How much should you contribute to your 401(k)?

Your mother probably told you to eat your fruits and vegetables. So now that you are a grown person, what should you eat? Only fruits and vegetables? How much? Is a pound of kale the same as a pound of grapes? Your mom had a good idea but obviously it's not enough. You need more information.

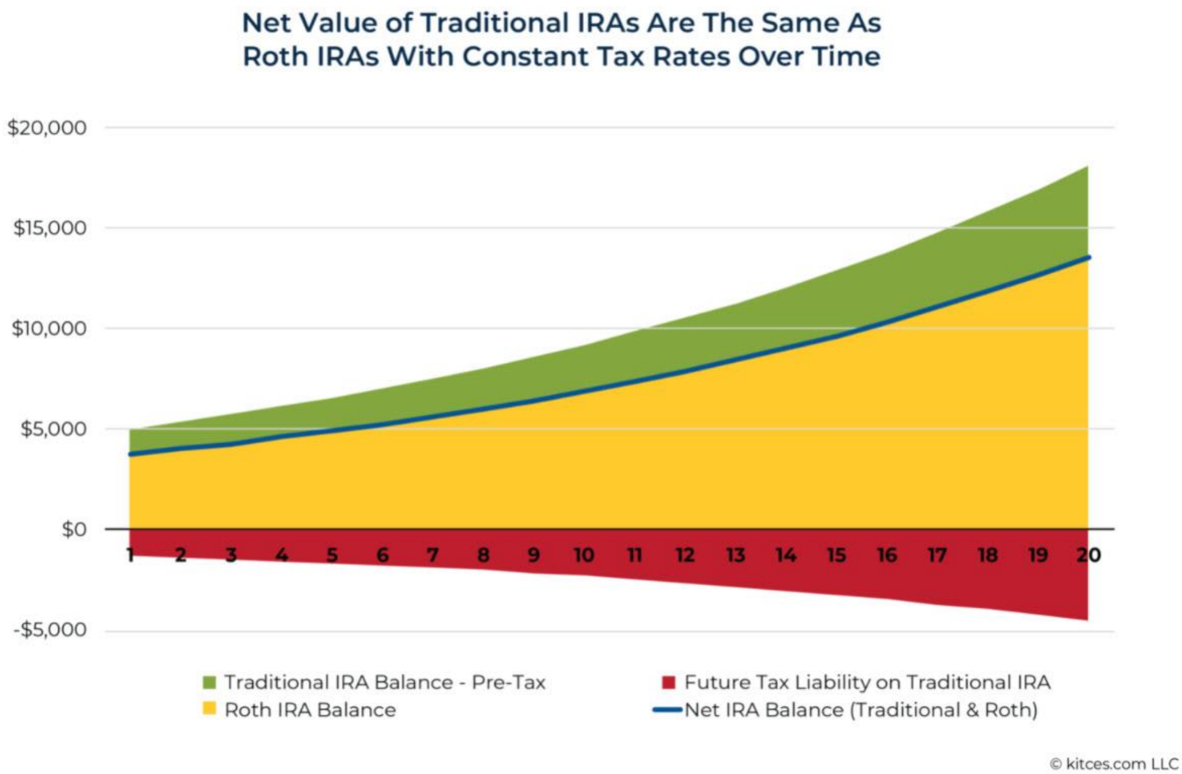
The same kind of thing can be said for advice on saving and investing. So much of what you hear as a kernel of truth in it but there is just not enough information to go on. Like when you go to work and have the chance to sign up for a 401(k). *Should* you do it? And how much should you put into it? Your mom might say save a little of everything you make. Some advisors will tell you save as much as possible. Neither of those is terribly helpful. Let's break it down into a few parts.

How much do you need to save for retirement? It depends on a lot of things, of course – when do you want to retire, what kind of lifestyle do you want, how much do you have already? If you are in your 30s or 40s, you can't even realistically answer two of those questions. So, as a rough place to start, let's go to the Center for Retirement Research in Boston. Depending on your age, they have found that to maintain the same lifestyle you had before retirement into retirement you probably need to save 12 to 14% of your income. That depends on a lot of things. But let's just start there.

So the next question, the one before us, is how much of that do you do in your 401(k)? Many advisors would say "all of it." But like the eat your fruits and vegetables suggestion, there are a bunch of assumptions built into that. Let's take it apart.

A 401(k), like a traditional IRA, has the benefit of taking deposits pretax. And your investments grow without being taxed until retirement. But that's not the only option open to you. There is also a Roth IRA (and, increasingly, a Roth 401(k)). The difference is that money goes into one of the Roth accounts *after* you have been taxed on it. It still grows without being taxed and the money comes out in retirement tax-free.

Which is better? Well, if we do a simple analysis like this one it looks like there's really no difference.




If you put money into a pretax account, accumulated over time, and then pull it out in retirement and pay the tax you end up with exactly the same amount as if you had taken money after tax, put it into a Roth account, let it accumulate and pull it out in retirement. But it's not really the same.

