

# Complexity in Retirement Savings Policy

## INTRODUCTION

The U.S. retirement system is often described as a three-legged stool in which the legs represent Social Security, employer pensions, and individual savings. This metaphor can be somewhat misleading, however, because it inaccurately suggests that the three sources of retirement income are approximately equal. In 2000, three-fifths of individuals age 65 and over received at least half their income from Social Security, and for nearly one-fifth Social Security was the only source (Social Security Administration, 2002a). The shares for the other “legs” are much smaller: only one-fifth of the population received as much as 20 percent of their income from individual savings, and just one-tenth received this much from employer pensions.<sup>1</sup>

Moreover, these figures vary dramatically with income: half of the over-65 population in the lowest income quintile received all of their income from Social Security, while a third of the population in the highest income quintile received at least half of their income from labor-market earnings. These differences illustrate an additional limitation of the stool metaphor—it is a static representation of a dynamic process. In particular, it does not consider the endogeneity of savings choices, and it is therefore of limited use in assessing the role of complexity in retirement savings behavior.

For workers, retirement savings behavior essentially involves a trade-off between current and future consumption. Tax policies can be constructed to allow a more efficient trade-off, but overly complex rules will certainly discourage their use. Unfortunately, the sections of the U.S. tax code and regulations dealing with retirement savings policy are among the most arcane areas of our current tax system, for both individuals and businesses.

## OVERVIEW OF RETIREMENT SAVINGS COMPLEXITY

### *Social Security*

As is widely known, Social Security is not sustainable under its current rules; unless reformed it is projected to be able to cover only 73 percent of program costs after 2041 (Social Security Administration, 2002b). Likely reforms include ben-

<sup>1</sup> Other sources of income not included in the “three-legged stool” metaphor include labor-market earnings and public assistance.

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efit cuts and/or tax increases, which may or may not be combined with the addition of personal retirement accounts to the program. This uncertainty complicates all retirement savings decisions because taxpayers cannot be sure of the benefits they will receive.

### *Employer Plans*

The employer retirement plan system is notable for its arcane rules, redundancy, and proliferation of plan types. Based on the principle that employers and employees receive favorable income-tax treatment for compensation paid in the form of retirement income, the system is heavily regulated under both the Internal Revenue Code (IRC) and the Employee Retirement Income Security Act of 1974 (ERISA). To qualify for favorable tax treatment, plans must negotiate a battery of tests regarding coverage, funding, distribution of contributions and benefits, and other plan attributes.

Much has been added to the IRC sections covering employer plans since 1974, such as the cash or deferred arrangements under section 401(k). New pension legislation continues to add new choices and rules at frequent intervals, including, most recently, the Economic Growth and Tax Relief Reconciliation Act of 2001, or EGTRRA. Concurrently, the employer plan terrain has been reshaped by strong trends, such as increased labor mobility and the decline of defined-benefit plans and rise of 401(k)-type plans and stock options.

The rules governing the employer plan universe also contain significant overlap, often in the form of separate sets of rules created to address situations differing only slightly from those covered by existing rules.<sup>2</sup> This overlap adds to the com-

plexity of the retirement savings sections of the IRC and associated regulations, making this one of the most difficult areas of current tax law for both employers and employees to understand and with which to comply.

### *Individual Savings Incentives*

#### *Individual Retirement Accounts*

IRAs began with a relatively simple idea a quarter-century ago, and have since been expanded several times. IRAs were introduced in 1974 (the same year as ERISA) in order to offer tax-preferred savings opportunities to workers without employer retirement plans. The concept was new in the sense that it explicitly provided consumption-tax-type treatment, rather than income-tax treatment, to individual retirement saving outside of the employer plan context. Consistent with consumption-tax treatment, contributions were deductible and account earnings accumulated tax-free; withdrawals were subject to ordinary income tax.

In 1981 IRA eligibility was expanded to all workers, and marketing by financial institutions and participation among workers vastly increased. The number of 1982 tax returns showing IRA deductions was more than triple the 1981 figure, and the dollar value of contributions increased by a factor of six. Participation continued to increase until 1986, when provisions of the Tax Reform Act imposed a set of income-based phase-outs on the deductibility of IRA contributions for workers with employer pension coverage. In 1987, the number of returns claiming IRA deductions fell by 53 percent (including, as will be shown later, a large number of returns still eligible for the IRA deduction), and the number has continued to decline.

<sup>2</sup> Two examples are the top-heavy rules, which are a second set of nondiscrimination tests that apply to plans with a less equitable distribution of benefits, and the relatively minor differences between the deferred compensation vehicles allowed under sections 401(k), 403(b), and 457.

