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A
STATEMENT ON

THE EFFECT ON PRIVATE PENSION PLANS OF
PENSION PROVISIONS IN THE TAX EQUITY AND FISCAL
RESPONSIBILITY ACT OF 1982

BY

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BEFORE THE

UNITED STATES SENATE COMMITTEE ON FINANCE

SUBCOMMITTEE ON SAVINGS, PENSIONS, AND
INVESTMENT POLICY

APRIL 11, 1983

* 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, sponsors, or other staff. Dr. Schieber is Research Director of EBRI.

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SUMMARY

Mr. Chairman, I am pleased to appear before you today to discuss the implications of the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982. 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.

TEFRA contains the most significant changes for employer-sponsored retirement plans since the passage of ERISA in 1974. The changes in TEFRA will affect both the substantive elements of plans as well as their administration. It is still extremely early, however, to expect that the full ramifications of TEFRA have yet taken effect or been measured.

My testimony today will focus on three points. The first is that the prevalence of tax incentives for pension plans, along with other factors, have contributed to the historical growth of pension protection. The second is that the pension system's growth pattern has been sensitive to changes in public policy. The third is the measurement and cost of the tax incentives provided to pension participants today. From this discussion, I hope the members of this Committee might garner a better perspective on pension policy issues in general, and the potential implications of TEFRA in particular.

<u>THE GROWTH OF PRIVATE PENSIONS</u>

The expansion of the role of pensions in the U.S. retirement income security system can be traced through the growth in the number of pension programs, their participants and beneficiaries.

Over the years, the combination of preferential tax treatment, employer

and union interest and social consciousness have contributed to the growth of private pension provisions, rising from 549 at the end of 1939 to 746,000 plans as of September 30, 1982.

Historically, the growing prevalence of private pension plans has led to a marked increase in pension participation. Outside agriculture, 68.3 percent of all civilian wage or salary workers between the ages of twenty-five and sixty-four, working at least half time, who had been with their employer for a year or more, were participating in a pension plan during 1979.

PENSION GROWTH AND THE SENSITIVITY TO PUBLIC POLICY

The purpose of this hearing is to assess the implications of TEFRA for various types of pension plans. To a certain extent, any assessment of the implications of TEFRA at this point in time is an exercise in the fine art of crystal ball gazing. Many of the pension provisions that are included in TEFRA will not take effect until after this year. Even if there has been an anticipatory response to TEFRA, the data is not yet available for assessing that response. The IRS data on plan qualifications and terminations for the last quarter of 1982 are not yet available and TEFRA was only signed into law on September 3, 1982. This does not mean, however, that certain directional implications cannot be hypotheized. Before undertaking such an exercise, it is worthwhile to show that pension policy changes matter.

The ERISA Experience

The most significant pension legislation in the history of private plans in this country has been the Employee Retirement Income Security Act. While ERISA has had many ramifications for the private pension system most have not been systematically measured. One notable exception is the effect of ERISA on plan formation and termination. Based on Internal Revenue Service determination letters, Table 4 shows the annual rates of plan qualifications and terminations between 1956 and September 1982. Between 1956 and 1974 there was steady growth in newly created defined benefit and defined contribution plans. In each of these nineteen years, qualified plan establishment exceeded terminations by more than a ten-to-one ratio. Consistently, there was greater net growth in the number of defined benefit plans over the number of defined contribution plans. During 1974 the net total of defined benefit plans increased by 30,000, while defined contribution plans registered growth of 24,600 units. ERISA was signed into law on Labor Day in 1974 and was largely implemented during 1975 and 1976.

Plan creation and termination rates changed radically after ERISA. From late 1974 to early 1977, private pension programs conformed to ERISA's principal regulations. It is important to note that 18,857 defined benefit plans were terminated between 1975 and 1977, com ared with 15,514 such terminations during the previous nineteen years. It is clear that ERISA resulted in a dramatic increase in plan terminations for whatever reason.

At the same time the number of plan qualifications declined markedly. The number of newly qualified defined benefit plans during 1976 was only about one-seventh the number of plans qualified only two years earlier. And the number of newly qualified defined contribution plans in 1975 was only about one-half the prior year's level.

Another facet of the ERISA experience is the notable shift toward defined contribution plans. PBGC studies indicate there was some direct shifting with defined benefit plans being terminated and replaced by defined contribution plans. Prior to the passage of ERISA, the number of newly qualified plans and net growth in defined benefit plans consistently exceeded qualifications and net defined contribution plan growth. Table 4 demonstrates a marked shift from defined benefit to defined contribution plans since 1976. Although the desirability of this shift has not been widely discussed, elements of TEFRA may further increase the prevalence of defined contribution over defined benefit plans.

The Relative Merits of Defined Benefit and Defined Contribution Plans

Both defined contribution and defined benefit plans are organized retirement plans. From the employee's perspective either type of plan helps provide income security in retirement. From the employer's perspective either helps in the orderly recruiting, maintenance and retirement of the necessary workforce.

The defined benefit plan provides a clearly stated retirement income level generally related to years of service and a measure of salary toward the end of employment tenure. The defined contribution plan, on the other hand, provides for specified contributions to an individually allocated investment account.

In the defined contribution plan, investment performance directly affects the level of benefits. Because contributions and interest accruals relate to specific persons, the risk of adverse market performance is borne by the individual worker. Under the defined benefit plan, on the other hand, the individual is promised a level of benefits related to final salary. Adverse market performance can reduce the value of the pension portfolio as in the case of the DC plan. However, the employer has guaranteed the benefit and has to adjust contributions to make up for bad investment performance.

The questions posed by the different benefit structures inherent in defined benefit and defined contribution plans give all parties concerned about federal retirement policy much to ponder. Neither the defined benefit nor the defined contribution structure is perfect to meet everyone's goals. It is the conflicting goals of different workers, employee groups, employer and public policy goals that makes it impossible to select one type of plan over the other as being ideal. But everyone should understand that there are good reasons for and against both plan types. That, more than any other reason, may account for the fact that most large employers in the United States today have both a defined benefit and defined contribution plan for their workers.

THE POTENTIAL IMPLICATIONS OF TEFRA

The impact of TEFRA on the U.S. private pension system will vary across various segments of the employer and plan universe. The variations will arise on the basis of plan size, the number of plans offered by the plan sponsor and the characteristics of the workforce covered by a plan.

Among the various TEFRA provisions that may affect the creation and maintenance of pensions are the changes to tax deductible contribution limits.

Lowering Section 415 contribution limits will reduce pension contributions and benefits relative to salary for some highly compensated executives and professionals. If these reductions occur, some pension plans may be modified to keep pension contribution rates for middle- and low-income workers in line with the lower rates that would result for the highly compensated.

While there is no information on the number of secondary plans being created, if these plans are established primarily to shield the income of incorporated professionals, newly established plans would include relatively few participants. In fact, many new pension plans are including significant numbers of workers. Imposing new limits, therefore, may hit a broad target -- not just a few high-income professionals.

TEFRA has extended to the "payor" or the plan administrator of pension and deferred compensation plans the obligation of tax withholding on pensions, annuities and deferred compensation payments. The Act allows the individual recipient to elect-out of withholding. At least once a year the payor has to notify the beneficiary of his or her right to change their status.

This provision is one of those that makes sense in concept but can result in various calamities in actual operation. When plan sponsors warned of potential problems during the TEFRA deliberations their concerns were largely unheard. The Washington Post of April 6th ran an interesting story in this regard on the Federal Government's experience with its own annuitants.
If these problems arise among other plans and persist beyond the start up period, Congress may want to reconsider certain of the provisions in this Section of the Act.

For plans that primarily benefit key employees there are special provisions in TEFRA. The top-heavy provisions are complicated in several regards, not the least of which is the determination of top heavy status. One particular problem with top heavy provisions could be the potential for firms to wander in and out of top-heavy status. It is certain that some firms that are not top heavy could be driven into such status by conditions beyond their control (e.g., layoffs during a recessionary period).

According to some pension consultants as many as 30 to 40 percent of small plans may be terminated. Others expect that large numbers of defined benefit plans may be terminated and replaced with defined contribution plans. If this is the desirable outcome of public pension policy it has never been openly discussed in the Congressional forum.

THE LESSONS FROM ERISA AND TEFRA

The private pension system today is in turmoil. In large measure the plan creation data of the last two to three years indicated that it had recovered from the initial shock of ERISA. The economics of high inflation during the latter 1970s and the extended recession of the early 1980s have caused problems that have been largely handled. The shock of TEFRA is being applied to a system that has been buffetted for most of the last ten years. The system has been extremely resilient until now and may survive TEFRA relatively unscathed. Then again, it may not.

Among plan sponsors ERISA was seen as the inevitable result of the policy process establishing new rules to resolve problems in the pension game. TEFRA, on the other hand is broadly perceived as a legislative game being played by policy advisors who do not understand the pension system or its problems. Furthermore, TEFRA is perceived as a precursor to more changes. With the publication of the 1984 federal budget there is new evidence that the pension system may again become a target of the budget process.

THE EFFECT OF PENSIONS ON THE BUDGET

As the Budget of the United States Government is prepared each year a set of "tax expenditure" estimates is developed by the Treasury Department and published as part of the Budget.

