[JOINT COMMITTEE PRINT]

DESCRIPTION AND ANALYSIS OF TAX PROPOSALS RELATING TO INDIVIDUAL SAVING AND IRAS

SCHEDULED FOR A HEARING

BEFORE THE

SENATE COMMITTEE ON FINANCE

ON MARCH 6, 1997

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

MARCH 3, 1997

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[ERRATA]

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ERRATA for Table 1 of JCS-2-97 (p.35) -- Funds Available to Taxpayer and Pattern of Tax Receipts Under Deductible IRA, IRA, and Nondeductible IRA

Funds Available to Taxpayer After 10 Years

Type of IRA	Funds contributed to IRA ($)	Gross funds available after 10 years ($)	Taxes due in year 10 ($)	Net funds available after tax in year 10 ($)
Deductible IRA	1,000	2,594	2,594 (t_{10})	2,594 $(1-t_{10})$
Back-end IRA	1,000 $(1-t_0)$	2,594 $(1-t_0)$	0	2,594 $(1-t_0)$
Nondeductible IRA	1,000 $(1-t_0)$	2,594 $(1-t_0)$	$(2{,}594-1{,}000)(1-t_0)t_{10}$	$2{,}594\ (1-t_0)-1{,}594\ (1-t_0)t_{10}$

Pattern of Income Tax Payments Under Three IRAs

Type of IRA	Tax payments in--		
	Current year ($)	Year 1-9 ($)	Year 10 ($)
Deductible IRA	0	0	2,594 (t_{10})
Back-end IRA	$1{,}000(t_0)$	0	0
Nondeductible IRA	$1{,}000(t_0)$	0	$1{,}594\ (1-t_0)t_{10}$

Assumptions:
Taxpayer has $1,000 of pre-tax income to invest in IRA, and the annual rate of return on IRA assets is 10 percent.
t_0 = marginal tax rate in year of IRA contribution
t_{10} = marginal tax rate in year of IRA withdrawal

[ERRATA]

CONTENTS

INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides a description and analysis of certain proposals relating to individual saving--including individual retirement arrangements ("IRAs"). The Senate Committee on Finance has scheduled a public hearing on March 6, 1997, on tax incentives for saving.

Part I of the pamphlet is a summary. Part II is a description of present law and legislative background. Part III describes the following proposals relating to saving: S. 2, S. 14, S. 197, and the President's Fiscal Year 1998 budget proposal. Part IV provides an economic analysis of IRAs generally. Part V discusses issues related to tax incentives for saving and IRAs.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Description and Analysis of Tax Proposals Relating to Individual Saving and IRAs* (JCS–2–97), March 3, 1997.

I. SUMMARY

A. Present Law and Legislative Background

Present law and legislative background of IRAs

Under present law, under certain circumstances, an individual is allowed to deduct contributions up to the lesser of $2,000 or 100 percent of the individual's compensation (or earned income) to an individual retirement arrangement (IRA). The amounts held in an IRA, including earnings on contributions, generally are not included in taxable income until withdrawn.

The $2,000 deduction limit is phased out over certain adjusted gross income (AGI) levels if the individual or the individual's spouse is an active participant in an employer-sponsored retirement plan. The phaseout is between $25,000 and $35,000 of AGI for single taxpayers and between $40,000 and $50,000 of AGI for married taxpayers. The phaseout of the deduction limit does not apply if neither the individual nor the individual's spouse is an active participant in an employer-sponsored retirement plan.

An individual may make nondeductible contributions (up to the $2,000 or 100 percent of compensation limit) to an IRA to the extent the individual is not permitted to make deductible IRA contributions. Nondeductible contributions provide the same tax benefits as deferred annuities, that is, earnings are not includible in income until withdrawn. However, deferred annuities are not subject to contribution limits.

Distributions from IRAs are generally includible in income when withdrawn. Distributions prior to death, disability, attainment of age 59½ are subject to an additional 10-percent tax. The 10-percent tax does not apply to distributions made in the form of an annuity.

The IRA provisions were originally enacted in the Employee Retirement Income Security Act of 1974 (ERISA). Under ERISA, an individual was permitted to make deductible IRA contributions only if the individual was not an active participant in an employer-sponsored retirement plan. The limit on IRA deductions was the lesser of $1,500 or 15 percent of compensation (or earned income).

The Economic Recovery Tax Act of 1981 increased the IRA deduction limit to its current level and removed the restriction on IRA contributions by individuals who were active participants in employer-sponsored plans. The IRA rules in their current form were enacted as part of the Tax Reform Act of 1986. The Small Business Job Protection Act of 1996 modified the IRA provisions to allow certain nonworking spouses to make deductible IRA contributions.

Tax-qualified retirement plans and cash or deferred arrangements

A plan of deferred compensation that meets the qualification standards of the Internal Revenue Code (a qualified plan) is accorded special treatment under present law. Employees do not include qualified plan benefits in gross income until the benefits are distributed, even though the plan is funded and the benefits are nonforfeitable. The employer is entitled to a current deduction (within limits) for contributions to a qualified plan even though the contributions are not currently included in an employee's income. Contributions to a qualified plan are held in a tax-exempt trust.

The tax treatment of contributions under qualified plans is essentially the same as that of present-law IRAs. However, the limits on contributions to qualified plans are much higher than the IRA contribution limits, so that qualified plans provide for a greater accumulation of funds on a tax-favored basis. In return for greater tax benefits, qualified plans are subject to rules that do not apply to IRAs, such as nondiscrimination rules that ensure that a qualified plan benefits a broad group of employees and does not discriminate in favor of highly compensated employees.

Qualified plan benefits are generally subject to tax when received under rules similar to those that apply to IRA withdrawals. There are additional exceptions to the 10-percent early withdrawal tax for qualified plan distributions that do not apply to IRA withdrawals. For example, the 10-percent additional tax does not apply to distributions from a qualified plan that are used to pay extraordinary medical expenses or for medical insurance in the case of certain unemployed individuals.[2]

A qualified cash or deferred arrangement is one type of qualified plan. In general, a cash or deferred arrangement is an arrangement under which an employee can elect to receive an amount in cash or have it contributed to a tax-qualified pension plan. Amounts that are contributed to the plan are not included in income until withdrawn from the plan. Qualified cash or deferred arrangements are subject to the rules applicable to qualified plans generally, and are also subject to additional rules, including special nondiscrimination rules.

The maximum annual amount that an employee can elect to have contributed to a cash or deferred arrangement is limited to $9,500 (for 1997). This dollar limit is indexed for inflation.

SIMPLE retirement plans

Under present law, certain small businesses can establish a simplified retirement plan called the savings incentive match plan for employees ("SIMPLE") retirement plan.[3] SIMPLE plans can be adopted by employers who employ 100 or fewer employees who received at least $5,000 in compensation during the preceding year and who do not maintain another employer-sponsored retirement plan. A SIMPLE plan can be either an IRA for each employee or part of a qualified cash or deferred arrangement ("401(k) plan").

A SIMPLE retirement plan allows employees to make elective contributions of up to $6,000 per year (indexed for inflation in $500 increments). The employer is required to match employee contributions under one of two alternative tests or make a nonelective contribution on behalf of each eligible employee.

Simplified employee pensions

In order to reduce unwanted administrative burdens on employers (particularly smaller employers), present law permits an em-

[2] Extraordinary medical expenses are those that would be deductible as an itemized deduction, i.e., expenses that exceed 7.5 percent of AGI.

[3] SIMPLE retirement plans were created in the Small Business Job Protection Act of 1996.

ployer to establish a simplified employee pension (SEP) for its employees. A SEP is an IRA. However, the same contribution limits that apply to qualified plans apply to SEPs, so that a SEP provides a greater opportunity for tax-favored saving than an individual IRA.

Other tax incentives for saving

The Internal Revenue Code contains a number of other provisions which permit individuals to save on a tax-favored basis. These include provisions relating to tax-sheltered annuities, annuity contracts, and life insurance.

B. Summary of Proposals

1. IRA Provisions of "The American Family Tax Relief Act" (S. 2)

S. 2 would increase the AGI limits applicable to deductible IRA contributions for active participants in 1997, 1998, 1999, and 2000. Thereafter, the bill would repeal the limits on IRA deductions for active participants in employer-sponsored retirement plans. In the case of married taxpayers filing a joint return, for years before 2001, the IRA deduction for active participants would be phased out between the following AGI amounts: for 1997, $65,000 and $75,000; for 1998, $90,000 and $100,000; for 1999, $115,000 and $125,000; and for 2000, $140,000 and $150,000. In the case of single taxpayers, for years before 2001, the IRA deduction for active participants would be phased out between the following AGI amounts: for 1997, $50,000 and $60,000; for 1998, $75,000 and $85,000; for 1999, $100,000 and $110,000; and for 2000, $125,000 and $135,000. The bill would provide that the IRA deduction limit for any individual is coordinated with the limit on elective deferrals under qualified cash or deferred arrangements and certain other plans. Thus, an individual's deductible contributions to an IRA and elective deferrals could not exceed the annual limit on elective deferrals.

Under the bill, an individual would not be considered an active participant in an employer-sponsored retirement plan merely because the individual's spouse is such an active participant. Thus, the bill would permit a nonworking spouse to make a deductible IRA contribution of up to $2,000 without regard to the present-law income phaseouts.

The bill would permit taxpayers to make nondeductible contributions to new tax-free IRA Plus accounts.

The bill would permit withdrawals from an IRA or an IRA Plus to be made income tax free and exempt from the 10-percent additional tax if made (1) for the business start-up expenses of the individual or the spouse of the individual; (2) in the event of long-term unemployment, for any reason; or (3) for the post-secondary education expenses of the individual, the spouse of the individual, or a dependent child of the individual or the individual's spouse.

2. IRA Provisions of the "Retirement Security Act of 1997" (S. 14)

The Retirement Security Act of 1997 (S.14) would establish an individual retirement plan for employees of employers who do not sponsor qualified plans. Each employee would make contributions under an employer payroll deduction system to an individual retirement plan maintained by a third party "contractor". The contractor would arrange with qualified professional asset managers to provide individuals with the opportunity to invest the amounts in their individual retirement plans in three types of funds. The rules governing IRAs (sec. 408) would apply to the payroll deduction individual retirement plans.

The bill would permit individuals with AGI under $30,000, who would otherwise be entitled to a deduction for contributions to an IRA, to claim a nonrefundable tax credit in lieu of the deduction.

The bill would increase the AGI limits applicable to deductible IRA contributions and apply cost-of-adjustments to the IRA deduction limit and the income limitations.

The bill would allow withdrawals from an IRA without imposition of the 10-percent early withdrawal tax to the extent the amount withdrawn is used for the purchase of a new home, for certain education expenses, or for financially devastating medical expenses of any child, grandchild or ancestor of the taxpayer or taxpayer's spouse. The bill would provide that the exception to the early withdrawal tax for distributions after age 59½ does not apply to amounts held in an IRA for less than 5 years.

3. The "Savings and Investment Incentive Act of 1997" (S. 197)

The bill would increase the AGI limits applicable to deductible IRA contributions for active participants in 1997, 1998, 1999, and 2000. Thereafter, the bill would repeal the limits on IRA deductions for active participants in employer-sponsored retirement plans. In the case of married taxpayers filing a joint return, for years before 2001, the IRA deduction for active participants would be phased out between the following AGI amounts: for 1997, $65,000 and $75,000; for 1998, $90,000 and $100,000; for 1999, $115,000 and $125,000; and for 2000, $140,000 and $150,000. In the case of single taxpayers, for years before 2001, the IRA deduction for active participants would be phased out between the following AGI amounts: for 1997, $50,000 and $60,000; for 1998, $75,000 and $85,000; for 1999, $100,000 and $110,000; and for 2000, $125,000 and $135,000.

Under the bill, an individual would not be considered an active participant in an employer-sponsored retirement plan merely because the individual's spouse is such an active participant. Thus, the bill would permit a nonworking spouse to make a deductible IRA contribution of up to $2,000 without regard to the present-law income phaseouts.

The bill would index the $2,000 IRA contribution limit in multiples of $500 after 1997.

Under the bill, the definition of coins eligible for the present-law exception for IRA assets invested in collectibles would be amended.

The bill would permit taxpayers to make nondeductible contributions to new tax-free IRA Plus accounts.

The bill would permit withdrawals from an IRA or IRA Plus to be exempt from the 10-percent additional tax on early withdrawals (sec. 72(t)) if made (1) for a qualified first-time homebuyer; (2) in the event of long-term unemployment, for any reason; (3) for the post-secondary education expenses of the individual, the spouse of the individual, or a dependent child of the individual or the individual's spouse; and (4) in the case of distributions for medical purposes, for any child, grandchild, or ancestor of the individual or the individual's spouse.

4. IRA Provisions Contained in the President's Fiscal Year 1998 Budget Proposal

In general, the President's budget proposal would: (1) increase the present-law income limits (in two steps) on deductible IRA contributions and increase the income phase-out range to $20,000 (so that, for married taxpayers in 1997, 1998, and 1999, the income phase-out range would be $70,000 to $90,000 of AGI, and $80,000 to $100,000 thereafter; and for single taxpayers in 1997, 1998, and 1999, the income phase-out range would be $45,000 to $65,000 of AGI, and $50,000 to $70,000 thereafter); (2) index the $2,000 IRA contribution limit and the income limits; (3) coordinate the IRA contribution limit with the elective deferral limit under qualified cash or deferred arrangements and certain other plans; (4) create nondeductible tax-free IRAs called "Special IRAs;" and (5) provide an exception from the 10-percent early withdrawal tax for IRA distributions used for higher education expenses, first-time home buyer expenses, medical expenses (in excess of 7.5 percent of AGI) of the individual's child, grandchild, parent or grandparent, and distributions to individuals who have been receiving unemployment compensation for at least 12 weeks. The proposal would also provide that IRA assets can be invested in qualified State tuition program instruments.

C. Issues Related to IRAs and Saving

Economic analysis of IRAs generally

Deductible IRAs allow taxpayers to deduct IRA contributions from income in the year contributed and pay income tax on the contributions plus earnings when withdrawn. This treatment creates two potential tax benefits: (1) taxpayers effectively earn a tax-free rate of return on IRA investments and (2) the contributions may be taxed at a lower marginal tax rate than the taxpayer's marginal tax rate when the contributions were made because IRA contributions are not taxed until withdrawn, at which time the taxpayer may be retired.

S. 2, S. 197, and the President's proposal all create a new type of nondeductible IRA, commonly referred to as a back-end IRA. Withdrawals from a back-end IRA are not taxable if contributions are held in the back-end IRA for a certain period of time.

From an economic perspective, back-end IRAs receive tax treatment generally equivalent to deductible IRAs. Because the taxpayer does not deduct back-end IRA contributions from income and pays no tax when amounts are withdrawn, the taxpayer is never taxed on the income earned on the investment. Whether the deductible IRA and back-end IRA are in fact economically equivalent depends on the difference between the taxpayer's marginal tax rate in the year contributions are made and the marginal tax rate in the year IRA funds are withdrawn. When marginal tax rates decrease over time (because tax rates change generally or taxpayers fall into lower tax brackets), the deductible IRA is more advantageous than the back-end IRA because the deductible IRA permits taxpayers to defer payment of tax until tax rates are lower. When marginal tax rates increase over time, a back-end IRA is more advantageous.

Additional differences exist between the deductible and back-end IRAs in the proposals. First, because the dollar limit on contributions to both the deductible IRA and the back-end IRAs is $2,000, the $2,000 back-end IRA contribution limit effectively increases the amount of tax-free saving that can be invested relative to the deductible IRA. A back-end IRA permits a taxpayer to accumulate tax-free income on $2,000 of after-tax dollars, whereas a $2,000 investment in a deductible IRA (which has not yet been subject to tax) is equivalent to only $1,440 in after-tax dollars (assuming a 28-percent marginal tax rate).

Second, because the 10-percent additional income tax on early withdrawals generally applies to the back-end IRA only during the first 5 years after a contribution has been made to the IRA, in general, the benefits of the back-end IRA are greater than those of the deductible IRA for taxpayers who desire to invest funds in an IRA for a relatively short period of time. However, because of the five year holding period under the proposals, this advantage of the back-end IRA exists only until a taxpayer attains age 59½, after which time the deductible IRA becomes more beneficial to the short-term investor.

Present value of revenue cost of IRAs to the Federal Government

Assessing the cost (in the form of forgone tax receipts) to the Federal Government of IRAs may be more difficult than assessing the costs of other tax provisions because IRAs change not only the amount of tax collected, but also the timing of tax collections. Traditional budget scorekeeping accounts for the revenue effects of proposed legislation on a cash-flow basis; in other words, the effect of a provision on budget receipts for a fiscal period is estimated without regard to whether the provision will also affect budget receipts in a subsequent period. This method scores deductible IRAs as generating a larger revenue loss than back-end IRAs, because more of the revenue loss occurs in the earlier years. However, a present-value calculation demonstrates that the long-term cost to the Federal Government of deductible IRAs and back-end IRAs will be approximately equal, except for the effects of changes in tax rates generally or for specific taxpayers, and the difference in the effective contribution limits.

Providing a choice between a deductible IRA and a back-end IRA is likely to increase the overall cost of IRAs to the Federal Government as compared to the cost of either option alone if taxpayers make accurate judgments about their future tax rates. Taxpayers who have reason to believe that their tax rates will decline over time will be more likely to invest in the deductible IRA, and taxpayers who believe their tax rate will increase over time or who intend to invest for a relatively short period of time will generally choose the back-end IRA.

Effectiveness of IRAs at increasing saving

IRAs have a number of attributes that may affect a taxpayer's saving decision. First, investments in IRAs earn a higher after-tax rate of return than investments in other assets. Second, IRAs may provide an incentive for retirement saving, as opposed to other forms of saving. Third, deductible IRAs may provide a psychological incentive to save in the case of taxpayers who owe the Federal Government income tax in excess of the amounts withheld and estimated tax payments made during a year. Fourth, advertising of IRAs by banks and other financial institutions may influence decisions to save.

Deductible IRAs have been very popular with taxpayers. Contributions to IRAs increased significantly when eligibility restrictions were eliminated in 1982. At the peak in 1985, over $38 billion was contributed to IRAs; this represented almost 33 percent of personal saving for that year. However, there is no consensus within the economics profession as to the effect of the pre-1986 IRA rules on personal saving. Some economists believe that IRAs had no effect on overall personal saving (i.e., they believe that IRA contributors merely shifted savings from one vehicle to another. Other economists believe that IRAs increased personal saving. Still other economists believe that IRAs would have eventually increased saving if the universally available deductible IRA had not been significantly restricted by the Tax Reform Act of 1986.

In 1985, 17.8 percent of all eligible returns reported contributions to an IRA. Of the returns reporting contributions, most (71 percent) reported AGI below $50,000. However, high-income taxpayers contributed at a much higher rate than lower-income taxpayers—61.8 percent of eligible returns with AGI of $50,000 or above reported contributions to an IRA, while only 13.8 percent of eligible returns with AGI below $50,000 reported contributions.

