Testimony Presented to the Senate Committee on Finance Subcommittee on Taxation and IRS Oversight

Hearing on Encouraging Savings and Investment: Stay the Course or Change Direction

June 30, 2005

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Introduction

Thank you Mr. Chairman and other members of the subcommittee for this opportunity to testify on this important subject affecting the financial and retirement security of tens of millions of American workers. My name is Brian Graff, and I am the Executive Director/CEO of the American Society of Pension Professionals & Actuaries (ASPPA).

ASPPA is a national organization of over 5,500 retirement plan professionals who provide consulting and administrative services for qualified retirement plans covering millions of American workers. ASPPA members are retirement professionals of all disciplines, including consultants, administrators, actuaries, accountants, and attorneys. Our large and broad-based membership gives it unusual insight into current practical problems with ERISA and qualified retirement plans, with a particular focus on the issues faced by small to medium-sized employers. ASPPA's membership is diverse, but united by a common dedication to the private retirement plan system.

The direction of savings policy has changed in recent years. Increasingly, Congress has either enacted or has been considering tax incentives for savings outside of the traditional employer-sponsored retirement plan system. These tax incentives include various legislative proposals introduced in the House and the Senate to provide special tax breaks to nonqualified annuities, as well as the present law for reduced tax rates for capital gains and dividends, which is a primary focus of this hearing.

ASPPA believes that if this trend should continue and further tax breaks for nonqualified investments are enacted, it will begin to undermine our current employer-based qualified retirement plan system, which has been successful in encouraging low- to moderate-income workers to finally save. Of particular concern are proposals likely to arise in the context of the upcoming tax reform debate to further reduce or eliminate the tax on capital gains and dividends.

The ASPPA Pension Education and Research Foundation (PERF) recently issued a report, authored by two former staff members of the Joint Committee on Taxation, Judy Xanthopoulos and Mary Schmitt, outlining the potential effects such tax reform options would have on the employer-sponsored retirement plan system. This report—"Savings Under Tax Reform: What Is The Cost to Retirement Savings?"—discusses these concerns in depth and can be found at www.asppa.org.

ASPPA applauds the subcommittee's leadership in examining our nation's savings policy, and the tax incentives designed to implement that policy. In doing so, ASPPA encourages the subcommittee to examine the crucial role played by the employer-sponsored retirement plan system in promoting savings by low- to moderate-income American workers. We implore the subcommittee to be wary of any proposed tax incentives for nonqualified investments that will potentially lessen the attractiveness of savings in a qualified retirement plan. This is

especially true in the context of small businesses, whose costs for maintaining a retirement plan are much greater on a per employee basis than for larger firms. As the tax incentives for nonqualified investments become more favorable on a relative basis, ASPPA is concerned that many small business owners, faced with higher costs for maintaining a retirement plan, will instead forego the plan and invest on their own, leaving their workers without a meaningful opportunity to save.

Not all savings are alike. Through the special incentives afforded the qualified retirement plan system, Congress has always acknowledged the importance of encouraging long-term retirement savings by our nation's workers. These plans are designed to ensure that needed savings will be available for retirement through restrictions on distributions and/or penalties for early withdrawal. However, improved tax incentives for nonqualified short-term investments run counter to that message. The zero capital gains and dividends tax rate for lower-income taxpayers that goes into effect for 2008 is a perfect example. The tax incentive of a zero capital gains rate is economically equivalent to a tax-deductible contribution to an IRA or 401(k) plan. Given that, why would a worker contribute on a long-term basis to an IRA or 401(k) plan if they can get the same tax break outside of a plan and always have access to their money? Without the savings discipline implicit in an IRA or 401(k) plan, how likely is it that savings in short-term nonqualified investment vehicles will be there for retirement? These are important questions the subcommittee should consider in reviewing our nation's savings policy.

