For future retirement income, the Tax Reform Act raises more questions than it answers.

Long-Term Effects of Tax Reform on Retirement Income: Many Unanswered Questions

The specific changes wrought by tax reform, when coupled with the reduction in marginal tax rates, will alter the future attractiveness of pension contributions compared to straight wage and salary payments, but to what degree remains uncertain, depending on how employers and employees react.

On balance, certain tax reform changes will increase retirement income, whereas other provisions in the same law will reduce it. The full impact of these changes can be expected to phase in over a worker's career, since pensions represent a long-term commitment by the employer to employees. According to simulations from EBRI's Pension Retirement Income Simulation Model (PRISM), pension recipiency for baby boom retirees (those age 30 to 39 in 1985) is strengthened by shortening the time required to guarantee pension benefits (vesting) to five years and by penalizing distributions of preretirement lump sums before age 59 1/2. EBRI simulations show these changes increasing total pension recipiency to nearly 74 percent for married men and to nearly 56 percent for married women. Unmarried men and women also make considerable recipiency gains.

In contrast, the gradual elimination of the ability to pay taxes on lump-sum distributions at one-tenth of the marginal rate (10-year forward averaging) and changes in the treatment of retirement benefits from after-tax employee contributions (repeal of the 3-year basis recovery rule) are expected to reduce retirement income, at least in the short run.

Provisions affecting 401(k) plans, IRA deductibility, and limits on the maximum amounts of compensation used to determine benefits were intended to affect relatively few individuals—generally high-income employees and executives. Changes in coverage, participation, and integration requirements are likely to affect small businesses in particular. But the long-term question is whether the new restrictions will improve the "equity" of these plans or will cause plan terminations and a decrease in retirement saving and coverage.
Introduction

The 1986 Tax Reform Act (TRAC) contains a host of provisions directly affecting employer-sponsored pension plans. Some of these provisions are slated to increase federal revenues and, as such, are part of the base-broadening component of tax reform. Other pension provisions have little revenue impact and were included to enhance the "equity" of the pension system.

The Employee Benefit Research Institute (EBRI) has tracked many of the proposals leading up to tax reform. Most recently, EBRI reviewed TRAC's employee benefit provisions following its enactment (EBRI Issue Brief, October 1986). This Issue Brief investigates the extent to which specific tax reform provisions may alter future pension income. Some provisions lend themselves to extensive quantitative analysis while others are harder to evaluate. Not every aspect of tax reform is considered. Nonetheless, the analysis seeks to measure the impact of this legislation on employees and on future retirement income. To date, the revenue-raising effects of the legislation have been the primary focus of analysis.

Eighty-six percent of participants in large and medium firms with defined benefit plans now have 10-year cliff vesting. Most plans will have to shorten their vesting schedules to comply with the law.

This Issue Brief discusses the provisions of TRAC in five general areas. The first area analyzes those provisions most likely to increase retirement income—five-year vesting and penalties on preretirement distributions. The second area consists of provisions that directly reduce some types of retirement income—the phase out of 10-year forward averaging and the 3-year basis recovery. The third area looks at those provisions that tend to affect high-income employees and executives, and the fourth area evaluates those provisions likely to affect small employers more than large employers. Finally, changes in the personal income tax are considered, including the reduction in marginal income tax rates and certain provisions to broaden the tax base. Changes in all five areas together are anticipated to alter the attractiveness of pension contributions compared to straight wage and salary payments.

Pension Plan Provisions to Increase Retirement Income

Two of the pension provisions found in TRAC were included in separate legislative proposals aimed at increasing the retirement income of future generations of retirees; they did not originally figure in previous tax overhaul proposals to reduce marginal tax rates by broadening the tax base. The first of these retirement income provisions, the reduction of the 1974 Employee Retirement Income Security Act (ERISA) vesting rules to essentially a five-year standard, was part of the proposed Economic Equity Act (S. 1169, H.R. 2472) and the Retirement Income Policy Act (S. 1784, H.R. 3594). This legislation was intended to provide individuals who have relatively few years on any one job with a vested right to a pension at retirement.

The second provision of tax reform likely to increase future retirement benefits is the imposition of a 10 percent penalty tax on lump-sum distributions made before age 59 1/2 (except for distributions of $3,500 or less at the discretion of the employer). This penalty tax can be avoided, however, if distributions made before retirement are rolled over into an individual retirement account (IRA) or another employer's pension plan. Such tax-deferred rollovers have been permitted since ERISA. The proposed Retirement Income Equity Act also suggested penalizing lump-sum distributions to ensure that they would be saved for retirement rather than consumed beforehand. Other exceptions to the penalty tax under tax reform include payments pursuant to the death or disability of the worker, payments as lifetime annuities, payments made after early retirement at the age of 55, payments used to cover certain medical expenses, and payments received from an employee stock ownership plan (ESOP) prior to January 1, 1990. As a practical matter, the ability to roll over lump-sum distributions into an IRA potentially has the broadest applicability.
Five-Year Vesting

TRAC requires faster vesting schedules for private-sector, single-employer plans than those originally specified by ERISA. Two vesting schedules have been approved, and are to be implemented for plan years beginning in 1989. The first schedule requires 100 percent vesting after five years of participation under the plan. The second provides a graded schedule in which a participant must be 20 percent vested after three years of service, with an additional 20 percent for each subsequent year of service, so that 100 percent vesting is achieved after seven years. Observers feel that most plans will adopt the five-year vesting schedule.

Five-year vesting is likely to be more expensive for firms with defined benefit plans than for firms with defined contribution plans.

The nationwide cost of five-year vesting has been estimated at 2 to 7 percent of total private pension plan contributions for the system as a whole, amounting to an increase in contributions of $1.4 billion to $4.7 billion in 1985 (EBRI Issue Brief, February 1986). These added costs could be paid by employers out of profits, by employees out of future wage hikes, or by consumers through higher prices.

The Joint Tax Committee made no specific estimate of the budget effects of the vesting provisions of TRAC in part because of uncertainty about the effects of this provision on plan terminations. Presumably, if five-year vesting is paid for out of profits or out of wages, immediate federal revenues will decrease by the amount of increased contributions times the appropriate marginal tax rate. At a 15 percent individual rate, the government could lose between one-quarter and three-quarters of a billion dollars annually if five-year vesting were paid for by workers out of future wage increases. A significant portion would be regained by the government, however, as workers retire, and pay federal income taxes on their pension income.

