Joint Economic Committee Democrats

Representative Pete Stark (D-CA) – Ranking Member

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Why The Pension Preservation and Savings Expansion Act of 2003 Fails to Live Up to Its Name

Executive Summary

The Pension Preservation and Savings Expansion Act of 2003 makes a number of costly changes to the current employer-sponsored pension system and individual retirement saving arrangements that would provide significant benefits to those who least need help in preparing for retirement, while doing little to meet the retirement income security needs of most workers and retirees. In particular, the bill would accelerate to 2003 and make permanent scheduled increases in 401(k) and IRA contribution limits, raise the income limits for tax deductible and Roth IRA contributions, and raise the age at which workers must begin withdrawing assets from retirement accounts. The bill would also change funding rules for defined benefit pension plans, allowing sponsors to contribute less money to plans that are in many cases already dangerously underfunded.

Taken together the legislation would:

- Cost $100 billion over ten years, diverting resources from more pressing needs, and impose significant budgetary costs beyond the 10-year budget window by making permanent the savings and pension provisions of the 2001 Tax Act.
- Provide significant tax subsidies to higher-income workers and retirees who already are accumulating sufficient resources for a comfortable retirement.
- Do little to increase pension coverage or retirement saving among low- and moderate-income workers who are most at risk of having inadequate resources for retirement.
- Put retirement benefits for many workers at risk by weakening funding rules for defined benefit plans.

Committing additional tax revenues to subsidize pensions and retirement saving for a relatively few well-off workers should not be a priority in today's budget environment. There are far more pressing shortcomings in private and public retirement income security arrangements if Congress chooses to devote more resources to these issues. New subsidies would be better used to support improvements that help the majority of workers, particularly those at most financial risk, either by encouraging additional saving among those groups or by strengthening Social Security and enhancing benefits for low- and moderate-income workers. Devoting an additional $100 billion over the next ten years and even more resources in subsequent decades to preserving and strengthening Social Security would do more to ensure the retirement income security of millions of Americans than the proposals in this bill.

Specific Problems With the Proposal

The Pension Preservation and Savings Expansion Act of 2003 would make a number of major changes to the rules governing employer-sponsored pensions and individual retirement saving arrangements. This analysis does not consider all aspects of the bill, but rather focuses on four key problems with the legislation.

Worsens the Short- and Long-Term Federal Budget Outlook

The federal budget situation has deteriorated enormously since President Bush took office in January 2001. At that time, the Congressional Budget Office (CBO) projected a 10-year budget surplus of over $5.6 trillion in fiscal years 2002 through 2011. In its latest projection, the CBO now anticipates a $378 billion deficit over the same 10 years. Those estimates are before consideration of current budget proposals including the additional spending needed to pay for the war and reconstruction in Iraq. The President's 2004 budget, which does not include paying for the cost of war and rebuilding, would increase the deficit in fiscal years 2002 through 2011 to $2.1 trillion. This is a stunning turnaround of $7.7 trillion in just two short years.

The budget situation would be even worse if not for the expected surpluses from the Social Security program. The CBO projects that Social Security revenues will exceed program outlays by $2.2 trillion over the 10 years 2002 through 2011. The deficit in the rest of the federal budget will more than consume the entire Social Security surplus. The 10-year on-budget deficit—which excludes the off-budget transactions of Social Security and the Postal Service—will reach $2.6 trillion in fiscal years 2002 through 2011. The President's 2004 budget would increase the 10-year on-budget deficit over the same period to $4.3 trillion.

The $4.3 trillion 10-year on-budget deficit is just the tip of the iceberg. When the country reaches 2011 it will face the added fiscal pressure of supporting a large and growing population of retirees. Faced with these budget realities, it is unclear why Congress should add an additional $100 billion to the 10-year deficit and even larger amounts in the future for tax subsides that benefit relatively few workers and retirees.

Federal Reserve Chairman Alan Greenspan and many others have emphasized the need to establish a stable and sustainable course for the federal government's fiscal policies over the long-term. This requires balancing tax cuts against the clear and imminent costs of supporting the health and retirement income needs of an expanding elderly population, and meeting pressing needs for additional spending on education, national defense, and homeland security. Congress should take a hard look at whether the country can afford to maintain the tax cuts enacted in 2001, rather than accelerating and making permanent selected parts of the 2001 Tax Act in a piecemeal fashion.

Provides Tax Subsidies for the Wealthiest

The more costly provisions of the legislation provide additional tax subsidies to workers who already are accumulating substantial assets for retirement, while doing little to help insure the retirement security of the majority of rank and file workers. These provisions include the increases in contributions limits for IRAs and pensions, an increase in the income limits for deductible and Roth IRAs, and an increase in the minimum age for required distributions from pension accounts.

