CENTER ON BUDGET AND POLICY PRIORITIES
820 First Street, NE, Suite 510, Washington, DC 20002
Ph: 202-408-1080 Fax: 202-408-1080
www.cbpp.org

*Revised May 1, 2000*

# WOULD RAISING IRA CONTRIBUTION LIMITS BOLSTER RETIREMENT SECURITY FOR LOWER– AND MIDDLE-INCOME FAMILIES OR IS THERE A BETTER WAY?

by Peter Orszag and Jonathan Orszag[1]

## Summary

Several pieces of legislation currently before Congress would raise the maximum amount that can be contributed to an Individual Retirement Account (or IRA) from $2,000 to $5,000 for an individual and from $4,000 to $10,000 for a married couple. This increase apparently is intended by its sponsors to boost retirement saving for middle-class families and to increase national saving.

The proposal would have virtually no effect, however, on families and individuals who do not make any deposits in IRAs under current law or who deposit less than the current $2,000 limit. This proposal would directly benefit only those already making the $2,000 maximum contribution; these are the sole households the current $2,000 limit affects. A recent analysis prepared by the Office of Tax Analysis at the Treasury Department found that *only four percent* of all taxpayers who were eligible for conventional IRAs in 1995 were at the $2,000 contribution limit.[2] Those at the limit almost certainly are among the most-affluent of the taxpayers eligible for IRAs.[3]

The analysis prepared by Treasury's Office of Tax Analysis also found that 93 percent of taxpayers eligible to make deductible contributions to a conventional IRA did not make *any* IRA contribution in 1995. Raising the IRA contribution limit would likely not do anything to increase the amount these taxpayers save for retirement. This proposal thus would have virtually

---

[1] Peter R. Orszag is President of Sebago Associates, Inc., an economics consulting firm, and lecturer in economics at the University of California, Berkeley. From 1995 to 1998, he served as Special Assistant to the President for Economic Policy and as Senior Economist on the Council of Economic Advisers. Jonathan M. Orszag is Managing Director of Sebago Associates. He previously served as Director of the Office of Policy and Strategic Planning at the Department of Commerce, and was an Economic Policy Advisor on the National Economic Council at the White House.

[2] Robert Carroll, "IRAs and the Tax Reform Act of 1997," Office of Tax Analysis, Department of the Treasury, January 2000. The paper notes that reliable and comprehensive data on Roth IRA contributions are not yet available.

[3] It may be noted that those at the limit tend to be older than other taxpayers. Among the working-age population, both income and asset-holdings tend to rise with age.

no effect on the vast majority of middle-class families, despite its cost of approximately $18 billion over five years and more than $40 billion over 10 years.

The tax subsidies for retirement saving the federal government currently provides already are skewed heavily toward more-affluent individuals. Treasury data show that two-thirds of the *existing* tax subsidies for retirement saving (including both private pensions and IRAs) accrue to the top 20 percent of the population. Only 12 percent of these tax subsidies accrue to the bottom 60 percent of the population. This suggests that any new retirement saving subsidies should be focused primarily on lower- and middle-income families.

The proposal to raise the IRA contribution limit to $5,000, however, would further skew the distribution of tax subsidies for retirement saving. An analysis by the Institute on Taxation and Economic Policy finds that *70 percent of the tax subsidies for retirement saving that would be provided by raising the IRA limit to $5,000 would accrue to the 20 percent of the population with the highest incomes*, the group that already receives the bulk of retirement tax subsidies under current law and that possesses the bulk of retirement savings. By contrast, the bottom 60 percent of the population would receive *only 5.5 percent* of the tax subsidies this proposal would provide.

The distribution of IRA tax subsidies partly reflects the fact that the income limits for deductible IRA contributions *do not apply* to individuals not covered by an employer-sponsored pension plan. Nearly 30 percent of all IRA contributors in 1995 were individuals whose incomes exceeded the IRA limits, such as small-business owners and executives and independent professionals who are not covered by an employer plan. These higher-income individuals made nearly 40 percent of the IRA contributions that year. They are the people who could most readily afford to raise their IRA contributions to $5,000 a year.

The proposal also raises other serious concerns.

- **It could have the effect of inducing a reduction in pension coverage for rank-and-file employees in small businesses.** The proposal would endanger pension coverage for workers at some small businesses because it would create significant incentives for small-business owners *not* to establish an employer pension plan and instead to meet their own retirement saving needs through the substantially enlarged IRA contributions the proposal would permit.

  Currently, a small-business owner with a high income can deposit $4,000 a year in a conventional IRA ($2,000 for the owner and $2,000 for the owner's spouse) if the small business has no pension plan. If the owner wants to set aside a larger amount, say $10,000, in tax-favored retirement savings, the owner must establish an employer pension plan and make the contributions through the plan. If the IRA contribution limits are raised to $5,000, however, the owner will be able to use IRAs to put away $10,000 a year in tax-advantaged retirement saving *without* having to incur the expense of operating and making contributions to an employer-sponsored pension plan for the firm's employees. Moreover, the owner would be able to take advantage of the increased contribution limits for conventional IRAs *only if the firm did not offer a plan.*

This would provide a strong inducement for small-business owners who otherwise might establish pension plans not to do so. Taking advantage of an increase to $5,000 in the IRA contribution limits would enable the owner to secure large tax-favored retirement contributions for himself or herself and a spouse without the administrative complexity of an employer-based pension plan. The IRA proposal has a strong potential to erode rather than strengthen retirement security for employees in small businesses.

- **The proposal also has the potential to reduce national saving.** The taxpayers most able to take advantage of an increase in IRA contribution limits and to place up to $5,000 a year in an IRA account would generally be more-affluent taxpayers who can readily shift funds from other saving or investment vehicles — rather than increasing the amount they save — to take advantage of the enhanced IRA tax break. Shifting funds from one vehicle to another does not raise national saving. For national saving to increase, the individuals who increase their IRA contributions must save more of their income. If the government's revenue loss from the IRA proposal were not offset by cuts in programs or increases in other taxes and this revenue loss exceeded the amount of *new* private saving the proposal induced — as could well be the case because of asset-shifting — national saving would decline.

