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THE RETIREMENT SAVINGS COMPONENTS OF LAST YEAR'S TAX BILL: Why It Is Premature to Make Them Permanent

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Last year's tax legislation included a package of changes to pensions and Individual Retirement Accounts (IRAs). All of these changes, like the rest of the tax bill, sunset in 2010 or before. On June 21, the House passed legislation to make almost all of the pension and IRA provisions permanent, rather than allowing them to sunset in 2010. When the full Senate considers pension legislation in late September, it may face an amendment to adopt the House legislation.

The House legislation (H.R. 4931) to make the retirement savings provisions permanent is problematic for three reasons:

- First, it is premature to make these provisions permanent. The provisions represent an untested "trickle down" approach to pension coverage, in which the tax laws governing retirement savings are made more generous for higher earners in the hope that the increased generosity will encourage more small businesses to offer pension plans, which will then cover 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. The early evidence is, if anything, not encouraging, which suggests further grounds for caution.

- Second, making the provisions permanent would cause a further deterioration in a budget outlook that has already worsened dramatically over the past 20 months — and would widen the projected deficits outside Social Security. The Joint Tax Committee has estimated the cost of the House legislation at $4 billion in 2012 alone.

- Third, the House 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, however, rather than in 2010 with all of the other pension provisions in the

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legislation. The House bill makes permanent only those provisions that sunset in 2010 and does *not* make the saver's credit permanent. In other words, the House bill makes permanent all of the pension provisions geared toward high-income individuals while failing to make permanent the principal provision designed to boost pension among lower- and moderate-income workers. This is particularly ironic since the early evidence suggests that the saver's credit — unlike the other provisions of the legislation — *is* producing a marked increase in pension participation rates.

A far better approach than the one embodied in the House legislation would be to wait for a few years before deciding whether to make the provisions permanent, so that their effects can be evaluated more fully. In addition, the saver's credit should be evaluated alongside the other provisions; it should not automatically be excluded from the package of provisions that is made permanent.

Problem 1: No Evidence that the Provisions Are Effective in Raising Retirement Saving

Last year's tax legislation, the Economic Growth and Tax Relief Reconciliation Act of 2001, included a series of important changes to the pension and IRA laws. The major provisions involve various changes that allow larger contributions by, and on behalf of, high-income workers. 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 to $15,000 by 2006 (and to $20,000 for those aged 50 or over). This change generally affects only people on the upper rungs of the income distribution: In 1996, for example, only 5.5 percent of participants in 401(k) plans made the maximum allowable contribution.[2] And those who make the maximum contribution are primarily high-income individuals. Increasing the limit to $15,000 disproportionately benefits individuals at or near the top of the compensation scale.

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 raises the maximum contribution to $5,000 apiece by 2008. In addition, as of 2006, taxpayers aged 50 or over will be able to contribute an additional $1,000. As a result, the total that a *couple* can contribute will rise from $4,000 to $10,000, and the maximum that a couple aged 50 or over can contribute will rise to $12,000. This change is likely to have little effect on families and individuals who made no IRA contributions under prior law or deposited less than the old $2,000 IRA limit. A 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.[3] The Treasury paper concluded: "Taxpayers who do not

[2] Donald Kiefer, Robert Carroll, Janet Holtzblatt, Allen Lerman, Janet McCubbin, David Richardson, and Jerry Tempalski. "The Economic Growth and Tax Relief Reconciliation Act of 2001: Overview and Assessment of Effects on Taxpayers." *National Tax Journal* 2002.

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

contribute at the $2,000 maximum would be unlikely to increase their IRA contributions if the contribution limits were increased….”[4] This provision, as well, thus is most likely to benefit more affluent individuals.

Advocates of these provisions argued last year that liberalizing the rules for higher-income workers in these ways would help middle- and lower-income employees. The early evidence, however, is not particularly favorable to this argument. A recent *Wall Street Journal* article, for example, found that very few workers seem to be taking advantage of the new "catch-up" 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 underwhelming,' says Jim Jaffe, [director of external affairs] of the Employment Benefits Research Institute, a data and policy research organization in Washington D.C."[5]

According to the article, only 6,259 of the 337,758 participants aged 50 and above in 401(k) plans administered by the financial firm T. Rowe Price are making catch-up contributions. In other words, fewer than two percent of eligible participants are making these additional contributions. (The article notes that one of the reasons for the low participation rate is that it takes time for firms to modify their pension plans to conform to the changes from last year's tax bill. But that itself 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 workers.