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

The 1981 Budget estimate of this particular tax expenditure for fiscal year 1981 was $14.7 billion. The 1982 Budget estimated the 1981 fiscal year tax expenditure for the identical category of plans at $23.6 billion -- a 60 percent increase. There was absolutely no explanation in the Budget documents explaining the changed estimate from one budget to the next. There is also a lack of analysis explaining even greater discrepancies between the 1983 and 1984 Budgets. The estimated fiscal 1982 tax expenditure due to net exclusion of employer pension contributions and trust fund earnings was 75.7 percent higher in the 1984 Budget than in the 1983 Budget. The projected growth in this category of tax expenditure was 254.8 percent higher in the 1984 Budget than in the prior year's estimate. Again, none of the Budget materials or other public documents explain the revised estimates.

Through an arduous process of telephone discussions with various staff at the Treasury Department a general explanation of the revised fiscal 1983 and 1984 estimates in the 1984 Budget has been pieced together. It appears the the primary reason for the significantly (some would say astronomically) higher estimate of employer contributions and pension trust earnings is that federal civilian and state and local pension plans were included in the tax expenditure calculations for the first time. It is indicative of the relative generosity of public and private plans to consider that adding the tax expenditures attributable to public plans covering about 15 percent of the U.S. workforce can increase the tax expenditure estimate by more than two thirds.

The Special Analysis G in the Federal Budget does not include separate estimates of the tax expenditures that are attributable to IRAs. The IRA related tax expenditures are imbedded in a broader category of retirement "plans for self-employed and others." One might have expected significant increases in the tax expenditure estimates after 1982 because of the passage of ERTA. Yet this tax expenditure has increased very little. But by the time the 1984 Budget was prepared there was evidence available suggesting that 1982 IRA utilization in response to ERTA jumped significantly over prior years.

CONCLUSIONS

Many of the critics of pension programs point to the tax expenditure numbers as a basis for significant tax policy and pension reform. These critics have not applied their analytic capacities to any thorough discussion of the numbers that are published in the Budget each year. They have not considered the structure of other tax code provisions that affect the estimates. They have not considered the life cycle structure of earnings, benefit accruals and marginal tax rates that provide a radically different distribution of the tax expenditures than naive cross sectional analyses. They have totally ignored the inconsistencies in the actual calculation of these estimates, to say nothing of the significant methodological difficiencies in the calculation procedure.

Until the Treasury Department is willing to spell out in detail the derivation and numerical basis of these estimates they should be treated as nothing more than idle musings or random numbers. To seriously base any policy deliberation or decision on totally unsubstantiated, but clearly flawed numbers may result in the implementation of undesirable policies. There is an impression in the pension community today, however, that these tax expenditure estimates played a central role in the consideration of TEFRA. Furthermore, the recent precipitous changes in these estimates are seen as an ominous sign that additional pension reform is high on someone's legislative agenda.

The historical response of the pension system to tax and regulatory provisions is fairly well documented. The pension system is clearly sensitive and responsive to policy change. This means that pension policy must be steady and even handed if the pension system is to be stable. Erratic policy or frequent adjustments will tend to destabilize existing pension programs and discourage employers from establishing new ones.

Mr. Chairman, I am pleased to appear before you today to discuss the implications of the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982. 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.

TEFRA contains the most significant changes for employer-sponsored retirement plans since the passage of ERISA in 1974. The changes in TEFRA will affect both the substantive elements of plans as well as their administration. It is encouraging that the Congress is concerned about the implications of these changes on the creation and maintenance of pensions in this country today. I hope that you understand though, that it is still extremely early to expect that the full ramifications of TEFRA have yet taken effect or been measured.

My testimony today will focus on three points. The first is that the prevalence of tax incentives for pension plans, along with other factors, have contributed to the historical growth of pension protection. The second is that the pension system's growth pattern has been sensitive to changes in public policy. The third is the measurement and cost of the tax incentives provided to pension participants today. From this discussion, I hope the members of this Committee might garner a better perspective on pension policy issues in general, and the potential implications of TEFRA in particular.

THE GROWTH OF PRIVATE PENSIONS

The expansion of the role of pensions in the U.S. retirement income security system can be traced through the growth in the number of pension programs, their participants and beneficiaries. The implications of these programs on the public fisc can be traced by considering the pattern of growth of employer contributions to pension trusts and the benefits paid by these trusts.

Pension programs have been publicly regulated, in one way or another, almost since their very beginnings. Dan McGill, who has written extensively on pension programs and policy, notes that even prior the enactment of regulatory legislation, reasonable employer pension payments to retirees or contributions to trust funds were tax-deductible expenses 1/. However, the funding of prior service credits and amortization of unfunded liabilities were not tax deductible. Furthermore, income accruing to either the employer or employee in an established trust fund was taxable. The 1921 Revenue Act eliminated current taxation of income for stock bonus and profit-sharing plans established by employers to benefit "some or all" of their workers.

Through an administrative ruling, pension trusts also were accorded preferential tax treatment, and the 1926 Revenue Act established this

1/ See Dan M. McGill, Fundamentals of Private Pension, 4th ed. (Homewood, Ill.: Richard D. Irwin, Inc. 1979), pp. 23-28, for a more detailed discussion of these developments.

treatment of pension trusts as law. The 1928 Revenue Act permitted reasonable deductions in excess of currently accruing liabilities, in effect allowing funding of past service credits. The 1928 Revenue Act allowed the continued provision of pensions for "some or all" of the employees of a sponsoring employer, which allowed owners and officers to establish plans under which they received preferential tax treatment while excluding rank-and-file workers.

Also at that time pension trusts were revocable. That is, a sponsor could establish a plan in a high-income year, make tax-free contributions to the plan, and revoke it in an unprofitable year. The 1938 Revenue Act modified the revocability provisions and required that a retirement trust be for the exclusive benefit of the employees covered until all liabilities were met under the plan.

In 1940, a sharp increase in corporate income tax rates greatly expanded the incentives to establish pension programs, particularly because the 1938 Revenue Act had not changed the provisions allowing selective coverage of the sponsor's work force. The 1942 Revenue Act and amendments to it in the 1954 Internal Revenue Code modified the tax qualification standards and changed the tax code to preclude plan sponsors from discriminating in favor of a sponsor's owners and officers.

Organized labor also played a major role in the evolution of pensions in the United States. When Inland Steel Company initiated mandatory retirement at age sixty-five in 1946, the union filed a grievance with the National Labor Relations Board (NLRB) arguing that the company's unilateral decision on this issue violated a provision in its negotiated contract dealing with separation from service. The employer argued that the mandatory retirement provision was an essential part of the company's pension program and that pensions were outside the realm of collective bargaining. The 1948 NLRB ruling, based on the 1947 Labor Relations Management Act, held that pensions were negotiable. The NLRB based its ruling on two principles: (1) that pensions fell under the term "wages" as defined in the law;, and (2) that pensions could be considered "other conditions of employment," which were negotiable. When the company appealed the ruling, the Seventh Circuit Court of Appeals found that the employer had reasonably argued that pensions were not wages but that premiums were clearly included in the "other conditions of employment" clause.

Inland Steel's original disagreement with the union over the negotiability of pensions linked to its mandatory retirement age provision indicates that employers do use their pension programs for manpower management. Over the years, the unions themselves have negotiated vigorously for pensions that help provide new jobs for younger workers as older ones retire. The Social Security Act's provision of a bottom tier of retirement income has further increased awareness that economic security for the elderly is of paramount importance. The policy focus on income adequacy since the 1960s has especially highlighted the needs of the elderly.

Over the years, the combination of preferential tax treatment, employer and union interest and social consciousness have contributed to the growth of private pension provisions. Table 1 reflects the dramatic increase in tax qualified plans, rising from 549 at the end of 1939 to 746,000 plans as of September 30, 1982.

