Inclusion in Asset Building: Research and Policy Symposium

Toward Progressive Pensions: A Summary of the U.S. Pension System and Proposals for Reform

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George Warren Brown School of Social Work

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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.[3]

To promote pension saving, the government offers a variety of tax incentives. The revenue loss from existing tax preferences for retirement savings amounts to roughly $85 billion per year, which is larger than the revenue loss from excluding health insurance from taxation.[4]

Pension coverage is, however, very unevenly spread. Half of the American workforce at any point in time lacks it. Pensions remain particularly scarce in specific segments of the labor market, especially among lower-income workers and employees in small businesses. Policy-makers, frustrated by the failure to raise overall coverage rates much above 50 percent and concerned about the implications of inadequate pension coverage for the coming retirement of the baby boomers, have been considering various approaches to bolstering pension security. For example, the House of Representatives voted 401 to 25 on July 19, 2000, to pass the "Comprehensive Retirement Security and Pension Reform Act." The Senate passed similar legislation in September 2000. (The Clinton Administration opposed parts of the legislation, and it did not become law in the fall of 2000. It appears likely, however, that the legislation will become law in 2001.)

The purpose of this paper is to review the current pension system in the United States, including its shortcomings for lower-income workers, and to evaluate different proposals for reform. Our conclusion is that the approach embodied in the legislation likely to become law in 2001 is fundamentally flawed and that a progressive matched savings program represents a much more auspicious mechanism for boosting retirement security among lower-income workers.

The paper has five sections. Section I summarizes the shortcomings in the current pension system. Section II examines the principal causes of the unequal coverage and accumulation rates documented in the first section. Section III discusses the benefits of progressivity in pension reform. Section IV examines a progressive set of policy changes to raise pension coverage and accumulation rates for lower- and moderate-income workers. Section V examines the proposed legislation, and explains why it may *endanger* pension security among many lower-income workers. Section VI then offers conclusions.

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[3] Social Security Administration (1999), page 6.

[4] 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 Office of Management and Budget (1999), Table 5-1, page 92.

Section I: Overview of shortcomings in pension system

Governments across the world provide tax incentives for private pensions. The fundamental motivation for such tax preferences is to encourage retirement saving, which itself reflects a belief that individuals would not save sufficiently for their own retirement in the absence of such tax preferences.[5]

Given this goal of encouraging retirement saving and retirement income security through a tax-preferred pension system, policy-makers examining the current system often note three substantial problems: First, at any given point in time, only about half of American workers is covered by an employer-provided pension. Second, pension coverage and contribution rates vary significantly across types of workers, and in particular are skewed toward higher earners.

Third, even for those workers covered by pensions, the amounts being accumulated may not be sufficient to finance expected consumption levels during retirement. This section examines these three shortcomings in turn.

A. Overall coverage rates

Data from the Current Population Survey suggest that the percentage of full-time private-sector wage and salary workers covered by a pension has fluctuated only narrowly since 1972, between 48 and 51 percent (see Table 1).[6]

Four brief points are worth noting about these figures. First, they apply to individual workers at any given point in time. Over a lifetime and on a household rather than individual worker basis, coverage rates are somewhat higher. For example, roughly two-thirds of households are covered by a pension at some point during their careers.[7] Second, although the overall coverage rate has remained roughly constant over the past three decades, the distribution of coverage between defined benefit and defined contribution plans has shifted substantially.[8] For example, in 1975,

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[5] Inadequate pension saving in the absence of employer-based tax incentives could arise from several factors, including bounded rationality, myopia, and the “moral hazard” that potentially results from government income security programs for the elderly (e.g., Supplemental Security Income).

[6] The General Accounting Office reports an improvement in pension coverage rates between 1988 and 1998. See General Accounting Office (2000a). Their figures, however, reflect only two points in time. They also include all workers, not just full-time workers. Between 1988 and 1998, the share of part-time workers in the workforce fell slightly and the share of full-time workers rose. In 1988, part-time workers represented 17.5 percent of employment; in 1998, they represented 16.9 percent.

[7] According to data from the Health and Retirement Survey, which provides information on the income and wealth holdings of people born between 1931 and 1941 and therefore currently in their peak retirement years, 65.6 percent of households had positive pension wealth. See Gustman, Mitchell, Samwick, and Stenmeier (2000).

[8] A defined benefit plan provides a payment in retirement that depends only on the worker’s wage and years of service: It thus defines the benefit that will be received. A defined contribution plan, on the other hand, defines the contribution that the firm will make, but the retirement benefit that can be financed from that contribution depends on the rate of return earned before retirement. Defined benefit plans thus assign accrual risk (the risk that funds set aside today do not accumulate at the expected rate of return) to the firm; given a worker's earnings history, retirement benefits are certain. Defined contribution plans, on the other hand, assign accrual risk to the individual worker; even conditional on an earnings history, retirement benefits depend on the efficacy with which contributions were financially managed.

71 percent of active pension participants were covered by defined benefit plans and 29 percent by defined contribution plans. By 1995, the figures had shifted to 35 percent for defined benefit plans and 65 percent for defined contribution plans.[9] Third, the coverage rate presented in Table 1 is based on household survey data from the Current Population Survey. Employer-based surveys suggest somewhat higher coverage rates.[10] Fourth, although the overall coverage rate has remained roughly 50 percent, the coverage rate for most age categories has declined.[11] The overall coverage rate has remained roughly constant despite the decline in most age-specific coverage rates because of the changing demographics of the workforce (toward older workers, who have higher coverage rates than younger workers).[12]

Table 1: Retirement plan coverage rates for full-time, private-sector workers

Year	All	Male	Female
1972	48%	54%	38%
1979	50%	55%	40%
1983	48%	52%	42%
1988	48%	51%	44%
1993	50%	51%	48%
1995	48%	49%	48%
1997	50%	51%	48%
161999	51%	52%	49%

Note: "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. Sources: U.S. Department of Labor, *Report on the American Workforce 1997*, Table 3-1, for 1972-1993, and U.S. Department of Labor, Pension and Welfare Benefits Administration, "Coverage Status of Workers under Employer Provided Plans," 2000, available at http://www.dol.gov/dol/pwba/public/programs/opr/CWS-Survey/hilites.html, for 1995-1999.

