T-167

Senate Committee on Finance

Hearing on:

"How Do Complexity, Uncertainty and Other Factors Impact Responses to Tax Incentives?"

Wednesday, March 30, 2011

10:00 a.m.

215 Dirksen Senate Office Building

Submitted Testimony by

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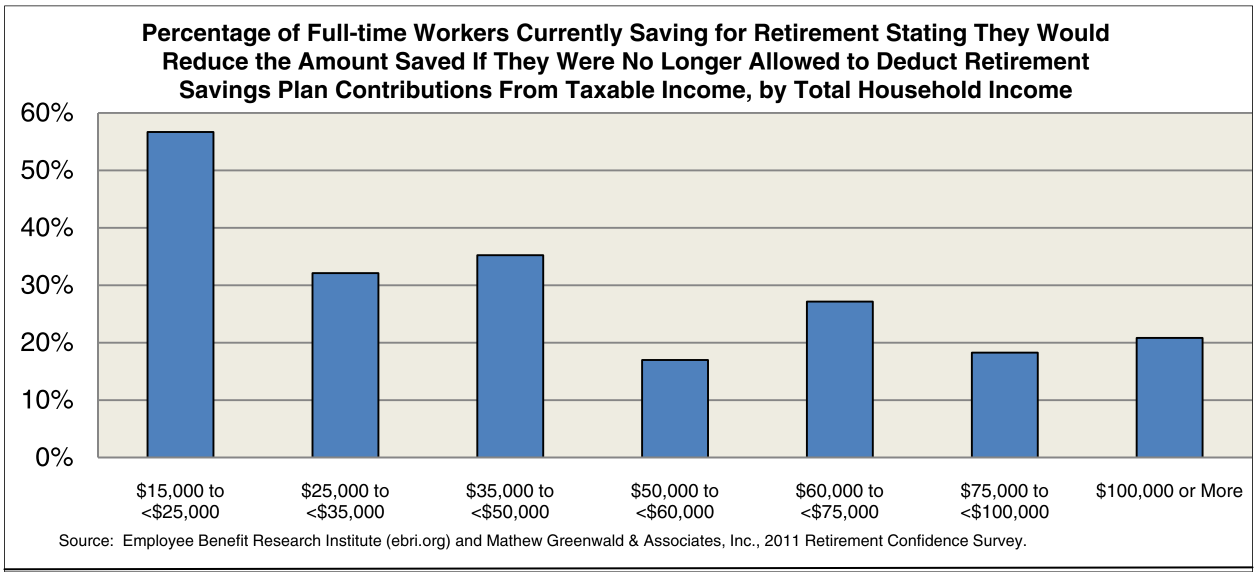
SUMMARY

If Congress were to modify the exclusion of employee contributions to retirement savings plans from taxable income, who would most likely cut back on their savings: lower-income workers, or those with higher income? This is examined in detail in the March 2011 *EBRI Notes*, a copy of which follows this summary and is available online at http://bit.ly/ebrimarch2011notes

Although conventional wisdom is that upper-income workers would be most affected, new findings by the nonpartisan Employee Benefit Research Institute (EBRI) suggest that lower-income workers are far more likely to say they would reduce their contributions if the tax exclusion for employee contributions to retirement savings plans were lowered or eliminated.

Results from EBRI's just-released 2011 Retirement Confidence Survey (RCS) show that more than half (56 percent) of full-time workers with household income of $15,000 to $25,000 currently saving for retirement say they would reduce the amount they save if they were no longer able to deduct retirement savings plan contributions from taxable income. By comparison, only 22 percent of full-time workers currently saving for retirement with household incomes of $100,000 or more say they would save less if the tax treatment of their retirement savings plan were reduced or eliminated.



The reactions become even starker as savings amounts grow, EBRI found: 71 percent of those with less than $1,000 in savings said they would reduce the amount saved if they were no longer allowed to deduct their contributions, compared with about 13 percent of those with $500,000 or more.

Additional groups found to be most likely to reduce their contributions to retirement savings plans include individuals who work for small private organizations as well as those with relatively low educational levels.

Background: In recent years, proposals have surfaced to reform the 401(k) system based on the assumption that higher-income individuals receive more tax-related benefits from these programs than do individuals in lower marginal tax brackets (as well as those who may pay no federal income taxes in a particular year). Some of these proposals have included modifications of the current federal income taxation treatment that excludes some or all of the contributions employees make to tax-qualified defined contribution plans.

From a strictly financial perspective, it is logical to assume that lower-income individuals (those most likely to pay no or low marginal tax rates and therefore have a smaller financial incentive to deduct retirement savings contributions from taxable income) would be least likely to rate the exclusion of employee contributions for retirement savings plans from taxable income as "very important."

