An Economic Appraisal of Pension Tax Policy in the United States

Other publications of the
PENSION RESEARCH COUNCIL

Concepts of Actuarial Soundness in Pension Plans—*Dorrance C. Bronson*

Social Aspects of Retirement—*Otto Pollak*

Positive Experiences in Retirement—*Otto Pollak*

Ensuring Medical Care for the Aged—*Mortimer Spiegelman*

Legal Protection of Private Pension Expectations—*Edwin W. Patterson*

Legal Status of Employee Benefit Rights under Private Pension Plans—*Benjamin Aaron*

Decision and Influence Processes in Private Pension Plans—*James E. McNulty, Jr.*

Fulfilling Pension Expectations—*Dan M. McGill*

Collectively Bargained Multiemployer Pension Plans—*Joseph J. Melone*

Actuarial Aspects of Pension Security—*William F. Marples*

Status of Funding under Private Pension Plans—*Frank L. Griffin, Jr.*, and *Charles L. Trowbridge* (out of print)

Guaranty Fund for Private Pension Obligations—*Dan M. McGill*

Preservation of Pension Benefit Rights—*Dan M. McGill*

Retirement Systems for Public Employees—*Thomas P. Bleakney*

Employer Guarantee of Pension Benefits—*Dan M. McGill*

Reciprocity among Private Multiemployer Pension Plans—*Maurice E. McDonald*

A New Look at Accounting for Pension Costs—*William D. Hall* and *David L. Landsittel*

Social Security and Private Pension Plans: Competitive or Complementary? *Dan M. McGill* (ed.)

Pension Mathematics—*Howard E. Winklevoss*

Indexation of Pension and Other Benefits—*Robert J. Myers*

Joint Trust Pension Plans—*Daniel F. McGinn*

Financing the Civil Service Retirement System—*Dan M. McGill* (ed.)

Continuing Care Retirement Communities—*Howard E. Winklevoss* and *Alwyn V. Powell*

Social Investing—*Dan M. McGill* (ed.)

Employer Accounting for Pensions—*E. L. Hicks* and *C. L. Trowbridge*

Pensions, Economics and Public Policy—*Richard A. Ippolito*

Search for a National Retirement Income Policy—*Jack L. VanDerhei* (ed.)

Inflation and Pensions—*Susan M. Wachter*

Pension Asset Management: An International Perspective—*Leslie Hannah* (ed.)

Fundamentals of Private Pensions, 6th ed.—*Dan M. McGill* and *Donald S. Grubbs, Jr.*

The Economics of Pension Insurance—*Richard A. Ippolito*

It's My Retirement Money—Take Good Care of It—*William C. Greenough*

An Economic Appraisal of Pension Tax Policy in the United States

Richard A. Ippolito
Chief Economist
Pension Benefit Guaranty Corporation

Published for the
Pension Research Council
Wharton School
University of Pennsylvania
by

IRWIN

Homewood, IL 60430
Boston, MA 02116

Sponsoring editor: Michael W. Junior
Project editor: Margaret A. Schmidt
Production manager: Ann Cassady
Compositor: Compset, Inc.
Typeface: 10/12 Melior
Printer: Arcata Graphics/Kingsport

Library of Congress Cataloging-in-Publication Data

Ippolito, Richard A.
An economic appraisal of pension tax policy in the United States / Richard A. Ippolito.
p. cm.
"Published for the Pension Research Council, Wharton School, University of Pennsylvania."
Includes bibliographical references.
ISBN 0-256-08544-7
1. Pensions—Taxation—United States. 2. Old age pensions—Taxation—United States. I. Wharton School. Pension Research Council. II. Title.
HJ4653.P5I66 1990
336.24'2—dc20 89–26875
CIP

Printed in the United States of America
1 2 3 4 5 6 7 8 9 0 K 7 6 5 4 3 2 1 0

To my parents, Frank and Cecile Ippolito,
with love and gratitude.

MEMBERS OF THE PENSION RESEARCH COUNCIL

Roger F. Murray, Emeritus Professor of Finance, Columbia University, Wolfeboro, NH

Robert J. Meyers, F.S.A., International Consultant on Social Security, Silver Spring, MD

George J. Pantos, Esq., Partner, Vedder, Price and Kaufman, Kammholz & Day, Washington, D.C.

James E. Pesando, Professor of Economics, University of Toronto

Samuel Preston, Chairman, Sociology Department, University of Pennsylvania

Anna M. Rappaport, F.S.A., Managing Director, Mercer, Meidinger, Hansen, Inc., Chicago

Jerry S. Rosenbloom, Chairman, Insurance Department, The Wharton School

Sylvester J. Schieber, Director of Research, Wyatt Company, Washington, D.C.

Ray Schmitt, Specialist in Social Legislation, Congressional Research Service, Washington, D.C.

Richard B. Stanger, National Director, Employee Benefits Services, Price Waterhouse, Washington, D.C.

