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# *Pension Tax Expenditures: Are They Worth the Cost?*

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Issue Brief

- The provision of tax incentives to encourage pension coverage reflects a longstanding policy of the U.S. government. Any individual who participates in a pension plan, whether he or she works for the federal government, a state or local government, or a private nongovernment organization, receives a deferral on income tax as the benefit accrues.

- The tax expenditure estimates for pensions are calculated on a cash flow basis. This is significant because it has the effect of placing no value on the pension promise itself, only on the advance funding of that promise. According to the FY 1993 federal budget, the pension tax expenditure was $56.5 billion for FY 1993: $27.9 billion (49.4 percent) for public-sector defined benefit pension plans; $19.3 billion (34.2 percent) for private-sector defined contribution plans (such as 401 (k) plans); $8.2 billion (14.5 percent) for private-sector defined benefit plans; and $1.1 billion (2 percent) for public-sector defined contribution plans. This compares with the tax expenditure for IRAs of $7.1 billion and $24.5 billion for the exclusion from taxation of a portion of Social Security and railroad retirement benefits.

- Taxpayers with income between $30,000 and $50,000 (29 percent of taxable returns) paid 18 percent of taxes, received 28 percent of the pension tax incentive value, and could experience an 18 percent tax increase if the incentives were removed. One percent report income above $200,000; these taxpayers pay 26 percent of all individual income taxes, obtain 7 percent of the value of total pension tax expenditures, and could experience a 3 percent tax increase if pension tax incentives were removed.

- Eighty-nine percent of those covered by pensions and 86.7 percent of participants had earnings below $50,000 in 1991. Among those earning less than $25,000 per year, 33.9 million were covered and 21.7 million participated in pension plans—51 percent of all covered persons and 41.9 percent of all participants. Among those earning between $25,000 and $49,999 per year, 25.3 million were covered and 23.3 million participated—38 percent of all those covered and 44.8 percent of all participants. Above $100, 000, 71,728 individuals participated, or 0.1 percent of all participants.

- Advance-funded pension plans expand total savings even though the magnitude has been debated. Pensions translate into billions of dollars being saved each year, with total pension assets exceeding $4 trillion in 1991. However, more money needs to be set aside: federal pension plans have combined unfunded liabilities of more than $1.6 trillion, private pension plans $51 billion.

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# Introduction

Pensions in their purest form are a means of providing income to individuals once they are no longer working. The primary reason that plans are established is to increase workers' economic security on reaching retirement age. Tax incentives are designed to encourage the expansion of pension coverage and increased saving levels and to provide a source of retirement income in addition to Social Security.

The provision of tax incentives to encourage pension coverage reflects a longstanding policy of the U.S. government. Under the Internal Revenue Code, an employer's contribution to a qualified plan is deductible within specified limits. Taxes on employer contributions and investment income are deferred for pension plan participants until the pension benefit is received and declared as income. Any individual who participates in a pension plan, whether he or she works for the federal government, a state or local government, or a private nongovernment organization, receives a deferral on income tax as the benefit accrues.

Individuals tend to focus on the immediate reduction in taxes that comes with pension tax treatment rather than on a calculation of the ultimate net tax gain or loss that will occur many years in the future. Because tax rates may be higher in the future than they are today, individuals may ultimately pay more taxes when they receive their benefit. Some people, as a result, would be better off never putting in the money. On the other hand, others may end up in a lower tax bracket in retirement than they were when working, meaning they would have been better off in tax terms having received a pension rather than cash. In short, although it is generally assumed that everyone wins with lower tax payments when they invest in tax-deferred pensions, not everyone does.

Nevertheless, the federal government gives a value to this "gain from deferral," which is referred to as a "tax expenditure," that is, a tax the government does not get paid today because the value of the pension benefit accrual is not taxed as income today. Each year a set of tax expenditure estimates is developed by the Department of the Treasury and published as part of the federal budget. The total reported pension tax expenditure (which includes civil service, state and local, and private pension plans) is $56.5 billion for FY 1993. The magnitude of pension plan tax expenditures estimates has attracted the attention of the media and public policymakers.

**At the same time, pension funds and their taxation have come to the forefront because of the tremendous accumulation of pension assets in the economy. Private and public pension plans now hold more than $4 trillion in assets. Some policymakers have looked to this large pool of assets as a means to fund economic development projects such as infrastructure. Moreover, the ever-increasing federal budget deficit has caused policymakers to assess whether the "cost" of lost federal revenues, which is measured by tax expenditure estimates, is appropriate.**

When we ask if pensions are worth the cost, we are focusing on the tax expenditures attributed to pensions. Are the tax incentives accorded to pensions meeting their public policy objectives? Do pensions provide enough benefit to individuals and the economy as a whole to justify the tax expenditure?

Several factors must be taken into account when evaluating the appropriateness of tax expenditures. First, analysts must determine what the numbers actually measure. **It is especially important to distinguish between the types of plans represented by tax expenditure estimates. Often, pension tax expenditure estimates are referred to as if they only represent revenue associated with private pension plans. However, the number reflects all pension plans including civil service, military,**

**state and local governments, and private plans.**

Second, to assess whether pensions are worth the cost, it is important to recognize the impact that the funding practices of different plan types have on the revenue numbers. Because the tax expenditure estimates for pensions are calculated by the government on a cash flow basis, no value is placed on the pension promise itself, only on the advance funding of that promise. With the exception of Social Security and federal employee defined benefit plans, most pension plans now seek to advance fund as a means of assuring that promises made will be kept. Federal law requires private pension plans to set aside funds for the purpose of paying benefits as they become due. However, public pension plans may operate on a pay-as-you-go basis, distributing benefits from current receipts. Defined contribution plans are always fully funded for accrued liabilities by definition because the participants' pension benefit consists of the contributions and investment returns on these contributions.

This *Issue Brief* reviews the history of the relationship between government and pensions; analyzes the tax expenditure cost of pensions and the allocation of that tax expenditure across individuals, types of plans, and employment sectors; considers the methodology used to determine the tax expenditure; provides statistics on pension plans and the individuals earning benefits; and provides information on the assets and income streams produced by pension plans in return for the tax expenditure. This *Issue Brief* provides a basis for answering the question: are pensions worth the cost?

## *Government and Pensions*

The U.S. government has taken steps since its earliest days to assure that retirees have income: beginning in 1776, the government provided retired veterans with pensions; in 1914, the government allowed for-profit employers to deduct the cost of pensions paid to employees and allowed employers to deduct contributions to a pension trust for retirement income programs; in 1921 and 1926, the government acted to allow taxes on trust earnings to be deferred until benefits are paid; in 1935, Social Security was established to pay retirement benefits; and in 1974, the government established tax incentives for individuals to allow pre-tax contributions to individual retirement accounts (IRAs) and the deferral of tax in earnings until funds were removed as income.

To assure that pension plans do not discriminate in favor of highly compensated employees, Congress enacted the first nondiscrimination rules in 1942.[1] Reporting and disclosure requirements were first enacted in 1947 and 1958. Keogh plans for self-employed individuals were established in 1962.

The Employee Retirement Income Security Act of 1974 (ERISA) made significant advance funding of private employer defined benefit pension plans mandatory, added new incentives for individuals to set aside funds in IRAs, established minimum standards in a number of areas to increase benefit entitlement, and established the Pension Benefit Guaranty Corporation (PBGC) to assure benefit security in private defined benefit pension plans. Prior to ERISA, many pension plans were operated on a pay-as-you-go basis. ERISA

*[1] The Internal Revenue Service issued January 8, 1993, a notice of proposed rulemaking on nondiscrimination requirements for qualified plans. The proposed regulations include a number of broad modifications relating to the safe harbor and general testing approaches and are aimed at increasing flexibility in meeting the nondiscrimination requirements.*

> *The 1980s saw a shift in federal policy related to retirement income programs, after decades of expanding incentives and requirements to prefund pension promises.*

requires private pension plans to set aside funds for the purpose of paying benefits as they become due. Advance funding of private defined benefit pension plans was desired to (1) increase benefit security and (2) to increase the pool of savings in the economy.

To further encourage both employers and workers to save for retirement, the Revenue Act of 1978 added section 401(k) to the code, which allows employees to elect to have a portion of their compensation (otherwise payable in cash) contributed to a qualified defined contribution plan. The employee contribution is often treated as a pretax reduction in salary. Tens of thousands of these plans exist in both the public and private sectors. The Federal Employee Thrift Plan functions like a 401(k) plan.

**The 1980s saw a shift in federal policy related to retirement income programs, after decades of expanding incentives and requirements to prefund pension promises. While the emphasis had traditionally been on employer action and encouragement of maximum funding, the 1980s brought a shift toward individual action, restrictions on the amount that could be contributed to employer-sponsored plans, and limits on the assets that could be maintained by a plan relative to benefits promised.**

Enactment of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) represented the most dramatic shift from the decades long policy of expansion. TEFRA reduced contribution and benefit dollar limits for all private and state and local plans by nearly one-third. Further restrictions and reductions on allowable retirement plan contributions were included in the Deficit Reduction Act of 1984 (DEFRA) and the Tax Reform Act of 1986 (TRA '86). Finally, the Omnibus Budget Reconciliation Act of 1987 (OBRA '87) was enacted with a new "full funding limitation" for defined benefit pension plans. The full-funding limit is essentially the lesser of roughly 100 percent of projected benefits (100 percent of benefits based on projected salary increases) or 150 percent of the plan's current liability, which essentially is all existing liabilities to employees and beneficiaries.[2] If sponsors contribute in excess of the full funding limit, the amount will be treated as a nondeductible contribution subject to a 10 percent excise tax. Because many private defined benefit plans are fully funded according to this new standard, many private employers have not been able to make deductible contributions to defined benefit pension plans in recent years.

