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PROPOSED PENSION CHANGES WOULD OVERWHELMINGLY BENEFIT CORPORATE EXECUTIVES AND OWNERS

Provisions Could Lead to Pension Reductions for Low- And Moderate-income Workers

by Peter R. Orszag, Iris Lav, and Robert Greenstein[1]

Tax legislation that the House Ways and Means Committee approved July 13 (H.R. 4843) would substantially expand pension tax preferences for high-income executives but likely lead to some reductions in pension coverage among low- and moderate-income workers and employees of small businesses. The provisions of this legislation, which is scheduled to come to the House floor the week of July 17, are similar to the pension tax provisions included in the large tax bill that President Clinton vetoed last summer.

The Proposed Pension Provisions

The bill the Ways and Means Committee approved includes important changes in the tax laws that govern employer-sponsored pensions. These provisions would cost more than $50 billion over 10 years and nearly $9 billion a year by the tenth year. These provisions are promoted as expanding pension coverage for working Americans. But while these pension provisions include several useful changes, their principal impact would be a major expansion of pension-related preferences for high-income individuals. Furthermore, these provisions likely would lead to *reductions* in pension coverage among ordinary workers.

Analysis by the Institute for Taxation and Economic Policy of the pension provisions of the bill finds 76.9 percent of the pension and IRA tax reductions from those provisions would accrue to the 20 percent of Americans with the highest incomes (see table on next page). More than 42 percent of the pension and IRA tax breaks would go to the five percent of the population with the highest incomes. In sharp contrast, the bottom 60 percent of the population would receive less than five percent of these tax benefits.

Pension provisions very similar to those in the pending legislation were among the provisions cited as unacceptable by the President when he vetoed last year's tax bill. In addition, on November 1, 1999, when the House appeared to be on the verge of considering similar

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Effects of the Comprehensive Retirement Security and Pension Reform Act
(scheduled for Ways and Means Mark-up on July 13, 2000)

Income Group	Income Range	Average Income	% of Total Tax Cut
Lowest 20%	Less than $14,000	$8,800	0.1%
Second 20%	14,000-25,000	19,400	0.5%
Middle 20%	25,000-41,000	32,100	3.7%
Fourth 20%	41,000-67,000	52,400	18.8%
Top 20%	67,000 or more	89,600	76.9%
ALL		$52,400	100.0%
ADDENDUM			
Bottom 60%	Less than $41,000	$20,100	4.3%
Top 5%	More than $134,000	$337,800	42.4%
Top 1%	More than $327,000	$937,000	19.4%

Note: Estimates include the effects of (1) increasing the annual IRA contribution limit to $5,000; (2) increasing the 401(k) annual contribution limit to $15,000, changing the 401(k) anti-discrimination rules, and changing the over age 50 "catch-up" rules; and (3) various other proposed retirement savings changes. The estimates do not include changes in the minimum distribution rules.

Source: Institute on Taxation and Economic Policy Tax Model, July 12, 2000.

pension provisions as part of minimum-wage legislation, Treasury Secretary Lawrence Summers and Labor Secretary Alexis Herman wrote to House Ways and Means Chairman Bill Archer sharply criticizing these provisions. Summers and Herman warned that the pension provisions that "...raise the maximum retirement plan contribution and considered compensation for business owners and executives and weaken the pension anti-discrimination and top-heavy protections for moderate- and lower-income workers....are regressive, would not significantly increase plan coverage...and could lead to reductions in retirement benefits for moderate- and lower-income workers."

The legislation coming to the House floor also has the potential to reduce national savings. Its most costly provision would raise the maximum amount that can be contributed to an Individual Retirement Account from $2,000 a year to $5,000. (For a couple, the limit would rise from $4,000 to $10,000.) Those taxpayers most able to take advantage of such an increase in the IRA contribution limits and to place $5,000 a year in an IRA account would be more-affluent taxpayers who can shift funds from other saving or investment vehicles rather than increasing the amount they save. National saving is the sum of private saving and government saving (i.e., government budget surpluses). If the government's revenue loss from a tax provision exceeds the new private saving the provision induces — as could well be the case here because of the widespread asset-shifting that would be likely to occur — national saving declines.

The Administration's Retirement Savings Account proposal, which focuses its saving incentives on low- and middle-income families — a group that has fewer assets to shift and thus generally must increase the amount it saves to take advantage of such incentives — would be a much more effective way of increasing national saving. Such an approach also would target its benefits on low- and middle-income workers, rather than placing them at risk.

