Report

Savings Under Tax Reform: What is the Cost to Retirement Savings?

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Summary—Retirement plans and personal savings, along with Social Security, are essential parts of the American retirement system. Policy changes that affect the ability to save or the composition of overall savings pose potential threats to retirement plan savings. There is a strong public interest in assuring that Americans have adequate resources during their retirement years; as policymakers consider alternatives to the current law tax system, it is important to consider whether potential reforms will put more Americans at risk of having inadequate savings during their retirement years.

Employers face substantial costs to establish and maintain qualified retirement plans for employees. These costs, coupled with the fact that employers are generally indifferent from a tax perspective whether an employee's compensation is provided as cash or tax-advantaged retirement savings, present a significant deterrent, even under current law, to retirement savings through employer-sponsored retirement plans.

Furthermore, our present tax system dilutes the demand for retirement savings by offering favorable tax treatment for investments that compete with qualified retirement plan savings.

Despite these impediments to retirement savings under current law, the employer-sponsored retirement plan system has proven effective for delivering retirement benefits to workers who would not otherwise save for retirement.

The President has established a tax reform commission that is exploring various alternatives to the current tax system. Many of the reform options under consideration would provide greater tax preferences for general savings such as consumption-style taxes or more targeted approaches such as those that eliminate the tax on capital gains and dividend income. Consumption taxes, in general, tax amounts consumed and, thus, do not tax amounts that are saved. Similarly, eliminating the tax on capital gains and dividends would provide a specific tax incentive for saving through investment in capital assets.

These reform proposals may increase aggregate savings by taxpayers. However, this increase in aggregate saving may come at the expense of retirement saving and may not provide uniform saving across all income classes. Evidence with lump-sum distributions from existing qualified retirement plans shows that employees, particularly lower income employees, who have access to their savings before retirement tend to spend these funds, rather than saving them for their retirement years. Thus, an overall increase in saving will not necessarily translate into an increase in saving for lower income individuals or to an increase in retirement savings.

Employer-sponsored qualified retirement plans generally offer all eligible workers the opportunity to save for retirement. The minimum participation and nondiscrimination rules guarantee that the tax benefits of qualified retirement plans are only available if the plan provides comparable benefits to all eligible employees. Many employer-sponsored qualified retirement plans provide additional incentives to workers to encourage savings, such as matching contributions. Indeed, under current law, an additional tax incentive (the SAVER's Credit) is provided to low-income individuals to help them save for retirement. As a result, qualified retirement plans provide the best opportunity for low-income workers to save for retirement. If qualified retirement plans were no longer offered by their employers, many low-income individuals would not possess adequate resources or motivation to save on their own for retirement.

Reform and targeted relief proposals that have been proposed will do little to alter the fact that individual savings tends to be very low among lower income individuals. Therefore, although tax reform potentially will increase overall saving, it is likely to come at the cost of retirement savings by lower-income individuals. As a result, providing favorable tax treatment for individual savings may erode retirement savings, leading to greater wealth disparities among retirees and threatening the financial security of a significant number of people.

I. Introduction

With the creation of the President's tax reform commission, there is increased debate about the advantages and disadvantages of the current tax system. Tax reform advocates are advancing proposals either to alter fundamentally or to eliminate the current law system. Among the proposals that are attracting the most attention is a consumption tax as an alternative or add-on to the current law system. In addition, there is ongoing interest in proposals to eliminate taxes on capital gains and dividends.

When considering tax reform proposals, policymakers need to be aware of the potential consequences of a consumption tax system on savings for retirement. Our current tax system provides a strong incentive for taxpayers to save for retirement by excluding from income contributions to a qualified pension plan or an Individual Retirement Arrangement (IRA). Even with this strong incentive, many people do not save enough for retirement and the saving that does occur tends to be positively correlated with income levels. However, if a consumption tax system is developed in which taxpayers are generally encouraged to save to avoid current tax, the current system's strong incentive to save specifically for retirement will be significantly reduced. Thus, it is reasonable to assume that under a consumption tax system, taxpayers will be less likely to favor saving for retirement because of the preference provided to savings in general. The implications of such a reduction in retirement saving could be devastating, particularly given the projected shortfalls in the Social Security system.

Employer-sponsored qualified retirement plans, personal savings and Social Security are all considered essential elements of the American retirement system (the so-called "three-legged stool"[1]). However, projected demographic trends and solvency concerns suggest that Social Security, if available, may offer lower benefits, which places greater emphasis on both qualified retirement savings and personal savings.[2] Encouraging retirement saving, through both employers *and* individual saving plans, remains critical to ensure the retirement security of future retirees.

In general, the current tax system provides the strongest incentive for retirement saving to occur through the employer-sponsored qualified retirement plan system. There is a substantially higher limit on the amount of permissible tax-qualified retirement savings if the savings occurs through an employer-sponsored plan. However, it is important to remember that employers are generally

[1] More recently, the three-legged stool analogy is changing to a four-legged stool to include wage income, as many retirees must continue to work in part-time positions throughout their retirement.
[2] The current Social Security debate focuses on the solvency of the system and the projected elimination of the trust fund in 2042. Proposals consider price-indexing benefits, delaying retirement age, as well as introducing personal accounts. In any event, any potential solution to the problems will likely reduce the amount of benefits that retirees will receive.

entitled to deduct compensation expenses, whether they are made in the form of cash or in contributions to a qualified retirement plan. Thus, an employer may be generally indifferent whether to pay employees in current compensation or to make contributions on their behalf to a qualified retirement plan. Furthermore, the costs of establishing and maintaining a qualified retirement plan can provide a significant deterrent to small and mid-sized employers.

Although the current tax system provides a strong incentive for employees to save through a qualified retirement plan, current law rules create substantial barriers to the establishment of such plans. The costs of establishing a plan can be significant. Once established, the plan must meet standards for participation and nondiscrimination so that the benefits are generally available to all eligible employees, regardless of income or ability to save. In the case of defined benefit pension plans, the plan also must satisfy annual minimum funding requirements. The costs of complying with these minimum funding requirements are significant.

Changes to the rules for qualified retirement plans occur with alarming regularity. Thus, employers are constantly facing the costs of amending their plans to comply with new laws and regulations. In recent years, the Congress has recognized that the incentives of current law may not be sufficient to induce employers to establish and continue qualified retirement plans. Thus, Congress has passed additional laws to assist smaller employers offer alternatives to defined benefit plans and expand existing retirement savings options. The available plans, from which employers may choose, each with detailed rules on participation and contributions, create a complex system.

Many people believe that some form of change or reform is necessary to reduce the barriers to employer sponsored retirement plans and expand further the coverage of workers. Yet, most discussions of reform focus on revamping the tax code through consumption or national sales taxes or through such targeted reform as decreasing the capital gains rate or eliminating tax on other forms of investment. These approaches may increase savings outside of qualified retirement plans and permit business owners to accomplish their savings objective without offering qualified retirement plans to their employees. Given the ambivalence of employers toward maintaining qualified retirement plans due to their costs and complexities, these changes are likely to have a detrimental effect on qualified retirement plans and, as a result, savings by employees.

Without careful consideration, both major reform and targeted preferential treatment of nonqualified investments could erode both sponsorship and participation in qualified retirement savings plans. Such tax policy could add further instability to an already unstable component of retirement security—qualified retirement plan savings—and place further pressure on personal savings and the Social Security system.

The following sections examine the potential impact of tax reform on retirement savings. The first section presents background information on the need for qualified retirement plan savings and examines available qualified retirement plans, providing an overview of the rules facing plan sponsors. The second section examines past tax provisions and the impact on qualified retirement plans. The final section looks ahead to reform, considering consumption based taxes and targeted preferential treatment of nonqualified investments.

A. Retirement Savings Reasons for Concern

Retirement saving remains an important policy issue for the US Congress. During the past ten years, the Congress passed major legislation that expanded qualified retirement savings, created new qualified savings vehicles and attempted to simplify existing policy. Changing demographics, low overall savings rates, inadequate savings for many retirees and problems with Social Security make retirement savings a critical policy issue; individually each issue raises important concerns for the retirement security of our aging populations, but collectively they underscore the need for maintaining a strong retirement savings system.

Demographic Shifts**—**During the next ten to 15 years, the largest birth cohort, baby boomers, will begin to retire.[3] The Census Bureau estimates that in 2050 approximately 87 million Americans will be aged 65 or older compared to 36 million in 2000.

Within the overall growth of seniors, another trend emerges. The number of people aged 85 and older increases five-fold in 2050 over the 2000 population as shown in Graph 1. By 2050, Census estimates that approximately 21 million Americans will be over the age of 85. This trend reflects not only the growing retiree population, but increased longevity.

The 2005 Social Security Trustees Report estimates life expectancy as 17.0 years for a man and 19.7 years for a woman who becomes 65 in 2005. By 2050, life expectancy increases to 19.7 years for men and 22.2 years for women. Compared to life expectancy in 1960, projected life expectancies for 2050 reflect an increase of 52 percent for men and 46 percent for women.[4]

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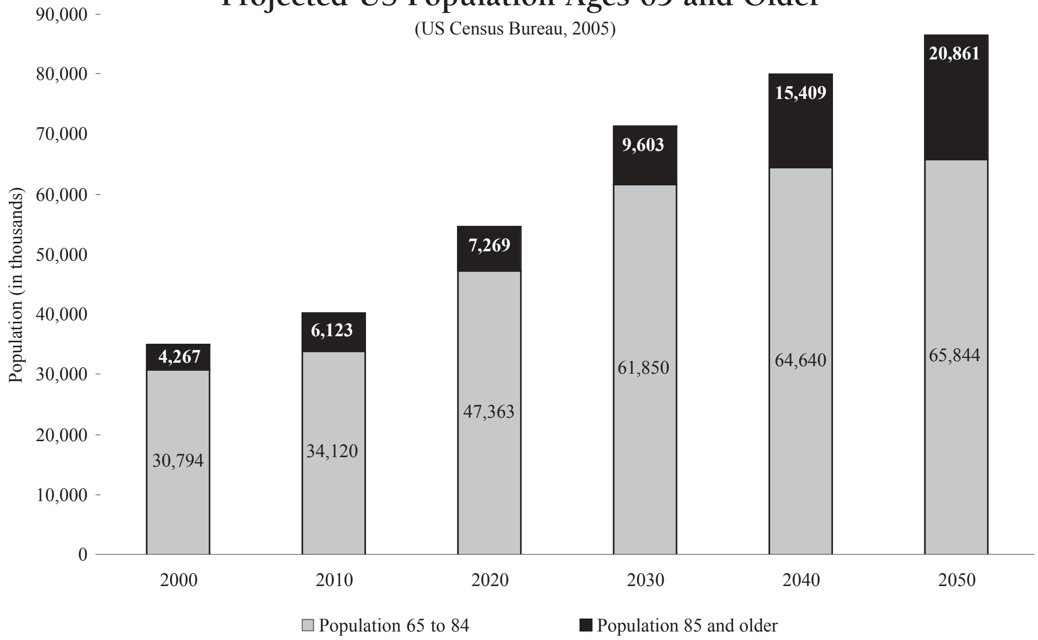
[3] The Census Bureau defines the baby-boomer cohort to include people born between 1946 and 1964.
[4] Social Security Administration, 2005 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Dis.ability Insurance Trust Funds, March 23, 2005.