## Retirement Saving Accounts

The Administration's proposal to establish "retirement savings accounts" (RSAs) represents an alternative way to boost retirement saving. The RSA proposal does not pose the array of problems the IRA proposal does. Under the RSA approach, the Treasury would provide tax credits to match contributions that married couples with incomes up to $80,000 a year (and individuals with incomes up to $40,000) make to retirement saving accounts. The matching rate would be highest for lower-income families and gradually phase down as income rose.

Compared to the proposal to raise the IRA contribution limits, the RSA proposal represents a far more efficacious way to increase retirement saving among middle- and lower-income working families. While the IRA proposal would directly benefit only a very small number of middle-income families — those that already deposit the full $2,000 in an IRA — and would give 70 percent of its tax subsidies for retirement saving to the top 20 percent of the population, the RSA tax subsidies would be focused heavily on middle- and lower-income families and individuals. Analysis of a somewhat similar proposal suggests that only about 20 percent of the RSA subsidies would accrue to individuals in the top 20 percent of the population; roughly 80 percent of the subsidies would go to the bottom four-fifths of the population.

**Fact and Fiction in Merrill Lynch's Promotion of the IRA Proposal**

Merrill Lynch recently ran a full-page advertisement in *Congressional Quarterly* and *National Journal* promoting the proposals to raise the IRA contribution limit to $5,000. The advertisement correctly notes that despite the economic boom, many Americans do not appear to be saving enough for retirement. But it includes two misleading statements.

First, the advertisement states that for "years the IRA has been an invaluable savings tool for over 30 million households of working Americans." This may create the impression that 30 million Americans a year are making deposits into IRAs. In fact, Treasury data show that the number of taxpayers making IRA contributions is about five million a year, or one-sixth of the 30 million number. (The most recent reliable data available show that 5.3 million taxpayers made contributions to IRAs in 1995.) The 30 million figure appears to reflect the number of people who have contributed to IRAs over a period of nearly 20 years, including large numbers of higher-income individuals who contributed in the early 1980s when there were no income limits on IRAs.

The advertisement also claims that "raising the IRA limit to $5,000 would encourage more savings and would especially benefit working women, whose savings needs are more acute because they are often in and out of the workforce to raise children." As this paper shows, however, the increase in the limit to $5,000 would have *no* direct effect on the vast majority of taxpayers, including both working men and working women. Only a very small percentage of working women would receive any benefit from the proposal.

Nor is there reason to believe there would be substantial differences between men and women in terms of the impact of the proposed IRA expansion. One recent report from the Employee Benefit Research Institute concluded that "working men and women are preparing similarly for retirement." [a] In addition, the percentage of high-income women who are not covered by an employer-provided plan – and therefore eligible to make deductible IRA contributions regardless of income – is similar to the percentage of high-income men not covered by an employer-provided plan.

---

[a] Pamela Ostuw, "Retirement Planning and Saving among Women: Results from the 1999 Women's Retirement Confidence Survey," January 2000.

As noted, raising the IRA contribution limit would have virtually no effect in increasing participation rates in IRAs among those not participating under current IRA rules and also would not be likely to affect those who participate in IRAs but contribute less than $2,000. IRA depositors who cannot afford to set aside $2,000 also cannot afford to set aside $5,000. By contrast, RSAs would provide subsidies to modest savers to increase the amounts they save by matching contributions they make, starting with the first dollar they save. As this analysis demonstrates, for most couples with incomes below $80,000 and most individuals with incomes below $40,000, RSAs would provide a substantially larger subsidy for retirement saving — and a much more powerful inducement for such saving — than raising the IRA contribution limit would.

Contributions to RSAs also would be more likely to add to national saving than contributions to IRAs, an important issue since increasing national saving should be one of the nation's top priorities in preparing for the retirement of the baby-boom generation. As noted, increasing the IRA limit would result in a large portion of the new IRA tax subsidies going to more-affluent taxpayers who can shift funds from existing saving vehicles, rather than increase the amount they save out of their income. By contrast, the RSA proposal would concentrate its subsidies on lower- and middle-income families; such families are much less likely to have substantial financial assets to shift. Deposits made in a saving vehicle such as RSAs consequently are more likely to represent new saving than the increased amounts that would be deposited in IRA accounts if the IRA contribution limit is raised.

The RSA proposal also would pose less danger of creating incentives for small businesses not to offer employer pension plans. An increase in the IRA contribution limits could obviate the need for small-business owners to offer employer plans in order to build substantial tax-advantaged retirement accounts for themselves. RSAs would not have such an effect because they would not be available to business owners (or anyone else) with incomes exceeding $80,000. Since RSAs would not provide retirement tax subsidies for well-compensated business owners or other high-income individuals, RSAs could not replace employer pension contributions for a business owner and a firm's top executives. Thus, the availability of RSAs would not provide an incentive to an owner to drop or fail to initiate a plan.

The IRA and RSA proposals have roughly similar costs. Proposals to raise the IRA contribution limit to $5,000 would cost more than $40 billion over 10 years.[4] The Administration's RSA proposal would cost $61.5 billion over 10 years but could be modified to cost somewhat less than that, and the costs of the RSA proposal appear to grow less rapidly after the end of the initial 10-year period than the costs of the IRA proposal. The costs of the two approaches are in the same general range. But their effects are decidedly different.

The conclusions from this analysis are clear. Policymakers who are interested in devoting roughly $50 billion over 10 years in tax subsidies to retirement savings — and who want to promote retirement security among lower- and middle-income families and boost national saving — would be much better off pursuing an RSA-type of approach than increasing the IRA contribution limit.

## IRA proposals

Under current law, a taxpayer and spouse may each contribute up to $2,000 to a conventional IRA or a Roth IRA. A couple thus may contribute $4,000. Under a conventional or "deductible" IRA, contributions are tax deductible, earnings and interest on the account accumulate tax-free, and withdrawals are taxed. Under a Roth IRA, contributions are *not* tax deductible, earnings and interest on the account accumulate tax-free, and withdrawals are *not* taxed.