Background

Along with Social Security and private savings, tax-favored pensions form an important leg of the "three-legged stool" of retirement income and security. One leg of the retirement stool is Social Security. A second leg is private savings, accumulated by families and individuals in a variety of forms (e.g., bank accounts and mutual funds). Pensions provide the third leg of the stool. Private and government pensions accounted for 18 percent of the total income of the elderly in 1996.[2]

Pension coverage is, however, very unevenly spread. Half of the American workforce lacks it. Pensions remain particularly scarce in specific segments of the labor market, especially among lower-income workers and employees in small businesses. For example, in 1993, only eight percent of full-time workers with earnings below $10,000 — and only 27 percent of those with earnings between $10,000 and $15,000 — were covered by pensions. By contrast, 81 percent of those with earnings above $75,000 had pension coverage.[3]

The lower rates of pension coverage among workers with smaller incomes, combined with higher marginal tax rates for high-income workers and higher contribution rates among highly compensated workers with pension coverage, mean that existing tax preferences for pensions disproportionately benefit upper-income workers. Higher-income workers enjoy more access to pension coverage than lower-income workers do. Covered higher-income workers also make larger contributions to pensions than lower-income covered workers. Furthermore, because higher-income workers pay taxes at higher marginal tax rates, they receive a larger tax break for each dollar of contribution they make than their lower-earning colleagues do. These factors explain why two-thirds of the tax benefits of current tax preferences for pensions accrue to those whose family incomes place them in the top fifth of the income scale.

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[2] Social Security Administration, Office of Research, Evaluation, and Statistics, *Fast Facts and Figures about Social Security* (1998), page 6.

[3] U.S. Department of Labor, Social Security Administration, Small Business Administration, and Pension Benefit Guaranty Corporation, *Pension and Health Benefits of American Workers*, 1994, Table B11. "Covered" means that the employee participated in any type of employment-based pension plan, including defined benefit plans, 401(k) type plans, deferred profit sharing plans, and stock plans. Pension coverage is even lower among part-time workers. Only 12 percent of part-time workers enjoy pension coverage, compared to 50 percent of full-time workers.

Benefits of Progressivity in Pension Policy

Sound pension policy reform entails directing more of the pension-tax incentives to middle- and lower-income workers who currently are saving little, if anything, in pensions. This emphasis on workers with low pension coverage is warranted for several reasons:

1. ***National saving.*** One of the nation's economic imperatives is to raise the national saving rate to prepare for the retirement of the baby boom generation. Tax incentives intended to boost pension saving will raise national saving if they increase private saving by more than the cost to the government of providing the incentive. (National saving is the sum of public saving and private saving. All else being equal, every dollar of lost tax revenue reduces public saving by one dollar. Consequently, for national saving to increase, private saving must increase by more than one dollar in response to each dollar in lost revenue.[4]) To raise private saving, the incentives must not simply cause individuals to shift assets into the tax-preferred pensions but must generate *additional* contributions.

   Since those with modest or low incomes are less likely to have other assets to shift into tax-preferred pensions, *focusing pension tax preferences on moderate- and lower-income workers increases the likelihood that lost tax revenue will reflect additional contributions rather than shifts in assets*.[5] Indeed, new research by Eric Engen of the Federal Reserve Board and William Gale of the Brookings Institution suggests that tax-preferred retirement saving undertaken by lower-income workers is much more likely to represent new saving (rather than asset shifting) than tax-preferred retirement saving undertaken by higher-income workers.[6]

2. ***Elderly poverty***. The revenue loss from existing tax preferences for pensions amounts to roughly $85 billion per year, which is larger than the

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[4] If the revenue loss is fully offset through other fiscal measures, then the net impact on national saving is simply the change in private saving. In this case, public saving would be unchanged.

[5] Economists continue to debate the impact on private saving from existing pension incentives. Most economists agree, however, that whatever the overall effect, focusing incentives on those with fewer opportunities to shift assets from taxable to non-taxable forms is likely to produce a larger increase in private saving for any given reduction in government revenue. For a discussion of the impact of existing tax preferences, see Eric Engen, William Gale, and John Karl Scholz, "Personal Retirement Saving Programs and Asset Accumulation: Reconciling the Evidence," National Bureau of Economic Research Working Paper 5599 (May 1996), and James Poterba, Steven Venti, and David Wise, "Do 401(k) Contributions Crowd Out Other Personal Saving?" *Journal of Public Economics*, Volume 58, 1995, pages 1-32.

[6] Eric Engen and William Gale, "The Effects of 401(k) Plans on Household Wealth," Paper prepared for the TAPES conference, Gerzensee, Switzerland, May 22-24, 2000.

revenue loss from excluding health insurance from taxation.[7] At least one of the reasons that we as a society are willing to provide such large tax preferences to pension contributions is the belief that they are an important leg of the three-legged stool of providing retirement security and reducing elderly poverty.[8] Yet higher-income workers are less likely to be in danger of living in poverty in older age. This is another reason it makes sense to focus attention on lower-income workers in fashioning new tax-favored pension initiatives.

