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WHO CONTRIBUTES TO INDIVIDUAL RETIREMENT ACCOUNTS?

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Introduction

Individual Retirement Accounts (IRAs) now hold nearly half of total private retirement assets. Although almost all of the growth in IRA assets is driven by rollovers from employer-sponsored retirement plans, individuals' contributions represent 13 percent of the new money flowing into IRAs each year. This *brief* uses data from the *Survey of Income and Program Participation* to examine the characteristics of those who contribute to an IRA.

The discussion proceeds as follows. The first section provides a brief history of IRAs and discusses the difference between traditional and Roth IRAs. The second section describes the enormous importance of IRAs among private sector retirement plans and the relative unimportance of contributions to the buildup of assets in IRAs. The third section, using latent class analysis, shows that IRA contributors fall into three distinct groups: 1) higher-income individuals in two-earner couples who often currently contribute to a 401(k); 2) individuals in middle-income, one-earner households who also tend to contribute to a 401(k); and 3) higher earners who are self-employed. The final section concludes that only a tiny fraction of all households use IRAs to gain access to tax-preferred retirement saving – the original intent behind the introduction of IRAs. Automatically enrolling those without an employer plan into IRAs would be an effective use of a retirement savings vehicle that today serves primarily as a passive receptacle for rollovers.

A Brief History of IRAs

Traditional IRAs were introduced in 1974 under the Employee Retirement Income Security Act (ERISA). The goal was to enable those without employer-sponsored retirement plans to save in a tax-deferred fashion. That is, the government does not tax the original contribution to an IRA nor the returns on those contributions until the funds are withdrawn from the plan. Withdrawals from traditional IRAs before age 59½ are generally subject to a 10-percent penalty and people must begin to withdraw their funds by age 70.

Although eligibility was initially limited to those without pensions, it was expanded in 1981 to encompass all workers. It soon became evident, however, that while IRAs were offered to all, they were being used primarily by higher-income people. As a result, Congress substantially tightened IRA provisions in the Tax Reform Act of 1986. These changes made

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contributions to IRAs fully tax deferred only for people who were not active participants in an employer-sponsored plan or whose adjusted gross income (AGI) fell below certain thresholds.[1]

The Taxpayer Relief Act of 1997 made more changes, including the creation of the Roth IRA.[2] In contrast to the traditional IRA, initial contributions to Roth IRAs are not tax deductible, but interest earnings accrue tax free and no tax is paid when the money is withdrawn. In addition, holders of Roth IRAs are not required to start withdrawing their funds during their lifetime.

In 2001, both Roth and traditional IRAs allowed a maximum contribution of $2,000. The Economic Growth and Tax Relief Reconciliation Act of 2001 raised these limits gradually to $5,000 and indexed them for inflation annually in $500 increments. The legislation also permits individuals ages 50 and over to make "catch up' contributions.[3] Table 1 summarizes the current provisions for traditional and Roth IRAs.

Table 1. Provisions of IRAs, 2017

Provision	Traditional IRA	Roth IRA
Taxes		
Contributions	Not taxed	Taxed
Earnings	Not taxed	Not taxed
Withdrawals	Taxed	Not taxed
Contribution limits	$5,500 ($6,500 if over 50)	$5,500 ($6,500 if over 50)
Income limits for full tax benefits[a]	No plan at work: no limits	$186,000 (couples)
	Plan at work: $99,000 (couples)[b] $62,000 (singles)	$118,000 (singles)
Required min. dist.	Starting at 70½	None

[a] Above these limits, the contribution amounts are gradually phased out. See endnote 4.
[b] If only one spouse has a plan, contributions are fully tax-deductible if modified AGI is less than $186,000.
Source: Internal Revenue Service (2016a).

Although the traditional and Roth IRAs may sound quite different, in fact they offer virtually identical tax benefits. Unfortunately, the easiest way to demonstrate this point is with equations. Assume that t is the individual's marginal tax rate and r is the annual return on the assets in the IRA. If an individual contributes $1,000 to a traditional IRA, then after n years, the IRA would have grown to $\$1,000\ (1+r)^n$. When the individual withdraws the accumulated funds, both the original contribution and the accumulated earnings are taxable. Thus, the after-tax value of the IRA in retirement is $(1-t)\ \$1,000\ (1+r)^n$.

