



tax break

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Whither Pensions? A Brief Analysis of Portman-Cardin III

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I. Introduction

Among its other features, the 2001 tax cut provided significant expansions in opportunities for tax-preferred saving. Specifically, the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) substantially raised the annual contribution limits on IRAs and 401(k) plans, increased the maximum benefit payable under defined benefit plans, and increased the maximum amount of compensation that could be considered in determining pension benefits. These saving-related provisions were drawn largely from earlier legislation cosponsored by Representatives Rob Portman, R-Ohio, and Ben Cardin, D-Md. EGTRRA also provided a savers' credit aimed at moderate-income households, modeled after a provision that had been introduced in Senate pension legislation. The credit is not refundable, however, and so does not apply to many lower-income households. As with other EGTRRA rules, the saving-related provisions are phased in over time and then sunset — the savers' credit in 2006 and the other provisions by 2010.

A major new proposal would largely continue in the same direction as EGTRRA. On April 11, 2003, Representatives Portman and Cardin introduced "Portman-Cardin III." Although an official revenue estimate is not available yet, Representative Portman indicated the bill as a whole would reduce revenues by more than \$100 billion over the next 10 years.¹ Among the

¹Representative Portman indicated the legislation would cost \$112 billion over 10 years. See National Journal's *Congress Daily*, Apr. 11, 2003.

provisions that appear to involve the most substantial revenue reductions:

- acceleration of scheduled increases in contribution limits for 401(k)s and IRAs enacted in the 2001 tax cut;
- permanent extension of all of the pension and IRA provisions enacted in the 2001 tax cut;
- an increase from \$160,000 to \$220,000 in the income limit for contributions to Roth IRAs by married couples;
- expansions in income limits for contributions to traditional IRAs by married couples; and
- a weakening of the "minimum distribution" rules.

This column examines the new Portman-Cardin proposals in the context of the pension system, the sluggish economy, and the deteriorating long-term budget outlook.²

- The basic thrust of both the saving provisions in EGTRRA and the new Portman-Cardin proposals is to provide new tax subsidies predominantly to a narrow cluster of households with very high income levels and/or with very high preexisting levels of saving.³ For example, raising annual contribution limits only helps the very small percentage of households who are currently making the maximum contributions.⁴ Raising the income limits only helps those households who are currently above the income limits.
- These provisions might make sense if: (a) the key problems facing the pension system were that workers with income above \$150,000 were unable to save adequately for retirement, and that low- and moderate-income workers were

²This article draws on Gale and Orszag (2003a), Orszag (2003), and Orszag and Greenstein (2003).

³The JCT (2001) estimates that the saving provisions in EGTRRA will cost \$49.6 billion in revenues between 2001 and 2011, of which 20 percent is due to the savers' credit and 70 percent is due to other policies mentioned in the text.

⁴It is sometimes claimed that raising the limits also helps those who contribute less than the limit because if business owners are allowed to contribute more for themselves, the nondiscrimination rules will give them incentives to contribute more on behalf of their employees. This claim is unsubstantiated empirically and also ignores the fact that most observers believe that employer-provided benefits are "paid for" by workers with lower after-tax wages (although the level of aggregation at which that offset occurs remains unclear).

currently receiving too many subsidies through the pension system; (b) the key budget problem was that projected surpluses were so large that policymakers were worried about ever-expanding surpluses; and (c) the economy needed to be slowed down in the short run. In fact, none of these conditions hold.