Most participants (86 percent) in large and medium firms with defined benefit plans now have 10-year cliff vesting schedules (U.S. Department of Labor, 1986). In other words, benefits in these plans are not vested at all until after 10 years, at which time the benefits are 100 percent vested. All of these plans, with the exception of the multiemployer plans, will have to shorten their vesting schedules in compliance with the law. A relatively small percentage have vesting standards that already meet the provisions under TRAC. Defined contribution plans tend to have faster vesting. For instance, according to Bureau of Labor Statistics' (BLS) data, most savings and thrift plans probably already meet the new standards. Consequently, five-year vesting is likely to be more expensive for firms with defined benefit plans than for firms with defined contribution plans. Since small employers are more likely to have defined contribution plans, they are less likely to incur significant additional costs from this provision. They will, however, be more likely to terminate costly defined benefit plans than will larger employers, who have greater financial resources to meet contribution increases. Firms with many employees in the 5- to 10- year tenure range will also find the change in vesting standards costly. Since job tenure tends to increase with age for most workers, firms with high numbers of "baby boom" workers are most likely to be affected. Some employers may need to redesign their plans and adjust their benefits if cost increases become unduly burdensome.

EBRI projected that in 1985, just under 2 million plan participants would have been added to the ranks of vested workers under five-year vesting (EBRI Issue Brief, February 1986). This would have represented a 7 percent gain in the number of vested male workers and a 10 percent gain in the number of vested female workers. In the absence of a five-year standard, a greater proportion of the estimated number of newly vested women than newly vested men with five-year vesting would probably never become entitled to benefits in their current jobs. Forecasts of retirement income receipt for future generations of workers, presented in the following sections, support this prediction.
Table 1
Future Pension Recipiecy at Age 67 Among the Baby Boom (Age 30-39 in 1985)
Before and After Tax Reform by Type of Benefit and Marital Status

<table>
<thead>
<tr>
<th>Type of Benefit</th>
<th>Married Men</th>
<th>Unmarried Men</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Before reform</td>
<td>After reform</td>
</tr>
<tr>
<td>Defined benefit (DB) plan only</td>
<td>34.9%</td>
<td>32.0%</td>
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<tr>
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<td>12.7%</td>
<td>15.0%</td>
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<tr>
<td>Both DB and DC plans</td>
<td>22.5%</td>
<td>26.7%</td>
</tr>
<tr>
<td>Total reciepy</td>
<td>69.4%</td>
<td>73.8%</td>
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<table>
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<th>Type of Benefit</th>
<th>Married Women</th>
<th>Unmarried Women</th>
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<td></td>
<td>Before reform</td>
<td>After reform</td>
</tr>
<tr>
<td>Defined benefit (DB) plan only</td>
<td>24.4%</td>
<td>25.2%</td>
</tr>
<tr>
<td>Defined contribution (DC) plan only</td>
<td>10.6%</td>
<td>16.8%</td>
</tr>
<tr>
<td>Both DB and DC plans</td>
<td>7.9%</td>
<td>13.7%</td>
</tr>
<tr>
<td>Total reciepy</td>
<td>42.7%</td>
<td>55.7%</td>
</tr>
</tbody>
</table>

Source: Employees Benefit Research Institute tabulations from the Pension and Retirement Income Simulation Model (PRISM) (EBRI, 1986).

Preretirement Distributions

According to Joint Tax Committee estimates, the combination of putting a 10 percent penalty tax on preretirement lump-sum distributions and the modification of the taxation of preretirement distributions that include employee contributions, will increase federal revenues by nearly $1.2 billion over the period from 1987 to 1991. The bulk of the projected increases in revenues stems from the 10 percent tax on preretirement distributions. The Joint Tax Committee assumed that relatively few recipients of preretirement distributions will roll over their money into an IRA.

In 1983, over 6.5 million workers reported receiving a lump-sum distribution at some time before retirement, representing 60 percent of workers who reported they were vested in a previous job (Atkins, 1986). Most reported spending part or all of their cash out instead of saving it for retirement (EBRI Issue Brief, July 1986). Although the majority of these workers received less than $5,000 from their plan distribution, the

1 Other provisions primarily affecting distributions at retirement age are discussed later.
percentage of workers eligible for preretirement distributions in the future is expected to increase as the number of employees participating in defined contribution plans increases. These plans are more likely to distribute fund balances to vested employees who terminate employment with the firm before retirement, instead of providing a pension at retirement age. According to recent estimates (Ippolito, 1986), the percentage of all plan participants covered only by a defined contribution plan grew from 12 percent in 1953 to 13 percent in 1981. This growth is expected to continue with the shift of employment from manufacturing to services. Jobs in the service sector are more likely to be with smaller employers; those small employers providing pensions are more likely to establish defined contribution plans.

Pension recipiency for baby boom retirees (age 30 to 39 in 1985) is strengthened overall by five-year vesting and the penalty on lump-sum distributions.

Five-year vesting will also increase the likelihood of preretirement lump-sum distributions. The 1984 Retirement Equity Act (P.L. 98397) raised the upper limit of vested pension accruals that defined benefit plans may cash out at their own discretion from $1,750 to $3,500. The combination of the increased cash-out limits and shorter vesting under most defined benefit plans will increase preretirement distributions. Nevertheless, under tax reform, employees receiving a distribution of $3,500 or less solely at the discretion of the employer will not be subject to the penalty tax. Consequently, these sums will be no more likely to be saved than under current law.

Future Retirement Income and Labor Market Effects

The long-term effects of shorter vesting and lump-sum distribution penalties are simulated for the baby boom generation upon their retirement. The likelihood of pension receipt and the dollar value of pensions (in constant 1985 dollars) are forecast using a version of the Pension Retirement Income Simulation Model (PRISM) developed for EBRI (Kennell and Shields, 1986). An assumption of no pension coverage growth is incorporated in the model, although this assumption might be too optimistic in view of other tax reform provisions discussed later. TRAC's pension policy provisions are simulated assuming a five-year vesting standard for private-sector, single-employer plans and an arbitrary 50 percent increase in the savings rate for preretirement lump-sum distributions. Lump-sum distributions at retirement are assumed to be consumed over the remaining lifetime of the retiree under both scenarios.

While the immediate impact of shorter vesting among current workers is relatively large, simulations show that the impact on retirees is only fully apparent when the baby boom retires (Andrews, November 1986). This finding is reasonable since pensions represent a long-term commitment by the employer to employees; the full impact of such policy changes would be expected to phase in over a career. Pension recipiency for baby boom retirees (those age 30 to 39 in 1985) is strengthened overall by the provisions in TRAC for five-year vesting and the penalty on lump-sum distributions (table 1). Total pension recipiency increases to nearly 74 percent for married men and to nearly 56 percent for married women. Unmarried men and women also make considerable recipiency gains. Increases in the total pension recipiency rate reflect increases in defined contribution plan recipiency (among those retirees only receiving benefits from defined contribution plans) and from increases in the

2PRISM is a microsimulation model that has had many applications. The model has improved over the years as it has been developed by many users, including EBRI. In addition, different users incorporated different economic and labor market assumptions. For instance, the model used here was developed for EBRI for our project on retiree health insurance; it differs from another recent version specified by AARP in several ways. The EBRI version is more conservative with lower rates of real wage growth and female labor force participation. These differences make direct comparison of the results impossible without the exact replication of the computer runs from each version of the model.
Table 2  
Pension Benefits at Age 67 Among the Baby Boom (Age 30-39 in 1985)  
Before and After Tax Reform by Type of Benefit and Marital Status

