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Statement of the Investment Company Institute
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Hearing on “Retirement Savings 2.0: Updating Savings Policy for the Modern Economy”
Committee on Finance
United States Senate

September 16, 2014

The Investment Company Institute¹ is pleased to provide this written statement in connection with the hearing in the U.S. Senate Committee on Finance titled “Retirement Savings 2.0: Updating Savings Policy for the Modern Economy.” The Institute strongly supports efforts to promote retirement security for American workers. We thank Chairman Wyden and Ranking Member Hatch for their past support of bipartisan retirement savings plan improvements, including provisions in the Pension Protection Act of 2006 (PPA) which made permanent the increased contribution limits and catch-up contributions for older workers introduced by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). Thanks in no small part to Congress’ efforts to promote retirement savings, Americans currently have \$23.0 trillion earmarked for retirement, with more than half of that amount in defined contribution (DC) plans and individual retirement accounts (IRAs).² About half of DC plan and IRA assets is invested in mutual funds, which makes the mutual fund industry especially attuned to the needs of retirement savers.

The Institute has devoted years of research and considerable resources to making and communicating an accurate assessment of America’s retirement system.³ We are concerned that those

¹ The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$17.1 trillion and serve more than 90 million shareholders.

² At the end of the first quarter of 2014, U.S. retirement assets totaled \$23.0 trillion, DC plan assets were \$6.0 trillion and IRA assets were \$6.6 trillion. *See* Investment Company Institute, “The U.S. Retirement Market, First Quarter 2014” (June 2014), available at www.ici.org/info/ret_14_q1_data.xls.

³ One of the major roles the Institute serves is as a source for statistical data on the investment company industry. With a research department comprising more than 40 people, including seven PhD-level economists, the Institute conducts public policy research on fund industry trends, shareholder characteristics, the industry’s role in U.S. and international financial markets, and the retirement market. For example, the Institute publishes reports focusing on the overall U.S. retirement market, fees and expenses, and the behavior of defined contribution (DC) plan participants and IRA investors. In its research on mutual fund investors, IRA owners, and 401(k) plan participants, the Institute conducts periodic household surveys that connect directly with savers.

who attempt to paint the current system as “broken” all too often proceed by isolating one component of the system or by focusing solely on account balances. But that is not how Americans plan and prepare for retirement. The U.S. retirement system relies upon the complementary components of Social Security, homeownership, employer-sponsored retirement plans (both defined benefit (DB) plans and DC plans offered by both private-sector and government employers), IRAs (both contributory and rollover), and other savings.

In retirement, different households will depend on each of these components in differing degrees, subject to overall saving levels, work history, and other factors. For most households, however, employer-sponsored retirement plans are crucial: about 8 in 10 near-retiree households have retirement assets (DC plans or IRAs), DB benefits, or both.⁴ Thanks to this multi-faceted system, successive generations of American retirees have been better off than previous generations.⁵

Even with its many successes, the U.S. retirement system can be strengthened further to help even more Americans achieve a secure retirement. The Institute supports policies that would improve access to retirement savings opportunities and make retirement plans more efficient and effective. These reforms would build upon the strengths of the current system. Unfortunately, many critics do not appear interested in building upon our current voluntary system—they want to tear it down, often relying upon selective information and overheated rhetoric to support their efforts. Claims that Americans are facing “pension poverty,” for example, are not used to bolster tax incentives for savings, but, rather, are cited to justify efforts to scrap the current system, limit or eliminate tax incentives, or create new and untested schemes that would take control over retirement preparedness away from Americans and their employers. As our research demonstrates, Americans do not want to lose that control, and employer-sponsored plans play an important role in preparing workers for retirement.

We commend this Committee for its willingness to look at the research and understand the facts in an effort to better assess Americans’ retirement prospects and the role that the current system plays in helping American workers reach their retirement goals. The Institute believes that a careful examination of the facts will lead this Committee to continue its support for policies that protect the tax incentives for retirement savings, improve the system, and help even more American workers achieve a secure retirement.

SUMMARY OF KEY POINTS

We have summarized the key points of our testimony below.

1. **While there is opportunity for improvement, the retirement system is working for millions of American workers.** A wide range of work by government, academic, and industry researchers who have carefully examined Americans’ saving and spending patterns, before and after

⁴ See Figure 13, p. 29, and Figure 14, p. 31, in Brady, Burham, and Holden, *The Success of the U.S. Retirement System*, Investment Company Institute (December 2012), available at www.ici.org/pdf/ppr_12_success_retirement.pdf.

⁵ *Ibid* (discussion, pp. 10–14).

retirement, shows that the American system for retirement saving is working for the majority of American workers and has grown stronger in recent decades.

- ***Americans’ retirement resources are best thought of as a pyramid.*** The pyramid has five layers (Social Security, homeownership, employer-sponsored retirement plans, IRAs, and other assets), and the importance of each layer varies across households.
 - ***Effective policymaking requires a better understanding of the “coverage gap.”*** Discussions about pension plan coverage often rely on misleading or incomplete coverage statistics. The fact is that the majority of private-sector workers needing and demanding access to pensions as part of their compensation have pension plan coverage. Efforts to expand coverage will be more successful if policymakers better understand the reasons underlying why specific populations are not participating in retirement savings vehicles.
 - ***The voluntary employer-provided retirement system is characterized by flexibility, competition, and innovation.*** A strength of the voluntary employer-sponsored retirement system is the flexibility built into its design. Combined with competition—among employers to offer attractive benefits packages that include retirement plans and financial services firms to provide services to those plans—this flexibility has led to tremendous innovation in retirement plan design over the past few decades and to continually lower costs for retirement products and services.
 - ***Retirement plan sponsors and investors are cost conscious and 401(k) plan assets tend to be concentrated in lower-cost mutual funds.*** At year-end 2013, 401(k) plans had \$4.2 trillion in assets and more than 60 percent of 401(k) plan assets were invested in mutual funds. Fees paid on mutual funds have trended down over the past two decades—both on mutual funds invested in 401(k) plans and industrywide—and investors tend to concentrate their assets in lower-cost funds.
2. **A deferral of tax is not equivalent to a tax exclusion or a tax deduction.** Exclusions and deductions reduce taxes paid in the year taken, but do not affect taxes in any future year. Tax deferrals—such as the deferral of tax on compensation contributed to an employer-sponsored retirement plan—reduce taxes paid in the year of deferral, but increase taxes paid in the year the income is recognized through distribution or withdrawal from a plan or account.
- ***Tax deferral equalizes the incentive to save.*** The incentive to save is the after-tax return savers earn on their savings. By effectively taxing all investment income at a zero rate, tax deferral simply ensures that a dollar of 401(k) contributions earns the same after-tax return regardless of the tax bracket workers are in.
3. **Vast majorities of U.S. households appreciate the tax treatment of DC plans and want to preserve the key features of DC plans.** Household survey data indicate that DC account–

owning households appreciate the tax advantages and investment features of DC plans. The tax incentives for retirement savings are vitally important in encouraging employers to create retirement plans and encouraging workers to participate. A vast majority of U.S. households, whether they have DC plans or IRAs, or not, reject the suggestion that DC plan contribution limits should be reduced. Reducing the tax incentives for retirement savings through employer plans or IRAs would undermine this system's foundation and put at risk our nation's progress on retirement security.

4. **Changes in retirement policy should build on the existing system—not put it at risk.** We urge this Committee to continue its leadership in pursuing policies to build on the strengths and successes of the U.S. retirement system. Any improvements, however, should preserve the tax incentives and other features that successfully encourage millions of Americans to accumulate savings during their working lives and therefore generate adequate income in retirement.

- ***The impact of proposals to reduce the tax benefits of employer-sponsored retirement plans would not be limited to taxpayers in the higher tax brackets.*** Reducing the incentive for employers to offer plans will lead to fewer employers offering plans. Lower-paid workers—who were never the intended target of the proposals—would lose the many benefits of participation in employer-sponsored plans. In addition to tax deferral, lower-paid workers covered by a DC plan benefit from the convenience of payroll deduction, the “nudge” of automatic enrollment and auto-escalation, employer matches, and financial education—as well as the host of regulatory protections that surround employer-sponsored retirement plans.
- ***Proposals to limit the up-front tax benefit of deferral would substantially change the tax treatment of retirement contributions.*** Proposals to “cap” the value of exclusions and deductions should not be applied to tax deferrals. Limiting the up-front benefit of tax deferrals would impact workers arbitrarily, substantially reducing benefits for those closest to retirement. In fact, some workers may find that they would be better off simply paying income taxes on their wages and investing in a taxable account.
- ***Limits on DC retirement plan contributions are already low by historical standards and should not be reduced further.*** Adjusted for inflation, the current annual contribution limit to DC plans is less than half the limit originally established by the Employee Retirement Income Security Act of 1974 (ERISA).
- ***Proposals to limit the amount individuals could accumulate through the combination of aggregate retirement savings and DB plan benefit accruals are unworkable and would discourage plan formation.*** Any proposal to place a dollar cap on individual retirement accumulations would add complexity to our nation's retirement system and would discourage employers from creating retirement plans and workers from participating.

I. THE U.S. RETIREMENT SYSTEM IS HELPING MILLIONS OF AMERICANS ACHIEVE A SECURE RETIREMENT

Retirement policy discussions often start from the premise that retirees' pension income has fallen over time. Contrary to this conventional wisdom, private-sector pension income has become more prevalent and more substantial—not less prevalent or less substantial—over time. Since the enactment of ERISA, increasing numbers of retirees receive benefits from private-sector pension plans (DB and DC) and receive more in benefits from these plans:

- Data from the Current Population Survey (CPS) show the share of retirees receiving private-sector pension income increased by more than 60 percent between 1975 and 1991, and has remained fairly stable since.⁶
- Among those receiving income from private-sector pensions, the median amount of inflation-adjusted income—which had remained fairly flat between 1975 and 1991—has increased nearly 40 percent between 1991 and 2012.⁷

Other evidence also points to retirees becoming better off over time.

- Poverty rates for people aged 65 or older have fallen over time. In 1966, the elderly poverty rate was nearly 30 percent. In 2012, it was 9 percent—and the elderly had the lowest poverty rate among all age groups.⁸
- Academic analysis has found that successive generations have reached retirement wealthier than the last.⁹

⁶ See Brady and Bogdan, “A Look at Private-Sector Retirement Plan Income After ERISA, 2012,” *ICI Research Perspective* 19, no. 8 (October 2013), available at www.ici.org/pdf/per19-08.pdf.

⁷ *Ibid* (Figure 7 and Table 19 in the supplemental tables). The increase in pension income since ERISA is likely understated because the survey data used to analyze retiree income do not fully capture payments from DC plans and IRAs. See also Figure 20 and discussion, pp. 20–22, in Sabelhaus and Schrass, “The Evolving Role of IRAs in U.S. Retirement Planning,” *Investment Company Institute Perspective* 15, no. 3 (November 2009), available at www.ici.org/pdf/per15-03.pdf.

⁸ See U.S. Census Bureau, “Living in Near Poverty in the United States: 1966–2012,” *Current Population Reports*, available at www.census.gov/prod/2014pubs/p60-248.pdf. In 2012, the poverty rate for individuals aged 18 to 64 was 14 percent, while it was 22 percent for those younger than 18. For historical time series, see Brady, Burham, and Holden, *The Success of the U.S. Retirement System*, Figure 6, p. 14.

⁹ See Haveman, Holden, Wolfe, and Romanov, “The Sufficiency of Retirement Savings: Comparing Cohorts at the Time of Retirement,” *Redefining Retirement: How Will Boomers Fare?* Edited by Madrian, Mitchell, and Soldo: pp. 36–69, New York: Oxford University Press (2007); and Gustman, Steinmeier, and Tabatabai, “How Do Pension Changes Affect Retirement Preparedness? The Trend to Defined Contribution Plans and the Vulnerability of the Retirement Age Population to the Stock Market Decline of 2008–2009,” *Michigan Retirement Research Center Working Paper* 2009-206 (October 2009), available at www.mrrc.isr.umich.edu/publications/papers/pdf/wp206.pdf.

