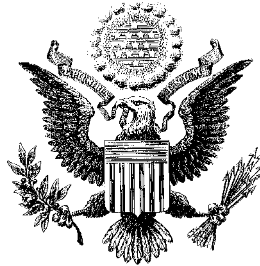
EXPANDING IRA BENEFITS

A JOINT ECONOMIC COMMITTEE STUDY



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Abstract

Providing new saving incentives to raise the U.S. saving rate is a primary goal for many policy makers. One of the most important saving incentives under current law is the Individual Retirement Account (IRA). IRAs offer families attractive tax benefits that encourage them to save for retirement, but restrictions on their use prevent or discourage many families from taking advantage of these benefits. Liberalizing these restrictions could substantially increase IRA participation and boost personal saving in the United States, thereby creating new incentives for financial empowerment and economic growth.

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EXPANDING IRA BENEFITS

Executive Summary

Under the current tax code, income used for consumption is taxed only once, but income used for saving is taxed at least twice. This bias discourages families from saving for future expenses. It also impedes economic growth by limiting the amount of domestic resources available for investment. Eliminating or reducing this bias through enhanced saving incentives would make the tax code fairer and more efficient.

One of the most important saving incentives under current law is the Individual Retirement Account (IRA). Expanding IRA tax benefits would generate significant gains for middle-income families while reducing the bias against saving that exists under current law. The tax laws enacted in 1997 have already made important progress in expanding IRAs. The income limits for deductible contributions have been raised; restrictions on penalty-free withdrawals have been liberalized to include college expenses and first-time homebuyer expenses; and the rules applying to uncovered spouses (spouses without employer pension plans) have been expanded. These changes will make IRA tax benefits available to the large majority of middle-income families, and they will encourage IRA participation.

However, the current $2,000 limit on IRA contributions has been in place since 1981 and should be raised. This limit does not reflect the increase in prices and wages that has taken place since 1981. It does not reflect the fact that individuals need to save more for retirement because of longer life expectancies, rising medical costs, and the deterioration in the financial status of Social Security. Finally, it does not reflect changes in the role of IRA saving that were created by the new tax laws. Raising the contribution limit would enhance the tax benefits of IRA saving, thus enhancing incentives for economic growth.

Benefits for Middle-Income Families

- Families can lower their tax liabilities for the year in which a contribution is made.
- Families can lower their tax liabilities by deferring taxes to a time when they fall into a lower tax bracket.
- Interest earned in an IRA is not taxed while it accrues. As a result, more money can be reinvested in the account each year, allowing assets to grow at a much faster rate. This benefit provides significant gains for families even if they do not qualify for tax deductible contributions based on their incomes.
- A family that makes annual contributions to their IRAs can accumulate a substantial nest egg from which they can finance important family expenses such as retirement, college expenses, and first-time homebuyer expenses among other things. Families with substantial savings are also guarded against future financial uncertainties.

Benefits for the Economy

- Raising the contribution limit would enhance IRA tax benefits and the associated saving incentives. This, in turn, would boost the level of personal saving in the United States.
- IRA saving is merely tax deferred, not tax exempt. Thus, much of the lost government revenue is recovered in the long run when distributions are made. The decline in personal tax revenue that results from eliminating the double taxation of saving is largely offset by two factors: (1) increased corporate tax revenue generated from a larger capital stock and (2) increased personal tax revenue generated from higher levels of investment earnings because of the tax deferred nature of IRA saving. Overall, IRA expansion should not adversely affect the government deficit so that the national saving rate should rise.
- A high national saving rate provides more resources for investment at a lower cost to investors. Increased investment generates productivity improvements that lead to higher wages and better living standards.
- A high national saving rate allows long-term interest rates to fall, creating an environment conducive to economic growth. It also reduces investors' reliance on foreign capital so that more of the benefits from the investment accrue to the U.S. economy.

EXPANDING IRA BENEFITS

The current tax code is biased against saving and investment—activities that are important to economic expansion and to our quality of life. This bias discourages families from saving for future expenses and unforeseen needs. It also impedes economic progress by limiting the amount of domestic resources available for investment.