---

[4] Last year, the Joint Tax Committee placed the cost of H.R. 802, a bill that raises the IRA contribution limit to $5,000, at $18 billion over five years. Based on the Joint Tax Committee's estimate of the bill's cost in the fifth year, the legislation would cost more than $40 billion over 10 years.

To be eligible to make tax-deductible deposits to a conventional IRA, the income of a taxpayer covered by an employer-sponsored pension plan may not exceed limits set in law. For taxpayers covered by an employer-sponsored plan, the limits are :

- **Conventional (or deductible) IRA**. In tax year 2000, the income limit for a single worker is $42,000 in adjusted gross income. (Eligibility phases down between $32,000 and $42,000.) For married couples filing joint returns, the income limit is $62,000. (It phases down between $52,000 and $62,000.) The income limits and phase-down ranges are scheduled to increase under current law. The income limits will reach $60,000 for single filers by 2005 and $100,000 for joint filers by 2007.

- **Roth IRA**. Eligibility phases out at $110,000 in adjusted gross income for single filers and $160,000 for married filers.

For some taxpayers, however, there are *no* income limits for deductible contributions to conventional IRAs. Taxpayers of any income level who are not covered by an employer-sponsored plan may make such contributions to conventional IRAs.[5] Business owners and executives whose firms do not offer pension plans can take advantage of these tax subsidies regardless of how much they earn. According to Treasury Department data, such high-income taxpayers accounted for 29 percent of those who contributed to conventional IRAs — and 38 percent of total IRA contributions — in 1995.[6]

Three bills before the House of Representatives would alter IRA rules. All three bills would raise the maximum contribution limit for both traditional and Roth IRAs from $2,000 to $5,000 for individuals and from $4,000 to $10,000 for couples. These bills differ in some other respects.

The simplest bill is H.R. 802, which was introduced by Rep. Dennis Moore (D-Kansas) and had 68 co-sponsors as of April 4, 2000. This bill would raise the contribution limit on conventional and Roth IRAs from $2,000 to $5,000 for each taxpayer and spouse, so the maximum contribution for a married couple would increase from $4,000 to $10,000.[7]

---

[5] If the individual is not an active participant in an employer-sponsored retirement plan but the individual's spouse is, the $2,000 deduction limit for both the traditional and Roth IRA is phased out for taxpayers with AGI between $150,000 and $160,000. The income limits on Roth IRAs apply regardless of pension coverage.

[6] Robert Carroll, "IRAs and the Tax Reform Act of 1997," Office of Tax Analysis, Department of the Treasury, January 2000, page 7.

[7] While material on Rep. Moore’s web site mentions only the increase in the amount that could be contributed to a deductible IRA without mentioning Roth IRAs, his bill raises the contribution limit for both types of IRAs to $5,000.

Another bill – H.R. 1357, introduced by Rep. Mark Souder (R- Indiana) – includes the same provisions as H.R. 802 but also increases the amount that a taxpayer and spouse can contribute each year to an Education IRA, from $500 to $2,000. A third bill – H.R. 1322, introduced by Rep. Elton Gallegly (R-CA) – would raise the contribution limit to a Roth IRA to $5,000 and index to inflation the $2,000 limit for deductible contributions to a conventional IRA.[8] This bill had 104 co-sponsors as of May 1.

## Effects of raising the IRA contribution limits

### Distribution of Benefits

Treasury data show that two-thirds of the subsidies from *existing* tax preferences for pensions and IRAs accrue to households in the top fifth of the income scale. The bottom 60 percent of the population receives only 12 percent of these tax subsidies. Given the disproportionate share of the tax subsidies accruing to higher-income individuals under current law, it is desirable for additional retirement saving subsidies to be less skewed.

Only a very small percentage of the eligible population takes advantage of IRAs. Just seven percent of eligible taxpayers in 1995 made *any* contribution to a conventional IRA.[9] Roughly 40 percent of those who did contribute did not make the maximum $2,000 contribution. This suggests that only about four percent of eligible taxpayers are constrained by the $2,000 limit on traditional IRA contributions; the other 96 percent of eligible taxpayers are not affected by the limit. As Robert Carroll of the Treasury Department's Office of Tax Analysis recently wrote, "Taxpayers who do not contribute at the $2,000 maximum would be unlikely to increase their IRA contributions if the contribution limits were increased whether directly or indirectly through a backloaded [Roth] IRA."[10] It is only the very small minority of eligible taxpayers contributing the maximum $2,000 who would likely benefit from raising the maximum contribution amount on IRAs above $2,000.[11]

---

8 H.R. 1322 also would increase the amount that can be contributed to a non-deductible conventional IRA from $2,000 to $5,000. Since the bill increases to $5,000 the allowable contribution to a Roth IRA, however, this proposal to raise the allowable non-deductible contribution to a conventional IRA would be beneficial only to high-income taxpayers whose incomes exceed the eligibility limits for Roth IRAs.

9 Robert Carroll, "IRAs and the Tax Reform Act of 1997," Office of Tax Analysis, Department of the Treasury, January 2000.

10 Carroll, page 7.

11 Advocates for raising the $2,000 limit may argue that doing so would attract more workers to contribute to IRAs in the first place. For example, one such argument would be that there are large fixed costs associated with learning about IRAs and investing in them, so that individuals will not find it worthwhile to do so in exchange for the opportunity to make a $2,000 deductible contribution but will find it worthwhile in exchange for the opportunity to make a $5,000 deductible contribution. Such an argument would strain credulity. Similarly, advocates may

(continued...)

It also is important to note that 29 percent of those who made contributions to a conventional IRA in 1995 were higher-income taxpayers not covered by an employer-provided pension plan.[12] These taxpayers are not affected by the income thresholds on IRAs. Raising to $5,000 the amount that can be contributed to a conventional IRA would disproportionately benefit these higher-income IRA contributors, who are able to save more of their disposable income than individuals with lower incomes and also are likely to have more financial assets they can readily shift into IRAs.