- Assets specifically earmarked for retirement have increased significantly over time. Adjusted for inflation and population growth, retirement assets were nearly seven times the level at year-end 2013 than at year-end 1975.¹⁰

These statistics speak to the impact of the combined changes implemented over many years, with the increased generosity of Social Security benefits, the enactment of ERISA in 1974, the creation of the 401(k) plan in 1978,¹¹ EGTRRA in 2001, PPA in 2006, and other measures. A crucial foundation of this success is the voluntary employer-sponsored retirement plan system, built around the laws and regulations that allow deferral of tax on compensation set aside for retirement. Rules allowing tax-deferred compensation date back to the origin of the income tax,¹² and play a crucial role in encouraging employers to establish and maintain retirement plans for their workers. While it is important to consider how the retirement system can be improved still further, Congress should *not* throw out decades of progress by taking away the ability of American workers to make full use of the retirement vehicles they value so highly.

II. THE COMPOSITION OF RESOURCES RELIED UPON IN RETIREMENT DIFFERS FROM HOUSEHOLD TO HOUSEHOLD

Assessing whether or not workers are saving enough for retirement requires a standard by which to judge savings adequacy. Retirement savings adequacy is typically defined as a relative, rather than an absolute, standard: savings would be judged to be adequate if the savings allowed retired households to maintain the standard of living they enjoyed while working. Another complicating factor in judging adequacy is that the focus on dedicated retirement savings typically occurs later in a working career. Younger households typically have other savings goals that compete with retirement savings, such as funding education, purchasing a home, and building a rainy-day fund. Importantly, this life-cycle pattern of savings observed in the data is consistent with rational economic behavior. Because of this change in focus over the life cycle, it is difficult to assess retirement preparedness for households that are not in or near retirement.

In assessing whether American workers are saving enough for retirement, it is also important to understand the different resources that most people will draw from in retirement and the role that each resource plays. The traditional analogy is that retirement resources are like a three-legged stool. This analogy implies that everyone should have resources divided equally among Social Security, employer-sponsored pension plans, and private savings. This is not, nor has it ever been, an accurate picture of

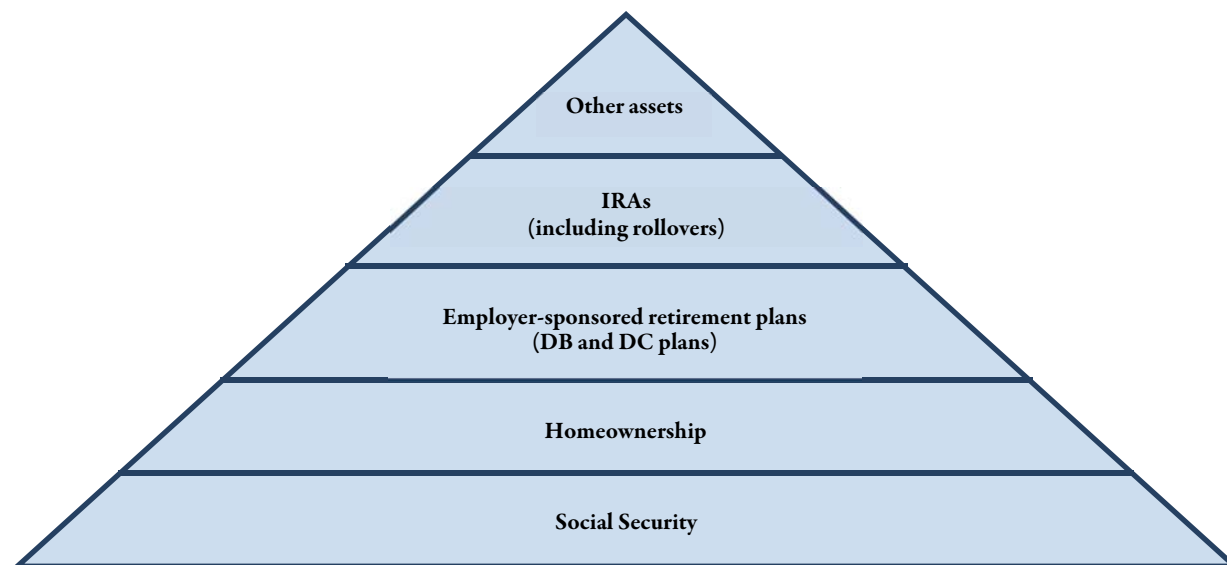
¹⁰ See Brady, Burham, and Holden, *The Success of the U.S. Retirement System*, Figure 4, p. 11 (updated to year-end 2013).

¹¹ Although Congress added section 401(k) to the Internal Revenue Code with the Revenue Act of 1978, it was not until November 10, 1981 that the Internal Revenue Service (IRS) formally described the rules for these plans. See discussion pp. 1–4 in Holden, Brady, and Hadley, “401(k) Plans: A 25-Year Retrospective,” *Investment Company Institute Research Perspective* 12, no. 2 (November 2006), available at www.ici.org/pdf/per12-02.pdf.

¹² The modern federal income tax was established in 1913. The deferral of tax on contributions to profit-sharing plans was codified in the Revenue Act of 1921, and deferral of tax on contributions to DB plans was added in the Revenue Act of 1926. The earlier statutory text is vague as to what forms of compensation represent current income, so it is not clear how deferred compensation was treated before these laws were enacted.

Americans' retirement resources. A pyramid is a better representation of retirement resources (*see* figure below). The retirement resource pyramid has five basic components: Social Security; homeownership; employer-sponsored retirement plans (both private-sector employer and government employer plans, as well as both DB and DC plans); IRAs (including rollovers); and other assets.¹³ The composition of the retirement resource pyramid—that is, the extent to which a household relies on any given resource—will differ from household to household.

Retirement Resource Pyramid



Source: Investment Company Institute; *see* Brady, Burham, and Holden, *The Success of the U.S. Retirement System* (December 2012)

It is possible to estimate the retirement resource pyramid for U.S. households, but doing so requires measuring the value of a household's future stream of Social Security and DB plan benefits. Gustman, Steinmeier, and Tabatabai (2009) undertook this exercise using data from the Health and Retirement Study (HRS).¹⁴ The analysis focuses on households approaching retirement—in this case, households with a member born between 1948 and 1953 (aged 57 to 62 in 2010). Their analysis is used

¹³ These assets can be financial assets—including bank deposits and stocks, bonds, and mutual funds owned outside of employer-sponsored retirement plans and IRAs—and nonfinancial assets—including business equity, nonresidential property, second homes, vehicles, and consumer durables (long-lived goods such as household appliances and furniture). Assets in this category tend to be owned more frequently by higher-income households. For a more complete discussion of the retirement resource pyramid, *see* Brady, Burham, and Holden, *The Success of the U.S. Retirement System*, Investment Company Institute (December 2012).

¹⁴ *See* Gustman, Steinmeier, and Tabatabai, "How Do Pension Changes Affect Retirement Preparedness? The Trend to Defined Contribution Plans and the Vulnerability of the Retirement Age Population to the Stock Market Decline of 2008–2009," *University of Michigan Retirement Research Center Working Paper* 2009-206 (October 2009). The paper used 2006 HRS data, and the authors provided updated data from the 2010 HRS, which are presented in the figure.

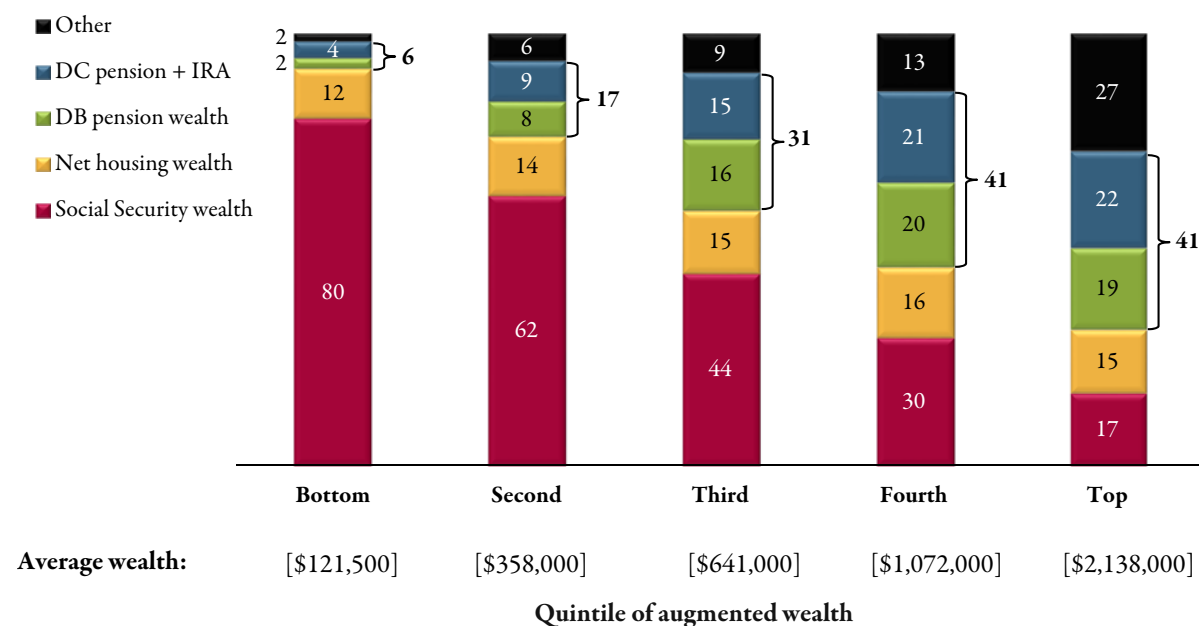
to estimate the components of the retirement resource pyramid for these households, with households grouped by their augmented wealth (*see* figure below). Reflecting the progressive benefit formula, households approaching retirement in the lowest augmented wealth quintile (the lowest 20 percent of households approaching retirement ranked by augmented wealth) rely heavily on Social Security benefits. In 2010, Social Security comprised 80 percent of total augmented wealth for households approaching retirement who were in the lowest augmented wealth quintile. Although Social Security typically replaces a high percentage of earnings for these households, many also had equity in their homes, accumulated retirement benefits, and other assets.

In comparison with those with lower augmented wealth, households approaching retirement in the middle of the augmented wealth distribution rely more heavily on resources other than Social Security. Social Security comprised a large portion of total augmented wealth (44 percent) for households approaching retirement in the middle of the augmented wealth distribution (*see* figure below). For this group, equity in their homes made up 15 percent of augmented wealth and the combination of employer-sponsored DB and DC retirement plans and IRAs comprised another 31 percent of augmented wealth. These households in the middle of the augmented wealth distribution are reliant on a mix of resources in retirement: some from Social Security, but more than half from employer-sponsored retirement plans and IRAs, equity in their homes, and other assets.

The highest augmented wealth quintile of households approaching retirement relies relatively little on Social Security, reflecting the fact that Social Security benefits typically replace a much smaller share of lifetime earnings for this group. For these households, employer-sponsored retirement plans, IRAs, and other assets are more important. For households approaching retirement in the top augmented wealth quintile, Social Security comprised only 17 percent of total augmented wealth (*see* figure below). For this group, 22 percent of total augmented wealth was composed of employer-sponsored DC plans and IRAs, 19 percent from DB plans, 15 percent from equity in their homes, and 27 percent from other assets.

Retirement Resource Pyramid Varies with Wealth

Percentage of wealth by wealth quintile, households with at least one member age 57 to 62, excludes top and bottom one percent, 2010



Source: Investment Company Institute tabulation derived from an updated Table 3 of Gustman, Steinmeier, and Tabatabai (2009) using Health and Retirement Study (HRS) data

A. Social Security

Although often ignored in retirement policy discussions, the United States already has a mandatory retirement plan: Social Security. Social Security stands at the base of the retirement resource pyramid, providing households across all levels of earnings with inflation-indexed income for life. For most households, Social Security is one of their most valuable resources.

