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Statement

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Hearing on

Individual Retirement Accounts

by

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STATEMENT OF PAUL J. YAKOBOSKI
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SUMMARY

The original objective of establishing individual retirement accounts (IRAs) was to provide a tax-deferred retirement saving vehicle for those workers who did not have an employment-based retirement plan. The fact is that today the vast majority of workers eligible for a tax-deductible IRA contribution do not contribute.

In 1993, among the 54 million civilian workers not participating in any type of employment-based retirement plan, *only* 6 percent reported having contributed to an IRA in the previous year (table 1). Therefore, over 90 percent of those eligible to make a tax-deductible IRA contribution chose not to do so. It is often speculated that this is due to a lack of money and a reluctance to put saving in a vehicle where it is beyond reach (without significant tax penalty) should it be needed before retirement age. Workers eligible for a tax-deductible IRA contribution in small firms were more likely than eligibles in large firms to contribute; however, their participation rates were still under 10 percent.

Salary reduction plans continue to grow as an important element of the employment-based retirement income system. The percentage of civilian nonagricultural wage and salary workers with an employer who sponsors a salary reduction plan increased from 27 percent in 1988 to 37 percent in 1993 (table 2). Over the same time period, the fraction of all workers participating in such plans rose from 15 percent to 24 percent. The fraction of participating workers among those where a salary reduction plan was sponsored also increased, rising from 57 percent to 65 percent (table 2). The growth in salary reduction plan sponsorship and participation has occurred across almost all worker and job-related characteristics, including firm size.

The likelihood of salary reduction plan sponsorship was greater among larger firms. However, when a plan was sponsored, the participation rate did not vary with firm size.

Among all salary reduction plan participants, the average amount contributed to the plan was $2,700 in 1993 (well below the maximum tax deductible amount allowed by law of $8,994 at that time).

As seen above, participation rates among eligibles is much higher for employment-based salary reduction plans than for IRAs. A relevant question for policy purposes in considering how best to increase retirement savings is why? Probably the single most important reason is the availability of employer matching contributions with salary reduction plans. Also, such plans tend to be marketed to employees by the sponsoring employer.

Finally, another point of note is that, despite the rapid growth in the number of defined contribution plans—primarily 401(k) arrangements—in small firms over recent years, it is at the small plan level where a noticeable gap in plan sponsorship remains. The question naturally arises as to what if anything can be done to fill this void?

STATEMENT OF PAUL J. YAKOBOSKI
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BEFORE THE SENATE FINANCE COMMITTEE
FEBRUARY 9, 1995

I am pleased to appear before you this morning to discuss issues of individual retirement accounts (IRAs), 401(k) plans, and individual saving. My name is Paul Yakoboski. I am a research associate at the Employee Benefit Research Institute (EBRI), a nonprofit, nonpartisan, public policy research organization based in Washington, DC.

EBRI has been committed, since its founding in 1978, to the accurate statistical analysis of economic security issues. Through our research we strive to contribute to the formulation of effective and responsible health and retirement policies. Consistent with our mission, we do not lobby or advocate specific policy solutions.

IRA Usage

Through enactment of the Employee Retirement Income Security Act of 1974 (ERISA), Congress established IRAs to provide workers who did not participate in employment-based retirement plans an opportunity to save for retirement on a tax-deferred basis. U.S. tax law has substantially changed the eligibility and deduction rules for IRAs since then. The Economic Recovery Tax Act of 1981 extended the availability of IRAs to all workers, including those with pension coverage. The Tax Reform Act of 1986 (TRA '86) retained tax-deductible IRAs for those not covered by an employment-based retirement plan but restricted the tax deduction among those with a retirement plan to individuals with incomes below specified levels. In addition, TRA '86 added two new categories of IRA contributions: nondeductible contributions, which accumulate tax free until distributed, and partially deductible contributions, which are deductible up to a maximum amount less than the $2,000 maximum otherwise allowable.[1]

