Amazing Waste: Tax Subsidies To Qualified Retirement Plans

By Calvin H. Johnson

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The proposal would repeal the tax advantages given to qualified retirement plans. Qualified plans are ineffective or counterproductive for their given rationales, which makes them a rich source of revenue when the United States needs money. Johnson argues that qualified plans provide a safety net where there is little need for it and provide no safety net where it is needed. Qualified plans are said to improve the value of a dollar by moving it from high-income working years to low-income retirement years. However, the tax advantages are distributed under a reverse-Robin Hood pattern to high-income groups (many with soaring salaries) and by negating the tax brackets. That distribution of benefits can be expected to reduce the utility of a dollar. Qualified plans are said to be an incentive for savings, but when government cost and deficits are considered, the plans reduce net national savings. It would be cost free and effective to increase retirement savings by mandating savings for retirement or by imposing default rules without a tax subsidy.

The proposal is offered as a part of the Shelf Project, a collaboration of tax professionals developing methods of raising revenue in ways that improve the fairness and efficiency of the tax base. Revenue raising is not on the political agenda, but inevitably it will be. The Shelf Project has 74 proposals so far. Comments are welcome either as public debate, directed to the Tax Notes editor, or privately to cjohnson@law.utexas.edu.

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Qualified retirement plans are an extraordinarily complex and expensive government tax program that is ineffective or counterproductive when tested by the rationales offered to support it. The program’s impact on retirement security could be replaced at a small fraction of the current cost, perhaps at no cost. Qualified plans forfeit $180 billion of government revenue a year with rules that are over-the-top complicated, even by tax standards. The rationales are untenable, making qualified plans rich pickings for reducing the deficit and U.S. debt, or reducing overall tax rates, whenever the United States is ready to raise some money.

Much of the political support for qualified plans comes from the argument that “nondiscrimination” describes a grand bargain under which rank-and-file employees will be given pensions in exchange for tax benefits to high-income officers. Typically, however, a qualified plan in full compliance with the nondiscrimination rules will give the median worker an expected value well under 1 percent of

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1Office of Management and Budget, “Analytical Perspectives, Budget of the U.S. Government, Fiscal Year 2015,” at 208 (Table 14-1, sum of lines 145-147, 149 for five years divided by five, equals $180.6 billion average a year).

the value given to the highest-paid employees. Qualified plans are like charities that spend all their money on fundraisers’ fees and trickle out trivial amounts to the supposed charitable beneficiaries. The rank-and-file employees are getting the short end of the bargain.

Another justification for qualified plans is that they increase the utility of a dollar for households by moving that dollar from high-income working years over to presumably lower-income retirement years. People should save for retirement, evenly spreading out their dollars over their adult lifetime, and they largely do save for retirement. But some households are myopic and do not save enough to maintain their standard of living in retirement, and in hindsight they regret it.

Because the distribution of the tax benefits from qualified plans is so top heavy, however, the plans give their benefits primarily to those who are not dropping their standards of living in retirement. As a group, the primary beneficiaries are making large transfers that signal that they are not under economic stress. The retirees who are under stress are getting nothing from the program. It is as if the safety net were installed under the elephants, because they are big players, and under the ringmaster, who runs the circus, but not under the trapeze artists.

Minor tinkering might improve the distribution somewhat, but the core logic of providing benefits pro rata to salary and in negation of the tax brackets is too flawed to be saved. Neither a high salary nor a high tax bracket is reasonable indicium of the need for a safety net or of stress in retirement. Overall, the tax advantages are reverse-Robin Hood, moving dollars from the average taxpayer to those who are in better economic shape. That should be expected to reduce, rather than increase, the utility derived from a dollar. If there are sympathetic individual beneficiaries of qualified plans, those few can be made whole, starting from scratch, far less than the $180 billion annual cost of the tax program.

A third rationale is that qualified plans are intended to increase national savings, but in fact, they unambiguously reduce net national savings once the government cost is considered. Savers for retirement tend to be target savers, and target savers save less, not more, when the higher after-tax return rates make their targets easier to reach. Households can also be expected to achieve the tax benefits with saving that would occur anyway or by borrowing. The data show that few are doing the harder work of reducing their current standard of living to increase real saving. In the rationalizing myth, qualified plans are a reward that will induce households to reduce their current consumption to increase their savings, but empirically, the target effect — borrowing and the saving that would be done, anyway — dominates the reward savings. Moreover, national savings are reduced by the government’s cost. If there is any ambiguity about whether the tax subsidies increase or decrease personal saving, the government’s costs, in terms of revenue from income it would otherwise collect, always mean the effect on net national savings is negative. Ending the tax advantages of qualified plans would reduce the national deficit and increase overall national savings.

Further, we do not want to increase national savings in the contraction phase of an economic cycle. Providing incentives to save more is the opposite of what we are trying to do when we use deficit spending as a countercyclical stimulus. The rationale of Keynesian stimulus is to move resources from further savings into immediate consumption until the diagnosed overcapacity is drawn down. Thrift, as a private virtue, ultimately suppresses overall economic activity in a downturn. If the government is trying to reduce savings during a deficit, the goal of the qualified plan program moves in the wrong direction. If qualified plans were more effective, they would do more serious harm. If the rationale for the individual tax advantages is inappropriate for the national goal, it should not be used to justify the tax advantages even if the plans are ineffective.

Under the proposal, both contributions and growth in a retirement account would be taxable. For defined contribution accounts in which separate accounts are maintained for each employee, the employee would be taxed immediately on contributions to the plan as compensation. Income from the trust, whatever the character, would be passed through to the employees and reported, as with other income, on their tax return. For defined benefit plans, the income would be treated as income of the employer, reducing the cost of satisfying the employer’s obligation to pay compensation, and the income would be passed through to the employer’s tax return. The employer’s deductions would be deferred until the employee included the compensation in income. The project also proposes a special tax on defined benefit plans of tax-exempt employers to prevent them from extending to their employees their tax exemption on investments.

The replacement for qualified pension plans must be outside the tax system. Plausibly, no subsidy is called for. People save more if the default rule with their employer is that they are enrolled for set-aside for retirement, even without a subsidy incentive. Mandatory set-asides, like Social Security, might be justified to overcome household myopia,
or they might not be justified. Any subsidy to retirement will reduce the savings made under the target saving model, and the subsidy could be achieved by diverting given savings from other vehicles. Any subsidy to savings will be wasted to the extent that it goes to savings that would occur otherwise.

If there is a subsidy paid for with real money, no one would distribute it in a reverse-Robin Hood pattern, with exclusions and deductions undoing progressive tax and in proportion to salary. No one would give a subsidy to rich people for savings that they do anyway. Qualified retirement plans run by tax advantages are an expensive, complicated, ineffective program that no one would rationally reproduce.

A. Current Law

1. Roths and regulars. Qualified pension plans come in two varieties:

   1. Roth-type retirement plans require the employee to make contributions from funds that bear employee tax, but they then provide a tax exemption for all further gains and distributions from the plan. In the Roth plans, all tax is prepaid before contribution, and there is no further income tax on the later gain or income.

   2. In traditional or regular retirement plans, contributions are made and invested without tax, either through an exclusion or a deduction for the contribution, and there is no tax on the accumulation of income or gains within the plan. Distributions are then taxable in full at ordinary income rates. For traditional or regular retirement plans, all tax is postpaid.