When Social Security was signed into law in 1935, it was intended to replace a modest portion of income. Changes to the system since its inception—in particular, two periods of expansion, first in the 1950s and then again in the 1970s—increased benefits substantially, especially for those with low lifetime earnings.¹⁵ Described as a “cornerstone” for U.S. retirement security at its beginning, Social Security has transformed into a comprehensive government-provided pension for workers with lower lifetime earnings and a strong foundation for retirement security for those with higher lifetime earnings.

The expansion of benefits has not come without costs. In 1937, the OASDI tax rate was 2.0 percent on up to \$3,000 of wages and salary (equivalent to about \$49,000 in constant 2014 dollars).

¹⁵ See Brady, Burham, and Holden, *The Success of the U.S. Retirement System*, Investment Company Institute (December 2012), pp. 17–20.

Today, Social Security mandates contributions for American workers of 12.4 percent of wages and salary from the first dollar they earn up to the maximum annual earnings covered by the system, *i.e.*, \$117,000 in 2014.¹⁶

Social Security benefits are designed to be progressive; that is, the benefits represent a higher proportion of pre-retirement earnings for workers with lower lifetime earnings than for workers with higher lifetime earnings. For example, for the cohort of individuals born in the 1940s, Congressional Budget Office (CBO) analysis shows that Social Security benefits are projected to replace 77 percent of average indexed earnings for the typical individual in the bottom 20 percent of individuals ranked by lifetime earnings.¹⁷ The replacement rate drops to 51 percent for the second quintile, and then declines more slowly as lifetime earnings increase. Social Security benefits are projected to replace a considerable fraction of indexed earnings—32 percent—for even the top 20 percent of earners.

These statistics, however, understate the generosity of Social Security benefits, as illustrated in a recent paper by Pang and Schieber.¹⁸ The replacement rate measures used by both the CBO and the Social Security Administration (SSA) measure Social Security benefits as a percentage of wage-indexed earnings. If a worker is seeking to maintain their standard of living in retirement, inflation-indexed, not wage-indexed, earnings represent a better metric of success. Because wages have grown more quickly than inflation over time, Social Security benefits replace a higher percentage of inflation-indexed earnings. To illustrate the impact, Pang and Schieber calculate replacement rates for workers born in 1949 and retiring at age 65 in 2014.¹⁹ Measured as a percentage of wage-indexed earnings, Social Security benefit replacement rates are 77 percent for very low earners, 42 percent for medium earners, and 28 percent for maximum earners (*see* figure below). Using inflation-indexed earnings, the replacement rates are 87 percent, 47 percent, and 31 percent, respectively.

¹⁶ See Social Security Administration, “Contribution and Benefit Base Determination,” available at www.ssa.gov/oact/cola/cbbdet.html. For historical tax rates, *see* www.ssa.gov/oact/progdata/taxRates.html. For the historical earnings base, *see* www.ssa.gov/oact/COLA/cbb.html. OASDI taxes as a percentage of earnings increased to 3.0 percent by 1950, to 6.0 percent by 1960, to 8.4 percent by 1970, to 10.16 percent by 1980, and reached the current 12.4 percent rate in 1990.

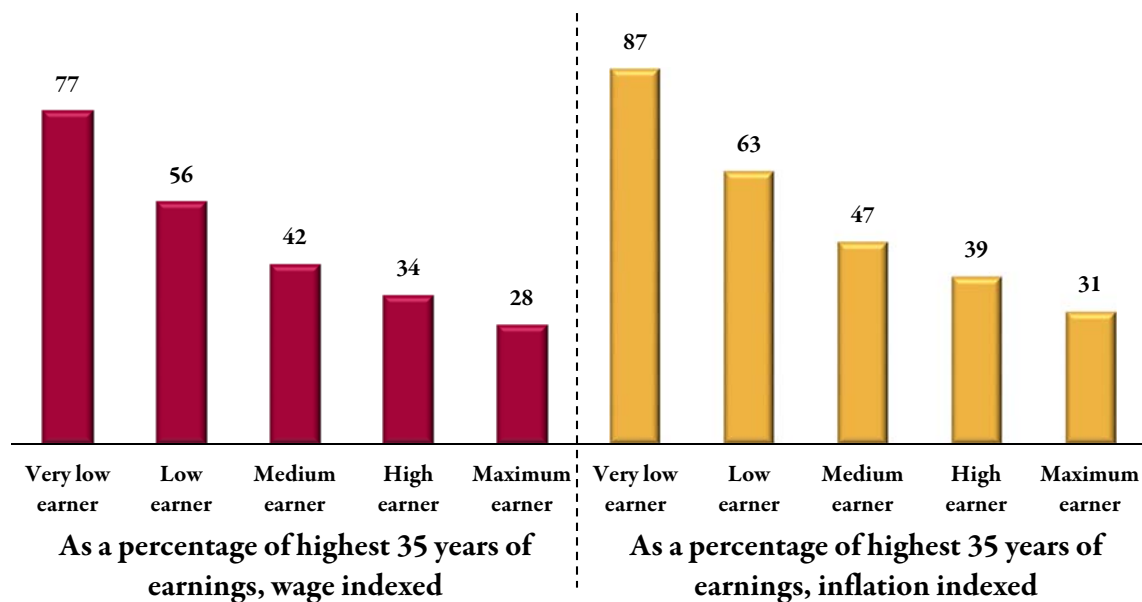
¹⁷ See Congressional Budget Office, *The 2013 Long-Term Projections for Social Security: Additional Information* (October 2013), available at www.cbo.gov/publication/44972. These are an update of the estimates in Brady, Burham, and Holden, *The Success of the U.S. Retirement System*, Investment Company Institute (December 2012), Figure 9, p. 19. *See also* Investment Company Institute, *2014 Investment Company Fact Book*, available at www.icifactbook.org.

¹⁸ See Exhibit 3 in Pang and Schieber, “Why American Workers’ Retirement Income Security Prospects Look so Bleak: A Review of Recent Assessments,” *Working Paper* (May 31, 2014), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2433193.

¹⁹ *Ibid.* The authors used wage profiles developed by SSA for five hypothetical workers with different levels of lifetime earnings.

Social Security Benefits Are More Generous to Workers with Low Lifetime Earnings

Alternative replacement rates for estimated Social Security benefits for SSA hypothetical workers born in 1949, retiring at age 65 in 2014



Source: Pang and Schieber (2014)

Because of the progressive benefit formula, Social Security benefits comprise a higher share of lower-earning households' retirement income. In addition, although this resource typically is not included in measures of household wealth, if it were to be counted as an asset, the value of future Social Security benefits would comprise a higher share of assets in such an augmented balance sheet for those households (as discussed above). In contrast, to maintain their standard of living in retirement, higher-earning households have a greater need to supplement Social Security benefits.

B. Homeownership

A second resource available to the vast majority of retired households is the home in which they live.²⁰ Homeownership increases with age and is high across all income groups among near-retiree households. Households who own homes often have no or low mortgage debt by the time they reach retirement age. Households do not have to sell their homes to benefit from them in retirement; they simply have to live in them. Homeownership is like having an annuity that provides rent, as the home provides a place to live that otherwise would have to be rented.

²⁰ See Brady, Burham, and Holden, *The Success of the U.S. Retirement System*, Investment Company Institute (December 2012), pp. 22–26.

C. Employer-Sponsored Retirement Plans and IRAs

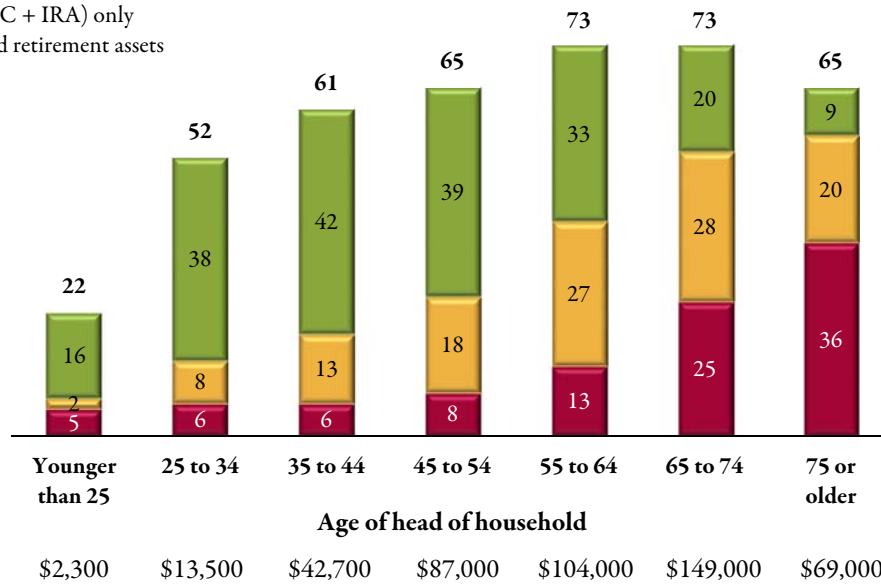
The next two layers of the retirement resource pyramid consist of accumulations in employer-sponsored retirement plans (both private-sector employer and government employer plans, as well as both DB and DC plans) and IRAs (both contributory and those resulting from rollovers from employer-sponsored plans). Near-retiree households across all income groups have these retirement benefits, but employer-sponsored retirement plans and IRAs typically provide a larger share of resources for higher-income households, for whom Social Security benefits provide a smaller share.

The share of households with retirement accumulations—that is, with benefits accrued in a DB plan or assets in a DC plan or IRA—follows a life-cycle pattern. Based on data from the 2013 Survey of Consumer Finances (SCF), conducted by the U.S. Federal Reserve Board, the share of households with retirement accumulations increases from 22 percent of households younger than 25, to 61 percent of households aged 35 to 44, to 73 percent of households aged 65 to 74 (*see figure below*). Similarly, among those with a DC plan or IRA, median retirement assets increase from \$2,300 for households younger than 25, to \$42,700 for households aged 35 to 44, to \$149,000 for households aged 65 to 74.

Share of Households with DB, DC, or IRA Increases with Age, as Do Retirement Assets

Households by age of household head, 2013

- Retirement assets (DC + IRA) only
- Both DB benefits and retirement assets
- DB benefits only



Note: Retirement assets include DC plan assets and IRAs. DB benefits include households currently receiving DB benefits and households with the promise of future DB benefits. Components may not add to the total because of rounding.

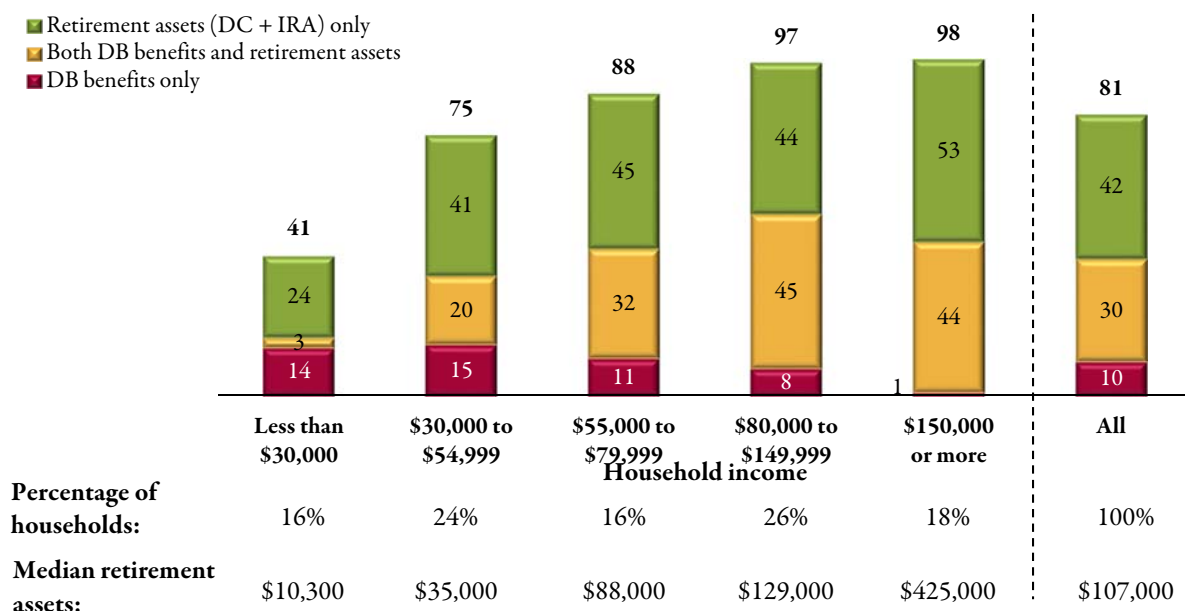
Source: ICI tabulations of the Survey of Consumer Finances

The figure above analyzed the incidence of retirement accumulations by age of household across all households to highlight the life-cycle pattern of focus on saving for retirement. The next figure looks more closely at households who are still working and are getting close to retirement. Focusing on these near-retiree households—that is, working households aged 55 to 64—81 percent have retirement

accumulations and, among those with DC plans or IRAs, median retirement assets are \$107,000 (see figure below). Pre-retirees across all income groups have retirement accumulations, including 41 percent of near-retiree households with income less than \$30,000 and 75 percent of near-retiree households with income of \$30,000 to \$54,999. For the top 60 percent of households by income, over 90 percent have retirement accumulations.