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9 Gale, Papke, and VanDerhei (1999).

10 The Current Population Survey is a monthly survey of roughly 50,000 households conducted by the Census Bureau for the Bureau of Labor Statistics. Pension coverage rates are higher in the Employee Benefits Survey (roughly 60 percent, relative to 50 percent in the Current Population Survey), an establishment-based survey conducted by the Bureau of Labor Statistics. For a discussion of the results from these two surveys, see Herz, Meisenheimer, and Weinstein (2000). It is worth noting that research suggests that individuals generally understand the broad features of their pension, but not necessarily the detailed features. See Gustman and Steinmeier (1999), and Starr-McCluer and Sunden (1999). Starr-McCluer and Sunden, for example, find that 77.5 percent of those surveyed in the Survey of Consumer Finances correctly identified the type of plan (defined benefit or defined contribution) under which they were covered.

11 For example, the coverage rate for those aged 16 to 24 has fallen from 27 percent in 1979 to 21 percent in 1993; the coverage rate for those aged 30 to 34 has fallen from 56 percent in 1979 to 50 percent in 1993; and the coverage rate for those aged 50 to 54 has fallen from 65 percent in 1979 to 61 percent in 1993. (The coverage rates for those aged 40 to 44 and 45-49 both increased. Those are the only age categories to experience an increase in coverage rates between 1979 and 1993. See Department of Labor (1997), Table 3-1.

12 The figures in Table 1 also do not reflect workers making contributions to Individual Retirement Accounts (IRAs), which were initially designed to assist those who were not covered by an employer-provided plan. But Carroll (2000) found that only seven percent of the taxpayers eligible for conventional IRAs in 1995 contributed to an IRA in that year (with at least one-fifth of these participants also covered by an employer-provided plan. Including IRAs in the analysis would thus not substantially affect the overall coverage rate.

In summary, Table 1 illustrates the first concern regarding the pension system: coverage rates have remained only about 50 percent over the past three decades.

B. Inequality in pension coverage and accumulation rates

The second policy concern is that pension coverage rates vary substantially by characteristics of the employee. For example, in 1999, only 14 percent of part-time workers were covered by a pension, relative to 51 percent of full-time workers; only 27 percent of all Hispanic workers were covered by a pension, relative to 47 percent of all white, non-Hispanic workers;[13] only 18 percent of workers with less than a high school degree were covered by a pension, relative to 62 percent of workers with a college degree or more; only 14 percent of workers aged 25 or under were covered by a pension, relative to 56 percent of workers aged 50-54; and only 6 percent of workers earning less than $10,000 per year were covered by a pension, relative to 76 percent of workers earning more than $50,000 per year. Other data also indicate that coverage rates are much lower in small businesses than in larger firms. For example, in 1993, only 13 percent of full-time workers in firms with fewer than 10 employees, and 25 percent of those in firms with between 10 and 24 employees, enjoyed pension coverage. But 73 percent of those in firms with 1,000 or more employees enjoyed such coverage.[14]

Pension coverage rates are only one source of inequality in pension contributions: contribution *rates* (contributions as a percentage of income) also vary across people covered by a pension, providing another source of inequality. For example, low-income workers typically contribute a smaller percentage of their pay to 401(k)-type pension plans than higher-income workers. Among workers aged 18 to 64 with a 401(k) plan in 1992, the average employee contribution rate (excluding employer matches) 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.[15]

The inequality in pension contributions manifests itself in various indicators. For example, the lower rates of pension coverage among workers with lower incomes, combined with the higher contribution rates and higher marginal tax rates among higher-income workers, mean that existing tax preferences for pensions disproportionately benefit upper-income workers. In other words, 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.

Table 2 presents Treasury Department data on the distribution of tax benefits from current pension and IRA provisions. As it shows, 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. The bottom 40 percent of the income distribution enjoys only 2.1 percent of the

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[13] These figures, along with the others that follow, include both part-time and full-time workers. See Department of Labor (2000).

[14] Department of Labor, Social Security Administration, Small Business Administration, and Pension Benefit Guaranty Corporation (1994), Table B9.

[15] General Accounting Office (1996), Table II.4.

total tax benefit, relative to the 10.1 percent enjoyed by the top 1 percent of the income distribution.

The inequality in pension contributions is also reflected in inequality in pension *wealth* (the accumulated value in a pension). Although pension wealth is distributed more equally than other forms of financial wealth,[16] it is still highly unequal. In 1995, for example, the top 10 percent of the wealth distribution accounted for 62.3 percent of the total pension wealth – somewhat less than their 89.8 percent share of bonds, but highly concentrated nonetheless.[17] More broadly, researchers have demonstrated substantial inequality in overall financial wealth (including assets outside pension funds) upon retirement. Much (but not all) of this inequality is related to household income and attitudes toward saving.[18]

Table 2: Distribution of Pension and IRA Tax Benefits

Family income quintile (as defined by family economic income)	Percent of present value tax expenditure benefit from pensions and IRAs
Lowest 20%	0.1%
Second 20%	2.0%
Middle 20%	9.5%
Fourth 20%	22.0%
Top 20%	66.4%
TOTAL	100.0%
Note:	
Top 10%	43.0%
Top 1%	10.1%

Source: Department of the Treasury, Office of Tax Analysis, March 30, 1999

C. Pension accumulations and preparations for retirement

In addition to substantial inequality in pension contributions and wealth, many policy-makers are concerned that the pension system is not producing adequate levels of retirement saving even for the typical worker. For example, according to data from the Survey of Consumer Finances, the median defined-contribution retirement account (including Individual Retirement Accounts)

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16 See, for example, Clark and Wolper (1997) and Kennickell and Sunden (1997).

