SUMMARY AND INTRODUCTION

The federal government helps increase retirement incomes through the tax advantages it gives to employer-sponsored retirement plans and to Individual Retirement Accounts (IRAs). The advantages given to these arrangements--generally called "qualified plans"--constitute one of the largest preferences in the federal income tax. Along with Social Security and other measures, they are intended to help assure adequate retirement incomes for as many workers as possible. They are also intended to stimulate national saving and economic growth.

Who uses the tax advantages? How large are they in the aggregate and how are they distributed across income classes and among those with similar lifetime incomes? Do they raise saving? What are the strengths and weaknesses of the variety of employer plans and IRAs in advancing retirement income objectives? What alternative policies could be pursued to ensure adequate incomes for retirees or to reduce the revenue losses of the tax advantages? These are the questions addressed in this paper.

DEVELOPMENT OF THE FEDERAL ROLE

As modern societies industrialized, they had to develop new ways for people to meet their consumption needs in retirement. The traditional systems of preindustrial society--the extended family, employer benevolence, craftsmen's guilds, war pensions, sinecures, and local charities--no longer could perform this function adequately, the more so as ever larger numbers of people lived beyond their prime working years and, increasingly, to advanced ages. New arrangements were needed to assure that workers and their dependents would have enough income to maintain themselves after retirement, disability, or death.

One nearly universal response to this movement from traditional to modern society has been the creation of public programs to meet the exigencies of retirement, disability, and death--such as, in this country, the

Social Security program. 1/ Most workers who spend much time in the labor force are required to participate in Social Security and, in exchange, are promised various levels of retirement income. Because Social Security is also designed to redistribute income, it replaces a larger proportion of earnings at lower income levels than at higher. 2/ At the bottom end of the income distribution, Social Security benefits can fully replace previous earnings levels. 3/

An equally important response in many developed countries has been the occupational pension, usually sponsored by employers. During this century, the U.S. government, like governments in other industrial societies, has steadily increased its intervention in occupational pensions and similar arrangements. The growth of federal income taxation required that the government decide how to tax pensions, deferred profit-sharing, and the other private sources of retirement income. 4/ Through tax incentives and regulation, it has encouraged and supervised a complementary tier to Social Security consisting primarily of employer-sponsored pensions and similar arrangements. Generally, these are described as "qualified plans" because they meet the various conditions laid out in the tax code for preferential tax treatment. The federal government has also intervened in pensions and other employer-based plans as an umpire in labor-management relations and as the principal regulator of national fair labor standards.

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1. The program's actual title is Old-Age, Survivors, and Disability Insurance (OASDI). The more common term Social Security is often meant to include the Medicare program as well. In this paper, the phrase Social Security connotes only the cash programs.

2. Compared with a typical occupational pension, lower-wage workers in Social Security receive above-average rates of return and replacement rates, and higher-income individuals receive correspondingly below-average rates of return and replacement rates.

3. The federal government's role in retirement security also encompasses other spending programs. For example, the Supplemental Security Income and other welfare programs provide means-tested cash and near-cash assistance for the elderly, disabled, and widowed. In addition, the Medicare and Medicaid programs limit the extent to which health expenditures can dominate the resources of such households.

4. The elderly have income and resources from private assets other than qualified plans, much of it fostered by the federal government. In particular, homeownership is an important form of asset accumulation for old age, which the federal government facilitates through the tax code, and other means.

THE NATURE OF THE TAX ADVANTAGES AND THEIR EFFECT ON REVENUES

Normally the federal government taxes income whether the taxpayer saves it or spends it. A deposit in a regular savings account or the purchase of an asset, such as stock, is not deductible from income. Subsequent income earned by the savings account or asset is also taxed, in many cases annually. Thus, for example, interest and dividends are fully taxable each year.

The largest exception to this rule is that granted to saving in IRAs and in employer plans that qualify under conditions of the Internal Revenue Code. In those cases, taxation of most contributions and all investment income is deferred until the funds are withdrawn. This deferral is equivalent to taxing a contribution at the beneficiary's tax rate in retirement, when rates are generally lower than during working years, and then not taxing the investment income earned by the after-tax contribution. (The tax advantages are substantially less when contributions are not initially excluded from taxable income, as in after-tax employee contributions to pensions, and, starting in 1987, IRA contributions by higher-income employees covered by a pension. In these cases, taxes on the investment income are merely deferred, not forgiven.) 5/

The annual revenue loss to the federal government from the tax advantages for employer plans, plans for the self-employed, and IRAs will be nearly $60 billion in 1988. It would be even greater had not the Tax Reform Act of 1986 reduced tax rates and restricted some uses of IRAs and qualified plans. It continues to account for the largest annual revenue loss of all the preferences in the individual income tax structure.