TABLE 1

SUMMARY OF QUALIFICATIONS AND TERMINATIONS

Period Ending	Number of Qualification Rulings to Date	Number of Terminations to Date	Net Number of Plans in Effect	Increase in Net Number of Plans Over Previous Period	% Annual Growth
Sept. 30, 1982 5/	884,936	144,963	745,973	56,693	8.2
Dec. 31, 1981	816,924	133,644	689,280	68,095	11.0
Dec. 31, 1980	741,387	120,202	626,185	56,063	9.9
Dec. 31, 1979	672,045	106,923	565,122	46,036	8.9
Dec. 31, 1978	615,168	96,084	519,086	50,398	10.8
Dec. 31, 1977	549,484	80,796	468,686	19,601	4.4
Dec. 31, 1976	514,068	64,981	449,087	3,494	0.8
Dec. 31, 1975	485,944	40,351	445,593	21,931	5.2
Dec. 31, 1974	455,905	32,243	423,662	54,781	14.8
Dec. 31, 1973	396,520	27,639	368,881	55,475	17.7
Dec. 31, 1972	336,915	23,509	313,406	45,815	17.1
Dec. 31, 1971	287,580	19,989	267,591	37,329	16.2
Dec. 31, 1970	246,916	16,654	230,262	30,268	15.1
Dec. 31, 1969	214,342	14,348	199,994	26,346	15.2
Dec. 31, 1968	186,267	12,619	173,648	22,339	14.8
Dec. 31, 1967	162,485	11,176	151,309	19,214	14.5
Dec. 31, 1966	141,964	9,869	132,095	16,973	14.7
Dec. 31, 1965	123,781	8,659	115,122	12,496	12.2
Dec. 31, 1964	110,249	7,623	102,626	10,667	11.6
Dec. 31, 1963	98,541	6,582	91,959	10,250	12.5
Dec. 31, 1962	87,397	5,688	81,709	9,359	12.0
Dec. 31, 1961	77,179	4,829	72,350	8,652	13.5
Dec. 31, 1960	67,792	4,094	63,698	9,399	17.3
Dec. 31, 1959	57,835	3,536	54,299	6,792	14.2
Dec. 31, 1958	50,569	3,062	47,507	6,551	15.9
Dec. 31, 1957	43,615	2,659	40,956	6,074	17.4
Dec. 31, 1956	37,190	2,308	34,882	4,944	16.5
Dec. 31, 1955	31,943	2,005	29,938	1,769(1)	6.3
June 30, 1955	30,046	1,877(2)	28,169(2)	3,290(2)	13.2
June 30, 1954	26,464	1,585	24,879	4,204	20.3
June 30, 1953	22,069	1,394	20,675	3,657	21.5
June 30, 1952	18,289	1,271	17,018	2,347	16.0
June 30, 1951	15,899	1,125	14,671	2,517(3)	20.7
June 30, 1950	13,899	--	--	--	--
June 30, 1949	12,865	711	12,154	896	8.0
June 30, 1948	11,742	484	11,258(4)	1,888	20.1
Aug. 31, 1946	9,370	--	9,370(4)	1,584	20.3
Dec. 31, 1944	7,786	--	7,786(4)	5,839	300.0
Sept. 1, 1942	1,947	--	1,947(4)	1,288	195.0
Dec. 31, 1939	659	--	659(4)	549	--

(1) Six month total
(2) See RR 101.-4
(3) Increase from June 30, 1949 (see RR 101.4)
(4) 28 month period, average 2,507 plans per year
(5) 9 month period, 1/1/82 - 9/30/82

*Does not include plans covering self-employed individuals (Keogh Act plans).

SOURCE: Charles D. Spencer Associates for 1930 to 1975, EBRI tabulations of IRS data for 1976 to 1982.

Historically, the growing prevalence of private pension plans has led to a marked increase in pension participation. First of all, the expansion of private pension system has been reflected by the steady growth in the number of participants and beneficiaries as shown in Table 2. Second, and perhaps more important, participation has grown more rapidly over the years than private sector employment. Private sector employment grew 15.4 percent from 1950 to 1959, 27.0 percent from 1960 to 1969 and 26.8 percent from 1970 to 1979. Over the same three periods pension participation increased by 85.7, 39.0 and 36.8 percent. Some have focused on the stabilization of the participation rate during the 1970s as an indication that the private pension system has stagnated. EBRI's previous research has identified the rapid growth in employment as the baby boom generation entered the work force, the rapid rise in female labor force participation rates during the 1970s and the implementation of ERISA as more reasonable explanations of stable pension participation rates during the 1970s. 2/

The stabilization of pension participation rates during the late 1970s was not because pension participation was not growing. It was the result of the simple mathematical calculation of participation rates where the numerator (pension participation) did not keep up with the denominator (workers) during a period in which the latter was growing at unprecedented rates. Expected private sector employment growth during the 1980s is only one-half to one-third the rate of the last half of the 1970s. Slower

2/ Sylvester J. Schieber and Patricia M. George, Retirement Income Opportunities in an Aging America: Coverage and Benefit Entitlement (Washington, D.C.: The Employee Benefit Research Institute, 1981), pp. 23-50.

employment growth means that continued pension expansion should result in higher pension participation rates during this decade.

Even considering the stabilization of pension participation rates during the 1970s, the result of the historical growth in private pension plans is that an increasing share of the work force is participating in at least one pension program other than Social Security. The May 1979 Current Population Survey (CPS) provides the most recent available statistics on recent pension participation levels. 3/ This survey, based on a sample of households representing the U.S. civilian work force, estimated that outside agriculture, 68.3 percent of all civilian wage or salary workers between the ages of twenty-five and sixty-four, working at least half time, who had been with their employer for a year or more, were participating in a pension plan.

TABLE 2
WAGE AND SALARY WORKERS AND BENEFICIARIES PARTICIPATING IN PRIVATE SECTOR PENSION PLANS FOR SELECTED YEARS

YEAR	PARTICIPANTS IN PRIVATE PENSION PLANS		
	WORKERS (Millions)	BENEFICIARIES (Millions)	ACTIVE WORKERS PER BENEFICIARY
1950	9.8	0.5	19.6
1955	14.2	1.0	14.2
1960	18.7	1.8	10.4
1965	21.8	2.8	7.8
1970	26.1	4.7	5.6
1975	30.3	7.1	4.3
1979	35.2	9.6	3.7

Sources: Alfred M. Skolnick, "Private Pension Plans, 1950-1974, Martha Renny Yohalem, "Employee Benefit Plans, 1975." Social Security Bulletin, June 1976 and November 1977, respectively; and estimates from the May 1975 and March 1980 Current Population Survey.

3/ Ibid., p. 25.

Another indication of the growth in private pensions is the level of employer contributions, the accumulated trust funds and the level of benefit disbursements from these plans. The time series date on these pension indicators are shown in Table 3. As in the case of the number of plans and the number of participants, the aggregate pension financial data indicate a strong historical growth pattern.

There has been some concern in recent years about the distribution of the benefits provided by private sector plans. The analysis of these benefits is often based on survey data sets such as the Current Population Surveys conducted by the Census Bureau. While these surveys are extremely valuable, they are subject to limitations that warrant care in their interpretation. For example, our analysis of defined contribution pension plans has found that most of these plans are not themselves annuity plans. 4/ At withdrawal or retirement, vested participants are generally given a lump-sum distribution. In some instances, the employer will arrange for conversion of the distribution into an annuity program, but the plan itself seldom pays pension benefits in the traditional sense.

This lump-sum distribution phenomenon results in undercounting of the number of pension beneficiaries on population surveys. For example, the Census Bureau's annual March Income Supplement to their Current Population Survey gathers information on the prevalence of the receipt of pension and

4/ Sylvester J. Schieber, Social Security: Perspectives on Preserving the System (Washington, D.C.: The Employee Benefit Research Institute, 1982) pp. 56-58.

TABLE 3

EMPLOYER CONTRIBUTIONS TO PRIVATE PENSION AND PROFIT SHARING FUNDS, PENSION FUND ASSETS AND BENEFITS PAID BY THESE PLANS FOR SELECTED YEARS

YEAR	EMPLOYER CONTRIBUTIONS	TRUST FUND ASSETS	BENEFITS PAID
	(dollar amounts in billions)		
1950	$ 1.7	$ 12.0	0.4
1955	3.4	27.4	0.9
1960	4.9	52.0	1.7
1965	7.6	86.5	3.5
1970	13.0	138.2	7.4
1971	15.0	152.8	8.6
1972	17.8	169.8	10.0
1973	20.7	182.6	11.2
1974	24.8	194.5	13.0
1975	27.6	210.7	14.9
1976	33.0	248.8	16.7
1977	38.4	290.2	19.7
1978	44.0	321.3	23.1
1979	48.9	424.0	27.3
1980	54.7	500.3	31.7
1981	60.2	520.2	N/A

SOURCES: Private plan contributions and benefits from U.S. Department of Commerce, The National Income and Product Accounts, 1948-1974 and Revised Estimates of the National Income Product Accounts (July 1977, and 1982); Asset totals from Federal Reserve Board of Governors Banking and Monetary Statistics, 1941-1970 and Annual Statistical Digest, various years.

the annual levels of benefits. Interviewers' instructions and training specifically direct that only regular income is to be recorded in the interview; one-time income is to be ignored. Unless defined-contribution plan lump-sum distributions are converted to an annuity, they never show up on the survey as retirement program benefits. As a result, the traditional survey estimates of pension receipt and benefit levels significantly underestimate the effectiveness of the private pension system in the delivery of benefits. For example, the March 1980 CPS provides an estimate of $18.8 billion in private pension benefits paid during 1979. The data in Table 3 from the National Income Accounts estimates private plan benefits in 1979 were $27.3 billion or more than 45 percent more than the CPS estimate.

It is partially the concern about the level of pension benefits being provided and the distribution of these benefits that leads to serious consideration of alternative tax provisions of pension programs. It is a pity that more concern is not placed on the quality of data and analysis that is available in this area. The reason that better analysis is critical is that private pensions, a vital part of the U.S. retirement system, are extremely sensitive to public policy developments.

PENSION GROWTH AND THE SENSITIVITY TO PUBLIC POLICY

The purpose of this hearing is to assess the implications of TEFRA for various types of pension plans. To a certain extent, any assessment of the implications of TEFRA at this point in time is an exercise in the fine art of crystal ball gazing. Many of the pension provisions that are included in TEFRA will not take effect until after this year. Even if there has been an anticipatory response to TEFRA, the data is not yet available for assessing that response. The IRS data on plan qualifications and terminations for the last quarter of 1982 are not yet available and TEFRA was only signed into law on September 3, 1982. This does not mean, however, that certain directional implications cannot be hypotheized. Before undertaking such an exercise, it is worthwhile to show that pension policy changes matter.

