

POLICYNOTE

401(K) TAX POLICY CREATES INEQUALITY

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INTRODUCTION

Though well-intentioned, the current system of tax deferral for retirement contributions undermines public policy aimed at strengthening retirement security for all Americans. In fact, it has become a regressive policy that contributes to wealth inequality. Two employees who are identical savers and investors in every way except for income, receive different rates of return due only to the effects of the tax code. For example, they can participate in the same 401(k) plan, contribute the same dollar amount each year and allocate their investment portfolios in exactly the same way¹, yet end up with different results. The high-income earner will enjoy a higher return because they receive a proportionately larger tax deduction.

Converting the current system of tax deductions for defined contribution retirement plans to a refundable tax credit would solve this problem and treat all retirement savers the same. A refundable tax credit would give direct grants to workers' retirement savings accounts instead of acting indirectly through tax deductions. Implementing the fix should not meet opposition² in Congress, whose legislative intent was not to create inequality.³

THE PROBLEM: HIGH-INCOME SAVERS SEE A GREATER BENEFIT

The Urban Institute finds that taxpayers in the top 20% of the income distribution receive a substantial 79% of the benefits from the current system of tax deductions.⁴ Qualified retirement tax deductions – which will cost \$399 billion in uncollected federal

tax revenue⁵ from 2014-2018 (not including state deductions) – compound over time so that current federal tax policy for retirement account contributions benefits fewer and fewer people.

With some irony, the described inequality is a result of the progressive nature of the federal income tax system, where higher incomes are subject to higher marginal tax rates.⁶ Congress (starting in 1912 and accelerating the deductions in 1978 with the establishment of the 401(k) plan) aimed to encourage retirement savings by allowing qualified retirement plan contributions to be deducted from adjusted gross income (AGI) and deferred until retirement, when income tax brackets are presumed to be lower for workers. The federally-funded tax deduction for retirement savings turns out to be asymmetric, benefiting higher income earners (those in the highest tax bracket) the most.

The unevenness of income taxation on retirement accounts takes effect both directly and indirectly. First, the high-income earner enjoys a larger tax deduction in the current period since they are using a higher tax rate to compute the deduction. For every dollar put into a retirement account they have proportionally more in their pocket.

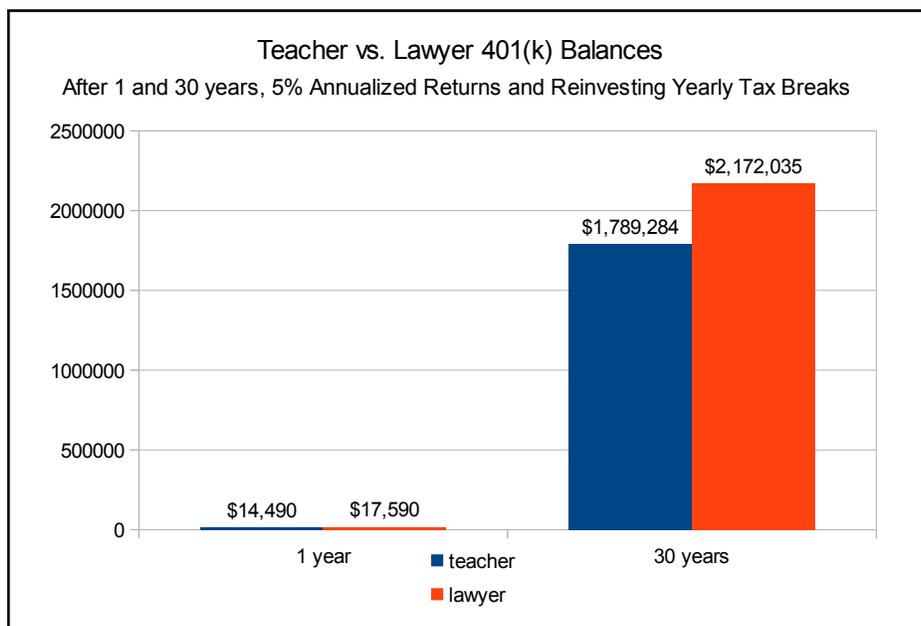
Second, for those savers who reinvest their current period tax savings back into their retirement accounts, the higher earners put away in effect more dollars for a comparable contribution than their lower income colleagues.⁷

ILLUSTRATION: RETIREMENT CONTRIBUTION TAX DEDUCTIONS CREATE WEALTH INEQUALITY

We present a hypothetical case of a kindergarten teacher earning \$36,000 a year and the school district's attorney who is paid \$407,000 a year. These low- and high-income workers work for the same employer and are enrolled in the same employer-sponsored qualified retirement plan.⁸ The marginal tax rate for the teacher under the current IRS tax code is 15%, while the lawyer's is 39.6%.⁹ Each employee decides to contribute \$1,000/month, or \$12,000/year to their retirement account. Each allocate their investments in exactly the same way.

