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TAX EXPENDITURES

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STATEMENT OF

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The views expressed in this statement are those of the witnesses and do not necessarily reflect the views of the Employee Benefit Research Institute, its Trustees, its members, or other staff.

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SUMMARY

The Institute appreciates the opportunity to address the Committee concerning "tax expenditures," especially those pertaining to employee benefits.

As you know, "tax expenditures" are defined 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."

"Tax expenditures" can arise from both employer and employee actions. For the individual they arise from such things as contributions to individual retirement accounts (IRAs). For employers they arise through contributions to employee benefit programs.

Employer contributions to tax-favored benefits that are not taxed as current income to the employee can be divided into two groups: benefits on which taxes are deferred and benefits that are tax-exempt. The National Income and Product Accounts provide statistics on both:

- o Tax-deferred benefits include, primarily, employer contributions to retirement income and capital accumulation plans. These constituted about 3.4 percent of total compensation in 1981. Taxation of these benefits is deferred until the employee withdraws funds from the plan.
- o Tax-exempt benefits include employer contributions to group health and life insurance, long-term and short-term disability income insurance, and a variety of smaller benefits that include dental insurance, child care, merchandise discounts and employer-provided meals. These benefits constituted 3.5 percent of total compensation in 1981.

Failure to distinguish among the growth of legally required employer payments, fully taxable employee benefits, tax-deferred benefits and tax-exempt benefits has greatly magnified the perception of the tax-base erosion that can be attributed to tax-favored and tax-exempt benefits.

The 1984 Reagan Budget lists separate categories and estimates of tax expenditures. Each is attributable to a decision by the Congress to provide preferential tax treatment to a specific kind of activity. For voluntary employee benefit programs more than 90 percent of the total tax expenditures can be attributed to health benefit programs or pension programs sponsored by employers.

Health Benefits

The 1984 Budget ranked the exclusion of employer health insurance contributions fourth among tax expenditures during fiscal 1983. These revenue estimates, however, are extremely sensitive to assumptions about employer contribution rates and the particular taxing options that are being considered. For example, in a CBO analysis of various tax cap levels, raising the cap from \$1,980 to \$2,160 for family coverage and from \$792 to \$864 for individual coverage, an increase of 9 percent, would reduce the potential tax revenue from the cap by 22 percent (see page 7 of full statement).

The sensitivity of the estimates to even relatively small changes in the level of the proposed cap reflects the relatively narrow range of employer contributions. There is little variance in the dollar amount of employer contributions across workers' earnings levels. That means that modest adjustment to the health benefits' tax cap can affect a large proportion of the workers who receive such benefits.

Because employer contributions are relatively constant, irrespective of income or earnings level, employer contributions for health insurance benefits represent a larger percentage addition to family income at lower income levels than for workers who are better off. Limiting or eliminating the tax incentives for employer health benefits, therefore, will place a

relatively heavy burden on workers at lower income levels.

One concern that policymakers should have is that the tax expenditure estimates are based on assumptions that behavior will not change. For example, consider the case of an employer who is providing family health insurance coverage that costs \$200 per married couple. The estimates of the revenues to be gained by a tax cap generally assume that such a cap of \$170 per month, as an example, would not result in different health benefits provisions under the modified tax treatment. That is, that the employer would continue to provide family health insurance that would cost \$200 per month, \$30 of which would be taxable income. Yet on the cost control side, proponents assume the tax cap would result in less comprehensive coverage. Less comprehensive coverage should be less expensive, reducing the premium rate below \$200, possibly even to \$170, thus eliminating the estimated revenue gain. Even if the employer cost did not decline there is the possibility that the portion of the premium that would become taxable would be shifted to another employee benefit still receiving preferred tax treatment. In this latter case, the tax cap might have no effect on either revenues or behavior.

RETIREMENT PROGRAMS

The largest single category of tax expenditure in the 1984 Budget is that attributed to the deferral of tax on employer pension plan contributions and earnings.

In the case of private retirement program tax expenditures the Treasury estimates the federal tax revenue losses that arise because pension and IRA contributions and the fund earnings are not taxed currently, even though taxes will be paid when benefits are ultimately paid.

Our testimony contains an example (pages 9 to 11) indicating that the

first year tax expenditure calculated by the Treasury for a \$1,000 pension contribution might exceed the total added accumulation over ten years that is attributable to tax deferral.

Were the law to be changed and pension contributions and interest accruals to become taxable all pension contributions would not flee to accounts providing their primary returns through capital gains (stocks), tax exempt interest (bonds), or tax deferred earnings (life insurance). But significant portions of these accounts might flee to other activities that are favored by the tax code rather than increasing Federal revenues.

There is no doubt that federal tax policy has contributed to the expansion of the pension system. There is no doubt that in the short term, the tax preference afforded retirement programs does cost the federal government some tax revenues. The conclusion that the number showing up in the annual Federal Budget is a fair representation of the pension system to federal taxpayers, however, is improper.

Methodological Problems in Retirement Program Tax Expenditure Estimates

The world is not quite as neat and simple as the example provided in our full statement. First, Treasury estimates the foregone taxes from exemption of employer pension contributions, personal IRA contributions, and the interest earned on these funds. Treasury then subtracts the estimated tax collections on pension benefits paid in the current year. The net difference is what they currently call the estimated tax expenditure resulting from the tax treatment of retirement programs.

The computation methodology does not consider that if taxes were now collected on pension contributions and trust fund interest accruals that this would necessarily result in a reduction in the taxes to be paid in the future

when benefits are disbursed. The methodology creates an upward bias because it does not consider the fact that current workers will have higher real earnings levels when they retire or the fact that the pension system is not yet mature.

From a purely conceptual basis the tax expenditure estimates are also flawed because the estimation procedure does not even attempt to account for the significant difference in the tax collections on current benefits paid and the time discounted value of future tax collections based on current contributions under these plans. From a more practical policy analysis perspective, the estimates are also flawed because of the totally unexplained variations in estimates from year to year.

Inconsistencies in IRA and Pension Tax Expenditure Estimates

The Special Analysis G in the Federal Budget does not include separate estimates of the tax expenditures that are attributable to IRAs. The IRA related tax expenditures are embedded in a broader category of "retirement plans for self-employed and others." One might have expected significant increases in the tax expenditure estimates between the 1982 and 1983 Budgets, in particular, because of the passage of ERTA which roughly doubles IRA eligibility for 1982. Yet this 1982 tax expenditure estimate only increased by 11 percent between the two annual Budgets. In fact, the 1984 Budget estimate of the 1982 fiscal year tax expenditure was only 23 percent greater than the 1982 estimate of the 1982 Budget and 12.5 percent greater than the 1981 estimate of the 1981 Budget.

