ON RETIREMENT Retirement Plan Advisers

401(k) plans are failing middle-class Americans

A new study finds that tax incentives for saving for retirement primarily benefit high-income households.

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A new report finds that the tax breaks designed to encourage Americans' retirement savings disproportionately benefit high-income households and do little to assist middle-class families.

More than half of the tax breaks for defined-contribution plans, such as 401(k)s and individual retirement accounts, go to those whose income puts them in the top 10%, according to new research from the National Institute on Retirement Security, a nonprofit, nonpartisan organization established to contribute to informed policymaking. NIRS' membership includes financial services firms, employee benefit plans, trade associations and other retirement service providers.

The ***report*** documents how current tax incentives fail to promote adequate retirement security for the middle class. It considers the impact of factors including marginal tax rates, retirement plan participation and income distribution on retirement savings levels. The research also offers potential solutions that could enhance retirement security for middle-class families.

"It is clear that there are many people approaching retirement with a Social Security benefit that will replace less than half of their current income, meager savings, and who are less likely to be accruing a pension benefit than middle-class workers in the past," the report found.

More than 40 years ago, when the 401(k) was created by the Revenue Act of 1978, saving for retirement through a 401(k) offered more benefits for a typical middle-class worker. However, recent changes to the tax code, the economy and life expectancy have made saving for a secure retirement through a 401(k) more challenging for middle-class families, who are also struggling to pay for ***health insurance*** and high housing costs, and to save for college for their kids.

Saving for retirement remains a good idea, but tax changes have altered the arithmetic regarding retirement savings. For one thing, top marginal income tax rates are much lower now than they were 40 years ago, so there is generally less advantage to be gained by lowering taxable income through contributions to a 401(k) or other retirement plan, the report noted.

Second, the standard deduction on federal income tax returns is much larger now, thanks to the Tax Cuts and Jobs Act of 2017. Those who are married and filing jointly need household income above $109,000 in 2022 to move beyond the 12% marginal tax bracket. Thus, the tax match available through saving for retirement is only 12% or less for many middle-class families, which is a weak, illiquid premium offer for locking up money for decades.

Finally, current ***interest rates*** are much lower than rates were 40 years ago. Investors must either take more risk or plan for lower returns on their investments by saving more.

Taken together, these changes mean that a typical middle-class family receives a smaller tax break through saving for retirement in a tax-advantaged plan like a 401(k) than a similar family did 40 years ago, while they're also expected to need more resources to achieve for a secure retirement.

Because of Social Security's progressive benefit structure and capped benefit amount, high-income earners need to save more for retirement through private means because they will receive a smaller replacement ratio from Social Security than low-income workers. While it's true that ***Social Security*** is generous to those with very low incomes, replacement rates drop off quickly for those in the middle class. But tax incentives aren't filling that gap until a taxpayer reaches significantly higher income levels, leaving a gaping hole into which much of the middle class falls, the report said.

Another major factor contributing to retirement incentives being skewed toward higher-income earners has nothing to do with tax policy, but is simply a function of the fact that there is a strong correlation between participating in an employer-based plan and income level. Participation in a workplace retirement plan rises as income levels increase, and workers are 15 times more likely to participate in a retirement saving plan if they're offered a plan through their employer, according to the AARP.

"Saving for retirement is one of the biggest financial challenges facing middle-class families," said Dan Doonan, NIRS executive director. "But the middle class is left behind by the retirement savings system in key ways, including tax incentives."

Doonan suggested that policymakers should look at ways to strengthen Social Security, increase access to and participation in retirement plans, which some states are already doing for workers who lack workplace plans, and reform the deduction-based tax system that favors high-income workers and replace it with a refundable tax credit that would benefit all.

One of the report's suggested Social Security reforms as the system grapples with long-term financing problems would be to eliminate the maximum taxable wage base — currently $147,000 per year — on which workers and their employers pay FICA taxes to fund Social Security benefits.

"While the percentage of workers with earnings above the tax max has held relatively steady for years, the percentage of earnings above the tax max has increased due to the increased amount of income inequality in the U.S.," the report said. "Eliminating the tax max completely would bring more revenue into the program."

(Questions about new Social Security rules? Find the answers in Mary Beth Franklin's new 2022 ebook at MaximizingSocialSecurityBenefits.com)