   If tax rates remain constant in the year of contribution and distribution, the return rate on investment is the same, and the amount of investment is sensitive to the upfront tax, the terminal value of a Roth and regular qualified plan will be the same. Table 1, column A describes a Roth-type IRA or section 401(k) plan. Salary is given at $167, and tax at an assumed 40 percent rate is imposed before the contribution to reduce the investable amount from $167 to $100. There then is no further tax on gain, income, or distributions. Column B describes the regular IRA: No tax is imposed on the contribution of the given $167 salary or on the accumulation of income within the plan, but ordinary tax is imposed on the total distribution. The table uses contributions that triple between contribution and withdrawal, which is consistent, for example, with a 2.8 percent annual growth for 40 working years. Both plans give the taxpayer the same result at the end:

<table>
<thead>
<tr>
<th>A. Roth Plan</th>
<th>B. Regular Plan</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Salary $167</td>
<td>$167</td>
</tr>
<tr>
<td>2. Tax at 40 percent $67</td>
<td>$0</td>
</tr>
<tr>
<td>3. Investable amount (1 minus 2) $100</td>
<td>$167</td>
</tr>
<tr>
<td>4. Growth (three times 3 over working life) $300</td>
<td>$500</td>
</tr>
<tr>
<td>5. Tax on profit at 40 percent $0</td>
<td>-$200</td>
</tr>
<tr>
<td>6. Terminal value $300</td>
<td>$300</td>
</tr>
</tbody>
</table>

Neither regular nor Roth plans reduce the pretax return, the tripling, from the investment within the plan. Qualification for long-term capital gain, which reduces gains by as much as 20 percent, is inferior to either variety of qualified plan.

The equivalence of regular qualified plans to the tax-exempt Roths is counterintuitive for some once the contributions have been made. Retirement and estate planners tend to forget the long-past prepayment of tax in the Roth and see only the tax still due on the regular plans. Still, the equivalence of Roth and regular plans can be generalized by algebra for any tax and return rate, as long as the growth rate is the same for both columns and the tax rate before contribution (line 2) is the same as the tax rate upon distribution (line 5), and the amount invested upfront varies according to the upfront tax.

Often, one or the other plan is preferable. A regular qualified plan will be better than the Roth tax exemption, for instance, if tax rates drop in retirement, which is common once salaries stop. A

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3See section 408A(b) (no deduction allowed for Roth IRA); section 408A(a) (exemption allowed); section 408A(d) (exclusion for distributions); section 402A(a)(1) (no exclusion for Roth election 401(k) contributions); section 402A(d) (exempting distributions from Roth 401(k) plan).

5A taxpayer gets no basis and does not need any allowance for recovery of basis from out of distributions in column B because none of the salary has been previously taxed. The distributions (line 4) might be thought of as receipt of salary for the first time. All tax is postpaid.

6Algebraically, the terminal value of column A, the Roth, is (1) $100 x (1-T) x (1+R)n x (1-0), where T is the tax rate and R the growth for period n. The "(1-0)" term just means there is no tax at the end. The terminal value of column B, the regular qualified plan, is (2) $100 x (1-0) x (1+R)n x (1-T). Terminal value (1) must equal terminal value (2) for the same value for the variables because the order of statement of terms does not matter in multiplication.
Roth plan, however, will be better if tax rates rise between the contribution and distribution.

Roth plans are also more advantageous if the taxpayer knows in advance that the growth rate within the plan will be higher than borrowing rates or alternative investments the taxpayer owns, so the taxpayer can finance the prepaid tax without reducing the amount invested in the superior investment. The equality of Roths and regular plans assumes that the amount available for investment under the Roth is first reduced by upfront tax (lines 2 and 3 of Table 1), but if the taxpayer can pay tax with borrowing or liquidation of another investment at a cheap enough price to keep the advantage of high-return investment in the Roth, the Roth terminal value will exceed that of the regular qualified plan. Because of the taxpayer election between the two, Roths will be used for high-return assets, for instance, where there is high labor input into the investment to cause its growth. Roths cost the government future tax revenue. Given that taxpayers elect Roths for high-return investments or for cases in which tax rates go up, Roth plans are like stealth government debt, and at a borrowing rate far higher than what the government would have to pay with straightforward debt.

2. Defined benefit versus defined contribution. Regular qualified plans define either the benefit retirees will receive or the contributions to the plan. In the classical, employer defined-benefit plan, the employer promises employees a pension for life after retirement. With that promise, the employer bears the risk that investment returns will drop or that life expectancy will increase, as well as variations in unknowns like employee turnover or increases in levels of vested pensions. A pension for life means employees avoid the risk that they will outlive their retirement nest eggs.

The alternative is to define the contribution to the plan, from either employer or employee, but not the ultimate benefit. What the employee will have available to spend over retirement, no matter how long, depends on the investment success of the specific employee account. Defined contribution plans have the decided virtue of giving the employee the right to carry fund balances to another job once they vest. Defined contribution plans rarely give the employee steady security if he lives too long, but the portability of contribution plans prevents a penalty on changing jobs.

There are many different types of defined contribution plans, and Congress has added to the inventory over the years. Profit-sharing plans, for example, define the contribution by reference to the employer’s profit. Elective or section 401(k) plans are now the most popular qualified plan. They allow the employer to choose, year by year, whether to take taxable cash immediately or add a tax-excluded contribution to the retirement account.

Before 1962, qualified pension plans were limited to plans for employees of corporations, but beginning in 1962, Congress allowed plans for sole proprietors and for partners. IRAs started in 1974 for workers who lacked access to an employer plan, but they are now available, with more restrictions, as a supplement even for employees who have access to a group employee plan. Elective section 401(k) plans and individual accounts can both be either Roth-type plans in which all tax is prepaid or regular tax-post-paid plans. In defined-benefit plans, by contrast, tax is always postpaid, upon distributions.
Defined benefit pensions once predominated but are now shrinking in importance. In 1974 defined benefit accounts constituted 87 percent of all plans, but by 2004, 92 percent of new plans were defined-contribution plans. The Office of Management and Budget estimates the revenue cost of all qualified plans to be $903 billion over the five years from 2014 through 2018, with 74 percent of that cost attributable to defined-contribution plans, and 26 percent the cost attributable to defined benefit plans.

Qualified pension plans have varied monetary limits on the contribution, all adjusted annually for inflation. A defined benefit plan may promise a pension of no more than $210,000. An employer-wide defined-contribution plan is allowed a contribution of up to $52,000 for 2014. For an employee who works for 40 years and then retires for 30 years, the defined contribution limit is more generous for return rates that are above (untaxed) 3.1 percent. Employerwide plans must satisfy complicated nondiscrimination rules, which require some pensions for rank-and-file employees. For reasons discussed below, the nondiscrimination rules themselves give median-pay workers a below-modest expected value. The limits for elective contributions when nondiscrimination requirements are unfeasible, however, are set lower than for defined benefit plans. IRAs have an annual contribution limit of $5,500, with another $1,000 allowed for individuals age 50 and above as a catch-up, with a complicated phaseout rule that depends on income and whether the worker’s employer also maintains a plan. An elective section 401(k) plan may have a contribution of no more than $17,500, with another $5,500 catch-up for older workers.

For the richest taxpayers, even the maximum $210,000 annual pension is not a serious contribution to their overall wealth. Still, qualified plans are a big revenue cost to the government. The OMB estimates the annual average revenue cost at $180 billion, which amounts to 35 percent of the current federal deficit.

B. Reasons for Change

The qualified plan program is ineffective and even counterproductive for its articulated goals. The nondiscrimination requirement is said to reflect a bargain to provide pensions to rank-and-file employees. However, it is a wasteful way to deliver to rank-and-file employees. Under one reasonable set of assumptions, the median employee gets benefits with an expected value of well under 1 percent of the value given to the highest-paid employees. If highly paid employees are getting their benefits as middlemen, they are taking too much out of the system. Qualified plans are said to improve utility by moving dollars from high-income working years to low-income retirement years, but the distribution of tax benefits is so top heavy that it is unlikely to identify people who will get especially high utility out of a dollar. And finally, the tax subsidy, which is said to improve savings, is reducing national savings, not increasing it. The program is expensive, complicated waste.