Although research on the effectiveness of the pre-1986 IRA provisions may shed light on the potential of the proposal to increase saving, several differences should be noted. First, marginal tax rates for most taxpayers are lower than they were before 1987. Thus, the tax advantages of IRAs are less valuable now than they were before 1987. Second, the proposed IRAs permit penalty-free withdrawals under different circumstances than the pre-1986 IRAs. Third, the back-end IRAs permit penalty-free withdrawals after only five years. Fourth, the growth of employer-based 401(k) savings plans may alter the attractiveness of IRAs for many taxpayers. These differences may increase or decrease the effect of IRAs on saving.

Issues relating to tax incentives for saving

Goals of tax incentives for saving

Some argue that tax incentives for saving are appropriate because the income tax system penalizes saving by taxing the return to income that is saved. This can affect both the national saving rate, as well as the assets taxpayers accumulate for particular purposes. Tax incentives for saving could be designed to encourage saving for particular purposes or to increase national saving.

IRAs have historically been viewed as vehicles for retirement saving. However, IRAs can provide substantial benefits to taxpayers who are saving for nonretirement purposes. For example, if funds are held in an IRA long enough, the taxpayer will benefit from the IRA even after payment of the income tax and the 10-percent early withdrawal tax.

Role of saving in the national economy

National saving is important to the economy because of its relationship to investment. The sources for investment are national saving and foreign investment. Increased investment increases the capital stock, which leads to greater productivity, higher wages and salaries, and increases in a nation's standard of living. Because of the possibility of foreign investment in the United States, a low saving rate does not necessarily mean a low investment rate. However, when foreign saving finances domestic investment, the profits from such investment are transferred abroad.

Net national savings declined through most of the 1980's, and is lower than that of other countries. Investment has declined as well over this period; however, foreign investment has compensated for some of the decline in domestic saving.

Adequacy of retirement savings

Social Security is the largest source of retirement income (40 percent in 1992), followed by income from assets (21 percent in 1992), earnings (17 percent in 1992), and private and government employee pensions (19 percent in 1992). The adequacy of retirement income is commonly measured by the replacement rate, that is, the ratio of retirement income to income during working years.

Available data indicate that Social Security and pension benefits replace roughly 33 percent of career high earnings and 50 percent of earnings over the last five years of employment. When spousal benefits are taken into account, replacement rates are slightly higher as a percentage of final earnings, averaging 30 to 33 percent of highest earnings and 60 to 70 percent of earnings over the last five years. These replacement rates are higher for individuals who had lower earnings.

It is not clear what an appropriate replacement rate is. A rate lower than 100 percent may be adequate. For example, people may desire to have more income during working years because some of that income is saved for retirement. People may also have lower expenses in retirement; for example, they may no longer be making payments on a home. On the other hand, a replacement rate of 100 may be too low. For example, a retiree may face much higher medical expenses than a younger person.

Although coverage by employer pension plans and Social Security is expected to be higher for current workers than for current retirees, the saving rate of current workers is lower than the rate at which current retirees saved during their working lives. Also, it is possible that the need for retirement income is increasing over time because of increases in life expectancies, trends toward early retirement, and rapid rises in medical costs.

II. PRESENT LAW AND LEGISLATIVE BACKGROUND

A. Individual Retirement Arrangements (IRAs)

1. Present-law rules for IRAs

In general

Under certain circumstances, an individual is allowed a deduction for contributions (within limits) to an individual retirement account or an individual retirement annuity (an IRA) (sec. 219). An individual generally is not subject to income tax on amounts held in an IRA, including earnings on contributions, until the amounts are withdrawn from the IRA. No deduction is permitted with respect to contributions made to an IRA for a taxable year after the IRA owner attains age 70½.

Under present law, the maximum deductible contribution that can be made to an IRA generally is the lesser of $ 2,000 or 100 percent of an individual's compensation (earned income in the case of self-employed individuals). A married taxpayer who files a joint return with his or her spouse is permitted to make the maximum deductible IRA contribution of up to $2,000 for each spouse (including, for example, a homemaker who does not work outside the home) if the combined compensation of both spouses is at least equal to the contributed amount. A single taxpayer is permitted to make the maximum deductible IRA contribution for a year if the individual is not an active participant in an employer-sponsored retirement plan for the year or the individual has adjusted gross income (AGI) of less than $25,000. A married taxpayer filing a joint return is permitted to make the maximum deductible IRA contribution for a year if neither spouse is an active participant in an employer-sponsored plan or the couple has combined AGI of less than $40,000.

If a single taxpayer or either spouse (in the case of a married couple) is an active participant in an employer-sponsored retirement plan, the maximum IRA deduction is phased out over certain AGI levels. For single taxpayers, the maximum IRA deduction is phased out between $25,000 and $35,000 of AGI. For married taxpayers, the maximum deduction is phased out between $40,000 and $50,000 of AGI. In the case of a married taxpayer filing a separate return, the deduction is phased out between $0 and $10,000 of AGI.[4]

An individual is an active participant in an employer-sponsored retirement plan for the taxable year if the individual is an active participant for the plan year ending with or within the individual's taxable year. An employer-sponsored retirement plan means (1) a qualified pension, profit-sharing, or stock bonus plan (sec. 401(a)); (2) a qualified annuity plan (sec. 403(a)); (3) a simplified employee pension plan (sec. 408(k)); (4) any SIMPLE retirement account (sec. 408(p)); (5) a plan established for its employees by the U.S., by a State or political subdivision, or by any agency or instrumentality of the U.S. or a State or political subdivision (other than a deferred

[4] A couple is not considered married for purposes of the IRA deduction rules if the individuals file separate returns and live apart from one another at all times during the taxable year; each spouse is treated as a single individual in such a case.

compensation plan of a State or local government (sec. 457)); (6) a plan described in section 501(c)(18); and (7) a tax-sheltered annuity (sec. 403(b)).

The determination of whether an individual is an active participant depends on the type of plan involved. In general, in the case of a defined benefit pension plan, an individual is treated as an active participant if the individual is eligible to participate in the plan. An individual is an active participant in a defined contribution plan only if any amounts are allocated to the account of the participant for the year.[5] The extent to which a person is vested in his or her benefits under an employer-sponsored plan is not taken into account under the active participant rules.

Nondeductible IRA contributions

Individuals may make nondeductible IRA contributions to the extent deductible contributions are not allowed because of the AGI phaseout and active participant rules. A taxpayer may also elect to make nondeductible contributions in lieu of deductible contributions. Thus, any individual may make nondeductible contributions up to the excess of (1) the lesser of $2,000 or 100 percent of compensation over (2) the IRA deduction claimed by the individual. An individual making nondeductible contributions is required to report the amount of such contributions on his or her tax return. As is the case with earnings on deductible IRA contributions, earnings on nondeductible contributions are not subject to income tax until withdrawn. Nondeductible IRAs provide the same tax benefit as deferred annuities. However, there are no limits on the amount that can be contributed to the purchase of a deferred annuity.

Taxation of withdrawals

Amounts withdrawn from IRAs (other than amounts that represent a return of nondeductible contributions) are includible in income when withdrawn. If an individual withdraws an amount from an IRA during a taxable year and the individual has previously made both deductible and nondeductible IRA contributions, then the amount includible in income for the taxable year is the excess of the amount withdrawn over the portion of the amount withdrawn attributable to investment in the contract (i.e., nondeductible contributions). The amount attributable to nondeductible contributions is the portion of the amount withdrawn that bears the same ratio to the amount withdrawn as the total amount of nondeductible contributions bears to the total current value of all IRAs of the individual.

To discourage the use of amounts contributed to an IRA for nonretirement purposes, withdrawals from an IRA prior to age 59½ are subject to an additional 10-percent income tax, unless the withdrawal is made (1) on account of death or disability, (2) in the form of annuity payments, (3) for medical expenses that exceed 7.5 percent of adjusted gross income ("AGI") or (4) for medical insurance (without regard to the 7.5 percent of AGI floor) if the individual has received unemployment compensation for at least 12 weeks,

[5] The definition of active participant under present law is generally the same as the definition of active participant that applied for purposes of determining eligibility to make IRA contributions prior to the IRA amendment adopted in the Economic Recovery Tax Act of 1981.

and the withdrawal is made in the year such unemployment compensation is received or the following year. If a self-employed individual is not eligible for unemployment compensation under applicable law, then to the extent provided in regulations, a self-employed individual is treated as having received unemployment compensation for at least 12 weeks if the individual would have received unemployment compensation but for the fact that the individual was self-employed. The exception to the additional tax ceases to apply if the individual has been reemployed for at least 60 days are generally subject to an additional 10-percent income tax (sec. 72(t)). The 10-percent additional income tax is intended to recapture at least a portion of the tax benefit of the IRA. A similar early withdrawal tax applies to withdrawals from qualified retirement plans and deferred annuities.

Present law imposes a 15-percent excise tax on excess distributions with respect to an individual during any calendar year from qualified retirement plans, tax-sheltered annuities, and IRAs. The purpose of the tax is to limit the total amount that can be accumulated on behalf of a particular individual on a tax-favored basis. In enacting the excise tax, Congress believed that an individual should not be permitted to accumulate excessive retirement savings, regardless of whether such excess was attributable to the receipt of multiple maximum benefits from several employers, very large appreciation in defined contribution plans, or the use of IRAs by individuals receiving significant employer-provided benefits.

In general, excess distributions are defined as the aggregate amount of retirement distributions (i.e., payments from applicable retirement plans) made with respect to an individual during any calendar year to the extent such amounts exceed $160,000 (for 1997). The dollar limit is indexed for inflation. Special rules apply in the case of lump-sum distributions and post-death distributions. The Small Business Job Protection Act of 1996 suspended the excise tax on excess distributions for 1997, 1998, and 1999.

2. Legislative background of IRAs

Employee Retirement Income Security Act of 1974

The individual retirement savings provisions of the Internal Revenue Code were originally enacted in the Employee Retirement Income Security Act of 1974 ("ERISA") to provide a tax-favored retirement savings arrangement to individuals who were not covered under a tax-qualified retirement plan maintained by an employer. Individuals who were active participants in employer-sponsored retirement plans were not permitted to make contributions to an IRA. As enacted in ERISA, the limit on the deduction for IRA contributions was generally the lesser of (1) 15 percent of the individual's compensation (earned income in the case of a self-employed individual) for the year, or (2) $1,500.

Economic Recovery Tax Act of 1981

The Economic Recovery Tax Act of 1981 ("ERTA") increased the deduction limit for contributions to IRAs and removed the restrictions on IRA contributions by active participants in employer-sponsored retirement plans. After ERTA, the deduction limit for IRAs was generally the lesser of (1) 100 percent of the individual's compensation (earned income in the case of a self-employed individual), or (2) $2,000. Any individual was entitled to make a deductible contribution to an IRA even if the individual was an active participant in an employer-sponsored retirement plan.

The ERTA changes were motivated by Congressional concern that a large number of workers, including many who were covered by employer-sponsored retirement plans, faced the prospect of retirement without the resources needed to provide adequate retirement income levels. The Congress concluded that retirement savings by individuals during their working years can make an important contribution towards providing retirement income security.

Tax Reform Act of 1986

The Tax Reform Act of 1986 ("1986 Act") added the present-law restrictions on deductible IRA contributions by active participants in employer-sponsored retirement plans. These restrictions are similar to those originally included in ERISA. In addition, the 1986 Act added the present-law rules permitting individuals to make nondeductible contributions to an IRA.

These changes were made because Congress determined at the time that the expanded availability of IRAs had no discernible impact on the level of aggregate personal saving. In addition, Congress believed that the wide availability of the option to make elective deferrals under cash or deferred arrangements and tax-sheltered annuities reduced the prior concern that individuals in employer-maintained retirement plans should be able to save additional amounts for retirement on a discretionary basis. Congress was also concerned that data had shown that IRA utilization was low among lower-income taxpayers and that taxpayers for whom IRA utilization was the largest would generally have saved without regard to the tax incentives. However, Congress also wished to provide a tax incentive for discretionary retirement savings for all taxpayers and therefore permitted all taxpayers to make nondeductible IRA contributions.

Small Business Job Protection Act of 1996

The Small Business Job Protection Act of 1996 ("1996 Act") modified the rule relating to the maximum deductible IRA contribution by permitting deductible IRA contributions of up to $2,000 to be made for each spouse (including a spouse who does not work outside the home) if the combined compensation of both spouses is at least equal to the contributed amount.

This change was made because Congress was concerned about the national savings rate, and believed that individuals should be encouraged to save. The Congress believed that the ability to make deductible contributions to an IRA is a significant savings incentive. However, this incentive was not available to all taxpayers under prior law. The Congress believed that the prior-law rules relating to deductible IRAs penalized American homemakers. The Congress believed that IRA contributions should be permitted for both spouses even though only one spouse works.

Health Insurance Portability and Accountability Act of 1996

The Health Insurance Portability and Accountability Act of 1996 ("HIPA") modified the 10-percent early withdrawal tax for certain IRA distributions to provide (1) that the tax does not apply to withdrawals from IRAs for medical expenses in excess of 7.5 percent of AGI and (2) withdrawals for medical insurance (without regard to the 7.5 percent of AGI floor) in the case of certain unemployed individuals.

B. Qualified Retirement Plans

In general

A plan of deferred compensation that meets the qualification standards of the Internal Revenue Code (a qualified plan) is accorded special tax treatment under present law. Employees do not include qualified plan benefits in gross income until the benefits are distributed, even though the plan is funded and the benefits are nonforfeitable. The employer is entitled to a current deduction (within limits) for contributions to a qualified plan even though the contributions are not currently included in an employee's income. Contributions to a qualified plan are held in a tax-exempt trust.

Employees, as well as employers, may make contributions to a qualified plan. Employees may, subject to certain restrictions, make both pre-tax and after-tax contributions to a qualified plan. Pre-tax employee contributions (e.g., contributions to a qualified cash or deferred arrangement (sec. 401(k) plan)) are treated the same as employer contributions for tax purposes.

The tax treatment of contributions under qualified plans is essentially the same as that of present law IRAs. However, the limits on contributions to qualified plans are much higher than the IRA contribution limits, so that qualified plans provide for a greater accumulation of funds on a tax-favored basis. The policy rationale for permitting greater accumulation under qualified plans than IRAs is that the tax benefits for qualified plans encourage employers to provide benefits for a broad group of their employees. This reduces the need for public assistance and reduces pressure on the social security system.

The qualification standards and related rules governing qualified plans are designed to ensure that qualified plans benefit an employer's rank-and-file employees as well as highly compensated employees. They also define the rights of plan participants and beneficiaries and provide some limits on the tax benefits for qualified plans.[6] Certain of the rules relating to qualified plans are designed to ensure that the amounts contributed to qualified plans are used for retirement purposes. Thus, for example, an early withdrawal tax applies to premature distributions from such plans, and the ability to obtain distributions prior to termination of employment from certain types of qualified plans is restricted.

[6] Qualified plans are subject to regulation under Federal labor laws (Title I of Employee Retirement Income Security Act of 1974 (ERISA)) as well as under the Internal Revenue Code. The ERISA rules generally relate to rights of plan participants and the obligations of plan fiduciaries.

Types of qualified plans

Qualified plans are broadly classified into two categories, defined benefit pension plans and defined contribution plans, based on the nature of the benefits provided.

Under a defined benefit pension plan, benefit levels are specified under a plan formula. For example, a defined benefit pension plan might provide an annual retirement benefit of 2 percent of final average compensation multiplied by total years of service completed by an employee. Benefits under a defined benefit pension plan are funded by the general assets of the trust established under the plan; individual accounts are not maintained for employees participating in the plan. Benefits under a defined benefit pension plan are guaranteed (within limits) by the Pension Benefit Guaranty Corporation ("PBGC"), a federal corporation within the Department of Labor.

Benefits under defined contribution plans are based solely on the contributions (and earnings thereon) allocated to separate accounts maintained for each plan participant. Profit-sharing plans and qualified cash or deferred arrangements (called 401(k) plans after the section of the Code regulating such plans) are examples of defined contribution plans.

Limits on contributions and benefits

Under present law, overall limits are provided on contributions and benefits under qualified plans. In the case of a defined benefit pension plan, present law limits the annual benefits payable under the plan to the lesser of (1) 100 percent of the participant's average compensation for his or her high 3 years, or (2) $125,000 (for 1997).[7] The dollar limits are increased for cost-of-living adjustments in $5,000 increments.

Under a defined contribution plan, the qualification rules limit the annual additions to the plan with respect to each plan participant to the lesser of (1) 25 percent of compensation or (2) $30,000. Annual additions are the sum of employer contributions, employee contributions, and forfeitures with respect to an individual under all defined contribution plans of the same employer.

Taxation of distributions

Under present law, a distribution of benefits from a qualified plan generally is includible in gross income in the year it is paid or distributed, except to the extent the amount distributed represents the employee's investment in the contract (i.e., basis). Special rules apply to lump-sum distributions, distributions rolled over to an IRA, and distributions of employer securities.

Early distributions from qualified plans generally are subject to the same additional 10-percent early withdrawal tax that applies to early distributions from IRAs. However, certain additional exceptions to the tax apply. For example, the early withdrawal tax does not apply to distributions made to an employee after separation from service after attainment of age 55. Qualified plan distribu-

[7] Annual benefits may in some cases exceed this dollar limitation under grandfather and transition rules contained in the Tax Equity and Fiscal Responsibility Act of 1982 and other legislation.

tions are also subject to the excess distribution tax applicable to IRA distributions.[8]

Qualified cash or deferred arrangements

As mentioned above, a qualified cash or deferred arrangement is a type of qualified pension plan. Thus, such arrangements are subject to the rules generally applicable to qualified pension plans. In addition, special rules apply to such arrangements.

A profit-sharing or stock bonus plan, a pre-ERISA money purchase pension plan, or a rural cooperative plan may include a qualified cash or deferred arrangement (sec. 401(k)). Under such an arrangement, an employee may elect to have the employer make payments as contributions to a qualified plan on behalf of the employee, or to the employee directly in cash. Contributions made at the election of the employee are called elective deferrals. The maximum annual amount of elective deferrals that can be made by an individual is $9,500 for 1997. This dollar limit is indexed for inflation in $500 increments. An employee's elective deferrals must be fully vested. A special nondiscrimination test applies to elective deferrals under cash or deferred arrangements. Employer matching contributions and after-tax employee contributions under qualified defined contribution plans are also subject to a special nondiscrimination test.

C. SIMPLE Retirement Plans

Under present law, certain small businesses can establish a simplified retirement plan called the savings incentive match plan for employees ("SIMPLE") retirement plan. SIMPLE plans can be adopted by employers who employ 100 or fewer employees who received at least $5,000 in compensation during the preceding year and who do not maintain another employer-sponsored retirement plan. A SIMPLE plan can be either an IRA for each employee or part of a qualified cash or deferred arrangement ("401(k) plan"). If established in IRA form, a SIMPLE plan is not subject to the nondiscrimination rules generally applicable to qualified plans (including the top-heavy rules) and simplified reporting requirements apply. Within limits, contributions to a SIMPLE plan are not taxable until withdrawn.

A SIMPLE plan can also be adopted as part of a 401(k) plan. In that case, the plan does not have to satisfy the special nondiscrimination tests applicable to 401(k) plans and is not subject to the top-heavy rules. The other qualified plan rules continue to apply.

