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THE SHRINKING TAX PREFERENCE FOR PENSION SAVINGS: AN ANALYSIS OF INCOME TAX CHANGES, 1985-2007

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To encourage workers to save for retirement, the federal government offers favorable tax treatment on money that is withheld from wages and saved inside a pension plan. Workers who make contributions into a qualified retirement account receive two important tax preferences. First, the investment income earned in a qualified account is not subject to income tax as long as the savings remain inside the plan. Second, taxation of contributions to a qualified plan is deferred until the contributions plus accrued investment income are distributed as an annuity or lump sum payment. This arrangement confers an additional benefit on workers who are in a lower tax bracket when retired than when at work. Estimates by the Office of Management and Budget (OMB) and the Congressional Joint Committee on Taxation (JCT) suggest that tax expenditures for the pension tax preference make it among the most costly of all preferences in the tax code. These estimates compare current taxes paid to taxes that would be paid if all pension savings were taxed the same as contributions to ordinary saving accounts. This method, however, does not capture the present value of the benefit from any year's contributions to qualified accounts, although OMB does publish a separate calculation of this present value benefit. In performing their calculations, both OMB and JCT assume that no other tax preference would be available to capital income if assets were held outside of a pension account. In fact, the tax code contains sizable tax preferences for assets held outside of pension accounts. To the extent that assets held in alternative kinds of accounts receive a tax preference, the benefit to workers of saving in a qualified retirement account and in which the cost to the government from qualified plans is less than if the alternative investment were taxable as ordinary income.

In this paper we calculate the net value of the pension tax preference for representative workers under stylized assumptions about their future expected earnings and taxable incomes. We perform these calculations under tax laws in effect in 1985, 1988, 2000, and 2007, years in which both the marginal tax schedule and the tax treatment of income from different assets varied. We estimate the financial advantage to workers of holding four kinds of assets in a pension account rather than a standard (not-tax-preferred) investment account: taxable bonds and equities that pay all, some, or none of their capital income flows in the form of dividends and the remainder in the form of realized and unrealized long-term capital gains.

The basic structure of the tax preference for pension savings has remained largely unchanged over the period covered by our analysis, although the types of plans to which workers and employers can contribute and the rules governing employee and employer contributions have varied over time. The pension

tax preference can be valuable to retirement savers, but its precise value is sensitive to the tax preference provided to capital income under the regular income tax code. Between 1985 and 2007 the most important tax changes affecting the value of the pension tax preference were connected to changes in the tax preference for equity income. The two biggest components of equity income, dividend payments and long-term capital gains, received varying tax treatment over the period. When one or both of these income components received more favorable tax treatment, the value of the pension tax preference fell. While it remained advantageous for workers to accumulate retirement savings in a pension account, the net tax advantage shrank.

Our findings can be summarized briefly. First, the value of the pension tax preference depends crucially on the particular asset that workers intend to hold in their retirement savings account. Some or all of the capital income flows of certain kinds of assets, such as stocks, receive favorable tax treatment if the assets are held in an ordinary investment account. The favorable treatment is lost if the assets are held in a pension account. The tax preferences available on equity income have varied over time, producing a wide variation in the net value of the pension tax preference for workers who accumulate equities in their retirement savings accounts. The value of the pension tax preference also depends on the nature of the alternative savings account in which workers accumulate retirement savings if they do not save inside of a pension. Savings accumulated inside an insurance contract obtains part of the favorable tax treatment provided to pension savings. In particular, the investment income accumulated inside an insurance policy is usually untaxed until money is withdrawn from the account, possibly in retirement.

Our calculations show that the pension tax preference continues to be economically significant for U.S. workers, especially those with average and above-average lifetime earnings, those who are deciding where to locate their savings early in their careers, and those who expect to convert their retirement savings into an annuity. For a typical U.S. worker who wishes to invest in taxable bonds and expects to convert the bonds into an annuity at retirement, the tax preference for saving inside a pension reduces the present value of taxes on gross earnings, future investment income, and withdrawals of proceeds from investment accounts as a share of gross earnings by about 21 percentage points. Compared with accumulating bond investments inside a deferred annuity insurance contract, saving inside a pension account reduces this tax as a share of gross earnings by about 13 percentage points. For typical workers who intend to invest in equities, the pension tax preference falls roughly in between these two figures. Finally, we find that changes in U.S. tax law, especially in the tax treatment of capital gains income and qualified stock dividends, have led to sizeable changes in the value of the pension tax preference. The value of the pension tax preference to worker-savers is lower than it was in the mid-1980s and substantially lower than it was in the late 1980s.

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