

# Boston FS Forum: Savings, Security and Economic Growth

## Retirement Series

Part 2 in a series of reports and briefings

## Council CEO stresses importance of retirement savings incentives

Sponsored by: **Boston Financial Services Leadership Council**

### Retirement Savings Facts:

- The oldest Baby Boomers began reaching age 65- the official retirement age- in January 2011
- About 2.8 million (more than 7,000 a day) Baby Boomers will turn 65 this year
- America has one of the lowest savings rates in the developed world
- Over 70 million working Americans, more than half of the workforce, have no access to workplace retirement savings accounts

### Workplace savings tax deferrals do not disproportionately help high-income earners, but are key for low and moderate income workers and small businesses

The law of unintended consequences threatens to wreak havoc with the nation's retirement system as Washington grapples with a monstrous budget gap and considers options to reform the tax code.

Policymakers are considering tax reform options that would reduce tax rates for individuals and corporations in exchange for eliminating or reducing various tax expenditures. The President's bipartisan deficit commission and the Senate "Gang of Six" both



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Mr. Reynolds is a founding member of the Boston Financial Services Leadership Council.

The Council publishes regular reports and briefings as part of its "Boston Financial Services Forum", focused on U.S. retirement policy and strategic opportunities for the FS sector in Boston and the Commonwealth. Each piece in the forum is led by one of the Council's CEOs and senior executives.

### Upcoming Forum Pieces:

*Renewing Our Vows- Why Boston Private Chose MA*, **Clayton Deutsch**, **Boston Private Financial Holdings**

*The Global Landscape for FS*, **John Hailer**, **Natixis Global Asset Management**

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proposed reforming, but not eliminating, tax incentives for retirement savings. Another proposal would replace existing tax deferrals with refundable tax credits.

However, retirement experts argue that reducing or capping the tax incentives for retirement savings would create unintended consequences.

While scaling back retirement tax incentives is unlikely to impact the retirement security of wealthier taxpayers, it could have a disproportionate impact on two seemingly unlikely groups – small business owners and low and moderate income workers.

“I suspect many of the people who have come out in favor of reducing or eliminating the tax advantages for 401K plans have only thought about the first step,” **said Jack VanDerhei, research director of the Washington-based Employee Benefit Research Institute (EBRI)**, a leading nonprofit, nonpartisan organization that focuses on public policy research and education on economic security and employee benefits.

Some policymakers have fallen into the trap of calling all tax incentives “expenditures,” suggesting that all tax incentives are merely spending by another name. Others may believe that retirement tax incentives are mainly a giveaway to the wealthy.

The data shows a different story however. “Sixty-two percent of these tax deferrals go to people earning less than \$100,000, while 38% of these deferrals go to those people earning more than \$100,000. Now consider the fact that these low and middle income workers pay just 26% of federal income taxes, so they get more than twice as large a share of tax deferrals as the share of income taxes they actually pay. On the flip side, 38% of the tax deferrals go to those earning more than \$100,000 – but these people pay 75% -- three-quarters – of all federal income taxes,” **said Robert Reynolds, CEO of Putnam Investments in Boston.**

Moreover, retirement tax saving is merely a deferral of tax – individuals get an up-front tax break to incentivize savings, but distributions are taxed when they withdraw their savings during retirement.

“The potential gains to the Treasury from cutting tax deferrals is vastly overstated, but the damage such caps could inflict is vastly underestimated. Access to workplace savings is the prime determinant of whether low and moderate income workers save -- at all. So capping or eliminating incentives for workplace and other retirement savings could have devastating impact – sending millions of low and moderate income workers towards retirement with essentially no savings,” **said Reynolds.**

So far, no one has proposed completely eliminating the incentives, but recommendations from last year’s deficit reduction commission may set the ball in motion to significantly reduce the incentive.

The commission proposed a cap on tax exempt retirement contributions equaling either 20 percent of income or \$20,000 per year, whichever is less.

While such a cap might seem deceptively restrained on its face, it could have a disproportionately negative impact on a very important sector – small businesses, **according to EBRI’s VanDerhei.**

Many small business owners offer retirement plans to their employees because it is a convenient add on to their own retirement savings accounts, he noted.

“Incentives for workplace savings do encourage employers, especially small businesses, to offer savings plans to low and middle income workers – not just to the owners and their key executives,” **said Reynolds.**

But a \$20,000 cap may act as a major disincentive to small business owners, who already face all of the expected paperwork hassles of offering these plans to their employees as well.

The concern is that as small business owners find their own savings capped, they decide it is no longer worth the hassle of offering these plans to their employees, **VanDerhei said.** Many retirement experts contend that this same scenario is at least partially to blame for the decline in the defined benefit (DB) plan world. As the tax deferral cap for DB plans was lowered, the more executives figured that offering a DB plan wasn’t worth their while and DB plans have been on the decline ever since.

EBRI research finds that more than 70% of those earning between \$30,000 and \$50,000 save for retirement – provided they have access to tax-deferred retirement savings plans at work. Fewer than 5% of moderate income workers who lack access to workplace savings open retirement savings plans on their own. Reducing retirement savings tax deferrals could leave millions of lower-income workers on track towards retirement with little or no savings at all.

