

**THE IRA PLUS PROPOSAL CONTAINED IN S. 1771:
EFFECTS ON LONG-TERM REVENUES AND ON INCENTIVES FOR SAVING**

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This memorandum discusses the incentive and long-term revenue effects of the IRA Plus proposal contained in S. 1771, introduced on October 19 by Senator Packwood and cosponsored by Senator Roth and others. The proposal would establish a new form of Individual Retirement Account (IRA) and allow the transfer of funds from existing IRAs into the new account. The memorandum addresses the likely long-term effect of the IRA Plus proposal on revenue and the deficit and the potential effect of the proposal on national saving. The analysis is preliminary because it is based on general descriptions of the proposal rather than on precise legislative language, which has not yet become available to the Congressional Budget Office.

Although the IRA Plus proposal would raise revenue relative to the CBO baseline (current tax law) in the first five years, it would lose revenue beginning shortly thereafter and continue to lose revenue each year, reducing revenue, on net, over the long term. Precise revenue effects of the proposal cannot be estimated beyond 1994 because of the absence of a revenue baseline as well as the other constraints mentioned below.

The revenue gain in the short-term arises primarily from the transferring of funds from existing IRA accounts into the new IRA Plus accounts. This transfer raises revenue by taxing the earlier contributions to existing IRAs at the time the funds are transferred. Because contributions and accumulated earnings in existing IRAs eventually would have been taxed under prior law, this short-term revenue gain is a prepayment of taxes rather than an actual increase in tax liability. However, this prepayment is accompanied by a forgiveness of future taxes on the earnings accumulated in the transferred accounts, making the transfer provisions net revenue losers over time. In addition, the higher level of contributions motivated by the IRA Plus accounts would lose revenue because of the provision exempting the earnings in the new accounts from taxation. In terms of present value, these losses would be similar to those caused by an expansion of current deductible IRAs. In summary, the IRA Plus proposal would lose revenue, on net, over the long term.

As for the question of the possible net contribution to saving from the IRA Plus, the proposal must raise private saving by more than it adds to the federal deficit in order to increase national saving. But the accounts cannot be counted on to have such an effect. First of all, individuals have not been found to be very responsive to higher rates of return. Second, unlike existing IRAs, the IRA Plus neither allows an up-front deduction nor does it strictly segregate funds for use in retirement. Some economists who believe that existing IRAs have increased national saving state that these two characteristics are important motivating factors.

Current Law

Under current law, deductible IRA contributions of up to \$2,000 are allowed to workers who are not covered by an employer pension plan or who have adjusted gross incomes of less than \$25,000 if single or \$40,000 if married and filing jointly. Ceilings on contributions are phased down to zero over the next \$10,000 of adjusted gross income.

Contributions to IRAs for an eligible worker and a spouse not in the workforce can total \$2,250.

Individuals not entitled to the maximum IRA deduction may make nondeductible contributions to IRAs. Earnings on these contributions are not taxed until the funds are withdrawn.

When funds are withdrawn from IRAs they are included in taxable income, except for any nondeductible contributions. Withdrawals before age 59½ are generally subject to an additional 10 percent income tax.

Proposed Change

The proposal contained in S. 1771 would modify current law by allowing all workers to contribute up to \$2,000 annually to an IRA Plus account beginning in 1990, with the allowed contribution increasing to \$3,000 by 1995. Spouses not in the workforce could contribute up to the same limit. Contributions to an IRA Plus account would not be tax deductible, but the earnings on the IRA Plus account would be tax-free when withdrawn after age 59½. Earnings would be taxable only for premature withdrawals, on which an additional 10 percent excise tax also would be due. There are significant exceptions to the rule: part of the IRA Plus funds could be withdrawn before age 59½ to purchase a first home, to pay college education expenses of family members (including grandchildren), or to pay catastrophic medical expenses, with a limit of 25 percent of funds withdrawn for all causes combined.

