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Retirement Security for Latinos:

Bolstering Coverage, Savings and Adequacy

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Retirement Security for Latinos:

Bolstering Coverage, Savings and Adequacy

By Peter R. Orszag and Eric Rodriguez

Introduction

Too many Americans — and too many Latinos* in particular — are not saving adequately for retirement. Half of all households nearing retirement have only $10,000 or less in an employer-based 401(k)-type plan or Individual Retirement Account (IRA). Among Hispanics, the figures are even more astonishing: over half of Hispanic households aged 55 to 59 have *no* accumulated assets in a 401(k) or IRA. A variety of other measures confirm that Latinos are disproportionately likely to be under-saving. Only one in two Hispanics has a basic transaction account, such as a checking or savings account. When surveyed, 43 percent of Hispanic workers described their personal knowledge of investing or saving for retirement as "knowing nothing," compared to 12 percent for all workers.[1]

According to the U.S. Census Bureau, Hispanic Americans are the fastest growing segment of the population at or near retirement. The number of Hispanics aged 65 and over will increase from 1.7 million in 2000 to a projected 15.2 million by 2050. As a share of the retirement age population, Hispanics will increase from 4.9 percent in 2000 to a projected 17.5 percent in 2050.[2]

Although the challenge of under-saving among Latinos may seem substantial, a growing body of empirical evidence points the way to a solution. Three common sense, empirically supported steps to increase retirement saving include:

- *Making it easier to save.* Work, family, and other more immediate demands often distract workers from the need to save and invest for the future. Those who do take the time to consider their choices find the decisions quite complex: individual financial planning is seldom a simple task. In the face of such difficult choices, many people simply procrastinate and thereby avoid dealing with the issues altogether, which dramatically raises the likelihood that they will not save enough for retirement. Disarmingly simple concepts — such as changing the default options in 401(k) plans and making it easy to save part of an income tax refund — have the potential to cut through this Gordian knot and improve retirement security through a set of common sense reforms. The evidence described below suggests that such changes may have particular benefit for Latino workers.

- *Increasing the incentives to save.* The federal tax system provides little incentive for participation in tax-preferred saving plans to middle- and lower-income households, those who need most to save more for retirement and whose contributions would most likely represent an actual increase in savings. Furthermore, the rules governing many means-tested government programs entail steep implicit taxes on saving, further diminishing any incentive for moderate- and low-income households to save. Savings incentives can be strengthened by revamping the Saver's Credit, which helps to correct the "upside-down" structure of tax incentives for retirement saving, and by reforming the asset tests associated with means-tested programs. These reforms may be especially effective at bolstering incentives for Hispanics to

Over half of Hispanic households aged 55 to 59 have no accumulated assets in a 401(k) or IRA.

* The terms "Latino" and "Hispanic" are used interchangeably by the U.S. Census Bureau and throughout this report to identify persons of Mexican, Puerto Rican, Cuban, Central and South American, Dominican, and Spanish descent; they may be of any race. Similarly, the use of the term "White" in this report denotes "non-Hispanic White."

save; Hispanics on average have lower incomes than others and therefore currently receive little or no incentive to save from the tax code, while being more likely to face steep implicit taxes on savings from asset tests. Data from the Census show, for example, that 53 percent of all Hispanic workers reported less than $25,000 in earnings in 2001, but only 25 percent of non-Hispanic Whites earned as little.[3]

- *Promoting financial counseling*. Targeted and tailored financial counseling appears to be an effective means to encourage retirement savings and sound investment choices, especially for middle- and lower-income workers. Yet the majority of workers have not even attempted to figure out how much they will need to save for retirement. Possible options to improve financial counseling and education for middle- and lower-income workers include grants to community tax preparation sites to provide opportunities for individual retirement savings counseling and assistance (perhaps in the form of a tax credit) to employers who provide employees with access to an independent financial counselor once a year.

This paper has five sections. The first section documents retirement savings and adequacy trends among Latinos. The second section explores ways of making it easier for Latinos to save. The third section examines reforms to increase the incentives for Hispanics to save. The fourth section discusses the importance of financial education in this effort to bolster retirement savings for the Latino community. The final section offers conclusions.

Retirement Savings and Adequacy Among Latinos

Latinos face particular challenges in preparing for retirement. Only about a quarter of Hispanic workers participated in an employer-provided pension plan in 2001, compared to about half of the overall workforce.[4] This low level of pension participation represents a threat to Latino retirement security.

The lower rate of Hispanic pension participation persists even within earnings, age, and firm size categories. For example, Table 1 shows that pension participation in 2003 was significantly lower for Hispanic workers than for White workers within any earnings category. (Note that native-born Hispanics had participation rates that were significantly higher than nonnative-born Hispanics. Participation rates for native-born Hispanics were only somewhat lower than those for White workers within the same earnings category.) Similar patterns emerge within age categories and within firm size categories.

Data on accumulated assets in 401(k)s and IRAs also point to lower retirement savings among Hispanics, including within any given income category. Table 2, which is based on data from the 2001 Survey of Consumer Finances, shows the average 401(k) and IRA balance and the median balance for all households and for Hispanic-headed households. Among all households, the median balance held in these types of retirement accounts was $600; the average was $53,670. Among Hispanics, the median was zero and the average was $10,480. The table also shows that asset balances for Hispanics are significantly lower in any given income category: among households with incomes between $50,000 and $75,000, for example, the average balance for all households was more than $50,000; among Hispanics, the average was only a little more than $12,000. The very modest account balances held by Latinos underscores the fundamental challenge of boosting retirement savings specifically for Latinos. Even when Latinos are participating in retirement savings vehicles, they do not take advantage of these options to the extent that they could. Making saving easier could increase retirement security for the Latino community.

Part of the explanation for the sharp differences in Table 2 is the lower rate of participation in 401(k)s and IRAs among

Only about a quarter of Hispanic workers participated in an employer-provided pension plan in 2001, compared to about half of the overall workforce.