Finally, in considering our nation's savings policy, high priority must be placed in encouraging greater savings by low- to moderate-income workers. With increasing pressure on the solvency and continued viability of the Social Security system, it is this sector of Americans whose future economic security is most at risk. The empirical evidence clearly suggests that further strengthening our employer-based retirement plan system will most effectively and efficiently achieve that objective.

The Success of the Employer-Sponsored Retirement Plan System in Encouraging Savings by Low- to Moderate-Income Workers

America is not inherently a nation of savers. Even today about a third of workers are not saving for retirement and many who are saving have retirement accounts that are inadequate to fund a comfortable retirement. Further, demographic shifts illustrate a growing retiree problem: approximately 85 million Americans will be 65 or older in 2050 compared to 36 million in 2000.

The existing provisions of our nation's income tax system that provide incentives for long-term retirement savings have encouraged a significant number of Americans of modest means to save for their retirement. In fact, the current employment-based retirement plan system, which has made middle-income Americans significant investors in the stock market, has been a major contributing force to the "ownership society," to which the President often refers.

Simply put, employer-sponsored retirement plans have been the only effective means to get low- to moderate-income workers to save. According to the Employee Benefits Research Institute, low- to moderate-income workers are almost 20 times more likely to save when covered by a workplace retirement plan. Of workers who earned $30,000 to $50,000 and were covered by an employer sponsored 401(k)-type plan, 77.7 percent actually saved in the plan, while only 4 percent of workers at the same level of income, but not covered by a 401(k)-type plan, saved in an individual retirement account. This stunning disparity cannot be overlooked when evaluating our nation's savings policy. In large part, the difference is due to the convenience of payroll deductions, the culture of savings fostered in the workplace and the incentive of the matching contributions provided by the employer.

Certainly, no one is suggesting that the employer-based retirement plan system is perfect. Coverage rates still need to be improved. In 2003, only 64.9 percent of full-time workers were employed by a firm sponsoring a qualified retirement plan. The lack of coverage is most acute among small business employees. In 2003, at firms with less than 25 employees, only 31.4 percent of full-time workers had access to an employer sponsored qualified retirement plan.

However, the failure to achieve universal coverage should not be an excuse to

abandon a system that so successfully encourages savings, particular by those workers who otherwise are not likely to save. Improvements to the system can be made. From 1994 to 2003, the percentage of full-time workers at small businesses with less than 25 employees that sponsored a qualified retirement plan increased from 26.5 percent to 31.4 percent. In many respects, this substantial increase in retirement plan coverage is due to positive legislation enacted by Congress specifically designed to increase the number of small business retirement plans.

When it comes to encouraging savings, the employer-sponsored retirement plan system has a proven track record. It is not surprising that one study showed that households covered by an employer-sponsored retirement plan are more than twice as likely to achieve retirement income adequacy as households not covered by a plan. As a result, ASPPA believes that any examination of our nation's savings policy must include consideration of new ways to expand coverage under the employer-sponsored retirement plan system.

In 2001, the Senate-passed version of the tax bill that ultimately became the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) included a 50 percent tax credit for qualified retirement plan contributions made on behalf of lower-paid workers, for the first three years of a new small business retirement plan. The provision was dropped in conference for revenue reasons. ASPPA strongly feels that enactment of such a provision would dramatically increase small business retirement plan coverage, thereby increasing the savings rates of small business workers.

Preferential Tax Rates for Nonqualified Investments Could Undermine Long-term Retirement Savings

Impact on Small Business Retirement Plan Coverage

The ASPPA PERF report entitled "Savings Under Tax Reform: What Is The Cost to Retirement Savings?" (Report) examines several possible tax reforms and their impact on retirement savings. We ask that the Report be included as an attachment to this testimony.

