Pension Policy

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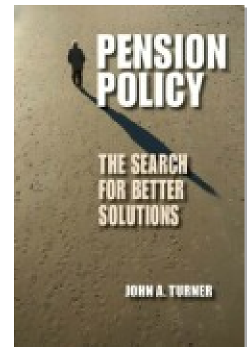

Published by W.E. Upjohn Institute

Turner, John A.
Pension Policy: The Search for Better Solutions.
First ed. W.E. Upjohn Institute, 2009.
Project MUSE.muse.jhu.edu/book/17381.

For additional information about this book
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Access provided at 28 Jan 2020 06:54 GMT with no institutional affiliation

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Tax Policy

Influencing Coverage and the Structure of Pensions

Tax policy concerning pensions has come under increasing scrutiny. That scrutiny is due to the high cost of pensions in terms of lost tax revenue. It is also due to the fact that tax policy provides larger incentives for higher-income workers than for lower-income workers because higher-income workers have higher marginal tax rates. Thus, the tax system provides the largest incentives to workers who are most likely to save and provides the smallest incentives to workers who are least likely to save.

While governments in a number of countries are using increasingly aggressive policies to encourage or mandate private pensions, tax policy is the engine of pension policy for the U.S. pension system. It encourages the growth of the private pension system by providing favorable tax treatment of private pension assets relative to other assets. All countries with well-developed voluntary pension systems provide tax preferences for saving through pensions, and no country lacking a tax preference for pensions has a robust pension system.

Tax policy, along with regulations, also provides brakes on the pension system. It sets limits as to the types of pension plans that receive preferential tax treatment. Some tax provisions, such as those relating to early distributions, are not designed to raise government tax revenue but rather are designed to regulate pension plans by influencing the behavior of pension plan sponsors or participants.

While the broad goals of pension tax policy are similar across developed countries, specific policies and practices vary considerably. This chapter examines pension tax policy across countries. Differing policies and practices demonstrate the range of options available to policymakers.

OVERVIEW

Pensions function by means of three transactions: 1) contributions, 2) investment earnings, and 3) benefit payments. The most common approach to taxing pensions in countries providing preferential treatment combines tax deduction of contributions, tax exemption of investment earnings, and taxation of benefits under the personal income tax. This is the U.S. approach. For workers facing the same marginal income tax rates while working and in retirement, they earn the preincome tax rate of return on their pension savings because the investment earnings on pension funds are not taxed under the personal income tax. This approach is called "exempt, exempt, taxed," or EET, for the tax treatment of the three stages of the worker's participation in the pension plan.

This tax arrangement is referred to as an expenditure or consumption tax because savings are not taxed. The personal tax only is levied when the benefit is received and presumably spent. Under a consumption tax, retirees generally pay higher taxes than under a personal income tax that raises equal revenue. A consumption tax avoids the double taxation of savings that occurs when 1) income is taxed when received and 2) the income on investments is also taxed. This avoidance of double taxation is a desirable aspect of a tax system, given the concern over inadequate savings, but its effect on total savings may be diminished by workers' reducing savings in other forms.

Under this approach, U.S. pension holdings in equities are not exempt from the corporate income tax paid by the corporations for which the pension fund holds shares. The United Kingdom provides relief to pension funds for the corporate income tax paid on the shares they hold.

Defined benefit pensions hold a tax advantage over 401(k) plans. No Social Security payroll tax is paid on pension contributions to defined benefit plans because defined benefit plans are financed almost entirely by employer contributions. By contrast, the Social Security (FICA) payroll tax is levied on workers' contributions to 401(k) plans. This tax treatment of employee contributions to 401(k) plans limits the erosion of the Social Security payroll tax base and is done to bolster Social Security financing.