Now consider a Roth IRA. The individual pays tax on the original contribution, so he puts $(1-t)$ $1000 into the account. After n years, these after-tax proceeds would have grown to $(1+r)^n\ (1-t)\ \$1,000$. Since the proceeds are not subject to any further tax, the after-tax amounts under the Roth and traditional plans are identical:

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

Note that the Roth IRA is more generous in terms of contribution amounts. This difference is not obvious given that individuals could contribute $5,500 under either plan in 2017. But for the individual in the 25-percent personal income tax bracket, a $5,500 after-tax contribution is equivalent to $7,333 before tax.

How Important Are IRAs?

In 2016, according to the Investment Company Institute's (ICI) *Survey of IRA Owners*, 43 million households (34 percent of the total) owned IRAs.[5] While the number of taxpayers owning an IRA is higher because the number of taxpayers exceeds the number of households, the percentages are comparable (see Table 2 on the next page). Households with traditional IRAs continue to outnumber those with Roths. Employer-sponsored IRAs, such as SEP or SIMPLE, account for only 6 percent of total households.[6]

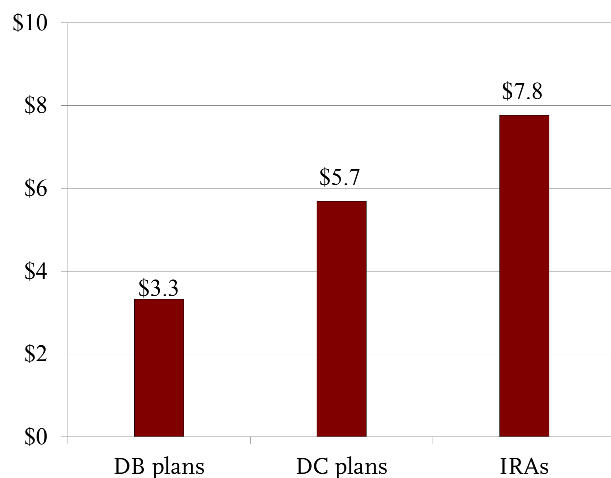
Table 2. Households Owning IRAs, 2016 and 2014

Type of IRA	ICI 2016 House-holds (Mil)	ICI 2016 % total	ICI 2016 Avg. assets (Thsd)	IRS 2014 Tax-payers (Mil)	IRS 2014 % total	IRS 2014 Avg. assets (Thsd)
Any IRA	42.5	34%	$177	57.3	39%	$128
Traditional	32.1	26	$166	45.4	31	$138
Roth	21.9	17	$68	18.6	13	$32
Employer-sponsored	7.2	6	–	6.0	4	$79

Notes: Some households and taxpayers own more than one type of IRA. All assets are in real 2016 dollars.
Sources: Investment Company Institute (2017) and Internal Revenue Service (2016b).

Today, the assets in IRAs account for almost half of all assets in private sector retirement plans, far exceeding those in either defined benefit or defined contribution plans (see Figure 1).

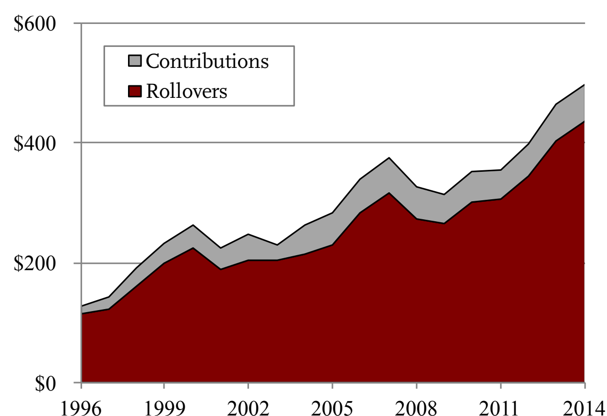
Figure 1. Private Retirement Assets by Plan Type, Trillions of Dollars, 2016 Q3



Source: U.S. Board of Governors of the Federal Reserve System, *Flow of Funds Accounts* (2016).

