EBRI ISSUE BRIEF

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THE PENSION EQUITY TAX ACT

On June 10, the House Ways and Means Committee held hearings on H.R. 6410 -- also known as the Rangel Bill or the Pension Equity Tax Act. Testimony presented to the Committee and other analyses suggest that this proposed legislation could have serious adverse implications for private pensions in general, not just for the tax preferences available to incorporated professionals. This Issue Brief addresses several broad equity issues in private and public pensions raised by H.R. 6410.

Lower Contribution Limits

H.R. 6410 proposes a 34 percent reduction of contribution and benefit limits under Section 415 of the tax code. Currently, annual contributions cannot exceed the lesser of $45,475 or 25 percent of compensation for defined contribution plans. Annual benefits under a defined benefit plan cannot exceed the lesser of $136,425 or 100 percent of compensation. These limits would be reduced to $30,000 and $90,000 respectively. Certainly the proposed reductions in tax advantage, by themselves, would reduce incentives to establish and maintain plans. Whether the remaining incentives will be sufficient to encourage any future pension growth is an open question.

Lowering Section 415 contribution limits would reduce pension contributions and benefits relative to salary for some highly compensated executives and professionals. If these reductions occur, some pension plans may be modified to keep pension contribution rates for middle- and low-income workers in line with the lower rates that would result for the highly compensated. None of the federal agencies that regulate or monitor pension programs have ever identified and evaluated the factors that promote pension plan creations. While simple economic theory suggests that lower incentives will result in less response, it is impossible to evaluate the significance of tax code modifications without undertaking substantive empirical research.

Freezing the Contribution Limits

Another H.R. 6410 provision would eliminate indexation of the contribution limits. One rationale for this proposal is that Congress is considering modifying cost-of-living adjustments (COLA) in Social Security and other benefit programs. Congressman Rangel's statement in the introduction of H.R. 6410 is: "Discussions of COLA freezes and benefit program reductions should apply equally to government spending through the tax system."1/ Coordination of private pension policy with federal benefit programs is complex, however. A comparison with Social Security exemplifies this complexity.

While discussion frequently focuses on CPI benefit adjustments, Social Security includes four distinct indexation factors:

- First, Social Security maximum taxable earnings and, thus, maximum payroll taxes are indexed to average wage growth. It is unlikely that Congress will seriously consider freezing Social Security's contribution limits in the near future.

- Second, Social Security indexes wages as the basis for benefit determination. By doing this, previous earnings are adjusted to determine lifetime average earnings which reflect current earning capacity. A worker retiring today, at age sixty-two, who has paid the maximum Social Security taxes every year since 1950 is eligible for an annual benefit of $5,696. If this worker's wages were not indexed in the calculation, the annual benefit entitlement would be only $3,897.

- Third, the Social Security benefit formula is itself indexed. Each year the benefit formula is adjusted to provide more generous benefits for a given level of average lifetime earnings. For example, the sixty-two year old retired worker referred to above is entitled to $773 more per year today than if the 1979 formula were used to calculate his benefit.

- Finally, once a worker starts receiving Social Security, benefits will be indexed annually with the CPI.

In recent years, private pension contribution limits have been indexed with the CPI. This indexing provision permits pension benefit financing for each new wave of retirees, which replaces roughly the same proportion of preretirement earnings as received by earlier groups of retirees. The indexing of maximum taxable income for Social Security accomplishes essentially the same result. There is some question whether the CPI is an appropriate basis for indexing pension contribution limits. Because pensions are wage-related programs, some argue that wage indexation would be more appropriate.

In any event, freezing contribution limits will reduce the income replacement capacity of pension programs over time. The suggested limits would affect a small number of current pension participants. As the general level of wages rises, however, the portion of the work force affected would increase. As more people reach the limits, the income replacement capacity of pensions would diminish. This, combined with Social Security's redistributive nature means an ever increasing share of the elderly would be unable to maintain preretirement living standards through benefits from organized retirement programs.

There is no simple comparison to be made between private pension contribution limits and postretirement indexation of Social Security benefits. Pension

1/ U.S. Congress, House, Congressional Record, 97th Cong., 2nd session, 1982, p. H. 2352.

programs do not directly provide for any of the other kinds of indexation inherent in Social Security. Most pension benefits bear a fairly direct relationship with earnings received at the end of a recipient's career. This indicates that private pension contribution growth has roughly approximated the combined effects of Social Security's wage and benefit formula indexation. Beyond this, few private or public retirement programs, other than federal programs, now provide full CPI indexation of postretirement benefits. In short, there is no direct relationship between indexation of the Section 415 pension contribution limits and the indexation of benefits under federal transfer programs.