Graph 1
Projected US Population Ages 65 and Older
(US Census Bureau, 2005)



In addition to larger numbers of retirees who live longer, another trend emerges for seniors, that of declining retirement ages. In general, men are retiring earlier than previous generations. Since 1950, fewer men aged 55 to 64 were working or looking for work, as the proportion fell from 87 percent in 1950 to 68 percent in 1985.[5] Since 1985, this proportion remains stable fluctuating between 67 to 69 percent.

With respect to retirement savings, these trends mean increased pressure on public systems. To the extent that Social Security and Medicare are unable to provide the same level of benefits, retirees must rely increasingly on qualified retirement plan and individual savings. While a majority of Americans indicate they are saving for retirement, the question remains of whether amounts saved are adequate to meet growing retirement needs.

[5] See the US Department of Labor, Bureau of Labor Statistics Web site, 2005.

Are We Saving Too Little?—Evidence indicates that Americans have become increasingly aware of the importance of personal savings for retirement security. The Employee Benefits Research Institute (EBRI) 2005 Retirement Confidence Survey (RCS) reveals that seven in ten (nearly 69 percent) workers are saving money for retirement or starting to save for retirement. Nonetheless, many of those who are saving apparently are not saving amounts necessary to ensure an adequate retirement. Estimates indicate that most families are saving at only one-third the rate necessary to maintain their present standard of living in retirement.[6]

There are two commonly cited measures of personal savings, the National Income and Products Accounts (NIPA) and the Flow of Funds Accounts (FFA). The NIPA reports that the rate of personal savings declined steadily over the past few decades and is approaching historic lows. The FFA shows a decline, but not nearly as steep as that shown in the NIPA. The EBRI finds that while the rate of personal savings is declining, overall the personal savings rate of US workers generally is higher than typically reported.[7] However, the question of whether the current level of personal savings is adequate to meet future retirement needs still remains. The EBRI 2005 RCS finds that of the 69 percent that are saving for retirement, most do not have an idea of the level of savings necessary to live comfortably in retirement.

Although nearly 69 percent of American workers are saving to some extent for retirement, more than one-third of the working population is not saving for retirement at all. Ironically, of those not saving, almost half express some confidence in their ability to fund their retirement. Some indicate that they will save “later,” while others believe they will obtain support from employers and family or friends.[8]

As retirement saving grows, through employer sponsored plans or through individual savings, other forms of savings decline. It is significant to note that retirement and other savings are largely substitutes for one another, not complementary. With respect to retirement security and the importance of both retirement and personal savings, this suggests that as people contribute to one form of savings, contributions to the other will decline.

EBRI reports that retirement savings as a percentage of total personal savings is growing. In other words, as workers save through employer-sponsored retirement plans they are less likely to save outside of those plans.

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[6] US Congressional Budget Office, “Social Security and Private Savings: A review of the Empirical Evidence,” July 1998.
[7] The National Income and Product Accounts shows a dramatic decrease in personal savings over the past ten years. However, Yakoboski and Devine indicate that NIPA does not measure realized capital gains on stocks and other assets which contributes to a significant increase in wealth.
[8] See EBRI Retirement Confidence Survey, 2005.

Graph 2
Personal Saving as a Percentage of Disposable Personal Income

Graph 2 shows personal savings as a percentage of disposable income from 1960 to 2004. As personal savings rates continue to decline, retirement savings becomes more and more important to retirement security. The EBRI analysis, coupled with the decline in personal savings, suggests that individuals are saving more through qualified retirement plans and less in non-qualified savings vehicles.

Research indicates that the likelihood of saving for retirement increases when the individual has access to an employer-sponsored plan. EBRI reports that 77.9 percent of workers making from $30,000 to $50,000 who are covered by an employer-sponsored 401(k)-type plan actually saved in that plan. However, only 7.1 percent of workers at the same income level not covered by a plan saved in an IRA. Low- to moderate-income workers are 11 times more likely to save when covered by an employer-sponsored plan.

A similar trend emerges when considering participation in the stock market and mutual funds. Many studies cite statistics indicating that half of all households participate in the stock market or own mutual funds. However, closer examination reveals that almost half of all households indirectly own such assets through their retirement account.[9] The Federal Reserve cites similar

[9] As of July 2003, an estimated 36.4 million US households, or almost half of all US households owning mutual funds, held such funds in employer-sponsored retirement plans. See Investment Company Institute, US Households Ownership of Mutual Funds in 2003, Vol. 12, No. 4 (October 2003).

statistics for stock market participation, reporting that individuals hold approximately 50 percent of all stocks through their retirement account. They find that as income falls, so does the likelihood of stock ownership outside a plan. They report that less than 25 percent of moderate-income and less than 10 percent of low-income households own stock outside of their retirement plan.[10]

Employer-Sponsored Retirement Plans—Many private-and public-sector employers offer either defined benefit or defined contribution retirement plans. Defined benefit plans offer a defined future benefit based on years of service and past salary levels. Defined contribution plans offer a future benefit determined by a defined level of contributions during the worker's participation.

Recent statistics show that 66 percent of private- and public-sector employers make available some form of retirement plan to their employees (full-time and part-time workers). Public sector employers offer plans at a much greater rate than private sector employers with approximately 87 percent of public and 62 percent of private employers offering a retirement plan.

These percentages fall when considering plan participation as opposed to availability. Approximately 79 percent of public-sector and 50 percent of private-sector employees actually participate in their employers' plans.[11] In most cases, employees do not participate because they do not meet certain eligibility criteria (for example, some part-time workers may not work sufficient hours for eligibility or seasonal workers may not work sufficient weeks during the year). In other cases, surveys indicate that workers do not feel they have sufficient disposable income to participate or they lack the knowledge or an understanding of plan benefits. In general, participation rates are lowest among lower income workers and women, both of whom are likely to have periods of part-time work, high turnover or absences from the workforce.

Worker turnover presents another problem for both employers that sponsor plans and employees wanting to participate. When worker turnover is high, employers often feel reluctant to sponsor or maintain a retirement plan. The employer faces ongoing costs when former employees leave small inactive accounts. When workers are entitled to the benefits, many plans do not want to hold inactive accounts for former employees. Also, workers with frequent job changes often are not fully vested when leaving the firm. In this case, they will forfeit some or all of their accumulated plan benefits. Further, workers with small vested accounts will frequently take their benefit in a lump sum distribution, pay the penalty and income taxes, and use the money for some other purpose (see the discussion below about this issue).

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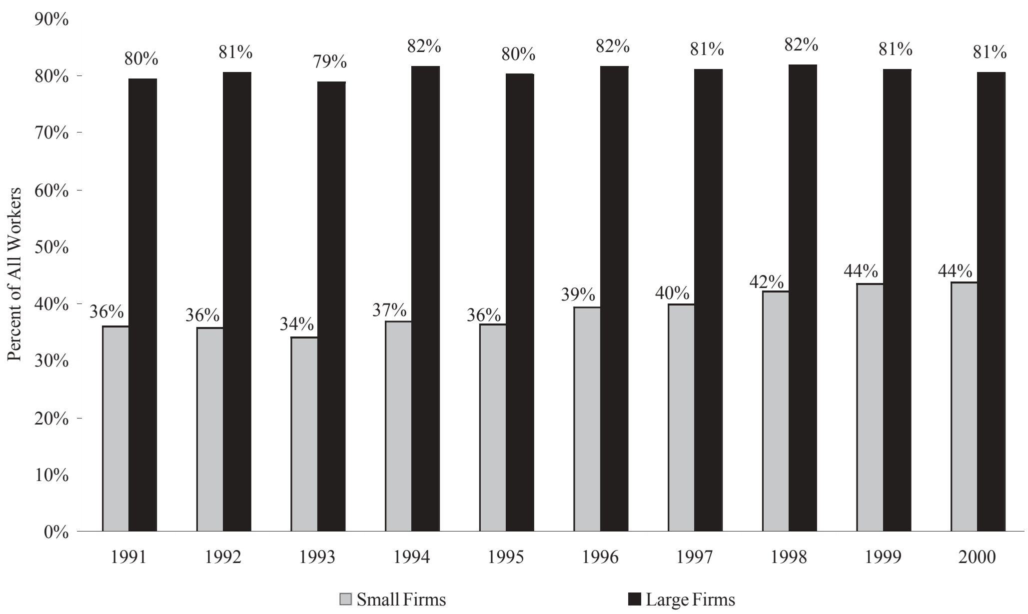
[10] See "Remarks by Governor Edward Gramlich at the National Savings Forum," July 2001.
[11] See Patrick Purcell, Pension Sponsorship and Participation: Trends and Policy Issues, Social Security Bulletin, Volume 64, Number 2, 2001/2002. Statistics include part-time workers.

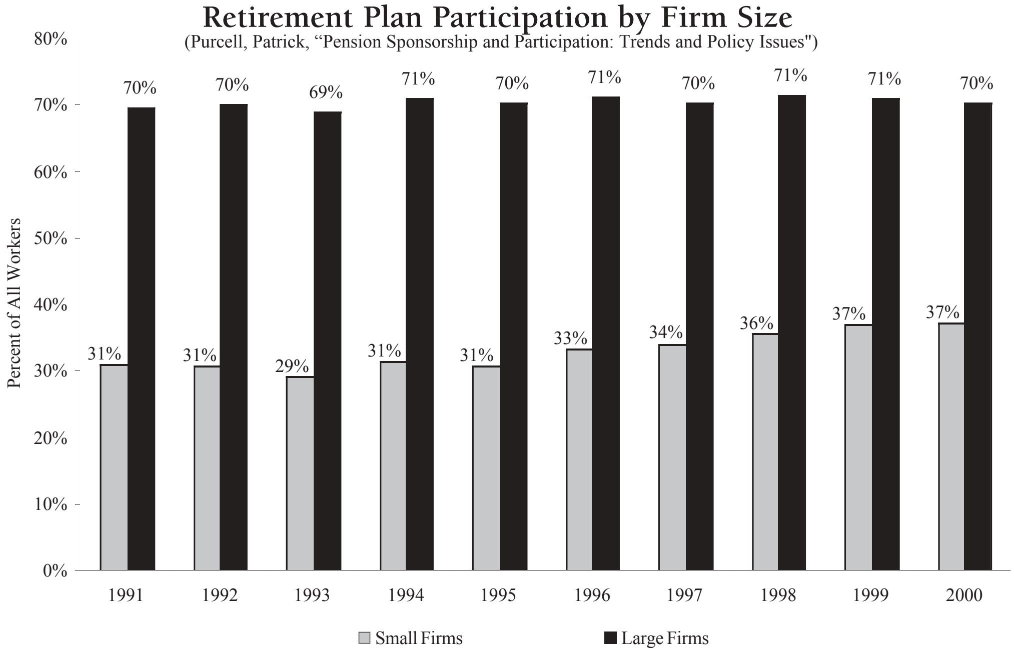
Another area of concern with respect to the availability of employer-sponsored plans is firm size. Private sector employment is bimodal, meaning that approximately the same number of employees work in large firms as do in small. Therefore, when considering plan sponsorship among small employers, it is important to remember that nearly 50 percent of the private-sector workforce works for small employers.