17 Mishel, Bernstein, and Schmitt (1999), Table 5.4. At the very top of the wealth distribution, the differences between pensions and other forms of wealth become somewhat more extreme: The top one percent of the wealth distribution in 1995 held 51.4 percent of stocks and mutual funds, and 65.9 percent of bonds, but 17.7 percent of pension funds. “Pension wealth” excludes the present value of Social Security benefits.

18 See, for example, Venti and Wise (1998) and Lusardi (2000). Venti and Wise note that substantial inequality in wealth holdings exists even at the same lifetime earnings level, and conclude that, “In the United States it is not only households with low incomes that save little. A significant proportion of high-income households also save very little; and not all low-income households are nonsavers. Indeed a substantial proportion of low-income households save a great deal.” Lusardi relates saving behavior to financial planning, and notes that approximately one-third of Americans who are close to retirement have done little or no retirement planning.

balance in 1998 among the 49 percent of families having such accounts through their current jobs was only $24,000. Among families with incomes between $25,000 and $50,000, the median balance was only $13,000. Even among those families headed by someone between the ages of 55 and 64 -- and therefore in their peak retirement years -- the median balance was only $46,800.[19] Many researchers and policy-makers are therefore concerned about a "savings gap." Indeed, several studies have suggested that households are saving too little to maintain their current living standards through retirement and that many households arrive at retirement with insufficient wealth, even when the present value of Social Security benefits are included in the analysis.[20]

Section II: Causes of unequal coverage and contribution rates

This section explores the causes of the unequal coverage and contribution rates documented in Section I. The General Accounting Office has found that four factors are particularly important in explaining pension coverage: It concludes that 85 percent of those in the labor force who worked and lacked pension coverage had low income, did not work full time, worked for a small firm, and/or were relatively young.[21] Another way of exploring the coverage issue is to examine whether uncovered workers are working in firms that do not provide pension coverage, or are instead working in firms with such coverage but for some reason do not participate in the plan. We adopt this perspective on coverage in this section.

Table 3 shows that in 1999, 58.5 percent of all private-sector workers (including part-time and full-time workers) were employed in firms that sponsored pension plans. Among these workers, 75 percent were covered by the plan and 25 percent were not. Therefore, 14.5 percent of the workforce (0.25*0.585) was employed by a firm sponsoring a pension plan but was not covered by that plan.

In total, 56 percent of the private workforce (including part-time and full-time workers) was not covered by a pension (the somewhat lower figures in Table 1 apply to full-time private-sector workers). The 56 percent of the private workforce not covered by a pension comprises 14.5 percent of the workforce employed by firms with pensions but not covered by them, plus the 41.5 percent of the workforce employed by firms without pensions. Thus, roughly three-quarters of the uncovered population worked for a firm that did not sponsor a pension plan. Low overall coverage rates arise both because many workers are employed by firms that do not offer pensions and because some workers in firms already offering pensions are not covered by them.

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[19] Kennickell, Starr-McCluer, and Surette (2000).

[20] See, for example, Moore and Mitchell (1997). For a different view regarding the adequacy of saving and a different interpretation of previous research, see Engen, Gale, and Uccello (2000). Engen, Gale, and Uccello emphasize the importance of how the savings benchmark is defined, and that the results are quite sensitive to that definition.

[21] General Accounting Office (2000a).

Table 3: Pension coverage of private-sector wage and salary workers, 1999		
	Number of workers (in thousands)	% of all workers
In firm sponsoring pension plan	57,437	58.5%
Covered by the plan	*43,078*	*43.9%*
Not covered by the plan	*14,359*	*14.6%*
In firm without pension plan (or "don't know")	40,795	41.5%
TOTAL	98,232	100%
Not covered by a pension:		**(% of those not covered)**
In firm with plan but not covered	14,359	26.0%
In firm without plan	40,795	74.0%
TOTAL	55,154	100%

Source: U.S. Department of Labor, Pension and Welfare Benefits Administration, "Coverage Status of Workers under Employer Provided Plans," 2000, available at http://www.dol.gov/dol/pwba/public/programs/opr/CWS-Survey/hilites.html, and authors' calculations.

Workers in firms without pension plans

The absence of pension plans in many firms, especially small businesses, reflects many factors. One of the most commonly identified factors is the complexity of the pension tax law. As Steuerle (1999) notes, "The number of rules and regulations applying to pension and saving plans is overwhelming...The consequent complexity reduces the net rate of return available to saving, in part because of the very large expenditure of time and paid labor that must be employed to interpret, administer, and seek to understand this universe...the issue is not whether there should be rules regarding eligible deposits, discrimination among employees, penalties for withdrawals, and so on, but whether there needs to be so many inconsistent rules and regulations across so many different plans."

The rules applying to pensions are indeed complicated and confusing.[22] It is important to note, however, that much of the complexity in the tax code comes from complicated provisions biased toward higher earners: For example, if tax-preferred status were reserved for plans that covered a firm's entire workforce and contributed the same percentage of pay to each worker, the rules would not have to be particularly complicated.[23]

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22 As just one example, the definition of a "highly compensated employee" for purposes of "non-discrimination" testing is different from the definition of a "key employee" for purposes of "top-heavy" testing. Numerous examples of such inconsistencies across concepts and plan types abound in the pension tax code.

