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- Proposed automatic IRA plans could increase benefit coverage and economic security for low-income retirees, at little cost to business or government.
- For retirees in the bottom income quartile, yearly incomes could increase 18 percent, or \$3,000.
- Automatic IRAs could boost retirement incomes for up to half of the lowest-income workers, though most would still struggle financially.

How Much Might Automatic IRAs Improve Retirement Security for Low- and Moderate-Wage Workers?

Barbara A. Butrica and Richard W. Johnson

Nearly a third of Social Security beneficiaries age 65 or older depend on the program for 90 percent or more of their total income (Social Security Administration 2010), a worrisome statistic because Social Security was not designed to be retirees' sole source of income. About half of seniors almost entirely dependent on Social Security received less than \$15,000 in income in 2008 (Social Security Administration 2010). One possible way to improve retirement security that has been advanced by experts across the political spectrum is to require employers that don't offer retirement plans to set up individual retirement accounts (IRAs) for their employees and automatically deposit a portion of pay into them.

This brief examines the potential of automatic IRAs to improve retirement security for low- and moderate-wage workers. The results, based on the Urban Institute's microsimulation model, show that automatic IRAs can significantly increase retirement plan coverage and economic security for low-income retirees, at little cost to business or the federal government.

Automatic IRA Proposal

Many Americans fail to save for retirement. About 40 percent of all wage and salary workers ages 25 to 59 in 2009 worked in jobs that didn't offer retirement plans (Butrica and Johnson 2010). Another 16 percent of workers with offers did not participate (Butrica and Johnson 2010). And many people—particularly those with limited resources—withdraw funds from their 401(k)s and IRAs during

their working lives, and even cash them out completely. Butrica, Zedlewski, and Issa (2010) find that 8 percent of retirement account owners made at least one withdrawal between 2004 and 2005. Withdrawals were more likely among African Americans, those without college degrees, and those with little or no assets.

Many workers eligible for retirement plans do not participate simply because they never bother to enroll. Increasingly, employers are overcoming this inertia by automatically enrolling new employees. The early results are promising: many studies document much higher participation in retirement plans for which participation is the default rather than an opt-in choice (Beshears et al. 2009; Choi et al. 2004; Madrian and Shea 2001). But automatic enrollment does not help workers whose employers do not offer plans.

One possible way to improve retirement security is to require employers that don't offer retirement plans to set up individual retirement accounts for employees and automatically deposit a portion of pay.

One in six retirees will have worked for at least 30 years but spent no more than 10 years in jobs that offered retirement plans. Half will have no private retirement benefits. Automatic IRAs could help these workers most, providing them with retirement plans that could boost their incomes substantially.

The automatic IRA, conceived by Mark Iwry of the Brookings Institution and David John of the Heritage Foundation, could boost retirement savings for millions of workers not offered employer-sponsored retirement plans (Iwry and John 2007). The proposal calls for employers with more than 10 workers that do not offer retirement plans to set up IRAs for their employees. Employers would automatically deduct a percentage of workers' pay and deposit it into their IRAs, but employers would not be required to contribute them-

selves. Employees could opt out of this retirement savings deduction or change the amount deducted. Automatic IRAs would be provided by the same private financial institutions that currently offer IRAs and be subject to the same contribution limits and regulations as existing IRAs.

Several bills have been introduced in Congress to create automatic IRAs. Some stipulated that workers participating in an automatic IRA or 401(k) would have their federal saver's credit automatically deposited into their retirement savings account. The saver's credit uses federal tax credits to match low- and moderate-income workers' contributions to their retirement savings accounts. Currently, however, the saver's credit is nonrefundable, so low-income people without any tax liability would not benefit. To address this shortcoming, some automatic IRA bills would expand the saver's credit by making it fully refundable.

The Obama administration has advocated creating automatic IRAs and expanding the saver's credit to help low- and moderate-income families build retirement savings. Although the automatic IRA was included in President Obama's FY2012 budget request, the expanded saver's credit was dropped (Gale and John 2011).

