All-Roth 401(k)s? Really?

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MarketWatch Blog by Alicia H. Munnell

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Congress has come up with a really bad idea.

I live in Boston, so when I report on current thinking in Washington, you should take it with a grain of salt. Nevertheless, in two recent meetings, participants – who do seemed to be plugged into Washington developments – suggested the only change in retirement policy we could expect is that all new 401(k) contributions would have to go into a Roth plan rather than a conventional 401(k) plan. If true, such a change is a craven play to increase tax revenues in the short run, without any consideration for long-run revenues or the effect on retirement saving.

Such a narrow and ill-conceived change is very frustrating to those of us who that think 401(k) plans need a number of changes – mandatory auto enrollment, mandatory auto escalation in the default contribution rate, mandatory default contribution rate of 6 percent, etc. – to serve as an effective retirement savings system. Changes are also required on the drawdown side so that people do not either spend their money too quickly and outlive their savings or spend it too slowly and deprive themselves of necessities. The tax treatment of 401(k)s could also be more equitable by replacing existing tax deductions for retirement savings with a government matching contribution. And even if we could get 401(k) plans to work perfectly, they are unlikely to provide adequate income for those who are covered, and they offer nothing for the more than 50 percent of private sector workers who have no such coverage. Congress should be discussing how to design a new tier of retirement accounts that cover everyone.

Instead, just as people finally understand how 401(k)s work, Congress is going to change the format. Instead of getting a deduction for their contribution, workers will have to put in after-tax dollars.

Technically, the outcome under a Roth and a conventional 401(k) is virtually identical.   Unfortunately, the easiest way to make this point is with an equation.

Assume that 't' is the individual's marginal tax rate and 'r' is the annual return on the assets in the 401(k). If an individual contributes \$1,000 to a conventional 401(k), then after n years, the 401(k) would have grown to $\$1,000(1+r)^n$.   When the individual withdraws the accumulated funds, both the original contribution and the accumulated earnings are taxable. Thus, the after-tax value of the 401(k) in retirement is $(1-t)\ \$1,000(1+r)^n$.

Now consider a Roth 401(k). The individual pays tax on the original contribution, so he puts

(1-t)\$1000 into the account. After n years, these after-tax proceeds would have grown to $(1+r)^n\ (1-t)\ \$1,000$. Since the proceeds are not subject to any further tax, the after-tax amounts under the Roth and conventional plans are identical:

Roth   Conventional

$(1+r)^n\ (1-t)\ \$1,000 = (1-t)\ \$1,000(1+r)^n$

Of course, the preceding exercise assumes that the tax rate people face in retirement is the same as that when they are young. If their tax rates decline after retirement when they withdraw the funds, then they will pay less tax and have more after-tax income with the conventional 401(k) than with the Roth. If tax rates rise in the future to cover the deficits in federal budget forecasts, then today's workers will face higher taxes in retirement and will have more after-tax income with a Roth 401(k) plan than with a conventional one. But, for most people, changes in tax rates before and after retirement are not that significant, so the two types of 401(k) plans can be viewed as identical from a technical perspective.

But they are not identical to a Congress focused on the short term. Under the conventional account, tax revenues are reduced in the short run as people take deductions for their 401(k) contributions. Revenues are then recouped in the long run as initial contributions and earnings on those contributions are taxed when retired workers withdraw their funds. Under the Roth, no such revenue loss occurs in the short run because the employee's contribution comes out of after-tax income. So tax revenues will be higher in the near term. Thus, if the goal is to improve the near-term budget outlook, Roth 401(k)s are to be preferred.

And the two accounts also do not look identical to individuals. At the most basic level, they now have to deal with a new form of retirement saving, which will take time to understand. In addition, Roth 401(k) plans are confusing because the *employer's* contribution is treated as a conventional 401(k) and not included in taxable income but is taxable when money is withdrawn. The confusion created by the additional version of the account may cause people to freeze and not participate. At a slightly deeper level, the tax treatment of the contribution may also lead to less saving. It is a positive feeling to see 401(k) contributions reduce one's taxable income and required tax payments. This pleasant sensation does not occur with a Roth, where the taxes are paid first, and the 401(k) contribution is made from after-tax income. With all the confusion and the change in the nature of the contribution, people will almost certainly cut back on their already inadequate retirement saving.

In short, a mandatory shift from conventional to Roth 401(k) plans is a really bad idea. If Congress cannot do anything constructive on the retirement savings front, then let's encourage it to at least do no harm.