<table>
<thead>
<tr>
<th>Type of Benefit</th>
<th>Married Men</th>
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<th></th>
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</thead>
<tbody>
<tr>
<td></td>
<td>Before reform</td>
<td>After reform</td>
<td>Before reform</td>
<td>After reform</td>
</tr>
<tr>
<td>Defined benefit (DB) plan only</td>
<td>$10,500</td>
<td>$10,700</td>
<td>$9,400</td>
<td>$9,800</td>
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<tr>
<td>Defined contribution (DC) plan only</td>
<td>10,900</td>
<td>13,400</td>
<td>8,000</td>
<td>13,200</td>
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<tr>
<td>Both DB and DC plans</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>DB only</td>
<td>8,200</td>
<td>7,800</td>
<td>7,600</td>
<td>6,500</td>
</tr>
<tr>
<td>DC only</td>
<td>13,000</td>
<td>14,700</td>
<td>14,200</td>
<td>17,400</td>
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<tr>
<td>Average pension benefits (all sources)</td>
<td>13,900</td>
<td>15,400</td>
<td>12,450</td>
<td>15,400</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Type of Benefit</th>
<th>Married Women</th>
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<tbody>
<tr>
<td></td>
<td>Before reform</td>
<td>After reform</td>
<td>Before reform</td>
<td>After reform</td>
</tr>
<tr>
<td>Defined benefit (DB) plan only</td>
<td>$3,500</td>
<td>$3,200</td>
<td>$6,600</td>
<td>$5,900</td>
</tr>
<tr>
<td>Defined contribution (DC) plan only</td>
<td>2,400</td>
<td>2,900</td>
<td>2,500</td>
<td>3,100</td>
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<tr>
<td>Both DB and DC plans</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>DB only</td>
<td>2,100</td>
<td>1,900</td>
<td>3,700</td>
<td>3,200</td>
</tr>
<tr>
<td>DC only</td>
<td>3,500</td>
<td>3,900</td>
<td>5,200</td>
<td>5,200</td>
</tr>
<tr>
<td>Average pension benefits (all sources)</td>
<td>3,600</td>
<td>3,700</td>
<td>6,000</td>
<td>5,700</td>
</tr>
</tbody>
</table>

Source: Employee Benefit Research Institute tabulations from the Pension and Retirement Income Simulation Model (PRISM) (EBRI, 1986).

The proportion of retirees receiving benefits from both a defined contribution and a defined benefit plan.

EBRI's PRISM simulations also indicate that total income from public and private employer-sponsored pensions will increase after tax reform from $13,900 to $15,400 for married men age 67 (and from $3,600 to $3,700 for married women) (table 2). Similar gains are registered for unmarried men. The effect of these tax reform provisions differs considerably by type of plan, however. Average pension amounts from defined benefit plans may decrease in many cases as a result of increased reciprocity under five-year vesting as more retirees receive benefits based on fewer years of service. Benefits from defined contribution plans tend to increase as a result of the simulated reinvestment of preretirement distributions.

To repeat, these favorable forecasts for future retirement income are based on constant pension coverage rates within industries and a 50 percent increase in the reinvestment of preretirement income.
distributions. Changes in these assumptions will change the simulation results. For instance, a more favorable prognosis for the pension coverage rate would increase future recipiency; a less favorable reinvestment rate for lump-sum distributions would decrease pension recipiency and retirement income.

◆ Pension Plan Provisions That Reduce Retirement Income

Two of the pension provisions of tax reform will reduce the after-tax benefits of many pension recipients. The first provision changes the method of taxing lump-sum distributions at retirement (10-year forward averaging). The second provision changes the taxation of pensions that are partially based on after-tax employee contributions (repeal of the three-year basis recovery rule). This provision would primarily affect federal and state and local government employees, although it would also affect private-sector retirees who draw benefits from thrift/saving or other contributory plans. Both provisions would increase tax revenues, but the repeal of three-year basis recovery would have the greatest impact.

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The Joint Tax Committee estimates that the replacement of 10-year forward averaging with 5-year forward averaging would increase federal revenues by $244 million over a 5-year period.

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Five-Year Forward Averaging

According to Joint Tax Committee estimates, the replacement of 10-year forward averaging with 5-year forward averaging would increase federal revenues by $244 million over a 5-year period. Although revenue enhancement may have motivated this provision, many felt that the ability to use 10-year forward averaging provided lump-sum retirement distributions with overly generous tax treatment.

Under 10-year forward averaging, lump-sum distributions are divided by 10 and each tenth is separately taxed at the marginal tax rate for single taxpayers (adjusted for the amount of the distribution accrued prior to 1974 that could be taxed as a capital gain). This treatment was provided by ERISA "to reflect the fact that individuals usually live about 10 years after retiring at age 65" (U.S. Department of Labor, 1974). This justification is less convincing in today's environment of increasing life expectancies and early retirement.

◆◆◆

In 1982, the average value of lump-sum retirement distributions for recently retired men was $20,000, and $6,600 for recently retired women. These average values can be expected to increase considerably by the time the baby boom retires.

◆◆◆

The president's original tax reform proposal would have repealed 10-year forward averaging altogether. Both the House and Senate reintroduced some tax advantage to lump-sum distributions but cut the averaging period to five years and only allowed a one-time use of the option. These were incorporated in TRAC. Also under TRAC, distributions will continue to be taxed apart from other income at the single taxpayer's rate and will consequently maintain that advantage over pension income paid in the form of an annuity.

Atkins (1986) clearly shows how alternative tax schemes affect the after-tax value of a lump-sum distribution at retirement. In two out of three cases, 10-year forward averaging is preferable to any other type of taxation presented (table 3). In all cases, full taxation as current income is the worst possible case. Only in the case of a distribution of $500,000 and for a distribution of $100,000 at a 16 percent marginal tax rate would pre-tax-reform capital gains taxation be preferable to 10-year forward averaging. Under tax reform (after 1987), of course, capital gains treatment
Table 3
Alternative Tax Treatment of Lump-Sum Distributions
(Based on Marginal Tax Rates Before Tax Reform for Joint Filers)