Modeling the Automatic IRA

To assess the potential impact on future retirees' incomes, we model the automatic IRA and the proposed changes to the saver's credit using the Urban Institute's Dynamic Simulation of Income Model (DYNASIM3). DYNASIM3 projects the major sources of wealth and income at retirement age, including pensions from employer-sponsored defined benefit (DB) plans, cash balance plans, and retirement accounts (defined contribution [DC] plans, IRAs, and Keoghs). Starting information about pension coverage on current and past jobs, pension contribution rates, and account balances comes from self-reported data in the

Survey of Income and Program Participation. Numerous data sources and models are used to project job changes, pension coverage, pension participation, and pension contributions. DYNASIM3 assumes that retirement accounts and other financial assets are converted into lifetime annuities, generating a fixed annual stream of payments from retirement until death. The model also estimates state and federal income taxes and the saver's credit. For a full description of DYNASIM3, see Favreault and Smith (forthcoming).

We simulate automatic IRAs for workers born between 1987 and 1996, under the assumption that they first become available in 2012. Thus, the automatic IRA option would be available to these workers for nearly their entire careers. We follow them for 46 years from age 25 until age 70 (between 2012 and 2066) and assign an automatic IRA to those who would not otherwise be offered an employer-sponsored retirement plan.

Because all versions of the original automatic IRA proposal allow workers to decline enrollment, we need to determine how many might opt out of an IRA when automatically enrolled. Automatic IRAs do not yet exist, so there is no direct empirical evidence to inform our models. To capture this uncertainty, we consider two different scenarios—a high-enrollment scenario and low-enrollment scenario. The high-enrollment scenario sets the target average participation rate at 70 percent, based on Nessmith, Utkus, and Young's (2007) estimate of 401(k) participation rates under autoenrollment without an employer match (since employers would not match automatic IRA deposits).

Alternatively, automatic enrollment may not affect participation much, so it may be more realistic to tie the average participation rate in automatic IRAs to current DC plan participation. According to data from the National Compensation Survey, 77 percent of workers offered DC plans participate (U.S. Bureau of Labor Statistics 2007). Even and

Table 1. Percent of Individuals Born 1987 to 1996 Receiving Private Retirement Benefits at Age 70 under the Baseline (in the Absence of Auto IRAs), by Personal Characteristics

	NO BENEFITS	ANNUAL BENEFITS ≥ \$5,000
All	24	46
Household income quartile at age 70		
Bottom	47	8
Second	24	37
Third	15	62
Top	10	77
Employment and retirement plan history		
≥ 30 years of employment, ≤ 10 years in retirement plan job (16%)	50	22
≥ 30 years of employment in retirement plan job (35%)	4	74

Source: DYNASIM3 projections.

Notes: Sample excludes individuals with incomes in the bottom and top 1 percent of the income distribution. Population shares are reported in parentheses. Financial amounts are measured in 2010 dollars.

MacPherson (2005) estimate that employer matches increase participation by about 30 percentage points, suggesting that participation in DC plans with no match would be only 47 percent. Additionally, workers less inclined to save for retirement tend to select jobs that don't offer retirement plans (Karamcheva and Sanzenbacher 2010), reducing likely enrollment rates in automatic IRAs. Accounting for this behavior suggests a target average participation rate of about 36 percent under the low-enrollment scenario. We use DYNASIM's existing models of DC participation to distribute the overall participation targets across individuals by their prior savings behavior, age, sex, marital status, number of dependents, earnings, and job tenure.

For workers predicted to participate in an automatic IRA, the analysis uses DYNASIM's model of DC contributions to estimate how much they will contribute, subject to statutory

IRA contribution limits. The model parameters are adjusted slightly to produce somewhat higher contributions under the high scenario than under the low scenario. We assume these contributions come out of household spending and do not offset other savings. The low- and high-enrollment scenarios are intended to represent the lower and upper bounds of possible outcomes in a world with automatic IRAs.

As with DC plans in DYNASIM, we assume that automatic IRAs are invested in stock and bond portfolios that vary by age and risk tolerance according to Survey of Consumer Finances (SCF) data on asset allocations.¹ Every year, DYNASIM3 rebalances the portfolios according to the allocation strategy for the individual's attained age and risk-tolerance categories. A few workers (mostly young workers and those with small balances) are simulated to cash out retirement account balances at job separation.