A defined benefit plan, like Social Security, promises a benefit based on a formula tied to years of service and/or earnings. To pay the benefit, the plan initially needs only enough funds to meet periodic cash flow. Initially, cash flow will be lower if the plan payments are made in the form of annuities rather than lump-sum distributions. Private employer defined benefit plans must make a current year contribution for the value of current year benefit accruals (normal cost) and amortize any liabilities attributable to past service over no more than 30 years.[3] However, the OBRA '87 full funding limitation can act to prohibit the employer from making even the normal cost contribution if it would lead the plan to be more than 150 percent funded for current promised benefits. This legislation also substantially changed minimum funding for underfunded plans.

Critics of these post-1981 policy changes say that policymakers enacted them as a means to raise federal revenue at the expense of sound retirement policy. In any case, the changes have contributed to a substantial reshaping of retirement programs.

**The number of private pension plans has grown significantly since the enactment of ERISA. From**

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[2] *A deduction is always allowed for a single-employer plan to make a contribution up to the level of its unfunded current liabilities if the plan has at least 100 participants.*

[3] *Plans in existence at the time of ERISA could amortize past service liability over a 40-year period.*

## Private Pensions

> *The tax expenditure estimates for pensions are calculated by the government on a cash flow basis. This is significant because it has the effect of placing no value on the pension promise itself, only on the advance funding of that promise.*

**1975 to 1989, the total number of tax-qualified employer-sponsored plans (both defined benefit and defined contribution plans) increased from 311,000 to 731,000, and gross participation (active workers, separated vested, survivors, and retirees) in such plans rose from 45 million to 76 million over the same period.[4]**

Defined benefit plans have historically been the cornerstone of the private pension system. In a defined benefit plan, the employer agrees to provide the employee a nominal benefit amount at retirement, based on a specified formula, which is tied to years of service and compensation. The sponsor must decide how to pay for the plan. Traditionally these plans only paid an annuity at retirement age, but more of them now offer individuals the option of a lump-sum distribution when they leave the job.

This century saw the advent of defined contribution plans. In these plans, the employer makes specified contributions to an account established for each participating employee. The final retirement benefit reflects the total of employer contributions, any employee contributions, investment gains or losses, and possibly losses from forfeitures of employees terminating before achieving 100 percent vesting. The final account balance is generally paid to the individual as a lump sum when he or she leaves the job or retires. The individual will either receive more or less than was contributed, depending on investment experience.

In 1975, there were 103,000 defined benefit plans, with 33 million participants and $186 billion in assets. In 1989, there were 132,000 such plans, down from the peak of 175,000 plans in 1982 and 1983. The number of gross participants has remained in the 40 million–41 million range since 1983, and there was $998 billion in assets in 1989. Over the same period, the number of defined contribution plans increased from 208,000 to 599,000. The number of participants increased from 12 million to 38 million in 1987 and decreased slightly in 1989, to 36 million.

**One of the most significant trends in pension coverage has been the tremendous growth of 401(k) plans over the past decade. Employee Benefit Research Institute (EBRI) tabulations of the May 1988 and May 1983 Current Population Survey (CPS) show that more than 27.5 million workers were covered by 401(k) plans in May 1988, up from 7.1 million in May 1983. These figures represented 24.2 percent and 7.1 percent of all workers, respectively. Participation grew from 2.7 million workers (2.7 percent of all workers) in 1983 to 15.7 million (13.8 percent of all workers) in 1988. And, in May 1988, the majority of 401(k) participants earned less than $30,000.[5]**

There are many reasons for having each type of plan (Employee Benefit Research Institute, 1989 and 1990). The advantage to the individual of a defined benefit plan is shown most graphically when a president of the United States leaves office. The defined benefit is based on no more than eight years of service and is defined as the annual salary of a current cabinet member (about $145,000), or 72.5 percent of the presidential

*4 Department of Labor, Pension and Welfare Benefits Administration, tabulations of the 1989 form 5500, unpublished (1993).*

*5 The U.S. Bureau of the Census will collect similar data in April 1993, which should be available for Employee Benefit Research Institute (EBRI) tabulations in Fall 1993.*

salary. The president is not taxed as the benefit accrues during his tenure but is taxed on the pension as it is paid. Even if the government put money aside in advance, it would not be treated as taxable income to the president.

Compare this to providing the president with a defined contribution plan. The law sets a maximum contribution of $30,000 per year, allowing $240,000 to be contributed over the eight years of a two-term president. Even with a high rate of investment return, the defined contribution plan would not fund two full years of retirement for the president. This example highlights the primary reason that defined benefit plans are valued: the ability to provide a targeted benefit at retirement based on a formula.

The second major difference is the ability to provide post-retirement inflation adjustments to individuals who receive a monthly pension benefit check. This is not done for defined contribution plan recipients or for those who take lump-sum distributions from either type of plan. Many government employee plans provide for automatic inflation adjustments, while many private plans provide ad-hoc adjustments (Piacentini and Foley, 1992).

The final major difference is that younger workers who are likely to change jobs several times will do better with defined contribution plans. Once they are older and enter a last job, however, they will likely retire from that job in the best financial condition if it provides a defined benefit plan.

The future mix of traditional defined benefit plans, new defined benefit plans, and defined contribution plans is likely to constantly change. Plan choice will be affected by the average age of the work force, the relative desire of employers to get positive employee motivation today from plans, work force mobility, growth rates in sectors of the economy (including heavily unionized and older industrial sectors) in which traditional defined benefit plan coverage is most firmly established, federal tax laws, and the level of basic income tax rates.

Employers will have to assess their objectives over time as they experience work force, economic, and regulatory change.

*Pension Costs*

## The Value of Tax Expenditures

The concept of tax expenditures was developed in the 1970s. The Congressional Budget and Impoundment Act of 1974 (section 3(a)(3) defines tax expenditures as: . . . "those 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 . . ." (Employee Benefit Research Institute, 1983).

Pension, Keogh (pensions for self-employed individuals) and IRA tax expenditures are different from most other tax expenditures because they represent tax-deferred expenditures rather than tax-exempt expenditures. For example, payments for health benefits are never taxed, while pensions are taxed when paid to the individual.[6]

**The tax expenditure estimates for pensions are calculated by the government on a cash flow basis. This is significant because it has the effect of placing no value on the pension promise itself, only on the advance funding of that promise.** First, the contributions made to plans and estimated investment earnings are treated as taxable wages. Second,

[6] *For a full discussion of pension taxation, see Employee Benefit Research Institute,* "Retirement Program Tax Expenditures," EBRI Issue Brief *no. 17 (Employee Benefit Research Institute, April 1983); and* "Pension-Related Tax Benefits," EBRI Issue Brief *no. 25 (Employee Benefit Research Institute, December 1983).*

Table 1
**Tax Expenditure Estimates by Budget Function, Fiscal Years 1993–1997**

| Function | 1993 | 1994 | 1995 | 1996 | 1997 | Total 1993–1997 |
|---|---|---|---|---|---|---|
| | | | ($ billions) | | | |
| Income Security | | | | | | |
| Net exclusion of pension contributions and earnings | 56.5 | 58.8 | 61.3 | 63.8 | 66.0 | 306.4 |
| **Private defined benefit** | **8.2** | **8.5** | **8.9** | **9.3** | **9.6** | **44.5** |
| **Private defined contribution** | **19.3** | **20.1** | **21.0** | **21.8** | **22.5** | **104.7** |
| **Public defined benefit** | **27.9** | **29.0** | **30.3** | **31.5** | **32.6** | **151.3** |
| **Public defined contribution** | **1.1** | **1.1** | **1.2** | **1.2** | **1.3** | **5.9** |
| Individual retirement plans (exclusion of contributions and earnings) | 7.1 | 7.4 | 7.6 | 7.9 | 8.2 | 38.3 |
| Keogh plans | 2.7 | 2.9 | 3.1 | 3.3 | 3.4 | 15.4 |
| Social Security and Railroad Retirement | | | | | | |
| Exclusion of untaxed Social Security and railroad retirement benefits | 24.5 | 25.7 | 27.0 | 28.3 | 29.7 | 135.4 |
| Health/Medicaid | | | | | | |
| Exclusion of employer contributions for medical insurance premiums and medical care | 46.4 | 51.3 | 56.9 | 63.0 | 69.6 | 287.2 |
| Medicare | | | | | | |
| Exclusion of untaxed Medicare benefits: | | | | | | |
| hospital insurance | 7.6 | 8.4 | 9.3 | 10.4 | 11.6 | 47.3 |
| supplementary medical insurance | 4.4 | 4.9 | 5.6 | 6.5 | 7.6 | 28.9 |

Source: Employee Benefit Research Institute (EBRI) and EBRI estimates by plan type using the EBRI Tax Estimating and Analysis Model (TEAM); and EBRI tabulations of data from U.S. Congress, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 1993–1997* (Washington, DC: U.S. Government Printing Office, 1992).

benefits paid by the plans are treated as taxable income. Third, the tax to be paid on benefits is subtracted from the tax that would have been paid on contributions and earnings to get a net tax expenditure estimate. Thus, a "tax expenditure" is only considered to have occurred if advance contributions are made.