The Report looks specifically at several suggested tax reform options, including the reduction or elimination of the tax on capital gains and dividend payments, as a strategy to boost national savings. Many tax reform advocates favor proposals such as these. The Report concludes that while this strategy might be achieved, it would be at a high cost—the loss of retirement savings plans for millions of Americans with modest means who already have difficulty putting aside adequate funds to support their senior years . Frankly, this is too high a price to pay, particularly when there are other mechanisms that could increase savings without jeopardizing the nation's retirement system.

The reduction or elimination of tax rates for capital gains and dividends threatens small business retirement plan coverage. Small employers hesitate to offer retirement plans for several reasons, including administrative complexity and cost, and the unpredictability of their financial condition. These hurdles are offset partly by the knowledge that the small business owner cannot maximize personal retirement savings without providing a plan for workers as well. Any changes that allow small business owners to meet their personal retirement savings goals on an individual basis, such as through a reduction or elimination of the tax on capital gains and dividends, would inevitably threaten the future of the plans they provide their workers.

Because small businesses have fewer employees, the cost of maintaining the plan on a per employee basis is higher as compared to larger firms. Costs are further heightened by ERISA mandated nondiscrimination rules which generally mandate contributions (*e.g.,* matching contributions) be made on behalf of employees in order for the small business owner(s) to save in the plan. For small businesses with less than 25 employees, the cost to the small business owner of these mandatory contributions (plus administrative costs) will typically be at least 30 cents for every dollar that he or she wants to save in the plan. Effectively from the small business owner's perspective, these costs are like a tax that must be paid in order for the owner to participate in the plan.

It has been the longstanding experience of ASPPA members that profit-maximizing small business owners rarely adopt retirement plans due to

employee pressure. The small business has usually operated successfully without a retirement plan for some time. Rather, the retirement security of the small business owner is the motivating factor, and the owner is typically happy to provide retirement benefits for workers if it makes financial sense from his or her perspective.

When capital gains and dividends were taxed at ordinary income rates, it always made sense for small business owners to save through a workplace retirement plan because of the incentive of the upfront deduction, notwithstanding the 30 percent cost for mandatory contributions for employees. However, as Figure 1 illustrates, that advantage went away somewhat with the enactment of the 15 percent rate on capital gains and dividends and goes away dramatically if tax rates on capital gains and dividends are further reduced.

Figure 1 assumes a small business owner contributing $1,000 per year toward savings over a 15, 20 and 30 year period and earning a 7 percent annual rate of return. Column A shows the accumulations if the owner invests in a tax-deductible qualified retirement plan. Column B shows the accumulation if the owner invests all of the money, including the 30 percent cost for mandatory employee contributions on the owner's behalf outside of a plan on an after-tax basis assuming a 15 percent capital gains tax rate. Column C shows the accumulation if the owner invests the same amounts in Column B on the owner's behalf outside of a plan on an after-tax basis assuming a zero capital gains and dividends tax rate.

Figure 1

Owner Savings Realized from Qualified Plan vs. Nonqualified Investments

	A	B	C
	Pre-tax qualified plan contribution	After-tax savings, increased for 30% cost of mandatory employee contributions, subject to present law capital gains and dividend tax rate (15%)	After-tax savings, increased for 30% cost of mandatory employee contributions, subject to zero capital gains and dividend tax rate
15 years	$17,477	$22,812	$24,967
20 years	$28,512	$35,997	$40,732
30 years	$65,697	$77,098	$93,854

As you can see, from the small business owner's perspective, the reduced tax rates on capital gains and dividends make investing on their own more financially advantageous compared to establishing a workplace retirement plan. As a general matter, ASPPA members have currently been able to rebut this math to small business owners by arguing that the 15 percent rate is temporary whereas the tax incentives for qualified retirement plans have been around for decades. The permanent extension of the 15 percent rate will make that rebuttal much more difficult. A further reduction in the tax rate on capital gains will make it virtually impossible to convince a small business owner to adopt a retirement plan, since the owner would have to forego the significantly greater accumulations afforded by investing outside of a plan.

