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Washington: Put Your (Retirement) Money Where Your Mouth Is

By Mike McNamee

When President Obama announced a new effort to expand access to retirement savings opportunities, ICI was among the first to applaud. The Administration's "myRA" looks to provide a new option for Americans who want to put money aside for retirement, but who might not have access to a retirement plan through their workplace. These accounts would complement the wide array of investment options already available to these workers.

But creating new opportunities will do little good if Washington limits the very incentives that have created the vibrant retirement savings system we have today. In his newly proposed budget for fiscal 2015, President Obama again is proposing to cap the incentives for retirement savings that have been central to the success of employer-provided retirement plans. ICI research shows that Americans have embraced the opportunity to save for retirement based on the current system, which is designed to provide savings opportunities to all. Yes, Washington needs to try to solve federal debt issues and simplify the tax code—but not at the expense of the retirement security of millions of hard-working Americans.

Misunderstanding Pension Taxation Leads to Misguided Proposals

A basic misunderstanding about how tax incentives for 401(k)s and similar retirement plans work has led to many a misguided and harmful policy proposal. The President's FY2015 budget contains two such proposals: a limit on the up-front tax benefits for many 401(k) and individual retirement account (IRA) savers, and a cap on the amount Americans can accumulate through the combination of defined benefit (DB) plans, defined contribution (DC) plans, and IRAs. (Just to make things worse, that cap happens to be a moving target from year to year—but more on that later.)

Regardless of income or method of deferral (i.e., DB plan, DC plan, or IRA), all workers receive the same tax treatment: they pay no tax on compensation set aside for retirement until they withdraw the money. Because deferral is not a deduction or an exclusion, everyone pays tax when the funds are distributed. There are no special tax breaks to fix, no loopholes to close. This tax treatment benefits Americans across the income-distribution spectrum and encourages employers to offer—and workers to participate in—retirement plans.

The 28 Percent Cap Would Affect All Income Levels

The first proposal in Obama's budget would limit the value of tax savings on an individual's retirement contributions to 28 percent. Limiting tax deferrals for the highest three income brackets (33, 35, and 39.6 percent) would substantially change the tax treatment of retirement contributions and undermine retirement security by reducing incentives for businesses to provide retirement plans. As this post explains, "limiting the up-front benefit of tax-deferred contributions to retirement accounts reduces the benefits of tax deferral, but does so arbitrarily...substantially reducing the tax benefits for those closest to retirement."

The potential spillover effects could be enormous. If some employees no longer assign as much value to the opportunity to save in employer-sponsored plans, some employers likely will find that the benefits their employees receive no longer justify the expense of offering a plan. Those employers may choose to eliminate their plans, using the savings to increase cash compensation. It is difficult to predict the size of the effect, but if the 28 percent cap or other similar proposals were applied to tax-deferred retirement contributions, this change would undoubtedly reduce the number of employers that voluntarily sponsor a retirement plan.

Impact of a Pension Savings Limit

The Administration's budget also proposes to cap the total amount a worker could accumulate in the combination of DB plans, DC plans, and IRAs—a cap that could prevent workers from reaching their full retirement savings goals.

Under this proposal, fluctuating interest rates or market returns could temporarily push an individual's total accumulations over the limit in a given year—forcing the saver to stop saving for some time and restart later. This approach is overly complicated and extremely difficult for businesses and families to track. It would create a "stop and go" system that penalizes workers who take responsibility over the long term to save for retirement.

Americans Support the Current System

Washington should not try to fix a system that isn't broken. Research shows time and again that the U.S. retirement system is strong and is working for millions of Americans, who overwhelmingly support the incentives that help them to achieve their savings goals.

Of course, we can and should do more to build on the successes of the current system. But that starts with keeping what works—and preserving the benefits of tax deferral for all savers working to build a secure retirement.

Visit our Retirement Resource Center to find out more about ICI research and other useful information about America's retirement system.

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