Furthermore, certain pension provisions in last year's tax legislation have the potential to *harm* lower-income workers. For example, the legislation significantly reduces 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) contributes to an employer-sponsored plan. This is especially beneficial to low-income workers who are less likely than other workers to make contributions to 401(k) plans. Last year's tax legislation, however, contains two changes that are expected to reduce sharply the attractiveness of money purchase plans to firms. These changes in law weakened the prior rules that effectively required many firms that wished to maximize pension contributions on behalf of their owners and executives to offer money-purchase plans to their rank-and-file employees. The elimination of these requirements is likely to lead to a significant reduction in the availability of money purchase plans, with the result that substantial numbers of lower-wage workers may lose a significant source of pension coverage they currently enjoy.

Materials issued by the financial firm Charles Schwab, Inc., underscore this danger. In a part of the Schwab website discussing pension plans, Schwab flatly states "…the need for money

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[4] Carroll (2000), page 7.

[5] Bridget O'Brian, "Older Investors Miss the Chance to Catch Up in Retirement Plans," *Wall Street Journal*, September 13, 2002.

purchase pension plans has been virtually eliminated."[6] Materials that Schwab is distributing to employers amplify this point, explaining that firms that needed in the past to offer a money purchase plan in order to maximize pension contributions for owners and executives no longer need to do so.[7]

Another danger is that by increasing to $10,000 the amount that a couple can place in an IRA, last year's tax legislation may induce some small business owners not to offer a pension plan for their employees. As a result of this change in law, small business owners will, for the first time, be able to put away $10,000 in tax-advantaged retirement savings each year ($12,000 if the owner is 50 or older) *without* having to set up an employer-sponsored pension plan and thus without having to provide pension coverage to their employees. Before policymakers make these provisions permanent, they should allow more time for the effectiveness of the provisions to be evaluated.

Problem 2: Fiscal Outlook

The second problem with making the provisions permanent is that the federal budget outlook has deteriorated dramatically since January 2001. 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 even these figures 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.

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[6] See "The EGTRRA — Better Known as the Tax Act," March 25, 2002, www.schwab.com.

[7] Under prior law, the combined employer-employee contribution to 401(k) plans and profit-sharing plans could not exceed 15 percent of aggregate pay. A separate limitation required that combined employer-employee contributions to *all* defined contribution pension plans a firm offered could not exceed 25 percent of pay (or $30,000, whichever was lower). In other words, the 25 percent cap under prior law applied to total contributions to all defined contribution plans, while the 15 percent cap applied only to 401(k) and profit-sharing plans. (Another difference is that the 25 percent cap applied on a worker-by-worker basis, whereas the 15 percent cap applied to aggregate contributions. But in many small businesses, this distinction was not important, since the individual pay for the owners and executives represented a large share of the aggregate pay for the firm as a whole.) Money purchase plans were not included in the 15 percent cap, so they were an important mechanism for small businesses to maximize tax-preferred retirement contributions for their executives. In particular, if a small business wished the combined contributions for top executives to equal 25 percent of compensation, it had to provide both a 401(k) plan or profit-sharing plan with a 15 percent limitation and a money purchase plan that contributed the other 10 percent of compensation. Last year's tax legislation raised the previous 15 percent limitation on contributions to 401(k) and profit-sharing plans to 25 percent, thereby virtually eliminating the incentive to set up money purchase plans. As the Schwab material emphasizes, "IMPORTANT: Beginning with the 2002 Plan Year, new tax laws increase the limit on deductible contributions to a Profit Sharing Plan alone from 15% to 25% of total compensation paid to all participants. This increase eliminates the need to pair a Money Purchase plan with a Profit Sharing plan in order to contribute the full 25%."(emphasis in original) The following page in the Schwab document then instructs employers that they no longer need a money purchase plan to contribute more than 15 percent of aggregate pay to a tax-preferred pension on behalf of owners and executives. Charles Schwab, Inc., "Review of QRP Plan Types, in *GUST-Approved Amendment and Restatement Materials*, available upon request to the author.

