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Revenue Estimates of Restricting Tax Deferral: It Ain't Necessarily So

By Peter Brady

Fifth in a series of posts about retirement plans and the policy proposals surrounding them.

In previous *Viewpoints* posts, I explained that retirement contributions are neither tax deductions nor tax exclusions, but rather are tax deferrals. I also explained why, in my opinion, the two most prominent proposals to restrict qualified deferred compensation are flawed (post three and post four).

Now I'd like to provide a note of caution regarding revenue estimates associated with proposals to restrict retirement plan contributions.

Official revenue estimates will play a pivotal role in any effort to reform the federal income tax or to raise tax revenue. As part of the legislative process, any proposal that affects the tax code is "scored" by the Joint Committee on Taxation, and under the budgeting rules set by Congress, changes in revenue must be estimated over a 10-year budget period.

Initial Revenue Gains Will Be Partially Offset by Later Losses

As I explained in *The Tax Benefits and Revenue Costs of Tax Deferral* and previous posts, tax deferral changes the amount of revenue the government collects at three points. When compared to savings funded with compensation that is subject to tax and invested in a taxable account, tax-deferred savings generate:

- Less tax revenue when workers make retirement contributions
- Less tax revenue when investment returns are earned on the contributions
- More tax revenue when distributions are taken in retirement

Thus, any proposal that restricts tax deferred retirement contributions will have different effects on tax revenue over time.

Initially, tax revenue would be increased because compensation that would have been contributed to a qualified plan would instead be included in workers' taxable compensation. In addition, if someone saving for retirement takes a portion of their compensation that otherwise would have been deferred and contributes it to a taxable account (after paying income taxes), tax revenue would be increased relative to current law because interest, dividends, and capital gains on the investments would be taxed. This effect initially would be small, but would grow over time. However, as individuals began to draw down their savings in retirement, the government would lose the revenue that it otherwise would have collected on withdrawals from tax-deferred retirement plans. This impact also would likely be small initially, but would grow over time.

Short-Term Gain, Long-Term Pain?

Because of the requirement to only consider changes in revenue over a 10-year budget period, a proposal to restrict or prohibit retirement plan contributions could look as if it raises considerable revenue. What would be missing from any official revenue estimate, however, would be the drop in future tax revenue when retirees draw down their savings in the years beyond the 10-year Congressional budget window.

Although the net long-term effect on tax revenue would still be positive, it would likely be less than the effect on revenue during the budget period. The shorter-term gain in revenue over the budget period would come at the expense of a reduction in tax revenue when today's workers retire.

Additional Resources:

The Tax Benefit and Revenue Costs of Tax Deferral

Other Posts in this Series:

- Retirement Plan Contributions Are Tax-Deferred—Not Tax-Free
- Marginal Tax Rates and the Benefits of Tax Deferral
- A 'Modest' Proposal That Isn't: Limiting the Up-front Benefits of Retirement Contributions
- Tax Reforms Should Not Favor DB Plans over DC Plans

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