Providing new saving incentives to raise the U.S. saving rate is a primary goal for many policy makers. One of the most important saving incentives under current law is the Individual Retirement Account (IRA). IRAs offer families attractive tax benefits that encourage them to save for retirement, but restrictions on their use prevent or discourage many families from taking advantage of these benefits. Liberalizing these restrictions could substantially increase IRA participation and boost personal saving in the United States, thereby creating new incentives for financial empowerment and economic growth.

I. WHAT IS WRONG WITH THE CURRENT TAX SYSTEM?

An ideal tax code would be completely neutral—it would neither encourage nor discourage any type of activity. (Of course, perfect neutrality is impossible to achieve because taxes necessarily affect individuals' decisions by distorting relative prices in the economy.) The current tax code seriously violates the principle of neutrality by favoring current consumption relative to saving (i.e., future consumption).

The disparity between the treatment of current consumption and saving occurs because the existing tax system is primarily an "income-based" system. The problem arises because the definition of income used to define the tax base generally includes both saving and the income earned from saving (i.e., interest, dividends, etc.). Thus income that is saved is taxed at two different levels. This double taxation raises the price of saving relative to the price of consumption.

For instance, consider a worker who receives a $2,000 bonus at work and is deciding between using the funds to start a saving account for graduate school or to pay for a vacation. If the worker chooses to save the bonus, the $2,000 is taxed as wage income, leaving $1,700 to deposit in the saving account (assuming a marginal tax rate of 15 percent). Any interest or dividends earned in the saving account are also taxed as income. In contrast, if the worker chooses to spend the bonus on a vacation, the $2,000 is taxed once as wage income, but any benefit derived from the vacation is not taxed. In other words, income used for consumption is taxed only once at the time the income is earned, but income used for saving is taxed twice—once when the income is earned and again when the saving generates any earnings.

This additional burden penalizes families who save. However, saving is important to a family's quality of life and to the potential for economic growth. Saving helps families finance education, home purchases, retirement and other important expenses. It also guards families against financial uncertainties, such as unemployment or medical emergencies. Moreover, a high level of saving provides the business sector with the resources it needs to invest in human capital (such as worker education and training) and physical capital (such as plants and equipment that enhance

worker productivity). Saving and investment also provide new, start-up firms with the capital they need to grow and create new jobs. In brief, saving and investment are key determinants to economic growth and productivity improvements. A larger, more productive economy generates new jobs, higher wages and better living standards.

Switching to a Consumption-Based Tax

Because saving is important to future economic prosperity, many policy makers have proposed restructuring the tax code to reduce or eliminate the bias against saving. Most tax reform proposals have one element in common: they would transform the current income-based tax system into one that is consumption based. Consumption-based taxes only tax the portion of income that is spent—they do not tax the portion of income that is saved. Thus, the main difference between the two types of taxes is that income-based systems tax the resources that people put into the economy, whereas consumption-based systems tax the resources that people take out of the economy. Murray Weidenbaum of Washington University in St. Louis notes: "Under a consumption-based tax, the basic way to cut taxes—legally—is for individuals and families to save more and for companies to invest more. To minimize tax liability under the existing tax structure, taxpayers have to earn less."[1]

Numerous studies have found that switching to a consumption-based tax would boost private saving and long-term economic growth. For instance, Eric Engen of the Federal Reserve Board and William Gale of the Brookings Institution found that moving from the existing system to a flat-rate consumption tax would raise the long-term saving rate by one-half percentage points and increase gross domestic product (GDP) by 1 to 2 percent in the long run.[2] Although these numbers are small in magnitude, they would make a significant contribution to future living standards.

The existing tax system is not a pure income-based system because it contains some provisions to shelter saving from taxation. One of these is the IRA. Contributions to an IRA are deducted from income and then taxed when the proceeds are withdrawn from the account and spent. Thus, the portion of income that families save in an IRA is taxed only once. IRA expansion would, therefore, be a simple way to begin the transformation toward a fairer, more efficient consumption-based tax. Expanding IRAs would not require a major overhaul of the current tax code and could, therefore, be implemented immediately, laying the foundation for broad-based reform in the future.

II. HOW IRAs WORK

IRAs are available to all individuals with earned income and to their spouses, but different individuals receive different tax benefits depending on their situation. If neither spouse is an active participant of an employer sponsored retirement plan, then each spouse can establish an IRA and contribute $2,000 to the IRA annually. The contribution is deducted from taxable income, and the interest earned in the account is not taxed while it accrues.