THE COMPARATIVE STRENGTHS OF DIFFERENT PLANS AND IRAs

Employer plans differ widely in the risks and rewards they pose, as do IRAs. Defined benefit plans--those that specify a monthly retirement benefit to the employee--impose large penalties on workers who leave employment much before retirement age. Participants in them are also penalized if a firm terminates its defined benefit plan. Defined contribution plans--those

5. Taxes are also deferred rather than forgiven on capital gains, deferred annuities, and life insurance policies.

that specify a regular contribution for the employee--do not penalize workers who change jobs (unless they leave before vesting) or when a plan is terminated. However, the payments from such plans are more uncertain for the career-long employee because they depend on the rate of return earned by a plan's investments.

IRAs, salary reduction plans such as 401(k) plans, and thrift plans allow people to tailor their retirement saving to their own needs more than do the mandatory plans employers have traditionally sponsored. Such flexibility also allows them to save too little to meet their retirement needs. The risk that they will save too little is moderated in thrift and salary reduction plans by nondiscrimination rules that frequently lead employers to encourage and supplement employee contributions. IRAs have no such incentives. Traditional pension and profit-sharing plans require generally uniform rates of benefit accrual or contribution that are difficult for individual workers to circumvent. Employer plans as a group, however, do not provide equal access to tax-advantaged saving because many employers choose not to offer plans, and because those who do offer them differ in the extent and type of their plans.

WHO USES QUALIFIED PLANS AND IRAs?

Pension participation grew rapidly after World War II and into the 1960s, but it has been constant since the early 1970s. In 1983, just over half of full-time employees participated in employer pension plans. Older and higher-paid employees, union members, and employees of large companies are most likely to participate. Among industries, participation ranges from 81 percent in government and communications to 67 percent in durable goods manufacturing, 36 percent in services, and 29 percent in retailing. As the baby boom generation moves into the ages and earnings levels where pensions are most common, participation may grow somewhat. On the other hand, it may remain at present levels if employment continues to shift from manufacturing to services, where smaller and nonunion employers have been traditionally less likely to sponsor pensions.

IRAs expanded rapidly after they became available to all workers in 1982. About 17 percent of all workers contributed in the first 16 months they were eligible. Participation in IRAs has been almost twice as common among those participating in pensions as among those who are not, and it has been even more concentrated among the older and higher paid. This means that the provision of the 1986 tax act phasing out the deduction for IRA contributions for people covered by employer pensions will affect the population that now most uses IRAs. Under the new limits, about 40 percent of those who most likely would have contributed to an IRA in 1988 will not be eligible for any deduction, and another 12 percent will be eligible for only a partial deduction.

Salary reduction plans, and 401(k) plans in particular, have been growing rapidly since 1982, although not as explosively as IRAs. Over a quarter of the employees in medium and large firms had the opportunity to contribute to such plans during 1985. The 401(k) plans appear to have been more successful than IRAs in attracting contributions from lower-paid and younger employees. This apparent success is probably because the 401(k) plans have been offered at firms whose employees are interested in such plans, because employers match employees' contributions under them, and because participants often have preretirement access to the funds through loan arrangements.

THE SIZE AND DISTRIBUTION OF POTENTIAL BENEFITS FROM THE TAX ADVANTAGES

The tax advantages of qualified pensions and IRAs can raise after-tax retirement incomes substantially. Projections of the retirement incomes of today's workers indicate that the gains will be distributed somewhat unevenly by income and even more unevenly by job tenure. This pattern of distribution results from a number of factors: not all workers participate in such plans; some plan rules exclude certain classes of employees and delay vesting; and people who change jobs are likely to lose much of the value of their defined benefits through preretirement inflation.

CBO estimates that the tax advantages, even without any increase in personal saving, will raise after-tax retirement incomes of retired couples by 21 percent in 2019. The projected gains are strongly related to income. The gain among the poorest quartile of elderly couples is 14 percent compared with 24 percent among the richest quartile. The poorer half of single persons, with incomes below or near the poverty level, gain almost nothing from the tax advantages. This population consists almost entirely of women with limited work histories and pension coverage and with very little income from the plans of former husbands.

The gains in retirement income are even more strongly related to job tenure than to income. Among lower-middle-income retired couples, for example, those who work 20 or more years for one employer will have gains from the tax advantages equal to 25 percent of their income, while those with shorter tenures will gain only 10 percent.

THE EFFECT OF QUALIFIED PLANS ON SAVING

Studies have consistently found that pensions are not fully offset by reduced saving, but add to the total wealth of participating employees. Recent estimates are that the total wealth of older workers increases by 30 cents to 40 cents per dollar of their pension wealth. (The increase in after-tax income should be somewhat smaller.) The estimated increase in wealth is within the range to be expected from the more rapid accumulation of assets permitted by the tax advantages of qualified plans, and therefore does not appear to reflect much increase in personal saving. Though pensions may not cause people to save more, their higher retirement wealth represents greater national saving unless the revenue loss from the tax advantages has been financed by greater federal borrowing or offsetting taxes on capital income. The evidence is inconclusive as to whether qualified plans raise wealth and saving among younger and poorer workers, or whether IRAs raise saving among workers of any age.