<table>
<thead>
<tr>
<th>Lump Sum Amount and Marginal Tax Rate</th>
<th>10-Year forward averaging</th>
<th>Capital gains</th>
<th>10 equal installments</th>
<th>lump sum</th>
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</thead>
<tbody>
<tr>
<td>$10,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>0.16</td>
<td>$ 550</td>
<td>$ 675</td>
<td>$ 1,600</td>
<td>$ 1,883</td>
</tr>
<tr>
<td>0.25</td>
<td>550</td>
<td>1,000</td>
<td>2,500</td>
<td>2,676</td>
</tr>
<tr>
<td>0.38</td>
<td>550</td>
<td>1,520</td>
<td>3,800</td>
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<td>0.50</td>
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<td>5,000</td>
</tr>
<tr>
<td>$100,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>0.16</td>
<td>$12,705</td>
<td>$11,152</td>
<td>$18,828</td>
<td>$36,641</td>
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<tr>
<td>0.25</td>
<td>12,705</td>
<td>13,636</td>
<td>26,762</td>
<td>40,303</td>
</tr>
<tr>
<td>0.38</td>
<td>12,705</td>
<td>16,490</td>
<td>38,104</td>
<td>44,968</td>
</tr>
<tr>
<td>0.50</td>
<td>12,705</td>
<td>20,000</td>
<td>50,000</td>
<td>50,000</td>
</tr>
<tr>
<td>$500,000</td>
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<td></td>
<td></td>
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</tr>
<tr>
<td>0.16</td>
<td>$139,469</td>
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<tr>
<td>0.25</td>
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<tr>
<td>0.50</td>
<td>139,469</td>
<td>100,000</td>
<td>250,000</td>
<td>250,000</td>
</tr>
</tbody>
</table>

Note: Tax calculations are based on 1985 tax tables, assuming the relationship between marginal tax rates and income is as follows: 0.16/$15,000; 0.25/$28,000; 0.38/$55,000; and 0.50/$180,000.


will be equivalent to the taxation of the lump sum as regular income. Taxes owed under 5-year forward averaging will be considerably higher than those owed under 10-year forward averaging because of the shortening of the averaging period. Atkins notes that those receiving small or medium distributions, with moderate income and a need for some asset liquidity, benefit substantially from 10-year forward averaging.

No published information is available on the actual use of 10-year forward averaging by pension recipients. Nonetheless, the prevalence of lump-sum distributions among current retirees and the expected prevalence of such distributions in the future indicate how widespread the effects of this change in the law could be. According to Social Security Administration data, in 1982, nearly 10 percent of newly retired men with prior pension coverage and nearly 15 percent of newly retired women with prior pension coverage received a lump-sum distribution from their last job (*EBRI Issue Brief*, July 1986). Other new retirees received distributions from another job. When the baby boom retires, nearly 42 percent of married men and over 30 percent of married women at age 67 are projected to receive some benefits from a defined contribution plan, according to EBRI's PRISM simulations. These benefits...
are most often paid as lump-sum distributions. Consequently, the prevalence of lump-sum distributions at retirement could increase considerably in the future.

The average value of lump-sum retirement distributions in 1982 for recently retired men was $20,000; the average value for women was $6,600. These average values can be expected to increase considerably by the time the baby boom retires. According to EBRI's PRISM simulations, the average asset (lump sum) value of benefits from defined contribution plans for married, baby boom men at age 67 is estimated at $71,200 (valued in 1985 dollars). The average asset value of benefits from defined contribution plans for married, baby boom women at age 67 is estimated at $23,000. While these estimates do not indicate how many pension plans provided these sums or how many defined contribution plan distributions are normally paid as annuities, the figures suggest that many average pension recipients in the baby boom generation would have owed less in taxes on their lump-sum distributions before TRAC.

No nationwide data document the distribution rules used by defined contribution plans. BLS indicates, however, that among thrift and savings plans, 99 percent provide lump-sum distributions. Nevertheless, 59 percent provide benefit payments in installments, and 29 percent provide benefits in the form of a lifetime annuity. With multiple benefit distribution options available, participants are able to choose the option that minimizes their tax burden after taking into account other cash-need considerations. Furthermore, if having lump-sum distributions with five-year forward averaging takes a bigger tax bite out of income than other distribution alternatives, more plans will start to offer those alternatives to their participants. While the baby boom generally may pay more taxes on lump-sum distributions than they would under 10-year forward averaging, the actual effect of 5-year forward averaging will depend on the tax rates in effect after the year 2000.

Treatment of Employee Contributions

TRAC changes the tax treatment of retirement benefits stemming from after-tax employee contributions. Prior to tax reform, if an individual's first three years of annuity payments equaled or exceeded the individual's contributions, these initial payments were treated as a return of after-tax employee contributions and were not taxed again. Tax reform eliminated this "three-year basis recovery rule." Now all annuity payments will consist of taxable and nontaxable portions based on the pro rata share of employee contributions. Under tax reform, the total amount that a retiree may exclude from income is limited to the actual amount of the employee's after-tax contributions. Prior to tax reform, retirees who lived longer than their projected life expectancies had some of their pension income remain tax free after the recovery of their own after-tax contributions.

According to Joint Tax Committee estimates, the five-year revenue effect of these provisions will add up to $8.9 billion, the largest revenue impact of all the pension provisions except for the IRA restrictions. The Internal Revenue Service (IRS) annually publishes information on the amount of pension income that is excluded from taxation among those filing tax returns. According to the latest published data, some 800,000 returns in 1983 reported pension income that was not included in taxable income amounting to $8.1 billion (U.S. Treasury, 1985). Over 50 percent of those paying units had returns with adjusted gross incomes (which form the base of the tax computation) of less than $25,000. For 1983, the IRS reported that another 1.1 million returns had pension incomes that were not fully reported as taxable income. Of these, 57 percent stemmed from paying units with taxable incomes of $25,000 or less. In sum, 12 percent of all paying units reporting pension incomes did not pay taxes on all or part of those incomes.

The IRS data suggest that many retirees will be affected by these tax reform changes. Retired federal workers use the three-year basis recovery rule because their pension system requires after-tax employee contributions. Many state and local workers also have partially contributory plans. According to the U.S. Census Bureau, 26 percent of total contributions to public employee retirement funds in 1983-1984 stemmed from employee contributions (U.S. Department of Commerce, 1985). Most retirees who will be affected by the repeal of the three-year basis recovery rule probably worked for a state or local government.

Although primary contributory pension plans are most common among public-sector employers, many private-
sector employers sponsor secondary plans that accept after-tax employee contributions. In medium and large firms, about 9 percent of all full-time employees are offered a savings and thrift plan on an after-tax basis. Other defined contribution plans also accept contributions in after-tax dollars. Under tax reform, some employees will only be able to make IRA contributions on an after-tax basis. All of these employees will be affected by the new tax provisions for basis recovery rules.

Most retirees who will be affected by the repeal of the three-year basis recovery rule probably worked for a state or local government.

In the private sector, the complexities of determining the taxable and nontaxable components of income may discourage the use of contributory plans. The new law may encourage some state and local plans to change over to a noncontributory basis to the extent that employees are willing to trade off wage increases for purely employer-provided pension payments. The percentage of total contributions to all state and local plans stemming from employee after-tax dollars already decreased 7 percentage points in nine years from the 33 percent rate posted in 1974-1975.

