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INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

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PENSION CONFERENCE SHOULD EXTEND SAVING PROVISIONS IN THE 2001 TAX ACT

A Senate-House conference is meeting to reconcile differing versions of pension reform legislation. The House version, H.R. 2830, the Pension Protection Act of 2005, contains language that would make permanent the pension and retirement saving provisions in Title VI of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). The Senate version, S. 1783, the Pension Security and Transparency Act of 2005, does not include the permanent extension of the 2001 provisions. The EGTTRA pension provisions will expire in 2011 if the Congress does not act. It would be good policy to include the House provision to make the changes permanent.

These provisions encourage greater saving by millions of workers, and reduce the cost and administrative burdens of employer-sponsored plans, making it easier for employers to offer the plans to their workers. The sooner these provisions are extended, the better. Employers and employees alike would benefit from the certainty that early renewal would bring. Waiting until the last minute is not a good option, because it is costly for plan sponsors to have to rewrite the rules, and it takes time to prepare materials for the open seasons attached to these programs.

Some of the key pension provisions of EGTRRA are:

- An expansion of amounts that may be contributed to pensions and IRAs;
- "Catch-up" amounts for workers over age 50;
- Greater portability among plans; and
- The low income saver's credit.

The U.S. private pension systems are the largest and best in the world. They have encouraged personal saving, and result in reduced dependency on government tax-transfer retirement programs that are under demographic pressure and financial threat. Unfortunately, under old law, many savers had "maxed out" on their allowable contributions, and were exposed to ordinary income tax treatment on additional saving, which discourages saving. By expanding the contribution limits on such programs, the 2001 Act gives more savers an incentive "at the margin" to add to their retirement plans. These higher contribution limits should be retained. The Act also gives matching funds to encourage saving by low income workers, exposing them to the advantages of setting money aside for retirement.

The pension and IRA provisions in the tax law partially offset a basic bias against saving inherent in an income tax. The ordinary income tax treats income used for saving more harshly than income used for consumption. Income is generally taxed when earned. If the after-tax income is spent on consumption, there is usually no further federal tax (except for a few selective federal excise taxes). One can buy a meal and enjoy the nutrition, or buy a television and watch a stream of programming, without owing the IRS anything more. However, if the after-tax income is put in a bank account, or used to buy a bond, the stream of interest (what one is

really buying in such a case) is taxed. If the after-tax income is invested in stock or a small business, the dividends, capital gains, or profit stream is taxed. This feature of the income tax, that it falls on income when earned and on the returns on the income if saved, is the basic income tax bias against saving. (This is compounded with two additional layers of tax if the saving is in corporate stock which is also subject to the corporate tax, and if the saving builds to levels at which it is subject to the estate and gift tax.)

The basic bias in the income tax drives up the cost of earning future income (or, as it is sometimes put, of obtaining future consumption) by more than it drives up the cost of current consumption. This is why the income tax is not "saving-consumption neutral". Two types of pension or IRA treatment are offered in the current tax system to correct this basic bias. Under the saving-deferred method, income that is saved is not taxed immediately. Rather, the tax is postponed when the income is put into a pension or IRA, where it earns and compounds on a tax-deferred basis, and is taxed when withdrawn for consumption. Under the returns-exempt method, as in a Roth IRA or tax-free bond, the income is taxed up front, and the saving is then free from further tax. Either restores parity in the treatment of current consumption and saving (or future consumption). All the fundamental tax reform proposals utilize one or the other method of restoring neutral treatment of saving, and would apply them to all saving, not just limited amounts.

Neutral treatment of saving is critical for a financially healthy retirement. Suppose one were to devote a thousand dollars a year to saving, pre-tax, from age 20 through age 70, at a 7.2% real return (about the historical average for stocks). Under ordinary income tax treatment, at a 20% tax rate, the annual contribution would be reduced to $800 post-tax, the annual build-up would fall to about 5.76%, and the savings would accumulate to roughly $240,000 after tax at age 70. Under either type of neutral pension arrangement, however, the after-tax lump sum at age 70 would be about $400,000, or two-thirds more than in the ordinary tax case. The income tax bias steals away about $160,000 of the potential retirement income.

The retirement saving provisions of EGTTRA are consistent with fundamental tax reform and are helping to create a healthier financial situation for workers in retirement. They should be made permanent.

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Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.