

Joint Committee on Taxation  
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ESTIMATES OF ADMINISTRATION PROPOSALS FOR FAMILY SAVINGS ACCOUNTS  
AND FOR IRA WITHDRAWALS MADE BY FIRST-TIME HOME BUYERS

This document provides estimates of the revenue effects of the Administration's proposal relating to family savings accounts (FSAs) and the proposal to waive the additional tax on withdrawals from individual retirement arrangements (IRAs) for first-time home buyers.

Description of Proposals

Family savings accounts.-- The Administration's savings proposal would permit individuals to make nondeductible contributions to an FSA. If these contributions remain in the account for 7 years or more, amounts withdrawn (including both the contributions and earnings thereon) would be excluded from gross income.

The maximum annual amount that could be contributed by an individual under the proposal would be limited to the lesser of \$2,500 or 100 percent of the individual's compensation (a married couple would be limited to \$5000 in annual contributions, if each spouse earned at least \$2500). Individuals who can be claimed as a dependent on another taxpayer's return could not contribute to an FSA.

Only individuals meeting certain adjusted gross income (AGI) limitations would be able to make a contribution to an FSA. Contributions would be permitted for single taxpayers with AGI of no more than \$60,000, for heads of households with AGI of no more than \$100,000, and for married taxpayers filing joint returns with AGI of no more than \$120,000. Amounts contributed to FSAs would not affect the amount that could otherwise be contributed to tax-favored retirement plans (e.g., section 401(k) plans or IRAs) or to other tax-favored forms of saving (e.g., education savings bonds).

Special rules would apply with respect to withdrawals of earnings allocable to contributions not held in the account for 7 years. To the extent a withdrawal consists of earnings allocable to contributions held less than 3 years, such earnings would be includible in gross income and subject to an additional 10-percent tax. To the extent a withdrawal consists of earnings allocable to amounts held at least 3 years but less than 7 years, such earnings would be includible in gross income, but no additional tax would apply.

IRA withdrawals.-- The Administration's IRA withdrawal proposal would allow certain individuals to withdraw up to \$10,000 from an IRA for the purchase of a first home without imposition of the present law 10-percent additional tax on early withdrawals. This proposal would apply to individuals who did not own a home in the last 3 years and who are purchasing or constructing a principal residence that costs no more than 110 percent of the median home price in the area where the residence is located.

Effective date.-- The proposals would be effective on January 1, 1990.

Revenue Estimates

The following estimates assume October 1990 enactment.

<u>Item</u>	<u>Fiscal Years</u>					<u>1991-95</u>
	<u>[Billions of Dollars]</u>					
	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	
Family Savings Account.....	-0.3	-0.6	-1.0	-1.3	-1.8	-5.0
Penalty-Free IRA Withdrawal.....	-0.2	-0.2	-0.2	-0.1	-0.1	-0.9

Long-Run Revenue Estimates

General observations

The above table provides revenue estimates for the fiscal years 1991 through 1995 only. For the reasons set forth below, the estimate does not quantify the revenue effects of the Administration's proposals for fiscal years beyond 1995.

The revenue estimates are based on the baseline macroeconomic forecast for the United States economy provided by the Congressional Budget Office (CBO). The CBO baseline forecast extends only through 1995. Any extrapolation of the baseline beyond 1995 either would require a purely mechanical approach (e.g., an assumption that economic trends would continue unchanged in the future) or would involve an independent forecast of such trends. Either approach would be arbitrary and could well result in the use of economic assumptions inconsistent with those underlying the CBO 5-year forecast. In addition, any baseline assumptions made by the staff of the Joint Committee on Taxation (staff) would likely create a debate about out-year macroeconomic growth which the staff has traditionally avoided.

The uncertainties inherent in long-range macroeconomic forecasting have led the staff to conclude that it would be inappropriate to project specific estimated revenue effects for the two proposals beyond 1995. The staff does believe, however, that certain qualitative observations concerning the likely post-1995 budget effects of these proposals may be helpful in assessing their general trend and magnitude.

