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New Research from EBRI:

Proposed Tax Changes to Retirement Savings Would Have Big Impact on Workers

WASHINGTON—Workers with the lowest incomes would be among the biggest losers under various proposals to reduce current-law tax limits for savings in 401(k)-type plans, according to testimony presented today to the Senate Finance Committee by the nonpartisan Employee Benefit Research Institute (EBRI).

At the Sept. 15 committee hearing, EBRI Research Director Jack VanDerhei presented new modeling results of who would likely be affected—and by how much—if the existing level of allowable tax-deferred savings in private-sector 401(k)-type defined contribution retirement plans is changed as some advocates have proposed.

"As expected, highest-income workers generally would be the most affected if federal tax limits in 401(k) type plans were lowered," VanDerhei said. "But the surprising result we found is that the lowest-income workers would also be very negatively affected, and many report that they would reduce contributions or stop saving in their work-based retirement plan entirely, if the current exclusion of worker contributions for retirement savings plans were ended."

For instance, VanDerhei said that if the current exclusion of worker contributions for retirement savings plans were ended in 2012 and replaced with flat-rate tax credits as recently proposed by Brookings Institution Fellow William Gale, the average reductions in 401(k) accounts at Social Security normal retirement age would range from a low of 11.2 percent for workers currently ages 26–35 in the highest-income groups, to a high of 24.2 percent for workers in that age range in the lowest-income group.

Earlier EBRI analysis of the bipartisan deficit commission's proposal to reduce 401(k) savings caps to either $20,000 a year or 20 percent of income (the so-called "20/20 cap") starting in 2012 would most affect the highest-income workers—not surprising, since those with high income tend to save the most in these kinds of retirement plans. However, EBRI also found the cap would cause a big reduction in retirement savings by the lowest-income workers as well.

EBRI's modeling is based on its proprietary Retirement Security Projection Model.® VanDerhei's complete testimony before the Senate Finance Committee hearing, on "Tax Reform Options: Promoting Retirement Security," is on EBRI's website at www.ebri.org/pdf/publications/testimony/T-170.pdf and also online at the committee's website.

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Currently, the combination of worker and employer contributions in a 401(k) plan is capped by the federal tax code at the lesser of $49,000 per year or 100 percent of a worker's compensation. As part of the effort to lower the federal deficit and reduce "tax expenditures" (as tax advantages are termed), two major proposals have surfaced:

- Most recently, a proposal by William Gale of the Brookings Institution that would replace existing 401(k) tax deductions with a flat-rate refundable credit that serves as a matching contribution in a retirement savings account, using either an 18 percent credit or a 30 percent credit.
- The so-called "20-20 cap," included by the National Commission on Fiscal Responsibility and Reform in their December 2010 report, "The Moment of Truth."

VanDerhei also noted that Gale's analysis assumes that workers will keep their aggregate retirement contributions constant and that employers will not make changes in their employer match in 401(k) plans. Under any cost-benefit analysis, VanDerhei said, it is very difficult to determine how workers not currently covered and/or participating in a defined contribution plan will react to the incentives under the Gale plan.

Earlier EBRI research showed that the adoption of automatic enrollment and auto-escalation of contributions in 401(k) plans has reduced the likelihood of Baby Boomers and Gen Xers being "at risk" of inadequate retirement income to cover basic expenses and uninsured health care costs in retirement. However, even with these improvements, almost one-half of Baby Boomers and Gen Xers are still at risk, and 70 percent of households in the lowest one-third when ranked by preretirement income were classified as "at risk."

In aggregate, EBRI estimates that the Retirement Savings Shortfalls (determined as a present value of retirement deficits at age 65) for Baby Boomers and Gen Xers (expressed in 2010 dollars) is $4.55 trillion, for an overall average of $47,732 per individual still assumed to be alive at age 65.

"Given that the financial fate of future generations of retirees appears to be so strongly tied to whether they are eligible to participate in employer-sponsored retirement plans, the logic of modifying (either completely or marginally) the incentive structure of workers and/or employers to save in a defined contribution plan needs to be thoroughly examined," VanDerhei said.

EBRI is a private, nonprofit research institute based in Washington, DC, that focuses on health, retirement, and economic security issues. EBRI does not lobby and does not take policy positions.

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