JOINT ECONOMIC COMMITTEE DEMOCRATS

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THE PRESIDENT'S SAVINGS PROPOSALS: BIGGER TAX BREAKS BUT LESS NATIONAL SAVING

At a time when the nation's saving rate is abysmally low, President Bush is likely to propose a number of saving incentives in his State of the Union Address. However, the kinds of proposals the President favors will do little to increase private saving and will reduce public saving by adding to the budget deficit. On balance, national saving is likely to decline even further.

In addition to being counterproductive with respect to national saving, these proposals will primarily benefit higher-income individuals who do not need additional incentives to save and who are likely to respond to the new incentives by simply shifting assets from taxable to nontaxable accounts. Moreover, these proposals could further weaken the retirement security of average workers.

The President's Likely Proposals

The President is likely to propose making permanent all of the expiring provisions of the tax cuts enacted during his term, including the increased contribution limits for retirement savings accounts. In addition, he is likely to propose creating new tax-advantaged savings accounts along the lines of his proposals in his past three budgets. These proposals are similar to the savings proposals put forward by the President's Advisory Panel on Federal Tax Reform.

Making the 2001 tax cut provisions permanent. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) increased the contribution limit for Individual Retirement Accounts (IRAs) in steps from $2,000 in 2001 to $5,000 by 2008.[1] After 2008, the limit will be increased to reflect inflation. The 2001 tax cut also increased the contribution limit for employer-sponsored defined contribution plans such as 401(k)s. The limit was raised from $10,500 in 2001 to $15,000 by 2006, after which the limit will be adjusted for inflation.[2] These provisions are due to sunset after 2010.

Retirement Savings Accounts (RSAs) would consolidate the three types of current-law IRAs into a single individual retirement account modeled on the Roth IRA. No upper income limits would apply, but participation would be limited to earners (and their spouses) and contributions could not exceed earnings. The temporary increases in contribution limits would be accelerated and made permanent. Contributions would be nondeductible but investment earnings and qualified withdrawals would be tax-free. Non-qualified withdrawals would be subject to income tax and penalty. Unlike traditional IRAs, there would be no minimum withdrawal requirements during the account holder's lifetime. Taxpayers could convert an existing traditional IRA into an RSA, paying any income taxes due on the rollover. Whereas current law restricts rollovers from traditional IRAs to Roth IRAs to taxpayers with incomes under $100,000, there would be no income limit on conversions to RSAs.

Employer Retirement Savings Accounts (ERSAs) would consolidate the various types of employer-sponsored defined contribution plans into a single account modeled on 401(k) plans.[3] The temporary contribution limit increases would be made permanent. Employee contributions to ERSAs could be made either pre-tax, as under current law, or after-tax, as under the RSA. Current-law minimum distribution requirements under 401(k) plans would apply to ERSAs.

Lifetime Savings Accounts (LSAs) would allow any individual to contribute up to $5,000 per year to an LSA. No income limits would apply, and contributions to LSAs could

be made on behalf of non-earners (for example, one's child). Contributions would be nondeductible but investment earnings and withdrawals would be tax-free. Withdrawals could be made at any time, for any purpose.

If these proposals were enacted, beginning in 2007, a family of four with two working parents could shelter up to $60,000 in savings per year—$5,000 per family member in an LSA, $5,000 for each parent in an RSA, and $15,000 for each parent in an ERSA. These amounts would increase in subsequent years as contribution limits are indexed to inflation.

Likely Consequences of the President's Proposals

Larger budget deficits. The Joint Committee on Taxation (JCT) estimates that making the EGTRRA retirement plan contribution limits permanent would cost a total of $20.4 billion from 2011 to 2015. Of that cost, $5.6 billion would occur in 2015 alone.[4]

Last year the JCT estimated that the President's FY2006 LSA and RSA proposals would result in a net revenue loss of $2.4 billion over ten years (2006-2015).[5] The relatively small short-term revenue losses mask significant long-term costs, however, as more investment income would be exempt from income tax over time.[6] The Congressional Research Service estimates that the long-term, steady-state costs could total about *$40 billion annually*.[7]

Finally, the JCT estimated last year that the president's ERSA proposal would cost about $3 billion over ten years.[8]

More benefits for high-income households. The vast majority of the tax benefits would accrue to high-income individuals who do not need additional tax incentives to save for retirement.[9]

Specifically, loosening rollover rules would benefit only households with income above $100,000—less than 10 percent of all households, while eliminating current income limits would benefit only households with income above $160,000. Similarly, increasing contribution limits would benefit only those individuals who currently make the maximum allowable contribution to IRAs or 401(k)-type plans—about 5 percent of eligible taxpayers, most of whom are high-income.[10] Finally, eliminating minimum distribution rules would enable high-income individuals to shelter more assets from the estate tax by passing on their retirement savings accounts to their heirs.

