An Economic Appraisal of Pension Tax Policy in the United States

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CHAPTER 3

Implementing a Neutral Pension Tax Policy

The last chapter showed that the federal government has been gravitating toward a national retirement policy that keeps the retirement decision in the domain of individual choice, subject to contracts freely entered into by workers and firms. Some of this policy is old. Pension tax policy dates back to 1926, though it had virtually no meaning until the income tax became an important institution in the United States during World War II (see Chapter 1). On the other hand, some income tax policy is quite new. Conforming the social security system to the same neutral policy was begun in 1977 and 1983 and will not be fully effective for two decades. If a neutral policy is to be pursued, we must ask which federal pension tax and related laws need to be reconsidered to complete the transition to a free-market system of retirement.

CONTRIBUTION LIMITS

I will start by reviewing current pension policies that already are consistent with a noninterventionist government role. First, existing tax policy extends to defined contribution plans. A more paternalistic policy might confine tax benefits to defined benefit pension plans in which firms presumably share investment risks. Second, the tax policy is applicable to plans that award lump-sum benefits. A more interventionist policy might award the tax rules only to plans that pay annuities until death and require joint and survivor annuities for spouses until their death.[1] Third, pensions are permitted to invest in a broad spectrum of portfolios that can include all bonds, all stock, and some holdings of "risky" securities like venture capital and small firm stocks. Pensions are not required to hold only "safe" securities like bonds or "blue chip" stocks.[2] Firms can offer, and individuals can choose,

among plans that offer different kinds of risk and different streams of consumption during the retirement period.

Limits, however, are imposed on the amounts that can be contributed to pension trust funds. For example, in defined contribution plans, the limit is $30,000 in contributions per worker per year (or 25 percent of compensation, whichever is lower). The $30,000 contribution limit is indexed to prices, but starting only after inflation accumulates in the amount of 33 percent; thus, the limit in real terms in the long run is $22,500.[3]

Presumably, these limits are intended to restrict the consumption tax properties of pension trust accounts without, at the same time effectively converting the entire income tax system into a consumption tax scheme. For example, if there were no restrictions on defined contribution plans, wealthy individuals presumably could hold all their assets in these plans, taking advantage of their tax-exempt status. The next chapter discusses the issue of restricting the tax-exempt provision to retirement savings *only*—one that has provoked a reconsideration of tax policy towards pensions.

The Tax Reform Act of 1986, subject to a transitional rule, set an overall limit of $112,500 (indexed to prices beginning in 1988) as the maximum annuity from tax-deferred vehicles.[4] Withdrawals from defined contribution plans in the form of lump sums can occur up to five times this amount over any consecutive five-year period. Amounts beyond this are subject to a special excise tax of 15 percent, intended to offset at least a substantial portion of the tax advantages embedded in pension annuities (recall Table 1–2).

From an efficiency perspective, why the consumption tax principle should not be extended to other savings besides retirement savings is not clear. The same reasoning used to justify tax-exempt status for pension savings can be used to justify tax-exempt status for other savings accounts as well. Taxation of interest and dividends works in the general direction of discouraging any type of postponed consumption and therefore works to reduce aggregate savings.[5] If the consumption tax principle is extended to all savings vehicles, however, the issue arises concerning how the reduced federal tax revenue will be offset.

There is much literature dealing with the efficiency effects of a broad-based consumption tax and the problems of implementing such a system in place of an income tax.[6] It is neither appropriate nor necessary to introduce this discussion here, except to note that in a consumption tax system, pension trust funds are not treated differently from any other saving accumulation vehicle, and thus presumably play a smaller role in providing savings for retirement.[7]

In this volume, I will keep the discussion about pensions in the context of the existing income tax system and will limit the discussion to policy options that are either tax neutral or revenue increasing (for

example, see proposals in Chapter 2). Thus, I simply accept the payout limit on overall tax-deferred income as a constraint on the system.

RESTRICTION OF TAX POLICY TO FIRM-OFFERED PENSIONS

The concern with limiting the tax-exempt status to pension trust funds is a natural outgrowth of applying consumption tax principles to vehicles designed to finance one subset of savings motives, namely, those aimed at supporting retirement consumption. As might be anticipated, this special tax status invites attempts to "overuse" these vehicles. Limits on payouts are ways to reduce "overuse" by higher-income workers. As we shall see in the next chapter, limits on contributions are designed to prevent stockholders from, in effect, using these funds as personal savings accounts of sorts. All of these problems would evaporate if Congress replaced the income tax with a consumption tax. Without such a change, regulatory costs designed to restrict the size of pension accounts are expected.