However, the RCS data show that those in the household income category of $15,000 to $25,000 actually have the largest percentage of respondents classifying the tax deductibility of contributions as "very important." While higher-income workers would be the most likely to be negatively affected by a proposal to cut or eliminate the exclusion of employee contributions to retirement savings plans from taxable income, EBRI notes that behavioral economics has shown that workers' reaction in similar situations are often at odds with what would have been logically predicted.

The Impact of Modifying the Exclusion of Employee Contributions for Retirement Savings Plans From Taxable Income: Results From the 2011 Retirement Confidence Survey

By Jack VanDerhei, Employee Benefit Research Institute

Introduction

In recent years proposals have surfaced to reform the 401(k) system based on the assumption that higher-income individuals receive more tax-related benefits from these programs than do individuals in lower marginal tax brackets (as well as those who may pay no federal income taxes in a particular year). Some of these proposals have included modifications of the current federal income taxation treatment that excludes some or all[1] of the contributions employees make to tax-qualified defined contribution plans. This article provides some stylized examples of how the total tax advantage of some defined contribution plans varies by marginal tax rate and contrasts these values with the potential reduction in defined contribution balances if contributions were no longer "deductible."[2] This is followed by an analysis of two new questions from the 21st wave of the Retirement Confidence Survey (RCS)[3] showing how workers[4] would likely react if they were no longer allowed to deduct retirement savings plan contributions from taxable income.

Current Tax Treatment and Potential Impact of Modifications

One of the most common types of retirement savings plan contributions today involves employee contributions to 401(k) plans. Although after-tax contributions to these plans have been utilized for several years (primarily in response to Sec. 402(g) limits and/or the need to comply with ADP/ACP nondiscrimination requirements)[5] and in Roth 401(k) plans that have recently been introduced for many employees, the majority of employee contributions to 401(k) plans are still so-called "before-tax" contributions.

Determining the overall tax advantage of making before-tax contributions to a 401(k) plan involves the prediction of several factors, including amounts and timing of contributions, marginal tax rates during the accumulation and decumulation periods, rates of return, and withdrawal behavior during the decumulation period. Figure 1 shows results for a highly stylized example in which an individual currently age 55 makes annual (end-of-year) contributions of a constant amount to a 401(k) plan for 10 years and then immediately takes the account balance out as a lump sum, paying taxes on the entire amount. In contrast, a second scenario is analyzed in which an individual currently age 55 makes annual (end of year) contributions of the after-tax value of the same amount (viz., (1-marginal tax rate) times the amount contributed in the first scenario) to a non-tax-advantaged vehicle for 10 years and then takes the account balance out as a lump sum paying no additional taxes at that time. Because the investment in the second scenario is made in a non tax-advantaged vehicle, it is assumed that federal income taxes on the investment income are paid at the end of each year.[6] The total tax savings are computed as the difference between the net accumulation after taxes from Scenario 1 and the net accumulations after taxes from Scenario 2. This savings is then divided by the net accumulation after taxes from Scenario 1 to show the advantage as a percentage of the amount that would be accumulated after 10 years.

Each of these scenarios is calculated at investment rates of return of 2.5, 5.0, and 7.5 percent, and marginal tax rates of 15, 28, and 35 percent. Rates of return and marginal tax rates are assumed to remain constant over the 10-year period. Figure 1 shows that within each assumed rate of return scenario, the total tax advantage (as measured by the percentage increase in retirement income available after 10 years of contributions) increases with higher tax brackets. However the absolute difference between the total tax advantage of the highest vs. the lowest tax bracket varies with the assumed rate of return. At a 7.5 percent rate of return assumption, the absolute difference is 6.4 percent; however, this decreases to 2.2 percent at a 2.5 percent rate of return assumption.

Some proposals have focused on this disparity by suggesting that the deductibility of 401(k) contributions be either reduced or eliminated. Presumably, those who continued to make contributions under these proposals on an after-tax basis would be able to recover those contributions free of federal income tax when withdrawn and pay taxes only on the investment income similar to what is available under the current tax code for non-Roth after-tax contributions.

Assuming that marginal tax rates will be constant over the accumulation and decumulation periods and that investment income continues to be tax-deferred under these proposals, one may expect that there would be little change in overall tax advantages accruing under the proposed 401(k) system, unless the participants are constrained in the amount of funds they have to contribute each year.

Assuming that the participants need to reduce their contributions to the point that they are only able to contribute (1-marginal tax rate) times the previous amount because of their financial constraints, and that 401(k) contributions are no longer deductible (in any amount), Figure 2 shows the percentage reduction in 401(k) balances from eliminating deductions of contributions as a function of marginal tax rates and assumed rate of return. Similar to Figure 1, within each rate of return scenario, the impact is greater for those in the larger tax brackets: a 5.9 percent difference between the highest and lowest tax brackets at a 7.5 percent rate of return but reducing to a 2.1 percent difference at a 2.5 percent rate of return.