Reducing the tax rates on nonqualified investments erodes the value of the tax incentives for investing in an employer-sponsored retirement plan from the small business owner's perspective. Without those incentives, small business owners will choose not to establish qualified retirement plans for themselves and therefore their workers. As the evidence shows, these workers are significantly less likely to save on their own without the convenience of a workplace retirement plan. As a consequence, the future financial retirement security of tens of millions of small business employees will be seriously at risk.

Impact on Long-term Retirement Savings

On their own accord, American workers do not save adequately for their retirement and other long-term financial needs. While 63 percent of Americans are saving to some extent for retirement, more than one-third of the working population is not. Meanwhile, demographic shifts illustrate a growing retiree population. Approximately 85 million Americans will be 65 or older in 2050 compared to 36 million in 2000. The growing retiree population also reflects increased longevity, with the number of people aged 85 or older expected to increase five-fold in 2050 over the 2000 population. The policy implications of these demographic changes are substantial, particularly given the projected shortfalls in Social Security and the need for current and future retirees to supplement their Social Security benefits with personal savings.

Our current tax system provides a strong incentive for taxpayers to accumulate assets for long-term savings through the employer-sponsored retirement plan system by providing for an exclusion from income for contributions made to a qualified retirement plan or IRA. The current system also works to ensure that the savings is there for retirement by placing restrictions on distributions and imposing tax penalties for early withdrawals. However, putting aside issues affecting small business owners, any further reductions in capital gains and dividends tax rates could seriously undercut the current incentives for long-term retirement savings.

Figure 2 illustrates this concern with respect to an employee's decision to save. Figure 2 assumes an employee contributing $1,000 per year toward savings over a 15, 20 and 30 year period and earning a 7 percent annual rate of return. Column A shows the accumulations if the employee invests in a tax-deductible qualified retirement plan. Column B shows the accumulation if the employee invests outside of a plan on an after-tax basis assuming a 15 percent capital gains tax rate and Column C shows the accumulation if the employee invests outside of a plan on an after-tax basis assuming a zero capital gains and dividends tax rate.

Figure 2

Employee Savings Realized from a Qualified Plan vs. Nonqualified Investments

	A	B	C
	Pre-tax qualified plan contribution	After-tax savings, present law capital gains and dividend tax rate (15%)	After-tax savings, zero capital gains and dividend tax rate
15 years	$17,477	$15,969	$17,477
20 years	$28,512	$25,198	$28,512
30 years	$65,697	$53,969	$65,697

Figure 2 shows that the employee's tax incentives are identical for investing in a qualified retirement plan (Column A) as compared to investing outside of a plan with zero capital gains and dividend tax rate (Column C). However, investing outside of a plan has a major advantage over investing in a qualified retirement plan. Such nonqualified investments are not subject to distribution restrictions or any tax penalties for early withdrawal. If the tax incentives for long-term retirement plan savings and nonqualified investments are economically equivalent, investing outside of a plan will always be favored since it allows for current, unfettered access to the savings.

If middle-income Americans begin to choose to save outside of a workplace retirement plan as a result, there is serious concern that such savings will not be there when needed for retirement. Without the discipline inherent in saving in a qualified retirement plan, it will naturally be more likely that savings will be spent for other reasons before retirement. The potential policy implications of such a

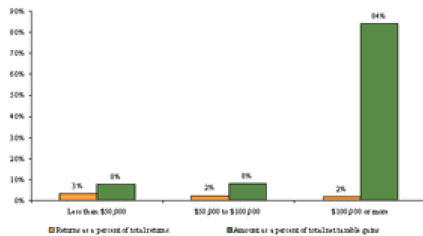
shift away from long-term retirement savings will be significant. The future retirement security of middle-income working families would likely be impaired.

