Three Tax Policy Ideas to Strengthen Retirement Security

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I usually turn down speaking requests, but accepted this one immediately, because:

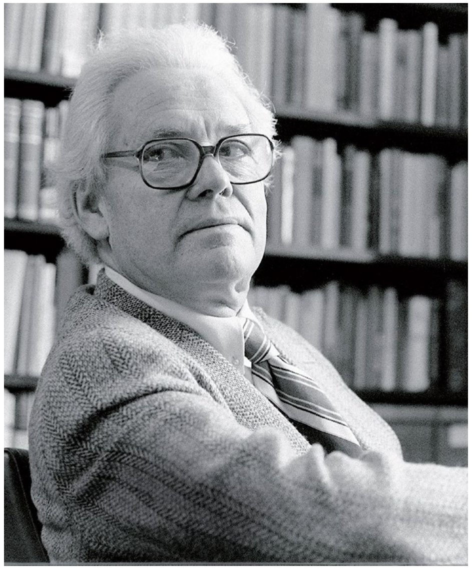
1. I like tax guys.

2. I need help on three ideas from experts like yourselves.

First, the tax guys.

Joseph Pechman got me into Harvard.

Richard Musgrave got me out of Harvard.



Only true gamblers would have taken such a risk!

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Next, let's talk about the three ideas for using tax policy to improve retirement security.

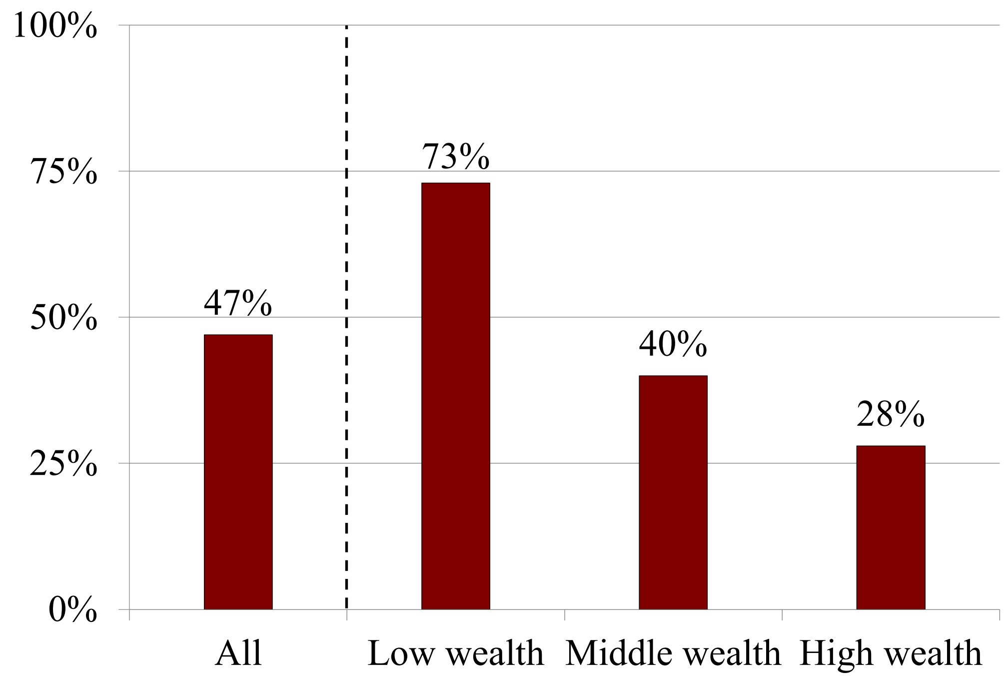
I. Expanding Property Tax Deferral to Help Retirees Meet Income Needs

II. Recognizing Legacy Debt in Constructing Financial Solutions for:
  - Social Security
  - Public Pensions

III. Making Tax Incentives for Retirement Saving Fairer and Smaller

The first notion is property tax deferral. Many retirees will be at risk of falling short.

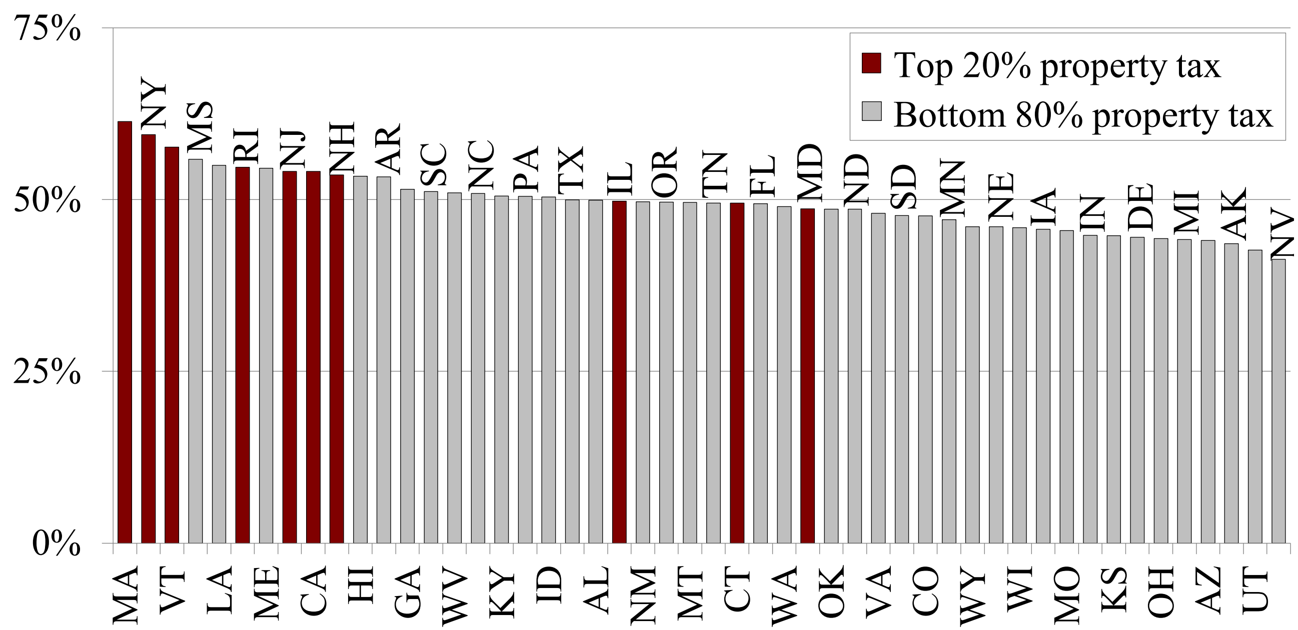
Percentage of Households "At Risk" at Age 65 by Wealth Group, 2019



Source: Yimeng Yin, Anqi Chen, and Alicia H. Munnell. 2023. "The National Retirement Risk Index: A Relaunch." *Issue in Brief* 23-9. Center for Retirement Research at Boston College.