Interestingly, most of the assets in IRAs come from 401(k) rollovers from employer-sponsored retirement plans rather than from individual contributions (see Figure 2). The reason is that workers do not want to leave their money with their old employer,

Figure 2. Sources of IRA Inflows, Billions of Dollars, 1996-2014

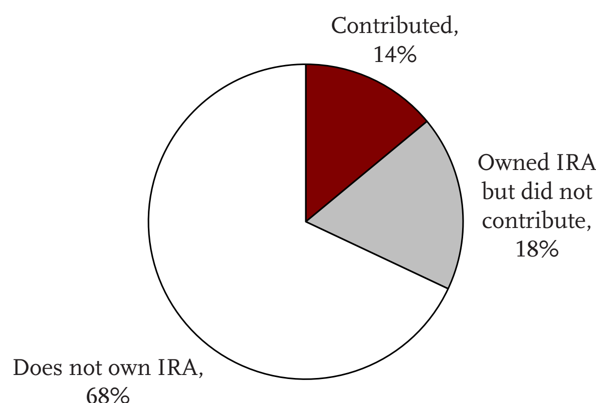


Source: Internal Revenue Service (2016b).

but moving money to their new employer's 401(k) is difficult and time-consuming. As a result, most workers find it much easier to roll over to an IRA instead. They also like the idea of consolidating a number of retirement accounts in a single location.

Nonetheless, in 2014, contributions still accounted for over $60 billion – close to 13 percent – of new money flowing into IRAs. Contributions were made by 14 percent of households (see Figure 3). About one third of the contributors put their money into a

Figure 3. Percentage of All Households that Contributed to IRAs, 2015

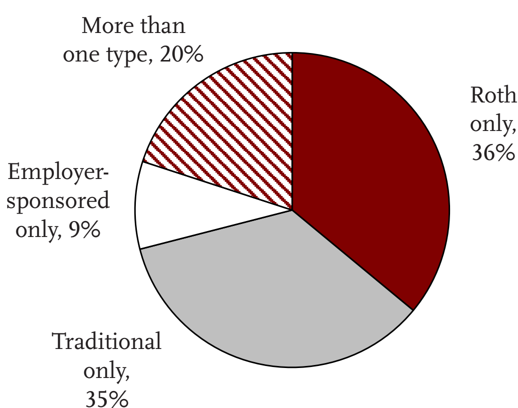


Source: Investment Company Institute (2016).

Roth IRA, another one third into a traditional IRA, about 10 percent into an employer-sponsored IRA, and 20 percent into more than one account (see Figure 4).[7]

The question is: who contributes to IRAs? In other words, are IRAs still primarily used by higher-income individuals who wish to decrease their tax burden and further accumulate retirement savings? Or, instead, are IRA contributors individuals not covered by an employer-sponsored plan?

Figure 4. Percentage of IRA Contributors, by IRA Type, 2015



Source: Investment Company Institute (2016).

Characteristics of IRA Contributors

To answer this question, the analysis shifts to the *Survey of Income and Program Participation* – one of the only surveys that provides both demographic and financial characteristics of individuals as well as information on whether they contribute to different types of retirement accounts. The disadvantage is that the latest year of data is 2011.

Table 3 compares, for IRA owners, the characteristics of contributors versus non-contributors. It shows that the contributors are more likely to be white, have a college education, and currently contribute to a 401(k). They also, on average, have higher household earnings.[8] At the same time, 14 percent of IRA contributors are self-employed relative to 9 percent of non-contributors. Since the self-employed rarely have a current 401(k), this finding may indicate that some of them are saving through an IRA as an alternative to an employer-sponsored plan. The likelihood of contributing to an IRA also differs somewhat by marital status, as married individuals in two-earner households are more likely to contribute. These descriptive results suggest that while at least a portion of IRA contributors are still higher earners, some variation exists.

Latent class analysis is one method that can be used to identify whether some identifiable subgroups exist within a population.[9] Applying this analysis to IRA contributors shows that they fall into three subgroups (see Table 4 on the next page). The first group, "dual-income super-savers," consists of married individuals largely in two-earner, higher-income households that often are currently contributing to a 401(k). These individuals may want to save extra and benefit from the tax-advantages of IRAs. The second group, "frugal breadwinners," consists of middle-income, one-earner households – either single individuals or one-earner married couples – that also tend to

Table 3. Characteristics of IRA Owners Ages 25-70, by Contribution Status, 2011

Characteristic	Not Contributing	Contributing
Demographic		
White	68%	86%
College or more	33%	61%
Average age	45	47
Marital status		
Single	30%	26%
Married one-earner	39%	35%
Married two-earner	31%	39%
Employment and financial		
Currently participates in a 401(k)	30%	53%
Average household earnings	$70,197	$110,523
Self-employed	9%	14%

Source: Authors' calculations from U.S. Census Bureau, *Survey of Income and Program Participation*, 2008 panel.

