Pension Tax Expenditure Estimates

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Pension Tax Expenditures – True Cost of Qualified Retirement Savings

- UNDERSTANDING THE TAX EXPENDITURE CONCEPT
- HOW THE CURRENT MEASURE OVERSTATES THE TRUE COST OF RETIREMENT SAVINGS
- BENEFIT OF PENSION PROVISIONS IS THE DEFERRAL OF TAX – NOT THE EXCLUSION
- ALTERNATIVE MEASURES TO CASH-FLOW ANALYSIS

Tax Expenditure – Defined

The Congressional Budget and Impoundment Control Act of 1974 defines a tax expenditure as:

revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.

(Pub. L. No. 93-344), sec. 3(3).

Tax Expenditure Concept

Tax expenditures measure:

- the economic benefits provided through the tax laws to various groups of taxpayers and sectors of the economy and
- the tax benefit actually provided to taxpayers by any reductions in income tax liabilities that result from special tax provisions or regulations.

Tax scholars consider these special provisions to be analogous to direct outlay programs. In other words, outlays and tax expenditures are alternative means of accomplishing similar budget policy objectives.

Tax Expenditure Measures

The legislative history of the Budget Act indicates that the appropriate measure of tax expenditures is relative to a normal income tax structure (also known as the normal income tax law).

The tax expenditure calculations in the Treasury Department and JCT annual reports rely on projections of actual claims under the various tax provisions, not the potential tax benefits to which taxpayers are entitled.

Revenue Estimates and Tax Expenditure Estimates

- Tax expenditure estimates differ significantly from revenue estimates
- Tax expenditures measure the difference between tax liability under present law and the tax liability from recalculating taxes *without* the benefit of the special tax provision.
- Tax expenditure estimates assume that taxpayer behavior remains unchanged for estimating purposes. (This simplifies the calculation and conforms the tax expenditure estimate to budget outlays.)

Revenue Estimates and Tax Expenditure Estimates

Three features distinguish tax expenditure calculations from revenue estimates. Considering the repeal of a tax expenditure provision, the revenue estimate calculation does:

- **Incorporate the effects of taxpayer behavioral changes anticipated in response to the repeal of a tax provision;**
- **Consider the short-term timing of tax payments, but rather focus on changes in the reported tax liabilities of taxpayers; and**
- **Consider changes in such other Federal taxes such as FICA, excise taxes, estate and gift taxes.**

Tax expenditure calculations do not include any of these effects.

Revenue Estimates and Tax Expenditure Estimates

Consequently, many policymakers mistakenly view repeal of tax expenditure provisions as an indicator of the revenue raising potential.

In many cases, the revenue estimate of repealing a special tax provision produces considerably less revenue compared to the tax expenditure estimate, because the expenditure estimate does not consider these timing effects and behavioral responses of the affected taxpayers.

Current Measures of Pension Tax Expenditures

- **The JCT and OTA staffs use different methodologies to calculate tax expenditures, both the JCT and OTA staff measure tax expenditures for retirement savings provisions on a *cash basis*.**
  - **Note: the OTA staff also presents alternative present-value estimates for provisions, such as retirement savings provisions, that result in a deferral of tax.**
- **The JCT staff notes that "the tax expenditure for 'net exclusion of pension contributions and earnings' is computed as:**
  - **the income taxes foregone on current tax-excluded pension contributions and earnings**
  - **plus the income taxes paid on current pension distributions (including the 10-percent additional tax paid on early withdrawals from pension plans)."**

Problems with Current Tax Expenditure Measures

Retirement savings provisions create two tax benefits

- ***a primary benefit of tax-exempt earnings on retirement savings and***
- ***a secondary benefit if taxpayers face lower marginal tax rates when they withdraw retirement savings than the tax rates they faced when contributing to retirement savings.***

Problems with Current Tax Expenditure Measures

- Measuring all tax expenditures on a cash-flow basis inflates the cost of certain tax expenditures that do not provide a permanent tax benefit.
- The tax expenditure estimates overstate costs for provisions that defer income taxes compared to those that provide a permanent tax reduction.
- A current deduction or tax credit permanently reduces the amount of income tax a taxpayer will pay.
- While a tax deferral provides a reduction in current taxes, taxpayers must include these amounts in taxable income in a later year.

Problems with Current Tax Expenditure Measures

- **In the case of retirement savings provisions, a cash-flow method measures the sum of:**
    - **taxes that would otherwise be paid on retirement savings contributions made during the year and the tax-exempt earnings on all existing retirement savings plans accrued during the year**
    - **minus taxes paid on all withdrawals from retirement savings that occur during the year.**
- **One way of providing a fair comparison in the tax expenditure estimates is to provide a net present-value measure of the estimates for those provisions that provide a tax deferral, rather than a permanent current tax benefit.**

An Alternate Tax Expenditure Measure Research Conducted with Mary Schmitt

As mentioned above, two components of the pension tax expenditure estimate includes:

- **the tax benefit of the deferral attributable to current-year retirement savings contributions and**
- **the tax benefit with respect to future earnings attributable to current-year retirement savings contributions.**

To capture correctly these benefits, it is important to consider these estimates in:

- **present value terms (to capture the time value of money) and**
- **over the life cycle of the taxpayer (to capture an accumulation, maintenance, and withdrawal phase).**

An Alternate Tax Expenditure Measure

Measuring the Tax Benefits of the Deferral – This analysis distributes current contribution amounts by age as well as income of the taxpayer.

- Distributing taxpayer contributions by age provides a sense of the duration of the contribution phase before withdrawals begin (assuming that taxpayers contribute until they reach 65 years of age).
- Withdrawals begin after age 65 and continue to withdraw until they reach 80 years of age.
- This characterizes the potential tax benefit of the pension deferral allowing for assumptions about the tax rate at the withdrawal phase. Generally, the analysis assumes that taxpayers would face a lower tax bracket in retirement – one tax bracket lower than the one faced during their accumulation phase.

An Alternate Tax Expenditure Measure

Measuring the Tax Benefits of Future Earnings – The tax benefit for future earnings relies on the same distribution of taxpayers (by age and income).

- Distributing current contributions by age provides an opportunity to capture more accurately the duration of the accumulation and withdrawal phases.
- Distributing the age cohorts by income captures the tax benefit of these future earnings. (The analysis assumes that accumulated amounts would earn a 4 percent rate of return.)
- **These new estimates represent the *lifetime benefit* of the contributions to defined contribution**

Summary – Pension Tax Expenditures

Measuring the Tax Benefits

- Traditional cash-flow measures of retirement savings overstate the true cost.
- Tax expenditure measures should not characterize deferrals and exclusions in the same way
- **These new estimates represent the *lifetime benefit* of the contributions to defined contribution**