A fundamental assumption of retirement income policy is that people will not save adequately for retirement on their own. That assumption justifies preferential tax treatment for pensions, compared to the taxation of most other forms of savings, because it encourages retirement savings. Without a tax subsidy, families arguably would save even less for retirement. Explanations for families saving insufficiently include that they are myopic, not adequately anticipating future needs, or that they lack discipline to save for the future needs that they recognize. However, workers contributing to a pension give up liquidity in that they often cannot access the money until retirement, or can access it only after paying a penalty. A tax incentive is needed to overcome this disincentive to participating in a pension.

By encouraging pensions through favorable tax treatment, governments incur a cost in lost tax revenue. Revenue is lost compared to what the government would have received if the pensions had been taxed in the same way as taxable savings accounts. The lost revenue is called a "tax expenditure" because it is equivalent in some respects to a government expenditure to finance pension benefits.

Some policy analysts are concerned about the distributional aspects of the tax expenditure. Because of the pattern of pension coverage, the tax expenditure disproportionately favors middle- and upper-income workers. Arguably, however, distributional issues should be considered within the larger framework of retirement income policy, including Social Security.

These tax subsidies, which take the form of income tax deductions or exclusions, deliver tax savings in proportion to the worker's marginal tax rate. This arrangement is "upside down," because it provides minimal incentives to the majority of American households—those who are in the 15 percent, 10 percent, or zero income tax brackets and who most need to save more to provide for basic needs in retirement—while reserving the largest incentives for the highest-income households.

Moreover, as a strategy for promoting national saving, these subsidies are poorly targeted. Higher-income taxpayers are likely to respond by shifting existing assets from taxable to tax-preferred accounts (Gale, Iwry, and Walters 2007). For these reasons, a tax credit, which would provide an incentive per dollar contributed to a pension for all participants paying taxes, arguably would be more efficient in encouraging

savings than the current system which provides higher subsidies per dollar contributed to a pension for people in higher tax brackets. Higher-income participants would still have an advantage because of the tax exemption of investment earnings on pension accounts.

Tax law plays a major regulatory function. To be "tax-qualified," a plan must meet minimum standards concerning participation, vesting, and fair treatment of lower-paid employees (nondiscrimination rules). When plans do not meet these requirements, the employer's contribution to the plan must be included in the employee's taxable income to be tax deductible for the employer, a situation that employees do not want.

PENSION TAX POLICY IN OECD COUNTRIES

Most high-income countries in the Organisation for Economic Co-operation and Development (OECD) use the EET approach to the tax treatment of pensions.[1] Ten countries—Austria, Canada, Finland, Greece, Iceland, the Netherlands, Norway, Poland, Switzerland, and the United States—come close to the pure EET approach in which pension benefits are subject to the same progressive income tax rates as other retirement income. Another twelve countries—Belgium, France, Germany, Ireland, Japan, Korea, Mexico, Portugal, the Slovak Republic, Spain, Turkey, and the United Kingdom—also use the EET approach, but withdrawals are generally taxed more leniently than in the first group of countries, or contributions are granted a tax credit rather than a deduction (Yoo and de Serres 2005). For instance, the United Kingdom, Ireland, Spain, France, Mexico, and Turkey allow a partial tax-free withdrawal of benefits in the form of a lump sum, while France, Germany, and Turkey allow a similar tax privilege to annuity pension income. In Mexico, Turkey, and the Slovak Republic, pension income up to a specified limit is tax free, while income above the limit is taxed at a relatively low rate.

While social security programs sometimes provide more generous benefits to larger families through benefits that are linked to family structure, employer-provided pensions and individual account plans

rarely have such a feature. In Germany, however, contributions to the individual account pensions called Riester pensions receive a subsidy that is larger the greater the number of children in the family. This tax treatment of pension contributions is consistent with a general German tax policy of encouraging families to have children.

