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ECONOMIC SCENE

In Retirement Planning, There Is Nothing Certain About Death and Taxes

By AUSTAN GOOLSBEE

For millions of Americans, November means open enrollment time — the brief period when employees make their choices about next year's benefits, including 401(k) savings.

If you are one of the millions of people trying to decide about 401(k)s, you have probably heard about the dangers of investing too much into your own company's stock and have compared the risks of investing in stocks versus bonds. You may even have asked co-workers for hints about what to do.

You probably have not given much thought to political tax risk, however, or perhaps have even heard of it. Yet the purely political question of what will happen to tax rates over the next 30 years has become one of the most important factors in thinking about tax-deferred savings accounts — more important than many of the conventional issues you have spent your time thinking about.

Future increases in tax rates potentially threaten to significantly reduce the value of your retirement savings and may even mean that you should not save in 401(k) accounts at all.

To understand why, think about the traditional advantages of a tax-favored account like a 401 (k). Relative to a regular account, where you first pay taxes on your income and then put money into the account and pay taxes on the interest you earn every year, a 401(k) gives you a bonus. You get to put money into the account without paying income tax on it this year and you do not have to pay taxes as it builds up. You just pay income tax on the full amount at the very end when you finally pull out the money in retirement.

The tax-free buildup can give you a nest egg that is significantly greater than conventional savings. That has induced millions of people to participate in these accounts.

But the lurking catch is that the tax you will pay on your account will be at the rate in place when you retire, not the rate now. And that may be very different.

Budget analysts unanimously agree that the current fiscal situation of the country is

unsustainable. According to the latest numbers from the Government Accountability Office (http://www.gao.gov/new.items/d061077r.pdf), the total fiscal gap facing this country in the future is about $60 trillion, and some budget experts suggest even that is an underestimate.

One of them, Laurence J. Kotlikoff, an economics professor at Boston University, says that if we try to close the fiscal gap with higher taxes, it will take an immediate and permanent increase of more than 80 percent in all income taxes. When I reached Professor Kotlikoff for a comment, he said, “The government’s accounting is far worse than Enron’s.” His view, summarized bluntly, is that “the U.S. is bankrupt.”

While future budget policy seems far removed from your company’s open enrollment, you had better pay attention. How the government decides, ultimately, to balance its budget will have a tremendous impact on your retirement savings. If income tax rates double between now and when you retire, the value of your 401(k) may be cut in half.

Professor Kotlikoff says that closing the fiscal gap entirely from income taxes is “a political nonstarter” and may be “economically ruinous.” But others think the public will never agree to the major cuts in Social Security and Medicare that would be needed to close the gap.

Will it be taxes or spending? No one knows. And that is exactly the point for your 401(k). Political uncertainty is an extremely important type of risk that most people, even the ones who spend time extensively analyzing whether to invest their 401(k) in this or that emerging market, have not given a moment of thought.

If you think the government will raise income tax rates in the future but will keep capital gains and dividend tax rates low, you may not want to invest in a 401(k) at all. Paying your income tax and then investing money in the stock market may leave you better off in your retirement than investing in the supposedly tax-advantaged savings accounts.

To be clear, if your employer gives you a generous match for the money you put into your 401 (k), that will tend to outweigh any tax risk and so you may as well take the free money and invest. Similarly, if you are the kind of person who invests only in bonds, so you have lots of interest payments, you should stick with the 401(k). If you need the restrictions of the 401(k) to keep you from spending your retirement savings, again, just go ahead and ignore the tax risks.

But if you are one of the millions of people who did not answer “yes” to any of those questions, you should be thinking about the reality of tax risk. One way to avoid such risk would be to put your retirement savings into a Roth I.R.A. Unlike the 401(k), you pay the income taxes on the money when you put it into the Roth rather than when you take it out. It gets the tax-free buildup but there are no taxes when you withdraw it. All the taxes are paid up front so you do not need to worry about what the rates will be when you retire. The problem is that if your

family income is more than $160,000 a year, you are not eligible. And even if you are eligible, you cannot put more than about $5,000 a year into a Roth account. Anything more you want to save will entail tax risk.

So what's a hard-working American to do? You really do not have the information you need. You will have to guess, and just realize that the amount you are going to have to subtract off the top of your 401(k) when you retire may be very big.

Ben Franklin wrote of the certainty of death and taxes, but he really missed the point that concerns us today. Old Ben never had to face an open enrollment deadline. These days there is nothing certain about the timing, at least, of death and taxes. And for planning your retirement, that can really cost you.

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