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## **THE WAYS AND MEANS COMMITTEE'S NEW TAX-CUT LEGISLATION ON CAPITAL LOSSES AND PENSIONS**

**By Peter R. Orszag<sup>1</sup>**

### **Summary**

On October 8, the House Ways and Means Committee approved two pieces of tax legislation that would:

- set the dangerous precedent of using the tax code to bail out investors following a stock market decline;
- provide significant tax subsidies to high-income investors, who already enjoy the vast bulk of existing investment tax preferences and who are least in need of additional government assistance;
- cost \$65 billion over 10 years, exacerbating federal budget problems over the medium- and long-term;
- also cause states to lose revenue, because of the linkages between federal and state tax codes, thereby deepening the budget crises that many states face and requiring deeper budget cuts or larger tax increases at the state level;
- make permanent some of the provisions from last year's tax legislation that disproportionately benefit higher earners before the efficacy of those provisions has been adequately evaluated; and
- provide little if any stimulus to the economy in the short run despite the significant budgetary costs involved.

These two pieces of legislation appear to be motivated by a desire to bail out investors, spur a slowing economy, and ensure adequate retirement income levels and security. The notion of having the federal government bail out investors constitutes unwise policy, however, and the proposals are poorly designed either to spur the economy or to ensure adequate retirement income. As Ways and Means Chairman Bill Thomas has stated, "This is not going to have any fundamental effect on the economy,

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<sup>1</sup> Peter R. Orszag is the Joseph A. Pechman Senior Fellow in Economic Studies at the Brookings Institution. The opinions expressed represent those of the author and should not be attributed to the staff, officers, or trustees of the Brookings Institution.

but for those people [directly benefiting] it will be a welcome change.”<sup>2</sup> That is precisely the point: the legislation would do little to spur the economy, while providing the vast bulk of its benefits to households with high incomes. Such inefficient and regressive tax subsidies are a luxury that the nation can ill afford given the dramatic deterioration in the budget outlook over the past 20 months.

### **Bailing Out Investors Would Set An Unwise Precedent**

One of these two pieces of legislation (H.R. 1619) would increase from \$3,000 to \$8,250 the amount of net capital losses that taxpayers could immediately deduct on their tax returns. This proposal, which would cost the Treasury \$24 billion over ten years, cause at least 35 states to incur state revenue losses,<sup>3</sup> and provide more than half of its tax subsidies to households with annual incomes exceeding \$100,000, carries dangers in both the short term and the long term.

In the short run, the provision could induce additional sales of stocks and thereby potentially cause further declines in the stock market. The provision also would represent a significant tax bail-out to investors and thereby set a dangerous precedent for the longer run. If investors come to believe that the government will bail them out when asset prices decline, they will have an incentive to take on excessive levels of risk, and the government may ultimately face large costs from such a partial “implicit guarantee” of private investments.

The government should not be in the business of bailing out private-sector investors when the stock market turns down, especially since the current downturn was preceded by an unprecedented stock market boom. As Treasury Secretary Paul O’Neill stated last year, “I’m certainly not for bailing out investors when they made a free-will decision and it turned out to be wrong.”<sup>4</sup> Having the government bail out investors who voluntarily accepted risks by investing in the stock market would establish an unwise precedent.

### **Retirement Provisions Offer Little Benefit to Most Workers**

The other piece of legislation the Ways and Means Committee has approved (H.R. 5558) would provide additional tax subsidies to certain individuals who possess the capacity to make large contributions to pensions and IRAs. Specifically, the legislation would accelerate some of the scheduled increases included in last year’s tax legislation in the maximum amounts that may be contributed to 401(k) accounts and IRAs (for example, the increase to \$15,000 a year for contributions to 401(k)s that individuals under age 50 can make and to \$20,000 a year for 401(k) contributions by individuals

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<sup>2</sup> “House Panel Supports Legislation Aimed at Easing Tax Burden,” *Wall Street Journal*, October 9, 2002, page A6.

<sup>3</sup> All states with an income tax except Alabama, Arkansas, New Jersey, Pennsylvania, Virginia, Wisconsin, and possibly Hawaii would experience revenue losses.