By the time the 1984 Budget was prepared there was evidence available suggesting that 1982 IRA utilization in response to ERTA jumped significantly over prior years. Contributions for 1982 exceeded total accumulations for the 1974 to 1981 period.

By the end of the 1982 tax year in mid-April of 1983, sources (see Table 7) were showing total IRA balances of \$80 billion. That means that within the 1982 tax year new IRA contributions equaled at least \$50 billion. The Treasury Department uses an average marginal tax rate of approximately 30 percent to estimate the pension tax expenditures and slightly lower rates to estimate the IRA related expenditures. Assuming a rate of 28 percent would yield an IRA tax expenditure for the 1982 tax year of at least \$14 billion. The Treasury should update its IRA estimates based upon currently available information and should present a separate tax expenditure line item for IRAs.

Other Issues

- o The abstract concept of tax expenditures has been applied to private pensions for some years now. The application of the concept has not recognized that the implementation of ERISA's minimum funding standards has escalated private employer's contribution rates in many instances. The more rapid funding of pension obligations in compliance with federal law has contributed to the growth in the tax expenditure estimates. By enhancing the "Retirement Income Security," provided by pensions, the primary goal of ERISA, plan security is now being jeopardized because the resulting increase in tax expenditures heightens political pressure to reduce contribution levels.
- o Each of the tax expenditures is calculated on an item by item basis at the margin. That is, each is considered to be an "exception to the normal structure" of taxes, but is calculated as though all other exceptions are part of the normal structure for purposes of deriving the estimate. This ignores the extent to which one "exception" might be magnified because of the existence of others. The utility of the pension tax expenditures estimate is extremely limited unless considered in the broader context of other tax provisions.
- o The Treasury combines private and public employer pension contributions even though the rules that govern them are fundamentally different. The Treasury should present separate numbers for private, federal, and state and local programs, and should generate numbers based upon uniform assumptions in order to allow comparisons.

CONCLUSIONS

A thorough analysis and discussion of the numbers that are published in the Budget each year is needed. Consideration of the effect of behavioral changes that might accompany tax law changes and of the structure of other tax code provisions that affect the estimates, should be undertaken. Consideration of the life cycle structure of earnings, benefit accruals and marginal tax rates that provide a radically different distribution of the tax expenditures than cross sectional analysis is essential. Finally, inconsistencies in the actual calculations of these estimates, to say nothing of the significant methodological deficiencies in the calculation procedure, must be explored.

The current budget situation certainly warrants the concerns of the Congress. There is no segment of the budget or tax code that should be beyond scrutiny, and that includes employee benefits. But, policymakers must understand that employee benefit incentives are crucial to the long-term welfare of broad cross sections of society. The Institute offers its assistance in evaluating the ramifications for future generations of program participants and tax payers of both current tax incentives and reform proposals. The Institute has a major study in progress that is looking at many of the issues raised in this testimony, the result of which will be shared with the Congress.

INTRODUCTION

Mr. Chairman, it is a pleasure to appear before you today. I appear in my capacity as Executive Director of the Employee Benefit Research Institute. With me is Dr. Schieber, EBRI's Research Director. EBRI is a nonprofit, nonpartisan, public policy research organization founded in 1978. EBRI sponsors research and educational programs in an effort to provide a sound information basis for policy decisions. EBRI as an institution does not take positions on public policy issues.

We are pleased to address the Committee concerning "tax expenditures," especially those pertaining to employee benefits. During the last two years there have been significant changes in federal tax laws affecting employer sponsored benefit programs and individually established retirement programs. The Economic Recovery Tax Act (ERTA) of 1981 expanded the availability of Individual Retirement Accounts (IRAs) to include workers already covered by a pension plan. The Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982 reduced tax-exempt contribution limits for many private plans.

These and earlier provisions of the U.S. Tax Code have been the subject of much discussion and debate in recent years. The dialogue has often centered on the impact that favorable tax provisions for employee benefits have on federal tax collections. Many believe that these provisions help insure the general public's welfare during their working lives and help provide income security during retirement. Others think they are excessive or totally unwarranted.

The discussion of these issues is now taking on a sense of heightened

proportions for two reasons. The first is that the Federal Budget continues to be plagued by unprecedented deficits, meaning that all tax incentives will be subject to closer scrutiny. The second is that the cost of these tax incentives for some categories of employee benefits have been significantly increased in the 1984 Budget over prior Budget estimates. Virtually no explanation was provided for these precipitously higher estimates.

CONCEPTUAL BACKGROUND ON TAX EXPENDITURE

As the Budget of the United States Government is prepared each year a set of "tax expenditure" estimates is developed by the Treasury Department and published as part of the Budget. The "tax expenditure" concept was first laid out in 1967 by Stanley S. Surrey, the Deputy Assistant Secretary for Tax Policy at Treasury from 1961 to 1969. He stated:

Through deliberate departures from accepted concepts of net income and through various special exemptions, deductions and credits, our tax system does operate to affect the private economy in ways that are usually accomplished by expenditures -- in effect to produce an expenditure system described in tax language.

When Congressional talk and public opinion turn to reduction and control of Federal expenditures, these tax expenditures are never mentioned. Yet it is clear that if these amounts were treated as line items on the expenditure side of the Budget, they would automatically come under close scrutiny of the Congress and the Budget Bureau. 1/

The Congressional Budget Act of 1974 (P.L. 93-344) formally institutionalized "tax expenditures" as part of the regular budget document. The act defined tax expenditures 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

1/ Stanley S. Surrey in a speech to Money Marketeers, New York City, November 15, 1967.

rate of tax, or a deferral of tax liability." 2/ Within this context, tax expenditures are defined as "exceptions to the normal structure" of individual and corporate tax rates.

A problem with the concept of tax expenditures is that the tax code does not include a definition of the "normal structure" of the tax system. As the 1983 Budget points out, the term itself is "unfortunate in that it seems to imply that Government has control over all resources. If revenues which are not collected due to 'special' tax provisions represent Government 'expenditures,' why not consider all tax rates below 100% 'special,' in which case all resources are effectively Government controlled?" 3/ As a result the practical definitions that have arisen in the measurement of annual tax expenditures are not always consistent within or across categories, or from year to year.