Near-Retiree Households Across All Income Groups Have Retirement Assets, DB Plan Benefits, or Both

Households with working head aged 55 to 64, by household income, 2013



Note: Near-retiree households are households with a working head aged 55 to 64 in 2013, excluding the top and bottom 1 percent of the income distribution. Retirement assets include DC plan assets and IRAs. DB benefits include households currently receiving DB benefits and households with the promise of future DB benefits. Components may not add to the total because of rounding.

Source: ICI tabulations of the Survey of Consumer Finances

As with Social Security benefits, assets specifically earmarked for retirement have increased significantly over time. In 1975, aggregate retirement assets, including assets in DB plans, represented about \$27,700 per household in constant 2013 dollars. By year-end 2013, that figure stood at about \$185,700—6.7 times the level in 1975.²¹

²¹ See Brady, Burham, and Holden, *The Success of the U.S. Retirement System*, Investment Company Institute (December 2012), Figure 4, p. 11 (updated to year-end 2013).

III. EFFECTIVE POLICYMAKING REQUIRES A BETTER UNDERSTANDING OF THE “COVERAGE GAP”

While the current retirement laws and policies are working well and are helping tens of millions of American workers accumulate savings and generate retirement income, some argue that the system is a failure in that not all Americans have access to an employer-sponsored retirement plan. This perceived failure is referred to as the so-called “coverage gap.” The fact is that the majority of private-sector workers needing and demanding access to pensions as part of their compensation have pension plan coverage.²² Discussions about coverage, however, often rely on misleading or incomplete coverage statistics. Household surveys, such as the Current Population Survey (CPS), typically show lower rates of pension coverage than surveys of business establishments, such as the National Compensation Survey (NCS). For example, the CPS data show that 57 percent of all full-time private-sector wage and salary workers had pension coverage in 2012.²³ The March 2014 NCS, on the other hand, shows that 65 percent of all private-industry workers and 74 percent of all full-time private-industry workers have access to a pension.²⁴

Even if one uses the CPS data for analysis, however, looking below the aggregate statistics paints a significantly different picture. Of the 80.6 million workers who report that their employer does not sponsor a pension plan in 2012, 18.2 million are either federal workers, state and local workers, self-employed, or work without pay.²⁵ This leaves 62.5 million private-sector wage and salary employees who report that their employer does not sponsor a retirement plan. Yet this still overstates the number on which to focus. Of these, 6.1 million are under 21 and 3.3 million are aged 65 or older. This leaves 53.1 million private-sector wage and salary employees aged 21 to 64 who report that their employer does not

²² See Brady and Bogdan, “Who Gets Retirement Plans and Why, 2012,” *ICI Research Perspective* 19, no. 6 (October 2013), available at www.ici.org/pdf/per19-06.pdf. Current Population Survey (CPS) data for 2012 indicate that 50 percent of private-sector wage and salary workers were employed by firms that sponsored retirement plans (including both DB and DC plans). However, access to retirement plans is not random. Limiting the analysis to full-time, full-year workers aged 30 to 64, access to retirement plans increases to 60 percent. If the analysis is narrowed further to the groups of workers most likely to be focused on saving for retirement—workers aged 30 or older with at least moderate levels of earnings and all but the lowest earning workers aged 45 or older—then 69 percent work for employers that sponsor retirement plans. In addition, some in this group without access to plans at their own employers have access to plans through their spouses’ employers. Taking into account access through spouses, 74 percent of workers who are likely to be focused on saving for retirement have access to employer-provided retirement plans, and 93 percent participate in the plans offered.

²³ *Ibid* (Figure 3). Pension coverage includes DB and/or DC plans.

²⁴ See Table 1 in U.S. Department of Labor, Bureau of Labor Statistics, “Employee Benefits in the United States – March 2014,” News Release USDL-14-1348 (July 25, 2014), available at www.bls.gov/news.release/pdf/ebs2.pdf. Pension coverage includes DB and/or DC plans.

²⁵ This includes 1.0 million federal government workers and 4.2 million state and local government workers who reported that their employers did not sponsor retirement plans (and possibly gave an inaccurate response to the survey). Another 13.0 million workers without an employer-sponsored retirement plan were self-employed and approximately 149,000 reported that they worked without compensation of any type. Self-employed workers are excluded because, being their own employer, they can access an employer-provided plan by exercising their option to establish a plan. See Figure 5 in Brady and Bogdan, “Who Gets Retirement Plans and Why, 2012,” *ICI Research Perspective* 19, no. 6 (October 2013).

sponsor a pension plan.²⁶ Of these, 21.7 million are part-time, part-year workers²⁷ and 7.6 million are full-time, full-year workers aged 21 to 29 (*see* figure below).²⁸ This leaves 23.8 million full-time, full-year private-sector wage and salary workers aged 30 to 64 who report that their employer does not sponsor a pension plan. Of these, 7.6 million earn less than \$26,000 a year²⁹ and 3.8 million earn \$26,000 to \$44,999 a year and are aged 30 to 44.³⁰ The result is 12.4 million private-sector wage and salary employees who are likely to desire to save for retirement in the current year and who do not have access to an employer plan. But 2.2 million of these have a spouse whose employer sponsors a plan. The final result is 10.2 million private-sector wage and salary employees who are likely to desire to save for retirement in the current year and who do not have access to an employer plan through their own employer or a spouse.

²⁶ *Ibid* (Figure 5).

²⁷ Most part-time, part-year workers have low income and high replacement rates from Social Security. They are unlikely to save for retirement in the current year if they work full-time or year-round in other years. *Ibid* (Figure 6).

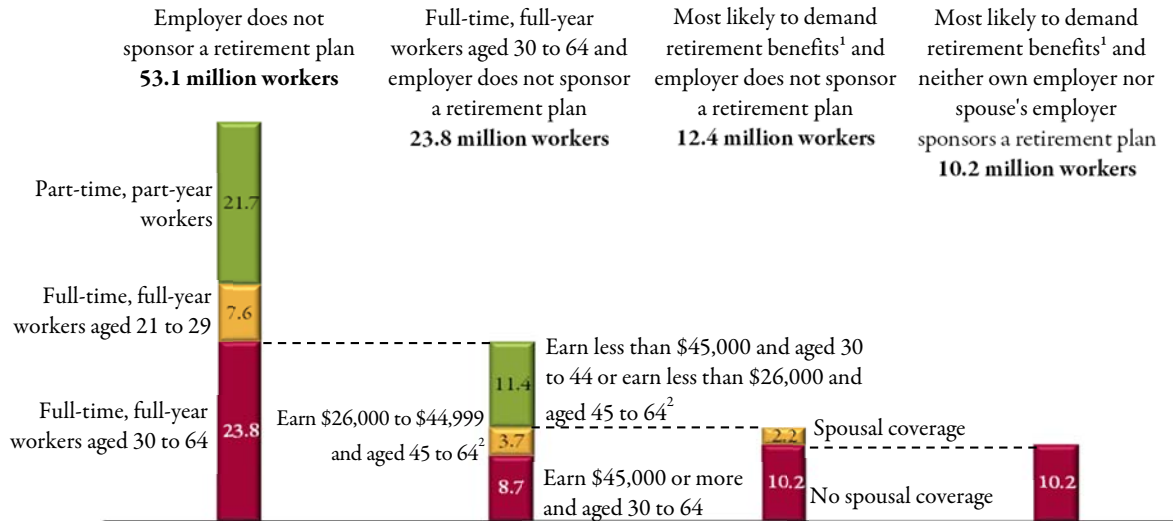
²⁸ Few in this age group save primarily for retirement. Workers age 21 to 29 save primarily for education, the purchase of a home, or for precautionary reasons. *Ibid* (*see* ICI tabulations from the 2010 Survey of Consumer Finances, Figure 1, p. 4).

²⁹ The primary concern for workers earning less than \$26,000 per year is they do not have enough to spend on food, clothing and shelter. In fact, many are eligible for government income assistance so that they will be able to spend more than what they earn on these items. If these workers consistently have low earnings throughout their careers, Social Security will replace a high percentage of their lifetime earnings. *Ibid* (*see* Tables 41 and 42 in Brady and Bogdan “Supplemental Tables for Who Gets Retirement Plans and Why, 2012,” available at www.ici.org/info/per19-06_data.xls).

³⁰ Workers age 30 to 44 who earn between \$26,000 and \$44,999 a year may have the ability to save, but have other saving priorities, such as starting a household and having children. Given that they get a substantial replacement rate from Social Security, they are likely to delay saving for retirement until later in life—perhaps after age 44. *Ibid* (Tables 41 and 42).

A Closer Look at Workers Who Are Not Covered by an Employer Plan

Millions of private-sector wage and salary workers aged 21 to 64, 2012



¹ Full-time, full-year workers who earn \$45,000 or more and are aged 30 to 64 or earn \$26,000 to \$44,999 and are aged 45 to 64.

² Among full-time, full-year workers aged 35 to 44, \$26,000 represents the top earnings of the 20th percentile of annual earnings and \$45,000 represents the top earnings for the 50th percentile of annual earnings.

Note: Components may not add to the total because of rounding.

Source: Investment Company Institute tabulations of March 2013 Current Population Survey; see Brady and Bogdan, "Who Gets Retirement Plan and Why, 2012," *ICI Research Perspective* 19, no. 6 (October 2013)

Access to retirement plans at work is not randomly distributed throughout the workforce. Differences in workforce composition appear to be a primary cause for the lower rate at which small employers sponsor retirement plans.³¹ As a group, the characteristics of small-firm employees differ substantially from the characteristics of large-firm employees. Nevertheless, workers at small firms that sponsor plans are very similar to workers at large firms that sponsor plans, and workers at small firms that do not sponsor plans are very similar to workers at large firms that do not sponsor plans. In particular, employees who work for firms that do not sponsor retirement plans are more likely to be younger, have lower earnings, and have less attachment to the workforce (see figure below). For example, among employers that do not sponsor retirement plans, 30 percent of their employees are younger than 30, 57 percent of their employees are low earners, and 41 percent of their employees are not full-time, full-year. In contrast, among employers that do sponsor retirement plans, only 18 percent of their employees are young, only 23 percent are low earners, and only 20 percent are not full-time, full-year.

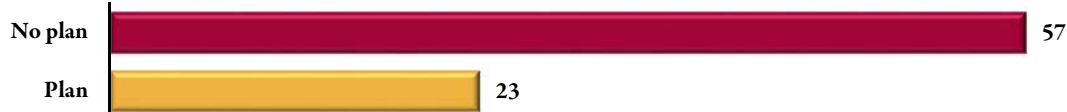
³¹ See Brady and Bogdan, "Who Gets Retirement Plans and Why, 2012," *ICI Research Perspective* 19, no. 6 (October 2013).

