

THE WAYS AND MEANS COMMITTEE PENSION TAX-CUT LEGISLATION: UN SOUND POLICY THAT DIGS THE NATION'S FISCAL HOLE DEEPER

by Peter R. Orszag and Robert Greenstein¹

The mark-up of pension legislation in the House Ways and Means Committee on July 18 generated unusual controversy on procedural matters.² This paper examines the substance of the legislation, which the Ways and Means Committee approved and which could come to the House floor later this week or (more likely) after Congress returns from its summer recess.³

The legislation is a revised version of a bill introduced earlier this year by Representatives Rob Portman and Ben Cardin. As with earlier Portman-Cardin bills, this measure includes both promising and problematic provisions. Most of the provisions that involve the largest revenue losses, however, represent problematic policy. At a time when the nation faces substantial budget deficits for the foreseeable future, these provisions would make the deficits still larger, primarily by providing additional tax subsidies to high-income individuals. Moreover, most of those individuals would likely save without the new tax breaks, and even without additional tax subsidies they tend to be much better prepared for retirement than other Americans with less income and wealth.

According to the Joint Committee on Taxation, the legislation would cost \$48 billion over ten years. This cost is artificially low, however, because some provisions in the bill sunset before the end of the ten-year budget window. In 2010 alone, the legislation would cost \$8.6 billion. This indicates that the cost of the legislation would likely exceed \$100 billion in the second decade it was in effect.

Two of the most costly provisions in the Ways and Means Committee legislation would set a particularly dangerous precedent, because they effectively reduce taxes owed on *withdrawals* from current 401(k) and Individual Retirement Account (IRA) balances.

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² See, for example, Juliet Eilperin and Albert B. Crenshaw, "The House That Roared: In Ways and Means Brawl, Names, Police and Sergeant at Arms Are Called," *Washington Post*, July 19, 2003, page A1, and Sheryl Gay Stolberg, "Sound, Fury, Pension Rules: Nasty Party Clash in House," *New York Times*, July 19, 2003, page A1.

³ The major elements of the legislation were contained in a pension bill introduced on April 11 by Reps. Portman and Cardin. For an analysis of that legislation, see Peter Orszag, "Examining the New Portman-Cardin Legislation: Are Further Pension Tax Subsidies for High-Income Households Affordable or Sound as Pension Policy?" Center on Budget and Policy Priorities, April 21, 2003, and William Gale and Peter Orszag, "Whither Pensions? A Brief Analysis of Portman-Cardin III," *Tax Notes*, April 28, 2003.

Contributions to 401(k)s and traditional IRAs are tax-deductible, and accumulations within the accounts occur on a tax-free basis⁴. The funds are then taxed when they are withdrawn. Trillions of dollars in revenue are expected to be collected on the withdrawals from these accounts in future decades.⁵ The fact that this expected future revenue is so substantial means that proposals to reduce the taxation of withdrawals from retirement accounts could significantly worsen a long-term fiscal outlook that is already quite bleak. An analysis by Goldman Sachs earlier this year concluded that “the nation’s long-term budget outlook is terrible, far worse than the official budget projections suggest.”⁶

The single most expensive provision in the bill — costing \$24 billion over the next 10 years and more than \$4 billion in 2013 alone — represents an unwise step in the direction of reducing taxes on withdrawals. It would relax the “minimum distribution” rules that are intended to ensure that tax-advantaged retirement accounts are used primarily to finance retirement needs, rather than for other purposes such as estate planning by wealthy individuals. Weakening the minimum distribution rules in this manner is unsound, as it would increase the ability of high-income individuals to use the tax preferences associated with pensions to accumulate assets that are not intended to be drawn down during retirement. In light of the nation’s grim fiscal outlook, this type of tax subsidy to wealthy households is unwarranted. Another provision of the Ways and Means bill would allow tax-free withdrawals from retirement accounts as long as the withdrawal took the specific form of a lifetime annuity (in which payments are made for as long as the account owner or spouse is alive). Although possibly well intentioned, this too represents an unwise and unaffordable step toward reducing taxes on withdrawals from accounts that already are tax-advantaged.

In addition, the legislation would accelerate scheduled increases in the amounts that can be contributed to 401(k)s and IRAs. These proposals would accelerate tax subsidies to upper-income households who least need additional help in preparing for retirement, while providing little or no benefit to the majority of families struggling to save for retirement.