There are other regulatory and efficiency costs inherent in the current system, unrelated to enforcing limits on the system. These costs are attributable to the remnants of a system that had, and has, the government directly intervening with savings and retirement decisions that ought to be determined by individuals and firms. This body of regulation is the subject of this section.

The Preference Principle

The biggest shortcoming of pension tax policy in the United States is that tax-exempt status is not given to all savings vehicles for retirement. With inconsequential exceptions,[8] special tax status for pensions is reserved for firm-offered pension plans. For reference, we can call this the *preference principle* in current tax policy. In order for workers to take advantage of the national tax policy for pension savings, they must entrust their implicit pension savings to firms that, in turn, promise to return these monies at some later date.

Pension regulation. In essence, this peculiar application of pension tax policy creates potential *agency problems*. The law effectively forces workers to entrust their savings with a nonfinancial institution—partnerships and corporations mostly. Since these institutions are not otherwise covered by existing financial regulations, Congress has erected new machinery to regulate the potential agency problems that Congress, itself, created.

Most of these laws are embodied in the Employee Retirement Security Act of 1974 (ERISA) and related Internal Revenue Service Code rules. These laws include fiduciary regulations, reporting requirements, vesting rules, funding rules and restrictions on benefit formulas.

In addition, the laws include mandatory federal insurance for defined benefit pensions. When a plan sponsor fails with underfunded pensions and is unable to make up the difference, the Pension Benefit Guaranty Corporation assumes the pension obligation.

Ironically, while undoubtedly imposing large costs on pension plans, the regulations actually have not apparently resulted in fewer agency problems or even reduced the potential for fraud[9] perpetrated by firms intent on cheating workers. The evidence suggests that pension promises are generally honored, a fact that is attributable to reputation and other mechanisms that operate in the private market, not to government regulation.[10]

What the regulation has succeeded in doing, besides raising the costs of operating pension plans (especially defined benefit plans), is to create a mechanism (through the insurance company) to transfer billions of dollars from workers in well-funded, viable firms to those in unfunded plans in dying industries. Because the insurance is not based on market prices, the system encourages large unhealthy firms to sponsor generous, unfunded pension plans on the assumption that workers in other firms will pay for them. The moral hazards created by the insurance have led to even more regulation and more interference with the operation of the private pension system.[11]

Anti-discrimination rules. The argument for the preference principle in current tax policy is buried in the Internal Revenue Code antidiscrimination rules. These rules were enacted in the Revenue Act of 1942. With some exceptions, the rules require firms to cover most of their workers, regardless of pay level, under the same plan and to treat all participants in the plan alike.[12] Ostensibly, these rules are designed to limit higher-wage workers from "overusing" the pension plan; to increase pension savings rates for lower-income earners; and perhaps to engineer some cross subsidies from high- to low-wage earners outside the federal budget.

The antidiscrimination rules make it likely that heterogeneous groups of employees will be covered by the same pension plan, virtually ensuring that most workers will have nonoptimal savings rates. Workers who want to save for higher levels of retirement consumption cannot do so except outside the pension system. Since this approach is costly (see Chapters 1 and 2), most likely these workers will be induced to retire later and consume less during retirement than they would prefer. These distortions on individual choice impose efficiency costs like those discussed in Chapter 2 (see Figure 2–1).

At the same time, those who otherwise would prefer to save less and perhaps have later retirement or lower consumption during retirement or who have some other source of wage replacement besides pensions (like low-wage earners that receive disproportionate replacement rates from the social security system [see below]) are essentially forced

to forgo more current consumption than they would prefer. Since these workers are forced to save more than they prefer, predictably, they will retire prematurely.

Supporters of the discrimination rules apparently either assume or are hopeful that one outcome of the rules is an off-budget transfer from high- to low-income workers. The numbers in Tables 1–2 and 2–1 demonstrate that the value of pension savings is greater for individuals subject to higher marginal income-tax rates. In effect, these individuals face greater effective income taxes if they save for retirement outside the pension system. Since lower-income workers may face low tax rates or pay no tax at all, they tend to be indifferent to saving in a pension plan or some outside vehicle.