THE TAX REFORM ACT OF 1986

The Tax Reform Act of 1986 made substantial changes in the rules governing qualified plans. By altering the tax rate structure and interest deduction rules, it has made even greater changes in the overall tax environment in which the plans operate.

Effects of Rules Changes

The act continues some recent trends in public policy toward qualified plans. These trends are in part a response to continuing budget deficits and in part a response to equity issues associated with use of the tax advantages.

First, the Congress has imposed further restrictions on the ability of relatively well-to-do people to accumulate large amounts of retirement income on a tax-favored basis. The effective income limits are generally lower for those types of plans that allow more individual flexibility. Hence, tax-favored saving through IRAs has been restricted the most, saving through qualified thrift and salary reduction arrangements less so, and that through traditional pension and profit-sharing plans the least.

Second, by imposing new coverage tests, faster minimum vesting schedules, tighter integration rules, and new nondiscrimination rules for salary reduction and thrift plans, the Congress has strengthened the policy objective expressed in other recent legislation--that the payments from, and tax advantages of, qualified plans should be more evenly distributed by income and job tenure. In particular, the Congress has reinforced the recent emphasis it has placed on benefit outcomes. The new integration rules also indicate a more deliberate attempt to correlate Social Security and qualified plans so as to produce certain combined payment results.

Third, the act reinforces the policy objective that qualified plan accumulations be used for retirement income, not for short-term saving. This goal was supported primarily by imposing an additional income tax on those who use their plan proceeds for nonretirement purposes, and an excise tax on employers when they retrieve excess plan assets.

While the effects of these changes on the distribution of probable outcomes from qualified plans have not been estimated, it is unlikely that the changes will greatly alter benefits from what would have occurred under prior law. In defined benefit plans, inflation before retirement will continue to erode most of the benefits accrued by short-service workers, including those benefits that were created by the 1986 act or that would be created by further restrictions in the coverage and vesting rules. In addition, few major plans fail to satisfy the coverage and integration limits of the 1986 act; and the top-heavy rules legislated in the Tax Equity and Fiscal Responsibility Act of 1982 have already eliminated the most skewed plans among small and medium-sized employers.

Effects of New Tax Rates

By itself, the new simplified tax rate structure with its two brackets of 15 percent and 28 percent probably will not alter the basic demand among workers for qualified plans. Even among the taxpayers for whom reductions in marginal rates will be most significant, saving through qualified plans will continue to generate a better rate of return than any other alternative. By the same token, however, because the lower tax-rate structure for the upper-income population will shrink their income gains from participating in qualified plans, it thereby diminishes the amount of such gains that can be redistributed to other workers.

The combined effect of the rule changes and new tax rates on qualified plans will vary: large plans in the industrial and unionized sectors of the economy will probably not be affected, while those of medium- and smaller-sized employers may. By shrinking the gains available to finance redistribution, and by making redistribution harder to avoid, the act may result in fewer traditional pension plans--with their fixed employer commitments--being established or continued in firms where the demand for retirement saving is weak. Thrift and salary-reduction plans, which allow rank-and-file workers to sort themselves according to their saving preferences, may become increasingly attractive in firms where the demand for retirement income is not very uniform.

Certain tax reduction strategies that enable people to combine qualified plan saving and interest-deductible borrowing will be heavily restricted. They will still be possible for many homeowners, however, because of the availability of deductions for mortgage interest.

LEGISLATIVE OPTIONS

The tax advantages for qualified plans and IRAs constitute the largest tax preference in the individual income tax. Yet, though these advantages boost retirement incomes, they probably do not significantly raise personal saving rates. In addition, the retirement income gains traceable to these advantages are skewed to highly-paid workers and, even more so, to workers who spend 20 years or more under one pension plan. Yet all other taxpayers--including workers who are never covered by a plan or who change jobs relatively often--bear the costs of these gains in retirement income in the form of higher tax rates, lower government spending, or increased federal debt. Because of the questionable saving effects and uneven distributional outcomes, the Congress might decide to alter further the size and distribution of these tax advantages. The paper examines the following measures that the Congress might consider.

First, the Congress could reduce the tax advantages either by imposing even tighter limits on contributions to qualified plans or by subjecting the investment income of qualified plan trusts and IRAs to a special income tax rate of, for example, 5 percent. The resulting reductions in retirement income would be borne by workers mostly in the upper half of the income distribution.

Second, as it has already done in legislation about vesting and the like, the Congress could further alter the distribution of the gains in income traceable to the tax advantages. In particular, the Congress could impose new requirements to limit the extent to which inflation erodes the value of deferred annuities in defined benefit plans. Additionally, by expanding salary reduction arrangements or tax-favored individual saving in ways beneficial to middle-income earners, the Congress could bring about a more even distribution of tax advantages among all workers.

Finally, the Congress could use monies from decreasing the tax advantages to expand Social Security or Supplemental Security Income payments to those elderly who now receive the least gains in retirement income from those tax advantages.