Table 1: Pension participation rates for wage and salary workers ages 21 - 64, 2003

Annual earnings	White	Hispanic Native-born	Nonnative-born	**All Hispanic**
Less than $15,000	17%	14%	6%	**9%**
$15,000-$29,999	44	35	21	**26**
$30,000-$49,999	65	59	41	**50**
$50,000 or more	75	73	58	**66**
All	53	41	22	**29**

Source: Craig Copeland, "Employment-Based Retirement Plan Participation: Geographic Differences and Trends," Employee Benefit Research Institute, Issue Brief No. 274, October 2004

Table 2: Assets held in 401(k)s and IRAs

Income class (thousands of 2000 dollars)	All households		**Hispanic households**	
	Average	Median	**Average**	**Median**
Less than 10	$2,572	$0	**$159**	**$0**
10-20	4,200	0	**2,331**	**0**
20-30	10,763	0	**1,383**	**0**
30-40	23,252	200	**6,896**	**0**
40-50	24,909	2,000	**15,404**	**0**
50-75	50,868	15,700	**12,136**	**900**
75-100	73,638	28,500	**34,655**	**7,000**
100-200	160,626	62,000	**61,293**	**58,000**
200-500	324,617	164,000	*	*
500-1,000	731,549	300,000	*	*
More than 1,000	718,832	308,000	*	*
All	53,670	600	**10,480**	**0**

Source: Authors' analysis of 2001 Survey of Consumer Finances
* Inadequate sample sizes

Latinos. Even among those with accounts, however, a significant difference generally remains. In other words, Hispanics are less likely to participate in 401(k)s and IRAs, and those Latinos who do participate typically contribute less than other participants. Table 3 shows the accumulated account balances for all households and for Hispanics when the analysis is restricted to those with an account. As the table shows, Hispanic households with a 401(k) or IRA tend to have significantly lower accumulated balances than all households with an account. For example, between $50,000 and $75,000 in income, the average balance for all households was more than $58,000; the average for Hispanics was under $23,000.

Finally, part of the explanation for the differences highlighted in Table 2 may reflect the age distribution of Hispanics compared to the overall population. Latinos are a younger population comparatively. But even among those aged 55 to 59, and therefore on the verge of retirement, Latino account balances are significantly lower than for other households. Small sample sizes do not permit a full presentation of all income categories, but Table 4 shows the figures for all incomes combined. Among all households in this age range, the median combined 401(k)-IRA balance was $10,400; among Latino households in the same age range, the median was zero. In other words, *the majority of Hispanic households aged 55 to 59 and therefore on the verge of retirement had nothing accumulated in either a 401(k) or an IRA.* Similarly, among all households in this near-retirement stage, the average combined 401(k)-IRA balance was almost $120,000; among Hispanics, it was just over $35,000.

This low level of pension accumulation means that Social Security benefits dominate as a source of income for retired Latinos. According to the Pew Hispanic Center, 76 percent of elderly Hispanics who receive Social Security benefits rely on those benefits for the majority of their income.[5] Perhaps even more astonishingly, Social Security benefits represent the *only* source of income for two in five (41 percent) of elderly Hispanic beneficiaries.[6] This is twice the percentage for all elderly beneficiaries, where 20 percent rely exclusively on Social Security – still too high a share, but much lower than among Latino beneficiaries.

Rigorous economic analysis also suggests disproportionate under-saving among Hispanics. For example, Engen, Gale, and Uccello incorporate the implications of uncertain wages into their analysis of retirement savings adequacy.[7] The analysis recognizes that because a household's future income is uncertain, the level of current assets necessary to live comfortably in retirement is also uncertain. They therefore generate a distribution of optimal wealth targets relative to earnings for narrow classifications of households (separated

Table 3: Assets held in 401(k)s and IRAs for those with an account

Income class (thousands of 2000 dollars)	All households		**Hispanic households**	
	Average	Median	**Average**	**Median**
Less than 10	$798	$300	*	*
10-20	13,071	3,200	*	*
20-30	15,761	4,000	**3,215**	**2,100**
30-40	34,890	9,200	**16,441**	**5,000**
40-50	34,971	14,000	**36,836**	**24,000**
50-75	58,848	29,000	**22,831**	**15,000**
75-100	85,526	60,850	**22,488**	**12,000**
100-200	164,449	91,000	**100,183**	**101,000**
200-500	408,992	231,200	*	*
500-1,000	799,103	418,000	*	*
More than 1,000	852,102	360,000	*	*
All	94,620	28,500	**38,555**	**14,000**

Source: Authors' analysis of 2001 Survey of Consumer Finances
* Inadequate sample sizes

Table 4: Assets held in 401(k)s and IRAs, households headed by a person ages 55 - 59

Income class (thousands of 2000 dollars)	All households		**Hispanic households**	
	Average	Median	**Average**	**Median**
All	$119,232	$10,400	**$35,050**	**$0**

Source: Authors' analysis of 2001 Survey of Consumer Finances

Social Security benefits represent the only source of income for two in five (41 percent) of elderly Hispanic beneficiaries.

by age, education, pension status, marital status, and current wage). They then compare actual wealth-earnings ratios to the simulated optimal targets, and see what share of households are above the median simulated optimal target. If every household were saving the right amount for retirement, and the Engen-Gale-Uccello model were exactly correct, half of households should have wealth-earnings ratios in excess of the median simulated optimal ratio for their household type. To undertake these comparisons, the authors apply three definitions of "wealth." "Broad wealth" is equal to all net worth other than equity in vehicles.[8] "Narrow wealth" is broad wealth excluding equity in the household's primary residence. "Intermediate wealth" is broad wealth excluding one-half of the household's equity in its primary residence.

Table 5 shows the Engen-Gale-Uccello results using the 2001 Survey of Consumer Finances for all households and for Latino households. As the table shows, much smaller percentages of Latino households than other households are at or above their median simulated optimal wealth-earnings ratio. For example, using the narrow wealth measure, 52 percent of all households are at or above the median simulated wealth-earnings ratio for their household type. Among Hispanic households, however, under 20 percent are at or above the median. In other words, under this more rigorous analysis, as under the simple asset calculations above, Latinos appear to be disproportionately saving inadequately for retirement.

According to official projections, Hispanics have higher life expectancy than other Americans (Table 6). At age 22, for example, Hispanics have a life expectancy of 60 years — three years longer than White non-Hispanics and more than seven years longer than Black non-Hispanics. At age 65, Hispanics have a life expectancy of more than 21 years, again significantly longer than non-Hispanics. Such relatively long life expectancies for Latinos reinforce the concerns about their savings adequacy:

Table 5: Percent of households at or above median simulated wealth-earnings ratio

	All	**Hispanics**
Narrow wealth	52.3%	**19.6%**
Intermediate wealth	61.0	**32.3**
Broad wealth	68.8	**41.0**

Source: Engen-Gale-Uccello analysis of 2001 Survey of Consumer Finances

Table 6: Life expectancy (number of years of additional expected life at given age)

Age	White, non-Hispanic	Black, non-Hispanic	**Hispanic**
22	57.0	52.7	**60.1**
65	18.3	17.1	**21.3**

Source: U.S. Census Bureau, 2004 Life Tables, from Projections of the United States by Age, Sex, Race, Hispanic Origin, and Nativity: 1999-2100 longer life expectancies, unless offset by later retirements, increase the accumulated assets needed in order to live comfortably throughout retirement. Studies like that of Engen-Gale-Uccello assume that Latinos have the same life expectancy as other people; to the extent that Latinos actually have longer life expectancies, their retirement saving adequacy is even worse than what is presented in Table 5.