- The economy needs a short-term stimulus currently. But to the extent that the Portman-Cardin proposals would be successful in raising national saving, they would tend to reduce current spending and thus hurt the economy's ability to recover quickly.
- Under current projections, the nation faces ever-increasing budget deficits. Even the administration projects continual and growing budget deficits and has called the current budget outlook "unsustainable" (OMB 2003, page 40). The costs of Portman-Cardin III would presumably come on top of the \$350 billion to \$550 billion in reconciliation tax cuts allowed by the recently adopted budget resolutions.
- The central goal of pension policy should be to encourage or provide adequate (rather than unlimited) and secure retirement income in a cost-efficient and equitable manner. Unfortunately, the current pension system falls short of these goals.⁵
- The pension system currently provides disproportionate and expensive benefits to households with high-income and large amounts of existing saving. Those benefits generate little improvement in the adequacy of saving for retirement, since the beneficiaries would save substantial amounts even without tax subsidies. Moreover, these tax subsidies generate little increase in private saving, since very-high-income or high-saving households tend to substitute existing assets or saving that would have been done anyway into tax-preferred vehicles, rather than reducing their current living standards to finance their deposits.
- In contrast, lower- and middle-income households have significantly lower pension coverage rates and those that are covered gain less from the pension system, but pension benefits targeted at these households can both increase saving and help households who would otherwise save inadequately for retirement.
- Although it contains some promising features, the basic thrust of Portman-Cardin III would continue to push the pension system in the wrong direction. The proposals would provide substantial new tax subsidies to upper-income households. These subsidies would be expensive and regressive, they would target those

who least need help in preparing for retirement, and they would have at best a small positive effect on national saving and more likely a negligible impact. At the same time, the proposals would provide little or no benefits to the majority of families struggling to save for retirement.

- A change of course is necessary to expand the number of workers who reach retirement with sufficient assets to sustain their living standards. Pension reform should focus on expanding tax incentives for lower- and moderate-income earners to save for retirement.

Section II describes some potentially promising features of the new Portman-Cardin proposals. Section III discusses features that aim to accelerate and make permanent items enacted in the 2001 tax cut. Section IV discusses additional changes in the proposed legislation, such as raising the contribution limit for Roth IRAs and loosening the minimum withdrawal rules.

II. Potentially Promising Provisions

Some of the Portman-Cardin provisions are potentially beneficial, especially with appropriate modifications. For example, the legislation would expand and make permanent the "saver's credit." This could play an important role in generating meaningful incentives to save for the lower- and moderate-income households who not only need to save more but appear to respond to those incentives by raising their saving. But the Portman-Cardin approach to expanding the credit has a fundamental flaw. The legislation does not make the credit refundable, so the credit would continue to be of little or no benefit to millions of workers with modest incomes.

The legislation would also encourage annuitization of account balances on retirement — that is, the transformation of an accumulated balance in a 401(k) or IRA into a payment per month that lasts as long as the worker or spouse is alive. To encourage annuitization, the legislation would allow up to \$2,000 per year of annuitized income to be tax-free. The legislation would phase this tax-free preference out for couples with incomes above \$150,000.

The objective of this proposal — to encourage broader annuitization — is sound, since annuitization is crucial to ensuring that retirees will not outlive their savings. The approach adopted in the legislation does not appear to be a good mechanism for reaching that goal, however, for several reasons. First, roughly 66 percent of elderly tax filers face a marginal tax of 15 percent or lower. Thus, for two-thirds of the elderly, the \$2,000 exclusion would save them at most \$300 a year in taxes. It is unclear how many people will be encouraged to annuitize from such savings, especially since annuitization currently involves an expected financial loss for the typical retiree.⁶ Second, \$150,000 in income is a relatively high threshold. About 95 percent of elderly couples have incomes below \$150,000.

⁵See Gale and Orszag (2003a) for elaboration of these points.

⁶Brown, Mitchell, Poterba, and Warshawsky (2001).

An elderly couple aged 65 could transform roughly \$2 million in assets into a joint-and-two-thirds-survivor annuity paying less than \$150,000 per year and thereby qualify for the tax break. Third, the political economy of exempting the first \$2,000 could be troubling. One could easily envision proposals to raise the exempt amount to much greater levels — just as recent legislation has advocated increases in IRA and 401(k) contribution limits. If that were to happen, it would create a significant hole in the tax system, because the original pension contribution would be deductible, the account earnings would accrue untaxed, and then the annuitized withdrawals would also be untaxed. This would generate negative effective tax rates on the applicable annuitized income.

The legislation would also reform the Supplemental Security Income (SSI) program. Currently, poor individuals who become disabled can be disqualified from receiving assistance unless they liquidate their defined contribution retirement accounts, leaving little or nothing in their accounts for their old age.

