A paradox

I want to begin with a paradox:

Half a year ago I came (analytically) to the same conclusion that the evidence in the Toder and Smith paper (Do Low-Income Workers Benefit From 401(K) Plans?) shows: the "value" of 401(k) savings (and 401(k) tax policy) produced for low-margin/no-margin employees (and, indeed, retirement plan tax policy in general) is inversely proportional to the value those employees themselves put on it.

Quoting from that paper: "The findings imply that both low- and high-income workers benefit from employer DC contributions. Low-income workers benefit because their total compensation rises." It rises because the low income employee gets $1 in benefits in return for (in the case of low paid males) only a $.29 give back in pay. This asymmetric tradeoff happens because (overwhelmingly, in my opinion at least) the low paid employee prefers cash over benefits. Quoting again: "Among those who would otherwise consume additional wages, the relative value of employer contributions depends on the size of their benefit from tax-free saving and their degree of preference for present over future consumption."

The paradox is that the size of the "benefit" goes up the less the participant values it. Thus low paid females value the benefit less, so they get a bigger pay increase -- they get $1 in benefits in return for a $.11 pay give back.

So: The less the employee values the benefit, the more the system is "working." Just think about that for a second.

Just to be clear -- by the analysis set forth in the paper, which, without revisiting certain first principles, I accept, $1 of 401(k) savings is only worth $.29 to a low-margin/no-margin (male) employee. (The value to female employees is lower -- $.11.) The other $.71 is credited as the "positive" result of tax policy. Put another way, the employee would have been just as happy with a $.29 increase in cash pay. And would have preferred a $.30 increase in cash pay to a $1 retirement savings contribution! And if the employee's preference for cash increased -- so that, for instance, the $1 of 401(k) savings were only worth $.10 -- then the "positive" result of tax policy would go up (as would the employee's pay)! Now, it would be producing $.90 in value.
What can that possibly mean?

It makes my eyes cross. Because, short of a revelation from God, I reject all notions of objective value. All value is just what some person or persons thinks something is worth. So -- why on earth would we provide someone something that costs "us" (us being the employer and the taxpayer) $1 when the person receiving it only values it at $.29?

I would say that, while proving that the current system is "fair" (in some sense), this paper has also raised the question -- is it stupid?

I now want to describe what I think are the three reasons why we have a tax policy that favors retirement savings.

A national retirement policy

I want to begin with the fundamental question: Why have a "national retirement policy" at all? Why not just let Americans save for retirement … or not save? By "national retirement policy" I mean laws of different sorts that mandate or encourage or subsidize retirement savings.

Starting as I do with a bias against allowing people in Washington tell all of the rest of how to live, I think that's a reasonable question.

One way of thinking of this question is to ask again, why do we provide something costing the employer/taxpayer $1 when the employee only values it at $.29?

I see three reasons why we should have such a policy.

Reason 1: To mitigate the tax on savings

Going back to the 19th century, economists have recognized that an income tax, in effect, penalizes saving and, as a result, creates a bias towards spending. If this bias is not addressed, economic behavior will be distorted -- you will have under-saving and over-spending that will, in the long run, be unsustainable.

This bias can be offset, as it is in many European countries, by a VAT or sales tax. Or it can be offset, as it is in this country, by tax incentives for retirement savings (and, for instance, lower capital gains tax rates).

To the extent that elements of a national retirement policy simply offset this bias in the income tax, they aren't really a "tax expenditure," the way, e.g., a credit for installing insulation in your attic is. They are, rather, a fundamental element of a rationally designed income tax system.

To dilate on this for a moment -- there are features of the Tax Code -- deductions, exclusions, etc. -- that formally look like "loopholes" but are in fact just elements of the definition of "what is income?" Maybe I'm naïve, but I do not think that anyone would suggest that a rationale depreciation allowance for the cost of a piece of "income
producing equipment" is a "tax expenditure." (Accelerated depreciation, of course, would be a loophole.)

The compensation for the spending bias of an income tax is like this -- it is more properly a "what is income" item and not a "tax expenditure."

Off on a tangent -- deductions vs. tax credits

I want to drop in here some remarks about an issue that is bound to come up whenever we discuss first principles of the taxation of retirement savings.

In a progressive income tax system, any deduction will, obviously, only benefit "the rich." One instant cure for this problem would be to convert to a flat tax.

Where the tax system is being used as a tool of fiscal policy, to steer capital towards preferred "investments" -- energy saver appliances, home ownership or, even, retirement savings -- an argument about deductions versus credits (even refundable credits) may be appropriate.

Where you are simply trying to get the "what is income" question right, an argument about tax credits is absurd. You write of the cost of a piece of equipment over its useful life against the income produced by that equipment (and the taxes paid with respect to that income), i.e., as a "deduction." Doing anything else is to move out of the realm of "getting the income tax system right" (e.g., an appropriate definition of "what is income") and into the realm of fiscal policy (of which, more below).