In evaluating the official life expectancy figures, it should be noted that researchers have raised questions about the longer-than-average life expectancies among Latinos. In particular, life expectancy for native-born Hispanics appears to be similar to that of non-Hispanics. The differential shown in Table 6 appears to arise solely from non-native-born Hispanics, and it is possible that the life expectancy differential for non-native-born Hispanics reflects measurement errors.[9]

The bottom line is that too many Latino families are failing to save adequately for retirement. As a recent NCLR issue brief concluded, "Policy-makers who purport to have an interest in opening the doors of economic opportunity for Latinos should ensure that the U.S. pension system works for all American workers and take steps to create more avenues for Hispanic workers to participate…With targeted policy interventions these pathways to prosperity can be enhanced for Hispanic workers, and only then will we begin to constructively address the disparity in wealth between Latino and other American families."[10]

In the rest of this paper, we explore several common sense reforms that would help to address the under-saving among Latinos highlighted by the data presented above. In particular, we present three key dimensions along which even relatively small steps could potentially translate into substantial improvements in Latino retirement security: making it easier to save, increasing the incentives to do so, and strengthening financial education.

Making It Easier to Save

The trend over the past two decades away from the traditional, employer-managed plans and toward savings arrangements directed and managed largely by the employees themselves, such as 401(k)s and IRAs, is in many ways a good thing. Workers enjoy more freedom of choice and more control over their own retirement planning. But for too many households, the 401(k) and IRA revolution has fallen short. As the first section of the paper demonstrates, a significant number of the households left behind are Hispanic.

To address this problem, policy-makers and corporate leaders should make it easier for households, including Hispanic households, to save for retirement. Two key steps that would move in this direction involve automating 401(k) plans and allowing part of tax refunds to be directly deposited into IRAs.

Automating the 401(k)

A 401(k)-type plan typically leaves it up to the employee to choose whether to participate, how much to contribute, which of the investment vehicles offered by the employer to invest in, and when to pull the funds out of the plan and in what form (in a lump sum or a series of payments).[11] Workers are thus confronted with a series of financial decisions, each of which involve risk and calls for a certain degree of financial knowledge. Many workers shy away from these burdensome decisions and simply do not choose. Those who do choose often make poor choices. Among those covered, many do not participate. Among those who participate, many contribute little to their accounts, and others take the money out before reaching retirement age. And workers often do not follow the most basic norms of prudent asset allocation. Many overinvest in their own companies'

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stock: in plans that allow employer stock as an investment option, 46 percent of participants hold more than 20 percent of their account balance in employer stock.[12] This overconcentration in employer stock means that any financial difficulties experienced by the employer could expose an employee not only to lost wages but also a substantial erosion of retirement security. The tendency to overinvest in employer stock further indicates the need for targeted financial education so that workers better understand the risks involved in investing.

To enroll in a 401(k), an eligible employee usually must complete and sign an enrollment form, designate a level of contribution (typically a percentage of pay to be deducted from the employee's paycheck), and specify how those contributions will be allocated among an array of investment options. Often the employee must choose from among 20 or more different investment funds. An employee who is uncomfortable making all of these decisions may well end up without any plan, because the default arrangement — that which applies when the employee fails to complete, sign, and turn in the form — is nonparticipation.

Heavy reliance on self-direction in 401(k) plans made more sense when 401(k) plans were first developed in the early 1980s. At that time, they were mainly supplements to employer-funded defined benefit pension and profit-sharing plans, rather than the worker's primary retirement plan. Since participants were presumed to have their basic needs for secure retirement income met by an employer-funded plan and by Social Security, they were given substantial discretion over their 401(k) choices. Today, despite their increasingly central role in retirement planning, 401(k)s still operate under essentially the same rules and procedures, based on those now-outmoded presumptions. Yet the risks of workers making poor investment choices loom much larger now that 401(k)s have become the primary retirement savings vehicle.

To improve the design of the 401(k), we should recognize the power of inertia in human behavior and enlist it to promote rather than hinder saving. Under an automatic 401(k), each of the key events in the process would be programmed to make contributing and investing easier and more effective.

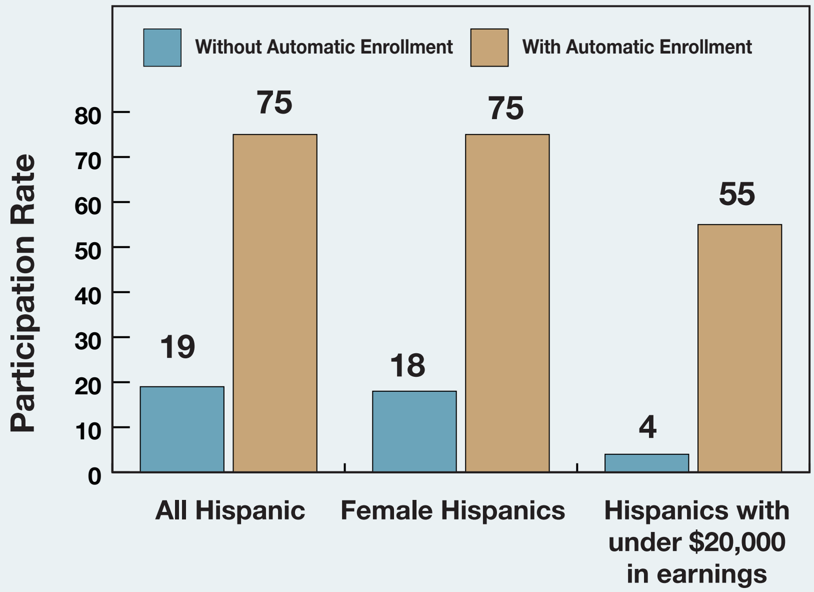
- ***Automatic enrollment:*** Employees who fail to sign up for the plan — whether because of simple inertia or procrastination, or perhaps because they are not sufficiently well organized or are daunted by the choices confronting them — would become participants automatically.

- ***Automatic escalation:*** Employee contributions would automatically increase in a prescribed manner over time, raising the contribution rate as a share of earnings.

