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POLICY STUDY

ANALYSIS OF THE BIDEN PROPOSAL TO EQUALIZE SAVING INCENTIVES

Dennis W. Jansen, Liqun Liu, and Andrew J. Rettenmaier

PERC Policy Study 2003
October 2020

SUMMARY

Democratic Presidential Nominee Joe Biden has proposed replacing the current tax deductions on contributions to 401(k) retirement accounts with a uniform refundable tax credit. The tax credit would be deposited into the taxpayer's retirement account as a matching contribution. The logic of the uniform tax credit is that it would give lower income workers added incentives to save for retirement because this arrangement would be more generous to them than is the current tax deductibility of contributions to 401(k) accounts.

The proposed reform, however, suffers from several implementation issues. If enacted, lower income workers would utilize the tax credit and higher income workers would switch to Roth savings plans. This would result in an overall increase in tax expenditures, another way of saying less tax revenue for the federal government. Additionally, it also produces unequal treatment for workers who participate in defined contribution plans relative to workers in defined benefit pension plans.

The intent of the Biden plan is to bolster the savings of lower income workers and to create a uniform tax credit across all workers who participate in defined contribution retirement plans. The realization of the reform's goals, while retaining revenue neutrality, will not be achieved unless all retirement savings options are also reformed.

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Private Enterprise Research Center
Texas A&M University
4231 TAMU
College Station, TX 77843-4231
(979) 845-7559
perc@tamu.edu

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Ashley Bullock

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INTRODUCTION

Democratic Presidential Nominee Joe Biden has proposed replacing the current tax deductions on contributions to 401(k) retirement accounts with a uniform refundable tax credit. The tax credit would be deposited into the taxpayer's retirement account as a matching contribution. The logic of the uniform tax credit is that it would give lower income workers added incentives to save for retirement because this arrangement would be more generous to them than is the current tax deductibility of contributions to 401(k) accounts. As we will see, the intent of the proposal will be difficult if not impossible to achieve due to a handful of implementation issues.

While not specified in the Biden tax plan, the estimated revenue neutral tax credit is 26%.[1] Supposedly, with this tax credit, the federal government's revenue losses on low earning workers due to the proposed policy change would be just offset by the revenue gains on high earning workers. To see why the tax credit is more attractive for lower earning workers, we must first determine the marginal tax rate that makes the existing tax deduction equivalent to a 26% tax credit. Under the Biden plan, for every (after-tax) $100 a worker contributes, another $26 is contributed to their savings account, for a total of $126. Suppose, however, that the (before-tax) $126 had been deposited in a 401(k) plan under the existing tax deduction. What is the marginal tax rate that equalizes the worker burden in the two situations? That is, what is the value for *t* in this equation: $\$100=\$126(1-t)$? The marginal tax rate that makes the existing tax deduction equivalent to the 26% tax credit is 20.6%.

Thus, wage earners who currently pay marginal tax rates lower than 20.6% will benefit from this policy change, but those who pay marginal tax rates higher than 20.6% will be hurt by it.

Currently, contributions to 401(k) accounts are untaxed, but withdrawals are taxed as normal income. Workers who contribute to these defined contribution plans essentially defer the tax payments on their contribution and on any growth through interest, dividends, and capital gains until funds are withdrawn in their retirement years. If workers' tax rates during retirement are lower than during their working years, this tax treatment allows them to lower their lifetime tax payments.

This year, the maximum contribution employees younger than 50 can defer, in addition to any contributions from their employers, is $19,500. Employees 50 and older can defer up to $26,000 in addition to contributions from their employers. Combined, the total employee and employer contribution that can be tax deferred is $57,000 for employees younger than 50 and $63,500 for employees 50 and above. Employees can also participate in Roth 401(k) plans. If offered by an employer, the employer's matching contributions are not taxed at the time they are deposited but are taxed at withdrawal. However, the employee's own contributions are made with after tax dollars and all interest, dividends, and capital gains are untaxed when withdrawn.

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[1]See, for example, "AN ANALYSIS OF FORMER VICE PRESIDENT BIDEN'S TAX PROPOSALS" by Gordon B. Mermin, Surachai Khitatrakun, Chenxi Lu, Thornton Matheson, and Jeffrey Rohaly https://www.taxpolicycenter.org/sites/default/files/publication/158624/An_Analysis_of_Former_Vice_President_Bidens_Tax_Proposals_1_2.pdf

The Biden plan is like the Roth savings plan in that workers' contributions are made with after-tax dollars. However, the Biden plan also adds the 26% tax credit, and importantly, withdrawals are subject to income taxes just as in traditional 401(k) plans.

A FEW EXAMPLES

A few simplified examples illustrate how the tax credit compares to the current tax treatment of traditional 401(k), Roth 401(k) plans and 'regular savings' that do not take advantage of tax deferral. These examples also point to some of the shortcomings of the stated goals of the Biden retirement savings tax credit.