The legislation does include some beneficial changes. For example, it expands and extends the “saver’s credit” created by the 2001 tax legislation, although the expansion is considerably less substantial than may initially appear to be the case because the credit is not refundable.⁷

This analysis focuses on the most expensive components of the Ways and Means legislation, which also are the most regressive — the effective reduction in taxes on withdrawals

⁴ The tax treatment of Roth IRAs and Roth 401(k)s is reversed: Contributions are included in taxable income, but withdrawals are tax-free.

⁵ Despite recent media reports to the contrary, most of this revenue is assumed in long-term budget projections. Policy-makers and others looking for a previously hidden pot of gold are likely to be disappointed. For further details, see Alan J. Auerbach, William G. Gale, and Peter R. Orszag, “Reassessing the Fiscal Gap: Why Tax-Deferred Saving Will Not Solve the Problem,” Brookings Institution, July 2003.

⁶ Bill Dudley and Ed McKelvey, “Budget Blues: Play It Again, Uncle Sam,” Goldman Sachs, March 14, 2003.

⁷ The Ways and Means legislation drops a promising provision in the original version of the Portman-Cardin bill that would have reformed the current rules in the Supplemental Security Income (SSI) program under which poor individuals who become disabled can be disqualified from receiving SSI benefits unless they liquidate their retirement accounts and spend the proceeds, leaving them with little or no assets for their old age.

from 401(k)s and IRAs and the acceleration of increased contribution limits for tax-advantaged retirement accounts. The analysis finds these proposals represent unsound pension policy and would be fiscally imprudent in the current budget climate. The analysis does not examine other controversial elements of the Ways and Means legislation, including changes to the interest rate used to compute employer obligations under defined benefit plans.

Loosening the “Minimum Distribution” Rules

The most expensive provision in the Ways and Means legislation, costing \$24 billion over the next 10 years and \$4 billion in 2013 alone, would 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.

To ensure that retirement plan assets are used primarily to finance retirement needs, workers generally must begin to draw down their accumulated pensions by age 70½, or when they retire, whichever is later.⁸ This rule ensures that pension accumulations are used at least in part during retirement. In the absence of such a rule, high-income individuals 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.”⁹

Pension experts agree that the minimum distribution rules are complicated. Efforts to simplify them already are underway, however, including important simplifications contained in recent IRS regulations.¹⁰ If further steps are required, an alternative approach — exempting a moderate level of assets from the minimum distribution rules — would ensure that the rules do not apply to the vast majority of retirees.

For example, the rules could be modified so each person could exempt up to \$50,000 of pension and retirement account assets from the minimum distribution requirements. Data from the 2001 Survey of Consumer Finances suggest that more than 70 percent of households aged

⁸ The rules for distributions from traditional IRAs are slightly different. Distributions from IRAs are required to begin by age 70½ regardless of whether the owner is retired. No minimum distribution rules apply to Roth IRAs until the death of the owner.

⁹ 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.

¹⁰ See *Internal Revenue Bulletin* (2001-11, page 865) on March 12, 2001.

55-64 own defined contribution and IRA assets of less than \$50,000. If the minimum distribution rules did not apply to assets of less than \$50,000, these rules would cease to affect approximately two-thirds or more of retirees. The impact of the rules also would be greatly reduced on retirees who have pension and retirement assets of modestly more than \$50,000. This approach could eliminate the need for most retirees to be concerned about the minimum distribution rules and would do so without creating powerful incentives for the very well-off to use retirement tax preferences primarily as estate-building mechanisms.

Moreover, the approach taken in the Ways and Means legislation — ultimately delaying from 70½ to 75 the age at which mandatory distributions must begin if the worker already is retired — is problematic for a number of reasons.¹¹