We also model the impact of an expanded saver's credit. Under current law, the saver's credit provides a tax credit of up to \$1,000 (\$2,000 if married filing jointly) for low- and moderate-income taxpayers who contribute to a retirement savings account. The credit equals 50 percent, 20 percent, or 10 percent of contributions, depending on taxable income, for those with incomes as high as \$28,250 (\$56,500 for joint filers) in 2011. Following the President's previous budget requests, we assume that the saver's credit would be reduced, but fully refundable and available to more taxpayers. We model a 50 percent credit up to \$500 (\$1,000 if married filing jointly) for taxpayers with income up to \$32,500 (\$65,000 for joint filers). We assume the match rates remain constant over the projection period, but we adjust the credit amounts and brackets for changes in prices through 2020 and changes in average wages after 2020, based on the Social Security trustees' intermediate-cost projections.

Automatic IRAs Can Significantly Increase Retirement Plan Coverage

Without automatic IRAs, nearly a quarter of people born between 1987 and 1996 will not receive any retirement income from DB pensions, DC plans, or IRAs when they reach age 70 (table 1). Close to half of these GenYers will receive at least \$5,000 per person in annual private retirement benefits at age 70 (measured in 2010 dollars).

Retirement security depends largely on having a retirement plan. Consider those retirees who will have the lowest incomes at age 70. Nearly half will have no private retirement benefits and only 8 percent will receive annual benefits of \$5,000 or more. By contrast, more than three-quarters of retirees with the highest incomes at age 70 will have private retirement benefits of at least \$5,000. Just more than a third of retirees will have worked for 30 or more years in retirement plan jobs between ages 25 and 65. About three-quarters of these retirees will receive \$5,000 or more in

Table 2. Mean Household Income at Age 70 and Percent Increase between Baseline (in the Absence of Auto IRAs) and Alternative Auto IRA Scenarios by Private Retirement Benefit Receipt at Age 70 (2010 \$)

	ALL			NO BENEFITS UNDER THE BASELINE			ANNUAL BENEFITS ≥ \$5,000 UNDER THE BASELINE		
	Income under baseline (\$000)	Percent Increase		Income under baseline (\$000)	Percent Increase		Income under baseline (\$000)	Percent Increase	
		Low scenario	High scenario		Low scenario	High scenario		Low scenario	High scenario
All	65	3	5	41	5	10	91	3	4
Household income quartile at age 70									
Bottom	16	6	13	15	7	13	20	0	5
Second	33	6	12	33	6	15	35	3	6
Third	59	5	7	58	9	14	60	3	5
Top	150	3	3	154	4	6	151	2	3
Employment and retirement plan history									
≥ 30 years of employment, ≤ 10 years in retirement plan job	63	6	11	55	5	13	87	6	9
≥ 30 years of employment in retirement plan job	84	2	4	44	5	7	99	1	2

Source: DYNASIM3 projections.

Notes: Sample excludes individuals with incomes in the bottom and top 1 percent of the income distribution. Household income is measured per person, after taxes, and in 2010 dollars.

annual private retirement benefits at age 70. However, one in six retirees will have worked for 30 or more years but spent no more than 10 years in jobs that offered retirement plans. Half of these retirees will have no private retirement benefits at age 70. Automatic IRAs could help these workers most, providing them with retirement plans that could boost their retirement incomes substantially.

A third of all adults born 1987 to 1996 will be eligible to participate in an automatic IRA in 2036 (when they are age 40 to 49, peak earning years) because they are working in a job that doesn't offer a retirement plan (not shown). In contrast, over half of these GenYers will work for employers that offer DC plans.

Under the low-enrollment scenario, 36 percent of those eligible for automatic IRAs

will participate in 2036. Under the high-enrollment scenario, participation rates will reach 70 percent (figure 1). Participation rates increase with earnings. Under the low scenario, 11 percent of those eligible in the bottom quarter of the earnings distribution will participate in automatic IRAs, compared with 72 percent of those in the top quarter. Under the high scenario, participation rates range from 34 percent for the lowest eligible earners to 98 percent for the highest earners.