23 Some rules would have to allow for employees who leave the firm early in the year and other complexities. But the rules would not have to be particularly complicated. For further discussion of a reform along these lines, see Halperin and Munnell (1999). (The Halperin and Munnell proposal, it should be noted, includes many other controversial elements in addition to the simplification described here.)

Other factors may be more important than complexity and administrative cost in discouraging some firms from offering pension plans. Indeed, surveys of small businesses suggest that complexity and administrative cost are important, but not the most important, factors in discouraging them from offering pension plans. (The availability of simplified pension plans that are exempted from most of the particularly complicated tax rules reinforces this point.) Table 4, taken from a recent survey conducted by the Employee Benefits Research Institute, highlights that many firms do not offer pension plans because workers prefer other forms of compensation or because the nature of the firm or the industry makes it difficult to adopt pension plans (for example, uncertain revenue combined with a required employer contribution, the absence of an ability to borrow, and risk aversion on the part of the business owner or executive would discourage pension plan adoption).

Table 4: Reasons for Not Offering a Retirement Plan

Reason	Percent of respondents identifying as most important factor for not offering plan
Employees prefer wages and/or other benefits	21%
Workers are seasonal, part-time, or high turnover	18%
Revenue is too uncertain	13%
Business is too new	11%
Costs too much to set up and administer	9%
Required company contributions are too expensive	8%
Too many government regulations	3%
Vesting requirements cause too much money to go to short-term employees	3%
Benefits for the owner are too small	3%
Owner has own deferred compensation arrangement	2%
Don't know where to go for information on starting a plan	1%
Other reasons	6%
TOTAL (with rounding)	100%

Source: EBRI, "The 2000 Small Employer Retirement Survey: Summary of Findings," available at http://www.ebri.org.

Table 4 suggests that while the failure of firms to offer pension plans may be the primary explanation for the relatively low overall pension coverage rate, many of the most important reasons for firms not creating such plans are not particularly amenable to policy interventions. Policy-makers may therefore be forced to consider other mechanisms for promoting retirement savings, outside of the employer-based system (as was the original motivation for the Individual Retirement Account, although that approach has not proven particularly successful in raising retirement saving among rank-and-file workers). Also note that only 3 percent of respondents listed inadequate benefits for business owners as the most important factor for not offering a plan. The legislation under discussion in Congress, which is examined in more detail in Section IV below, is predicated on the questionable argument that inadequate benefits for business owners is a critical, and perhaps the critical, factor dissuading firms from creating pension plans.

Workers in firms with pension plans, but who are not covered by such plans

Workers who do not participate in a pension plan that their employer sponsors represent about one-quarter of all workers lacking a pension. These workers comprise two sub-groups: those who are involuntarily excluded from their employer's plan and those who are eligible to participate but choose not to participate.

It may seem surprising that some workers in a firm offering a pension may be barred from participating. After all, the Internal Revenue Code stipulates a series of conditions that must be met by "qualified pension plans" (i.e., those that benefit from tax-preferred status). In particular, a qualified plan must not discriminate in favor of highly compensated employees either in its coverage or its contributions and benefits. Nonetheless, many qualified plans succeed in excluding lower-income workers and in tilting contributions toward higher earners.

Under current law, for example, firms are allowed to exclude certain employees – employees under age 21 or with under one year of service with the firm – from participation in a pension plan. A year of service is generally defined as 1,000 hours during a 12-month period. Thus, part-time and seasonal workers who do not work 1,000 or more hours for a single employer *never* qualify to participate in the pension plan. Table 4 shows that more than half (55 percent) of those excluded from employer-sponsored plans either do not meet the age or years of service requirements (36 percent) or do not work enough hours (19 percent) to qualify for participation in the plan.

After excluding all workers who are either under age 21 or have less than one year of service, the firm also is allowed to exclude *up to 30 percent of the remaining rank-and-file workers from the plan.* A qualified pension plan must meet one of two minimum coverage tests: the ratio percentage test and the average benefits test.[24] These rules effectively allow firms to exclude entire categories of workers. Table 5 indicates that 6 percent of uncovered workers in firms with pension plans were not covered because their type of job was not eligible for the pension coverage. (Table 5 also indicates that roughly one-quarter of uncovered workers in firms sponsoring pension plans choose not to participate, highlighting that some workers – disproportionately younger workers and those with low income or short tenure[25] – choose not to save even if offered a tax-preferred mechanism for doing so.)

[24] Under the ratio percentage test, the percentage of non-highly compensated employees who benefit from the plan must be at least 70 percent of the percentage of highly compensated employees who benefit. (A highly compensated employee earns $80,000 or more.) In computing this ratio, the firm excludes those who do not qualify because of years of service or age. Employees covered by collective bargaining agreements and airline pilots are also excluded. Under the average benefits test, the average benefit percentage of the non-highly compensated employees (as a group) must be at least 70 percent of the average benefit percentage of the highly compensated employees, and the plan must meet a nondiscriminatory classification test (which means that the classification must be reasonable, and that the classification meets a specific quantitative test also). In applying the average benefits test, there are restrictions on excluding employees because of age and service (although the limitations are relatively minor).

[25] General Accounting Office (2000a), page 17.

Table 5: Reasons for non-coverage of private-sector wage and salary workers employed by firms sponsoring pension plans, 1999	
Reason	Percent of workers identifying reason
Don’t meet age and/or service requirements	36%
Don’t work enough hours	19%
Choose not to contribute	26%
Type of job not covered under plan	6%
Other or don’t know	12%
TOTAL	100%

Source: U.S. Department of Labor, Pension and Welfare Benefits Administration, “Coverage Status of Workers under Employer Provided Plans, ” 2000, available at http://www.dol.gov/dol/pwba/public/programs/opr/CWS-Survey/hilites.html, Table 13.