And retirees in states with high property taxes face a more serious situation.

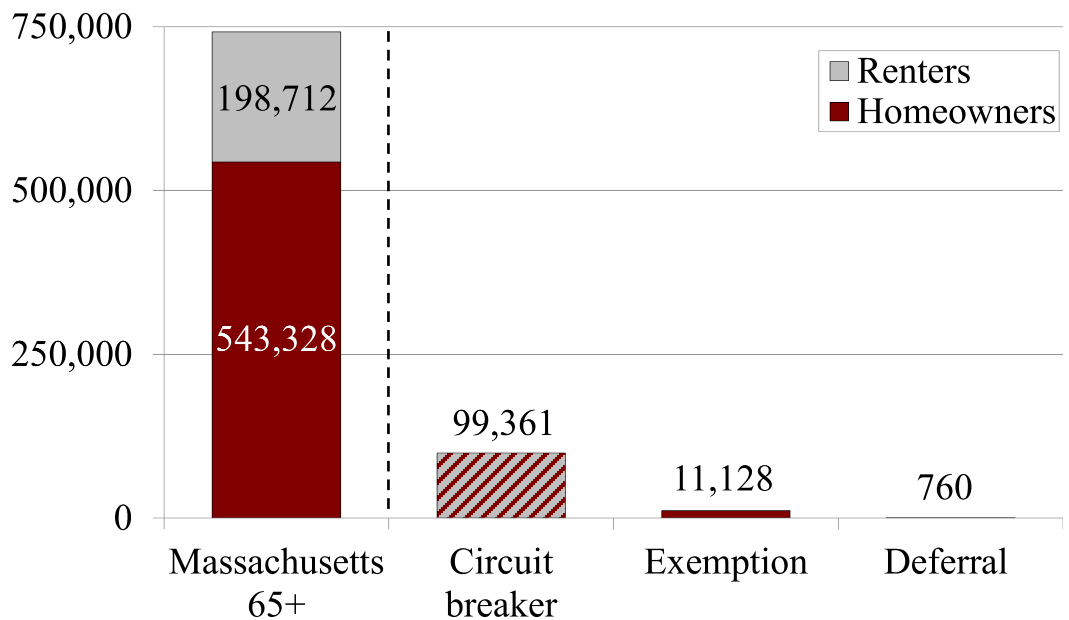
Percentage of State Single Population 65+ Below the Elder Index by Property Tax Level, 2020



Note: Property tax level is for homeowners ages 65+.
Sources: Jan E. Mutchler, Yang Li, and Ping Xu. 2021. "Late-life Gender Disparities in Economic Security in the Context of Geography, Race and Ethnicity, and Age: Evidence from the 2020 Elder Index." University of Massachusetts Boston, Center for Social and Demographic Research on Aging; and U.S. Census Bureau. *American Community Survey,* 2020.

Currently, states do offer property tax relief, but programs are targeted at the poor 65+.

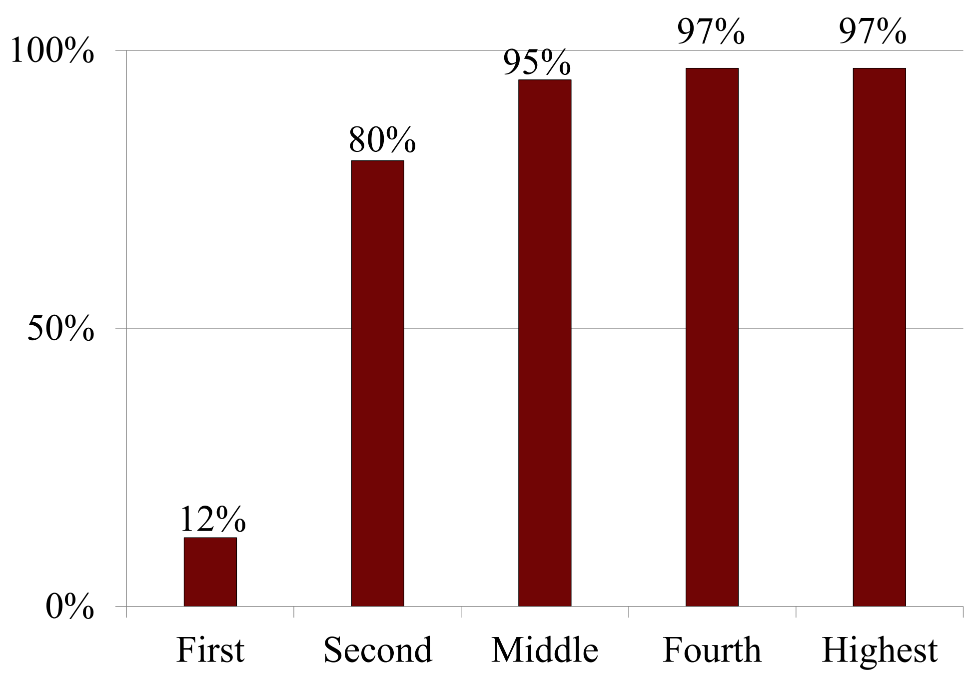
MA Property Taxpayers 65+ and Participants in Property Tax Relief Programs, FY2021



Sources: U.S. Census Bureau. *American Community Survey,* 2021; Massachusetts Department of Revenue. 2021. "Senior Circuit Breaker Credit Usage Report by Community."; and Massachusetts Department of Revenue, Division of Local Services. 2021. "Municipal Databank/Local Aid Section: Exemptions Granted and Dollars Abated."

One option – property tax deferral – could allow all homeowners to tap home equity.

Percentage of Homeowners Among Households Ages 62-70, 2019, by Net Worth Quintile



Source: Author's calculations from U.S. Board of Governors of the Federal Reserve System. *Survey of Consumer Finances,* 2019.