The practice in other OECD countries differs from the EET approach because contributions or investment income are taxed. In Italy, Denmark, and Sweden, the tax treatment of private pensions is closer to the model of exempt (E), taxed (T), and taxed (T) concerning the treatment of contributions, investment earnings, and benefit payments. While these three countries allow for the deferral of taxation on contributions, they tax accrued income from fund investment—albeit at preferential rates—and pension benefits at withdrawal. In Sweden, for example, all capital income is taxed at a preferential flat rate of 15 percent on the theory that because capital is more mobile than labor, Sweden cannot tax capital at the same rate that it taxes labor income. This tax treatment of capital income is carried over to the taxation of the investment earnings of pension funds at a flat rate of 15 percent.

Australia, New Zealand, the Czech Republic, Hungary, and Luxembourg tax contributions to private pension schemes. In the latter three countries, either employees' or employers' contributions are exempt from taxation, but not both. In the United States, employee contributions to 401(k) plans are tax exempt, but employee contributions to private sector defined benefit plans are not.

TAX POLICY ANALYSIS

This chapter now discusses in greater detail effects of the tax treatment of pension contributions, investment earnings, and benefit payments. Tax systems can be analyzed in terms of whether they affect the choices made by workers and employers by causing them to take actions they would not have done in the absence of the taxes. Pension taxation can affect decisions concerning wages, deferred wages, other employee benefits (such as health insurance), defined benefit versus defined contribution pension plans, employee contributions versus

employer contributions, self-employment versus employee status, lump sum benefits versus annuities, and equity versus bond investments in pension portfolios.

Contributions

Contributions can be made both by employers and employees, and the tax treatment differs in the United States.

Employer contributions. The United States, Canada, the United Kingdom, and most other countries with well-developed pension systems allow a tax deduction for employer contributions to pensions. In this way, employer contributions for wages and pension contributions receive equal tax treatment under the corporate income tax.

U.S. employer contributions to a pension plan are not taxed as income to the employee, avoiding both personal income taxes and Social Security taxes. The exemption from Social Security taxes reduces the current tax burden on workers, but it also reduces their future Social Security pension benefits in the United States, where future benefits are tied to Social Security–covered compensation.

Employee contributions. In the United Kingdom, Canada, and most other OECD countries, employee contributions are also tax deductible to both defined benefit and defined contribution plans. This treatment creates equality of tax treatment between the two types of plans. In the United States, however, employee contributions are not tax deductible to defined benefit plans in the private sector. The tax treatment differs between the public and private sectors. Employee contributions are tax deductible for state and local government employees. Thus, the nondeductibility of employee contributions to U.S. private sector defined benefit plans is an oddity in the pension world.

Employee contributions are tax deductible for certain types of defined contribution plans, such as 401(k) plans, but not others, such as money purchase plans. Perhaps because of this feature, 401(k) plans are by far the most popular type of defined contribution plan. Employee contributions to those plans are tax deductible under the personal income tax but still are taxed under the Social Security payroll tax so as to not erode the tax basis for Social Security. In pension parlance,

employee tax deductible contributions are equivalent to a salary reduction contribution. If an employee contribution reduces the employee's taxable salary, it is equivalent to a tax deductible contribution.

Providing the option of tax deductible employee contributions to defined benefit plans might make defined benefit plans more attractive to employers. Employee contributions could provide an assured steady source of funding for those plans. Presumably, when employees are required to contribute to their pension plans, wages adjust upwards in comparison to what they would be in a similar job where the employer was responsible entirely for the funding of the defined benefit plan. This assumption of economists, based on the theory of compensating differentials, is not accepted by many pension practitioners, but it is clearly visible in the setting of collective bargaining.

If a U.S. employee does not fully make use of his or her tax deduction to the pension plan for the plan year by making the maximum allowable contribution, the missed contribution cannot be made up in the future. By contrast, the system in Canada allows workers greater flexibility as to the timing of their contributions. An individual's unused contribution in a year is carried forward indefinitely for use in subsequent years, subject to certain dollar limits. Similarly, contributions not deductible in the year they are paid because they exceed the allowable amount may be deducted in subsequent years.