Table 1

Employee A	Traditional 401(k)	Roth 401(k)	Biden Plan	No Tax Deferral
Employer contribution %	7%	7%	7%	7%
Employee tax deferred contribution %	7%	N/A	N/A	N/A
Rate of return	6.5%	6.5%	6.5%	6.5%
Marginal tax rate	12%	12%	12%	12%
Tax credit	N/A	N/A	26%	N/A
Age 50				
Salary	25,000	25,000	25,000	25,000
Employer contribution	1,750	1,750	1,750	1,750
Employee tax deferred contribution	1,750	0	0	0
Taxable income	23,250	25,000	25,000	26,750
Taxes	2,596	2,806	2,806	3,016
After tax income	20,654	22,194	22,194	23,734
After tax employee contribution	0	1,540	1,540	3,080
Income after income taxes and contributions	20,654	20,654	20,654	20,654
Total retirement contribution	3,500	3,290	3,290	3,080
Total contribution with tax credit			3,690	
Age 65				
Taxable Income	9,001	4,501	9,491	4,841
Nontaxable income	0	3,961	0	3,080
Taxes	1,080	540	1,139	581
After tax income	7,921	7,921	8,352	7,340

The example calculations in Table 1 assume that Employee A is 50 years of age, and has an annual salary of $25,000, that the employer and employee each contribute 7% to the worker's traditional 401(k)

plan, and that the worker earns 6.5% per year on the contribution to the account. This worker has a marginal tax rate of 12%. It is assumed that the worker will be in the same tax bracket 15 years later at retirement. This assumption allows us to see how the tax deferral with the traditional 401(k) and the Roth 401(k) is identical.

Consider the traditional 401(k) in the first column. The employer and the employee each contribute $1,750 to the account when the employee is 50 years of age for a total contribution of $3,500. The worker's $1,750 contribution lowers taxable income to $23,500 and the worker pays income taxes of $2,596. While the marginal tax rate is 12%, the worker pays 10% on the first $9,700 in taxable earnings. Together, this results in income of $20,654 after income taxes and contributions.

The bottom panel of the table presents the value at age 65 of the contribution that was made at age 50. The employee's $3,500 grows to $9,001 at retirement. Assume that this amount is "marginal" income at age 65 and that the worker is in the same marginal tax bracket. The worker pays $1,080 in taxes and has after tax income of $7,921.

The next column illustrates the outcome had the employee instead participated in an employer-sponsored Roth 401(k) plan. In this case, we assume that the 7% employer contribution is identical as in the traditional 401(k) with identical tax treatment. So, the employee's taxable income is $25,000, because the Roth contribution is made with after tax dollars. The employee's income taxes are $2,806 and income after paying taxes is $22,194. We made the Roth contribution $1,540 to ensure that the worker has the same income after taxes as with the traditional 401(k).

Again, the bottom panel identifies the value at age 65 of the contributions made at age 50. The employer's contribution of $1,750 grows to $4,501 at retirement. Since the contribution was initially tax deferred, the worker must pay taxes of $540 on its withdrawal at age 65, for a net withdrawal of $3,961. Combining this with the nontaxed income from the employee's own Roth contribution of $3,961 produces the same after-tax income as in the case with the traditional 401(k), or $7,921. Thus, these two savings vehicles produce the same income in retirement, assuming that the tax rate while working and during retirement is the same. If the expected tax rate during retirement is lower than during one's working years, the traditional 401(k) is preferred, but if the expected tax rate is higher, the Roth 401(k) is preferred.

The next column illustrates how the Biden plan may be implemented. As with the Roth 401(k) example, we again assume that the employer contributes 7% of the worker's salary, or $1,750, to a tax deferred account and that the employee contributes $1,540 to an after-tax account. Income after income taxes and contributions at age 50 is again $20,654. However, the employee's contribution is increased by 26%, the assumed Biden tax credit, resulting in the total deposit of $1,940. This amount is combined with the employer contribution for a total contribution, inclusive of the tax credit, of $3,690. Among the four options, this is the largest contribution at age 50.

Assuming the deposit grows at 6.5% for 15 years, the contribution results in income at age 65 of $9,491. Netting out taxes of 12% results in after-tax income of $8,352 when the employee is 65. Thus, this employee benefits from the Biden plan, given that the marginal tax rate is lower than 20.6%. This example illustrates the intended effect of the tax reform – that lower income employees' contributions to their retirement plans increase and their retirement incomes increase. This of course assumes that

there are no behavioral responses. If employees lower other savings or reduce their years in the labor force as a result of the Biden plan, then the plan may fail to achieve the intended result.

The final column illustrates the outcome if the worker does not take advantage of either traditional or Roth 401(k) plans. For this example, we assume that the employer contribution is taken as additional salary at age 50. We again determine the amount that is saved for retirement, $3,080, to ensure that the income after taxes and contributions is the same as in the previous cases. In the bottom panel, we see that income after taxes at age 65 is the lowest among the four in the table.

