Modifying the Federal Tax Treatment of 401(k) Plan Contributions: Projected Impact on Participant Account Balances

EBRI Policy Forum #70
"After" Math: The Impact and Influence of Incentives on Benefit Policy

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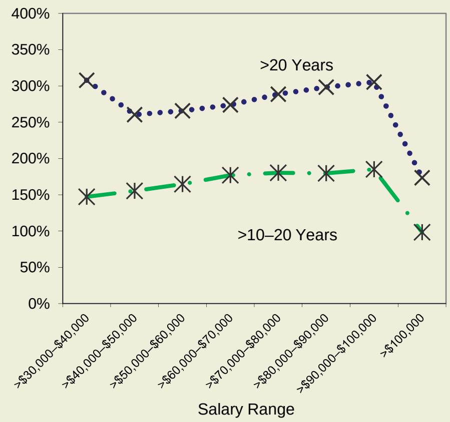
Outline

- Background
  - Financial vs. behavioral economics
  - Upside-down incentives?
- Employee responses to generic questions on excluding employee contributions from taxable income (2011 RCS)
- Specific proposal to modify federal income tax treatment for employee and employer contributions in exchange for 18 percent flat-rate refundable tax credit (Gale, 2011)
  - Employee survey (2012 RCS)
  - Employer survey (AllianceBernstein, 2011)
  - Impact of proposal on simulated 401(k) account balances at retirement age
    - By age and salary
    - By plan size and salary for employees 26-35

Background

- Upside down incentives?
  - From a financial economics perspective, the current federal tax treatment for 401(k) plans has advantages for workers with a higher marginal tax rate IF other elements of the tax code are ignored
  - IRC Sections 402(g) and 415(c) combined with ADP requirements have resulted in a relatively flat multiple of final earnings at retirement as a function of salary (graph)
- Behavioral influences
  - 45% of DC-owning households state that they probably would not be saving for retirement at all if it weren't for their DC plans (Holden and Bass, 2012)
    - 54% for those with household income less than $30,000
    - 29% for those with household income greater than $100,000
- Plan Sponsors' Anticipated Effects of Completely Removing Ability of Employees to Deduct 401(k) Plan Deferrals (The Principal Financial Group, 2011)
  - 65% indicate that it would decrease or significantly decrease their desire to continue offering a defined contribution/ 401(k) plan

Year-end 2010 Ratio of 401(k) Account Balance to Salary for Participants in Their 60s, by Tenure



Source: VanDerhei, Holden, Alonso and Bass (2011)
Note: The tenure variable is generally years working at current employer, and thus may overstate years of participation in the 401(k) plan.

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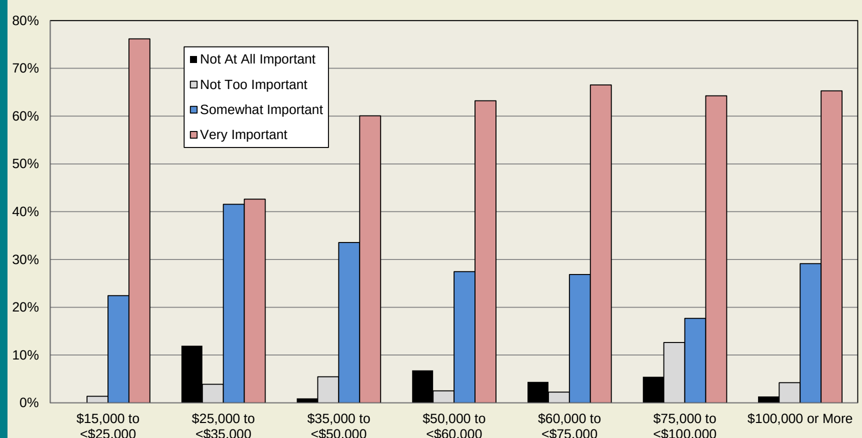
Importance of Being Able to Deduct Retirement Savings Plan Contributions From Taxable Income as an Encouragement to Save for Retirement, Among Full-time Workers, by Total Household Income



Source: Employee Benefit Research Institute (ebri.org) and Mathew Greenwald & Associates, Inc., 2011 Retirement Confidence Survey.

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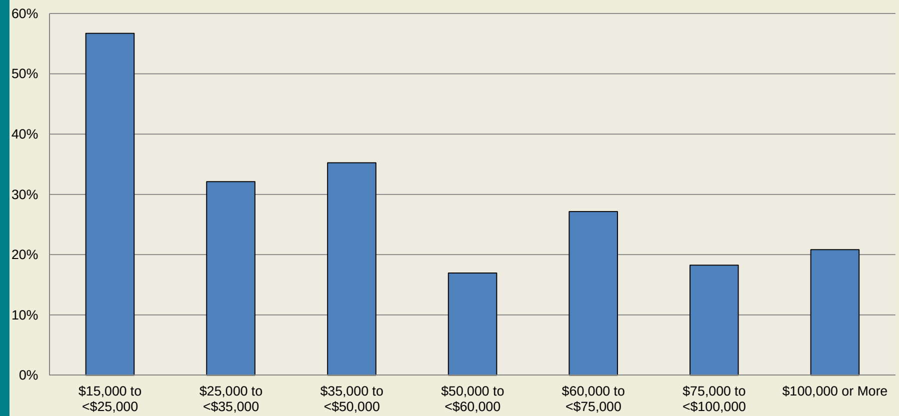
For more detail, see VanDerhei (March 2011)

Percentage of Full-time Workers Currently Saving for Retirement Stating They Would Reduce the Amount Saved If They Were No Longer Allowed to Deduct Retirement Savings Plan Contributions From Taxable Income, by Total Household Income



Source: Employee Benefit Research Institute (ebri.org) and Mathew Greenwald & Associates, Inc., 2011 Retirement Confidence Survey.