III. Accelerating and Extending EGTRRA

As noted above, EGTRRA included changes to pensions and IRAs. The main provisions allow larger contributions by, and on behalf of, high-income individuals, such as business owners and executives. Under pre-EGTRRA law, workers were allowed to contribute \$10,500 each year to a 401(k) account. The 2001 tax cut raises the maximum gradually to \$15,000 by 2006 (and to \$20,000 for those aged 50 or over). Similarly, the legislation more than doubles the amount that a taxpayer and spouse can contribute each year to an IRA. Under prior law, a taxpayer and spouse could each contribute \$2,000; the 2001 legislation gradually raises the maximum contribution to \$5,000 apiece by 2008 (and to \$6,000 apiece for those aged 50 or over).

A. Accelerating the Increases in Contribution Limits

The Portman-Cardin legislation would accelerate these increases, making the full increases in the 401(k) and IRA contribution limits effective in 2003. The proposal to accelerate the increases in contribution limits is unsound pension policy and ineffective (and possibly counterproductive) economic stimulus.

As pension policy, the primary effect is likely to be that high-income households shift other saving they already are undertaking from taxable accounts to the tax-preferred accounts. By shifting funds, these households would be able to capture the additional tax subsidies without raising their overall level of saving.⁷ Thus, the changes are likely to generate little if any net addition to national saving, and to the extent that they do raise national saving the changes would be unlikely to target families who would otherwise be saving inadequately for retirement.

⁷For further discussion of this point in the context of the administration's proposal for expanded tax-free savings accounts, see Burman, Gale, and Orszag (2003).

Moreover, increasing the contribution limits would have little effect on middle- and upper-middle-income families and individuals. The vast majority of Americans do not make the maximum contributions to their 401(k)s or IRAs today and therefore would benefit little, if at all, from accelerating the increases in the maximum contribution levels. An unpublished study by a Treasury economist in 2000 found that only 4 percent of all taxpayers who were eligible for traditional IRAs in 1995 made the maximum allowable contribution, which was \$2,000 at that time.⁸ The General Accounting Office found that an increase in the contribution limit for 401(k)s would directly benefit fewer than 3 percent of participants.⁹ Other recent studies have reached similar conclusions, finding that the fraction of individuals constrained by the IRA or 401(k) limits in place before enactment of the 2001 tax-cut legislation was very small.¹⁰

The stimulus effects are related to the saving effects noted above. Since firms currently have excess capacity and could produce more if there were more demand for their goods and services, additional consumption would spur the economy in the short term. If national saving were to rise in response to the enactment of the Portman-Cardin III proposals, consumption spending would fall as a share of GDP, and thus hurt the economy's short-run prospects for recovery. If national saving essentially stays constant in response to the proposals, then consumption spending would also remain roughly constant. In the former case, the proposal would be counterproductive as a stimulus, in the latter it would merely be ineffective. In any case, the very premise of the proposal — that it would increase saving — makes it inappropriate as a short-term policy under current sluggish economic conditions.

B. Making the Increases Permanent

The new Portman-Cardin bill would not only accelerate increases in the contribution limits, it would also make these increases permanent. This is problematic both as pension policy and long-term budget policy.

The problem from the perspective of pension policy is simply that the proposals are likely to do little or nothing to improve the adequacy of retirement saving, since they are aimed predominantly at a group that is already saving substantial amounts. Moreover, these provisions were promoted in part on the grounds that if retirement saving rules were made more generous for higher-income owners and executives, the increased generosity would encourage more small businesses to offer pension plans, which would result in

⁸Carroll (2000).

⁹General Accounting Office (2001). The GAO also found that 85 percent of those who would benefit from an increase in the 401(k) contribution limit earn more than \$75,000. (These figures reflect the effects of other changes included in EGTRRA that have already taken effect, such as the elimination of the previous percentage cap on the amount of combined employer-employee contributions that can be made to defined contribution plans.)