The next example illustrates the same calculations as outlined in Table 1, but for an employee earning $250,000. This worker has a marginal tax rate of 35%. As above, for comparability across the four options, the income after income taxes and contributions at age 50 is set to be the same and this determines the employee's contribution to the Roth 401(k) and the Biden plan.

Table 2

Employee B	Traditional 401(k)	Roth 401(k)	Biden Plan	No Tax Deferral
Employer contribution %	7%	7%	7%	7%
Employee tax deferred contribution %	7%	N/A	N/A	N/A
Rate of return	6.5%	6.5%	6.5%	6.5%
Marginal tax rate	35%	35%	35%	35%
Tax credit	N/A	N/A	26%	N/A
Age 50				
Income	250,000	250,000	250,000	250,000
Employer contribution	17,500	17,500	17,500	17,500
Employee tax deferred contribution	17,500	0	0	0
Taxable income	232,500	250,000	250,000	267,500
Taxes	56,569	62,694	62,694	68,819
After tax income	175,932	187,307	187,307	198,682
After tax employee contribution	0	11,375	11,375	22,750
Income after income taxes and contributions	175,932	175,932	175,932	175,932
Total retirement contribution	35,000	28,875	28,875	22,750
Total contribution with tax credit			31,833	
Age 65				
Taxable Income	90,014	45,007	81,868	35,759
Nontaxable income	0	29,255	0	22,750
Taxes	31,505	15,753	28,654	12,516
After tax income	58,509	58,509	53,214	45,994

Again, the after-tax income generated at age 65 is identical under the traditional 401(k) plan and the Roth 401(k) plan at $58,509. This is based on the assumption that the employee's marginal tax rate is the same at age 50 and at age 65. The income from the Biden plan at age 65 is 9% lower at $53,214. This illustrates that the Biden plan produces a lower result for high income employees. However, it also illustrates that if the traditional 401(k) plan is replaced with the Biden plan, higher income workers will simply move to a Roth 401(k) plan and achieve the same results as with the traditional 401(k).

ISSUES

As these examples illustrate, this proposed change to the tax policy applied to retirement savings raises several issues that affect the ability to effectively implement the reform.

Double taxation – The Biden proposal does not include any change in the tax treatment at the time of withdrawal, which makes the new tax regime effectively amount to double taxation: workers will pay taxes on the same income (their own contribution) twice, once when the money is put in and once when the money is taken out. As we saw above the employee contribution is made after taxes are paid, and yet at retirement taxes must be paid on the withdrawals given that an additional tax credit was applied to the original deposits in the account. While the tax credit can be thought of as equivalent to a tax deduction, the actual implementation amounts to double taxation.

Incentive to contribute to 401(k) plans – The proposed change is touted to "equalize saving incentives,"[2] but while the incentive to contribute to the new plans will be strengthened for workers who are currently paying marginal tax rates lower than 20.6%, the incentive to utilize the tax credit is weakened for those who are paying marginal tax rates higher than 20.6%. Indeed, those who expect to pay marginal tax rates higher than 20.6% at retirement would stop contributing to their traditional 401(k) plan altogether, and switch to a Roth 401(k) plan.

Revenue neutrality – The claim that the proposed policy change is revenue-neutral is based on the assumption that the contribution patterns would not change. This assumption, however, is unrealistic. Given that higher earning workers are expected to switch to Roth savings plans, the counted-on revenue gains from high earning workers to ensure revenue neutrality of the Biden proposal would not materialize.

Horizontal Equity with Defined-Benefit Pensions – Horizontal equity, or the equal treatment of similar taxpayers, is a principle for good tax policies. Many workers have defined benefit pensions instead of defined contribution retirement plans such as 401(k) plans, but the Biden proposal has said nothing about how a similar "equalizing saving incentives" change would be implemented for workers who participate in defined benefit pensions. Without a corresponding change for these workers, low-income workers in the reformed defined contribution retirement plans would be treated better than similar low-income workers in defined benefit retirement plans, whereas high-income workers in the reformed defined contribution retirement plans would be treated worse than similar high-income workers in defined benefit retirement plans.

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[2] www.joebiden.com/older-americans

CONCLUSION

The Biden plan to provide a uniform tax credit for employees who participate in defined contribution retirement plans suffers from several implementation issues. If enacted, lower income workers would utilize the tax credit and higher income workers would switch to Roth savings plans. This would result in an overall increase in tax expenditures, another way of saying less tax revenue for the federal government. While the proposal attempts to encourage additional saving among lower earning workers, it also produces unequal treatment for workers who participate in defined contribution plans relative to workers in defined benefit pension plans.

The intent of the Biden plan is to bolster the savings of lower income workers and to create a uniform tax credit across all workers who participate in defined contribution retirement plans. As we have seen, the realization of the reform's goals, while retaining revenue neutrality, will not be achieved unless all retirement savings options are also reformed.