Automatic IRAs Increase Incomes

Under the baseline (in the absence of automatic IRAs), after-tax household incomes at age 70 will average \$65,000 (2010 dollars) per person among adults born 1987 to 1996 (table 2). If automatic IRAs become avail-

able in 2012, their incomes will increase 3 percent overall under the low-enrollment scenario and 5 percent under the high-enrollment scenario. The effects on incomes will vary significantly by work history, income level, and private retirement benefits. Relative to the baseline, the high-enrollment scenario would raise average per person income 10 percent at age 70 for retirees who would not otherwise receive any private retirement benefits. As expected, automatic IRAs would provide the most help to adults with low and moderate incomes, those with limited plan coverage but strong work histories, and those without private retirement benefits. Thus, the proposal seems to have the largest impact on those it was designed to target. Under the high-enroll-

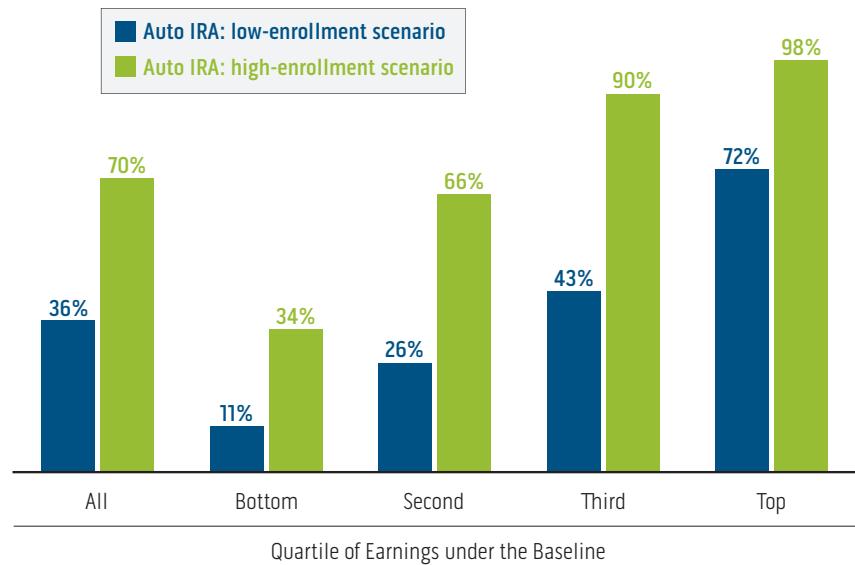
ment scenario, retirees with incomes in the second quarter of the distribution without private retirement benefits would gain most (15 percent) and retirees with \$5,000 or more in annual benefits who participated for many years in their employer's retirement plan would gain least (2 percent).

Figure 2 shows that automatic IRAs would make about a third of adults under the low scenario and half of adults under the high scenario better off in retirement (i.e., increase after-tax incomes at age 70 by at least 2 percent). Retirees in the second quarter of the income distribution are most likely to gain—44 percent of those under the low scenario and 61 percent of those under the high scenario. In contrast, retirees in the top quarter of the distribution are less likely to experience income gains—only 29 percent of those under the low scenario and 41 percent of those under the high scenario.

Automatic IRAs will boost retirees' incomes, but by enough to significantly improve retirement security? Figure 3 shows the percentage increase in age-70 incomes among those with gains under the high scenario. For the roughly half of retirees in the bottom income quartile and the three-fifths of retirees in the second income quartile who will gain, mean incomes will increase 18 percent. On average, these gains amount to \$3,000 per year for those in the bottom quarter and \$6,000 per year for those in the second quarter. Even with these income gains, age-70 incomes would average only about \$20,000 for those in bottom quartile and \$39,000 for those in the second quartile—considerably less than what retirees in the top half of the income distribution would have in the absence of automatic IRAs. (The low-enrollment scenario generates similar income boosts for those with gains, but fewer retirees would gain because participation rates are lower.)

Our simulations predict that some automatic IRA enrollees would contribute little to their accounts each period, others would borrow from them or cash them out before retirement, and a few would earn poor investment