<sup>4</sup> Transcript from hearing on “State of the International Monetary Financial System,” House Financial Services Committee, May 22, 2001.

## House-passed Tax Cuts Already Exceed Budget Resolution Targets

House Ways and Means Chairman Bill Thomas maintains that the proposed tax cuts are affordable because they fit within the \$28 billion allocation for tax cuts between 2003 and 2007 that was included in the House budget resolution.

- The House, however, has already passed tax cuts totaling \$46 billion between 2003 and 2007.
- When looked at over *ten* years rather than five — from 2003 through 2012 — these House-passed bills lose *\$450 billion* of revenue. Much of this cost reflects the impact of making permanent the provisions in last year's tax-cut package that expire at the end of 2010, outside the period covered by the House's five-year budget resolution.
- If the House also passes the new measures the Ways and Means Committee has approved, the House will have passed tax cuts totaling \$70 billion through 2007, exceeding the House's own five-year budget resolution targets by more than \$42 billion.
- Over ten years, if it adopts these two new bills, the House will have passed tax cuts totaling \$509 billion.

For further information, see Joel Friedman and Andrew Lee, "House to Consider More Tax Cuts Even Though Tax Cuts It Has Already Passed Exceed Budget Resolution Targets," Center on Budget and Policy Priorities, September 12, 2002.

aged 50 and over). These increases in the contribution limits would affect only the very small percentage of workers who can afford to make contributions of this magnitude.

The vast majority of Americans do not make the maximum contributions to their 401(k)s or IRAs and would benefit little, if at all, from accelerating the increases in the maximum contribution levels to these plans. A Treasury Department study in 2000 found that only four percent of all taxpayers who were eligible for conventional IRAs in 1995 made the maximum allowable \$2,000 contribution.<sup>5</sup> The Treasury paper concluded:

"Taxpayers who do not contribute at the \$2,000 maximum would be unlikely to increase their IRA contributions if the contribution limits were increased whether directly or indirectly..."<sup>6</sup> The proposed 401(k) changes similarly would affect a very small percentage of the population. The General Accounting Office has concluded that an increase in the contribution limit for 401(k)s would directly benefit fewer than three percent of participants. (The GAO also found that 84 percent of those who would benefit are individuals who earn more than \$75,000.)<sup>7</sup>

<sup>5</sup> Robert Carroll, "IRAs and the Tax Reform Act of 1997," Office of Tax Analysis, Department of the Treasury, January 2000.

<sup>6</sup> Robert Carroll, *op. cit.*, page 7.

<sup>7</sup> General Accounting Office, "Private Pensions: Issues of Coverage and Increasing Contribution Limits for Defined Contribution Plans," GAO-01-846, September 2001.

In addition, the legislation would allow individuals to shelter more of their pension funds from income taxation by delaying the age at which personal withdrawals from pension accounts must begin. This proposal would be of primary benefit to affluent individuals who have sufficient income and other assets to delay withdrawals from their pension accounts and who could take advantage of this provision to turn their pension accounts more into estate planning devices.

H.R. 5558 would cost \$41 billion over ten years at the federal level and significant additional amounts at the state level. (For example, all states with an income tax except Arkansas, Pennsylvania, and Virginia would lose revenue as a result of the provisions accelerating the scheduled increases in the 401(k) and IRA contribution limits.) Yet the bill would provide the bulk of its benefits to higher-income individuals and have no effect on the vast majority of middle-income workers. Further, the bill would make permanent the higher pension and IRA contribution limits included in last year's tax legislation, thereby imposing further substantial budgetary costs outside the 10-year budget window and doing so before the effectiveness of these provisions has been determined.