HOW TAX DEDUCTIONS ENCOURAGE RETIREMENT SAVING:

Each pre-tax dollar contributed to a qualified retirement plan reduces the current taxable income dollar for dollar, and the income tax due is deferred until retirement. For example: a worker's tax rate is 10% and they earn \$100. The worker pays \$10 in taxes and has \$90 of after-tax income. Now, the worker contributes \$20 to a qualified retirement plan. Taxable income becomes \$80 and the tax due is \$8. The after-tax income is \$72, plus a retirement account balance of \$20. The worker's wealth is \$92, more than the \$90 net worth they would have otherwise. But what of the deferred tax liability? Most retirees earn less income and face a lower tax rate than they did while working. For this example, the tax rate drops to 5%. At retirement, their \$20 contribution requires a \$1 tax due (assuming it does not grow over time). Net worth after the deferred tax liability would be \$91, still higher than not having contributed to the plan at all.



The teacher's taxable income is reduced by his retirement contribution from \$36,000 to \$24,000, and he owes \$3,600 in income tax.¹⁰ This leaves him with an after-tax income of \$20,400. Including the \$12,000 added to the retirement account, his net worth is \$32,400. Had he not made contributions to his retirement account, his after-tax net worth would have been \$30,600. By doing so, he generated a current tax savings of \$1,800.¹¹ From the point of view of the teacher, the tax break for retirement plan contributions is working as intended.

Now let's consider the lawyer. Her taxable income is reduced to \$395,000, and she owes \$156,420 in taxes. Her after-tax income is \$238,580, and her net worth is \$250,580. If she had not contributed to the plan, her net worth would be \$245,828 – contributing to the plan generated a current tax savings of \$4,752. From the point of view of the lawyer, the tax break for retirement plan contributions is working as intended.

As you can see, the lawyer gets back more money than the teacher – \$2,952 more¹² – by virtue of the differential tax treatment on the same \$12,000 retirement contribution. This is the direct inequality effect which benefits higher income earners in the current period. From a public policy perspective, the system is not working as it was intended.

The indirect effect can be seen when take our example one step further. Understanding the benefits of investing on a tax-deferred basis, our teacher and lawyer seek to maximize those benefits by adding the amount saved through the tax break to their initial contribution. In short, they reinvest their tax savings each year. By doing so, our teacher ends up contributing not \$12,000, but \$13,800 and the lawyer now puts away \$16,752. Assuming they earn the same 5% return after the first year, the teacher's balance grows to \$14,490 and the lawyer's to \$17,590. The \$2,952 discrepancy has grown to \$3,100. The inequity builds each year as the deviations compound.

Fast-forward this process of reinvestment each year for thirty years of employment with similar annual returns: the lawyer would see a return at retirement 21% greater than our unfortunate teacher

(See Graph). Each saved the same \$12,000 annually, each earned a 5% net annual return on their investments, and each both dutifully re-saved their annual tax breaks. It wasn't having a lower salary in and of itself that allowed the teacher to fall so far behind the lawyer. And it was not market savvy that put the lawyer so far ahead of the teacher. Rather, it was the way the tax code acted on their retirement plan contributions.

In practice, most workers save a fixed percentage of pay per year rather than a set dollar amount.¹³ Continuing the example under that rule, the teacher and lawyer elect to contribute a 10% share of their pay each year. Regrettably, this serves to make our teacher even worse off. He would now put away \$3,600, and the lawyer would end up at the maximum contribution level of \$18,000 (and not \$40,700).¹⁴ Instead of the tax subsidy causing a wealth difference of \$2,952 in the first year, the difference grows to \$7,128 resulting in a substantial \$13,860 difference in our two workers' 401(k) balances at the start of the first year. This is the case even when the teacher reinvests his tax savings while the lawyer remains capped out. After 30 years, the 21% of excess returns we saw for the lawyer in the previous scenario has ballooned to over 330%.

THE SOLUTION: CHANGE RETIREMENT CONTRIBUTION DEDUCTIONS TO A CREDIT

To ensure the tax code treats savers of different incomes equally, the tax deduction for qualified retirement plan contributions should be converted to a tax credit. If the \$399 billion in foregone tax revenue from retirement deductions was distributed fairly to all savers regardless of income, the impact on equity would be substantial. For example, replacing the tax deduction with a credit in the case of the teacher and lawyer would equalize their 401(k) balances and returns. They would each receive the mean tax break, \$3,276¹⁵, and their retirement account balances would no longer diverge over time.