3. ***Progressivity and fairness***. As noted above, two-thirds of the benefits from *existing* tax preferences for pensions accrue to those in the top fifth of the income scale. Given the disproportionate share of the benefits from existing provisions accruing to upper-income workers, any *additional* preferences should be less skewed.

Pension reforms should therefore be judged primarily in terms of how much additional coverage for moderate- and low-income workers they deliver and at what cost in terms of lost revenue.

Description of Pension Provisions in the "Comprehensive Retirement Security and Pension Reform Act"[9]

This section describes some of the pension provisions in the "Comprehensive Retirement Security and Pension Reform Act," which the House Ways and Means Committee approved on July 13. This legislation includes several beneficial reforms in the pension laws. For example, it would require faster vesting than current law. Vesting occurs when a worker acquires a right to a pension benefit. Once a worker is vested, his or her pension benefit cannot be taken away if the worker switches jobs. If a worker whose employer has contributed $1,000 to the worker's pension leaves the firm before the worker is vested, the worker is not entitled to any pension benefit from this contribution.

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[7] The revenue loss from the net exclusion of pension contributions and earnings in fiscal year 1999 is estimated to be $72.4 billion for employer-provided plans, $10.8 billion for Individual Retirement Accounts, and $3.8 billion for Keogh plans. The exclusion of employer contributions for medical insurance and medical care is estimated to cost $76.2 billion in fiscal year 1999. See *Budget of the United States Fiscal Year 1999: Analytical Perspectives*, Table 5-1, page 92.

[8] For an overview of the tax provisions affecting employer-provided pensions, see Joint Committee on Taxation, *Overview of Present-Law Tax Rules and Issues Relating to Employer-Sponsored Retirement Plans* (JCX-16-99), March 22, 1999.

[9] This analysis examines the provisions of this legislation, as described in the Joint Committee on Taxation's document of July 11, 2000 entitled "Description of the Comprehensive Retirement Security and Pension Reform Act."

Vesting is important to remove artificial barriers to labor mobility and to ensure equitable treatment of all employees. The Employee Retirement and Income Security Act of 1974 (ERISA) requires that employer contributions to a pension be vested in no more than five years. The legislation would reduce the maximum vesting period for 401(k) plans to three years, a useful change for some workers.[10] The legislation also simplifies the rules on rolling over account balances from one type of retirement account to another, which may increase pension portability for some workers (see box on pages 10 and 11).

But while the pension provisions are helpful in some respects, their main thrust is the relaxation of various rules intended to limit opportunities for high-income executives to enjoy pension benefits without providing similar benefits to rank-and-file employees. The apparent theory behind the proposals' changes in this area is that by liberalizing the rules for higher-income executives, the legislation will lead more businesses to adopt pension plans and thereby help their middle- and lower-income employees. However, no credible empirical evidence supports this theory, and analysis of the provisions in the conference bill suggests that the "trickle-down" approach comes at a steep price. The legislation will likely do little, if anything, to increase pension coverage among rank-and-file workers, while providing significant benefits to higher-income workers (and also costing the federal government billions of dollars a year in lost revenue). Furthermore, the legislation also includes provisions that create incentives for employers to *reduce* pension coverage. The legislation thus represents an approach to pension policy that is both inefficient and regressive.

Among the provisions in the legislation that would relax current pension rules for high-income individuals are:

Increased Dollar Limits for Employee Contributions

Workers are currently allowed to deposit a maximum of $10,500 out of their wages in a 401(k) account each year. The bill would raise the maximum to $15,000 in 2005.[11] (The

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[10] Alternative rules apply under both current law and the legislation if the vesting occurs gradually. The vesting improvements under the legislation, however, do not apply to all workers — only 27 percent of full-time workers in 1993 were covered by a 401(k) plan — and the benefit of these provisions to many covered workers may be limited, since many firms offering 401(k) plans already provide faster vesting than current law requires.