A SIMPLE retirement plan allows employees to make elective contributions which cannot exceed $6,000 per year. The $6,000 dollar limit is indexed for inflation in $500 increments. The employer is required to satisfy one of two contribution formulas. Under the matching contribution formula, the employer generally is required to match employee elective contributions on a dollar-for-dollar basis up to 3 percent of the employee's compensation. Under a special rule applicable to a SIMPLE IRA, the employer can elect a lower percentage matching contribution for all employees (but not less

[8] This excess distribution tax is suspended for 1997 through 1999.

than 1 percent of each employee's compensation). In addition, a lower percentage cannot be elected for more than 2 out of any 5 years.

Alternatively, for any year, an employer is permitted to elect, in lieu of making matching contributions, to make a 2 percent of compensation nonelective contribution on behalf of each eligible employee with at least $5,000 in compensation for such year, whether or not the employee makes an elective contribution.

In order for the employer to lower the matching percentage, (in the case of a SIMPLE IRA), or to make a nonelective contribution for any year, the employer has to notify employees of the applicable match within a reasonable time before the 60-day election period for the year. The 60-day election period is the period within which each eligible employee can elect to participate in the SIMPLE plan and modify any previous elections regarding the amount of contributions. The 60-day period is the 60-day period before the beginning of any year or the 60-day period before an employee first becomes eligible to participate.

No contributions other than employee elective contributions, required employer matching contributions or employer nonelective contributions can be made to a SIMPLE plan. All contributions to an employee's SIMPLE account must be fully vested.

Contributions to a SIMPLE plan generally are deductible by the employer and excludable from the employee's income. Early withdrawals from a SIMPLE plan generally are subject to the 10-percent early withdrawal tax. However, in the case of a SIMPLE IRA, withdrawals of contributions during the 2-year period beginning on the date the employee first participated in the SIMPLE IRA are subject to a 25-percent early withdrawal tax.

D. Simplified Employee Pension

Under present law, certain employers (other than tax-exempt and governmental employers) can establish a simplified employee pension (SEP) for the benefit of their employees. A SEP is an IRA which may receive contributions from the employer in an amount that is greater than the normal IRA deduction limits. The employee is always 100-percent vested in employer contributions. SEPs are generally subject to the same rules that apply to IRAs. In addition, certain other rules apply. Each employee who (1) has attained age 21, (2) has performed services for the employer during at least 3 of the immediately preceding 5 years, and (3) received at least $400 (for 1997) in compensation from the employer for the year. An employee can participate even though he or she is also a participant in one or more other qualified retirement plans sponsored by the employer. However, SEP contributions are added to the employer's contribution to the other plans on the participant's behalf in applying the limits on contributions and benefits (sec. 415).

Effective for taxable years beginning after December 31, 1996, employers can no longer establish a salary reduction SEP ("SARSEP") under which the employees can elect to have contributions made to the plan or to receive the contributions in cash (sec. 408(k)(6)). However, employers may continue to make contributions, under rules in effect prior to January 1, 1997, to SARSEPs that were established before 1997. In addition, employees hired after December 31, 1996, may participate in SARSEPs established by their employers prior to January 1, 1997.

E. Other Tax Incentives for Saving

Tax-sheltered annuities

Tax-sheltered annuities are another form of employer-based retirement plan that provide the same tax benefits as qualified plans and IRAs. Employers may contribute to such annuities on behalf of their employees, and employees may contribute on a pre-tax basis through salary reduction. Tax-sheltered annuities are subject to rules similar to some of the rules applicable to qualified plans. Tax-sheltered annuity plans may be maintained only by certain types of organizations, in particular, tax-exempt charitable organizations and educational institutions.

Annuity contracts

Present law provides that income credited to a deferred annuity contract is not currently includible in the gross income of the owner of the contract nor is the income taxed to the insurance company issuing the contract. No deduction is provided for, and no dollar limits are imposed on, amounts used to purchase annuity contracts. In general, amounts received by the owner of an annuity contract before the annuity starting date (including loans under or secured by the contract) are includible in gross income as ordinary income to the extent that the cash value of the contract exceeds the owner's investment in the contract. In addition, a portion of each distribution received after the annuity starting date is treated as ordinary income based on the ratio of the investment in the contract to the total distributions expected to be received.

A 10-percent additional income tax is imposed on certain early withdrawals under an annuity contract. This additional tax does not apply to any distribution made after the owner of the contract attains age 59½, receives annuity payments under the contract, or satisfies certain other requirements.

Life insurance

Under present law, the investment income ("inside buildup") earned on premiums credited under a life insurance policy generally is not subject to current taxation to the owner of the policy or to the insurance company issuing the contract. This favorable tax treatment is available only if a life insurance contract meets certain requirements designed to limit the investment character of the contract. The contract must satisfy the statutory definition of life insurance by meeting either of two statutory tests: the "cash value accumulation" test, or the "guideline premium/cash value corridor" test.

No deduction is provided for, and no dollar limits are imposed on, amounts used by an individual to purchase life insurance contracts.

Death benefits paid under a life insurance contract are excluded from income, so that neither the policyholder nor the policyholder's beneficiary is ever taxed on the inside buildup if the proceeds of the policy are paid to the policyholder's beneficiary by reason of the death of the insured.

Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includible in income only to the extent that the amounts distributed exceed the taxpayer's basis in the contract; such distributions generally are treated first as a tax-free recovery of basis, and then as income. In the case of a modified endowment contract, however, distributions are treated as income first, loans are treated as distributions (i.e., income rather than basis recovery first), and an additional 10-percent tax is imposed on the income portion of distributions made before age 59½ and in certain other circumstances.

III. DESCRIPTION OF PROPOSALS

A. IRA Provisions of the "American Family Tax Relief Act" (S. 2)[9]

1. Restoration of IRA deduction for all taxpayers (sec. 401 of the bill)

The bill would increase the AGI limits applicable to deductible IRA contributions for active participants in 1997, 1998, 1999, and 2000. Thereafter, the bill would repeal the limits on IRA deductions for active participants in employer-sponsored retirement plans. Thus, under the bill, after 2000, an individual would be entitled to make a $2,000 deductible IRA contribution without regard to whether the individual was an active participant in an employer-sponsored retirement plan.

In the case of married taxpayers filing a joint return, for years before 2001, the IRA deduction for active participants would be phased out between the following AGI amounts: for 1997, $65,000 and $75,000; for 1998, $90,000 and $100,000; for 1999, $115,000 and $125,000; and for 2000, $140,000 and $150,000.

In the case of single taxpayers, for years before 2001, the IRA deduction for active participants would be phased out between the following AGI amounts: for 1997, $50,000 and $60,000; for 1998, $75,000 and $85,000; for 1999, $100,000 and $110,000; and for 2000, $125,000 and $135,000.

The bill would provide that the IRA deduction limit for any individual is coordinated with the limit on elective deferrals under a qualified cash or deferred arrangement and under certain other plans. Thus, the sum of an individual's deductible contributions to an IRA and the individual's elective deferrals could not exceed the annual limit on elective deferrals.

The provision would be effective for taxable years beginning after December 31, 1996.

2. Deductible IRAs for nonworking spouses (sec. 402 of the bill)

Under the bill, an individual would not be considered an active participant in an employer-sponsored retirement plan merely because the individual's spouse is such an active participant. Thus, the bill would permit a nonworking spouse to make a deductible IRA contribution of up to $2,000 without regard to the present-law income phaseouts.

The provision would be effective for taxable years beginning after December 31, 1996.

3. Nondeductible contributions to tax-free IRA Plus accounts (sec. 403 of the bill)

The bill would permit taxpayers to make nondeductible contributions to new IRA Plus accounts. Generally, IRA Plus accounts would be treated in the same manner as and be subject to the same

[9] S. 2 was introduced on January 21, 1997, by Senators Roth, Lott, Abraham, Allard, Ashcroft, Brownback, Craig, D'Amato, DeWine, Domenici, Enzi, Faircloth, Gorton, Grams, Hagel, Hatch, Helms, Hutchison, Kyl, Murkowski, Nickles, Roberts, Santorum, Sessions, Smith (New Hampshire), Smith (Oregon), Thomas, Thurmond, Warner, Coverdell, Coats, and Kempthorne.

rules applicable to deductible IRAs. However, a number of special rules would apply.

Contributions to an IRA Plus would be nondeductible. The amount of nondeductible contributions to an IRA Plus that could be made for any taxable year would be tied to the limits for deductible IRAs, so that the aggregate amount of contributions to an IRA Plus could not exceed the excess of (1) the IRA deduction limit for the year (determined without regard to the rule coordinating the IRA deduction limit with the elective deferral limit) over (2) the amount of IRA contributions actually deducted for the year.

Under the bill, any qualified distribution from an IRA Plus account would not be included in gross income and would not be subject to the 10-percent additional income tax on early withdrawals. A qualified distribution from an IRA Plus account would include any payment or distribution (1) made on or after the date the IRA Plus owner attains age 59½, (2) made to a beneficiary of the IRA Plus owner after death, (3) on account of disability of the IRA Plus owner, or (4) which is a qualified special purpose distribution (i.e., a distribution for medical expenses, the costs of starting a business of the IRA Plus owner or the owner's spouse, long-term unemployment, and higher education expenses).

The bill provides that a distribution, which is made on account of attainment of age 59½, would not be treated as a qualified distribution if it is made within the 5-taxable year period beginning with the first taxable year for which the individual made a contribution to an IRA Plus account (or such individual's spouse made a contribution to an IRA Plus account). In addition, the bill provides that a distribution would not be treated as a qualified distribution if, in the case of a distribution attributable to a qualified rollover contribution, the distribution is made within the 5-taxable year period beginning with the taxable year in which the rollover contribution was made.

In the case of a distribution from an IRA Plus account that is not a qualified distribution, in applying the rules of section 72, the distribution would be treated as made from contributions to the IRA Plus account to the extent that such distribution, when added to all previous distributions from the IRA Plus account, does not exceed the aggregate amount of contributions to the IRA Plus account. Thus, nonqualified distributions from an IRA Plus account would not be included in income (and subject to the additional 10-percent tax on early withdrawals) until the IRA owner had withdrawn amounts in excess of all contributions to the IRA Plus account.

Rollover contributions would be permitted to an IRA Plus only to the extent such contributions consist of a payment or distribution from another IRA Plus or from an individual retirement plan. Such rollover contributions would not be taken into account in determining the contribution limit for a taxable year. The normal IRA rollover rules would otherwise govern the eligibility of withdrawals from IRA Plus accounts to be rolled over.

The bill would permit amounts withdrawn from IRAs to be transferred into an IRA Plus. The amount transferred would be includible in gross income in the year the withdrawal was made, except that amounts transferred to an IRA Plus before January 1, 1999, would be includible in income ratably over a 4-year period. The 10-percent early withdrawal tax would not apply to amounts transferred from an IRA to an IRA Plus account.

Under the bill, the excise tax on excess distributions from qualified retirement plans (sec. 4980A) would not apply to distributions from an IRA Plus account or to any qualified rollover contribution from an individual retirement plan to an IRA Plus account.

The provisions of the bill relating to IRA Plus accounts would be effective for taxable years beginning after December 31, 1996.

4. IRA withdrawals for business startup, long-term unemployment, and post-secondary education expenses (secs. 404-406 of the bill)

The bill would permit withdrawals to be made income tax free and exempt from the 10-percent additional tax if made (1) for the business start-up expenses of the individual or the spouse of the individual; (2) in the event of long-term unemployment, for any reason; or (3) for the post-secondary education expenses of the individual, the spouse of the individual, or a dependent child of the individual or the individual's spouse.

For purposes of this provision, business start-up expenses include expenses associated with the establishment of the business that are incurred on or before the business start date and on or before the date which is one year after the business start date, such as start-up expenditures within the meaning of section 195(c), organizational expenses within the meaning of sections 248(b) and 709(b), and other expenses related to starting a business (e.g., purchasing a computer, software, inventory, etc.). No deduction otherwise allowable with respect to any business start-up expense will be allowed to the extent this provision applies to such expense. In addition, to the extent this provision applies to any portion of business start-up expenses which are properly chargeable to capital account, the basis of the property to which such expenses are chargeable will be reduced by the amount taken into account under this provision.

For purposes of this provision, long-term unemployment has the same meaning as under present law (i.e., the individual has received unemployment compensation for at least 12 weeks).

For purposes of this provision, post-secondary education expenses would be defined as the student's cost of attendance as defined in section 472 of the Higher Education Act of 1965 (generally, tuition, fees, room and board, and related expenses).

The provision would be effective for distributions after December 31, 1996.

B. IRA Provisions of the "Retirement Security Act of 1997" (S. 14)[10]

1. In general

The Retirement Security Act of 1997 (S. 14) would establish a system by which employees of employers who do not sponsor qualified plans would be permitted to elect to make contributions under an employer payroll deduction system to an IRA maintained by a third party "contractor". The contractor would arrange with qualified professional asset managers to provide individuals with the opportunity to invest the amounts in their individual retirement plans in three types of funds. The rules governing IRAs (sec. 408) would apply to the payroll deduction IRAs.

The bill would permit individuals with AGI under $30,000, who would otherwise be entitled to a deduction for contributions to an IRA, to claim a nonrefundable tax credit in lieu of the deduction.

The bill would increase the AGI limits applicable to deductible IRA contributions and apply cost-of-adjustments to the IRA deduction limit and the income limitations.

The bill would allow withdrawals from an IRA without imposition of the 10-percent early withdrawal tax to the extent the amount withdrawn is used for the purchase of a first home, for certain education expenses, or for financially devastating medical expenses. The bill would provide that the exception to the early withdrawal tax for distributions after age 59½ does not apply to amounts held in an IRA for less than 5 years.

2. Payroll deduction IRAs (secs. 101-108 of the bill)

The bill would permit employees of employers who do not sponsor qualified plans for their employees to elect to have contributions made to an IRA f the employee through payroll deductions. Under a system established by a third party contractor, IRAs would be established by and maintained for eligible employees. Upon request of the employee, the employer would withhold from the employee's compensation amounts designated by the employee and remit the amounts to the contractor for investment in the employee's plan. An employer who fails to remit payroll deduction amounts to the contractor would not be allowed a deduction for such amounts. The employee would be permitted to change the amount of payroll deduction, and request payroll deductions be made by new employers to an existing plan. The sum of the employee's payroll deduction contributions and the employee's other IRA contributions could not exceed $2,000 per year (indexed for inflation).

The contractor would enter into arrangements with qualified professional asset managers to provide individuals with the opportunity to invest amounts in their plans in a government securities fund, a fixed income fund and a common stock index fund. Employees would elect the investment funds into which the contributions to their plans would be invested. The contractors would be private entities selected by the Secretary of Labor and would be subject to

[10] S. 14 was introduced on January 21, 1997, by Senators Daschle, Boxer, Kennedy, Bingaman, Moseley-Braun, Rockefeller, Graham, Mikulski, Kerry, Reid, Durbin, Inouye, Torricelli, and Breaux.

performance standards established by the DOL. The rules applicable to individual retirement arrangements (sec.408) would apply to the individual retirement plans established under this program.

The system established under this provision would take effect on the first day of the sixth month following the month in which the contract with a private entity is awarded.

3. Tax credit (sec. 111 of the bill)

Individuals, with AGI under $30,000, who would otherwise be entitled to deductions for contributions to individual retirement plans would be permitted to claim a nonrefundable tax credit in lieu of the deduction. The amount of the credit would be as follows: $450 if AGI is not over $15,000; $400 if AGI is over $15,000 but not over $20,000; $350 if AGI is over $20,000 but not over $25,000; $300 if AGI is over $25,000 but not over $30,000. Married taxpayers must file a joint return to claim the credit.

The credit would not apply to employer contributions to a SEP or to any amount contributed to a SIMPLE IRA. In addition, the credit would not be allowed upon the individual's attaining age 70½ or with respect to rollover contributions. The credit would not be allowed for amounts contributed to an endowment contract (sec. 408(b)) allocable to the cost of life insurance. The credit would not be allowed with respect to any amount contributed to an inherited IRA.

The provision would be effective for taxable years beginning after December 31, 1997.

4. Deductible IRA contributions (secs. 121-122 of the bill)

The bill would increase the income limits at which the IRA deduction is phased out for active participants in employer-sponsored retirement plans. In the case of married taxpayers, the income limit would increase from $40,000 to $70,000 for 1997, 1998, 1999 and to $80,000 thereafter. In the case of single taxpayers, the income limit would increase from $25,000 to $45,000 for 1997, 1998, 1999 and to $50,000 thereafter. The phase out range would be equal to 10 times the deductible dollar amount for the year. For example, for 1997, the maximum IRA deduction would be phased out between $70,000 and $90,000 of AGI for married taxpayers and between $45,000 and $65,000 of AGI for single taxpayers. These limits, and the $2,000 limit on deductible IRA contributions, would be indexed for inflation beginning after 1996.

The provision would be effective for taxable years beginning after December 31, 1996.

5. Exceptions to the early withdrawal tax (sec. 131 of the bill)

The bill would provide exemptions from the 10-percent early withdrawal for distributions from IRAs used for certain purposes. Penalty-free withdrawals could be made for (1) qualified first-time homebuyer distributions or (2) qualified higher education distributions. The bill would expand the scope of the exception for distributions in the case of financially devastating medical expenses.

Qualified first-time homebuyer distributions would be any distributions received by the individual that are used within 60 days to pay costs of acquiring, constructing, or reconstructing the principal residence of a first-time homebuyer who is the taxpayer, taxpayer's spouse, or a child or grandchild of the taxpayer or taxpayer's spouse. A first-time homebuyer would be an individual who has not had an ownership interest in a principal residence during the 3-year period ending on the date of acquisition of the principal residence to which the distribution relates.

Qualified higher education expenses generally would be those meeting the requirements for tuition and fees at most colleges and universities and certain vocational schools. A taxpayer could make a penalty-free IRA withdrawal for the qualified higher education expenses of the taxpayer, the taxpayer's spouse, the taxpayer's dependent, or any child or grandchild of the taxpayer (even if not a dependent for tax purposes).

The bill would extend the exception for medical care expenses to apply to the medical expenses of any child, grandchild, or ancestor of the taxpayer or taxpayer's spouse, regardless of whether such person would otherwise qualify as the taxpayer's dependent.

The provision would be effective for distributions after December 31, 1996.

6. Age 59½ withdrawal exception (sec. 132 of the bill)

The bill would provide that the exception to the early withdrawal tax for distributions after age 59½ does not apply to amounts that have been held in an IRA for less than 5 years. The 5-year holding period does not apply to amounts in an IRA attributable to qualified rollover contributions from a qualified plan, qualified annuity plan (sec. 403), or tax-sheltered annuity (sec. 403(b)).

Under the bill, for purposes of this 5-year holding period, distributions from an IRA would be treated as having been made first from the earliest amounts contributed to the IRA (and the portion of earnings attributable to such contributions). In addition, amounts are treated as having been held by an IRA for the period that such amounts were held by an IRA from which such amounts were transferred.

The provision would be effective for contributions (and earnings allocable thereto) made after December 31, 1996.