For one thing, if you put money into a Roth IRA today and have to pay a little more tax, how likely are you to adjust your Roth IRA contribution for the additional tax you will have to pay? You probably won't. If you get a smaller refund or have to make a tax payment, you will probably just take that smaller refund or pay the difference out of spending money. This is one of those examples where economic theory runs up against behavioral economics. Rather than adjusting your bank account for the pretax equivalent, you will probably just spend a little less on your next vacation. What you have in your retirement accounts is what you have. So having more money and a tax-free bucket is better.

A lot of the advice out there suggest you use your 401(k) because you will probably have less income (and, therefore, be in a lower tax bracket) in retirement. But that's probably not true for a few reasons.

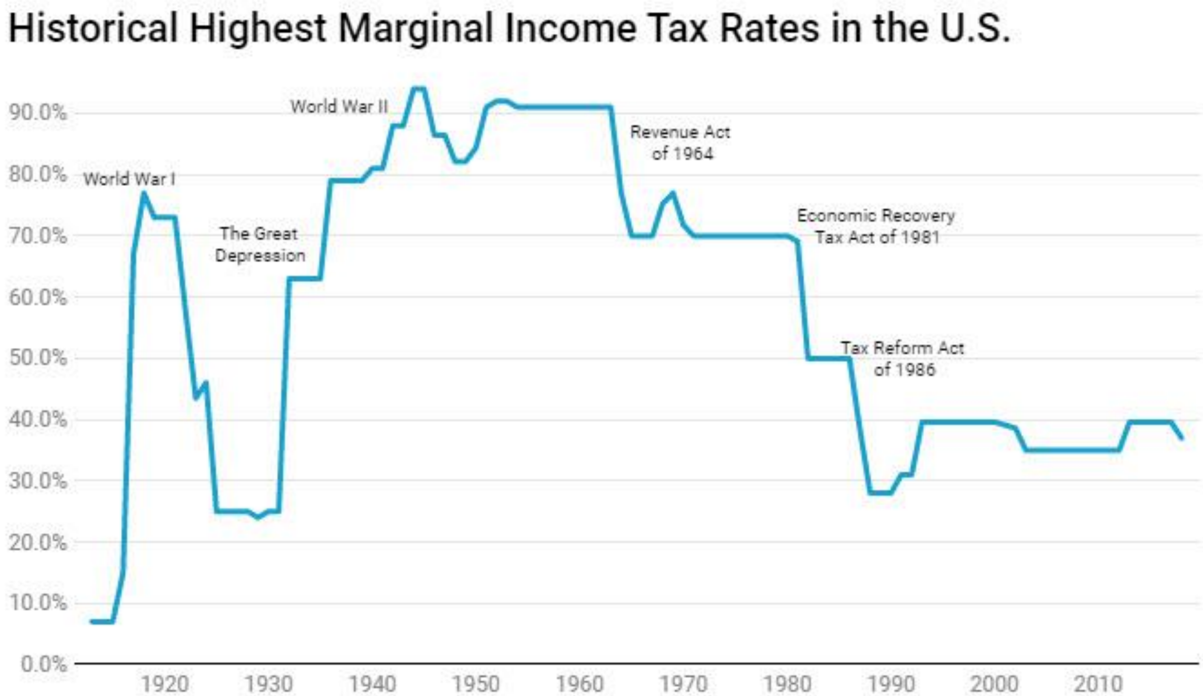
One assumption is that you will need less income to maintain the same lifestyle in retirement. It's called replacement ratio. When I started doing financial planning, we were taught that we could assume that people will need 70% of their pre-retirement income in retirement. As time has progressed, we are finding that's not true. Here is a table from Vanguard that shows what people actually spend as a proportion of their pre-retirement income at different income levels based on how much they saved before they retired. The reality is you will probably need closer to 85% of what you made before retiring.