### **Proposals Would Fail to Provide Economic Stimulus**

Another possible motivation for these two bills is to stimulate the economy. To be sure, the economy is currently growing more slowly than its potential growth rate (that is, the growth rate that the economy could achieve without sparking higher inflation), and this may argue for additional stimulus from the government. The history of fiscal stimulus measures, however, suggests they are often mistimed, taking effect after the economy has begun to grow rapidly again. Furthermore, even if short-term fiscal stimulus is appropriate now, none of these proposals would be particularly effective at delivering it, and some could be counterproductive.<sup>8</sup> The proposals are flawed as short-run stimulus measures for two reasons:

- The proposals would do little, if anything, to boost demand for the goods and services that firms produce, which is crucial to economic recovery in the short run. These tax cuts would provide a large and disproportionate share of their benefits to higher-income taxpayers, who tend to spend a smaller percentage of additional income they receive than lower-income taxpayers do.<sup>9</sup> Furthermore, the pension and IRA proposals — whatever their actual effects — are ostensibly designed to shift resources from

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<sup>8</sup> For further discussion of short-term stimulus measures, see William Gale, Peter Orszag, and Gene Sperling, "Tax Stimulus Options in the Aftermath of the Terrorist Attack," *Tax Notes*, October 8, 2001. See also William Gale and Peter Orszag, "A New Round of Tax Cuts?" Center on Budget and Policy Priorities, Revised August 23, 2002.

<sup>9</sup> See Karen E. Dynan, Jonathan Skinner, and Stephen P. Zeldes, "Do the Rich Save More?" NBER Working Paper 7906, National Bureau of Economic Research, September 2000; Jonathan Parker, "The Consumption Function Re-estimated," August 1999; and Jonathan McCarthy, "Imperfect Insurance and Differing Propensities to Consume Across Households," *Journal of Monetary Economics*, November 1995, 301-27.

## Pushing States Deeper Into the Hole

Many states are now facing serious fiscal difficulties. Most states already took action to reduce expenditures, increase taxes, and/or draw down reserves to close deficits that totaled approximately \$44 billion in their 2002 fiscal years, and states have instituted additional budget cuts to close deficits projected for 2003. Some of these budget cuts, such as those in Medicaid and child care assistance, have especially affected low-income families, while many middle-income families have been affected by reductions in higher education funding that have driven up tuition at state schools.

Moreover, with revenue collections continuing to come in below projections due to the slumping stock market and the underperforming economy, budget deficits have reopened in states across the country. Nearly all states are required to balance their budgets, regardless of the condition of the economy, and further waves of budget cuts lie ahead. In a report issued September 29, the National Governors Association concluded that: "The evidence is overwhelming that 2003 will be much worse than 2002 and states will be forced to make huge spending cuts particularly in Medicaid." NGA noted that low-income individuals are likely to be "severely impacted" by these cuts.<sup>10</sup>

The tax legislation that the Ways and Means Committee has passed would aggravate these problems. Most states with an income tax traditionally conform their definitions of what is taxable and what is not to the definitions in the federal income tax code. As a result, the proposals to increase the amount of capital losses that can be deducted, to increase the limits on tax-deductible or tax-deferred contributions to 401(k) plans and IRAs, and to raise the age at which distributions must begin to be taken from retirement accounts would cause states to lose revenues.

Each one of these proposals would result in at least 35 states suffering revenue losses. Since the federal and state tax benefits from these provisions would principally accrue to affluent individuals, while state budget cuts and tax increases typically hit middle- and lower-income families most heavily, the likely effect in many states would be to reduce after-tax income or services for middle- and lower-income families to make up for revenue losses caused by tax reductions for more affluent

consumption to saving in the near term, precisely the *opposite* of what one should do to stimulate a sluggish economy.

- In addition, the proposals would be permanent rather than temporary. They therefore would exacerbate the nation's long-term fiscal imbalance, which in turn would put upward pressure on long-term interest rates.<sup>11</sup> Increases in long-term interest rates would attenuate any small stimulus

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<sup>10</sup> National Governors Association, "State Fiscal Crisis Worsens; Time Winding Down for Congress to Pass Relief Bill," September 29, 2002.