The IRA income limits created a source of complexity for a significant number of taxpayers, and have probably contributed to a decline in IRA participation even among taxpayers who are still eligible for a deduction. But other rules complicate IRA participation as well. Prior to simplifying regulations finalized this year, the required minimum distribution (RMD) rules, which govern when withdrawals must be made and how much must be withdrawn at each age, were notoriously esoteric and virtually demanded professional advice for optimal compliance.

Proliferation of IRA types is a major source of what is sometimes called “choice complexity.” The 1986 Act effectively created a new type of IRA, because workers above the income limits were still allowed to contribute to an IRA, but contributions were not deductible.<sup>3</sup> In 1997 Roth IRAs were introduced, offering a new twist on the consumption–tax theme: contributions are not deductible, but qualified withdrawals are tax–free. Economists have noted the equivalence of the treatment relative to traditional IRAs (except for a quibble on effective contribution limits), if tax rates remain constant over time and individuals are indifferent between two tax schemes with different timing but the same present value. However, actual participants are left contemplating on which end they would rather receive the tax benefit, as well as deliberating the implications of more subtle differences such as the exemption of Roth IRAs from required minimum distributions or the more generous basis–recovery rules offered by Roth IRAs.

#### Contribution Credit

EGTRRA introduced a new individual saving incentive in the form of a temporary nonrefundable tax credit for retire-

ment contributions made by low–income taxpayers. The credit is intended as a supplementary incentive to low–income savers, for whom a deduction alone may not be worth much (though the nonrefundability of the credit reduces its worth to those same taxpayers). The credit rate steps down with income in three uneven strides from 50 percent to zero. The temporary credit does not introduce an additional savings vehicle; however, by layering a new set of eligibility criteria on top of existing tax preferences it nonetheless adds to the confusion of the individual retirement savings universe.

#### THE PROBLEM WITH COMPLEXITY

The current level of complexity in retirement savings policies imposes high costs on individuals, businesses and government, and can discourage the activity it was intended to promote. Data on compliance and decision–making costs are notoriously difficult to collect. However, the Department of Labor collects income–statement information from all private pension plans on Form 5500. In 1998 (the most recent year available), plans reported \$10 billion in total administrative expenses, including, among other expenses, investment management, accounting, actuarial and legal fees (U.S. Dept. of Labor, 2002). Additional compliance and complexity costs are incurred by other parties, including individual taxpayers.

#### *Decision–Making Costs*

As a result of rapid proliferation of alternatives, employers and individuals must devote increasing resources to learn enough about each option to make informed decisions. For example, a private employer offering a new retirement plan must decide whether to offer a defined–

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<sup>3</sup> These are often referred to as “nondeductible IRAs,” though it might be more precise (if long–winded) to say “nondeductible contributions to a traditional IRA.”

benefit (DB) or defined-contribution (DC) plan, and what specific type of plan (e.g., a traditional or cash-balance DB plan, or one of the many types of DC plan listed in Table 1). In addition, it could involve considerable detail, including matching rates, vesting schedules, and investment options. The employer must also decide whom to include in the plan, and whether to provide the plan in-house or hire outside service providers to help administer the plan and ensure compliance. To make an informed decision, the employer will need to spend time studying the implications of each of the options, or hire a consultant.

One might be tempted to assume employees at least are relieved of this burden, since the choice of employer plan is made by the employer. But this is unfortunately not the case, because ultimately the decision rests (collectively) with employees. Potential employees considering competing job opportunities must take employer plan characteristics into account to make an informed decision about relative compensation levels. Employers must be conscious of the need to design compensation packages that are valued by employees, and hence must take worker preferences into account when making

employer plan decisions. In addition, employees must decide how to choose their investments, and allocate their retirement savings between the employer plan and outside alternatives, such as IRAs.

*Compliance Costs*

Employers and Employees

Complex rules consume substantial resources on the part of both taxpayers and the government in order to achieve compliance. Employers who sponsor a retirement plan must ensure that the plan conforms to minimum coverage, nondiscrimination, and top-heavy rules, and must report accurate information to employees and the government. Ensuring compliance can employ teams of actuaries, accountants, tax counsel, and other professionals. These resources all come with real costs, which are ultimately borne by employees and shareholders.