Another option that government plans could adopt (Metz, 1986) would be the so-called "pick up" plans under section 414(h)(2), in which employee contributions characterized as employer contributions are excludable from current gross income for federal income tax purposes. According to Metz, many states and cities have already adopted these plans. The effect of such changes on the after-tax pension income of future retirees cannot be predicted easily. Nonetheless, the immediate gain to the Treasury from the change in the basis recovery rules will reduce the initial retirement income of many retirees.

**Pension Plan Provisions Affecting Upper-Income Employees**

A number of the pension provisions of TRAC primarily affect high-income employees and executives and have little if any effect on the majority of pension plan participants. The largest revenue gain to the federal government, $23.8 billion, results from the restrictions on the eligibility to make pretax contributions to an IRA. Other provisions that generate sizable additional revenues for the Treasury include those provisions affecting 401(k) plans and the capping of early retirement benefits at lower levels for retirees receiving maximum pensions from defined benefit plans prior to full Social Security benefit entitlement. Other upper-income provisions, apparently enacted for "equity" reasons, are new limits on the maximum compensation used to determine pension benefits (or contributions) and an excise tax on pension distributions above a certain sum (125 percent of the defined benefit plan limit). In addition, the contribution limit of 25 percent of compensation is tightened, and the maximum contribution limit for defined contribution plans is capped until the maximum defined-benefit-to-defined-contribution plan limits reach a four-to-one ratio.

To understand how these provisions currently affect high-income employees and executives, the distribution of earnings within the work force should be considered. Very few wage and salary workers earned above $75,000 in 1985. Only 1.8 percent of men and far fewer women had earnings above that level. Among pension participants, only 2.7 percent of men earned $75,000 or more, and only 1.5 percent earned $90,000 or more. The proportion of high-income employees increases, however, among those nearer retirement age. Among male pension plan participants age 45 to 64, 4.9 percent earned $90,000 or more in 1985. Nonetheless, relatively few current workers are likely to be exposed to the tax-reform maximum contribution limits.

**Individual Retirement Accounts**

Fully deductible IRA contributions are maintained for the majority of wage and salary earners. All workers who are not active participants in an employer-sponsored plan, regardless of their income levels, may
continue to make their $2,000 deductible contributions to an IRA. According to IRS, an "active participant" for a year is someone covered by a retirement plan. IRA contributions by pension plan participants, however, are restricted for employees earning above a certain level. Deductible IRA contributions are reduced for single taxpayers with adjusted gross incomes (AGIs) between $25,000 and $35,000 who are active plan participants. Single workers who are pension plan participants and have more than $35,000 in AGI cannot make tax-deductible IRA contributions. Pretax IRA contributions are similarly reduced for married taxpayers filing jointly with AGIs of $40,000 to $50,000 if either spouse is an active participant in an employer-sponsored pension plan. Such couples with incomes above $50,000 can no longer make tax-deductible IRA contributions. All wage earners can make nondeductible IRA contributions to the extent they are prohibited from making deductible contributions. Earnings on nondeductible contributions are tax deferred until withdrawn.

The majority of taxpayers who could have made tax-deductible contributions to an IRA before TRAC can still make full, tax-deductible contributions. Using Current Population Survey data, EBRI estimates that 93 percent of single taxpayers and 94 percent of one-earner couples can make fully deductible IRA contributions in 1987 (table 4). The percentage declines somewhat among high-earning, two-earner couples but remains well over three-quarters of such taxpaying units. Because those with higher earnings are more likely to contribute to an IRA, the percentage of current contributors who can continue making their contributions after tax reform is likely to be somewhat lower. Nevertheless, over 75 percent of single taxpayers and nearly 85 percent of one-earner couples will be able to keep making their tax-deductible contributions. This figure drops to nearly 62 percent of all two-earner couples, however, who are more likely to be adversely affected by IRA eligibility restrictions. But, another 16 percent of two-earner couples will be eligible to make partially deductible contributions and nondeductible contributions.

Even with reductions in eligibility, most of the IRA market theoretically remains intact. Furthermore, these assets will continue to grow if those receiving

Table 4
Pretax IRA Eligibility Under Tax Reform by Filing Status

<table>
<thead>
<tr>
<th>All Taxpayers</th>
<th>Single Taxpayers</th>
<th>One-Earner Couples</th>
<th>Two-Earner Couples</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Fully eligible</td>
<td>93.3%</td>
<td>94.2%</td>
</tr>
<tr>
<td></td>
<td>Partly eligible</td>
<td>4.7</td>
<td>2.5</td>
</tr>
<tr>
<td></td>
<td>Ineligible</td>
<td>2.9</td>
<td>3.3</td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

| Taxpayers with IRAs | Fully eligible | 75.6 | 84.7 | 61.9 |
|                     | Partly eligible| 14.7 | 5.3  | 15.8 |
|                     | Ineligible     | 9.7  | 10.0 | 22.3 |
|                     | Total          | 100.0| 100.0| 100.0|

Source: EBRI estimates based on tabulations from the May 1983 CPS pension supplement.
lump-sum distributions avoid the 10 percent penalty tax levied on early distributions through reinvestment in IRAs. EBRI's PRISM simulations indicate that before tax reform, 41 percent of baby boom families could be expected to receive retirement income from IRAs (Chollet, 1986). Since nearly all taxpayers can continue to make such contributions, this percentage would not be expected to drop precipitously. Nonetheless, EBRI simulations also indicate that even before TRAC, IRAs would only provide $3,000 of retirement income to baby boom couples at age 67 and $2,000 to single, baby boom retirees. The role of IRA contributions for retirement income, of course, depends on the extent to which IRAs represent new savings. Current evidence about how much saving IRAs generate is inconclusive.

Qualified Cash or Deferred Arrangements (401(k) Plans)

The substantial changes made by TRAC in qualified cash or deferred arrangements (401(k) plans) are likely to have their greatest impact on high-income employees and managers. These provisions are estimated to generate an additional $3.4 billion for the Treasury over the five-year, 1987-1991 period. These revenues derive in part from the reduction in maximum 401(k) plan contribution limits from a maximum of $30,000 a year (where it is the sole plan) to a maximum of $7,000 (indexed for inflation). Although this reduction is considerable in dollar terms, at most the top 10 percent of those participating in a 401(k) plan are likely to be affected. Anyone earning less than $50,000 is unlikely to reach the maximum contribution limit, since that would require a substantial 14 percent contribution at that earnings level.

New, more restrictive 401(k) plan nondiscrimination requirements are also added. The nondiscrimination test is satisfied if the actual deferral for the highly compensated group of employees does not exceed the greater of (1) 125 percent of the actual deferral percentage for all other eligible employees; or (2) the lesser of (a) 200 percent of the actual deferral percentage for all other eligible employees or (b) such actual deferral percentage plus 2 percentage points. In other words, the highly compensated group could easily be restricted to contributions of less than $7,000, depending on the contribution rates of the nonhighly compensated group.