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[1] Murray L. Weidenbaum, "True Tax Reform: Encouraging Saving and Investment," *Business Horizons*, May 1995, Volume 38, No. 4.

[2] Eric M. Engen and William G. Gale, "Consumption Taxes and Saving: The Role of Uncertainty in Tax Reform," *The American Economic Review*, May 1997, 87: 114-155.

When funds are withdrawn from the IRA, the entire amount of the withdrawal is subject to income tax. If funds are withdrawn before the individual reaches the age of 59 ½, the distribution is subject to a 10 percent penalty. Premature withdrawals are allowed without penalty in the case of the individual's death or disability, to pay for medical expenses that exceed 7.5 percent of adjusted gross income (AGI), or to purchase health insurance while unemployed. In addition, distributions are not penalized if they are withdrawn in the form of a lifetime annuity. Minimum distributions are required each year when the individual reaches the age of 70 ½, and contributions are not allowed after this age.

If either spouse is an "active participant" of an employer plan, the couple still can make fully tax deductible contributions to their IRAs as long as their combined AGI does not exceed $40,000 ($25,000 for single filers). Partial deductions are allowed for taxpayers with AGI between $40,000 and $50,000 ($25,000 and $35,000 for single filers). Couples who do not qualify for tax deductible contributions based on their incomes can still benefit from IRAs because their savings accumulate on a tax deferred basis.[3] The benefit of tax deferral is quite substantial and is discussed later.

Expanding IRAs

Recent changes in the tax laws have liberalized the restrictions on IRA participation. The Taxpayer Relief Act of 1997 gradually doubles the income limits at which fully deductible contributions are allowed. For couples filing jointly, the income limit will increase from $40,000 to $80,000 with a phase-out range of $80,000 to $100,000. For single tax filers, the income limit will increase from $25,000 to $50,000 with a phase-out range of $50,000 to $60,000. In addition, a spouse who is *not* an active participant of an employer plan will be allowed to make a fully tax deductible contribution to an IRA even if his or her spouse *is* a participant of an employer plan provided that their joint AGI does not exceed $150,000 (phase-out range of $150,000 to $160,000). Finally, the 10 percent penalty on early withdrawals will not apply if the proceeds are used to finance higher education expenses or "first-time" homebuyer expenses.[4,5] A more detailed outline of the new IRA provisions is contained in the Appendix.

The new legislation has made important progress in the expansion of IRAs. Increasing the income limits and changing spousal rules will make deductible contributions available to a large majority of middle-income families; liberalizing the restrictions on early withdrawals will encourage IRA participation. However, the contribution limit of $2,000 is too low and cannot allow families the opportunity to increase their saving significantly. The maximum contribution must be raised in order to provide new incentives for financial empowerment and economic growth.

In February 1997, Congressmen Jim Saxton (R-NJ), Richard Armey (R-TX) and Tom DeLay (R-TX) introduced H.R. 891, a bill that would gradually increase the maximum deductible

[3] For individuals who make non-deductible contributions, only the earnings generated by the savings are taxed upon withdrawal because the principle is taxed at the time the contribution is made.

[4] Penalty-free withdrawals for first-time homebuyer expenses are subject to a $10,000 lifetime cap. A "first-time" homebuyer is defined as someone who has not had a property interest in a principle residence for at least two years.

[5] The new tax laws also created two new types of IRAs: Roth IRAs and Education IRAs. Contributions to these accounts are not tax deductible, but the proceeds are not subject to income tax when withdrawn as long as certain conditions are met. The benefits discussed throughout this paper mainly apply to traditional tax deductible IRAs.

contribution from $2,000 per year to $7,000 per year.[6] Raising the contribution level to this amount would generate significant benefits for middle-income families and for the economy.

III. BENEFITS FOR MIDDLE-INCOME FAMILIES

IRAs were established in 1974 to encourage individuals to save for retirement if they were not covered by employer sponsored retirement plans. In 1981, IRA participation was expanded to include all workers regardless of their participation in an employer pension plan. The Tax Reform Act of 1986 limited IRA participation so that workers with employer plans could make tax-deductible contributions only if they met certain income limits. As a result, most of the tax benefits from IRAs are now directed toward low- and middle-income families who otherwise might not save without the appropriate incentives. IRAs provide several important tax benefits that would be augmented if the maximum contribution were increased above $2,000.