Amounts in existing IRAs could either be left in those accounts or could be transferred into an IRA Plus account, provided the transfer was made before January 1, 1992. Individuals choosing to transfer funds from existing IRAs into an IRA Plus account would be required to include previously deducted contributions in income. These contributions would be included in income over four years. Income earned on existing IRA accounts before they were transferred into the IRA Plus account would not be included in income unless withdrawn prematurely for non-designated purposes.

Effects of the Proposal on the Deficit

There is considerable uncertainty about the magnitude of the proposal's short-term and long-term revenue effects. There is, however, considerably less doubt about the profile of the revenue effects over time: the proposal would increase tax revenue relative to the CBO baseline over the next few years and decrease revenue thereafter. In terms of present value, the long-term revenue losses would exceed the short-term revenue gains, thereby increasing the debt in the long term.

The pattern of short-term revenue gains and long-term losses reflects the interplay of three separate responses to the proposal by taxpayers. The first is the transferring of funds in existing IRAs to IRA Plus accounts. This transfer must take place before

January 1, 1992. The second is the new contribution, in each future year, of funds to IRA Plus accounts by taxpayers unable to make tax deductible IRA contributions. The third is the contribution, in each future year, of funds to IRA Plus accounts by taxpayers eligible to contribute to a deductible IRA under current law, who elect instead to contribute to an IRA Plus account.

Effects of Transferring Existing IRAs

The IRA Plus proposal raises tax revenue relative to the baseline in the short term primarily because taxpayers are given an incentive to transfer amounts from existing deductible IRAs into IRA Plus accounts. Individuals making such transfers would pay taxes now rather than in retirement on contributions already made to existing deductible IRAs, and these prepayments of future taxes would increase tax revenue in the short term.

There is an incentive to switch for two reasons. First, taxpayers transferring assets to an IRA Plus would be required to pay tax only on the original contributions and not on earnings in the existing IRA. In comparison, if funds were not transferred, taxes would be collected on the entire account--contributions plus earnings--when amounts were withdrawn.

Second, since the prepayment of tax does not reduce the amount in the IRA, taxpayers are effectively allowed a one-time chance to increase the amount of their IRAs compared with what they were allowed to contribute under prior law. For example, a taxpayer who contributed the maximum of \$2,000 into a deductible IRA expects a *pre-tax* return of \$2,000 plus interest, all of which is subject to tax. However, by prepaying tax on the principal now, the taxpayer earns an *after-tax* return of \$2,000 plus interest. If the taxpayer is in the 28 percent tax bracket during retirement, the IRA is essentially increased by \$778 over the original limit.¹

Benefit to the Individual. The following example illustrates how the individual is better off by transferring amounts from a deductible IRA into an IRA Plus. Suppose that the individual had deposited \$2,000 in a deductible IRA in 1985 and planned to withdraw the account in the year 2010 when he or she retired. By that time the account would have accumulated to \$13,697 at an 8 percent interest rate and the individual would owe \$3,835 in taxes at the 28 percent rate. The present value of those taxes in 1990 would be \$1,251.² If instead of leaving the funds in the deductible IRA until retirement the individual elects to transfer the funds to an IRA Plus account in 1990, he or she owes tax on just the original \$2,000 contribution. Assuming the person is in the 28 percent bracket, he or she pays \$560 in taxes. This amount has a present value of \$516 because the tax payments are spread out over four years. The present value of this

¹\$2,778 in pre-tax income yields \$2,000 after tax at a 28 percent rate.

²The discount rate is the individual's after-tax interest rate, which is 5.76 percent (8% minus 28% x 8%).

tax liability is just 41 percent of the present value of taxes that would have been paid had the transfer not taken place.

As this example shows, transfers from existing deductible IRAs to IRA Plus accounts not only shift some taxes from the future to the present, they also forgive other taxes. The net result is to reduce the present value of taxes that would be due under current law.

Implicit Borrowing Cost to the Government. The actual revenue loss to the government depends on very uncertain assumptions about how individuals would react to the incentives described above. However, it is relatively straightforward to estimate the cost to the government of each dollar raised due to the transfer of funds out of existing IRAs into IRA Plus accounts. Such transfers push receipts to the present, while incurring costs in the future and, therefore, are analogous to government borrowing.