The ERISA Experience

The most significant pension legislation in the history of private plans in this country has been the Employee Retirement Income Security Act. As the earlier analysis pointed out, by the mid 1970s private pension funds held billions of dollars in assets. A few, highly publicized cases of inadquate funding, poor administration and occasional embezzlement received wide publicity. To remedy these problems and to increase pension participant and beneficiary rights, Congress enacted the 1974 Employee Retirement Income Security Act (ERISA). This legislation does not require employers to adopt employee pension programs. Where voluntary plans are established, however, they must comply with extensive reporting and fiduciary requirements and minimum standards of coverage, participation, vesting and benefit funding. ERISA also created the Pension Benefit Guaranty Corporation to ensure a level of vested benefits when defined benefit plans terminate.

Under ERISA, private employer pension plans generally must provide coverage on a nondiscriminatory basis to all employees age 25 or older with one or more years of service. Employers must also adopt a vesting schedule that satisfies one of three vesting standards. One standard requires total vesting after ten years of service. The other two require phased-in vesting after a designated period of service or a specified combination of service and age, and full vesting after fifteen years of service.

Though ERISA established extensive minimum requirements, employers continue to have considerable flexibility in determining many plan design aspects. For example, private plans can be defined contribution or defined benefit. In both instances benefit levels generally rise with increases in employee's wages and length of service. Though some private employer plans are contributory most are noncontributory. Additionally, each employer can establish an individual plan, use a preapproved master plan or join other firms in a multiemployer plan. As long as plan design features are nondiscriminatory, employers can provide more liberal coverage, participation and vesting privileges than those specified by ERISA.

While ERISA has had many ramifications for the private pension system most have not been systematically measured. One notable exception is the effect of ERISA on plan formation and termination. Based on Internal Revenue Service determination letters, Table 4 shows the annual rates of plan qualifications and terminations between 1956 and September 1982. Between 1956 and 1974 there was steady growth in newly created defined benefit and defined contribution plans. In each of these nineteen years, qualified plan establishment exceeded terminations by more than a ten-to-one ratio. Consistently, there was greater net growth in the number of defined benefit plans over the number of defined contribution plans. During 1974 the net total of defined benefit plans increased by 30,000, while defined contribution plans registered growth of 24,600 units. ERISA was signed into law on Labor Day in 1974 and was largely implemented during 1975 and 1976.

Plan creation and termination rates changed radically after ERISA. From late 1974 to early 1977, private pension programs conformed to ERISA's principal regulations. In 1973, 2,222 defined benefit plans terminated, in

TABLE 4

CORPORATE AND SELF-EMPLOYED PENSION PLAN QUALIFICATIONS

TERMINATIONS AND NET PLAN INCREASES 1/

	Defined Benefit Plans			Defined Contribution Plans			
Year	Plans Qualified	Plans Terminated	Net Plans Created	Plans Qualified	Plans Terminated	Net Plans Created	Net Total Plans Created
1955							
1956	3,175	192	2,983	2,072	111	1,961	4,944
1957	3,527	180	3,347	2,898	171	2,727	6,074
1958	3,883	224	3,659	3,071	179	2,892	6,551
1959	3,824	270	3,554	3,442	204	3,238	6,792
1960	5,011	300	4,711	4,946	258	4,688	9,399
1961	4,919	374	4,545	4,468	361	4,107	8,652
1962	5,188	476	4,712	5,030	383	4,647	9,359
1963	5,840	441	5,399	5,304	453	4,851	10,250
1964	6,581	509	6,072	5,127	532	4,595	10,667
1965	7,495	512	6,983	6,037	524	5,513	12,496
1966	10,124	603	9,521	8,059	607	7,453	16,973
1967	11,292	602	10,690	9,229	705	8,524	19,214
1968	12,896	672	12,224	10,886	771	10,115	22,339
1969	14,692	969	13,824	13,383	861	12,522	25,905
1970	16,512	1,142	15,370	16,062	1,164	14,898	30,268
1971	22,493	1,605	20,888	18,171	1,730	16,441	37,329
1972	28,265	1,745	26,520	21,070	1,775	19,295	45,815
1973	33,830	2,222	31,608	25,775	1,908	23,867	55,475
1974	32,579	2,577	30,002	26,806	2,207	24,599	54,601
1975	15,319	4,550	10,769	14,720	3,558	11,162	21,931
1976	4,790	8,970	-4,180	21,030	6,775	14,255	10,075
1977	6,953	5,337	1,616	28,463	10,478	17,985	19,601
1978	9,728	4,625	5,103	55,956	10,661	45,295	50,398
1979	15,755	3,267	12,488	41,122	7,574	33,548	46,036
1980	18,849	4,297	14,552	50,493	8,982	41,511	56,063
1981	23,789	4,536	19,253	51,748	8,906	48,812	68,095
1982 1/	22,102	3,651	18,451	45,910	7,668	38,242	56,693

SOURCE: EBRI compilation of IRS data.
NOTE: This table is based on IRS plan qualification determination letters.

1/ Through September 30, 1982.

1975 this increased to 4,550 and in 1976, 8,970 defined benefit plans terminated. This pattern has continued; it significantly exceeds any projected plan termination trends suggested in the twenty years preceding ERISA's implementation. ERISA had an even greater effect on defined contribution plan terminations. In 1973, 1,908 defined contribution plans terminated, this increased to 3,558 in 1975, and 6,775 in 1976. More than 10,000 defined contribution plans were terminated in each of the next two years.

Some analysts have contended that the plan terminations that occurred after the passage of ERISA were mainly the desirable elimination of bad or financially unsound plans. Some unscrupulous sponsors and bad plans were undoubtedly weeded out by ERISA. There has never been any substantive evidence, however, that suggests that the majority of terminating plans could be so classified. In fact, the Pension Benefit Guaranty Corporation (PBGC) has found that about 40 percent of the participants in defined benefit plans terminated during the early days of ERISA were recovered by newly established defined-contribution plans. 5/ It is important to note that 18,857 defined benefit plans were terminated between 1975 and 1977, compared with 15,514 such terminations during the previous nineteen years. It is clear that ERISA resulted in a dramatic increase in plan terminations for whatever reason.

At the same time the number of plan qualifications declined markedly. The number of newly qualified defined benefit plans during 1976 was only about one-seventh the number of plans qualified only two years earlier. And

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5/ Pension Benefit Guaranty Corporation, Analysis of Single Employer Defined Benefit Plan Termination, 1976, 1977, 1978, 3 vols. (Washington, D.C.: PBGC 1977, 1978, 1979).

the number of newly qualified defined contribution plans in 1975 was only about one-half the prior year's level.

Table 4 shows net growth of 51,600 tax-qualified plans during the three years 1975 to 1977 compared to 54,600 plans in 1974. The average annual plan growth rates during the implementation of ERISA were less than one-third the rate for the years immediately prior to the passage of ERISA. This slow-down in pension plan growth during the mid-1970s contributed to a slower growth in pension participation rates than would have occurred otherwise.

Another facet of the ERISA experience is the notable shift toward defined contribution plans. The PBGC studies cited above indicate there was some direct shifting with defined benefit plans being terminated and replaced by defined contribution plans. Prior to the passage of ERISA, the number of newly qualified and net growth in defined benefit plans consistently exceeded qualifications and net defined contribution plan growth. If the 1973 defined benefit plan creation rate had persisted, nearly 190,000 net plans would have developed between 1975 and 1980. Actual net growth was 40,348 defined benefit plans. Based on the same criteria, however, only 144,000 defined contribution plans would have been created but actual growth was 157,175. When these figures are combined, the expected 1975-1980 private plan increase was 334,000 plans; actual increase was only 197,523 plans. Table 4 demonstrates a marked shift from defined benefit to defined contribution plans since 1976, although the desirability of this shift has not been widely discussed. Elements of TEFRA may further increase the prevalence of defined contribution over defined benefit plans. Before turning to specific aspects of TEFRA and their potential implications, a brief comparison of defined benefit and defined contribution plans is presented.

The Relative Merits of Defined Benefit and Defined Contribution Plans

Both defined contribution and defined benefit plans are organized retirement plans. Without inferring who actually bears the incidence of program costs, most of these programs in the private sector are largely supported by employer contributions. From the employee's perspective either type of plan helps provide income security in retirement. From the employer's perspective either helps in the orderly recruiting, maintenance and retirement of the necessary workforce.