Multiple Plan Contribution Limits

H.R. 6410 would also reduce the combined contribution limits for sponsors who establish multiple plans. Under current law, sponsors with both a defined contribution and defined benefit plan are permitted contributions and benefits up to 1.4 times those permitted under a single plan. Under H.R. 6410, the single plan limit would apply even if secondary plans were established. This proposal is aimed at reducing excessive tax deferrals for highly compensated individuals. The argument against this proposal is that it would contribute to termination of some secondary plans and inhibit creation of new plans.

It is easy to make a case that some high-income workers are receiving substantial tax deferrals under current rules. Clearly, anyone now benefiting from the .4 supplemental limit will lose this preferential tax treatment of their contributions to secondary plans. The important issue, however, is whether secondary plans will be terminated if this measure is implemented. If secondary plans will be terminated, then policymakers must ask whether the added tax revenues are worth reducing private pension benefits not only to high-income plan workers, but to rank and file workers as well.

Little empirical evidence exists about where or why secondary plans are established. Some believe they are set up primarily by small professional service corporations so high-income professionals can avoid taxes. A countervailing opinion holds that they are established as the private sector's answer to postretirement benefit indexation. Private plan sponsors cannot fully underwrite unanticipated inflation in their defined benefit pension programs. Secondary plans, therefore, provide pension beneficiaries with a second line of defense against the insidious effects of inflation on retirement income.

While there is no information on the number of secondary plans being created, if these plans are established primarily to shield the income of incorporated professionals, newly established plans would include relatively few participants. According to IRS data, on all plan creations in 1979, 57,000 newly tax qualified plans had an average of thirty-six participants; in 1980, 69,000 newly qualified plans averaged fifty-five participants; and in 1981, roughly 82,500 new plans averaged forty-three participants. While some individuals or small professional groups may incorporate to take advantage of existing Section 415 limits, many new pension plans are including significant numbers of workers. Imposing new limits, therefore, may hit a broad target -- not just a few high-income professionals.

Actuarial Reductions

H.R. 6410 would actuarially reduce private pension benefits payable before age sixty-five. The bill makes no similar reductions, however, in federal workers' pensions. Neither the Civil Service nor Military programs have actuarial reductions for normal retirement benefits prior to age sixty-five. Under the Civil Service Retirement System (CSRS), most classes of workers are eligible for normal retirement benefits by age fifty-five with thirty years of service, age sixty with twenty years and age sixty-two with only five years. The median age at normal retirement under the Military Retirement program is thirty-nine. If such provisions are legislated for private programs, equity suggests that parallel reductions in federal retirement benefits are in order.

Integration Policy Considerations

Among the most significant elements in H.R. 6410, is the proposed modification to integration rules. H.R. 6410 would change the basic rationale of integration. Current regulations seek to coordinate Social Security and pension benefits. This means that employers can design their pension benefits to partially account for the redistributional nature of Social Security. H.R. 6410 would change this and focus on the value of Social Security taxes paid by employers for each worker. Before making such fundamental changes, there should be ample discussion on their ramifications.

With Social Security's problems still unresolved, it is premature to take major policy steps that have such far reaching effects on private pensions. The National Commission on Social Security Reform has been looking into the relative roles of pensions and Social Security. It will probably address the integration issue before completing its work. The Commission may also speak to other aspects of pension policy that will need Congressional consideration. Without doubt, it is time for integration rules to be evaluated. Integration rules need to be simplified and existing flaws and vagaries should be corrected. This must be done carefully and in the context of broader retirement policy considerations.

Pension Equity and Tax Policy

The tax incentives provided by Congress have affected both the prevalence and design of private pension plans. Private employer contributions to qualified plans are deductible business expenses. Neither employer contributions nor the return on pension fund assets is treated as taxable income to pension plan participants until benefits are actually paid. Unpublished data from the Office of Tax Analysis, U.S. Department of the Treasury, indicate that preferential tax treatment accorded private pensions reduced federal tax revenues by an estimated $11.3 billion in fiscal 1979, $12.9 billion in 1980 and $14.7 billion in 1981. These foregone tax revenues are often referred to as tax expenditures by fiscal policy analysts.