Results From the 2011 Retirement Confidence Survey

Although this highly stylized analysis suggests that higher-income employees would be the most likely to be negatively affected by a proposal to cut or eliminate the deductibility of 401(k) contributions (at least to the point they are constrained with respect to the annual funds available to contribute to a 401(k) plan),[7] behavioral economics[8] has shown that the reaction of employees in situations similar to this are often at odds with what would have been predicted by an objective concerned simply with optimizing a financial strategy. In an attempt to better understand potential employee behavior with respect to a proposed elimination of deductions for 401(k) contributions, this year's RCS included two new questions. The first asked respondents how important is being able to deduct their retirement savings plan contributions from their taxable income in encouraging them to save for retirement. When confined to full-time workers (n=591), the weighted results were as follows:[9]

Not at all important	4.3%
Not too important	5.0%
Somewhat important	27.8%
Very important	61.5%

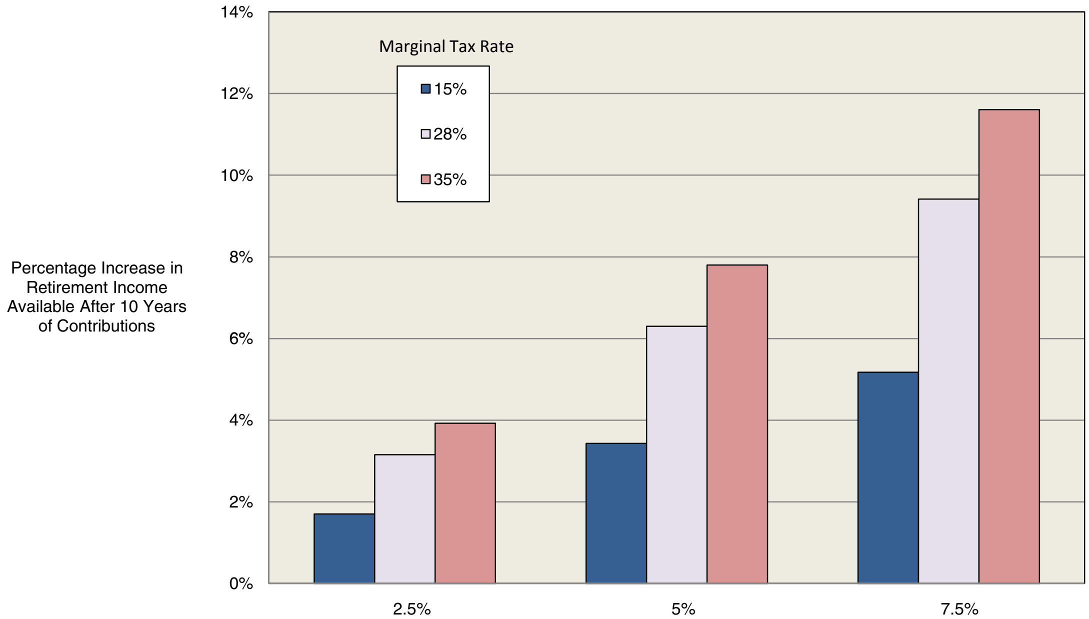
If one were to look at this from a strictly financial perspective, one would assume that the lower-income individuals (those most likely to pay no or low marginal tax rates and therefore have a smaller financial incentive to deduct retirement savings contributions from taxable income) would be least likely to rate this as "very important." However, Figure 3 shows that those in the lowest household income category ($15,000 to less than $25,000) actually have the largest percentage of respondents classifying the tax deductibility of contributions as very important (76.2 percent).

The second question asked of those currently saving for retirement was "Suppose you were no longer allowed to deduct retirement savings plan contributions from your taxable income. What do you think you (and your spouse) would be most likely to do?" When confined to full-time workers (n=460), the weighted results were as follows:[10]

Stop saving for retirement altogether	4.7%
Reduce the amount you save	20.5%
Continue to save what you do now	56.2%
Increase the amount you save for retirement	17.1%