The defined benefit plan provides a clearly stated retirement income level generally related to years of service and a measure of salary toward the end of employment tenure. The defined contribution plan, on the other hand, provides for specified contribtuions to an individually allocated investment account. Without comparing the actual level of benefits provided to specific individuals under one plan or the other, the two types of plans can be compared from an equity perspective. In this regard Trowbridge argues:

> That the employer contributes the same percentage of pay for every covered employee is a philosophical strength of the defined contribution arrangement. The underlying principle of equity is that individual workers enjoy benefits of equal value.
>
> In defined benefit pension plans, as in most group insurance arrangements, the principal is one of equal benefits. Equal benefits are rarely the same as benefits of equal value, because employees vary as to age, sex, and other risk characteristics.
>
> In summary, defined contribution plans define individual equity in terms of equal employer contributions and accept the necessarily unequal benefits that equal contributions provide. Defined benefit plans define equity in terms of equal benefits and accept the necessarily unequal employer contributions. 6/

6/ Charles L. Trowbridge, "Defined Benefit and Defined Contribution Plans: An Overview," in Economic Survival in Retirement: Which Pension Is for You? (Washington, D.C.: The Employee Benefit Research Institute, 1982), pp. 3-34.

In addition to these equity differences that apply under the *ceteris paribus* conditions, there are other differences in the two approaches to pension provision that arise because other things are not always equal. These arise partly because of the inherent differences in the two types of plans, but also because of tradition and the differential treatment of the plan types under the tax and regulatory code.

The relative desirability of a defined benefit versus a defined contribution plan depends a great deal on the goals the plan is supposed to meet. If everyone's goals coincided, then an ultimate plan design could be arrived at easily. There are always several players concerned about the design of a retirement plan who do not have coincidental goals.

Defined benefit (DB) plan are often preferred because they can provide retrospective credits whereas defined contribution (DC) plans are prospective. This is especially the case at the time the plan is established if there are workers with several years of tenure who will be covered by the new plan. This ability to grant past service credits is particularly attractive where an employer is offering a pension for the first time. This may not be important if the employer has a plan and is considering a new one but may be important if current workers are given the option and encouraged to transfer to the new program. It is also important in the case of benefit enhancements. Under DB plans such enhancement can be granted on the basis of prior service. With a DC plan this is far more complicated, if not practically impossible.

An important reason that it is difficult to provide such retroactive protection under a DC plan is that employers do not typically keep lifetime historical earnings records on which such a benefit increase would be based. The most important reason, however, is because of the different funding procedures used in the two approaches. The DC plan by nature is always fully funded. To grant retroactive credits under such a plan could require a crushing contribution to fund such benefits. The DB plan, on the other hand, would allow the creation of an unfunded liability that could be amortized over several years. While it is impossible to project the likelihood of future benefit enhancements at the inception of any new pension plan, private defined benefit plans have a long history of gradual benefit improvements, often retroactively.

The differences in funding provisions and the tax code may provide the employer the incentive to provide more generous benefits under a defined benefit than a defined contribution plan. This occurs because the defined contribution credits have to be funded in the period in which they occur, whereas the defined benefit accruals can be funded at a later point in time. This offers the plan sponsor the opportunity to fund the plan to a greater extent during profitable periods and to delay contributions during leaner times. It is partly this difference in funding requirements that makes profit sharing plans the predominant type of defined contribution program.

Another difference between DB and DC plans is that they are structurally different. This is important because it affects the participants' understanding and attitudes toward the plan. In the DB plan the participants can be educated to understand that their benefits will replace a closely estimated percentage of their final earnings and that the pension in combination with Social Security will maintain an estimable portion of the preretirement standard of living. The DC plan provides a clearly perceptible growing account balance. A problem that many workers have is in comparing the relative values of the two types of plans. The defined benefit is stated in flow terms while the defined contribution is a stock.

The stock and flow differentials in the two plan types can be easily reconciled by actuaries and economists. For the individual worker the stock concept may be more easily understood during the period of accumulation, but it is the flow of income that is important in retirement. A person's standard of living is largely determined by the flow of goods and services they can consume over time. While the defined contribution accumulation can be converted to an annuity at retirement most workers cannot readily estimate the extent to which their preretirement earnings will be replaced until the end of their career. In part, this is the result of the arithmetic involved in converting stocks to flows. It is also the result of uncertain projections of the stock values which themselves are subject to inflationary and market forces that are not always understood.

The latter point relates to a third difference between DB and DC plans. In the defined contribution plan, investment performance directly affects the level of benefits. Because contributions and interest accruals relate to specific persons, the risk of adverse market performance is borne by the individual worker. Under the defined benefit plan, on the other hand, the individual is promised a level of benefits related to final salary. Adverse market performance can reduce the value of the pension portfolio as in the case of the DC plan. However, the employer has guaranteed the benefit and has to adjust contributions to make up for bad investment performance.

There are also traditional differences between DB and DC plans that have evolved because they are perceived differently by workers. The perceived accrual of a capital stock in the defined contribution plan raises the employee's consciousness of the value of accumulating assets. The accumulated value of the asset is also much more portable than a vested defined benefit promise. The individually assigned assets can be liquidated and reinvested in an individual retirement account, making them highly portable. This combined perception of a definable asset, along with relative portability may combine to account for typically shorter vesting in DC plans. For the highly mobile worker, the defined contribution plan may be preferred because of its portability characteristics. For the long-term stable employee, on the other hand, the primary concern is likely to be an adequate level of benefits to maintain preretirement earnings standards. This will more likely be assured through a defined benefit plan. Most defined contribution plans do not have automatic provisons to convert the accumulated assets to an annuity at retirement. The more typical cash-out provisions in these plans are often criticized because it is feared the accumulated funds are often not used for retirement income security purposes. There is virtually no extant data that allows analysts to evaluate the actual utilization of asset accumulations in defined contribution plans. The May 1983 Current Population Survey being conducted by the Census Bureau and jointly sponsored by EBRI and the Department of Health and Human Services will gather such information for the first time. The survey will elicit information on the prevalence and level of lump sum distributions from retirement plans and the disposal of these assets.

The questions posed by the different benefit structures inherent in defined benefit and defined contribution plans give all parties concerned about federal retirement policy much to ponder. Neither the defined benefit nor the defined contribution structure is perfect to meet everyone's goals. It is the conflicting goals of different workers, employee groups, employer and public policy goals that makes it impossible to select one type of plan over the other as being ideal. But everyone should understand that there are good reasons for and against both plan types. That, more than any other reason, may account for the fact that most large employers in the United States today have both a defined benefit and defined contribution plan for their workers.

The Potential Implications of TEFRA

The impact of TEFRA on the U.S. private pension system will vary across various segments of the employer and plan universe. The variations will arise on the basis of plan size, the number of plans offered by the plan sponsor and the characteristics of the workforce covered by a plan.

Among the various TEFRA provisions that may affect the creation and maintenance of pensions are the changes to tax deductible contribution limits. The Section 415 dollar limitations on annual benefits payable under a defined benefit plan were reduced from $136,425 to $90,000. Similarly, the dollar contributions under a defined contribution plan are reduced from $45,475 to $30,000. These limits are to be frozen until 1986 when they will be allowed to rise in accordance with Social Security COLA adjustments.

For participants covered by both a defined benefit and defined contribution plan, the Section 415 contribution limits affecting multiple plans were also reduced. Under pre-TEFRA provisions a plan sponsor with multiple plans who had contributed the maximum under one contribution limitation could not make a tax deductible contribution of more than 40 percent of the other contribution limitation to the second plan. This 140 percent or 1.4 limit was reduced to 1.25 by TEFRA.

TEFRA further adjusted the Section 415 limits for defined benefit plans where benefits commence prior to age 62. Under TEFRA the defined benefit that can be funded is actuarially reduced to $75,000 for retirement at age 55. TEFRA also allows for incremental adjustments to benefits that are taken after age 65.

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

In recent years, private pension contribution limits have been indexed with the CPI. This indexing provision permits pension benefit financing for each new wave of retirees, which replaces roughly the same proportion of preretirement earnings as received by earlier groups of retirees. The indexing of maximum taxable income and the benefit formula bend points for Social Security accomplishes essentially the same result. There is some question whether the CPI is an appropriate basis for indexing pension contribution limits. Because pensions are wage-related programs, some argue that wage indexation would be more appropriate. In any event, freezing contribution limits will reduce the income replacement capacity of pension programs over time. The TEFRA freeze would affect a small number of current pension participants. As the general level of wages rises, however, the portion of the work force affected would increase if the TEFRA freeze is extended. As more people reach the limits, the income replacement capacity of pensions would diminish. This, combined with Social Security's redistributive nature means an ever increasing share of the elderly would be unable to maintain preretirement living standards through benefits from organized retirement programs.

Social Security contribution limits are indexed. So are earnings in the benefit formula for purposes of determining benefit levels. Benefits are indexed to keep up with inflation after retirement. There is no simple comparison to be made between private pension contribution limits and the various indexed components of Social Security. Pension programs do not directly provide for any of the kinds of indexation inherent in Social Security. Most pension benefits bear a fairly direct relationship with earnings received at the end of a receipient's career. This indicates that private pension contribution growth has roughly approximated the combined effects of Social Security's earnings and benefit formula indexation. Beyond this, few private or public retirement programs, other than federal programs, now provide full CPI indexation of postretirement benefits.

To the extent that an employer has a single plan and will be affected by the contribution limit reductions or freezes, there will now be added incentive to establish a secondary plan to take advantage of the combined contribution limitations. The reduction of the Section 415 limits for multiple plans may also encourage the reduction of some existing plans, however.