THE MAGNITUDE OF TAX EXPENDITURES FOR VOLUNTARY EMPLOYEE BENEFIT PROGRAMS

The 1984 Budget of the United States Government submitted to the Congress by the Reagan Administration listed ninety-five separate categories and estimates of the related tax expenditures arising from special provisions in the United States Tax Code. Each of the special provisions in the tax code that gives rise to a tax expenditure represents a decision by the Congress to provide preferential tax treatment for a specific kind of activity. For example, the tax deductibility of home mortgage interest expenses represents a decision by the Congress to provide a tax incentive for individual home ownership. This provision in the tax code does not actually represent a direct expenditure by the Federal Government, but does result in lower total taxes

2/ Special Analysis Budget of the United States Government Fiscal Year, 1983 (Washington, D.C.: Office of Management and Budget, 1982) p. 3.

3/ Special Analyses Budget of the United States Government Fiscal Year 1983 (Washington, D.C.: Office of Management and Budget, 1982) p. 3.

being collected under the individual income tax, all other things being equal. The 1984 Budget estimate of the tax expenditure arising because of the deductibility of mortgage interest on owner-occupied homes during fiscal 1983 is \$25.1 billion dollars. ^{4/} This does not mean the government will provide homeowners with \$25.1 billion this year, but rather that homeowners would have to pay \$25.1 billion more in federal income taxes if their mortgage interest were not deductible, and if they did not change their behavior in any way relative to the tax code if this provision were eliminated.

It is not the purpose of this testimony to focus on the whole range of tax expenditures listed in the Budget but rather to evaluate those that pertain to employee benefit programs established by employers on a voluntary basis. The major categories of programs and the estimated tax expenditures related to each are shown in Table 1. More than 90 percent of the total tax expenditures for voluntary employee benefit programs can be attributed to either pension programs or health benefit programs sponsored by employers.

HEALTH BENEFITS TAXATION

There are basically three reasons why employers are willing to sponsor health insurance programs. The first reason, and this ranking does not infer that it is the primary motivation, is that a healthy workforce will be more productive than an unhealthy one. The second is that the employer can purchase health insurance on a group basis and realize significant economies of scale for the group that they could not realize as individuals. As a result, the aggregate cost of insurance is reduced for a given level of coverage. The third reason is that the purchase price of the health insurance is tax deductible if purchased through an employer's health benefit plan

^{4/} Special Analysis Budget of the United States Government Fiscal Year, 1984 (Washington, D.C.: Office of Management and Budget, 1983) p. G-32.

TABLE 1

FEDERAL REVENUE LOSS ESTIMATES FOR "TAX EXPENDITURES" FOR
 SELECTED VOLUNTARY EMPLOYEE BENEFIT PROGRAMS
 (in millions of dollars)

	Fiscal Years		
	1982	1983	1984
Exclusion of contributions to pre- paid legal services plans	\$ 20	\$ 25	\$ 25
Investment credit for ESOPs	1,390	1,250	1,375
Exclusion of employer contributions for medical insurance premiums and medical care	16,365	18,645	21,300
Exclusion of pension contributions and earnings:			
Employer plans	45,280	49,700	56,560
Plans for self-employed and others	2,835	3,755	4,230
Premiums on group term life insurance	2,035	2,100	2,259
Premiums on accident and dis- ability insurance	120	115	120
Income of trusts to finance supplementary unemployment benefits	10	5	5

SOURCE: Special Analysis Budget of the United States Government Fiscal Year, 1984 (Washington, D.C.: Office of Management and Budget, 1983) p. G-32.

but is not so deductible if it is purchased individually. Recently there has been considerable discussion of changing the tax treatment of health benefits programs.

Probably the primary argument used today for reducing the tax preferences for employer-provided health insurance is that it would reduce the comprehensiveness of insurance being provided. The literature is rich with analyses that show that more comprehensive coverage leads to increased utilization of health care services. It is argued that lowering the tax preferences will reduce the comprehensiveness of coverage, and thus, utilization levels. One rationale is that lower service utilization levels will dampen the well-known inflationary problem in health care prices.

Opponents of this logic argue that it is overly simplistic. They argue that given the inflation rate in this segment of the economy it is unlikely many will reduce the comprehensiveness of their coverage in response to changing tax preferences. This is especially the case for hospital coverage, a prime engine in medical cost inflation. On the other hand, physician coverage, preventive service coverage and dental and vision care coverage, where prices have been relatively stable, may be particularly vulnerable to changes in the tax provisions.

Neither of these arguments is well founded in the research literature. Thus another rationale may ultimately be crucial in determining the outcome of this issue. The consideration that might ultimately be of greatest significance is the need for added federal tax revenues. The 1984 Budget ranked the exclusion of employer health insurance contributions fourth among potential sources of new federal revenues during fiscal 1983. These revenue estimates, however, are extremely sensitive to assumptions about

employer contribution rates and the particular taxing options that are being considered. For example, in a CBO analysis of various tax cap levels, raising the cap from \$1,980 to \$2,160 for family coverage and from \$792 to \$864 for individual coverage, an increase of 9 percent, would reduce the potential tax revenue from the cap by 22 percent. ^{5/}

The sensitivity of the estimates to even relatively small changes in the level of the proposed cap reflects the relatively narrow range of employer contributions. There is little variance in the dollar amount of employer contributions across workers' earnings levels. That means that modest adjustments to the health benefits' tax cap can affect a large proportion of the workers who receive such benefits.

Because employer contributions are relatively constant, irrespective of income or earnings level, employer contributions for health insurance benefits represent a larger percentage addition to family income at lower income levels than for workers who are better off. Limiting or eliminating the tax incentives for employer health benefits, therefore, will place a relatively heavy burden on workers at lower income levels. At the same time, it is highly questionable whether the revised tax policy would result in less comprehensive hospital care coverage, the area of greatest health care cost inflation. In any event, the marginal effect of the tax cap legislation on budget deficits of \$170 to \$180 billion would be minimal.

One concern that policymakers should have if they view changes to the tax treatment of employee health benefits as a potential revenue source is that

^{5/} Computed from estimates presented in: Congress of the United States, Congressional Budget Office, "Containing Medical Care Costs Through Market Forces" (May 1982), p. 35.

the tax expenditure estimates are based on assumptions that behavior will not change if current tax provisions are modified. For example, consider the case of an employer who is providing family health insurance coverage that costs \$200 per month for a married employee. The estimates of the revenues to be gained by a tax cap generally assume that such a cap of \$170 per month, as an example, would not result in different health benefits provisions under the modified tax treatment. That is, that the employer would continue to provide family health insurance that would cost \$200 per month, \$30 of which would be taxable income. Yet on the cost control side, proponents assume the tax cap would result in less comprehensive coverage. Less comprehensive coverage should be less expensive, reducing the premium rate below \$200, possibly even to \$170, thus eliminating the estimated revenue gain. Even if the employer cost did not decline, there is the possibility that the portion of the premium that would become taxable would be shifted to another employee benefit still receiving preferred tax treatment. In this latter case, the tax cap might have no effect on either revenues or behavior.