[11] The legislation would also create "qualified plus contribution" accounts, which would be 401(k) accounts that operate in a manner similar to a Roth IRA: The contribution to the account would *not* be deductible from income for tax purposes, but the withdrawal would be excluded from income. (Under a conventional 401(k), the contribution is deductible from income but the withdrawal during retirement *is* taxable.) The creation of qualified plus accounts *raises* revenue in the short run, since some contributions that would have been made to conventional 401(k) plans (and thus deductible for income tax purposes) would instead be made to qualified plus plans (and thus not deductible for income tax purposes). Indeed, the qualified plus provisions are estimated to raise more than $500 million in revenue over the next five years. In later years, however, the qualified plus provisions *reduce* revenue, since the withdrawals from such accounts are excluded from income (whereas withdrawals from conventional 401(k) accounts are not). The creation of qualified plus accounts thus artificially reduces the cost of

(continued...)

maximum contribution is $10,500 today; CBO inflation forecasts suggest this limit will reach $12,000 in 2005 under current law as a result of inflation indexing.) Only highly paid individuals generally make the $10,500 maximum contribution today; fewer than five percent of those with 401(k) plans now deposit the maximum $10,500 allowed. These are the only people this provision would benefit. The average compensation among those making the maximum $10,500 contribution today is approximately $130,000. In other words, increasing this limit to $15,000 would benefit only those at or near the top of the compensation scale.

Increased Maximum Employer-employee Contributions

Under current law, the $10,500 limit on deposits to a 401(k) account applies to employ*ee* contributions. Current law also requires that *combined* employer-employee contributions to 401(k)s and other defined contribution pension plans not exceed $30,000, or 25 percent of pay, whichever is lower. The bill would raise the maximum combined employer-employee contribution to $40,000. This change, too, is of benefit primarily to highly paid individuals, who are the only people whose earnings are high enough to afford pension contributions of $30,000 or more. The bill also would eliminate the requirement that such contributions not exceed 25 percent of pay.

Expansions of Individual Retirement Accounts

The legislation would more than double the amount that a taxpayer and spouse can contribute each year to an IRA. Under current law, a taxpayer and spouse may each contribute $2,000; the proposal would raise the maximum contribution to $5,000 by 2003.[12] Thus, the total amount a couple could contribute would rise from $4,000 to $10,000.

This, too, would favor higher-income taxpayers. By its nature, the proposal would benefit only those who are at the $2,000 IRA contribution limit under current law. It would have virtually no effect on families and individuals who either do not make any IRA contributions under current law or who deposit less than the current $2,000 IRA limit. The logic here is clear: those who can not afford to deposit $2,000 in a IRA cannot deposit $5,000 and consequently would not be affected by an increase in the IRA contribution limit. This proposal would directly benefit only those already making the $2,000 maximum IRA contribution.

A recent Treasury study shows that in 1995 (the latest year for which these data are available) only a tiny percentage of taxpayers contributed the maximum amount to a conventional

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[11] (...continued)
the pension provisions over the next five years; the short-term savings from the qualified plus accounts are offset by their longer-term costs.

[12] The $5,000 maximum would be available to individuals age 50 and over starting in 2001, rather than 2003.

IRA. Comparable data are not yet available for Roth IRAs, which did not exist in 1995, but the results are likely to be similar.[13]

The Treasury study found that *only four percent* of all taxpayers who were eligible for conventional IRAs in 1995 made the maximum allowable $2,000 contribution.[14] The analysis also found that only seven percent of taxpayers eligible to make deductible contributions to a conventional IRA made *any* IRA contribution in 1995. 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 through a backloaded [Roth] IRA."[15] It is only the very small minority of eligible taxpayers contributing the maximum $2,000 to an IRA who would likely benefit from raising the maximum contribution amount on Roth IRAs above $2,000.

In addition, as discussed below, an increase in the IRA contribution limits to $5,000 is likely to work to the detriment of some low- and middle-income workers by inducing some small businesses not to offer an employer-sponsored pension plan.

Increased Maximum Considered Compensation

Under current law, tax-favored pension benefits are based on compensation up to a maximum compensation level of $170,000.[16] For example, suppose a firm contributes five percent of wages to a *defined contribution* pension plan. The maximum contribution the firm can make for its executives is $8,500 (five percent of $170,000). An individual who is paid $200,000 a year could not receive an employer contribution equal to five percent of $200,000. Similarly, the maximum earnings that a firm can consider in determining benefits under a *defined benefit*

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[13] The reason for the similar effect is that the lifetime tax benefit from a dollar deposited in a Roth IRA is generally the same as the lifetime tax benefit from a dollar deposited in a conventional IRA. Participation rates are unlikely to be substantially higher in Roth IRAs than in conventional IRAs.

One could argue that relatively more Roth IRA depositors may be at the $2,000 maximum contribution level because the income limits for making Roth IRA contributions are significantly higher than the income limits for making deductible deposits to a conventional IRA. But it also is possible that the number of contributors to Roth IRAs who are at the $2,000 level may be *smaller* than the number of depositors to conventional IRAs at this level, because *very* high-income taxpayers who are *not* covered by an employer-provided pension plan are eligible to make contributions to a conventional IRA, but not to a Roth IRA. IRS data show that in 1995, roughly *one-third* of all taxpayers who made deductible contributions to conventional IRAs had incomes *above* the income limits for those IRAs.