- Such a delay in the age at which distributions from pension plans must begin to be made would provide a significant tax benefit to those high-income individuals who have sufficient assets or income to enable them to delay withdrawals from pensions and IRAs past age 70½.¹² The vast majority of American workers retire before age 70½ and need to begin withdrawing funds from their pensions before then.¹³ Thus, for the vast majority of workers, the minimum distribution rules are not generally relevant, either because these workers lack retirement assets or because they will already have begun to take regular distributions from their pensions well before the age by which the distributions must begin.
- Raising the required age consequently would affect primarily high-income retiree households that have such ample income and assets that they can delay withdrawals from their tax-preferred pension accounts, despite the fact they are no longer working. This would significantly expand the potential for these households to use their tax-preferred retirement accounts as estate planning devices.
- Raising the required age for minimum distributions also could *discourage work* among high-income elderly individuals. Currently, for example, an affluent individual between age 70½ and 75 needs to continue working if he or she is intent on *not* withdrawing any funds from a 401(k), since the rules requiring distributions to start at age 70½ do not apply if the individual remains employed. The Ways and Means bill would enable such

¹¹ The legislation would raise the age for mandatory withdrawals from 70 ½ to 72 for 2004 through 2007, and to 75 thereafter. It would also loosen the rules applying to non-spouse beneficiaries and ease other aspects of the minimum distribution rules. In part because of the phase-in in the age for mandatory withdrawals, the long-term cost of the provision is much larger than the Joint Tax Committee’s 10-year total cost figure might suggest. The cost in 2013 alone is \$4.1 billion.

¹² In addition to allowing deferral of tax while the account owner is alive, the change may substantially defer income tax after the owner has died. In particular, if distributions from the account have not begun before the death of the owner, the designated beneficiary on the account is generally allowed to spread the withdrawals for income tax purposes over his or her entire lifetime. A delay in the mandatory beginning age will expand the pool of assets that have not begun distributions before the death of the owner, thereby substantially deferring the income tax owed and reducing the effective tax rate on the accounts.

¹³ The typical 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.

individuals to retire without having to make any withdrawals from their 401(k)s until age 75.

- Finally, and perhaps most important, loosening the minimum distribution rules would represent a dangerous step toward effectively reducing taxes on withdrawals from 401(k)s and IRAs. Relaxing the minimum distribution rules would allow account holders to enjoy more years of tax-advantaged accumulation within the accounts, which reduces the effective tax rate on the accounts.¹⁴ As emphasized above, large deficits are projected in the future, even after the trillions of dollars in revenue expected to come from 401(k) and IRA withdrawals are taken into account. Reducing taxes on those withdrawals thus would exacerbate an already bleak fiscal outlook.

Excluding Certain Annuity Payments from Taxation

The legislation also would allow limited tax-free withdrawals from retirement accounts as long as the withdrawals take the form of a lifetime annuity — that is, a payment per month that lasts as long as the worker or spouse is alive. In particular, the legislation would allow up to \$2,000 per year of annuitized income to be tax-free for the first five years of the annuity payments. The legislation would phase this tax-free preference out for couples with incomes above \$120,000.

On the one hand, the objective of this proposal — to encourage broader annuitization — is sound, since annuitization is crucial to ensuring that retirees will not outlive their savings. On the other hand, this proposal would exempt from taxation income that already has been granted substantial tax preferences: Contributions made to 401(k) or IRA accounts were tax-deductible, and the accumulation of funds within the accounts is not taxed. Providing yet another tax advantage to these funds — by partially exempting withdrawals from taxation if an account is annuitized — is not sound tax policy. Nor is it clear that this approach is the best mechanism for encouraging annuitization. Roughly 66 percent of elderly tax filers face a marginal tax of 15 percent or lower. For two-thirds of the elderly, the \$2,000 exclusion in the Ways and Means bill thus would save them at most \$300 a year in taxes, and only for the first five years of the annuity contract. It is unclear how many people will be encouraged to annuitize by these modest savings.

Finally, this provision — like the minimum distribution provision — effectively reduces the taxes owed on withdrawals from 401(k) and IRA accounts (although in this case only if the

¹⁴ The additional years of deferral of taxes that would be permitted under the relaxed minimum distribution rules do not reduce the present value of the revenue on the withdrawals, since the additional deferral of taxes should just offset the higher level of taxes on the accumulated balances upon withdrawal. Allowing longer deferral of taxes, however, reduces the present value of the revenue that would be collected on the assets if they had been withdrawn from the tax-advantaged account earlier and deposited in a taxable account. In other words, allowing longer deferral of taxes on a tax-preferred account provides a benefit to the account owner and a cost to the government, assuming the alternative to the tax-preferred account is saving in a taxable account. In addition, if the assets are not exhausted before the death of the owner, they are taxed at the marginal rate of the beneficiary, which may be lower than the marginal rate of the owner. To the extent that an older mandatory beginning age raises the likelihood that the assets will not be exhausted before the death of the owner, and to the extent that the marginal tax rate of the beneficiary is lower than the owner, deferral further reduces the effective tax rate on the account.