In addition, participating employees face their own compliance costs, including mastering the rules associated with contributions, loans, and withdrawals. Similarly, IRA participants face compliance costs in following the rules governing deductions, traditional-to-Roth con-

**TABLE 1**  
TYPES OF EMPLOYER RETIREMENT PLANS\*

	1998 Share of (percent):		
	Plans	Active Participants	Assets
Defined Benefit	8	31	48
Defined Contribution	92	69	52
1. Profit-sharing and Thrift-savings	74	58	44
2. Money Purchase	14	6	4
3. Stock Bonus	1	4	4
4. 403(b)	2	< 1	< 1
5. IRAs	< 1	< 1	< 1
6. Other DC	1	1	< 1
Special features**			
401(k)-type	41	51	38
ESOP	1	9	10

\*Private plans only, from 1998 Form 5500 Reports.

\*\*Some types of DC plan can include 401(k)-type and/or ESOP features.

versions, and required minimum distributions, among other things. More complicated rules likely lead to higher error rates, resulting in additional costs.

#### Government

Compliance also imposes additional costs on government, and hence on all taxpayers. Substantial resources are spent creating the elaborate rules in the first place—highly paid professionals spend hours developing and drafting complicated legislative proposals in an attempt to satisfy multiple competing constraints. After legislation is passed, another round of creation costs is borne when agencies spell out the details in regulations.

Finally, the rules must be enforced, and more complicated rules carry higher enforcement costs. In addition to everyday enforcement costs such as IRS document-matching programs and audits, additional resources are often required to monitor and combat rapidly evolving types of abuse or fraud. The relationship between complexity and abuse is especially insidious because complexity encourages abuse while anti-abuse rules create more complexity. Furthermore, complexity and abuse both breed cynicism and undermine faith in the system.

#### SOURCES OF COMPLEXITY IN U.S. RETIREMENT SAVING POLICY

Much of the complexity inherent in the current collection of retirement savings rules derives from a desire to target tax benefits to specific taxpayers and purposes. For example, income limits target IRA incentives to lower-income taxpayers and taxpayers without employer retirement plans. A policy justification is that higher-income taxpayers with employer retirement plans are likely to be saving for retirement already and hence less in need of the tax incentive. Therefore, the rationale goes, revenue can be saved without harming overall retirement security by

limiting the incentive to lower-income workers or those without employer plans. Similarly, the required minimum distribution rules target the IRA incentive to savings for retirement consumption by preventing the incentive from being used as an estate-planning tool.

However, complexity is the cost of targeting, because targeting requires precise definitions of which taxpayers are eligible for the favorable tax treatment and for how much. Targeting also requires rules governing which behavior constitutes proper use of the incentive and what constitutes abuse. Learning the rules to determine their eligibility is a burden for taxpayers, particularly when the rules are arcane.

#### *Individual Savings Incentives*

##### Complexity of IRA Income Limits

The traditional IRA deduction is potentially available to taxpayers who are not age 70½ or older by the close of the tax year and who have “includible” compensation in that tax year. The 70½ rule is arbitrary, and the compensation test requires another layer of definitions to be mastered, spelling out what is and what is not includible compensation.

To learn the amount of the allowable IRA deduction requires greater endurance. The deduction is generally the lesser of the actual contribution or the amount of includible compensation, but if either the taxpayer or spouse is an active participant in an employer retirement plan, the deduction may be reduced or eliminated according to income. This rule requires precise definition of what constitutes active participation in an employer plan, and what constitutes income. It also requires that the taxpayer know his or her income, which may not occur until after the close of the tax year for many taxpayers.

The actual income limit depends upon filing status, upon which spouse is the active participant, and upon the tax year

(because the income limits change over time). Separate income limits are used for Roth IRAs and yet another income limit applies to conversions of traditional to Roth IRAs. Moreover, because the income limits applying to Roth IRAs apply even to individuals who are not eligible to participate in an employee plan, it is possible for a high-income individual to be eligible for a deductible IRA but not a Roth IRA. Table 2 summarizes the IRA income limits.

Once the income limits are established, and the taxpayer knows his or her income, the taxpayer can go about calculating the allowable deduction (or, in the case of a Roth IRA, the allowable contribution). The income limits are administered as phase-outs rather than “cliffs,” and subject to rounding rules and minimum positive deductions. Table 3 illustrates the formula for calculating the maximum allowable IRA deduction for a single filer who is an active participant in an employer plan in 2002. The formula shown in Table 3 is a distilled representation of a worksheet that appears in the 90-page IRS publication explaining IRA rules. While these calculations may appear tedious but not particularly burdensome to the typical tax practitioner, it is likely onerous for the targeted population of lower-income workers without pension plans. Moreover, if income is uncertain, the absence of predictability potentially limits participation.