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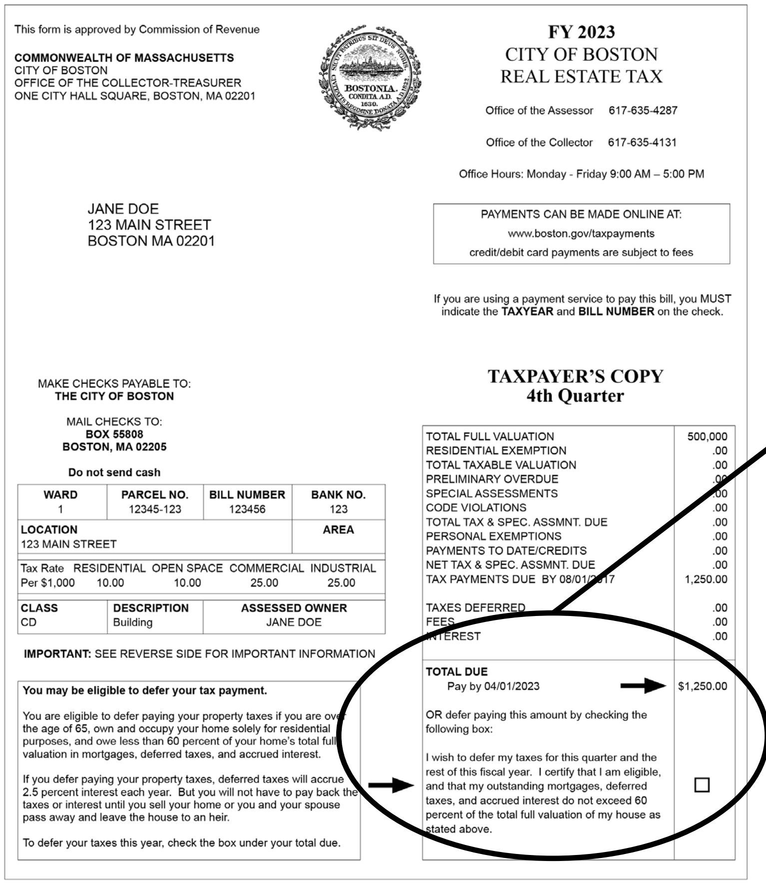
A new statewide property tax deferral program could function as follows:

- All households, regardless of income, could defer taxes on up to $1 million in assessed value.
- Deferrals, accumulated interest, and mortgages would be capped at 60 percent of assessed value.
- The interest rate on deferrals would be the state's borrowing cost plus a buffer for administrative costs and defaults.
- The state would reimburse localities for foregone taxes.
- Households would repay the state when they move or die.

The new program would also make sign-up very simple: just check a box.



This form is approved by Commission of Revenue

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4th Quarter

WARD	PARCEL NO.	BILL NUMBER	BANK NO.
1	12345-123	123456	123

LOCATION	AREA
123 MAIN STREET	

Tax Rate Per $1,000	RESIDENTIAL	OPEN SPACE	COMMERCIAL	INDUSTRIAL
	10.00	10.00	25.00	25.00

CLASS	DESCRIPTION	ASSESSED OWNER
CD	Building	JANE DOE

TOTAL FULL VALUATION	500,000
RESIDENTIAL EXEMPTION	.00
TOTAL TAXABLE VALUATION	.00
PRELIMINARY OVERDUE	.00
SPECIAL ASSESSMENTS	.00
CODE VIOLATIONS	.00
TOTAL TAX & SPEC. ASSMNT. DUE	.00
PERSONAL EXEMPTIONS	.00
PAYMENTS TO DATE/CREDITS	.00
NET TAX & SPEC. ASSMNT. DUE	.00
TAX PAYMENTS DUE BY 08/01/2017	1,250.00
TAXES DEFERRED	.00
FEES	.00
INTEREST	.00

IMPORTANT: SEE REVERSE SIDE FOR IMPORTANT INFORMATION

You may be eligible to defer your tax payment.

You are eligible to defer paying your property taxes if you are over the age of 65, own and occupy your home solely for residential purposes, and owe less than 60 percent of your home's total full valuation in mortgages, deferred taxes, and accrued interest.

If you defer paying your property taxes, deferred taxes will accrue 2.5 percent interest each year. But you will not have to pay back the taxes or interest until you sell your home or you and your spouse pass away and leave the house to an heir.

To defer your taxes this year, check the box under your total due.

TOTAL DUE
Pay by 04/01/2023 $1,250.00

OR defer paying this amount by checking the following box:

I wish to defer my taxes for this quarter and the rest of this fiscal year. I certify that I am eligible, and that my outstanding mortgages, deferred taxes, and accrued interest do not exceed 60 percent of the total full valuation of my house as stated above. ☐

TOTAL DUE Pay by 04/01/2023	$1,250.00
OR defer paying this amount by checking the following box: I wish to defer my taxes for this quarter and the rest of this fiscal year. I certify that I am eligible, and that my outstanding mortgages, deferred taxes, and accrued interest do not exceed 60 percent of the total full valuation of my house as stated above.	☐

Source: Author's illustration.

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On average, homeowners ages 65+ in MA could defer about $5,000 per year.

Average Property Value, Average Property Taxes, and Median Income for MA Households Ages 65+, Statewide and Highest and Lowest Counties, 2021

County	Property value	Property tax	Median income (before taxes)
Statewide average	$554,573	$4,919	$70,500
Lowest county (Berkshire)	328,173	3,627	53,200
Highest county (Middlesex)	738,217	5,956	83,300

Source: U.S. Census Bureau. *American Community Survey,* 2022.