- ***Automatic investment:*** Funds would be automatically invested in balanced, prudently diversified, and low-cost vehicles, whether broad index funds or professionally managed funds, unless the employee makes other choices. Such a strategy would improve asset allocation and investment choices while protecting employers from potential fiduciary liabilities associated with these default choices.

- ***Automatic rollover:*** When an employee switches jobs, the funds in his or her account would be automatically rolled over into an IRA, 401(k) or other plan offered by the new employer. At present, many employees receive their accumulated balances as a cash payment upon leaving an employer, and many of them spend part or all of it. Automatic rollovers would reduce such leakage from the tax-preferred retirement savings system. At this stage, too, the employee would retain the right to override the default option and place the funds elsewhere or take the cash payment.

Figure 1: Effect of automatic enrollment among newly hired Hispanic employees



Source: Calculations by Brigitte Madrian, University of Pennsylvania

In each case — automatic enrollment, automatic escalation, automatic investment, and automatic rollover — workers can always choose to override the defaults and opt out of the automatic design. Automatic retirement plans thus do not dictate choices any more than does the current set of default options, which exclude workers from the plan unless they opt to participate. Instead, automatic retirement plans merely point workers in a pro-saving direction when they decline to make explicit choices of their own.

These steps have been shown to be remarkably effective. For example, studies indicate that automatic enrollment boosts the rate of plan participation from a national average of about 75 percent of eligible employees to between 85 and 95 percent.[13] The evidence also suggests that automatic enrollment is particularly effective in boosting participation among Hispanics: among new Hispanic employees, automatic enrollment has increased participation from 19 percent to 75 percent (Figure 1).[14] And even among the lowest earning Hispanic workers, those with earnings below $20,000, automatic enrollment raised participation from 4 percent to 55 percent. Table 7 shows more detail on the effect of automatic enrollment among Hispanics, demonstrating significant increases in participation in each sub-classification.

Despite its demonstrated effectiveness in boosting participation, especially for Hispanics, only a small minority of 401(k) plans today have automatic enrollment. According to a recent survey, 8 percent of 401(k) plans (and 24 percent of plans with at least 5,000 participants) have switched from the traditional "opt-in" to an "opt-out" arrangement.[15] Automatic enrollment is a recent development, and therefore it may yet become more widely adopted over time, even with no further policy changes. But policy-makers could accelerate its adoption through several measures. Some of these policy measures would be appropriate only if automatic enrollment were adopted in conjunction with other features of the automatic 401(k), especially automatic escalation:

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Table 7: Effect of automatic enrollment on newly hired Hispanic workers

	Participation rate without automatic enrollment	Participation rate with automatic enrollment
All Hispanic workers	18.9	75.1
Gender		
Male Hispanics	22.2	75.0
Female Hispanics	17.8	75.2
Age		
Age <20	--	75.0
Age 20-29	9.3	72.8
Age 30-39	20.5	76.7
Age 40-49	37.7	77.8
Age 50-59	33.3	72.7
Compensation		
<$20K	3.5	54.8
$20-$29K	14.7	76.4
$30-$39K	29.4	90.0
$40-$49K	40.0	69.0
$50K+	53.8	80.9

Source: Calculations by Brigitte Madrian, University of Pennsylvania

- First, the law governing automatic enrollment could be better clarified. In some states, some employers see their state labor laws as potentially restricting their ability to adopt automatic enrollment. Although many experts believe that federal pension law preempts such state laws as they relate to 401(k) plans, additional federal legislation to confirm this explicitly would be helpful. Any such explicit preemption should be undertaken only to the extent necessary to protect employers' ability to adopt automatic enrollment.

- Second, some plan administrators have expressed the concern that some new, automatically enrolled participants might demand a refund of their contributions, claiming that they never read or did not understand the automatic enrollment notice. This could prove costly, because restrictions on 401(k) withdrawals typically require demonstration of financial hardship, and even then the withdrawals are normally subject to a 10 percent early withdrawal tax. One solution would be to pass legislation permitting plans to "unwind" an employee's automatic enrollment without paying the early withdrawal tax if the account balance is very small and has been accumulating for a short period of time.

- Third, Congress could give plan sponsors a measure of protection from fiduciary liability if the default investment they have prescribed is an appropriate one, such as a "balanced" mutual fund that invests in both diversified equities and bonds or other stable-value instruments. The exemption from fiduciary responsibility would not be total: plan fiduciaries would retain appropriate responsibility for avoiding conflicts of interest, excessive fees, lack of diversification, and imprudent investment choices. However, it would provide meaningful protection under ERISA (the Employee Retirement Income Security Act of 1974, the principal legislation governing employer pension plans), thus encouraging more employers to consider automatic enrollment.

- Fourth, Congress could establish the federal government as a standard-setter in this arena by incorporating automatic enrollment into the Thrift Savings Plan, the defined contribution retirement savings plan covering federal employees. The Thrift Savings Plan already has a high participation rate, but if automatic enrollment increased participation by even a few percentage points, that would draw in tens of thousands of eligible employees who are not currently contributing. Moreover, the Thrift Savings Plan's adoption of automatic enrollment, along with other elements of the automatic 401(k), would serve as an example and model for other employers.

- Finally, broader adoption of automatic enrollment and the other key pieces of the automatic 401(k) could be encouraged by reforming an exception to the rules governing nondiscrimination in 401(k) plans. Many firms are attracted to automatic enrollment because they care for their employees and want them to have a secure retirement, but others may be motivated more by the associated financial incentives, which stem in large part from the 401(k) nondiscrimination standards. Policy-makers could change the rules to allow the matching safe harbor only for plans that feature automatic enrollment and the other key parts of the automatic 401(k).

In sum, a growing body of evidence suggests that the judicious use of default arrangements — arrangements that apply when employees do not make an explicit choice on their own — holds substantial promise for expanding retirement savings. The effects appear to be particularly promising for Hispanic households, who often have the greatest need to increase their savings. Retooling America's voluntary, tax-subsidized 401(k) plans to make sound saving and investment decisions more automatic, while protecting freedom of choice for those participating, would require only a relatively modest set of policy changes — and the steps taken thus far are already producing good results for those with access but who do not participate or who have low participation rates. Expanding these efforts will make it easier for millions of Hispanic American workers to save, thereby promising greater retirement security.

Allowing Part of a Tax Refund to be Deposited into an IRA

Most American households — including the majority of Hispanic households — receive an income tax refund every year.[16] For many, the refund is the largest single payment they can expect to receive all year. Accordingly, the more than $200 billion issued annually in individual income tax refunds presents a unique opportunity to increase personal savings. Census data show that 3.8 million Hispanic households were eligible for the Earned Income Tax Credit in 2002.[17] Millions more Hispanic households likely received an income tax refund because of over-withholding throughout the year.