#### Contribution Credit Income Limits

The nonrefundable retirement contribution credit included in EGTRRA layers an additional set of income limits on top of the IRA limits. In an attempt to avoid the complexity of a smooth phase-out, the credit disappears in three discrete income-based steps of irregular width, dropping from 50 percent of the amount contributed to 20 percent, then 10 percent and finally zero. The income thresholds vary by filing status. The cliffs in the step-function effectively increase marginal tax rates at the cliff points.

#### Combined Effect of Income Limits

Figure 1 illustrates the combined effect of the IRA and contribution-credit income limits on the tax price (i.e., one minus the marginal tax rate) of a one-dollar contribution to a traditional IRA. A kink is produced each time the taxpayer changes tax brackets, drops to a lower credit rate, or begins or ends the phase out of the IRA deduction. The figure contains 13 kinks, with effective tax prices ranging from 0.35 to 1. It is difficult to imagine that a taxpayer would be able to determine and respond directly to the precise tax incentive being offered.

#### Required Minimum Distributions

The tax code sections and regulations covering required minimum distributions (RMDs) are sufficiently complicated that a detailed explanation is not practical here. In brief, there are separate rules for distributions required during retirement and after death. Retirement distributions must start by April 1 of the year following the calendar year the taxpayer reaches age 70  $\frac{1}{2}$ . The entire IRA balance must be distributed over either the life expectancy of the taxpayer or the joint life expectancy of the taxpayer with a designated beneficiary. The rules covering the distribution of IRA balances after the death of the owner vary depending on whether the death occurs before or after required withdrawals have begun. A 50 percent excise tax applies to any shortfall between actual and required withdrawals.

Prior to the 2002 regulations, RMD calculations were extremely complex for taxpayers. Each year's RMD depended upon age, upon whether there was a designated beneficiary, upon the age difference between the IRA owner and designated beneficiary, and upon whether the designated beneficiary was the taxpayer's spouse.

The amount of the annual distribution also depended upon a one-time choice (on the part of the taxpayer) whether to re-determine the life expectancies of the tax-

**TABLE 2**  
**IRA INCOME LIMITS**  
**(MODIFIED AGI, IN DOLLARS)\***

Year	Not an Active Participant	Deductible IRA Contributions			Roth IRA Contributions			Traditional-to-Roth Conversions
		Active Participant	Active Participant in Employer Plan	Spouse is Active Participant	Regular Contributions	Joint	MFS***	
		Single/ HoH**	Joint	MFS***	Single/ HoH**	Joint	MFS***	
2002	none	44,000	64,000	10,000	110,000	160,000	10,000	100,000
2003	none	50,000	70,000	10,000	110,000	160,000	10,000	100,000
2004	none	55,000	75,000	10,000	110,000	160,000	10,000	100,000
2005	none	60,000	80,000	10,000	110,000	160,000	10,000	100,000
2006	none	60,000	85,000	10,000	110,000	160,000	10,000	100,000
2007	none	60,000	100,000	10,000	110,000	160,000	10,000	100,000

\*Modified AGI is AGI plus the following otherwise excludable or deductible items: savings bond income used for higher-education expenses, employer adoption-expense payments, interest paid on qualified education loans, qualified tuition and educational expenses, foreign earned income, and IRA contributions.

\*\*Head of Household filer

\*\*\*Married filing separately

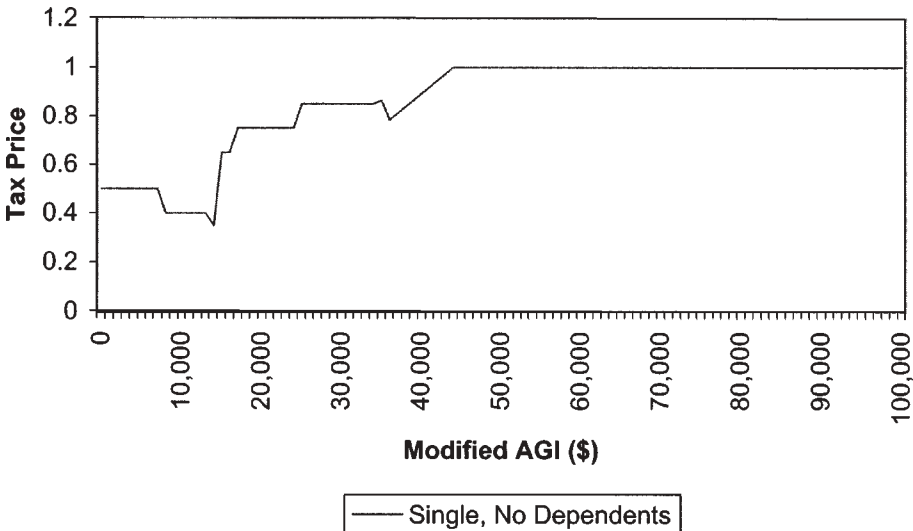
**TABLE 3**  
CALCULATING THE MAXIMUM IRA DEDUCTION