<sup>11</sup> For a discussion of the relationship between fiscal deficits and long-term interest rates, see Matthew B. Canzoneri, Robert Cumby, and Behzad Diba, "Should the European Central Bank and the Federal Reserve Be Concerned About Fiscal Policy?" Jackson Hole Symposium on "Rethinking Stabilization Policy", August 2002; William G. Gale and Samara R. Potter, "An Economic Evaluation of the Economic Growth and Tax Relief Reconciliation Act of 2001," *National Tax Journal*, March 2002, and Peter R. Orszag, "The Budget and the Economy," Testimony before the Senate Budget Committee, January 29, 2002.

benefit the proposals might otherwise have in the short run. (Increasing the *current* budget deficit provides a direct spur to economic activity today, since it raises demand in the midst of a sluggish economy even though it also raises interest rates. Increasing *future* budget deficits, by contrast, does *not* have a direct effect on current economic activity but still raises current long-term interest rates and thereby impairs economic activity today by increasing the cost of business investment and mortgage financing.)

### **Better Solutions Exist to Address Economic and Retirement Concerns**

The two pieces of tax legislation approved by the Ways and Means Committee are fundamentally flawed. The government should not be in the business of insuring investors against short-term stock market fluctuations, and the proposals are poorly designed either to stimulate the economy in the short run or to shore up retirement accounts for most workers. The one sure thing the legislation would accomplish is to add to the federal budget deficit over the longer term while providing larger tax subsidies to high-income investors.

Finally, for each of the possible motivations for this legislation, much better solutions exist. More open and complete accounting practices (such as requiring that firms expense their options in their financial statements), stronger regulation, and a more auspicious long-term fiscal outlook would give investors more confidence to invest in the stock market. Increased federal aid to state governments and targeted extensions of unemployment benefits would provide a bigger short-term economic boost than the tax policies in these bills. Expanding the new “saver credit” (a progressive matched savings tax credit created by last year’s tax legislation) and making it permanent, along with other changes to expand pension coverage, would do more to enhance retirement security than the provisions being considered. Finally, the nation’s long-term economic outlook could be improved more significantly by getting our fiscal house in order.

### **H.R. 1619: Raising the Amount of Deductible Capital Losses**

H.R. 1619 would increase the amount of net capital losses that can be deducted for federal income tax purposes. Currently, taxpayers can deduct \$3,000 in net losses. For example, if a taxpayer had \$50,000 in realized capital gains and \$53,000 in realized capital losses, she would have a net capital loss of \$3,000. If the taxpayer had realized losses beyond \$53,000, she could not deduct the additional losses in the *current* year but could carry the additional losses forward and deduct them either against gains in future years or as a net loss in future years.

Net capital losses up to the allowable amount can be deducted against ordinary income, despite the fact that the tax rate on capital *gains* is substantially lower than the tax rate on ordinary income. Consider a high-income taxpayer in the 38.6 percent marginal tax bracket. The capital gains tax rate for such a taxpayer, assuming that he or she has owned the stocks for at least one year before selling them, is 20 percent. The taxpayer would therefore pay \$600 on a \$3,000 net long-term capital gain (20 percent of

\$3,000). But the taxpayer would receive a tax benefit equal to \$1,158 — nearly twice as much — on a \$3,000 net capital loss (38.6 percent of \$3,000).

H.R. 1619 would raise the amount of net losses that can be immediately deducted from \$3,000 to \$8,250. Such a proposal is flawed for several reasons.

- The proposal would represent a government bail-out for investors who had willingly risked funds in the stock market and consequently would represent a dangerous precedent: The government ought not be in the business of insulating investors from short-run market fluctuations. It also is peculiar to consider such a proposal at this time, since the current stock market declines follow unusually high stock market returns over the past 20 years. Individuals who have been invested in the market for a considerable period of time and who have held a broadly diversified portfolio are still well ahead overall.
- The proposal would have no direct effect on any tax-preferred retirement account, since the net capital loss rules do not apply to such accounts. It would therefore do nothing to address directly the declines in retirement wealth.
- Raising the amount of deductible capital losses could cause a *decline* in stock prices, since it would encourage people to sell stocks in companies whose share prices have declined. Consider, for example, an individual with exactly \$3,000 in net capital losses who holds a stock that has declined in value. Under the current tax system, the individual's incentive to sell the stock is reduced, since the capital loss on the stock could not be immediately deducted. If the limit on deductible net capital losses were raised, however, the individual may be tempted to sell the stock. As a result, firms that have already been hit the hardest by declines in stock prices could be hit once again by this policy, since the policy could lead more shareholders to sell shares.
- The change would be regressive, further reducing any economic stimulus effect. Analysis using the Urban Institute-Brookings Tax Policy Center model shows that if the net capital loss deduction were increased to \$6,000 in 2003, more than half of the tax cut would accrue to tax filers with incomes above \$100,000.<sup>12</sup> The results would be similar for raising the net capital loss deduction to \$8,250, as under H.R. 1619. The fact that this change would be regressive would attenuate its impact in boosting the economy through more consumer spending, since higher-income taxpayers tend to spend a smaller percentage of additional income they receive than lower-income taxpayers do.