This flexibility in Canada for contributions to defined contribution plans was introduced to achieve equal footing with the flexibility available to employers for contributions to defined benefit plans. In most countries, employers with well-funded plans have flexibility as to the timing of their contributions, so long as their plans are not overfunded to the extent that further contributions are not allowed or underfunded to the extent that large contributions are required.

The tax preferences provide weak incentives to the majority of American households—those who are in the 15 percent, 10 percent, or zero income tax brackets. The Saver's Credit, enacted in 2001, was designed to address this problem. As the only major pension tax incentive targeted specifically at the majority of American households, it was designed to level the playing field by giving taxpayers earning less than $50,000 a year a tax credit for contributions to 401(k) plans, IRAs, and similar retirement savings plans. Although it was originally proposed

as a permanent tax credit, Congress sought to save revenue for other purposes by enacting the Saver's Credit with a 2006 sunset date. The Pension Protection Act of 2006 has made the Saver's' Credit permanent and indexed its income eligibility limits to inflation (Gale, Iwry, and Walters 2007). Because the Saver's Credit is nonrefundable, it offsets a taxpayer's tax liability; it provides no saving incentive for lower-income households that have no income tax liability.

Employee nondeductible contributions. Three reasons explain why employees may make nondeductible contributions to pension plans. First, employee contributions to defined benefit plans are not deductible. While it is unusual in the private sector, a few defined benefit plans require employee contributions, which are nondeductible. Second, some employees make nondeductible contributions to Individual Retirement Accounts because they wish to contribute to those accounts and they are not eligible to make deductible contributions. Third, some employees make nondeductible contributions to 401(k) plans because they wish to contribute more than the allowable limits on deductible contributions.

When employees claim benefits, they are not taxed on that part of the benefits that equals the nominal value of the nondeductible contributions they made. Contributions made 20 years earlier or more, however, could easily have lost half their value as a deduction because of inflation. Thus, this treatment of nondeductible contributions, which does not recognize the eroding effect of inflation on the value of past nominal contributions, results in unfavorable tax treatment because of the limited deduction for those contributions when benefits are received.

Table 5.1 summarizes the tax treatment of employee contributions and highlights the lack of deductibility for contributions to private sector defined benefit plans. Contributions are tax deductible for contributions to 401(k)-type plans in both the private and public sectors. Employee contributions are tax deductible for defined benefit plans for state and local government employees but not federal government employees. The major exception to the tax deductibility of employee pension contributions in the United States, and indeed around the world, is for U.S. private sector defined benefit plans.

Table 5.1 Tax Treatment of Employee Pension Contributions

	Defined benefit	401(k)-type plans
Private sector	Not tax deductible	Tax deductible
State and local government	Tax deductible	Tax deductible

NOTE: Employee contributions to defined benefit plans are not tax deductible for federal government employees. Employee contributions to non-401(k)-type defined contribution plans are not tax deductible.
SOURCE: Author's calculations.

Contribution limits. Countries generally set a maximum on allowable tax deductible contributions that can be made by, or on behalf of, a worker. The maximum is expressed both as an absolute amount and as a percentage of the worker's pay, with the lower maximum being effective. Maximums are set to limit the government's loss of tax revenue. Also, as a matter of fairness to low-income taxpayers, the maximums limit benefit amounts and tax preferences received by high-income workers.

The tax treatment of pensions in Canada is based on the principle that all workers should have equal access to a tax-preferenced pension, whether or not their employer provides a pension plan. This principle is viewed as an important policy aspect of interpersonal equity, and it is not an aspect of the U.S. pension system. To achieve it, each worker's maximum allowable contribution to a Registered Retirement Savings Plan (RRSP) is reduced by a pension adjustment to reflect the worker's accruals in an employer-provided defined benefit or defined contribution plan. RRSPs are the Canadian equivalent of Individual Retirement Accounts (IRAs) in that they are individual plans established by workers without the involvement of employers. Integrating contribution limits for employer-provided plans with individual plans assures that all workers may set aside a roughly equivalent amount in tax-preferenced pension plans. This policy differs considerably from the tax treatment of U.S. pensions, where employer-provided plans are heavily favored relative to individual plans in terms of allowable contributions.