**According to the FY 1993 federal budget, the pension tax expenditure is $56.5 billion for FY 1993.** The tax expenditure number reported by the government should represent all types of pension plans—civil service, military, state and local, and private—because pension participants gain economic value and tax deferral regardless of where they work. However, the number reportedly does not currently include military plans. The estimate does cover both defined benefit and defined contribution plans.

The range of tax expenditures for employee benefits are presented in table 1. The total reported pension tax expenditure of $56.5 billion for FY 1993 has been broken down using the EBRI Tax Estimating and Analysis Model (TEAM) to show the numbers by sector (private, federal, state and local) and plan type (defined benefit and defined contribution). **Based on present law and funded status of plans, the largest portion of the tax expenditure, $27.9 billion (or 49.4 percent), is attributable to public-sector defined benefit pension plans. Private sector defined contribution plans (such as 401(k) ) are next at $19.3 billion (34.2 percent), followed by private-sector defined benefit plans at $8.2 billion (14.5 percent) and public-sector defined contribution plans at $1.1 billion (2 percent). This compares with the tax expenditure for IRAs of $7.1 billion, $2.7 billion for Keogh plans, and $24.5 billion for the exclusion from taxation of a portion of Social Security and railroad retirement benefits.**

In a recent article using unpublished data from the Department of the Treasury, Munnell (1992) broke out an estimated 1991 total pension tax expenditure of $48 billion as being $25.5 billion private (53 percent); $14.7 billion state and local (31 percent); and $7.8 billion civil service retirement (16 percent), for a public plan allocation of 47 percent. She notes that the military program was apparently not included by the Treasury. Using data from the 1991 report of the Military Retirement System (MRS) actuary, the program would have represented a tax expenditure of $5.5 billion in 1991. This would adjust the total to $53.5 billion and the public plan share to 52.3 percent.

The EBRI-TEAM numbers presented in table 1 assume the inclusion of military retirement and allocate the tax expenditure on that basis, finding a public plan total for 1993 of 51.3 percent of the total pension tax expenditure of $56.5 billion.

Table 2
**Per Capita Tax Expenditures, 1991**

| | Gross Participants (millions) | Active Participants (millions) | Tax Expenditures ($ billions) | Tax Expenditure per Active Participants |
|---|---|---|---|---|
| Civil Service Retirement System | 4,167 | 1.826 | $ 3.5 | $1,917 |
| Federal Employees Retirement System | 1,180 | 1.136 | 2.2 | 1,936 |
| Military | 3,763 | 2.130 | 4.0 | 1,877 |
| Thrift Savings | 1,625 | 1.419 | 2.7 | 1,902 |
| State and Local | 16,684 | 11.357 | 13.1 | 1,152 |
| Total Public | 27,419 | 17.868 | 29.0 | 1,623 |
| Private Defined Benefit | 41,000 | 28.000 | 8.2 | 292 |
| Private Defined Contribution | 37,000 | 29.000 | 19.3 | 665 |

Source: Employee Benefit Research Institute tabulations.

**Generally, the pension tax expenditure number is discussed as if it only applies to private employer plans, and then sometimes only to private defined benefit plans. As the foregoing discussion makes clear, the number covers all plans, with a near equal split between the tax expenditure for private and public employees.**

In 1983, pension tax expenditures were estimated at $25.8 billion in the federal budget; however, those same tax expenditure items were reestimated at $43.5 billion in the 1984 federal budget—an increase of 75 percent for the year—without a word of explanation. The change primarily reflected the addition of state and local workers and federal civilian workers to the estimate (Employee Benefit Research Institute, 1983).

As a result, the tax expenditure attributed to private pensions has often been exaggerated. Public pension plans are seldom mentioned as part of the equation. **More often than not during a call for private pension plan "reform" an advocate states that change must be made because of the "$56 billion tax expenditure." Would this be less compelling if the number was limited to the $8.2 billion for private defined benefit plans? Suddenly the elements of the total pension tax expenditure would be significantly smaller relative to that for mortgages, medical premiums, capital gains at death, or accelerated depreciation. It would also show that the number attributable to private plans had grown little from the number published in the 1983 budget and earlier as the tax expenditure for pensions. Finally, it would show that the tax expenditure for private defined benefit plans had declined significantly as the system matured.**

It would put the discussion of pension policy issues on a more informed basis if the tax expenditure were broken down by plan type in government publications so that policymakers could clearly see the distribution of tax incentives.

## What Is the Value Per Participant?

Breaking out tax expenditure numbers by plan type and sector also provides another way to focus on the more than 66 million individuals covered by pension plans, in addition to the millions now retired (Piacentini and Foley, 1992).

The better funded the plan and the larger the annual benefit payments relative to annual contributions and investment earnings, the lower the tax expenditure per employee/participant as currently calculated by the government.

Taking estimated tax expenditure numbers and dividing by the number of employees provides a per capita value. There were about 6.5 million active participants in federal civilian and military pension plans in 1991 (table 2). Based on present contributions, earnings, and benefits paid by these plans, the tax expenditure represents approximately $1,900 per active participant. Were federal plan funding to accelerate to pay off present liabilities over the next 40 years, the tax expenditure would increase to over $4,000 per active participant, and the tax expenditure number presented in the budget would leap upward by several billion dollars.

There are 11.4 million active participants in state and local government pension plans. For these plans the tax expenditure is equal to about $1,152 per active participant. For the 28 million active participants in private defined benefit plans the value would be a tax expenditure of about $292 per capita. For private defined contribution plans, with about 29 million active participants, the per capita tax expenditure is about $665 (table 2).

**Because public plans generally include a post-retirement inflation adjustment of benefits, the value of accruals and the necessary level of contributions are likely to be higher in the future than those for private pension plans. In addition,**

**federal plans have such large unfunded liabilities that funding them will require larger contributions. As a result, we are likely to see a growing proportion of the tax expenditure coming from public-sector pension plans.**

Table 3
**Exposure Levels at Single Employer Plans Facing the Pension Benefit Guaranty Corporation 1978–1991**

| Year | Exposure (in 1991 dollars) |
|---|---|
| | ($ billions) |
| 1978 | $145 |
| 1979 | 157 |
| 1980 | 91 |
| 1981 | 52 |
| 1982 | 49 |
| 1983 | 44 |
| 1984 | 32 |
| 1985 | 40 |
| 1986 | 61 |
| Average | 75 |
| 1987–1989 | a |
| 1990 | 32 |
| 1991 | 40 |

Source: Data for 1978 to 1986 are from Employee Benefit Research Institute compilations based on Richard A. Ippolito, *The Economics of Pension Insurance* (Philadelphia, PA: Pension Research Council, Wharton School, University of Pennsylvania, 1989); data for 1990 are from the Pension Benefit Guaranty Corporation's *Annual Report* adjusted to 1991 levels; data for 1991 are from the Pension Benefit Guaranty Corporation, "Pension Underfunding Growth Continues in PBGC's Top 50 List," News release, 19 November 1992.
Note: Figures are adjusted to 1991 levels using the Consumer Price Index for All Urban Consumers (CPI-U).
[a]Not available.

## Private Expenditures for Retirement Income

Private employers contributed $24 billion to defined benefit and $13 billion to defined contribution plans in 1975, growing to $25 billion to defined benefit plans and $71 billion to defined contribution plans in 1989. Defined contribution plans represented 35 percent of contributions in 1975 and 74 percent in 1989. Private employer contributions represented 3.9 percent of wages and salaries in private organizations, with a range, depending upon industry, of 1.8 percent in retail trade to 5.6 percent in transportation and utilities (Piacentini and Foley, 1992). Private retirement plans have about 78 million active, separated, and retired participants.

Private employer contributions to defined benefit plans grew to $48 billion in 1982 as plans responded to ERISA's funding requirements. Excellent investment returns during the 1980s, combined with federal legislation during the decade that placed limits on funding and benefits, have caused contributions to decline. More than 85 percent of private defined benefit plans are fully funded today, compared with less than 25 percent when ERISA was enacted (Goodfellow and Schieber, 1992). Contributions to defined contribution plans can generally be viewed as a percentage of income. As incomes have increased and as the number of workers given the opportunity to participate has grown, contributions have grown as well (Salisbury, 1989).