Little net impact on private saving. Whereas tax-advantaged retirement saving by low- and moderate-income individuals is likely to represent new saving, high-income individuals are more likely to use expanded savings opportunities to shift existing savings from taxable accounts to tax-advantaged accounts.[11] For that reason, in its analysis of a similar proposal in the President's FY 2004 budget, the Congressional Budget Office concluded that expanding tax-free savings accounts would have little effect on private saving.[12]

IRS data suggest that recent increases in contribution limits have had a significant impact on individuals already taking advantage of IRAs, but have not encouraged new participation in such savings vehicles.[13] The proposals described above would similarly do little to change existing incentives to save among low- and moderate-income individuals.

Less national saving. Unless there were cuts in government spending or increases in other federal revenues to offset the significant decrease in future income tax revenues, these proposals would increase federal budget deficits. With little or no increase in private saving to offset the decline in public saving, national saving would fall.

Possible weakening of future retirement income security. If tax advantaged savings accounts became more pervasive, some small employers might stop sponsoring retirement plans. One reason employers sponsor such plans is to be able to participate themselves. With much higher limits on tax-advantaged savings outside of employer-sponsored retirement plans, employers would have less incentive to participate in—and sponsor—those plans.

Additionally, because LSA balances could be withdrawn at any time, for any purpose, individuals may redirect savings in more restrictive retirement accounts to a more flexible LSA. The increased flexibility may encourage more individuals to save for the short-term, but the danger is that long-term savings will fall. This would reduce the already low number of individuals who save adequately for retirement.

A shift of the tax burden toward wages. Over time, the proposals would exempt from tax nearly all investment income for all but the wealthiest families. As more capital income becomes tax-exempt, taxes on earnings would account for an ever greater share of revenues, resulting in a more regressive income tax.

Conclusion

Like the vast majority of the Bush tax cuts, the President's savings proposals would primarily benefit higher-income individuals. Consequently, they would do little to increase private saving. Moreover, because they would significantly worsen the budget deficit, particularly in the long term, they would likely *decrease* national saving. Eventually, the proposals would exempt most saving from taxes, shifting more of the tax burden to wages. Even as wage earners were forced to bear a larger share of the tax burden, the proposals would likely weaken the retirement security of average workers. In its recent report, the President's Advisory Panel on Federal Tax Reform recommended a similar set of savings accounts. However, because it recommended significantly higher contribution limits, it would go even further in exempting nearly all investment wealth from taxes and tilting the benefits of tax incentives for saving towards those individuals least in need of such incentives.[14]

Endnotes

[1] The limit was increased by an additional $1,000 for taxpayers ages 50 or older.

[2] The limit was increased to $20,000 for workers ages 50 or older.

[3] For employers with 10 or fewer employees, the ERSA rules would be simplified, as is the case under the current SIMPLE IRAs for small employers.

[4] Joint Committee on Taxation, *Estimated Revenue Effects of H.R. 2830, The "Pension Protection Act of 2005," As Passed by the House of Representatives on December 15, 2005,* JCX-87-05, December 16, 2005.

[5] Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2006 Budget Proposal*, JCX-10-05, March 9, 2005.

[6] In the short term, the revenue gains from taxing IRA conversions and from new after-tax contributions are assumed to offset the revenue losses associated with exempting increasing amounts of investment income from income tax.

[7] Gravelle, Jane G., *Proposed Savings Accounts: Economic and Budgetary Effects*, Congressional Research Service Report RL32228, March 25, 2005.

[8] Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2006 Budget Proposal*, JCX-10-05, March 9, 2005.

[9] For example, analysis by the Urban Institute-Brookings Institution Tax Policy Center suggests that over 90 percent of the tax benefits associated with RSAs would accrue to the wealthiest 2 percent of households (with incomes exceeding $200,000). See Peter R. Orszag, "Progressivity and Saving: Fixing the Nation's Upside-Down Incentives for Saving," Testimony before the House Committee on Education and the Workforce, February 25, 2004.

[10] Congressional Budget Office, *Utilization of Tax Incentives for Retirement Saving*, August 2003.

[11] Conventional economic theory and empirical research suggest that expansions to retirement accounts, particularly those with tax-free earnings and withdrawals such as the proposed RSAs, are not likely to increase overall retirement savings. See Thomas L. Hungerford and Jane G. Gravelle, "Individual Retirement Accounts (IRAs): Issues and Proposed Expansion," Congressional Research Service, Report to Congress 30255, updated December 9, 2005.

[12] U.S. Congressional Budget Office, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2004*, March 2003.

[13] Copeland, Craig, "IRA and Keogh Assets and Contributions," Employee Benefits Research Institute, January 2006.

[14] The panel recommended creating a Save for Retirement account, similar to the President's Retirement Savings Account, and a Save for Family account, similar to the President's Lifetime Savings Account, but each with annual contribution limits of $10,000 instead of $5,000. The panel also recommended a Save at Work account, which, like the President's Employer Retirement Savings Account, would use current-law 401(k) contribution limits. See the President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System*, November 2005.

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