1. Nondiscrimination. Much of the political support for qualified plans arises from the argument the Treasury secretary (arguing that qualified plans were a tax subsidy that should be allowed only if extended to lower-salaried employees).

21IR-2013-86 (announcing the limits with inflation adjustments for 2014).

22OMB, supra note 1, at 208 (Table 14-1) ($903 billion over five years, or $180 billion per year).


1Revenue Revision of 1942: Hearings on H.R. 7378 before the House Committee on Ways and Means, 77th Cong. 2405-2406 (1942) (statement of Randolph Paul, special tax adviser to the Revenue Act of 1942 committee). (Footnote continued in next column.)
that the plans are providing income security for rank-and-file employees. Employer qualified plans must satisfy nondiscrimination rules that provide that if an employer is going to give access to the tax advantages for its highest-income employees, rank-and-file employees must get pensions under the same logic.\(^{25}\) Nondiscrimination is often described as the core deal underlying qualified plans. Qualified plans are described, for instance, as designed to "strike a balance between providing incentives for employers to start and maintain voluntary, tax-qualified pension plans and ensuring participants receive an equitable share of the tax-favored benefits."\(^{26}\)

When Congress or the IRS targets some abuse of the qualified plans, defenders commonly reply that unless the current abuse is allowed, employers will abandon qualified plans and cut off the rank-and-file employees from any pensions.\(^{27}\)

The nondiscrimination rules deliver little of the $180 billion annual cost to rank-and-file employees. Nondiscrimination is an extraordinarily complicated area, even for tax lawyers, and indeed even for employee benefit specialists,\(^{28}\) but the rules are not restrictive. Under a reasonable set of assumptions, the median worker should expect pension benefits that are well under 1 percent of the value of the benefits that the best-paid employees can expect. Even if we look at the pension amount and not just the tax benefits, the pension for a rank-and-file worker is still very modest. Giving big tax subsidies to highly paid employees is an inefficient way to deliver pensions to median and lower-income employees.

Data from the building construction industry provide an illustration. Under the logic of the nondiscrimination "bargain," a company will give its median employees as little as allowed by the nondiscrimination rules in order to deliver the maximum allowed amount to top-paid officers, who control the company. Providing the maximum to the top-paid workers and the minimum to lower-paid workers is a rational assumption in this model because lower-paid workers are younger, more in need of immediate disposable income for other reasons, and get less from tax exclusions.

The important reasons for the trivialization of nondiscrimination restrictions are that:

- pensions are pro rata to salary, with a limit now at $260,000 on the salary that can be counted;
- tax benefits are pro rata to the tax rate, which is higher at the CEO level;
- nondiscrimination is measured by pension payout, but cost and value are measured by discounted present value; younger people are cheaper, and their future pension is less valuable now, but that is not captured in the nondiscrimination tests;
- Social Security payout is subtracted from the employer's obligation, and $10,000 a year may be used as a rough measurement of Social Security pensions;
- benefits are forfeited if the employee leaves in less than three years and turnover is high in the lower incomes; and
- workers classified as independent contractors and employees working half time or less get no benefits.

\textbf{a. Pro rata to salary.} Nondiscrimination is satisfied by pensions that are a constant percentage of salary.\(^ {29}\) In testing nondiscrimination, however, the highest salary that can be taken into account is limited by an amount, now $260,000, which is adjusted annually for inflation.\(^ {30}\) The maximum annual pension allowed for qualified plans under

\(^{25}\text{Paul statement, supra note 21.}\)

\(^{26}\text{Barbara J. Bovbjerg, Government Accountability Office, quoted in "GAO Primer Provides Private Pension Plan Guidance," GAO-02-745SP, at 1738 (Sept. 18, 2002).}\)

\(^{27}\text{See, e.g., "Industry Committee and Los Angeles Bar Oppose Rangel Pension Proposal," Tax Notes, July 26, 1982, p. 308 (saying that proposed restrictions on plan loans to beneficiaries removes "incentives for employers to adopt and maintain qualified plans . . . and may indeed encourage the termination of many existing plans or the cutback of existing retirement benefits for all participants" and reduces capital formation). Other arguments relying on the pension to rank-and-file employees include Joint Committee on Taxation, "Present-Law Tax Rules Relating to Qualified Pension Plans," JCS-9-90 (Mar. 22, 1990) ("complexity of the employee benefits laws is reducing the number of employees covered under employer-provided plans"); AALU Says Proposed Nondiscrimination Regulations Eliminate Incentives for Maintaining Qualified Plans, Tax Notes, July 23, 1990, p. 409 (arguing that a proposal to eliminate even small disparities in benefits would significantly eliminate the incentive to maintain qualified plans); Special Committee on Simplification of the New York State Bar Association, "A Process Awaits: Federal Pension Laws," Tax Notes, Apr. 24, 1989, p. 463 (calling for amelioration of the rules because "disenchantment with the sponsorship of private pension plans is becoming rampant in the business community").}\)


\(^{29}\text{Section 401(a)(5)(B) (providing that plans are not discriminatory because benefits or contributions are uniform in relationship to compensation).}\)

\(^{30}\text{Section 401(a)(17); Notice 2013-73, 2013-49 IRB 598.}\)
The current law is $210,000, meaning that the maximum pension is 81 percent of the maximum cognizable salary. If the employees with salaries at $260,000 or more are to get their maximum pension, lower-paid workers must also be promised a pension that is 81 percent of their salary, albeit with further adjustments described below. The median salary for workers in the building construction industry was $31,000 in 2012, and 81 percent of that would be a pension of $25,000 a year. The $210,000 pension allowed for high-bracket employees allowed by the nondiscrimination rules is 8.4 times higher than the pension for the median worker.

The limitation on cognizable salary in testing for nondiscrimination under section 401(a)(17) is important, although insufficient to justify the program as a whole. CEO salaries are reaching ratios on the order of 354 times rank-and-file salaries. The ratio has been increasing steadily since the 1950s when CEOs were paid only 20 times rank-and-file salaries. A salary of 322 times the median for building construction would be about $10 million, and the maximum $210,000 pension would be a mere 2.1 percent of salary. Without the section 401(a)(17) limit, the median worker would then need to be promised just 2.1 percent of $31,000 or $651 a year, less Social Security, which leaves a very modest pension indeed. Absent the section 401(a)(17) limit, the CEO would have a pension 322 times higher, not just 8.4 times higher than the median. Still, as the analysis continues, the cost of the qualified plans is not justified by the benefits to the rank-and-file employees even with the section 401(a)(17) limits.

b. Proportional to tax. The CEO avoids tax at 39.6 percent on compensation by reason of qualified plans, and for the median worker, the tax on compensation that is avoided is at 15 percent. Thus, a contribution for the CEO saves tax that is 39.6/15 or 2.64 times higher than the median worker.

