The Case for Automatic Enrollment in Individual Retirement Accounts

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Automatic enrollment in individual retirement accounts (the Auto IRA) offers a relatively simple and effective approach to helping more workers save for retirement. This In Brief summarizes key findings on the economic impact of the Auto IRA and its potential to bolster retirement security from two recent papers written for the Public Policy Institute by experts at the Brookings Institution and the Urban Institute.¹

Introduction

The Auto IRA proposal has the potential to increase retirement security for tens of millions of Americans by addressing the two biggest impediments to retirement savings, particularly for low- and middle-income workers—lack of access and inertia. Too few workers currently have access to a workplace retirement plan that offers the convenience of payroll deduction and a framework for simplified investment decisions. For many workers, the burden of establishing an IRA and making the associated decisions are too much to overcome.

The basic idea of the Auto IRA is simple: Automatically enrolling workers in a payroll deduction retirement savings plan will increase the number of Americans who save for their retirement. Automatic enrollment has been shown to boost participation in 401(k) plans, and the expectation is that it would have some measure of success for IRAs.

Under current Auto IRA proposals, most firms with more than 10 employees that do not offer a retirement plan would be required to provide a payroll deduction IRA to their employees. In general, unless workers explicitly opted out of participating, they would be automatically enrolled in an IRA at a default contribution rate of 3 percent of pay.

Recent proposals introduced in the House of Representatives by Congressman Richard Neal (H.R. 4049) and in the Senate by Senator Jeff Bingaman (S. 1557), and that included in the president’s fiscal year (FY) 2013 budget, differ in the type of default account (traditional or Roth IRA), default investment (life-cycle fund or retirement bond—R Bond), and along other dimensions. Despite these differences, all the proposals are intended to be simple for employers to implement at a low cost (for example, employers could not contribute to the accounts and would receive tax credits for setting up the deduction) and designed to minimize the administrative fees charged to workers.

Who Would Be Covered under the Auto IRA?

Harris and Fischer estimate that between 24 and 43 million workers without current access to a workplace retirement plan or traditional pension would have access to an Auto IRA under the proposal. That represents from one in five to one in three private-sector workers, a number that could
significantly reshape the retirement savings landscape.

Workers covered under the Auto IRA are typically full-time employees, and most have low to moderate earnings—a group known to have the most difficulty saving for retirement. Harris and Fischer estimate that about 80 percent are full-time employees, and more than 80 percent of the population eligible for automatic enrollment under the proposal have earnings of less than $50,000.

The wide range in the potential number of workers covered reflects estimates based on different assumptions regarding employers’ response to the proposal and two different data sets—the U.S. Census Bureau’s Current Population Survey (CPS) and the Federal Reserve Board’s Survey of Consumer Finances (SCF).

Harris and Fischer’s baseline estimates of the number of workers covered under the proposal are 24 million (SCF) and 36 million (CPS). The baseline accounts for the various exemptions provided for under the proposals. In particular, the proposals exempt new businesses and certain groups of employees, including workers in the public sector, workers of church or religious organizations, workers under age 18, and workers with fewer than three months of job tenure.

Harris and Fischer also estimate the potential number of workers affected under an assumption that some small employers not covered under the Auto IRA will elect to participate. They argue that the growth in the number of employers voluntarily adopting automatic enrollment in their 401(k) plans, along with the expected low cost of implementing the Auto IRA, justify this assumption. Assuming that half of employers with 10 or fewer employees would voluntarily participate in the Auto IRA, they estimate that the number of eligible workers would increase by about 5 million (from 24.4 to 29.3 million using the SCF) to 7.5 million (from 35.7 to 43.1 million using the CPS).

The authors also examine the trend of workers covered under the Auto IRA. Comparing data from the CPS for 1997 and 2008, they find that the percentage of workers who would have been eligible is growing. Under the baseline scenario, 6.6 million more workers would have been covered under the Auto IRA proposal in 2008 than in 1997—an increase from 23.4 percent of private-sector workers in 1997 to 26.6 percent in 2008.

If this trend continues, their estimate of the number of workers covered under the Auto IRA will be an underestimate. It is also important to note that they provide a point-in-time estimate and do not account for workers who may switch from an employer who offers a workplace retirement plan to one that does not. This represents a key feature of the Auto IRA proposal—it increases the likelihood that employees will have continuous coverage under a retirement plan even after switching jobs.