Single Taxpayer, Active Participant, 2002	
Income (MAGI)*	Maximum IRA Deduction
< \$34,000	min{3000, compensation**}
\$34,000 to \$33,999	min{max{round[0.3*(44000-MAGI)+4.99,10],200}, compensation**}
> = \$44,000	0

\*Modified AGI is AGI plus the following otherwise excludable or deductible items: savings bond income used for higher-education expenses, employer adoption-expense payments, interest paid on qualified education loans, qualified tuition and educational expenses, foreign earned income, and IRA contributions.

\*\*Compensation includes wages, salaries, etc. properly included in Box 1 of the W-2, positive net self-employment earnings less deductible retirement contributions and deductible self-employment taxes, and taxable alimony payments.

**Figure 1.** Tax Price of \$1 Traditional IRA Contribution 2002



payer and spouse each year (using an IRS life table) or simply to reduce the previous year's life expectancies by one. The decision was complicated because, while the re-determination method produced smaller distributions for each year of life, it would have fairly dire tax implications upon death—the relevant life expectancy would become zero, producing much larger required distributions. Thus the ex-ante optimal strategy depended on the taxpayer's private expectations about the life expectancies of the participant and beneficiary.

This made for an extremely knotty decision, which many IRA owners felt required professional estate-planning advice.

**New RMD Regulations**

The 2002 RMD regulations simplify the calculation of RMD by removing the choice whether to re-determine life expectancy each year, and instead giving all IRA owners the re-determination method without the "zeroing out" of life expectancy upon death (instead, beneficiaries spread out distributions over their own

life expectancies). The life table also results in smaller required distributions, since it is updated to account for longer life expectancies and uses a single factor based on an assumption of a designated beneficiary ten years younger than the IRA owner.<sup>4</sup>

### *Employer Retirement Plans*

Relative to individual incentives, incentives offered through a third party (employers) are almost guaranteed to require an even more complicated set of rules. One source of additional complexity in the employer–plan context is the fact that many employers' workforce structures have undergone significant changes in recent years, with workers spread across multiple subsidiaries, temporary workers, unions, and independent contractors.

Increasing labor mobility has raised issues of what happens to employees' retirement plans when the employees leave their jobs. The Dept. of Labor estimates that the average worker holds nine jobs between the ages of 18 and 34 (DOL, 2000a). In 2000, the median tenure with the current employer was only 3.5 years, and 40 percent of workers had tenures of less than three years (DOL, 2000b). Increasing labor mobility has been associated with a change in employees' preferences for types of retirement compensation, featuring a declining interest in traditional DB plans that heavily reward years of service and an increasing interest in 401(k) and stock–option plans that workers find more portable.

An additional complication in the employer context is the vast disparity in resources available for maintaining a retirement plan between large and small employers. In 1998, only 24 percent of employees of small firms (those employing fewer than 100) were covered by a DB or DC plan, compared to 55 percent of employees of firms employing at least 100.

In the Employee Benefits Research Institute's 2002 Small Employer Retirement Survey, small employers without plans were asked their major reasons for not offering a plan. A third reported that plan set–up and administration costs were too high, a quarter cited plan administration being too burdensome, a quarter listed that there were too many government regulations, and about a fifth noted the concern of being out of compliance with government regulations. Together, these responses indicate a major role of complexity in the reasons why small employers do not sponsor retirement plans.

Moreover, to reduce the negative impact of incurring additional liability, employers often strongly value flexibility in designing their retirement plan. Since provision of an employer retirement plan is voluntary, policymakers seeking to encourage employer plans have tended to allow employers such flexibility in plan design. However, this flexibility is part of the reason for the striking proliferation of DC plan types, such as those listed in Table 1.

### COMPLEXITY AND PARTICIPATION: THE EXAMPLE OF IRA INCOME LIMITS

The direct and non–pecuniary costs of complexity can reduce participation in retirement savings plans by reducing the net benefit to employers and employees. For example, after IRA income limits were imposed in 1986, IRA participation declined even among lower–income taxpayers still eligible for a deduction.