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

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

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

Given that the 1.4 limits were reduced to 1.25 and not completely eliminated the likelihood that many plans will be terminated is probably slight. The complete elimination of the tax incentive to set up secondary plans, on the other hand, would make them less desirable for many plan sponsors. Any individual who is benefitting from the maximum contribution limits under this provision of the bill will almost certainly be in a high marginal tax bracket during their retirement years. The benefits provided to such individuals by this section of the tax code represent almost completely a tax deferral and not a tax expenditure as discussed later in this testimony. To chance elimination of plans beneficial to lower and middle-income workers to reduce the tax deferrals available to a small number of high-income taxpayers may not be a wise policy option to pursue further.

Withholding Provisions - TEFRA has extended to the "payor" or the plan administrator of pension and deferred compensation plans the obligation of tax withholding on pensions, annuities and deferred compensation payments. The Act allows the individual recipient to elect-out of withholding. At least once a year the payor has to notify the beneficiary of his or her right to change their status.

This provision is one of those that makes sense in concept but can result in various calamities in actual operation. When plan sponsors warned of potential problems during the TEFRA deliberations their concerns were largely unheard. The Washington Post recently ran an interesting story in this regard on the Federal Government's experience with its own annuitants.

> The OPM says that many retirees apparently didn't undestand the new withholding system. Some, OPM says, put down the amount they wanted deducted for the entire year. But that amount is being taken out each month, and will be until the retiree "corrects" it.
>
> Others, OPM said yesterday, put down a dollar amount to be withheld monthly, unaware that that amount would be added to the amount to be deducted based on the number of exemptions they claim.
>
> Members of Congress from the Washington area have been inundated with calls from angry, frustrated retirees. The National Association of Retired Federal Employees says it has been hearing from retirees all over the country, who are wondering what happened to their annuity checks. 7/

If these problems arise among other plans and persist beyond the start up period, Congress may want to reconsider certain of the provisions in this section of the Act.

Social Security Integration - For defined contribution plans TEFRA does not allow the contribution rate below the Social Security taxable income maximum to be more than the OASDI tax rate below the contribution rate above that income tax level. Prior to TEFRA, the differential

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7/ Mike Causey "Uncle's Double Whammy on Retirees' Checks," The Washington Post (Wednesday April 6, 1983), p. c2.

contribution rate above and below the taxable maximum was 7 percent. The TEFRA provision was aimed at reducing the extent of Social Security integration in profit sharing and other defined contribution plans.

The early indications are that many plans will be modified to reduce the contribution rates on incomes in excess of the Social Security taxable maximum. This provision does not seem to recognize the substantial redistributive characteristics of Social Security. Nor does it recognize the low rates of return that individuals will receive on their combined employer-employee payroll tax if they are at or above the taxable income maximum and expect to retire after the mid 1990s. The differential contribution rates of 1.3 percent in 1984 between pre or post-TEFRA provisions or .8 percent beyond 1990 would not completely offset the redistributive capacity of Social Security or ameliorate its poor rate of return provisions for workers who would benefit.

Top-Heavy Plan Provisions - For plans that primarily benefit key employees there are special provisions in TEFRA. First TEFRA provides for three-year cliff or six-year graded vesting. Second, there are minimum benefit or contribution provisions for non-key employees. Third, there is a limitation of $200,000 of any employees salary that can be considered for purposes of making plan contributions. Fourth, top heavy plans have special Section 415 limits when multiple plans are offered. Finally, distributions to key employees prior to age 59 1/2 are subject to a special 10 percent tax. Also distributions to key employees have to begin by age 70 1/2.

The top-heavy provisions are complicated in several regards, not the least of which is the determination of top heavy status. It is clear that these provisions will effect primarily smaller employers. To the extent that the provisions are complicated and may require special administration expense they may discourage pension plan creation by some smaller firms. To the extent the firms stay small, not much pension coverage will be foregone. If the firms expand, the delay in establishing a plan can mean substantial losses in ultimate retirement security for significant numbers of workers.

One particular problem with top heavy provisions could be the potential for firms to wander in and out of top-heavy status. It is certain that some firms that are not top heavy could be driven into such status by conditions beyond their control (e.g., layoffs during a recessionary period).

According to some pension consultants as many as 30 to 40 percent of small plans may be terminated. Others expect that large numbers of defined benefit plans may be terminated and replaced with defined contribution plans.8/ If this is the desirable outcome of public pension policy it has never been openly discussed in the Congressional forum.

Self-Employed and Personal Service Corporation Plans - The provisions of TEFRA have eliminated the disparities between the tax treatment of plans established by the self employed and those set up by individuals who have incorporated in the past to take advantage of corporate pension tax provisions. These provisions may result in the disbanding of some personal service corporations. The higher contributions limits now available to the self employed may encourage more rapid expansion of Keogh plans.

8/ Diane Hal Grupper, "The Furor Over TEFRA," Institutional Investor (February, 1983), pp. 71-80.

THE LESSONS FROM ERISA AND TEFRA

The private pension system today is in turmoil. In large measure the plan creation data of the last two to three years indicated that it had recovered from the initial shock of ERISA. The economics of high inflation during the latter 1970s and the extended recession of the early 1980s have caused problems that have been largely handled. The shock of TEFRA is being applied to a system that has been buffetted for most of the last ten years. The system has been extremely resilient until now and may survive TEFRA relatively unscathed. Then again, it may not.

Just because a policy shift might result in significant adjustments in the pension system does not mean that it should be judged bad policy, however. It is clear that ERISA has provided some positive reforms; it has also created some problems. One stark difference in the evolution of ERISA and TEFRA was the time and deliberation that went into their development.

ERISA evolved through careful and extensive discussions between most of the major parties interested in a healthy pension system. TEFRA evolved quickly in an environment of overwhelming budget deficits when pension reform was considered in the context of closing tax loopholes for the rich. It was understood that ERISA would result in some plan terminations, but that was accepted because those plans were believed to be unstable anyway. It was thought that TEFRA might result in some plan terminations also, but mainly those offered by unscrupulous sponsors out to beat the spirit of the tax provisions favoring pensions.

Among plan sponsors ERISA was seen as the inevitable result of the policy process establishing new rules to resolve problems in the pension game. TEFRA, on the other hand is broadly perceived as a legislative game being played by policy advisors who do not understand the pension system or its problems. Furthermore, TEFRA is perceived as a precursor to more changes. With the publication of the 1984 federal budget there is new evidence that the pension system may again become a target of the budget process.

THE EFFECT OF PENSIONS ON THE BUDGET

During the last two years there have been significant changes in federal tax laws affecting employer sponsored and individually established retirement programs. The Economic Recovery Tax Act (ERTA) of 1981 expanded the availability of Individual Retirement Accounts (IRAs) to include workers already covered by a pension plan. The Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982 reduced tax exempt contribution limits for private plans.

These and earlier provisions of the U.S. Tax Code have been the subject of much discussion and debate in recent years. The dialogue has often centered on the impact that favorable tax provisions allowed pensions and individual retirement programs have on federal tax collections. Some policy analysts believe that current provisions in the tax law favoring retirement programs are unwarranted.

The discussions of these issues are bound to take on a sense of heightened proportions in the coming year for two reasons. The first is that the Federal Budget continues to be plagued by unprecedented deficits meaning that all favorable tax provisions will come under closer scrutiny. The second is that the Treasury Department has recently increased its estimate of "tax expenditures" for employer-sponsored retirement plans by 75 to 80 percent. Virtually no explanation has been provided for this precipitous increase.

Conceptual Background on Retirement Program Tax Expenditures

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

> Through deliberate departures from accepted concepts of net income and through various special exemptions, deductions and credits, our tax system does operate to affect the private economy in ways that are usually accomplished by expenditures -- in effect to produce an expenditure system described in tax language.
>
> When Congressional talk and public opinion turn to reduction and control of Federal expenditures, these tax expenditures are never mentioned. Yet it is clear that if these tax amounts were treated as line items on the expenditure side of the Budget, they would automatically come under close scrutiny of the Congress and the Budget Bureau. 9/

The Congressional Budget Act of 1974 (P.L. 93-344) formally institutionalized "tax expenditures" as part of the regular Budget document. The act defined tax expenditures as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability." 10/ Within this context, tax expenditures are defined as "exceptions to the normal structure" of individual and corporate tax rates.

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

10/ Special Analyses Budget of the United States Government Fiscal Year, 1981 (Washington, D.C.: Office of Management and Budget, 1980) p. 207.

A problem with the concept of tax expenditures is that the tax code does not include a definition of the "normal structure" of the tax system. As the 1983 Budget points out, the term itself is "unfortunate in that it seems to imply that Government has control over all resources. If revenues which are not collected due to 'special' tax provisions represent Government 'expenditures,' why not consider all tax rates below 100% 'special,' in which case all resources are effectively Government-controlled?" 11/ As a result the practical definitions that have arisen in the measurement of annual tax expenditures are not always consistent within or across categories, or from year to year.

An example of this is the Department of Treasury's estimates of the revenue losses or tax expenditures that can be attributed to the favorable tax provisions afforded pensions and individual retirement accounts. In this case the Treasury estimates the federal tax revenue losses that arise because neither pension and IRA contributions nor the fund earnings are taxed until benefits are paid. The theoretical basis for these estimates is that if employer contributions to pension trusts or individual contributions to IRAs were taken as regular income that additional tax obligations would arise at the time the contribution is made. The amount of the tax expenditure, however, is not simply current reductions on tax revenues but recognizes that there will be future tax collections at the point of distribution and thus represents taxes deferred, not taxes foregone.

