II. WORK AND OLDER AMERICANS

Who Benefits from Increasing Contribution Limits for Defined-Contribution Plans?[1]

Howard Wial
Working for America Institute

Abstract

The package of increases in defined-contribution pension plan contribution limits that Congress enacted in 2001 could have benefited at most 8 percent of plan participants and 3 percent of all workers. High earners were potentially more likely to benefit than low earners, and potential beneficiaries generally had higher earnings than other participants. The increase in the percentage limit on combined employer and employee contributions was potentially of the most benefit to low and moderate earners. The increase in the dollar limit on combined employer and employee contributions was potentially of the least benefit to those workers.

As part of a broader package of tax-cutting legislation, Congress in 2001 raised the limits on the amounts of tax-deferred money that workers and employers could contribute to defined-contribution (DC) pension plans.[2] Proposals for further increases may be on the legislative agenda in the near future. Proponents of increases in DC plan contribution limits assert that raising these limits will enhance employer incentives to start new plans and improve existing plan coverage, especially for employees of small businesses. Opponents contend that these measures will primarily benefit high earners and will do little or nothing to improve pension coverage for low- or moderate-income workers. This paper estimates the number and earnings of workers in DC plans ("DC participants") who were in a position to benefit from three of the key increas-

Author's address: Working for America Institute, 815 Sixteenth Street NW, Washington, DC 20006

es in contribution limits that Congress enacted and compares them with the number and earnings of other DC participants and other workers.

Background

The federal tax preference for contributions to pension plans is a subsidy to retirement savings. Statutory limits on tax-deferred contributions to DC plans have existed in some form at least since the passage of the Employee Retirement Income Security Act of 1974. Congress has periodically changed existing limits and enacted new ones. These limits exist to prevent the federal government from subsidizing excessively large pension benefits through the tax system.

Although a variety of statutory limits on DC plan contributions exist, public debate about limit increases has focused on three of the limits that Congress raised in 2001. All of these limit increases first took effect in 2002.

There is a dollar limit on the amount that an employee may contribute to a DC plan. In 1998, the year to which the data analysis in this paper pertains, this limit was $10,000 per year for most DC plans. (All dollar amounts are expressed in current dollars, unadjusted for inflation.) In 2001, it was $10,500. Beginning in 2002, this limit rose. It will reach $15,000 in 2006 and be indexed for inflation thereafter.

There is a dollar limit on the combined amount that an employer and employee may contribute to a DC plan. In 1998, this limit was $30,000 per year. In 2001, it was $35,000. Beginning in 2002, it was $40,000 and is indexed for inflation, as it was in the past.

There is a limit on the percentage of an employee's compensation for which combined employer and employee contributions to DC plans may account. In both 1998 and 2001, this limit was 25 percent. Beginning in 2002, it was 100 percent.

This paper analyzes the effects of all three contribution limit increases as a package and also examines the increases individually. Because the goal is to estimate the number and earnings of DC participants who could potentially have benefited from the increases rather than the amount by which those participants could have benefited, the analysis does not depend on the specific amounts of the limit increases that Congress enacted or on the timing of those increases.

Data and Methods

The results reported below are based on microdata from the Federal Reserve Board's 1998 Survey of Consumer Finances (SCF). The SCF's nationally representative sample of 4,309 households contained data on 4,776 individuals who were at least 18 years old and working at the time of the survey (including the self-employed) and whose earnings could be expressed as an annual dollar amount. These observations were the source of data on "all workers" reported below. From among all workers, DC participants were defined as those who were included in a DC plan through a job. Individual retirement accounts and Keogh plans were not counted as DC plans because those plans are entirely outside the employment relationship and because different limits on tax-deferred contributions apply to them.

Potential beneficiaries of an increase in the package of increases in all three DC plan contribution limits were defined as DC participants whose employer and/or employee contributions in 1998 were greater than or equal to at least one of those limits. (Because the data on DC plan contributions pertain to the year 1998, contributions were compared with the 1998 contribution limits.) This definition was used for three reasons. First, participants with contributions at the statutory limits (or their employers) were in a position to increase their contributions when the limits were raised. It was not likely that participants with contributions below the limits would respond to an increase in the limits by contributing more than the preincrease limits. Second, the SCF does not distinguish between tax-deferred contributions and other contributions to DC plans or between plans that do and those that do not qualify for tax preference, so it is impossible to identify participants whose tax-deferred contributions exactly equaled the statutory limits. This limitation of the analysis could make the estimates of potential beneficiaries of limit increases both under- and overinclusive, but it does not bias the estimates either upward or downward a priori. The general pattern of results was not sensitive to alternative definitions of potential beneficiaries. Finally, because the SCF is not a panel data set, it was impossible to estimate the number of DC participants who would ever be in a position to benefit from the limit increases at any time in their lives, which would be a larger and more comprehensive measure of the number of potential beneficiaries.

