The Implications of Reducing the Tax Expenditure for 401(k) Plans

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Tax expenditures for 401(k) plans can be reduced in one of two ways. The deferral provisions could be limited to, say, a lower dollar amount or the taxation of saving outside of 401(k)s could be treated more favorably – that is, capital gains rates further reduced. The question is how such a change would affect work-based savings plans, which currently are the only effective mechanism for retirement saving.

In all probability, employers would retain work-based saving plans even with smaller tax advantages. Some economists have argued that employers view 401(k) plans as a useful mechanism for attracting a better class of worker. People who value 401(k)s are more careful with company equipment, take fewer sick days, and are generally more productive. And employers could see such plans as a way to promote an orderly retirement process. Older employees, whose productivity has declined, can stop working only if they have adequate resources. If employers see sufficient personnel management advantages, they will continue to sponsor these plans. After all, employer-based pensions – albeit the far more powerful management tool of the defined benefit plan – originated without any tax advantage.

On the other hand, people do not like locking their money up for long periods of time with limited access. Generally speaking, the money in 401(k) plans cannot be withdrawn until age 59 ½ without a 10-percent penalty. Borrowing is possible, but only up to limited amounts. Thus, if owners, managers, and highly compensated employees want equity investments and resist locking their money up without substantial tax advantages, 401(k) plans could be an endangered saving vehicle.

401(k) plans may not be perfect, but currently they are the only game in town. Virtually all saving by the working-age population currently takes place within employer-sponsored pension plans. Most individuals save virtually nothing on their own, other than through their home. According to the Federal Reserve's 2007 *Survey of Consumer Finances*, the financial saving outside of pensions of households approaching retirement (those aged 55-64) was only $30,000.

The fact that workers clearly accumulate retirement saving within an employer-sponsored plan does not help to sort out whether the saving reflects the tax advantages of pension saving or the 'Christmas Club' aspect of pensions, harking back to days when workers committed to set aside $10 or so each week so they would have money to buy presents at Christmas time.

What is clear is that without employer-sponsored plans, workers would be on their own. They would need to decide each month how much of their paycheck to put aside for the future. They would have to find a mechanism for investing these funds, for changing these investments as they age, and some form of self-discipline to keep the money invested until retirement. Available evidence shows that most people are not very good at this. In fact, the experience with 401(k)s has exposed people's proclivity to make mistakes at every step along the way. Thus, a retrenchment of work-based pensions could lead to substantially less saving.

In short, whatever changes are made to 401(k) tax expenditures should be done carefully. While everyone wants government spending – either explicit outlays or expenditures through the tax system – to be efficient, it is not in anyone's interest to damage the existing saving infrastructure.