It is difficult to assign causality, but one likely conclusion is that many potential participants near the phase–out ranges decided the deduction was not worth the inconvenience of the eligibility or deduction calculation or the risk of running afoul of the IRS, or that many taxpayers incorrectly believed themselves ineligible.

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<sup>4</sup> In cases in which the designated beneficiary is a spouse who is more than ten years younger, the actual ages are used.

This could be particularly true among lower-income taxpayers, who may be less likely to have the financial sophistication and access to financial advice to be confident of compliance with the rules.

Table 4 shows results from an analysis of Treasury's ten-year panel of tax returns investigating how many 1987 taxpayers were affected by the IRA income limits over the following decade, and what happened to IRA participation behavior.<sup>5</sup> In each year from 1987 to 1996, the phase-out range for single taxpayers was \$25,000 to \$35,000; for married taxpayers it was \$40,000 to \$50,000 (the limits are not indexed for inflation).

Table 4 shows that 28 million taxpayers were affected by the new income limits in 1987, in the sense that they were potentially eligible for an IRA (i.e., met the age and compensation requirements), were active participants in an employer plan,

and had modified AGI above the start of the relevant phase-out range. This figure represents 21 percent of working taxpayers in 1987.

Following the 1987 cohort forward to 1996, about 79 million were affected by the IRA income limits sometime over this ten-year period. This represents three-fifths of 1987 working taxpayers. This figure is significant because it shows that many more taxpayers are affected by an income-based limitation over time than in a single year. The number grows over time as taxpayers move into higher-paying jobs and more of them become covered by pensions.

A third of workers with 1987 incomes under \$25,000 (i.e., below all income limits) were affected by the limits over the following decade, as were two-thirds of taxpayers with 1987 incomes between \$25,000 and \$35,000. A similar pattern is

**TABLE 4**  
1987 WORKING TAXPAYERS AFFECTED BY IRA INCOME LIMITS

	Affected in 1987		Affected anytime 1987 to 1996	
	Total	In Phaseout Range	Total	In Phaseout Range
<b>Total</b>				
Number (thousands)	28,036	10,303	79,033	47,534
Share (%)	21	8	60	36
<b>Percent Affected</b>				
<b>By 1987 Income*</b>				
< \$25,000	0	0	33	25
25,000 to 35,000	10	10	66	55
35,000 to 50,000	36	31	87	70
50,000 to 75,000	66	6	91	30
75,000 to 100,000	60	0	88	11
100,000 and over	41	0	81	3
<b>By 1987 Age</b>				
21 to 30	11	6	60	44
31 to 40	25	9	70	42
41 to 50	31	10	68	35
51 to 60	26	8	53	27
61 to 70	13	5	21	11
<b>By Gender</b>				
Male	22	8	62	35
Female	20	8	59	38

\*"Income" is nominal AGI plus foreign earnings, tax-exempt interest, penalty for early retirement withdrawals, IRA, Keogh and SEP contributions, moving expenses, alimony payments, and deferred compensation.

<sup>5</sup> The Treasury panel follows a representative sample of about 127,000 1987 taxpayers (including many high-income filers) forward through 1996. See Smith (2002) for more details.

seen for young workers: only 11 percent of workers aged 21 to 30 were affected in the first year (1987), but 60 percent of these workers were affected sometime in the next ten years.

Table 4 establishes that a large share of working taxpayers was affected by the IRA income limits between 1987 and 1996. Table 5 explores what happened to IRA participation over this period. Because the panel begins in 1987, we do not observe the large first-year drop between 1986 and 1987. However, a cursory look at the 1986 (non-panel) data shows that five million returns, or a third of those claiming IRA deductions, report AGI above the highest 1987 income limit. These returns account for two-fifths of the contributions. This is a lower bound on the count of those who lost eligibility from 1986 to 1987; a more

precise figure would account for differences in income limits by marital status and would produce a larger figure.

Beginning in 1987, however, we have a detailed panel data set that allows precise calculations. It may not be surprising to see a lower IRA participation rate after the imposition of income limits, because lower-income taxpayers are less likely than higher-income taxpayers to have the liquid assets available to take advantage of tax-preferred savings opportunities. However, we see a significant reduction in participation even conditioning on income and eligibility. Overall, participation among eligible taxpayers dropped by a third from 9 percent in 1987 to 6 percent in 1996. This pattern is concentrated among lower-income taxpayers; there was no drop among those with current income of at least \$75,000.<sup>6</sup>

A simple before-and-after comparison like that in Table 5 cannot prove that increased complexity caused a reduction in participation among eligible taxpayers. Other factors could have played a role, such as reduced marketing by IRA providers, increasing 401(k) participation, or lack of interest among taxpayers expecting to become ineligible within a few years.