And coming back to Earth -- concluding --

Just focusing on this one policy objective -- mitigating the tax on saving -- I would make the following points:

There is no reason to compensate for the tax benefits provided by a mitigation of the tax on savings by providing some benefit to low margin taxpayers. They have no (or a low) tax disincentive to save.

Understanding this "at the margin:" high income taxpayers preferences are, in some sense, inelastic relative to tax effects. That is, if they want to buy something they will. And otherwise, they will save. Middle income taxpayers are much more likely to be motivated by tax incentives to save and not spend. Thus, a policy addressing this issue (the income tax on savings) exists primarily to change the behavior of that group. In that regard, I would be interested in an analysis of behavior within the so-called high paid group in the Toder and Smith paper.

What is probably the same point, with regard to the tax on savings, the first dollar saved is the most important and returns diminish from there.

Finally, all this begs a question -- why not a tax benefit for all savings? The Bush Administration in fact proposed something like that (the LSA, RSA, ERSA proposal).
**Reason 2: The grasshopper and the ant**

Over 5,000 years, we've learned that, left to their own devices, people just won't save enough for retirement. For whatever reasons -- evolutionary adaptation, the fall of Adam or just "human nature" -- humans have a natural bias towards spending rather than saving, for what will make them happy now vs. what they will need in the future. And retirement (vs. a buying a house or paying for children's college expenses) is the most "in the future" of any need they have.

(Here, by the way, the remarks about deductions and tax credits above most emphatically do not apply -- tax credits to advance this end seem to me to be perfectly appropriate.)

For these reasons, all modern states have recognized the need for some sort of mandated retirement savings. In the United States, that mandate is Social Security and Medicare.

**Reason 3: The "safety net"**

Most Americans, left and right, believe there should be some sort of social safety net. Left and right will have different views on how "generous" the safety net should be -- but some element of a national retirement policy will involve a transfer of wealth from those who have more to older persons who have less.

**Who should pay for a national retirement policy?**

Brute fact number 1: it cannot be employers. Any tax (or mandated contribution) on wages must be viewed as paid by the employee (or, perhaps, the taxpayer), even if it is "paid" by the employer. The math is simple. A $10 job is a $10 job. You can't pass a law saying it's an $11 job, with $1 going to retirement savings -- that job will simply move to China. Or the company will become inefficient and die (viz., GM). You can pass a law that says $1 of the $10 will go to retirement savings. But that is forcing the employee to give up cash that is likely to be needed for other and more important things.

Brute fact number 2: not all employees can provide enough savings out of their income to pay for a minimally adequate retirement. If the employer cannot pay for this, then, somehow, the American taxpayer will have to.

Something like this is, as I analyze it, what is happening in numbers in the Toder and Smith paper. I would say -- and Karen may disagree -- that, after you subtract the portion of benefits-as-wages that are paid directly by the taxpayer (whatever minimal tax benefit the low margin taxpayer gets), the additional cost that is paid to low-margin/no-margin employees (the $.70 - .90 that they "don't value") comes out of the "pay" (abstractly conceived as cash wages + employee benefits + tax benefits) of high margin employee taxpayers.

Thus the "value" provided to low-margin/no-margin employees is a decrement to the tax benefit of the high margin employee/taxpayer. That is, the tax benefit to high margin employee/taxpayer must at least be worth at least the $.70 - .80 paid to low margin taxpayers. And only the net -- the tax benefit to the high margin employee/taxpayer
minus the additional, non-valued cost of the benefit to the low margin employee/taxpayer -- is a "true" mitigation of the tax on saving.

That dark side: public choice effects

There is, of course, another factor effecting the tax equation. Just as builders and realtors are the most vociferous advocates of the mortgage deduction (and other policies that "promote" home-buying), there are businesses that benefit from government (that is, taxpayer) support for retirement savings: the investment management community and other plan service providers. Certainly some portion of the tax expenditure for retirement savings leaks into their pockets and is simply a return (a "rent") to their lobbying efforts (rent-seeking).

Let's consider an irony --

The GAO report on leakage states:

Because the incidence and amount of leakage from 401(k) accounts have remained relatively steady, the 10 percent penalty has continued to provide a steady source of revenue to IRS. Officials told us that the penalty serves a dual purpose: it deters participants from tapping into their 401(k) account when they have other sources of money available, and it allows the federal government to recoup a portion of the subsidy provided to keep the money tax-deferred. According to published IRS data on early withdrawals from qualified retirement plans, including 401(k) plans and IRAs, more than 5 million tax filers paid $4.6 billion in early withdrawal penalties in tax year 2006.

