Strengthening Social Security and Improving Retirement Savings Accounts

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Introduction

The US currently faces a few different problems when dealing with how we manage our policies surrounding retirement. For example, a lot of people do not have enough pension income and personal savings to maintain their standard of living after retirement. This could be dealt with by expanding Social Security benefits, but the system has a long term funding shortfall due to the aging of the population, so that problem would have to be managed as well. When it comes to retirement savings, the US has myriad of different tax favored savings accounts all with their own rules and restrictions, but research shows that these accounts do little to encourage more savings, add a lot of complexity to our tax code, and lose a lot of tax revenue by providing high income households with valuable tax shelters.

Dealing with these problems is going to need two general types of reform. First, more resources are going to have to be brought into the Social Security system which can be done by raising the income cap on payroll taxes dedicated to the program, which can then be used to expand benefits and reduce the long term funding shortfall. Second, our complex system of retirement accounts is going to have to be reformed and simplified over the long term by creating a new account that utilizes the latest policy insights to ensure its success, and then shifting resources to that type of account in order to consolidate the system.

Providing More Resources for Social Security

One problem with our present system of retirement is that some people will not be able to maintain their current standard of living once they retire. One study by the Center for Retirement Research at Boston College (Munnell et al 2012) found that 51% of households risk not being able to maintain their spending levels after retirement if they retire at age 65. They also found that 85% of households would be able to maintain their spending if they retired at age 70. Clearly, then a lack of pension income and retirement savings will force a lot of people to feel pressure to work later on in life, but even this might not be enough to protect everyone from shortfalls in income and wealth. Increasing Social Security benefits for those most at risk would be one way to ease this financial pressure as people get older, but doing so would require new sources of revenue in order to pay for it.

At the same time, due to the aging of the population, Social Security faces a long run funding shortfall. Based on the most recent estimates from the Social Security Administration, existing resources from payroll taxes and the Social Security trust fund will not be able to pay the full amount of benefits starting in 2034, at which point it can fund only about three quarters of all benefits. Over a 75 year time period, this funding shortfall amounts to about 1.1% of GDP (SSA 2020). In theory, this funding shortfall could be paid for either through benefit cuts or increases in revenue, but given that people already face shortfalls in pension income and retirement savings, this problem is likely going to require more tax revenue to be raised instead.

Policymakers could raise more revenue by increasing the payroll tax dedicated to Social Security up from the 6.2% paid by individuals and the 6.2% paid by employers. This basic 12.4% rate has not changed since 1990, except for 2 years during the Obama administration, when the payroll tax was cut by 2 percentage points to help with the recovery from the 2008 financial crisis.(1) This would likely be politically unpopular because so many people would face a tax increase, and in addition the rich would largely be able to avoid the new tax because of the income cap on the payroll taxes dedicated to Social Security. A better alternative would be to raise this income cap so that higher income households, who have done relatively well in recent times, would pay more in taxes, while the vast majority of population, who has not done as well, would face no tax increase at all.

The income cap on payroll taxes is currently at $137,700 for 2020, and was last adjusted by Congress in 1977, where it was set at a level so that 90% of all earnings would be covered by the tax. The cap is adjusted every year based on the growth in the average wage, but well off households have seen much faster growth in their incomes over the past several decades, so the percent of wages covered by the payroll tax has declined to 82% (Romig 2016). Some people have called for eliminating the income cap entirely, but I would propose raising the cap so that it covered 95% of all earnings. This would still raise a substantial amount of revenue, but also avoid raising marginal tax rates on the richest Americans too quickly, which could undermine bipartisan support for the Social Security system.

This option would raise about $150 billion a year (or about 0.7% of GDP) and I would recommend spending about half of that on new benefits and half of that on reducing the long term funding shortfall. Using half the money on higher benefits would increase the average benefit by about $120 a month (or $1,400 a year), but this could be restructured so that the lowest income households get a larger share of benefits since they are also the ones most likely to face an overall income and savings shortfall when they reach retirement. This would also reduce the long term funding shortfall by about a third, which would extend the date at which Social Security runs out of money, but not eliminate the long term funding shortfall entirely.(2)

Improving Our System of Retirement Accounts

There are a variety of important problems in our current system of tax favored retirement accounts that should be addressed in any attempt at reform. The first problem is that optional accounts that take some effort to enroll in are generally quite ineffective at encouraging new savings. The latest evidence from Denmark suggests that for every dollar spent on tax subsidies you only get one cent in new savings for these types of accounts (Chetty et al 2014). In addition, our current system of accounts is incredibly complex, where there are many different types of accounts, and all of them have their own specific rules on contributions, tax liability, and disbursements. On top of that, those accounts cost taxpayers a lot of money, where the tax subsidies for defined contributions plans and IRAs (both traditional and Roth) cost the public more than $150 billion a year.(3) This has turned into a bit of a complex policy quagmire, but there are ways to do better.

If the US wants to improve the way it manages retirements savings accounts, it should try and follow six basic rules. First, the US should create one comprehensive, well designed account, go with that one alone, and try and eliminate all the other types of accounts. This would likely require some attempt at consolidation, which is a tricky maneuver to pull off. One way to do this would force people to convert their other accounts into this new account, and then have them immediately pay whatever taxes they have deferred. This of course would be incredibly unpopular since everyone who owned a tax deferred account like a 401(k) or traditional IRA would be forced to make a huge one time tax payment as soon as the funds were converted. Another option would force people to convert all their funds to this one account but forgive all the deferred taxes they might owe, which also presents some problems because it would give up a huge source of future tax revenue. Alternatively, the old accounts could be phased out gradually by reducing contributions limits down to zero, so no new funds could go into those accounts. After a few decades, with no new contributions going into those accounts and a lot of the funds disbursed as more people retire, then a forced conversion might become politically viable with many fewer people having those accounts and those that do would have much smaller balances.