A necessary reservation is that defined benefit plans are disappearing, and the contribution under a defined contribution plan is unaffected by the time value of money. Without the variable discounting of defined benefits, the analysis would return to the previously found 22-times-better ratio for defined contributions, with further adjustments below.

c. Present value. Under defined benefit plans, nondiscrimination is tested by the pension promised, but the economic burden of the cost and the value of a pension is its present value. Pensions for younger, lower-paid workers are cheaper to fund and symmetrically give less present value to the young employee because the pension is so far away. Assume, for instance, that the CEO will retire next year and the median building construction worker is now 25 and has 40 years until retirement, and each will have a 20-year pension after retirement. Using a 3 percent discount rate, the cost of the CEO pension is 3.17 times higher per dollar of pension than the 25-year-old worker’s. That turns an undiscounted ratio of 22 times better into a net present value benefit, that is, 70 (or 3.16 x 22) times higher for the CEO than for the median worker.

d. Subtract Social Security. Consistent with nondiscrimination, an employer plan may treat Social Security as part of the retirement security promised to employees and thus subtract a retiree’s Social Security receipts from the amount the employer must pay. There is a safe harbor, not strictly equal to the Social Security pension, under which the plan

31Section 415(b)(1)(A), IR-2013-86 (updated with inflation adjustments).
32$210,000/$260,000 = 80.77 percent.
35Mishel and Sabadish, supra note 34.
can subtract a fixed dollar amount of up to $10,000 a year.\footnote{Section 401(l)-3(d)(4).} Because the median employee’s pension, calculated above, is $25,000, the Social Security offset reduces the employer-provided pension to $15,000. The maximum $210,000 annual pension must consistently be reduced by $10,000 to $200,000. The $10,000 reduction for everyone means the pension of the highly paid employee is 13.3 times the pension of the median worker rather than just a ratio of 8.4:1.\footnote{Multiplying the ratio for base pension (less Social Security), times tax rate factor, times discounted time value yields 13.3 x 2.64 x 3.17 = 111.6.} Making the tax rate and time value adjustments would increase the ratio of present value for the higher-paid (more than $260,000) to median-paid employee to 112 times.\footnote{Section 416(g).} The median employee will be paid a pension from the company that is worth 0.9 percent of what the higher-paid employees will get.

The expected value of benefits to median- and low-income employees also drops toward zero because of high turnovers in low-income jobs, and because of high percentages of independent contractors and half-time workers.

e. Turnover. Employees who leave before their benefits vest get no benefits. Turnover of lower-paid employees is high, and most employees hired by a company will never be eligible for a pension benefit. Nondiscrimination would be especially troublesome in top-heavy plans, defined by statute as plans in which more than 60 percent of the benefits go to highly paid employees.\footnote{Section 416(b)(1)(A). A top-heavy plan may also elect to vest under a schedule in section 416(b)(1)(B) under which 100 percent of vesting does not occur until after six years, but the schedule requires vesting of 20 percent and 40 percent of benefits in the second and third year, respectively. The trade-off is deferring the vesting of 40 percent and 20 percent of benefits to the fourth and fifth years, by comparison to cliff-effect 100 percent vesting after three years. Given that turnover rates will feel the vesting of low-income employees. To calculate the least benefits for low-income workers, the full vesting after three years reduces the pension they must be promised.} For top-heavy plans, the employee’s pension benefits must become nonforfeitable, for instance, for 100 percent of the benefits after three years of employment.\footnote{BLS, “Job Openings and Labor Turnover Survey News Release,” Table 16 (Mar. 11, 2014).}

A three-year vesting rule means that employers need not cover most of their rank-and-file employees. In 2013 the overall national average for separation from employment for all employment sectors was 38 percent of employees.\footnote{Id.} Conversely, 62 percent of employees stay for a year or more. Translating the annual separation figures into a separation figure at the end of three years depends on information we lack about how time in employment affects separation rates. If all employees are equally likely to leave, then after three years, (62 percent)\footnote{If all employees are equally likely to leave, then after three years, (62 percent) x 0.9 percent (34.5 percent of 0.9 percent) of the expected pension is between 322 and 2,500 times higher per capita than what they are delivering to the median worker.} or only 23 percent of the original workforce would be eligible for accrual of a pension. If all separations occur in the first year and it is always the same new replacement workers who are leaving, 62 percent of the workforce would become vested.

For some industries, separation rates are higher. In the construction industry, for example, 65.5 percent of employees separate from service every year.\footnote{Id.} If the separation rate is independent of time in employment, then, over three years, only 4 percent of the employees will remain long enough to achieve vesting. If employees leave only in their first year, then 34.5 percent will vest after three years. In the construction industry, the company will need to provide for a pension for somewhere between 34.5 percent and 4 percent of its workforce.

Any given employee either vests or does not, but an employee can discount the pension beforehand by the probability of vesting to reach a discounted expected value without knowing the outcome. The expected value is between 4 percent (if separation is independent of longevity) and 34.5 percent (if separation is only in the first year) of the value of a pension. The pension for the median employee, considering pro-rata-to-salary contributions, tax rates, and Social Security, is 0.9 percent of the pension of the highly paid employees. Having no data, we might estimate that the highest-paid employees have already vested on their way to the top or will assuredly vest. If vesting is nearly assured, vesting affects the value of the lower-income pension but (almost) not at all the pensions at the top. Combining the expected value of vesting with prior factors means that the median employee is getting a pension that has an expected value that is between 0.04 percent (4 percent of 0.9 percent) and 0.31 percent (34.5 percent of 0.9 percent) of the expected value of the highly paid employee’s pension. If higher-paid employees are getting their benefits in order to give pensions to the median worker, they are taking a fee for their middleman service that is between 322 and 2,500 times higher per capita than what they are delivering to the median worker.

The ratio of value of high-income to low-income pensions is also affected by the exclusion of independent contractors and half-time workers. It is plausible that the exclusions disproportionately affect employees with lower wages and reduce the expected value of the pension significantly, but
information available here does not allow reasonable quantification of the effects.

f. **Independent contractors.** Independent contractors need not be included in the plan for employees. Increasingly, employers are claiming workers are independent contractors rather than employees and are not giving them benefits. Misclassification of employees is apparently not well enforced.\(^{45}\) Indeed, the tests separating employee from independent contractor status are especially vaporous, which makes them difficult to enforce.\(^{46}\) Given the vagueness of the rules, one wonders why there are so many “employees.” Still, independent contractors, even with recent growth, are estimated to constitute only 7 percent of the workforce.\(^{47}\) Without knowing how independent contractor status is correlated to salary, age, and turnover, information that 7 percent of the whole pool consists of independent contractors does not give us enough information to adjust the expected value of a pension and the ratio between benefits for highly paid and low-paid employees.

g. **Part-time employees.** Employees who are half time or less may be excluded from employee plans without violating the nondiscrimination rules.\(^{48}\) Women are more likely than men to be part-time workers. Thirty-one percent of employed women work less than 34 hours a week, but only 18 percent of men do.\(^{49}\) Exclusion from a pension is allowed at the half-time mark — 20 hours a week — whereas the national statistics measure part time by more or less than 34 hours a week. Part-time status plausibly should lead to further discounting of the expected value, but without data tied to the half-time nondiscrimination definition and, again, without data on whether part-time status is independent or correlated with other factors, the quantity of the discount cannot be fairly estimated. Still, it is plausible that the expected value of a pension for the median worker, already measured in hundredths of a percent of the expected value at the top, drops even further in the comparison because independent contractors and half-time workers do not get benefits. At those levels, it is fair to characterize nondiscrimination as a sham or a joke.

An alternative measure of effectiveness would be to ask how much pension must be given to the median worker rather than how much of the $180 billion tax cost the median employee gets. If employees too poor to pay tax get a pension, they get no tax benefit, but the program might deliver a badly needed pension. The pension value can be measured easily by dividing it by the assumed tax rate, 15 percent. Thus, the value of the tax benefits to the median worker is between 0.04 percent and 0.31 percent, and the pretax pension would thus have a value of 0.21 percent and 2.06 percent of the tax benefits given to the high-income employees. Yet, the higher-paid employees are taking far more out of the system than a bargain would imply, and the median worker and those below are getting modest benefits.

If rank-and-file employees were the object of charity served by qualified plans, the plans would resemble the charities that have glossy pictures of needy, even pitiful children, which, however, spend all the money they raise for the fundraisers’ fees.

Nondiscrimination rules might be amended in incremental ways to give a bit better value to the rank-and-file side of the bargain. Nondiscrimination might well be tested by the present value of long-distant pensions. We might stop the subtraction of Social Security and require immediate vesting. We might require coverage of part-time (predominantly female workers) and “independent contractors.” Still, the first steps — pensions pro rata to salary and tax benefits pro rata to tax bracket — are an ineffective way to focus on the retirees who are going to have trouble in retirement and for whom a dollar will have special value. Most of the dollars will be wasted on retirees who are doing fine without the tax breaks. Nondiscrimination rules are complicated, nearly impossible to understand (even for lawyers who specialize in the taxation of employee benefits), and they do not deliver on their promises even after all the complexity. It is time to repeal both the overly complicated and ineffective nondiscrimination rules and repeal qualified plans as well.