PBGC was created under ERISA to strengthen retirement security by guaranteeing some benefits for defined benefit plan participants. PBGC is funded by premiums paid by private defined benefit plans sponsors. **PBGC has been the focus of attention during the past two years because of a present single-employer program deficit of $2.7 billion and a potential 40 year exposure of $40 billion** (Yakoboski, Silverman, and VanDerhei, 1992). Some have questioned whether a general taxpayer bailout might be necessary if the liabilities exceed assets. Table 3 shows the present single-employer defined benefit plan liabilities faced by PBGC in underfunded plans. The numbers demonstrate the general strengthening of funding in these plans that has resulted from federal legislation. The overall defined benefit system currently has $1.3 trillion in assets to cover $900 billion in liabilities. Therefore, while there is significant underfunding within individual plans, there are also sufficient resources available within the defined benefit system itself—the payers of PBGC premiums—to cover this underfunding.

The ERISA requirements for pension plan funding have generally provided the benefit security sought by the law.

## State and Local Expenditures for Retirement Income

Table 4
**Financial Assets of Private and Government Pension Funds, 1983-1992**

| Year | Single Employer: Defined benefit | Single Employer: Defined contribution | Multi-employer | Private Insured | Federal Government Retirement | State and Local Government | Total |
|---|---|---|---|---|---|---|---|
| | ($ billions) | | | | | | |
| 1983 | $ 526 | $286 | $ 79 | $252 | $112 | $311 | $1,566 |
| 1984 | 535 | 322 | 81 | 291 | 130 | 357 | 1,716 |
| 1985 | 643 | 392 | 121 | 347 | 149 | 405 | 2,057 |
| 1986 | 739 | 447 | 143 | 410 | 170 | 469 | 2,378 |
| 1987 | 770 | 471 | 148 | 459 | 188 | 517 | 2,553 |
| 1988 | 857 | 522 | 170 | 516 | 208 | 606 | 2,879 |
| 1989 | 1010 | 623 | 200 | 572 | 229 | 735 | 3,369 |
| 1990 | 965 | 584 | 194 | 636 | 251 | 752 | 3,382 |
| 1991 | 1,208 | 780 | 238 | 678 | 276 | 877 | 4,057 |
| 1992 | 1,266[a] | 886 | 256 | 720 | 303 | 916 | 4,347 |
| | (percentage of total pension assets) | | | | | | |
| 1983 | 34.0% | 18.1% | 5.5% | 15.8% | 7.0% | 19.5% | 100.0% |
| 1984 | 31.7 | 19.0 | 5.5 | 16.4 | 7.3 | 20.1 | 100.0 |
| 1985 | 31.7 | 18.9 | 6.2 | 16.7 | 7.2 | 19.4 | 100.0 |
| 1986 | 31.1 | 18.8 | 6.0 | 17.3 | 7.2 | 19.8 | 100.0 |
| 1987 | 29.4 | 18.7 | 5.8 | 18.2 | 7.5 | 20.5 | 100.0 |
| 1988 | 28.9 | 17.9 | 5.8 | 18.4 | 7.4 | 21.6 | 100.0 |
| 1989 | 29.0 | 17.9 | 5.6 | 17.7 | 7.1 | 22.7 | 100.0 |
| 1990 | 27.8 | 16.9 | 5.3 | 19.4 | 7.6 | 22.9 | 100.0 |
| 1991 | 29.1 | 18.1 | 5.3 | 16.9 | 7.3 | 23.2 | 100.0 |
| 1992 | 29.1 | 20.4 | 5.9 | 16.6 | 7.0 | 21.1 | 100.0 |

Source: Employee Benefit Research Institute, *Quarterly Pension Investment Report,* second quarter 1992 (Washington, DC: Employee Benefit Research Institute. 1992); Board of Governors of the Federal Reserve System, *Flow of Funds Accounts: Assets and Liabilities Outstanding First Quarter 1992* (Washington, DC: Board of Governors of the Federal Reserve System, June 1992).
[a]All 1992 numbers are preliminary estimates.

State and local governments generally provide defined benefit pension plans to their work force. About 12 million active employees and another 5 million former employees, retirees, and survivors are covered. Employer contributions to these plans grew from $15 billion in 1975 to an estimated $47 billion in 1990. Most of these plans have been advance funded, resulting in significant investment earnings in addition to contributions. Total assets reached $916 billion in 1992 (table 4). There are pockets of underfunding in some state and local plans (Government Finance Officers Association and U.S. General Accounting Office, 1992).

## Federal Direct Expenditures for Retirement Income

The most significant retirement income programs funded by the federal government are Social Security, the military retirement programs, and the civil service retirement programs. This *Issue Brief* focuses on the latter two, the pension programs provided to federal workers. These federal employee programs include about 6.5 million active participants and 4 million participants who are retired or have left federal employment but will receive a benefit at a later date. These programs represent a sizable liability to the federal government and thus to the American taxpayers.

Budgeted outlays (inclusive of interest paid on bonds held as assets by the plans) for these employee pension programs grew from $21 billion in 1975 to $73 billion in 1991 and are projected to grow to $92 billion in 1997 (U.S. Budget, 1992).

The Civil Service Retirement and Disability Fund consists of two programs that are part of both the pension tax expenditure and the direct federal outlays. The Civil Service Retirement System (CSRS) covers those hired as federal civilian employees prior to 1984, and the Federal Employee Retirement System covers those hired after 1984. **Table 5 indicates that the programs represent a larger future obligation for taxpayers than cash outlays imply. These two programs had an unfunded liability of $864 billion in 1991, compared with $831 billion in 1990. Combined contributions were just enough to cover benefit payments in both years, with the unfunded liability growing as a result of new benefit accruals. The unfunded liability of the two plans increased by $33 billion in 1991. The present**

Table 5
**Civil Service Retirement and Disability Fund, September 30, 1990–September 30, 1991**

| | CSRS[a] | FERS[b] | 9/30/91 Total | 9/30/90 Total |
|---|---|---|---|---|
| | | ($ billions) | | |
| Actuarial Value of Future Benefits | $1,010 | $115 | $1,126 | $1,069 |
| Assets | 237 | 24 | 261 | 238 |
| Unfunded Termination Liability | 773 | 91 | 864 | 831 |
| Normal Cost as a Percentage of Payroll | | | | |
| Employer Civil Service Retirement System | | | 21.3% | 21.3% |
| Employer Federal Employees Retirement System | | | 12.9% | 12.9% |
| Cost to Fund Plan as a Percentage of Pay (40 year amortization) | | | 68.1% | 69.3% |
| Actual Contributions as Percentage of Pay | | | 36.9% | 36.4% |
| Undercontribution as Percentage of Pay | | | 31.2% | 33.0% |
| Contributions | 29.0 | 5.0 | 34.0 | 31.9 |
| Investment Income | 21.0 | 1.7 | 22.7 | 20.8 |
| Benefit Payments | 32.9 | 0.2 | 33.1 | 31.3 |
| Participants (millions) | 1.9 | 1,.3 | 3.2 | na[c] |
| Annuitants (millions) | 2.1 | 22.7 | 2.2 | na[c] |

Source: Employee Benefit Research Institute compilation from *An Annual Report to Comply with the Requirements of Public Law 95-595. Sept. 30,1991, RI 10-27, March 1992*, table 1, pages 3 and 8.
[a]Civil Service Retirement System.
[b]Federal Employees Retirement System.
[c]Not available.

**unfunded liability for CSRS is equal to $407,000 per active CSRS participant.**

For the federal civilian plans, the actual contributions being made as a percentage of pay are substantial at 36.9 percent (table 5), compared with a reported 3.9 percent for private employers. However, the federal government would need to contribute 68.1 percent of pay in order to amortize the unfunded liability over 40 years, or an added $35 billion. Funding for the value of one year's growth in promised benefits for present workers ("normal cost") requires a contribution equal to 34.19 percent of pay.

MRS presents a future financial challenge for taxpayers and policymakers as well. **MRS had an unfunded liability of $701.6 billion at the end of FY 1991, compared with $682.5 billion at the end of FY 1990** (table 6). This increase of $19.1 billion, when combined with the federal civilian pension plans, means a combined FY 1991 increase in unfunded liabilities of $52.1 billion faced by future taxpayers. The actual contributions to MRS were a substantial 66.2 percent of pay, compared to MRS normal cost of 42.7 percent of pay. Funding the plan over the next 40 years would require contributions of 129 percent of pay. For FY 1991 this would have meant an added contribution of $27 billion.