Among those who are eligible to participate in a pension plan, a complicated set of non-discrimination laws is intended to ensure that the tax benefits are widely shared. In practice, however, the rules allow significant disparities between the benefits flowing to higher-income and lower-income workers. In effect, the rules allow higher-income workers to contribute (or receive) a higher percentage of their compensation in pension benefits than lower-income workers – as long as the differential does not exceed certain thresholds.

For example, the “permitted disparity” rules allow integration of the employer’s pension plan with Social Security. By integrating the plan with Social Security, the firm is allowed to provide higher contributions to high-income workers without triggering the non-discrimination rules that normally apply.[26] In effect, the pension component of the integrated plan discriminates in favor of high-earners, but that regressivity is considered to be “compensated” by the progressivity of the Social Security system.

Approximately 50 percent of workers covered by <u>defined benefit</u> plans in medium and large firms are in an integrated plan.[27] In <u>defined contribution</u> plans, Social Security integration is much less common. But 401(k) plans allow a different kind of disparity: In such plans, the contribution rates of higher-income executives are allowed to exceed those of rank-and-file workers, as long as the differential does not exceed certain generous bounds. A complicated set of tests is used to determine whether the differential is excessive.

Many pension consultants have grown adept at circumventing the intent of the non-discrimination rules by exploiting the various loopholes that exist within them. In so doing,

[26] The maximum permitted disparity between the contribution rate above the Social Security maximum taxable earnings ($76,200 in 2000) and below it is 5.7 percentage points. In other words, a firm can contribute 10 percent of pay to the defined contribution plan for earnings below $76,200 and 15.7 percent of pay for any earnings above $76,200 without violating the non-discrimination rules.

[27] Slusher (1998).

they often succeed in directing 80 percent to 90 percent, and sometimes even more, of the tax-preferred contributions to top executives rather than rank-and-file workers.[28]

In summary, in both defined benefit and defined contribution plans, significant disparities are permitted in the generosity of the pension relative to income. Firms are often able to take advantage of the rules to skew benefits substantially toward higher earners.

Section III: Benefits of Progressivity in Pension Policy

Sections I and II documented, and explored the causes of, gaps in the current retirement saving system. Our attention now turns to how best to fill those gaps. Given the gaps in the current system, our thesis is that 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, including national saving, elderly poverty, and equity.

A. 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.[29]) 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*.[30] Indeed, Engen and Gale (2000) suggest 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.

For example, assume the government announces a new tax incentive that allows individuals to exclude from taxable income up to $1,000 deposited in a retirement account. If a higher-income

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[28] For a discussion of how some firms are able to satisfy the non-discrimination rules while still directing 90 percent or more of their contributions to executives, see Orszag (2000).

[29] 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.

[30] 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 Engen, Gale, and Scholz (1996), and Poterba, Venti, and Wise (1995).

individual in the 31 percent marginal tax bracket takes $1,000 from an existing savings vehicle and moves it to the tax-preferred account, the government loses $310 in tax revenue that year without any corresponding new private saving (since the individual has merely shifted his or her assets from one account to another). On the other hand, if the tax incentive induces an individual in the 15 percent marginal tax bracket to save an additional $1,000, private saving increases by $1,000 while government revenue falls by only $150.

The smaller a worker's opportunity for shifting assets and the lower the worker's marginal tax bracket, the more likely it is that $1,000 deposited in such a worker's account will represent an increase in national saving. This example illustrates why focusing tax incentives on low- and moderate-income workers who do not have many other assets is more likely to raise national saving than tax incentives focused on higher-income workers. Focusing new pension tax preferences on low- and moderate-income workers would increase the likelihood that the new incentives actually would boost national saving.

B. Elderly poverty

The revenue loss from existing tax preferences for pensions amounts to roughly $85 billion per year, which is larger than the revenue loss from excluding health insurance from taxation. 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.[31] 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.

C. 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.

Given these substantial benefits of progressivity in pension policy, pension reforms should 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.

Section IV: Proposals for expanding pension security

This section explores a progressive set of reforms to bolster pension security among lower- and moderate-income workers. They are based on the (admittedly limited) evidence on "what works and what doesn't," and involve a progressive government matching formula, improved financial education, more automatic contribution mechanisms, and other steps. The next section discusses an alternative approach based on a trickle-down theory, under which raising the maximum limits

[31] For an overview of the tax provisions affecting employer-provided pensions, see Joint Committee on Taxation (1999).

on benefits and contributions allowed under the tax law redounds to the benefit of lower- and moderate-income workers.

A progressive set of pension reforms should center on three factors that have generally been shown to boost pension participation, especially among lower- and moderate-income workers: providing some sort of progressive government matching contribution for employee contributions; making it easier to save; and providing financial education in the workplace about the benefits of saving. In addition, we suggest reforms to the asset tests under means-tested government benefit programs such as Supplemental Security Income and the food stamp program.

A. Progressive Government Matching Contribution

One auspicious approach to bolstering retirement income security among lower- and moderate income workers would involve a progressive government matching formula. Data on participation rates in 401(k) plans among lower- and moderate-income workers suggest that such a progressive matching approach may be highly beneficial. In particular, a surprisingly large share of lower- and moderate-income workers participate in a 401(k) plan *if offered the chance*. For example, data from 1993 suggest that 44 percent of workers earning between \$10,000 and \$15,000 in 1993 (which corresponds to between \$14,000 and \$20,000 in 2000) who were offered the opportunity to participate in a 401(k) chose to do so.[32] Unfortunately, only 21 percent were offered the opportunity, so that the overall participation rate was only 9 percent (see Table 6).