Graph 3
Availability of Retirement Plans by Firm Size
(Purcell, Patrick, "Pension Sponsorship and Participation: Trends and Policy Issues")



In general, larger firms are more likely to offer pension plans compared with firms that employ fewer than 100 employees. Approximately 81 percent of firms that employ 100 or more employees offer some retirement plan compared to only 44 percent of employers with fewer than 100 employees as shown in Graph 3. Participation rates for larger firms are approximately 70 percent for full-time workers (about 30 percent for part-time workers). Participation rates in smaller firms are significantly less: approximately 37 percent for full-time workers (about 20 percent for part-time workers) as shown in Graph 4. As is discussed below, the barriers to plan sponsorship can be a particular problem for small and mid-sized employers.

Graph 4
Retirement Plan Participation by Firm Size
(Purcell, Patrick, "Pension Sponsorship and Participation: Trends and Policy Issues")



The Leakage of Retirement Savings—Retirement assets do not contribute to retirement security if the assets do not accumulate. When workers take pre-retirement distributions and do not roll over their benefits to other tax-qualified savings, retirement assets begin to erode.

As mentioned, worker turnover often provides employees the ability to access their retirement savings balances prior to retirement. When workers change jobs, many receive the value of their retirement benefits in the form of a lump-sum distribution. Some will roll over such distributions to other tax-qualified savings to preserve their benefits. However, others may pay the income and penalty tax, taking pre-retirement withdrawals in lump sums to finance other spending.

With respect to lump-sum distributions resulting from a job change, EBRI finds that the size of the distribution and the recipient's age will influence the person's decision to spend or save the pension distribution.[12] As the size of the distribution increases, the individual is more likely to roll over the funds to another tax-qualified savings vehicle.[13] Not surprisingly, as the age at which a lump-sum distribution is received increases, the more likely the individual will preserve those assets rather than spend the assets. Approximately 25 percent of teens compared to 62 percent of those 50 or older saved their lump-sum distributions.

[12] EBRI Data Book, Chapter 9.
[13] The National Commission on Retirement Security Final Report indicates that individuals with smaller accounts are less likely to preserve those assets. Specifically, only 20 percent of distributions of less then $3,500 were rolled over into tax-deferred retirement accounts.

Many who receive lump-sum distributions report using those assets for a new home purchase, educational expenses, debt elimination or starting a new business. However, the most common use of pre-retirement distributions was other spending. Consequently, those individuals not only lost retirement assets, but also shortened their savings horizon and the corresponding gains from compounding interest.

Workforce turnover can also affect the accumulation of pension assets. It is not unusual for a worker to have many different employers throughout their employment history. Each transition to a new employer may mean a waiting period before the worker becomes fully vested in the plan. If the worker should move to another employer prior to vesting, the worker may lose accumulated benefits. Depending upon the type of plan, some benefits may move with the employee (fully portable); however, when workers are unable to transfer pension assets, the result is slower accumulations and lower yields for their retirement assets.

Accumulated Retirement Assets—Most studies confirm that about 60 percent of households have some type of retirement asset. However, it is more important to ask if the savings will be sufficient to maintain a person's or a family's pre-retirement standard of living. One general rule of thumb is that retirees will need to replace approximately 75 percent of their pre-retirement income to maintain their living standard. Circumstances will vary with each individual situation, suggesting that some will require greater savings and others less. For instance, the 75 percent replacement estimate assumes that retirees will have fewer household members during their retirement years and lower job-related costs in retirement. Often those owning their own home will have paid off their mortgage before retiring, lowering their overall need for higher income. One study estimates that only 44 percent of households will accumulate adequate retirement savings to maintain pre-retirement living standards throughout their retirement years.[14]

The likelihood of owning any retirement assets increases with age and educational attainment. As shown in Table 1, there is a greater prevalence of retirement savings as age and educational attainment rise.

Table 1

Prevalence of Retirement Assets by Age and Education

("Retirement Savings of American Households: Asset Levels and Adequacy", CP Montalto.)

Age	Reporting Any Retirement Asset	Educational Attainment	Reporting Any Retirement Asset
Less than 35 years	47.6%	Less than High School	37.5 %
35 to 44 years	67.1 %	High School	57.6 %
45 to 54 years	71.0 %	Some College	66.5 %
55 to 64 years	71.4 %	Bachelor's Degree	80.0 %
65 years and older	60.4 %	Graduate School	84.3 %

Estimates of adequate retirement savings rely on a life-cycle model that incorporates projected Social Security benefits, employer-sponsored and non-employer based retirement plans, as well as private savings. When evaluating the levels of saving and the adequacy of such savings, another important trend emerges. Specifically, higher income households are most likely to have adequate retirement savings. Approximately 54 percent of households with incomes between $50,000 and $100,000 will retire with adequate savings. Further, as income increases above $100,000, 69 percent of households will have adequate retirement savings.[14]

This direct positive correlation between adequate retirement saving and income makes intuitive sense. Low-income individuals frequently do not have the disposable income to make contributions to qualified retirement plans, even if they qualify to participate in such plans. The percentage of low-income individuals making IRA contributions is significantly lower than other income levels. Congress has recognized that low-income taxpayers face significant barriers to retirement saving by enacting a temporary tax credit (SAVER's Credit) to provide a greater subsidy for retirement contributions by low-income individuals. Under the temporary SAVER's Credit (which is due to expire in 2006), the Congress provides a special tax subsidy up to $1,000 for low-income individuals who make contributions to qualified cash or deferred arrangements, IRAs and certain other plans.

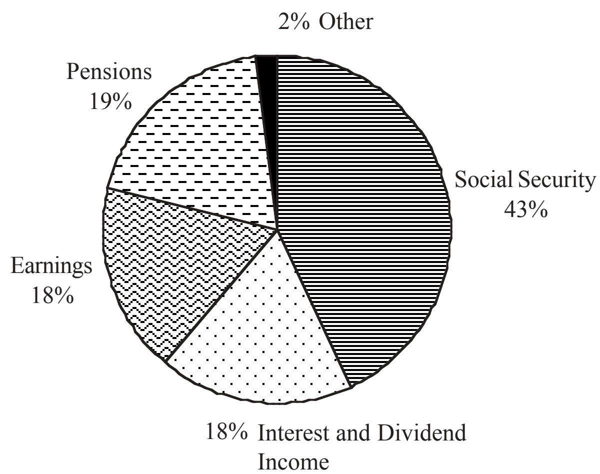
The likelihood of retiring with adequate savings also depends upon whether the individual participated in an employer-sponsored plan. Overall, 55 percent of households covered by employer-sponsored plans will have adequate savings compared to 24 percent of those without employer plans.[14]

Reliance on Social Security—When evaluating adequacy of retirement savings, most studies include Social Security. We know that Social Security is a pivotal part of most workers' retirement security. In fact, Social Security provided 43 percent of all income received by Americans aged 65 or older in 2002. Nearly two-thirds of the current 40 million Social Security recipients receive more than half of their retirement income from this source.[15] One current policy debate centers on reforming the Social Security system, which faces significant solvency issues in the future. Social Security will not have the legal authority to pay promised benefits when the trust fund balances are exhausted.[16]

[14] See Montalto, CP, "Retirement Savings of American Households: Asset Levels and Adequacy," for a further statistics and analysis.
[15] EBRI Data Book, 4th Edition, Chapter 7. See also, Ettlinger, Michael and Chapman, Jeff, "Social Security and the Income of the Elderly," EPI Issue Brief #206, March 23, 2005.
[16] While estimates vary about when that may happen, it is clear that the spend-down of the trust fund will begin as more of the baby boomer cohort begins to retire.

When Social Security reform takes place, retirees may need to rely much more heavily on qualified retirement plan savings and personal savings, making these forms of savings an even more critical component of retirement savings. However, most studies indicate that retirement savings, both in qualified retirement plans and private saving, are inadequate to substitute for the potential loss of Social Security income. Graph 5 shows the composition of current retirement income by category.

Graph 5
Composition of Retirement Income
(EBRI Data Book, 4th Edition, Chapter 7)



As current retirees do now, future retirees will have to supplement Social Security payments with personal savings. Financial experts tell us, however, that current levels of personal retirement savings are not nearly adequate to ensure financial independence for most Americans when they retire—even *with* pension and Social Security income. According to some estimates, the oldest baby boomer cohort is saving just one-third of what they will need to maintain their current standard of living during retirement.[17]

B. Qualified Retirement Plan Rules

Under current law, federal tax benefits are provided to encourage employers to establish qualified retirement plans on behalf of their employees. These retirement plans are classified into two broad categories—defined benefit pension plans and defined contribution plans. A defined benefit pension plan generally promises a plan participant a specific annual benefit payable when the

[17] US Congressional Budget Office, "Social Security and Private Savings: A review of the Empirical Evidence," July 1998.

participant retires. Under a defined contribution plan, a participant is entitled to the contributions (plus earnings) in an account that has been established on the participant's behalf. Under a qualified retirement plan, contributions may be made to the plan by the employer, by the plan participants or by both.

A significant difference between a defined benefit plan and a defined contribution plan is that the employer sponsoring a defined benefit pension plan bears the risk of investment losses. Thus, plan participants are entitled to their promised benefits at retirement irrespective of whether there are adequate assets in the plan. A minimum level of pension benefits is guaranteed by the Pension Benefit Guaranty Corporation in the event that a defined benefit pension lacks sufficient assets to pay promised benefits.

The employer-based qualified retirement plan system is a voluntary system. Employers are not required to establish or maintain qualified retirement plans. An employer that chooses to establish a qualified retirement plan is required to comply with a complex set of rules that govern a wide range of issues relating to the plan's operation, including: (1) the employees who are required to participate in the plan, (2) benefits that may be provided under the plan, (3) the extent to which the plan can favor highly-compensated employees, (4) contributions that may or must be made to the plan, (5) the tax deduction that is permitted for employer contributions to the plan and (6) disclosure of information to plan participants and the federal government. The plan must meet the approval of the federal government both in form and in operation. The costs of complying with these rules are a significant reason why many employers either do not establish or decide to terminate qualified retirement plans.

Plan Participation, Vesting and Nondiscrimination—The qualified retirement plan participation rules require that employers permit employees to participate in a qualified retirement plan as long as the employee meets certain minimum eligibility requirements. In general, employees who have one year of service with an employer and have attained age 21 must be entitled to participate in an employer's qualified retirement plan. However, certain classes of employees (*e.g.,* part-time and seasonal employees) can be excluded from plan participation. Employers in certain industries (*e.g.,* fast food) have significant turnover so that a large percentage of employees leave employment before becoming eligible to participate in an employer's plan. In addition to the minimum participation requirements, qualified retirement plans also are required to satisfy rules to prevent the plan from discriminating in favor of highly compensated employees.

Employees who participate in an employer's qualified retirement plan are required to become fully vested (*i.e.,* entitled to receive 100 percent of their accrued benefit upon termination or other payment events) after either five years of service with the employer or, if the plan uses a graduated vesting schedule, after seven years of service.[18]

[18] Employer contributions made in proportion to the employee's own savings are required to be vested faster—after three years, or using a graduated six year vesting schedule.