However, the panel data show that the income limits either force taxpayers to perform an eligibility calculation each year, or create a compliance-cost barrier that many taxpayers find too high. Thus, Table 5 is consistent with the explanation that increasing complexity contributes to reduced participation.

## BARRIERS TO SIMPLIFICATION

In isolation, simplification seems straightforward to achieve. But in the presence of competing policy goals that

**TABLE 5**  
IRA PARTICIPATION RATES BY INCOME AND AGE

	Participation Rate Among Eligibles		
	1987	1992	1996
Total	9	6	6
By Current Income <sup>a</sup>			
< \$25,000	4	3	2
25,000 to 35,000	11	7	7
35,000 to 50,000	15	8	8
50,000 to 75,000	17	12	13
75,000 to 100,000	23	21	22
100,000 and over	21	21	22
By Current Age			
21 to 30	3	2	2
31 to 40	7	5	5
41 to 50	11	7	8
51 to 60	18	12	10
61 to 70	20	14	12
By Gender			
Male	10	7	7
Female	8	6	6

<sup>a</sup>“Income” is nominal AGI plus foreign earnings, tax-exempt interest, penalty for early retirement withdrawals, IRA, Keogh and SEP contributions, moving expenses, alimony payments, and deferred compensation.

<sup>6</sup> Current income means nominal income in the year of measurement (either 1987 or 1996). Income is modified AGI plus foreign earnings, tax-exempt interest, penalty for early retirement withdrawals, IRA, Keogh, and SEP contributions, moving expenses, alimony payments, and deferred compensation.

are traded off against each other in the political process, simplicity is rarely able to hold its own. In many cases there are compelling reasons for choosing other policy goals at the expense of simplicity. In other cases, the political process itself appears to be biased against simplification.

### *Competing Policy Goals*

Simplification is almost never the primary policy goal of a tax proposal. One of its most compelling competitors is fairness. Fairness comes in two varieties, horizontal (equal treatment of equals) and vertical (different treatments for taxpayers of different income, e.g., progressivity). In the presence of marked taxpayer heterogeneity, vertical equity can push policy towards increasingly individualized or customized treatment, and hence more tax-code complexity. But horizontal equity also plays a role in complexity—as illustrated by the number of policy changes based on attempts to provide a “level playing field.” Thus, while undeniably a critical policy objective, fairness concerns often make a complex tax code even more complex.

An equally compelling competitor is the opportunity cost of revenue. Scarcity of resources ensures that every effort will be made to trim the cost of each tax provision in order to accommodate the most proposals in a given package—often resulting in a collection of income phase-outs, provision phase-ins, sunsets, and other revenue-saving, but complicating, provisions.

A case in point is the targeted tax incentive—deductions, exemptions, exclusions, or credits for certain taxpayers who do certain things. Such incentives are attractive, because they perform triple

duty—they address a policy goal while simultaneously cutting taxes, and with limited revenue costs due to the targeting. Moreover, some have argued that taxpayers are always willing to fill out another form in order to receive another tax benefit.

However, each targeted tax incentive introduces a new source of complexity. One reason is that efficient targeting is often difficult, because of uncertainty about which circumstances should be treated as exogenous and which as endogenous. Taxpayers in exogenously bad circumstances are generally sympathetic, while those in endogenously bad circumstances generally are less so (and providing them a benefit would create moral hazard). Targeting the incentive invariably leads to both Type I and Type II errors—“deserving” taxpayers who do not receive the benefit and “undeserving” taxpayers who do. Attempts to refine targeting to address such errors typically add more complexity. Implicitly, both types of errors are currently weighted more heavily in the social loss function than is complexity. Finally, if most taxpayers benefit from one type of targeted tax incentive or another, it raises the questions whether taxpayers are really paying less tax, or are better off, than they would under a simpler tax system with lower rates.

### *Political Process*

In a democratic system, the policy-making process is affected by many interested voices, which can lead to a patchwork of special rules and provisions. However, there is not usually a voice advocating simplicity. This situation could be addressed by reforms or additions to the tax-writing process.<sup>7</sup> Process reforms would likely help going forward, but an

<sup>7</sup> For example, Steuerle (2001) recommends periodic complexity reports, greater IRS involvement in analyzing the costs and benefits of specific provisions, simplification testimony at markups and conferences, and production of mock tax forms during policy debates.

additional barrier to simplification is that it almost always involves removing existing options for some taxpayers. Once provisions are in the law, they are very difficult to remove. Not only are there defenders of every existing special rule, but one special rule often leads to others as other parties seek symmetric treatment. Moreover, taxpayers who would lose a benefit under simplification rules may be disproportionately vocal compared to a potentially larger, but often less organized, group of taxpayers who would gain.