Let's note that this amount of penalty taxes paid is fully 10 percent of the "tax expenditure" for 401(k) type retirement savings (which is around $50 billion) -- so it is not inconsiderable. Frankly, I was shocked when I read this number. In writing this I had to go back and check my memory, the number seems so incredible.

Let's also speculate that this tax is, in all likelihood, paid by low paid employees experiencing financial stress -- I assume the number went up in 2009. I haven't thought it all the way through, but I would ask how this fits into the analysis in the Toder and Smith paper. I would say that it's very obviously a tax paid by the 401(k) system -- because these are employees you need to contribute (to pass the nondiscrimination test), who not only have no particular reason under the current tax system to contribute, but have a negative 10 percent incentive (in view of their preference for liquidity) not to contribute.

Remarks on Lurie and Ramnath "Long-Run Changes In Tax Expenditures On 401(K)-Type Retirement Plans"

Of course I agree with the basic analysis of this paper, although the (admitted and obvious) assumption-dependent-ness of the analysis may un-fit it for real policymaking.
Since the current (cash flow) tax expenditure for 401(k) type plans is $40-50 billion, I don't see how a $33 billion NPV savings is just a "drop in the bucket." I don't think I'm totally mixing categories there -- but perhaps I am.

Note that the Toder and Smith paper implies that cutting high income tax benefits will result in a pay cut for low paid. Also -- and the math on this should be interesting -- since all of current wage increases (by my analysis at least) are coming right out of the hide of high contributors, and the reduction in this "tax expenditure" will suck all that money back to the Treasury, the loss of tax benefits for the high paid will result in a nearly one-for-one reduction in "additional wages" for the low paid.

But also note that we are the only people who will notice this effect -- the low paid employee literally doesn't care -- he (if he is male) will simply get a $.29 raise.

What are we trying to do, again?

At a strategic level, it seems to me that we meet our minimum safety net needs via Social Security and Medicare. If we think that those benefits are in-adequate, we should improve those programs. I believe there are significant problems in those programs -- but that is for some other forum.

In the voluntary system, it seems to me that we are trying to tilt tax policy towards enhanced saving -- for those three reasons I identified above. I think it's important we tread lightly here. Frankly, I think there are lots of situations in which it would be better to give a low paid employee a $.30 cash raise rather than $1 in taxpayer funded retirement savings. And much of the outcomes produced by the current system (e.g., the $5 billion in taxes paid each year in early withdrawal penalties) suggests that the current system is significantly over-tilting towards savings.

In that regard, I would note the following:

Particularly for lower paid employees, Social Security provides significant income replacement.

All of our notions of adequacy are premised on the idea of an age 65 retirement. It is, perhaps, "not so nice" to have to work to age 70, but for most people -- who are not in physically taxing jobs or disabled -- it is not a tragedy. Working longer is the best Plan B. Not being able to find a job -- that is a tragedy. So that the dynamism and vitality of the US economy is more critical to retirement policy than all the pension and 401(k) plans put together.

Some suggestions

I find the Toder and Smith paper's numbers disturbing (although not surprising). Think about it. If we are to take these numbers literally, a working woman would prefer eliminating the 401(k) plan and a pay increase of $.12 per $1 spent by the employer on her. I would argue that a system that produces that result is over-subsidizing retirement savings. I would, in addition -- and this is simply based on 35 years of dealing with one
section of the Tax Code -- argue that the nondiscrimination rules and the entire nondiscrimination system is entirely too complicated.

I would argue for a much simpler and more explicit system: a mix of deductions (to the extent you are mitigating the tax on savings) and refundable credits (to the extent you are enhancing the safety net). The Rs and Ds can argue and change this mix as Administrations and Congresses come and go. In combination it all helps the grasshoppers be more ant-like.

But -- I would make the limits and the overall tax expenditure significantly lower. I think the data show a system that is out of balance.

I could probably be talked out of that conclusion -- if you could persuade me that the current system is providing significant benefits to middle income/high margin employee/taxpayers. I'm not sure that it is.

The role of the employer

I want to conclude by addressing the issue of whether, in this scheme, it makes sense to -- as we currently do -- give employers the privilege of dispensing greater retirement savings tax benefits than are available to individuals. Frankly, I don't know. I have, simply, the following observations:

Employers provide certain net advantages with respect to retirement savings: efficient administration; a nexus for implementing "nudge" principals (payroll deduction and default savings); at larger employers, meaningful investment management scale. But … these advantages should justify establishing an employer plan without regard to any particular tax incentive.

I have a Burkean respect for things that work, and for a long time I believed that our private, employer-based retirement system worked. Now, I'm not so sure. Traditional DB plans are, for most employers, hopelessly problematic. And the 401(k) system's discontents may outweigh its virtues. This is not the place -- but I strongly believe we need more innovative plan designs than we currently have.

I wouldn't tear the whole thing down -- but I would retrench to something more modest.