**Direct federal expenditures for retirement income are substantial. Were taxpayers funding these promises as fast as private employers are required by ERISA to fund theirs, the annual outlay—and either taxes or borrowing—would have to increase by at least $62 billion: more than the reported tax expenditure for all public and private-sector employer pension plans. This would have meant added direct taxes of $62 billion to fund contributions plus an added $14.6 billion in reported tax expenditures, using the Treasury methodology. Adjusting Munnell's numbers to reflect MRS and a minimum required contribution with 40 year amortization would have increased the total tax expenditure to $68.1 billion, with civil service and MRS accounting for $27.9 billion, or 41 percent, of the total. Combined with state and local plans, the public share would climb to $42.6 billion, or 62.5 percent of the total pension plan tax expenditure (if public plans were required to meet ERISA funding standards).**

Many analysts write as if every dollar of tax expenditure increases the federal deficit. When one looks at the tax expenditure represented by civil service and military plans, one sees that it is more complicated. When a pension promise is made to a civilian or military employee, a liability is created that effectively increases the federal deficit because it represents a promise taxpayers must eventually pay. However, it creates no tax expenditure and is not reported as part of the deficit because of cash accounting. Only if a contribution is made to secure

Table 6
**Military Retirement System Actuarial Status Information as of September 30, 1991 and September 30, 1990**

| | September 30, 1991 | September 30, 1990 |
|---|---|---|
| | ($ billions) | |
| Present Value of Future Benefits | $795.3 | $762.9 |
| Actuarial Value of Assets | $93.7 | $80.4 |
| Unfunded Termination Liability | $701.6 | $682.5 |
| Normal Cost as a Percentage of Pay | 42.7% | 43.3% |
| Cost to Fund Plan and Liabilities as Percentage of Pay (40 year amortization) | 129.0% | 131.3% |
| Actual Contributions | 66.2% | 67.7% |
| Underfunding as a Percentage of Pay | 62.8% | 63.6% |
| Normal Cost Contribution | $16.3 | $17.2 |
| Investment Income | $7.8 | $8.95 |
| Capital Gains | $8.6 | $4.4 |
| Unfunded Liability Amortization | $10.6 | $10.8 |
| Benefit Payments | $23.2 | $21.6 |
| Participants | 1.6 million | |
| Annuitants | 1.7 million | |

Source: Employee Benefit Research Institute compilation from *Chapter 95 of Title 31, U.S.C. Report on the Military Retirement System as of Sept. 30, 1991*, Table 5 p.17, Table 6 p.19, Table 7 p.20 unpublished report.

the benefit will a tax expenditure arise or the reported deficit be affected. The future taxpayer's obligation has in theory been reduced because a contribution has been made and the plan now has lower liabilities and more assets. Yet, in the case of the CSRS and other federal plans, most of the assets are Treasury securities that represent a liability of the federal taxpayer, which means the nation accounts for the liability explicitly.

Federal employees may have implicit benefit security because the promise is made by the federal government, which is expected to be here to pay its bills. However, the magnitude of the liabilities of the plans now in place, and the level of future payments required, justify concern.

For the taxpayer, there should be an annual discussion of the increase in the growth of the federal pension obligation along with discussion of the tax expenditure for pension plans.

## What Would Taxpayers Save by Ending Federal Pensions?

**Because federal pensions are not being funded at the rate ERISA requires for private plans, the tax expenditure that would otherwise be attributable to them is quite low. Ironically, a higher contribution would produce both a higher direct federal expenditure and a higher reported tax expenditure.** Were federal civilian employees provided only with Social Security, the 1991 employer payroll tax payment would have been less than $6 billion. This compares with the actual contribution to just the CSRS plan of $29 billion (21.29 percent of pay). If applied to the federal government, ERISA would have required a CSRS contribution in excess of $64 billion. This higher contribution would have increased the pension tax expenditure number in the budget by $8.5 billion, or more than 15 percent.

The military contribution for Social Security would have been about $2.5 billion (6.2 percent of pay), compared with a normal cost pension contribution of $16.3 billion (42.7 percent of pay). An additional $11.1 billion was contributed to help pay off the plans' unfunded liability (26.3 percent of pay). To meet the ERISA funding requirement for private plans, the total contribution would have been more than 130 percent of pay and more than an additional $28 billion in contributions. Adding in this contribution by the military plan would have increased the pension tax expenditure in the budget by an additional $6.5 billion, or more than 11 percent.

The size of the foregone revenues would indeed be large, but would the taxpayer be better off making no contributions to public pension plans? Lower contributions would lower the reported tax expenditure, but it would in no way reduce what must eventually be paid in taxes to provide the promised pension benefits. Taxpayers must eventually pay for public employee pension promises. **Focusing on the tax expenditure for pensions makes much less sense than focusing on whether pension promises should be made, and if they are, how and when should they be paid for. For all pension participants it is better to know that there is already "money in the bank" than to depend on future goodwill.**

Table 7
**Distribution of Income by Class of All Returns, Taxable Returns, Tax Liability, and Pension Tax Expenditures at 1992 Rates, 1992 Law,[a] and 1992 Income Levels**
[Money amounts in millions of dollars, returns in thousands]

| | A | B | C | D | E | F | G | H | I | J | K | L |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | All Returns | | Taxable Returns[b] | | Tax Liability | | Value of Pension Tax Exp. | | | Tax Accruals vs Distributions | | |
| Income Class[c] | No. | % | No. | % | $ | % | $ | % | % of taxes | $ | % | % of taxes |
| Less than $10,000 | 22,449 | 19.7% | 4,501 | 5.4% | -$ 1,780 | 0.0% | $ 335 | 0.0% | 0.0% | $ 457 | 0.0% | 0.0% |
| $10,000–$19,999 | 24,260 | 21.3 | 13,924 | 16.8 | 8,156 | 1.7 | 775 | 1.4 | 9.5 | 1,425 | 2.1 | 17.5 |
| $20,000–$29,999 | 19,039 | 16.7 | 16,694 | 20.1 | 28,980 | 6.1 | 4,000 | 7.1 | 13.8 | 6,092 | 9.1 | 21.0 |
| $30,000–$49,999 | 24,245 | 21.2 | 23,826 | 28.7 | 86,347 | 18.2 | 15,870 | 28.1 | 18.4 | 21,062 | 31.3 | 24.4 |
| $50,000–$99,999 | 19,583 | 17.2 | 19,472 | 23.5 | 157,965 | 33.2 | 24,210 | 42.8 | 15.3 | 27,145 | 40.4 | 17.2 |
| $100,000–$199,999 | 3,452 | 3.0 | 3,436 | 4.1 | 72,150 | 15.2 | 7,550 | 13.4 | 10.5 | 7,500 | 11.2 | 10.4 |
| $200,000 and over | 1,114 | 1.0 | 1,111 | 1.3 | 123,759 | 26.0 | 3,760 | 6.7 | 3.0 | 3,568 | 5.3 | 2.9 |
| Total | 114,143 | 100.0 | 82,959 | 100.0 | 475,577 | 100.0 | 56,500 | 100.0 | 11.9 | 67,249 | 100.0 | 14.1 |

Source: Employee Benefit Research Institute tabulations from the EBRI Tax Estimating and Analysis Model and other data from U.S. Congress, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 1993–1997* (Washington, DC: U.S. Government Printing Office, 1992).
[a]Tax law as in effect on January 1, 1992, is applied to the 1992 level and sources of income and their distribution among taxpayers. Excludes individuals who are dependents of other taxpayers.
[b]Includes filing and nonfiling units. Filing units include all taxable and nontaxable returns. Nonfiling units include individuals with income that is exempt from federal income taxation (e.g., transfer payments, interest from tax-exempt bonds, etc.).
[c]The income concept used to place tax returns into classes is adjusted gross income (AGI) plus: (1) tax-exempt interest, (2) employer contributions for health plans and life insurance, (3) inside buildup on life insurance (4) workers' compensation, (5) nontaxable Social Security benefits, (6) deductible contributions to individual retirement arrangements, (7) the minimum tax preferences, and (8) net losses, in excess of minimum tax preferences, from passive business activities.

## Who Benefits from the Tax Incentives?

The benefits of the pension system can be viewed in many ways, and the same numbers can be presented as positive or negative indicators. **An analysis of who benefits most from the system based on the earnings distribution of participants finds most of the coverage going to those earning between $10,000 and $50,000 per year.** An analysis of the system based on rates of participation reinforces this finding.

*Who Benefits?*

The Joint Committee on Taxation publishes statistics on taxpayers and tax expenditures, including the distribution of returns and taxes paid (table 7). Using the EBRI TEAM, the pension tax expenditure was allocated across taxpayers in the same way (column G). (The government last published its own income distribution of the pension tax expenditure in 1983.) Table 7 also shows the proportion of all taxes paid by each income group represented by the pension tax expenditure. Columns I and L show by how much income taxes would increase if pension tax incentives were eliminated and individuals received cash income that could not be tax sheltered.

One percent of all tax returns report income above $200,0000; these taxpayers pay 26 percent of all individual income taxes (U.S. Congress, 1992b). Table 7 allocates the value of pension tax incentives by income class and shows that high income taxpayers obtain 6.7 percent of the value of total pension tax expenditures (column H). If this group of taxpayers were to lose pension tax incentives, they could experience a 3 percent tax increase (column I).

Seven percent of the value of tax expenditures is received by taxpayers with income between $20,000 and $29,999, who pay 6 percent of all individual income taxes. This group could experience a tax increase of 14 percent if pension tax incentives were removed.