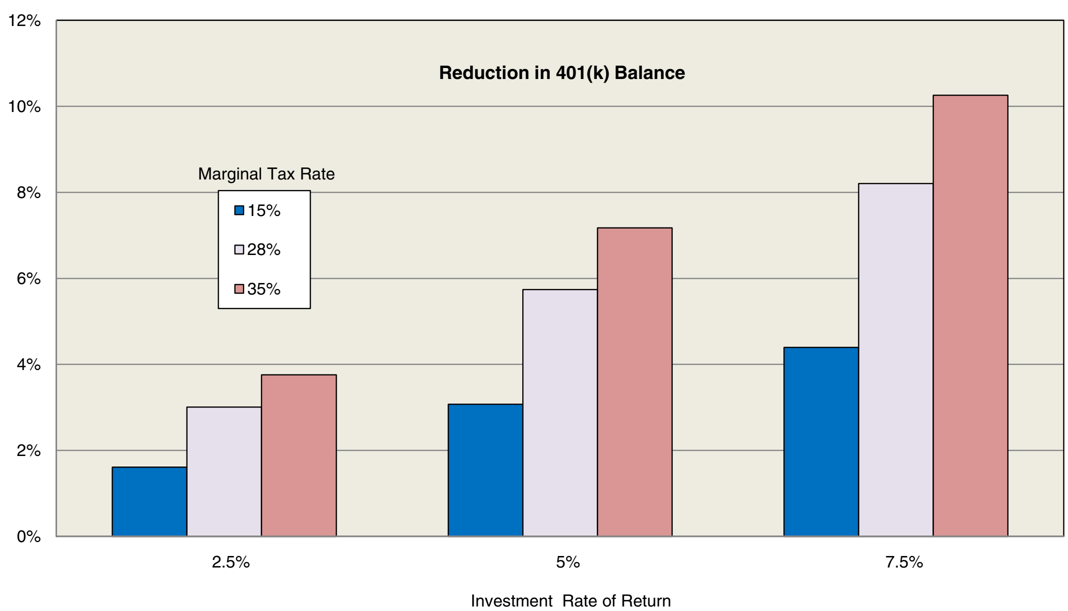
Combining the first two categories above (and eliminating those who refused to answer or responded that they did not know) results in approximately 1 in 4 full-time workers (25.6 percent) who indicated that they would reduce (in some cases completely) their contributions if the ability to deduct them was eliminated. Figure 4 shows the distribution of the percentage of full-time workers currently saving for retirement who state that they would either stop saving for retirement altogether or reduce the amount they save as a function of household income. Similar to Figure 3, the lowest-income category ($15,000 to less than $25,000) has the largest negative reaction to this proposal, with 56.7 percent indicating a savings reduction.

Figure 1
Stylized Examples of the Total Tax Advantage of a 401(k) Plan, as a Function of Marginal Tax Rate and Assumed Rate of Return



Source: Employee Benefit Research Institute (ebri.org) calculations. See text for explanation of scenarios and assumptions.

Figure 2
Stylized Examples of the Reduction in 401(k) Plan Balances From Eliminating Deductions of Contributions, as a Function of Marginal Tax Rate and Assumed Rate of Return



Source: Employee Benefit Research Institute (ebri.org) calculations. See text for explanation of scenarios and assumptions.

retirement altogether or reduce the amount they save as a function of household income. Similar to Figure 3, the lowest-income category ($15,000 to less than $25,000) has the largest negative reaction to this proposal, with 56.7 percent indicating a savings reduction.

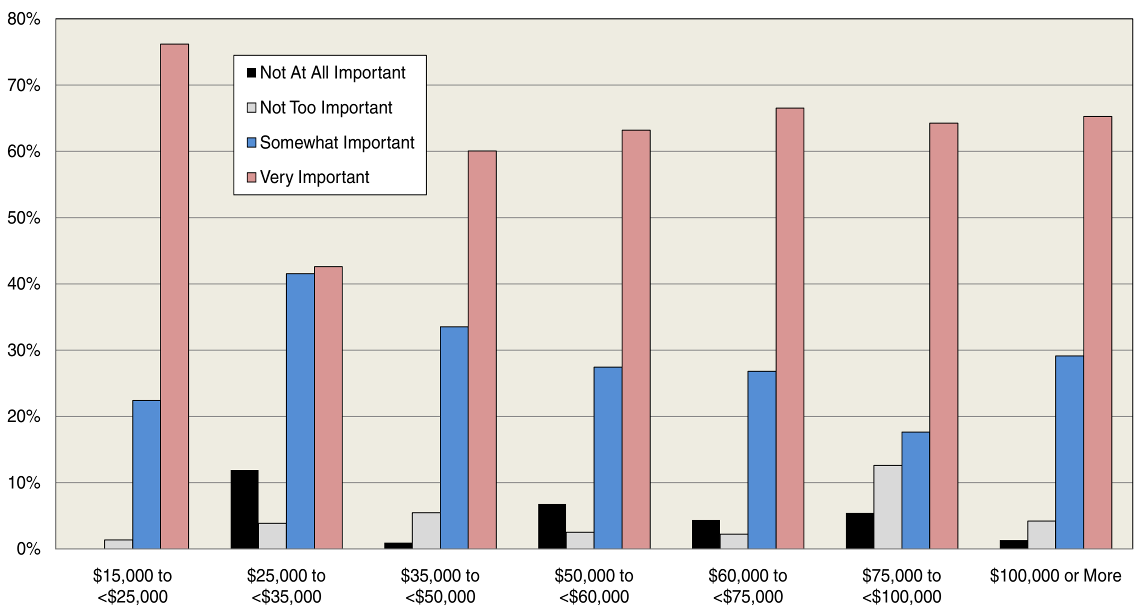
A similar occurrence takes place when the percentage of those stating they would reduce the amount they are saving or stop saving altogether is displayed by the amount they currently have in savings and investments, not including the value of their primary residence or the value of defined benefit plans. Figure 5 shows that there is a significant increase in the self-reported propensity to reduce savings for those in the lowest savings categories. For example, of the full-time workers who are currently saving for retirement who report that they currently have less than $1,000, 71.3 percent indicate they would reduce the amount saved. This value declines to 38.8 percent for those with savings of $1,000 to less than $10,000.