Accelerate and make permanent increases in 401(k) and IRA contribution limits: Under current law workers can contribute up to $3,000 to an individual retirement account and up to $12,000 to an employer-sponsored deferred compensation plan such as a 401(k) plan. In addition to those contributions, workers age 50 and over can make additional catch-up contributions of up to $500 to an IRA and $2,000 to a 401(k) plan. The contribution limits for both regular and catch-up

contributions are scheduled to increase over the next 3-5 years. When fully in place, the contribution limits will be $5,000 for IRAs and $15,000 for 401(k)'s and similar plans. The limit for catch-up contributions will be $1,000 for IRAs and $5,000 for pensions. At the higher limits, a couple in which both spouses are age 50 or over could contribute a combined $40,000 to a 401(k) or similar pension plan and an additional $12,000 to their IRAs.

The Pension Preservation and Saving Expansion Act of 2003 would make the scheduled increases in the contribution limits fully effective in 2004. The benefits do not justify the cost for the following reasons.

Few workers would benefit. Raising the contribution limits would only help those already at the maximum. Few workers currently contribute the maximum amount. Estimates by the Treasury Department, the General Account Office (GAO), and independent researchers suggest that at most about 5 percent of eligible workers contribute the maximum amount to deductible IRAs. About the same percentage of eligible workers contribute the maximum to their 401(k) plans. [1]

Most of the benefits would go to high earners. Not surprisingly, workers who do make the maximum contribution tend to be high earners. The GAO found that only 4 percent of participants in defined contribution pension plan with earnings of $40,000 or less would benefit from an increase in the contribution limits while 58 percent of participants with incomes of $150,000 or more would benefit from the same change.

Likely to decrease rather than increase national saving. The whole point of providing tax subsidies to pensions and retirement saving is to encourage workers to save for retirement who otherwise would not do so on their own. Yet workers contributing the maximum amount to IRAs and pensions tend to have substantial amounts of other assets, including assets in taxable accounts. Increasing contribution limits to IRA and 401(k) plans would encourage contributors at the maximum to shift assets from taxable to non-taxable accounts.

The net effect would be to reduce national saving. National saving is the sum of public and private saving. Public saving would decline because of the increase in federal deficits. Private saving would not increase at all, if all IRA and 401(k) contributions above the current limits came from existing assets, or go up by a small amount if there is some new saving because of the increased limits. In either case, there would not be enough new private saving to offset the decline in public saving. Less national saving eventually translates into less national income, leaving the economy in worse shape to support a growing retired population.

Raise the income limits for tax deductible IRA and Roth IRA contributions for married couples: Under current law workers with incomes above certain limits cannot make tax-deductible contributions to a traditional IRA (although they can make non-deductible contributions and still receive some of the tax benefits) or to a Roth IRA. The income limits do not apply if neither spouse is covered by an employer-sponsored plan. If a married worker is covered by an employer-sponsored plan, then he or she cannot make deductible IRA contributions if the couple's income exceeds $70,000. If a married worker is not covered by an employer-sponsored plan but his or her spouse is covered, then he or she cannot make deductible contributions if the couple's income is greater than $160,000.

The income limits for a Roth IRA are different. Married couples filing joint returns cannot make Roth IRA contributions if their combined income exceeds $160,000.

The income limits for deductible contributions are scheduled to increase over the next few years. The proposed legislation would further raise the income limits for married couples for both deductible and Roth IRAs. The bill would eliminate the income limit for contributions by a non-covered spouse

even if the other spouse participated in a qualified pension plan.

These changes would have no impact on married couples with incomes below the current limits. Thus, in the case of Roth IRAs, only couples with incomes of $160,000 would benefit fully from this change. Again, this will encourage high-income workers to shift assets from taxable accounts to tax-advantaged retirement saving.

Raise the age at which workers must withdraw assets from retirement accounts: Workers cannot retain assets in traditional IRAs or 401(k) accounts indefinitely. In most cases workers must begin withdrawals at age 70 ½. Workers still employed at age 70 ½ can delay withdrawals from an employer-sponsored plan, but not a traditional IRA, until the year after they stop working. There is no required distribution age for Roth IRAs. Failure to comply with the minimum distribution rules results in a 50 percent excess tax on the amount that should have been distributed.

The proposed legislation would increase the required distribution age to 75. It would reduce the excess tax for failing to comply with the distribution rules to 20 percent.

The purpose of having a required distribution age is to ensure that tax favored retirement accounts are used for their intended purpose—to enable retirees to accumulate assets for their retirement—and not as a permanent tax shelter or a way of accumulating assets to leave as a bequest.

Raising the required distribution age would undermine that purpose. Supporters of the legislation argue that an increase is warranted because of increased life expectancy for retirees. Though life expectancy has increased since the time that the minimum age was established, the typical age of retirement has not. More than half of all workers retire by age 63, and most retire by age 65. Those who continue to work past age 70 are not required to tap into their accounts held in employer-sponsored plans.