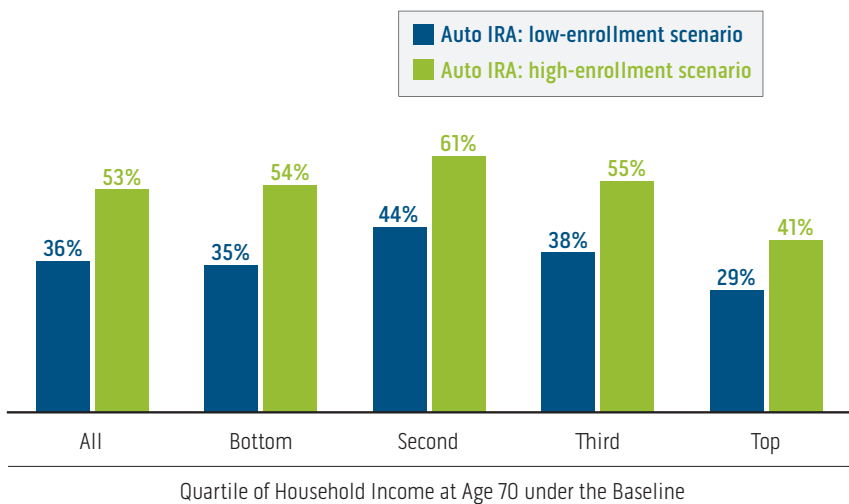
Figure 1. Participation Rates in 2036 among Individuals Born 1987 to 1996 and Offered Automatic IRAs



Source: DYNASIM3 projections.

Notes: Sample excludes individuals with incomes in the bottom and top 1 percent of the income distribution.

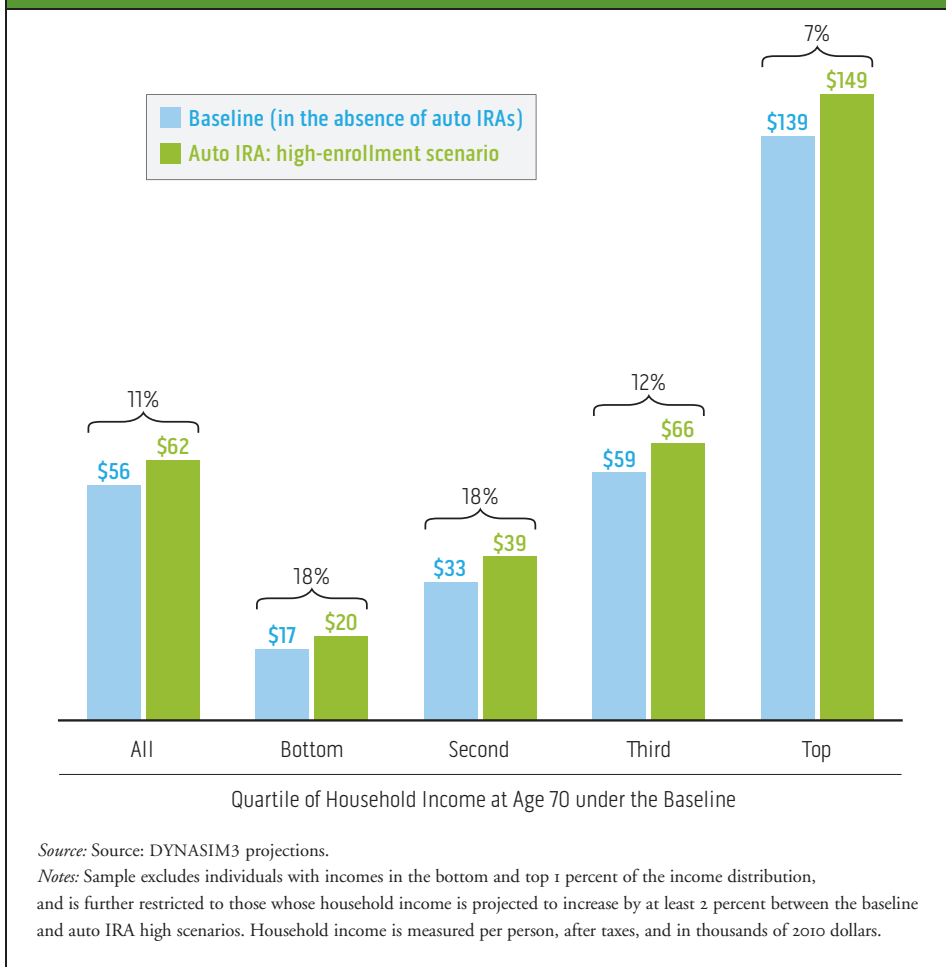
Figure 2. Share Who Gain Income at Age 70 between the Baseline (in the Absence of Auto IRAs) and Alternative Auto IRA Scenarios



Source: DYNASIM3 projections.

Notes: Sample excludes individuals with incomes in the bottom and top 1 percent of the income distribution. Household income is after taxes.