C. The "Savings and Investment Incentive Act of 1997" (S. 197)[11]

1. IRA deduction limits (sec. 101 of the bill)

The bill would increase the AGI limits applicable to deductible IRA contributions for active participants in 1997, 1998, 1999, and 2000. Thereafter, the bill would repeal the limits on IRA deductions for active participants in employer-sponsored retirement plans. Thus, under the bill, after 2000, an individual would be entitled to make a $2,000 deductible IRA contribution without regard to whether the individual was an active participant in an employer-sponsored retirement plan.

[11] S. 197 was introduced on January 22, 1997, by Senators Roth, Lott, Breaux, Grassley, Nickles, Murkowski, Abraham, Kyl, Helms, D'Amato, Craig, Hutchison, McConnell, Thomas, Smith (Oregon), DeWine, Inhofe, Bryan, Roberts, Mikulski, Smith (New Hampshire), Hatch, Bennett, Kempthorne, Inouye, Enzi, Ford, Burns, Lieberman, Hagel, Gramm, Dodd, Collins, Gregg, Grams, Bond, and Kohl.

In the case of married taxpayers filing a joint return, for years before 2001, the IRA deduction for active participants would be phased out between the following AGI amounts: for 1997, $65,000 and $75,000; for 1998, $90,000 and $100,000; for 1999, $115,000 and $125,000; and for 2000, $140,000 and $150,000.

In the case of single taxpayers, for years before 2001, the IRA deduction for active participants would be phased out between the following AGI amounts: for 1997, $50,000 and $60,000; for 1998, $75,000 and $85,000; for 1999, $100,000 and $110,000; and for 2000, $125,000 and $135,000.

2. Deductible IRAs available for nonworking spouses (sec. 101(a)(2) of the bill)

Under the bill, an individual would not be considered an active participant in an employer-sponsored retirement plan merely because the individual's spouse is such an active participant. Thus, the bill would permit a nonworking spouse to make a deductible IRA contribution of up to $2,000 without regard to the present-law income phaseouts.

3. Indexing of IRA contribution limit (sec. 102 of the bill)

The bill would index the $2,000 IRA contribution limit in multiples of $500 after 1997.

4. Coins and bullion not treated as collectibles (sec. 103 of the bill)

Under the bill, the definition of coins eligible for the present-law exception for IRA assets invested in collectibles would be amended. Thus, the bill would define a coin eligible for the exception as (1) any coin certified by a national grading service and traded on a nationally recognized electronic network, or listed by a recognized wholesale reporting service and was legal tender in the country of issuance or was issued under the laws of any State and (2) any gold, silver, platinum, or palladium bullion (whether fabricated in the form of a coin or not) of a fineness equal to or exceeding the maximum fineness required for metals that may be delivered in satisfaction of a regulated futures contract subject to regulation by the Commodity Futures Trading Commission under the Commodity Exchange Act. The bill would require that the coin or bullion be in the physical possession of the IRA trustee.

5. Nondeductible contributions to tax-free IRA Plus accounts (sec. 111 of the bill)

The bill would permit taxpayers to make nondeductible contributions to new IRA Plus accounts. Generally, IRA Plus accounts would be treated in the same manner as and be subject to the same rules applicable to deductible IRAs. However, a number of special rules would apply.

Contributions to an IRA Plus account would be nondeductible. The amount of nondeductible contributions to an IRA Plus account that could be made for any taxable year would be tied to the limits for deductible IRAs, so that the aggregate amount of contributions to an IRA Plus account could not exceed the excess of (1) the IRA deduction limit for the year (determined without regard to the rule

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coordinating the IRA deduction limit with the elective deferral limit) over (2) the amount of IRA contributions actually deducted for the year.

Under the bill, any qualified distribution from an IRA Plus account would not be included in gross income and would not be subject to the 10-percent additional income tax on early withdrawals. A qualified distribution from an IRA Plus account would include any payment or distribution (1) made on or after the date the IRA Plus owner attains age 59½, (2) made to a beneficiary of the IRA Plus owner after death, (3) on account of disability of the IRA Plus owner, or (4) which is a qualified special purpose distribution (i.e., a distribution for first-time home purchase, medical expenses, long-term unemployment, and higher education expenses).

The bill provides that a distribution would not be treated as a qualified distribution if it is made within the 5-taxable year period beginning with the first taxable year for which the individual made a contribution to an IRA Plus account (or such individual's spouse made a contribution to an IRA Plus account). In addition, the bill provides that a distribution would not be treated as a qualified distribution if, in the case of a distribution attributable to a qualified rollover contribution, the distribution is made within the 5-taxable year period beginning with the taxable year in which the rollover contribution was made.

In the case of a distribution from an IRA Plus account that is not a qualified distribution, in applying the rules of section 72, the distribution would be treated as made from contributions to the IRA Plus account to the extent that such distribution, when added to all previous distributions from the IRA Plus account, does not exceed the aggregate amount of contributions to the IRA Plus account. Thus, nonqualified distributions from an IRA Plus account would not be included in income (and subject to the additional 10-percent tax on early withdrawals) until the IRA owner had withdrawn amounts in excess of all contributions to the IRA Plus account.

Rollover contributions would be permitted to an IRA Plus only to the extent such contributions consist of a payment or distribution from another IRA Plus or from an individual retirement plan. Such rollover contributions would not be taken into account in determining the contribution limit for a taxable year. The normal IRA rollover rules would otherwise govern the eligibility of withdrawals from IRA Plus accounts to be rolled over.

The bill would permit amounts withdrawn from IRAs to be transferred into an IRA Plus. The amount transferred would be includible in gross income in the year the withdrawal was made, except that amounts transferred to an IRA Plus before January 1, 1999, would be includible in income ratably over a 4-year period. The 10-percent early withdrawal tax would not apply to amounts transferred from an IRA to an IRA Plus account.

Under the bill, the excise tax on excess distributions from qualified retirement plans (sec. 4980A) would not apply to distributions from an IRA Plus account or to any qualified rollover contribution from an individual retirement plan to an IRA Plus account.

The provisions of the bill relating to IRA Plus accounts would be effective for taxable years beginning after December 31, 1996.

6. IRA withdrawals for first-time home purchase, long-term unemployment, post-secondary education expenses, and qualified medical expenses (sec. 201 of the bill)

The bill would permit withdrawals to be exempt from the 10-percent additional tax on early withdrawals (sec. 72(t)) if made (1) for a qualified first-time homebuyer; (2) in the event of long-term unemployment, for any reason; (3) for the post-secondary education expenses of the individual, the spouse of the individual, or a dependent child of the individual or the individual's spouse; and (4) in the case of distributions for medical purposes, for a child, grandchild, or ancestor of the individual or the individual's spouse.

A qualified first-time homebuyer distribution would mean any distribution received by an individual if it is used within 60 days to pay qualified acquisition costs with respect to a principal residence of a first-time homebuyer who is the individual, the individual's spouse, or any child, grandchild, or ancestor of the individual or the individual's spouse. Qualified acquisition costs include the costs of acquiring, constructing, or reconstructing a residence and any usual or reasonable settlement, financing, or other closing costs. An individual generally is a first-time homebuyer if the individual (and the individual's spouse, if married) did not have an ownership interest in a principal resident during the 2-year period ending on the date of acquisition of the principal residence.

For purposes of this provision, long-term unemployment has the same meaning as under present law (i.e., the individual has received unemployment compensation for at least 12 weeks).

For purposes of this provision, qualified higher education expenses would be defined as tuition, fees, books, supplies, and equipment required for enrollment or attendance at an eligible educational institution. The amount of qualified higher education expenses would be reduced by any amount excluded from income upon redemption of a qualified U.S. savings bond (sec. 135).

The provision would be effective for distributions after December 31, 1996.

D. IRA Provisions Contained in the President's Fiscal Year 1998 Budget Proposal[12]

1. In general

In general, the President's budget proposal would: (1) increase the present-law income limits (in two steps) on deductible IRA contributions and increase the income phase-out range to $20,000 (so that, for married taxpayers in 1997, 1998, and 1999, the income phase-out range would be $70,000 to $90,000 of AGI, and $80,000 to $100,000 thereafter; and for single taxpayers in 1997, 1998, and 1999, the income phase-out range would be $45,000 to $65,000 of AGI, and $50,000 to $70,000 thereafter); (2) index the $2,000 IRA contribution limit and the income limits; (3) coordinate the IRA contribution limit with the elective deferral limit; (4) create nondeductible tax-free IRAs called "Special IRAs;" and (5) provide an exception from the 10-percent early withdrawal tax for IRA dis-

[12] See Department of the Treasury, *General Explanation of the Administration's Revenue Proposals, February 1997.* Also, Office of Management and Budget, *Budget of the United States Government, Fiscal Year 1998.*

tributions used for higher education expenses, first-time home buyer expenses, medical expenses (in excess of 7.5 percent of AGI) of the individual's child, grandchild, parent or grandparent, and distributions to individuals who have been receiving unemployment compensation for at least 12 weeks. The proposal would also provide that IRA assets can be invested in qualified State tuition program instruments.

2. Deductible IRA contributions

The proposal would increase the income limits at which the maximum IRA deduction is phased out for active participants in employer-sponsored retirement plans in two steps. For married taxpayers in 1997, 1998, and 1999, the income phase-out range would be $70,000 to $90,000 of AGI, and $80,000 to $100,000 thereafter. For single taxpayers in 1997, 1998, and 1999, the income phase-out range would be $45,000 to $65,000 of AGI, and $50,000 to $70,000 thereafter. The income thresholds would be indexed for inflation, beginning after 2000.

The IRA deduction limit would be coordinated with the limit on elective deferrals so that the maximum allowable IRA deduction for a year could not exceed the excess of the elective deferral limit over the amount of elective deferrals made by the individual.

The proposal would provide that the exception to the early withdrawal tax for distributions after age 59½ does not apply to amounts that have been held in an IRA for less than 5 years.

3. Inflation adjustment for IRA contribution limit

The $2,000 IRA deduction limit would be indexed for inflation for taxable years beginning after 1997.

4. Nondeductible contributions to tax-free Special IRAs

Under the proposal, individuals who are eligible to make deductible IRA contributions also would be eligible to make nondeductible contributions to a Special IRA. Special IRAs generally would be treated the same as IRAs, but also would be subject to special rules. The IRA deduction limit and the limit on contributions to Special IRAs would be coordinated. Thus, the maximum contribution that could be made in a year to a Special IRA would be the excess of the IRA deduction limit applicable to the individual over the amount of the individual's deductible IRA contributions. Distributions from Special IRAs would not be includible in income to the extent attributable to contributions that had been in the Special IRA for at least five years. Withdrawals of earnings from Special IRAs during the 5-year period after contribution would be subject to income tax, and also would be subject to the 10-percent tax on early withdrawals unless used for one of the special purposes described below (or unless a present-law exception to the tax, other than the exception for distributions after age 59½, applies).

An individual whose AGI for a year does not exceed $100,000 for married taxpayers and $70,000 for single taxpayers could convert an existing IRA into a Special IRA without being subject to the 10-percent tax on early withdrawals. The amount transferred from the deductible IRA to the Special IRA generally would be includible in the individual's income in the year of the transfer.[13] However, if a transfer is made before 1999, the amount to be included in the individual's income with respect to the transfer would be spread evenly over four taxable years.[14]

5. Special purpose withdrawals

The proposal would provide exceptions to the 10-percent early withdrawal tax for distributions from IRAs or Special IRAs used for certain special purposes. Penalty-free withdrawals would be withdrawals (1) for qualified higher education expenses of the taxpayer, the taxpayer's spouse, or the taxpayer's child or grandchild (whether or not a dependent), (2) for acquisition of a principal residence for a first-time home buyer who is the taxpayer, the taxpayer's spouse, or the taxpayer's child or grandchild, (3) for medical expenses (in excess of 7.5 percent of AGI) of the individual's child, grandchild, parent or grandparent, whether or not that person otherwise qualifies as the individual's dependent, and (4) made by individuals who have been receiving unemployment compensation for at least 12 consecutive weeks.

6. Investment in qualified State tuition program instruments

The proposal would provide that any IRA assets can be invested in qualified State tuition program instruments. To the extent the instrument is converted into tuition and fees, the account holder would be treated as receiving a distribution equal to the cost of such tuition and fees as of the time of the conversion. Further, such a deemed distribution would be treated as a special purpose withdrawal for qualified higher education expenses, and thus would not be subject to the 10-percent additional tax on early withdrawals. The tax treatment of the deemed distribution would depend on whether the instrument is held by an IRA or a Special IRA.

7. Effective date

The proposal would generally be effective on January 1, 1997.

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[13] The amount transferred would not be included in the taxpayer's AGI for purposes of applying the income limits on IRA contributions to the taxpayer for the year of transfer.

[14] In the case of such a transfer before 1999, the amount of such transfer would also be taken into account for purposes of the 15-percent excise tax on excess distributions ratably over a four-year period.

IV. ECONOMIC ANALYSIS OF IRAS GENERALLY

A. Comparison of Deductible IRAs, Back-End IRAs, and Nondeductible IRAs

1. General comparison of IRAs

Present law and proposals to create back-end IRAs present the taxpayer with three different tax-preferred saving vehicles, each of which is called an Individual Retirement Arrangement: deductible IRAs, back-end IRAs, and nondeductible IRAs. In general, the deductible IRA and back-end IRA both offer the taxpayer a greater after-tax return than does the nondeductible IRA. The difference in return arises because the deductible and back-end IRAs effectively exempt earnings on invested funds from tax, while the nondeductible IRA taxes the earnings, but on a deferred basis.

Deductible IRAs

Deductible IRAs allow taxpayers to deduct IRA contributions from income in the year contributed, but include the entire amount in income when withdrawn. There are two potential advantages of deductible IRAs over fully taxable savings vehicles. First, taxpayers earn a tax-free rate of return on IRA investments. Second, taxpayers postpone taxation of the contribution until the contributions are withdrawn, at which time they may be taxed at a lower rate than when the contribution is made.

The following example illustrates why a deductible IRA investment receives a tax-free rate of return. Assume a taxpayer with a marginal tax rate of 28 percent contributes $1,000 to an IRA. The initial savings from the IRA is $280, the tax that would have been paid on the $1,000. For the purpose of this example, assume that the taxpayer withdraws the funds after one year without penalty. If the annual rate of return on the IRA assets is 10 percent, the value of the IRA is $1,100, total tax due is $308, and the taxpayer is left with $792. Notice that if the taxpayer had paid the initial tax of $280 and invested the remaining $720 at 10 percent, then the taxpayer would have had $792 after one year. If the income had not been invested in an IRA, the taxpayer would have to pay tax on $72 dollars of earnings (a tax of $20.16), and would be left with $771.84 after payment of taxes. The value of the IRA is that the taxpayer does not have to pay the additional $20.16 tax. Thus, the deductible IRA allows the taxpayer to get a tax-free rate of return on an investment of $720.

This analysis is independent of the number of years the IRA investment is held. The value of the tax exemption, however, increases with the number of years the IRA is held. For instance, if in the above example, the taxpayer holds the IRA for 10 years, the IRA would be worth $1,867, whereas a fully taxed investment would be worth $1,443 after 10 years.

The deductible IRA investment can be viewed as an investment that is jointly shared by the government and the taxpayer. The government's share is equal to the tax rate (28 percent in the above example). When the IRA funds are withdrawn, the government receives its share of the funds. In the above example, when the funds are withdrawn after one year, the government receives 28 percent of $1,100 ($308), and the taxpayer receives 72 percent of $1,100 ($792). The taxpayer pays no tax on the earnings attributable to the taxpayer's share of the investment, and thus receives a tax-free rate of return on the investment. This is one advantage of investing through an IRA.

A second advantage of a deductible IRA arises if the taxpayer's marginal tax rate in the year the funds are withdrawn is lower than the marginal tax rate in the year of the contribution. Because the government's share of the investment is equal to the taxpayer's tax rate in the year the funds are withdrawn, the lower the tax rate prevailing at that time, the smaller the government's share. In the example above, for instance, if the tax rate when the funds are withdrawn is 15 percent, then the tax paid after one year would be $165. Not only does the taxpayer receive a tax-free rate of return on the taxpayer's share of the investment, but the taxpayer share of the investment is 85 percent rather than 72 percent.

Tax rates might be lower at the time the funds are withdrawn because the beneficiaries may be receiving untaxed social security benefits and reduced taxable income from other sources. However, the marginal tax rate could be lower or higher because tax rate schedules may change over time.

Back-end IRAs

From an economic perspective, back-end IRAs are similar to deductible IRAs. With a back-end IRA, the taxpayer does not deduct the IRA contribution from income, but pays no tax when the funds are withdrawn. In other words, the government takes its share before the funds are invested. The taxpayer is never taxed on the interest earned on the investment, and thus earns a tax-free rate of return on the IRA investment. This is the same tax benefit provided to deductible IRAs.

However, in the case of the back-end IRA, the tax is paid on the initial contribution at the time of contribution, and in the case of the deductible IRA, the tax is paid on the initial contribution at the time of withdrawal. In effect, the government's share of the back-end IRA is equal to the taxpayer's marginal tax rate at the time the funds are contributed, whereas the government's share of the deductible IRA is equal to the taxpayer's marginal tax rate at the time the funds are withdrawn. Whether the deductible IRA and back-end IRA are economically equivalent depends on the difference between the taxpayer's marginal tax rate in the year the contribution is made and the taxpayer's marginal tax rate in the year the IRA funds are withdrawn.

If these two marginal tax rates are equal, then the back-end IRA provides the same overall benefits as the deductible IRA. For example, if a taxpayer earns $1,000 and chooses to use it for a back-end IRA, the taxpayer first pays tax on it. If the taxpayer's marginal tax rate is 28 percent, the taxpayer will have $720 to invest. After one year earning interest at 10-percent per year, the taxpayer has $792, the same amount that the taxpayer has in the deductible IRA example above.

If the tax rate in the year the contribution is made is different from the tax rate in the year the funds are withdrawn, then the deductible IRA and the back-end IRA are no longer equivalent.

When tax rates decrease over time (either because tax rates change or taxpayers fall into lower tax brackets), the deductible IRA is more advantageous, because it permits taxpayers to defer payment of tax until tax rates are lower. When tax rates increase over time, a back-end IRA is more tax-favored.

Nondeductible IRAs

Present law permits taxpayers who cannot make the maximum amount of deductible IRA contributions (because they are covered under an employer-provided pension plan and their income exceeds the dollar limits) to make nondeductible contributions to IRAs. Unlike back-end IRAs, earnings on present-law nondeductible IRA contributions are includible in income when withdrawn. The tax advantage of these IRAs is that taxes on earnings are deferred, rather than assessed annually. This permits the earnings to compound faster than with annual taxation of earnings. This advantage is the same advantage implicit in the tax treatment of the earnings on deferred annuities, which are taxed when the annuities are paid rather than when the earnings accrue.

For example, compare the accumulation of income for an investor with a 28-percent marginal tax rate on $720 which is invested for a period of 10 years at a 10-percent annual rate of return. If the earnings are taxed annually, the total available funds at the end of 10 years would be $1,443.05. The investor's annual after-tax return is 7.2 percent. If the tax is deferred for 10 years and assessed on the accumulated interest at the end of the 10-year period at a 28-percent marginal tax rate, the value of the taxpayer's investment would be $1,344.60, which represents an annual return of 7.9 percent. Unlike the deductible and back-end IRAs discussed above, the after-tax rate of return of investment in a nondeductible IRA increases as the holding period increases; as the holding period increases, accumulated earnings increase, and thus the value of deferring tax on the accumulated earnings increases.