Marc M. Twinney, Manager of Pension Department, Ford Motor Company, Dearborn, MI

L. Edwin Wang, Past President, Board of Pensions in Lutheran Church in America, Minneapolis, MI

Howard E. Winklevoss, President, Winklevoss Consultants, Inc., Greenwich, CT

Howard Young, F.S.A., Adjunct Professor of Mathematics, University of Michigan, Ann Arbor, MI

STRUCTURE AND ROLE OF THE COUNCIL

Founded in 1952, the Pension Research Council is one of several research organizations within the Wharton School of the University of Pennsylvania. As part of the nation's first school of business, the Council functions in a bracing environment of academic freedom and objectivity. The basic purpose of the Council is to undertake research that will have the effect of strengthening those arrangements designed to provide the financial resources needed for a secure and dignified old age. It seeks to broaden public understanding of these complex arrangements through basic research into their social, economic, legal, actuarial, and financial foundations. Although geared to the long view of the pension institution, projects undertaken by the Council are always relevant to real-world concerns and frequently focus on issues under current debate.

The Council is composed of individuals from large corporate plan sponsors, organized labor, actuarial consulting firms, the accounting profession, the legal profession, investment counselors, banks, insurance companies, not-for-profit organizations, and several academic disciplines. The Council does not speak with one voice and espouses no particular point of view. The members do share a general desire to encourage and strengthen private sector approaches to old age and economic security, while recognizing the essential role of Social Security and other income maintenance programs in the public sector.

The members of the Council are appointed by the Dean of the Wharton School and serve indeterminate terms. The Council reviews the findings of current research projects, acts to generate new research proposals, and reviews external proposals. In performing these functions, the members identify areas in which additional research is needed, consider the general form the research should take, then evaluate the qualifications of persons deemed capable of carrying out the approved projects.

The research projects are carried out by persons commissioned under individually designed ad hoc arrangements. The researchers are normally academic scholars, but non-academic experts with special qualifications for the tasks involved may be used. The research findings are reviewed by members of the Council, who may offer criticism as to both the substance of the report and the inferences drawn from the studies. The author of any manuscript is free to accept or reject the criticisms of the Council members, but the latter have the privilege of recording in the published document their dissent from any interpretative statements or points of view expressed by the author. Whether or not written dissents are included, publication should not be interpreted to indicate either agreement or disagreement by the Council or its individual members with the substance of the document or its inferences.

Preface

This monograph addresses the appropriate tax treatment of pensions in the United States. Except for analysis of recent changes in technical pension tax provisions, the arguments draw on the existing economics literature. The novelty of this book lies in its treatment of pensions in the tax code as part of an overall national retirement policy, including pension tax rules, pension regulations, the social security system, and individual retirement accounts. The volume evaluates these institutions against a hypothetical national retirement policy that puts the government in the role of maximizing the freedom of individuals and firms to generate the distribution of retirement ages and retirement consumption that best suits their needs.

Changes over the past 10 years in the social security system, as well as the essence of pension tax policy, conform to this hypothetical policy, likely resulting in large welfare gains for U.S. workers. A substantial portion of this volume is devoted to identifying other changes in tax policy and regulation that would more completely transform existing institutions to be consistent with the above notion of a national retirement policy. If these changes are made, labor productivity and workers' well-being could increase significantly. Yet these changes would not require the government to abandon its current policies requiring all workers to participate in some retirement income system, and transferring some monies from higher- to lower-income workers. In addition, the changes would not reduce federal tax revenue. Less pension regulation and more individual freedom can be consistent with these policy goals because important changes have occurred in the social security and tax-collection systems that make many of the original tax-related pension regulations outmoded today.

The views expressed in this volume are highly personalized. Other policy analysts, even those who might subscribe to my hypothetical national retirement policy, likely would disagree with some of the specifics of my prescriptions. Others who believe in a more interventionist government undoubtedly will have stronger disagreements with the overall thrust of my conclusions. Nevertheless, it was my hope that, by bringing together the various parts of the overall retirement system, analyzing them against a single theme, and bringing to light some of the more esoteric aspects of pension tax law, a framework would be created to help others think about optimal pension and retirement policy from perhaps a different perspective. Needless to say, the views I express do not represent the official views of the Pension Benefit Guaranty Corporation.

Richard A. Ippolito

ACKNOWLEDGMENTS

I owe a debt of gratitude to numerous individuals who directly or indirectly helped me develop this volume. First, and foremost, I would like to thank Carolyn Weaver for suggesting the idea to me, and for providing much-needed guidance on an early version. I would also like to express my appreciation to Dan McGill and Jack VanDerhei for providing intellectual and technical support for my continuing research on pensions, and for reviewing in detail earlier versions of this monograph. Also, I would like to thank other members of the Pension Research Council who provided comments indirectly to me, and who supported publication of the volume despite their own misgivings about some of my policy conclusions.

Finally, I would like to thank my many colleagues at the U.S. Department of Labor, the Pension Benefit Guaranty Corporation, and other agencies in the federal government for contributing hundreds of hours of their time trying to teach me about the details of pension tax policy and related regulatory and retirement policy issues. These individuals are too numerous to list, but I would be remiss if I did not make special mention of David Lindeman, who during his tenure at the Congressional Budget Office and as a colleague at the PBGC, spent many sessions teaching me and debating with me esoteric pension tax topics and their implications for public policy. His previous volume (with Larry Ozanne) on pension tax policy was an indispensable source for my work on pension taxation.

Contents

LIST OF TABLES

LIST OF FIGURES