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Executive Summary

HOUSE-PASSED 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]

On July 19, the House of Representatives approved tax legislation (H.R. 4843) that would substantially expand pension tax preferences for high-income executives but likely lead to reductions in pension coverage among low- and moderate-income workers and employees of small businesses. The legislation also has the potential to reduce national savings. The provisions of this legislation are very similar to the pension provisions included in the large tax bill that President Clinton vetoed last summer. The Senate is expected to consider similar legislation in September.

The legislation would cost more than $50 billion over 10 years and nearly $9 billion a year by the tenth year. Although the legislation is promoted as expanding pension coverage for working Americans, the bulk of its pension tax benefits would go to higher-income individuals, not ordinary workers.

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Analysis of the legislation by the Institute for Taxation and Economic Policy finds that 76.9 percent of its tax reductions would accrue to the 20 percent of Americans with the highest incomes (see table on next page). More than 42 percent of its 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 *only four percent* of the legislation's pension tax benefits.

Pension provisions very similar to those in the House-passed legislation were among the provisions cited as unacceptable by the President when he vetoed last year's tax bill. On November 1, 1999, when the House appeared to be on the verge of considering similar 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 or national savings, and could lead to reductions in retirement benefits for moderate- and lower-income workers." All of those provisions are included in the House legislation.

What These Pension Provisions Do

These provisions would confer an array of pension tax preferences on highly paid individuals despite the fact that they are the individuals who already have the most generous pensions. Provisions of current law that place upper limits on the tax-favored contributions that highly paid individuals may make to pension plans would be relaxed. So would the limits on the amount

Effects of the Comprehensive Retirement Security and Pension Reform Act
(approved by the House of Representatives on July 19, 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.

of pension payments that high-income individuals may receive when they retire.

For example, the legislation would increase the maximum tax-favored contribution an employed individual is permitted to make to a 401(k) plan to $15,000 a year by 2005. (The 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.) This increase in the maximum contribution limit would benefit the fewer-than-five-percent of individuals covered by a 401(k) plan who make the maximum $10,500 contribution today; this is a group that receives average pay of $130,000. The legislation also would increase the maximum pension benefit a retiree can receive under a defined benefit pension plan from $135,000 a year to $160,000, a change that would benefit only those at the top of the income distribution whose salaries are so large that they would be able to qualify for annual pension payments of more than $135,000 when they retire.

In addition, the legislation would raise the maximum amount that can be contributed to an Individual Retirement Account from $2,000 (or $4,000 for a couple) to $5,000 (or $10,000 for a couple). This change would affect only those taxpayers already at the $2,000 IRA contribution limit; those who cannot afford to contribute $2,000 cannot afford to contribute $5,000. IRS data from 1995 (the latest year for which these data are available) show that only four percent of all tax filers eligible to make deductible IRA contributions made the maximum $2,000 contribution. These are the only individuals who would benefit from the increase in the IRA contribution limit. They are likely to be among the most affluent of IRA depositors. (Nearly 30 percent of those making deductible contributions to IRAs in 1995 were individuals with incomes *exceeding* the income limits on deductible IRA contributions; these income limits do *not* apply to individuals whose firms do not offer an employer-sponsored pension plan. Those are the individuals who are likely to benefit disproportionately from the proposed increase in the IRA contribution limit.)

The legislation also contains provisions that significantly reduce the incentives of firms to offer or maintain a type of pension plan known as a “money purchase” plan. This is one of the types of pension plans that are most beneficial to low- and moderate-income workers. Many firms currently must combine a money purchase plan with a 401(k) plan if they wish to maximize contributions for owners and executives.

Some 77 percent of the legislation’s tax reductions would go to the 20 percent of Americans with the highest incomes, while the bottom 60 percent of the population would receive only four percent of the legislation’s tax benefits.

Under the legislation, many of these firms would be able to maximize contributions for owners and executives *without* providing money-purchase plans, a change that could adversely affect substantial numbers of lower-paid workers.

Effects on Low- and Middle-Income Workers

A number of these provisions would be likely to lead to reduced pension coverage among lower- and middle-income workers. For example, by raising pension contribution limits for highly-paid corporate executives and owners, these provisions would enable owners and top executives to maintain the current level of contributions for their own pension plans while reducing contributions for other employees. The legislation also would weaken "non-discrimination" and "top-heavy" rules that prevent employers from skewing too great a proportion of pension contributions to owners and executives at the expense of ordinary employees. The proposed dilution of these protections could induce further erosion in coverage among low- and moderate-income workers. And as noted, other provisions of the legislation would reduce the need for firms to offer money-purchase plans.

To take one of these areas, under current law, a firm may make pension contributions on the first $170,000 of an individual's salary. The legislation would raise this limit to $200,000. As a result, if a business owner who makes $250,000 seeks a pension contribution of $10,000 a year for himself, the firm currently must make a pension contribution of about six percent of wages (six percent of $170,000 equals just over $10,000). If the $170,000 limit is raised to $200,000, however, the owner could secure a $10,000 contribution level for himself while setting the pension contribution rate at five percent. Such an action would keep pension contributions high for the owner while saving money for the business by reducing pension contributions by one-sixth for the firm's employees.

The IRA provisions are particularly troubling. The provision raising the amount that people can contribute to an IRA from $2,000 to $5,000 is likely to 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

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institute one in the first place. As Donald Lubick, then Assistant Secretary of the Treasury for Tax Policy, noted in Congressional testimony last year, "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."[1]

Those who promote these pension proposals argue that generous new benefits for highly-paid owners and executives would induce more firms to offer pension plans and result in a trickle-down effect benefitting low- and moderate-income workers who currently lack pension coverage. As with a number of other areas of tax policy where proponents of tax cuts primarily benefitting well-off taxpayers claim trickle-down effects, however, there is no empirical evidence to support this claim. This legislation is much more likely to reduce pension protections for low- and moderate-income employees than to expand them.

Most of the provisions of this legislation are drawn from a pension bill that Reps. Rob Portman and Ben Cardin introduced last year. In analyzing that legislation, University of Alabama law professor Norman Stein 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

Proponents argue that generous new benefits for highly-paid owners and executives will induce more firms to offer pension plans and result in a trickle-down effect benefitting ordinary workers. As with many other claims of trickle-down effects for tax cuts skewed to higher-income individuals, no empirical evidence supports this claim.

well-intentioned but flawed legislation is enacted, for it may well be remembered as a retirement reduction act."[2]

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 away 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 only owners of businesses and to reduce dramatically the benefits granted to non-owner employees in small business plans."[3]

Potential to Reduce National Saving

The legislation also has the potential to reduce national saving. Its most costly provision is the provision to raise to $5,000 ($10,000 for a couple) the maximum amount that can be contributed to an Individual Retirement Account. The taxpayers who would most be able to take advantage of this provision and to place $5,000 a year in an IRA account are more-affluent taxpayers, who generally would be able to take advantage of the expanded IRA tax break by shifting 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 that the provision induces — as could very well be the case here because of the widespread asset-shifting that would be likely to occur — national saving declines.

The Clinton 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 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 has the virtue of targeting its benefits on low- and middle-income workers, rather than concentrating benefits on high-income individuals and placing ordinary workers at some risk.

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2. 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.

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

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

This analysis is a short version of a fuller Center report on this issue. The full report, which has the same title and includes a more extensive discussion, is available from the Center and is posted to the Center's web site at www.centeronbudget.org