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

It is really differential marginal tax rates over time that give rise to the estimated tax expenditures. For example, consider a simple case where a person's life is made up of only two periods. During the first period the person works, earns income and pays income taxes. Assume that this person's employer establishes a pension plan during the first period and makes a $1000 contribution in behalf of the worker. Assume further that this contribution would have been paid to the worker as wages if it had not been contributed to the pension plan. Furthermore, for simplicity, assume the worker's marginal tax rate is 50 percent. That is, for each additional dollar of earnings the worker's tax liability would increase by 50 cents. Finally, assume that the time price of money or rate of return between the two time periods is 10 percent.

If the employer contribution to the worker's pension account is not taxed during the first period then the government foregoes $500 in tax revenue. (.50 X $1,000) during the period. At the beginning of period 2, assume that the worker retires and is eligible to receive the $1,000 plus $100 in interest accrued on the fund since its investment. If the person is still in the 50 percent tax bracket the tax liability on this retirement income will be $550. Given the time price of money, this is equivalent to the tax liability if the pension has been taxed at the point of contribution and if the taxes collected had drawn interest until period 2. In this instance the person does not avoid any taxes by participating in the pension plan; the taxes are merely deferred from the first period to the second. There is no tax expenditure in this case.

If it is assumed, however, that the marginal tax rate in the second period is lower than that in the first then the result is quite different. Assume that in the second period that the person's marginal tax rate drops to

30 percent, then the contribution in period 1 results in reduced tax revenues of \$500. When the contribution plus interest is taxed in period 2 it nets only \$330 in tax revenues. Discounting the period 2 taxes back to period 1 to account for the time price of money means that the value of taxes to be collected on the contribution will only be \$300. Since \$500 is foregone in the current period and the future taxes are only worth \$300, the cost to the public fisc, or the tax expenditure, is \$200.

Methodological Problems in Estimating Retirement Program Tax Expenditures

The world is not quite as neat as this simple example, however, and thus, the actual estimation of tax expenditures for retirement programs is quite complicated. First, Treasury estimates the foregone taxes from exempting employer pension contributions and personal IRA contributions and the interest paid to these funds. From this foregone collections estimate Treasury subtracts the estimated tax collections on pension benefits paid. The net difference is their estimated tax expenditure resulting from the tax treatment of retirement programs.

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

In the simple single-worker, two-period example used above it was possible to show how the tax expenditures in question arise. The tax expenditure that arose in that case was the difference in the value of the person's lifetime tax obligations that resulted because part of earnings could be deferred as a pension contribution. In the actual estimates of tax expenditures for retirement program the foregone revenues are estimated on the basis of one set of individuals and the tax collections on pension benefits are estimated on a totally different set of individuals. This procedure would upwardly bias the estimated tax expenditure for two reasons.

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

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

Table 5, based on tabulations of information that plan sponsors filed with the IRS (form 5500) in compliance with ERISA for the 1977 plan year, indicates a clear relationhsip between plan age and beneficiaries in defined-benefit plans. Defined benefit plans cover two-thirds of private plan participants and an even larger segment of the public plan members. Among other things, form 5500 requires reporting the "effective plan date" or date the plan was set up. It also requires the number of active participants in the plan, and the number of beneficiaries be reported. The age of the plan can be calculated from the effective plan date. As expected, most of the young plans have more work rs per participant than older plans do. Less than 10 percent of the plans that had been created in the previous five years reported fewer than five workers per retired beneficiary. For plans operating twenty-five years or longer, nearly 49 percent had fewer than five active participants per beneficiary. The changes in this relationship with increasing plan age are too consistent to be coincidental. At the other end of the participant/beneficiary range, the pattern is comparably consistent. More than 55 percent of plans less than five years old had twenty or more active workers per beneficiary, while less than 11 percent of the oldest plans reporting had as many as twenty participants per beneficiary.

Undoubtedly many of the older plans with high participant/beneficiary ratios are in firms that are expanding. High participant/beneficiary ratios will contiue as some plan sponsors continue to expand in the future, but such sponsors will still have increasing numbers of beneficiaries over the years.

This relationship of plan age and beneficiary rates becomes particularly significant in comparison with defined-benefit plan creation data. 12/ Using 1977 as the reference year, because it corresponds with the ERISA data, the universe of private defined-benefit programs grew by 218,487 plans in the previous twenty years; 32.0 percent of this growth occurred between 1973 and 1977 and 72.7 percent between 1968 and 1977. If all 28,169 tax qualified plans in existence at the end of 1955 were assumed to be defined-benefit plans, which is certainly not the case, 62.7 percent of all defined-benefit plans would have been less than ten years old at the end of 1977. The defined-benefit pension system in this country today is still quite young. As the system matures, the ratio of workers to beneficiaries will markedly decline, much as the ratio of workers to beneficiaries in the Social Security program declined during the 1950s and 1960s. The ratio will decline not because of fewer covered workers, but because of more beneficiaries. The relatively small number of beneficiaries today, however, results in significant overestimates of retirment program tax expenditures.

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

Unexplained Variations in the Estimates

One of the problems with the estimates of tax expenditures arising from the special tax provisions for retirement programs is precipitous changes in the estimates from year to year that are not explained. As an example of this

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

TABLE 5

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

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

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

a/ Includes plans with no beneficiaries reports.

TABLE 6

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

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

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

inconsistency Table 6 shows the tax expenditure estimates due to the tax treatment of employer sponsored plans included in the last four Federal Budgets.

The 1981 Budget estimate of this particular tax expenditure for fiscal year 1981 was $14.7 billion. The 1982 Budget estimated the 1981 fiscal year tax expenditure for the identical category of plans at $23.6 billion -- a 60 percent increase. There was absolutely no explanation in the Budget documents explaining the changed estimate from one budget to the next. The only explanation that we have found for the 1980 and 1981 Budget differences is by Munnell who writes that the "Revised estimates employ higher, and therefore move realistic, marginal tax rate assumptions. These indicate a substantially larger tax expenditure for private plans." 13/ The explanation that higher marginal rates were used to generate the 1982 Budget estimates is plausible. What is interesting is that there is absolutely no published documentation on

13/ Alicia H. Munnell, The Economics of Private Pensions (Washington, D.C.: The Brookings Instituteion, 1982) p. 44.

the actual rates used to generate either the 1981 or 1982 Budget estimates. Not only does Munnell ignore this completely throughout her book on private pensions but she also fails to explain her conclusion that the higher tax rate assumptions used in the 1982 Budget estimate are "therefore more realistic." There is certainly no a priori reason to believe that any set of assumptions in more realistic than another without an analytical basis on which to evaluate them. Such analysis was not available to compare the 1981 and 1982 Budgets. There is also a lack of analysis explaining even greater discrepancies between the 1983 and 1984 Budgets. The estimated fiscal 1982 tax expenditure due to net exclusion of employer pension contributions and trust fund earnings was 75.7 percent higher in the 1984 Budget than in the 1983 Budget. The projected growth in this category of tax expenditure was 254.8 percent higher in the 1984 Budget than in the prior year's estimate. Again, none of the Budget materials or other public documents explain the revised estimates.

Through an arduous process of telephone discussions with various staff at the Treasury Department a general explanation of the revised fiscal 1983 and 1984 estimates in the 1984 Budget has been pieced together. One reason for the difference in the two Budgets is that the analyst who did the 1983 Budget estimates retired and a new analyst prepared the 1984 Budget estimate. The new analyst has been able to partially clarify the discrepancy. The difference in the estimates for fiscal 1982 is $19.515 billion (i.e., $45.280 - $25.765). Of this $17.135 billion is attributable to higher estimated contributions and pension trust earnings. The remaining $2.380 billion in the higher tax expenditure estimate from the 1984 Budget is attributable to changes in the tax rate assumptions.

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

Table 7 includes recent annual contributions to privately sponsored retirement programs, state and local plans and the federal Civil Service Retirement System. While the latter does not include all federal civilian pension costs it does capture at least 90 percent of these costs and is sufficient for this comparative analysis. What is immediately apparent is that adding in the public employer plan contributions increases the basic private employer contribution in 1981 by 63.5 percent (i.e., $38.26/$60.26). As stated above the 1983 Budget estimate of retirement plan related to tax expenditures in 1982 was $25.8 billion. The 1984 Budget tax expenditure estimate was $17.1 billion (or 66.3 percent) higher because of added trust fund contributions and interest income considered. It appears that virtually all of this adjustment can be laid directly to the inclusion of the public plans for the first time.

The remaining $2.4 billion discrepency in the 1983 and 1984 Budget estimates of retirement program tax expenditures for 1982 was attributed to changes in the tax rate assumptions. At first blush one might think that the effects of the Economic Recovery Tax Act of 1981 would be to reduce the tax

TABLE 7

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

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

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

rates considered for estimating these tax expenditures. Also the reductions in the contribution limits and other provisions in the Tax Equity and Fiscal Responsibility Act of 1982 should reduce the pension contributions and accruals for some individuals in the high marginal tax brackets. Finally, the recommendation of the National Commission on Social Security Reform to tax Social Security benefits that was implemented in the Social Security legislation passed by Congress will raise marginal tax rates for many elderly pension recipients. Higher marginal tax rates among pension recipients should reduce the pension tax expenditures under the current estimation methodology.