Given these results, it is not surprising that the higher propensity to indicate a reduction in savings as a response to eliminating the deduction for contributions is also observed for those with lower educational levels. Figure 6 shows that 32.2 percent of high school graduates indicate they would reduce savings, whereas only 22.1 percent of those with a graduate or professional degree have a similar response.

Marital status also appears to have a very significant impact on the likelihood that a full-time worker currently saving for retirement would reduce the amount saved. Figure 7 shows that more than 2 in 5 respondents that are single, never married (44 percent) as well as those not married, living with a partner (47 percent) would reduce their savings. However, only 22 percent of married respondents, 16 percent of divorced or separated, and 14 percent of widowed respondents indicated they would reduce their savings.

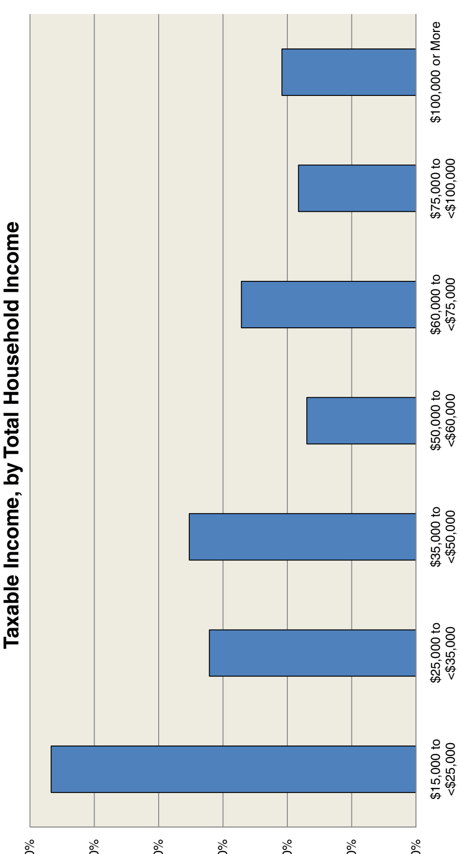
Figure 3

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



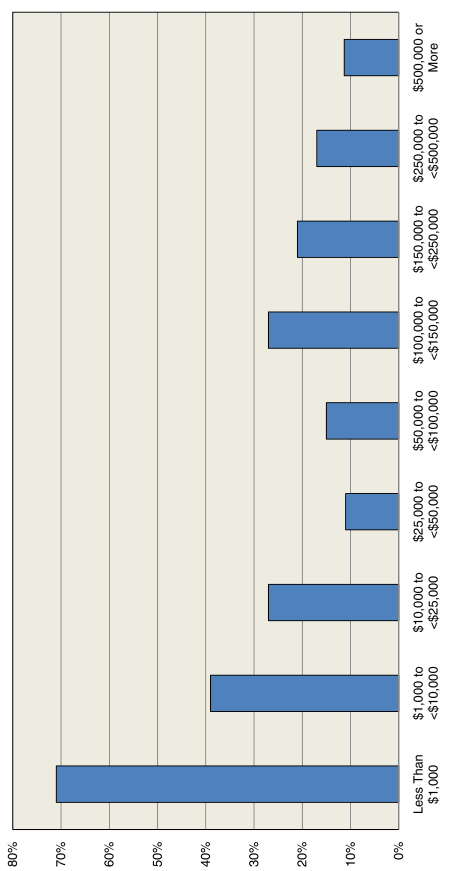
Source: Employee Benefit Research Institute (ebri.org) and Mathew Greenwald & Associates, Inc., 2011 Retirement Confidence Survey.

Figure 4
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



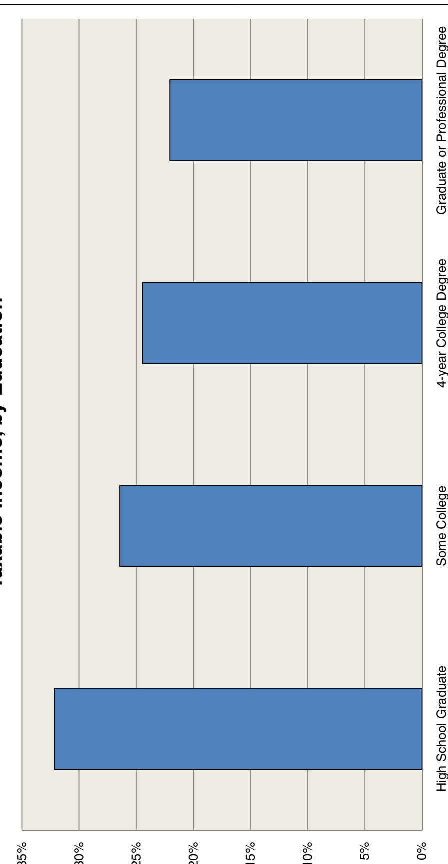
Source: Employee Benefit Research Institute (ebri.org) and Mathew Greenwald & Associates, Inc., 2011 Retirement Confidence Survey.