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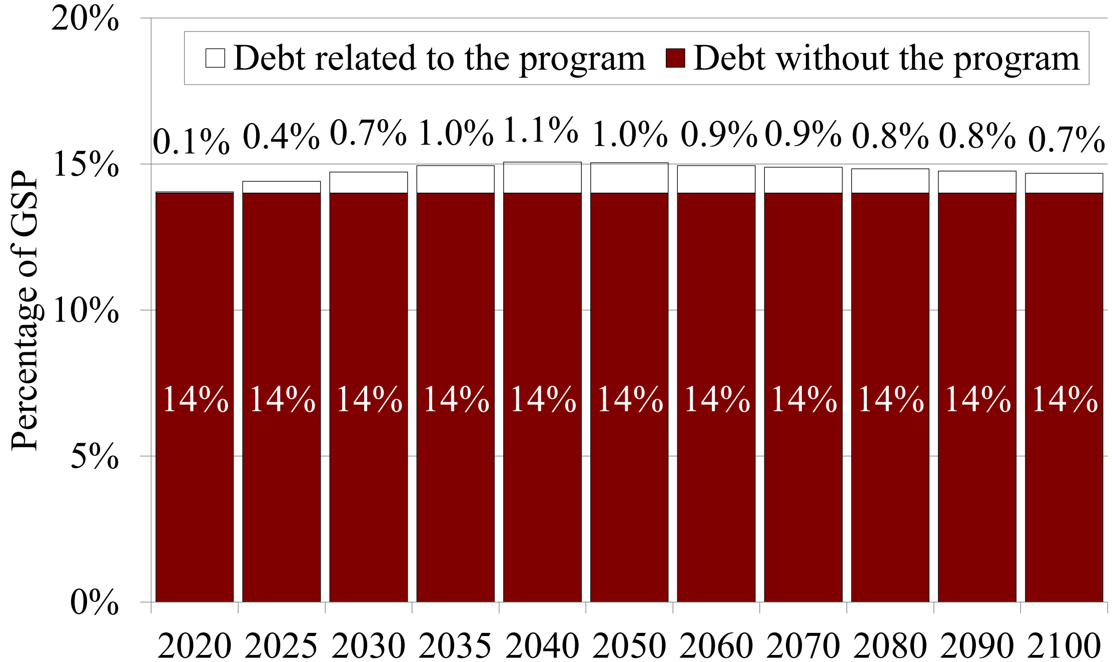
And property tax deferral is a better way to access home equity than a reverse mortgage.

- Simpler: deferral programs do not require a lengthy application process or mandatory counseling.
- Cheaper: deferral programs have no up-front costs, and interest rates would likely be lower.
- For full disclosure, reverse mortgages offer one advantage: access to more home equity.

Deferrals are cost neutral at household level, but pose a cash-flow issue for government.

Massachusetts Debt Relative to Gross State Product With and Without the Program, Assuming 20-Percent Participation Rate, 2020-2100



Sources: Commonwealth of Massachusetts, *Comprehensive Annual Financial Reports,* Fiscal Years 2001-18; Federal Reserve Bank of St. Louis. 2018. "Total Gross Domestic Product for Massachusetts." U.S. Bureau of Economic Analysis; and authors' projections.

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How to proceed?

- This idea has received an enthusiastic response from policymakers and public finance experts.

- Several MA legislators have filed bills to adopt the approach, including a pilot program to test it out.

- To date, though, nothing has been enacted; COVID didn't help, and we're not very good lobbyists!

- I'm sure it's possible to improve on the policy design, and clearly we need help on legislative strategy.

Now let's turn to legacy debt – what is it and why does it matter?

- Legacy debt is the leftover cost from the start-up of retirement programs.
- Legacy debt makes today's benefits look more expensive than they are and distorts debates over financing.
- The question is how to deal with legacy debt in today's retirement systems.

Starting with Social Security, the "poster child" for legacy debt is Ida May Fuller.

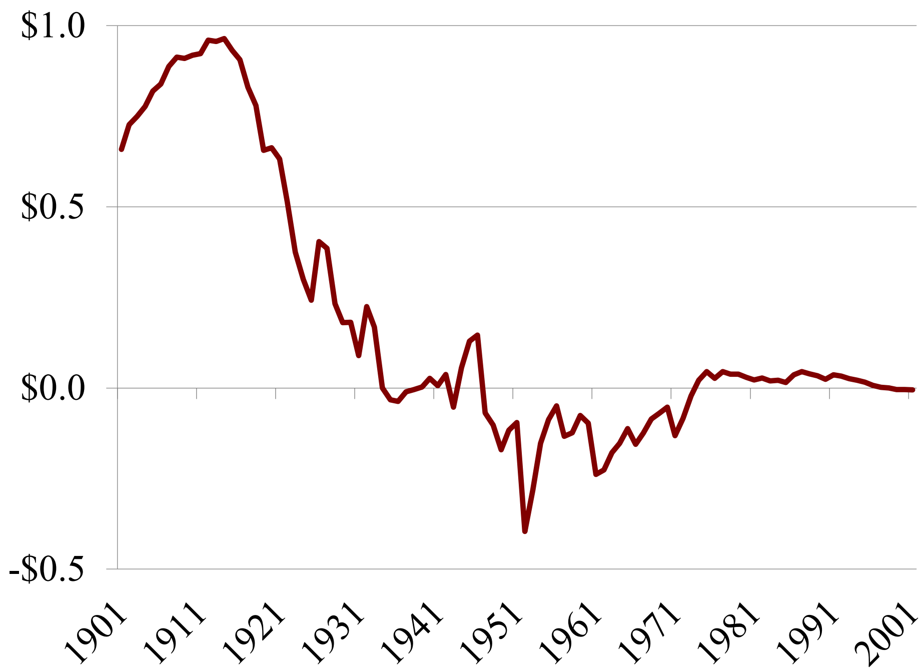
Ida May Fuller. Photo: St. Augustine Record.

Fuller paid $25 in total Social Security taxes and received $23,000 in benefits over her lifetime.

Source: Larry DeWitt. 1996. "Details of Ida May Fuller's Payroll Tax Contributions." Research Note 3. U.S. Social Security Administration.

Giving benefits far in excess of contributions made it impossible for Social Security to accumulate a trust fund.

Benefits in Excess of Contributions Under Current Law, by Birth Cohort, Trillions of 2016 Dollars



Source: Alicia H. Munnell, Wenliang Hou, and Geoffrey T. Sanzenbacher. 2019. "The Implications of Social Security's 'Missing Trust Fund.'" *Issue in Brief* 19-9. Center for Retirement Research at Boston College.