RETIREMENT PROGRAM TAX EXPENDITURES

The largest single category of tax expenditure in the 1984 Budget is that attributed to the deferral of tax on employer pension plan contributions and earnings.

In the case of private retirement program tax expenditures the Treasury estimates the federal tax revenue losses that arise because pension and IRA contributions and the fund earnings are not taxed currently even though taxes will be paid when benefits are ultimately paid. The theoretical basis for these estimates is that if employer contributions to pension trusts or individual contributions to IRAs, or investment earnings on the assets were

taken as regular income, additional tax obligations would arise at the time the contribution is made or when the investment return is paid. The amount of this particular tax expenditure, however, is not simply current reductions of tax revenues but should recognize that there will be future tax collections at the point of distribution and thus, at least in part, represents taxes deferred not taxes foregone.

Consider the case of a worker who is in the 50 percent marginal tax bracket and is ten years from retirement. Assume this worker has \$1,000 in pre-tax income that can be invested in one of three ways: (1) a regular savings account; (2) a pension plan; or (3) an investment vehicle where all return on the investment is ultimately realized as a capital gain. Assume that the annual rate of return in each of these options would be 10 percent per year.

If the \$1,000 in pre-tax income is to be invested in a regular savings account then taxes have to be paid on the initial income, meaning that only \$500 will actually be deposited in the account. In each year, as the account accumulates interest taxes will also have to be paid on the annual returns. The value of the account at the end of each year over the ten years is shown in the regular savings account column in Table 2. At the end of ten years this account would accumulate to a value of \$814.45 under the posited assumptions and would be payable to the holder without any additional tax obligations.

The next column of Table 2 shows the accumulation of the \$1,000 pre tax dollars invested in a tax qualified pension plan. The difference is significant. First, the full \$1,000 can be invested and the taxes payable on the initial amount can be deferred until the benefits are actually distributed. Also the interest paid to the account each year is not taxable

TABLE 2

HYPOTHETICAL ALTERNATIVE INVESTMENTS AND RETURNS FOR A
WORKER IN 50 PERCENT TAX BRACKET

	Regular Savings Account	Pension Account Contributions	Tax Expenditure in Given Year	Capital Gains Vehicle
Pre Tax Income	\$1,000.00	\$1,000.00	--	\$1,000.00
Post Tax Income	500.00	1,000.00	\$ 500.00	500.00
Value of account at end of year				
1	525.00	1,100.00	50.00	550.00
2	551.25	1,210.00	55.00	605.00
3	578.81	1,331.00	60.50	665.50
4	607.75	1,464.10	66.55	732.05
5	638.15	1,610.51	73.21	805.26
6	670.05	1,771.56	80.53	885.78
7	703.55	1,948.72	88.58	974.36
8	738.73	2,143.59	97.44	1,071.79
9	775.66	2,357.95	107.18	1,178.97
10	814.45	2,593.76	117.90	1,296.88
Cash distribution	814.45	2,593.76	--	1,296.88
Tax liability on final distribution	--	1,296.88	--	159.38 <u>1/</u>
Disposable balance	848.45	1,296.88	--	1,137.50

SOURCE: EBRI calculations. Assumes 10 percent annual rate of return and 50 percent marginal tax bracket in each year.

1/ This is the capital gains tax not regular income tax.

until distribution. In the hypothetical example presented here the \$1,000 pension contribution will accumulate to a value of nearly \$2,600 over the ten years and will provide a post-tax distribution of \$1296.88. This is \$482.43 more than the post-tax accumulation under the regular savings vehicles. In other words, 37.2 percent of the pension accumulation in this example results because of the favored tax treatment accorded pensions compared to a conventional savings program.

Under the current method of computing the tax expenditures used by the Treasury Department, the tax revenues foregone because pension contributions and interest are not treated as regular income are estimated each year. The stream of tax expenditure estimates for the hypothetical case considered here are shown in Table 2. In the first year in which the deposit is made to the pension account the tax expenditure is calculated to equal \$500, thus actually exceeding in one year the total added accumulation over the ten year period that is attributable to the tax deferral on the pension accrual. This points to one potential problem in the calculation of tax expenditures that is evaluated in more detail later. Before turning to that discussion, however, it is instructive to consider the base against which the tax expenditures are estimated.

It is clear from the example described above that the tax system clearly encourages retirement accumulations in pensions versus regular interest bearing accounts, all other things being equal. However, it is unrealistic to assume that if the pension preferences in the tax code were eliminated all expected pension contributions would end up in conventional savings vehicles. For example, the right-hand column in Table 2 shows the potential post-tax accrual the hypothetical worker described above could acquire if the

initial post-tax \$500 were invested in an asset that did not pay a regular dividend but rather provided its return through the increasing value of the asset itself. In this case the post-tax disposable balance from the initial \$500 investment after ten years would be \$1,137.50 or within \$60 of the post-tax accrual under the pension option.

This does not mean that if pension contributions and interest accruals became taxable that all pension contributions would flee to accounts providing their primary returns through tax-exempt interest or capital gains. But significant portions of these accounts might flee to other activities that are favored by the tax code. For higher income individuals, in particular, this could be expected because the size of their savings over time makes it worthwhile to seek those opportunities that will minimize their tax liabilities on investment income. In this sense the estimated tax expenditures accruing to high income individuals through their pension participation are greatly exaggerated.

Middle-income individuals who have significantly lower tax rates during retirement than during their working careers receive much greater advantage from the tax treatment of pensions, on the other hand. For example, in the hypothetical case considered earlier, if the marginal tax rate is 20 percentage points lower in retirement than during the working career then the disposable retirement benefits provided by the pension increase by more than \$500 to \$1815.63. In this case the preferential tax treatment of the pension would account for 55 percent of the retirement benefit relative to the accumulation under a regular savings account. The elimination of preferential tax provisions for pensions will leave middle income workers with less adequate retirement benefits because they will not be able to adjust their investment

portfolio in the sophisticated manner that higher income individuals can.

There is no doubt that federal tax policy has contributed to the expansion of the pension system. There is no doubt that in the short term, the tax preferences afforded retirement programs do cost the federal government some tax revenues. The conclusion that the number showing up in the annual Federal Budget is a fair representation of the pension system to federal taxpayers, however, is improper.

Methodological Problems in Retirement Program Tax Expenditure Estimates

The world is not quite as neat as the simple example discussed above and thus, the actual estimation of tax expenditures for retirement programs is quite complicated. First, Treasury estimates the foregone taxes from exemption of employer pension contributions, personal IRA contributions and the interest earned on these funds. From this foregone collections estimate Treasury subtracts the estimated tax collections on pension benefits paid in the current year. The net difference is what they currently call the estimated tax expenditure resulting from the tax treatment of retirement programs.