Currently, taxpayers may instruct the Internal Revenue Service to deposit their refund in a designated account at a financial institution. The direct deposit, however, can be made to only one account. This all-or-nothing approach discourages many households from saving any of their refund. Some of the refund is often needed for immediate expenses, so depositing the entire amount in a savings account is not a feasible option. Yet directly depositing only *part* of the refund in such an account is not possible.

Allowing taxpayers to split their refund could make saving simpler and, thus, more likely — especially if combined with the stronger incentives to save discussed on the next page. The

Policy-makers could change the rules to allow the matching safe harbor only for plans that feature automatic enrollment and the other key parts of the automatic 401(k).

To improve the financial incentives for households to save, two key steps include strengthening the Saver's Credit and reducing the heavy implicit taxes on savings often imposed through means-tested benefit programs.

Administration has supported divisible refunds in each of its last two budget documents, but the necessary administrative changes have not yet been implemented. The Internal Revenue Service could provide a split refund option by administrative action without the need for legislation. Although implementation does raise a variety of administrative issues, none of these administrative issues appears to present an insuperable obstacle.[18]

Once refund splitting is implemented, a key obstacle that might limit participation is the need to have an IRA to receive the refund. This may be of special concern for Latinos: only 42 percent of Hispanic households even owned an interest-earning account at a financial institution in 2002.[19] If a household does not already have an IRA, an IRA would have to be set up (including choosing a vendor, choosing investments, and taking any other steps necessary to open the account). These steps may be a significant impediment in some cases. One possibility would be to allow taxpayers who do not have an IRA to direct on their tax return that the government open an IRA in their name at a designated "default" financial institution that has contracted with the government to provide low-cost IRAs for this and related purposes. Another possibility, suggested by Professor Peter Tufano of Harvard Business School, is to allow tax filers to elect part of their refund to be invested in a government savings bond, which would not require an IRA to be created in their name.

In summary, allowing households to split their tax refunds and deposit part of them directly into an IRA would make saving easier. Since federal individual income tax refunds total more than $200 billion a year, even a modest increase in the proportion of refunds saved could represent a significant increase in savings.

Increasing Incentives to Save

In addition to making it easier to save, policy-makers should increase the incentives for middle- and lower-income households to do so. A ground-breaking new study from The Retirement Security Project in collaboration with H&R Block shows that the combination of a clear and understandable match for savings, easily accessible savings vehicles, the opportunity to use part of an income tax refund to save, and professional one-on-one assistance could generate a significant increase in retirement savings participation and contributions, even among middle- and lower-income households.[20] The study found that higher match rates significantly raise IRA participation and contributions. Average IRA contributions among those offered a 20 percent or 50 percent match were 4 and 8 times higher, respectively, than in a control group that received no match.

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Strengthening and Expanding the Saver's Credit

For decades, the U.S. tax code has provided preferential tax treatment to employer-provided pensions, 401(k) plans, and IRAs relative to other forms of savings. The effectiveness of this system of subsidies remains a subject of controversy.[21] Despite the accumulation of vast amounts of wealth in pension accounts, concerns persist about the ability of the pension system to raise private and national savings, and in particular to increase savings among those households most in danger of inadequately preparing for retirement.

Many of the major concerns stem, at least in part, from the traditional *form* of the tax preference for pensions. Pension contributions and earnings on those contributions are treated more favorably for tax purposes than other compensation: they are excludible (or deductible) from income until distributed from the plan, which typically occurs years if not decades after the contribution is made. The value of this favorable tax treatment depends on the taxpayer's marginal tax rate: the subsidies are worth more to households with higher marginal tax rates, and less to households with lower marginal rates.[22]

The pension tax subsidies, therefore, are problematic in two important respects. First, they reflect a mismatch between subsidy and need. The tax preferences are worth the least to lower-income families, and thus provide minimal incentives to those households who most need to save more to provide for basic needs in retirement. Instead, the tax preferences give the strongest incentives to higher-income households, who, research indicates, are the least likely to need additional savings to achieve an adequate living standard in retirement.

Second, as a strategy for promoting national savings, the subsidies are poorly targeted. Higher-income households are disproportionately likely to respond to the incentives by shifting existing assets from taxable to tax-preferred accounts. To the extent such shifting occurs, the net result is that the pensions serve as a tax shelter, rather than as a vehicle to increase savings, and the loss of government revenue does not correspond to an increase in private savings. In contrast, middle- and lower-income households, if they participate in pensions, are most likely to use the accounts to raise net savings.[23] Because middle-income households are much less likely to have other assets to shift into tax-preferred accounts, any deposits they make to tax-preferred accounts are more likely to represent new savings rather than asset shifting.

The Saver's Credit, enacted in 2001, was designed to address these problems. The Saver's Credit in effect provides a government matching contribution, in the form of a nonrefundable tax credit, for voluntary individual contributions to 401(k) plans, IRAs, and similar retirement savings arrangements. Like traditional pension subsidies, the Saver's Credit currently provides no benefit for households that owe no federal income tax. However, for households that owe income tax, the effective match rate in the Saver's Credit is higher for those with lower income, the opposite of the incentive structure created by traditional pension tax preferences.

The Saver's Credit is the first and so far only major federal legislation directly targeted toward promoting tax-qualified retirement savings for middle- and lower-income workers. It was enacted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001. In principle, the credit can be claimed by middle- or lower-income households who make voluntary retirement savings contributions to 401(k) plans, other employer-sponsored plans (including SIMPLE plans), or IRAs. In practice, however, the nonrefundability of the credit means it offers no incentive to save to the millions of lower- and middle-income households with no income tax liability.

The matching rates under the Saver's Credit reflect a progressive structure — that is, the rate of government contributions per dollar of private contributions falls as household income rises. This pattern stands in stark contrast to the way tax deductions and the rest of the pension system subsidize savings. The Saver's Credit is currently a small exception to this general pattern: the Treasury Department estimates that the tax expenditures associated with retirement savings preferences in 2005 will total roughly $150 billion, of which only $1 billion is attributable to the Saver's Credit.[24]

The Saver's Credit applies to contributions of up to $2,000 per year per individual. As Table 8 shows, the credit rate is 50 percent for married taxpayers filing jointly with adjusted gross income (AGI) up to $30,000, 20 percent for joint filers with AGI between $30,001 and $32,500, and 10 percent for joint filers with AGI between $32,501 and $50,000. The same credit rates apply for other filing statuses, but at lower income levels: the AGI thresholds are 50 percent lower for single filers and 25 percent

Table 8: Saver's Credit

AGI range for:

Joint filers	Singles	Credit rate	Tax credit for $2,000 contribution	After-tax cost incurred by individual to create $2,000 account balance	Effective after-tax matching rate
0-$30,000	0-$15,000	50%	$1,000	$1,000	100%
$30,001-$32,500	$15,001-$16,250	20%	$400	$1,600	25%
$32,501-$50,000	$16,251-$25,000	10%	$200	$1,800	11%

Source: Authors' calculation using the 2001 Survey of Consumer Finances.