Summary

Table 1 compares the funds available after 10 years to a taxpayer who saves $1,000 of pre-tax income in a deductible IRA, a back-end IRA, and a nondeductible IRA, assuming that no penalty tax applies and that the rate of return on the IRA assets is 10 percent per year. The tax rate in the year contributed is labeled t_o, and the tax rate in the year the funds are withdrawn is labeled t_{10}. Table 1 also summarizes the timing of the Federal Government's tax receipts.

As was noted above, the difference in the funds available to the taxpayer investing $1,000 of pre-tax income in the deductible IRA compared to the back-end IRA depends only on the difference between the marginal tax rate the taxpayer faces in the year the funds are contributed, t_0, and the marginal tax rate in the year the funds are withdrawn, t_{10}. The funds available in the nondeductible IRA are always smaller than those in the back-end IRA. Both of these IRAs tax the contribution at a tax rate t_0 but the back-end IRA effectively exempts earnings from additional tax, whereas the nondeductible IRA only defers earnings from tax.

Table 1.—Funds Available to Taxpayer and Pattern of Tax Receipts Under Deductible IRA, Back-End IRA, and Nondeductible IRA

Funds Available to Taxpayer After 10 Years

Type of IRA	Funds contributed to IRA	Funds available after 10 years	Taxes due in year 10	Funds available after tax in year 10
Deductible IRA	$1,000	$2,594	$2,594 ($t_{10}$)	$2,594 ($1-t_{10}$)
Back-end IRA	1,000 ($1-t_{10}$)	2,594 ($1-t_{10}$)	0	2,594 ($1-t_0$)
Nondeductible IRA	1,000 ($1-t_{10}$)	2,594 ($1-t_{10}$)	(2,594–1,000) $(1-t_0)t_{10}$	2,594 ($1-t_1$)– $1,594 $(1-t_{10})t_{10}$

Pattern of Income Tax Payments Under Three IRAs

Type of IRA	Tax payments in—		
	Current year	Year 1-9	Year 10
Deductible IRA	0	0	$2,594 ($t_{10}$)
Back-end IRA	$1,000	0	0
Nondeductible IRA	1,000	0	1,594 $(1-t_{10})t_{10}$

Assumptions:

Taxpayer has $1,000 of pre-tax income to invest in IRA, and the annual rate of return on IRA assets is 10 percent.
t_0=marginal tax rate in year of IRA contribution.
t_{10}=marginal tax rate in year of IRA withdrawal.

Table 1. Funds Available to Taxpayer and Pattern of Tax Receipts Under Deductible IRA, Back-End IRA, and Nondeductible IRA—Continued

Example: t_0=.28 t_{10}=.28

Type of IRA	Funds contributed to IRA	Funds available after 10 years	Taxes due in year 10	Funds available after tax in year 10
Deductible IRA	$1,000	$2,594	$726	$1,868
Back-end IRA	720	1,868	0	1,868
Nondeductible IRA	720	1,868	321	1,547

Type of IRA	Tax payments in—		
	Current year	Year 1–9	Year 10
Deductible IRA	0	0	$726
Back-end IRA	$280	0	0
Nondeductible IRA	280	0	321

2. Other potential differences between deductible IRAs and back-end IRAs

The deductible and back-end IRAs may have a number of differences in addition to those due to differences in marginal tax rates. These differences involve the contribution limit, the holding period requirement, the penalty for early withdrawals, and the interaction with social security benefits.

Contribution limit

Assume the contribution limit applied to back-end IRAs is the same as that currently applicable to deductible IRAs, $2,000. Contributions to a deductible IRA are limited to $2,000 of pre-tax income, whereas contributions to a back-end IRA are limited to $2,000 of after-tax income. The $2,000 back-end IRA contribution limit effectively increases the amount of tax-free saving that can be invested in the back-end IRA relative to the deductible IRA. The following example illustrates this difference. In the case of a taxpayer with a marginal tax rate of 28 percent who contributes $2,000 to a deductible IRA earning 10 percent per year, the IRA balance will be $2,200 after one year. The taxpayer will owe $616 in tax, leaving $1,584. This is equivalent to the taxpayer having paid an initial tax of $560, or 28 percent of $2,000, and investing the remaining $1,440 at an after-tax return of 10 percent. Thus, the $2,000 limit on pre-tax income is like a limit of $1,440 on after-tax income for a taxpayer with a 28-percent marginal tax rate. If instead the investor had contributed $2,000 to a back-end IRA, the funds available to the taxpayer after one year would be the full $2,200, since no additional tax would be due.[15] The difference in the limits is only valuable to taxpayers who want to invest more than $2,000 of pre-tax income in an IRA. However, according to the IRS Taxpayer Usage Survey, in 1984, approximately 75 percent of all IRA contributors contributed the maximum permissible amount, indicating that this difference between the deductible IRA and the back-end IRA may be significant for a large number of taxpayers.

Holding period and penalties for early withdrawal

Funds in a deductible IRA that are withdrawn within five years and are withdrawn before age 59½ are subject to a 10-percent additional tax, unless certain exceptions apply. In contrast, some proposals would permit funds invested in an IRA to be withdrawn after only five years without additional tax. Thus, such proposals would provide benefits for taxpayers who plan to keep funds invested for a relatively short period of time, as well as for taxpayers who have longer investment horizons.[16]

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[15] More generally, for a taxpayer facing a marginal tax rate of t, the equivalent contribution limit for a deductible IRA is C/(1-t) where C is the contribution limit for the back-end IRA.

[16] Note that for taxpayers older than age 54½, the required holding period for new contributions will actually be shorter for deductible IRAs than for proposals that require a five-year holding period (because of the age 59½ rule for deductible IRAs). Thus, older taxpayers may prefer to contribute to deductible IRAs.

Treatment of IRA withdrawals for purposes of taxing social security benefits

Another potential difference between the deductible and the back-end IRAs is the effect of withdrawals on the taxation of social security benefits. Under present law, social security benefits are exempt from tax except for taxpayers whose income exceeds certain income thresholds. The income thresholds are defined by reference to modified adjusted gross income (AGI). Modified AGI is the taxpayer's AGI increased by the amount of interest received or accrued by the taxpayer during the taxable year that is otherwise exempt from tax. The IRS has stated that tax-exempt interest required to be included in modified AGI is the amount of interest on tax-exempt obligations received or accrued by the taxpayer during the taxable year.[17] Interest earnings that accrue on contributions to a deductible IRA are arguably not included in modified AGI because tax on such earnings is deferred, rather than exempt. However, taxable distributions from the taxpayer's IRA are part of AGI and consequently are part of modified AGI. Since distributions from a deductible IRA are taxable, but those from a back-end IRA are not, distributions from a deductible IRA are included in the taxpayer's modified AGI, but distributions from a back-end IRA are not, except perhaps to the extent that the amounts attributable to the earnings on back-end IRA contributions are deemed to be exempt interest required to be included in modified AGI.[18]

This may be an additional advantage of the back-end IRA for taxpayers who are making withdrawals from IRAs when they are also receiving social security benefits. However, it is an advantage only for taxpayers who expect their incomes to be close enough to the threshold income level that distributions from IRAs make them exceed that level.

3. Eligibility for deductible IRAs under present law

Both present law and proposals to modify IRAs limit IRAs to taxpayers with earned income. Thus, the 25 percent of tax returns that report no earned income cannot contribute to an IRA, and will not be affected by the proposals.

Table 2 focuses on taxpayers with earned income. Under present law, taxpayers who are covered by employer-sponsored pension plans and whose income exceeds certain thresholds are not eligible to make deductible IRA contributions. These restrictions prohibit 28 percent of all tax returns with earned income from claiming deductible IRA contributions, and limit eligibility for an additional 13 percent.

The percentage of taxpayers eligible to make deductible IRA contributions differs significantly by filing status and by number of earners. For instance, nearly 51 percent of joint returns with two earners, 36 percent of joint returns with one earner, and nearly 23 percent of all returns of taxpayers who are single, head of household, or married filing separately cannot claim any deductible IRA contributions. Taxpayers in the phaseout range can claim some deductible IRA contributions, but less than the maximum; 13.3 per-

[17] Rev. Rul. 84-173, 1984-2 C.B. 16.
[18] Present law is unclear on this point. See Code section 86 and its legislative history.

cent of joint returns with two earners, 11.2 percent of joint returns with one earner, and 13.3 percent of the single, head of household, and married filing separately returns fall in this category.

Table 2.—Eligibility of Taxpayers With Earned Income To Make Deductible IRA Contributions Under Present Law, Projected 1997 Returns [1]

Adjusted gross income	Returns with earned income			
	Returns (thousands)	Percent eligible for maximum deductible IRA contribution	Percent in phaseout range	Percent not eligible for any IRA deduction
Joint returns with one earner:				
Less than $10,000	1,420	100.0	0.0	0.0
$10,000 to $20,000	2,327	100.0	0.0	0.0
$20,000 to $30,000	2,068	100.0	0.0	0.0
$30,000 to $40,000	1,965	96.9	3.1	0.0
$40,000 to $50,000	1,697	0.5	99.5	0.0
$50,000 to $75,000	2,922	4.3	0.0	95.7
$75,000 to $100,000	1,299	9.7	0.0	90.3
$100,000 to $200,000	1,311	13.9	0.0	86.1
$200,000 and over	590	9.7	0.0	90.3
All income classes	15,599	52.7	11.2	36.1
Average dollars eligible per return	....	[2] $2,131	[3] $217	....

Table 2.—Eligibility of Taxpayers With Earned Income To Make Deductible IRA Contributions Under Present Law, Projected 1997 Returns [1]—Continued

Adjusted gross income	Returns with earned income: Returns (thousands)	Percent eligible for maximum deductible IRA contribution	Percent in phaseout range	Percent not eligible for any IRA deduction
Joint returns with two earners:				
Less than $10,000	1,125	100.0	0.0	0.0
$10,000 to $20,000	2,277	100.0	0.0	0.0
$20,000 to $30,000	2,930	100.0	0.0	0.0
$30,000 to $40,000	3,564	95.4	4.6	0.0
$40,000 to $50,000	3,931	1.8	98.2	0.0
$50,000 to $75,000	8,509	4.0	0.0	96.0
$75,000 to $100,000	4,336	7.3	0.0	92.7
$100,000 to $200,000	2,906	10.1	0.0	89.9
$200,000 and over	559	16.6	0.0	83.4
All income classes	30,137	36.0	13.3	50.6
Average dollars eligible per return	....	[2] $3,096	[3] $225	....

Table 2.—Eligibility of Taxpayers With Earned Income To Make Deductible IRA Contributions Under Present Law, Projected 1997 Returns[1]—Continued

Adjusted gross income	Returns with earned income: Returns (thousands)	Percent eligible for maximum deductible IRA contribution	Percent in phaseout range	Percent not eligible for any IRA deduction
Heads of households, single returns, and married filing separately:[4]				
Less than $10,000	12,312	100.0	0.0	0.0
$10,000 to $20,000	15,498	99.9	0.1	0.0
$20,000 to $30,000	11,294	54.5	45.5	0.0
$30,000 to $40,000	6,644	0.4	99.6	0.0
$40,000 to $50,000	3,725	4.2	95.8	0.0
$50,000 to $75,000	3,095	5.6	0.0	94.4
$75,000 to $100,000	610	11.1	0.0	88.9
$100,000 to $200,000	462	13.4	0.0	86.6
$200,000 and over	160	13.1	0.0	86.9
All income classes	53,800	64.1	13.3	22.6
Average dollars eligible per return	....	[2] $1,944	[3] $79	....
Total, all returns	**99,536**	**53.8**	**13.0**	**28.1**
Average dollars eligible per return	....	**[2] $2,206**	**[3] $143**	....

[1] Note that the table includes imputed returns of taxpayers who do not file income tax returns, and is thus intended to be representative of the population, rather than of taxable returns. The table also includes returns filed by dependents, and may include some returns of taxpayers over age 70-½ who have earned income but who are not eligible to make deductible IRA contributions.

[2] Average eligible contribution amount for taxpayers eligible to make maximum contribution.

[3] Average contribution amount for taxpayers in phaseout range.

[4] Some returns with income below $40,000 are phased out because they are returns of married individuals filing separately. IRA eligibility is phased out between $0 and $100,000 of AGI for such married individuals who live together and between $25,000 and $35,000 of AGI for such married individuals who live apart.

Source: Joint Committee on Taxation estimates for 1997.

These eligibility percentages and the real value of the IRA contribution limits will decrease over time, because present law does not index the contribution limits or the income eligibility limits for inflation. For example, the $40,000 AGI-limitation for joint filers to claim a fully deductible IRA contribution was established first effective for 1987 and is equivalent to an adjusted gross income today of almost $55,000 after adjusting for inflation. The real value of a $2,000 contribution has declined 43 percent since 1986 because of inflation.

Taxpayers whose eligibility is limited by the present-law rules may be likely to contribute to IRAs if eligibility were restored. As Table 4, below, demonstrates, in 1985, taxpayer returns reporting income of $50,000 or more were more than four times as likely to claim deductible contributions to an IRA as were lower-income taxpayers. After eligibility was limited in 1986, IRA contributions fell substantially. Total IRA contributions fell from a high of $38.2 billion in 1985 to $8.4 billion in 1995 (see Table 3, below). In 1996 dollars (i.e., adjusting for inflation), total IRA contributions were $55.7 billion in 1985 and $8.6 billion in 1992, representing a real decrease of 85 percent.

Under present law, for joint returns with AGI between $50,000 and $75,000, 11 percent of returns with one earner and only 8 percent of returns with two earners can claim the maximum deductible IRA contribution because neither spouse is an active participant in an employer-sponsored retirement plan. In the case of a joint return with two earners, it is possible that only one spouse is an active participant in an employer-sponsored plan. Thus, the spouse who is not an active participant is not eligible to make deductible IRA contributions because of the income reflected on the joint return. If the income phaseouts and active participant rules were applied separately to spouses filing joint returns (i.e., if all taxpayers were treated as single individuals for purposes of determining eligibility for deductible IRA contributions), then more taxpayers would be eligible to make deductible IRA contributions.

Another reason that the IRA eligibility of married couples with two earners is so low is that the income of these couples is higher generally than the income of married couples with one earner. Almost 50 percent of married couples with two earners have AGI greater than $50,000, whereas only 25 percent of couples with one earner do.

B. Present Value of Revenue Cost of IRAs to Federal Government

Assessing the cost (in the form of forgone tax receipts) to the Federal Government of IRAs may be more difficult than assessing the costs of other tax provisions, because IRAs not only change the amount of tax collected, but also change the timing of tax collections. For instance, the traditional deductible IRA can be viewed as a provision which both delays payment of tax on the contribution until withdrawal, and effectively exempts from tax any earnings on capital accumulation beyond the amount that represents interest on the delayed tax. Thus, the timing of tax payments results in a revenue loss to the government in the first years, but a revenue gain in the later years when the funds are withdrawn (see Table

1). The back-end IRA, on the other hand, loses little revenue in the beginning years, but gains no revenue in the later years because withdrawals are not taxed.

Traditional budget scorekeeping accounts for the revenue effects of proposed legislation on a cash-flow basis; in other words, the effect of a provision on budget receipts in the five or 10-year budget period is estimated without regard to whether the provision will also affect budget receipts in any year beyond the five or 10-year period. This method scores deductible IRAs as bigger revenue losers than back-end IRAs. However, a present-value calculation demonstrates that the long-term cost to the Federal Government of deductible IRAs and back-end IRAs will be approximately equal. This is because a present-value approach recognizes that tax will eventually be collected on funds in IRAs, although possibly at a lower tax rate when withdrawn.

In order to evaluate the present value of the program's cost,[19] it is also necessary to know how taxpayers would have behaved in the absence of the IRA provision. Consider first the case of a taxpayer whose tax rate in the contribution year is the same as in the year the funds are withdrawn. Then, the tax advantage of the IRA is the ability to earn a tax-free rate of return on savings. However, the cost to the government depends on what the taxpayer would have done in the absence of the program. If, in the absence of the tax benefits accorded to IRAs, the taxpayer would not have saved the money invested in the IRA, then the IRA program does not lose any government revenue in the long run. For instance, consider the example of a taxpayer who decides to invest $1,000 in an IRA. If, in the absence of the IRA, the taxpayer would have paid the $280 tax on the earnings, and spent the remaining $720, the total amount of tax collected from that $1,000 over the taxpayer's lifetime by the government would have been $280. If instead of spending the income, the taxpayer invests it in a back-end IRA, the government collects $280 from the earnings, and then never taxes the income again. Once again, the total amount collected over the taxpayer's lifetime is $280. Further, assume that the taxpayer invests in a deductible IRA for 10 years in a fund that earns 8 percent per year. In the first year, the government loses $280 in revenue, since the taxpayer deducts the $1,000 from income. In year 10, the $1,000 has grown to $2,158.93, and the taxpayer owes $604.50. Since $604.50 is exactly equal to $280 plus 10 years of interest at 8 percent per year, the government receives the $280 with interest, and collects the same amount of revenue that it would have had there been no IRA program. In present value terms, the taxpayer pays $280 over his or her lifetime. To the extent that deductible IRAs permit taxpayers to pay tax on their funds at a lower marginal rate than when the contribution was made, the government does lose revenue even if the funds invested in the IRA represent funds which would otherwise have been consumed (i.e., new saving.)

On the other hand, if the contribution to the IRA represents income that would have been invested for the same 10 years in an

[19] To calculate the present value of the cost to the government of IRAs, it is necessary to use the government's discount rate. If repayment of taxes is uncertain, then the discount rate used should be higher than the government's borrowing rate.

interest-bearing account (i.e., old saving), the IRA reduces revenues to the government. If the earnings in the above example would have instead been invested in a fully taxable asset earning 8 percent per year, the government would have collected the $280 tax on the initial earnings, plus an additional $136 in present value (using a discount rate of 8 percent) of taxes on the annual interest earnings. Thus, the cost of the IRA program in this case for this particular taxpayer would be $136.

The above examples represent the polar cases of the present value of the revenue effect for IRA contributions--contributions that represent only new savings and contributions that represent savings that would otherwise have been invested in a fully taxable asset.[20] Other possibilities can also be considered. For instance, saving for an IRA may be diverted from other tax-favored assets, in which case the tax loss is not as great. For example, under the bills, if taxpayers who contribute to a deductible IRA would have invested in a nondeductible IRA under present law, then the tax loss consists of the difference between the tax advantage of the deductible IRAs and the tax advantage of the nondeductible IRAs. Similarly, investment in housing is currently tax favored. If taxpayers divert income that would have been invested in housing to IRAs, the present value of the revenue cost to the Federal Government may be relatively small.

Finally, giving taxpayers the choice between the deductible and the back-end IRA is likely to increase the present value of the revenue cost of the IRA program relative to a program offering either IRA alone. Taxpayers who have reason to believe that their tax rates will decline over time should be more likely to choose the deductible IRA, and taxpayers who believe their tax rates will increase over time should choose the back-end IRA.