The distributional consequences of the three contribution limits were also analyzed one at a time by use of a three-stage sequential method. First, the percentage limit on combined employer and employee contributions was raised, while holding the dollar contribution limits fixed. Potential beneficiaries at this stage of the analysis were DC participants whose contributions were limited only by the percentage limit on combined employer and employee contributions and DC participants whose contributions were limited by both the percentage limit on combined employer and employee contributions and the dollar limit on employee contributions. Next, the dollar limit on employee contributions was raised, while holding the dollar limit on combined employer and employee contributions fixed. Potential beneficiaries at this stage were DC participants whose contributions were limited only by the dollar limit on employee contributions. Finally, the dollar limit on combined employer and employee contributions was raised. Potential beneficiaries at this final stage are those DC participants whose contributions were limited by the dollar limit on combined employer and employee contributions (including those whose contributions were limited by one or both of the other two limits in addition to the percentage limit on combined employer and employee contributions).

Results

Only about 3.1 million (or 8 percent) of the 38.8 million DC participants were potential beneficiaries of the package of increases in all three contribution limits that was enacted into law. Potential beneficiaries generally had higher earnings than other DC participants. Of the 3.1 million potential beneficiaries, 24 percent earned less than $40,000 per year, while 22 percent earned at least $150,000 per year (table 1). Of the 35.7 million DC participants who

TABLE 1

Potential Beneficiaries and Nonbeneficiaries of Increasing All Contribution Limits, by Earnings, 1998 (millions of workers)

Earnings (1998 dollars)	Potential Beneficiaries	Nonbeneficiaries	All DC Participants
< $40,000	0.7	20.2	20.9
	4%	96%	100%
	24%	57%	54%
$40,000–74,999	0.9	12.3	13.2
	7%	93%	100%
	29%*	34%*	34%
$75,000–149,999	0.8	2.7	3.5
	23%	77%	100%
	25%	8%	9%
≥ $150,000	0.7	0.5	1.2
	58%	42%	100%
	22%	1%	3%
All earnings levels	3.1	35.7	38.8
	8%	92%	100%
	100%	100%	100%

Note: In each cell, the first number is the number of workers (in millions), the second is the row percentage, and the third is the column percentage. Percentages are based on unrounded estimates and may not total 100 percent in all rows and columns due to rounding.

*Differences among these percentages are not significant at 0.05 level. Differences among all other pairs of interior row percentages within a column or column percentages within a row are significant at 0.05 level.

Source: Federal Reserve Board, 1998 Survey of Consumer Finances.

were not potential beneficiaries of the limit increases, 57 percent earned less than $40,000 per year, and 1 percent earned at least $150,000 per year. The share of participants who could potentially have benefited also increased with earnings. About 58 percent of participants who earned at least $150,000 per year, but only 4 percent of participants who earned less than $40,000, could have benefited from the limit increases.

Because DC participants are a small and generally high-earning group of workers, these results overstate potential beneficiaries as a percentage of all workers and understate the overall regressivity of the package of limit increases that Congress enacted in 2001. Only about 36 percent of all workers participated in DC plans in 1998 (table 2), so the 8 percent of DC participants potentially benefiting from the limit increases make up only about 3 percent of all workers. Among DC participants, 54 percent earned less than $40,000 per year, compared with 70 percent of all workers, while 12 percent of participants and 8 percent of all workers earned $75,000 or more. About 28 percent

TABLE 2

DC Plan Participation by Earnings, 1998 (millions of workers)

Earnings (1998 dollars)	DC Participants	DC Nonparticipants	All Workers
< $40,000	20.9	54.1	75.0
	28%	72%	100%
	54%	79%	70%
$40,000–74,999	13.2	10.9	24.1
	55%*	44%	100%
	34%	16%	22%
$75,000–149,999	3.5	2.6	6.1
	57%*	43%	100%
	9%	4%	6%
≥ $150,000	1.2	1.2	2.4
	49%*	51%	100%
	3%	2%	2%
All earnings levels	38.8	68.8	107.6
	36%	64%	100%
	100%	100%	100%

Note: In each cell, the first number is the number of workers (in millions), the second is the row percentage, and the third is the column percentage. Percentages are based on unrounded estimates and may not total 100 percent in all rows and columns due to rounding.

*Differences among these percentages are not significant at 0.05 level. Differences among all other pairs of interior row percentages within a column or column percentages within a row are significant at 0.05 level.

Source: Federal Reserve Board, 1998 Survey of Consumer Finances.

of all workers with earnings under $40,000 participated in DC plans, but 49 percent of those with earnings of $150,000 or more did so.

The sequential analysis of increases in each of the three separate contribution limits shows that the increase in the percentage limit on combined employer and employee contributions was potentially of benefit to the largest number of people. About half of the 3.1 million people who could have benefited from the entire package of limit increases could have benefited from the increase in this limit alone (table 3). In contrast, only an additional 1.1 million people (34 percent of the 3.1 million) could have benefited when the increase in the dollar limit on employee contributions was added, and only 519,000 (17 percent) more could have benefited when the increase in the dollar limit on combined employer and employee contributions was added to the other two limit increases.

