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Stripping 401(k) Tax Breaks Won't Fix Social Security

By Peter Brady

More American retirees get income from retirement plans today than ever before. In combination with Social Security benefits, this income helps most maintain their standard of living as they transition into retirement.

These facts may come as a surprise to many given the steady stream of headlines about a looming retirement crisis and widespread concerns about the shift from defined benefit (DB) plans to defined contribution (DC) plans in the private sector.

To be sure, the US retirement system faces substantial challenges as the American population ages. Arguably the biggest challenge will be funding the government programs that have served as the foundation of the system, especially Social Security.

A recent Social Security proposal, however, would do more harm than good. The proposal, included in the most recent issue of *The Journal of Retirement*, calls for eliminating tax deferral for DC plans and using the revenue raised to shore up Social Security's finances. As I explain in a response published in the same issue of the journal, this proposal would very likely cause the voluntary retirement plan system to unravel and, in doing so, undermine the entire US retirement system.

Social Security and retirement plans are designed to work in tandem to provide retirement security—they shouldn't be pitted against each other.

Misreading the Evidence

The primary justifications for the proposal are the claims that employer-sponsored retirement plans do not work and that they primarily benefit high earners.

However, the weight of the evidence indicates that employer plans are working and that their importance has increased over time. For example, resources set aside in retirement plans have more than doubled as a share of GDP since 1975, as has the share of retirees getting income from these plans.

The evidence also shows that the benefits of employer plans are not restricted to high earners. Most workers get income in retirement from these plans. A recent study analyzing tax data that I co-authored with fellow ICI economist Steven Bass found that three-quarters of individuals aged 72 received income from employer plans (inclusive of both DB and DC plans) and/or individual retirement accounts (IRAs). It also found that this income is more important to those in the middle of the income distribution than to those at the very top.

Further, the ICI tax data study suggests employer plans are largely working as intended. The formula used to calculate Social Security benefits ensures that Social Security replaces a much higher portion of earnings for workers with lower lifetime earnings. To maintain living standards in retirement, workers with higher lifetime earnings rely more heavily on employer plans and IRAs to supplement Social Security. Based largely on the combination of income from Social Security and non-Social Security retirement plans, the typical 72-year-old replaces over 90 percent of the inflation-adjusted spendable income they earned in their mid- to late-50s. In other words, their take-home pay stayed the same over time. In fact, despite being more reliant on Social Security, workers with lower pre-retirement income typically had higher replacement rates in retirement.

Unraveling the System

Proposing to radically alter the US retirement system warrants considerable caution. Tax deferral for contributions to employer plans has been part of the income tax for most of its history—since 1921 for DC plans and since 1926 for DB plans.

Deferring taxes on retirement plan contributions until distributions are taken in retirement has been the primary underpinning of the voluntary employer plan system. An income tax generally discourages savings by taxing investment returns. By effectively taxing investment returns at a zero rate, tax deferral removes that inherent disincentive to save.

Eliminating tax deferral would likely unravel the entire employer plan system. It would remove the primary incentive for workers to seek out jobs that offer retirement plans. As a result, employers would be unlikely to provide them. This would cause the competitive and innovative market for firms providing services and investments to these plans—which has delivered economies of scale to workers who might otherwise not invest—to shrink.

The proposal would damage the voluntary component of the retirement system and would not solve the long-term issues facing Social Security, instead just kicking the can down the road. Even if the proposal raised as much revenue as predicted (which would be unlikely), it would not be enough to close the Social Security financing gap. Further, by the authors' own admission, eliminating tax deferral would boost revenue more in the short run than in the long run. This is because the proposal would initially increase taxes on savings while continuing to the tax retirement distributions of current retirees. Eventually revenue will fall as taxable retirement plan distributions go away.

In the end, current and future workers will still have to pay to bring Social Security finances into balance—either by paying higher taxes or receiving lower benefits—while also having a much harder time supplementing those benefits in retirement.

The Bottom Line

Both Social Security and employer-sponsored retirement plans are vital components of the US retirement system. While it is imperative to put Social Security on sound financial footing and preserve its basic structure, that should not be achieved by sacrificing employer plans.

This is not the first proposal to attack employer plans and IRAs, and it won't be the last. The evidence shows voluntary retirement plans have become increasingly important and are currently providing income to millions of American retirees. It's essential to keep those facts front and center in any debate on the future of the US retirement system.

Peter Brady is a Senior Economic Adviser at ICI.

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