**Table 1**

**Effects of Proposed Increase in IRA Contribution Limits**

| Income Group | Income Range (at 2000 levels) | % of Total Tax Cut |
|---|---|---|
| Lowest 20% | Less than $14,000 | 0.1% |
| Second 20% | 14,000 – 25,200 | 0.6% |
| Middle 20% | 25,200– 40,600 | 4.8% |
| Fourth 20% | 40,600 – 67,100 | 24.5% |
| Top 20% | 67,100 or more | 69.9% |
| All | | 100.0% |
| ADDENDUM | | |
| Bottom 60% | Less than $40,600 | 5.5% |
| Top 5% | 133,900 or more | 26.6% |

Source: Institute on Taxation and Economic Policy Tax Model, March 2000. Income in the ITEP model includes all cash income, including earned income, unearned income, and transfer payments. This definition of income is similar to that which CBO uses in its distributional analyses and that which Treasury uses when conducting distributional analyses based on cash income rather than family economic incomes.

Note: Table shows the effects of the proposed increases in H.R. 802. The effects of the proposed increases in H.R. 1322 would be similar.

It is not surprising therefore that analysis by the Institute on Taxation and Economic Policy of H.R. 802, a bill that raises the IRA contribution limit to $5,000, finds that upper-income taxpayers would enjoy the majority of the bill's new tax breaks. Analysis of H.R. 1322 would show similar results. As shown in Table 1, some 70 percent of the new retirement tax subsidies that these bills would provide would accrue to individuals in the top 20 percent of the population. Some 27 percent of the new tax subsidies would accrue to the top five percent of the population. By contrast, the bottom 60 percent of the population would receive only 5.5 percent of the new tax subsidies, or only about one-fifth as much as the top five percent of the population (and less than one-thirteenth as much as the top 20 percent of the population). The proposed IRA expansion thus

---

[11] (...continued)
argue that the $2,000 limit provides a psychological benchmark against which individuals judge their savings behavior, so that someone always saving "half the benchmark" would save more if the limit were $5,000 rather than $2,000. This argument is not especially persuasive either; those who contribute to IRAs today but deposit less than $2,000 are likely to do so because they cannot afford to put $2,000 aside, not because they wish to save "half the benchmark" or some other such fraction of it. Moreover, even if this argument were valid, its effects would be limited — only seven percent of eligible taxpayers made *any* contribution to a deductible IRA in 1995.

[12] Carroll, page 7.

would further skew toward affluent households the tax subsidies the government provides for retirement savings.

Some other IRA proposals, although not the bills discussed here, would raise the IRA income thresholds for individuals covered by employer-sponsored pension plans. Such provisions were part of the tax bill that Congress passed and President Clinton vetoed last year and are virtually certain to be pushed again in coming years.[13] If the IRA contribution limit is raised to $5,000 *and* the IRA eligibility limits are subsequently increased, the tax subsidies provided by raising the IRA contribution limit to $5,000 would be skewed still more heavily toward individuals in the upper parts of the income spectrum.

### Effects on Pension Coverage in Small Businesses

The proposed IRA increases could adversely affect pension coverage for rank-and-file workers, particularly in smaller firms. Such workers already suffer from low pension coverage rates. In 1993, only 13 percent of full-time workers in firms with fewer than 10 employees enjoyed pension coverage. By contrast, 73 percent of those in firms with 1,000 or more employees enjoyed such coverage.[14] In addition, only 27 percent of full-time workers with earnings between $10,000 and $15,000 were covered by pensions in 1993. Some 81 percent of those with earnings above $75,000 had coverage.[15]

Under current law, a small-business owner with a high income can contribute $4,000 to conventional IRAs ($2,000 to his or her own IRA and another $2,000 to his or her spouse's IRA) if the firm does not offer an employer-sponsored pension plan. If the owner wants to put away a larger amount in a tax-favored retirement saving account, the owner must offer a pension plan through the business. Under the proposed IRA legislation, the small business owner could deposit a total of $10,000 in IRAs. The owner consequently would have less need to offer a pension plan through the business.

Stated another way, under current law, a well-compensated owner loses the ability to make $4,000 a year in IRA contributions for himself or herself and a spouse if the owner offers

[13] More than 80 percent of taxpayers already are eligible for IRA tax preferences under current law. Raising the income thresholds would help only those taxpayers whose incomes exceed the existing thresholds. Increasing the income eligibility thresholds would provide benefits to the top 20 percent of the income distribution, a group with the least need for additional tax subsidies for retirement saving.

[14] U.S. Department of Labor, Social Security Administration, Small Business Administration, and Pension Benefit Guaranty Corporation, *Pension and Health Benefits of American Workers*, 1994, Table B9.

[15] U.S. Department of Labor, Social Security Administration, Small Business Administration, and Pension Benefit Guaranty Corporation, *Pension and Health Benefits of American Workers*, 1994, Table B11. "Covered" means that the employee participated in any type of employment-based pension plan, including defined benefit plans, 401(k) type plans, deferred profit sharing plans, and stock plans. Pension coverage is even lower among part-time workers. Only 12 percent of part-time workers enjoy pension coverage, compared to 50 percent of full-time workers.

an employer-sponsored pension plan. Under the proposed legislation, the owner would forgo the right to make $10,000 a year in IRA contributions by having an employer-sponsored plan. The only way for a small-business owner to take advantage of the higher IRA contribution amounts would be for the owner not to offer a company pension plan. Increasing the IRA contribution limits would not only fail to create any incentive for firms to set up employer-provided plans, but would make it significantly less attractive for some firms to do so. Raising the IRA limit could create significant disincentives for some small-business owners to establish such plans.

The legislation's effect in inducing small-business owners to *drop* existing pension plans would likely be smaller than its effect in inducing new businesses, and businesses that have reached a level of stability at which they otherwise might institute a plan, not to establish one in the first place. Given the high rate of small-business creation and expansion in the U.S. economy, the effect over time could be substantial. Raising the IRA contribution limit to $5,000 could induce erosion in employer pension coverage among small businesses over time.