If IRAs do not generate new saving, then IRAs reduce the present value of revenues of the Federal Government. If the Federal Government responds to these reduced revenues by reducing expenditures or increasing other taxes, then IRAs that do not increase personal saving will have no effect on national saving.[21] If, on the other hand, the Federal Government offsets the reduced revenues by borrowing, then IRAs will actually reduce the national saving rate.

C. The Effectiveness of IRAs at Increasing Saving

1. Theoretical effects

In general

IRAs have a number of attributes that may affect a taxpayer's saving decision. First, investments in IRAs earn a higher after-tax rate of return than investments in other assets. Second, IRAs may provide an incentive for retirement saving, as opposed to other forms of saving. Third, deductible IRAs may provide a psychological

[20] Actually, the revenue loss can be even greater than the case presented. If IRAs reduce saving, then not only does the government lose the tax revenue that would have been collected on the IRA investment, but it also loses the tax revenue on the saving that was not undertaken because of the IRA. The possibility that IRAs reduce private saving is discussed below.

[21] This assumes that neither reduced expenditures nor increases in other taxes affect personal saving.

incentive to save. Fourth, advertising by banks and other financial institutions of IRAs may influence people's saving decisions. The following discussion focuses on each of these attributes.

Rate of return

In general

Both the deductible IRA and the back-end IRA effectively exempt the return on savings from tax, thereby increasing the rate of return to saving. When the return on saving increases, the price of future consumption decreases, because the taxpayer has to forgo fewer dollars today to consume a dollar's worth of consumption in the future.

This price decrease can affect saving in two ways. Since future consumption is now cheaper, taxpayers may choose to substitute future consumption for current consumption. This effect increases saving. When the price of future consumption falls, though, the amount of investment necessary to achieve any particular level of income in the future decreases. For example, a taxpayer in the 28-percent marginal tax bracket may set aside $1,300 today to help defray tuition expenses of his child 15 years from now. If the taxpayer's investment earns 8 percent annually and those earnings are taxed annually at a 28-percent tax rate, in 15 years the investment will be worth $3,000. If the taxpayer instead invested in a back-end IRA, an investment of only $946 today would be worth $3,000 in 15 years (assuming the same 8-percent return). This effect decreases saving because the tax benefit permits the taxpayer to save less to accumulate the same amount of money in the future.

Substantial disagreement exists among economists as to the effect on saving of increases in the net return to saving. Some studies have argued that one should expect substantial increases in saving from increases in the net return.[22] Other studies have argued that large behavioral responses to changes in the after-tax rate of return need not occur.[23] Empirical investigation of the responsiveness of personal saving to after-tax returns provides no conclusive results. Some find personal saving responds strongly to increases in the net return,[24] while others find little or a negative response.[25]

Even if increasing the rate of return on all saving does increase saving generally, it is still possible that increasing the rate of return on IRAs would not affect saving. For increased rates of return to influence taxpayers to substitute future consumption for current consumption, the marginal rate of return on savings must increase so that if the taxpayer increases saving, that saving receives a higher rate of return. In order for IRAs to increase the marginal return to saving, taxpayers must not be able to finance the IRA profitably by borrowing, must not have other similar assets that

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[22] See, Lawrence H. Summers, "Capital Taxation and Accumulation in a Life Cycle Growth Model," *American Economic Review*, 71, September 1981.

[23] See, David A. Starrett, "Effects of Taxes on Saving," in Henry J. Aaron, Harvey Galper, and Joseph A. Pechman (eds.), *Uneasy Compromise: Problems of a Hybrid Income-Consumption Tax* (Washington: Brookings Institution), 1988.

[24] See, Michael Boskin, "Taxation, Saving, and the Rate of Interest," *Journal of Political Economy*, 86, April 1978.

[25] See, George von Furstenberg, "Saving," in Henry Aaron and Joseph Pechman (eds.), *How Taxes Affect Economic Behavior* (Washington: Brookings Institution), 1981.

can be easily shifted into an IRA, and must intend to save less than the maximum contribution allowed. The following discussion provides examples of how each of these situations may affect the impact of IRAs on saving.

Borrowing

When interest on borrowed funds is deductible, it may be profitable for a taxpayer to borrow to contribute to an IRA. For example, consider a taxpayer with a 28-percent marginal tax rate without any assets. If the taxpayer can borrow at an interest rate equal to the rate of return on an IRA investment, then one would not expect the taxpayer to increase the amount of income saved. Instead, the borrower can borrow $2,000, invest in the IRA and deduct the interest cost. Since the IRA earnings are effectively exempt from tax, the taxpayer receives the full value of the IRA benefit, but does not increase saving.[26] Given that the taxpayer can receive the IRA benefit without increasing saving, the decision of whether to save an extra dollar is unaffected, because that extra dollar will not receive a higher after-tax return than it would have without the availability of tax benefits for IRAs.

If the taxpayer must pay a higher interest rate on the loan than can be received on the investment, the benefits to borrowing to finance an IRA are reduced, but not eliminated. For example, if investments in IRAs earn 10 percent per year and the taxpayer's marginal tax rate is 28 percent, the taxpayer could profitably borrow to fund the account even if the annual interest rate on the loan was as high as 13.8 percent. However, in this case, the taxpayer would gain little from borrowing, and might choose to finance the IRAs with increased savings instead.

Present law permits taxpayers to deduct investment interest but not most personal interest. It is unclear whether interest on a loan used to finance a deductible IRA would be considered investment interest or personal interest. It is likely, however, that interest on a loan used to finance a back-end IRA would not be deductible, whether or not secured by the taxpayer's home, because it would be viewed as interest on amounts used to finance tax-exempt interest and subject to section 265. Furthermore, present law does not allow IRA assets to be used as security for a loan. Because interest paid on home-equity loans generally is deductible, the easiest way to borrow to finance IRAs may be through home-equity loans. Borrowing against home equity to finance IRAs is similar to shifting existing assets into IRAs.

Shifting of existing assets

Taxpayers who have existing assets that exceed the IRA contribution limits can also receive the benefit of IRAs without increasing saving. Consider a taxpayer who saves only $400 annually, but has been saving for years, and has $4,500 in financial assets. The first year the taxpayer has the opportunity to invest in an IRA, the taxpayer can shift $2,000 from the financial assets to the IRA. The second year, the taxpayer can once again shift $2,000

[26] However, if the taxpayer begins repaying the loan before the IRA funds are withdrawn, even this loan-financed IRA investment might be associated with increased saving. This possibility is discussed in greater detail below.

into the IRA. Only in the third year will the tax benefits accorded to IRAs increase the rate of return on new saving.

Shifting of planned assets

Finally, taxpayers who would have saved without the IRA may not increase their saving due to the availability of IRAs. For example, consider a taxpayer who habitually saves $4,000 per year. If this taxpayer is provided the opportunity to invest in an IRA, then $2,000 of these savings will be diverted to the IRA. However, the IRA does not provide a marginal incentive to save. If the taxpayer saves $4,001, the return on that extra dollar of saving will be no higher than it would have been without the IRA program. The taxpayer may even decrease the amount saved, since the first $2,000 of saving that is in the IRA will provide more income in the future, and hence the need for saving may decrease.

Type of saving

The above discussion focused on saving in general. Many authors have noted that certain IRAs may provide incentives for retirement saving, as opposed to saving for other purposes.[27] For instance, consider the effect of the deductible IRA, which is subject to additional tax unless held until retirement or used for other qualified purposes. An individual who is saving only for a "rainy day" may not have much saving that is expected to last until retirement. When offered a higher rate of return on retirement saving, that individual may choose to increase the total amount of saving by maintaining the rainy day saving and adding retirement saving.

Similarly, an individual who takes out a home equity loan to finance an IRA may not save any additional money in the year the IRA contribution is made. But if that individual slowly repays that loan, and this repayment represents saving the taxpayer would not otherwise have done, then the IRA increased that individual's saving.

To the extent the provisions for penalty-free early withdrawal of the IRA and the reduced holding period requirements of the proposals to modify IRAs increase the substitutability of IRA saving for other saving, this retirement saving attribute of IRAs is diminished, making substitution of current savings for IRA savings more likely.

Psychological impact of IRAs and effects of increased advertising

Some observers have noted that IRAs may have a larger impact on saving than standard economic analyses would predict.[28] These observers suggest that the immediate reward of the tax deduction and the active marketing campaigns in the mid-1980s contributed to the high IRA participation rates observed; in fact, IRA participation was larger than was expected. The sharp decline in advertis-

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[27] See the discussion in William G. Gale and John Karl Scholz, "IRAs and Household Saving," *American Economic Review*, 84, December 1994, and Steven F. Venti and David A. Wise, "Tax Deferred Accounts, Constrained Choice, and Estimation of Individual Saving," *Review of Economic Studies*, 53, August 1996.

[28] See, Richard H. Thaler, "Psychology and Savings Policies," *American Economic Review*, 84, May 1984.

ing after 1986 may explain the decline in IRA contributions among taxpayers who are still eligible.

Furthermore, there may also be a psychological factor that contributes to the impact of IRAs on saving. One study found that taxpayers who owed money to the IRS in excess of taxes withheld were significantly more likely to make IRA contributions than were other taxpayers.[29] One might expect this psychological factor only to induce deductible IRA contributions, which will have an immediate effect on taxes paid. However, another author[30] noted that taxpayers who owe the IRS money generally have higher incomes and this may be why they are more likely to contribute to IRAs, rather than any psychological factor.

2. Empirical research on the effect of IRAs on saving

Deductible IRAs have been very popular with taxpayers. As Table 3 reports, contributions to IRAs increased significantly when eligibility restrictions were eliminated in 1982. At the peak in 1985, over $38 billion was contributed to IRAs. This represented almost 20 percent of personal saving for that year.

[29] Feenberg, Daniel, and Jonathan Skinner, "Sources of IRA Saving," in Lawrence Summers (ed), *Tax Policy and the Economy*, vol. 3 (Cambridge: Massachusetts Institute of Technology Press), 1989.

[30] Gravelle, Jane, "Do Individual Retirement Accounts Increase Savings?", *Journal of Economic Perspectives*, 5, Spring 1991.

Table 3.—IRA Participation 1979–1995

Year	Returns claiming IRA deduction (millions)	Percentage of all returns (percent)	Deductions claimed ($ billions)
1979	2.5	2.6	3.2
1980	2.6	2.7	3.4
1981	3.4	3.6	4.8
1982	12.0	12.6	28.3
1983	13.6	14.1	32.1
1984	15.2	15.3	35.4
1985	16.2	15.9	38.2
1986	15.5	15.1	37.8
1987	7.3	6.8	14.1
1988	6.4	5.8	11.9
1989	5.8	5.2	10.8
1990	5.2	4.6	9.9
1991	4.7	4.1	9.0
1992	4.5	3.9	8.7
1993	4.4	3.8	8.5
1994	4.3	3.7	8.4
1995 [1]	4.3	3.7	8.4

[1] Preliminary data.

Source: Internal Revenue Service, *Statistics of Income*, various years.

However, it is unclear whether IRAs actually increased total saving. There is no consensus within the economics profession on the effect of the pre-1986 IRAs on personal saving. Some economists believe that IRAs had no effect on overall personal saving; some believe that IRAs increased personal saving; and some economists believe that IRAs would have eventually increased saving if the universally available deductible IRA had been maintained.

A number of economists argue that most of the IRA contributions consisted of taxpayers shifting into IRAs from existing assets.[31] They point to the fact that IRA contributions were concentrated at the top of the income distribution, and that IRA contributors had large stocks of financial assets compared to noncontributors with the same income. Both of these facts suggest that IRA contributors had assets and desired saving above the contribution limit. Others note that IRAs are only one component of an individual's wealth and substitution of IRA assets for other financial assets is not the only possible response. Most IRA contributors held substantial housing equity and IRA contributions could substitute for increasing the equity in one's home.[32]

Economists who believe that IRAs did not increase saving point to the fact that personal savings in the United States was not higher during the years that deductible IRAs were available to all tax-

[31] See, for example, Galper, Harvey and Charles Byce, "Individual Retirement Accounts: Facts and Issue," *Tax Notes*, vol. 31, June 2, 1986, pp. 917-921.

[32] See, Eric M. Engen, William G. Gale, and John Kohl Scholz, "The Illusory Effects of Saving Incentives on Saving," *Journal of Economic Perspectives*, 10 Fall 1996. These authors are generally skeptical of the econometric evidence offered in support of the thesis that IRAs increase saving.

payers.[33] Some also find the magnitude of IRA contributions as implausibly large in comparison to total personal saving to have represented substantial new saving. For example, personal saving in 1985 was $206.2 billion (see Table 7), and IRA contributions were $38 billion, or almost one fifth of all personal saving.

A number of economists argue that IRA contributions between 1982 and 1986 consisted largely of new saving.[34] These proponents also observe that the empirical evidence in favor of the thesis that IRAs increase national saving can be replicated on several different sources of data.[35] Some of these economists have investigated whether IRA contributors shifted existing assets from taxable accounts into IRAs. If such shifting had occurred, they argue, one would expect to find a reduction in taxable asset earnings following the IRA contribution. However, one study found that taxpayers who contributed to IRAs generally were also increasing their investment in taxable assets.[36] Although this does not prove that the money invested in IRAs would not have been saved otherwise, it may provide evidence against the simple existing asset shifting view.

Further, proponents of IRAs note that to the extent that taxpayers do shift existing assets into IRAs, most taxpayers do not have enough financial assets to continue asset shifting indefinitely. Hence, they conclude, IRAs would eventually provide a marginal incentive to save.[37]

Some economists have noted that the introduction in Canada of savings incentives similar to the IRA was followed by large increases in Canadian saving. They argue that this can be taken as evidence that IRAs are effective in increasing national saving.[38] However, others note that since Canadians are not able to deduct home mortgage interest from taxable income, they should be less likely to finance tax-favored savings with home borrowing, and therefore savings incentives in Canada may be more likely to induce increased saving than in the United States.

Even if some portion of the monies contributed in IRAs represents new saving, net national saving need not increase. Increases in saving by an individual household do not create increases in saving by the nation, if the saving was financed by a reduction in tax revenues which necessitates government borrowing.

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[33] See Gravelle, Jane "Do Individual Retirement Accounts Increase Savings?".

[34] See, Venti, Steven F. and David A. Wise, "The Evidence on IRAs," *Tax Notes*, vol. 38, January 25, 1988, pp. 411-416. Venti and Wise have authored several studies that use different data to analyze IRAs and household saving. They generally conclude that IRAs increase household saving. The aforementioned article summarizes these studies. Some analysts have criticized the methodology of studies which claim IRAs create new saving and argue that the reported results of the effect of IRAs on saving are implausibly large. See Gravelle, Jane G., "Capital Gains Taxes, IRA's, and Savings," CRS Report for Congress 89-543, September 26, 1989. A recent critique is provided by Gale, William G. and John Karl Scholz, "IRAs and Household Saving," *American Economic Review*, 84, December 1994.

[35] See, James M. Poterba, Stevin F. Venti, and David A. Wise, "How Retirement Saving Programs Increase Saving," *Journal of Economic Perspectives*, 10, Fall 1996. This study reviews the evidence in favor of the thesis that IRAs increase national saving and offers criticism of the results and methodology of those studies that find little saving effect.

[36] See, for example, Feenberg, Daniel, and Jonathan Skinner, "Sources of IRA Saving." Also, Venti, Steven F. and David A. Wise, "Government Policy and Personal Retirement Saving," in James Poterba (ed.), *Tax Policy and the Economy*, vol. 6, (Cambridge; Massachusetts Institute of Technology Press), 1992.

[37] See Skinner, Jonathan, "Do IRAs Promote Saving? A Review of the Evidence," *Tax Notes*, vol. 54, January 13, 1992, pp. 201-202.

[38] See, Carroll, Chris, and Lawrence H. Summers, "Why Have Private Saving Rates in the U.S and Canada Diverged?" *Journal of Monetary Economics*, 20, September 1987.

Some analysts have attempted to measure the amount of new household saving that would be necessary for the net increase in private capital accumulation to exceed the present value of the tax revenue loss to the government over the life of an IRA account. As discussed in Part IV.B., above, IRAs lose tax revenue by the first year deduction and because taxes are postponed on funds that would otherwise have been saved in taxable accounts. Upon withdrawal, IRAs generate tax revenue. Such a benefit/cost calculation is sensitive to assumptions about interest rates, tax rates and the length of time for which the IRA is held. One study estimated that if none of each dollar contributed in an IRA were new saving by the household, net private capital would increase by 22 cents for each dollar of government revenue loss.[39] That is, the government spends one dollar in forgone tax revenue to produce 22 cents worth of private capital formation. The study estimates that if 10 cents of each dollar contributed to an IRA were new household saving, their net private capital would increase by 81 cents for each dollar of government revenue loss. However, the study estimates that if 19 cents of each dollar contributed to an IRA were new household saving, then net private capital would increase by $1.51 for each dollar of government revenue loss.[40] Such a calculation suggests that modest contributions of new household saving to IRAs may lead to increases in the capital stock in excess of the government revenue loss incurred. However, as the study's authors caution, such calculations are sensitive to the selection of tax rate and investment earnings parameters.

3. Distributional effects of IRAs under present and prior law

Tables 4 and 5 summarize information on IRA participation in 1985 and 1995. In 1985, 71 percent of all returns reporting IRA contributions had AGI below $50,000, and 29 percent had AGI of $50,000 or above. However, taxpayers with AGI of $50,000 or above represented only 8 percent of all returns eligible for IRAs. Thus, although many lower-income individuals contributed to IRAs, most did not, whereas most taxpayers with AGI of $50,000 or above did contribute when eligible. Taxpayers with AGI of $50,000 or above were more than four times as likely to contribute to an IRA than were taxpayers with AGI below $50,000--61.8 percent of eligible returns with AGI of $50,000 or above reported contributions to an IRA, while only 13.8 percent of eligible returns with AGI below $50,000 reported IRA contributions.

Higher income taxpayers made larger contributions as well. Taxpayers with adjusted gross incomes of $50,000 or more constituted approximately 29 percent of all IRA contributors in 1985, but accounted for more than 35 percent of IRA contributions. In 1995, taxpayers with adjusted gross incomes of $50,000 or more con-

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[39] Private capital increase even if the monies contributed to an IRA are not new household saving because the household implicitly invests the value of the IRA tax-deductible contribution.

[40] See, R. Glenn Hubbard and Jonathan S. Skinner, "Assessing the Effectiveness of Saving Incentives," *Journal of Economic Perspectives*, 10, Fall 1996. This analysis assumes assets are held in the IRA for 22 years, contributions were made when the taxpayer was in a 36-percent tax bracket, withdrawals were made when the taxpayer was in a 28-percent tax bracket, that 29 percent of the portfolio was invested in equities earning 9.35 percent annually, and the remainder was invested in bonds earning 4.0 percent annually. The discount rate on government debt was assumed to be 5.55 percent.

stituted approximately 21 percent of all IRA contributors, but accounted for approximately 32 percent of IRA contributions.

Because the value of the IRA is the effective exemption of the earnings from tax, the higher a taxpayer's marginal tax rate, the more valuable the ability to invest through an IRA. Because people in higher income classes generally have higher tax rates, the value of their IRA is larger than the value of IRAs for taxpayers in lower income classes. However, the value of the IRA depends on tax rates throughout the period the IRA is held, and not just the marginal tax rate in the year the contribution is made.

