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HOW THE INCOME TAX TREATMENT OF SAVING AND SOCIAL SECURITY BENEFITS MAY AFFECT BOOMERS' RETIREMENT INCOMES

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Changes in federal income tax provisions directly affect the amount of wealth individuals can accumulate during their working years and, for a given amount of wealth, the living standards they can enjoy in retirement. Tax changes enacted in 2001 and made permanent in 2006 expanded access to and increased the amounts people can contribute to tax-preferred individual retirement accounts and employer-sponsored retirement saving plans. Tax changes enacted in 2003 and extended in 2005 reduced tax rates on capital gains and dividends through the end of 2010, thereby increasing after-tax returns outside of tax-favored retirement saving accounts. Tax provisions affecting the treatment of Social Security benefits have not changed since 1993, but the share of Social Security benefits included in taxable income is continually increasing under current law because the threshold levels for inclusion of benefits in income are not indexed for inflation.

This paper uses the Urban Institute's Dynamic Simulation of Income Model (DYNASIM3) to simulate how potential changes in the tax treatment of retirement savings, Social Security benefits, and income from assets outside of retirement saving plans may affect boomers' retirement incomes. We provide estimates of effects of these policies on income at age 67 for leading boomers (born between 1946 and 1950) and trailing boomers (born between 1960 and 1964), grouped by gender, marital status, race, education, lifetime earnings, and household income.

Key findings include the following:

- Reducing 401(k) contribution limits to their real values prior to tax law changes since 2000 will reduce the average after-tax income of boomers by only a small amount because few people contribute the maximum amount. The modest losses would be concentrated among high-income individuals because they are the ones most likely to participate in 401(k) plans and to be constrained by the contribution limits. Losses are larger for trailing boomers who have more years to be affected by the policy change.

- Permanently extending recently enacted tax rate cuts for capital gains and dividends would increase the average after-tax incomes of 40 percent of leading boomers and 58 percent of trailing boomers, but gains would be heavily concentrated among those with the highest lifetime earnings and household incomes and would be much larger for whites and college graduates than for others. For example, trailing boomers in the top income quintile, with 43 percent of total income at age 67, will receive 96 percent of the income gain from lower tax rates on capital gains and dividends.

- Indexing Social Security thresholds would increase after-tax income for 22 percent of leading boomers and 29 percent of trailing boomers. The gains would be largest for middle-income retirees. Boomers in the lowest income quintile would gain little because they would pay little or no income tax on Social Security benefits even with fixed thresholds, while boomers in the highest income quintile would gain little because most would continue to pay tax on 85 percent of their benefits even with the higher thresholds.

- Eliminating Social Security thresholds and including 85 percent of Social Security benefits in adjusted gross income for all beneficiaries would reduce average after-tax income by 0.6 percent for leading boomers and 0.2 percent for trailing boomers, and increase taxes for 31 percent of leading boomers and 23 percent of trailing boomers. Again, those in the middle income quintiles would be most affected by changes in the thresholds.

Under policy options that increase or reduce returns to saving, trailing boomers — who have up to 18 years longer than leading boomers to accumulate wealth — are more likely than leading boomers to experience a change in their retirement incomes. Trailing boomers also receive more benefits than leading boomers from indexing the thresholds for taxing Social Security benefits because the difference in value between indexed and unindexed thresholds rises over time. But eliminating the thresholds for taxing Social Security benefits has less effect on trailing than on leading boomers because over time the real value of the currently unindexed thresholds will erode.

As policymakers are forced to confront shortfalls in Social Security financing, they could consider income tax changes as an alternative to or in conjunction with reducing benefits or increasing payroll taxes. Different income tax changes, however, will have substantially different effects on the income distribution of future retirees. Proposals to change the income thresholds for exempting Social Security benefits from income tax will have the largest impact on middle-income boomers. In contrast, proposals that change the tax incentives for retirement saving or reduce taxes on capital gains and dividends will mostly affect the highest income boomers. Before enacting proposals that reduce retirement incomes of low- and middle-income retirees, policymakers could consider changing income tax rules that benefit the more affluent future retirees.

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