The second rule to follow when reforming a system of retirement accounts is to make sure people are automatically enrolled as soon as those accounts become available. Ideally, any new well designed account would be available to everyone as soon as they became employed, and their new employer would sign them up in order to start diverting some of their income into these accounts each month. If the worker did not want this to happen, they could easily opt out, which seems like a trivial difference but one of the most striking results in behavioral economics is that switching from an opt-in system to an opt-out system with automatic enrollment dramatically increases participation in the program.(4)

The third rule to follow when reforming a system of retirement accounts is to make sure participants have a limited set of investment options. Giving people free choice over how they invest the money in their retirement accounts dramatically increases the administrative costs of the system, which eats away at the overall returns of the system over time. Any new account should follow the example of the Thrift Savings Plan used by the government to administer retirement savings for their employees and only offer a limited menu of options, which dramatically reduces administrative costs of this system. The accounts should also create an automatic default for each participant that invests their money in a mix of asset classes appropriate for their age that could then be changed by the account owner if they wanted.

The fourth rule to follow when reforming a system of retirement accounts would have all the disbursements to the accounts come from post-tax income rather than pre-tax income. Doing it this way would avoid any need to have a specific deduction in the tax code for retirement account contributions. This would also save a lot of money since it would increase taxable income, and would prevent taxpayers in the highest tax brackets from getting a much bigger benefit for the same contribution. Account holders would not have to worry about all the complicated decisions surrounding tax timing, and the complex system of rules surrounding forced disbursements for tax deferred balances could be avoided entirely. This would make any new system of retirement savings accounts much simpler and much less costly.

The fifth rule to follow when reforming retirement accounts would have the investment gains in these new accounts accrue tax free. Psychologically, there appears to be a need for some sort of commitment device designed to encourage people to save for retirement. That means there needs to be some tax advantage to induce people to contribute, and this could be achieved by offering investment gains to collect tax free. This would cost some money, but it would be much simpler and less expensive than allowing pre-tax contributions. Just to be safe, there should be contribution limits on these accounts to make sure they do not turn into a massive tax shelter, but that is already standard practice for the current accounts.

The sixth rule to follow when reforming retirement savings accounts is that at first the accounts should have no penalty for early withdrawal. If there is no deduction on your income tax and there is no government match then there is no need for a penalty to prevent people from gaming the system by getting the tax benefits and then taking the money out later. This dramatically increases the amount of flexibility in the system and gets rid of all the complicated rules on when money can be withdrawn from the account and for what purposes. In theory, the early withdrawal penalty helps people save by making the account a true commitment device that you cannot easily reverse later, but behavioral economics has shown that defaults and automatic contributions can go a long ways by themselves, and there would be some financial benefit from keeping the money in the account because the investment income accrues tax free. Getting rid of the penalties would also encourage more people to participate by reducing the future costs if they change their mind down the road and need the funds they saved in their accounts right now. If this did not work and people just kept taking their money out all the time, then the government could offer a flat 25% or 50% match up to a certain amount and add in penalties for early withdrawal in order to make the accounts a stronger commitment device.

Conclusion

The first part of this policy memo confronted the lingering problems with Social Security by raising the income limits on the payroll tax dedicated to this program. This would bring in a substantial amount of new revenue while protecting the vast majority of the public from seeing their taxes go up. Once this new revenue started coming in, the elderly could see their benefits increase by significant amounts, while also reducing the overall funding gap that risks the long term financial health of the program. This way two of the major problems with our retirement system could be confronted head on while protecting most of the public from any financial setback.

The second part of this policy memo suggests some rules to guide us when reforming our complex system of retirement accounts. These six rules would ensure that any new tax favored retirement savings account would be simpler and less costly, while also making reforms to encourage people to save more. Phasing out the complex system of existing accounts would likely take decades to accomplish, but that just means policymakers need to start now, so we can move over to a better system that much more quickly.

End Notes

#1 – Obama passed the Making Work Pay tax credit in 2009, which reduced taxes by $400 for single individuals and $800 for married couples in 2009 and 2010. The tax credit was not extended into 2011, but in December of 2010, a 2% cut in payroll taxes was enacted to take its place that lasted until the end of 2012 at which point it was allowed to expire for 2013.

#2 – Social Security currently raises $945 billion a year from the payroll tax when it covers only 82% of all earnings. Raising that to 95% would increase revenue from the payroll tax by about 16% (.95 / .82) or $150 billion a year, which represents about 0.7% of a $21 billion economy. The average benefit is about $1,500 so an 8% increase would raise average benefits by about $119. The funding shortfall is 1.1% of GDP so providing more resources worth about 0.35% of GDP would reduce that by about a third (0.35/1.1).

#3 – The Joint Committee on Taxation Estimates that defined contribution plans will cost the government $125 billion in lost tax revenue for 2020. For the same year, traditional IRAs will cost the government about $20 billion, and Roth IRAs about $8 billion. Adding these together gets you a total cost of $153 billion.

#4 – In their iconic paper, Brigitte Madrian and Dennis Shea (2001) showed how changing from an opt in to an opt out system of enrollment for a company's 401(k) plan caused participation to dramatically increase.

References

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