These figures represent astonishingly large declines from the forecast that CBO issued just 20 months ago. Moreover, the new CBO projection for the time period of 2002 through 2010 — which does not include 2011 and thus is not distorted by assumptions about the expiration of the tax cut at the end of 2010 —shows a unified budget deficit of essentially zero ($13 billion) for this period, as compared to a projected surplus of *$4.7 trillion* for this period in CBO's January 2001 projection. In addition, the projected outcome for 2002 alone changed by $470 billion, from a surplus of $313 billion in the January 2001 projection to a deficit of $157 billion in CBO's August 2002 forecast.[8] Outside the ten-year budget window, the fiscal outlook is even less encouraging.

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 permanent at $4 billion in 2012 alone.

As noted above, it is much too early to know whether these pension provisions will prove effective at raising retirement saving among rank-and-file workers. 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.

Problem 3: Exclusion of the Saver's Credit

The final problem with the House legislation is that it does *not* make permanent the one provision that is the most auspicious piece of the retirement package in last year's tax legislation: the "saver's credit." The saver's credit is a matching tax credit that equals up to 50 percent of contributions of up to $2,000 a year that low- and moderate-income workers make to IRAs and 401(k)s. The tax credit is progressive, equaling 50 percent of the amounts (up to $2,000) that the lowest-income families contribute, with this percentage phasing down as income rises and phasing out when income reaches $50,000 a year for couples and $25,000 for single filers.

To be sure, several crucial details of the credit result in its being of limited value. It provides little or no benefit to the vast majority of lower-income workers and only a small benefit to others. In particular, since the tax credit is not refundable, it provides *no* additional saving incentive to most working families who qualify on paper for the 50 percent credit rate based on their income. These low-income workers are excluded from the credit because they have no income tax liability against which the credit can be applied. For families with somewhat higher incomes, the fact that the credit is not refundable poses much less of a problem. But for these families, the credit provides such a small incentive for saving as to be of little value. For example, a married couple earning $35,000 a year receives only a $200 tax credit for depositing $2,000 into a retirement account. This small credit represents a very low matching rate and

[8] For further discussion, see William Gale and Peter Orszag, "The Vanishing Budget Surplus: Interpreting CBO's New Projections and Fiscal Prospects," The Brookings Institution, August 29, 2002; and Richard Kogan and Robert Greenstein, "The New Congressional Budget Office Forecast and the Remarkable Deterioration of the Surplus," Center on Budget and Policy Priorities, September 3, 2002.

therefore provides little incentive to participate. These flaws could be addressed by expanding the saver's credit and making it refundable.

Despite its flaws, the saver's credit appears to be having a positive effect. A recent poll taken in June 2002 by Diversified Investment Advisors found that among employers that have modified their pension plans to take advantage of the changes in last year's tax legislation, "the tax credit for lower-income participants is turning out to be a major success….Some 71% say that plan participation is up because of this provision, including 18% who report a major participation surge. On average, plan sponsors report that 34% of their workforce is eligible for the tax credit."[9]

The credit, however, sunsets in 2006. The House legislation makes permanent only those pension provisions that expire in 2010, and does not extend this provision, letting its 2006 expiration date stand. It is ironic that the one provision that appears to offer the most hope of raising pension participation rates among rank-and-file workers is the only significant pension provision that is not made permanent under the House approach.

Conclusion

It is premature to make the retirement provisions from last year's tax legislation permanent. The jury is still out on the effects of these provisions, and policymakers will have much more information about their impact in a few years. Furthermore, the budget outlook has deteriorated dramatically over the past 18 months, and making the provisions permanent would cause further deterioration. Finally, the House approach to making the provisions permanent excludes the one provision that is likely to prove most effective at raising pension saving among moderate-income workers: the saver's credit. The early evidence suggests that this credit, unlike the provisions that *would* be made permanent under the House approach, may be effective at raising pension participation rates among rank-and-file workers.

Retirement planning does require some certainty about the long-term rules applying to pensions, but at this point, the benefits of waiting to evaluate the effects of last year's retirement provisions before making them permanent outweigh the costs. Furthermore, the saver's credit should be evaluated alongside the other retirement provisions; it should not automatically be excluded from the package of provisions that is made permanent, as under the House approach.

[9] Fred Schneyer, "Saver's Credit Boosts Participation," plansponsor.com, July 23, 2002.