2. **Reverse-Robin Hood distribution.** As might be expected from the nonrestrictiveness of the nondiscrimination rules, the distribution of tax benefits of qualified plans is skewed to the top. Figure 1 and Table 2 show the value of qualified retirement accounts, including both the defined benefit and
defined contribution plans, by their value to households at retirement age — that is, age 65 to 68. Defined benefit plans are valued by their actuarial value based on post-retirement expected life. Defined benefit plans are valued by their actuarial value based on post-retirement expected life.50

Table 2 shows the same information in table form.

Benjamin H. Harris, C. Eugene Steuerle, Signe-Mary McKernan, Caleb Quakenbush, and Caroline Ratcliffe of the Tax Policy Center reached a similar distribution, allocating the tax benefits from qualified plans among taxpayers according to their extended cash income, rather than by wealth at retirement age. The tax benefits were measured under a simulation that assumed the plans’ qualified status was repealed.51

Table 3, reflecting shares of tax benefits, uses the same underlying data as Figure 2. It shows that the bottom quintile gets half a percent of the aggregate tax benefits, and the highest-income quintile gets 71.4 percent of the tax benefits from employersponsored plans, defined to include both defined benefit and defined contribution plans.

Figure 1. Distribution of Defined Benefit and Defined Contribution Account Values by Wealth at Age 65-68 (in thousands of dollars), 2008

Table 2. Value of Defined Benefit and Defined Contribution Accounts at Retirement Age 65-68 by Wealth

<table>
<thead>
<tr>
<th>Wealth Quintile</th>
<th>Total Value of (2) and (3)</th>
<th>(2) Defined Benefits (Actuarial Value)</th>
<th>(3) Defined-Contribution Accounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Poorest 10%</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>At 30% poorest</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>At midpoint</td>
<td>$15,000</td>
<td>$0</td>
<td>$15,000</td>
</tr>
<tr>
<td>At 70% wealthiest point</td>
<td>$158,000</td>
<td>$83,000</td>
<td>$75,000</td>
</tr>
<tr>
<td>At top 10%</td>
<td>$676,600</td>
<td>$329,600</td>
<td>$347,000</td>
</tr>
</tbody>
</table>

Table 3. Share of Tax Benefits

<table>
<thead>
<tr>
<th>Expanded Cash Income Quintile</th>
<th>Percentage of Total Tax Benefits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Least income 20 percent</td>
<td>0.5%</td>
</tr>
<tr>
<td>Second quintile</td>
<td>3%</td>
</tr>
<tr>
<td>Middle quintile</td>
<td>8%</td>
</tr>
<tr>
<td>Fourth quintile</td>
<td>17%</td>
</tr>
<tr>
<td>Top quintile</td>
<td>71.4%</td>
</tr>
</tbody>
</table>

50 James Poterba et al., “Correction: The Composition and Drawdown of Wealth in Retirement,” 27 J. Econ. Persp. 219, 221 (2013) (Table 2).
The tax benefits for IRAs not connected with an employer are smaller, consistent with the lower contribution limits on individual plans, but the distributions and the shares for individual plans are similar to those for employer plans.

Table 4 compares the share of tax benefits from individual and employer plans by quintile of expanded cash income, carrying the shares of employer plans over from Table 3.

Table 4. Share of Tax Benefits

<table>
<thead>
<tr>
<th>Expanded Cash Income Quintile</th>
<th>Percentage of Employer Plan Tax Benefits</th>
<th>Percentage of Individual Plans</th>
</tr>
</thead>
<tbody>
<tr>
<td>Least income 20 percent</td>
<td>0.5%</td>
<td>0.7%</td>
</tr>
<tr>
<td>Second quintile</td>
<td>3%</td>
<td>4.4%</td>
</tr>
<tr>
<td>Middle quintile</td>
<td>8%</td>
<td>11%</td>
</tr>
<tr>
<td>Fourth quintile</td>
<td>17%</td>
<td>19%</td>
</tr>
<tr>
<td>Top quintile</td>
<td>71.4%</td>
<td>65%</td>
</tr>
</tbody>
</table>

3. Benefits to those without need. A second rationale for qualified plans (the nondiscrimination bargain being the first rationale) is to increase the utility that a household gets out of a dollar by moving the dollar from high-income working years to presumably low-income retirement years. People should save for retirement. They should spread their receipts evenly over their adult lifetime to get the most value.52 The theory that supports constant lifetime consumption of a lifetime of receipts is the same marginal utility of money theory that supports a tax bracket system. Everyone spends for the most critical needs first and then spends for continuously less important needs as income increases. If one spends as earnings come in, one spends for less critical needs in the very good years, leaving one, in the no-income years, with no money to pay the rent and trying to eat sand. People display diminishing utility by risk aversion regarding one’s basic nest egg, by buying insurance even when the straight odds disfavor that, and by saving for rainy days and retirement.

However, households are myopic, according to the rationale. They act more like grasshoppers than ants. They do not save enough to maintain their constant standard of living in retirement, and they live to regret that.53 We do not want to send our elderly to the work house — or to daughters’ attics — which is how prior generations handled destitution in old age.

Without doubting the benefit of saving for retirement, the pattern of benefits from qualified retirement plans makes it unlikely that the plans are identifying the retirees with great needs or even those who are dropping in consumption in retirement in economic stress. With compensation for CEOs and high officers reaching record heights, much of the benefit of qualified plans goes to people who are not going to be in economic stress, either during working years or in retirement.

Employees save anyway for retirement because they are concerned about their own future welfare. Without denying some myopia, there is a strong motive to protect oneself in retirement. Subsidies of any kind to saving that would be done anyway are a waste of money because they do not add to security or effect change of any kind. It is impossible to determine what fraction of qualified plans would be saved by individuals in any event, but it is fair to conjecture that most contributions would be done anyway.

A 1990 survey of the economic literature concluded that retirees are about as well off as the

52 The seminal works are Albert Ando and Franco Modigliani’s “The ‘Life-Cycle’ Hypothesis of Saving: Aggregate Implications and Tests,” 53 Am. Econ. Rev. 55-84 (1963); and Milton Friedman’s A Theory of the Consumption Function (1957).

non-elderly.\(^54\) The elderly were spending “sustainable consumption” (defined as the amount they could consume if they annuitized their wealth over their remaining life and consumed evenly every year) at least at the same level as the non-elderly, and possibly considerably higher.\(^55\) It is rare that retirees drop dangerously in consumption.\(^56\) People of retirement age who have been poor all their lives are indeed in need, maintaining their poverty carried over from working years, but the distribution of tax benefits indicates that the poor are not getting anything out of qualified plans.\(^37\)

Beneficiaries of the tax subsidies from qualified plans are also signaling that they do not think they are under economic stress: they are making large gifts in retirement to children and charity. Large voluntary gifts during life reliably represent the donor’s assessment that his household has a surplus that can be transferred. William G. Gale and John Karl Scholz estimated that at least 20 percent of wealth is transferred by voluntary gifts while the donor household is alive.\(^58\) The Michigan Health and Retirement Survey reported that 29 percent of households headed by (on average) 51-year-olds gave substantial gifts to children and grandchildren, and 25 percent of households headed by (on average) 78-year-olds reported such gifts.\(^59\) Transfers of value to children and younger generations are said to be underreported. Still, the reported inter vivos transfers of substantial amounts are good evidence that the donor household was not under financial stress in its own judgment.