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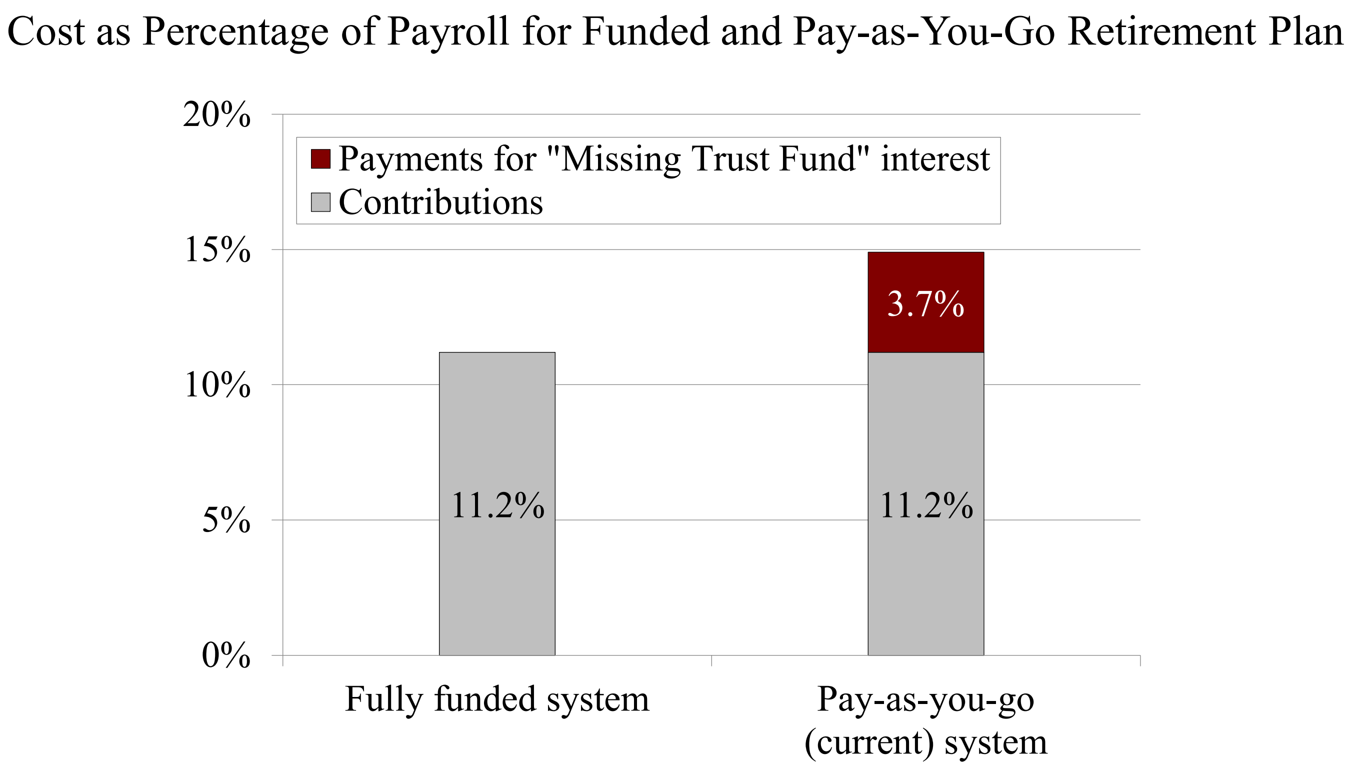
The missing trust fund, mostly due to the legacy debt, has big cost implications.



Note: The fully funded system assumes contributions from ages 22 to 65 that accrue interest at a real rate of 2.3 percent with assets used to buy an actuarially fair annuity at age 65.
Source: Alicia H. Munnell. 2023. "Social Security's Financial Outlook: The 2023 Update in Perspective." *Issue in Brief* 23-9. Center for Retirement Research at Boston College.

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So, while today's payroll tax would almost cover current benefits in a funded system, the missing trust fund means more is needed.

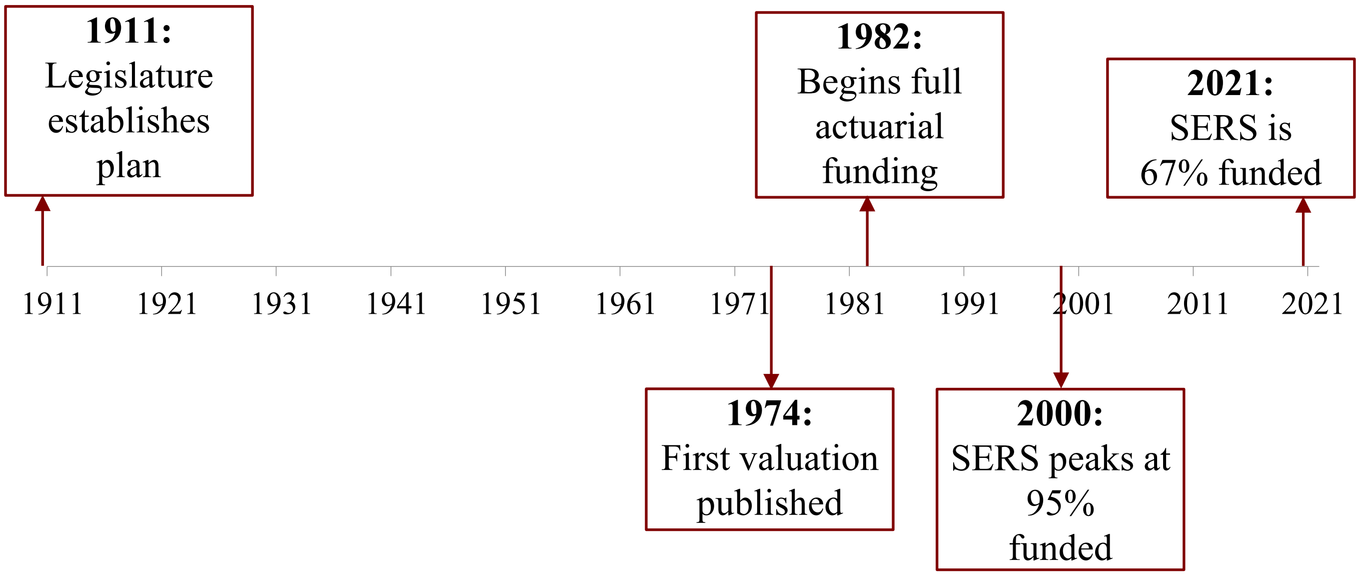
To address this need, two main options exist:

1. Current law would require workers to pay the permanently higher payroll tax of 3.7 percent to make up for the missing trust fund.

2. But a better alternative is to transfer the legacy burden to the whole population by raising general revenues.

Let’s turn to states, which have paid benefits since the early 1900s but adopted modern actuarial funding only in the ’70s and ’80s.

