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From the Editor

Looking for Tax Revenue in All the Wrong Places: 401(k) Plans Under Attack

If we could help restore our nation's fiscal health by reducing employer and employee contributions to 401(k) and other defined contribution (DC) plans, the cutback might justify the harm caused by discouraging retirement savings. But every current proposal before Congress to scale back or even eliminate the 401(k) deduction is premised on the federal government's erroneous calculation of the tax revenue currently lost through such retirement plans. Proper accounting would expose the lunacy that we could somehow balance the budget if workers just saved less money.

Employee retirement plans are ranked each year in the top three on the "Most-Wanted List" of largest tax expenditures, alongside tax breaks for health care and the home mortgage deduction. For 2011, the Congressional Joint Committee on Taxation (JCT) put the amount of lost tax dollars (a "tax expenditure" in government parlance) from all retirement plans at $120 billion, estimating that cost will rise to $174 billion by 2013. The US Government Accountability Office (GAO), using a slightly different set of assumptions, puts the 2011 bill at $134 billion. Over half of this lost revenue comes from employee 401(k) contributions, employer matches and other DC contributions, IRAs, and self-employed Keogh plans. Desperate for revenue, you can see why Presidential commissions, Congress, and many pundits are targeting 401(k) plans to help fix the nation's financial woes.

Given that it is one of the largest tax expenditures, you'd think Congress would want to carefully measure the cost of retirement plans. Instead, like a man who loses his car keys inside a cave but searches outside because the light is better, Congress uses a relatively easy but fundamentally flawed estimate based on each year's particular cash flow. Both the GAO and JCT add up the taxes that would have been paid on that year's contributions and all investment earnings in all retirement plans, then subtract the total taxes and penalties paid on that year's withdrawals. This is a gross overstatement. In fact, *all* retirement savings are eventually taxed—as ordinary income—upon distribution to the employee. Unlike the exclusion for employer-provided health benefits or the deduction for mortgage interest—which do constitute permanent revenue losses, 401(k)s and similar plans are only tax deferrals. Eventually, the feds get their money.

Logically, federal number crunchers should offset their cost savings by the future tax revenue the Treasury will receive when retirement funds are paid out down the road. In fact, the primary (and perhaps only) cost to the government from the tax deferral on retirement savings (and benefit to participants) is that 100 percent of plan contributions are immediately invested in the 401(k) account, rather than what's left after taxes.

To illustrate, say that Penelope, who is in the 20 percent bracket, contributes $1,000 of her salary to a 401(k) plan, earns a 5 percent investment return, and then withdraws the money the next year, paying taxes at 20 percent, without any early withdrawal penalty. Penelope would end up with $840 in her pocket: $1,000 contribution plus $50 earnings less $160 in taxes. Now assume that there was no tax deferral and Penelope was taxed on the $1,000 salary before it was contributed. After one year, Penelope would have $832, the original $1,000 less $200 in up-front taxes plus $40 earnings on the $800 less $8 in taxes on those earnings. The $8 difference between the two examples is the real cost (to the government) or benefit (to the individual) from the deferral and it comes simply because Penelope was able to invest $1,000 instead of $800 for one year. Of course, this compounds over time: the longer the period of deferral, the greater the cost/benefit.

However, if an employee's 401(k) account does not grow or even declines in value, there is no lost tax revenue or benefit to the employee. Given the zero investment return that many retirement plans have unfortunately posted over the last decade (and counting), many retirement plans of late haven't cost the government a dime in lost tax revenue.

Beside the deferral, there is one other possible source of lost revenue to the Treasury—if the employee is in a lower tax bracket when his retirement contributions are withdrawn than when the contributions were made. If Penelope in the above example were in the 15 percent income bracket when she took her distribution, rather than the 20 percent bracket when it was earned, the government would lose an added $52.50 in income tax. Unlike the income deferral, the government's present value cost from the potentially lower rates on distribution decreases the longer the contributions remain in the plan.