¹⁰Copeland (2002) and Richardson and Joulfaian (2001).

| Table: Phaseout Range for IRA Contributions for Joint Filers, 2010 | | |
|--|---------------------|----------------------|
| | Current Law | Portman-Cardin |
| Roth IRAs | \$150,000-\$160,000 | \$190,000-\$220,000* |
| Traditional IRAs | | |
| Both members of couple covered by employer-provided plan | \$80,000-\$100,000 | \$100,000-\$120,000 |
| One member covered by employer-provided plan | \$150,000-\$160,000 | No Limit** |
| * Effective 2004. | | |
| ** Effective 2007. | | |

pension coverage being extended to more rank-and-file workers. This approach had little empirical backing when the legislation was passed, and little information has emerged since enactment of the legislation to indicate that these provisions are promoting retirement saving among middle and lower earners.

The problem from the viewpoint of budget policy, of course, is the staggering deficits projected when the baby-boom generation retires in large numbers (Gale and Orszag 2003b). Making the pension provisions permanent at this time would cause a further deterioration in a budget outlook that has already worsened dramatically since the 2001 tax legislation was enacted.

At the very least, Congress should wait for information on the impact of the 2001 changes on pension coverage before rushing to lock these provisions into permanent law. Given the budgetary situation, policymakers should impose a high burden of proof on new legislation with significant long-term budget costs, particularly in cases where it is unclear whether the legislation will achieve its ostensible goals. Retirement planning does require some certainty about the long-term rules applying to pensions, but it is not the existence of IRAs and 401(k)s that are in question, just the level of the contribution limits. For all of these reasons, at this point, the benefits of waiting to evaluate the effects of EGTRRA's retirement provisions before making them permanent substantially outweigh the costs.

IV. Subsidies for High-Income Households

Portman-Cardin III would also expand tax subsidies for high-income households beyond those included in EGTRRA. For example, it increases the income limit for full contributions to Roth IRAs by joint filers from \$150,000 to \$190,000 and the income limit for any contributions to Roth IRAs from \$160,000 to \$220,000. It also eliminates all income limits on tax-deductible IRA contributions by a high-income worker who is not covered by an employer-provided pension plan even if his or her spouse is covered by such a pension plan. In addition, it substantially weakens the "minimum distribution" rules, which are intended to ensure that the tax subsidies provided for pension saving are used to finance needs during retirement, not as estate planning devices for affluent individuals.

A. Higher Income Limits for IRAs

Under current law, eligibility for contributions to Roth IRAs is phased out between \$150,000 and \$160,000 in adjusted gross income for married couples filing

joint returns. Eligibility for tax-deductible contributions to traditional IRAs for joint filers who are covered by employer-provided plans is currently phased out between \$60,000 and \$70,000 in adjusted gross income. That phaseout range is scheduled to increase to between \$80,000 and \$100,000 by 2007.

If neither member of a couple is covered by an employer-provided plan, no income limit applies to tax-deductible contributions to traditional IRAs. If one member of the couple is covered by an employer-provided plan but the other one is not, the uncovered member of the couple can make tax-deductible contributions to a traditional IRA, subject to the same limits as Roth IRA contributions (that is, the phaseout begins at \$150,000).

The Portman-Cardin legislation would increase all of these limits for joint filers, as shown in the table below. The increases would be substantial: In 2004, for example, couples earning \$190,000 would be entitled to make \$6,000 in contributions to Roth IRAs (\$3,000 per spouse), compared to zero under current law. (Since current law phases in an increase in the traditional IRA limit and since Portman-Cardin III would also phase in its expansion in traditional IRA limits, the table below shows the results under current law and the Portman-Cardin proposal for 2010, at which point all the provisions would be fully in effect.)

The press materials accompanying the Portman-Cardin legislation present these changes as ensuring that the income limits for joint filers are twice those for single filers to address a marriage penalty in IRA eligibility. Yet these changes would have no effect on the vast majority of married families.

In particular, the changes would have no effect on joint filers with income below \$150,000. The expanded eligibility for Roth IRAs included in Portman-Cardin affects only married couples with incomes between \$150,000 and \$220,000, most of whom already benefit from tax-preferred employer-based retirement plans and who tend to accumulate adequate retirement saving. Similarly, the proposal that would eliminate income limits on tax-deductible contributions to traditional IRAs for workers who are not covered by employer-provided plans, but whose spouses are, would only affect couples with more than \$150,000 in income. For those with lower incomes, the current rules already allow tax-deductible contributions to traditional IRAs.

