I’ve written a couple of recent columns on fixes needed to restore the value of 401(k) and other deferred tax retirement plans for young median-wage workers. The presidential campaign of Joe Biden and Kamala Harris has a proposal aimed at that issue. It’s a step almost exactly in the wrong direction.

Under current policy, standard deferred tax retirement plans, including 401(k)s, IRAs and other variants, are taxed at distribution time rather than contribution time. (“Roth” variants do not have this feature.) Biden-Harris propose to tax the plans at both contribution and distribution, and to offer a refundable tax credit to make up for the double taxation. The idea is justified on the basis of fairness, since avoiding tax at contribution time is worth only 12% to most middle-income workers, but 37% for the highest-income workers.

This represents a common misconception, which is that the tax advantage of 401(k)s lies in the fact that contributions are not taxed. But if you make a $100 contribution, and it doubles in value by retirement, and you are in the same—say 12%—bracket both times, it doesn’t matter if you pay tax at the beginning and have $88 double to $176, or pay tax at the end and have $100 double to $200, which is $176 after paying 12% tax.

Using data from the Bureau of Labor Statistics we see that the bottom quartile of households average near-zero marginal federal, State and local income tax rates over their working years and in retirement. Second quartile households, about $35,000 to $52,000 annual income, average about 10% during working years and 3% in retirement, so they gain 7% of the total 401(k) account value by paying at distribution rather than contribution time. The third quartile pays 18% while working and 15% in retirement, so they gain 3%. The top quartile, above $80,000, pay 26% while working and 32% in retirement, so they lose 6% by deferral.

Therefore, if fairness is a consideration, what matters is not the worker’s marginal income tax rate at contribution time, it’s the difference between the rate at the time of contribution time and the rate at the time of distribution. If anyone is treated unfairly currently, it’s top quartile earners.

But changing the rules to favor high earners is a bad idea for two reasons. The first is that there is more of a variety of situations within income quartiles than among them. Some people in all quartiles get a great advantage by deferring, some take substantial losses. People move among quartiles. Any fix based on average tax rates will introduce as much new unfairness as it fixed old unfairness. Second, the Biden-Harris proposal ignores the purpose of 401(k)s, which is to encourage retirement saving, not to remedy inequality. The plan should be designed for maximum encouragement at minimum expense. Inequality is much better addressed through other tax changes, such as increasing the Earned Income Tax Credit or increasing marginal income tax rates. (I favor the former and oppose the latter, but my point is both are more efficient means to reduce inequality without screwing up anyone’s retirement planning.)

The other problem of the Biden-Harris proposal is focusing on the minor advantage of tax-deferred retirement plans and overlooking the major one. Imagine someone started a 401(k) in January 1980 (when they were introduced) at age 25, and paid $100 per month—increasing with inflation—into an S&P 500 Index fund with no fees. At the end of 2019, at age 65, this person would have contributed a total of $105,698 and the account would have grown to almost exactly 10 times that amount, or $1,056,952.

In a taxable account, an investor in the maximum current tax brackets — 37% on income and 20% on capital gains — would see the government take 59% of the end total, leaving only $431,356. The reason is the government doesn’t tax just once; it taxes the original contribution, all reinvested cash flows, the cash flows from the reinvestments and then the capital gains at the end. (Not to mention corporate income tax taken as well.)
And don’t forget about inflation, which takes a third, leaving purchasing power of $287,575. If the saver is in a place with high marginal State and local income taxes, like New York City or California, and exposed to marginal taxes arising from taxation of Social Security, ACA subsidy losses and Medicare parts B&D charges, she can be left with less than $200,000. And that’s before any fees and using a tax-efficient index fund that generates mostly capital gains, during the greatest bull market in stock market history.

In a tax-deferred account, the investor pays the marginal tax rate only once, 37% in this case rather than 59%. For lower-income taxpayers, the comparison is paying the government 12% of the $1,056,952 in a tax-deferred account versus 19% in a taxable account, or 22% tax-deferred versus 41% taxable. This is the big tax advantage of the 401(k) — investment growth is taxed only once. Biden-Harris don’t touch this aspect of tax-deferred plans.

We have a massive problem in the U.S. that people are not saving enough for retirement. The reason is not some minor unfairness with 401(k) rules, it’s the massive discouragement of savings in taxable accounts, due to taxing the same money over and over. We won’t fix it by offering a 26% tax credit on retirement savings and then taxing them at both contribution time and distribution time. A 26% tax credit means the worker is paid $26 for a $100 contribution to a 401(k), so the worker is out of pocket $74. The $26 the government supplies is 35% of the $74, so this is effectively a 35% match on contributions.

The people whose behavior needs to change are often ignoring 100% employer matches at the moment, so what is a 35% match going to accomplish? Especially if it requires accepting double taxation of contributions? The solution is to remove the tremendous barriers the government puts in place to investing. My concern is for young median and below wage workers. They face a double whammy of regressive FICA payroll deductions that take 15.3% (this treats the employer contribution share as reducing wages, which seems likely) of their wages off the top, making it hard to find money to save, and then taxing investment profits multiple times so even low marginal rates add up quickly, preventing the markets from making up the loss. Paying workers some cash today in exchange for adding one more layer of retirement plan taxation doesn’t strike me as a sensible approach.

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