The popularity of 401(k) plans has been increasing steadily in recent years. In 1983, less than 7 percent of private-sector employees reported being offered a 401(k) plan (Andrews, 1985). By 1985, the Bureau of Labor statistics reported that 26 percent of all employees in medium and large firms were offered a plan with 401(k) provisions (U.S. Department of Labor, 1986). Other surveys suggest that participation rates have been climbing as well. Recent growth in 401(k) plans has undoubtedly exceeded the recent growth of all other retirement income vehicles.

Nevertheless, because rapid growth has outstripped the availability of nationwide data, little analysis can be done on the effect of even the $7,000 restriction. Furthermore, no information is available on the extent to which employees make contributions beyond the employer matching contribution provided by many plans. Economists Venti and Wise (1986) attempted to measure the effect of IRAs on saving, and their study raises an interesting point from the standpoint of 401(k) plans. They suggest that only some individuals are "savers," saving both through IRAs and other financial instruments. Are contributors to 401(k) plans also primarily "savers," and have 401(k) plans increased savings? Answers to these questions would help ascertain the effect of tax reform on future retirement income. Ideally, up-to-date data on the income, assets, 401(k) plan participation, and contributions of individuals would be needed to respond to these questions.

Tax reform is likely to reduce the amounts saved through 401(k) plans for those affected by the contribution limits, and it may cause some plans to terminate. If former contributors save to the same extent as they did before tax reform by shifting their assets, plan termination will not reduce future retirement income. If savers and savings are encouraged by 401(k) plans, however, restrictions in 401(k) limits will reduce retirement income to some extent.

Conversely, the loss of the tax-deferred IRA by high-income pension participants will make the 401(k) plan an attractive additional benefit, despite the $7,000
limit. This increased interest in 401(k) plans could lead to continued plan growth. Employers also might have to make these plans more attractive to low-income individuals through improved employer matches, since tax reform restricts access to 401(k) funds for other than retirement income purposes. At the same time, employer interest in "cost sharing" retirement income expenses continues to grow. The realization that employers want their employees to share in the responsibility for their future retirement income will encourage continued growth of 401(k) plans. The recent enactment of the Federal Retirement Thrift Savings Plan for federal government employees (as part of the massive new federal employee pension redesign) signals substantial congressional interest in preserving the 401(k) option. Once again, whether such plans will increase future retirement income depends on the extent of employer matching provisions and the extent to which future unmatched voluntary contributions increase retirement saving.

Maximum Early Retirement Benefits

Reducing the maximum pension benefits permitted under tax-qualified defined benefit plans at different early retirement ages has the third largest federal revenue gain according to the Joint Tax Committee's estimates. Over a five-year period, tax revenues will increase by $4.5 billion because of this provision. Today, relatively few workers are affected, however, even though the maximum allowable benefits for those retiring at age 55 drop from $90,000 to $40,600 (table 5).

Section 415 normal retirement benefit limits were projected to affect a growing percentage of future retirees (EBRI, 1985). While only 2.7 percent of employees now in their fifties were projected to hit the $90,000 defined benefit maximum at retirement, just under 10 percent of baby boom retirees were projected to
receive the defined benefit maximum. The proportions hitting the new actuarially reduced early retirement limits are likely to be similar; and many employees already leave their jobs before normal retirement age.

The future impact of the new early retirement limits can be expected to affect more employees in some industries than others. For instance, for the baby boom, only 5 percent of those who retired from service-sector jobs were projected to reach the normal retirement defined benefit maximum, compared to 19 percent of those who retired from careers in finance, insurance, and real estate. Special early retirement incentives are often used to restructure the labor force of particular firms or industries to improve their competitiveness. In recent years, such "early retirement windows" have been provided to middle management (in industries such as banking and chemicals), whose salaries and, hence, pensions are above nationwide averages. In the future, if employers in industries in which more pensions are capped need to restructure their work forces, they will be less able to rely on the defined benefit plan as the major or sole early retirement mechanism.

Other Provisions Affecting High-Income Employees

TRAC also limits contributions by capping income eligible for pension contributions at $200,000, by placing an excise tax on most annual plan distributions (including IRAs) over $112,500,3 and by limiting defined contribution plan contributions to $30,000 until the defined benefit limit reaches $120,000. The only other provision affecting high-income employees with a marked tax-revenue effect is the tightening of the 25-percent-of-compensation limitation on pension contributions (the adjustments to section 404 limitations). Even in this case, the revenue impact for the five-year period 1987 to 1991 is estimated at only $207 million. Consequently, the contribution and distribution limits affecting high-income employees and executives appear to be "equity based."

 Contribution and benefit limits are intended to discourage high-income employees and executives from using their pension plans as tax shelters.

Little is known about the effects of these provisions on participants and future retirees. A very small percentage of the population earns $200,000 or more. Relatively few pension recipients are likely to be subject to the 15 percent excess-distribution tax since few receive pensions over $112,500 per year. Few lump-sum distributions are likely to fall under the excess distribution tax either since the lump-sum maximum is raised to five times the $112,500 limit.

In public policy terms, contribution and benefit limits are intended to discourage high-income employees and executives from using their pension plans as tax shelters. By contrast, pension plan tax deferral is supposed to encourage employers to sponsor plans that will help provide adequate retirement income for the majority of their employees. Some have suggested, however, that overstringent contribution and benefit limits may separate the interests of executives and decision makers from the labor force rank and file. Benefit consultants and managers suggest that executives will now rely more heavily on nonqualified plans that are not funded or subject to ERISA standards. They hypothesize that, as a consequence, pensions from tax-qualified plans will no longer be improved as readily as in the past; some plans will terminate; and companies will not institute new plans. Contribution and benefit limits will obviously limit the maximum benefits provided by tax-favored plans. Yet we are unable to forecast the extent to which these limits may affect plan formation, benefit

3The provisions are extremely complicated. A 15 percent excise tax is imposed on aggregate annual distributions (excluding basis recovery and rolled over amounts) to an individual exceeding 1.25 percent of the indexed defined benefit plan limit, or $112,500 in 1987. Under a complicated transition rule, the tax either will not apply to "excess" benefits accrued before August 1, 1986, or the applicable dollar threshold will be increased to $150,000. A fuller description of this provision can be found in EBRI Issue Brief 59 (October 1986).
enhancement, and coverage growth. It is precisely the size of these effects that remains in dispute.

**Pension Plan Provisions Affecting Small Businesses**

A number of provisions of TRAC will more heavily affect small businesses than large businesses. Small businesses are often considered to be those that employ fewer than 100 employees. In 1983, over 45 percent of all nonagricultural wage and salary workers were in firms with fewer than 100 workers. Less than 23 percent of these workers were covered by a pension plan, compared to an 82 percent pension coverage rate among those employed in firms with 500 or more workers.