Other data sources tell a similar story: The *conditional* participation rate (that is, the participation rate among those workers who are offered the opportunity to save through a 401(k) plan) is surprisingly high, even for lower-income workers. To be sure, those offered the opportunity to participate in a 401(k) plan may be different (in terms of their propensity to save) from the rest of the population.[33] But our intepretation of the evidence still is that *offering low- and moderate-income workers the opportunity to participate in a matched saving program may be particularly important in encouraging a significant share of them to save.*[34] The evidence from

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[32] It is worth noting that these figures are for earnings, not household income. Some lower-income workers may be from relatively high-income families.

[33] This issue is the subject of heated debate. See, for example, Poterba, Venti, and Wise (1995). For an opposing view, see Engen, Gale, and Scholz (1996).

[34] *The relatively low level of participation in IRAs, relative to the conditional 401(k) participation rate, may highlight four important factors in encouraging saving: a positive matching rate, financial education in the workplace (firms often offer such education in conjunction with their 401(k) plans), peer effects, and the role of the non-discrimination rules (which tie maximum contribution rates for higher-income workers to those undertaken by lower-income workers). The evidence on the impact of matching contributions in 401(k) plans is actually somewhat mixed, although we believe that the balance of the evidence suggests that higher matching rates do induce higher rates of participation and contributions. Some researchers find that higher 401(k) match rates induce higher rates of employee contributions; other researchers do not find such an effect. For example, Poterba, Venti, and Wise (1994) find evidence of higher participation rates when employers match contributions and of higher contribution rates at higher match rates. Kusko, Wilcox, and Poterba (1994), however, find little impact of matching in one large employer. The fact that the Kusko, Poterba, and Wilcox study was limited to one employer may limit its general applicability.*

401(k) plans, furthermore, suggests that once someone starts to save, he or she continues to do so: Participation is persistent.[35]

Table 6: Conditional Participation Rates in 401(k) Plans

Implied 2000 earnings*	Number of workers in 1993 (thousands)	Percent offered a 401(k)	Percent offered who choose to contribute
Under $14,000	15,061	10%	30%
$14,000-$20,000	13,617	21%	44%
$20,000-$28,000	12,257	35%	55%
$28,000-$35,000	10,056	43%	64%

* Scales 1993 earnings levels by the percentage change in the Social Security average wage index between 1993 and 2000. Source: 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 C7.

A progressive government matching formula – one that provides relatively larger matches to lower-income workers than higher-income workers – could thus be particularly beneficial for at least two (potentially related) reasons: First, the tax treatment of pension contributions naturally creates an implicit *regressive* government matching formula. For every $1 that a taxpayer in the 39.6 percent marginal tax bracket contributes to a tax-preferred pension, for example, the taxpayer receive a 39.6 cent tax benefit. A taxpayer in the 15 percent marginal tax bracket, however, receives only a 15 cent tax benefit for the same $1 contribution. To offset the regressivity of the implicit match provided by the tax code, the explicit government match should be *progressive.* Second, although the conditional participation rate for lower-income workers offered 401(k) plans is higher than many analysts may have suspected, it is substantially lower than that for higher-income workers. To encourage lower-income workers to participate at higher rates may therefore require a more aggressive matching formula for the lower-income workers. (Some of the lower conditional participation rates among lower-income workers may be explained by their smaller implicit government match through the tax code. It likely also reflects the large share of available disposable income that must be devoted to necessities, and therefore a fundamental difficulty in saving, among some lower-income families.)

Several variants of a progressive government matching contribution have been proposed. In its FY 2000 proposals, for example, the Clinton Administration proposed using part of the projected budget surpluses for Universal Savings Accounts (or USAs). The USAs would have provided progressive, refundable tax credits to match the contributions that individuals would make to savings accounts for retirement. The USA proposal would also have provided an automatic contribution on behalf of workers, to ensure high participation among lower-income workers. In its FY 2001 budget, the Clinton Administration put forward a modified and substantially scaled-back proposal, which would create Retirement Savings Accounts. The RSA proposal is much more modest than the earlier USA version (for example, the RSA proposal does not include the automatic contributions).

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35 See, for example, Papke, Petersen, and Poterba (1996).

The RSA plan included two types of matching contributions: First, an individual would receive a two-to-one match on the first $100 deposited. Thus, an individual contributing $100 to an RSA would have that matched with $200 from the Treasury, bringing the total to $300. (This match would phase down as the family's income increased and would phase out completely for families with incomes of more than $80,000.) Second, an individual would receive a one-to-one match on the next $900 deposited. Thus, for amounts contributed between $100 and $1,000, the depositor would receive a dollar-for-dollar match from the Treasury. An individual putting in an additional $300 (above the first $100) thus would receive a $300 match for that part of his or her contribution. (Again, this match would phase down as income rose, and would be completely phased out for families with incomes exceeding $80,000.)

To be sure, the RSA plan involves complicated administrative arrangements and adds yet another retirement savings vehicle to an already confusing mix of existing plans. Nonetheless, the benefits of the progressive matching formula appear to be worth the costs of additional administrative complexity (which, it should be noted, are unlikely to be more substantial than in the rest of the voluntary pension system), and some variant of this general approach is worth serious consideration.

B. Making it easier to save

The evidence suggests that whether workers must affirmatively indicate they want to participate, or whether they can be automatically enrolled in a pension plan (unless they object), significantly affects participation rates. In particular, participation is significantly higher if workers are enrolled in a savings plan unless they specifically opt out of the plan, relative to the participation rate if workers are *not* enrolled in the plan unless they specifically opt in.