withdrawal occurs in a particular form). As emphasized above, the fiscal outlook is dismal, even with the trillions of dollars in revenue expected to be collected in future years on withdrawals from 401(k) and IRA plans. The danger is that if this provision is enacted, the \$2,000 limit eventually will be raised and the restriction that this tax break applies only to the first five years of the annuity payments eventually will be weakened or eliminated. However well-intentioned this provision may be, it represents a dangerous precedent toward reducing taxes on those withdrawals and thereby exacerbating the troubled budget outlook.

Accelerating Higher IRA and Pension Limits from the 2001 Tax Legislation

Another set of provisions in the legislation accelerates various aspects of the Economic Growth and Tax Relief Reconciliation Act of 2001 (the 2001 tax-cut law), which included a series of major changes in the tax laws governing pensions and IRAs. The main pension provisions in the 2001 tax-cut law make various changes that allow larger contributions by (and on behalf of) high-income individuals, such as business owners and executives. The 2001 tax-cut law gradually phases in most of these changes and then sunsets all of them by the end of 2010.

For example, in 2001, prior to enactment of the 2001 tax-cut legislation, workers were allowed to make a maximum of \$10,500 in tax-favored contributions to a 401(k) account. The 2001 tax-cut law raises the maximum gradually to \$15,000 by 2006 (and to \$20,000 for those aged 50 or over). Similarly, the 2001 tax legislation more than doubles 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; the 2001 legislation gradually raises the maximum contribution to \$5,000 apiece by 2008 (and to \$6,000 apiece for those aged 50 or over).

The Ways and Means bill would accelerate these increases, making the increases in the 401(k) and IRA contribution limits effective in 2004 and indexing them to inflation thereafter. These changes would cost more than \$5 billion over the next 10 years. This acceleration of the 401(k) and IRA contribution limits is problematic both as pension policy and as economic policy:

- 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 today and therefore would benefit little, if at all, from accelerating the increases in the maximum contribution levels. An unpublished study conducted in 2000 by an economist in the Office of Tax Analysis at the Treasury Department found that *only four percent* of all taxpayers who were eligible for traditional IRAs in 1995 made the maximum allowable contribution, which was \$2,000 at that time.¹⁵

Likewise, the proposed 401(k) changes would affect only a very small percentage of the population. The General Accounting Office has found that an increase in the statutory

¹⁵ Robert Carroll, "IRAs and the Tax Reform Act of 1997," Office of Tax Analysis, Department of the Treasury, January 2000.

contribution limit for 401(k)s would directly benefit *fewer than three percent* of participants;¹⁶ this indicates that increasing the limit on employee 401(k) contributions to \$15,000 immediately would disproportionately benefit those on the higher rungs of the compensation scale. Other recent studies have reached similar conclusions, finding that the fraction of individuals constrained by the IRA or 401(k) limits that were in place prior to enactment of the 2001 tax-cut legislation was very small.¹⁷

- The households whom the contribution limits affect — and who would benefit from accelerating the scheduled increases in these limits — are primarily higher-income households. Yet such households do not need this incentive: they already are much more likely to have pensions and to save adequately for retirement than other workers. Furthermore, the pension contributions they make are less likely to represent new saving and more likely to represent asset shifting — that is, the shifting of existing savings from a taxable account to a tax-preferred account — than the pension accumulations of lower-income earners.¹⁸ In other words, the primary effect of increasing the contribution limits is likely to be that high-income households shift other saving they already are undertaking from taxable accounts to the tax-preferred accounts. By shifting funds, such households would be able to capture the additional tax subsidies without raising their overall level of saving.¹⁹
- Finally, given current economic conditions, the acceleration would represent unsound economic policy today if it did succeed in boosting saving. Whatever their actual effects, increases in contribution limits are typically advertised as inducing additional *saving*, not additional spending. To boost the economy in the near term, the appropriate policy approach is to induce additional *spending* now, not more saving. Since firms have excess capacity and could produce more if there were more demand for their goods and services, it is additional consumption that would spur the economy in the near term. The Ways and Means legislation is a peculiar bill to be advocating in the current sluggish economic

¹⁶ General Accounting Office, “Private Pensions: Issues of Coverage and Increasing Contribution Limits for Defined Contribution Plans,” GAO-01-846, September 2001. The GAO also found that 85 percent of those who would benefit from an increase in the 401(k) contribution limit earn more than \$75,000. (These figures reflect the effects of other changes included in EGTRRA that have already taken effect, such as the elimination of the previous percentage cap on the amount of combined employer-employee contributions that can be made to defined contribution plans.)

