"Middle" Grounds

Do middle income workers have less of a tax incentive to participate in a 401(k) plan?

By Nevin Adams

A recent report entitled, "The Missing Middle," by the National Institute on Retirement Security (NIRS) treads some all-too-familiar ground, myopically focusing on one element of the nation's private retirement system.

According to the paper, the tax incentives that arguably existed at the birth of the 401(k) have been muted due to lower marginal tax rates and the expansion of the standard deduction — both of which serve to mitigate the tax burden on lower-income individuals — but in the process also arguably lessen the financial incentive for deferring taxes. And if that were not enough, the authors also argue that the "…tax benefits relating to investment returns may be less in a market with lower returns."

Of course, the focus of the authors here is the tax incentives for retirement savings — and, unsurprisingly, the premise is that those with lower incomes — and thus less tax liability — get less from the current tax deferrals afforded 401(k) contributions than do those at higher incomes (who pay more in taxes). And, if you look only at that aspect — and that's where most such critiques stop — it's a fair point.

Before going into the shortcomings in that analysis, I'll admit that there are certain legitimate economic realities that the paper highlights — that higher-income (and by this we don't necessarily mean wealthy) individuals are more likely to have access to a retirement plan through work, that there are racial aspects that correlate to wealth inequities and access in the workplace, that the Saver's Credit as currently designed (requiring a long-form tax filing to claim and being non-refundable) aren't available to many who would otherwise be eligible, and that Social Security — though an underlying foundation of private requirement as a whole, and particularly for lower-income individuals — has funding issues of its own to fulfill the current benefit promises.

"Missing" Interactions

Unfortunately, as noted above, these types of analyses always gloss over the interrelationships between the tax incentives and the creation of these plans in the first place. It is assumed (generally implicitly) that employers that want to be considered an "employer of choice" will be forced to offer these plans regardless of the tax preferences to do so. Let's face it, the tax preferences — though modest at an individual level — do provide an incentive to not only offer the plan, but, in most cases, to provide a matching contribution… a matching contribution that these types of critiques always seem to gloss over (it does make their math simpler). And let's face it, there's no question that having access to a plan matters — even this paper acknowledges that those with access are 15 times more likely to save.

What's also glossed over is the impact of non-discrimination tests and legal contribution limits — limits that work, and work as designed, to keep an effective balance between the benefits of higher-paid and other workers. In fact, data from the Employee Benefit Research Institute has proven that while higher-income individuals do have higher account balances, those balances are in rough proportion to their incomes.

In calling for a "recalibration" of what they see as a "fundamentally inequitable system," the ostensibly well-intentioned authors are missing the mark. They focus exclusively on the individual tax preferences but ignore the influence of tax preferences on the decision to offer a plan in the first place, as well as the impact of non-discrimination testing in both encouraging an employer match (not to mention the financial impact that has on the retirement prospects of non-highly compensated workers), and on keeping the deferrals of higher-income individuals within a reasonable proximity to that of those with lower incomes. In choosing to do so, they miss the point — not to mention the very "middle" they claim the current system overlooks.

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