Table 4.—IRA Participation by Income Class, 1985

Adjusted gross income class	Returns reporting IRA contributions		
	Number in millions	Percent of eligible returns [1]	Contributions ($ billions)
All classes	16.2	17.8	38.2
Under $10,000	0.6	2.3	1.1
$10,000 to $30,000	5.1	13.6	9.7
$30,000 to $50,000	5.7	32.9	13.5
$50,000 to $75,000	3.0	56.5	8.7
$75,000 to $100,000	0.9	74.1	2.7
Over $100,000	0.8	76.1	2.6

[1] Eligible taxpayers include self-employed persons as well as wage and salary employees. However, taxpayers whose income consists solely of interest income, for example, were ineligible to contribute to IRAs.

Source: Internal Revenue Service, *1985 Statistics of Income.*

Table 5.—IRA Participation by Income Class, 1995

Adjusted gross income class	Returns reporting IRA contributions		
	Number in millions	Percent of returns with wage and salary income [1]	Contributions ($ billions)
All classes	4.3	4.3	8.4
Under $10,000	0.3	1.1	0.5
$10,000 to $30,000	1.6	4.5	2.8
$30,000 to $50,000	1.4	7.2	2.4
$50,000 to $75,000	0.4	3.6	1.1
$75,000 to $100,000	0.2	4.7	0.6
Over $100,000	0.3	6.7	1.0

[1] Includes self-employed persons reporting wage income as well as wage and salary employees. However, because the income limitations enacted by the Tax Reform Act of 1986, not all such taxpayers are eligible to make deductible contributions to IRAs.

Source: Internal Revenue Service, *1995 Statistics of Income* (Preliminary).

Other authors have noted that even the taxpayers with low income who did contribute to IRAs owned more financial assets than other low-income taxpayers and that, therefore, IRA contributors may not be representative of taxpayers in general. Table 6 presents information on the assets of households with IRAs compared to the assets of households without IRAs. Part of the reason that IRA contributors have larger holdings of assets than noncontributors is that contributors to IRAs tend to be older than noncontributors, and older taxpayers have been accumulating assets longer.

Table 6.—Estimated Median Financial Assets of Households With IRAs and Households Without IRAs, 1985

Income	Households with IRAs	Households without IRAs
Less than $10,000	$7,625	$0
$10,000 to $20,000	6,538	200
$20,000 to $30,000	6,365	900
$30,000 to $40,000	6,015	1,692
$40,000 to $50,000	10,000	2,694
$50,000 to $75,000	14,516	5,100
$75,000 and over	36,085	9,735

Source: Steven Venti and David Wise, "The Saving Effect of Tax-Deferred Retirement Accounts: Evidence from SIPP," in B. Douglas Bernheim and John Shoven (eds.), *National Saving and Economic Performance* (Chicago: University of Chicago Press), 1991, p. 110.

4. Expected differences between effects of pre-1986 IRAs and proposed modifications

Although research on the effectiveness of the pre-1986 IRA provisions can shed light on the potential of IRAs to affect savings, several differences between the pre-1986 experience and today should be noted. First, marginal tax rates for most taxpayers are lower now than they were before the passage of the Tax Reform Act of 1986. The tax advantage of IRAs is the exemption from tax of the investment's return and, for the deductible IRA, the possibility that the rate at which the contribution is taxed will be lower when the contribution is withdrawn. Both of these advantages may be less valuable now than they were before 1987, especially for higher income taxpayers because their marginal tax rates decreased the most. For example, if prior to 1987, a taxpayer in the 50-percent marginal tax bracket received a 10-percent return on his or her investment, excluding such income from tax would increase his or her net return to 10 percent from an after-tax return of 5 percent. At the present, such a taxpayer would be in the 39.6-percent marginal tax bracket and the exemption would increase his or her net return to 10 percent from an after-tax return of 6.04 percent. Thus, the exemption provided a greater increase in net return prior to 1987. Similarly, if taxpayers believe that tax rates are likely to increase over time because of the Federal Government's budget deficit, or because current tax rates are relatively low from a historical perspective, then the deductible IRA will look less attractive than it appeared in the past.

Second, some proposals to modify IRAs would create IRAs that are different from the pre-1986 IRAs, both because they provide additional exceptions to the early withdrawal penalty, or by requiring a relatively short required holding period. These differences may alter the effectiveness of IRAs at increasing saving. To the extent that taxpayers already save for education, housing, and medical expenses, allowing IRAs to be used for these purposes increases the likelihood that existing assets or existing planned saving will be shifted into IRAs, reducing the effectiveness of IRAs at increasing savings. Similarly, to the extent that taxpayers already save for short-term goals and for "rainy days," reducing required holding periods may also encourage more asset shifting. Further, permitting short holding periods and penalty-free early withdrawal may cause taxpayers to keep their money in the IRAs a shorter period of time.[41] On the other hand, to the extent that taxpayers who would otherwise choose to save in the form of IRAs would not do so because they believe they might need the funds before retirement, this added flexibility may encourage more taxpayers to invest in IRAs and increase their saving rate. Finally, permitting penalty-free withdrawals before retirement age diminishes the effectiveness of IRAs as explicit retirement savings vehicles, but may not change the overall effectiveness of IRAs to increase saving.

The ability of individuals to save through employer-sponsored retirement plans, particularly qualified cash or deferred arrangements (sec. 401(k) plans) may affect the level of IRA contributions. While such plans existed prior to 1986, they have become more prevalent since then. Section 401(k) plans offer benefits similar to those of IRAs. However, individuals may contribute more to such plans on a pre-tax basis ($9,500 for 1997), and may obtain increased benefits if, as is often the case, the employer matches employee contributions. Despite these advantages, some may still view an IRA as attractive, for example, because IRA funds may be withdrawn at any time (subject to the early withdrawal tax), whereas the ability to obtain withdrawals from section 401(k) plans prior to termination of employment is more limited. On the other hand, many section 401(k) plans permit individuals to borrow from their account, making investments in such plans more liquid.

The ability to contribute both to a section 401(k) (or similar) plan and an IRA could affect IRA contributions in a number of ways. For example, some individuals would save only through a section 401(k) plan, others would chose the IRA, and still others would split savings between a section 401(k) plan and an IRA. A number of factors may affect such choices, including the amount the individual wishes to save, the period and purpose for which they wish to save, and the particular terms of the section 401(k) plan they are eligible to participate in.

[41] Although once funds are withdrawn from an IRA, they can only be replaced at a rate no faster than the annual contribution limit per year.

V. ISSUES RELATING TO TAX INCENTIVES FOR SAVING AND IRAs

A. Comparison of IRAs With Other Tax-Favored Assets

Present law contains various tax incentives for savings. Tax incentives are provided to encourage taxpayers to save for certain purposes and to encourage taxpayers to save in certain forms. Saving for the purpose of education and retirement is subsidized through the tax treatment of certain Treasury bonds and of certain retirement plans. Incentives are also provided for people to save in the form of investments in housing, life insurance, and municipal bonds.

Tax-favored treatment of assets does not always increase the rate of return on saving. If the supply of a tax-favored asset is limited relative to the demand for that asset, much of the benefit of the tax treatment will be realized by the initial owners of the asset, rather than by the subsequent holders of the asset. For instance, holders of municipal bonds may not receive a higher after-tax rate of return than holders of taxable bonds because, even though the earnings are tax exempt, municipal bonds offer lower rates of return. The issuers of municipal bonds receive a tax benefit because they can pay lower interest rates than the rates paid on other securities.

The tax benefits of IRAs and pension funds, however, are not limited to particular assets. Because investors in IRAs and pension funds can invest in a wide range of assets, and because the amount of funds permitted to be invested through these tax-favored vehicles is limited (the demand is small relative to the supply of assets), investors in IRAs and pension funds do receive a higher rate of return than that available through other investments, and thus do benefit from the tax-favored treatment.

Enactment of additional saving incentives would be expected to alter taxpayers' choices among various taxable and tax-preferred assets. Because the income earned on assets held in IRAs effectively is exempt from tax, the taxpayer maximizes the benefit of the tax preference by directing the investment of IRA contributions in assets which are not otherwise tax preferred. The benefits of tax preferences for assets that are tax preferred to one degree or another are maximized when such assets are held outside an IRA.

The expansion of IRAs could be expected to increase the demand for otherwise taxable instruments at the expense of instruments which are tax preferred under present law. On the other hand, the annual contribution limitation of the IRA would limit the effect on the demand for other tax-preferred instruments. Moreover, to the extent that savings incentives generate increases in saving, the demand for all instruments would increase. If this were to occur, the issuers of instruments which are tax-preferred under present law conceivably could benefit as the cost of capital declined.

B. Goals of Tax Incentives for Saving

Some argue that tax incentives for saving are appropriate because the income tax system taxes the return to income that is saved, thereby lowering the return to saving. This lower return on saving affects both the national saving rate, as well as the assets that taxpayers accumulate for particular purposes. There is some disagreement about whether the goal of tax incentives for saving should be to encourage saving for particular purposes or to increase national saving.[42] These purposes are not mutually exclusive; if effective, incentives to save for particular purposes will increase national saving. However, general saving incentives will not necessarily fulfill more specific goals. Whether new tax incentives for saving should be aimed at increasing national saving in general, or increasing retirement saving, depends on the perceived adequacy of each type of saving.

In particular, IRAs have historically been viewed as vehicles for retirement savings. When IRAs were introduced in 1974, they were provided only to individuals without employer-provided pension plans. The original intention of the IRA was explicitly to encourage individuals not participating in an employer-sponsored plan to increase their retirement savings and to provide a higher return on such savings. Even with the liberalization of eligibility requirements for IRAs in the Economic Recovery Tax Act of 1981, IRAs still have been largely devoted to retirement saving. Withdrawals of IRA funds before age 59½ generally are still subject to an additional 10-percent tax.

However, IRAs can provide substantial benefits to taxpayers who are saving for nonretirement purposes. For example, consider a taxpayer with a 28-percent marginal tax rate who has $1,000 of earnings to devote to saving. Without an IRA, the taxpayer would pay a tax of $280, leaving $720 to be invested. If this amount earns 8 percent annually and the earnings are taxed annually at a 28-percent marginal tax rate, the taxpayer will have $1,261 at the end of 10 years. If, however, the taxpayer can deduct the $1,000 and accumulate 8-percent annual interest tax free, the investment will be worth $2,159 at the end of 10 years. After including the distribution in income, subject to the additional 10-percent tax on early withdrawals, the taxpayer will have $1,339, or $78 more than the taxpayer has if a taxable investment is made.

Similarly, the present-law exceptions to the early withdrawal tax may permit taxpayers to use deductible IRAs for nonretirement saving. Under present law, a taxpayer may make penalty-free withdrawals from an IRA prior to attaining the age of 59½ if the distributions are made over certain periods. For example, a taxpayer could purchase an annuity which promises level payments for the remainder of the taxpayer's life. This exception may offer many taxpayers a way to receive a substantial percentage of the tax-favored funds prior to age 59½ and avoid the 10-percent penalty. At age 50, the average American male has a life expectancy of approximately 26 years.[43] At a 10-percent discount rate, an annuity which pays $1,000 per year for 26 years has a present value of approximately $9,160. The present value of the payments received during the first 10 years of such annuity is approximately $6,145, or 67 percent of the total value of the annuity. Consequently, if the

[42] Part V. C, below, discusses the importance of national saving. Part V. D, below, discusses the adequacy of retirement saving.

[43] Bureau of the Census, U.S. Department of Commerce, *Statistical Abstract of the United States, 1990*, p. 73.

taxpayer withdrew the $9,160 from his IRA to purchase the $1,000 annuity, he would receive 67 percent of the total value of the annuity prior to age 60.[44]

C. Role of Saving in the National Economy

Investment and economic growth

When an economy's rate of investment increases, the economy's stock of capital increases. A larger, capital stock permits greater production of goods and services. Because the larger a country's capital stock, the more productive its workers, investment also leads to higher wages and salaries. Thus, increases in investment lead to future increases in a nation's standard of living.

It is important to distinguish gross investment from net investment. Gross investment includes investment in new capital as well as investment that is undertaken to replace depreciated or worn out capital. Net investment measures increases to the capital stock. (Net investment is equal to gross investment less depreciation).

In the short run, increases in gross investment will increase the capital stock. As the capital stock increases, worker productivity increases and the economy will experience a higher rate of growth. In the long run, any given rate of investment will just be sufficient to replace the existing, though larger, capital stock as it depreciates. Thus, in the long run, an increase in the level of investment increases a nation's standard of living, but may not increase a country's long run rate of growth.

It is possible that a higher investment level can lead to a higher growth rate even in the long run. Even if there is no growth in net investment, investment to replace depreciated capital may still enhance economic growth to the extent that the replacement capital embodies improved (and more efficient) equipment and technologies. The higher the gross investment rate, the more new capital is purchased each year, and thus the rate at which new technologies get adopted may be higher.

Sources of investment funds

Investment involves a trade-off between consumption today and consumption tomorrow. Investment can either be financed by national saving, or by foreign borrowing (saving by foreigners). A basic accounting identity of the national income and product accounts states that:[45]

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[44] If an 8-percent discount rate were used, the percentage recovered in the first 10 years would be approximately 62 percent.

If such an annuity were purchased by a 40-year old male (life expectancy an additional 35 years), he would receive approximately 64 percent of the present value of the annuity (discounting at 10 percent) in the first 10 years and 88 percent by age 60.

[45] The national income and product accounts measure the flow of goods and services (product) and income in the economy. Two common measures of the size of the economy are the gross domestic product (GDP) and the gross national product (GNP). GDP measures the total value of the output of the American economy. GNP measures the total annual value of goods and services produced by Americans, their gross income. GDP is greater than GNP by the payment of factor income to the rest of the world (such as profits to foreign owners of U.S. based businesses), but is less than GNP by the amount of factor income received from the rest of world by Americans (such as wages paid to Americans who work abroad). Examining the income measure, GNP, is useful in understanding the trade-off between consumption tomorrow. GNP may be measured in several ways. One way is to measure GNP by expenditure on final product in the economy. By this measure,

Continued

Investment = Private Saving + Government Saving + Net Foreign Borrowing

Many analysts in the past ignored the foreign sector, primarily because at the time it was small relative to the U.S. economy. These analysts interpreted this basic relationship as saying that national investment must equal national saving, where national saving is the sum of private saving and public saving.

However, national investment need not equal national saving if foreigners can invest in the United States. The experience of the 1980s, when investment in the United States greatly exceeded national savings, demonstrates how important this source of funds can be. When demand for investment funds in the United States outstrips the supply of national savings, interest rates rise in response. Increases in interest rates attract foreign capital to the United States, and the excess of investment over national saving is financed by foreigners' saving.

Foreign investment in the United States also is related to the value of the dollar and the trade deficit. To take advantage of high interest rates in the United States, foreign investors first must convert their currencies to dollars. This increases demand for the dollar, thereby increasing the dollar's exchange rate relative to the foreign currency. A stronger dollar makes imported goods relatively cheaper and our exports relatively more expensive. As a consequence, net exports fall and the trade deficit increases. A further accounting identity states that: [46]

Net Foreign Borrowing = (IMPORTS-EXPORTS)

When net foreign borrowing increases, the trade deficit (the difference between imports and exports of goods and services) also increases. Thus, many people have blamed the trade deficits of the 1980s on the low national savings rate during that period.[47]

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(1) GNP = C + I + G + (X-M).

Equation (1) is an accounting identity which states that gross national product equals the sum of consumption expenditures (C), investment expenditures on plant, equipment, inventory, and residential construction (I), governmental purchases of goods and services (G), and net exports (exports less imports of goods and services or X-M).

An alternative is to measure GNP by the manner in which income created in the economy is disposed of. By this measure,

(2) GNP = C + S + T.

Equation (2) is another accounting identity which states that gross national product equals the sum of consumption expenditures, saving by consumers and businesses (S), and net tax payments to the government (T) (net tax payments are total tax receipts less domestic transfer, interest, and subsidy payments made by all levels of government).

Because both measures of GNP are simple accounting identities, the right hand side of equation (1) must equal the right hand side of equation (2). From this observation can be derived an additional national income accounting identity,

(3) I = S + (T-G) + (M-X)

This is the basis for the statement that national investment equals private saving (S), plus public saving (T-G), and net imports (M-X).

[46] This ignores the relatively small amount of unilateral transfers to foreigners. For a more detailed discussion of foreign trade and domestic saving and investment, see Joint Committee on Taxation, *Background and Issues Relating to the Taxation of Foreign Investment in the United States* (JCS-1-90), January 23, 1990.

[47] For instance, see Hatsopoulos, Krugman, and Summers, "U.S. Competitiveness: Beyond the Trade Deficit," *Science*, 15 July 1988, vol. 241, pp. 299-307.

Is the United States' saving rate too low?

Consequences of a low saving rate

The consequences of a low saving rate depend on the mobility of international capital. If capital is not mobile, then, as discussed above, investment is equal to national savings. When the saving rate is low, so is the investment rate. Historically, there has been a strong relationship between a country's rate of investment and its rate of saving.[48] Although this relationship has become weaker over time,[49] it is still true that countries with high saving rates also generally have high investment rates.

If capital is mobile (that is, if foreigners can invest in the United States at low cost and without a lot of added risk), then investment will not decline as much when the saving rate falls. Instead, investment will be financed by foreigners, either by direct foreign investment in the United States or by foreign lending to American investors. When domestic saving rates are low, foreign financing of domestic investment results in a higher rate of investment than would be possible if investment were financed by domestic saving. Foreign investment in the United States does increase the productivity of American workers. However, the profits generated by foreign investment flow abroad, since the United States has to pay interest on the funds it borrows. Furthermore, eventually the debt will have to be repaid, so the net wealth that is left to future generations of Americans is smaller than it would be if the investment were financed by domestic saving.

Trends in national saving and investment

National saving is generally divided into private saving and public saving. Private saving is comprised of household or personal saving and business saving. Households save by not spending all of their disposable income (i.e., after-tax income). Businesses save by retaining some of their earnings. Public saving reflects the extent to which the Federal, State, and local governments run budget surpluses or deficits. Table 7 presents data on the components of net national saving in the United States.

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[48] See, for instance, Martin Feldstein and Charles Horioka, "Domestic Saving and International Capital Flows," *Economic Journal*, vol. 90 (June 1980) pp. 314-29.

[49] See Phillippe Bacchetta and Martin Feldstein, "National Saving and International Investment", in Douglas Bernheim ad John Shoven (eds.), *National Saving and Economic Performance* (Chicago: The University of Chicago Press), 1991.

