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Statement of

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before the

Ways and Means Committee

House of Representatives

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

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EBRI

June 7, 1982

The Honorable Dan Rostenkowski
Chairman, House Ways and Means Committee
and Distinguished Members
United States House of Representatives
Washington, D.C. 20515

RE: Pension Equity Tax Act of 1982 (HR 6410)

Dear Mr. Chairman & Members:

Attached, please find my statement on provisions of the above proposed legislation.

The Employee Benefit Research Institute stands ready to conduct analysis of this legislation or alternative proposals upon request.

I appreciate the opportunity of presenting views to you on this legislation.

Respectfully Submitted,

Sylvester J. Schieber

Sylvester J. Schieber
Research Director

Attachment

Mr. Chairman, I am pleased to appear before you today to comment upon the Pension Equity Tax Act (HR6410). I appear today in my capacity as Research Director of the Employee Benefit Research Institute. EBRI is a nonprofit organization dedicated to providing research and analysis which can serve as a basis for sound policy toward employee benefits. Prior to joining EBRI I served as the Deputy Director of the Office of Policy Analysis in the Social Security Administration. Prior to that I was the Deputy Research Director of the Universal Social Security Coverage Study, a study mandated by Congress. While the views that I express here are based on several years of research and analysis sponsored by various private and public organizations, they are my own and do not represent the official position of EBRI or any other organization.

My testimony today makes three basic points. First, our retirement system is a set of integrated parts. Policies that affect pensions or Social Security benefits or private savings affect the ability of the entire system to assure adequate retirement income security for the elderly. Second, pension equity must look beyond private pensions. The purpose of the HR6410, to promote equity in our pension system is not best served by adjusting the tax treatment of private pensions alone. Finally, I wish to raise several questions about specific elements of the legislation being considered. We have not begun to assess the ultimate impact of the provisions of this bill in the context of an interdependent retirement system. Such assessments should be developed prior to the implementation of legislation that is bound to have significant effects.

RETIREMENT INCOME SECURITY SYSTEM

In our research at EBRI we have argued that decision makers should consider the following points as they make retirement policy. They should consider the existing system's structure and the relative role of its component parts. None of the elements in our retirement system exists in a vacuum. Policy changes that affect one component of the system have reverberating implications for each of the complementary parts.

It is encouraging that this fact is gaining recognition. The very establishment of the President's Commission on Pension Policy and the nature of their mandate attests to it. The fact that the National Commission on Social Security Reform has devoted considerable time to the consideration of the role of pensions does also. Each of the component elements of the U.S. retirement system has evolved in response to an economic need. There has been little coordination of this evolution, however. Both equity and economic efficiency dictate that we begin to consider retirement policy on a more comprehensive basis than we have traditionally.

Social Security is this society's joint retirement endeavor. Through it, employers and employees participate in a program that is redistributive, helping the lower-wage earner relatively more than those who earn more. It is portable, helping the mobile and stable worker alike. Historically, it has shared the benefits of growing national productivity with each wave of new retirees. It is an element of our retirement system that has become totally woven into our economic fabric.

But Social Security is not enough. Employer pensions have evolved for many reasons -- some implicit, others explicit. Some pensions predate Social Security but most have come to exist since 1940 when Social Security benefits were first paid. Certainly one of the reasons that pensions have become so popular is that Social Security benefits by alone are not sufficient to meet the retirement income security needs of all members of our society.

While pensions are agreements between workers and their employers it is still in the public interest to encourage their existence and continued expansion. There are several reasons that this is so. In our economy today pensions are providing a major source of capital. They are providing benefits to rapidly growing proportions of the elderly. As they continue to expand in the future they have the potential of alleviating some of the long-term benefit pressures that the baby boom poses for Social Security. Our estimates are that by early next century more than three-fourths of all elderly households will be receiving a pension.

Social Security and pensions are both vital to the continued retirement income security of older Americans. Their roles are complementary and that reinforces the advantages of each. It is in this context that pension equity should be considered.

PENSION EQUITY AND TAXES

Without a doubt, the tax incentives provided by Congress have encouraged 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 the assets in the pension fund are treated as taxable income to the participants in the pension until benefits are actually paid. Unpublished data from the Office of Tax Analysis, Department of the Treasury estimates that the preferential tax treatment provided private pensions reduced Federal tax revenues by $11.3 billion in fiscal 1979, $12.9 billion in 1980, and $14.7 in 1981. These forgone tax revenues are often referred to as tax expenditures by fiscal policy analysts.