As Donald Lubick, then Assistant Secretary of the Treasury for Tax Policy, noted in Congressional testimony last year, "Currently, a small business owner who wants to save $5,000 or more for retirement on a tax-favored basis generally would choose to adopt an employer plan. However, if the IRA limit were raised to $5,000, the owner could save that amount – or jointly with the owner's spouse, $10,000 – on a tax-preferred basis without adopting a plan for employees. Therefore, higher IRA limits could reduce interest in employer retirement plans, particularly among owners of small businesses. If this happens, higher IRA limits would work at cross purposes with other proposals that attempt to increase coverage among employees of small businesses."[16]

## Effect on National Saving

To raise national saving, tax incentives for saving must increase private saving by a greater amount than the cost to the government of providing the tax incentive.[17] National saving equals the total of government (or public) saving and private saving. (Government saving equals federal, state, and local government budget surpluses minus any federal, state, and local budget deficits.) All else being equal, every dollar of lost tax revenue not offset by an increase in other government revenue or a decrease in government expenditures reduces government saving by

[16] Statement of Donald C. Lubick, Assistant Secretary of the Treasury for Tax Policy, before the Subcommittee on Oversight, House Committee on Ways and Means, March 23, 1999.

[17] Briana Dusseault and Jonathan Skinner have recently argued that there has been no long-run cost to the government of providing the IRA incentive. See Briana Dusseault and Jonathan Skinner, "Did Individual Retirement Accounts Actually Raise Revenues?" *Tax Notes,* February 7, 2000. Jane Gravelle has sharply criticized their argument. See Jane Gravelle, "IRAs as Revenue-Raisers: A Critique," *Tax Notes*, February 28, 2000.

one dollar. Consequently, for national saving to increase, private saving must increase by more than one dollar in response to each dollar in lost government revenue.[18]

One question regarding the proposed IRA expansions is whether they would induce taxpayers to save more (and consume less) than taxpayers otherwise would, or whether taxpayers would respond primarily by shifting funds from other saving and investment vehicles into IRAs to take advantage of the enhanced IRA tax breaks. The more that individuals shift existing financial assets into IRAs, rather than increasing the total amount they save and reducing the amount they consume, the less that private saving will increase in response to an IRA tax incentive. Affluent individuals who already have substantial saving and investment assets are more likely to have assets they can readily shift into IRAs than are individuals of lesser means.

Economists have long debated the impact of existing IRA tax incentives on saving. Eric Engen of the Federal Reserve Board, William Gale of the Brookings Institution, and Karl Scholz of the University of Wisconsin (a former Deputy Assistant Secretary for tax policy at the Treasury Department) have concluded that "little, if any, of the overall contributions to existing saving incentives have raised saving."[19] Similarly, a recent review in *Tax Notes* concluded that the idea that "incentives might foment new private saving in an amount exceeding the revenue loss to the government has been around long enough to have been studied and debunked. The evidence on whether IRAs and other savings incentives increase saving is inconclusive at best, and more recent analyses show that these incentives fail to increase private saving while they reduce public saving."[20] Some other economists have argued that IRAs have had a more positive effect on national saving.[21] But a substantial body of well-respected economists concur that any such effect is small.

Because of the dubious effect of IRA incentives on private saving, many economists believe such incentives are, at best, an inferior approach to raising national saving than paying down the debt. In other words, these economists believe that in terms of raising national saving, IRA tax breaks tend not to be worth their budgetary cost. For example, Jane Gravelle, a highly regarded economist and tax expert at the Congressional Research Service, recently concluded

[18] If the revenue loss is fully offset through other fiscal measures, then the net impact on national saving is simply the change in private saving. In this case, government saving would be unchanged.

[19] Eric M. Engen, William G. Gale, and John Karl Scholz, "The Illusory Effects of Savings Incentives on Saving," *Journal of Economic Perspectives*, Fall 1996, page 115.

[20] Lee Sheppard, "Roth IRAs: Should We Expand a Bad Idea?" *Tan Notes*, April 5, 1999.

[21] See, for example, James Poterba, Steven Venti, and David Wise, "Personal Retirement Saving Programs and Asset Accumulation: Reconciling the Evidence," in David Wise, editor, *Frontiers in the Economics of Aging* (University of Chicago Press: Chicago, 1998).

that "reducing the deficit is a better approach to increasing saving than devoting funds to IRAs."[22]

Relative to IRAs, subsidies for retirement saving that focus more of the new subsidies on lower- and middle-income families should have a more beneficial effect on national saving. To raise private saving, incentives must generate *additional* contributions to saving accounts or other investment vehicles, rather than simply lead individuals to shift assets from one vehicle to another vehicle that offers a greater after-tax return because it provides a much-larger tax subsidy. Since households with modest or low incomes are less likely to have substantial amounts of other financial assets to shift into tax-preferred retirement accounts, focusing retirement tax preferences on lower- and middle-income workers increases the likelihood that contributions to retirement accounts will reflect new saving, rather than shifts in assets. In other words, since lower- and middle-income workers have fewer other assets to shift into retirement saving vehicles than higher-income individuals do, contributions to tax-favored retirement accounts by lower- and middle-income workers are more likely to represent new saving than are the increased contributions to such accounts that higher-income individuals could be encouraged to make.

Assume, for example, that the government announces a new tax incentive allowing individuals to deduct from taxable income up to $1,000 deposited into a retirement account. If a higher-income individual in the 31-percent marginal tax bracket takes $1,000 from an existing savings vehicle and moves it to the tax-preferred account, the government loses $310 in tax revenue that year without any increase in private saving. (There is no increase in saving because the individual has merely shifted assets from one account to another.) By contrast, if the tax incentive induces an individual in the 15-percent marginal tax bracket to save an additional $1,000, private saving increases by $1,000 while government revenue falls by only $150.

The smaller a worker's opportunity to shift assets and the lower the worker's marginal tax bracket, the more likely it is that $1,000 deposited in such a worker's retirement account will represent an increase in national saving. Targeting new tax preferences for retirement savings on low- and moderate-income workers, who typically do not have other substantial financial assets, would increase the likelihood that deposits into the tax-preferred accounts actually boost national saving. While economists may differ on the impact that existing tax incentives have on saving, most economists agree that focusing saving incentives on individuals with fewer opportunities to shift assets from taxable to non-taxable vehicles (rather than on individuals who already have more substantial financial assets) would increase the likelihood that deposits would represent additional private saving.

