How Much Do 401(k)s Cost the Treasury?

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MarketWatch Blog by Alicia H. Munnell

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Contributions to 401(k) plans are treated favorably under the federal personal income tax. The government does not tax either the employee or employer contributions to these plans or the investment earnings on the contributions until the monies are withdrawn in retirement. In addition, deferral shifts income to a time of life when people have less income and thereby face a lower tax rate. This treatment significantly reduces the lifetime income taxes of those employees who receive part of their compensation in contributions to a 401(k) compared to those who receive all their money in cash wages.

This favorable treatment costs the Treasury money. Precisely how much it costs has become a hotly debated topic given the enthusiasm, in the face of large and rising deficits, for increasing revenues by cutting tax expenditures.

Historically, the federal government estimated the revenue loss on a cash basis. Under this concept, the loss is the net of two figures: 1) the revenue that would be gained from the current taxation of annual contributions and investment earnings in, say, 2010, and the amount that would be lost in 2010 from not taxing benefits in retirement, as is done currently.

While the cash flow approach is meaningful for permanent deductions and exclusions, it does not properly account for deferrals. Consider the case

where annual contributions to a plan and investment earnings exactly equal withdrawals during that year. Under cash flow accounting, the revenue loss would equal zero. Yet, individuals covered by these plans enjoy the advantage of deferring taxes on contributions and investment earnings until after retirement. The problem is not that cash flow calculations overstate or understate the revenue loss; the problem is that they do not measure the benefit of deferral.

The correct way to estimate the true economic cost of the tax provisions associated with 401(k)s and similar defined contribution plans –referred to below simply as 401(k) plans – is the present value of the revenue foregone, net of the present value of future tax payments, of activities undertaken in a given year. Unfortunately, the present value estimates range from $134 billion (Table 17-4, "Tax Expenditures," Analytic Perspectives, *Budget of the United States*) to $27 billion ("Retirement Savings and Tax Expenditure Estimates," American Society of Pension Professionals & Actuaries (ASPPA), May 2011).

What's a reasonable number? Our estimate, which will be discussed in next week's blog post, is between $50 and $70 billion. Why then is the ASPPA number so low and the *Budget* number so high?

The ASPPA estimate is so low because the authors assume that contributions in 2010 amounted to $110 billion. However, data for 2009 from the Department of Labor Form 5500 show employer contributions of $110 billion and employee contributions of $172 billion for a total of $283 billion. So the ASPPA estimate is based on less than 40 percent of the total contributions to defined contribution plans.

The *Budget* number is so high for two reasons. First, it is based on IRS Statistics of Income data, which suggest 401(k) contributions 30 percent larger than the Department of Labor Form 5500. Second, the *Budget* calculation assumes that all 401(k) money is invested in bonds. Therefore, if the money were not in a 401(k) account – the counterfactual – it would be taxed annually at the full rate. In fact, two thirds of 401(k) assets are invested in equities where gains are taxed only when realized and both dividends and gains are taxed at a preferential rate of at most 15 percent.

In short, the ASPPA number is simply incorrect because it is based on only 40 percent of contributions. The *Budget* number is too high because of unrealistic assumptions. The preferences accorded 401(k) plans probably amount to between $50 and $70 billion each year, still a non-trivial sum.