Raising the required distribution age would benefit those fortunate few retirees who have sufficient other resources to support themselves in retirement and are able to continue to reap the tax advantages of their retirement saving accounts.

Does Little to Increase Pension Coverage and Retirement Saving for Most Workers

Only about half of all workers in the private sector participate in an employer sponsored pension plan at any point in time. Low and moderate-earnings workers are much less likely than high earners to participate in a plan. For example, among prime age workers in the private sector, the pension coverage rate in 2001 was about 70 percent for both men and women earnings $52,000 or more, but less than 20 percent for workers with annual earnings of $15,000 or less.[2] Certain provisions in the bill aimed at increasing pension coverage and retirement savings among lower income workers are not likely to have much effect.

Increase contribution limits for SIMPLE plans: Lack of coverage is associated with a number of factors, but one of the key factors is working for a small firm. Recent pension legislation has introduced a number of measures intended to increase pension coverage in small firms. Generally, that legislation has made it easier for small employers to take advantage of tax subsidies for retirement saving. Because the use of those incentives for the benefit of the employer is tied to providing coverage for their employees, the trickle down effect would be an increase in coverage among employees in small firms.

The proposed legislation would enhance and make permanent certain incentives for small employers to create and contribute to saving incentive match plans for employees (SIMPLE plans). There is no evidence that these incentives have created the trickle down increases in coverage and account accumulations for employees of small firms. Congress should evaluate the effect of provisions

already in place before extending and making them permanent.

Extend and make permanent the saver's credit: Rather than providing incentives for employers to extend pension coverage to more workers, a more successful strategy for increasing retirement income security may be to encourage workers to save on their own either through individual arrangements or an employer-sponsored plan.

The saver's credit enacted in the 2001 Tax Act is one such incentive. The credit equals 50 percent credit of qualified contributions to an IRA or a defined contribution pension plan such as a 401(k). The credit rate phases down for taxpayers with higher income. No credit is available to married couples with income in excess of $50,000 or to single filers with incomes in excess of $25,000. The saver's credit is scheduled to expire after 2006.

The proposed legislation would permanently extend the saver's credit, increase the maximum credit rate to 55 percent, and extend the income eligibility limits to $60,000 for married couples and $30,000 for single filers.

The saver's credit is estimated to cost $9 billion over the 5 years 2002-2006. Permanently extending the credit with the proposed modifications would add at least $10 billion to the 10-year cost of the credit.

The saver's credit has a number of problems. Because it is not refundable, families with little or no income tax liability cannot benefit from the credit. This includes working families who pay payroll taxes. Second, because the credit does not phased down at a smooth rate, it creates substantial penalties for small amounts of additional earnings at certain earning amounts. For example, a married couple with combined earnings of $30,000 and combined IRA contributions of $2,000 qualifies for a $1,000 credit. A small amount of additional earnings that pushes the couple's income above $30,000 would reduce their credit to $400.

The lack of refundability is a particular problem for families with children because the saver's credit applies after the child tax credit. As a result, a married couple with two children would not qualify for any credit in 2004 unless their income was at least $32,600, and not more than $50,000. At that level of income, the value of the credit is small—$100 for every $1,000 in qualified IRA contributions. The child credit is $600 per child in 2004, and is scheduled to rise to $1,000 by 2010. A higher child credit obviously helps families with children, but will wipe out any benefit from the saver's credit for many more families. If the child credit was $1,000 per child in 2004, a married couple with two children would qualify for the current saver's credit only if their income was at least $37,900 and not more than $50,000.

The proposed legislation partially addresses the problem of the sharp drop off in the amount of the credit as income rises, but still leaves major discontinuities. Making the credit refundable and smoothing the phase down of the credit rates would greatly improve the credit.

Weakens Funding Rules for Defined Benefit Pension Plans

The legislation would change funding rules for defined benefit plans, allowing plan sponsors to set aside less pension money each year to meet future benefit obligations.

Specifically, it would allow businesses with "blue-collar" workers to use a different set of mortality projections for future retirees that build in a shorter expected lifetime for retirees from blue-collar occupations. The practical effect of this change is that companies that employ blue-collar workers could project to pay retirement benefits to each of its retirees for fewer years, and thus need to set aside less money today to meet those obligations.

Second, the legislation would allow firms to calculate the cost of future pension obligations using the interest rate on long-term corporate bonds. In

the past, plan sponsors calculated the cost of future pension payments using the interest rate on 30-year Treasury securities, which generally are lower than the rate on long-term corporate bonds. Using the higher corporate bond rate, sponsors will need to set aside less money today to meet future benefit payments. Because the Treasury no longer issues 30-year bonds, there is a need for a permanent replacement benchmark rate. For the past two years, sponsors have used an interim replacement for the rate on 30-year Treasury bonds.