Companies That Don't Offer Pension Plans Have Workforces That Are:

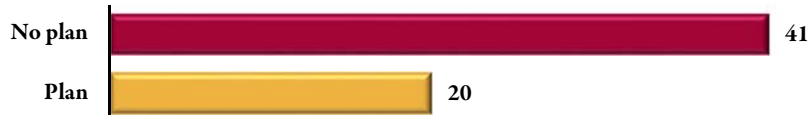
Younger (percentage of employees younger than 30)



Lower-earning (percentage of employees earning \$26,000 or less)



Less attached to workforce (percentage of employees not full-time, full-year)



Source: Investment Company Institute tabulations of March 2013 Current Population Survey; see Brady and Bogdan, "Who Gets Retirement Plans and Why, 2012," *ICI Research Perspective* (October 2013)

It is also important to remember that households with earned income have access to IRAs to save for retirement on a tax-advantaged basis. For example, Congress designed the traditional IRA with two goals in mind: (1) to create a contributory retirement account for workers, and (2) to provide a rollover vehicle to preserve assets accumulated in employer-sponsored retirement plans (both DB and DC). Although a small share of individuals contributes to traditional IRAs in any given year,³² the majority of those who contribute make repeat contributions in succeeding years.³³ In addition, many of those IRA investors contributing to traditional IRAs contribute at the limit.³⁴

Many more workers will have access to an employer-sponsored retirement plan at some point during their working careers and will reach retirement with work-related retirement benefits than is implied by looking at a snapshot of coverage among all workers at any point in time. Data from the SCF show that accrued benefits and asset accumulations in employer-sponsored retirement plans and IRAs

³² A number of factors may account for this relatively low contribution rate. Two of the major determinants of individuals' decisions to contribute to traditional IRAs are their assessment of their need for additional retirement savings and their ability to deduct contributions from their taxable income. Individuals who are covered by retirement plans at work may find that they can meet their saving needs through those plans. In addition, coverage by such plans may curtail their eligibility to make tax-deductible contributions. For lower-income households, Social Security replaces a much higher fraction of pre-retirement earnings, which may reduce their need for additional retirement savings. Furthermore, there is some evidence that confusion about IRA rules may prevent some individuals from contributing. See Holden and Bass, "The IRA Investor Profile: Traditional IRA Investors' Activity, 2007–2012," *ICI Research Report* (March 2014), available at www.ici.org/pdf/rpt_14_ira_traditional.pdf.

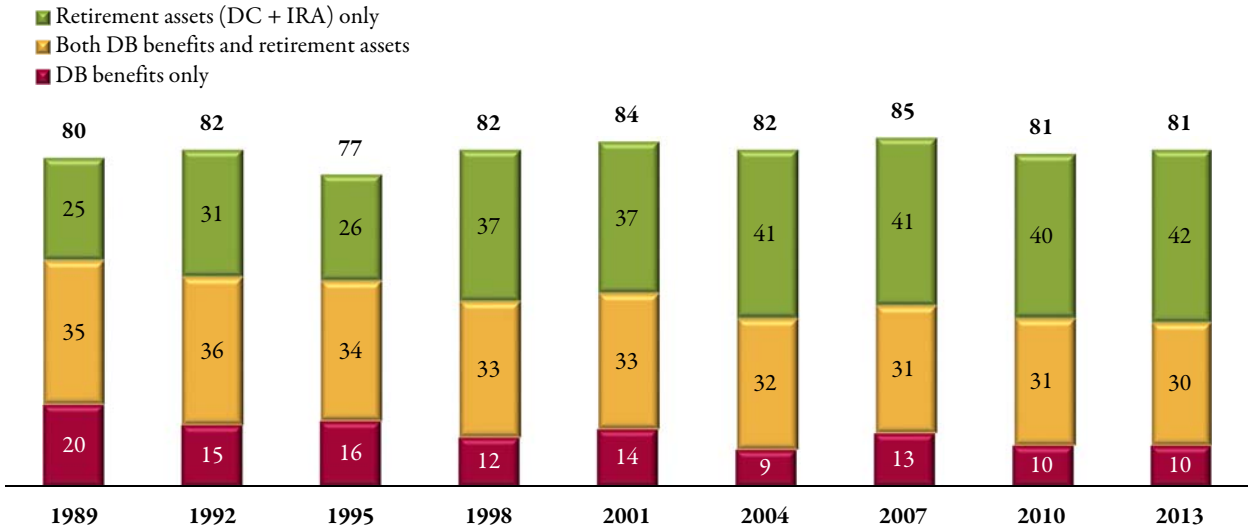
³³ *Ibid.*

³⁴ *Ibid.*

constituted a resource for about 80 percent of near-retiree households in 2013 (see figure below).³⁵ For the past two decades about 80 percent of near-retiree households—those with a working head of household aged 55 to 64 in the year indicated—have consistently accrued DB, DC, or both types of retirement plan benefit (from private-sector employer and government employer plans), or IRAs (rollover and contributory). Despite the fact that DC plans have grown relative to DB plans among private-sector employers, the portion of near-retiree households with retirement accumulations has remained stable. What has changed is the composition of those retirement accumulations: in 1989, 55 percent of near-retiree households had DB benefits and 60 percent had retirement assets (DC plans or IRAs, or both), compared with 2013, when 40 percent of near-retiree households had DB benefits and 72 percent had retirement assets.

Vast Majority of Near-Retiree Households Have Accrued Pension Benefits

Percentage of near-retiree households, 1989–2013



Note: Near-retiree households are households with a working head aged 55 to 64 in the year indicated, excluding the top and bottom 1 percent of the income distribution. Retirement assets include DC plan assets and IRAs. DB benefits include households currently receiving DB benefits and households with the promise of future DB benefits. Components may not add to the total because of rounding.

Source: Investment Company Institute tabulations of the 1989–2013 Survey of Consumer Finances

³⁵ Update of tabulations in Brady, Burham, and Holden, *The Success of the U.S. Retirement System*, Figure 13, p. 29.

IV. THE VOLUNTARY EMPLOYER-SPONSORED RETIREMENT SYSTEM IS CHARACTERIZED BY FLEXIBILITY, COMPETITION, AND INNOVATION

A strength of the voluntary employer-provided retirement system is the flexibility built into its design. This flexibility has allowed a tremendous amount of innovation to take place over the past few decades, due to the combined efforts of employers, employees, and plan service providers. Some of these innovations—for example, making contributions through regular payroll deduction, which provides convenience and stability, or employer matching contributions, designed to further incentivize employee participation—are now taken for granted as standard plan features. Another important improvement has been automatic enrollment to increase plan participation.³⁶ Another change, auto-escalation, gradually increases the share of pay contributed each pay period until it reaches a desired goal. Further, target date funds also have become increasingly popular both as a default and as an employee choice and have been successful in ensuring that investors have a diversified portfolio that rebalances to be more focused on income and less focused on growth over time.³⁷

It is important to remember that the employer-sponsored retirement system is premised on its voluntary and flexible nature; employers can choose to provide retirement plans to their employees tailored to their specific needs—but they are not required to do so. The current tax structure—including allowing the deferral of tax on compensation contributed to employer-sponsored retirement plans—provides a strong and effective incentive for individuals at all income levels to save for retirement and encourages employers to sponsor plans that provide significant benefits to American workers of all income levels. Untoward changes in the retirement tax incentives would require each employer to reevaluate and potentially redesign its retirement plan offerings and could prompt them to consider eliminating their plans entirely.

A. 401(k) Plan Assets Tend to Be Concentrated in Lower-Cost Mutual Funds

Employers design and offer 401(k) plans to attract and retain qualified workers, and financial companies compete to provide services to the plans. Competition and a growing asset base have contributed to the success of 401(k) plans by reducing investment costs, which results in cost-effective investing for 401(k) participants. In this respect, Institute research shows that the costs 401(k) plan participants have incurred for investing in long-term mutual funds have trended down over the past decade. For example, in 2000, 401(k) plan participants incurred expenses of 0.77 percent of the 401(k)

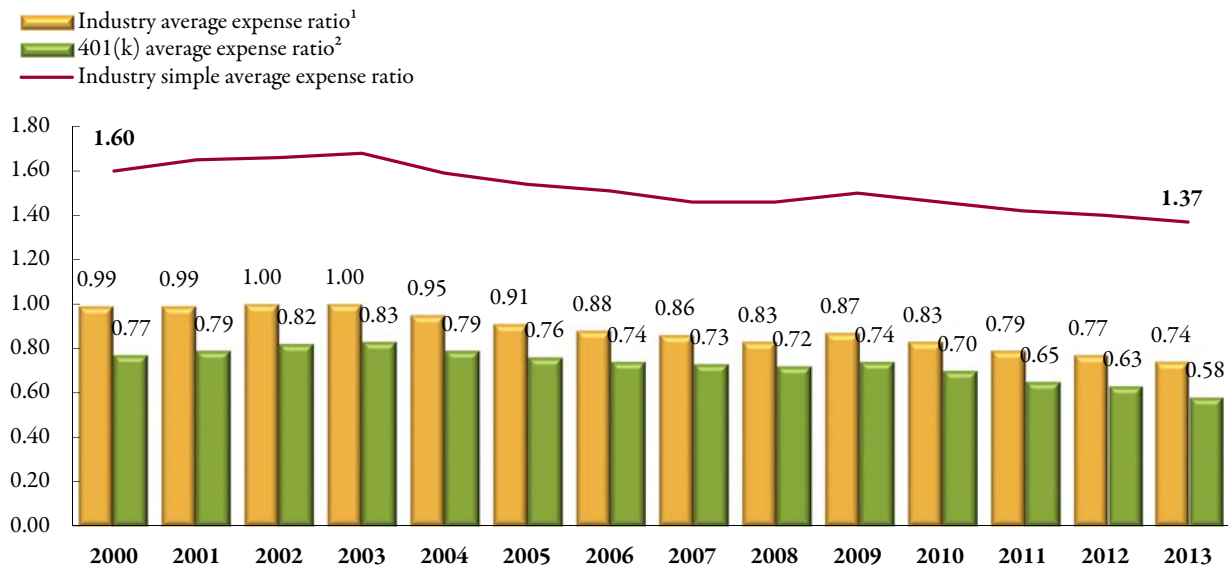
³⁶ The EBRI/ICI 401(k) Accumulation Projection Model demonstrates the increases in retirement income that can result from automatic enrollment. Replacement rates, modeled after adding automatic enrollment and investing contributions in a target date fund, increase significantly. See Holden and VanDerhei, “The Influence of Automatic-Enrollment, Catch-Up, and IRA Contributions on 401(k) Accumulations at Retirement,” *Investment Company Institute Perspective* 11, no. 2, and *EBRI Issue Brief*, no. 283 (July 2005), available at www.ici.org/pdf/per11-02.pdf and www.ebri.org/pdf/briefspdf/EBRI_IB_07-20054.pdf. Furthermore, studies find that adopting an automatic enrollment feature has a particularly strong impact on improving participation rates among low-income and younger workers. See, e.g., Utkus and Young, *How America Saves, 2014: A report on Vanguard 2013 defined contribution plan data*, Vanguard Center for Retirement Research (2014), available at <https://institutional.vanguard.com/iam/pdf/HAS14.pdf>.

³⁷ See Charlson, “Diversification Pays Off for Target-Date Funds,” *Morningstar Advisor* (January 17, 2013).

assets they held in equity funds (*see* figure below).³⁸ By 2013, that had fallen to 0.58 percent, a 25 percent decline.³⁹ The expenses 401(k) plan participants incurred for investing in hybrid and bond funds also fell from 2000 to 2013, by 19 percent and 21 percent, respectively.⁴⁰ It is also significant that participants in 401(k) plans tend to pay lower fees than fund investors overall. The 0.58 percent paid by 401(k) investors in equity funds is lower than the expenses paid by all equity fund investors (0.74 percent) and less than half the simple average expense ratio on equity funds offered for sale in the United States (1.37 percent). The experience of hybrid and bond fund investors is similar.