Note: Figures in table assume that couple has sufficient income tax liability to benefit from the nonrefundable income tax credit shown, and do not take into account the effects of tax deductions or exclusions that might be associated with the contributions or any employer matching contributions.

lower for heads of households.
The credit's effect is to correct the inherent bias of tax deductions or exclusions in favor of high-marginal-rate taxpayers. A $100 contribution to a 401(k) by a taxpayer in the 35 percent marginal federal income tax bracket generates a $35 exclusion from income, resulting in a $65 after-tax cost to the taxpayer. In contrast, without the Saver's Credit, a taxpayer in the 15 percent marginal bracket making the same $100 contribution to a 401(k) gets only a $15 exclusion from income, resulting in an $85 after-tax cost. Thus, the tax deduction is worth more to the higher-income household. However, if the lower-income taxpayer qualifies for a 20 percent Saver's Credit, the net after-tax cost is $65 ($100 minus the $15 effect of exclusion minus the $20 Saver's Credit). Thus, the Saver's Credit works to level the playing field by increasing the tax advantage of saving for middle- and lower-income households.

The credit represents an implicit government matching contribution for eligible retirement savings contributions. The implicit matching rate generated by the credit, though, is significantly higher than the credit rate itself. The 50 percent *credit* rate for gross contributions, for example, is equivalent to having the government *match* after-tax contributions on a 100 percent basis. Consider a couple earning $30,000 who contributes $2,000 to a 401(k) plan or IRA. The Saver's Credit reduces that couple's federal income tax liability by $1,000 (50 percent of $2,000). The net result is a $2,000 account balance that costs the couple only $1,000 after taxes (the $2,000 contribution minus the $1,000 tax credit). This is the same result that would occur if the net after-tax contribution of $1,000 were matched at a 100 percent rate: the couple and the government each effectively contribute $1,000 to the account. Similarly, the 20 percent and 10 percent credit rates are equivalent to a 25 percent and an 11 percent match, respectively (Table 8).

Although it is too soon to obtain a definitive reading of the impact of the Saver's Credit, preliminary estimates and evidence can be useful in identifying some basic themes. The nonrefundability of the credit substantially reduces the number of people eligible for it. Further, the low match rates for middle-income households substantially reduce the number of people eligible to receive a significant incentive. Nonrefundability results in a credit that provides no incentives to tens of millions of low-income filers who qualify on paper for the 50 percent credit rate, but who have no income tax liability against which to apply the credit.

In 2005, 59 million tax filers will have incomes low enough to qualify for the 50 percent credit.[25] Since the credit is nonrefundable, however, only about one-seventh of them actually would benefit from the credit *at all* by contributing to an IRA or 401(k).[26] Furthermore, of the 59 million eligible filers, only 43,000 — or fewer than one out of every 1,000 — could receive the maximum credit ($1,000 per person) if they made the maximum contribution. These are the households who have sufficient tax liability to benefit in full from the Saver's Credit but sufficiently low income to qualify for the highest match rate.

For families with somewhat higher incomes, the nonrefundability of the credit poses much less of a problem, since more of these families have positive income tax liabilities. For these families, however, the credit provides only a modest incentive for saving. For example, a married couple earning $45,000 a year receives only a $200 tax credit for depositing $2,000 into a retirement account. This small credit reflects the modest matching rate at that level of income, which provides less incentive to participate.

IRS data indicate that about 5 million tax filers claimed the Saver's Credit in 2002 and in 2003. Calculations based on the Survey of Consumer Finances suggest that Hispanics represent a share of these 5 million filers in rough proportion to their population share. Since Latinos make up roughly 14 percent of the population (without including residents of Puerto Rico), the implication is that at least 685,000 Latinos are benefiting from the Saver's Credit. Moreover, data from H&R Block suggest that a slightly higher share of Latinos benefit from the Saver's Credit than other H&R Block clients. Tax Policy Center data similarly suggest that over 45 percent of the benefits from the current credit accrue to filers with cash income between $10,000 and $30,000 and that a disproportionate share of Latinos are in this income bracket, making the Saver's Credit of important consequence to the Hispanic community. Households with income below $10,000 receive almost none of the benefits, an outcome that reflects the nonrefundability of the credit.

The results of a recent study conducted by The Retirement Security Project confirms the basic idea behind the existing Saver's Credit.[27] The study, which involved randomized assignment of different match rates for contributions made to an IRA by tax filers, shows that offering a stronger incentive to save to middle- and lower-income households can encourage them to contribute significantly more to retirement accounts.[28] The study also suggests, however, that the existing Saver's Credit could be made more effective in encouraging additional contributions. Some options to do so are already under active discussion among policy-makers:

- First, the credit could potentially be made more salient and effective by redesigning it as a matching contribution that goes into the account, rather than a tax credit. As Table 8 shows, the current design results in a substantially higher implicit match rate than the credit rate. Instead of the current design in which a tax credit generates cash for a worker, it may be desirable to have matching contributions made directly to a worker's account.

- Second, in order to reduce the apparent revenue cost, Congress stipulated that the existing credit would sunset at the end of 2006. It would cost between $1 billion and $2 billion a year to make the existing program permanent, which seems relatively

Tax Policy Center data similarly suggest that over 45 percent of the benefits from the current credit accrue to filers with cash income between $10,000 and $30,000 and that a disproportionate share of Latinos are in this income bracket, making the Saver's Credit of important consequence.

The asset tests thus represent a substantial implicit tax on retirement savings — and one that may significantly burden Latino families struggling to save.

modest when the potential impact to increase retirement savings and retirement security among lower-income workers is considered. Given that many Latinos qualify for the Saver's Credit, extending and strengthening the credit could help to develop retirement savings for the fastest growing minority population.