General nondiscrimination rules also apply to qualified retirement plans. A qualified retirement plan cannot discriminate in contributions or benefits in favor of highly compensated employees. In the case of certain plans, such as qualified cash or deferred arrangements [*i.e.,*401(k) plans], these nondiscrimination rules contain very detailed testing requirements to ensure that highly compensated employees are not disproportionately benefiting under the plan.

Together, the participation, vesting and nondiscrimination rules are designed to ensure that employer-sponsored qualified retirement plans benefit a broad-based group of employees. This is the price that employers and employees pay for the higher contribution and benefit limits that apply to qualified retirement plan savings compared to other tax-favored forms of retirement savings (such as IRAs).

Benefit Limits—Qualified retirement plans are subject to dollar limits on contributions and benefits. For 2005, the annual limit on benefits under a defined benefit pension plan is $170,000. The 2005 annual limit on contributions to a defined contribution plan is $42,000. The 2005 elective deferral limit (*i.e.*, the amount of compensation that an individual employee can elect to defer) for a qualified cash or deferred arrangement is $14,000.

The dollar limits on contributions to qualified retirement plans are significantly higher than the limits on other tax-favored forms of retirement savings, such as IRAs. For 2005, the limit on contributions to an IRA is $4,000 ($4,500 for taxpayers who have reached age 50). Thus, individuals generally prefer to save for retirement through a qualified retirement plan because they are able to accumulate greater retirement savings. See the discussion below of the tax benefits attributable to a qualified retirement plan.

Funding and Deductions—Employers who establish qualified retirement plans are subject to specific rules governing the plan's funding and the extent to which the employer can deduct contributions to the plan.

The rules governing defined benefit pension plans are particularly detailed and complex. These rules not only specify the extent to which an employer is required to make annual plan contributions to ensure that there will be adequate funds available in the plan to pay promised benefits, but also provide limits on employer contributions designed to preclude overfunding of a plan. Substantial taxes are imposed on the termination of an overfunded defined benefit plan if the excess assets revert to the employer. Defined benefit pension plans carry significantly higher costs to establish and maintain than defined contribution plans. For small to mid-sized employers, the burdens of complying with the rules for defined benefit pension plans often are prohibitively expensive.

Treatment of Withdrawals—The amounts participants withdraw from qualified retirement plans by plan participants are subject to restrictions on both the timing and the nature of the benefit payments. Participants may be subject to a 10 percent tax penalty if they make a withdrawal prior to retirement or the attainment of age 59 1/2, unless the amounts withdrawn are used for certain specified purposes.

In addition, a qualified retirement plan participant who is no longer working is required to commence receiving retirement benefits and paying tax on such benefits at age 70 1/2 whether or not the individual needs the retirement income at that time. This provision encourages the depletion of retirement savings without regard to the individual's specific needs of the individual.

C. Tax Benefits of Qualified Retirement Plans

Under current law, an employer is permitted, within limits, to deduct contributions to a qualified retirement plan. The contributions are made to a trust that generally is exempt from federal income tax. Employees who participate in these plans are not required to include amounts contributed to the plans in gross income until the amounts are withdrawn by the employee.

From a federal tax perspective, an employer is generally indifferent as to whether current wages are paid to employees or whether contributions are made on behalf of the employees to a qualified retirement plan because the employer generally is entitled to a current deduction with respect to both payments. Certain employer contributions to qualified retirement plans are also not subject to Social Security and Medicare taxes (employment taxes), so the employer and employee share of these taxes may be reduced.[19]

On the other hand, employees generally should prefer to have contributions made to a qualified retirement plan on their behalf because the contributions will reduce their current tax liability.[20] However, employees should be indifferent to receiving compensation in the form of contributions to qualified retirement plans and other forms of tax-favored compensation that permit the accumulation of savings on a tax-free basis.[21] Despite the federal tax benefits for saving for retirement in a qualified pension plan, some employees might prefer to receive compensation in the form of current salary if they have insufficient disposable income to meet their current needs.

[19] Economists generally believe that employees bear the incidence of these taxes.
[20] Certain employer contributions to qualified retirement plans are also excluded from income for purposes of calculating the employer and employee share of Social Security and Medicare payroll taxes. While this increases the incentive for retirement savings because it further lowers current federal tax liability, there is a trade-off for employees whose compensation is below the social security taxable wage base because their credits for social security benefits are reduced to the extent their current compensation is reduced. Thus, if an employer makes a contribution on behalf of an employee to a qualified retirement plan, the employee's current taxable compensation is reduced for income and employment tax purposes, but the employee's future social security benefits may be reduced as a result.
[21] Additional discussion of this issue is below. For example, under current law, certain tax benefits are provided for savings for education. These tax benefits not only provide a deferral of tax on the amounts contributed, but in some cases, the individual is entitled to a tax exemption for the withdrawal of amounts contributed. In such cases, the tax benefits of saving for education are more generous than the tax benefits attributable to qualified retirement plans.

Some of the reasons that an employer might prefer a qualified retirement plan over current wages include:

- The owner of the business might prefer to defer paying taxes on some of his or her own current income and a qualified retirement plan provides one mechanism for doing this;
- Employees have indicated their preference to have a qualified retirement plan; and
- The employer feels that it has an obligation to assist employees in saving for retirement.

The desire of a business owner to defer paying taxes on some of his or her own current income is likely a significant factor in the formation of a qualified pension plan by small and mid-sized firms.

On the other hand, employers might prefer to pay current wages instead of contributions to a qualified retirement plan because:

- There are significant regulatory burdens and costs to establishing and maintaining a qualified retirement plan;
- Certain types of qualified retirement plans (*e.g.*, defined benefit pension plans) require a long and ongoing commitment of contributions and the employer may be concerned for various reasons (*e.g.*, projected profits) to take on such a commitment; or
- Employees do not prefer to have contributions made to a qualified retirement plan (*e.g.*, if the employees generally are lower paid and cannot afford to save for retirement).

***Value of Tax Benefits of Qualified retirement plans to Employees*—**From an economic perspective, the tax benefits of a qualified retirement plan are generally equivalent to a permanent exemption from tax of the earnings on contributions made to the plan. This principle can be illustrated with the following example:

> Assume that a $10,000 contribution is made to a qualified retirement plan on behalf of an employee. Assume that the employee's marginal tax bracket is 28 percent, so the employee would have $2,800 of current income tax if the contribution had been received as taxable compensation. Assume that the $10,000 earns an 8 percent return ($800) in Year 1 so at the end of Year 1; there is a balance of $10,800. Further assume that the $10,800 is withdrawn at the beginning of Year 2 and no penalty taxes apply to the withdrawal. In Year 2, the amount withdrawn is subject to $3,024 of tax ($10,800 times 28 percent), leaving a balance of $7,776.

If the taxpayer had received instead taxable compensation and invested in a taxable account, he or she would have had $7,200 [$10,000 minus $2,800 (the tax on the compensation)] to invest. The earnings on this amount at 8 percent would be $576, subject to tax of $161.28 for a net of $414.72. Thus, upon withdrawal, the taxpayer would have $7,614.72.

The difference in what the taxpayer has available under the two options ($7,776 versus $7614.72) is the $161.28 tax on the earnings. It should be noted that, if the taxpayer is in a different marginal tax bracket when the withdrawal is taken, the tax benefits will be different (see the example below).

In addition to the value of the exemption of earnings from tax, the contributions that are made on an employee's behalf to a qualified retirement plan may reduce the employer and employee share of employment taxes that are owed.[22]

The value of tax incentives for savings is further illustrated in Table 2. For this purpose, tax-preferred retirement savings refers to plans that allow taxpayers to deduct from taxable income their contributions to such plans and accumulate earnings on the account on a tax-deferred basis.[23] In this form of savings, withdrawals are fully taxed. Tax-free savings refers to plans (such as Roth IRAs) in which contributions are made on an after-tax basis (*i.e.,* no deduction or exclusion for contributions), earnings accumulate tax-free, and there is no tax on withdrawals.

Tax-preferred savings, through an employer plan and through personal savings, may have a positive effect on the saving decision. In general, the current tax incentives encourage tax-preferred savings (*e.g.,* retirement savings) over savings for other purposes. The advantages of tax-preferred savings are that taxpayers earn a tax-free rate of return on their investments and postpone their tax liability until retirement, when presumably they have a lower tax rate. Table 2 compares the benefits of tax-preferred and tax-free savings plans to a taxable savings plan. In this example, a taxpayer who is in a 28 percent marginal tax bracket has $10,000 of compensation available for savings and investment. The initial contribution (minus income taxes, where applicable) accumulates for ten years at 8 percent annual interest and is withdrawn when the taxpayer is in a 15 percent marginal tax bracket.

[22] This exemption from employment taxes does not apply to elective deferrals under a qualified cash or deferred arrangement. In addition, the exemption may reduce the amount of social security benefits to which an individual is ultimately entitled.
[23] In addition to traditional defined benefit and defined contribution plans, this includes IRAs, 401(k) and other contributory savings plans.

Table 2
Compare Tax-Preferred. Tax-Free and Fully-Tax Savings Plans
Amount Available for Deposit = $10,000
Interest Rate = 8%
Tax Rates = 28% (pre-retirement) and 15% (retirement)
Years of Accumulation = 10

	Tax-Preferred	Tax-Free	Fully Taxed Savings
Initial Deposit	$10,000	$7,200	$7,200
Accumulated Balance	$21,589	$15,544	$12,605
Available after paying tax	**$18,350**	**$15,544**	**$12,605**

As the above example indicates, an individual saving $10,000 in a tax-preferred savings vehicle generally will have a greater amount to invest, because the dollars are pre-tax dollars. If the tax rate is, indeed, lower at retirement, the benefits of the tax-preference remain. It is important to note that the majority of taxpayers will face a lower tax rate at retirement. Therefore, the benefits of the tax deduction and inside buildup are measurable.

If a taxpayer faces the same marginal tax rate in retirement as he or she does when a contribution is made, the effect of the tax-deferred and tax-free savings vehicles would be equal. As noted above, these plans generally provide the equivalent of an exemption from tax for the earnings on the amounts contributed. In reality, most taxpayers face a lower tax rate in retirement than during their working years, so if all other things are equal, they should prefer the tax-deferred form of saving to the tax-free form.

Compared to other savings, tax-preferred or tax-free retirement savings may encourage individuals to save for retirement. However, as the types of tax-preferred savings vehicles increase, there is a danger that savings become diluted as individuals direct their tax-preferred savings to shorter-term savings needs (*e.g.*, first time home purchase or higher education for child or spouse).

II. Effect of Tax Reform On Qualified Retirement Plan Savings

The tax benefits available for retirement savings through an employer-sponsored qualified retirement plan often are not sufficiently large to overcome the substantial costs that employers must incur to establish and maintain these plans. This fact is particularly true for small and mid-sized employers. The statistics on plan formation and termination bear this out by showing that small and mid-sized employers are much less likely to establish qualified retirement plans (only 44 percent of employers with fewer than 100 employees establish plans) and much more likely to terminate the plans that they do establish (see graph 3).

In addition, certain statutory provisions that either provide tax incentives for non-retirement saving or specifically discourage retirement savings impact the amount of retirement savings that accumulate under current law. These provisions include preferential tax rates for capital gains and dividends, tax incentives for such other types of savings such as health savings accounts and education savings accounts, and limits on the amount of qualified retirement savings.