A reduction in required contributions increases the risk of plan defaults in plans that are already underfunded, putting more retiree pensions in jeopardy. The Pension Benefit Guaranty Corporation (PBGC) estimates that private sector defined benefit plans are currently underfunded by over $300 billion. Implementing the pension funding provisions in the proposed legislation would exacerbate the current serious underfunding problem.

It is not clear that the long-term corporate bond rate is the appropriate rate to use to determine funding levels. For example, plans with many older workers face higher obligations that are only a few years away. It would be more appropriate for these plans to use the rates on short-term securities to calculate the cost of those obligations. Because rates on short-term securities generally are lower than long-term rates, those sponsors would need to set aside more money today to meet benefit obligations in the near future.

Congress should take steps to ensure adequate funding of defined benefit pension plans before deciding on a permanent replacement rate for the 30-year Treasury rate. In recent Congressional testimony, Steven Kandarian, Executive Director of the Pension Benefit Guaranty Corporation noted that using a long-term corporate bond rate in place of the interest rate on 30-year Treasury obligations "would allow plan funding to fall below the already low levels permitted under current law."[3] In testimony at the same hearing, Peter Fisher, Treasury Undersecretary for Domestic Finance, advised Congress to consider broader issues in determining the appropriate funding level before selecting a permanent replacement rate for the 30-year Treasury rate.[4] Both Treasury and PBCG supported extending the current interim funding rules for two additional years to allow adequate time to develop a permanent replacement measure for the 30-year Treasury rate.

Congress should also avoid making changes in mortality assumptions without further study. The implementation of a "blue-collar' adjustment to mortality projects has a number of problems and could put benefits of blue collar workers at serious risk if it causes sponsors to underfund their plans. Edwin C. Hustead, the chairman of the actuarial panel that developed the new mortality tables, said that he was concerned that the data were being used in an improper way. In a letter to the Treasury he said "I do not agree that the tables should adjust for differences in mortality for blue-collar and white-collar employees."[5]

Conclusion

The Pension Preservation and Savings Expansion Act of 2003 does introduce some positive changes in current pension policies that would increase the portability of retirement savings when workers change jobs, provide better access to retirement planning information, and encourage retirees to annuitize a portion of their retirement savings so that they do not outlive their retirement resources. However, these improvements are greatly overshadowed by the bill's negative features. It contains several costly provisions that benefit only high-income earners, diverting scarce government resources from more pressing priorities. It does little to secure and improve the retirement income security of most workers.

More fundamentally, any new spending on retirement income security should be considered in a broader context. Most workers depend on the Social Security program for a substantial portion

of their retirement income. Currently, 90 percent of people ages 65 or older receive some payment from Social Security. About two-thirds (64 percent) of aged Social Security beneficiaries receive at least half of their income from Social Security. For about 20 percent, Social Security is the only source of income.

Social Security coverage is nearly universal. Workers do not need to worry about losing coverage when they change jobs. Social Security provides a defined retirement benefit that is not subject to the vagaries of the stock market. Monthly payments are a fixed amount, indexed to keep pace with increases in consumer prices, and last as long as the beneficiary or his or her survivor lives.

The Social Security program faces a long-run deficit. The most recent Trustee's report estimates that over the next 75 years the deficit in the combined retirement and disability programs will be about .7 percent of GDP. Devoting the revenues that this legislation would cost over the coming decades to preserving and strengthening Social Security would do more to ensure the retirement income security of millions of Americans than the proposals in this bill.

Endnotes

[1] See Donald Kiefer, Robert Carroll, Janet Holtzblatt, Allan 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*, Vol. LV, No. 3, September 2002; Paul Smith, "A Longer Term Perspective on IRA Participation: Evidence From A Panel of Tax Returns." U.S. Department of Treasury, Office of Tax Analysis, January 2001; David Richardson and David Joulfaian, " Who Takes Advantage of Tax-Deferred Saving Programs? Evidence for Federal Income Tax Data." *National Tax Journal*, Vol. LIV, No. 3, September 2001; General Accounting Office, "Private Pensions: Issues of coverage and Increasing contribution Limits for Defined Contribution Plans." GAO-01-846, September 2001; and Craig Copeland, "IRA Assets and Characteristics of IRA Owners." EBRI Notes, December 2002.

[2] JEC tabulations from the U.S. Bureau of the Census, Current Population Survey, March 2002.

[3] Statement of The Honorable Steven A. Kandarian, Executive Director, Pension Benefit Guaranty Corporation. Testimony before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means, April 30, 2003.

[4] Statement of The Honorable Peter fisher, Undersecretary for domestic Finance, U.S. Department of the Treasury. Testimony before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means, April 30, 2003.

[5] The New York Times, "House Considers Measure to Cut Billions in Pension Obligations", May 6, 2003.

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