**Middle-income households gain the most from pension tax incentives. Taxable returns showing income between $30,000 and $50,000 (29 percent of taxable returns) paid 18 percent of taxes, received 28 percent of the pension tax incentive value, and could experience an 18 percent tax increase if the incentives were removed.** Upper middle income households at $50,000 to $100,000 (24 percent of taxable returns) paid 33 percent of taxes, received 43 percent of the tax expenditure, and

Table 8
**Pension Coverage and Participation of the Civilian Nonagricultural, Wage and Salary Work Force by Earnings, Firm Size, and Age, and the ERISA Work Force, 1991**

| | Work Force | | Pension Coverage | | | Pension Participation | | |
|---|---|---|---|---|---|---|---|---|
| | No. (millions) | % of work force | No. (millions) | % of covered | % of group | No. (millions) | % of participants | % of group |
| General Work Force[a] | 119.8 | 100.0% | 66.6 | 100.0% | 55.6% | 52.0 | 100.0% | 43.4% |
| Annual earnings | | | | | | | | |
| less than $10,000 | 36.1 | 30.2 | 10.4 | 15.7 | 28.9 | 3.6 | 7.0 | 10.1 |
| $10,000–$24,999 | 42.1 | 35.1 | 23.5 | 35.3 | 55.9 | 18.1 | 34.9 | 43.1 |
| $25,000–$49,999 | 32.4 | 27.1 | 25.3 | 38.0 | 78.1 | 23.3 | 44.8 | 71.8 |
| $50,000–$74,999 | 6.4 | 5.3 | 5.2 | 7.8 | 81.8 | 5.0 | 9.5 | 77.5 |
| $75,000–$99,999 | 2.7 | 2.2 | 2.0 | 3.1 | 76.1 | 1.9 | 3.7 | 71.5 |
| $100,000 or more | 0.1 | 0.1 | 0.1[b] | 0.1 | 75.8 | 0.1[c] | 0.1 | 64.8 |
| Firm size | | | | | | | | |
| fewer than 25 workers | 28.5 | 23.8 | 5.5 | 8.2 | 19.2 | 4.1 | 7.9 | 14.3 |
| 25–99 workers | 16.7 | 14.0 | 6.8 | 10.2 | 40.5 | 5.1 | 9.9 | 30.7 |
| 100–499 workers | 18.3 | 15.3 | 10.9 | 16.4 | 59.6 | 8.4 | 16.1 | 45.9 |
| 500–999 workers | 7.2 | 6.0 | 5.1 | 7.7 | 70.8 | 4.0 | 7.7 | 55.7 |
| 1,000 or more workers | 49.1 | 41.0 | 38.4 | 57.6 | 78.1 | 30.3 | 58.4 | 61.8 |
| Age | | | | | | | | |
| Under 25 years | 21.7 | 18.1 | 7.2 | 10.9 | 33.4 | 2.7 | 5.2 | 12.5 |
| 25–44 years | 63.6 | 53.1 | 37.6 | 56.5 | 59.2 | 30.3 | 58.2 | 47.6 |
| 45–64 years | 30.9 | 25.8 | 20.2 | 30.4 | 65.5 | 18.0 | 34.7 | 58.3 |
| 65 years and over | 3.6 | 3.0 | 1.5 | 2.3 | 42.3 | 0.9 | 1.8 | 26.6 |
| Work status | | | | | | | | |
| Full time[d] | 94.1 | 78.6 | 58.3 | 87.5 | 61.9 | 48.8 | 93.9 | 51.8 |
| Part time[e] | 25.7 | 21.4 | 8.3 | 12.5 | 32.4 | 3.2 | 6.1 | 12.3 |
| ERISA Work Force[f] | 70.9 | 100.0% | 47.2 | 100.0% | 66.6% | 41.5 | 100.0% | 58.5% |

Source: Employee Benefit Research Institute tabulations of the March 1992 Current Population Survey.
[a]Civilian, nonagricultural, wage and salary work force.
[b]Equals 84,000.
[c]Equals 71,728.
[d]Employees reporting that they usually worked 35 or more hours per week at this job.
[e]Employees reporting that they usually worked fewer than 35 hours per week at this job.
[f]Civilian, nonagricultural wage and salary workers aged 21 and older with at least one year of tenure who reported in March 1992 that they worked 1,000 or more hours in 1991. A proxy for tenure was created because the March Current Population Survey does not include that variable. An employee is assumed to have at least one year of tenure if he or she reported having only one employer in the previous year and had worked 50 or more weeks during that year.

could experience a 15 percent tax increase with the end of pension incentives.

## What If We Used Accruals for Tax Expenditures?

Using pension contributions, earnings, and benefits to calculate tax expenditures produces a low number if low contributions are made. Because federal plans make low contributions relative to the benefit being earned, they are not "charged" with as much tax expenditure as they would be if they contributed at a faster rate. Using the benefit being earned—the benefit accrual—as the basis of calculation would lead to a different distribution of value. Table 7 shows that using accruals would have produced a tax expenditure of $67.2 billion (column J) rather than $56.5 billion (column G).

This approach shows that the actual value of pensions is distributed more heavily at the middle and lower end of the income spectrum than the present method of calculating tax expenditures implies.

Pension plans are distributing more benefits to lower- and middle-income individuals than tax expenditure numbers imply. Those between $30,000 and $50,000 represent $15.9 billion of the cash flow tax expenditure, while earning $21 billion in accruals. Were all public and private pensions being fully advance funded, the numbers would be the same.

## Pensions Primarily Benefit Those with Income Below $50,000

According to EBRI tabulations of the March 1992 CPS, the number of civilian workers covered by pensions (working for an employer with a plan) grew to 66.6 million. Active participants (currently earning a benefit) grew to 52.0 million (table 8). **EBRI tabulations of the May 1988 CPS show that the number of**

**entitled participants (those with a vested and irrevocable right to a benefit) exceeded 32 million in May 1988.** Entitled participants represented 68 percent of all participants in May 1988, compared with 52 percent in May 1979.

Pension coverage and participation rates increase with income. Because of the income distribution of the population, most of those earning pensions are at lower income levels. As shown in table 8, among those earning less than $25,000 per year, 33.9 million were covered and 21.7 million participated. While this represents relatively low coverage and participation rates of 43 percent and 28 percent of all such persons, these workers represented 51.0 percent of all covered persons and 41.9 percent of all participants. Among those earning between $25,000 and $49,999 per year, 25.3 million were covered and 23.3 million participated. They represented 38.0 percent of those covered and 44.8 percent of participants. Among those earning between $50,000 and $74,999 per year, 5.0 million participated, representing 9.5 percent of all participants (table 8).

**The average coverage and participation rates are highest in the range of income from $25,000 to $74,999, at 80.0 percent and 75.0 percent. Among those earning between $75,000 and $99,999, 1.9 million participated, or 3.7 percent of all participants. Above $100,000, 71,728 individuals participated in pension plans, or 0.1 percent of all participants (table 8).**

*The average coverage and participation rates are highest in the range of income from $25,000 to $74,999, at 80.0 percent and 75.0 percent. Among those earning between $75,000 and $99,999, 1.9 million participated, or 3.7 percent of all participants. Above $100,000, 71,728 individuals participated in pension plans, or 0.1 percent of all participants.*

Another major factor of variation in pension coverage and participation is age, with 12.5 percent of those under 25 participating, compared to 47.6 percent of those between age 25 and 44 and 58.3 percent between age 45 and 64. This low rate among the young holds down the rate for the total work force, even though the inevitability of aging means that millions will move into covered jobs and become participants (table 8).

In firms with fewer than 25 workers, 19.2 percent of workers (5.5 million) were covered, and 14.3 percent (4.1 million) participated in an employer-sponsored plan in 1991. By comparison, in firms with 1,000 or more workers, 78.1 percent (38.4 million) were covered and 61.8 percent (30.3 million) participated. **The small employer issue is very significant in assessing the prospects for the future of pension coverage.** EBRI tabulations of the March 1992 CPS reveal that employers with fewer than 100 workers accounted for 37.8 percent of all workers in 1991 (table 8). Policymakers would like small employers to establish pension plans, but most did not when marginal tax rates were high, regulation limited, and competition less strenuous. For these employers, the cost of Social Security is also a significant expense. As a result, retirement policy should probably assume that there will never be significant voluntary pension growth among small employers.

Rising health costs assure that this will be even more true in the future, because employees and employers place a higher priority on health protection for today than on retirement savings for tomorrow (Snider, 1992). The Medicare payroll tax will continue to rise, and there is the prospect of mandatory expenditures for worker health care. This moves small employer pension sponsorship with employer contributions even further away as an achievable policy objective.