The discrimination rules restrict the use of different plans for different workers in the firm on the basis of wage levels. This restriction suggests that higher-income workers might agree to "bribe" lower-income workers into accepting a more generous pension plan by paying them higher cash wages. These wage subsidies are financed by higher tax benefits available from a more generous plan to higher-wage workers. Put another way, the pension tax policy is a way to "rebate" the extra income tax assessed on earnings for future consumption inherent in the income tax system. The discrimination rules may effectively cause higher-wage earners to lose part of this rebate, thereby recreating the so-called second tax on future consumption except that the extra "tax" revenue goes directly to low-wage earners instead of passing through the Treasury. For their part, lower-wage workers receive hidden subsidies in the form of higher pension benefits, which work in the direction of encouraging them to leave the work force at earlier ages.

In addition, the antidiscrimination rules essentially require the firm to impose the same quit costs and the same incentives to retire on all workers in the firm, regardless of wage levels. This constraint can be costly if it is important for the firm to provide special incentives to some of its workers, say the higher-paid employees. If the firm were free to stylize pensions for different segments of the work force, it could set up different generosity parameters and accrual rates, thus imposing different magnitudes of costs on those who quit "too early" or stay "too late."

Those workers in the firm for which these behavioral patterns pose smaller productivity effects might, for example, be offered a smaller defined benefit plan or one with different rules or a defined contribution plan that would give them the opportunity to leave the firm at the time they chose, without forgoing part of their pension benefits. Constraining the firm's ability to offer more diverse pensions across its work force, ensures that the firm will impose penalties that are too low for some workers and too high for others. Thus, overall firm productiv-

ity is lower than it would be if the firm had more freedom to set different rules and different pension costs across its workforce.

Efficacy of Discrimination Rules

The preference of pension tax policy for firm-offered pensions and the antidiscrimination rules that apparently are the source of the exclusion create potential agency problems. Because of the tax incentives embedded in firm-offered pension trusts, firms are virtually forced to offer pensions, and workers are likewise essentially forced to accept them, even though, in a more competitive system, they might choose some other institution to entrust their retirement savings.

These potential problems, in turn, are used to justify a large federal regulatory mechanism that involves three government agencies.[13] The rules distort savings decisions, retirement ages, and mobility patterns for virtually all workers covered by pensions. Some of these costs are out-of-pocket regulatory costs,[14] and some are hidden in the form of efficiency costs affiliated with lower productivity and nonoptimal retirement decisions.

Despite these costs, the discrimination rules are often redundant or ineffective. The rules are not necessary to limit "overuse" of the pension system by higher-income workers. When these rules were established in 1942, the possibility of monitoring millions of individual tax reforms was prohibitively costly. Thus, some argument could be made that alternative, albeit cumbersome, rules had to be imposed on a more manageable number of pension plans that could be monitored at reasonable cost.

Given the availability of high-speed computers, these arguments are no longer valid. The limit on payouts from all deferred wage plans to the $112,500 (indexed) limit enacted in the Tax Reform Act of 1986 makes indirect attempts to impose limits on higher-wage earners redundant.[15] The new limits also displace the need for constraints on participant contributions to each pension plan. These constraints are at best redundant and, at worst, interfere with the optimal use of pension plan types and optimal savings rates.[16]

Moreover, the system is not very effective in forcing lower-income workers to increase their retirement savings. While the rules undoubtedly work to force some lower-paid workers to earn more pension credits, they do not affect the lowest-income workers who never work for a pension-covered firm. As Table 3–1 demonstrates, the probability of being covered by a pension is much smaller for lower-wage workers.

In 1979, workers earning less than $5,000 per year (median annual

TABLE 3–1 Pension Coverage by Income Level, 1979

Annual Wage	*Percent*
Less than $5,000	10
5,000–9,999	31
10,000–14,999[a]	54
15,000–19,999	72
20,000–24,999	77
$25,000 or more	78

NOTE: Medium income in 1979 was $13,800 per year.

SOURCE: Daniel Beller, "Coverage Patterns of Full-Time Employees under Private Retirement Plans," *Social Security Bulletin* (July 1981), pp. 3–11.