Some owners and managers of small businesses will be affected directly by provisions that tighten benefit and contribution limits. Other pension provisions of tax reform, such as coverage, participation, and integration requirements, are likely to affect small businesses (and some larger employers as well). None of these provisions are expected to augment or diminish federal tax revenues significantly. Rather, their intent is to ensure that pension plans are not primarily established to benefit the firm’s more highly compensated employees and managers at the detriment of others working for the company.

First, tax reform changed the way in which employers could explicitly integrate their pension benefits with Social Security to ensure that low-income workers receive their fair share of pension benefits. 4 Although relatively little data are available on integration formulas, very small plans (fewer than 50 participants) appear more likely to have benefit formulas in which benefits are integrated with Social Security. According to Kotlikoff and Smith’s (1983) tabulations of plan provisions submitted to the Department of Labor immediately after the enactment of ERISA, benefits were explicitly integrated with Social Security among firms with fewer than 50 participants in 62 percent of the cases. By contrast, 37 percent of the plans with 50 to 99 participants had an explicitly integrated benefit formula and 42 percent of plans with 100 or more participants had an explicitly integrated benefit formula.

Current top-heavy rules, which are intended to ensure that pension accruals are fairly distributed, are more likely to affect smaller firms with higher management-to-worker ratios.

New minimum-coverage and participation rules were also enacted to ensure that most employees are not excluded from a firm’s pension plan. The minimum-coverage rules provide that one of the following three tests be satisfied: (1) seventy percent of all nonhighly compensated employees 5 are covered in the plan; (2) the percentage of nonhighly compensated employees covered by the plan is at least 70 percent that of highly compensated employees covered; or (3) the group of employees covered by the plan satisfies the pre-tax-reform test, and the average benefit provided to all nonhighly compensated employees is at least 70 percent of the average benefit provided to highly compensated employees (all as a percent of compensation). 6 The new participation rules require that a qualified plan must benefit no fewer than the lesser of (1) 50 employees or (2) 40 percent or more of all employees of the employer.

Nonhighly compensated employees are those who are not in the highly compensated group. The highly compensated group consists of employees who are (1) 5 percent owners of the employer; (2) earn more than $75,000 in annual compensation form the employer; (3) earn more than $50,000 annual compensation from the employer and are members of the top-paid group of employees; or (4) are officers of the employer and receive compensation greater than 150 percent of the dollar limit on annual additions to a defined contribution plan.

4See EBRI Issue Brief 59 (October 1986) for a fuller presentation.

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4Most pensions are implicitly integrated with Social Security since they are intended to supplement the program's benefits.
These provisions are more likely to affect smaller employers if only because they will have less flexibility to cover distinct groups of employees when very few people work for the firm. According to a survey by the National Federation of Independent Business (NFIB) (1985), 69 percent of all small businesses providing retirement benefits to their employees offered them to all full-time employees. By contrast, among the larger firms surveyed (those with more than 100 full-time employees), 81 percent provided retirement benefits to everyone.

Current top-heavy rules, which are intended to ensure that pension accruals are fairly distributed, are more likely to affect smaller firms with higher management-to-worker ratios. The Small Business Administration sponsored a January forum on the regulation of small business pension plans, which included a discussion of the top-heavy rules. Changes in the definition of highly compensated employees and employee leasing standards are also more likely to affect small businesses. The leasing provisions of tax reform are intended to ensure that employee leasing is not used as a scheme to provide generous benefits to only one part of the employer's work force.

Under tax reform, profit sharing plans are no longer permitted to increase their plan contributions by that part of their contribution limit that was unused in prior years. Such "carryovers" had been permitted to let employers make up plan contributions they had reduced in less profitable years. Although the use of the carry-over provision has not been documented, this change would tend to make profit sharing less attractive to the employer. Through another provision of tax reform, however, employer contributions to profit sharing plans are no longer limited to the employer's current or accumulated profits. This provision would tend to make profit sharing plans more attractive. Although the offsetting effects of these two provisions are uncertain, small employers are more likely than large employers to provide benefits through profit sharing plans.

According to NFIB survey data, which primarily includes small employers, the most common form of defined contribution plan is the profit sharing plan. Profit sharing was used by just over half of those businesses identifying the type of defined contribution plan they had established.

TRAC also changed the requirements for simplified employee pensions (SEPs), which were originally enacted as an easy, low-cost means to encourage small employers to establish pension plans. The new law now permits employees to make elective pre-tax contributions through salary reduction, under certain conditions, up to $7,000 (coordinated with the new 401(k), 403(b), and 457 plan limits). In addition, the SEP participation and nondiscrimination requirements are amended. Furthermore, the employer may now compute benefits according to the firm's tax year rather than just the calendar year.

Before tax reform, relatively few employers had established SEPs. According to NFIB, only 6 percent of the firms surveyed said they had a SEP. An earlier EBRI focus group report identified reasons why employers might shy away from SEPs (Employee Benefit Notes, May 1986). The tax reform provisions may make SEPs somewhat more desirable, but they do not address any of the objections raised by small employers in EBRI's focus group study. These employers found immediate vesting a disadvantage and were not enthusiastic about the participation requirements which stipulate that part-time employees who have worked for an employer three out of the last five years have to be included in the plan. Other small employers prefer to reward their employees on a selective basis through bonuses rather than through nondiscriminatory pensions.

The impact of tax reform on small business plans is hard to evaluate. Little in the legislation is likely to induce employers to establish new plans. Nevertheless, more workers will get better benefits from small-employer plans when they retire if the participation and coverage provisions include more workers and if the integration provisions improve benefit recipiency. Policymakers would like more employees to participate in employer-sponsored pension plans. Without that outcome, few would care if some discriminatory plans were forced to close down. But, nondiscriminatory plans could also terminate if the administrative costs involved with tax reform compliance are too burdensome. Which of these effects is likely to predominate cannot be predicted until the new law has been in effect for some time.
Lower Rates and a Broader Base

The tax reform pension provisions need to be considered within the broader context of the tax reform law. Rate reduction and base broadening form the essence of TRAC. For personal income, tax reform combines an across-the-board reduction in marginal tax rates with the repeal of a number of provisions that narrowed the taxable wage base. Both economic theory and experience indicate that taxpayers choose between savings and consumption and decide on their investments, in part, because of tax considerations. In other words, the overall tax system is likely to influence the size and growth of employee benefits. The question is whether these effects can be measured.

Lower Marginal Tax Rates

An important component of tax reform reduces marginal tax rates from our current schedule to substantially lower rates starting in 1988 (after a transition in 1987). The tax rate structure will be compressed from the 15 brackets in effect in 1986 to 2 brackets in 1988. The top marginal tax rate will be reduced from 50 percent to 28 percent. As a result of the phase out of some of the exemptions accorded to low-income taxpayers, the top marginal tax rate actually peaks at 33 percent but falls to 28 percent after the phase out is completed. Will the lowering of the marginal tax rate schedule change the provision of employer-sponsored pension plans?