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<sup>12</sup> Such filers account for 11 percent of tax filing units and 46 percent of adjusted gross income.

Finally, the proposal would exacerbate the long-term fiscal imbalance facing the nation. The Joint Committee on Taxation estimates that H.R. 1619 would cost \$23.9 billion over ten years.

## **H.R. 5558: Providing Larger Pension Subsidies to Higher Earners**

The other piece of legislation approved by the Ways and Means Committee would accelerate the increases in IRA and 401(k) contribution limits included in last year's tax legislation, make these increases permanent, and allow more pension and IRA assets to be diverted from their basic purpose of financing retirement needs.

### **Accelerating the Contribution Limit Increases**

Last year's tax legislation, the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), included a series of significant changes to the pension and IRA laws. The major provisions involved various changes that allow larger contributions by, and on behalf of, high-income workers (often business owners and executives). These increases in the maximum allowable contribution limits are phased in over time.

For example, in 2001, workers were allowed to deposit a maximum of \$10,500 in a 401(k) account. Last year's tax legislation raises the maximum gradually to \$15,000 by 2006 (and to \$20,000 for those aged 50 or over). Similarly, last year's tax-cut law more than doubled the amount that a taxpayer and spouse can contribute each year to an IRA. Under prior law, a taxpayer and spouse could each contribute \$2,000; last year's legislation gradually raises the maximum contribution to \$5,000 apiece by 2008. In addition, starting in 2006, taxpayers aged 50 or over will be able to contribute an additional \$1,000 apiece.

H.R. 5558 would accelerate the phase-ins in these increases, making the full increases in these contribution limits effective in 2003. Such an acceleration would represent unsound policy.

- Whatever their actual effects, increases in contribution limits are typically advertised as inducing additional *saving*, not additional spending. Yet from a short-term economic perspective, inducing additional spending is the right thing to do at the moment, since it is additional consumption that would spur the economy. H.R. 5558 is thus a peculiar one to be advocating in the current sluggish economic environment: Even if it is successful in achieving its ostensible goal of raising retirement saving, it would be counterproductive today from an economic perspective.<sup>13</sup>

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<sup>13</sup> Since the increases take effect only after December 31, 2002, one could make the theoretical argument that they could lead some individuals to shift saving from 2002 into 2003, which arguably would be beneficial from an economic perspective. It is unlikely that this effect will be significant, however, especially since so few workers are affected by the limits. The most likely outcome is that these provisions will have little effect on the economy, one way or the other, in the short run.

- In addition, increasing the contribution limits would have little effect on middle- and upper-middle-income families and individuals. The vast majority of Americans do not make the maximum contributions to their 401(k)s or IRAs and therefore would benefit little, if at all, from accelerating the increases in the maximum contribution levels. For example, a Department of Treasury study in 2000 found that only four percent of all taxpayers who were eligible for conventional IRAs in 1995 made the maximum allowable \$2,000 contribution.<sup>14</sup> The Treasury paper concluded: “Taxpayers who do not contribute at the \$2,000 maximum would be unlikely to increase their IRA contributions if the contribution limits were increased whether directly or indirectly...”<sup>15</sup> The proposed 401(k) changes similarly would affect a very small percentage of the population. The General Accounting Office has concluded that an increase in the contribution limit for 401(k)s would directly benefit fewer than three percent of participants. The GAO also found that 84 percent of those who would benefit earn more than \$75,000,<sup>16</sup> which indicates that an immediate increase in the limit to \$15,000 would disproportionately benefit those on the higher rungs of the compensation scale.