[14] Robert Carroll, "IRAs and the Tax Reform Act of 1997," Office of Tax Analysis, Department of the Treasury, January 2000.

[15] Carroll, page 7.

[16] The compensation ceiling applies to all qualified retirement plans, including both defined contribution and defined benefit plans.

pension plan is $170,000. Any earnings above that level do not accrue pension benefits under a defined benefit plan.

The legislation would raise the maximum compensation level that can be used in figuring pension contributions from $170,000 to $200,000. This would benefit only those paid more than $170,000 a year, the highest-paid one percent of workers. In addition, as explained below, this provision is likely to induce some firms to make smaller contributions for their middle- and low-income employees than they would provide if the maximum limit remained at $170,000.

Increase in Benefit Payable under a Defined Benefit Pension Plan

Under current law, the maximum allowable annual payment from a defined benefit pension plan is $135,000. The legislation would increase the $135,000 limit to $160,000. This increase would benefit only those at the very top of the income distribution whose salaries are large enough to yield annual pension payments of more than $135,000.

Less Rigorous Nondiscrimination Rules

Under current law, tax-preferred pension plans must not discriminate in favor of highly compensated employees. For example, pension plans are not allowed to use a more liberal formula in figuring employer pension contributions for high-income executives than other employees. The nondiscrimination rules play an important role in ensuring that tax preferences for pension plans serve the public purpose of boosting pensions among a wide array of workers, rather than just among highly compensated workers. The legislation [directs] the Secretary of the Treasury to issue regulations easing the nondiscrimination rules.

Relaxed Top-heavy Protections

Under current law, an additional set of rules apply to pension plans that, while meeting the nondiscrimination rules, deliver most of their benefits to company officers and owners. The "top-heavy" protections, as these safeguards are known, apply to plans in which 60 percent or more of the pension benefits accrue to such key employees. These protections require firms to take additional steps to protect middle- and low-income workers in such circumstances, through accelerated vesting and certain minimum contributions or benefits.

The tax bill would relax the top-heavy safeguards by redefining who qualifies as a "key" employee, by selectively counting and not counting certain pension contributions in evaluating the top-heavy criteria, and by changing the rules governing the division of assets among family members. The legislation also removes the top-heavy protections for so-called "safe harbor"

Pension Provisions with Important Constituencies but Few Beneficiaries

The proposed legislation includes several changes that produce concentrated benefits for relatively few people. For example, under current law, distributions from different types of defined contribution plans (401(k), 403(b), and 457 plans) may be rolled over into a new plan of the same type, but cannot be rolled over into another type of plan (e.g., 401(k) assets cannot be rolled over into a 403(b) account). The legislation would allow rollovers across defined contribution plan types so that, for example, 401(k) assets could be rolled over into 403(b) accounts. This change represents sound policy; it is important for workers who switch between the public, private, and non-profit sectors. Nevertheless, this provision is a tiny component of the overall package: Its cost amounts to $22 million over 10 years, or four one-thousandths of one percent of the total cost of the bill.

Another change with an important constituency but relatively few beneficiaries involves section 415(b). Under current law, the allowable annual payment from a defined benefit pension plan is generally the lesser of: (a) the worker's average compensation during his or her highest three consecutive years of earnings, and (b) $135,000. (The $135,000 limit is the figure for tax year 2000; it is indexed to inflation.) This limit is contained in section 415(b) of the Internal Revenue Code and is often referred to as the "415(b) limit."

These maximum levels apply to someone retiring at the full benefit age under Social Security,[a] which is 65 and 2 months for those turning 62 this year. For those who retire before the Social Security full benefit age, the law stipulates that the maximum allowed annual pension benefit be reduced to reflect the larger number of years over which these annual pension payments will be made. Under current law, someone retiring at age 59 can receive a maximum annual pension of $80,175; this is the actuarial equivalent of receiving $135,000 per year starting at age 65. Someone retiring at age 62 can receive a maximum of $101,250, while someone retiring at age 55 can receive a maximum of $60,005 per year.

The section 415(b) limit on maximum allowable pension payments applies to very few workers. Although data do not exist on the exact number of people directly affected by the $135,000 limit and the equivalent limits on benefits for early retirees, some insight can be gained by examining data on the distribution of earnings and the typical generosity of defined benefit pension plans. Most workers receive a pension that is substantially lower than their earnings; for example, one recent survey suggests that 90 percent of large private-sector single-employer defined benefit plans pay pension benefits that equal no more than 41 percent of previous earnings.[b] Given a 40 percent "replacement rate," the $60,005 maximum defined benefit pension at age 55 would affect only those who earned $150,000 or more in their final years of work (since 40 percent of $150,000 is $60,000). Workers earning less than $150,000 would not be affected.