Despite the fact that there is a recognized need to encourage individuals to save for retirement, few policymakers focus on the devastating effect that various tax reform proposals may have on saving for retirement. While many focus on the advantages or disadvantages of a consumption tax as an addition to or alternative to the current law income tax system, few are aware that the switch to a consumption tax system or an elimination of the tax on capital gains and dividends will likely result in an alarming reduction in individuals' retirement saving.

This section provides an overview of the current tax provisions of current law that potentially affect a taxpayer's decision to save for retirement and provides an overview of the potential direction of various tax reform proposals.

A. Tax Provisions That Affect Retirement Savings

Capital Gains and Dividends—Reductions in capital gains rates have long been touted as a way to stimulate the economy, reduce the economic distortions of current law that favor debt versus equity and increase national savings. Reduced capital gains and dividend tax rates make investments in stock and other capital assets more tax favored relative to other investments.

Under current law, capital gains generally are subject to tax rates below the ordinary income tax rates. The gains are included in income when they are recognized, which generally occurs when the asset is sold or otherwise disposed of. Long-term capital gains generally are subject to tax at a maximum rate of 20 percent (10 percent for income that would be subject to ordinary income tax at a 15 percent rate). From 2003 through 2008, these rates are reduced to 15 percent and 5 percent, respectively (the 5 percent rate is reduced to zero in 2008).[24] After 2008, the 20 percent/10 percent rate structure again applies.

These reduced tax rates also apply to dividends received by individuals for 2003 through 2008.[24] After 2008, dividends received by individuals are subject to tax at ordinary income tax rates.

Lower tax rates on capital gains and dividends can affect an individual's decision when making investments in retirement savings. All amounts withdrawn from qualified pension plans are subject to income tax as ordinary income.

There is a significant disadvantage to investing qualified retirement plan assets in stocks and capital assets because of the greater tax advantages available if the assets are held directly by individuals. For example, if a qualified pension plan holds a capital asset that was purchased for $1,000 and sold for $10,000, the $9,000 of capital gain will be taxed at ordinary income rates when it is distributed to a plan participant. A taxpayer in the 28 percent marginal rate bracket would pay $2,520 ($9,000 x .28) of federal income tax. If the same taxpayer held the capital asset directly, rather than through a qualified pension plan, he or she would pay $1,350 of federal income tax ($9,000 x .15) on the gain.

If the current tax provisions imposing a 15 percent/5 percent rate structure for capital gains and dividends expire as scheduled, the tax advantage to holding capital assets and stocks directly is reduced, but not eliminated, as the rates return to 20 percent/10 percent. Taxpayers still have an incentive to reduce their holding in capital assets in qualified retirement plans and increase their personal holdings in taxable capital assets. In the example above, the taxpayer would pay $1,800 ($9,000 x .20) of federal income tax if the capital asset is held directly, rather than $2,520 if the asset is held in a qualified retirement plan, which is still a substantial difference in tax benefits and one that makes saving outside the qualified retirement plan more attractive.

Furthermore, it is important to remember that withdrawals from qualified pension plans may be subject to an early withdrawal penalty if they occur prior to retirement. On the other hand, as long as a capital asset is held for at least one year, the reduced tax rates apply. In general, taxpayers can control the timing of taxation on capital gains by selling the asset when the gains are needed. Thus, an additional advantage of holding capital assets directly is that taxpayers can avoid paying any penalty taxes for accessing their gains.

[24] Various other special provisions apply to specific types of capital gains, so lower or higher rates may apply depending upon the nature of the investment. For example, capital gains on collectibles generally are taxed at either 15 or 28 percent.

Similarly, taxpayers who invest directly in capital assets may hold the asset as long as they want, whereas taxpayers whose assets are invested in qualified retirement plans are generally required to begin receiving distributions (and, therefore, paying federal income tax) at the later of (1) attainment of age 70 1/2 or (2) retirement.

The bottom line is that taxpayers with adequate resources can effectively establish what amount they will accumulate for retirement by investing their money in capital assets and dividend-producing stocks. Taxpayers can time the recognition of their capital gains to match their income needs in retirement. Taxpayers who need to access funds at an earlier time will not be subject to any specific tax penalty as long as they have held a capital asset for at least one year. Furthermore, there are no limits on the amount of tax-favored investments that can occur in this manner, unlike qualified pension plans, which are available on a dollar-limited basis.

This incentive to invest outside of qualified retirement plans may, over time, reduce small business owners' decisions to offer qualified retirement pension plans as they find that the costs and administrative burdens of maintaining qualified retirement plans, combined with the favorable tax treatment of capital gains and dividends, make saving in qualified retirement plans far less attractive than personal savings.

This situation is most relevant to small employers, with one or two more highly compensated employees and several lower-compensated employees. As the costs and administrative burdens rise, the small employer is more likely to view other savings options as more attractive than sponsoring a qualified retirement plan. The small employer could eliminate the qualified retirement plan and offer bonuses to his employees. By depositing the after-tax bonus in stock or equity investment funds, the favorable capital gains and dividend tax treatment could provide benefits greater than or equal to those in the qualified retirement plan—with far less effort and expense.

In addition to the current tax incentives for saving for retirement, there are a number of tax incentives for "special purpose" saving. The two most significant "special purpose" federal tax incentives are the incentives for savings for education and those for health savings accounts (HSAs).

Tax Incentives for Education Savings—The tax incentives for saving for education may take one of two principal forms—Section 529 qualified tuition programs and Coverdell education savings accounts. A qualified tuition program is established by a state or a qualified educational institution to provide a mechanism for higher education saving.[25] Amounts contributed to such a program are not deductible, but the earnings accumulate on a tax-free basis and withdrawals used for qualified education expenses are not included in income. There is no dollar limit on contributions to a qualified tuition program. However, withdrawals not used for qualified

[25] Certain of the special provisions for qualified tuition programs expire at the end of 2011.

education expenses are included in income and subject to a 10 percent penalty tax. Because the exclusion from income is available only for withdrawals for qualified education expenses, there is an inherent limit on the amount of savings invested under these programs.

A Coverdell education savings account is a trust or custodial account where contributions are made for a beneficiary who generally is under age 18 (unless the beneficiary has special needs) to save for qualified education expenses. The maximum annual contribution to a Coverdell education savings account is $2,000 (after 2011, the annual contribution limit becomes $500). The annual contribution limit is phased out for taxpayers with income above certain levels. The amounts contributed to a Coverdell education savings account are not deductible, but the earnings grow on a tax-free basis and withdrawals used for qualified education expenses are not included in income. Like the qualified tuition program, withdrawals that are not used for qualified education expenses are included in income and subject to a 10 percent penalty tax. The allowable qualified education expenses for purposes of a Coverdell education savings account are broader than those for a qualified tuition program because they include expenses for elementary and secondary education.

In addition to the qualified tuition programs and the Coverdell education savings accounts, current tax provides an exclusion from income for interest earned on qualified US Series EE savings bonds issued after 1989 to the extent the proceeds of the bond do not exceed the qualified higher education expenses of the taxpayer during the year.

The tax benefits attributable to qualified tuition programs and Coverdell education savings accounts are similar to the tax benefits attributable to saving in a Roth IRA. Contributions are not deductible, earnings are excluded from income and withdrawals are not subject to tax (provided the withdrawals are used for the permitted purposes). If a taxpayer's marginal tax rate remains the same over time, this tax treatment is equivalent to the treatment accorded to qualified retirement plans in which the initial contribution is not taxed, earnings are tax free and withdrawals are included in income.[26]

The tax incentive for saving through a qualified tuition program or a Coverdell education savings account is in general equivalent to the incentive to save in a qualified retirement plan. However, fewer taxpayers are likely to anticipate that they will incur qualified education expenses eligible for the special tax treatment. While any taxpayer can ultimately utilize the favorable tax benefits of qualified retirement plan saving, only those taxpayers who actually have qualified education expenses will enjoy the full benefit from these education tax incentives. Thus, it is likely that the saving for education will attract a more narrow class of taxpayers who anticipate such expenditures.

[26] In reality, the taxpayer who receives a withdrawal from one of these programs may be in a lower tax bracket than the taxpayer who made the initial contribution to the program or account.

Yet saving in these plans may encourage some taxpayers to divert retirement savings to educational savings, as most families have limited resources for savings. The addition of such plans provides a competing, not complementary, form of savings.

Also, because saving under a qualified tuition program is not dollar-limited, those taxpayers who anticipate incurring qualified higher education expenses have a substantial incentive to make contributions to such a program to take advantage of the tax saving.

In addition, taxpayers who do not anticipate incurring qualified education expenses might also find the vehicles attractive. This is because, under certain situations, the 10 percent penalty tax on withdrawals not used for qualified education expenses may not fully cancel the tax advantages of these programs relative to a taxable account. Thus, for a taxpayer whose retirement saving is limited by the dollar limits for qualified retirement plans, the education savings vehicles may still provide an attractive form of tax-favored savings.

***Tax Incentives for Health Savings*—**Current law provides tax incentives for savings for health care expense through HSAs. These accounts are a tax-exempt trust or custodial account created exclusively to pay qualified medical expenses. The accounts are similar to IRAs. However, in some cases, the tax advantages of HSAs are more favorable than those for qualified requirement savings. Contributions to an HSA are deductible, earnings grow on a tax-free basis and withdrawals from the HSA for qualified medical expenses are excluded from income. Thus, by providing an exclusion from income for such withdrawals, an HSA provides a greater tax benefit than qualified retirement saving.[27]

An individual must have coverage under a high deductible health plan and have no other health plan to make contributions to an HSA. In general, the annual limit on contributions to an HSA is $2,650 (for 2005) for a taxpayer with self-only coverage and $5,250 for a taxpayer with family coverage. The annual limit increases for individuals over age 55. A high deductible health plan has a deductible of at least $1,000 for self-only coverage and $2,000 for family coverage.

While the annual dollar limits on the deduction are relatively low, HSAs are likely to be attractive savings vehicles, because they offer benefits that are greater than those offered by qualified retirement savings. Because HSAs are fairly new savings vehicles, it is likely that their use will continue to grow. It is too early to have any reliable statistics on HSA use.

[27] Withdrawals that are not used for qualified medical expenses are subject to both an income and a 10 percent penalty tax.

Limits on Qualified Retirement Plan Savings—Recent legislation has continued to erode the tax incentive for qualified retirement plan saving by introducing different tax incentives for different forms of saving. As more and more taxpayers begin to consider alternative tax-favored forms of saving, the dollar limits that apply to qualified retirement savings are likely to continue to be a deterrent to the establishment and maintenance of qualified retirement plans by small and mid-sized businesses.

It is important to recognize that a major impetus to small business owner forming a qualified retirement plan is the ability to shelter the owner's current income from tax. The limits on contributions and benefits under qualified retirement plans can be juxtaposed against the substantial costs of establishing and maintaining a qualified retirement plan.[28] Ultimately, a small business owner may conclude that other forms of tax-favored savings that do not entail such costs are a more efficient use of the owner's resources.

B. Direction for Reform

Advocates of tax reform—those seeking to overhaul the income tax system—are encouraging the move toward consumption taxes (pure consumption or national sales tax) and away from income taxes. Any minor tax change creates winners and losers. Such a dramatic reform would generate considerable change and inevitably, raises many questions about who wins or loses. We focus our attention on the effect major tax reform might have on retirement savings, both from the perspective of individual savings and retirement security and of the desire or willingness of employers to offer retirement plans as a part of total compensation.