The maximum allowable tax deductible contribution for UK personal pension plans increases with the worker's age. It rises from 17.5 percent of earnings for those under age 36 to 40 percent for those ages 61 to 74. The idea behind this policy is that older workers are more aware of their retirement income needs and may be more motivated to

save for retirement. The United States has adopted a simplified variant of this approach; it allows higher tax deductible contributions, called “catch up” contributions, for workers age 50 and older than for younger workers. That policy could be extended by allowing even higher catch-up contributions for workers age 60 and older.

Perhaps because the aging of populations has raised the level of total tax deductions for pensions in many countries, a trend has occurred toward reducing the maximum amount that a worker can deduct (relative to wages). This reduction has occurred in Australia, Canada, the United Kingdom, and the United States, where maximum contributions are considerably lower in real terms than they were in the past.

Investment Earnings

In Canada, the United States, and the majority of countries with well-developed private pension systems, the investment earnings on pension funds accumulate tax free, which is the second E in the EET tax system for pensions. This is not the case, however, in Australia, Belgium, and Sweden.

Defined benefit plans in the UK offer employers the chance for a windfall tax shelter for surplus pension funds. Because an employer withdrawing surplus funds will have received the benefit of tax preferences, employers have an incentive to contribute more to their pension plans than is required to assure adequate funding. British employers are allowed to withdraw surplus funds without terminating a plan, whereas the only way a U.S. employer can withdraw surplus funds is to terminate the plan, and then the surplus funds are subject to extra taxes. These taxes have basically ended that strategy. By denying tax deductibility to contributions when funding reaches a certain level, the UK’s Inland Revenue (the tax collection authority) has limited contributions to plans with surpluses.

Some U.S. policy analysts have discussed the possibility of encouraging greater funding by creating “sidecar trusts,” also called solvency trusts. The money employers contribute to these trusts could be used to fund a defined benefit pension if needed or could be used to finance other employee benefits, such as retiree health, if the associated defined benefit pension fund had surplus assets.

Assets

Pension assets are not taxed in most countries. However, as they grow in size in conjunction with an aging population and the maturing of pension systems, the political pressure to tap this potential source of revenue may grow. Pension assets are taxed, for example, in Japan, Australia, and Belgium.

Disbursements

The tax system can be used to favor particular forms of benefit receipt. For example, taxation can be used to favor or discourage workers' taking lump sum benefits as compared to annuitized benefits. The progressive taxation of benefits can cause income redistribution toward lower-income taxpayers. Sweden, Chile, and the United Kingdom tax benefits the same as wages. Progressive taxation of pension benefits tends to favor women because they generally have lower incomes than men.

Taxing pension benefits as ordinary income received by retirees is the most common way for pension disbursements to be taxed. Any payment from a Canadian or U.S. pension plan, whether at death, retirement, or end of service, is taxable income, except for payments that are essentially repayments of contributions that were taxable, which is called "basis" in U.S. tax terminology.

While it is commonly assumed that contributing more to a tax-favored pension plan is financially advantageous, that may not always be the case, for three reasons. First, taxable withdrawals in retirement can put the participant in a higher tax bracket in retirement. Second, withdrawals can cause the participant's Social Security benefits to be taxed. Third, the tax rates could be higher in retirement than while working (ESPlanner 2005).

An important aspect of pension benefit policy is whether the money contributed to a pension plan is "locked in" until retirement. In the United States, pension payments received before retirement are subject to a penalty tax, while in Canada pension payments cannot be made until retirement age.

Pension policy analysts generally favor annuities over lump sum distributions. Annuities provide insurance against retirees outliving their pension benefits. Some countries provide special tax treatment for annuities. In Japan, pension annuities are subject to preferential income tax treatment. They are tax free up to a certain amount per year, with a deduction that declines in percentage terms in increments for benefits exceeding a certain level. In 2006, Spain reduced the generosity of the tax treatment of lump sum benefits to encourage workers to purchase annuities (Social Security Administration 2007).