### *Frequent Legislation*

Frequent legislation creates a permanent state of uncertainty. Constantly changing rules (particularly with provisions legislated to phase in over time for budget reasons) make compliance more difficult. Moreover, each legislative or regulatory change is typically accompanied by transition relief or grandfathering, further increasing the number of regimes on the books.

## RECENT DEVELOPMENTS AFFECTING SIMPLIFICATION

Two recent catalysts have contributed to a renewed awareness of complexity—the passage of EGTRRA and the release of the Joint Committee on Taxation (JCT's) simplification study.

### *EGTRRA*

Due in part to the political process that created it, EGTRRA emerged as an act that added new complexity to retirement savings policy. The main retirement provisions of EGTRRA feature higher limits for IRA and DC (including 401(k)) contributions, maximum DB payments and compensation considered in calculating plan benefits. Other major provisions include catch-up contributions for participants

aged 50 or over, portability measures, a new type of 401(k) plan with different tax treatment, contribution credits for low-income participants, and a repeal of the DB full-funding limit.

Some of EGTRRA's provisions provided simplification, including the portability provisions, repeal of the DB full-funding limit, and a qualifying test known as the multiple-use test, a coordinated definition of compensation, and simplification of the top-heavy rules. However, the bill also added new complexity in the form of the catch-up provisions and the new type of 401(k) plan, as well as the long phase-ins of provisions, the quick disappearance of the contribution credit in 2007, and the sunset of the entire bill in 2010.

### *Simplification Studies*

Recent simplification studies by the JCT (2001), the IRS Taxpayer Advocate (2001), and the American Bar Association together with the American Institute for Certified Public Accountants and the Tax Executives Institute (2001) have focused additional attention on complexity and made recommendations for simplification. The studies include several specific recommendations for simplifying retirement savings policy. In the area of IRAs, these include repealing income limits and nondeductible IRAs, conforming age limits and basis recovery rules across types of IRA, repealing required minimum distributions, and removing the half-years from the age limits.

The most comprehensive study by far is JCT's 1,300-page report, which alone tackled the tangled thicket of qualified employer plan rules, and even this study proposed relatively moderate changes. The JCT study recommended uniform rules for vesting, basis recovery, SIMPLE IRAs and SIMPLE 401(k)s, 401(k) and 403(b) contribution limits, and the definitions of compensation and "highly com-

pensated".<sup>8</sup> It also recommended simplifying nondiscrimination testing, replacing half-years with whole years and repealing required minimum distributions during the life of the taxpayer. However, the study considered but omitted recommendations that would require more fundamental policy changes, such as establishing model qualified plans and establishing a single elective deferral vehicle (i.e., 401(k)-type account) for all DC plans.

### *Simplification Opportunities*

The simplification studies by JCT and other commentators make helpful recommendations and raise the profile of the complexity issue. Going forward, significant simplification opportunities are available. In the realm of IRAs, repealing income limits and minimum required distribution rules would provide maximum simplification and would encourage IRA participation. Consolidating the multiple types of IRAs into a single type and repealing age limits for contributions would also reduce complexity. Finally, simplifying the exemptions from the early-withdrawal penalty would be helpful.

In the realm of employer plans, simplifying nondiscrimination and coverage rules and eliminating overlap by consolidating the various flavors of elective deferral vehicles into a single option would provide the largest amount of simplification, and might further encourage participation. Additional simplification measures might be considered for small employers, such as providing an attractive model retirement plan with comprehensively reduced testing and qualification requirements.<sup>9</sup>

## CONCLUSIONS

The current level of complexity in retirement savings policy is remarkable. The causes include changing workforce structures and heterogeneity in taxpayers' preferences and constraints, as well as competing policy goals, the incentives inherent in the policy-making process, and the difficulty of removing complicating provisions once they become established. However, the complexities of EGTRRA and the release of recent simplification studies have focussed renewed attention on issues of complexity and simplification. The next few years may provide a new opportunity to take stock of the current retirement savings policy landscape, and perhaps perform some long-overdue simplification.

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<sup>8</sup> The tax benefits received by "highly compensated" employees are compared to those received by "non-highly compensated employees" as part of the nondiscrimination rules.

<sup>9</sup> These and other options currently are being studied as part of the Treasury simplification effort, but as of this writing, policy decisions have not yet been made.

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