This calculation procedure would result in a \$500 tax expenditure in the first time period in the example cited above. The computation methodology does not consider that if taxes were now collected on pension contributions and trust fund interest accruals that this would necessarily result in a reduction in the taxes to be paid in the future when benefits are disbursed.

From a purely conceptual basis the tax expenditure estimates in this instance are flawed because the estimation procedure does not even attempt to account for the significant difference in the tax collections on current benefits paid and the time discounted value of future tax collectins based on current contributions under these plans. From a more practical policy analysis

perspective, the estimates are further flawed because of the totally unexplained variations in estimates from year to year. Each of these problems is discussed in more detail below.

In the simple example used above it was possible to show how the tax expenditures arise and how they are measured. If the tax-expenditure concept is to have any semblance of validity in the context of pensions, then the annual measurement of these expenditures should estimate the differences in the value of a person's lifetime tax obligations that arise because part of earnings can be deferred as a pension contribution. In the aggregate, foregone revenues in the current time frame should be adjusted to account for the present value of future collections that will result because the pensions funded today will ultimately be taxed. In the current Treasury estimates of tax expenditures for retirement programs the foregone revenues are estimated on the basis of one set of individuals and the tax collections on pension benefits are estimated on a totally different set of individuals. This procedure upwardly biases the estimated tax expenditure for two reasons.

The first is that current workers will have higher real earnings levels over their lifetime than current beneficiaries. It is this phenomenon that raises the real level of Social Security and pension benefits alike for succeeding cohorts of retirees. As a result, the marginal tax rates that will be paid on pension benefits earned today will be higher than the marginal tax rates on benefits that are paid today. Underestimating the marginal tax rates that will apply to currently earned benefits will overestimate the magnitude of tax expenditures.

The second reason that current estimation techniques result in biased estimates of retirement program tax expenditures is that the pension system in

this country is not yet mature. For example, consider the case of a new pension plan in a firm with middle age and younger workers. For several years the employer will make contributions, representing foregone tax collections in the calculation, but no benefits will be paid, and thus, there are no offsetting tax revenues collected that enter the tax expenditure calculation. If the expenditure was estimated by subtracting future discounted taxes on pensions from foregone taxes on current trust fund contributions and interest it would make no difference if there were beneficiaries or not. The maturity of the pension system would not be important if the tax expenditures were estimated as in the hypothetical example, but it is critically important given the actual method of calculation.

Table 3, based on tabulation of information that plan sponsors filed with the IRS (Form 5500) in compliance with ERISA for the 1977 plan year, indicates a clear relationship between plan age and beneficiaries in defined-benefit plans. Defined-benefit plans cover two-thirds of private plan participants and an even larger segment of the public plan members. Among other things, Form 5500 requires reporting the "effective plan date" or date the plan was set up.

It also requires that the number of active participants in the plan and the number of beneficiaries be reported. The age of the plan can be calculated from the effective plan date. As expected, most of the young plans have more workers per beneficiary than older plans do. Less than 10 percent of the plans that had been created in the previous five years reported fewer than five workers per retired beneficiary. For plans operating twenty-five years or longer, nearly 49 percent had fewer than five active participants per beneficiary. The changes in this relationship with increasing plan age are too

TABLE 3

WORKING PARTICIPANTS PER BENEFICIARY IN DEFINED BENEFIT
PENSION PLANS WITH MORE THAN 100 ACTIVE PARTICIPANTS
DURING 1977 BY PLAN AGE

	Total	Plan Age						Unknown
		Less Than 5 Years	5-10 Years	11-15 Years	16-20 Years	21-25 Years	Over 25 Years	
Total Plans (number)	22,467	4,092	5,418	3,839	3,008	2,258	3,628	224
Working Participants Per Beneficiary		Percentage of Plans						
Two or less	5.5	1.9	2.1	3.4	7.0	10.5	12.0	7.6
More than 2, up to 5	19.8	7.5	10.2	17.2	27.9	31.3	36.9	21.9
More than 5, up to 10	20.1	10.7	17.4	23.5	25.9	24.9	23.1	21.9
More than 10, up to 20	15.4	13.1	19.6	19.3	15.7	12.1	9.4	12.5
More than 20	30.0	55.5	39.7	26.7	16.9	14.4	10.8	26.3
Unknown <u>a/</u>	9.3	11.3	10.9	9.9	6.7	6.7	7.7	9.8

SOURCE: EBRI tabulations of 1977 plan disclosure data submitted to IRS in compliance with ERISA.

a/ Includes plans with no beneficiaries reports.

consistent to be coincidental. At the other end of the participant/beneficiary range, the pattern is comparably consistent. More than 55 percent of plans less than five years old had twenty or more active workers per beneficiary, while less than 11 percent of the oldest plans reporting had as many as twenty participants per beneficiary.

Undoubtedly many of the older plans in Table 3 with high worker/beneficiary ratios are in firms that are expanding. High worker/beneficiary ratios will continue as some plan sponsors continue to expand in the future, but such sponsors will still have increasing numbers of beneficiaries over the years. This relationship of plan age and beneficiary rates becomes particularly significant in comparison with defined-benefit plan

creation data. 6/ Using 1977 as the reference year, because it corresponds with the ERISA data, the universe of private defined-benefit programs grew by 218,487 plans in the previous twenty years; 32.0 percent of this growth occurred between 1973 and 1977 and 72.7 percent between 1968 and 1977. If all 28,169 tax qualified plans in existence at the end of 1955 were assumed to be defined-benefit plans, which is certainly not the case, 62.7 percent of all defined-benefit plans would have been less than ten years old at the end of 1977. The defined-benefit pension system in this country today is still quite young. As the system matures, the ratio of workers to beneficiaries will markedly decline, much as the ratio of workers to beneficiaries in the Social Security program declined during the 1950s and 1960s. 7/ The ratio will decline not because of fewer covered workers, but because of more beneficiaries. The relatively small number of beneficiaries today, however, results in significant overestimates of retirement program tax expenditures.

This bias in the tax expenditure estimates will decline, to some extent, as programs mature but can never be totally resolved because of the wage growth phenomenon cited earlier.

Unexplained Variations in the Estimates

One of the problems with the estimates of tax expenditures arising

6/ These data are spelled out in detail in Sylvester J. Schieber, Social Security: Perspectives on Preserving the System (Washington, D.C.: The Employee Benefit Research Institute, 1982) p. 52.

