss is offset by cuts to government programs.

Second, programs and policies with similar purposes should be compared side by side, whether they're funded through general revenues, off-budget programs like Social Security, or tax expenditures. A subsidy channeled through the tax system is no less a government expenditure than direct spending. It's incoherent to focus on Social Security's long-term budget deficit while urging more saving in tax-favored accounts and ignoring their cost. It's also incoherent to incentivize saving through some programs while disincentivizing saving through Medicaid asset tests and similar provisions.

Retirement policies should be judged by their cost-effectiveness and distributional impact. This is difficult to do in the case of tax subsidies for retirement saving because both the cost and the benefit are hard to quantify. The benefit should not be measured by the total wealth held in tax-favored accounts, but rather by the additional savings, over and above the taxpayer subsidy, held by families who might otherwise see a larger drop in living standards at retirement. This is hard to measure because it is unclear how much wealth people would have absent the subsidy. Subsidizing investment earnings for wealthy people not only does little to promote retirement security, it actually causes inequality to snowball. Meanwhile, what we know from surveys about the distribution of retirement account wealth suggests that most people would be better off if the subsidies were simply deposited directly into retirement accounts with no effect at all on private saving but also no regressive redistribution.

This is not the first time we've heard talk of comprehensive tax reform as a top priority for Congress – do you think this year we'll actually see action?

You would think so, given that one party controls three branches of government and has said they will take up the challenge. Though I agree with conservative tax wonks on certain issues, such as the need to reform the home mortgage interest deduction, I'm guessing that anything the Congressional majority and President could agree on would make things worse, not better. For example, I don't see them taking up President Obama's proposal to cap deductions and exclusions at 28 percent, though I'd love to be proven wrong. Instead, I'm counting on internal disagreement and other distractions scuttling any deal.