According to EBRI tabulations of the April 1993 Current Population Survey employee benefits supplement (CPS-ebs), in 1993, among the 54 million civilian workers not participating in any type of employment-based retirement plan, *only* 6 percent reported having contributed to an IRA in the previous year (table 1). Therefore, over 90 percent of those eligible to make a tax-deductible IRA contribution chose not to do so. It is often speculated that this is due to a lack of money on the part of lower income workers, but these results hold across different income levels. Only 2 percent of those eligible for a tax-deductible contribution in the lowest earning bracket (under $5,000 annually) contributed to an IRA. While the contribution rate among eligible higher earners is greater, the vast majority still do not participate. Three-quarters of those with earnings of $50,000 or more and not participating in an employment-based plan did not contribute to an IRA (table 1). An additional reason hypothesized for low participation rates among those eligible is that individuals, especially lower income individuals, are reluctant to put their saving in a vehicle where it is beyond their reach (without significant tax penalty) should they need it before retirement age.[2]

Workers eligible for a tax-deductible IRA contribution in small firms were more likely than eligibles in large firms to contribute; however, their participation rates were still under 10 percent. The IRA participation rate among workers without a retirement plan in very small firms (with fewer than 10 employees) was 9 percent. This dropped to 5 percent for those in firms with 1,000 or more employees. This may be at least partially explained by the availability of simplified employee pensions with a salary reduction option (SARSEPs) at firms with fewer than 25 employees.[3]

Among those without an employment-based plan who did contribute to an IRA, the average contribution was $1,845 in 1992 (or slightly under the deductible limit of $2,000 for single filers). While those in smaller firms were more likely to contribute to an IRA, they also tended to make smaller contributions relative to contributors from large firms. The average contribution rate of participants in firms with fewer than 10 employees was $1,792, compared with $1,992 for those in firms of 1,000 or more employees.

Not surprisingly, the average IRA contribution (among those without an employment-based retirement plan) tended to increase with the worker's annual earnings. The average contribution was $1,410 for those earning less than $5,000 annually, compared with $2,121 for those earning $50,000 or more annually.

The original objective of establishing IRAs was to provide a tax-deferred retirement saving vehicle for those workers who did not have an employment-based retirement plan. The fact is that today the vast majority of workers eligible for a tax-deductible IRA contribution do not contribute.

Salary Reduction Plans

Salary reduction plans include 401(k) plans, 457 plans, and 403(b) plans. The Revenue Act of 1978 permitted employers to establish 401(k) arrangements, named after the Internal Revenue Code (IRC) section authorizing them. In 1981, the Internal Revenue Service (IRS) issued the first set of proposed regulations covering such plans. These proposed regulations provided some interpretive guidelines for sec. 401(k) and specifically sanctioned "salary reduction" plans. Through 401(k) arrangements, participants may contribute a portion of compensation (otherwise payable in cash) to a tax-qualified employment-based plan. Typically, the contribution is made as a pretax reduction in (or deferral of) salary that is paid into the plan by the employer on the employee's behalf.[4] In many cases, an employer provides a "matching" contribution that is some portion of the amount contributed by the employee, generally up to a specified maximum. The employee pays no federal income tax on the contributions or on the investment earnings that accumulate until withdrawal. Some plans also permit employee after-tax contributions; the earnings on these contributions are also not taxed until withdrawal.

Public-sector employers can establish similar plans under IRC sec. 457; charitable organizations qualified under IRC sec. 501(c)(3) (for example, a tax-exempt hospital, church, school, or other such organization or foundation), and public school systems and public colleges and universities can establish tax-deferred annuity plans under sec. 403(b). The 1983 Social Security Amendments required that a new civil service retirement system be established to cover federal employees hired after December 31, 1983. The Federal Employees Retirement System (FERS), which Congress adopted in 1986 and which went into effect in January 1987, combines Social Security, a defined benefit pension, and an optional tax-deferred thrift plan similar to a private-sector 401(k) arrangement. Employees hired before the end of 1983 were given the option of joining the new system or remaining in the old Civil Service Retirement System (CSRS) during a six-month period ending in December 1987.[5]

Such plans, while providing for many workers who may not otherwise have had an employment-based retirement plan, do involve explicit decision making on the part of individuals that will directly impact their retirement income security. These decisions start with whether or not to participate in the plan. If workers do decide to participate, they must then decide how much to contribute to the plan and usually how that money is to be allocated among the various investment options offered by the plan. They may also have to decide how employer matching contributions are to be allocated. Decisions do not end there. When plan participants change jobs, they receive lump-sum distributions of their vested account balances and must decide whether to roll the money over and preserve it on a tax-deferred basis or spend it and in the process incur federal income and, if under age 59 1/2, penalty taxes.