Figure 3. Change in Mean Household Income at Age 70 under the High-Enrollment Scenario, among Those with Projected Income Gains of 2 Percent or More (2010 \$)



a half of workers in the bottom quarter of the income distribution at age 70. Between two-fifths and three-fifths of workers in the second quarter of the age-70 income distribution would also benefit.

Although average retirement incomes would increase nearly a fifth for low- and moderate-income adults who would benefit from the program, they would remain relatively low. The impact of automatic IRAs would not be larger because workers in jobs that do not offer retirement plans tend to have lower earnings and more intermittent work histories than those in jobs with employer-sponsored retirement plans. Therefore, even with a relatively high contribution rate, their ability to significantly increase their savings is constrained by their low earnings and income. Nonetheless, any additional savings created by automatic IRAs, no matter how small, will improve retirement security (as long as the new savings doesn't offset other savings). Another positive side-effect of automatic IRAs is that they could improve financial literacy by introducing more people—especially those with low incomes—to financial instruments that demonstrate the value of saving.

This improvement to retirement security would not cost businesses or government much, an important consideration given the competitive pressures confronting employers and the growing size of the federal debt. Employers would not contribute to the new accounts, and the administrative burden seems modest, since financial institutions would manage the accounts. Because automatic IRA contributions would be tax deferred (like traditional IRA contributions) and some low-income savers would receive small tax credits, the proposal would cost the federal government some tax revenue. But it would help spread the tax benefits currently received by many high-wage workers on their 401(k) contributions across income groups.

It is difficult to project income 45 years, so our estimates of how automatic IRAs might

returns, potentially limiting the program's impact on retirement incomes. However, additional simulations that we ran showed that these factors do not significantly reduce the effectiveness of automatic IRAs. Retirement incomes would increase slightly—particularly for retirees with the lowest incomes—if no workers cashed out any of their automatic IRA balances or if all contributed at least 6 percent of wages, but outcomes would not substantially improve. Guaranteeing workers a 3 percent real rate of return, instead of having them invest their accounts in risky stocks and bonds, would slightly reduce overall retirement

incomes. No enrollees would lose any money, but no one would reap the big windfalls sometimes generated by the stock market.

Policy Implications

Requiring employers that don't offer retirement plans to establish IRAs for their workers and automatically direct a portion of pay into their accounts is one of the most promising ways to improve retirement security for low- and moderate-wage workers. Our results suggest that if implemented early in their careers, automatic IRAs would boost retirement incomes for between a third and

promote retirement security are necessarily uncertain. One of the major unknowns involves whether low-wage workers will choose to remain in the program after they have been automatically enrolled. Workers struggling to make ends meet may object to voluntary payroll deductions, even if they would raise future retirement incomes. Evidence from firms that automatically enroll workers into 401(k) plans is encouraging, however. About three-quarters of automatic enrollees with earnings less than \$30,000 per year continue to contribute to their plans (Nessmith, Utkus, and Young 2007). Of course, firms typically match their employees' 401(k) contributions, increasing the financial incentive to participate, so outcomes may be less favorable for automatic IRAs.

Even if automatic IRAs prove to be widely successful, however, low-wage work-

ers will continue to receive the bulk of their retirement income from Social Security. Policymakers working to improve the financial solvency of Social Security should consider options that protect low-income seniors. Currently, Social Security benefits replace a larger share of career earnings for lower-wage earners than for higher-wage earners. Reform proposals that maintain these relatively high replacement rates for lower earners would preserve benefits for the most vulnerable. A new Social Security minimum benefit, enacted alone or as part of a larger reform package, also could protect low-income retirees (Favreault et al. 2007).

Beyond this, policymakers could take additional steps to strengthen the social safety net. One option would be to reform and strengthen Supplemental Security Income (SSI), a means-tested program that provides

cash benefits to poor seniors and people with disabilities. Increasing the asset limit (set in 1972) to reflect cost-of-living changes and boosting the maximum benefit to the poverty threshold would allow more seniors to qualify for SSI and raise their annual benefits. Expanding SSI would enable the program to fulfill its mission of protecting older and disabled adults from economic hardship.

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Note

1. Our analysis uses a multinomial logit equation to assign individuals one of five possible asset allocations (no stock, 20 percent stock, 50 percent stock, 80 percent stock, and 100 percent stock). The equation is estimated on pooled 1998 to 2007 SCF data and controls for age, education, and marital status.

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