Timeline of Key Funding Events for MA SERS, 1911-2021



Source: Jean-Pierre Aubry. 2022. “Forensic Analysis of Pension Funding: A Tool for Policymakers.” *State and Local Plans Issue in Brief* 83. Center for Retirement Research at Boston College.

Of course, even after states shifted to modern actuarial funding, their unfunded liabilities continued to grow due to:

- poor investment returns relative to expectations;
- changes to actuarial assumptions;
- actual experience of plan members relative to expectations; and
- benefit increases in the ‘80s and ‘90s (to a lesser extent).

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But legacy debt accounts for a big share of unfunded liability in many troubled systems.

Legacy Debt and Unfunded Liability for a Sample of
Poorly Funded Retirement Systems, 2019, Billions of Dollars

State	Retirement system	Legacy debt	Unfunded liability	Legacy debt/ unfunded liability
CT	SERS	$9.1	$22.3	41%
CT	Teachers	6.2	13.1	47
IL	SERS	12.6	30.3	42
IL	Teachers	30.1	78.0	39
IL	Universities	13.1	26.8	49
MA	SERS	6.8	15.4	44
MA	Teachers	9.8	26.0	38
OH	PERS	16.8	22.8	74
OH	School Employees	2.2	6.0	37
OH	Teachers	16.4	22.3	74
PA	School Employees	5.4	44.1	12
PA	State ERS	7.3	22.4	33
RI	ERS	0.9	5.3	17
Average		$10.5	$25.8	42%

Source: Jean-Pierre Aubry. 2022. "Forensic Analysis of Pension Funding: A Tool for Policymakers." *State and Local Plans Issue in Brief* 83. Center for Retirement Research at Boston College.

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Ignoring legacy debt causes problems in a modern actuarial framework.

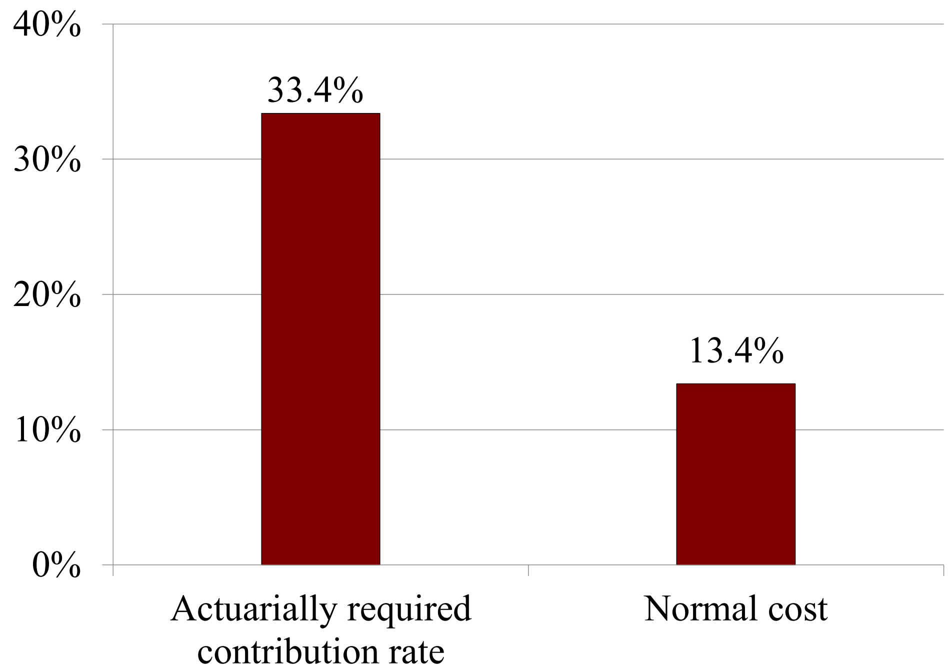
1. It places most of the burden on the current generation, which is no more responsible for the legacy debt than any other.

2. It makes the unfunded liability look overwhelming, encouraging long amortization periods and high assumed investment returns to value liabilities.

3. It makes currently promised benefits look more expensive than they are.

Amortization payments make benefits look more than twice their current cost.

Actuarially Required Contribution Rate vs. Normal Cost for State and Local Government Pension Plans, 2021



Source: Public Plans Database. 2021. Center for Retirement Research at Boston College, MissionSquare Research Institute, National Association of State Retirement Administrators, and the Government Finance Officers Association.

Addressing these problems requires a new approach to funding policy.

1. Recognize the unique aspect of legacy liabilities by separating them and spreading the cost over multiple generations;

2. Treat unfunded liabilities and normal costs as fixed and variable costs, respectively; and

3. Adopt modern finance techniques by using the average yield on investment-grade municipal bonds (adjusted for the tax-exemption) to calculate liabilities and required contributions.

How to proceed?

- It's hard to get the legacy debt issue into debates over how to fix Social Security.
  - The press and public are not interested.
  - It's very complicated for Congressional debates.

- At the state level, some progress has been made with CT SERS and TRS.
  - And studies have already been done for states with the biggest problem.
  - Need to convince policymakers and practitioners to adopt the new approach.

The final topic is making tax incentives for retirement saving fairer and smaller, and use the savings to help fund Social Security.

- Current tax advantages for retirement saving favor high earners, and even a fairer system would do little to generate new saving.
- An obvious fix is to change the deduction to a credit and gradually reduce the credit, freeing up revenue that could go to Social Security.
- But high earners could always switch to Roths to avoid any cut in tax benefits, providing a strong rationale for getting rid of Roths.
- Let's go through this argument one step at a time.

The tax code aims to boost saving through Roth and traditional 401(k)s/IRAs. Assuming equal tax rates, they offer identical benefits.

Roth		Traditional
$(1+r)^n\,(1-t)\ \$1{,}000$	$=$	$(1-t)\ \$1{,}000(1+r)^n$

These, and other, tax breaks for retirement saving are expensive.