Beginning in 2008, this becomes a very real issue. In 2008, the capital gains and dividends tax rates drops to zero for middle-income Americans. As noted earlier, although the Saver's Credit provides added incentive for lower-income individuals to save in a qualified retirement plan, there will literally be millions of American workers who will now have no real incentive to lock up their savings for retirement. It is true that many workers will be provided matching contributions by their employer, which will act as an incentive to invest in the plan. However, the matching contributions may not be enough of an incentive for some workers, or workers may choose to invest outside of the plan once they have taken full advantage of the matching contribution. Further, many employers do not offer matching contributions at all. Finally, there are tens of millions of working Americans who are still not covered by a workplace retirement plan, and only have an IRA as an option. How many of them will choose to save on a long-term basis in an IRA where there is absolutely no tax incentive to do so?

ASPPA is very concerned that the permanent extension of the current reduced tax rates for capital gains and dividends or any further reductions in such rates will lead to reduced long-term savings. If long-term savings no longer enjoy a special tax advantage, low- to moderate-income workers will save less for retirement. Instead, if they save at all, it will likely be in a short-term savings plan to which they will have ready access, making it more likely than not that these savings will be spent, in whole or in part, well before retirement, thereby threatening their future economic security.

Distribution of Net Taxable Capital Gains
Tax Year 2002

Source: IRS SOI Public Use Files



see full size graph

We also note that the permanent extension of the current reduced tax rates for capital gains and dividends will do very little to promote savings by low- to moderate-income individuals. For example, as Figure 3 shows based on 2002 IRS data, less than 8 percent of tax returns filed reported capital gains income. This translates to about 12 million individuals or only 4 percent of the US population. Further, 84 percent of filings reporting capital gains are by households with more than $100,000 in adjusted gross income, while only 8 percent of filings reporting capital gains are by households with less than $50,000 in adjusted gross income. Given this, we question whether the permanent extension of the reduced rates on capital gains and dividends makes sense given scarce revenue dollars and ASPPA's belief that the priority should be placed on increasing savings rates by low- to moderate-income Americans.

ASPPA alternatively suggests making the current law Saver's Credit permanent. We would further recommend that the credit be made refundable so that it provides a real incentive to working families that have no tax liability. Finally, we recommend that the Saver's Credit be greatly expanded so that more middle-income families are eligible and incentives are provided for greater levels of contributions. Specifically, we believe that households with adjusted gross incomes up to $75,000 should be eligible for some level of Saver's Credit and that the credit should apply to annual savings contributions up to $2,000 per individual. We believe this proposal would be less costly from a revenue perspective while providing a meaningful savings incentive for almost 70 percent of American households as compared to the less than 10 percent of American households likely to benefit from the reduced tax rates on capital gains. We strongly feel this is a much more efficient and effective use of precious revenue

dollars to actually fulfill the priority of increasing lower-income savings rates.

Summary

As the Social Security debate has shown, Americans are appropriately worried about economic security in retirement. Consequently, it has never been more appropriate to examine our nation's savings policy and the various incentives provided for savings. We again applaud the members of the subcommittee for conducting this hearing.

ASPPA believes that a sound national savings policy must abide by the following three principles:

- Priority must be given to promoting increased savings by low- to moderate-income workers. These are the Americans who save the least and whose future financial security is most at risk.
- A national savings policy should favor long-term retirement savings with distribution restrictions over other savings vehicles that are readily accessible to help ensure that working families have some needed savings when they reach retirement.
- Recognition must be given to the critical role played by the employer-sponsored retirement plan system in achieving the first two principles. Workplace retirement plans have been, by far, the most effective way to encourage long-term savings by low- to moderate-income workers.

ASPPA believes that continued and further reduced tax rates for capital gains and dividends may run counter to the above principles. As discussed earlier, more favorable tax rates for nonqualified investments would create a significant disadvantage to investing through the employer-sponsored retirement plan system because individual savings in capital investments generally are not "locked-up" until retirement. If long-term retirement savings no longer enjoy a special tax advantage, low- to moderate-income workers will save less for retirement. Instead, if they save at all, it will likely be in a short-term savings plan to which they will have ready access, making it more likely than not that these savings will be spent, in whole or in part, well before retirement.