If the Tax Code was static, it would be reasonable to assume in estimating the cost of 401(k) plans that most employees would be in a lower tax bracket in retirement. But tax rules and tax rates are anything but predictable. Given our current fiscal mess, it is likely that Congress eventually will have to increase tax rates to help reduce the deficit. Alternatively, a retiree's plan distributions may trigger the alternative minimum tax (AMT) or make his or her Social Security benefits taxable. It's also conceivable that a future fiscal reform could add means-testing for full eligibility to Social Security benefits, so a retiree's 401(k) distributions could cause a benefit reduction—thereby saving the feds money. Given these possibilities, therefore, the federal budget should not be predicated on wild guesses of future tax rates, and the government's tax predictions should ignore the possibility of "tax bracket arbitrage."

Congress's faulty calculations have spawned multiple legislators to attack what they label the 401(k) "loophole." Their current weapon of choice is the so-called 20/20 plan, which would limit total deferrals for 401(k), IRAs, and the like to $20,000 or 20 percent of income, whichever is lower. Besides the specious estimates of additional revenue this proposal would generate, proponents argue that overall retirement savings would not decline because the wealthy earners who would be most likely to be affected by the cap would still put aside savings—they would just do so outside of employer-sponsored retirement plans.

That's bad policy for several reasons. First, in our consumer culture, even many high earners lack the discipline to save without the push from their companies' 401(k) plans. Take away the convenience and tax deferral of 401(k)s, and some of these savings would disappear into consumption. Second, even lower income employees would be affected in good years when, for whatever reason, they would be able to sock away more money. The fallacy of the "attack the wealthy" argument is that it assumes employees reside permanently in a given income category, when most people bounce between several economic stations during their working years. Third, whenever Congress has curtailed any tax benefit that management and business owners receive from their company-sponsored retirement plans, they have tended to respond by reducing or eliminating those plans for *all* employees. The only effective way to promote a voluntarily retirement system would be for the high paid and lower paid to eat out of the same pot, with proportionate benefits for all.

Some academics have proposed replacing the current deferral on retirement savings with a tax credit that would theoretically have the same or lower "cost" as the current system. In one version, all 401(k) and employer matching contributions would be taxed when contributed, but the government would add a tax-free match equal to 30 percent of the employee's contribution. A tax credit offers a fairness advantage over deductions because it provides the same tax break to folks in all income brackets. However, the claim by proponents that such a credit would not reduce tax revenue is based on the GAO's erroneous cost estimates; in fact, such a credit would cause a permanent loss of tax revenues. It might also be harder to nudge lower-paid employees to make after-tax versus pretax contributions, and the credit approach would discourage company management from offering these "un-401(k) plans." Finally, some employees (especially those with lower income) might not be able to afford the immediate tax hit on taxable employer matching contributions—with the result that employees might decide *not* to save to avoid paying taxes on the company match.

Analysts outside of government who genuinely understand the calculus of retirement plan tax deferrals say Congress is overstating the actual loss of tax revenue by 34 percent to 54 percent (depending on which government agency is doing the figuring and their projections of future interest rates, earnings, and the like). But I think the wonks are being too conservative. In the long run, Uncle Sam's finances are actually improved by 401(k) contributions because a huge chunk of deferred tax revenue will come due as Baby Boomers start retiring in droves. In a neat fiscal twist, this added revenue will arrive preciously as those retirees strain the Social Security and Medicare systems, thus matching the revenue with entitlement spending. As a matter of its own fiscal policy, the government should encourage 401(k) contributions to prepare for the looming Boomer onslaught.

A final benefit of the government's deferring tax revenue is Washington's own profligacy. The Bush and Obama administrations have managed over the years to spend roughly 110 percent of tax revenues; deferring tax revenues will operate as an automatic break on this deficit spending.

Proper understanding of the long-term positive impact of the 401(k) and DC contributions on tax revenues, plus the benefit of better preparing future retirees for retirement (who would, thus, be less likely to go on the dole), make a clear case for continued support of 401(k) and other retirement programs. Let's hope that Congress—having already eviscerated employer pension plans through decades of overregulation—does not now muck up the only remaining functioning retirement vehicle. Making policy decisions based on faulty cost estimates will result in lower savings rates, with nothing to show for it. A much better way of viewing the *tax expenditures* from retirement plans is as *deferred* government revenue, benefiting employees and the government alike.

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