The borrowing cost to the government depends primarily on the amount of IRA earnings on which taxes would be forgone relative to the accumulated contributions. CBO projects that by 1990 there will be roughly \$400 billion in existing deductible IRA accounts, consisting of \$210 billion in contributions and \$190 billion in accrued earnings. Assume that the typical transfer is from an IRA with earnings and contributions in this proportion, and that the typical IRA would earn 8 percent a year for 20 more years until withdrawn in retirement. In this case, every dollar that the government collects in short-term tax receipts (in present value) would cost approximately \$9.93 in lost future revenues.³ This amount is equivalent to issuing tax-exempt bonds paying a rate of interest of 12.2 percent.

By comparison, the government's current borrowing cost is approximately 8 percent, but part of that interest is returned in the form of taxes. In other words, the cost to the government of borrowing through conventional means is below 8 percent compared with 12.2 percent through the IRA transfer provision.

Long-Term Effects on the Deficit. The exact amount of both the short-term revenue gain and the overall long-term revenue loss depends on the amount of funds in existing IRAs that would be transferred into IRA Plus accounts. Under current law, the present value of taxes owed on the estimated \$400 billion in IRAs is roughly \$84 billion, assuming that future withdrawals are taxed at an average rate of 21 percent.⁴ In the extreme, if all of these IRA accounts were transferred to IRA Plus accounts, the revenue collected in the 1990-1994 period would be approximately \$44.1 billion (21 percent of \$210 billion). Since these payments are spread out over four years, their present value

³The short-term tax receipts, which are spread out over four years, are discounted at the government's borrowing rate, assumed to be 8 percent.

⁴The appropriate tax rate could be higher or lower than this average. While the typical retired person is in a lower tax bracket than the same person earlier in his or her life, the typical IRA participant has a higher than average tax rate.

is \$39.4 billion, or less than half of the present value of taxes that would have been collected on these accounts under current law.

Despite the incentive, individuals are unlikely to transfer all existing funds from deductible IRA accounts. The main reason is that they would need to come up with the cash to pay the taxes on the contributions transferred--a factor that is especially likely to constrain lower income taxpayers with limited sources of funds. Transfers are also likely to be held down by the expectation of some taxpayers that their tax rates will be lower when they retire, which would reduce the incentive to prepay their tax, even on very favorable terms. In addition, the short time period allowed for the transfer combined with limited information may constrain some taxpayers.

The Joint Committee on Taxation estimates that the revenue gain in the 1990-1994 period from instituting IRA Plus accounts will be \$11.5 billion. The largest component of this amount is the taxes on transferred IRAs. According to CBO calculations, however, the short-term gain of \$11.5 billion comes at the expense of about \$22 billion in future revenues in present value, so that the net revenue effect is a loss of about \$10 billion in present value.

The Joint Committee's revenue estimate assumes that many individuals with existing IRA balances will not transfer them to IRA Plus accounts. This estimate is reasonable; nonetheless, the exact amount of transfers is highly uncertain. The short-term revenue gain could be higher than that estimated by the Joint Committee if higher-than-expected amounts are transferred from existing IRA accounts to IRA Plus accounts.

The preceding analysis pertains to transfers from existing deductible IRA accounts. Since 1987, taxpayers have also been able to make nondeductible contributions to separate IRAs, and these accounts also could be transferred to IRA Plus accounts. The transfer of these accounts into IRA Plus accounts would raise no revenue in the short term because the contributions were not deductible originally and hence would not be taxable when transferred. There would be a permanent future revenue loss, however, because the earnings on the nondeductible contributions would no longer be taxable.

Effects of New Contributions to IRA Plus Accounts

New contributions to IRA Plus accounts, above and beyond the contributions that would be made to current IRAs in the absence of the IRA Plus, would cause a small revenue loss in the initial years because the earnings on these contributions would go untaxed, unlike earnings in taxable accounts. Over time, the annual revenue loss would grow as the earnings in IRA Plus accounts increase.