The following discussion refers to these arrangements generically as salary reduction plans. A worker's benefit from such plans consists of employee contributions, any employer matching contributions, forfeitures of nonvested benefits by former participants, plus any investment gains and less any investment losses.[6]

Salary reduction plans continue to grow as an important element of the employment-based retirement income system. According to EBRI tabulations of the April 1993 CPS-ebs, the percentage of civilian nonagricultural wage and salary workers with an employer who sponsors a salary reduction plan (the sponsorship rate) increased from 27 percent (27 million workers) in 1988 to 37 percent (39 million workers) in 1993 (table 2). Over the same time period, the fraction of all workers participating in such plans (the participation rate) rose from 15 percent (16 million workers) to 24 percent (25 million workers).

The fraction of participating workers among those where a salary reduction plan was sponsored (the sponsored participation rate) also increased, rising from 57 percent to 65 percent (table 2). The growth in salary reduction plan sponsorship and participation has occurred across almost all worker and job-related characteristics, including firm size.

The likelihood of salary reduction plan sponsorship and participation increased with firm size (table 2). In 1993, 5 percent of those employed by a firm with fewer than 10 employees reported that their employer sponsored a salary reduction plan, compared with 54 percent of those employed by firms with 1,000 or more employees. Note that when a plan was sponsored, the participation rate did not vary systematically with firm size. In all but the smallest employer category, the participation rate among workers where a plan was sponsored was about two-thirds. In the smallest firms (with fewer than 10 employees), almost three-quarters of workers where a plan was sponsored chose to participate. Therefore, the positive relationship between firm size and overall participation rates was solely a function of the positive relationship between firm size and sponsorship rates.

Among all salary reduction plan participants, the average amount contributed to the plan was $2,700 in 1993 (well below the maximum tax-deductible amount allowed by law of $8,994 at that time). This was up slightly from $2,400 in 1988 (1993 $) (table 3). Except for workers in the smallest firm size category (fewer than 10 employees), the average amount contributed did not vary greatly with firm size. It ranged from a low of $2,400 for participants in firms with 25-49 employees to a high of $2,800 for participants in firms with 1,000 or more employees. The average contribution among those participants with an employer with fewer than 10 employees was $1,700 in 1993, down dramatically from $3,100 (1993 $) in 1988.

Discussion

As seen above, participation rates among eligibles is much higher for employment-based salary reduction plans than for IRAs. A relevant question for policy purposes in considering how best to increase retirement savings is why?

Probably the single most important reason is the availability of employer matching contributions with salary reduction plans. Among workers whose employer sponsored a salary reduction plan in 1993, 51.3 percent reported that their employer provided matching contributions to the plan. The actual percentage was likely higher, as 30.2 percent did not know if their employer matched contributions. Among those responding that their employer did provide a matching contribution, the average reported match rate was 65 percent (i.e., for every $1 the employee contributed, the employer contributed 65 cents). Such employer matching contributions are not available with IRAs.

While workers reporting an employer match available were more likely to participate in the plan than those reporting no match, the difference was not as great as might be expected, according to EBRI tabulations of the April 1993 CPS-ebs. The participation rate among those reporting an employer match was 77.8 percent, compared with a rate of 71.8 percent among those reporting no match. The true difference in participation rates between those with a match available and those without a match available may have been understated by these tabulations to the extent that those who did not know whether a match was available were more likely, in actuality, not to have had a match than to have had a match. Other studies have found evidence that the availability of an employer match does have a more significant effect on participation. For example, a 1993 Hewitt Associates' study of 401(k) plans found an average participation rate of 77 percent in plans with an employer match as opposed to an average of 59 percent in plans with no employer match.[7]

In addition, participation in a salary reduction plan is generally more convenient since it is offered through the workplace and involves automatic contributions from a worker's paycheck before he or she even sees it. Plan sponsors will also market the plan to their employees and typically educate them as to the importance for their retirement income security of participating in the plan. With IRAs, on the other hand, an individual must make a conscious decision to seek out such information on his or her own. Furthermore, it has been speculated that some workers who are eligible for a tax-deductible IRA contribution may not be aware of their eligibility.