[28] For 2005, the dollar limit on contributions to a defined contribution plan is $42,000. The dollar limit on benefits under a defined benefit pension plan is $170,000.

III. Closer Look at The Impact—Effect On Qualified Retirement Plans

A. Consumption-Based Taxes

In principle, the difference between a consumption tax and income tax is the treatment of savings. Consumption is income less savings. Conversely, income is equal to consumption plus savings. These simple identities form the basis for either taxing consumption or income.

Economists define income as anything that increases an individual's ability to consume. Thus, income includes compensation for services, rents, royalties, life insurance proceeds and alimony. Under a pure income tax, anything that increases the ability to consume is income that is subject to tax. Under a pure consumption tax, taxpayers must consume a portion of their income or savings to incur a tax liability. Therefore, if a person chooses to delay consumption and save their income, they will also delay the tax until such time as they consume their savings.

In a pure income tax world, all income (both from capital and labor) is subject to tax. In a pure consumption tax world, only amounts spent on goods and services are subject to tax. However, in the real world, any tax system—whether income or consumption tax—might exhibit characteristics of one or the other or combine elements of both tax systems.

For example, under our present income tax system, we treat certain tax qualified savings as if it were savings in a consumption tax world. In other words, we allow taxpayers to deduct from income amounts saved in a tax-qualified retirement plan and exempt from income any earnings on that savings until amounts are withdrawn at retirement when withdrawals are then treated as income.

Excluding contributions to qualified pension plans and IRAs from current income in essence provides consumption tax treatment for these amounts by excluding them from income when they are contributed and taxing them only upon withdrawal.[29] Because the contributions to these plans and accounts are limited under current law, the consumption tax treatment is limited to the permitted dollar limits on contributions. Similarly, current law provides consumption tax treatment for unrealized capital gains and to the extent that certain capital expenditures can be expensed by small businesses. However, because current law provides limited consumption tax treatment for specific items, many argue that current law provides consumption tax treatment for certain income as a way of encouraging specific behavior by taxpayers, such as retirement saving.

In general, consumption taxes tax the purchase or use of goods and services and therefore, by their nature, favor savings. Consumption taxes make it more expensive to purchase goods and

[29] It should be noted that Roth IRAs are essentially equivalent to deductible IRAs by taxing the income that is contributed to a Roth IRA and providing an exclusion from income for any withdrawals, as long as the tax rate faced by the taxpayer is the same when a contribution is made and when a withdrawal is taken.

services. Thus, the less a taxpayer consumes and, therefore, the more he or she saves, the less tax is paid. A consumption tax could replace the current federal income tax, or supplement the income tax with a separate revenue raising structure.

Consumption taxes may take a variety of forms. These include the value-added tax (VAT) or retail sales tax and consumed income tax. There are two features that distinguish the various types of consumption-style taxes—the source of the tax revenue and the source of the tax burden. In general, with a VAT the producer pays the tax and wages or workers bear the tax burden (depending upon whether there is a tax on old capital). With retail sales and consumed income taxes the consumer pays the tax and all consumers share the tax burden, regardless of their employment status.

Value Added Tax—The most common form of consumption tax used throughout the world is the VAT. A value-added tax generally is a tax imposed and collected on the "value added" at every stage in the production and distribution process of a good or service. Although there are various ways to compute the value added (***i.e.***, taxable base) for a VAT, in general the amount of value added are the difference between the value of sales (outputs) and the value of purchases (inputs) of a business.[30]

An important feature of a consumption-style VAT is that a company's investment is expensed rather than depreciated, causing the effective tax rates on investment to be zero with full expensing. Rather than taxing directly the investment, the return from the investment generates the tax. This return is the increase in value of the goods and services generated by the investment.

Another way to think about the VAT is in terms of the value of the inputs—labor and capital. During the production process, the labor and capital inputs add value as the product moves from raw materials to finished goods. If all new investment avoids tax through expensing, the labor through the value of their wages and old capital would bear the burden of the VAT.

When considering tax reform that relies on a VAT, it is important to consider the impact on old capital or capital acquired before tax reform. This distinction between old and new investment is an important one. Because of this distinction, the transition from an income tax system to a VAT system would not flow seamlessly. If the new VAT does not impose taxes on old capital, then the VAT becomes purely a wage tax. However, if old capital is subject to tax, then capital is taxed twice—once under the former income tax system and again through the VAT system.

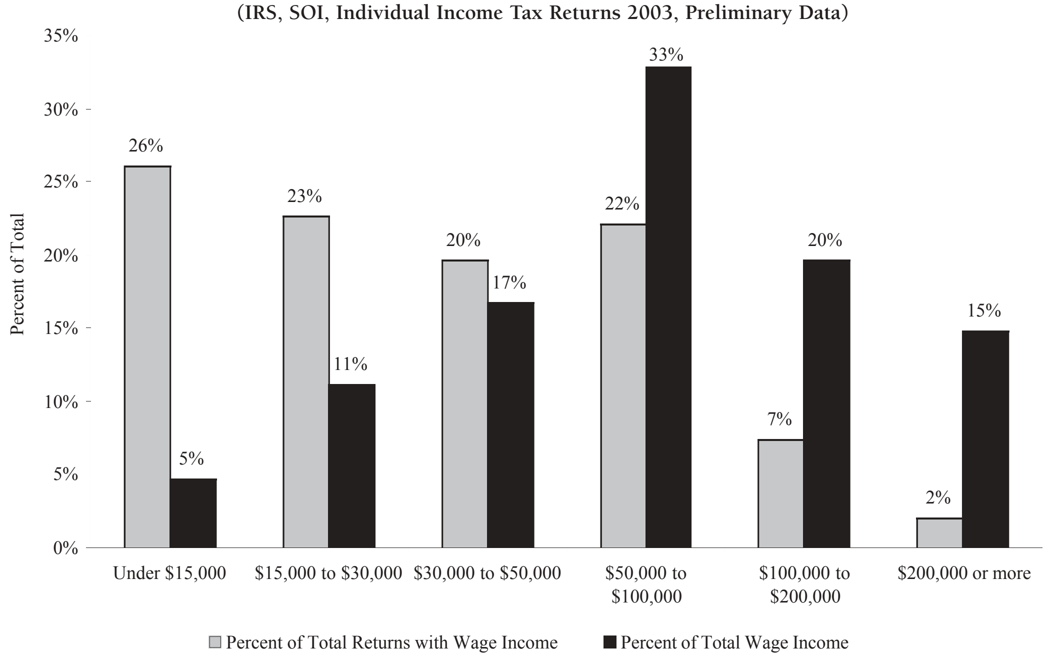
The VAT also differs from other forms of consumption taxes in the way that other assets avoid tax. Consider for example, a person who discovers a valuable resource on otherwise worthless land or a

[30] There are two primary types of VAT—the credit invoice method and the subtraction method (sometimes referred to as a business transfer tax).

person who develops an idea. Under a VAT, consumption from the proceeds of the resource or the idea would escape tax. Generally speaking, any consumption financed with savings acquired prior to the VAT would also avoid tax.

These simple situations suggest more complicated policy questions to consider when thinking of implementing a VAT under tax reform, specifically whether the VAT would be more or less progressive (regressive) than the current income-based tax system. While the answer to that question is complicated, some simple statistics provide an intuitive indication to that answer. Consider first the income distribution of those earning wages. Graph 6 shows the wage income (as a percentage of total wage income) and returns reporting wage income (as a percentage of total returns) distributed by income class. The percentage of returns is concentrated at the lowest income levels, but upper-middle income returns report the greatest share of wage income.

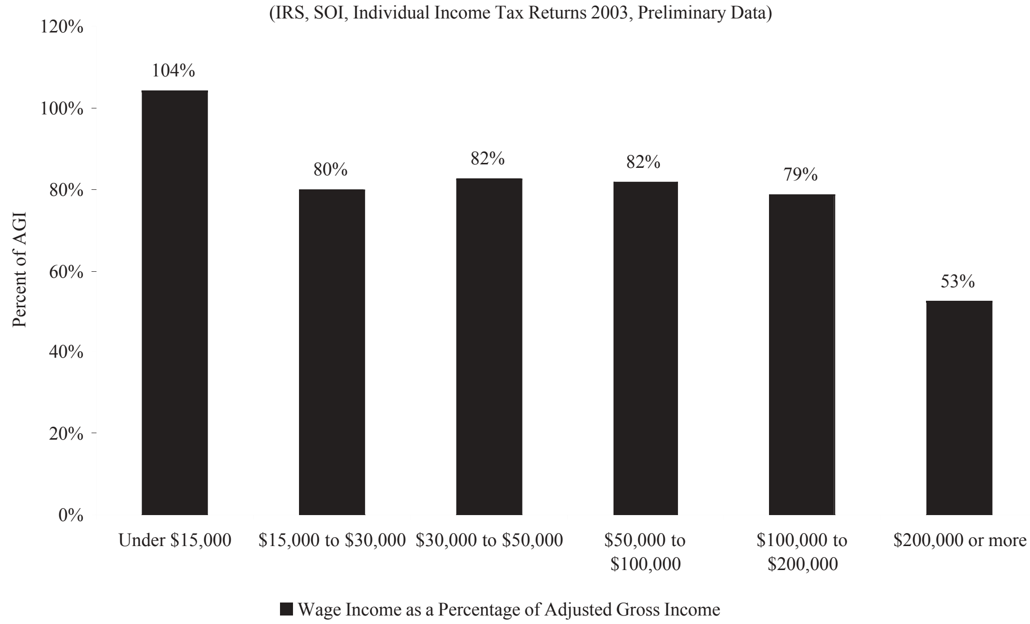
Graph 6
Wage and Salary Income, Percent of Total Return and Percent of Total Wage and Salary Income, 2003
(IRS, SOI, Individual Income Tax Returns 2003, Preliminary Data)



It appears based on gross reporting of wage and salary income that a VAT that derives its value from wages would derive its greatest source of revenue from higher income classes. However, consider wage income as a percentage of total adjusted gross income and a different picture emerges as shown in Graph 7. Wage income comprises the majority of income for the lowest income classes.[31] As incomes rise, the VAT derives tax on a smaller share of total income, as defined under the present system.