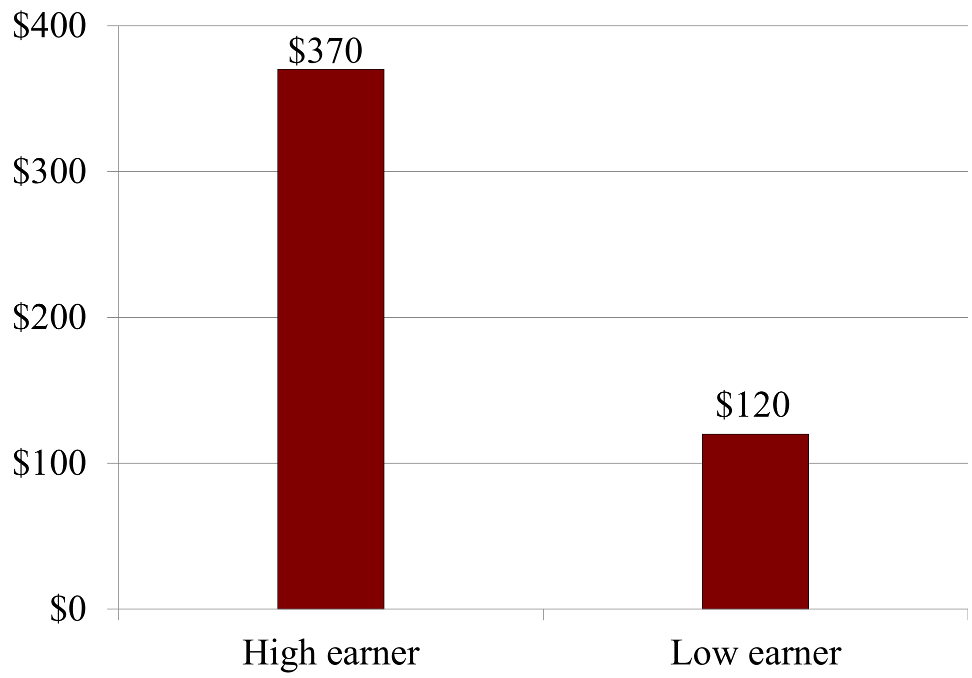
Present Value of Tax Expenditures for Retirement Saving, Calendar Year 2022, in Billions

Plan	Tax expenditures
Defined benefit	$81.1
Defined contribution	184.6
IRAs (contributions, earnings, and non-deductible earnings)	2.8
Exclusion of Roth earnings and distributions	0.4
Exclusion of contributions and earnings for self-employed plans	7.7
Total	$276.6

Source: Office of Management and Budget. 2023. *Budget of the U.S. Government FY 2024, Analytical Perspectives*.

And the system favors high earners, who get a much bigger bang for their buck.

Amount of Tax Relief for Each $1,000 in Qualified Retirement Saving



Note: High earner is assumed to be in the 37-percent bracket; low earner in the 12-percent bracket.

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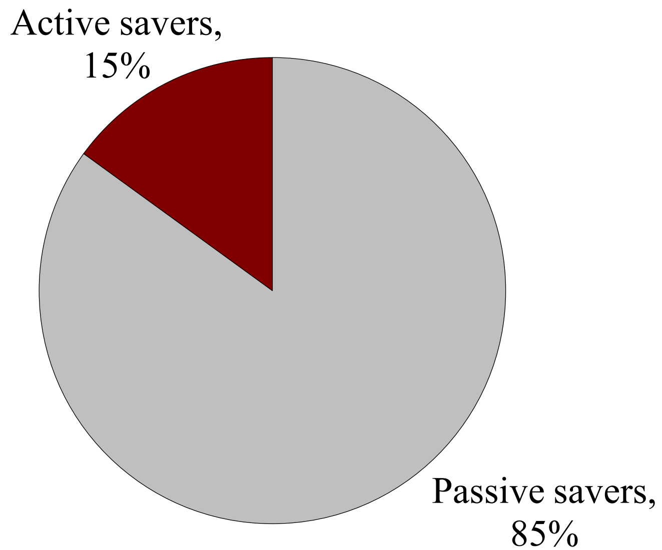
Even if the system were more equitable, tax incentives do not affect saving much.

Estimated Percentage of Passive and Active Savers Among Sample of Danish Taxpayers



Source: Raj Chetty, John N. Friedman, Soren Leth-Petersen, Torben Heien Nielsen, and Tore Olsen. 2013. "Subsidies vs. Nudges: Which Policies Increase Saving the Most?" *Issue in Brief* 13-3. Center for Retirement Research at Boston College.

In response, some have proposed restructuring and/or trimming tax breaks.

- Experts have suggested replacing the deduction with a flat-rate credit.
- President Biden’s campaign made such a proposal, with a revenue-neutral credit rate of 26 percent.
- But this policy wouldn’t affect Roths, so high earners could simply shift their contributions to evade this reform.
- For this reason alone, it would be helpful to get rid of Roths.

Roths also have two other drawbacks. First, they are used as a federal budget gimmick.

The SECURE 2.0 Act gets its revenue offsets from "Rothification."

Revenue reductions in SECURE 2.0	$ (millions)	% of total
Saver's credit match	$9,318	18%
Age increase for required minimum distributions	7,047	14
Auto-enrollment for new 401(k)s	5,089	10
Tax credits for employers	3,539	7
Other	25,465	50
Total	$50,458	100%

Revenue increases ("offsets") in SECURE 2.0	$ (millions)	% of total
Roth required for catch-up contributions	$16,637	33%
Roth allowed for employer matches	13,652	27
Roth treatment of emergency savings plans	12,228	24
Roth allowed for SIMPLEs & SEPs	832	2
Other	7,677	15
Total	$51,026	100%

Source: Joint Committee on Taxation. 2022. "Estimates of SECURE 2.0."

And, second, Roth IRAs provide the very wealthy with a big tax dodge.

