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BUILDING RETIREMENT SAVINGS CAN CAUSE LOW- AND MODERATE-INCOME WORKING FAMILIES TO LOSE MEANS-TESTED ASSISTANCE IN TIMES OF NEED

Current Rules in Means-Tested Programs Discourage Saving

The proposal in the Senate Finance Committee - approved version of H.R. 1102 that would provide a tax credit to lower- and moderate-income workers for contributions to 401(k) plans, similar employer-sponsored pension plans, and Individual Retirement Accounts would have an unintended side effect. It could cause some of these workers and their families to be made ineligible for health insurance coverage through Medicaid, as well as for food stamp assistance, when they experience hardship and substantial losses of income during periods such as recessions. This side effect is the result of an archaic aspect of asset rules drafted in the 1970s in various means-tested programs. Under these rules, amounts in *defined-benefit* pension plans are excluded from the asset tests in these programs but amounts in *defined-contribution* plans and IRAs are counted, despite penalties for early withdrawal.

To be eligible for Supplemental Security Income, Medicaid, or food stamp benefits, applicants generally must meet an assets test as well as an income test. The assets tests are stringent. For example, the food stamp asset limit for non-elderly households is $2,000; for the elderly, the limit is $3,000. In SSI, the limits are $2,000 for a single individual and $3,000 for a couple. In neither program are these limits adjusted for inflation. The asset limits in both programs have been frozen now for more than a decade.

Some resources are excluded from these assets tests, such as an individual's home, household goods, and an automobile (in the case of food stamps, only up to $4,650 of the market value of a car is excluded). Any assets that are not accessible to the household also are excluded. Other assets count, including retirement accounts that can be cashed in prior to retirement.

Because defined benefit pension funds are *not* accessible to households while withdrawals can be made from many defined contribution plans, low-income workers whose employers offer a defined contribution plan are placed at a disadvantage. *Low-income workers who participate in defined contribution plans generally must withdraw most or all of the balance in their accounts — regardless of early withdrawal penalties or other tax consequences — and spend these assets down before they can qualify for means-tested programs such as Medicaid and food stamps*.[1] Similarly, poor elderly and disabled people who otherwise would

[1] Technically, in Medicaid, states can address this problem by excluding amounts in defined contribution accounts, using the authority of sections 1902(r) and 1931 of the Medicaid statute to do so. These authorities,

qualify for SSI are required to consume upfront nearly all of the funds they have accumulated in a defined contribution plan, leaving little for their remaining years, before they can receive SSI benefits. By contrast, benefits that a worker or retiree has accrued in a defined benefit pension plan are *not* considered an asset. (The monthly income provided by the defined benefit plan, or any other retirement plan, is counted as part of an individual's income when the individual retires and begins to receive this income.)

These features of federal law and regulations were fashioned in the 1970s and have been given little attention since. When these rules were designed a quarter-century ago or more, far fewer employers offered defined contribution retirement plans than do today. As the number of low-income workers with defined contribution plans grows, an increasing number stand to lose eligibility for means-tested benefits; the balances in their accounts will be counted as available assets that should be withdrawn and consumed before means-tested assistance can be provided.[2] To the degree the new tax credit that the Senate Finance Committee has designed to provide greater incentives for lower- and moderate-income workers to contribute to such accounts is successful, it will exacerbate this problem.

In addition, workers with defined contribution pensions who experience temporary periods of need, such as during a recession, will be forced to liquidate their accounts (and also to pay early withdrawal penalties) to be eligible for food stamps or Medicaid during the economic downturn. Some workers who are hard-pressed during a downturn — and withdraw and consume most of the accumulated funds in their retirement accounts to qualify for means-tested assistance — could reach retirement with little left in their accounts. This is a significant concern. Most of those who could benefit from the new tax credit would not be eligible for Medicaid or food stamps today because their current incomes are too high, but a sizeable number of such workers could be eligible at some future point when they experience a temporary decline in income.

Forcing low-income workers and retirees to deplete their savings before they can access means-tested benefits runs counter to efforts to encourage low-income workers to save for retirement, efforts that may become particularly important if Social Security benefits ultimately are reduced to help restore long-term solvency in that program. Federal policies ought to promote the growth of personal retirement savings, not provide low-earners a disincentive to save.

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however, are not well understood by states. We are not aware of any state with an asset test in its Medicaid program that has acted to exclude defined contribution plans.

[2] Just between 1984 and 1991, for example, the share of families with earnings between $10,000 and $20,000 (in 1991 dollars) who participated in a 401(k) rose from 3.3 percent to 13.9 percent. See Eric Engen and William Gale, “The Effects of 401(k) Plans on Household Wealth,” paper prepared for the TAPES conference, May 2000, Table 1.

Reform is needed in this area. Under current law, if an individual (whether working or retired) withdraws funds from a tax-deferred retirement account, the amounts withdrawn are counted as income in means-tested programs. This is as it should be. But policymakers should consider excluding the balances in a pension or retirement accounts from the asset tests used for means-tested programs regardless of whether a plan is a defined benefit plan or a defined contribution plan. Whether a worker is entitled to a means-tested benefit without first consuming his or her pension savings should not depend on the form of retirement account a worker's employer has offered.

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