For example, one recent study examined 401(k) savings behavior of employees in a large U.S. corporation before and after changes to the 401(k) plan. Before the plan change, the employees had to elect to participate in the 401(k); after the change, employees were automatically enrolled unless they specifically requested to opt out. Given that none of the economic features of the plan changed, the purely "rational" model of economic behavior would suggest that the change would have no effect on 401(k) savings behavior. Contrary to the predictions of the model, however, the study found that 401(k) participation increased dramatically once automatic enrollment went into effect. It also found that the change affected not only participation, but also the amount people chose to contribute. The authors conclude their results suggest that "changes in savings behavior can be motivated simply by the 'power of suggestion.'"[36]

The Internal Revenue Service has recently extended automatic enrollment options to a wider array of defined contribution plans.[37] In addition, several recent proposals have involved a "payroll deduction" IRA, which would facilitate easier participation in IRAs. Under current law, individuals who contribute to an individual retirement account (IRA) typically do so by depositing funds into the IRA and then claiming a deduction on their income tax form. Under

[36] Madrian and Shea (2000).

[37] See IRS Announcement 2000-60 (July 14, 2000), and Jeannine Aversa, "Treasury Chief Hopes New Rules Will Boost Retirement Savings," The Associated Press, Wednesday, July 19, 2000.

the proposal, employers could withhold requested amounts from the employee's paycheck for deposit into the employee's IRA, and then exclude such amounts from the employee's income for income tax purposes. In other words, amounts of up to $2,000 made to an IRA through such payroll deductions could be excluded from an employee's income so that the worker would not have to claim a deduction for the deposit. The evidence suggests that such reforms may help to bolster retirement savings.

C. Financial Education

Financial education appears to be extremely effective in bolstering private retirement saving and elective pension contributions. Unfortunately, financial literacy is surprisingly low in the United States. As just one example of the "education gap," a 1998 Employee Benefit Research Institute (EBRI) survey concluded that only 45 percent of workers have even attempted to figure out how much they will need to save for their retirement. Other surveys have found that only half of Americans know the difference between a stock and a bond, only 12 percent know the different between a load and no-load mutual fund, and only 16 percent understand the details of an Individual Retirement Account (IRA).[38]

The evidence suggests that the impact of employer-provided financial education on lower-income workers is *greater* than on higher-income workers. This result may not be surprising, since higher-income workers tend to be more financially sophisticated to begin with, and therefore the employer-provided education does not benefit them as much as lower-income workers.[39]

Several recent efforts to promote financial education may help to reduce this financial education gap. Expanded financial education campaigns and more encouragement to firms to provide financial education in the workplace may prove to be beneficial in raising retirement security for lower- and moderate-income workers.

D. Defined contribution pension plans and the asset tests in means-tested benefit programs

Another area related to pension policy that warrants examination is the treatment of pensions under the asset tests that means-tested government benefit programs employ. The basic rules governing the treatment of pensions under the asset tests used in the food stamp program, Medicaid, and the Supplemental Security Income program were established in the 1970s. Federal policymakers have since given them little attention, and significant problems have arisen as a result.

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[38] Levitt (1998).

[39] Bernheim and Garrett (1996) find that the effect of firm-provided education on raising total saving is stronger at the 25th percentile of workers than at the 75th percentile. They also find that education has a smaller absolute effect, but a larger proportional effect, on 401(k) balances for those at the 25th percentile of workers than those higher in the income distribution. They conclude that "the effects of education are particularly pronounced among those least inclined to save..." Bayer, Bernheim, and Scholz (1996) also find that firm-provided seminars stimulate 401(k) participation, and that the effect is larger for non-highly compensated employees than for highly compensated employees.

To be eligible for Supplemental Security Income, Medicaid, or food stamp benefits, applicants generally must meet an asset test as well as an income test. The asset tests are stringent. For example, the food stamp asset limit for the non-elderly is $2,000; for the elderly, the limit is $3,000. In SSI, the limits are $2,000 for a single individual and $3,000 for a couple. The limits in both programs are not indexed to inflation, and have not been adjusted for more than a decade.

Some resources are excluded from these asset tests, including an individual's home, household goods, and an automobile (although in the case of food stamps, only up to $4,650 of the market value of a car is excluded), as well as assets that are not accessible.[40] Other assets count, including retirement accounts that can be cashed in prior to retirement (even if there is a penalty for early withdrawal).

Because defined benefit pension funds are *not* accessible, while withdrawals can be made from many defined contribution plans, low-income workers whose employers offer a defined contribution plan are often disadvantaged relative to those whose employer provides a defined benefit plan. Low-income workers who participate in defined contribution plans generally must withdraw most or all of the balance in their accounts (regardless of early withdrawal penalties or other tax consequences) and spend those assets down, before they can qualify for means-tested programs such as Medicaid and food stamps.[41] Similarly, poor elderly and disabled people who otherwise would qualify for SSI are required to consume upfront nearly all of the funds they have accumulated in a defined contribution plan, leaving little for their remaining years, before they can receive SSI benefits. By contrast, benefits that a worker or retiree has accrued in a defined benefit pension plan are not considered an asset. (The monthly income provided by the defined benefit plan is counted as part of an individual's income when the individual retires and begins to receive this income.)

When these features of federal law and regulations were crafted in the 1970s, far fewer employers offered defined contribution retirement plans than do today. As the number of low-income workers with defined contribution plans grows, an increasing number will stand to lose means-tested benefits if the balances in these accounts are counted as assets.[42] Moreover, workers with defined contribution pensions who experience temporary periods of need, such as during a recession, will be forced to liquidate their accounts (and also pay early withdrawal penalties) to be eligible for food stamps or Medicaid during the economic downturn. Some workers who are hard-pressed during an economic downturn, and who withdraw most of the accumulated funds in their retirement accounts to qualify for means-tested assistance, could then reach retirement with little left in their accounts.