Tax Deductible Contributions. Individuals who qualify for tax deductible contributions can lower their tax liabilities for the year in which a contribution is made. If a married couple invests the maximum amount of $2,000 each, they would lower their taxable income by $4,000. This would result in a tax cut of up to $600 for families in the 15 percent tax bracket and $1,120 for families in the 28 percent tax bracket. If the maximum contribution were increased, the savings would be much higher. For instance, if the contribution were raised to $7,000, as proposed in H.R. 891, a family in the 15 percent tax bracket could lower their tax bill by as much as $2,100, and a family in the 28 percent tax bracket could lower their tax bill by $3,920.

Tax Deferred Contributions. The benefit of tax deferral allows individuals to potentially lower their tax liabilities over time. Many workers often have higher incomes during their working years than during their retirement years, thus they may fall into a lower tax bracket when they retire. IRAs allow individuals to potentially lower their tax liabilities by deferring their taxes to a time when their marginal tax rates are lower. Consider an individual who contributes $60,000 to an IRA during his or her working years when he or she falls in the 28 percent tax bracket. The contributions allow the individual to defer up to $16,800 of taxes. If the individual's marginal tax rate falls to 15 percent during retirement when the funds are withdrawn, the $60,000 contributions generate a maximum tax liability of only $9,000. Deferring taxes thus allows the individual to save $7,800.

Conversely, tax liability will increase if an individual falls into a higher tax bracket when distributions are made. However, the individual can choose to make non-deductible contributions if this is believed to be the case so that the distributions are taxed at the lower marginal tax rate. Even if distributions are taxed at a higher marginal tax rate, the benefit of tax deferred saving (discussed next) often outweighs the cost associated with moving into a higher tax bracket.

Tax Deferred Saving. Not only are contributions to IRAs tax deferred, but income earned in an IRA, or "inside build up," is also tax deferred. In other words, the interest earned in the account is

[6] The bill is also co-sponsored by Spencer Bachus (R-AL), Steve Chabot (R-OH), Jo Ann Emerson (R-MO), Mark Foley (R-FL), Martin Frost (D-TX), Dan Miller (R-FL), Christopher Smith (R-NJ), Bob Stump (R-AZ), James Talent (R-MO), and Dave Weldon (R-FL).

not taxed while it accrues. Therefore, more money can be reinvested in the account each year. This allows assets to grow at a much faster rate.

The benefit of tax deferred saving generates significant gains for families that will often outweigh the tax increase associated with moving into a higher tax bracket. Consider an individual who contributes $2,000 per year to a tax deductible IRA that earns 10 percent annually. Table 1 shows that the individual would accumulate $126,005 after 20 years. If the savings are withdrawn at the end of the 20th year and taxed at 28 percent, the individual would be left with $90,724. If an equivalent amount of dollars were contributed to a non-deferred account (such as a saving account at a financial institution) under the same rate assumptions, the individual would have only $64,683 after 20 years.[7] Thus, the benefit of tax deferral is worth $26,041 in this example. The income tax rate for a middle-income individual would have to increase to over 48 percent to equalize the value of the two accounts (the highest tax rate under current law is 39.6 percent).[8] This demonstrates that even if the individual is in a higher tax bracket during retirement years, the benefit of tax deferral would probably outweigh the tax increase associated with the higher tax bracket.

Table 1.
VALUE OF TAX DEFERRED SAVING

	After 5 Years	After 10 Years	After 15 Years	After 20 Years
IRA Balance (10% growth)	$13,431	$35,062	$69,899	$126,005
IRA Balance, after tax (28% tax bracket)	$9,670	$25,245	$50,328	$90,724
Non-Deferred Balance, after tax (28% tax bracket)	$8,913	$21,531	$39,394	$64,683
Equalizing Tax Rate	33.64%	38.59%	43.64%	48.67%

Source: Joint Economic Committee calculations.