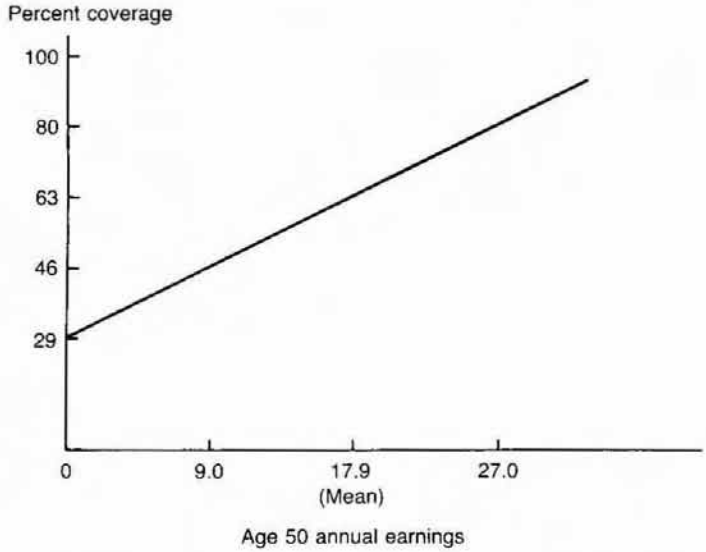
earnings in 1979 were $13,800) had only a 10 percent chance of belonging to a pension plan, in comparison to 54 percent coverage for those earning between $10,000 and $15,000 per year. Some of this difference might be attributable to age and other factors (older workers earn more and are more likely to be covered by a pension). Even with other factors constant, however, pension coverage increases markedly with income level.

This point is demonstrated by the data portrayed in Figure 3–1; the data reflect estimated pension coverage rates for 50-year-old workers holding constant tenure in the firm and various demographic characteristics. The coverage rate for workers earning $5,000 was only 38 percent compared to 86 percent for those earning $30,000. Moreover, even though some low-wage earners are covered by defined benefit pensions, to the extent that they quit these jobs, they cannot retain the full value of their benefits. As demonstrated in Chapter 1, workers who quit the firm, in most cases, forfeit much of the value of their pension credits (see Table 1–1).

Since the government cannot force low-wage workers to work for firms that offer pensions and cannot constrain their mobility among firms, pensions, obviously, are not efficient vehicles to impose forced savings policies on the population at large. For the same reasons, they are not good vehicles to attempt to effect transfers among workers. If Congress wishes to effect transfers, it should treat all low-income earners alike and use a mechanism that is properly reflected in the federal budget. In fact, Congress has already created such a mechanism in the form of the social security system.

The social security system, in part, has been designed specifically to provide all workers with some minimum income support during retirement. The system requires all workers to participate. Thus, the system, in effect, forces all workers to postpone current consumption in exchange for the right to collect an annuity during retirement. In ad-

FIGURE 3–1 Pension Coverage at Age 50



SOURCE: Stuart Dorsey, "A Model and Empirical Estimates of Worker Pension Coverage in the U.S.," *Southern Economic Journal* 49 (October 1982), 506–20.

dition, the wage replacement ratio has been deliberately skewed to provide transfers from high- to low-income workers.

Social security wage replacement rates are shown in Table 3–2. The data apply to 1976 but are not qualitatively different from current replacement rates.[17] Workers earning about 40 percent of the median wage ("low" wage in the table) receive wage replacement rates roughly double those earning incomes equal to the maximum taxable wage base. Males 65-year-old with low earnings and with spouses also age 65 have replacement rates equal to almost 100 percent. If these workers are also covered by a pension, they have combined replacement rates far in excess of 100 percent.[18]

Not surprisingly, these replacement rates generate unusually early retirement amongst low-wage earners. Table 3–3 provides estimates of the probability of accepting social security benefits at the earliest permissible age (62) for a sample of workers eligible to receive benefits in 1973. The earnings threshold in 1973, at which the earnings test was applied, was $2,100. Thus, some portion of those earning $2,100 might

TABLE 3–2 Social Security Replacement Rates

Type of Beneficiary	*Earnings*		
	Low	*Median*	*Maximum†*
Male, Age 65			
Single	66.3	46.2	33.0
With wife‡	99.4	69.3	49.5
Male, Age 62			
Single	53.0	36.9	26.4
With wife‡	77.9	54.3	38.7

†Low, median, and maximum wages in 1975 were $3,439, $8,255 and $14,100.
‡Same age as spouse.

NOTE: Numbers in table are percents.