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For more detail, see VanDerhei (March 2011)

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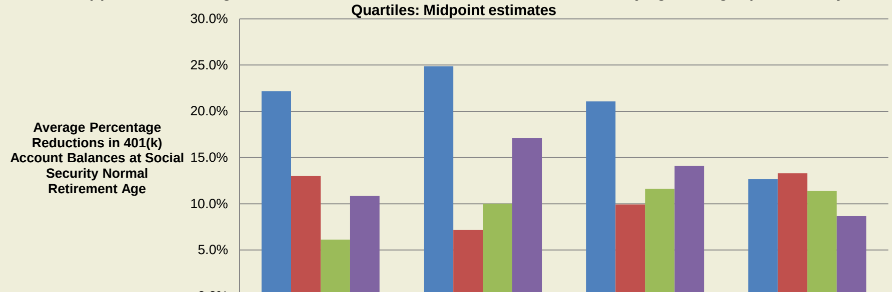
Simulated Impact of Proposal to Modify the Federal Tax Treatment of Employer and Employee Contributions for 401(k) Plans In Exchange for an 18 Percent Match from the Federal Government, by Age and Age-specific Salary Quartiles: Midpoint estimates



	26-35	36-45	46-55	56-65
Lowest income quartile	22.2%	24.9%	21.1%	12.7%
2	13.0%	7.2%	9.9%	13.3%
3	6.1%	10.0%	11.6%	11.4%
Highest income quartile	10.8%	17.1%	14.1%	8.7%

Source: Author's calculations based on results from EBRI Retirement Security Projection Model Version 1471, and responses to AllianceBernstein (2011) and Employee Benefit Research Institute and Mathew Greenwald & Associates, Inc., 2012 Retirement Confidence Survey.
Note: This simulation models only the financial impact of the expected reduction in 401(k) account balances for employees who are not automatically enrolled by modifying the behavior of plan sponsors and participants and does not attempt to assess behavioral modifications on the part of eligible nonparticipants. The simulated rates of return are the same as in VanDerhei and Copeland (July 2010). This version of the analysis assumes no job turnover, withdrawals or loan defaults. The full stochastic nature of the model will be included in a future analysis. Results for participants currently older than 35 are limited to high-tenure participants as explained in the text. Plan sponsor and participant reactions to the proposal are explained in the text. Employer increases or decreases to contributions are represented by the midpoint of the range denoted on the AllianceBernstein survey.

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For more detail, see VanDerhei (March 2012)

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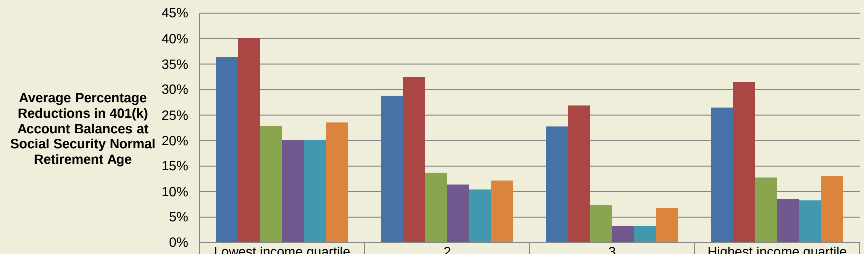
Simulated Impact of Proposal to Modify the Federal Tax Treatment of Employer and Employee Contributions for 401(k) Plans In Exchange for an 18 Percent Match from the Federal Government for Employees Currently 26-35, by Plan Size and Age-specific Salary Quartiles: Midpoint Estimates



	Lowest income quartile	2	3	Highest income quartile
<1M	36.4%	28.8%	22.8%	26.5%
1-10M	40.1%	32.4%	26.9%	31.5%
10-50M	22.8%	13.7%	7.4%	12.8%
50-250M	20.2%	11.4%	3.3%	8.5%
250-500M	20.2%	10.4%	3.2%	8.3%
>500M	23.5%	12.2%	6.8%	13.1%

Source: Author's calculations based on results from EBRI Retirement Security Projection Model Version 1472, and responses to AllianceBernstein (2011) and Employee Benefit Research Institute and Mathew Greenwald & Associates, Inc., 2012 Retirement Confidence Survey.
Note: This simulation models only the financial impact of the expected reduction in 401(k) account balances for employees who are not automatically enrolled by modifying the behavior of plan sponsors and participants and does not attempt to assess behavioral modifications on the part of eligible nonparticipants. The simulated rates of return are the same as in VanDerhei and Copeland (July 2010). This version of the analysis assumes no job turnover, withdrawals or loan defaults. The full stochastic nature of the model will be included in a future analysis. Plan sponsor and participant reactions to the proposal are explained in the text. Employer increases or decreases to contributions are represented by the midpoint of the range denoted on the AllianceBernstein survey.

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