7/ For example, the percentage of workers participating in Social Security during 1940 was about twenty-five times the percentage of elderly receiving benefits in that year. As the program matured, this difference declined to less than four times in 1950 and then gradually moved toward and reached equality in the mid-1970s. It took Social Security about thirty-five years until beneficiaries made up a segment of the retired population that was comparable to the segment of the workforce that was contributing to the program.

from the special tax provisions for retirement programs is precipitous changes in the estimates from year to year that are not explained. As an example of this inconsistency Table 4 shows the tax expenditure estimates due to the tax treatment of employer sponsored plans included in the last four Federal Budgets.

The 1981 Budget estimate of this particular tax expenditure for fiscal year 1981 was \$14.7 billion. The 1982 Budget estimated the 1981 fiscal year tax expenditure for the identical category of plans at \$23.6 billion -- a 60 percent increase. There was absolutely no explanation in the Budget documents explaining the changed estimate from one budget to the next. The only explanation that we have found for the 1980 and 1981 Budget differences is by

TABLE 4

FEDERAL REVENUE LOSS ESTIMATES FOR "TAX EXPENDITURES" DUE TO
NET EXCLUSION OF PENSION CONTRIBUTIONS AND EARNINGS PRESENTED IN
SELECTED FEDERAL BUDGETS

	Fiscal Year				
	1980	1981	1982	1983	1984
	(dollar amounts in millions)				
1981 Budget	\$ 12,925	\$ 14,740			
1982 Budget	19,785	23,605	\$ 27,905		
1983 Budget		23,390	25,765	\$ 27,500	
1984 Budget			45,280	49,700	\$ 56,560

SOURCES: Special Analysis G of the Budget of the United States Government for Fiscal Years 1981-1984 (Washington, D.C.: Office of Management and Budget).

Munnell who writes that the "Revised estimates employ higher, and therefore more realistic, marginal tax rate assumptions. These indicate a substantially larger tax expenditure for private plans." ^{8/} The explanation that higher marginal rates were used to generate the 1982 Budget estimates is plausible. What is interesting is that there is absolutely no published documentation on the actual rates used to generate either the 1981 or 1982 Budget estimates. Not only does Munnell ignore this completely throughout her book on private pensions but she also fails to explain her conclusion that the higher tax rate assumptions used in the 1982 Budget estimate are "therefore more realistic." There is certainly no a priori reason to believe that any set of assumptions is more realistic than another without an analytical basis on which to evaluate them. Such analysis was not available to compare the 1981 and 1982 Budgets. There is also a lack of analysis explaining even greater discrepancies between the 1983 and 1984 Budgets. The estimated fiscal 1982 tax expenditure due to net exclusion of employer pension contributions and trust fund earnings was 75.7 percent higher in the 1984 Budget than in the 1983 Budget. The projected growth in this category of tax expenditure during fiscal 1983 was 254.8 percent higher in the 1984 Budget than in the prior budget's estimate. Again, none of the Budget materials or other public documents explain the revised estimates.

Through an arduous process of telephone discussions with various staff at the Treasury Department a general explanation of the revised fiscal 1983 and 1984 estimates in the 1984 Budget has been pieced together. One reason for the difference in the two Budgets is that the analyst who did the 1983 Budget estimates retired and a new analyst prepared the 1984 Budget estimate. The new

^{8/} Alicia H. Munnell, The Economics of Private Pensions (Washington, D.C.: The Brookings Institution, 1982) p. 44.

analyst has been able to partially clarify the discrepancy. The difference in the estimates for fiscal 1982 is \$19.515 billion (i.e., \$45.280 - \$25.765). Of this, \$17.135 billion is attributable to higher estimated contributions and pension trust earnings. The remaining \$2.380 billion in the higher tax expenditure estimate from the 1984 Budget is attributable to changes in the tax rate assumptions.

It appears the primary reason for the significantly (some would say astronomically) higher estimate of employer contributions and pension trust earnings is that federal civilian and state and local pension plans were included in the tax expenditure calculations for the first time. It is interesting that adding the tax expenditures attributable to public plans covering about 15 percent of the U.S. workforce can increase the tax expenditure estimate by more than two thirds. This element of the revised tax expenditure estimate can be better understood by looking at recent annual contributions to pension trusts in the various sectors.

Table 5 includes recent annual contributions to privately sponsored retirement programs, state and local plans and the federal Civil Service Retirement System. While the latter does not include all federal civilian pension costs it does capture at least 90 percent of these costs and is sufficient for this comparative analysis. What is immediately apparent is that adding in the public employer plan contributions increases the previously considered employer contribution in 1981 by 63.5 percent (i.e., \$38.26/\$60.26). As stated above the 1983 Budget estimate of retirement plan related tax expenditures in 1982 was \$25.8 billion. The 1984 Budget tax expenditure estimate was \$17.1 billion higher (or 66.3 percent) because of added trust fund contributions and interest income considered. It appears that

TABLE 5

EMPLOYER CONTRIBUTIONS TO RETIREMENT PROGRAMS FOR
SELECTED PRIVATE AND PUBLIC EMPLOYER PLANS

Year	Private Pension and Profit Sharing Contributions		State and Local Contributions		Federal Civil Service Retirement Contributions		Aggregate Employer Contributions
	(billions)	(Percent) (of total)	(billions)	(Percent) (of total)	(billions)	(Percent) (of total)	(billions)
1970	\$ 13.0	66.3%	\$ 4.6	23.5%	\$ 2.0	10.2%	\$ 19.6
1971	15.0	65.5	5.2	22.7	2.7	11.8	22.9
1972	17.8	66.2	5.8	21.6	3.3	12.3	26.9
1973	20.7	66.3	6.6	21.2	3.9	12.5	31.2
1974	24.2	65.8	7.8	21.2	4.8	13.0	36.8
1975	27.6	63.6	9.1	21.0	6.7	15.4	43.4
1976	33.0	64.0	10.7	20.7	7.9	15.3	51.6
1977	38.4	63.9	12.4	20.6	9.3	15.5	60.1
1978	44.0	64.0	13.7	19.9	11.0	16.0	68.7
1979	48.9	63.5	15.3	19.9	12.8	16.6	77.0
1980	54.7	62.3	17.5	19.9	15.6	17.8	87.8
1981	60.2	61.2	20.0	20.3	18.2	18.5	98.4

SOURCES: Private Plan contributions from U.S. Department of Commerce, The National Income and Product Accounts, 1948-1974 and Revised Estimates of the National Income Product Accounts (July 1982); State and Local Government plan contributions from U.S. Bureau of the Census, Finances of Employee Retirement Systems of State and Local Governments, 1970-1971; 1972-1973; 1973-1974; 1975-1976; 1976-1977; 1977-1978; 1978-1979; 1979-1980; 1980-1981. Table 2; Federal Civil Service Plan Contributions from United States Office of Personnel Management, Federal Fringe Benefit Facts 1980, 1980, Table 5-1, p. 15; and unpublished data from the Office of Personnel Management.

virtually all of this adjustment can be laid directly to the inclusion of the public plans for the first time.