SOURCE: Alicia Munnell, *The Future of Social Security* (Washington, D.C.: Brookings Institution, 1977), p. 26.

have accepted social security at age 62 and continued to work. For other wage levels, social security acceptance likely implies retirement from the work force. The numbers hold constant other factors that might also affect the retirement decision, including private pension coverage, education, and marital status.

The results show that workers earning roughly one third of median earnings, or $2,100 per year, had a 56.5 percent early acceptance rate. As stated above, since the earnings test exempts all $2,100 in earnings from the earnings test, some of these recipients might have remained in the work force and still collected their social security benefits. Those with earnings equal to two thirds of the median wage had a 37.5 percent acceptance rate, while those with wages 50 percent higher than the median wage had only a 5.7 percent early acceptance rate. It is not surprising that a system that provides such high wage replacement benefits to low-wage earners encourages their relatively early exit from the workforce. The numbers question the need—and dramatically suggest the likely effect of—imposing subsidized private pensions on top of the social security system for low-wage earners.

Integration rules. In fact, until 1986, federal tax policy incorporated this kind of reasoning. By permitting private plans to *integrate* their benefits with the social security system, firms could offset private pension payments in consideration of social security benefits received by workers. This policy had the effect of permitting firms to escape some of the impact of discrimination rules because firms could at least account for different savings preferences and different incentive effects as they varied from high- to low-income workers.

Unfortunately, in the Tax Reform Act of 1986, the integration rules

TABLE 3–3 Age-62 Acceptance Rates under Social Security

Annual Earnings	*Percent*
$2,100	56.5
4,200	37.5
6,300 (mean)	21.2
8,400	10.0
9,700	5.7

NOTE: Estimates hold constant other factors that might affect age of acceptance, including private pension coverage, marital status, education, and total credits accumulated under the social security system. For workers with annual earnings less than $2,100, social security acceptance does not necessarily imply retirement because the earnings test did not apply to this level of earnings at the time of the study.

SOURCE: Richard Burkhauser, "The Early Acceptance of Social Security," *Industrial Labor Relations Review* 33 (1980), pp. 484–492.

were altered substantially. Integration can still be a feature of private pension plans, but the degree to which high- and low-income workers can be affected by the rules is substantially diminished.[19]

PROPOSAL FOR A MORE EFFICIENT PENSION TAX POLICY

In essence, the exclusion of tax policy toward firm-offered pensions and related discrimination rules conflict with other legislation enacted to reduce the influence of the government on private retirement decisions. The neutrality principles inherent in the tax-exempt status of pension trust funds and the new social security policies to eliminate incentive effects for the system are contradicted by the preference for firm-offered pensions and consequent discrimination rules.

Tax policy towards retirement savings can be made more consistent with a national policy that has a more neutral influence on retirement age if two simple but important changes are made in the Internal Revenue Code: *First, the limit on contributions to individual retirement accounts should be increased to the levels applicable to defined contribution plans; and second, tax rules covering IRAs should be made identical to those covering firm-offered pension plans.* These changes are the equivalent of repealing the preference principle in current tax policy towards pensions. The payout limit on tax-deferred income ($112,500 indexed to prices beginning in 1988) can be retained because it already accommodates payouts from IRAs.

These simple changes would create a competition between IRAs and firm-offered pension plans. If firm-offered plans resulted in either sufficiently higher firm productivity (and thus higher wages) or sufficiently high group annuity benefits, presumably they would sur-

vive. Otherwise, all savings for retirement would be made through IRAs.

To permit firm-offered pensions to compete fairly with individual retirement accounts, most regulatory constraints on firm-offered pension plans should be eliminated. The repeal of the preference principle from pension tax policy essentially would eliminate the agency problem. Firms that presumably are marginal candidates for sequestering workers' retirement savings would not survive as sponsors of pension plans.[20] Presumably, only firms with strong reputations would survive the market test. In any event, since the federal government would offer workers the choice whether to use firm-offered pensions or IRAs (or some combination, subject to the overall payout limit during retirement), there would be less argument for federal regulation of agents that survived the new policy.