401(k) Mutual Fund Investors Concentrate Their Assets in Lower-Cost Equity Funds

Percent, 2000–2013



¹The industry average expense ratio is measured as an asset-weighted average.

²The 401(k) average expense ratio is measured as a 401(k) asset-weighted average.

Note: Data exclude mutual funds available as investment choices in variable annuities.

Sources: Investment Company Institute and Lipper; *see* Collins, Holden, Chism, and Duvall, “The Economics of Providing 401(k) Plans: Services, Fees, and Expenses, 2013,” *ICI Research Perspective* (July 2014)

B. American Workers Show Strong Support for the Defined Contribution Retirement Plan System

Given this progress in building nest eggs for American workers, it is no surprise that Americans highly value their DC plans and the features typically associated with them. A fall 2013 household

³⁸ *See* Collins, Holden, Chism, and Duvall, “The Economics of Providing 401(k) Plans: Services, Fees, and Expenses, 2013,” *ICI Research Perspective* 20, no. 3 (July 2014), available at www.ici.org/pdf/per20-03.pdf.

³⁹ *Ibid* (Figure 6, p. 12).

⁴⁰ *Ibid* (Figure 6, p. 12).

survey demonstrated American households' strong support for key features of DC plans, including DC plans' tax benefit, and their appreciation for the investment opportunity these plans provide.⁴¹

- **Americans overwhelmingly support preserving the tax incentives for retirement saving.** Eighty-six percent of all U.S. households disagreed when asked whether the tax advantages of DC accounts should be eliminated. Eighty-three percent opposed any reduction in employee contribution limits.⁴²
- **Vast majorities of American households oppose altering key features of DC plans.** Eighty-six percent of all U.S. households disagreed with the idea that individuals should not be permitted to make investment decisions in their DC accounts.⁴³
- **Investors like choice and control of investments.** Ninety-six percent of all DC account-owning households agreed that it was important to have choice in, and control of, the investment options in their DC plans. Eighty-six percent said their plan offers a good lineup of investment options.⁴⁴
- **Most households have positive attitudes toward the 401(k) system.** Sixty-six percent of all U.S. households surveyed in fall 2013 had favorable impressions of 401(k) and similar plan accounts, similar to the support shown in surveys taken in the prior four years.⁴⁵ More than three-quarters of households expressed confidence that DC plan accounts could help participants reach their retirement goals.⁴⁶

ICI's household surveys during the past five years find that despite the experience of a recent bear market and a broad economic downturn, Americans remain committed to saving for retirement and value the characteristics, such as the tax benefits and individual choice and control that come with DC plans.

V. TAX-DEFERRED COMPENSATION IS NOT TAX-FREE COMPENSATION

Discussion and policy proposals surrounding tax incentives for retirement often proceed from premise that compensation that is saved for retirement is similar to an exclusion or deduction, or in other words "tax-free." That premise is false. The tax code allows workers to *defer* taxation on compensation that is set aside for retirement in a qualified employer plan or in an IRA. With a deferral, taxes are collected in the year the worker receives the compensation (through a plan distribution or an

⁴¹ See Burham, Bogdan, and Schrass, "Americans' Views on Defined Contribution Saving," *ICI Research Report* (January 2014), available at www.ici.org/pdf/ppr_14_dc_plan_saving.pdf. The survey included 3,021 U.S. adults interviewed in November 2013 and December 2013. Survey results were weighted to be representative of U.S. households.

⁴² *Ibid* (Figure 3, p. 9).

⁴³ *Ibid* (Figure 3, p. 9).

⁴⁴ *Ibid* (Figure 2, p.7).

⁴⁵ *Ibid* (Figure 1, p. 5).

⁴⁶ *Ibid* (Figure 5, p. 13).

IRA withdrawal), rather than in the year the compensation is earned. When a distribution is taken, taxes are paid on both the original deferred compensation and the earnings on those deferrals from the plan or IRA.

A deferral of tax is *neither* a tax deduction *nor* a tax exclusion. Tax deductions (such as the deduction of mortgage interest expense) and tax exclusions (such as the exclusion of employer-paid health insurance premiums from taxable compensation) reduce taxes paid in the year taken, but do not affect taxes in any future year. In contrast, setting aside a portion of compensation until retirement reduces taxes paid in the year the compensation is earned, but *increases* taxes paid in the year the compensation is received.

The simple calculations used to quantify the tax benefits and revenue costs of tax exclusions and tax deductions accordingly do not apply to tax deferrals. Unlike a deduction or an exclusion, the benefits an individual receives from deferring tax on compensation cannot be calculated by simply multiplying the amount of compensation deferred by the individual's marginal tax rate. This is because the tax benefit is not the up-front deduction.⁴⁷

Instead, the benefits of deferral depend on many factors, with the most important factor being the length of time a contribution remains invested (which in turn is generally driven by the saver's age at the time of the contribution). The dollar value of the tax benefit also will depend on an individual's marginal tax rate, but that relationship is complex. In fact, under current law, controlling for the length of deferral, there already is little difference in the dollar value of the tax benefit generated by a \$1,000 retirement contribution among individuals in the top five federal income tax brackets (with marginal tax rates of 25, 28, 33, 35, and 39.6 percent).⁴⁸

A. Proposals to Limit the Up-Front Benefit of Tax Deferral Are Misguided

Because a *tax deferral* is neither a *tax deduction* nor a *tax exclusion*, it should not be included in proposals that limit the tax benefit of deductions and exclusions. In particular, because the tax benefit of a deferral is not the up-front tax savings, proposals that limit the up-front tax savings change the tax treatment substantially. Capping the up-front tax savings on retirement contributions would arbitrarily penalize workers, substantially reducing the tax benefits for those closest to retirement.

⁴⁷ As a rough approximation, the benefits of tax deferral are equivalent to facing a zero rate of tax on investment income. In the absence of deferral, an individual saving for retirement would first pay tax on her compensation, contribute the after-tax amount to a taxable investment account, and then pay taxes on investment returns each year. Other than tax on unrealized capital gains, no tax would be paid when account balances were withdrawn. Tax deferral changes the tax treatment at three different points in time: no tax is paid up front; no tax is paid on investment returns during the deferral period; and both contributions and investment returns are taxed upon withdrawal. If there is no change in an individual's marginal tax rate, the tax paid upon distribution pays back to the government, with interest, the up-front reduction in taxes. The remaining difference represents the tax benefit of deferral: tax-free investment income on the portion of the initial contributions that would have been contributed to a taxable account. See Brady, *The Tax Benefits and Revenue Costs of Tax Deferral*, Investment Company Institute (September 2012), available at: www.ici.org/pdf/ppr_12_tax_benefits.pdf.

⁴⁸ *Ibid.*

Several proposals intended to limit the up-front benefit of tax-deferred retirement plan contributions have been introduced in recent years. Since fiscal year 2011 (FY2011), the Administration's budget has included a proposal to "cap" the benefits of itemized deductions at 28 percent. Starting with the FY2013 budget, the proposal was expanded so that the 28 percent cap also applied to tax-deferred employee contributions to DC plans and tax-deferred IRA contributions. In his tax reform discussion draft, Ways and Means Committee Chairman Camp (R-MI) included a proposal that would subject tax-deferred employee and employer contributions to DC plans to a 10 percent surtax. Although the 10 percent surtax proposal appears to be much different from the 28 percent cap proposal, the combination of the surtax with a top marginal rate of 25 percent is equivalent to having a top marginal rate of 35 percent and a 25 percent cap. Both the 28 percent cap proposal and the 10 percent surtax proposal are variants of proposals that have been around for some time: turning all deductions and exclusions into flat-rate credits. For example, in 2006, Batchelder, Goldberg, and Orszag proposed to turn all "tax incentives" into refundable 15 percent credits.⁴⁹ More recently, Gale, John, and Smith released a similar proposal specifically for retirement contributions.⁵⁰

The idea of limiting the tax benefits of deductions and exclusions, rather than eliminating them altogether, may seem at first glance to be a modest proposal. Under current tax law, a deduction or exclusion generally reduces a taxpayer's income tax by the amount of the item multiplied by the taxpayer's marginal tax rate. For example, an additional \$1,000 of mortgage interest deduction would reduce income taxes by \$350 for a taxpayer in the 35 percent tax bracket, and by \$250 for taxpayer in the 25 percent tax bracket. Under both the Administration's 28 percent cap proposal and the Camp 10 percent surtax proposal, the tax benefit of the mortgage interest deduction would remain unchanged for the 25 percent marginal rate individual, but would be reduced to \$280 or \$250, respectively, for the 35 percent marginal rate individual.

When applied to tax deferrals, however, the impact of these proposals is anything but modest. These proposals would substantially change the tax treatment of retirement contributions. To implement a cap on the up-front benefit, taxpayers would pay an additional "cap tax" or "surtax" on retirement plan contributions. For example, a taxpayer in the 35 percent bracket would pay a tax on a \$1,000 contribution of \$70 (7 percent, or 35 percent less 28 percent) under the 28 percent cap proposal, a tax of \$100 with a 10 percent surtax, and a tax of \$200 (20 percent, or 35 percent less 15 percent) with a 15 percent credit. Taxes paid in retirement would remain unchanged, however, with all distributions from the account subject to tax.⁵¹ Thus, the up-front value of the tax deferral is reduced by the "surtax"

⁴⁹ See Batchelder, Goldberg, and Orszag, "Efficiency and Tax Incentives: The Case for Refundable Tax Credits," *New York University Law and Economics Working Papers*, Paper 77 (October 2006), available at lsr.nellco.org/nyu_lewp/77.

⁵⁰ See Gale, John, and Smith, "New Ways to Promote Retirement Saving," *AARP Public Policy Institute Research Report* no. 2012-09 (October 2012), available at www.aarp.org/content/dam/aarp/research/public_policy_institute/econ_sec/2012/new-ways-promote-retirement-saving-AARP-pp-econ-sec.pdf.

⁵¹ This is the case with the 15 percent credit proposal, the Camp 10 percent surtax proposal, and the Administration's FY2013 28 percent cap proposal. Responding to criticism that workers could be made worse off by contributing to a retirement plan, the Administration's FY2014 proposal included a provision for an unspecified basis adjustment. Any basis adjustment that would ensure no worker is made worse off contributing to a retirement plan would be unintuitive, complex,

or “cap tax,” but the tax ultimately paid on income from the retirement account is not reduced. In effect, taxpayers would be taxed on contributions made to the retirement account and again as they receive the amounts in the form of distributions.

The additional “surtax” or “cap tax” would create a drag on a saver’s return, sharply reducing the benefits of tax deferral. In fact, some workers close to retirement age may find that they would have been better off paying taxes on the wages and investing in a taxable account.⁵² For example, a worker invested in stocks would need to hold the investment for 13 years before the benefits of deferral offset the impact of a 10 percent surtax.⁵³

Reducing the value of tax-deferred retirement contributions will reduce the incentives for employers to offer DC plans to their employees. Highly paid employees will no longer assign as much value to the opportunity to save in employer-sponsored plans. Some employers likely will find that the benefits their employees receive no longer justify the expense of offering a plan, and may choose to eliminate their plans and use the savings to simply increase cash compensation. It is difficult to predict the size of the effect, but if the 10 percent surtax or 28 percent cap were applied to tax-deferred retirement contributions, this change would undoubtedly reduce the number of employers that voluntarily sponsor a retirement plan.

B. Contribution Limits Already Are Low by Historical Standards

Several proposals have been made to reduce contribution limits to DC plans. The National Commission on Fiscal Responsibility and Reform’s so-called “20/20 proposal” suggested limiting the combination of employer and employee contributions to DC plans to the lesser of \$20,000 annually or 20 percent of compensation. Chairman Camp’s tax reform discussion draft would suspend inflation adjustments to DC plan contribution limits and DB plan benefit limits for 10 years.