If contributions to and withdrawals from IRA accounts are taxed at the same rate, the present value of the revenue loss from a dollar of pre-tax income contributed by the taxpayer to an IRA Plus will be the same as the present value of the revenue loss from a deductible IRA. That is, the revenue losses on a fully deductible IRA are just equal,

in present value terms, to the revenue losses due to the tax exemption of earnings in a nondeductible IRA Plus.

Of course, tax rates may differ. If the tax rate on withdrawals is lower than the tax rate on contributions, the present value of the revenue loss from an IRA Plus account will be lower than the comparable revenue loss from a fully deductible IRA. The opposite is true if a higher tax rate applies to withdrawals than to contributions. Estimating the net revenue effect of the IRA Plus proposal, therefore, depends partly upon conjectures about participants' future tax rates compared to their current rates.

Moreover, for taxpayers who would contribute the \$2,000 maximum to either type of IRA, the loss in revenue from a nondeductible IRA such as the IRA Plus will be greater than that from a deductible IRA. The reason is that a \$2,000 contribution to an IRA Plus account is out of after-tax income, while the \$2,000 contribution to a deductible IRA is essentially pre-tax income. As a result, the same dollar limit on contributions allows for the sheltering of more saving that would otherwise be included in taxable income in a nondeductible IRA Plus than in an IRA in which the contribution is deductible.

These distinctions aside, the main difference between the revenue effects of the two types of IRA accounts is one of timing. Deductible IRAs provide a tax deduction when funds are invested, while taxing withdrawals; the IRA Plus provides no tax deduction at the time of contribution, but does not tax withdrawals.

Thus, a fully deductible IRA loses tax revenue in the present; an IRA Plus loses tax revenue in the future. These revenue losses in the out-years from the IRA Plus would be in addition to the aforementioned long-term revenue losses resulting from transfers of existing IRA funds into IRA Plus accounts.

Effects on National Saving

To raise national saving, the IRA Plus proposal must raise private saving by more than it reduces net federal revenues. An increase this large cannot be counted on. The effect of deductible IRAs on savings is a matter of debate, and the IRA Plus differs from a deductible IRA in ways that might lessen its effect.

The incentive for increased saving in an IRA Plus is the tax-free rate of return on earnings. The tax-free rate of return will not stimulate saving by individuals who would have been saving more than the maximum allowable contribution in the absence of the IRA Plus. They would simply substitute IRA Plus accounts for other savings. Even individuals currently saving less than \$2,000, for whom the tax-free rate of the IRA Plus represents a new incentive to save more, may not be willing to sacrifice much current consumption for the higher return on savings. Most empirical studies of personal saving show it to be largely unresponsive to increased rates of return.

If deductible IRAs do raise saving, it may be more because of special features not shared by the IRA Plus account. Even though the net tax incentive in a deductible IRA is equivalent to that in an IRA Plus, the up-front tax deduction provided by a deductible IRA may be crucial in convincing many individuals to contribute. The penalty for withdrawal may also help convince individuals to leave their IRA savings for retirement and in addition to save for other needs. This incentive is weakened in the IRA Plus, which allows 25 percent to be withdrawn for a home purchase, college education, or catastrophic medical expenses. In fact, the ability to transfer funds from an existing IRA to an IRA Plus and then withdraw them for current needs could reduce the contribution to savings of past IRAs.

Some aspects of the IRA plus may attract more savings than did deductible IRAs, but these cannot be counted on to have a major effect. The \$2,000 limit on the IRA Plus contributions is effectively higher than for deductible IRAs because it is specified in after-tax income, and it is also proposed to rise to \$3,000 by 1994. This higher limit means that more taxpayers will receive an incentive for new saving. The access to a portion of account funds before retirement could also increase the willingness of taxpayers to contribute to the IRA Plus relative to the deductible IRAs. However, much if not all of this increase would be at the expense of saving in other accounts. On balance, the IRA Plus cannot be counted on to raise private saving by more than it reduces federal revenue.