Bequests that take effect on death are also sometimes voluntary transfers of surplus above what the retired household needed. Laurence J. Kotlikoff and Lawrence H. Summers estimated that the overwhelming percentage (78.1 percent) of personal savings is transferred to the next generations during life or at death. Only 21.9 percent of savings, once accomplished, is later consumed by the household that saved it.\(^60\) Kotlikoff and Summers have a broad definition of intergenerational transfers, which includes, for instance, college tuitions. Others prefer narrower definitions. For example, tuition for children might well not represent the older generation’s perception of a surplus that can be given away without economic stress.\(^61\) Jeffrey R. Brown and Scott J. Weisbenner, counting only bequests on death, found that the bequests constituted 50 percent of the wealth of households in the top quintile of wealth, and that is the group that gets 65 to 70 percent of the tax benefits from qualified plans.\(^62\)

A transfer at death does not necessarily signal that the decedent perceived a transferable surplus in retirement. Some unascertainable proportion of transfers at death consists of unplanned transfers of cautionary savings. With cautionary savings, the donor household sets aside a large cushion to cover future medical expenses or ordinary living expenses. In some cases, death occurred before the cautionary savings were needed.\(^63\) Yet even the cautionary savings passed on at death indicate that the donor did not in fact need the cushion. The donor household also accepts cushions that are too large for expected needs and does not buy annuities that would cover needs until death (but not beyond) because a bequest or charitable gift taking effect on death is an acceptable result. The premise of giving tax advantages to qualified plans is that they are moving funds to retirees in distress. Large voluntary gifts, including large gifts acceptably taking effect only upon death, are a signal that the donor household was not under financial stress in retirement. Qualified plans are putting the safety net under taxpayers who are not in special danger of falling, and the safety net is not being provided where it is needed.


\(^{55}\)Id. at 617. If households are richer in retirement than while working, moving from working years to retirement years can be expected to reduce the utility from a dollar, under the same theory that supports saving to carry over the dollars to low-income years.

\(^{56}\)See Laurence J. Kotlikoff and Lawrence H. Summers, “The Adequacy of Savings,” National Bureau of Economic Research working paper 627, at 17 (Feb. 1981) (only 1 percent of retirees face reduction in consumption by 40 percent, and none face reduction in consumption by 60 percent, but because of Social Security and defined pensions).

\(^{57}\)Id. at 630.

\(^{58}\)Gale and Scholz, “Intergenerational Transfers and the Accumulation of Wealth,” 8 J. Econ. Persp. 145 (1994). The Gale and Scholz estimate excludes (1) bequests at death, which might be accidental transfers of a cautionary cushion of savings that the decedent turned out not to need; (2) gifts less than $3,000, which at the time defined small routine gifts not part of testamentary transfers under the gift and estate tax rules; and (3) payments of tuition and ordinary support, which might not be evidence of surplus funds.


\(^{60}\)Kotlikoff, “Intergenerational Transfers and Savings,” 2 J. Econ. Persp. 41, 43 (1988).


Some individuals drop enough in income or wealth in retirement to be in economic stress, but those few can be identified and bought off at a price considerably below the $180 billion committed by qualified pension plans annually. Moreover, not every drop in retirement consumption needs to be an object of national concern. People should largely be responsible for their own future welfare. The government may not have a legitimate right to tell households when to spend their money. The qualified plans are an extraordinary complicated and expensive program, and it should apply only when wealth is seriously depleted in retirement. Not every fluctuation should warrant a complicated welfare system like qualified plans as a remedy.

4. Utility of the dollar. Qualified pension plans give offsets to a progressive tax bracket system, which tries to impose tax where it does the least harm. A tax bracket system imposes higher tax rates on taxpayers with higher income. The premise of the tax brackets is that dollars have a diminishing marginal utility as economic position improves. The underlying intuition behind diminishing marginal utility is that people spend money for most critical needs first (food and shelter for survival) and then less critical needs only thereafter. Diminishing marginal utility is displayed by people saving for a rainy day and buying insurance even in the face of high transaction costs, and by risk aversion. With higher incomes, taxpayers can spend a greater percentage on discretionary, non-subsistence items. Surveys consistently find that more income increases self-reported happiness; however, the increase in happiness per dollar is steep for those with little income, and the increase has a shallow-slope, diminishing effect for those with more income.

If we treat people as of equal value in the eyes of the law, dollars become less valuable when received by the wealthy. The poorest citizen will allocate his total value over a few dollars. The richest citizen must allocate his value, which exceeds $75 billion, so that each dollar has 0.000000013 percent of the set value of a person. A government that wants to do the least possible damage to the private economy as a whole with its tax system will take its dollars disproportionately from those who have more of them.

The tax advantage given by qualified retirement plans is the negation of the bracket system. Even if tax brackets should be less progressive, it is unreasonable to assume that the negation of the pattern is correct or that the negation is identifying people with higher utility for a dollar. It is implausible that the person with $75 billion gets more value from a dollar than the person with almost no money even in retirement.

The distribution of qualified plans’ tax advantages is even worse than simple negation of the brackets. Pensions satisfying nondiscrimination are pro rata to salaries. It is difficult to believe that the highest-paid CEO in America, receiving $96 million a year, gets more value from a dollar than the lowest-paid employee.

The distribution of the tax advantages in negation to progressive taxation and pro rata to salary make it doubtful that the qualified plans are effectively identifying persons who have a higher diminishing marginal utility because they have so few dollars. We can assume, at least arguendo, that people sometimes act like grasshoppers when they should be saving for retirement and that people would be better off if they consumed their lifetime income by even amounts over their life. Still, the theory of diminishing marginal utility of a dollar that justifies spreading out dollars over into retirement is the same theory that justifies tax brackets. In looking only to relatively small drops in income in retirement, the justification ignores the larger disparities in income among taxpayers. The tax benefits are going disproportionately to those who are not especially needy, even in retirement. That the tax benefits are skewed so strongly to the top makes implausible the argument that qualified retirement plans are in fact overall shifting dollars to a higher utility user.

5. Harm to national savings. Increasing national savings is also said to be one of the reasons for qualified plans. Qualified plans increase the return on investments, compared with taxable investments, because the return becomes tax exempt under either the Roth or regular plan mode.

See supra discussion accompanying notes 50 and 51. See, e.g., Senate Committee on the Budget, Compendium of Background Materials on Individual Provision, S. Prt. 111-58, at 967 (Dec. 2010) (prepared by the Congressional Research Service) (saying the major economic justification for the favorable (Footnote continued on next page.)
The difficulty with the increasing-savings rationale is that the increase in return rates probably reduces personal savings. At least positive added savings in response to higher returns are “fleeting and fragile.” When the government’s cost of the plans is considered, qualified plans unambiguously reduce national savings. Repealing qualified plans would improve net national savings.

A higher return could reduce personal (nongovernmental) savings, increase or decrease personal savings, or have no effect on personal savings, depending on which of three theoretically possible models dominates.

**a. Target saving model.** If a household has a fixed target to save for, savings will go down in reaction to an increase in after-tax return. Retirement security savings are usually target savings. When after-tax return rates go up, the taxpayer can reach the target with a smaller savings and with a smaller shrinkage of current spending and standard of living. Target savers reduce their savings in reaction to the tax benefits of qualified plans.

Assume a taxpayer projects that annual retirement income of $50,000 will suffice for retirement needs; that his retirement will start in 25 years, at which point life expectancy will be 20 years; and that pretax returns are 5 percent, reduced by 40 percent tax down to 3 percent. To satisfy a $50,000 pension for 20 years, to start in 25 years, the household needs an endowment of $744,000. To reach that endowment at 3 percent, the taxpayer will need to set aside $20,400 per year for the next 25 years.

