Retirement Income
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401(k) Reforms: More Enviable Than Viable

By Editor Test *Wed, Sep 28, 2011*

Proponents of 401(k) reform met defenders of the status quo in a Senate Finance Committee hearing on Sept. 15. The reforms have some justification, but they could hurt the very people who decide whether to sponsor a plan or not.

The defined contribution system is full of flaws. Many participants, particularly in small plans, pay too much in fees. They get meager average returns. The system isn't universal. And, worst of all, it offers no mechanism for turning savings into retirement income.

But it's clear from the testimony presented to the Senate Committee on Finance on September 15 that attempts to cure the system of its ills would probably irritate plan sponsors and perhaps discourage them from offering plans at all.

Well-intended government efforts to reform the pension industry have backfired before, as the history of defined benefit pensions illustrates.

Take, for instance, the proposal put forward by William G. Gale of the Brookings Institution. Instead of letting 401(k) plan participants exclude contributions (up to $49,000) from their taxable income, the government would credit a certain percentage of the contribution to the participants' tax-deferred savings accounts.

The size of the credit would determine its cost. If the credit—i.e., the tax subsidy—were equal to a flat 18% of the contribution, it would reduce the federal tax expenditure on 401(k) plans by $450 billion over the next 10 years. If the credit were set at 30%, it would maintain the current tax expenditure, which is estimated at about $70 billion a year ($123 billion for all retirement savings programs).

Gale's proposal would help reduce the federal deficit. It would also ensure that participants save rather than spend the federal subsidy of their contribution and sweeten the subsidy for the participants in the lowest tax brackets.

In short, he offers something for liberals, who claim that tax expenditures that encourage retirement saving accrue disproportionately to those in the highest tax brackets, and something for conservatives, who want to reduce the federal deficit.

But the proposal, by flattening the subsidy, would effectively raise the taxes of a company's owners and highest-paid employees—the people on whose favor the decision to sponsor a plan or not usually (unless the employees are unionized) depends. According to Gale's data, the 18% subsidy would mean a tax hike for the top 40% of earners; the 30% subsidy would raise taxes for the top six percent of earners.

Karen Friedman of the Pension Rights Center proposed four additional reforms. The freshest and most intriguing of those ideas seemed to be the "reverse match." Employers would make the initial contributions to their employees' defined contribution accounts, and employees would be encouraged to match those.

Under the current system, employers make no contributions unless the employee contributes.

In her hypothetical example, an employer might contribute 3% of pay to all employees, and the employee might be able to contribute up to 6%. This would ensure a contribution for all employees who don't currently contribute at all.

But it would also mean, presumably, a vast reduction in the current contribution limit (100% of compensation, up to $49,000 or $54,500 for those over age 50), and a consequent reduction in tax benefits for those able to make large contributions. Again, it's hard to imagine corporate decision makers warming up to that idea.

At the heart of the debate over 401(k) equitability is a sharp disagreement over how the spoils of the annual federal tax expenditure to encourage retirement savings are divided, and how they should be divided.

During the September 15 Senate hearings, Jack Van der Hei of the Employee Benefit Research Institute, whose members include all the major 401(k) service providers, and Judy Miller, representing the American Society of Pension Professionals and Actuaries, whose members are mainly third-party plan administrators, testified that most of the federal subsidy accrues to the non-wealthy.

Households with less than $100,000 in AGI pay about 26% of income taxes but receive about 62% of the defined contribution plan tax incentives, Miller said. Friedman said that two-thirds of the value of tax expenditures for retirement savings plans go to households in the top income quintile, or top 20% of earners.

Common sense suggests that, on a per capita basis, the benefits of the federal tax expenditures for retirement savings would go disproportionately to those with the highest compensations and the biggest tax bills. But common sense would also suggest that the majority of the tax expenditures would inevitably go to households earning under $100,000, simply because they represent 80% of all taxpayers, according to the Census Bureau.

Does someone who pays more in taxes deserve a bigger tax incentive to save? The 401(k) reformers would say no. They argue that those with high incomes need no incentive at all—that they would save even without incentives because they earn more than they "need." (Need, of course, remains stubbornly indefinable.)

So the debate drones on. As long as the law doesn't require company owners and decision-makers to sponsor workplace retirement savings plans, reforms that hurt them in their wallets won't get traction. If reformers push them too hard, some sponsors will stop sponsoring. To persuade people who have other options, carrots make the best motivators. The stick approach alone has limitations.