Tax deferred saving also makes IRAs attractive to individuals who do not qualify for tax deductible contributions. Table 2 below shows that if an individual contributes $2,000 after taxes to an IRA earning 10 percent annually, he or she would have $126,005 after 20 years. If the savings are withdrawn at the end of the 20th year, the earnings would generate a tax liability of $24,081 (only investment earnings are taxed when distributions are withdrawn), leaving the individual with $101,924. If after-tax contributions of $2,000 were made each year to a non-deferred account, the

[7] A $2,000 contribution to a regular saving account generates a tax liability of $560, assuming a 28 percent marginal tax rate. A $2,000 contribution to an IRA generates no tax liability. In order to equalize the values of the two contributions, one must assume that the $560 tax liability generated by the former is deducted from the contribution. Thus, this example assumes $2,000 annual contributions to the IRA and $1,440 annual contributions to the saving account. In other words, $2,000 pre taxes equal $1,440 after taxes. Upon withdrawal, the entire IRA distribution is subject to income tax, but only the earnings from the saving account are taxed.

[8] This is a modified example from Wallace F. Helin, "Deferring Tax is Good Financial Planning," *Management Accounting (USA),* December 1994.

Table 2.
VALUE OF TAX DEFERRED SAVING WHEN CONTRIBUTIONS ARE NOT TAX DEDUCTIBLE

	After 5 Years	After 10 Years	After 15 Years	After 20 Years
IRA Balance (10% growth)	$13,431	$35,062	$69,899	$126,005
IRA Balance, after tax (28% tax bracket)	$12,470	$30,845	$58,727	$101,924
Non-Deferred Balance, after tax (28% tax bracket)	$12,379	$29,904	$54,714	$89,838
Difference	$91	$941	$4,013	$12,086

Source: Joint Economic Committee calculations

individual would have only $89,838 after 20 years. In this case, the benefit of tax deferred saving is worth $12,086.

This benefit would be even more valuable if the annual contribution were raised above $2,000. For instance, if an individual contributed $7,000 per year to an IRA earning 10 percent annually, he or she would have $356,733 after taxes at the end of 20 years. If the contributions were made to a non-deferred saving account, the individual would have $42,300 less.

Financial Independence. The personal saving rate in the United States averaged only 4.9 percent during the 1990s compared to 7.4 percent in the 1960s and 8.1 percent in the 1970s.[9] The low rate of personal saving indicates that American families are not saving enough for future expenses and unforeseen financial needs. In 1992, the median value of all assets held by families who owned assets was only $13,000[10] (excluding home equity)—hardly enough to ensure a family's financial security. Raising the limit on deductible contributions would provide families with the opportunity and incentives they need to save more.

The $2,000 ceiling on IRA contributions has been in place since 1981. This limit does not reflect changes in the economy and in the role of IRAs that have taken place. For instance, the $2,000 limit does not reflect the increase in economy-wide prices and wages. It does not reflect the fact that individuals may need more money during retirement because of longer life expectancies, rising medical costs, and the deterioration in the financial status of Social Security. Moreover, a wider variety of expenses have been given penalty-free status so that the role of IRAs has expanded beyond that of a saving vehicle for retirement only. The $2,000 limit may have been adequate in the early 1980s, but it now needs to be increased to reflect the changes that have taken place since then.

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[9] Council of Economic Advisers, *Economic Report of the President*, (Washington, DC: Government Printing Office) 1997, Table B-28.

[10] Arthur B. Kennickell and Martha Starr-McCluer, "Changes in Family Finances from 1989 to 1992: Evidence from the Survey of Consumer Finances," *Federal Reserve Bulletin*, October 1994.

Raising the contribution limit would make IRAs an important saving vehicle for middle-income families. A family that contributes $7,000 per year to an IRA earning 8 percent annually would have $249,092 after taxes (assuming a 28 percent marginal tax rate) after 20 years. A nest egg of this size could be used to finance retirement, children's education, a home purchase, and other important expenses. It would also guard families against future financial uncertainties, such as unemployment or unforeseen medical expenses. A higher contribution limit would, therefore, allow families to become financially independent and less reliant on the federal safety net.

Furthermore, since IRAs are self-directed, families have the freedom to invest their savings as they see fit. This allows them the opportunity to increase their incomes relative to what the government can provide for them through social spending programs.