Tax Treatment of High Earners

One of the policy debates is over the extent to which high earners should benefit from the tax preferences afforded pensions. One argument, based on a particular concept of fairness, favors limiting the maximum benefits and maximum contributions to a lower level to limit the tax preferences going to higher earners. The opposite argument, based on a supposed incentive effect, favors higher limits for benefits and contributions to encourage national savings and because high earners may be more likely to support providing pensions for lower-income workers. Sometimes trade-offs are suggested, such as allowing for higher maximum benefits and contributions for high earners if the company covers all of its employees.

Plan Terminations

If a U.S. plan sponsor terminates an overfunded defined benefit plan and reverts the excess assets to the employer, the sponsor must pay a 50 percent tax on the reversion. This tax is in addition to a 35 percent corporate income tax and state income taxes. Together, the taxes rise nearly to 100 percent, with the purpose of the excise tax being to discourage plan terminations with reversions. Not surprisingly, no tax revenue is raised by this tax because no reversions are taken (Pang and Warshawsky 2009).

Pension Taxation versus Social Security Taxation

An issue in judging the tax treatment of pensions is whether it ought to be, and is, equivalent to the tax treatment of Social Security benefits. The issue is complicated by the different tax treatment of defined benefit plans and 401(k) plans, and by different treatment of low and high earners. U.S. Social Security benefits are tax free for people earning below a fixed level of income, making the tax treatment of Social Security benefits more favorable for many people than the tax treatment of pensions, where the benefits are taxed as regular income for most people. Lower-income retirees are not taxed on their Social Security benefits, while higher-income retirees must include 50 percent of their benefits in taxable income, a figure that rises to 85 percent at even higher income levels. The effective income tax rate on the employee's share of Social Security contributions and the part of the benefits that the employee must include as taxable income depend on the employee's income tax rate, which varies across people and in some cases is zero.

Social Security receives equal contributions from workers and employers. Workers contribute from after-tax income (they cannot deduct the contributions from their taxable income), while employers' contributions are from before-tax income (they can deduct them from their taxable income, and the contributions are not treated as taxable income to workers).

Implicit Taxes

An implicit tax may effectively reduce pension benefits received by some U.S. retirees by taxing them at a high marginal rate. As just mentioned, Social Security benefits are taxable under the personal income tax when a retiree's income exceeds a certain level. For some workers, this causes double taxation of pension benefits in the sense that the marginal tax rate jumps because of the taxation of Social Security benefits. Double taxation occurs when pension benefits raise the retiree's total income to a level where Social Security benefits are taxable. Each extra dollar of pension benefits raises the retiree's tax payments by the tax on the pension benefit plus the tax on the Social Security benefit.

In Canada, the income-tested component of the social security system discourages low-income workers from participating in pension plans. For each dollar of retirement income exceeding a certain amount, social security Guaranteed Income Supplement benefits are reduced by 50 cents. The net result is that Canadian retirees with low lifetime earnings face a 50 percent tax rate on private pension income on top of any personal income tax liability. A similar effect can occur in the United States if pension benefits cause a reduction in eligibility for food stamps for low-income recipients.

Tax Expenditures

The federal government, as well as state and local governments, loses tax revenue because of the preferential tax treatment of pensions. This revenue loss is called a tax expenditure. The Office of Management and Budget (OMB) and Congress's Joint Committee on Taxation (JCT) define tax expenditures as losses in revenues resulting from deviations from the "normal" individual and corporate income tax bases. The tax expenditure is the cost side of the tax preferences–provided pensions. It is measured relative to the tax treatment of standard, nontax-preferred savings vehicles. One study has measured it as 27 cents per dollar contributed to a pension plan in the United States, with a comparable figure of 13 cents for the Netherlands and 31 cents for Canada (Table 5.2).