Some have argued that boosting retirement contribution limits would help fuel the stock market. As emphasized above, however, it would set a dangerous precedent for the government to attempt to manipulate stock market values through tax policy. Moreover, even if this were an appropriate policy goal, raising contribution limits would be a highly inefficient way of boosting stock values. Evidence suggests that most contributions to retirement accounts made by high-income individuals — the group that constitutes a disproportionate share of those who make the maximum allowable pension contributions and might increase their contributions if the contribution limits were raised — do *not* represent net additions to saving but rather are reshuffled assets.<sup>17</sup> Increases in contributions to IRAs and 401(k)s by such individuals would represent amounts that likely would be saved in some other form in the absence of increases in the IRA and 401(k) contribution limits. For this reason, the total amount saved and invested in the stock market would likely remain largely unchanged. (Another reason why this proposal would do little to affect stock prices is that since relatively few people are constrained by the current contribution limits, the additional amounts that would be placed in 401(k)s and IRAs if these limits were raised would be too small to have more than a minimal market impact.)

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<sup>14</sup> Robert Carroll, “IRAs and the Tax Reform Act of 1997,” Office of Tax Analysis, Department of the Treasury, January 2000.

<sup>15</sup> Robert Carroll, *op. cit.*, page 7.

<sup>16</sup> General Accounting Office, “Private Pensions: Issues of Coverage and Increasing Contribution Limits for Defined Contribution Plans,” GAO-01-846, September 2001. This figure is conditional on other changes (in particular the elimination of the previous percentage cap on combined employer-employee contributions to defined contribution plans) that were included in EGRTRRA and have already taken effect.

<sup>17</sup> Eric Engen and William Gale, “The Effects of 401(k) Plans on Household Wealth,” paper prepared for the TAPES conference, Gerzensee, Switzerland, May 2000.

The legislation also would accelerate the scheduled increases in the maximum contribution limits for workers *aged 50 or over*; last year's tax legislation set the limits at higher levels for these workers than for other workers. The provisions that establish the contribution limits for workers aged 50 or over at higher levels — for example, at \$20,000 a year for 401(k) contributions by 2006 — were advertised during the debate over last year's tax bill as disproportionately benefiting women. The General Accounting Office has since found that such claims were groundless; the GAO has concluded that the provisions setting higher contribution limits for workers 50 and over will benefit only eight percent of the female workers aged 50 and over who participate in defined contribution plans, as compared to 13 percent of male workers aged 50 and over who participate in these plans.<sup>18</sup> In other words, these provisions would affect only a small percentage of workers who participate in defined contribution plans and would disproportionately benefit men, rather than women. This should not be surprising, given that men make up a disproportionate share of those who have higher incomes.

### **Making the Contribution Limit Increases Permanent**

The contribution limit increases in last year's tax legislation, like the rest of that legislation, sunset in 2010 or before. H.R. 5558 would not only accelerate the increases in the contribution limits but also make them permanent.<sup>19</sup> Making these provisions permanent at this time is another step that does not represent sound policy.<sup>20</sup>

These provisions represent an untested “trickle down” approach to pension coverage: they were promoted last year on the grounds that if the tax laws governing retirement savings were made more generous for higher earners, the increased generosity would encourage more small businesses to offer pension plans, which would result in pension coverage being extended to more rank-and-file workers. This approach did not have any empirical backing when the legislation was passed. It therefore is prudent to wait and see how the approach works in practice over the next few years before permanently locking in the changes, which carry a not inconsiderable cost. The early evidence is, if anything, not encouraging, which suggests further grounds for caution.

A recent *Wall Street Journal* article, for example, found that very few workers seem to be taking advantage of the new rules that raise the maximum contribution limits to higher levels for those aged 50 and older. The article reported, “At this point, no comprehensive numbers exist to show how many — or rather, how few — people have taken advantage of the catch-up provisions. ‘If there were numbers, they'd be pretty

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<sup>18</sup> General Accounting Office, “Private Pensions: Issues of Coverage and Increasing Contribution Limits for Defined Contribution Plans,” GAO-01-846, September 2001.