Contribution limits are already low by historical standards.⁵⁴ As illustrated in the figure below, for 2014, the Internal Revenue Code Section 415(c) limit for total DC plan contributions (employer plus employee) is \$52,000. The original limit set under ERISA (\$25,000 in 1975; or about \$114,000 in today’s dollars) was indexed to inflation until 1983, when it was reduced to \$30,000 (or about \$71,000 in today’s dollars) and subsequently frozen. The Tax Reform Act of 1986 delayed reinstating inflation

burdensome on taxpayers, and difficult for the IRS to enforce. And, in the end, the benefits of tax deferral would still be reduced substantially.

⁵² See Brady, “A ‘Modest’ Proposal That Isn’t: Limiting the Up-Front Benefits of Retirement Contributions,” *ICI Viewpoints* (September 18, 2013), available at www.ici.org/viewpoints/view_13_limiting_upfront_benefits.

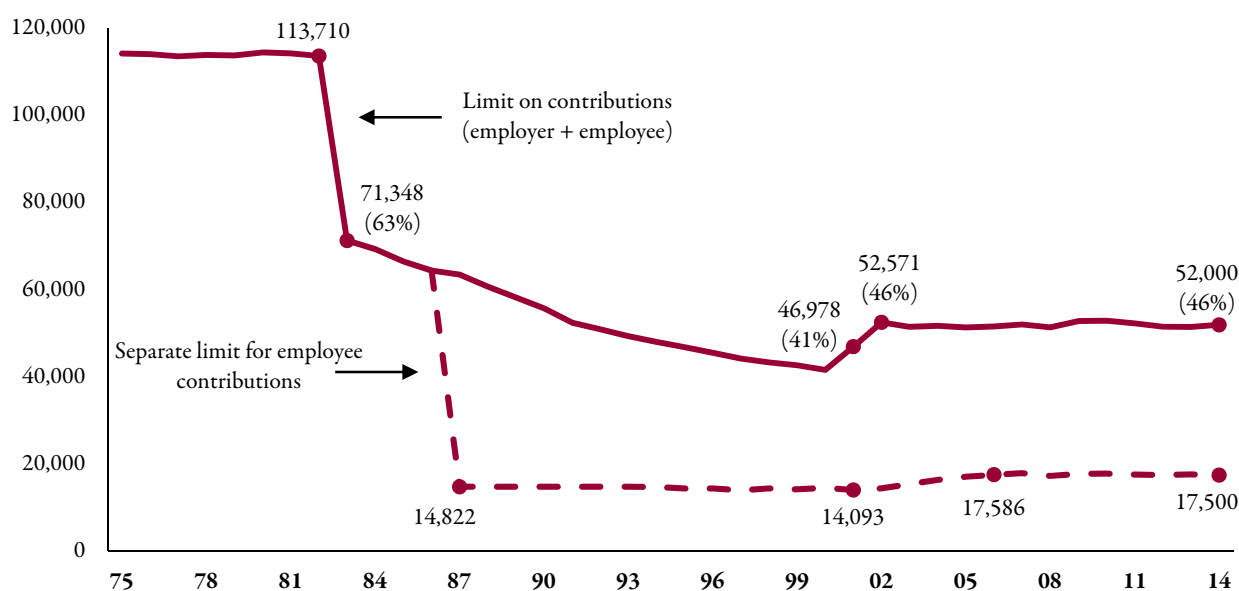
⁵³ This calculation assumes the up-front benefit is capped at 25 percent and the taxpayer is subject to a 35 percent marginal tax with no change in marginal tax rate over time and is not subject to penalty for early withdrawal. Investments are assumed to earn a 6.0 percent nominal rate of return composed of 3.0 percent long-term capital gains and dividend payments, 0.5 percent short-term capital gains, and 2.5 percent unrealized capital gains.

⁵⁴ For a discussion of the history of contribution limits, see pp.10–11 in Holden, Brady, and Hadley, “401(k) Plans: A 25-Year Retrospective.” *Investment Company Institute Research Perspective* 12, no. 2 (November 2006), available at www.ici.org/pdf/per12-02.pdf.

adjustment and implemented a \$5,000 “round-down” rule. The combined effect was the limit was unchanged until an inflation adjustment increased the limit to \$35,000 (or about \$47,000 in today’s dollars) in 2001. EGTRRA subsequently increased the limit to \$40,000 in 2002. The current limit, however, is less than half of the original limit in inflation-adjusted dollars. In addition, the Tax Reform Act of 1986 instituted a separate limit on employee contributions, whereas previous law only limited the combination of employer and employee contributions. EGTRRA increased the employee contribution limit in steps from 2002 to 2006, at which point the limit was indexed for inflation.

DC Plan Contribution Limits Are Low by Historical Standards

Limit on annual contributions to defined contribution plans, constant 2014 dollars, 1975–2014; percentage of ERISA limit, various years



Source: Investment Company Institute

Proposals to reduce those limits further would represent an unprecedented restriction on the ability of working individuals to defer a portion of their current compensation until retirement. Based on Congressional Budget Office (CBO) inflation assumptions, a 10-year freeze would effectively reduce contribution limits by about 20 percent. A \$20,000 limit would be below the original limit set in 1974 in *nominal* dollars.

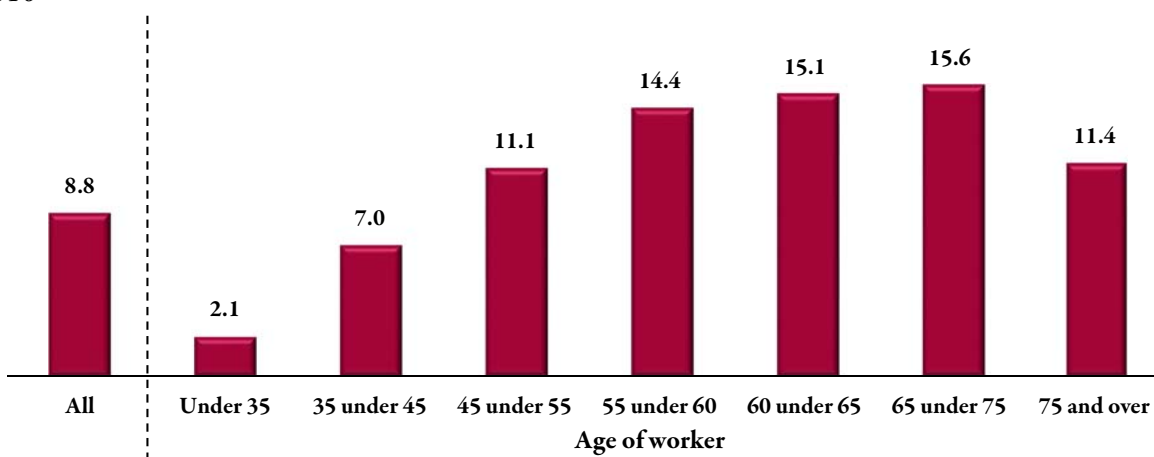
DC plan contribution limits are particularly important because of the uneven life-cycle pattern of retirement savings. The amount that workers contribute to their 401(k) plans is unlikely to be smooth and steady throughout their career. As a group, younger workers are less focused on retirement savings. They typically invest in other ways, such as funding education, purchasing a home, and raising children. Retirement savings typically ramps up as workers get older, both because earnings typically increase with age and because other expenses, such as childcare and education, decline.

The impact of the life-cycle pattern of retirement savings can be seen in statistics on workers who make the maximum allowable employee contribution to a DC plan.⁵⁵ Limit contributors typically are in their prime savings years and have moderate income: 69 percent of limit contributors were aged 45 to 64, and 58 percent had adjusted gross income (AGI) of less than \$200,000.⁵⁶

Although contribution limits may impact few workers in any given year, many more workers are affected at some point in their career. Only about 9 percent of workers with elective deferrals contributed the maximum allowed by law in 2010, but the share of workers at the limit increases with age (see figure below). For example, only about 2 percent of workers under 35 contribute at the limit, but that percentage increases to 15 percent for workers aged 60 to under 65.

Workers Are More Likely to Contribute at the Limit as They Approach Retirement

Percentage of W-2 workers with elective deferrals who contribute at the 402(g) elective deferral limit, by age, 2010



Source: Internal Revenue Service Statistics of Income Division

As with proposals to “cap” or apply a surtax to the tax benefit of employee contributions, freezing the employee and employer contribution limits or adopting the 20/20 proposal likely would cause some firms that previously offered retirement plans to terminate their plans. Employees affected by a lower effective contribution limit would face reductions in the tax benefits they receive. For some employers, the reduction in tax benefits received by their employees (including employees who currently have contributions in excess of proposed lower limits, or employees closer to retirement age who have

⁵⁵ The statistics used in this analysis are from IRS Statistics of Income Division (SOI) tabulations of Form W-2 data, available at www.irs.gov/uac/SOI-Tax-Stats-Individual-Information-Return-Form-W2-Statistics and described in Pierce and Gober, “Wage Income and Elective Retirement Contributions from Form W-2, 2008–2010,” *Statistics of Income Bulletin* (Summer 2013): pp. 5–21, Washington, DC: Internal Revenue Service Statistics of Income Division, available at www.irs.gov/pub/irs-soi/13insumbulw2.pdf. The data are from the 2010 tax year, the most recent available. Limits are adjusted for catch-up contributions for workers age 50 or older. Some workers will be prevented from contributing the maximum allowed by law by rules established by their employer’s plan. These workers are not included in the statistics for limit contributors.

⁵⁶ *Ibid* (Table 2.F.3 and Table 2.G.3 in the data files).

anticipated the prospect of higher contributions later in their careers), would tip the balance, and these firms would decide to no longer offer a plan.

C. Tax Reform Should Not Favor DB Plans over DC Plans

Any comprehensive effort to address fiscal policy or tax reform should maintain one aspect of the current income tax: neutral tax treatment of qualified deferred compensation. Tax-deferred contributions to both DB plans and DC plans are treated equally under the tax code. Employees pay no tax on compensation contributed on their behalf to a qualified retirement plan, and no tax on the investment earnings of a plan while they accrue. Taxes are due only when employees take distributions from a plan. In addition, limits on DC plan contributions are intended to be roughly equivalent to the restrictions on the generosity of DB plans.

Many proposals focus on limiting the tax benefits of DC plans. For example, proposals to limit the up-front benefit of deferral only apply to DC plans. The Camp 10 percent surtax proposal would apply only to employee and employer DC plan contributions. The Administration's 28-percent proposal would apply only to employee elective deferrals to DC plans and tax-deferred IRA contributions. The 20/20 proposal would reduce the DC plan contribution limit, but leave the DB plan benefit limit unchanged. As a result the ratio of the DB benefit limit to the DC contribution limit would move from four to one to nearly ten to one.

Changing the rule only for DC plans means that benefits a worker gets from deferral will depend on how their employer structures their compensation. For example, consider the impact of the 20/20 proposal on two workers who both have an annual salary of \$100,000. The first is a private-sector worker who only has access to a DC plan. Under the proposal, the maximum amount of deferred compensation—that is, the combination of elective employee deferrals and employer contributions—would be \$20,000. The second is a federal government employee who is covered under the Federal Employee Retirement System (FERS). Under the proposal, this individual could contribute \$15,000 to the Thrift Savings Plan (TSP) and receive \$5,000 in employer contributions, for a total of \$20,000 in contributions. The federal government employee, however, would also be accruing DB pension benefits. For a worker approaching retirement, the additional DB benefit accrued in a year of work represents—depending on the length of service and other factors—an additional \$20,000 to \$50,000 in deferred compensation.

To maintain the neutrality of the current tax code, any changes to retirement plans should apply equally to DB plans and DC plans. In addition, any changes in the treatment of contributions should not single out employee versus employer contributions.

D. Limiting Accruals of Deferred Compensation Would Add Complexity, Could Cause Small Businesses to Terminate Plans

The Administration's FY2014 budget proposal to limit the total amount that an individual could accrue in retirement benefits would make the system more complex, place additional compliance burdens on individuals, and likely cause some employers—particularly small businesses—to terminate their retirement plans. Current law limits on the amount of tax-deferred compensation generally apply

to the benefits a worker receives from a single employer.⁵⁷ The proposal would place an additional limit on the total value of deferred compensation accumulated by any one individual—inclusive of accrued DB benefits, DC plan account balances, and IRAs.