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[a] Government employees, employees of tax exempt organizations, members of the merchant marine, and qualified police and firefighters are allowed to retire at or after age 62, but before the Social Security full benefit age, without a reduction in the maximum allowed defined benefit payment.

[b] Dan N. McGill, Kyle N. Brown, John J. Haley, and Sylvester J. Schieber, *Fundamentals of Private Pensions* (University of Pennsylvania Press: Philadelphia, 1996), page 416.

With a 40 percent replacement rate, a worker earning $50,000, for example, would receive a $20,000 pension at age 55, far less than the $60,005 pension limit set under section 415(b). Such a worker thus would not be affected by this limit. Even a worker earning $100,000 and then retiring at age 55 generally would not be affected, since his or her pension would be $40,000 (40 percent of $100,000), which would be well under the legal limit of $60,005 for a 55-year-old.

Few people earn more than $100,000 per year. The vast majority of workers consequently are in no danger of being affected by the 415(b) limit, even if they retire as early as age 55 and their pension replacement rate is as high as 40 percent. Census data indicate that only 5.5 percent of all full-time workers between the ages of 50 and 60 who participated in a pension plan earned more than $100,000 in 1998. Only 2.9 percent of such full-time workers earned more than $140,000.

These data indicate that the section 415(b) limit on maximum pension payments affects only a small percentage of the workers who retire in their fifties. In some unionized industries that have pension plans with higher replacement rates, the percentage of affected workers is likely to be somewhat higher. But in the aggregate, very few workers are affected.

Under the proposed legislation, the maximum annual pension payment available at age 55 under a defined benefit plan would increase from $60,005 to roughly $95,000, an increase of more than 50 percent. Such a change would allow $35,000 more per year in benefits for those who retire at age 55 and who have earnings so high — earnings that place them among the top few percent of all workers in that age category — that their pensions are affected by the current section 415(b) limits on benefits. This annual $35,000 increase in benefit payments would be received every year in retirement, producing a very large lifetime benefit gain. Payments of $35,000 per year starting at age 55 and continuing until death are, on average, worth the equivalent of an immediate benefit of more than $500,000 to a worker aged 55.

The legislation also would raise the amount that could be received by workers retiring at age 62 from $101,250 to $160,000. (In addition, the legislation would remove the current rule that payments from a multi-employer defined benefit plan may not exceed the average of a worker's three highest consecutive years of compensation, a change that represents sound public policy and would affect some rank-and-file workers, although it would have only a limited impact; its cost equals less than one-one hundredth of one percent of the total cost of the legislation.)

It is worth noting that because few people would benefit from these section 415(b) provisions, they account for only a tiny fraction of the pension and IRA tax benefits this legislation provides. The cost of the 415(b) provisions amounts to $541 million over 10 years ($454 million from raising the amount available at age 65, $45 million from altering the rules applying to early retirement, and $42 million from repealing the rule that annual payments from multi-employer pensions plans not exceed the average of a worker's three highest consecutive years of earnings). Thus, the various 415(b) changes combined account for just one percent of the overall pension and IRA tax benefits in the bill.

401(k) plans, which are not subject to the nondiscrimination rules because of specific features of these plans.[17]

Reduced Incentive for Money Purchase Plans

The legislation also would significantly reduce firms' incentives to maintain the type of plan — known as a "money purchase" pension plan — that ensures a pension for many lower-income workers. Under a money purchase plan, a firm is required to contribute a fixed percentage of each worker's compensation to the plan, regardless of whether the worker himself (or herself) is contributing to an employer-sponsored plan. By contrast, under 401(k) plans, the percentage of compensation that the employer contributes varies; it depends on the percentage of compensation the employee contributes. Higher-income workers tend to contribute a larger percentage of pay. Hence, they tend to secure employer contributions that equal a higher percentage of their wages.[18]

Under current law, the combined employer-employee contribution to 401(k) plans may not exceed 15 percent of aggregate pay. A separate limitation under current law requires that combined employer-employee contributions to *all* defined contribution pension plans a firm offers may not exceed 25 percent of pay, or $30,000, whichever is lower. (In other words, the 25 percent cap and $30,000 limit under current law apply to total contributions to all defined contribution plans, while the 15 percent cap applies only to 401(k) and other profit-sharing plans.)[19]

If an employer wishes the combined contributions for top executives to equal 25 percent of compensation, the employer must provide both a 401(k) plan with a 15 percent limitation and a money purchase plan that contributes the other 10 percent of compensation. Under the money purchase plan, the employer would contribute an amount equal to 10 percent of pay for *all* employees, including those who earn low or modest wages and tend to make few, if any, contributions themselves. For many of these lower-wage workers, the money purchase plan can

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[17] To qualify for the safe-harbor provision, the employer must either match on a dollar-for-dollar basis the first three percent of pay the employee contributes — and contribute an additional 50 cents for each dollar the employer contributes on the next two percent of pay — or contribute at least three percent of pay for each *non*-highly compensated employee, regardless of whether the employee makes elective contributions on his or her own. The safe-harbor rules also include vesting and notification requirements.

