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DO LOW-INCOME WORKERS BENEFIT FROM 401(K) PLANS?

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Overview

This paper explores the hypothesis that employer contributions to defined contribution (DC) plans may affect total compensation differently for low and high-income workers. Using a longitudinal data set that allows us to measure worker quality based on their prior earnings, we estimate the effects on earnings in new jobs of employer contributions to DC plans. We find evidence that additional employer contributions to DC plans reduce money wages much less for low-income than for high-income workers. This means that employer DC contributions increase the total pretax compensation of low-income relative to high-income workers, offsetting in part the relatively larger tax benefits that these contributions provide to high-income workers.

Background and Theory

Economists frequently assume that employees "pay for" employer-provided fringe benefits, including contributions to qualified retirement plans, by accepting lower pretax wages. Researchers often also assume that the each dollar of contributions replaces a dollar of money wages for all employees, leaving total pretax compensation unchanged. For example, studies of the distributional effect of tax incentives for retirement saving estimate the benefit of these savings as the present value of increased lifetime income from additional amounts invested in tax-qualified retirement plans.

But qualified retirement plans may affect the distribution of pretax contributions if low-income employees assign a much lower value to retirement contributions than high-income employees and thus are less willing to accept a lower money wage. Low-income employees in the 0 or 15 percent tax rate bracket gain much less from the availability of tax-free accrual in qualified retirement plans than high-income employees because they face much lower taxes on capital income accrued outside of these accounts. In addition, the exemption of employer contributions from the base for computing payroll taxes and benefits provides relatively less benefit to low-income than to high-income employees because Social Security retirement and disability benefits are relatively higher per dollar contributed for low-income employees than for high-income employees. Finally, low-income employees are more likely than high-income employees to prefer consumption to meet immediate needs to additional saving and so on average place a lower subjective value from compensation to retirement plans in which it is costly to access funds immediately.

Because of non-discrimination rules, some employers must subsidize additional participation of low-income employees in DC plans in order to provide tax-preferred retirement saving opportunities to the high-income employees who value them. These employers who wish to offer qualified retirement plans to attract the most qualified employees to high-paying positions may be unable to reduce money wages to low-income workers in exchange for the benefits they provide to all workers.

Methodology and Findings

Econometric efforts to estimate how much fringe benefits, such as health insurance and pension contributions, substitute for wages explain money wages as a function of worker attributes and job characteristics, including fringe benefits. Many of these studies have failed to identify the expected negative relationship between wages and fringe benefits. Researchers often cite the difficulty of identifying workers who might command high total compensation in the marketplace (worker quality) as a main source of the failure to identify these compensating differentials.

This paper uses a data source that matches the 2004 and 2008 panels of the Survey of Income and Program Participation (SIPP) with longitudinal Social Security administrative earnings data from the Summary Earnings Records (SER) and Detailed Earnings Records (DER). The SIPP provides data on demographic characteristics of workers (education level, race, age, gender) and job characteristics, such as whether workers are offered a pension or health insurance plan, the pension plan type (DB, DC, or cash balance), and whether and how much employers contribute to a plan. The availability of historic earnings from administrative data allows for a much better adjustment for worker quality than could be obtained using only the income and demographic variables reported on the SIPP.

We estimate equations that predict cash wages of workers who have held their current job between one and five years as a function of job characteristics, demographic variables, and earnings history on prior jobs. We estimate separate equations for male and female workers, and for male and female workers in low-income households (defined as the bottom 40 percent of the income distribution) and in high-income households (defined as the top 40 percent of the income distribution).

The first set of equations estimates the effects of offers of pension coverage on earnings in a new job, holding past earnings, demographic characteristics of workers, and other job characteristics fixed. We find that workers offered pension and health insurance coverage receive higher wages than those without offers of coverage, adjusting for worker characteristics, prior earnings histories, and coverage by a union contract. This suggests a form of labor market segmentation, where some jobs offer both higher wages and benefits and others lower wages and no benefits.

The second set of equations finds, however, that among those workers with DC coverage additional employer contributions do substitute for money wages. Among male workers, the estimates show that, for any given level of employee contributions, an additional dollar of employer DC contributions replaces 90 cents of wages for workers with high family income, but only 29 cents for workers with low family income. Among female workers, an additional dollar of employer DC contributions replaces 99 cents of wages for those with high family income, but only 11 cents for those with low income.

The findings imply that both low and high-income workers benefit from employer DC contributions. Low-income workers benefit because their total compensation rises. High-income workers benefit because the increased access to tax-advantaged saving more than offsets their loss of money wages, even though their total compensation is about the same. This suggests that conventional approaches may overstate the share of benefits from tax-preferred retirement saving plans with employer participation that go to high-income employees by assuming that contributions reduce wages equally for all employees.

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