## Retirement Savings Accounts

The Administration's fiscal year 2001 budget includes a proposal for Retirement Savings Accounts (RSAs). This proposal would focus subsidies for retirement saving on lower- and

[22] Jane Gravelle, "IRAs as Revenue-Raisers: A Critique," *Tax Notes*, February 28, 2000.

middle-income workers. The basic idea behind RSAs is to provide a progressive tax credit to match the contributions that individuals make to savings accounts for retirement. (The concept of a government match for contributions to private retirement accounts was apparently first advanced by Eugene Steuerle of the Urban Institute in two articles in 1996.[23]) Individuals also would receive a tax deduction for contributions to such accounts.

Last year, the Clinton Administration proposed using part of the projected budget surpluses for Universal Savings Accounts (or USAs). The USAs would have provided progressive, refundable tax credits to match the contributions that individuals would make to savings accounts for retirement. When fully implemented, the USA proposal would have cost $38 billion *per year*. Congress did not take action, and the Administration did not push the proposal hard during last year's budget debate.

This year, the Clinton Administration has put forward a modified and substantially scaled-back proposal, which would create Retirement Savings Accounts. The new proposal is considerably more modest than last year's version.

The basic elements of the RSA proposal are as follows. When fully phased in (after 2004), a single filer could contribute up to $1,000 a year to an RSA. For married couples, both spouses could make a $1,000 contribution, for a total of $2,000. Like IRAs, RSAs would provide individuals a broad range of investment options. And also like IRAs, RSA contributions would be tax deductible.[24] To be eligible, a taxpayer would have to be between the ages of 25 and 60 and have earnings of at least $5,000 or have a spouse who earns at least $5,000.

The RSA plan includes two types of matching contributions:

- An individual would receive a two-to-one match on the first $100 deposited. Thus, an individual contributing $100 to an RSA would have that matched with $200 from the Treasury, bringing the total to $300. A couple could contribute $200 to an RSA and receive a match of another $400, bringing the total deposits to the account to $600. (This match would phase down as the family's income increased and would phase out completely for families with incomes of more than $80,000.)

- An individual would receive a one-to-one match on the next $900 deposited. Thus, for amounts contributed between $100 and $1,000, the depositor would receive a dollar-for-dollar match from the Treasury. An individual putting in an additional $200 (above the first $100) thus would receive a $200 match for that

[23] Eugene Steuerle, "Privatizing Social Security: A Third Option, Part One" *Tax Notes*, December 9, 1996, and "Privatizing Social Security: A Third Option, Part Two" *Tax Notes*, December 16, 1996. It should be noted, however, that Steuerle recommended linking the government match to the Social Security payroll tax, whereas the RSA proposal is not connected to Social Security. This difference is an important one.

[24] If an individual contributed to an RSA, the amount the individual could contribute to an IRA would be reduced by the amount deposited in the RSA.

part of his or her contribution. Couples could receive the one-to-one match on the next $1,800 contributed above the first $200. (Again, this match would phase down as income rose, and would be completely phased out for families with incomes exceeding $80,000.)

- The total match would combine these two elements. An individual contributing $600 would receive a match of $200 on the first $100 contributed, and a match of $500 on the next $500 contributed, for a total match of $700. The total deposit into the account would be $1,300 — $600 from the individual and $700 from the matching contribution.

Eligibility for these matches would depend on income:

- The two-for-one initial match would be available to individuals with adjusted gross income of up to $12,500 and married couples with adjusted gross income of up to $25,000. It would gradually phase down from a 200-percent match to a 20-percent match (i.e., a dollar in matching funds for each $5 the depositor contributes) for individuals with incomes between $12,500 and $25,000 and for married couples with incomes between $25,000 and $50,000. The match would then remain at 20 percent until income reached $40,000 for individuals or $80,000 for married filers, at which point the 20 percent match would be entirely eliminated.

- The additional one-for-one match on contributions above $100 would phase out over the same income ranges as the initial two-for-one match. Table 2 illustrates how several types of taxpayers would fare under the RSA proposal.

Under the RSA plan, the Treasury matching contribution would be provided through employers or financial institutions. If a married couple with income of $25,000 contributed $2,000 either to an RSA account administered through an employer or a bank, the $2,200 matching contribution from the Treasury would be provided as a $2,200 tax credit to the employer or bank. The employer or bank would be required to deposit an amount equal to the tax credit in the couple's account. The employer or financial institution would thus be an intermediary for the tax credit, not its ultimate beneficiary.

This approach is effectively equivalent to providing the matching contribution as a refundable tax credit that the couple must deposit in its RSA. Low- and moderate-income working families with no income tax liability would be able to participate in RSAs and to receive matching contributions, just as middle-class families could do. Channeling the tax credit through the employer or financial institution thus produces the same results as a refundable tax credit but does so in a way that is more feasible and practical for the IRS to administer than a refundable tax credit made for this purpose to individual taxpayers would be.

**Table 2**

| Illustrative examples of RSA contributions | | | | |
|---|---|---|---|---|
| *Type of taxpayer* | *Income* | *Contribution made to RSA* | *Contribution made by the Treasury to RSA* | *Total amount in RSA* |
| Individual | $10,000 | $1,000 | $1,100 | **$2,100** |
| Head of household (individual) | $35,000 | $1,000 | $200 | **$1,200** |
| Couple | $25,000 | $2,000 | $2,200 | **$4,200** |
| Couple | $40,000 | $2,000 | $1,120 | **$3,120** |
| Couple | $60,000 | $2,000 | $400 | **$2,400** |

Financial institutions also could claim a $10 per account tax credit to defray the administrative costs associated with establishing an RSA.