- Third, as noted, tens of millions of lower-income workers are unable to benefit from the existing program because the credit is nonrefundable. The incentives provided by a matching program for retirement contributions should be extended to lower-income working families. Doing so, which would cost perhaps $2 billion to $3 billion per year if based on the current design, would help equalize the tax benefits of saving for higher- and lower-income households, leveling the playing field between income tax payers and workers who pay payroll tax but have no income tax liability. Extending the matching contributions in this manner would significantly benefit lower-income earners, with almost 38 percent of the tax benefit accruing to individuals and families with $20,000 or less in cash income. A disproportionate share of the benefit would likely flow to Hispanic families as many are working in low-paying jobs.

- Finally, another set of possible expansions would extend eligibility to additional middle-income households. The matching contributions could be expanded in this way along three dimensions: changes to the credit rate, the income limit, and the manner in which the credit is phased out. These options are explored in another Retirement Security Project discussion paper.[29]

If reformed in this manner, the Saver's Credit offers the potential to help correct the nation's "upside-down" tax incentives for retirement savings. The current tax system provides the weakest incentives for participation in tax-preferred savings plans to those who most need to save for retirement and who are more likely to use tax-preferred vehicles to increase net savings than to serve as a shelter from tax. The changes described would further help middle- and lower-income families save for retirement, reduce economic insecurity and poverty rates among the elderly, and raise national savings.

Reducing the Implicit Taxes on Retirement Saving Imposed by Asset Tests

Policy-makers have expressed a goal of increasing retirement savings among those with low or moderate incomes. But the asset rules in means-tested benefit programs could penalize any low- and moderate-income families who do save for retirement, by disqualifying them from the means-tested benefit program.[30] The asset tests thus represent a substantial implicit tax on retirement savings — and one that may significantly burden Latino families struggling to save.

Many low-income families rely on means-tested programs at times during their working years — during temporary spells of unemployment or at times when earnings are insufficient to make ends meet. The major means-tested benefit programs, including food stamps, cash welfare assistance, Medicaid, and Supplemental Security Income (SSI), either require or allow the application of asset tests when determining eligibility. The asset tests may in effect force households that rely on these benefits — or might rely on them in the future — to deplete retirement savings before qualifying for benefits, even when doing so would involve a financial penalty. As a result, the asset tests not only penalize low-income savers but may also actually discourage retirement saving in the first place.[31]

Asset tests in means-tested programs, as currently applied, thus constitute a barrier to the development of retirement savings among the low-income population. Modifying or eliminating these asset tests, or even disregarding savings in retirement accounts when applying the tests, would allow low-income families to build retirement savings without having to forgo means-tested benefits at times when their incomes are low during their working years.

In addition to imposing what amounts to a steep implicit tax on savings, the asset tests treat retirement savings in a confusing and seemingly arbitrary manner. For example, policy-makers often encourage workers to roll the balances in a 401(k) account into an IRA when they switch jobs, rather than cashing out the 401(k) balance. Yet in some cases, rolling the 401(k) account into an IRA could disqualify a worker for means-tested benefits. For example, under the Food Stamp Program, some types of retirement savings accounts are counted toward the food stamp asset limit, while other types of retirement accounts are excluded. Most employer-sponsored retirement plans, including 401(k) plans, are excluded. IRAs, however, are counted. Thus, if the cash value of a 401(k) is "rolled over" into an IRA, it loses its exclusion and becomes a countable asset following the rollover. This rule is very significant. An employee often must take his or her retirement benefits out of the employer's 401(k) plan when he or she stops working for the firm. For such funds to remain in a tax-favored retirement savings account, the employee must then roll the funds over into an IRA (unless the employee is able to roll the funds into a new employer's retirement plan). A large share of IRAs are from 401(k) or other defined contribution accounts that have been rolled over. The food stamp rule means that changing jobs or being laid off can cause a low-wage working family with a modest retirement account to lose the exclusion for the account and hence to be terminated from the Food Stamp Program unless the family liquidates its retirement account and spends the proceeds.

Fortunately, substantial progress can be made to mitigate the penalty on saving and to simplify the rules in a number of means-tested programs. Congress could amend the tax code so that retirement accounts that receive preferential tax treatment (such as 401(k) plans and IRAs) are disregarded for purposes of eligibility and benefit determinations in federal means-tested programs. There is precedent for including such cross program provisions in the tax code; the part of the tax code related to the Earned Income Tax Credit (EITC) includes a provision regarding the treatment of the EITC by other means-tested programs. Congress included a similar provision in the 2001 tax-cut legislation, with regard to treatment of the child tax credit by means-tested programs. Provisions that exclude certain federally-funded Individual Development Accounts from being counted as assets in federal means-tested programs provide another precedent.

Even in the absence of such a cross-program disregard, important recent changes in federal policies have given states the flexibility to craft a more coherent set of asset rules in several means-tested programs to exempt more retirement savings from asset tests, while simplifying program administration. For example, in Medicaid, the State Children's Health Insurance Program (SCHIP), and programs funded under the Temporary Assistance for Needy Families (TANF) block grant, states have complete discretion over the treatment of assets, including retirement accounts. In 2002, 10.5 million Latinos (26.6 percent) were covered by government health insurance (Medicare and Medicaid); 14.6 percent of all persons covered by government health insurance that year were Latino.[32] It is reasonable to suppose that if asset tests were restructured in the Medicaid program, many Latinos would encounter opportunities to bolster their retirement savings. In the Food Stamp Program, states have the ability to liberalize asset rules within federal parameters and, for the time being, to disregard all retirement accounts if they are disregarded in the state's TANF cash assistance or family Medicaid program.

In order to receive SSI, they cannot save much outside of a few income- and asset-exempt items, further compromising Latino retirement security.

State policy-makers could thus begin to move the system in the right direction by taking steps such as:

- Aligning rules regarding retirement accounts in Medicaid (for nonelderly households) and TANF cash assistance to the Food Stamp Program rules, by exempting 401(k) accounts and similar employer-based plans as assets under the Medicaid and TANF programs.

- Disregarding IRAs in Medicaid (for nonelderly households) and TANF cash assistance, as well as in the Food Stamp Program, to the extent that forthcoming food stamp rules allow states to do so, so that families with children and people with disabilities who have an IRA, including those who do not have access to an employer-based retirement plan and those who must roll over funds from an employer-based plan into an IRA when they are laid off or change employers, will not have to liquidate retirement savings to obtain means-tested benefits during a period of need.

- Eliminating the Medicaid asset test for families with children, as 22 states have already done.