[18] Higher-income workers contribute a larger percentage of compensation to 401(k) plans than do lower-income workers. For example, among workers aged 18 to 64 with a 401(k) plan in 1992, the average contribution rate was 3.7 percent of pay for those with household income less than $25,000 and 7.9 percent of pay for those with household income exceeding $75,000. General Accounting Office, "401(k) Pension Plans: Many Take Advantage of Opportunities to Ensure Adequate Retirement Income," GAO/HEHS-96-176, 1996, Table II.4.

[19] Technically, the 25 percent cap applies to each individual, whereas the 15 percent cap applies to the ratio of aggregate contributions to aggregate compensation. However, since the 25 percent cap applies to each individual, it also imposes a 25 percent cap on the ratio of aggregate contributions to aggregate compensation. As noted in the text above, the legislation would eliminate the 25 percent cap.

be much more important than a 401(k) plan.[20] In fact, among workers with incomes below $25,000, the number participating in a money purchase plan substantially exceeds the number participating in a 401(k) or similar plan.

The bill would change these rules in several ways. As noted earlier, it would eliminate the requirement that combined employer-employee contributions to *all* defined contribution plans not exceed 25 percent of pay and would raise from $30,000 to $40,000 the maximum combined contribution that can be made to all defined contribution plans on behalf of an employee. These changes would generally benefit only highly paid executives and business owners but would not necessarily cause firms to reduce use of money purchase plans. The legislation also contains two other changes, however, that *would* reduce the need for firms to use money purchase plans, and in so doing risk substantial harm to low- and moderate-wage workers. First, the bill would raise the 15 percent limitation on contributions to 401(k) plans to 20 percent, thereby reducing the incentive to set up money purchase plans. Furthermore, the bill would also exclude employee contributions from that higher 20 percent limitation on contributions to 401(k) plans; this limitation henceforth would apply only to *employer* contributions, not to the combination of employer and employee contributions. This would effectively raise the 20 percent limit still further. The combined effect would be to *reduce greatly the need for some firms to add a money purchase plan* for their executives to secure the maximum pension contributions allowed. Over time, this provision would likely lead to a significant reduction in money purchase plans, which would cause many lower-wage workers to lose the one significant source of pension coverage they currently enjoy.

Impact of Pension Provisions in the Bill on Low- and Middle-income Workers

The combined effect of these various pension changes in the tax bill would be a significant increase in the tax-preferred benefits of high-income workers, with little expansion in pensions for the moderate- and low-income workers who most need to build savings for retirement. In fact, some of the changes could lead to *reduced* coverage for some low- and middle-income workers. (See table for a summary of the bill's provisions.)

As one example, consider a small business owner with compensation of $250,000 who wants to have the business contribute at least $10,000 a year to his pension. Given the current compensation limit of $170,000, the small business owner adopts a pension plan that contributes six percent of a worker's compensation. The pension contribution for the owner is six percent of the $170,000 limit, or a little over $10,000. The pension contribution for other employees in the

[20] In 1992, some 8.7 percent of workers with household incomes below $25,000 were covered by defined contribution plans other than 401(k), 403(b), and 457 plans. A large share of these 8.7 percent of workers participated in money purchase plans. By comparison, only 3.5 percent of workers with household incomes below $25,000 participated in a 401(k), 403(b), or 457 plan.

Pension Provisions in the Tax Bill

Contributions to 401(k) plans	Maximum employee contribution raised from $10,500 to $15,000
Combined employer-employee contributions to defined contribution plans	Requirement that contributions not exceed 25% of pay eliminated Maximum contribution limit raised from $30,000 to $40,000
IRAs	Maximum contribution to IRAs increased from $2,000 to $5,000 per person
Maximum considered compensation	Increased from $170,000 to $200,000
Annual maximum payment allowed under defined benefit plan	Increased from $135,000 to $160,000 Maximum amounts allowed for early retirees raised
Nondiscrimination rules	Secretary of the Treasury directed to relax these rules
Top-heavy rules	Definitions loosened and so-called "safe harbor" 401(k) plans exempted
Money purchase plans	Reduced incentives to set up money purchase plans. These plans are particularly beneficial to low- and moderate-income workers.

firm also is six percent of their compensation. If the maximum compensation level used in figuring pension contributions were increased to $200,000 as the legislation provides, the business owner could reduce the contribution rate for his employees to five percent and still have the firm contribute $10,000 to his pension.