Table 7.—Components of Net National Savings, Selected Years, 1959–1995

[Amounts in billions of dollars]

Year	Private saving			Public saving			Total net national saving
	Net personal saving	Net business saving	Total net private saving	Federal surplus or deficit (−)	State and local surplus	Total public saving	
1959	24.3	13.9	38.2	2.6	9.6	12.2	50.4
1960	23.3	12.7	36.0	7.4	9.9	17.3	53.3
1961	28.3	13.0	41.3	2.9	10.4	13.3	54.6
1962	29.5	18.7	48.2	2.8	11.7	14.5	62.7
1963	28.6	21.2	49.8	5.4	13.0	18.4	68.2
1964	35.5	24.3	59.8	0.9	14.7	15.6	75.4
1965	37.8	29.9	67.7	3.4	15.1	18.5	86.2
1966	39.1	31.7	70.8	2.6	17.3	19.9	90.7
1967	48.9	28.9	77.8	−8.3	17.3	9.0	86.8
1968	46.8	26.3	73.1	−2.8	20.0	17.2	90.3
1969	46.9	22.6	69.5	8.7	21.1	29.8	99.3
1970	61.0	17.7	78.7	−14.1	20.8	6.7	85.4
1971	68.6	27.7	96.3	−25.3	21.7	−3.6	92.7
1972	63.6	34.2	97.8	−20.5	32.2	11.7	109.5
1973	89.6	37.6	127.2	−11.1	33.4	22.3	149.5
1974	97.6	21.5	119.1	−16.9	30.5	13.6	132.7
1975	104.4	40.1	144.5	−73.9	27.6	−46.3	98.2
1976	96.4	47.0	143.4	−57.2	35.9	−21.3	122.1
1977	92.5	53.4	145.9	−46.3	44.7	−1.6	144.3
1978	112.6	62.0	174.6	−31.7	52.6	20.9	195.5
1979	130.1	53.5	183.6	−18.4	52.3	33.9	217.5
1980	161.8	23.0	184.8	−61.0	54.4	−6.6	178.2
1981	199.1	33.3	232.4	−57.8	55.4	−2.4	230.0

1982	205.5	26.3	231.8	−134.7	51.3	−83.4	148.4
1983	167.0	54.3	221.3	−174.4	64.9	−109.5	111.8
1984	235.7	91.0	326.7	−156.0	86.9	−69.1	257.6
1985	206.2	92.9	299.1	−162.9	91.0	−71.9	227.2
1986	196.5	54.2	250.7	−177.5	94.9	−82.6	168.1
1987	168.4	75.6	244.0	−128.9	83.8	−45.1	198.9
1988	189.1	103.3	292.4	−121.3	85.9	−35.4	257.0
1989	187.8	76.2	264.0	−113.4	95.1	−18.3	245.7
1990	208.7	77.2	285.9	−154.7	80.1	−74.6	211.3
1991	246.4	126.0	372.4	−196.0	75.8	−120.2	252.2
1992	272.6	73.1	345.7	−280.9	86.3	−194.6	151.1
1993	214.4	108.0	322.4	−255.6	94.9	−160.7	161.7
1994	189.4	138.6	328.0	−190.2	99.7	−90.5	237.5
1995	249.3	143.3	392.6	−161.7	95.0	−66.7	325.9

Source: Department of Commerce, Bureau of Economic Analysis.

Table 8 presents net saving by component as a percentage of gross domestic product (GDP). As the table demonstrates, net business saving,[50] net private saving, and public saving were all lower during the 1980s then in any of the three previous decades. Net national saving declined through most of the 1980s.

Some analysts suggest that because households save out of their disposable income (i.e., after-tax income), it is more appropriate to examine personal saving relative to disposable income than to examine personal saving relative to GDP. Table 9 presents personal saving as a percentage of disposable income. Generally, the same trends observed in Table 8 are evident in Table 9.

[50] Tables 7 and 8 present net saving, which equals gross saving less capital consumption (depreciation).

Table 8.—Components of Net National Savings as a Percentage of GDP, Selected Years, 1959–1995

Year	Net personal saving	Net business saving	Total net private saving	Public saving	Total national saving
1959	4.79	4.79	7.53	2.41	9.94
1960	4.42	2.41	6.84	3.29	10.12
1961	5.19	2.39	7.58	2.44	10.02
1962	5.04	3.20	8.24	2.48	10.71
1963	4.63	3.43	8.07	2.98	11.05
1964	5.35	3.67	9.02	2.35	11.37
1965	5.26	4.16	9.41	2.57	11.99
1966	4.96	4.02	8.99	2.53	11.51
1967	5.87	3.47	9.33	1.08	10.41
1968	5.14	2.89	8.03	1.89	9.92
1969	4.77	2.30	7.08	3.03	10.11
1970	5.89	1.71	7.60	0.65	8.25
1971	6.10	2.46	8.56	−0.32	8.24
1972	5.14	2.76	7.90	0.95	8.85
1973	6.48	2.72	9.20	1.61	10.81
1974	6.52	1.44	7.96	0.91	8.86
1975	6.40	2.46	8.86	−2.84	6.02
1976	5.30	2.58	7.88	−1.17	6.71
1977	4.56	2.63	7.20	−0.08	7.12
1978	4.91	2.71	7.62	0.91	8.53
1979	5.09	2.09	7.18	1.33	8.50
1980	5.81	0.83	6.64	−0.24	6.40
1981	6.39	1.07	7.46	−0.08	7.38
1982	6.34	0.81	7.15	−2.57	4.58
1983	4.75	1.55	6.30	−3.12	3.18
1984	6.04	2.33	8.37	−1.77	6.60
1985	4.93	2.22	7.15	−1.72	5.43
1986	4.44	1.23	5.67	−1.87	3.80
1987	3.59	1.61	5.20	−0.96	4.24
1988	3.74	2.05	5.79	−0.70	5.09
1989	3.45	1.40	4.85	−0.34	4.52
1990	3.63	1.34	4.98	−1.30	3.68
1991	4.16	2.13	6.29	−2.03	4.26
1992	4.37	1.17	5.54	−3.12	2.42
1993	3.27	1.65	4.92	−2.45	2.47
1994	2.73	2.00	4.73	−1.30	3.42
1995	3.44	1.98	5.41	−1.30	4.49
Average 60–69	5.06	3.19	8.26	2.46	10.72
Average 70–79	5.64	2.36	8.00	0.19	8.19
Average 80–89	4.95	1.51	6.46	−1.34	5.12
Average 90–95	3.60	1.71	5.31	−1.85	3.46

Source: Department of Commerce, Bureau of Economic Analysis.

Table 9.—Personal Saving as a Percentage of Disposable Personal Income, Selected Years, 1929–1996

Year	Personal saving as a percentage of disposable personal income
1929	3.2
1939	2.6
1944	25.1
1949	3.9
1954	6.3
1959	7.0
1964	7.7
1969	7.0
1974	9.3
1975	9.0
1976	7.6
1977	6.6
1978	7.1
1979	7.4
1980	8.2
1981	9.1
1982	8.8
1983	6.6
1984	8.4
1985	6.9
1986	6.2
1987	5.0
1988	5.2
1989	4.8
1990	5.0
1991	5.7
1992	5.9
1993	4.5
1994	3.8
1995	4.7
1996 [1]	4.8

[1] Arithmetic average of first three quarters.

Source: Department of Commerce, Bureau of Economic Analysis.

Prior to 1980, domestic saving generally financed domestic investment as well as providing funds for Americans to be net investors abroad (negative net foreign investment). During the 1980s, net savings fell short of domestic investment as a share of GDP. Domestic investment declined from its 1984 peak and net foreign investment provided for the difference in domestic savings and investment. Thus, although the decline in saving was coincident with a decline in investment, this decline was not as severe as it might have been had there not been foreign investment.

Comparison between the saving rates of the U.S. and other countries

The United States' national saving rate is low when compared to that of other nations. Table 8 showed that the United State's net national saving averaged approximately 5 percent of GDP in the 1980s. The net national saving rate of Canada during the 1980s averaged 7.3 percent of GDP. For Japan the comparable rate was 17.9 percent; Germany, 9.2 percent; Italy, 8.3 percent; France, 6.7 percent; the United Kingdom, 4.5 percent; and Australia, 3.4 percent.[51] Table 10 presents a comparison for household or personal saving. As Table 10 indicates, the household saving rate of the United States during the 1980s was below the household saving rates of Canada, Germany, and Japan.[52]

[51] Organization for Economic Co-Operation and Development, *National Accounts, 1960-1989*, vol. 1, 1991.

[52] The data on international saving rates in the text and in Table 10 are not directly comparable to the data in Tables 8 and 9 because such data are not always compiled consistently across nations. For example, in computing household saving rates, the OECD subtracts household interest expense from income to determine U.S. household disposable income. The Bureau of Economic Analysis does not make a similar adjustment in defining household disposable income. Also, while the source of the international comparisons draws on data from the OECD, which attempts to provide data on an internationally comparable basis, the data are not fully comparable. For example, in computing household saving rates, the definition of the household sector is not identical across all countries. In particular, except in Japan, France, and Italy, private nonprofit institutions are included in the household sector. See, Andrew Dean, Martine Durand, John Fallon, and Peter Hoeller, "Saving Trends and Behaviour in OECD Countries," OECD, Economics and Statistics Department Working Paper, No. 67, June 1989.

Table 10.—Net Household Saving as a Percentage of Disposable Household Income in Certain Countries, Selected Years, 1972–1995

Country	1972	1976	1980	1984	1988	1990	1991	1992	1993	1994	1995	Average 1986–1995
United States	7.5	7.6	8.4	8.6	5.3	5.2	5.8	5.7	4.7	4.2	4.9	5.2
Japan	18.2	23.2	17.9	15.8	13.0	12.1	13.2	13.1	13.4	12.8	13.0	13.2
Germany ...	14.4	13.3	12.8	11.4	12.8	13.8	12.9	12.9	12.2	11.7	11.6	12.5
Canada	8.7	11.8	13.6	15.0	9.7	9.7	9.9	10.3	9.6	7.6	7.0	9.4
Australia ...	11.8	11.1	10.8	9.9	6.1	6.9	5.2	4.6	3.3	3.2	2.6	5.1

Source: Organization for Economic Co-Operation and Development, OECD Economic Outlook, 60, December 1996.

Generally, saving rates of all nations have declined from the rates of the late 1960s. In percentage terms, the decline in the national saving rate of the United States between 1967 and 1989 update is greater than the decline of the saving rates of Japan and Germany, but comparable to the decline of the saving rates of France and Italy.

Although many people have pointed to the low saving rate in the United States as a cause of declining productivity, others argue that the United States has long been a relatively low-saving nation, and yet has enjoyed substantial economic growth. They note that many of the nations with higher saving rates were nations which needed to rebuild after the destruction of war on their own territory.

Furthermore, some argue that the low saving rate in the United States may be a product of demographics, and that the saving rate will increase as the baby boomers enter their forties and fifties, typically the years during which people do much of their retirement saving. However, others note that in the past, demographic changes have not been very successful at predicting saving rates.

In general, the decline in private saving rates is not well understood. It is likely that demographic changes, capital market liberalization, increased insurance availability, and increased social security benefits have all contributed to the decline. However, these factors have not proved significant enough to account for the total decline in the saving rate. Similarly, there is no convincing explanation for why saving rates have declined in other nations as well.

D. The Adequacy of Retirement Savings

1. Economic status of the elderly

Sources of retirement income

Social security is the largest source of retirement income (40 percent in 1992), followed by income from assets (21 percent in 1992), earnings (17 percent in 1992), and private and government employee pensions (19 percent in 1992).[53] Many researchers have attempted to measure whether people have adequate savings for retirement. A common measure of retirement savings adequacy is called the replacement rate, which is defined as the ratio of retirement income over income during the working years.

The issue of what replacement rate should be called adequate depends on a number of factors. A replacement rate of 100 percent means that the person's income during retirement is equal to their income during working years. There are a number of reasons that a replacement rate of 100 percent may not be optimal. First, people may desire to have more income during the working years because some of that income is saved for retirement. If people choose to have constant consumption over time, they save during their working years and dissave during retirement. Second, most elderly own their own homes (in 1994, more than 80 percent of those households headed by an individual aged 65 to 74 and 73.5 percent of

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[53] Social Security Administration as reported in Joint Committee on Taxation, *Selected Materials Relating to the Federal Income Tax System Under Present Law and Various Alternative Tax Systems* (JCS-1-96), March 14, 1996, p.41.

households headed by an individual age 75 or over[54]) and most of these (83 percent in 1987[55]) have paid off their mortgages. Thus, most elderly receive housing without incurring any expenses beyond maintenance and utilities, whereas during their working years, they were likely to have been making mortgage payments. Third, few elderly households care for children, and therefore household expenses are likely to be lower. Fourth, the elderly are generally covered by Medicare, which provides insurance against large medical expenses and pays for most expenditures on health. Fifth, social security benefits, which represent the major source of retirement income, are largely untaxed.[56] Thus, social security benefits can be smaller than income earned during the working years and still provide the same after-tax income. For the lowest income groups, this effect is not large since earned income is subject to the payroll tax, but probably not subject to the income tax.

These arguments suggest that the appropriate replacement rate for the elderly to have adequate retirement savings is less than 100 percent. However, there may be some factors which dictate that the replacement rate should be higher than 100 percent. First, although the elderly are covered by Medicare, they are also more likely to incur large medical expenses which may not be completely covered by medicare. Similarly, Medicare generally does not cover nursing home care or the costs of care in other long-term care facilities, and only those elderly poor enough to receive Medicaid or eligible through veterans' assistance are covered.

Replacement rates for social security and pension income for retired workers are calculated using two methods. The first method calculates the ratio of social security and pension benefits relative to a worker's highest career earnings.[57] The second method calculates benefits relative to the average earnings in the five years preceding retirement.[58] It seems likely that the career high earnings overstate average earnings, and earnings during the five years preceding retirement understate average earnings. Thus, these two replacement rates may be seen as upper and lower bounds of estimates of the replacement of average career earnings. These replacement rates measure the replacement of income through retirement benefits, and do not include any income earned during retirement or any income from savings. Such calculations indicate that social security and pension benefits replace roughly 33 percent of the career high earnings and 50 percent of earnings over the last five years for individuals. When spousal benefits are taken into account, replacement rates are slightly higher, averaging 30 to 33 percent of highest earnings but 60 to 70 percent of last earnings. Such calculations also demonstrate that replacement rates are highest for the poor. For the lowest income quartile, individual re-

[54] *Statistical Abstract of The United States 1995,* Table 1288 page 736.
[55] *Statistical Abstract of The United States 1990,* Table 1278, page 722.
[56] Social security benefit recipients with modified AGI exceeding certain limits have to include up to 50 percent of their benefits in income. The Joint Committee on Taxation staff projects that in 1997, 23 percent of all elderly included some portion of social security benefits in taxable income.
[57] Earnings are indexed by the rate of wage growth. Highest career earnings are defined as the average of the highest five years of earnings.
[58] This measure is calculated only for those individuals who worked a significant amount during the five years preceding retirement.

placement rates varied between 34 and 39 percent of highest earnings, and 72 to 94 percent of last earnings.[59]

Finally, social security benefits have increased over time. Social security benefits relative to the income of the elderly have increased substantially over the past 40 years.

Poverty

Another method used to examine the economic status of the elderly is to compare their rates of poverty to those of the general population. Poverty among the elderly has declined dramatically over the last 30 years, from over 35 percent in 1959 to 12 percent in 1988. By 1988, the poverty rate of the elderly was less than the poverty rate of the general population. The poverty rate of elderly persons living in families (with a spouse or children) was 6.2 percent, lower than for any other group. The major explanation for this decline in poverty is the increase in social security benefits and coverage described above.

2. Expected retirement income and needs of current workers

The above discussion demonstrates that, as a group, the elderly are as well off as the rest of society, indicating that given social security and pension benefits, savings were adequate. However, to determine whether the savings of current workers are enough to provide adequate retirement income, it is necessary to examine how this group might differ from current retirees.

Social security and employer-provided pension plan coverage

Because social security coverage of workers has increased over time,[60] and because the labor force participation of women has also been increasing, current workers are more likely to be covered by social security than current retirees. Similarly, pension coverage of current workers is also substantially larger than of current retirees.[61]

Personal saving

Although coverage by pensions and social security is expected to be higher for current workers than it is for current retirees, the saving rate of current workers may be lower than the rate at which current retirees saved during their working lives. This would imply that although one source of retirement income, retirement benefits, is expected to be higher for current workers, another source, income from savings, may be lower.

The measure of personal saving used in the National Income and Product Accounts attributes all corporate pension contributions and earnings to the household sector. Thus, the increased pension coverage is already included in the measure of household saving. Table 8, above, shows that personal saving has been declining over the past 15 years. Private saving, which includes the saving of

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[59] Susan Grad, "Earnings Replacement Rates of New Retired Workers," *Social Security Bulletin 53, October 1990.*

[60] For a discussion of the legislative history of social security coverage, see Committee on Ways and Means, *Overview of Entitlement Programs* (WMCP 102-9), May 7, 1991, pp. 105-106.

[61] *EBRI Databook on Employer Benefits*, 1990, p. 75.

business, and which may provide a better measure of total households saving since businesses are ultimately owned by households, exhibits the same downward trend. Thus, the saving of the current generation of workers for their retirement seems to be low relative to the past.

In a recent study, the Congressional Budget Office ("CBO") reported that while the saving rate of current workers appears low relative to the past, this may not imply that the level of savings is inadequate for retirement. That CBO study concludes that the so-called "baby boom" generation appears to be accumulating assets at a rate equivalent to that of their parents who are currently retired. The CBO concludes that the continued increase in real wages, the fact that baby boomers are more highly educated than their parents, and the increased participation of women in the labor force portend "increases in household incomes of baby boomers in retirement."[62] Some have criticized the conclusion of this study as too optimistic. Critiques note that finding that baby boomers have accumulated approximately the same amount of assets as had their parents at a similar age does not bode well for retirement income. Having the same amount of assets would imply only the potential for the same amount of income as experienced by current retirees, and as incomes grow this would imply future retirees would be less well off compared to the rest of society than are current retirees. Critics also note that current retirees benefited from increases in social security benefits and unexpected capital gains on housing that the baby boomers may not reasonably expect to experience.[63]

3. Increased retirement costs

Finally, it is possible that the need for retirement income is increasing over time. Increases in life expectancies and trends toward earlier retirement increase the number of years in retirement and therefore, increase the need for saving. Furthermore, the normal retirement age for social security was changed in 1983. In 1995, the normal retirement for social security (the age at which retirees receive full benefits) is 65. By 2010, normal retirement will be 67 years. If the increase in the normal retirement age means that individuals will be working more years, then current saving need not adjust. However, if the historical trend toward earlier retirement continues, then the increase in normal retirement age for receipt of full social security benefits means that individuals should increase their retirement saving.

Similarly, increased life expectancies and rapid medical cost inflation increase the probability of large medical expenses. Out-of-pocket medical expenditures for the elderly have been steadily increasing over the last 15 years. Also, many people have noted that

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[62] Congressional Budget Office, "Baby Boomers in Retirement: An Early Perspective," September 1993, p. xiv. Also see, Joyce Manchester, "Baby Boomers in Retirement: An Early Perspective," in Dallas Salisbury and Nora Super Jones (eds.), *Retirement in the 21st Century: Ready or Not?* (Washington: Employee Benefits Research Institute), 1994.

[63] B. Douglas Bernheim, "Adequacy of Savings for Retirement and the Role of Economic Literacy," in Dallas Salibury and Nora Super Jones (eds.), *Retirement in the 21st Century: Ready or Not?* (Washington: Employee Benefits Research Institute), 1994.

the probability of an individual requiring long-term care some time in their lifetime has been increasing.

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