¹⁷ See, for example, Craig Copeland, “IRA Assets and Characteristics of IRA Owners,” *EBRI Notes*, December 2002, and David Richardson and David Joulfaian, “Who Takes Advantage of Tax-Deferred Saving Programs? Evidence from Federal Income Tax Data,” Office of Tax Analysis, US Treasury Department, 2001.

¹⁸ For the empirical evidence on these points and for a discussion of proposals for progressive pension reform, see William G. Gale and Peter R. Orszag, “Private Pensions: Issues and Options,” in H. Aaron, J. Lindsay, and P. Nivola, eds., *Agenda for the Nation* (Brookings: forthcoming), and Peter Orszag and Robert Greenstein, “Toward Progressive Pensions: A Summary of the U.S. Pension System and Proposals for Reform,” in M. Sherraden and L. Morris, eds., *Inclusion in the American Dream: Assets, Poverty, and Public Policy* (Oxford University Press: forthcoming).

¹⁹ For further discussion of this point in the context of the Administration’s proposal for expanded tax-free savings accounts, see Leonard Burman, William Gale, and Peter Orszag, “The Administration’s Saving Proposals: A Preliminary Analysis,” *Tax Notes*, March 3, 2003.

environment. If it were successful in achieving its ostensible goal of raising retirement saving in the short term, it would be counterproductive now from an economic perspective.²⁰

Extending and Slightly Expanding the Saver's Credit

One beneficial component of the legislation would extend and slightly expand the “saver’s credit” created by the 2001 tax legislation. Expanding and extending this credit could be a promising proposal, since this credit could play an important role in encouraging saving among middle and lower earners. The credit currently is scheduled to sunset at the end of 2006; the legislation would extend the credit through 2010, when the rest of the 2001 tax-cut law sunsets.

The approach that the Ways and Means bill takes to expanding the credit, however, has a fundamental weakness. The legislation does not make the credit refundable. As a result, the credit would continue to be of little or no benefit to millions of workers with modest incomes, the very workers who most need to boost their retirement saving.²¹

Conclusion

The pension legislation that the Ways and Means Committee adopted in a contentious atmosphere on July 18 would make numerous changes in tax provisions that govern retirement saving. A few of these changes are beneficial. The bulk of the revenue loss from the legislation, however, results from provisions that are problematic.

The bill would reduce revenue by nearly \$50 billion over the next 10 years, a figure that would more than double in the second ten years. As this analysis indicates, the single most costly provision — relaxation of the minimum distribution rules — would permit high-income households to shelter more savings from taxation and thereby exacerbate an already bleak fiscal outlook.

Pension reform should focus instead on expanding tax incentives for lower- and moderate-income earners to save for retirement. Contributions to tax-preferred retirement accounts by such workers are more likely to represent new saving, rather than asset shifting. Such contributions also are much more likely to reduce the risk of living in poverty during retirement.

Many of the principal provisions of the legislation thus move in the wrong direction. Given the deeply troubling fiscal outlook the nation faces, the case for the bill’s expanded tax

²⁰ To the extent that the Ways and Means legislation would result purely in such asset shifting, it would not have this adverse short-term macroeconomic effect since it would not raise saving in the short run. This component of the legislation thus either is misguided as short-term macroeconomic policy, misguided as pension policy, or some combination thereof. Despite the claims of its proponents, the legislation is unlikely to raise private saving significantly, so its principal shortcoming is that it fails as pension policy.

²¹ See Peter Orszag and Matt Hall, “The Saver’s Credit,” *Tax Notes*, June 9, 2003

subsidies for higher-income households is weak. The legislation is an example of the type of attractive-sounding measure that the nation now can ill afford and that policymakers must begin summoning the courage either to pay for or to resist, if there is to be much hope of bringing our fiscal house in order.