## Comparative Effects of the RSA proposal

Boosting retirement savings, especially among lower- and middle-income workers, should be a policy priority. The RSA proposal would be substantially more beneficial in this regard than the IRA proposals. For families with incomes below $80,000, the RSA proposal would provide a significantly larger incentive to save up to $2,000 than IRAs do. This is particularly true for low- and moderate-income families.

Compare the savings incentives of IRAs and RSAs. One can think of a deductible IRA as essentially providing a regressive matching contribution — the matching rate is zero for those with no income tax liability (because they cannot use the tax deduction), 15 percent for those in the 15-percent tax bracket (because the tax deduction they receive for an IRA deposit equals 15 percent of the deposit), 28 percent for those in the 28 percent tax bracket, and so on. The RSA proposal also contains this regressive match because it, too, provides a tax deduction for deposits made in retirement accounts. But the RSA proposal couples this regressive match with a more generous, and highly progressive, matching formula for contributions. As a result, its *overall* matching structure is both more generous and much more progressive than the IRA "match" for the vast bulk of families with incomes up to $80,000 (up to $40,000 for individuals).

Table 3 shows how four low- and middle-income married couples without children would fare under IRAs and RSAs if they deposited $2,000 in an account. As the table demonstrates, the total subsidy — the value of the tax deduction plus, in the case of RSAs, the Treasury matching contribution — is substantially larger under RSAs for all four married couples. Consider a couple that has $10,000 in adjusted gross income. As a result of the standard deduction and personal

**Table 3**

| Comparison of RSA and IRA Benefits on Illustrative Married Couples Without Children That Deposit $2,000 | | | | |
|---|---|---|---|---|
| | **Couple A** | **Couple B** | **Couple C** | **Couple D** |
| *Adjusted Gross Income* | $10,000 | $25,000 | $40,000 | $60,000 |
| *Taxable Income* | $0 | $12,500 | $25,000 | $45,000 |
| *Marginal Income Tax Rate* | 0 | 15% | 15% | 28% |
| **Retirement Savings Accounts** | | | | |
| *Benefit from Tax Deduction* | $0 | $300 | $300 | $560 |
| *Government Match* | $700 | $2,200 | $1,120 | $400 |
| ***Total Benefit*** | ***$700*** | ***$2,500*** | ***$1,420*** | ***$960*** |
| **Individual Retirement Accounts** | | | | |
| *Benefit from Tax Deduction* | $0 | $300 | $300 | $560 |
| ***Total Benefit*** | ***$0*** | ***$300*** | ***$300*** | ***$560*** |
| ***Benefit of RSAs over IRAs*** | ***$700*** | ***$2,200*** | ***$1,120*** | ***$400*** |

exemptions, the couple would have no taxable income and thus could not benefit from a tax deduction; if the couple made a $500 contribution to an IRA, its subsidy would be zero. By contrast, under the RSA proposal, if the couple placed $500 in an RSA, the couple would receive a $700 matching contribution. The RSA proposal consequently would encourage savings even among families with little or no income tax liability.

Moderate and middle-income couples also would have much stronger incentives to contribute under the RSA proposal than to contribute to an IRA. Consider couple C, a couple with $40,000 in income. The subsidy the couple would receive for contributing $2,000 would be more than $1,100 higher under the RSA proposal than under an IRA.

The total benefit under the RSA proposal is found to be higher for most of these married couples even if a $2,000 contribution to an RSA is compared to a $5,000 contribution to an expanded IRA. For couple C, for example, a $2,000 contribution to an RSA would produce a tax deduction and government match worth $670 more than the tax benefits from a $5,000 contribution to an expanded IRA. And such a comparison overstates the relative value of the IRA proposal, since few couples that would be eligible for RSAs (i.e., couples with incomes below $80,000) would be able to afford to set aside $5,000 a year and deposit that much in an IRA.

In short, the design of the RSA proposal makes it substantially more beneficial than an expanded IRA for both lower-income families and the large majority of middle-income families. Distributional analysis of the RSA proposal is not available. But some insight into the distributional effects of RSAs can be gained from data about the distributional effects of USAs under last year's USA proposal.

The USA proposal would have provided 80 percent of its tax subsidies to the bottom 80 percent of the population; only 20 percent of its tax benefits would have accrued to the 20 percent of households with the highest incomes.[25] The distribution of benefits under the RSA proposal should be roughly similar.[26]

The contrast between the RSA proposal and the proposal to raise IRA contribution limits is stark. The bottom 80 percent of the population would receive only about 30 percent of the retirement subsidies that H.R.802 and H.R. 1322 would provide. These households would receive roughly 80 percent of the retirement subsidies under the RSA proposal.

The RSA proposal also would not pose as great a risk to pension coverage in small businesses as the IRA proposal.[27] The RSA proposal is intended to supplement any employer matching contributions. It has some potential, however, to supplant a portion of those contributions; some firms could reduce their own matching contributions in response to the presence of a Treasury match. Fortunately, this risk is lessened because RSAs would not be available to higher-income employers or business owners. A small business owner who reduced matching contributions in response to RSAs would reduce contributions for himself or herself and for executives and well-paid employees earning over $80,000, along with the firm's other

---

[25] The White House, "President Clinton Introduces Universal Savings Accounts: Providing Millions of Americans A New Opportunity to Save for Retirement," April 14, 1999.

[26] Two differences between USAs and RSAs cut in opposite directions in assessing how the distributional impact of RSAs would compare to that of USAs. The USA proposal would have allowed taxpayers of *any* income level — including those at very high income levels — to receive a 50 percent matching contribution if they are not covered by an employer pension plan. The RSA proposal does not include such a provision. That difference would tend to make the share of benefits that would accrue to the bottom 80 percent of the population larger under RSAs than under USAs. On the other hand, the USA proposal included an automatic Treasury contribution that would have been made even to individuals who did not place any funds of their own in a USA account. That feature is not part of the RSA proposal; its deletion would tend to reduce the share of benefits going to lower-income workers. The net effect of these two differences is difficult to determine, but the share of the benefits going to the bottom 80 percent of the population under the RSA proposal should be relatively close to the share that would have gone to the bottom 80 percent of the population under the USA proposal.