Benefits for Low-Income Families

A common argument against IRA expansion is that low-income families would not benefit because they do not have enough disposable income from which they can save. However, low-income families would benefit from IRA expansion regardless of whether they participate in IRA saving. Any policy that boosts the level of saving will generate significant benefits for low-income families. A higher saving rate provides more resources for investment. A higher level of investment stimulates productivity improvements and economic growth. As mentioned earlier, a larger, more productive economy generates new jobs, higher wages and better living standards. Expanding IRA benefits would, therefore, benefit everyone in the economy, even if they do not participate in IRA saving.

IV. BENEFITS FOR THE ECONOMY

IRA expansion would benefit the economy by enhancing the incentive to save and, in turn, the incentive to invest. Investment is important to the economy because it increases the domestic stock of capital, thereby promoting productivity improvements that lead to higher wages and better living standards.

Investors have two sources of funds available to them: national saving (the sum of private and government saving) and foreign investment. If national saving falls short of investment demand, then investors must compete for scarce resources, thereby driving up the interest rate. Higher interest rates, in turn, attract foreign capital. The inflow of foreign capital allows investment to increase even if national saving is low. However, relying on foreign capital has several drawbacks. First, the profits from the investment flow overseas so that less benefit accrues to the U.S. economy. Second, the foreign borrowing has to be repaid with interest so that future generations inherit a less wealthy, more burdened economy. Third, high interest rates increase the cost of capital, thus preventing investment from increasing as much as it otherwise would. A high national saving rate is, therefore, desirable because it reduces investors' reliance on foreign capital and places downward pressure on long-term interest rates.

Would IRA Expansion Increase National Saving?

Personal Saving

There are some analysts who contend that IRA expansion would not increase personal saving. These analysts argue that expanding IRA benefits would merely encourage families to shift their existing savings into IRA investments, so that net saving would be unaffected. Although this argument may have theoretical appeal, the weight of the evidence suggests that asset-switching does not occur to any great extent in reality.

Some of the most compelling evidence against this argument has been provided by James Poterba of MIT, Steven Venti of Dartmouth College and David Wise of Harvard University. Poterba, Venti and Wise have analyzed saving data for families who contributed to IRAs after participation rules were expanded in 1981. The data show that the increase in IRA saving far outweighed the decrease in the holdings of non-IRA assets. The data also show a low level of substitution between IRAs and other retirement plans, such as 401(k) plans. The authors conclude that the increase in IRA saving that occurred in the 1980s largely represented new saving.[11] Several other studies concur with this conclusion.

It is reasonable to believe that some degree of asset switching takes place, especially in the first two or three years in which taxpayers establish new IRAs. However, most families save very little and have not accumulated enough assets to shift into IRA investments for more than a few years.[12] As mentioned earlier, the median value of assets held by families in 1992 was only $13,000. This amount could fund IRA contributions for a married couple for only three years (and even less if IRA contribution limits are raised). Thus, asset switching is thought to be negligible beyond the transition period.

Overall, the evidence strongly suggests that expanding IRA benefits would generate new saving. However, the contribution limit needs to be raised above $2,000 in order for IRAs to have a significant impact on new saving. The studies discussed above analyze IRA contributions made in the 1980s when the maximum tax rate on income was higher than it is now. Because tax rates are lower than they were prior to 1987, the tax benefit from IRAs is smaller now than it was in the 1980s. Thus, IRA expansion in the current tax environment may not generate the same incentives as it did in 1981 unless the contribution limit is raised to enhance the tax benefits.

Government Saving

A rise in personal saving would not necessarily raise the national saving rate. Some critics admit that expanding IRAs would raise personal saving rates, but argue that IRA expansion would generate large revenue losses that would adversely affect the federal deficit (i.e., government dis-saving). Government dis-saving may offset the increase in personal saving so that national saving is unchanged.

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[11] James Poterba, Steven Venti and David Wise, "Personal Retirement Saving Programs and Asset Accumulation: Reconciling the Evidence," *National Bureau of Economic Research*, May 1996.

[12] Martin Feldstein, "The Effects of Tax-Based Saving Incentives on Government Revenue and National Saving," *National Bureau of Economic Research*, March 1992.