EBRI is now studying the potential impact on small business owners of a cap on retirement savings and is expected to release an estimate in the near future, **VanDerhei said.**

“To the extent you are discouraging small employers, that is a key issue,” said **David Certner, legislative policy director for the AARP.**

Though it may be counterintuitive, low and moderate income workers are also likely to suffer disproportionately from a reduction or a cap in retirement plan tax incentives, **VanDerhei said.**

Surveys conducted by EBRI show that such upper income workers would continue to save for retirement, even if they lose some of the tax incentives. However, the EBRI survey indicated that low income workers are more likely to drop out of the retirement savings system altogether.

“From a behavioral standpoint, that is likely the only thing that motivates people to save in the first place,” **he said.**

Finally, a \$20,000/20 percent cap, extended over decades, could significantly reduce the retirement savings of millions of workers, **EBRI warns.**

**EBRI President Dallas Salisbury** indicates that a \$20,000/20 percent cap could ultimately reduce the retirement savings of the younger (26-35), lower income workers by 12 percent. (Their better paid compatriots would also take a hit, seeing total retirement account savings drop by between 3 to 5 percent.)

He contends that the reduction in savings will be magnified if the \$20,000 cap is not adjusted for inflation since the value of the annual contributions will fall over time.

**Salisbury compares** it to the unanticipated impact of the Alternative Minimum Tax (AMT), which was designed in 1969 to prevent the wealthy from using loopholes to escape taxes. The AMT thresholds were not adjusted for inflation, and they now hit millions of middle-income taxpayers.

“The percentage of people who are adversely affected will grow larger and larger,” **said Salisbury** of the proposed cap, who called it yet another example of the “law of unintended consequences.”

The law of unintended consequences following the cut or reduction in retirement tax benefits could play out in other, even less predictable ways as well, **AARP’s Certner contends**.

Congress’ decision in 1986 to scale back IRA tax benefits for the wealthy ended up reducing participation as a whole, including among less well paid workers who were still eligible. That is because financial institutions responded to the new policy by cutting back their marketing efforts, which in turn led to a drop in participation among individuals at all income levels.

“We think that subsidies to help people save for retirement are important given the dramatic changes we are seeing in the retirement system in general, such as the reduction in home values and higher health care costs,” **Certner said**.

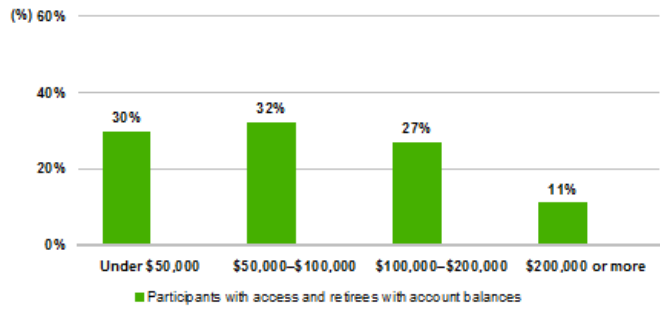
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The **Boston Financial Services Leadership Council (BFSLC)** brings together CEOs and senior executives from the Boston financial services community with academic partners to advocate for the sector in Massachusetts, to shape relevant state and national policy, and to establish regional and global partnerships to support Boston's role as a global finance center.

The Council was organized and is staffed by **Mass Insight Global Partnerships**, a Boston-based public policy research and consulting firm that builds strategic pre-competitive alliances between higher education, industry and government, both regionally and globally.

For more information on the Boston Financial Services Leadership Council’s work and the retirement challenge, please visit [www.massinsight.com](http://www.massinsight.com).

## Share of tax expenditures going to workplace savers by income levels

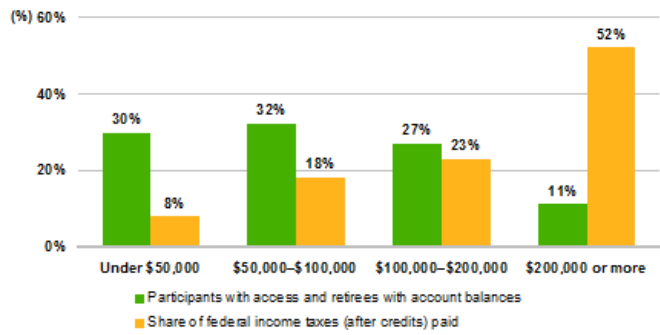


Source: American Society of Pension Professionals and Actuaries, 2011.

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## Share of tax expenditures vs. share of federal income taxes paid — by income levels

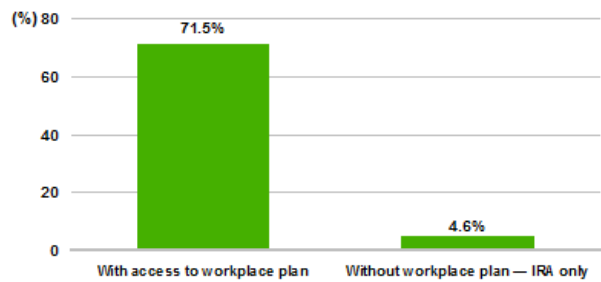


Source: American Society of Pension Professionals and Actuaries, 2011.

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## The impact of access: Percent of moderate income workers (\$30,000-\$50,000) who save for retirement



Source: Employee Benefits Research Institute (2010) estimate using 2008 Panel of SIPP (Covered by an Employer Plan) and 2009 estimate (Not Covered by an Employer Plan/IRA only).

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