[27] We also are sympathetic to the concern that the RSAs would add yet another tax-preferred saving vehicle to a somewhat confusing mix of existing programs. Given their benefits, however, the additional complexity RSAs would create seems well worth the costs involved. Nonetheless, a broader program of simplifying and unifying the myriad existing savings vehicles, as has been advocated by Eugene Steuerle and others, seems worth exploring.

employees. Yet the owner and the more highly paid employees would not qualify for RSAs to replace their lost employer contributions. This should reduce the incentives for employers to scale back contributions in response to RSAs. In addition, unlike the expanded IRA proposal, the RSA proposal would not create an incentive for small-business owners to drop or fail to create employer pension plans in order for the owner to qualify for a retirement tax subsidy. A high-income owner would not qualify for an RSA regardless of whether the small business has a pension plan.

The RSA proposal consequently seems to be much sounder policy than the proposed IRA changes. Even so, there are at least two issues regarding RSAs that require careful consideration and that may suggest a need for modest changes in the RSA design.

- **Administrative costs**. The Administration's proposal includes a one-time tax credit for financial institutions of $10 per account to defray the administrative costs of setting up new RSA accounts. The costs of setting up such an account, however, may be higher than $10. In addition, the tax credit does not apply to the costs of maintaining the account over time, nor to the administrative costs borne by employers who set up RSA accounts for their employees.

  Administrative costs therefore could be a concern, especially for smaller accounts.[28] (Administrative costs may be of more concern with regard to small accounts, because financial institutions will not secure much in the way of assets to reinvest from these accounts.) If so, some modifications to either the $10 credit or the design of the accounts may be needed.

  For example, administrative costs tend to be substantially lower for accounts with limited investment choices (e.g., accounts where choices are limited to a modest number of index funds, as under the Federal Thrift Savings Plan). This suggests that investment choices for RSAs probably should be limited rather than left wide open. Such an approach also could be beneficial in helping low- and moderate-income taxpayers with limited investment knowledge avoid poor investment choices.

- **Participation rates, matching, and financial education**. The RSA proposal is designed to induce people to save by providing a generous matching contribution. The evidence on the impact of matching contributions in 401(k) plans is mixed. Some researchers find that higher 401(k) match rates induce higher rates of employee contributions; other researchers do not find such an effect.[29] Even

---

[28] Such concerns also were raised in connection with the USA proposal. See Pamela Perun, "Matching Private Saving with Federal Dollars: USA Accounts and Other Subsidies for Saving," Urban Institute, Brief Series Number 8, November 1999.

[29] For example, Poterba, Venti, and Wise find evidence of higher participation rates when employers match
(continued...)

among those covered by a 401(k) plan, the participation rate tends to be lower for lower-income workers than for higher-income workers; in 1993, some 44 percent of workers earning between $10,000 and $15,000 who were offered the opportunity to participate in a 401(k) plan chose to do so, compared to 90 percent of workers earning $75,000 or more.[30] Some of that difference may reflect the fact that the exclusion from taxation of 401(k) contributions is more valuable to higher-income than lower-income workers. Some of it also undoubtedly reflects differences in the ability to save for retirement out of current income. This suggests that inducing lower-income workers to save voluntarily may still be a significant challenge.

On the other hand, the RSA proposal differs from most 401(k) plans in providing more generous matching contributions for low-income workers and a progressive matching structure that provides a higher percentage match for those with lower incomes. In addition, the 44 percent participation rate cited above among low-income workers with the opportunity to participate in a 401(k) plan appears to exceed the participation rate in IRAs for both low- and middle-income workers.

Furthermore, studies of the impact of financial education on saving suggest that educational efforts may have a particularly beneficial impact on lower-income workers.[31] Ways of combining RSAs with educational programs that enable lower- and middle-income workers to have the tools they need to make more informed decisions may be worthy of exploration.

The bottom line here is that while some aspects of the RSA proposal may benefit from further work, it remains clear that if the basic goal is to increase the number of families saving for retirement, the RSA proposal would do far more than the proposal to raise the IRA contribution limits. As explained above, raising the IRA contribution limit to $5,000 would do nothing to raise retirement saving among families not currently making IRA contributions.

---

[29] (...continued)
contributions and of higher contribution rates at higher match rates. See James Poterba, Steven Venti, and David Wise, "401(k) Plans and Tax-Deferred Saving," in David Wise, ed., *Studies in the Economics of Aging* (Chicago: University of Chicago Press, 1994). Kusko, Wilcox, and Poterba, however, find little impact of matching in one large employer. See Andea Kusko, James Poterba, and David Wilcox, "Employee Decisions with Respect to 401(k) Plans: Evidence from Individual-Level Data," NBER Working Paper 4635, 1994. The fact that the Kusko, Poterba, and Wilcox study was limited to one employer may limit its general applicability.

[30] U.S. Department of Labor, Social Security Administration, Small Business Administration, and Pension Benefit Guaranty Corporation, *Pension and Health Benefits of American Workers*, 1994, Table C7.

[31] Patrick J. Bayer, B. Douglas Bernheim, and John Karl Scholz, "The Effects of Financial Education in the Workplace: Evidence from a Survey of Employers," NBER Working Paper 5655, July 1996; and B. Douglas Bernheim and Daniel M. Garrett, "The Determinants and Consequences of Financial Education in the Workplace: Evidence from a Survey of Households," NBER Working Paper 5667, July 1996.

## Conclusion

The proposed expansions in IRAs would provide only 30 percent of their subsidies for retirement saving to the bottom 80 percent of the income distribution, could endanger pension coverage for some workers at small businesses, and may reduce national saving. For roughly the same cost, the RSA proposal would provide approximately 80 percent of its benefits to the bottom 80 percent of the income distribution and not pose the dangers the IRA proposal does.

The RSA proposal represents a promising approach to increasing retirement saving and retirement income for lower- and middle-income working families. Policymakers who seek to boost retirement security among such families and are willing to spend $40 billion or $50 billion over the next ten years to do so will obtain much more beneficial results for these resources from the RSA proposal than the IRA proposals.