The remaining \$2.4 billion discrepancy in the 1983 and 1984 Budget estimates of retirement program tax expenditures for 1982 was attributed to changes in the tax rate assumptions. At first blush one might think that the effects of the Economic Recovery Tax Act of 1981 would be to reduce the tax rates considered for estimating these tax expenditures. Also the reductions in the contribution limits and other provisions in the Tax Equity and Fiscal Responsibility Act of 1982 should reduce the pension contributions and accruals for some individuals in the high marginal tax brackets.

Finally, the recommendation of the National Commission on Social Security Reform to tax Social Security benefits that was implemented in the

Social Security legislation passed by Congress will raise marginal tax rates for many elderly pension recipients. Because the adjusted gross income thresholds at which Social Security benefits become taxable are not indexed the marginal tax rates of pension recipients should increase gradually in the future. Higher marginal tax rates among pension recipients should reduce future pension tax expenditure estimates under the current estimation methodology.

The assignment of pension contributions across individuals in the Treasury's Tax Model has not been publicly described, making it difficult to understand the reasons for or mechanics of adjusting tax rates for purposes of these calculations, however. The analyst who generated the pension tax expenditure estimates for the 1984 Budget did not know how such contributions were assigned in the model when we called to ascertain such information. Nor was he able to provide such documentation in time for development of this discussion.

One possible reason for using higher tax rate assumptions in the 1984 Budget calculations than used a year earlier is the inclusion of public workers, especially those employed by the Federal government. "The mean annual earnings from the total civilian population employed full time in 1977 was approximately \$13,849. The mean annual salary level of Federal employees covered by CSRS in April was \$16,000." ^{9/} Inclusion of federal workers with their higher than average earnings may account for the revised tax rate assumptions used to calculate the pension tax expenditures in the 1984 Budget.

Inconsistencies in IRA and Pension Tax Expenditure Estimates

The Special Analysis G in the Federal Budget does not include separate

^{9/} Final report of the Universal Social Security Coverage Study Group, The Desirability and Feasibility of Social Security Coverage for Employees of Federal, State and Local Government and Private, Nonprofit Organizations (Washington, D.C., 1980), p. 31.

estimates of the tax expenditures that are attributable to IRAs. The IRA related tax expenditures are embedded in a broader category of "retirement plans for self-employed and others." Table 6 shows the tax expenditure estimates for this broader category from the last four Federal Budgets. One might have expected significant increases in the tax expenditure estimates between the 1982 and 1983 Budgets, in particular, because of the passage of ERTA which roughly doubled IRA eligibility for 1982. Yet this 1982 tax expenditure estimate only increased by 11 percent between the two annual Budgets. In fact, the 1984 Budget estimate of the 1982 fiscal year tax expenditure was only 23 percent greater than the 1982 estimate in the 1982 Budget and 12.5 percent greater than the 1981 estimate in the 1981 Budget.

Even the 1983 Budget estimates might be understood since that Budget was prepared well before any substantive information on 1982 IRA utilization

TABLE 6

FEDERAL REVENUE LOSS ESTIMATES FOR "TAX EXPENDITURES" DUE TO
NET EXCLUSION OF CONTRIBUTIONS TO RETIREMENT PLANS FOR THE
SELF-EMPLOYED AND OTHERS PRESENTED IN SELECTED FEDERAL BUDGETS

	Fiscal Year				
	1980	1981	1982	1983	1984
	(dollar amounts in billions)				
1981 Budget	\$ 2,125	\$ 2,520			
1982 Budget	1,925	2,105	\$ 2,305		
1983 Budget		2,170	2,560	\$ 3,760	
1984 Budget			2,835	3,755	\$ 4,230

SOURCES: Special Analysis G of the Budget of the United States Government for Fiscal Years 1981-1984 (Washington, D.C.: Office of Management and Budget).

levels was available. But by the time the 1984 Budget was prepared there was evidence available suggesting that 1982 IRA utilization in response to ERTA jumped significantly over prior years. For example, EBRI released the data in Table 7 in a news release on November 19, 1982. This information was picked up quickly in both the trade press and the conventional media. This includes such newspapers as USA Today and The Washington Post. Table 7 shows that the IRA contributions during fiscal 1982 had to have been at least \$21 billion.

In the preparation of the 1983 Budget, the 1981 expenditure for private plans was estimated at \$23.4 billion (see Table 4) on contributions of \$60.2 billion (see Table 5) and income on the trust funds. According to Munnell the average marginal tax rate of workers covered by a pension used to

TABLE 7

ASSETS IN INDIVIDUAL RETIREMENT ACCOUNTS, 1981-1982				
Financial Institution	Year-end 1981	April 30, 1982	June 30, 1982	September 30, 1982
	(dollar amounts in billions)			
Commercial Banks 1/	\$7.0	\$13.0	\$14.9	\$16.2
Mutual Savings Banks 1/	3.4	4.5	5.8	5.9
Savings and Loans 1/	9.2 2/	16.3	n.a.	n.a.
Mutual Funds	2.6	4.0	4.3	5.0
Credit Unions	0.2	0.5	n.a.	n.a.
Life Insurance Co.	3.3	n.a.	n.a.	n.a.
Total Assets	\$25.7	\$41.6 3/	\$45.1 3/	\$46.5 3/

SOURCES: EBRI tabulations of data provided by Federal Reserve Board, National Association of Mutual Savings Banks, National Credit Union Administration, Federal Home Loan Bank Board, U.S. League of Savings Associations, Investment Company Institute and American Council of Life Insurance.

1/ IRA and Keogh deposits.

2/ Estimated.

3/ Baseline estimates using latest available date for each institutional category. The estimates provide a minimum total asset amount, which may under report the actual amount of total assets outstanding.

compute the pension tax expenditure was something in excess of 23 percent.^{10/} If the average marginal tax rate of 23 percent is applied to the minimum of \$21 billion in IRA contributions then the foregone federal tax would be around \$4.8 billion for fiscal 1982. Given higher rates of IRA utilization among upper income individuals this assumed marginal tax rate is likely to be quite low, understating foregone tax revenues in the current period. Few individuals are yet receiving significant IRA based annuities so the tax collections on such annuities cannot explain the discrepancy between the \$4.8 billion estimated here and the \$2.8 billion estimated in the 1984 Budget. The discrepancy is even harder to reconcile when the Budget's inclusion of Keogh plans is considered.