Compliance with the new limit would require additional reporting from employer-sponsored plans to the IRS and place additional compliance burdens on individuals. Some employers, particularly small businesses, may choose no longer to offer a plan to their employees if the business owner or key employees can no longer accrue additional benefits. Such a change would also pose substantial difficulties for individuals as they plan for retirement or strategize about investing through their IRA. Imposition of such a proposal would therefore not only create significant administrative burdens, but would effectively penalize people for being diligent about their planning and saving and for accumulating retirement resources. This outcome is simply incongruent with the Committee's previous thinking and actions in the retirement policy sphere.

E. All Employees Will Be Hurt When Firms Drop Retirement Plans

The impact of the proposals which target DC plans would not be limited to taxpayers in the top three tax brackets (or taxpayers in Chairman Camp's proposed 35 percent tax bracket), or workers with contributions in excess of proposed lower limits. As discussed above, if these proposals are adopted, some firms that currently offer plans likely will decide to terminate their plans. With the loss of plans, lower-paid workers—who were never the intended target of the proposals—would lose the opportunity to save through an employer plan. While they receive substantial tax benefits from contributing, low- and moderate-income workers likely benefit as much or more from the non-tax features of employer-sponsored retirement plans. For example, these workers may value more highly the convenience of payroll deduction, the economies of scale that reduce the cost of investing, and the professional investment management offered through employer plans. There is also evidence that workers with moderate and high income are willing to accept lower cash wages in exchange for retirement benefits, whereas lower-income workers are not.⁵⁸ Thus, employer contributions are more likely to represent an increase in total compensation for lower-income workers, rather than a shift in the form of compensation. The loss of such contributions if employers drop their plans would be detrimental to the retirement security of lower-income workers.

F. Tax Deferral Equalizes the Incentive to Save

A criticism often leveled against tax deferral is that it provides an “upside-down” incentive to save. That is, it is argued that tax deferral results in higher-income workers having a larger incentive to save than lower-income workers.

⁵⁷ If an employer has multiple DB plans, the DB plan benefit limit would apply to all benefits accrued from the employer. Similarly, if an employer has multiple DC plans, the DC plan contribution limit would apply to all (employer and employee) contributions to plans sponsored by the employer. The lone exception to this rule is the limit on elective employee deferrals to 401(k)-type plans, which applies to the taxpayer rather than to the benefits received from a single employer.

⁵⁸ See Toder and Smith, “Do Low-Income Workers Benefit from 401(k) Plans?” *Center for Retirement Research Working Paper* no. 2011-14 (September 2011), available at: crr.bc.edu/wp-content/uploads/2011/10/wp_2011-14_508-1.pdf.

The incentive to save is the after-tax rate of return earned on investments. Normal income tax treatment discourages savings by reducing the after-tax rate of return. Because the tax on investment returns increases with income, the rate of return falls more for higher-income taxpayers.

Far from providing an “upside-down” incentive to save, tax deferral equalizes the incentive to save. The benefit of tax deferral is that it effectively taxes investment income at a zero rate.⁵⁹ By removing the difference between the market rate of return and the after-tax rates of return, tax deferral equalizes the incentive to save. That is, for any given investment, a dollar invested in a 401(k) plan will provide the same after-tax rate of return regardless of a worker’s tax bracket.

VI. CHANGES IN RETIREMENT POLICY SHOULD BUILD ON EXISTING SYSTEM—NOT PUT IT AT RISK

As the Committee on Finance considers possible changes to the U.S. retirement system, the Institute urges you to focus on the following policy objectives and improvements to ensure that as many American workers as possible are successful in retirement:

- **Continue to prioritize the goal of promoting retirement savings.** Promoting retirement savings must remain one of the nation’s top policy priorities.⁶⁰ We urge this Committee to continue its leadership in pursuing tax policies to improve our nation’s retirement system. As outlined above, the success of the current system has resulted in significant part from our existing and successful tax incentive structure, which works effectively to facilitate retirement plan savings by American workers and families. Even seemingly small changes that at first glance appear to affect only high-income individuals would, as detailed above, severely disrupt the success of the current system.
- **Recognize the significance of Social Security.** Social Security provides the foundation of retirement security for almost all American workers—and for the majority, it may be the largest single income source in retirement. Yet the Social Security system faces a projected long-term

⁵⁹ For an explanation of why this is the case, see discussion in Brady, *The Tax Benefits and Revenue Costs of Tax Deferral*, Investment Company Institute (September 2012), available at www.ici.org/pdf/ppr_12_tax_benefits.pdf; and Brady, “Retirement Plan Contributions Are Tax-Deferred—Not Tax-Free,” *ICI Viewpoints* (September 16, 2013), available at www.ici.org/viewpoints/view_13_deferral_explained. If a taxpayer’s marginal tax rates at the time of contribution and the time of distribution are the same, tax deferral is equivalent to taxing investment income at a zero rate. If tax rates are lower at the time of distribution, the benefits of tax deferral are increased. If tax rates are higher at the time of distribution, the benefits of tax deferral are reduced.

⁶⁰ A vast majority (79 percent) of U.S. households surveyed from November 2012 to January 2013 agreed that continuing retirement savings incentives should be a national priority. See Figure 12 in Holden and Bass, “America’s Commitment to Retirement Security: Investor Attitudes and Actions, 2013,” *ICI Research Report* (February 2013), available at www.ici.org/pdf/ppr_13_retir_sec_update.pdf.

imbalance.⁶¹ It is absolutely imperative to preserve Social Security as a universal, employment-based, progressive safety net for all Americans.⁶²

- **Foster innovation and growth in the voluntary retirement savings system.** Policymakers, plan sponsors, and service providers strive to improve the ability of American workers to make sound decisions about retirement savings and investing. Congress was instrumental in encouraging rules that improved disclosure of 401(k) plan fees and associated investment information. Now, we urge Congress to go further by promoting electronic delivery of plan information, interactive educational tools, and materials to help American workers understand their savings options. Employers should be encouraged to use automatic enrollment if appropriate for their employee base; employers may want to enroll their workers at higher levels of savings and escalate the savings more substantially than is perceived appropriate under current law. As noted above, studies show that automatic enrollment has a particularly notable impact on the participation rates of lower-income and younger workers because these groups are typically less likely to participate in a DC plan where affirmative elections are required.⁶³
- **Offer simpler plan features and easier access to multiple employer plans (“MEPs”) for small employers.** Small businesses often face particular challenges in establishing and maintaining retirement plans. Special attention should be given to addressing legal requirements that may create obstacles to plan sponsorship among smaller employers. Creating a new type of SIMPLE plan for small employers would encourage greater plan creation and coverage in smaller workplaces. The new plan would be modeled on existing SIMPLE plans, but would not require

⁶¹ For projections related to these programs, see The Board of Trustees, Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds, *The 2014 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds* (July 2014), Washington, DC: U.S. Government Printing Office, available at www.ssa.gov/OACT/tr/2014/tr2014.pdf; The Boards of Trustees, Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds, *2014 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds* (July 2014), Washington, DC: Centers for Medicare and Medicaid Services, available at www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/ReportsTrustFunds/Downloads/TR2014.pdf; Congressional Budget Office, *The 2014 Long-Term Budget Outlook* (July 2014), available at www.cbo.gov/sites/default/files/cbofiles/attachments/45471-Long-TermBudgetOutlook_7-29.pdf; and Social Security Administration, “Detailed Reports on the Financial Outlook for Social Security’s Old-Age, Survivors, and Disability Insurance (OASDI) Trust Funds,” (2014), available at www.ssa.gov/OACT/tr/index.html.

⁶² Regardless of the form they take, changes to Social Security will likely increase the importance of employer-sponsored retirement plans and IRAs to provide for retirement adequacy. If Social Security benefits are cut, future retirees will need to accumulate more retirement resources. If taxes are raised on workers, net earnings will fall, but the amount of earnings that would need to be set aside to supplement Social Security benefits in retirement would remain largely unchanged. To the extent that either the benefit cuts or tax increases are structured to exempt workers with low lifetime earnings, it would place an even heavier burden on those already most dependent on employer-sponsored retirement plans and IRAs. For a discussion of how different methods of cutting Social Security benefits would impact workers with different levels of lifetime income, see Brady, “Measuring Retirement Resource Adequacy,” *Journal of Pension Economics and Finance* 9, no. 2 (April 2010): pp. 235–262.

⁶³ See note 36 and accompanying text, *supra*.

employer contributions. It would have contribution limits above traditional and Roth IRA limits, but below existing SIMPLE plan limits.⁶⁴ The Institute also supports easing restrictions on “open” MEPs, but targeting the provision to employers with fewer than 100 employees—the employer segment most in need of solutions to encourage retirement plan sponsorship.⁶⁵

- **Support flexible approaches to retirement saving and lifetime income.** Employers have a number of options for savings plans today,⁶⁶ but it is important for Congress to recognize that mandating a particular plan or contribution level would not work for workplaces where the majority of workers are focused on saving for goals other than retirement—such as education, a home, or an emergency fund.⁶⁷ The voluntary employer-provided retirement system recognizes that employers need the flexibility to design benefit packages that meet the unique needs of their particular workforce in the business’ specific competitive environment. This flexibility is also important in the context of proposals intended to assist plan participants and retirees in ensuring that they don’t run out of income in retirement or in determining how much retirement income they can generate from a 401(k), IRA, and other savings. All retirement income products and strategies involve tradeoffs and consideration of an individual’s personal circumstances, such as the amount of annuitized income to be received from Social Security,⁶⁸ other assets or income, health status and life expectancy, the need for emergency reserves, specific goals in retirement, and the need to provide for other family members. As a matter of public policy then, it is important to ensure a level playing field for all products and services.

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The promotion of retirement savings—whether through employer-sponsored retirement plans or IRAs—has long been one of the Committee on Finance’s top priorities and legacies. In recent years, the Committee strengthened the private-sector retirement system by raising contribution limits in 2001

⁶⁴ We note that a conceptually similar provision, referred to as the “starter k” plan, has been proposed by Ranking Member Orrin Hatch (R-UT) in S. 1270, the “Secure Annuities for Employee (SAFE) Retirement Act of 2013.”

⁶⁵ For a discussion of how pension coverage varies by plan size, see Brady and Bogdan, “Who Gets Retirement Plans and Why, 2012,” *ICI Research Perspective* 19, no. 6 (October 2013).

⁶⁶ DC plans, traditional DB plans, hybrid plans, and SIMPLE IRAs all are available to meet the varying needs of employers.

⁶⁷ See Haveman, Holden, Wolfe, and Romanov, “The Sufficiency of Retirement Savings: Comparing Cohorts at the Time of Retirement,” *Redefining Retirement: How Will Boomers Fare?* Edited by Madrian, Mitchell, and Soldo: pp. 36–69, New York: Oxford University Press (2007); and Gustman, Steinmeier, and Tabatabai, “How Do Pension Changes Affect Retirement Preparedness? The Trend to Defined Contribution Plans and the Vulnerability of the Retirement Age Population to the Stock Market Decline of 2008–2009,” *Michigan Retirement Research Center Working Paper* 2009-206 (October 2009), noting that households are more likely to focus on saving for retirement as they get older and as their income increases, and that younger and lower-income households, which are already contributing 12.4 percent of income to Social Security, tend to earmark the balance of their additional saving for liquidity, education, future large purchases, or to purchase homes.

⁶⁸ See discussion of Social Security replacement rates and how the role of Social Security varies by income and wealth on pages 9–11, *supra*.

(EGTRRA) and making those provisions permanent in 2006 (PPA). We welcome the Committee's continued leadership in pursuing policies to improve our nation's retirement system. But any changes should only build upon a successful system that tens of millions of U.S. households rely on to help them achieve retirement security. Consistent with the views of the overwhelming majority of Americans, we urge this Committee to preserve the current retirement savings tax incentives, including the compensation deferral rates without new caps or other limitations, and allow our successful employer-provided retirement system to flourish.