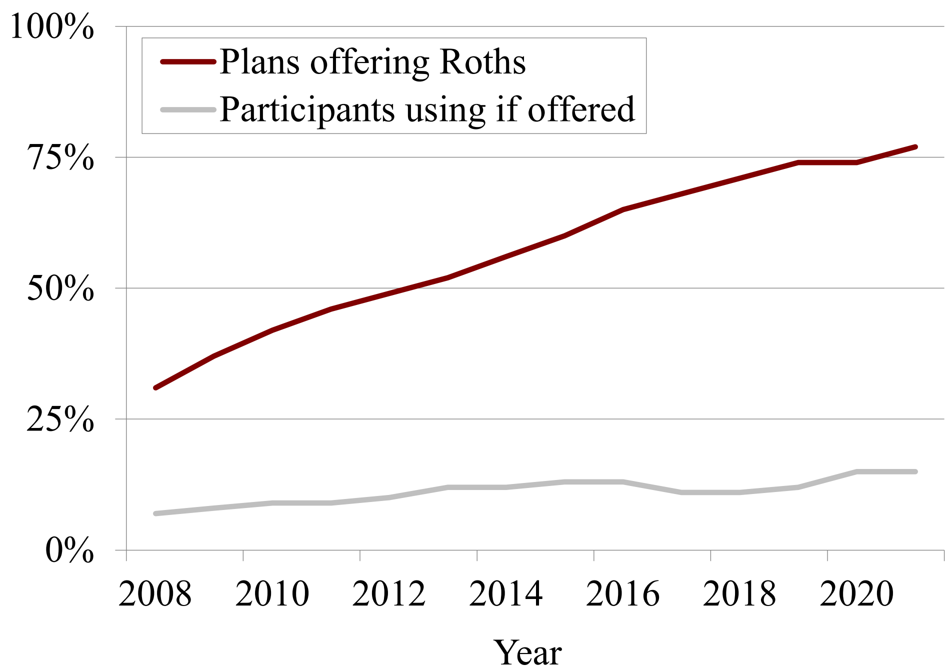
IRA Accounts with $5 Million or More, 2019

IRA balances (millions)	Number of taxpayers	Aggregate balances (billions)	Average balance (millions)
$5-$10	24,990	$160	$6.4
$10-15	2,275	27	11.8
$15-25	853	16	18.7
$25 or more	497	77	154.1
Total	28,615	$280	$9.8

Note: Numbers are rounded.
Source: Thomas A. Barthold. 2021. "Revenue Estimate Memorandum." Joint Committee on Taxation.

So, many reasons exist for getting rid of Roths, and they are not that entrenched.

Percentage of 401(k) Plans Offering Roth 401(k)s and
Percentage of Take-up by Plan Participants, 2008-2021



Sources: Vanguard. 2012-2022. "How America Saves."

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With Roths gone, the next step could be reducing the credit and redirecting the savings.

- Over time, a tax credit system with a 26-percent rate could be gradually reduced to 12 percent.

- As a result, the government would have substantial extra tax revenue, which could be used to help cover the legacy cost in the Social Security system.

- Such an infusion of revenue into Social Security would minimize the payroll tax increase needed to restore long-term solvency.

How to proceed?

Policymakers and practitioners would need to be convinced that:

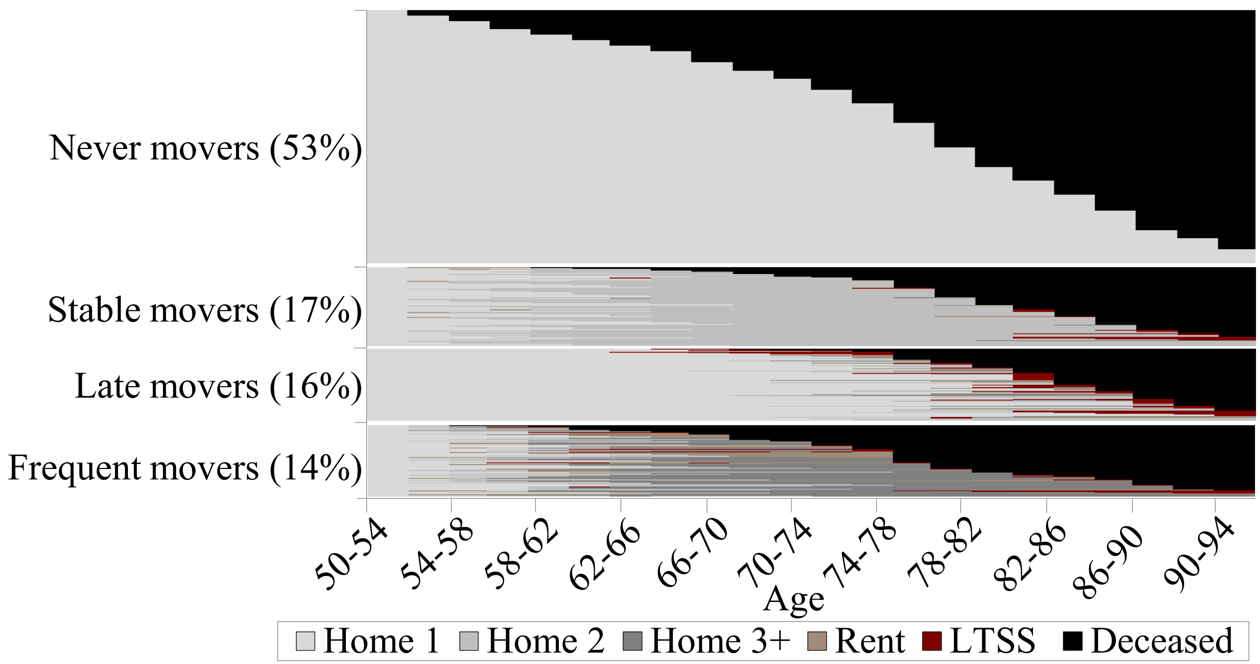
- Roths do more harm than good;
- tax incentives do not increase saving; and
- moving revenues from tax incentives to Social Security would strengthen the overall retirement system.

Conclusion

- Tax policy can strengthen retirement security by:
  - encouraging widespread use of property tax deferral;
  - addressing the legacy debt that distorts the policy debates over Social Security and state and local pensions; and
  - making tax breaks for retirement saving fairer and smaller, while directing the additional revenue to Social Security.
- And tax guys are great!

High participation rates are feasible, in part because most households 50+ don't move.

Sequence Groups for Home-owning Households, Ages 50 and Over



Source: Alicia H. Munnell, Abigail N. Walters, Anek Belbase, and Wenliang Hou. 2020. "Are Homeownership Patterns Stable Enough to Tap Home Equity?" Working Paper 2020-7. Center for Retirement Research at Boston College.

To get to a post-Roth world, two other issues need to be addressed.

- First, state auto-IRA programs use Roths so low and moderate earners can withdraw contributions tax free for emergencies.
  - But traditional IRAs can work as it is now a bit easier for workers to make limited penalty-free withdrawals.
  - And the new refundable Saver's Credit will boost saving incentives generally.

- Second, moving the tax system from deductions to credits could result in clever lawyers creating DB plan alternatives.
  - Thus, some parallel changes to DBs would be needed.

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