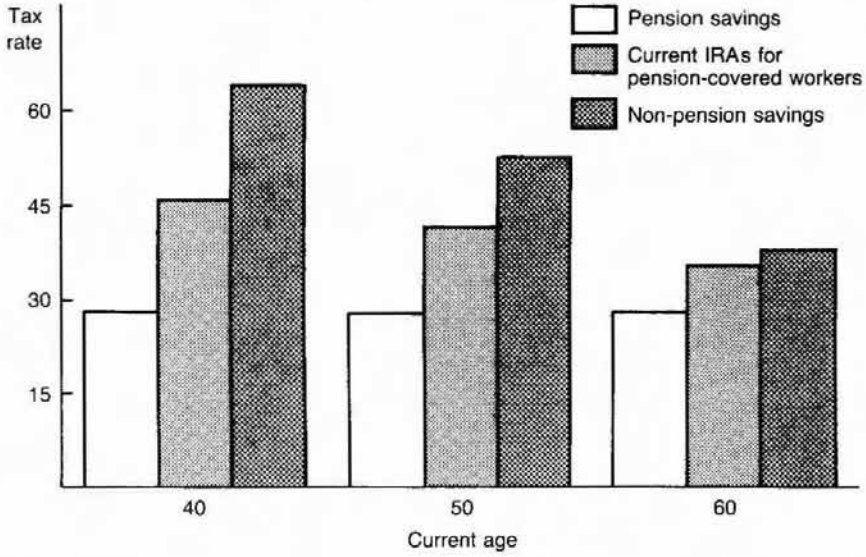
However, some regulations, such as fiduciary rules aimed at preventing misappropriation of funds and the like, should be continued. These regulations are parallel to those that cover commercial and investment banks, mutual funds, and insurance companies, presumably the institutions that will and do offer individual retirement accounts. Other regulatory apparatus, however, should be dismantled, including vesting rules, discrimination rules, social security integration rules, minimum funding rules, mandatory insurance, benefit accrual rules, contribution limits (which are redundant to the payout limit on total tax-deferred income[21]), and other nuisance constraints on incentives permitted in private pension plans.[22]

With firms free to set their own pension rules, unencumbered by regulatory constraints, pensions could be designed to generate the optimal combination of productivity effects and individual choice. If workers chose these plans either to fully or partially replace their IRA options, then we could conclude that surviving firm-offered pension plans would be characterized by substantial productivity or group annuity benefits.

Individuals would be free to supplement these plans (subject to the payout limit) or to subscribe exclusively to one or many IRA combinations and to work for firms that offered no pension benefits. These IRAs could include annuity contracts from insurance companies or various types of lump-sum accounts characterized by various levels of risk. If pooling effects are important, the firm could act as a collection agent of sorts to give workers access to group contracts available from institutions (like insurance companies) offering IRAs.

Tax rules for IRAs. As a final matter, to be competitive, IRAs must enjoy the same tax status as firm-offered pensions. This means that all contributions must be tax deductible, and IRA trust funds must be tax exempt. All distributions should be treated as ordinary taxable income,

FIGURE 3–2 Tax Rates on Age 65 Consumption



NOTES: Marginal tax rate: 28%. Interest rate: 10%.

perhaps segregated with other tax-deferred income to eliminate the income-smoothing effect now embedded in pension tax policy (see Chapter 2).

Current tax policy toward IRAs conforms to these rules, but only for workers not covered by firm-offered pensions.[23] IRAs held by pension-covered workers are taxed at higher rates than firm-offered pensions because they are taxed twice: First, earnings contributed to IRAs are subject to income tax. Second, when the earnings are withdrawn, all interest earned during the accumulation period is treated as ordinary income. Since interest earnings essentially represent the amount needed to adjust the value of earnings across periods, the tax on interest amounts to a second tax on the same earnings. Thus, the total tax is substantial in relation to the single tax levied against firm-offered pension plans. However, since the tax on interest earnings is deferred until retirement, the tax levy still is lower than the tax on ordinary tax-exposed savings accounts.

Figure 3–2 demonstrates (1) firm-offered pension tax policy, (2) current IRA tax policy for workers covered by pension plans, and (3) tax policy towards outside savings vehicles. The figures apply to an individual who pays a 28 percent tax rate on income; the interest rate is set at 10 percent. For age-40 workers, the effective tax rate applied

against age-65 consumption for savings made through a pension plan is 28 percent. The tax rate on the same savings outside the pension plan is 64 percent. The tax rate for IRA accounts for workers already covered by a pension is between these numbers, or 46 percent. While better than a tax-exposed account, current IRA tax policy clearly is inferior to pension tax policy.