Who Would Benefit?

Harris and Johnson examine the economic impact of the Auto IRA using the results described above. In particular, Harris and Johnson estimate the distributional impact of the proposal under various take-up rates. These rates (the percentage of workers covered under an Auto IRA who do not opt out) range from a low of 31.0 percent to 46.5 percent under the intermediate scenario up to a high of 62.0 percent.

Because an IRA is a tax-preferred savings plan, Harris and Johnson model the distributional impact through the proposal’s effect on after-tax income. The tax benefits, however, are not only based on the initial deduction, in the case of a contribution to a traditional IRA, but
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also on the period of time that income taxes on the contribution and its earnings are deferred and the effective tax rate at the time of distribution. As a result, Harris and Johnson measure the stream of tax benefits on a present-value basis.

Harris and Johnson estimate that between 5 percent (low assumptions) and 15 percent (high assumptions) of taxpayers would receive a tax cut under the proposal. Looking at the intermediate assumptions, taxpayers in the bottom income quintile are the least likely to receive a tax cut (about 4 percent), compared to 12 to 16 percent of taxpayers in the other income quintiles (table 1).

The Auto IRA benefits taxpayers in the middle-income quintile more than those in the bottom or top quintile. As Table 1 shows, taxpayers in the middle three income quintiles receive an average 0.08 percent to 0.09 percent increase in after-tax income, compared to 0.05 percent for taxpayers in the bottom and top quintiles. These changes in after-tax income are small, but this is not surprising considering that only a small percentage of taxpayers actually benefit from the proposal.

The fourth column of table 1 shows the change in after-tax income only for those who benefit from the proposal, and the last column shows the average increase.

in IRA contributions among these taxpayers. Among those who participate in an IRA under the proposal, taxpayers in the bottom quintile receive the largest increase in after-tax income, and the tax benefits are progressive throughout the income distribution: Lower-income taxpayers receive a larger increase in after-tax income than higher-income taxpayers. The average contribution for taxpayers in the top quintile ($2,684) is almost three times as much as that for taxpayers in the bottom quintile ($991). Nonetheless, the average contribution for lower-income taxpayers is not trivial.

Overall, taxpayers who benefit from the proposal receive an increase in after-tax income of 0.5 percent, but those in the bottom quintile receive an increase of 1.3 percent. This relationship may seem surprising, but it likely reflects the effects of age on income distribution. Younger workers are more likely to have lower income, but their IRA contribution is also likely to get preferential tax treatment for a longer period. This longer sheltering period translates into a higher present value of the tax benefit relative to other groups.

Cost and National Savings

One macroeconomic argument in favor of proposals such as the Auto IRA is that they increase national savings—resulting

<table>
<thead>
<tr>
<th>Cash Income Percentile</th>
<th>Percentage of Taxpayers with Tax Cut</th>
<th>Percent Change in After-Tax Income</th>
<th>Average Change in Contributions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lowest</td>
<td>3.8</td>
<td>0.05</td>
<td>$991</td>
</tr>
<tr>
<td>Second</td>
<td>12.1</td>
<td>0.09</td>
<td>$840</td>
</tr>
<tr>
<td>Middle</td>
<td>14.9</td>
<td>0.09</td>
<td>$1,164</td>
</tr>
<tr>
<td>Fourth</td>
<td>15.9</td>
<td>0.08</td>
<td>$1,566</td>
</tr>
<tr>
<td>Top</td>
<td>13.7</td>
<td>0.05</td>
<td>$2,684</td>
</tr>
<tr>
<td>All</td>
<td>11.4</td>
<td>0.06</td>
<td>$1,436</td>
</tr>
</tbody>
</table>

Source: Tables 5 and 9 from Harris and Johnson, Economic Effects of Automatic Enrollment in Individual Retirement Accounts.

*Author’s calculations based on results reported in the table.
in a larger capital stock that drives a faster-growing economy. Under the Auto IRA proposal, the change in national savings equals the increase in private savings (i.e., the increase in IRA contributions less any shifting of savings from taxable accounts to nontaxable IRA accounts) less the reduction in government revenue. The Auto IRA proposal would reduce federal receipts because IRAs are tax-favored accounts.