## People Not Percentages

Most analysts focus on the proportion of those at given income levels who participate in pension plans and declare that this indicates that pensions favor high-

Table 9

**Retirement Benefit Payments from Private and Public Sources, Selected Years 1970–1990**

| Source of Benefit[a] | 1970 | 1975 | 1980 | 1985 | 1986 | 1987 | 1988 | 1989 | 1990 |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | ($ billions) | | | | |
| Private Pensions | $7.4 | $15.9 | $36.4 | $97.7 | $120.2 | $120.8 | $124.1 | $133.6 | $141.2 |
| Federal Employee Retirement[b] | 6.2 | 14.5 | 28.0 | 41.1 | 42.2 | 44.9 | 48.1 | 50.6 | 53.9 |
| State and Local Employee Retirement | 4.0 | 8.2 | 15.1 | 25.5 | 28.4 | 31.2 | 34.1 | 36.6 | 39.2 |
| Subtotal | 17.6 | 38.6 | 79.5 | 164.3 | 190.8 | 196.9 | 206.3 | 220.8 | 234.3 |
| Social Security Old-Age and Survivors Insurance Benefit Payments[c] | $28.8 | $58.5 | $105.1 | $167.2 | $176.8 | $183.6 | $195.5 | $208.0 | $223.0 |
| Total | $46.4 | $97.1 | $184.6 | $331.5 | $367.6 | $380.5 | $401.8 | $428.8 | $457.3 |
| Total | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |
| | | | | | (percentage of total) | | | | |
| Private Pensions | 16.0 | 16.4 | 19.7 | 29.5 | 32.7 | 31.8 | 30.9 | 31.2 | 30.9 |
| Federal Employee Retirement[b] | 13.4 | 14.9 | 15.2 | 12.4 | 11.5 | 11.8 | 12.0 | 11.8 | 11.8 |
| State and Local Employee Retirement | 8.6 | 8.4 | 8.2 | 7.7 | 7.7 | 8.2 | 8.5 | 8.5 | 8.6 |
| Subtotal | 37.9 | 39.8 | 43.1 | 49.6 | 51.9 | 51.8 | 51.3 | 51.5 | 51.2 |
| Social Security Old-Age and Survivors Insurance Benefit Payments[c] | 62.1 | 60.3 | 56.9 | 50.4 | 48.1 | 48.3 | 48.7 | 48.5 | 48.8 |

Source: Employee Benefit Research Institute tabulations based on U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business, January 1992* (Washington, DC: U.S. Government Printing Office, 1992); *The National Income and Products Accounts of the United States: Statistical Supplement, 1959–1988*, Vol. 2 (Washington, DC: U.S. Government Printing Office, 1992); and U.S. Department of Health and Human Services, Social Security Administration, *1991 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* (Baltimore, MD: Social Security Administration, 1991).

[a]Includes only employment-based retirement benefits.

[b]Includes civilian and military employees.

[c]Includes payments to retired workers and their wives, husbands, and children.

income persons. Looking again at table 8, among workers earning less than $10,000, 10.1 percent participated in pensions in 1991, or 3.6 million persons. This compares with a participation rate of 64.8 percent for those earning above $100,000, but this group includes only 71,728 people, according to EBRI tabulations. Eighty-nine percent of those covered by pensions and 86.7 percent of participants had earnings below $50,000 in 1991.

In addition, analysts have focused on retiree's share of income as represented by pension payments (U.S. Congress, 1992c). The foregoing analysis points out that Census surveys treat only annuity payments from pensions as pension income. As a result, lump-sum distributions paid prior to retirement are not "credited" to the pension system. For 1989, this resulted in a major difference in the number reported by the Social Security Administration as retiree pension income and the number reported by the Commerce Department in the National Income and Product Accounts as pension benefit payments (Salisbury, forthcoming).

As a result of current tax laws and methods of data collection, an assessment of the results of the pension system must focus primarily on the current work force, rather than the retiree population. This is in fact an unfortunate result and may argue for both policy change and for much improved data collection.

## Pension Plans and Benefit Payments

Pension plans have had a history of significant increases in benefit payments. Pension plans paid more in benefits in 1990 ($234 billion) than Social Security retirement ($223 billion).

Employer pensions are an important source of retirement income and are growing. The data available understate pension plans' contribution to retirement income because they do not include lump-sum distributions made prior to and at retirement. In spite of this, the number of retirees with pension income continues to grow. Fifty-seven percent of married couples and 34 percent of unmarried persons aged 65 and over (representing 44 percent of all aged households) reported pension income in 1990 (Grad, 1992). According to the 1991 Advisory Council on Social Security, the percentage

Table 10
**Percentage of Single Individuals and Married Couples[a] Aged 65 and Over with Income from Specified Sources, Selected Years 1976–1990**

| Source of Income[b] | 1976 | 1978 | 1980 | 1982 | 1984 | 1986 | 1988 | 1990 |
|---|---|---|---|---|---|---|---|---|
| | (millions) | | | | | | | |
| Number | 17.3 | 18.2 | 19.2 | 19.9 | 20.8 | 21.6 | 22.3 | 23.1 |
| Percentage with | | | | | | | | |
| Retirement benefits | 92% | 93% | 93% | 93% | 94% | 94% | 95% | 95% |
| Social Security[c] | 89 | 90 | 90 | 90 | 91 | 91 | 92 | 92 |
| Retirement benefits other than Social Security | 31 | 32 | 34 | 35 | 38 | 40 | 42 | 44 |
| railroad retirement | 3 | 3 | 2 | 2 | 2 | 2 | 2 | 2 |
| government employee pensions | 9 | 10 | 12 | 12 | 14 | 14 | 14 | 15 |
| private pension or annuities | 20 | 21 | 22 | 23 | 24 | 27 | 29 | 30 |
| Earnings | 25 | 25 | 23 | 22 | 21 | 20 | 22 | 22 |
| Income from assets | 56 | 62 | 66 | 68 | 68 | 67 | 68 | 69 |
| Veterans' benefits | 6 | 5 | 5 | 4 | 5 | 5 | 5 | 5 |
| Public assistance | 11 | 10 | 10 | 16 | 16 | 7 | 7 | 7 |

Source: Susan Grad and Karen Foster, *Income of the Population 55 and Over, 1976*, U.S. Department of Health, Education, and Welfare, pub. no. 13-11865 (Washington, DC: U.S. Government Printing Office, 1979); Susan Grad, *Income of the Population 55 and Over*, 1978, 1980, 1982, and 1984, U.S. Department of Health and Human Services, Social Security Administration, pub. no. 13-11871 (Washington, DC: U.S. Government Printing Office, 1981–1985); and Susan Grad, *Income of the Population 55 or Older, 1986*, U.S. Department of Health and Human Services, Social Security Administration, pub. no. 13-11871 (Washington, DC: U.S. Government Printing Office, 1988); Susan Grad, *Income of the Population 55 or Older, 1988*, U.S. Department of Health and Human Services, Social Security Administration, pub. no. 13-11871 (Washington, DC: U.S. Government Printing Office, 1990); and Susan Grad, *Income of the Population 55 or Older, 1990*, U.S. Department of Health and Human Services, Social Security Administration, pub. no. 13-11871 (Washington, DC: U.S. Government Printing Office, 1992).

[a]Couples are included if they are married, living together, and at least one is aged 65 and over.

[b]Receipt of sources is ascertained by a yes/no response to a question that is imputed by the Current Population Survey for 1976–1986. A married couple is counted as receiving a source if one or both persons are recipients of that source. Data for 1988 and 1990 are from the Survey of Income and Program Participation.

[c]Recipients of Social Security may be receiving retired-worker benefits, dependents' or survivors' benefits, transitionally insured, or special age 72 benefits. Transitionally insured benefits are monthly benefits paid to certain persons born before January 2, 1987. The special age 72 benefit is a monthly benefit payable to men who reached age 72 before 1972 and to women who reached age 72 before 1970 and who do not have sufficient quarters of coverage to qualify for a retired worker benefit either under the fully or transitionally insured states provisions.

of elderly families receiving income from employer-sponsored pensions is expected to increase from the current 44 percent to 76 percent by the year 2018 (Reno, 1992). Among married couples currently aged 45 to 59, nearly 70 percent are earning a pension right, and others who are not now participating in pension plan report a pension right from a former employer (Goodfellow and Schieber, 1992).

In 1990, private pension benefits, estimated by the Department of Commerce at $141.2 billion, accounted for 31 percent of the $457.3 billion in total estimated retirement benefit payments (table 9).[7] By comparison, private pension benefits totaled $7.4 billion in 1970. Combined with benefits paid by the federal civilian and military retirement system and state and local government employee retirement systems, employer payments of $234.3 billion accounted for 51 percent of total benefits in 1990. Social Security benefits for retirees and their spouses and dependents totaled $223 billion and accounted for the other 49 percent of total benefits. Actual private benefits in 1989 were closer to $164 billion than the $133.6 billion reported for 1989 (table 9). This surge of benefit payments appears to be the result of lump-sum distributions paid by plans as part of early retirement programs, including growing use of such lump sums by defined benefit plans.

Pension payments to individuals have increased over the years as the pension system has matured. Table 10 shows the maturity of the pension system, with 44 percent of retirees reporting pension income in 1990, compared with 31 percent in 1976.