### Married filing jointly

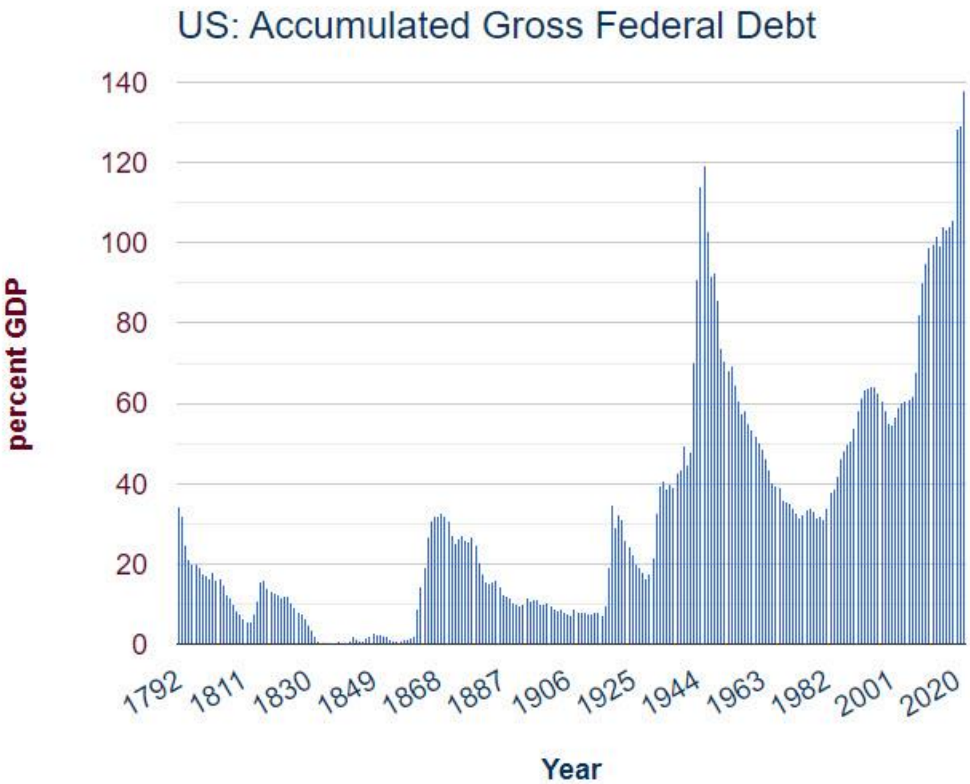
| Savings/year (%) | | 5% | 10% | 15% | 20% |
|---|---|---|---|---|---|
| Today's income | $ 25,000 | 101% | 96% | 92% | 86% |
| | 50,000 | 91 | 87 | 82 | 78 |
| | 75,000 | 91 | 85 | 80 | 74 |
| | 100,000 | 91 | 86 | 81 | 75 |
| | 125,000 | 89 | 85 | 80 | 75 |
| | 150,000 | 88 | 83 | 79 | 74 |
| | 175,000 | 88 | 83 | 78 | 73 |
| | 200,000 | 89 | 83 | 78 | 73 |
| | 300,000 | 90 | 85 | 79 | 69 |
| | 400,000 | 92 | 87 | 77 | 67 |
| | 500,000 | 92 | 85 | 72 | 64 |

If we think about saving on taxes today, we may also forget that our income will be going up over time. It rises along with the cost of living (inflation) but it also rises because as we get more skilled and experience we merit a higher paycheck. As you progress through your career, your income does not just go up by the rate inflation, it goes up more than that. In fact, according to Payscale.com, it probably continues to go up into your late 50s. So if you are on the younger side of that, you will probably retire at a much higher income level than you have today. And a higher income level may mean a higher tax bracket.


But here's the biggest whammy that really blows up the argument about saving money on taxes today. It assumes that tax rates will be level. They won't be. I can say that with confidence because it is written into the tax law. Our current rates are the result of the Tax Cuts and Jobs Act of 2017. Written right into the law is an expiration of those rates. If Congress does nothing (which is probably the safest bet when it comes to raising taxes), income tax rates will rise on January 1, 2026. Okay, they are not scheduled to rise dramatically. So let's take a look at the bigger picture.




Here's a history of tax rates since 1913. You can see that we are in a period of relatively low taxes. Not the lowest, certainly, and these are just the top rates. You probably don't pay the top rate. But without getting overly complicated, this is a convenient way to look at it. If we only return to the historic average, rates will go up. But there's more to it.




Here is a history of how much debt the US government has. As a proportion of the total economy, it is the highest it has ever been. Just over the last couple years as we have battled the pandemic, the government has pumped trillions of dollars into the economy. We have to figure out how to pay that back somehow. It's hard to imagine how they will pull it off without raising taxes. Maybe substantially. So if you want to take advantage of today's tax rates, you will put money in a tax-free account like a Roth and happily pay (okay maybe not happily but less grudgingly) at today's lower tax rate.

There is one other consideration that has a big impact on the decision. And that is whether your employer matches contributions.

Most company retirement plans get deposits from the employer as well as you, the employee. In about 71% of those plans, that employer contribution is structured as a match, meaning the more you put in the more they put in. The most common strategy is to match $0.50 for every dollar you put in up to a certain limit, most commonly 6%. That means if you put in 6% they will put in 3%. And that's where it stopped. If you put in 7%, 8%, even 15%, they still just put in 3%.

Whatever you need to do to get the most from your employer is worth doing. If not, you're leaving money on the table. It would be like your employer offering you a raise and taking a pass. So put in enough to maximize the match. Even if you have to figure out a way to rearrange your household budget, it's worth looking into.

BTW, don't contribute ahead to reach the max early in the year. How companies match.

Here, then, is the strategy. You thought this would be a simple question so I will give you a relatively simple answer. Contribute as much to your company plan as it takes to maximize what the company will put in. Then start contributing to a Roth IRA (or Roth 401(k) if you have it available). If you reach the contribution limit on your Roth IRA, you can either switch back to the 401(k) or, if you earn enough and can commit to consistent contributions over a long period of time, look at some other tax-free retirement savings options that are out there.

You might not have thought that how much you put in your 401(k) involves doing tax planning so far into the future. But retiring as close to when you want to with the lifestyle you want takes planning as early as possible.