This discrepancy is easy to eliminate. Assuming that the smoothing effect is eliminated for private pension plans, a policy equivalent to pensions can be applied to IRAs. The policy can be effected either by subjecting contributions to IRAs to the normal income tax and treating distributions as tax-free income or by permitting deductions for IRA contributions from current taxation, but treating distributions from IRAs as taxable income during retirement. If the smoothing effect is not eliminated, the latter choice must be used to generate tax neutrality between IRAs and pension plans.[24]

CONCLUSION

The hallmark of pension tax policy is its preference for firm-offered pensions. This preference appears to have its roots in antidiscrimination rules embodied in the Revenue Act of 1942. The preference of tax policy for plans operated by firms (and other nonprofit organizations), as opposed to pension programs offered by financial organizations like banks and insurance companies, give rise to potential agency problems. These problems, in turn, are used to justify regulatory machinery to protect workers from being cheated by plan sponsors that might not be chosen as agents to invest retirement savings in the absence of the tax preference for firm-sponsored pension plans. The rules and the regulations they entail impose large and unnecessary costs on the U.S. economy.

The discrimination rules appear to be designed to limit the use of tax-exempt pension trust funds by high-wage earners, to force lower-wage workers to save more for their retirement, and to effect off-budget transfers from high- to low-wage earners. When the rules were enacted in 1942, they might have been the most effective means for accomplishing these goals. Almost 50 years later, however, these rules clearly are outdated.

The use of cheap, high-speed data processing now enables the Internal Revenue Service to monitor individual tax returns and thus to enforce payout limits on total tax-deferred income during retirement. Moreover, the social security system, which was in its infancy in 1942, now enjoys almost universal coverage, awards much higher benefits in real terms, and is specifically designed to generate extraordinary wage replacement rates for low-wage earners. Low-wage men retiring at age 65 have replacement rates from 66⅔ percent to 100 percent depending on their marital status and age of spouse. The system explicitly effects

transfers from higher- to lower-wage earners. In short, intended transfers that might have attended the creation of the 1942 discrimination rules have been superceded by a more equitable, universal social security system.

In light of the changed conditions that now characterize the U.S. economy and its social programs, Congress should rethink the cost and effectiveness of a policy that almost surely is outmoded. This reassessment is particularly important now that the social security system has been restructured to substantially reduce its influence on retirement decisions. Allowing for a phase-in period, the social security system now reflects the same neutrality principles similar to those embedded in fundamental tax policy towards pension.

An effective way to expand the principle of neutrality in all aspects of tax policy towards retirement savings is to eliminate limits for contributions to individual retirement accounts (the payout limits for deferred earnings during retirement would be retained) and to make these accounts available to all workers on the same tax basis as firm-offered pension plans. These changes would effectively eliminate the potential agency problem created by the tax preference for firm-offered pensions and would create a competition between pension plans and the financial organizations that offer IRAs for workers' retirement savings. The overall payout limit for retirees of $112,500 (indexed), imposing a limit on the use of all pension and IRA plans for each worker, should be retained.[25]

With a fully competing IRA alternative in place, firms should be set free of most pension regulation, permitting them to arrange their plans in ways most likely to maximize worker benefits and labor productivity. The deregulation of pensions would require the repeal of most of the Employee Retirement Income Security Act and some parts of the Internal Revenue Code, notably discrimination rules, integration rules, and contribution limits. With these steps, the government would complete the building of a policy that leaves retirement decisions primarily in the domain of a free market.

ENDNOTES

1. Current law provides that all defined benefit plans offer joint and survivor annuities as their standard form of benefit payment, but workers may opt out of the provision if the worker and his/her spouse agree.
2. There are some restrictions that apply to most pension plans. Usually, a plan is not permitted to invest more than 10 percent of its holdings in the plan sponsor's own securities, and diversification across many securities is, in effect, required. "Prudence" is defined in terms of the risk and return of the entire portfolio, not particular investments.
3. Technically, the limit is tied to another limit in the tax code that puts a ceiling on projected benefit levels in defined benefit plans at $90,000, which was in-

dexed to the price level beginning in 1988. When this limit reaches $120,000, the $30,000 contribution limit is scheduled to be indexed to prices.