According to the Current Population Survey conducted by the Bureau of the Census, there were more than 31 million active participants in private pensions in May 1979. Private pension plan filings required by ERISA suggest that the actual number of participants may be much higher. In any event, tax incentives granted to pension plans have resulted in a very large number of private sector workers sharing in these "tax expenditures."

Pension equity issues go beyond private pensions. Although private plans benefit from tax incentives, public retirement programs are directly financed through tax revenues collected from the general public. The "real expenditures" which finance public plans is an issue that should enter into any discussion of pension equity and pension tax policy.

During 1979, the federal government administered 83 pension plans. By comparison, there were 571,000 tax qualified private sector plans and an additional 500,000 Keogh plans in existence at that time. Among federal plans, the Military Retirement System (MRS) and the CSRS accounted for more than 90 percent of all federal pension plan participants. In 1979, MRS paid $10.3 billion in benefits to 1.3 million beneficiaries. CSRS paid $12.5 billion in benefits to 1.6 million beneficiaries. By comparison, all private sector plans paid $23.6 billion in benefits to 8.7 million beneficiaries that year. While federal employment comprises less than 5 percent of total employment, federal pension benefits in 1979, excluding Social Security benefits, exceeded all private sector pension payments that year.

If the CSRS were funded on a normal cost basis, it would cost 36.5 percent of covered payroll. This would meet currently accruing liabilities but would not amortize any previously accrued unfunded liabilities. Employees covered under CSRS contribute 7 percent of their earnings to their pension plan, leaving the taxpayer with a liability of 29.5 percent of federal civilian payroll or 80.8 percent of the program's cost. If these liabilities were currently funded, taxpayers would have to ante up $16.7 billion in 1979 alone.

The MRS is totally noncontributory for those covered and has a normal cost of 49 percent of payroll. Meeting current liabilities for this system would have raised taxpayer liability by $8.9 billion in 1979. Again, the figure includes no amortization of previously unfunded liabilities. Neither of these programs, however, is funded on this basis and the taxpayer burden actually exceeds the normal cost estimates. The MRS outlays alone in 1979 were $10.3 billion and were equivalent to more than 90 percent of the total "tax expenditure" attributed to all private pensions.

The rate at which we are losing ground on federal pensions, moreover, is staggering. The unfunded liabilities in the two largest federal retirement programs grew by $147 billion in fiscal 1980 and nearly $129 billion in 1981. The annual growth in the present value of future federal pension obligations for taxpayers is running at ten times the total annual tax expenditures for all private pensions.2/

A Related Equity Issue

Social Security and pensions are complementary. H.R. 6410 would significantly alter the relationship of many private plans to Social Security. The relationship of public pensions to Social Security should also be considered. The exemption of certain classes of workers from participation in Social Security raises equity issues. Roughly 2.5 million federal workers, 3 million state and local workers and a growing number of nonprofit employees are not

2/ U.S. Department of Treasury, Fiscal Service, Bureau of Government Financial Operations, Statement of Liabilities and Other Financial Commitments of the United States Government as of September 30, 1981 (Washington, DC: 1982).

covered by Social Security. Most of these workers, however, will ultimately qualify for Social Security benefits on an extremely preferential basis because of short-term or part-time work in covered jobs. This is often referred to as the "double dipper" problem, although the label is misleading. The House of Representatives Report on the Social Security Amendments of 1939 called these preferential benefits "unwarranted bonuses" and warned that "such bonuses are unwise and endanger the solvency of the system." The 1980 Report of the Universal Social Security Coverage Study Group estimated these unwarranted bonuses were costing full career payroll taxpayers $2 billion per year. This is an equity issue.

It is an equity issue because more than 90 percent of today's workers participate in the Social Security program -- most of them on a mandatory basis. These participants support this program which provides proportionately more generous benefits to low-wage workers than to high-wage workers. Part of the payroll tax contributions of higher wage earners who are covered by Social Security is used to subsidize benefits of retirees with low average lifetime covered earnings. Public employees, especially federal employees, have higher than average earnings. They escape contributing to this redistributive program and reap sizable unwarranted bonuses to boot.

<u>Revenue Considerations</u>

If the Pension Equity Tax Act would significantly enhance federal revenues, it might warrant immediate consideration. The Office of Tax Analysis estimates, however, that this legislation would generate added tax revenues of only $100 million in fiscal 1983 and cumulative added revenues of only $1.7 billion over the next three fiscal years. In light of the limited revenue prospects offered by H.R. 6410, its potential costs and ultimate inequity warrant more serious congressional scrutiny.