By the end of the 1982 tax year in mid-April of 1983, the same sources which provided the information for the compilation of Table 7 were reporting total IRA balances of \$80 billion. That means that within the 1982 tax year new IRA contributions equaled at least \$50 billion. The Treasury Department uses an average marginal tax rate of approximately 30 percent to estimate the pension tax expenditures and slightly lower rates to estimate the IRA related expenditures. Assuming a rate of 28 percent would yield an IRA tax expenditure for the 1982 tax year of at least \$14 billion. Moving from a tax year period to a fiscal year period would allow some slight variation from this estimate for fiscal 1983. However, the tax year versus fiscal year discrepancy should have very little effect on the fiscal 1984 or subsequent fiscal year estimates.

Other Issues

The abstract concept of tax expenditures has been applied to private

^{10/} Alicia H. Munnell, The Economics of Private Pensions (Washington, D.C.: The Brookings Institution, 1982) p. 44. Munnell explains that the 23 percent rate was used to prepare the estimate for the 1981 Budget but that higher marginal rates were used in preparing the estimate for subsequent budgets.

pensions for some years now. The application of the concept has not recognized that the implementation of ERISA's minimum funding standards has escalated private employer's contribution rates in many instances. The more rapid funding of pension obligations in compliance with federal law has contributed to the growth in the tax expenditure estimates. By enhancing the "Retirement Income Security," provided by pensions, the primary goal of ERISA, plan security is now being jeopardized because the resulting increase in tax expenditures heightens political pressure to reduce contribution levels. The tax expenditure concept is now being applied to state and local and federal civilian plans as well. The military retirement program is still not included in the 1984 Budget estimates of tax expenditures for employer sponsored retirement programs. The estimate does include some amount attributed to military disability benefits -- but they make up only about 9 percent of the military retirement program. The military retirement program paid \$13.7 billion in benefits during fiscal 1981 and thus is the second largest pension plan in the United States, behind the Civil Service Retirement System. In combination the federal civilian and military retirement programs cover about 5 percent of the total U.S. work force and paid retirement benefits in 1979 exceeding the benefits paid by all private pension programs. 11/

Why then, if including the federal civilian retirement program so significantly affects the tax expenditure estimates isn't the military retirement program included? One reason is that the military retirement program is totally unfunded with outstanding unfunded liabilities at the end of fiscal 1981 of \$476.9 billion. Under the computation method used to estimate

11/ EBRI ISSUE BRIEF #10 "Federal Pensions." (Washington, D.C.: EBRI, July 1982) p. 5.

them no tax expenditure arises in this case. There is no contribution to or interest paid to a trust fund since none exists. The benefits paid are all taxable since the program is noncontributory.

Since the funding pattern of the plan doesn't fit the mold assumed by the computation method then the "tax expenditure" is ignored. In fact, the Civil Service plan is also largely financed on a pay-as-you-go basis. If these two retirement plans had met their normal cost contribution plus the 40 year annual amortization schedule stipulated in ERISA as the minimum funding requirement for private plans established before 1974, the total employer contribution to these two plans would have been \$89.2 billion during fiscal 1981. ^{12/} This is 48.5 percent more than the total employer contribution that went to all private plans in 1981 shown in Table 5 earlier. In other words, only one-fifth (\$18.2 billion) of the federal contribution that would be required of private plans under ERISA is considered in the tax expenditure estimates when the Treasury Department estimates these for federal plans. If the estimates of tax expenditures are to be consistent, then the federal plans' tax expenditure estimates should be generated on a basis consistent with those used to estimate the private plan number. Because of the significant differences in plans across the various sectors and the role of government sponsorship or regulation, the tax expenditure estimates should be presented separately for federal, state and local, and private plans.

Relationship to Other Tax Expenditure Categories

Each of the tax expenditures is calculated on an item by item basis at

^{12/} This is based on actuarial reports on the Civil Service Retirement System and military retirement program filed with the United States Congress in compliance with Public Law 95-595 for fiscal year 1981.

the margin. That is, each is considered to be an "exception to the normal structure" of taxes, but is calculated as though all other exceptions are part of the normal structure for purposes of deriving the estimate. This ignores the extent to which one "exception" might be magnified because of the existence of others.

For example, consider the case of a 66 year-old single man who received \$8,400 in Social Security benefits during 1982 and an additional \$8,400 in pension benefits. Assume there was no other income received and no special deductions considered for calculating tax liability. This person would have adjusted gross income of \$8,400 under current law. He would be eligible for a double exemption since he was over age 65 and so his taxable income would be \$6,400. Schedule X of 1982 Federal Income Tax Tables indicates a tax liability of \$592.

Assume as an alternative, that this man had not enjoyed the double exemptions for being over age 65 or the nontaxability of Social Security benefits. These two provisions of the tax law are considered to be "exceptions to the normal structure" because tax expenditures are calculated for them as well. The Treasury analysts use the actual \$592 in taxes paid on current benefits to estimate pension tax expenditures. However, if these other two "exceptions to the normal structure" of taxes did not exist then the man's 1982 tax liability would be \$2,546.

It is clear that other "exceptions to the normal structure" give rise to large portions of tax expenditures attributed to pensions because they drastically lower marginal tax rates for the elderly. The utility of the pension tax expenditures estimate then, is extremely limited unless considered in the broader context of other tax provisions. Yet virtually no analysis of this kind is now available.

CONCLUSIONS

A thorough analysis and discussion of the tax expenditure numbers that are published in the Budget each year is needed. Consideration of the structure of other tax code provisions that affect the estimates should be undertaken. Consideration of the life cycle structure of earnings, benefit accruals and marginal tax rates that provide a radically different distribution of the tax expenditures than cross sectional analyses is essential. Finally, inconsistencies in the actual calculation of these estimates, to say nothing of the significant methodological deficiencies in the calculation procedure must be explored. 13/

The current budget situation certainly warrants concern. There is no segment of the budget or tax code that should be beyond scrutiny, and that includes employee benefits. But, policy makers must understand that employee benefit incentives are crucial to the long-term welfare of broad cross sections of society. The Institute offers its assistance in evaluating the ramifications for future generations of program participants and tax payers of both current tax incentives and reform proposals.

13/ See EBRI ISSUE BRIEF #17 "Retirement Program Tax Expenditures" (Washington, D.C.: EBRI, April 1983) and EBRI statement to the Senate Finance Committee on "The Tax Treatment of Employee Benefits," June 22, 1983.