4. The maximum was set as the greater of $150,000 in nominal terms or $112,500 indexed to prices beginning in 1988. Thus, over some indeterminant period, the maximum permissible limit in real terms will be higher than depicted by $112,500 indexed to prices.
5. It has been estimated that if the income tax were replaced by a consumption tax in the United States, national income would increase by roughly one percent which, in present value terms, would be valued at more than one trillion dollars (1989 dollars). See Don Fullerton et al., "Replacing the Income Tax with a Progressive Consumption Tax," *Journal of Public Economics* 20 (1983), 3–23.
6. A small selection of this literature includes Henry Aaron, Harvey Galper, and Joseph Pechman, eds., *Uneasy Compromise: Problems of a Hybrid Income-Consumption Tax* (Washington, D.C.: Brookings Institution, 1988); Alan Auerbach and Martin Feldstein, *Handbook of Public Finance* (Amsterdam: North Holland Press, 1985); David Bradford, *Blueprints for Basic Tax Reform* (Washington, D.C.: U.S. Department of the Treasury, 1977); Nicholas Kaldor, *An Expenditure Tax* (London: Allen and Unwin, 1955); Robert Hall and Alvin Rabushka, *The Flat Tax* (Stanford: Hoover Institution, 1985); John Makin, *Real Tax Reform: Replacing the Income Tax* (Washington, D.C.: American Enterprise Institute, 1985); Joseph Pechman, *Federal Tax Policy*, 5th ed. (Washington, D.C.: Brookings Institution, 1987); and Charles Walker and Mark Bloomfield, *The Consumption Tax: A Better Alternative?* (Cambridge: Ballinger, 1987).
7. Pensions would still exist in such a world if they offered important advantages to workers and firms, including their potential effects on productivity and cost of annuities.
8. Individual Retirement Accounts (which limit contributions to $2,000 per year) and so-called Keough plans for self-employed individuals (which limit contributions to $7,000 per year) are also permitted under current law.
9. Here, fraud refers to cheating workers out of their expected pension benefits by firing them at older ages or terminating the pension plan.
10. See Richard A. Ippolito, "A Study of the Regulatory Effect of the Employee Retirement Security Act," *Journal of Law and Economics* (April 1988), 85–125; and Christopher Cornwell et al., "Opportunistic Behavior."
11. The most recent reforms are contained in the Pension Protection Act of 1987. For a complete discussion of the operation of the insurance, see Richard A. Ippolito, *The Economics of Pension Insurance* (Homewood, IL: Richard D. Irwin for the Pension Research Council, 1989).
12. Usually, it is permissible to have separate plans for blue- and white-collar workers, particularly if one or both plans cover unionized workers. If a firm has several subsidiaries, it need not cover all with the same plan.
13. Fiduciary and reporting rules are enforced by the U.S. Department of Labor; discrimination, funding, and vesting rules are enforced by the Internal Revenue Service; and the insurance program is operated by the Pension Benefit Guaranty Corporation.
14. These include the cost of completing government annual reports and other disclosure costs; special actuarial calculations; and consultants to ensure that the plans continue to conform to ever-changing federal regulations and legislation.
15. Recall that the limit is subject to a transitional rule as specified in note 4.
16. For example, it is well known that contribution limits in defined benefit plans are more likely constraining for younger workers compared to defined contribu-

tion plans. See E. Allen, et al., *Pension Planning*. In addition, they tend to discriminate against workers saving disproportionately late in their worklife for retirement.

17. For example, see the Social Security Administration, *Social Security Bulletin, Annual Statistical Supplement*, 1987.
18. The average primary pension plan has a replacement rate of 25 percent; roughly half of all plans have replacement rates higher than this.
19. The ways the new rules work are complex. But in a defined contribution plan, for example, if the highest-income participant ends up with a contribution rate to his account equal to 10 percent of salary then, after accounting for the integration formula, the lowest-income worker cannot receive less than a 5 percent contribution rate. See E. Allen et al., *Pension Planning*.
20. It might be possible, however, for these firms to act as collection agents of sorts to enable workers to obtain pooling advantages of IRAs from large financial institutions such as insurance companies.
21. See note 4.
22. These include, for example, rules that limit firms' ability to impose retirement incentives at normal retirement age and those that limit "backloading" of contributions towards later in the career with the firm.
23. Some exceptions are made for pension-covered workers who have an adjusted gross income below some threshold amount and for nonworking spouses.
24. In the absence of a smoothing effect, the present value revenue implications to the U.S. Treasury would be the same under either scheme. But the short-term flows would be quite different. If contributions are taxed, short-term revenues would increase dramatically.
25. See note 4.