Table 4. Distribution of IRA Contributors by Alternative Latent Class Assignment and Cohort, for Individuals Ages 25-70, 2011

Characteristic	Dual-income super-savers	Frugal breadwinners	Successful entrepreneurs
Demographic			
White	86%	84%	92%
College or more	67%	54%	64%
Average age	46	47	51
Marital Status			
Single	0%	61%	3%
Married one-earner	16%	39%	97%
Married two-earner	84%	0%	0%
Employment and Financial			
Currently participates in a 401(k)	64%	55%	3%
Self-employed	4%	2%	100%
Average household earnings	$149,149	$59,527	$140,152
Percentage by Earnings Quintile			
Lowest	1%	15%	11%
Second	2%	22%	9%
Middle	9%	29%	14%
Fourth	23%	28%	19%
Highest	65%	6%	47%
Percentage of contributors	47%	42%	11%

Source: Authors' calculations from SIPP 2008 panel.

contribute to a 401(k). These individuals perhaps are thrifty people who understand the income requirements in retirement and want to be prepared. The third group, "successful entrepreneurs," consists of higher-income, self-employed individuals who are not currently contributing to a 401(k). Thus, these individuals are using IRAs as an alternative to 401(k)s to save for retirement.

These findings then need to be put into some perspective. Only 14 percent of all households contribute to an IRA, so about 6 percent of all households are dual-income super-savers, 6 percent are frugal breadwinners, and 2 percent are successful entrepreneurs. IRAs – as currently used – have drifted very far from their original intent of providing tax-preferred retirement saving for those without an employer plan. These vehicles currently do little to encourage retirement saving, but rather serve as the landing place for assets originally accumulated in 401(k) plans.

Conclusion

In 1974, IRAs were included in ERISA to ensure that those without an employer plan at work had some way to save on a tax-preferred basis. Today, IRAs are primarily a receptacle for rollovers from employer plans and, among those contributing to an IRA, more than half are also contributing to an employer plan. It is time to turn IRAs back into an active savings vehicle by auto-enrolling those without an employer plan into these accounts, with the ability to opt out. Ideally, such an auto-IRA policy would be a federal government initiative. But, absent federal action, a number of states are stepping into the breach.

Endnotes

1 The AGI thresholds at the time were $40,000 for couples and $25,000 for individuals.

2 The 1997 legislation also gradually increased the income thresholds for fully deductible IRAs and introduced a spousal IRA.

3 The legislation also created the Saver's Credit, a non-refundable tax credit that is in addition to a tax deduction, for households under certain income limits. For a discussion of the Saver's Credit, see Munnell and Chen (2016). For more general information on the legislation, see Topoleski (2008).

4 In traditional IRAs, the phase-out range is $99,000-$119,000 for couples and $62,000-$72,000 for singles. In Roth IRAs, the phase-out range is $186,000-$196,000 for couples and $118,000-$133,000 for singles.

5 ICI conducts the *IRA Owners Survey* each year. The 2016 sample included 3,205 representative households owning traditional IRAs or Roth IRAs.

6 Under a SEP (simplified employee pension) IRA, an employer contributes to IRAs on behalf of its employees. A salary reduction SEP (or SAR-SEP) allowed employees to contribute their own compensation in an IRA. In 1996, Congress created the SIMPLE IRA for small employers, which replaced the SAR-SEP and allows both employers and employees to make contributions.

7 Interestingly, the data for 2016 show that, when employer-sponsored plans are excluded, Roth IRAs are more popular among those who contribute. Perhaps one reason is that – for workers who also have an employer retirement plan – Roths have higher income limits.

8 This result has been found in earlier studies. Dynan, Skinner, and Zeldes (2004) provide a review of existing literature. Gale and Scholz (1994) highlight established empirical evidence that households that contribute to IRAs tend to save more overall.

9 Latent class analysis (LCA) is a tool allowing researchers to identify relationships among observed categorical variables as a function of some unobserved grouping. Conditional on an assumed number of classes, LCA outputs two sets of estimates: 1) the share of the population within each class; and 2) the conditional probabilities of having a given value for each observed variable within each class. These parameters are estimated by maximum likelihood estimation, where the inputs are the observed probabilities. The conditional probabilities have special interpretation within LCA since they represent a measure of association between the class and the observed characteristic.

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