Figure 5
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 Amount They Currently Have in Savings



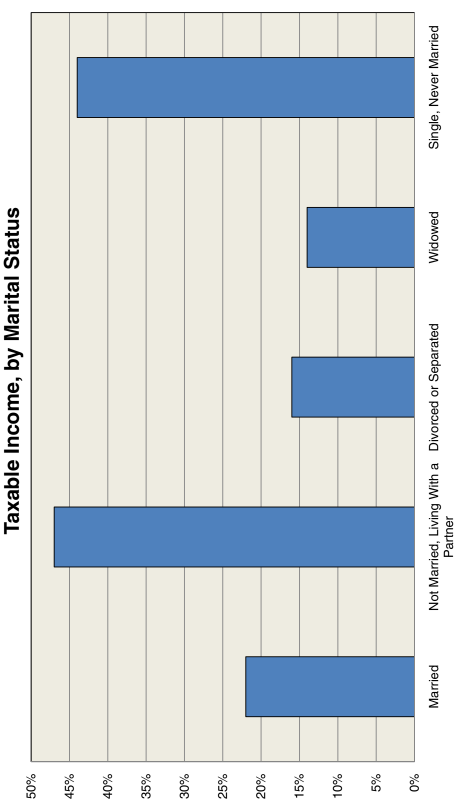
Source: Employee Benefit Research Institute (ebri.org) and Mathew Greenwald & Associates, Inc., 2011 Retirement Confidence

Figure 6
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 Education



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

Figure 7
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 Marital Status



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

The type of entity that the respondent works for also appears to have a significant impact on their likelihood to reduce savings. Figure 8 shows that within private organizations, only 22 percent of the employees working for corporations with more than 1,000 employees indicate that they would reduce savings. This percentage increases to 30 percent for employees working for businesses with 100–1,000 employees, and 35 percent for businesses with less than 100 employees. Public employees have a lower-than-average propensity to decrease contributions (20 percent for federal employees and 16 percent for state and local employees).

Many workers may have two financial advantages to participate in an employer-sponsored retirement plan: An employer match, as well as the tax deductibility of contributions. Everything else equal, it would be logical to assume those employees who do not have an employer match available would be more sensitive to the potential loss of the tax deductibility. This is indeed what is observed in Figure 9, where the percentage of those without an employer match indicating that they would reduce the amount saved is much larger (31.2 percent) than those whose employer matches all or part of their contributions (22.5 percent).

Conclusion

Proposals to modify the exclusion of employee contributions for retirement savings plans from taxable income may have unintended consequences according to results from the 2011 RCS. Instead of reducing the contribution levels of those who might be thought to be most impacted (i.e., those with larger taxable incomes and hence higher marginal tax rates), the RCS results suggest that the categories of full-time workers most likely to reduce (in some cases completely) their contributions are those:

- With the lowest household income.
- With the lowest current amounts in savings and investments, not including the value of their primary residence or the value of defined benefit plans.
- With the lowest educational levels.
- Who are single, never married or not married, living with a partner.
- Who work for small private organizations.

VanDerhei and Copeland (July 2010) document a significant reduction in the percentage "at risk" for inadequate retirement income between 2003 and 2010, based in large part on the advent of auto-enrollment in 401(k) plans; however, for the one-third of the households with the lowest indexed[11] pre-retirement income, the at-risk percentages, while much smaller (they were 80 percent in 2003) are still extremely high (70 percent in 2010). Of course, when one limits the analysis to those who are already saving, the numbers improve substantially: among Gen Xers without any future eligibility for participation in a defined contribution plan, the at-risk percentage is 60 percent, but it drops all the way to 20 percent for those with 20 or more years of future eligibility.[12]