Finally, the other point of note from the data presented above is that, despite the rapid growth in the number of defined contribution plans—primarily 401(k) arrangements—in small firms over recent years, it is at the small plan level where a noticeable gap in plan sponsorship remains. The question naturally arises as to what if anything can be done to fill this void?

There is no easy answer to this question. SEPs and SARSEPs do exist and were created specifically to appeal to small employers, but they simply are not utilized to any significant degree. To the extent that we are dealing with businesses that have marginal profits and whose workers are relatively young and have relatively low earnings, there may not be great interest on either side for an employment-based retirement plan. The firm cannot afford such a plan, nor are the workers willing to sacrifice earnings for a plan at this point in their careers. Of course, this generalization does not cover all small employers, and therefore it may be possible to create some vehicle that will appeal to them and that financial companies will find worthwhile to market to small employers and their employees.

Endnotes

[1]Under current law, individuals who are not active participants in a qualified employment-based retirement plan can make fully tax-deductible contributions up to a $2,000 maximum per year to an individual retirement account (IRA). Individuals who are active participants or whose spouse is an active participant in a qualified employment-based plan and whose adjusted gross income (AGI) does not exceed $25,000 (single taxpayers) or $40,000 (married taxpayers filing jointly) may make a fully deductible IRA contribution. Individuals who are active participants or whose spouse is an active participant in a qualified employment-based plan and whose AGI falls between $25,000 and $35,000 (single taxpayers) and between $40,000 and $50,000 (married taxpayers filing jointly) may make a fully deductible IRA contribution of less than $2,000 and a nondeductible IRA contribution for the balance, as follows. The $2,000 maximum deductible deduction is reduced by $1 for each $5 of income between the AGI limits. Individuals who are active participants or whose spouse is an active participant in a qualified employment-based plan and whose AGI is at least $35,000 (single taxpayers) or at least $50,000 (married taxpayers filing jointly) may only make nondeductible IRA contributions of up to $2,000; earnings on the nondeductible contribution are tax deferred until distributed to the IRA holder. IRAs can also be established as rollover vehicles for lump-sum distributions from employment-based retirement plans or other IRAs.

[2]Distributions from IRAs are taxed as ordinary income in the year received, except for the portion of the total IRA distribution that is attributable to nondeductible contributions, which are excludable from gross income. Taxable distributions prior to age 59 1/2 are subject to a 10 percent penalty tax, unless they are taken as part of a series of equal payments made for the life (or life expectancy) of such employee and his or her beneficiary, or the IRA owner dies or becomes disabled.

[3]The Revenue Act of 1978 established a new tax-favored retirement plan aimed primarily at small employers—the simplified employee pension (SEP). SEPs are arrangements under which an individual retirement account (IRA) is established for each eligible employee. These arrangements are sometimes called SEP-IRAs. The Tax Reform Act of 1986 (TRA '86) added a salary reduction feature under which employees in small firms (25 or fewer employees) may elect to have a portion of their pretax salary contributed to a SEP. Such arrangements are sometimes referred to as SARSEPs. An employer may offer both an employer-funded SEP and a salary reduction SEP as long as the total amount contributed per employee does not exceed certain limits.

[4]TRA '86 placed a $7,000 limit on pretax employee contributions to private-sector 401(k) plans. This limit was indexed to the consumer price index beginning in 1988. The 1995 limit is $9,240.

[5]The thrift plan is available to workers covered by either the Federal Employees Retirement System (FERS) or the Civil Service Retirement System (CSRS), but different rules apply to the two groups. FERS employees are automatically covered under the thrift plan, and the government contributes the equivalent of 1 percent of pay for each employee whether or not the individual contributes. Employees may make further contributions of up to 10 percent of base salary (up to the same maximum as 401(k) plans). The government will then match, dollar for dollar, the first 3 percent of employee contributions and 50 percent of the next 2 percent, with no match beyond 5 percent. CSRS participants may contribute up to 5 percent of their salaries to the thrift plan but are not entitled to government contributions.

[6]Workers are immediately vested (that is, entitled to receive nonforfeitable and nonrevocable benefit payments from the plan) in their own contributions and any investment gains on those contributions. Workers are also immediately vested in employer contributions counted for ADP (actual deferral percentage) testing and earnings on those contributions; otherwise, only after having worked for the sponsoring employer for a minimum number of years do they become vested in any employer matching contributions and investment gains on those contributions.

