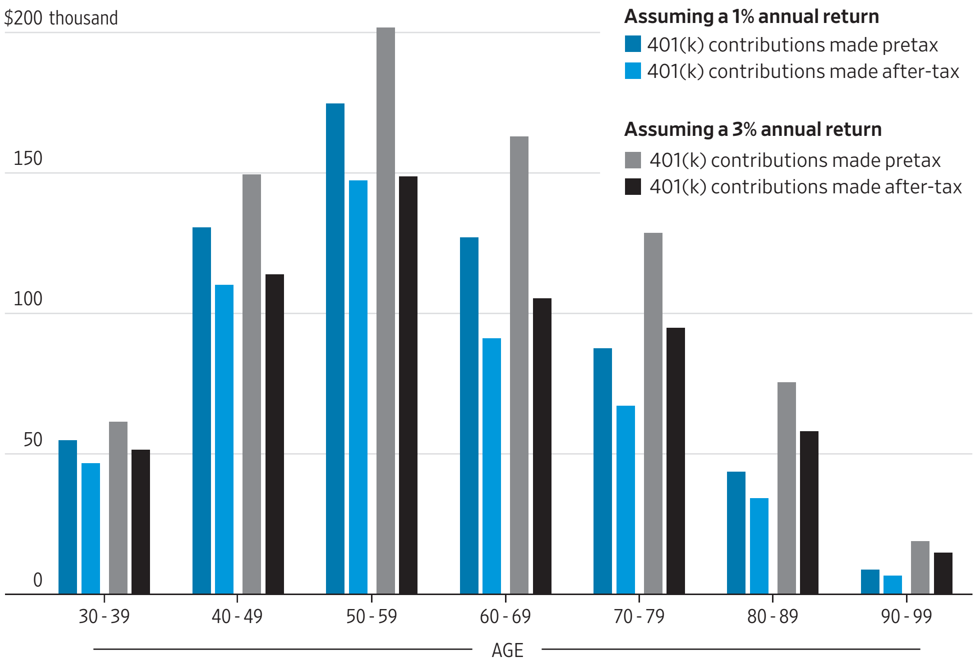
A Rothified Retirement?

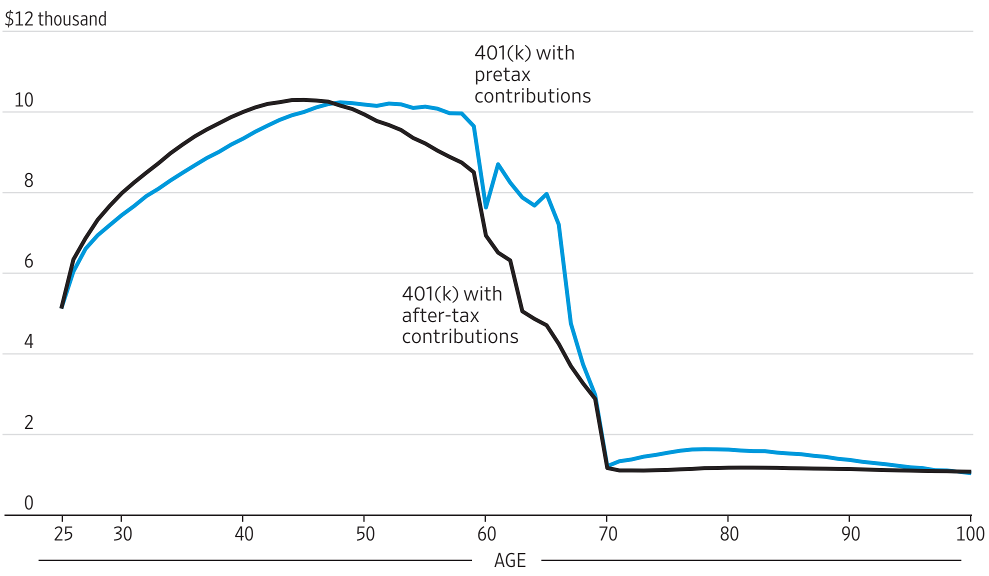
A recent study looked at how 401(k) assets, taxes and Social Security claims could be affected under a 401(k) plan based on after-tax contributions, compared with the long-established pretax-contribution system.