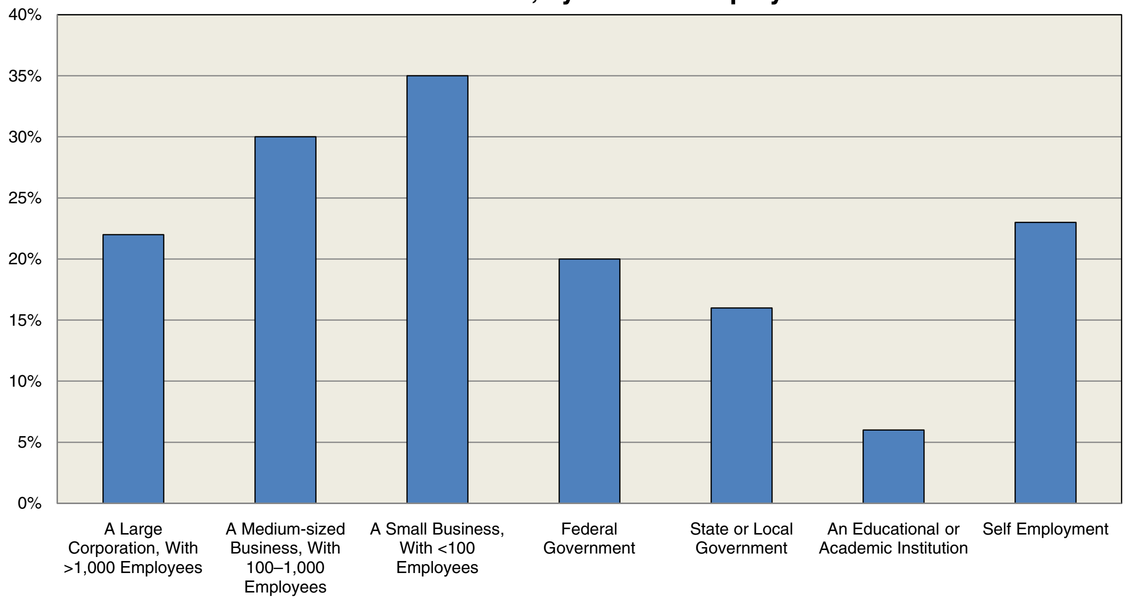
However, the potential increase of at-risk percentages resulting from a substantial portion of low-income households decreasing or eliminating future contributions to savings plans as a reaction to the exclusion of employee contributions for retirement savings plans from taxable income needs to be analyzed carefully when considering the overall usefulness of such proposals.

References

- Helman, Ruth, Craig Copeland and Jack VanDerhei. "The 2011 Retirement Confidence Survey: Confidence Drops to Record Lows, Reflecting 'the New Normal.'" *EBRI Issue Brief,* no. 355 (Employee Benefit Research Institute, March 2011).
- DiCenzo, Jodi. "Behavioral Finance and Retirement Plan Contributions: How Participants Behave, and Prescriptive Solutions," *EBRI Issue Brief,* no. 301 (Employee Benefit Research Institute, January 2007).
- VanDerhei, Jack. "Retirement Income Adequacy for Today's Workers: How Certain, How Much Will It Cost, and How Does Eligibility for Participation in a Defined Contribution Plan Help?" *EBRI Notes,* no. 9 (Employee Benefit Research Institute, September 2010): 13−20.
- VanDerhei, Jack, and Craig Copeland. "The EBRI Retirement Readiness Rating:™ Retirement Income Preparation and Future Prospects." *EBRI Issue Brief,* no. 344 (Employee Benefit Research Institute, July 2010).

Figure 8

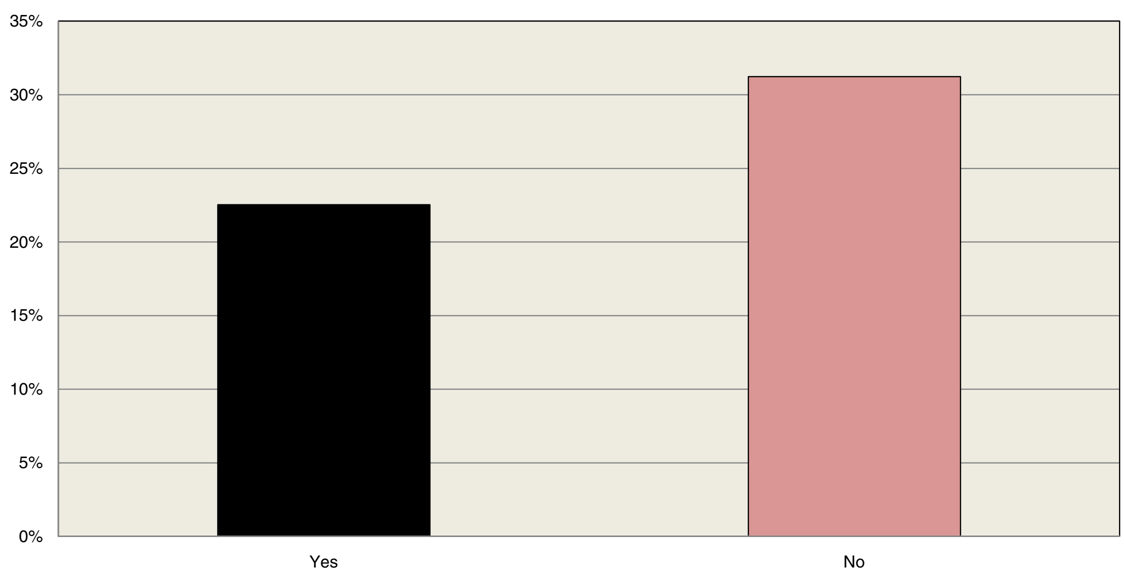
Percentage of Full-time Workers Currently Saving for Retirement Stating They Would Reduce the Amount Saved If They Were No Longer Allowed to Deduct Retirement Savings Plan Contributions From Taxable Income, by Current Employer