### Family Savings Accounts

For the period immediately following fiscal year 1995, the staff expects that: (1) the FSA proposal would continue to result in revenue losses; (2) these revenue losses would be somewhat larger in size than the 1995 level; and (3) these losses would grow faster than the economy as a whole. During the years immediately following 1995, the amount of untaxed investment income in FSAs will grow at a compound rate, while the aggregate amount contributed to these accounts will grow at a linear rate as the number of people making use of the FSA savings vehicle stays roughly the same. Overall, then, the amount of income sheltered from tax by FSAs will grow substantially over the time period immediately following fiscal year 1995.

However, in subsequent years, demographic considerations would begin to have significant impacts on the economics of FSAs. For instance, the savings behavior of individuals has historically been sensitive to age, with greater saving taking place in the latter stages of a person's working career (e.g., from age 45 on). As the population of the United States ages, the number of people in these traditionally higher-savings age groups will increase. This demographic shift would be expected to increase the amount of aggregate national savings, affecting the amount of saving that is conducted in the form of FSAs. Certain countervailing factors, however, have led the staff to conclude that it might not be appropriate to base estimates of future savings behavior on this historical pattern. In particular, the previously observed age-related savings behavior might be altered if, in the future, people experience longer lifespans or choose later retirement ages. To the extent the overall saving decisions of individuals are affected by such factors, the portion of saving taking place in FSAs will also be affected.

In addition, the characteristics of the portion of the United States population utilizing FSAs will change over time, as even modest levels of inflation will significantly erode the real value of both the annual contribution and the annual income limitations. For example, over a 20-year period, annual inflation of 3.5 percent would approximately halve the real value of these limits. These lower real levels would necessarily restrict the use of FSAs to people with real incomes substantially lower than those enjoyed by eligible taxpayers during the years covered by the revenue estimate.

Finally, the performance of investments held in an FSA will directly affect the revenue cost of the FSA proposal, since higher yielding assets held in an FSA will result in greater revenue cost. It is expected that investors will attempt to hold high-yield, tax-disfavored (fully taxable if not held in a specially treated account) assets in their FSAs. Generally, high-yield assets are characterized by a relatively high degree of uncertainty regarding their eventual realized outcome. Given that risk premiums (the expected return above that for riskless assets) often change over time, the expected yields for these assets (and hence the eventual revenue impacts of the FSA proposal) are inherently unpredictable.

#### Waiver of excise tax on IRA withdrawals by first-time home buyers

For the period immediately following fiscal year 1995, the revenue losses could be expected to be similar in size to the 1995 level. During these years, the number of people making use of their IRA to save for a house down-payment is expected to remain relatively constant as the largest number of people willing and able to use an IRA to save for the purchase of their first home will do so during this period. The number of people making deposits into their IRA to save for a home purchase will be roughly a constant proportion of the number withdrawing up to \$10,000 to buy their first home.

Like the FSA proposal, demographic changes would begin to have significant impacts on the use of IRAs as a vehicle to save for a first home in subsequent years. For instance, as the United States population ages, a smaller percentage of people will be in a position to use IRAs to save for purposes of purchasing first homes. An offsetting effect, though, may be a change in the rate of household formation, with younger people (perhaps larger numbers of single people) entering the market as first-time home buyers. It is uncertain which of these effects will be more important.

Similar to FSAs, the performance of the economy will have a major impact on the desirability of IRAs as a form of saving for first-time home buyers. For example, inflation is expected to have a significant impact on the number of people able to make deductible IRA contributions. Assuming trends in coverage under employer-provided pension plans are unchanged, the income phaseouts for deductibility of IRA contributions will apply to many more taxpayers, given even modest levels of inflation. This will mean that relatively fewer people will be able to claim a deductible IRA contribution and that fewer people will use their IRA to save for the purchase of a first home. Along the same lines, the value of the \$2,000 deduction for an IRA contribution and the \$10,000 penalty-free withdrawal for first-time home buyers will also decline substantially in real terms.