According to the May 1979 Current Population Survey conducted by the Bureau of the Census, there were more than 31 million active participants in private pensions during that month. According to the private pension plan filings required by Employee Retirement Income Security Act (ERISA) the actual number may be much higher. In any event, the tax incentives granted 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. Few will deny that private plans benefit from these so-called "tax expenditures." Public retirement programs, on the other hand, are directly financed through tax revenues collected from the general public. Because public plans are financed by "real expenditures" they should certainly enter into any discussion of pension equity issues linked to tax policy. Because of the complementary nature of Social Security and pensions, the relationship of Social Security to public plans must also be considered.

The Social Security coverage issue is one that the general public does not fully understand or there would be a much greater outcry for its resolution. The problem is that roughly 2.5 million Federal workers, 3 million State and local workers and a growing number of nonprofit employees are not covered by Social Security. Most of these workers will ultimately get Social Security benefits on an extremely preferential basis. This is often referred to as the "double dipper" problem although that label is misleading. In 1939 the House of Representatives Report on the Social Security Amendments of that year 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. Resolving that issue is a tax equity issue. But the public pensions and equity issues go beyond this.

During 1979 the Federal Government had some 83 pension plans that it administered. By comparison there were 571,000 tax qualified private sector plans. In addition there were an estimated 500,000 KEOGH plans in existence at that time. Among the Federal plans the Military Retirement System and the Civil Service Retirement System accounted for more than 90 percent of all pension plan participants. In 1979 the military plan paid $10.3 billion in benefits to 1.3 million beneficiaries. The Civil Service System 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 the Federal pension benefits in 1979 exceeded all private sector pensions payments in that year.

This is a tax equity issue because the taxpayers bear the burden. If the Civil Service Retirement System were funded on a normal cost basis it would cost 36.5 percent of covered payroll. This would not amortize any previously accrued unfunded liabilities but only meet currently accruing liabilities. The employees covered under this system contribute 7 percent of their earnings to the pension plan which leaves the taxpayer with a liability of 29.5 percent. In 1979 this would have amounted to $16.7 billion that the taxpayers would have been required to ante up. The Military Retirement System is totally noncontributory for those covered and has a normal cost of 49 percent of payroll. This would have equated to a taxpayer liability of $8.9 billion in 1979 just to meet currently accruing liabilities (i.e., 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 military retirement 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.

What would be even more disconcerting if the tax payers understood it is the rate at which we are losing ground on Federal pensions. According to the Statement of Liabilities and Other Financial Commitments of the United States Government for the end of the fiscal years 1979, 1980 and 1981 (published by the Department of Treasury, Bureau of Government Financial Operations) the unfunded liabilities in the two largest Federal retirement programs grew by $147 billion in fiscal 1980 and $128.7 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.

THE PENSION EQUITY TAX ACT

Without doubt it is time that the Congress began to focus on pension equity and related tax issues. But that focus should not be solely toward private plans. In the context of the Pension Equity Tax Act the estimates by the Congressional Budget Office and Department of Treasury suggest that HR6410 would result in relatively small increases in total Federal revenue. In comparison to the Federal pension numbers, I have been citing they become insignificant.

If the bill cannot be justified on the basis of its "revenue enhancement" capabilities then it should be judged in the context of national retirement policy. In order to do that, it is necessary to carefully determine the relative roles, strengths and goals of each component of the retirement system.

The overall goal of these programs in combination is retirement income adequacy. The role of pensions in meeting this goal has been expanding rapidly in recent years. The number of tax qualified plans increased more than 56,000 in 1980 and more than 68,000 in 1981. Certain elements of HR6410 may in fact slow down this growth. Specifically the proposed changes to the 415 limits may do so. In this case there is a need for a clearer articulation of the policy target.

Is the goal to keep high income earners from shielding "too much" income from taxes? One thing that should be kept in mind is that employees benefiting from maximum contributions will probably still be subject to high tax rates in retirement. In those instances the tax treatment of pension contributions is more a tax deferral than a tax reduction. It should also be kept in mind that a large share of the "tax expenditures" attributed to pensions result from the low tax rates applied against pension benefits for retirees. These low tax rates occur largely because of the favorable tax treatment of Social Security benfits, not special treatment of pensions.