A number of studies have addressed the question of how marginal tax rates affect the share of total compensation paid as employee benefits. These studies generally indicate that under lower marginal tax rates, employee benefits would make up a smaller share of compensation. Estimates vary considerably, however, about the effect of a given tax-rate reduction. Estimates of the effect of a 10 percent decrease in the average marginal tax rate range from a decrease of slightly over 2 percent to a decrease of 20 percent in the share of compensation paid as benefits.

Preliminary estimates of the average decrease in marginal tax rates are 6 percentage points or less for most taxpayers and from 9 to 17 percentage points for the three percent of taxpayers whose earnings exceed $75,000 (Lindeman, October 1986). An average decline in the marginal tax rate on wages and salaries from 27 percent to 22 percent represents an 18.5 percent decrease. According to U.S. Commerce Department data, discretionary benefits accounted for 9.7 percent of compensation in 1985 (excluding legally required benefits). Given a one-for-one percentage decrease in marginal tax rates and in the share of compensation, an 18.5 percent decrease in the marginal tax rate alone would reduce the share of benefits to 9.5 percent (a reduction of 0.2 percentage points). Such a reduction could take place if fewer employers provided benefits or if the benefits provided were lower. Nonetheless, an 18.5 percent reduction in the share of compensation allocated to benefits turns out to be relatively small.

Of course, this reduction could be centered entirely on pension plans, while other types of benefits, such as health plans, are maintained in full. Recent studies reach no consensus on this point. Research also only focuses on modeling what the work force wants in terms of benefits, assuming that the employer's costs of providing wages or benefits are the same. In addition, the personal preferences of executive decision makers are assumed to have no influence on the firm's benefit package even among small employers. Finally, no empirical study investigates (or could have investigated) the effect of simultaneously reducing tax rates and broadening the base of taxation. In other words, empirical studies show that marginal tax rates make a difference, but they cannot provide a full answer to the question of how TRAC is likely to affect pension plans.

A Broader Tax Base

The studies discussed above, like all analyses, make a number of simplifying assumptions, including, in this case, the assumption that benefits are the only type of tax-preferred income, an assumption that probably does no damage to the analysis in the absence of other changes in the tax structure. But tax reform specifically removes a number of provisions of the tax code which ensured that certain types of taxpayer behavior were taxed at lower rates than other types of behavior.

The inclusion in AGI of items that were previously excluded will affect many middle-income taxpayers. Such provisions include the repeal of the two-earner deduction, the exclusion of employee business expenses for nonitemizers, the increase in the threshold for medical and dental expense deduction for itemizers, the exclusion of the itemized deduction for sales taxes, and the exclusion of the interest deduction for consumer purchases. In addition, capital gains will be taxed at
ordinary income rates with the repeal of the exclusion of 60 percent of capital gains income. An analysis of 1983 individual income tax returns indicates that the exclusions referred to above, which now are eliminated by tax reform, amounted to 7.5 percent of all wage and salary income for taxpayers with AGIs between $1 and $50,000.

The effective tax on the exclusions mentioned above (which have been repealed under tax reform) for those taxpayers who use them will increase from zero to 15 percent and either 28 or 33 percent in 1988.

Presumably, individuals will shift their expenditures and investments from some of the above categories now taxed to other categories that have not experienced a substantial increase in marginal tax rate. Investment in assets that produce capital gains will seem less advantageous than in the past. Consumption will seem less desirable compared to saving because consumer interest and sales taxes can no longer be deducted from individual income taxes. Business expenses (which might be viewed as investment in the worker) will also be less desirable compared to consumption. Additional income in two-earner families will be less desirable from a tax standpoint (as will marriage for couples who both work). And saving in the form of an employer-sponsored pension plan may look relatively more desirable than other options for consumption or saving.

We cannot predict how the base-broadening provisions are likely to increase the desire for employer-sponsored pensions. Some of that demand could also be channeled into an increased demand for housing, since capital gains in housing are still essentially untaxed and interest remains fully deductible (for two houses at least). Nevertheless, the base-broadening provisions are likely to make employer-sponsored pensions more desirable, and this effect could help mitigate any reduction in the demand for pensions resulting from the lower marginal tax rates.

♦ Conclusion

A review of the current economic status of the aged helps put TRAC in perspective. A recent report of the Social Security Administration (Radner, 1986) shows that between 1967 and 1983, the income of the aged (age 65 and over) rose relative to the nonaged.

Furthermore, during that same period, income inequality declined substantially for the aged group as a whole and for each detailed age group among the aged. By contrast, income inequality rose for the nonaged group. Between 1967 and 1983, the composition of income among the aged changed, with the share of earnings falling substantially and the share of Social Security income and property income rising. The share of pension income also rose. Poverty fell sharply among the aged between 1967 and 1983. This report confirms and extends the findings of other studies, including those of EBRI (Andrews, 1985). To evaluate the potential effects of tax reform on future retirement income, we start from a situation in which the objective of securing an adequate base of income for our retiree population has met with considerable success.

Employer-sponsored pensions would have become a more important source of retirement income even before TRAC. Ten-year vesting under ERISA would have improved recipiency in general; increased female labor force participation would have helped women in particular. Gains in pension income were expected, despite the projected shift in employment toward the service sector. With future employment gains probably concentrated among service-sector firms with lower pension coverage rates, no increase in the pension coverage rate was forecast. In fact, the Census Bureau's pension participation rate has declined for prime-age workers (age 25 to 64) since 1979. (Employee Benefit Notes, December 1986).^{7}

TRAC sends mixed signals for the future of pensions as a source of retirement income. Tax reform could significantly increase pension receipt in the future because of five-year vesting and the penalties on lump-sum distributions. Changes in coverage, participation, and integration requirements, however, are not likely to affect many employees. Tax reform gives sponsors little encouragement to improve existing plans or to institute new plans. On balance, the base-broadening and rate-reducing provisions of the tax overhaul are not likely to increase the growth of pension coverage.

^{7}Although the participation rate of those under age 25 increased in 1985, probably as a result of the 1984 Retirement Equity Act, young workers change jobs frequently and are unlikely to qualify for future benefit entitlement.  

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Tax reform does not clearly favor either defined benefit or defined contribution plans.

The unanswered question is whether those provisions primarily affecting high-income executives and employees and those provisions affecting small employers will lead to additional coverage declines in the future. In passing tax reform, Congress did not intend these provisions to adversely affect the pension system. Yet, the answers to these questions will only be apparent, and perhaps imperfectly, several years hence. Nevertheless, barring a sharp reduction in coverage, employer-sponsored pensions still can be expected to become an increasingly important source of retirement income.

References


8New information on coverage, participation, and vesting for May 1988 will be available in 1989 through the new Current Population Survey pension supplement being developed by EBRI, the Social Security Administration, and other survey sponsors, and conducted by the U.S. Bureau of the Census.
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