These numbers represent annuity payments only, so that the billions of dollars now paid each year in lump-sum distributions and taken into income would

[7] *Department of Commerce estimates of private pension benefit payments lag actual data by three years.*

Table 11
**Pension Coverage and Pension Participation of the Civilian, Nonagricultural Wage and Salary Work Force, by Earnings and Interest and Dividend Income, 1991**

| | Total | Pension Coverage | | Pension Participation | |
|---|---|---|---|---|---|
| | (millions) | (millions) | (percentage) | (millions) | (percentage) |
| Total | 119.8 | 66.6 | 55.6% | 52.0 | 43.4 |
| Less than $10,000 | 36.1 | 10.4 | 28.9 | 3.6 | 10.1 |
| $10,000–$24,999 | 42.1 | 23.5 | 55.9 | 18.1 | 43.1 |
| $25,000–$49,999 | 32.4 | 25.3 | 78.1 | 23.3 | 71.8 |
| $50,000–$74,999 | 6.4 | 5.2 | 81.8 | 5.0 | 77.5 |
| $75,000–$99,999 | 2.7 | 2.0 | 76.1 | 1.9 | 71.5 |
| $100,000 or more | 0.1 | 0.1 | 75.8 | 0.1 | 64.8 |
| Without Interest Income | 50.1 | 20.8 | 41.5 | 14.1 | 28.1 |
| Less than $10,000 | 21.5 | 5.3 | 24.4 | 1.7 | 8.0 |
| $10,000–$24,999 | 19.7 | 9.4 | 47.6 | 6.9 | 34.9 |
| $25,000–$49,999 | 7.9 | 5.5 | 69.8 | 4.9 | 62.3 |
| $50,000–$74,999 | 0.7 | 0.5 | 69.6 | 0.5 | 62.3 |
| $75,000–$99,999 | 0.2 | 0.1 | 53.1 | 0.1 | 45.8 |
| $100,000 or more | 0.1 | a | 100.0 | a | 100.0 |
| Without Dividend Income | 99.8 | 51.6 | 51.8 | 38.7 | 38.8 |
| Less than $10,000 | 33.4 | 9.3 | 27.7 | 3.2 | 9.5 |
| $10,000–$24,999 | 37.6 | 20.4 | 54.3 | 15.5 | 41.2 |
| $25,000–$49,999 | 24.3 | 18.6 | 76.2 | 16.9 | 69.5 |
| $50,000–$74,999 | 3.4 | 2.6 | 78.5 | 2.5 | 73.1 |
| $75,000–$99,999 | 1.1 | 0.8 | 69.8 | 0.7 | 65.7 |
| $100,000 or more | a | a | 74.9 | a | 49.9 |

Source: Employee Benefit Research Institute tabulations of the March 1992 Current Population Survey.
[a]Less than 50,000.

result in earnings reported as asset income. As the pension system continues to change, it will become increasingly important to find a way to identify this pension-created wealth. The growth in the numbers in table 10, it should be stressed, would be significantly greater if all income attributable to past pension distributions could be documented.

## Pensions and Savings

**Pension plans that are advance funded serve to expand total savings (VanDerhei, 1992). The magnitude has been debated, and studies show wide variation, from a low of $0.32 per $1.00 of pension savings to a high of $0.84. At either level, this translates into billions of dollars each year, with total pension assets exceeding $4 trillion in 1991.** As previously noted, federal pension plans have combined unfunded liabilities of more than $1.6 trillion. If federal plan participants have saved less because of the pension income promise, then federal plans may have served to decrease personal savings, as private and state and local plans have served to increase personal savings with substantial advance funding.

Another way to assess the degree to which a pension plan assists individuals with total savings is whether or not they report income other than earnings that would suggest other than pension savings. EBRI tabulations show that the lowest earners are likely to have only earned income. In 1991, 14.1 million persons with no interest income participated in their employer's pension plan, and 38.7 million persons with no dividend income participated (table 11). While these percentage participation levels and rates are lower than would be desirable, the number of people is significant. These individuals will likely be better off economically than the 36 million reporting no interest income and no pension participation, or the 61.1 million reporting no dividend income and no pension participation. Whether advance funded or not, for millions of individuals with an accrued pension benefit but no interest or dividend income, the pension may well be the only income producing savings they have as they approach retirement.

## The Need for More Complete Presentations

Some analysts and policymakers have suggested raising revenue by imposing taxes on pension funds. Often, however, they have not considered the potential effects that changing the tax treatment could have on the availability and extent of pension benefits, the financial markets, and the U.S. economy.

A recent Congressional Research Service (CRS) analysis includes the following paragraph:
"To tax defined benefit plans can be very difficult since it is not always easy to allocate pension accruals to specific employees. It might be particularly difficult to allocate accruals to individuals not vested. This complexity would not, however, preclude taxation of trust earnings at a specified rate." (U.S. Congress, 1992c)

No further analysis or discussion is provided in the CRS analysis. Policymakers would also need to consider (1) the implications for the federal budget and state and local budgets (and benefit security) of requiring the payment of a portion of accumulated assets as an excise tax by public pension plans; (2) the implications for PBGC of decreasing the assets in private defined benefit plans by taxing them away (they might suggest an increase in the PBGC premium payment instead) at a time when the agency says that it has insufficient income and the plans it insures have insufficient assets; and (3) the implications for plan terminations and ultimate retirement income if defined benefit assets are taxed but the assets of defined contribution plans are not.

When making changes in the pension system, these interrelationships should be considered before policy actions are taken. And, the primary objective of pensions—economic security—should not be overlooked.

## Conclusion

A 1991 *National Tax Journal* article concluded with the following: "Whereas the case for employer-sponsored pensions as an institution is strong, the case for a major tax expenditure is weak . . . given the demands on the budget, eliminating a tax expenditure that benefits a declining and privileged proportion of the population should be given serious consideration."[8]

This *Issue Brief* has shown that the proportion of workers with entitlement to a pension has been growing—from 24 percent in 1979 to 28 percent in 1988—and the number increasing—from 23 million workers to 32 million—during the same period—while the proportion of workers with coverage and participation has flattened (Piacentini, 1989). Entitlement is growing because of the earlier participation and shorter vesting periods required by ERISA and TRA '86. A mobile and aging work force promises continued improvement in benefit entitlement, the true test of a pension system.

This *Issue Brief* has shown that the primary value of pensions accrues to middle- and lower-income taxpayers (tables 7 and 8). Elimination of the tax expenditure by taxing individuals would place the greatest burden on these individuals.

Some analysts have suggested recovering the tax expenditure by levying a 2.5 percent tax on pension reserves. Applied to private defined benefit pension plans insured by PBGC, a 2.5 percent levy would amount to $35 billion rather than the $8.2 billion tax expenditure attributed to private plans. Taxation of insured assets held by insurance companies for annuities purchased by pension plans would raise an additional amount of more than $15 billion, but it would also assure losses for the insurers because the tax would not have been anticipated when the annuities were priced. The tax in PBGC-insured plans could increase PBGC's problems. It might be better to increase the premiums these plans pay to PBGC than to tax away reserves. However, a number of analysts and some members of Congress have argued that an increase in premiums might cause employers to terminate plans. A tax that is bigger than PBGC premiums could be expected to do the same, eliminating plans paying premiums to PBGC in the process. It is interesting to note that total premiums paid to PBGC are less than $1 billion per year, compared with

[8] *See Alicia H. Munnell, "Are Pensions Worth the Cost?"* National Tax Journal *(September 1991): 393–403.*

*For millions of low-income Americans the value of the pension they are entitled to may represent the only income producing savings they have.*

the $35 billion trust tax that advocates suggest be taxed away from PBGC-insured plans.

Recovery of the $19.3 billion tax expenditure associated with private defined contribution plans could be achieved by a 2.5 percent levy on reserves. Given the individual account nature of the plans and the level of interest rates relative to inflation today, this tax could cause many individual accounts to have no real investment return or a negative return. The annual loss of account balance could significantly reduce the ultimate account balance and discourage saving in the first place. And, for any participant making an early withdrawal and paying the 10 percent excise tax, the loss would be even more significant. In hindsight, investment of after tax-dollars in tax-exempt municipal bonds would look like what the individual should have done.

Recovery of the $28 billion tax expenditure associated with public employee defined benefit pension plans through an excise tax would be constitutional but would require increased future contributions by taxpayers to the plans to compensate for the loss of investment earnings on the money taxed away.

For the federal government the levy would simply increase what it ultimately had to contribute to the plans to pay benefits. A solution that sounds simple and is labeled “feasible” by some analysts may not prove to be so.

Legislative actions of the 1980s that reduced the amounts that could be contributed to public and private pension plans have reduced the tax expenditure for pensions. They have also served to increase the level of pension promises that are unfunded and, thus, not fully secured. This *Issue Brief* has used the funding of federal pension plans to show that the pension tax expenditure number currently is, and in the future will be, influenced by contributions made to the federal civil service and military pension plans. The federal plans underline the potentially misleading nature of the tax expenditure number. The federal worker is being promised a future benefit, to be paid for by taxpayers, whether or not advance contributions are made. If an advance contribution is made, a tax expenditure is recorded, which is said to increase the deficit. Yet, the real deficit, the obligation that something must be paid by future taxpayers, was increased with the promise. At minimum, this argues for presentation of pension tax expenditures in government documents by sector and, ideally by plan type. Ideally, we would also begin to see more focus on the financial status of the public pension plans.

This *Issue Brief* has also sought to clarify that the debate over whether or not funded pensions add to national and individual savings is a debate over magnitude. For millions of low-income Americans the value of the pension they are entitled to may represent the only income producing savings they have.

The *Issue Brief* has also sought to underline the need for much better data on pension distributions and what individuals do with them. As more private defined benefit and most public and private defined contribution plans pay benefits as a single lump-sum distribution when the employee leaves, issues of “erosion in the value of vested pension credits after job termination” and “the erosion of benefits after retirement” become less important than issues of preservation of distributions and retirement planning.

The case for employer-sponsored pensions as an institution is strong, as is the case for the tax incentives that encourage the creation, growth, and maintenance of pension plans.

This *Issue Brief* was written by Dallas Salisbury, EBRI president, with assistance from the Institute's research and education staffs.

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