Real behavior tends to compound the gap in unequal returns between low- and high-income earners. Because those with lower

salaries are inclined to invest more conservatively on average¹⁶ than high-income earners, they will likely earn lower returns in the long run. Moreover, giving a larger deduction to high-income earners is inefficient; they do not require as much of an incentive as low-income workers to save in lieu of present consumption. Providing increased subsidies for saving to high-income workers violates the principal of vertical and horizontal equity.

CONCLUSION

Best-selling author and economist Thomas Piketty¹⁷ argues that inequality is the result of higher returns on wealth, which in turn pulls away from lower-income earners. The tax treatment of contributions to qualified retirement plans is an example of this inequality. Ideally, retirement savers of all income levels should enjoy equal treatment for their contributions. The tax favoritism for 401(k) and IRA contributions gives the highest income retirement account holders a greater reward for putting away the same dollar as the low-income earner.

This is not a general criticism of progressive taxation, but rather a specific instance of how this sort of tax system provides more benefits for qualified retirement plan contributions from those in higher tax brackets. These deductions vary in size for a given contribution depending on what level of savings an employee's tax bracket affords them. When the tax deduction is subsequently reinvested on top of the initial contribution, the result is growing wealth inequality. If, however, the tax code allowed for a dollar-for-dollar tax credit for qualified retirement plan contributions, the mechanisms leading to wealth inequality via retirement plan contributions would be eliminated.

ENDNOTES

- ¹ Both plan participants will also be paying the same fees, and obtaining the same pre-tax investment return.
- ² Bowles, E., & Simpson, A. (2010). *The Moment of Truth: Report of the National Commission on Fiscal Responsibility and Reform*.
- ³ Marr, C., & Highsmith, B. (2011). *Reforming Tax Expenditures Can Reduce Deficits While Making the Tax Code More Efficient and Equitable*. Center on Budget and Policy Priorities.
- ⁴ Steuerle, C. Eugene. "Who Benefits from Asset-Building Tax Subsidies?" The Urban Institute (2014)
- ⁵ Estimates of Federal Tax Expenditures for Fiscal Years 2014-2018, the Joint Committee on Taxation (JTC) August 5, 2014, JCX-97-14
- ⁶ A progressive federal income taxes means that the IRS charges a progressively higher tax rates per dollar earned as the income of the taxpayer increases.
- ⁷ Savers who maximize the present value of their wealth and

whose deferred tax liability is presumed to be less than the current tax liability would save their tax breaks in order to subject their income to their future lower tax rate as much as possible.

- ⁸ For public school employees the appropriate qualified retirement account would be a 403(b) plan. For private for-profit schools it would be a 401(k) plan.
- ⁹ We use the 2014 IRS marginal tax rates for single taxpayers and 2015 401(k)/IRA contribution maximum limits.

2014 IRS marginal tax brackets for single taxpayers:

If taxable income is:	The tax rate is:
Not over \$9,075	10% of taxable income
\$9,076 - \$36,900	15%
\$36,901 - \$89,350	25%
\$89,351 - \$186,350	28%
\$186,351 - \$405,100	33%
\$405,101 - \$406,750	35%
Over \$406,750	39.6%

- ¹⁰ For simplicity we use an estimation of taxes owed using only the marginal tax rate, and which does not include any personal exemptions or standard deductions. Using a more exact but complicated methodology for estimating taxes owed would not change the results of our example.
- ¹¹ There is a deferred tax liability on the 401(k) contribution and any gains that may accrue. Here, we assume both the teacher and the lawyer will both retire at the lowest marginal tax rate.
- ¹² \$4752 in tax savings for the lawyer minus the \$1,800 in tax savings for the teacher = \$2952.
- ¹³ Hayes, Adam. 2014. Working paper on Do HR Professionals Influence Employee Decisions in 401(k) Plans
- ¹⁴ For a worker intending to put away \$1,000 per month, the marginal tax rate required to reach the maximum contribution limit would be 50% : $((\$18,00 - \$12,000)/\$12,000)$. This rate is beyond the maximum tax bracket presently, but historically the top marginal tax rates have been higher than this for periods of time. If our workers wished to save \$1,250 per month instead, or \$15,000 per year, the marginal tax rate at which the maximum IRS contribution limit would be reached would be 20%.
- ¹⁵ The average of the \$4,752 tax deduction for the lawyer and \$1,800 tax deduction for the teacher is \$3,276.
- ¹⁶ Hayes, Adam. Working paper on Risk Preference by Income Group and Age in 401(k) Plans (2014)
- ¹⁷ Piketty, Thomas. 2014. *Capital in the 21st Century*. Cambridge, Mass.: Harvard University Press