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Responding To Critics of Rolling Back the Retirement Tax Break

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In a recent paper, Boston College economist Alicia Munnell and I put forward a controversial proposition: that the federal tax break for retirement savings is ineffective and that those funds would be better used to address Social Security's substantial long-term funding shortfall. When one puts forward a controversial proposal, critiques are to be expected. But in this case criticism came mostly from friends and experts in the field, meaning their views cannot be dismissed as either ill-willed or ill-judged. And yet, the responses to our proposal have not undermined my belief in our conclusions. In fact, the shortcomings of these critiques have strengthened my confidence. As Winston Churchill said, there's nothing so nice as to be shot at and missed.

The federal tax preference for retirement savings is commonly misunderstood. Most people understand that contributions to a 401(k) or other retirement plan are excluded from their taxable income, but they then pay income taxes on benefits received them in retirement. If their income tax rate is lower in retirement than during their working years, the saver reaps a gain – and, of course, the federal government loses money. But this is just part of the deal. The real action is that retirement account balances are exempted from capital gains taxes. According to the U.S. Treasury Department, the tax preference for retirement plans had a net cost in 2019 of around $185 billion, or about 0.9% of GDP.

The tax preference's logic is that, by lowering the tax on savings, saving becomes more attractive and so we'll do more of it. This doesn't just help retirement security, the critics say, it helps the economy. As Veronique DeRugy, Charles Blahous and Jason Fichtner write for the Mercatus Institute, "If savings are excessively taxed—and double taxation would surely qualify as excessive—they are heavily discouraged, leading to lower levels of investment and a slower rate of economic growth." Double taxation, they say, occurs when a dollar of income is first subject to income taxes and then, if saved, hit with capital gains or other investment taxes.

But this description is oversimplified. If we wished to reduce the taxation of investments, we would simply lower the capital gains tax. The retirement tax preference does something very different: it lowers taxes on one form of savings but retains ordinary taxes on other savings. This opens up another response: instead of changing *how much* we save, the tax preference changes *where* we save: households shift money from taxable investment accounts to non-taxable retirement plans to get the tax break.

The households who receive the lion's share of the tax preference are perfectly situated to do that. According to the Tax Policy center, about 59% of the tax break is received by the highest-

income fifth of households, who not only have incomes in excess of $150,000 but who hold non-retirement financial assets nearly double the size of their retirement account balances. Any high-income household with financial acumen will shift as much money as they can to tax-preferred retirement savings.

But will they save more overall? It's unclear. Economists think that people respond to incentives "at the margin," meaning on the next dollar of income or savings. And, for these high-income households, the marginal tax rate on savings doesn't change because they already have savings on top of their retirement accounts. The marginal dollar of savings is subject to the capital gains tax. And second, the tax break they receive on their retirement savings means that they can reach any savings goal while saving less. Strange as it may sound, a simple economic model doesn't point to the tax preference raising total savings.

And multiple research studies reach the same conclusions. For instance, Yale economic Orazio Attanasio and his co-authors analyzed how household finances changed when households enrolled in IRA accounts. Household spending did not decline, which implies that household saving did not increase. Moreover, assets in ordinary taxable account fell by approximately the amounts that went into IRA accounts. In other words, these households received the tax preference, but they didn't save more. Similar studies find the same for the United Kingdom, Denmark, Spain, Italy, and Latvia.

Adam Michel of the Cato Institute points to studies concluding that the tax preference does boost savings, but these references are mostly off-topic. For instance, some studies have claimed that IRA accounts increase savings. But these studies are disputed, including by those cited above.

Moreover, IRA accounts differ from 401(k)s in important ways. IRAs are do-it-yourself, requiring individuals to locate a provider, set up an account, choose how much to contribute, how to invest it, and so forth. Perhaps the tax preference is helpful in overcoming those burdens, but it can't be doing *that* much: very few Americans actually contribute to IRAs, versus using them as repositories for 401(k) rollovers.