Average 401(k)-plan assets*



Average annual tax payments*†

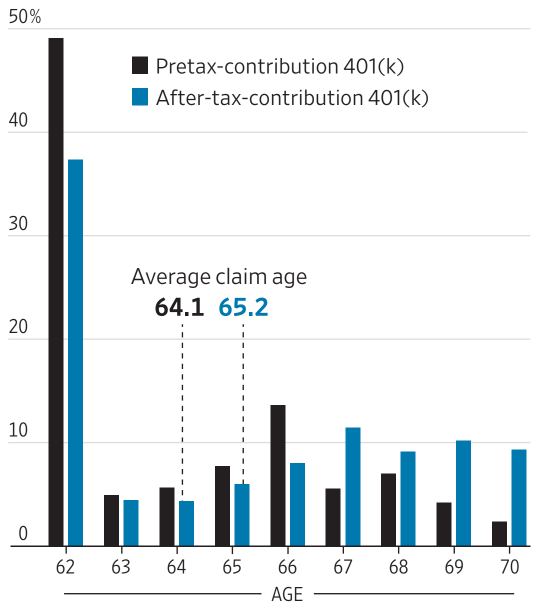
How average tax payments per individual could look over a life cycle under the long-established pretax-contribution system compared with an after-tax-contribution approach



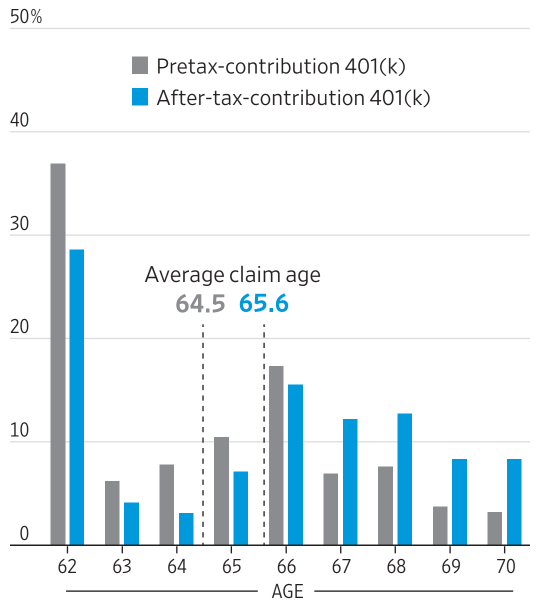
Social Security Claims

How an after-tax 401(k) plan could affect the average age for claiming Social Security benefits, by gender

Female



Male



*Results depict average outcomes for the entire U.S. population. Earnings information from the nationally representative Panel Study of Income Dynamics was used to estimate lifetime labor earnings profiles for men and women at three educational levels. Data were then used to simulate 100,000 representative individuals from each subgroup as they work, save, spend, pay taxes, invest, draw down their assets, retire, and, eventually, die.
†Including payroll taxes, income taxes and early-withdrawal penalties
Source: "How Would 401(k) 'Rothification' Alter Saving, Retirement Security and Inequality?" by Vanya Horneff, Raimond Maurer and Olivia S. Mitchell

EXPERTS' VOICES

Reverse Mortgages

Reverse mortgages are one of the more promising ways to protect against falling home prices and outliving assets.

One of the key characteristics of the loans is that they are "nonrecourse" products—meaning that homeowners don't have to pay back any balance if it's more than the value of their home. Let's say that the owner of $400,000 home takes out a $200,000 reverse mortgage on their 65th birthday with a 4% interest rate. After 25 years, they'll owe about $535,000 on the loan.

But because of the nonrecourse feature, they are off the hook from owing any amount over the value of the house. If their $400,000 home didn't appreciate, that's a $135,000 windfall.

There are lots of caveats, however, including that lenders can foreclose on a home if borrowers don't pay their taxes.

—Benjamin Harris executive director of the Kellogg School of Management's Public-Private Interface and former chief economist to Vice President Joe Biden

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The Impact of 'Rothifying' 401(k)s

It would boost tax returns in the short term, but leave retirees worse off

By Olivia S. Mitchell And Raimond Maurer

There's a lot of talk these days about overhauling the retirement-savings system. In Washington, much of the discussion centers on ways to give an immediate boost to government revenues by limiting retirement tax breaks.