Further, with continued reduced or eliminated tax rates for capital gains and dividends employers, particularly small business owners, would be able to accomplish their savings objectives outside of a qualified retirement plan and would be unlikely to incur the cost and potential liability associated with establishing or maintaining a qualified retirement plan. Such plans have clearly shown to be the most effective way to get low- to moderate-income workers to save. Given this track record, a sensible national savings policy should emphasize greater employer-sponsored retirement plan coverage, not less.

Instead, ASPPA believes our national savings policy should focus on tax incentives that will most effectively accomplish the above three principles. Such tax incentives would include an expanded and refundable Saver's Credit and greater incentives for the establishment of workplace retirement plans, particularly by small employers.

The policy implications of reduced long-term retirement savings by working Americans could be substantial, particularly given potential limitations of Social Security and the need for current and future retirees to supplement their Social Security benefits with personal savings. ASPPA stands ready to work closely with the members of this subcommittee and Congress to make sure this does not happen.

It is true that the Saver's Credit provides an added tax incentive to American workers to save in an IRA or 401(k) plan. However, there are literally millions of American households that would be eligible for the zero capital gains and dividends tax rate that are not eligible for the Saver's Credit. The Saver's Credit is equal to 10 percent of contributions to an IRA or 401(k) plan up to $2,000 for married taxpayers with adjusted gross income between $32,500 and $50,000. The zero capital gains and dividend tax rate is available for married taxpayers with taxable income up to $58,100 and whose adjusted gross income could be well in excess of that in light of the standard deduction and personal exemptions. In addition, many working families have no tax liability. Since the Saver's Credit is not refundable, it offers no incentive to these families.

As of July 2003, an estimated 36.4 million US households, or almost 70 percent of all US households owning mutual funds, held mutual funds in employer-sponsored retirement plans. *Investment Company Institute, US Household Ownership of Mutual Funds in 2003, Vol. 12, No. 4 (October 2003).*

Employee Benefits Research Institute (EBRI, based on 2003 data). It should be noted that this disparity exists notwithstanding likely eligibility for the Saver's Credit.

Congressional Research Service (September 10, 2004), Pension Sponsorship and Participation: Summary of Recent Trends.

Id.

Id.

For example, the Small Business Job Protection Act of 1996 created the SIMPLE plan, a simplified retirement plan for small businesses with lower administrative costs. The Economic Growth and Tax Relief Reconciliation Act of 2001 included, among other things, a tax credit for the start-up costs for establishing a new small business retirement plan.

At the time, the Joint Committee on Taxation estimated the revenue cost of the provision to be approximately $2.8 billion over 10 years.

The Report and its Executive Summary can be found at www.asppa.org.

In fact, there is a special nondiscrimination rule that is applicable only to small business retirement plans called the top heavy rules, which often mandate that a small business must make a retirement plan contribution on behalf of lower-paid workers equal to 3 percent of their compensation. See IRC Section 416.

Although Figure 2 shows a continued tax advantage for qualified retirement plan investing as compared to investing outside of a plan subject to a 15 capital gains and dividends tax rate, there is some concern that the differential may not be sufficient to make up for the fact that the qualified retirement plan investments are “locked up” and not generally accessible without substantial penalty. Further, some different economic modeling by other organizations suggests that the 15 percent tax rate can be more favorable in certain cases. See Dalbar Inc., *Dalbar Model Uncovers Benefits and Risks of Tax Cut to 401(k) Retirement Plans*.

For example, if an employer matches up to 3 percent of pay, a worker may choose to save just up to 3 percent of pay to take advantage of the match and then do any further saving outside of the plan.

Although this data is from a period when the reduced tax rates on capital gains and dividends were not in effect, we do not believe the data will materially change in future years particularly among the lower-income brackets.