The increase in the percentage limit on combined employer and employee contributions was by far the least regressive of the three limit increases.

TABLE 3
Potential Beneficiaries of Each Contribution Limit Increase, by Earnings, 1998 (millions of workers)

Limit Increase	Earnings < $40,000	Earnings $40,000–74,999	Earnings $75,000–149,999	Earnings ≥ 150,000	All Earnings Levels
Potential beneficiaries of percentage limit on combined employer and employee contributions	0.7 48% 100%	0.7 44% 74%	0.1 7% 13%	0.0 0% 0%	1.5 100% 50%
Additional potential beneficiaries of dollar limit on employee contributions	0.0 0% 0%	0.2 16% 20%	0.6 54% 76%	0.3 30% 46%	1.1 100% 34%
Additional potential beneficiaries of dollar limit on combined employer and employee contributions	0.0 0% 0%	0.0 7% 4%	0.1 19% 12%	0.4 74% 56%	0.5 100% 17%
Potential beneficiaries of one or more limit increases	0.7 24% 100%	0.9 29% 100%	0.8 25% 100%	0.7 22% 100%	3.1 100% 100%

Note: In each cell, the first number is the number of workers (in millions), the second is the row percentage, and the third is the column percentage. Percentages are based on unrounded estimates and may not total 100 percent in all rows and columns due to rounding. Differences among all pairs of interior row percentages within a column or column percentages within a row are significant at 0.05 level. Earnings are in 1998 dollars.

Source: Federal Reserve Board, 1998 Survey of Consumer Finances.

About 48 percent of potential beneficiaries of this limit increase earned less than $40,000 (table 3), compared with 54 percent of all DC participants and 70 percent of all workers. The third-stage increase in the dollar limit on combined employer and employee contributions was the most regressive of the limit increases. About 74 percent of all participants who could have benefited from this limit increase earned at least $150,000, compared with 3 percent of all DC participants and 2 percent of all workers. The second-stage increase in the dollar limit on employee contributions had predicted distributional effects that fell between those of the other two limit increases; 30 percent of the potential beneficiaries of this limit increase earned at least $150,000. The sequence in which the limits were raised had little effect on the results of the analysis.

Discussion

The increases in DC plan contribution limits that Congress enacted in 2001 could have benefited only a small fraction of DC participants and an even smaller fraction of all workers. The limit increases as a package were regressive among potential beneficiaries and even more so among all workers. High earners were potentially more likely to benefit from the increases than low earners, and potential beneficiaries generally had higher earnings than other DC participants. Of the three separate limit increases that were enacted, the increase in the percentage limit on combined employer and employee contributions was potentially of the most benefit to participants with low and moderate earnings, while the increase in the dollar limit on combined employer and employee contributions was likely to be of the least benefit to those workers.

These findings are based on the assumption that the number of DC plans and participants does not change in response to contribution limit increases. Some industry associations and pension consultants dispute this assumption. They assert that some employers, especially small employers, could find higher limits attractive enough to form new DC plans that would extend pension coverage to employees not previously covered. Other employers, they claim, could find higher limits attractive enough to expand coverage and/or increase their contributions for low- and moderate-earning participants in their existing DC plans. One way for high-earning small business owners to take maximum advantage of limit increases would be to start new tax-deferred DC plans; if they chose to do this, then the tax law would require them to include some lower-earning employees in those new plans. There are no time-series data that could be used to assess these arguments, and disentangling the effects of contribution limit increases from other influences on plan participation and formation would be a formidable challenge even if the data did exist.

According to the Employee Benefit Research Institute's 2001 Small Employer Retirement Survey (Employee Benefit Research Institute, n.d.), insufficient tax benefits for the firm's owner ranked ninth out of twelve major reasons that small employers who did not offer pension plans gave for their decision not to offer a plan. In that survey, 48 percent of employers who had five to 100 employees and who did not offer a plan cited uncertain revenue as a major reason for not offering a plan, and 18 percent of those employers cited this as the most important reason. Only 16 percent of employers surveyed said that "tax benefits for the owner are too small" was a major reason why they did not offer a plan, whereas 1 percent said that it was the most important reason. Although these data are based on employer perceptions and measure average rather than marginal effects, they suggest that limits on tax-deferred pension contributions are not among the most important reasons why small employers may not offer DC plans.

Proponents of a consumption tax as a replacement for the federal income tax may also find increases in DC plan contribution limits desirable as a first step toward the eventual goal of exempting all savings from taxation. For consumption tax proponents who value progressive taxation, though, the distributional effects of limit increases could make this strategy undesirable.

References

Employee Benefit Research Institute, n.d. *The 2001 Small Employer Retirement Survey (SERS) Summary of Findings*, available at www.ebri.org/sers/2001/01serses.pdf.

Notes

1. This paper is based on work that the author performed for the U.S. General Accounting Office. The views expressed here do not necessarily reflect those of the General Accounting Office or any other agency of the U.S. government.

2. In a DC plan, such as a 401(k) plan, pension benefits are based on the contributions to and investment returns on individual accounts.