However, the loss in government revenue is not as large as many forecasters portray. IRA savings are merely tax deferred, not tax exempt. Consequently, government revenue falls in the short run when contributions are made, but increases in the long run when distributions are withdrawn. For instance, in Table 1 above, tax deductible contributions of $40,000 are made over 20 years. These contributions generate earnings of $86,005 that are not taxed while they accrue. Overall, government revenue falls by $35,281 (126,005 x 0.28) over the 20 years that contributions are being made. However, when the funds are withdrawn after 20 years, the individual pays income taxes equal to $35,281 on the entire distribution so that the government recovers the lost revenue when the distribution is made. Some individuals may end up in lower tax brackets when distributions are made, but others will end up in higher tax brackets so that, on average, the revenue effect of expanding IRAs should be roughly neutral in the long run. Many forecasters only estimate the effect on revenue for a five-year period. Such short-term estimates are important because of their impact on current operating expenses, but they are misleading because they do not capture the large revenue gains that occur in the long term when IRA funds are withdrawn.

The real loss in revenue occurs because income saved in IRAs is taxed only once instead of twice.[13] However, this decline in revenue is offset by at least two factors. First, as shown in Tables 1 and 2, investment earnings in an IRA are not taxed while they accrue. As a result, the savings appreciate at a faster rate relative to savings in a non-deferred account with the same interest rate. When the higher level of income is withdrawn and taxed, the government collects more revenue than it otherwise would. For instance, in Table 2, the IRA generates earnings of $86,005 whereas the regular saving account generates earnings of only $61,924. Thus, the earned income in the IRA generates a higher tax liability than the earned income in the non-IRA account. As a result, IRA expansion can potentially generate revenue gains in the long run.

Second, economist Martin Feldstein notes that it is inappropriate to concentrate on the loss in personal tax revenue while ignoring the gain in corporate tax revenue.[14] An increase in private saving increases the capital stock, and the return on this additional capital increases corporate tax payments. The increase in corporate tax payments should be sufficient to offset the loss of personal income tax revenue. Dr. Feldstein concludes that:

> Recognizing the important effect of IRA plans on corporate tax revenue changes previous conclusions about the revenue effects of IRA plans in fundamental ways. The revenue loss associated with IRAs is either much smaller than has generally been estimated or is actually a revenue gain, depending on time horizon and key parameter values.[15]

Overall, it is reasonable to expect that IRA expansion will not result in large revenue losses and may even generate small revenue gains in the long run. As a result, it is likely that IRA expansion will increase the national saving rate, thereby generating long-run economic gains that raise wages and living standards.

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[13] Some analysts argue that IRA expansion does not reduce government revenue at all because the increase in saving is new. In other words, the income would have been consumed instead of saved without the enhanced IRA incentives. Since consumption is taxed only once, there is no loss in revenue.

[14] *Op. Cit.,* "The Effects of Tax-Based Saving Incentives on Government Revenue and National Saving."

[15] *Ibid.*

V. CONCLUSION

Saving is essential to a family's financial security and to the potential for economic growth. However, the existing tax code discourages saving by taxing the income used for saving at two or three different levels. Several proposals have been introduced to reduce or eliminate this bias in order to encourage more saving. One proposal that would enhance saving incentives is the expansion of IRAs.

Recent changes in the tax laws have made important progress in expanding IRAs. The income limits at which deductible contributions begin to phase out will gradually double; spouses without employer pension plans will be allowed to deduct their contributions even if their spouses are covered by employer plans; and penalty-free withdrawals will be allowed for first-time homebuyer and higher education expenses. These changes will make IRA benefits available to more middle-income families and encourage IRA participation. However, the current contribution limit of $2,000 is too low and does not provide families with sufficient opportunities to significantly increase their savings.

Raising the maximum contribution limit above $2,000 would enhance the tax benefits of IRAs, thereby encouraging more families to save. Families that contribute to their IRAs could amass a significant amount of savings from which they could finance important expenses and unforeseen needs. Moreover, an increase in personal saving would promote economic growth and productivity improvements. Low-income families who do not participate in IRA saving would benefit from productivity-driven increases in wages and living standards.