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40 Under legislation enacted in October 2000, states will be given the option of conforming the limit on the value of an automobile a food stamp household may own to the limit used in the state's Temporary Assistance to Needy Families program, so long as that limit is not more restrictive than the federal food stamp limit.

41 Technically, in Medicaid, states can address this problem by excluding amounts in defined contribution accounts, using the authority of sections 1902(r) and 1931 of the Medicaid statute to do so. These authorities, however, are not well understood by states. We are not aware of any state with an asset test in its Medicaid program that has acted to exclude defined contribution plans.

42 Between 1984 and 1991, for example, the share of families with earnings between $10,000 and $20,000 (in 1991 dollars) who participated in a 401(k) rose from 3.3 percent to 13.9 percent. See Engen and Gale (2000), Table 1.

Forcing low-income workers and retirees to deplete their savings before they can access means-tested benefits runs counter to efforts to encourage low-income workers to save for retirement, efforts that may become particularly important if Social Security benefits ultimately are reduced to help restore long-term solvency in that program. Federal policies should promote the growth of personal retirement savings, not provide low-earners a disincentive to save.

Therefore, reforms in this area merit consideration. Under current law, if an individual (whether working or retired) withdraws funds from a tax-deferred retirement account, the amounts withdrawn are counted as income. That is as it should be. But policymakers should also exclude amounts remaining within the pension from the asset tests used for means-tested program eligibility purposes, regardless of whether the plan is a defined benefit plan or a defined contribution plan. Whether a worker is entitled to a means-tested benefit should not depend on whether the worker has a defined benefit or defined contribution pension plan.

Section V: The Portman-Cardin approach

In July 2000, the House of Representatives passed pension legislation (H.R. 4843) that was very similar to legislation that House Reps. Bob Portman and Ben Cardin introduced last year (H.R. 1102). Similar legislation passed the Senate in September 2000. The legislation did not become law in 2000, but it is likely that it will in 2001, perhaps with modest modifications.

The legislation 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, many of 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 7). 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 similar to those in the most recent legislation were among the provisions cited as unacceptable by President Clinton when he vetoed the large tax bill that Congress approved in 1999. In addition, 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...and could lead to reductions in retirement benefits for moderate- and lower-income workers."

The legislation the House passed 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.

Table 7: Effects of the Comprehensive Retirement Security and Pension Reform Act

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.

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

The legislation the House passed in July 2000 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.)

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 House legislation would reduce the maximum vesting period for 401(k) plans to three years, a useful change for some workers. 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.

But while the bill's 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 very generous 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. No credible empirical evidence supports this theory, however, 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 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. (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.) 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.[43] 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

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

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 IRA. Comparable data are not yet available for Roth IRAs, which did not exist in 1995, but the results are likely to be similar.[44]

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.[45] 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."[46] 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. A large share of such taxpayers are likely to be higher earners who are not covered by an employer-provided pension and are therefore eligible for making contributions to conventional IRAs regardless of their income. (The income limits on eligibility do not apply to those who are not covered by an employer-provided pension.) 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. 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

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44 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.

45 Carroll (2000).

46 Carroll (2000), page 7.

consider in determining benefits under a *defined benefit* 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 Non-discrimination Rules. Under current law, tax-preferred pension plans must not discriminate in favor of highly compensated employees. For example, pension plans are not generally allowed to use a more liberal formula in figuring employer pension contributions for high-income executives than other employees (as discussed above, there are loopholes in the rules). The non-discrimination 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 non-discrimination 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 significantly weaken 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" 401(k) plans, which are not subject to the nondiscrimination rules because of specific features of these plans. [47]

Proponents of relaxing the top-heavy protections charge that the current rules impose large administrative burdens on pension plans, especially in small businesses, and thus contribute to low rates of pension coverage among workers in such businesses. A new report from the

[47] 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.

General Accounting Office (GAO), however, challenges these assertions. 48 It finds that the top-heavy rules generally do not involve substantial administrative costs and that the rules may be important in ensuring a more equitable division of the tax benefits from pensions than would otherwise be the case.

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.

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.) 49

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 be much more important than a 401(k) plan. 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. 50

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

48General Accounting Office (2000b).

49 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.

50 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. General Accounting Office (1996).

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 exclude employee contributions from this 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.

As one example, note that the effects of the IRA provisions 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 the Assistant Secretary of 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. (Indeed, if the owner's income were above the limits for eligibility for IRAs, the only way in which the owner could become eligible for a traditional IRA is if the owner was not covered by an employer-provided plan. The income limits for eligibility do not apply if the owner is not covered by a pension.) 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." [51]

51 Lubick (1999).

As another 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 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).

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.

As noted above, most of these provisions are drawn from the Portman-Cardin pension legislation. In analyzing the effects of that legislation, Stein (1999) 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."

Section VI: Conclusions

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 legislation moving through Congress would accrue instead to higher-income workers who already enjoy high rates of pension coverage. Some 76.9 percent of the bill's 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 would likely 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.

A much more auspicious approach to bolstering retirement security would include providing some sort of progressive government matching contribution for employee contributions, as in the Clinton Administration's proposed Retirement Savings Account plan; making it easier to save;

and providing financial education in the workplace about the benefits of saving. In addition, some of the beneficial provisions included in the Portman-Cardin legislation – such as making it easier to roll over account balances from one type of pension to another – could be adopted. Changing the treatment of defined contribution pension plans under the asset tests used in means-tested government benefit programs, as described above, would also be worthwhile.

The benefits of such a progressive approach to retirement security include a much higher likelihood of adding to national saving, reducing elderly poverty, and improving the distribution of retirement tax subsidies. For both efficiency and equity reasons, this progressive package thus is much more attractive than the legislation moving through Congress.

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