<sup>19</sup> Joint Committee on Taxation, “Description of H.R. 5558.” JCX-98-02. See footnotes 4 and 6.

<sup>20</sup> See Peter R. Orszag, “The Retirement Savings Components Of Last Year's Tax Bill: Why It Is Premature To Make Them Permanent,” Center on Budget and Policy Priorities, September 18, 2002.

underwhelming,' says Jim Jaffe, [director of external affairs] of the Employment Benefits Research Institute, a data and policy research organization in Washington D.C.”<sup>21</sup>

According to the article, only 6,259 of the 337,758 workers aged 50 and over who participate in 401(k) plans administered by the financial firm T. Rowe Price — or fewer than two percent of the eligible participants in these plans — are making additional contributions. (The article notes that one of the reasons for the low participation rate may be that it takes time for firms to modify their pension plans to conform to the changes in last year’s tax bill. That itself, however, is a reason why it is prudent to allow more time to evaluate the effectiveness of the provisions before making them permanent.) It also is likely that those who are making the additional contributions consist disproportionately of higher-income individuals.

Another reason that it would be ill-advised to make the pension provisions of last year’s tax legislation permanent at this time is that doing so would cause a further deterioration in a budget outlook that has already worsened dramatically over the past 20 months and would widen projected deficits outside Social Security. The Congressional Budget Office now projects a 10-year baseline surplus of only \$335 billion for 2002-2011 and \$1.0 trillion for 2003-2012, and these figures themselves paint much too sanguine a picture of the budget outlook; they do not include the President’s required defense and homeland security increases, which Congress is certain to approve, and they assume that the entire tax cut will expire by the end of 2010. Moreover, even these overly sanguine projections show that outside of Social Security, the budget has a *deficit* of \$2.0 trillion for 2002-2011 and \$1.5 trillion for 2003-2012.

In this budgetary context, policymakers should generally avoid enacting new legislation with significant long-term budgetary costs, particularly when it is unclear whether the legislation will achieve its ostensible goals. The Joint Tax Committee has estimated the cost of making the retirement provisions of the last year’s tax legislation permanent at \$8 billion in 2012 alone. The troubling fiscal outlook adds weight to the view that it would be more prudent to wait before acting to make the retirement provisions permanent.

Finally, the Ways and Means Committee legislation does *not* make permanent perhaps the most auspicious piece of the retirement package in last year’s tax bill: the “saver’s credit.” This credit, under which moderate-income workers receive a tax credit for contributions they make to retirement accounts, is one of the few retirement provisions in last year’s tax bill that holds significant promise of helping moderate-income families build retirement saving. The credit sunsets in 2006. An early version of the Ways and Means legislation would have expanded the saver’s credit and made it permanent, but the final version does neither. In other words, the Ways and Means bill makes permanent the main pension provisions of last year’s tax legislation that were geared toward high-income individuals while failing to make permanent the principal provision designed to boost pensions among lower- and moderate-income workers.

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<sup>21</sup> Bridget O’Brian, “Older Investors Miss the Chance to Catch Up in Retirement Plans,” *Wall Street Journal*, September 13, 2002.

## Loosening the Minimum Distribution Rules

The legislation would also loosen the minimum distribution rules for defined contribution plans, such as 401(k)s. These rules are intended to ensure that the substantial tax benefits provided for pensions and IRA contributions are actually used to finance retirement needs. As Mark Warshawsky, currently a Deputy Assistant Secretary at the Treasury Department, has previously written: “The public policy purpose of the minimum distribution requirements...is to ensure that tax-qualified retirement plans serve primarily as vehicles for providing income during the retirement of the plan participant and his or her spouse....The government also intends that the use of retirement plans for tax avoidance schemes and the accumulation of large estates should be minimized.”<sup>22</sup>