According to results from the Tax Policy Center microsimulation model, 90 percent of joint filers in 2003 have incomes below \$150,000. For 90 percent of

joint filers, the proposed changes are thus not relevant. For the top 10 percent of joint filers who would benefit, the additional new tax subsidies are likely to result primarily in asset shifting and more tax sheltering, rather than new saving.

B. Loosened 'Minimum Distribution' Rules

The legislation would also loosen the minimum distribution rules for defined contribution plans, such as 401(k)s. These rules are intended to ensure that the substantial tax benefits provided for pensions and IRA contributions are actually used to finance retirement needs.

To ensure that retirement plan assets are used primarily to finance retirement needs, workers generally must begin to draw down their accumulated pensions by age 70½, or when they retire, whichever is later.¹¹ This rule ensures that pension accumulations are used at least in part to finance retirement. In the absence of such a rule, high-income individuals could use the tax benefits associated with pensions and IRAs as tax shelters, making contributions to tax-preferred pension and IRA accounts that they never intend to use for retirement needs. In that case, the tax preferences associated with pensions and IRAs would not be serving their basic public policy purpose of bolstering retirement security.¹²

Pension experts agree that the minimum distribution rules are complicated. Efforts to simplify them are already underway, however, including important simplifications contained in recent IRS regulations.¹³ If further steps are required, an alternative approach of exempting a moderate level of assets from the minimum distribution rules would ensure that the rules do not apply to the vast majority of retirees.

For example, the rules could be modified so that each person could exempt up to \$50,000 of pension and retirement account assets from the minimum distribution requirements. Data from the 2001 Survey of Consumer Finances suggest that more than 70 percent of households aged 55-64 own defined contribution and IRA assets of less than \$50,000. If the minimum distribution rules did not apply to assets of less than \$50,000, these rules would thus cease to affect approximately two-thirds or more of retirees. This approach could eliminate the need for most retirees to be concerned about the minimum distribution rules and would do so without creating powerful incentives to

¹¹The rules for distributions from traditional IRAs are different. Distributions from IRAs are required to begin by age 70½ regardless of whether the owner is retired. No minimum distribution rules apply to Roth IRAs until the death of the owner.

¹²As Soled and Wolk (2000) have written, "There seems little justification for a system that, on one hand, allows the highly compensated to amass significant tax-favored wealth on the theory that it was needed for retirement, but, on the other hand, permits them to perpetuate their own financial dynasties as this wealth moves across multiple generations, retaining its tax-favored status."

¹³See 2001-11 IRB 865, *Doc 2001-5399 (2 original pages)*, 2001 TNT 38-82.

use retirement tax preferences primarily as estate-building mechanisms.

Moreover, the approach taken in Portman-Cardin — delaying from 70½ to 75 the age at which mandatory distributions must begin if the worker is already retired — is problematic for a number of reasons. First, the vast majority of American workers retire before age 70½ and need to begin withdrawing funds from their pensions before then.¹⁴ For them, the minimum distribution rules simply are not relevant, either because these workers lack retirement assets or because they will have begun taking regular distributions from their pensions well before the age by which distributions must begin. As a result, raising the required age would primarily affect high-income households who have sufficient other income and assets to delay withdrawals from their tax-preferred pension accounts. This would expand the potential for these households to use tax-preferred retirement accounts purely as estate planning devices.

Second, raising the required age for minimum distributions could discourage work among high-income elderly individuals. Currently, an affluent individual aged 72, for example, needs to continue working if he or she is intent on not withdrawing any funds from a 401(k), since the rules requiring distributions to start at age 70½ do not apply if the individual remains employed. The Portman-Cardin bill would enable these individuals to retire without having to make any withdrawals from their 401(k)s until age 75.

V. Conclusion

The new Portman-Cardin pension proposals would make numerous changes in tax provisions governing retirement saving. Some of these changes are beneficial, but the bulk are problematic. On balance, the proposal would make the pension system more expensive and regressive, without materially improving its ability to generate adequate and secure retirement income; it would exacerbate the long-term budget outlook; and it would prove counterproductive as an economic stimulus.

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