At the same time even if they don't enact a cross-program disregard, Federal policy-makers should implement specific rule changes within the asset tests applying to SSI, and also explore a variety of ways in which the implicit tax on retirement savings can be reduced.[33] Latinos tend to be disproportionately dependent on SSI because their work histories and lower wages may make it harder for them to qualify for Social Security, or they may receive such low benefits from Social Security that they still qualify for SSI. Latino participation rates in the SSI program tend to be higher than that of other groups. Almost one-tenth (9 percent) of Hispanic couples over 65 receive SSI, compared to 3 percent of Black couples over 65 and 2 percent of White couples over 65.[34] For unmarried Hispanic women over 65, the results are also striking: 18 percent of unmarried Hispanic women receive SSI, compared to 14 percent for Black unmarried women over 65 and 5 percent of White unmarried women over 65.[35] These high levels of benefit receipt demonstrate perhaps two challenges to Hispanic retirement security. First, Latinos are less likely to have been able to participate in pensions or to receive Social Security. Second, in order to receive SSI, they cannot save much outside of a few income- and asset-exempt items, further compromising Latino retirement security.

Promoting Financial Counseling

A final mechanism for policy-makers — as well as employers — to bolster retirement security and savings among Hispanics involves tailored financial counseling strategies.[36] The evidence suggests that disinterested financial education is an effective tool in raising savings levels. Households that have planned for retirement tend to save more than other households, even when controlling for income and other characteristics.[37] Employer-provided financial education also tends to generate higher savings, but should be done in a targeted fashion that responds to their employees' unique concerns. Investments in financial education and counseling are particularly crucial if policy-makers and firms fail to take aggressive steps to make it substantially easier to save. Furthermore, implementation of the critical retirement savings opportunities addressed could prove less effective at addressing wealth creation opportunities for Latinos if such steps are not combined with a financial counseling effort.

For Hispanics, financial counseling is an especially important subject. Forty-three percent of Hispanic workers described their personal knowledge of investing or saving for retirement as "knowing nothing," compared to 12 percent for all workers.[38] Part of this gap arises because many Hispanics remain disconnected from mainstream financial institutions. Up to one-half of Latinos do not have a transaction account, such as a savings or checking account, which is a basic starting point in financial management and wealth-building for many families. Foreign-born Latinos, in particular, are unlikely to use basic financial services at mainstream institutions. Thus, when discussing these efforts to bolster retirement security for the Latino community, a tailored financial counseling effort plays a critical role so opportunities to increase economic security are maximized.

According to one study, among those with access to retirement education in the workplace, 77 percent report using the educational resources. Moreover, this study revealed a rise in 401(k) participation with the presence of educational activity. Thus, improvements in financial knowledge can boost pension plan participation.[39] The research also shows that many Latino workers lack access to financial information, which is essential for understanding the importance of investing in employer-sponsored retirement plans. In 2001, one survey found that only 32 percent of Latino workers surveyed were provided with educational materials or had attended seminars about retirement planning from their employer.[40] Thus, a tailored effort to address financial education and counseling is necessary to bolster retirement security.

The research also suggests that individual counseling may produce better results for Latinos than generic financial education targeted to workers. One study showed that workplace financial education, combined with one-on-one financial counseling, affects workers' attitudes and behaviors in a positive way.[41] More specifically, workers with access to financial counselors were more likely to participate in an employer-sponsored retirement plan and to increase contributions to that plan as well. EBRI's 2003 Retirement Confidence Survey found that 42 percent of Latino workers surveyed reported that investment advice was "very effective." Forty-eight percent of Latino workers reported that individual access to a financial planner was also "very effective." On the other hand, videos, online services, brochures, and computer software received low marks among Latino workers.[42]

Since Latinos have specific financial education needs and financial choices, a "one-size-fits-all" approach to pension plan counseling is not the best approach to raising their financial knowledge. For example, when targeting materials and products to Hispanics, financial education materials often are translated from English to their literal equivalent in Spanish, which may be unintelligible or difficult for the reader to understand. Care must be taken to convey a clear, easy-to-grasp sense in Spanish of what the English text says. Images and idiomatic Spanish phrases can be used, a process known as "transcreation," so that the Spanish dominant reader learns the same concepts as an English-dominant reader, regardless of how the English original was phrased. Unfortunately, while there are many publications in Spanish, very few have been transcreated from their English original.

Another challenge is that Hispanic workers often hold multiple jobs and are limited to fixed periods of time during the day or week in which to participate in programs. Therefore, in addition to choosing the right curriculum and financial education program, Latino-focused financial education providers must be increasingly mindful of the conditions under which lower-wage Hispanic workers are able to participate at all in such efforts. Providers now often need to make other key decisions before they implement and design a program that affects a working family's ability and willingness to participate, including addressing issues of child care, transportation needs, and program length.

Work-based financial education and counseling could be improved if employers:

Since Latinos have specific financial education needs and financial choices, a "one-size-fits-all" approach to pension plan counseling is not the best approach to raising their financial knowledge.

- Include access to an independent financial planner for one-on-one counseling.

- Include information that is custom-tailored to address the unique and complex financial challenges that Latinos face. (e.g., immigration status, language barriers, ID requirements).

- Market or promote pension participation as a way of providing security for one's family, as opposed to emphasizing the direct financial value to the employee.

Policy-makers must also do more to support financial education programs in the workplace and enable workers, especially those that are lower income, to access financial counselors:

- One option could be to provide financial incentives, perhaps through a tax credit, for employers who provide their employees with access to an independent financial counselor once a year. The Department of Labor could create and maintain a list of certified and approved financial counselors. This effort would require a balance between employers' need to be shielded from liability issues and workers' need to be protected against conflicts of interest and other abuses of the financial advisory role.

Finally, community-based organizations (CBOs) are also major providers of financial education, especially to middle- and lower-income families. Many Latino-serving CBOs are social service providers with connections reaching deeply into the community and a history of community support and resources are needed to support their financial education efforts. These CBOs could assist in the effort to increase financial counseling.

To increase and improve financial counseling infrastructure at the community level, policy-makers could:

- Provide grants to community tax preparation sites to expand services to provide individual retirement savings counseling. This way middle- and lower-income workers could discuss a range of investment options for their income tax refunds and their plans for retirement savings, including using their tax refunds to save.

Conclusion

Too many Hispanics are currently under-saving for retirement, but empirical evidence points the way toward addressing the problem. The common sense reforms described in this paper — making it easier to save, increasing the incentives to do so, and promoting financial education — could substantially improve retirement security for the Hispanic community.

Endnotes

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Mission Statement

The Retirement Security Project is dedicated to promoting common sense solutions to improve the retirement income prospects of millions of American workers.

The goal of The Retirement Security Project is to work on a nonpartisan basis to make it easier and increase incentives for middle- and lower-income Americans to save for a financially secure retirement.

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