Table 5.2 Net Tax Cost per Dollar Contributed to a Pension, Different Countries, 2006

Country	Net tax cost (%) per dollar contributed to a pension
Canada	30.6
Japan	23.8
Netherlands	13.2
United Kingdom	29.9
United States	26.8
OECD average	21.5

NOTE: The net cost is the reduction in taxes per dollar contributed.
SOURCE: Yoo and de Serres (2005).

The measurement of tax expenditures is controversial. Policy analysts have no commonly agreed-upon tax baseline against which to measure departures. In spite of this, most economists believe that measuring tax expenditures is useful because tax benefits can have the same effect on beneficiaries as direct spending programs, and they impose similar opportunity costs in terms of higher taxes, reduced federal spending, and higher deficits (Burman, Toder, and Geissler 2008).

Workers' wages, their marginal tax rates, and their probability of participating in the pension system tend to rise with age, which would raise the annual tax expenditure per person as pension participants age. However, a factor that generally more than offsets this pattern is that for a given wage level, the tax expenditure is higher for younger workers because they have more years over which they benefit from the tax free buildup in their pension plans.

Two assumptions used in the tax expenditure calculations can have a particularly important effect on the results. Those assumptions are 1) the choice of a discount rate in the present value discounting and 2) the assumed tax rates on future withdrawals, which depend on assumptions as to tax rates in the future.

Three approaches are commonly used in estimating tax expenditures (Yoo and de Serres 2005). First, the revenue-foregone method measures the amount by which tax revenues are reduced by a particular tax concession, usually assuming unchanged behavior by workers and firms. Second, the outlay-equivalent method measures the cost of providing the same monetary benefit through direct spending, assuming also that behavior is unchanged as a result of the tax concession. Contrasting with those two approaches, the revenue-gain method considers potential behavioral responses and provides an ex ante measure of the expected increase in revenues if the concessions were repealed.

Within these methods, at least two approaches can be used—the present value approach and the cash flow approach. The present value approach, used in the United States, considers the future flows of revenues foregone on accrued income and of revenues collected on withdrawals corresponding to contributions made in a given year. In this respect, it is not influenced by the history of past contributions or by demographic changes. Given that the present-value method directly

incorporates the intertemporal shift in tax revenues, it may provide a more accurate picture of the underlying budgetary cost associated with participation in tax-favored schemes, in particular during the first few years after a plan has been introduced.

The more commonly used cash flow method differs from the present value method in that it does not consider future offsetting flows. Its budgetary cost in a given year is measured as the net amount of revenues foregone on contributions, revenues foregone on accrued investment income, and revenues collected on withdrawals, which are all realized during that same year. In such a case, the revenues foregone on accrued investment and the revenues collected on withdrawals correspond to contributions made in previous years. The latter approach is better suited to capture the influence of demographic changes on the profile of net fiscal revenues from tax-favored retirement plans at different points in time. The approach has been used in recent studies to estimate the current and future profile of tax costs and benefits related to tax-favored pension regimes in OECD countries (Boskin 2003; CBO 2003).

CONCLUSION

In the private sector, employee contributions to 401(k) plans are tax deductible. In the public sector for state and local government employees, employee contributions to both defined benefit and defined contribution plans are tax deductible. The only major group of participants in the U.S. pension system who are denied tax deductibility of contributions are participants in private sector defined benefit plans. Extending tax deductibility to those participants would level the playing field between defined benefit plans and 401(k) plans. Tax deductibility of employee contributions is provided in most countries with sizable pension systems.

Tax changes could be made to encourage annuitization through 401(k) plans. Such changes could include providing less favorable tax treatment to lump sum payments through 401(k) plans.

The tax system could be used to encourage broader coverage through defined benefit plans. For example, the allowable maximum income considered for determining defined benefit plan benefits could be raised in plans that provided 100 percent coverage to all full-time workers. Switching to a tax credit instead of a tax deduction would provide greater incentive for participation to low-income workers.

Note

1. This survey summarizes the study done for the OECD by Yoo and de Serres (2005).