One idea that gets discussed is to repeal the current structure of pretax contributions to retirement accounts in favor of a system where contributions would come only from *after-tax* income—as contributions to Roth IRAs do now. It's an idea, called Rothification, that has been championed at times in the past. But it could be given new life by the government's current enormous need for revenue to plug budget gaps and rein in the nation's debt.

Given that possibility, we wanted to ask the question: How would such a system affect workers saving for retirement?

The short answer: poorly.

To explain, let's be clearer about what the change would entail. Right now, most U.S. savers contribute to retirement accounts with money that's deducted from their taxable income, and pay taxes on those accounts only when the money is paid out in retirement. The rationale for this approach to saving in 401(k), 403(b) and individual retirement accounts is that the tax protection those accounts provide gives employees an incentive to set aside money for their golden years. The assets in defined-contribution plans and IRAs hit $18.3 trillion as of the third quarter of 2019, according to the Investment Company Institute.

So why does this system need an overhaul?

For one thing, the federal deficit has ballooned to more than $1 trillion in the current fiscal year, while the federal debt has hit $23 trillion, according to the U.S. Treasury. And we have an additional $43 trillion in Social Security underfunding, according to the 2019 report of the Social Security and Medicare trustees. Amid this tsunami of government red ink, the Treasury estimates it will forgo $2.4 trillion in tax revenue on the nation's tax-deferred retirement savings over the next decade.

Under Rothification, retirement contributions would come from after-tax income and savers would pay no additional income tax on investment returns or on withdrawals in retirement. Instead of the Treasury delaying the collection of substantial tax revenue until retirees withdraw money from their accounts, it would get its money now.

One thing is clear: A new system would impose different tax burdens on low-paid workers and higher-wage workers. During their working lives, the lack of a tax deferment for retirement savings would result in a bigger tax hit for workers in higher tax brackets than for those who make less. But in retirement, higher-paid workers would benefit more on the tax front, since they tend to make larger withdrawals from retirement accounts.

Beyond those effects, there is little evidence from experience to help us predict how Rothification could affect workers. So we've built a detailed economic model to help us understand the potential impacts of such a reform. Here's what the model predicts:

$18.3 trillion

Assets in defined-contribution retirement plans and IRAs

● In the Roth world, people's lifetime work hours would decline slightly. That's because contributions to retirement accounts wouldn't reduce income taxes, so after-tax salaries would be lower. That would prompt some people to work more to make up for the lost income, but our research suggests that more people would work *less* because their time at work would be less valuable.

● Under a Roth regime, workers would claim Social Security benefits a year later on average. Currently, since retirees pay income taxes on their 401(k) withdrawals, withdrawing more in order to delay claiming Social Security benefits and ultimately receive a higher payout from the government must be weighed against those taxes. This trade-off has to account for the fact that only a portion of Social Security benefits are included in taxable income—up to half could be tax-free.

But such complex tax considerations would become irrelevant under a Roth regime, since withdrawals wouldn't be taxed. Workers would be more likely to defer their Social Security benefits to boost the amount—especially higher-paid workers, who would have more in their retirement accounts to cover their expenses while waiting to take Social Security.

● Over their lifetimes, workers would accumulate one-third less in their 401(k)s under a Roth system. This is because, with no tax advantage from contributing to a 401(k), workers would save less and those lower contributions would earn less over the years.

● Lifetime tax revenue generated by the average worker under a Roth regime would fall 6% to 10%, compared with the current regime. This is because people contribute and accumulate much more in their retirement accounts currently than they would under Rothification. The taxes collected on withdrawals of that money exceed the amount of additional income taxes that would be collected during people's working lives under Rothification.

Bottom line: Switching to a system where contributions to retirement accounts are made only with after-tax money would boost tax revenue in the near term, but only as much as it would reduce it in the longer term. And it would leave retirees worse off.

*Dr. Mitchell is a professor of business economics/policy and director of the Pension Research Council at the Wharton School of the University of Pennsylvania. **Dr. Maurer** is a professor of finance at Goethe University of Frankfurt. They can be reached at **reports@wsj.com**.*