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

One possible reason for using higher tax rate assumptions in the 1984 Budget calculations than used a year earlier is the inclusion of public workers, especially those employed by the Federal government. "The mean annual earnings from the total civilian population employed full time in 1977 was approximately $13,849. The mean annual salary level of Federal employees covered by CSRS in April was $16,000." 14/ Inclusion of federal workers with

14/ Final report of the Universal Social Security Coverage Study Group, The Desirability and Feasibility of Social Security Coverage for Employees of Federal, State and Local Government and Private, Nonprofit organizations (Washington, D.C., 1980), p. Inconsistencies in IRA and Pension Tax Expenditure Estsimates their higher than average earnings may account for the revised tax rate assumptions used to calculate the pension tax expenditures in the 1984 Budget.

Inconsistencies in IRA and Pension Tax Expenditure Estimates

The Special Analysis G in the Federal Budget does not include separate estimates of the tax expenditures that are attributable to IRAs. The IRA related tax expenditures are imbedded in a broader category of retirement "plans for self-employed and others." Table 8 shows the tax expenditure estimates for this broader category from the last four Federal Budgets. One might have expected significant increases in the tax expenditure estimates between the 1982 and 1983 Budgets, in particular, because of the passage of ERTA and roughly doubling of IRA eligibility for 1982. Yet this 1982 tax expenditure estimate only increased by 11 percent between the two annual Budgets. In fact, the 1984 Budget estimate of the 1982 fiscal year tax expenditure was only 23 percent greater than the 1982 estimate in the 1982 Budget and 12.5 percent greater than the 1981 estimate inthe 1981 Budget.

TABLE 8

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

BUDGET	FISCAL YEAR				
	1980	1981	1982 (in millions)	1983	1984
1981 Budget	$ 2,125	$ 2,520			
1982 Budget	1,925	2,105	$ 2,305		
1983 Budget		2,170	2,560	$ 3,760	
1984 Budget			2,835	3,755	$ 4,230

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

Even the 1983 Budget estimates might be understood since that Budget was prepared well before any substantive information on 1982 IRA utilization levels was available. But by the time the 1984 Budget was prepared there was evidence available suggesting that 1982 IRA utilization in response to ERTA jumped significantly over prior years. For example, EBRI released the data in Table 9 in a news release on February 3, 1983. This information was picked up quickly in both the trade press and the conventional media. This includes such newspapers as USA Today and The Washington Post. Table 9 shows that the IRA contributions during fiscal 1982 had to have been at least $23 billion. In the development of the 1983 Budget, the 1981 tax expenditure for private plans was estimated at $23.4 billion (see Table 2) on contributions of $60.2 billion (see Table 7) and income on the trust funds. According to Munnell the average marginal tax rate of workers covered by a pension used to compute the pension tax expenditure was something in excess of 23 percent. 15/ If the average marginal tax rate of 23 percent is applied to the minimum of $23 billion in IRA contributions then the foregone federal tax would be around $5.3 billion for fiscal 1982. Few individuals are yet receiving significant IRA based annuities so the tax collections on such annuities cannot explain the discrepancy between the $5.3 billion estimated here and the $2.8 billion estimated in the 1984 Budget. The discrepancy is even harded to reconcile when the Budget's inclusion of Keogh plans is considered.

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

Other Foibles and Inconsistencies

The abstract concept of tax expenditures that has been applied to private pensions for some years now. It has now been applied to state and local and federal civilian plans as well. Some might find it intriguing that the military retirement program is still not included in the 1984 Budget estimates of tax expenditures for employer sponsored retirement programs. The estimate does include some amount attributed to military disability benefits -- but they make up only about 9 percent of the military retirement program. The military retirement program paid $13.7 billion in benefits during fiscal 1981 and thus is the second largest pension plan in the United States, behind the Civil Service Retirement System. In many regards the military plan is the most generous large retirement program in this country today. In combination the federal civilian and military retirement programs cover about 5 percent of the total U.S. work force and paid retirement benefits in 1979 exceeding the benefits paid by all private pension programs. 16/

Why then, if including the federal civilian retirement program so significantly affects the tax expenditure estimates isn't the military retirement program included? One reason is that the militry retirement program is totally unfunded with outstanding unfunded liabilities at the end of fiscal 1981 of $476.9 billion. Under the computation method used to estimate them no tax expenditures arises in this case. There is no contribution to or interest paid to a trust fund since none exists. The benefits paid are all taxable since the program is noncontributory.

16/ EBRI ISSUE BRIEF "Federal Pensions: An Island of Privilege in a Sea of Budget Austerity" (Washington, D.C.: EBRI, July 1982) p. 5.
Since the funding pattern of the plan doesn't fit the mold assumed by the

computation method then the "tax expenditure" is ignored. In fact, the Civil Service plan is also largely funded on a pay-as-you-go basis. If these two retirement plans had met their normal cost contribution plus the 40 year annual amortization schedule stipulated in ERISA for private plans established before 1974, the total employer contribution to these two plans would have been $89.2 billion during fiscal 1981. 17/ This is 48.5 percent more than the total employer contribution going to all private plans in 1981 shown in Table 3 earlier. In other words, only one-fifth ($18.2 billion) of the employer contribution that would be required of private plans is considered in the tax expenditure estimates when the Tresury Department estimates these for federal plans. If the estimates of tax expenditures are to be consistent, then the federal plans' tax expenditure estimates should be generated on a basis consistent withthose that used to estimate the private plan number. Because of the significant differences in plans across the various sectors and the role of government sponsorship or regulation, the tax expenditure estimates should be presented separately for federal, state and local, and private plans.

Relationship to Other Tax Expenditure Categories

Each of the tax expenditures is calculated on an item by item basis at the margin. That is, each is considered to be an "exception to the normal structure" of taxes, but is calculated as though all other exceptions are part of the normal structure for purposes of deriving the estimate. This ignores the extent to which one "exception" might be magnified by its relationship to others.

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

TABLE 9

ASSETS IN INDIVIDUAL RETIREMENT ACCOUNTS, 1981-1982

Financial Institution	Year-end 1981 (billions)	April 30, 1982 (billions)	June 30, 1982 (billions)	September 30, 1982 (billions)	December 29, 1982 (billions)
Commercial Banks 1/	$7.0	$13.0	$14.9	$16.2	$18.1
Mutual Savings Banks 1/	3.4	4.5	5.8	5.9	6.3
Savings and Loans 1/	9.2 2/	16.3	n.a.	n.a.	21.7 2/
Mutual Funds	2.6	4.0	4.3	5.0	n.a.
Credit Unions	0.2	0.5	n.a.	n.a.	n.a.
Life Insurance Co.	3.3	n.a.	4.6	n.a.	n.a.
Total Assets	$25.7	$41.6 3/	$46.4 3/	$48.5 3/	$56.2 3/

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

1/ IRA and Keogh deposits.
2/ Estimated.
3/ Baseline estimates using latest available date for each institutional category. The estimates provide a minimum total asset amount, which may underreport the actual amount of total assets outstanding.

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

Assume as an alternative, that this man had not enjoyed the double exemption for being over age 65 or the nontaxability of Social Security benefits. These two provisions of the tax law are considered to be "exemptions to the normal structure" because tax expenditures are calculated for them as well. The Treasury analysts use the actual $592 in taxes paid on current benefits to estimate pension tax expenditures. However, if these other two "exceptions to the normal structure" of taxes did not exist then the man's 1982 tax liability would be $592 without the pension or $2,546 with it.

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

CONCLUSIONS

Many of the critics of pension programs point to the tax expenditure numbers as a basis for significant tax policy and pension reform. These critics have not applied their analytic capacities to any thorough discussion of the numbers that are published in the Budget each year. They have not considered the structure of other tax code provisions that affect the estimates. They have not considered the life cycle structure of earnings, benefit accruals and marginal tax rates that provide a radically different distribution of the tax expenditures than naive cross sectional analyses. They have totally ignored the inconsistencies in the actual calculation of these estimates, to say nothing of the significant methodological difficiencies in the calculation procedure.

Until the Treasury Department is willing to spell out in detail the derivation and numerical basis of these estimates they should be treated as nothing more than idle musings or random numbers. To seriously base any policy deliberation or decision on totally unsubstantiated, but clearly flawed numbers may result in the implementation of undesirable policies. There is an impression in the pension community today, however, that these tax expenditure estimates played a central role in the consideration of TEFRA. Furthermore, the recent precipitous changes in these estimates are seen as an ominous sign that additional pension reform is high on someone's legislative agenda.

The historical response of the pension system to the tax and regulatory provisions is fairly well documented. The pension system is clearly sensitive and responsive to policy change. This means that pension policy must be steady and even handed if the pension system is to be stable. Erratic policy or frequent adjustments will tend to destabilize existing pension programs and discourage employers from establishing new one.