[7]See Hewitt Associates, *401(k) Plan Hot Topics, 1993* (Lincolnshire, IL: Hewitt Associates, 1993).

Table 1
Individual Retirement Account (IRA) Participation by Workers Not Participating in Any Employment-Based Retirement Plan (Includes Salary Reduction Plans) Among Civilian Nonagricultural Wage and Salary Workers, Aged 16 and Over, by Firm Size and Earnings, 1993

	Total (thousands)	Percentage Contributing to an IRA in 1992	Average Contribution (1993 $)
Total	53,636	6.3%	$1,845
Firm Size			
Fewer than 10	12,505	9.0	1,792
10–24	6,537	8.0	1,832
25–49	4,700	6.2	1,782
50–99	3,553	6.6	1,729
100–249	3,614	4.8	2,400
250–499	2,037	2.7	1,670
500–999	2,090	5.4	1,763
1,000 or more	13,361	4.8	1,992
Annual Earnings, 1993 $			
Less than $5,000	7,007	2.1	1,410
$5,000–$9,999	8,943	3.3	1,962
$10,000–$14,999	10,385	3.2	1,485
$15,000–$19,999	7,478	4.6	1,481
$20,000–$24,999	4,572	7.4	1,503
$25,000–$29,999	3,179	8.1	1,601
$30,000–$49,999	4,392	13.1	2,078
$50,000 or more	1,463	24.1	2,121

Source: Employee Benefit Research Institute tabulations of the April 1993 Current Population Survey employee benefit supplement.

Table 2
Civilian Nonagricultural Wage and Salary Workers, Aged 16 and Over, by Salary Reduction Plan Sponsorship and Participation, by Firm Size, 1988 and 1993

	Total Workers		Sponsorship Rate[a]		Participation Rate[b]		Sponsored Participation Rate[c]	
	1988	1993	1988	1993	1988	1993	1988	1993
	(thousands)				(percentage)			
Total	101,745	105,815	26.9%	36.8%	15.3%	23.8%	57.0%	64.6%
Firm Size								
Fewer than 10	13,561	14,032	3.0	5.1	2.2	3.8	74.3	74.3
10–24	8,164	8,466	8.0	12.1	5.7	8.4	70.9	69.5
25–49	6,781	6,716	14.2	20.1	7.8	12.7	55.2	62.9
50–99	5,563	6,185	18.0	29.9	11.0	20.9	61.2	69.8
100–249	7,497	7,775	22.8	39.0	13.3	25.0	58.4	64.2
250 or more	51,274	54,709	41.5	53.2	23.4	34.5	56.2	64.9
250–499	d	5,471	d	49.9	d	32.5	d	65.2
500–999	d	5,485	d	47.8	d	30.5	d	63.7
1,000 or more	d	43,753	d	54.3	d	35.3	d	65.0

Source: Employee Benefit Research Institute tabulations of the May 1988 and April 1993 Current Population Survey employee benefit supplements.

[a]The fraction of workers whose employer sponsors a salary reduction plan for any of the employees at the worker's place of employment.

[b]The fraction of all workers participating in a salary reduction plan.

[c]The fraction of workers participating in a salary reduction plan among those whose employer sponsors a plan for any of the employees at the worker's place of employment.

[d]Data not available.

Table 3
Average Annual Dollar Contributions Among Civilian Nonagricultural Wage and Salary Workers, Aged 16 and Over, Who Participate in a Salary Reduction Plan, by Firm Size 1988 and 1993

	Total Participants (thousands)		Average Contribution (1993 $)	
	1988	1993	1988	1993
Total	15,586	25,148	$2,443	$2,681
Firm Size				
Less than 10	303	536	3,147	1,667
10–24	462	714	2,406	2,608
25–49	530	850	2,311	2,368
50–99	613	1,292	2,157	2,480
100–249	999	1,944	2,177	2,461
250 or more	11,973	18,889	2,501	2,780
250–499	a	1,780	a	2,609
500–999	a	1,671	a	2,615
1,000 or more	a	15,438	a	2,816

Source: Employee Benefit Research Institute tabulations of the May 1988 and April 1993 Current Population Survey employee benefit supplements.
[a]Data not available.