Now assume that the tax on the return is effectively forgiven by a qualified plan, so that the taxpayer will achieve 5 percent return even considering tax. The higher return means that he can reach the defined target of $50,000 pension for 20 years with an endowment of only $623,111, reached by setting aside only $13,056 annually until retirement. The lower set-aside will free up $7,344 per year, which the taxpayer can spend now instead of saving.

The results generalize for all target savings even beyond the specific assumptions used: When the return increases, the target can be met with lower sacrifice of current consumption and the household will save less.

**b. Divert fixed sacrifice model.** Under the second, “fixed sacrifice” model, qualified plans provide a benefit for saving that would be done anyway through some other vehicle, but they do not decrease current spending. The household keeps the same standard of living and spending pattern. It makes contributions to qualified plans or accepts a reduction of cash compensation for employer contributions into employer plans by borrowing or by diverting existing savings or savings that would occur anyway. Diversion comes from taxable vehicles, including savings accounts, and also from mutual funds — including investments that generate favorably taxed, but still positively taxed, capital gains.

One should expect any household to achieve tax subsidies in the way that involves the least sacrifice. Borrowing or diverting fixed savings into qualified plans does not require the hard sacrifice of actually reducing the baseline standard of living. For young people especially, retirement is far away and the lifestyle spending they have now is far more salient. You are only young once. Indeed, in low-income early years, the taxpayer might be richer in retirement so that moving money from poor early years to rich later years would reduce the utility of the dollar under the same theory that supports the subsidy to retirement savings. Under the “fixed sacrifice” model, qualified plans generate no added personal savings or contribution to national savings.

When retirement savings are funded by debt, the taxpayer achieves no net savings. The debt reduces net worth by the same amount that the contribution to the qualified plans increases it. At retirement, the repayment of the debt reduces the amount available to support retirement consumption. Neither borrowing nor diversion of given savings increases personal savings.

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**Footnote continued on next page.**

70The net present value of the $50,000 pension for 20 years at 3 percent under the standard annuity formula is $50,000 x (1 - (1 + 3 percent)^20)/3 percent = $743,874.

71The future value of $743,874 is reached by annual contributions of A, where A x ((1 + 3 percent)^25 - 1)/3 percent = $743,874, and A is therefore $20,400 per year.

72The net present value of the $50,000 pension for 20 years at 5 percent under the standard annuity formula is $50,000 x (1 - (1 + 5 percent)^20)/5 percent = $623,111.

...
c. Reward model. Under a third model, an increase in return will give the taxpayer a higher reward, and that higher reward will induce him to spend less now to be able to save more because the reward for deferring consumption becomes higher. The argument that qualified plans increase personal savings relies on this reward model, but it is the model least seen in the empirical data.

Empirically, target savings seem to dominate the real savings in our economy, or at least the fixed sacrifices and target savings prevent the reward factor from expanding savings. When interest rates go down, savings usually go up, apparently because of the reaction of target savers. For qualified plans specifically, there is good evidence that contributions come out of existing savings or savings that taxpayers would have set aside anyway, which is the result predicted by the fixed sacrifice model. The painless ways to achieve the tax benefits — borrowing or diversion — triumph over the painful reduction of current lifestyle spending. Any increase in savings in reaction to increased returns is modest at best. There is a certain amount of wishful thinking because everyone likes to see a justification for a tax break, but it is a consensus of the economics profession across the political spectrum that any increase in savings from an increase in returns is a “fragile and fleeting thing.”

When the government’s cost is also considered, qualified plans strongly reduce national savings even when and if the plans modestly increase private savings. The total savings in the economy is private savings plus or minus public savings. The deficit is negative savings, absorbing rather than producing capital. The deficit, now estimated to be $514 billion, is a reduction of total national savings. Qualified plans increase the current deficit by the cost to the federal government in terms of revenue the government forgoes by allowing the equivalent of a tax exemption on plan earnings that would otherwise be taxed. Since the tax given up by the qualified plans has a modest or negative effect on private savings and is entirely an increase in deficit on the federal level, the net effect of the qualified plans on national savings is unambiguously negative.

6. Consumption tax norms. Qualified plans are commonly defended by reference to consumption tax norms. Either a tax-prepaid Roth mode or a tax-post-paid regular qualified mode is said to be necessary to prevent the double taxation of income from capital.

for a regular IRA should be too, because the two generally have the same economic effect. However, regular IRAs might be interpreted as tax-deferred rather than “wholly exempt” vehicles, which would free them from section 265. Section 72(p)(3) takes away the interest deduction if a qualified plan is used as collateral for the loan. Still, the interest disallowance rules are generally based on how borrowed proceeds are used (reg. section 1.163-8T(c)), and a taxpayer can usually achieve the same economic result by tracing borrowed proceeds to something that allows the interest deduction, like a home mortgage or business, and freeing up other cash for the qualified plan or for current spending. Moreover, if interest is disallowed, the taxpayer can achieve the same income-erasing function that the interest deduction gives by selling taxable investments and using the proceeds for the qualified plan to maintain current consumption. Liquidation of a fully taxable investment generally has the same impact as an interest deduction.


Eric M. Engen et al., “The Illusory Effects of Saving Incentives on Saving,” 10 J. Econ. Persp. 113 (1996) (finding little or no effect from contributory plans’ tax savings and explaining away apparent findings that savings respond to interest); Jane G. Gravelle, The Economic Effects of Taxing Capital Income 193-197 (1994) (summarizing studies of IRAs); Orazio P. Attanasio and Thomas C. DeLeire, “The Effect of Individual Retirement Accounts on Household Consumption and National Savings,” 112 Econ. J. 504 (2002) (finding evidence that IRA contributions mostly came out of existing savings or savings that taxpayers would have set aside anyway).
Without undercutting this proposal, we can assume that a progressive consumption tax, allowing a deduction of investments and taxing withdrawals from investing, is an attractive norm. Current and future consumption are competing commodities, like apples versus oranges, and a tax on one (the future consumption) but not the other (current consumption) will create a deadweight loss above the revenue collected, because it distorts private preferences. Moreover, the only difference between a pure income tax and a pure consumption tax is taxation of the risk-free interest rate. The risk-free return rate on capital is trivial, under 1 percent both now and historically, and it is often negative.\textsuperscript{82} Interest, less inflation, is currently negative.\textsuperscript{83} The higher returns to entrepreneurial skill, risk premium, protected position, and sheer luck should be taxed under both a consumption tax and an income tax.\textsuperscript{84} The effective tax rate collected by our income tax on capital, whatever the theory, seems to be trivial because there are so many opportunities to avoid the tax.\textsuperscript{85} “Rents” defined as returns that exceed the minimum interest return necessary to justify savings are very attractive things to tax. The attractiveness of a progressive cash flow consumption tax as a general norm does not, however, justify qualified plans under current law.

If the consumption tax is not just a Trojan horse to shift tax onto poor people, the taxpayers who get the tax advantages of qualified plans under current law would pay at least as much tax under a consumption norm. Rate increases on higher-bracket employees who get most of the qualified plan advantages should offset the advantage of a shift to a consumption tax. Some current beneficiaries of qualified plans would be worse off under a consumption tax beyond the increase in tax rates. Thus, an employee who simultaneously devotes compensation to a qualified retirement plan and borrows an equal amount for consumption would get no improvement from the qualified plan and would lose the interest deduction on the borrowing — or even worse, he would have to include the borrowed proceeds in income.\textsuperscript{86} Under a general consumption tax that reaches entrepreneurial profits, risk premium, and protected rents, the extraordinary gains now put into Roth plans would no longer be exempt, and the revenue from the extraordinary capital returns would be subject to progressive ordinary tax rates. A general consumption tax on the extraordinary returns would repeal the Roth option to exempt extraordinary return from tax. With the countervailing increase in rates, the disallowance of interest deductions, and the repeal of the Roth option, appeal to consumption tax norms is cherry-picking, looking to only some aspects of a consumption tax without moving over to a complete and coherent consumption tax system.