But 401(k)s don't require nearly the effort of IRAs. They are offered in the workplace, making enrollment easy; many plans today offer automatic enrollment, default contribution rates and automatic asset allocation. The fact that so many Americans participate in 401(k)s while very few use IRAs indicates that 401(k)'s structural advantages are far more important than the tax preference.

Indeed, 401(k)s illustrate the weakness of the tax preference as an incentive to participate. Behavioral economists have shown that many eligible workers don't sign up for a 401(k), meaning that they're ignoring the tax preference. When employees are automatically enrolled, most continue to participate. Likewise, the majority of automatically-enrolled 401(k) participants contribute either at the default contribution rate or at the rate at which they maximize the employer matching contribution. Only around one-in-six 401(k) participants maximizes the tax preference, which again is unexpected.

It’s true, as I’ve long argued, that 401(k)s have increased retirement savings. Compared to the traditional pensions that preceded them, 401(k)s are more attractive to employers and therefore more widespread. Likewise, while pensions were funded only by employers, both employers and employees pay into 401(k)s. I’m not talking down 401(k)s. But the tax preference isn’t the main thing 401(k)s have going for them, while costing billions each year.

To be clear, this isn’t an argument about fixing Social Security with tax increases or benefit reductions. Prof. Munnell and I have almost diametrically opposed views on that point. In fact, the Social Security reforms I have proposed, which would gradually transition the program to resemble Australia’s flat benefit retirement system, reduce long-term costs well beyond what even most conservative lawmakers would consider.

But even with this ambitious plan, Social Security will require significant extra revenues over the next several decades, simply because any benefit changes take time to be phased in and because, quite simply, politicians have delayed action for decades. We can get those additional revenues from rolling back the retirement tax preference.

Or we can get that money from other sources, such as raising the 12.4 percent payroll tax rate paid by every worker, or by eliminating the ceiling on wages subject to payroll taxes, which hits every American earning more than $168,000 with a 12 percentage point increase in their marginal tax rate. It is hard to argue that these alternative revenue-raisers would not have a bigger damaging effect on the economy.

Now, one forceful critique of our proposal argues that using an outside revenue source would undermine the self-financing ethos that has been central to Social Security since its founding. DeRugy, Blahous and Fichtner write, “To bail out Social Security with general revenues, regardless of the rationale, would effectively put an end to Social Security’s continued functioning as an earned-benefit program. Thereafter, there would be no rhyme or reason to the benefit levels that Social Security offers.”

But I would argue that the (largely mistaken) perception of a self-funding system with earned benefits has made reforms harder. For instance, Congress has known since 1984 that Social Security faced a long-term funding gap, and since 2010 that the program was running cash deficits. But due to balances in the Social Security trust funds – essentially, IOUs we have written to ourselves – reforms probably won’t take place until insolvency is imminent in the 2030s. By then, all our choices will be bad ones. Likewise, Americans’ perception that they have earned and paid for their benefits drives a strong emotional opposition to any benefit changes, even if the Congressional Budget Office and the Social Security Administration calculate that people retiring today are promised far more in benefits than they ever paid in taxes. The idea of earned benefits means we must pay high benefits even to people who don’t need them, which means taxes must be higher than the safety net-oriented programs in countries such as the United Kingdom, Canada, Australia and New Zealand. This year, a two-earner couple who each earned the maximum taxable salary over their careers can retire with combined Social Security benefits topping $96,000. That’s two to three times more than the maximum benefits offered in these

other countries. It’s not remotely needed to prevent poverty, and simply displaces real savings high-earners would do on their own. That in turn reduces economic growth.

There are no villains in this story, other than the politicians who for decades failed to show the leadership (or even the followership) to enact Social Security reforms before a funding crisis became imminent. Even today, increasing numbers of ostensibly conservative Republican lawmakers oppose any benefits reductions, while failing to propose the tax increases needed to avoid them. And so we are left with no good options, only a choice between less-bad ones. I believe that rolling back a tax break that neither significantly raises retirement savings nor helps people at risk of poverty in old age is superior to raising the payroll tax rate or eliminating the wage ceiling for payroll taxes. And, unfortunately, those are increasingly the choices we face.