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

Figure 9

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 Existence of Employer Match



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

Endnotes

[1] Elective Deferrals are limited to $16,500 in 2011 by Internal Revenue Code Sec. 402(g)(1). A plan may permit participants who are age 50 or over at the end of the calendar year to make additional elective deferral contributions. The elective deferral limit increases by $5,500 for those over age 50 in 2011. Effective for years beginning on or after January 1, 2006, if a plan adopts a Roth feature, employees can designate some or all of their elective contributions as designated Roth contributions (which are included in gross income), rather than traditional, pre-tax elective contributions.

[2] Under a 401(k) plan, an employee can elect to have the employer contribute a portion of the employee's cash wages to the plan on a pre-tax basis. These deferred wages (elective deferrals) are not subject to federal income tax withholding at the time of deferral, and they are not reflected as taxable income on the employee's Form 1040, U.S. Individual Income Tax Return.

Although this is does not technically mean that the employee contributions are "deductible," it was easier to specify that treatment to Retirement Confidence Survey respondents using the common parlance.

[3] These findings are part of the 21st annual Retirement Confidence Survey (RCS), a survey that gauges the views and attitudes of working-age and retired Americans regarding retirement, their preparations for retirement, their confidence with regard to various aspects of retirement, and related issues. The survey was conducted in January 2011 through 20-minute telephone interviews with 1,258 individuals (1,004 workers and 254 retirees) age 25 and older in the United States. Random digit dialing was used to obtain a representative cross section of the U.S. population. To further increase representation, a cell phone supplement was added to the sample. Starting with the 2001 wave of the RCS, all data are weighted by age, sex, and education to reflect the actual proportions in the adult population. Data for waves of the RCS conducted before 2001 have been weighted to allow for consistent comparisons; consequently, some data in the 2011 RCS may differ slightly with data published in previous waves of the RCS. Data presented in tables in this report may not total to 100 due to rounding and/or missing categories. In theory, the weighted sample of 1,258 yields a statistical precision of plus or minus 3 percentage points (with 95 percent certainty) of what the results would be if all Americans age 25 and older were surveyed with complete accuracy. There are other possible sources of error in all surveys, however, that may be more serious than theoretical calculations of sampling error. These include refusals to be interviewed and other forms of nonresponse, the effects of question wording and question order, and screening. While attempts are made to minimize these factors, it is impossible to quantify the errors that may result from them. The RCS was co-sponsored by the Employee Benefit Research Institute (EBRI), a private, nonprofit, nonpartisan public policy research organization, and Mathew Greenwald & Associates, Inc., a Washington, DC, based market research firm. The 2011 RCS data collection was funded by grants from more than two dozen public and private organizations, with staff time donated by EBRI and Greenwald. RCS materials and a list of underwriters may be accessed at the EBRI Web site: www.ebri.org/rcs.

For more detail, see Helman, Copeland and VanDerhei (March 2011, online at www.ebri.org/surveys/rcs/2011/).

[4] In the RCS, retiree refers to individuals who are retired or who are age 65 or older and not employed full time.

Worker refers to all individuals who are not defined as retirees, regardless of employment status.

[5] In order to ensure that a traditional 401(k) plan satisfies nondiscrimination requirements, the employer must perform annual tests, known as the Actual Deferral Percentage (ADP) and Actual Contribution Percentage (ACP) tests, to verify that deferred wages and employer matching contributions do not discriminate in favor of highly compensated employees. Other types of 401(k) plans (e.g., safe harbor 401(k) plans) are subject to less complex rules.

[6] All investment income is assumed to be taxed as ordinary income in this example.

[7] Actually, the constraints would need to be compared to the 402(g) limit as well as any plan-specific constraints on tax contributions (primarily for the Highly Compensated Employees).

[8] DiCenzo (January 2007).

[9] 1.4 percent responded that they did not know.

[10] 18 percent responded that they did not know and 0.35 percent refused to answer.

[11] See endnote 17 of VanDerhei and Copeland (July 2010) for more detail.

[12] VanDerhei (September 2010) also demonstrates that eligibility for a defined contribution retirement plan has a significant positive impact on reducing the additional compensation most families need to achieve the desired level of retirement income adequacy.