To ensure that retirement plan assets are used primarily to finance retirement needs, workers must generally begin to draw down their accumulated pensions by age 70½, or when they retire, whichever is later.<sup>23</sup> This rule ensures that pension accumulations are used at least in part during retirement. In the absence of such a rule, high-income workers could use the tax benefits associated with pensions and IRAs as tax shelters, making contributions to tax-preferred pension and IRA accounts that they never intend to use for retirement needs. Instead, in the absence of some form of minimum distribution rule, tax-preferred pension and IRA accounts could be used to accumulate substantial estates (rather than to provide income during retirement). In that case, the tax preferences associated with pensions and IRAs would not be serving their basic public policy purpose of bolstering retirement security. As Professor Jay Soled of Rutgers University and Bruce Wolk of the University of California at Davis have written, “There seems little justification for a system that, on one hand, allows the highly compensated to amass significant tax-favored wealth on the theory that it was needed for retirement, but, on the other hand, permits them to perpetuate their own financial dynasties as this wealth moves across multiple generations, retaining its tax-favored status.”<sup>24</sup>

Pension experts agree that the minimum distribution rules are complicated. Efforts to simplify them are underway, however, including important simplifications contained in recent IRS regulations.<sup>25</sup> Moreover, the approach in H.R. 5558 — delaying the age at which mandatory distributions must begin from 70½ to 75 if the worker is already retired — is problematic.

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<sup>22</sup> Mark J. Warshawsky, “Further Reform of Minimum Distribution Requirements for Retirement Plans,” *Tax Notes*, April 9, 2001.

<sup>23</sup> The rules for distributions from traditional IRAs are slightly different. Distributions from IRAs are required to begin by age 70 ½ regardless of whether the owner is retired or not. No minimum distribution rules apply to Roth IRAs until the death of the owner.

<sup>24</sup> Jay A. Soled and Bruce A. Wolk, “The Minimum Distribution Rules and Their Critical Role in Controlling the Floodgates of Qualified Plan Wealth,” *Brigham Young University Law Review*, 2000, page 616.

<sup>25</sup> See *Internal Revenue Bulletin* (2001-11, page 865) on March 12, 2001.

Such a delay in the age at which distributions from pension plans must begin would provide a significant tax benefit to high-income individuals who have sufficient assets and income to delay withdrawals from their pensions and IRAs past age 70½. The vast majority of American workers retire before age 70½, and need to begin withdrawing funds from their pensions before then.<sup>26</sup> For the vast majority of workers, the minimum distribution rules are therefore not relevant, since they will have begun taking distributions from their pensions well before the age at which distributions are required to begin. Raising that required age would thus primarily affect high-income households that have sufficient other income and assets to delay withdrawals from their tax-preferred pensions, and significantly expand the potential for such households to use their tax-preferred retirement accounts as estate planning devices.

The tax benefits for those who could make aggressive use of this change in the distribution rules are large. The Joint Committee on Taxation estimates that even though this change would be phased in slowly over time, it would cost \$27 billion over the next ten years at the federal level. It would result in additional revenue losses at the state level.

## **Conclusion**

The two pieces of legislation approved by the Ways and Means Committee are flawed. One would establish the dangerous precedent of using the tax code to bail out investors following a stock market decline, while costing \$24 billion over the next 10 years. The other, costing \$41 billion over 10 years, would accelerate and make permanent some of the retirement provisions from last year's tax legislation that will do little if anything to bolster retirement security for the vast majority of American workers and are untested as pension policy. The legislation also would loosen minimum distribution rules intended to ensure that the tax preferences provided for retirement saving are actually used to boost retirement income, not as a tax shelter and estate planning device for the more affluent.

As noted, the government ought not be in the business of insuring investors against short-term stock market fluctuations. Nor is it advisable to enact proposals that are poorly designed to stimulate the economy in the short run and would do little if anything to shore up retirement accounts for most workers, but would expand the federal budget deficit over the longer term.

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<sup>26</sup> The average retirement age – that is, the age at which half of men are no longer in the labor force -- is approximately 63. See Gary Burtless and Joseph Quinn, "Retirement Trends and Policies to Encourage Work Among Older Americans," *Brookings Economic Papers*, January 1, 2000.