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APPENDIX

CHANGES IN IRA PROVISIONS		
	Existing Rules	**New Rules**
Maximum contribution allowable	$2,000	$2,000
Income limit for fully tax deductible contributions		
Joint tax filers	$40,000	$80,000[1]
Single tax filers	$25,000	$50,000[2]
Phase out for tax deductible contributions		
Joint tax filers	$40,000 - $50,000	$80,000 - $100,000[1]
Single tax filers	$25,000 - $35,000	$50,000 - $60,000[2]
Penalty-free withdrawals[3]	Death or disability Health insurance if unemployed Lifetime annuity Catastrophic medical expenses	Death or disability Health insurance if unemployed Lifetime annuity Catastrophic medical expenses Qualified college expenses "First-time" homebuyer expenses ($10,000 lifetime cap)
Rules applying to uncovered spouses[3]	An individual who *is not* an active participant of an employer sponsored plan cannot make a deductible IRA contribution if his or her spouse *is* an active participant of an employer plan unless their joint AGI is $40,000 or less (partial deduction allowed for AGI between $40,000 and $50,000).	An individual who *is not* an active participant of an employer sponsored plan will be allowed to make a deductible IRA contribution even if his or her spouse *is* an active participant of an employer plan as long as their joint AGI is less than $150,000 (partial deduction allowed for AGI between $150,000 and $160,000).

[1] Phase in as follows: $50,000-$60,000 in 1998: $51,000-$61,000 in 1999; $52,000-$62,000 in 2000; $53,000-$63,000 in 2001; $54,000-$64,000 in 2002; $60,000-$70,000 in 2003; $65,000-$75,000 in 2004; $70,000-$80,000 in 2005; $75,000-$85,000 in 2006; and $80,000-$100,000 in 2007 and after.
[2] Phase in as follows: $30,000-$40,000 in 1998; $31,000-$41,000 in 1999; $32,000-$42,000 in 2000; $33,000-$43,000 in 2001; $34,000-$44,000 in 2002; $40,000-$50,000 in 2003; $45,000-$55,000 in 2004; $50,000-$60,000 in 2005 and after.
[3] Changes effective in 1998

In addition to the changes made to traditional IRAs, two new types of IRAs have been created: Roth IRAs and Education IRAs.

Roth IRA

Beginning in 1998, taxpayers will be allowed to make an after-tax contribution of up to $2,000 per year to a Roth IRA. Contributions are *not* tax deductible, but income earned in the account accrues tax free. The key benefit of the Roth IRA is that qualified distributions are tax free.

In other words, the income earned in the account is never taxed. Qualified distributions include withdrawals made: (1) after the age of 59 ½; (2) in the case of death or disability and (3) for the purpose of paying first-time homebuyer expenses. Qualified distributions must be made five years after the first contribution is made to the account. All other distributions are subject to a 10 percent early withdrawal penalty, and the earned income is subject to income tax. Penalty-free withdrawals are allowed for qualified college expenses, catastrophic medical expenses, or to purchase health insurance if unemployed. Although the 10 percent penalty is waived for these distributions, income tax still applies to the earnings. Individuals can continue contributing to a Roth IRA after reaching reach the age of 70 ½, and there are no required minimum distributions at this age. Contributions to Roth IRAs begin to phase down for single tax filers with AGI between $95,000 and $110,000 and for joint tax filers with AGI between $150,000 and $160,000. It is important to note that the total contribution between a Roth IRA and a regular IRA cannot exceed $2,000 annually. Any contribution made to either account in excess of $2,000 is subject to a 6 percent penalty.

Education IRA

Beginning in 1998, taxpayers will be allowed to make an after-tax contribution of up to $500 per year to an Education IRA for each qualifying child. This contribution can be made in addition to the $2,000 contribution to a Roth IRA or a regular IRA. Contributions are *not* tax deductible, but income earned in the account is tax free for qualified higher education expenses. All other distributions are subject to a 10 percent penalty, and earned income is subject to taxation. The contribution income limits are identical to those of the Roth IRA. Before the account's beneficiary reaches the age of 30, any funds remaining in the account must be rolled over into another Education IRA for a qualifying child, or they must be liquidated. The liquidated funds are subject to the 10 percent penalty and to income tax (to the extent of earned income).