The U.S. Treasury estimated the cost of the Auto IRA proposal as included in the president’s FY 2013 budget at $14.4 billion over the nine-year period from FY 2013 through 2021. Because of the uncertainty around a variety of factors under the Auto IRA, Harris and Johnson provide 10-year revenue estimates and distributional analysis for the Auto IRA under low-, intermediate-, and high-cost assumptions. The different scenarios relate to different assumptions regarding the number of workers eligible, take-up rates, type of account (Roth vs. traditional IRA), and contribution rates for high-income workers (3.0 percent to 4.5 percent).

The estimated 10-year revenue loss is $3.8 billion under the low-cost assumption, $28.2 billion under the intermediate-cost assumption, and about $66 billion under the high-cost assumption. To put these estimates in perspective, consider the estimated tax expenditures associated with tax-preferred retirement savings. In 2015, the estimated cost of the Auto IRA is about 1 percent of the estimated tax expenditures on 401(k)-type plans and IRAs ($1.1 billion/$106.5 billion).

Harris and Johnson estimate that under the intermediate-cost assumption, the Auto IRA would increase national savings by up to 0.12 percent of gross domestic product (GDP). Contributions to IRAs are estimated to increase by about $27 billion in 2015 (about 0.14 percent of GDP). The revenue loss associated with this proposal would offset this increase in IRA contributions by 0.02 percent of GDP. There would also be another offset resulting from a reduction in private savings (a shift from savings in a taxable account to an IRA) that the authors are unable to estimate. So the combined net effect can be assumed to be an upper bound on the increase in national savings.

Saver’s Credit

In addition to modeling the effects of the Auto IRA proposal alone, Harris and Johnson model the effects in conjunction with an expansion of the current-law Saver’s Credit. The Saver’s Credit is a nonrefundable tax credit that provides low- and moderate-income taxpayers with a 50, 20, or 10 percent tax credit on up to $2,000 in contributions to an IRA or 401(k)-type plan.

The Saver’s Credit suffers from some well-recognized flaws that President Obama had proposed fixing in his FY 2011 Budget (this proposal was not included in more recent budgets). The most significant of these changes are making the credit refundable and expanding the income limits for eligibility. Expansion of the Saver’s Credit and the Auto IRA could be viewed as complementary proposals in that the Auto IRA makes it easier to save for retirement, while an expanded Saver’s Credit increases the incentives to do so.

Harris and Johnson estimate that including an expansion of the Saver’s Credit along with the Auto IRA would significantly increase the cost in foregone revenues. Under the intermediate-cost assumption, the 10-year revenue loss would increase from $28 billion to $101 billion. However, they also estimate that the number of taxpayers benefiting would increase from 11.4 percent to 25.8 percent of taxpayers, with those in
the second and third quintiles most likely to benefit. The total distributional effects of a combined proposal would be more progressive than the Auto IRA proposal alone: The increase in after-tax income for taxpayers in the bottom two quintiles is estimated to increase by about 0.35 percent, while the increase for taxpayers in the top quintile is only 0.05 percent.

Retirement Security

While Harris and Johnson estimate the distributional and economic impact of the Auto IRA proposal, they estimate its effects only a few years into the future. To get a better sense of the impact of the Auto IRA proposal on retirement security requires looking out even further. Butrica and Johnson\(^5\) try to quantify the effects on retirement income of a current cohort.

Butrica and Johnson use a microsimulation model called Dynamic Simulation of Income Model (DYNASIM3) that projects the major sources of wealth and income at retirement age. They examine the impact of the Auto IRA and expansion of the Saver’s Credit on the retirement income at age 70 of workers born between 1987 and 1996. They find that between 36 percent (under the low-enrollment scenario) and 53 percent (under the high-enrollment scenario) of these households would experience a 2 percent or more increase in retirement income at age 70 under the combined proposal. Further, the change in the average household income at age 70 could be substantial. In particular, they find that among households whose income increases by more than 2 percent, the average retirement income increases by 18 percent for households in the bottom and second quartiles, 12 percent for households in the third quartile, and 7 percent for households in the top quartile.

Social Security will continue to be the foundation of a secure retirement, particularly for low- and moderate-income workers. But these papers suggest that the Auto IRA could improve retirement security for millions of workers while boosting America’s saving rate, leading to improved living standards for future generations.

Endnotes


2 Taxpayers could include a single filer or a married couple filing a joint return.