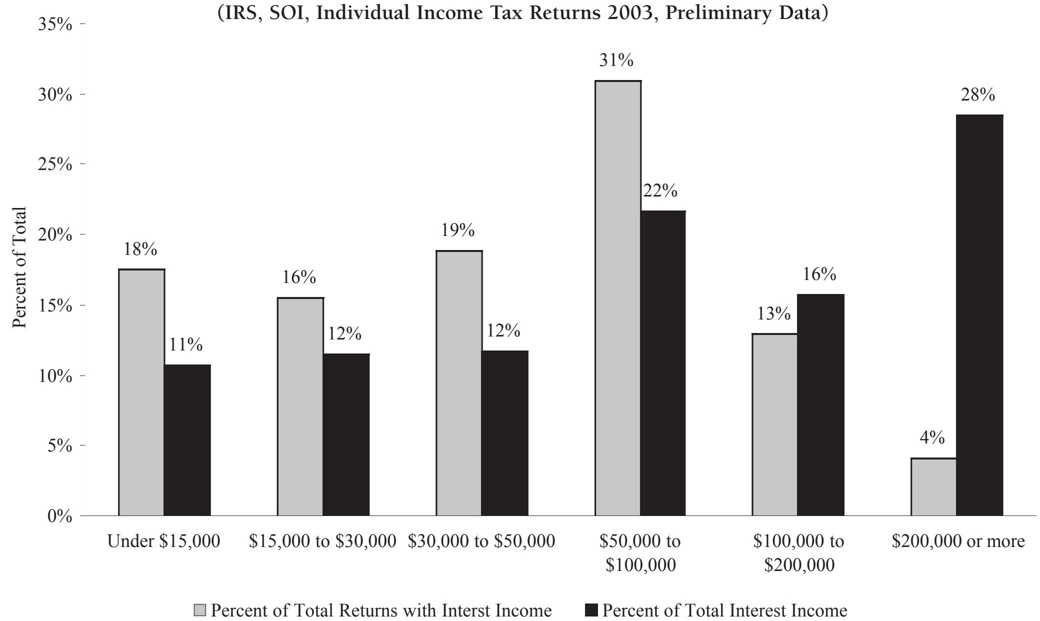
[31] Note that adjusted gross incomes for the lowest income classes typically include net capital losses, making wage income greater than the total.

Graph 7
Wage Income as a Percentage of AGI, 2003



If a VAT does not tax old capital or assets accumulated before implementing a VAT consumption financed by such assets is not subject to tax. As one might expect, the accumulation of assets is positively correlated with income as Graph 8 suggests, which considers interest income as a proxy for the base of accumulated assets. As incomes rise, the percent of total taxable interest income also rises. This positive correlation reinforces the fact that savings is positively correlated with income and that lower income households generally do not save outside employer-sponsored plans.

Graph 8
Taxable Interest Income as a Percent of Total Returns and Total Interest Income, 2003
(IRS, SOI, Individual Income Tax Returns 2003, Preliminary Data)



National Retail Sales Taxes—Retail sales taxes are a common form of consumption tax used by state and local governments. Under a national retail sales tax, goods and services sold to households would be subject to sales taxes.[32] However, only the new sales or production is subject to tax. Sales of used goods or previously owned items would not constitute retail sales.

In general, a national retail sales tax would tax all goods and services. Note that state and local governments generally exempt from the base such items as food, housing and health care. However, if certain goods and services are exempt from the national sales tax, the rate must increase.[33]

Advocates of this approach believe that a flat tax would apply to all retail sales, and that this flat tax would greatly simplify the tax system. Further, they believe that a retail sales tax would eliminate the need for deductions, exemptions and tax preferences. Taxpayer compliance and tax administration would focus on the base of retail sales, rather than the income generated to pay for those sales. Advocates of national sales tax proposals suggest lower tax rates would be revenue neutral, but generally do not consider compliance costs and tax avoidance schemes.

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[32] Business-to-business and household-to-household transactions would qualify as retail sales.
[33] Some studies estimate that a budget-neutral move to a national sales tax from the present income tax would require a 60 percent tax rate. The 60 percent tax rate is a "tax-exclusive" rate. The tax-inclusive rate is 38 percent. See Gale, William, "National Retail Sales Tax," Brookings Institute, 2004.

Whatever the sales tax rate, it is important to consider that most states impose sales taxes in addition to state income taxes. Eliminating the federal income tax system would require states to increase their sales tax rates.

With respect to existing savings, imposing a national sales tax raises equity issues. Consider a person in retirement that finances consumption exclusively from retirement savings and Social Security income. Assume that the individual's annual Social Security benefits are $9,000 and retirement benefits are $6,000 for a combined retirement income of $15,000. Under present law, with limited income, the Social Security benefits are not taxable. After a personal exemption and standard deduction, the retirement income is also not taxable. This retiree would not pay any federal income taxes under the present system. However, under a national retail sales tax, every dollar spent would include sales taxes. Regardless of the rate, 20, 30 or 60 percent, this represents a significant tax increase and a reduction in consumption for retirees.

Moving from an income tax system to a national sales tax system raises many questions with respect to the tax treatment of existing savings, both tax-preferred savings and after-tax savings. Such distinctions create the need for complex transition rules or potentially excluding certain items from the retails sales tax base. However, as mentioned above, reducing the tax base would increase the sales tax rate.

Consumption represents a larger share of income for lower income households. A recent Tax Policy Center publication estimated the amount of income spent on consumption. They estimated that households with incomes between $10,000 and $20,000 per year spend 75 percent of their total income on food, housing and clothing. Households with incomes greater than $200,000 spend approximately 16 percent on these necessities. Overall when considering consumption of both necessities and other goods, low-income families consume virtually all of their income, compared to their high-income counterparts that consume approximately 37 percent.[34] Implementing a flat national retail sales tax rate on all consumption would create a regressive tax system compared to the current income tax system, by taxing a greater share income earned by low income households compared to higher income households.

However, if policy makers wished to minimize the regressive nature of a national retail sales tax, they have limited options. Ideally, one might to impose different rates by income class. However, to do so means that tax rates would gradually increase with income to create a more progressive

[34] See Burman, Leonard and Troy Kravitz, "Lower-Income Households Spend Largest Share of Income," Tax Analysts, Tax Facts, Tax Policy Center, November 8, 2004.

tax system. Functionally, this would be impossible, because retailers would not be able to determine the right level of tax at the time of purchase. In order to make a retail sales tax more progressive, policy makers would have to exclude certain goods and necessities from the tax base. Again, excluding items from the base would necessitate increasing the tax rates that consumers would face.

Consumed Income Tax—In addition, a consumption tax could be constructed in a manner that retains the current law structure of the federal income tax, but imposes a zero tax rate on a taxpayer's savings; this is commonly referred to as a consumed income tax. For example, the current tax structure could be modified to provide an exclusion from the income tax for all amounts contributed by a taxpayer to a savings account. This approach would provide a current deduction for contributions to a specified savings account and an exemption from tax for earnings on the account. Under this approach, withdrawals from the savings account would be taxed as income because these amounts represent negative savings. Also, rarely mentioned, loans received by individuals and used for consumption would also be subject to tax.

The consumed income tax would again favor higher income taxpayers who consume only a small portion of their income. Further, from a policy perspective, this tax also raises issues about the distribution of wealth and wealth accumulation. Much of the wealth in our country remains concentrated in a small segment of our total population. Moving to a consumed income tax system would further this concentrated wealth accumulation and expand the wealth distribution. Since low income households spend all or most of their incomes, they are unable to save outside qualified retirement plans and would not accumulate any personal savings.

One might assume that taxing consumption and excluding all savings from tax might produce greater retirement savings and improve overall income security for retirees. However, looking more closely at the effects of tax reform on qualified retirement plan savings offers a very different conclusion.

Possible Effects of a Consumption Tax System on Qualified Retirement Plans—As we have discussed above, from a tax perspective, employers generally are indifferent with respect to whether they pay current wages or make contributions for employees to a qualified retirement plan. However, for a small employer, the regulatory and maintenance costs attributable to a qualified retirement plan are a significant deterrent to establishing and maintaining such a plan. Often, employers will establish the plans because the business owner or employees wish to use available tax benefits for themselves.

Current law can be viewed as having a consumption tax component to the extent that there is a tax benefit provided for savings. However, under current law, only specified types of savings are given favorable tax treatment, which provides a powerful incentive for savings to occur in the favored form. From an individual's perspective, saving for retirement is one of the more tax-favored forms of saving. The limits on the amounts that can be saved on a tax-favored basis are considerably greater for retirement savings than for other forms of savings, such as savings for education.

The introduction of a consumption tax, either as an alternative to the current tax system or in addition to such a system, fundamentally alters the decision to establish and maintain a qualified retirement plan. Under a consumption tax system, whether an employer makes contributions to a qualified retirement plan will not affect the employer's tax liability or the employee's tax liability. Consequently, there would no longer be any tax incentives to establish and maintain a qualified retirement plan within its accompanying distribution restrictions.

Effect of a Consumption Tax System on Withdrawals from Existing Qualified Retirement Plans—A significant issue to be addressed if a substantial consumption tax system is adopted is the proper treatment of existing assets in qualified pension plans. Under current law, if a participant makes a withdrawal from a qualified retirement plan, the withdrawal is treated as taxable ordinary income and may be subject to a 10 percent early withdrawal penalty tax.[35] The early withdrawal tax generally is intended to discourage the use of retirement savings for nonretirement purposes. However, if taxpayers are generally encouraged to save under a consumption tax system, will the penalty tax continue to apply? If the penalty tax continues to apply to qualified retirement plan withdrawals for nonretirement purposes, then taxpayers who want to consume a portion of savings will likely consume from general savings rather than from their retirement savings. In a sense, the continued imposition of the penalty tax would continue the current tax incentive to use savings in a qualified retirement plan for retirement purposes only.

On the other hand, if general savings face a potential consumption tax, some might argue that it is inequitable to impose a penalty on consumption from one source of savings rather than another. Since money is fungible, it does not necessarily make sense to impose a penalty on consumption from one particular source of savings.

[35] The early withdrawal penalty tax does not apply if the withdrawal is made (1) on or after the participant attains age 59 1/2, (2) to a beneficiary after the death of the participant, (3) on account of the participant's becoming disabled, (4) as part of a series of substantially equal periodic payments over the employee's (or the employee's and his or her spouse's) life or life expectancy, (5) after separation from service after attainment of age 55, (6) for certain medical expenses, (7) to a former spouse under a qualified domestic relations order or (8) to certain unemployed individuals for health insurance premiums.

B. Reduced Taxation of Capital Gains And Dividends

Under current law, a reduced tax rate applies to capital gains realizations and dividends received by an individual from a domestic corporation and from certain qualified foreign corporations. The reduced tax rate generally is 15 percent, except that it is 5 percent for taxpayers in the 10 or 15 percent income tax bracket. The 5 percent rate is reduced to zero in 2008. After 2008, the rates of tax applicable to capital gains realizations will be 20 percent (10 percent for taxpayers in the 15 percent income tax bracket). After 2008, individuals must report dividends as ordinary income making them subject to the ordinary income tax rates.

Some proponents would like to make permanent the reduced tax rate for capitals gains and dividends received by individuals. In addition, others would like to further reduce the rates to zero or eliminate entirely the tax on these sources of income. Both proposals assume that our current tax system remains intact, rather than considering these proposals as part of a larger reform that changes the tax system from income-based to consumption based.

Proponents believe that eliminating tax on capital gains and dividends will reduce economic distortions created by the income tax system. Relative to other investments, this approach would make investments in stock and other capital assets more tax favored than under current law and would end the current tax benefit of debt versus equity. Consequently, many argue that this proposal would increase savings and investments.

Because the proposal is assumed to occur as a modification to the current tax system, investments in qualified retirement plans would continue to be tax favored. However, because taxpayers generally could gain similar tax benefits by investing in capital assets, taxpayers may prefer to hold their savings outside of a qualified retirement plan by investing directly in stock and other capital assets. The owners of small and mid-sized businesses may particularly find that the costs of maintaining a qualified retirement plan outweigh the benefits of holding assets in a qualified pension trust if there are substantial benefits that accrue to direct investments in stock and other capital assets.