A qualified plan regime within a general cash flow consumption tax has a different impact than a qualified plan within a general income tax environment. Personal savings react to qualified plans in the negative direction, or, at best, barely positive under an income tax environment. But some of the reasons why disappear under a general consumption tax. We should thus expect the response of retirement savings to exemption to be not as low or as negative under a consumption tax when compared with an income tax. First, under an income tax, an employee can borrow to maintain his current standard of living to allow a contribution equal to the borrowing to the qualified plan without any sacrifice. The interest deduction adds enough value to make the borrowing rational, even if borrowing rates exceed savings returns. Under a consumption tax, however, the interest deduction on all borrowing disappears, so there is no tax arbitrage advantage in borrowing. Borrowers tend to be skeptical enough to charge interest high enough that the borrowing would be irrational once the interest deduction disappears.

Second, under an income tax, a taxpayer has a motive to divert existing savings (or savings that would be done anyway) away from corporate stock or other taxable investments and into qualified plans. Under a general tax consumption tax, however, the basic risk-free return on capital is tax exempt whether in a retirement plan or some alternative, which means that there is no tax advantage in diverting savings over into the retirement plan.

\textsuperscript{82}Between 1926 and 2013, Treasury bills gave a return that was 0.6 percent greater than inflation. Ibbotson, “Stocks Bonds, Bills and Inflation, 1926-2013.”

\textsuperscript{83}One-month Treasury bills currently give an interest rate that is 1.48 percent below the rate of inflation, available at http://www.federalreserve.gov/releases/h15/update/rcn (May 9, 2014) Treasury bill interest of 0.02 percent); BLS, “CPI Detailed Report” (Mar. 2014) (inflation rate of 1.5 percent over last year).


For both a consumption tax and an income tax, however, retirement savings would be comfortably modeled as target savings. Target savings move in the wrong direction in reaction to investment incentives, because the target of income security can be met more easily when the return rate increases. Retirement security requires more savings when tax reduces the available return.

It would be an empirical question whether the target savings model or the reward model would predominate under a general consumption tax, but borrowing and diversion of taxable investments would no longer suppress the amount of new savings. The government cost would remain the same under a consumption tax, except just by redefinition of the accounting concept of cost. If a consumption tax is going to reduce national savings, however, that is a good reason not to adopt it.

7. Savings stimulus versus Keynesian stimulus. The goal of increasing savings is inconsistent with Keynesian deficit spending techniques. Keynesian deficit stimulus is based on the premise that there is overcapacity in the economy in the contraction part of a business cycle, and that the problem of overcapacity is to be remedied by moving resources away from savings and over to increased current consumption until the overcapacity is used up. The diagnosis is that thrift, which is private virtue, nonetheless becomes a public vice. Government deficits are a stimulus because they shift resources from savings to current spending.

Stimulating savings, which qualified plans are meant to do, runs directly counter to the Keynesian attempt to shift toward consumer spending. The failure to increase savings, reflected in the data, might indeed be rescuing qualified plans from bad effects in Keynesian stimulus terms. Still, it is difficult to see a justification for qualified plans based on a purpose that is contrary to what the government is trying to do.

C. Explanation of Proposal

1. Repeal. The proposal would repeal the special tax privileges for qualified plans. Employer contributions identified to a specific employee would be compensation income immediately. Qualified plan trusts would be treated as passthrough entities. For defined contribution plans, or plans in which the employees have separate accounts, the income or capital gains from the plan would be passed through to the employees and included on the employees’ tax returns at year-end.

For defined benefit plans in which accounts are not maintained as owned by separate employees, the income within a pension plan trust would be treated as an economic benefit to the employer, reducing the burden of the employer’s obligation to pay compensation by pensions in retirement, and the income of the trust would be passed through to the employer and included on the employer’s tax return. The employer would not be entitled to a deduction for compensation expense under section 162 until the employee included the amount in income. Ordinarily, the employee would be taxed only upon distribution (although the employee would also be taxed if specific funds vest, under section 83 standards).

Under the proposal to pass through the investment income from defined benefit plans back to the employer, the income from defined benefit plans of tax-exempt and government employers would continue to accumulate tax free. Tax-exempt and government employers should be expected to react by shifting from defined contribution plans to defined benefit plans. Using the tax-exempt status to allow tax-exempt growth seems like an inappropriate extension of the tax exemption to the benefit of ordinary employees. The proposal, accordingly, would tax the fund of a funded pension program maintained by a tax-exempt entity at the highest corporate rates. Moreover, because government and tax-exempt employees are commonly without credit risk, they do not generally need a fund to pay future retirees. The proposals would, accordingly, cover the cases in which the tax-exempt employer had no fund identified with employees by providing for a imputed fund, measured as the net present value of vested pensions, computed under sound actuarial principles. The tax due would be measured by the corporate tax rate on the imputed interest income, at the employer’s long-term borrowing rate on a fund equal to the present value of the future benefits.

Because qualified plans have a detrimental effect on national savings, compensation contributed to a retirement plan would be neither deducted nor

excluded, starting with the date of an announce-
ment giving notice of the pending legislation. Leg-
islation to stop detrimental effects may be applied
retroactively to a reasonable period before enact-
ment.89

Taxpayer reliance on existing qualified plans is
ambiguous: Qualified plans might decrease per-
sonal savings by a bit, increase personal savings by
a bit, or keep personal savings about the same. The
plans are counterredistributorial, transferring from
average taxpayers to the well-to-do, and that
should be limited as quickly as possible. Because
there is some possible reliance but not much, and
because the plans are counterredistributorial, the
proposal would allow continuation of the tax ex-
emption for the plan trust for 10 years but require
distributions that would at least distribute all assets
evenly over 10 years.

2. Replacement? Replacement for qualified plans to
subsidize pensions needs to come from outside the
tax system. Subsidies proportional to the astro-
nomical salaries and in negation of the tax brackets
do not identify retirees who are dropping in wealth
in retirement enough to be of concern. If the tax
benefits for qualified retirement plans were re-
pealed, no one would create a replacement program
that matches their distribution.

If workers are myopic about their future welfare,
nonfinancial tools are superior to subsidies. If work-
ers err and we are willing to do something about it,
mandatory set-asides, much like an expanded So-
cial Security, might be called for. However, “soft
paternalism” — that is, government nudges — also
seem to be quite effective. Thus, automatic enroll-
ments that the worker can opt out of with a bit more
paperwork seem to be effective in inducing greater
savings.90

Plausibly, no subsidy for retirement savings is
justified, despite the myopic grasshopper-like be-
behavior of households. That is because retirement
savings are target savings, and a subsidy would
reduce the amount of money set aside. There also
seems to be no administrable way to stop the
borrowing or diversion of funds from other uses to
qualify for a subsidy, although the borrowing or
diversion of savings that would be done anyway
should not be subsidized. The studies of mandatory
or default set-asides give confidence that a viable
program for retirement security can be created
without being expensive. The automatic enroll-
ments and similar devices do not require the $180
billion annual cost to the government, or much of
anything.

89 United States v. Carlton, 512 U.S. 26 (1994) (holding that
Congress could retroactively take away a $10 million deduction
for stock of an employee stock ownership plan stock). See cites
and discussion of the cases, Boris I. Bittker and Lawrence
Lokken, Federal Taxation of Income, Estates and Gifts, para. 1.2.6
(2014).

90See, e.g., Brigitte C. Madrian, “Matching Contributions and
Savings Outcomes,” NBER working paper 18220 (2012) (argu-
ing that automatic enrollment, simplification, planning aids,
reminders, and various commitment devices potentially have a
much greater impact on savings plan participation and contribu-
tions, often at a much lower cost); Chetty et al., supra note 77
(finding modest effect of financial incentives on retirement
savings in sample of all Denmark, but substantial effect with
mandatory or default set-asides).