All of the other employees in the firm, as well, would then receive contributions of five percent of compensation, rather than six percent. The employer contribution for an employee who earns $40,000 would drop from $2,400 (six percent of $40,000) to $2,000 (five percent of $40,000).

The effects of the IRA provisions also could be deleterious. The provision raising the amount that people can contribute to an IRA from $2,000 to $5,000 could reduce pension coverage among workers in small businesses. Under current law, a small business owner can contribute $2,000 to his or her own IRA and another $2,000 to his or her spouse's IRA, or $4,000 in total. Under the legislation, a small business owner and his or her spouse could deposit a total of $10,000 into their IRAs rather than $4,000.

With the higher proposed limits, the small business owner may not see the need for a company pension plan and may drop such a plan (or fail to institute a plan in the first place). This is the opposite of the trickle-down effect the bill's supporters tout. As Donald Lubick, then Assistant Secretary of the Treasury for Tax Policy, noted in Congressional testimony, "Currently, a small business owner who wants to save $5,000 or more for retirement on a tax-favored basis generally would choose to adopt an employer plan. However, if the IRA limit were raised to $5,000, the owner could save that amount – or jointly with the owner's spouse, $10,000 – on a tax-preferred basis without adopting a plan for employees. Therefore, higher IRA limits could reduce interest in employer retirement plans, particularly among owners of small businesses. If this happens, higher IRA limits would work at cross purposes with other proposals that attempt to increase coverage among employees of small businesses."[21]

A number of the legislation's other pension provisions also could harm low- and middle-income workers. These include the provisions loosening the non-discrimination and top-heavy protections against disproportionate pension benefits for higher-income workers, as well as the provisions reducing the need for firms to offer money-purchase plans.

Most of these provisions are drawn from pension legislation that House Reps. Bob Portman and Ben Cardin introduced last year (H.R. 1102). In analyzing the effects of that legislation, Norman Stein, the Douglas Arant Professor of Law at the University of Alabama School of Law, concluded, "Although there are good things in the Portman-Cardin bill, some of its major provisions would not contribute enough to good retirement policy to justify their substantial price tags, and other of its provisions would harm more people than they would help. It would be ironic and deeply unfortunate if this well-intentioned but flawed legislation is enacted, for it may well be remembered as a retirement reduction act. I fear that this possibility, an illustration of the law of unintended consequence, is all too real."[22]

Similarly, Dianne Bennett, the president of a 170-lawyer law firm in Buffalo and a leading authority on pension law, has cautioned, "In spite of the laudable goals, I am convinced that most of the significant provisions of the Portman-Cardin bill will have the opposite effect. The most significant provisions will shift tax benefits to higher-income taxpayers. Virtually every significant provision is designed to grant tax benefits to participants in plans who earn more than $100,000 annually. The likely result is to shift the tax burden from higher-income taxpayers to lower-income taxpayers and to take benefits <u>away</u> from middle- and lower-income taxpayers. I believe it is likely that the effects of Portman-Cardin, were it to pass, would be to expand retirement plans that benefit <u>only</u> owners of businesses and to reduce dramatically the benefits granted to non-owner employees in small business plans."[23]

Conclusion

Both to build national saving and to strengthen retirement security, pension reforms should be directed primarily at expanding pension coverage among moderate- and low-income workers. Most of the pension benefits in the tax bill would accrue instead to higher-income workers who already enjoy high rates of pension coverage. Some 76.9 percent of the bill's

[21] Statement of Donald C. Lubick, Assistant Secretary of the Treasury for Tax Policy, before the Subcommittee on Oversight, House Committee on Ways and Means, March 23, 1999.

[22] Norman Stein, Testimony before the Subcommittee on Oversight, House Committee on Ways and Means, March 23, 1999.

[23] Dianne Bennett, written testimony submitted to the Subcommittee on Oversight, House Committee on Ways and Means, March 22, 1999.

pension-related tax benefits would accrue to individuals in the top 20 percent of the income distribution, the same people who already receive two-thirds of the pension-related tax benefits under current law. Moreover, various components of the legislation could result in reduced pension coverage for some low- and middle-income employees. Public policy should seek to expand pension coverage for such workers, not to induce contractions in coverage. Overall, this legislation represents a highly inefficient and regressive approach to pension policy.