For the sake of discussion assume that the 415 limits are established at some lower level. In the pursuit of pension equity how do the proposed actuarial reductions match up with what is provided by Federal pensions? Neither the Civil Service nor military programs have actuarial reductions for normal retirement benefits prior to age 65. Under Civil Service most classes of workers are eligible for normal retirement benefits by age 55 with 30 years of service, age 60 with 20 years and age 62 with only five years. The median age at normal retirement under the military retirement program is age 39.

Actuarial reductions for benefits payable before age 65 may be desirable especially in relation to discussions of raising Social Security retirement ages. But the policy must be consistent in order to be equitable.

Also the proposal for freezing the 415 limits deserves scrutiny regardless of the level at which they are set. The military and civilian Federal retirement programs are affected by two types of indexation. While those covered are working toward retirement their wages grow in two dimensions. They grow because of promotions and service increments. They also grow because of annual pay increases separate from the longevity/merit growth. As their wages grow their retirement benefits grow because in both systems benefits are calculated on the basis of earnings toward the end of Federal service. Once Federal pension benefits commence they are fully indexed for increases in the consumer price index. Private employees, by and large, benefit from the same kind of indexation as Federal workers receive prior to retirement. They do not, in any significant numbers, receive comparable post-retirement benefit increases. In order for there to be pension equity, the Federal retirement programs would have to be subjected to comparable limits, adjusted to account for the post-retirement COLA protection afforded Federal retirees.

But the freeze on the 415 limits, at whatever level, should not be judged solely on a comparative basis. More important are the absolute effects it may have over time. At first, the suggested limits would affect a small minority of current pension participants. Over time as the general level of wages rises the portion of the workforce affected would increase. Freezing the limits would result in their value declining over time in real dollar terms and relative to wages. As more and more people would bump up against the limits the income replacement capacity of pensions would be diminished. In combination with the redistributive nature of Social Security this would mean an ever increasing share of the elderly would receive inadequate retirement benefits from organized retirement programs. This would imply a policy goal of the Ways and Means Committee of shrinking the purchasing power of private pension programs. If so, why start with private pensions which now receive a minor share of the Federal largesse?

While high income executives benefit from the 140 percent limits, these limits could well account for the creation of many secondary plans. The beneficial result, however, is that the employers of such executives must also be covered by the secondary plan for it to be tax qualified. There is the clear potential for the elimination of the 140 percent limits to result in some secondary plan terminations. Plan terminations or forgone plan creations could potentially have their full effect about the time Social Security will be buffeted by the baby boom retirement problem. The elimination of the special deferrals for a few high-wage earners may lead to the reduction of valued benefits for many more middle income workers. Is it really the desire of the Ways and Means Committee to reduce the pension benefits of middle-class workers?

On Social Security integration the concern seems to be that employers are taking undue advantage of the redistributive nature of Social Security. The intent, implementation and implications of the integration regulations are probably the most misunderstood aspect of pension policy today. The evidence that is used to assess integration is either old or unrepresentative of the universe of plans. If the concern is that some workers are being integrated out of a pension then we should at least know of the prevalence with which it occurs. I might add that even where it does occur the combined pension/Social Security benefit structure of such a plan is still more re-distributive than the Civil Service Retirement System.

EBRI is currently sponsoring a major study of integration which is being conducted by Dr. James Schulz of Brandeis University and President of the Gerontological Society of America. That study will be completed this summer and will be shared with the Congress at that time.

You have heard estimates today that passage of HR6410 could result in reduced benefits for 68 percent of those participating in private pensions. I have not tried to verify those estimates but I do know that plan terminations tripled during the implementation of ERISA and are still running much higher than before ERISA's implementation.

With the problems of Social Security as yet unresolved it may be premature to take major policy steps that could potentially jeopardize the retirement income security of today's workers. This is not to suggest that this legislation is without merit or that new policy initiatives are not appropriate. I merely want to suggest that we need to step back and take a broader look at all elements of the retirement system, private and public, and be sure of the relative roles we want each program to play before making major legislative changes. This is the position that the Administration and Congress have prudently taken with regard to the National Commission on Social Security Reform.

Finally, I want to thank you for allowing me to appear today. In closing, I offer the services of the Employee Benefit Research Institute in assisting you in this study and policy formulation process in whatever way we can.