It is important to remember that taxpayers must include in income all amounts withdrawn from qualified pension plans and treat those withdrawals as ordinary income. Thus, it would not make sense to invest qualified retirement plan assets in stocks and capital assets because assets held directly receive greater tax advantages if the proposal eliminating tax on capital gains and dividends is enacted. For example, if a qualified pension plan holds a capital asset that was purchased for $1,000 and is sold for $10,000, the $9,000 of capital gain is taxed at ordinary income rates when it is distributed to plan participants.

Table 3 shows the potential erosion of qualified retirement plan benefits compared to saving outside of the qualified retirement plan when capital gains and dividends receive preferential treatment. Assume that the business owner contributes $1,000 per year to his qualified retirement plan. The plan invests in an equity fund and earns 7 percent each year on that return. Column two shows the benefits of the qualified retirement plan over 15, 20 and 30 year savings horizons. The results reflect the tax deduction received for the contribution and the tax-free accumulations over time. Further, the final balance from the qualified retirement plan is the after-tax balance (assuming a 35 percent ordinary income tax rate).

Column three shows the accumulated balance if the same person invests the funds outside of the pension plan. In this case, if the business owner treats the $1,000 as a bonus, the after-tax amount deposited each year is $650 [$1,000 x (1 - .35) = $650]. This example assumes that present law tax treatment of capital gains and dividends applies. Again, if the account invests in an equity fund earning an after-tax return of 6 percent [7 x (1 - .15) = 6], the accumulated balance is not subject to tax at the end of the time horizon. In this case, the qualified retirement plan maintains a slight advantage over the bonus account.

Column four shows the accumulated balance if the same person invests funds outside the pension plan, but the tax rate applied to capital gains and dividends falls to zero from 15 percent. In this case, the accumulated bonus is equivalent to those amounts accumulated in the qualified retirement plan after taxes paid upon distribution.

Consider one more situation that accounts for the administrative costs to maintaining a qualified retirement plan. If the business owner faces a 10 percent plan administrative cost of the plan, but decides to increase the bonus to account for this cost, then the after-tax amount of the contribution increases from $650 to $722. In light of zero capital gains and dividend taxes, the benefit of investing in an equity plan would exceed those of investing in a qualified retirement plan.

Table 3
Compare Accumulated Account Balances, Qualified Retirement Plans and Bonuses under Various Tax Treatments

	Qualified retirement plan	Bonus, present law capital gains and dividend tax rates	Bonus, zero capital gains and dividend tax rates	Bonus, increased for administrative costs, subject to zero capital gains and dividend tax rates.
15 years	$17,477	$15,969	$17,477	$19,419
20 years	$28,512	$25,198	$28,512	$31,680
30 years	$65,697	$53,969	$65,697	$72,997

Eliminating taxes on capital gains distributions and dividend income has obvious benefits for higher income taxpayers. About 50 percent of all households report owning stock, either directly or through their retirement account.[36] But less than 10 percent of low income households own stock directly.

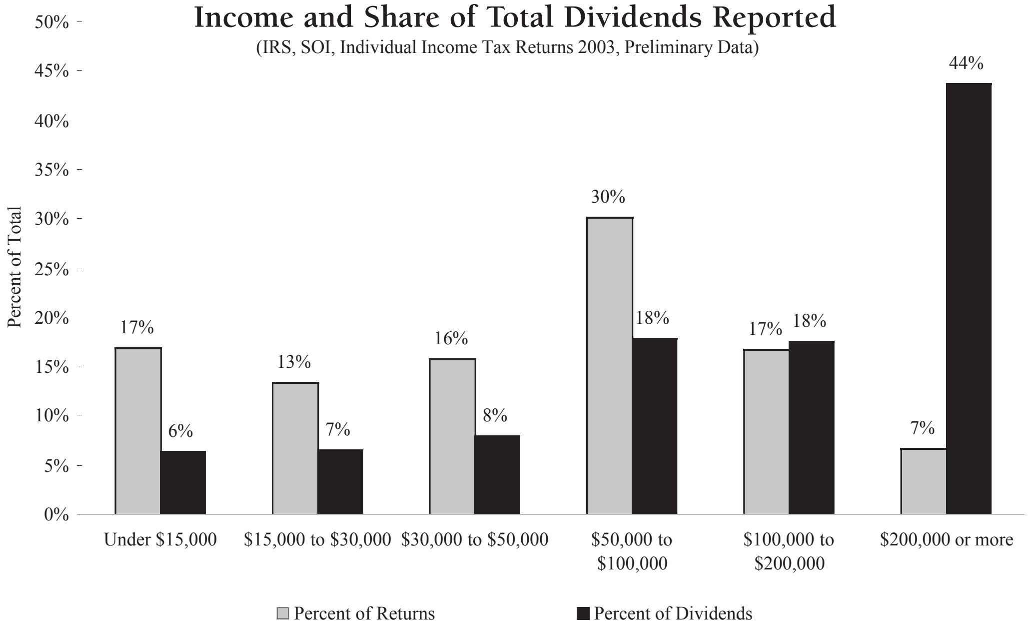
Referring to Graphs 9 and 10, in 2003, returns with adjusted gross income less than $15,000 reported only 6.3 percent of all dividend income. Returns with adjusted gross income in excess of $200,000 reported 43.8 percent of all dividend income. Similar trends are present in reporting of capital gains distributions. Returns with adjusted gross income less than $15,000 reported 2.1 percent of all net capital gains while returns with adjusted gross income in excess of $200,000 reported 74.4 percent.

The most important point is not that such a disparity in wealth exists, rather that eliminating tax on dividend and capital gains provides benefits to a select segment of the population. It is true that this targeted tax relief would increase savings, but only for a small segment of taxpayers.

Graph 9

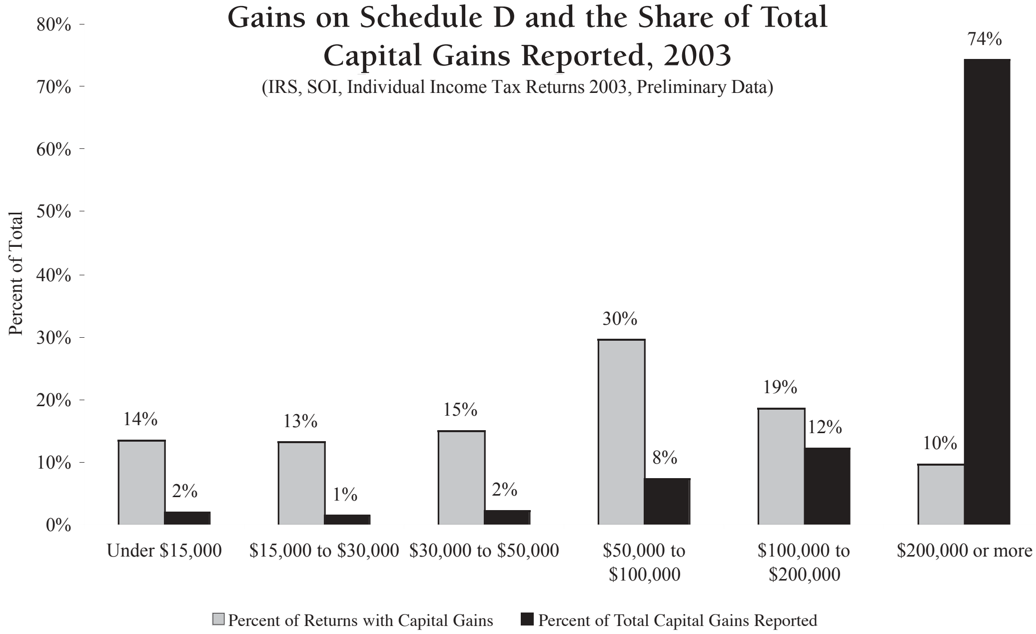
Percent of all Returns Reporting Dividend Income and Share of Total Dividends Reported

(IRS, SOI, Individual Income Tax Returns 2003, Preliminary Data)



[36] Comments made by Federal Reserve Governor Gramlich to the National Savings Forum, 2001.

Graph 10
Percent of all Returns Reporting Capital Gains on Schedule D and the Share of Total Capital Gains Reported, 2003
(IRS, SOI, Individual Income Tax Returns 2003, Preliminary Data)



The Joint Committee on Taxation estimates the tax expenditure or cost of the current reduced rates on dividends and long-term capital gains is approximately $357 billion over the next five years.[37] Estimates of eliminating the tax on dividends project a reduction in federal receipts by approximately $300 to $400 billion over the next ten years. Given the behavioral response of eliminating the capital gains tax on long-term gains, it is unclear how large the revenue loss would be.[38] However, given the magnitude of the current tax expenditure and the potential increased costs of eliminating taxes on dividends and capital gains, it is important to consider the effect on retirement savings and overall wealth accumulation. The purpose of qualified retirement plan incentives is to encourage retirement saving behavior and ensure retirement security for older people. However, targeted tax reform policies that increase savings for only a small segment of the population could potentially create greater problems as the wealth distribution widens.

[37] See JCS-1-05, "Estimates of Federal Tax Expenditures, 2005 through 2009," Joint Committee on Taxation, January 2005.
[38] It is likely that a zero rate of tax on capital gains and dividends would have substantial behavioral effects on taxpayers.

IV. Impact on Retirement Saving—Conclusions And Recommendations

Retirement and personal savings, along with Social Security, are essential parts of the American retirement system. Policy changes that affect the ability to save or the composition of overall savings pose potential threats to retirement savings. Our present tax system already dilutes the demand for retirement savings by offering some favorable tax treatment for investments outside qualified retirement plans.

When considering such major reforms as consumption-style taxes or targeted approaches that eliminate the tax on capital gains and dividend income, it is important to consider the impact on qualified retirement savings. Consumption-style taxes, in general, would tax amounts consumed and would not tax amounts saved. Targeted tax preferences would exclude capital gains and dividend income from tax, thereby treating the majority of investment as if it were in a consumption tax system. While it may be true that major reform or targeted policies would increase aggregate savings, it is also true that such policies would not provide uniform savings across all income classes.

One of the most important features of qualified retirement plans is that they offer the opportunity to save to all eligible workers. In light of minimum participation and nondiscrimination rules, workers receive equitable treatment and receive comparable savings incentives. Without qualified retirement plans, most low-income individuals would not possess adequate resources to save outside of their qualified retirement plan. Reform and targeted relief does little to alter that fact. With tax reform and targeted tax preferences, the potential exists to exclude savings from tax, while threatening financial security and creating greater wealth disparities among retirees.

With the baby boom generation less than ten years away from retirement, tax policy and tax reform should consider carefully the impact that reform would have on qualified retirement savings. Changing demographics and lower personal savings rates suggest that retirement savings through qualified retirement plans is becoming increasingly more important over time. Increasing savings through consumption-style taxes or through targeted tax-favored investments would do little to ensure that individuals enter their retirement years with adequate savings. Given the costs of such reform policy changes and their significant distributional impacts, it is important to consider the effect on retirement savings. As tax reform proposals eliminate or dilute the incentives for qualified retirement plans, it is likely that many employers will cease to offer qualified retirement plans and the prospect for adequate retirement savings for the majority of Americans will diminish significantly.

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