

## WOULD RAISING IRA CONTRIBUTION LIMITS BOLSTER RETIREMENT SECURITY FOR LOWER- AND MIDDLE-INCOME FAMILIES?

by Peter Orszag and Jonathan Orszag<sup>1</sup>

### Executive Summary

Legislation 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. An analysis prepared last year 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.<sup>2</sup> Those at the limit almost certainly are among the most affluent of the taxpayers eligible for IRAs.<sup>3</sup>

The analysis that Treasury's Office of Tax Analysis prepared 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 no effect on the vast majority of middle-class families, despite its cost of more than \$40 billion over 10 years.

Furthermore, the proposal could have two deleterious effects — it could result in a *reduction* in pension coverage among low- and moderate-

income workers in small businesses and also could lead to a reduction in national saving.

**! Pension coverage for rank-and-file employees in small businesses.** The proposal would endanger pension coverage for workers at some small businesses and firms because it would create incentives for small-business owners and partners in professional firms not to establish an employer pension plan and instead to meet their own retirement saving needs through the 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, such as \$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 (for the owner and his or her spouse) 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 pension plan*, since individuals above certain income limits may make deductible contributions to IRAs only if their place of employment offers no plan.

This would provide a significant inducement for small-business owners who otherwise might establish pension plans not to do so. Taking advantage of the 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 or cost of an employer-based pension plan. The IRA proposal thus has the potential to erode rather than strengthen retirement security for employees in small businesses and professional firms.

- ! **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 to take advantage of the enhanced IRA tax break rather than increasing the amount they save. Shifting funds from one vehicle to another does not raise national saving. For national saving to increase, the IRA contributions must represent new saving: those making the IRA deposits must save more of their income and consume less of it. If the government's revenue loss from the IRA proposal is not fully offset by budget cuts in federal programs or increases in other federal taxes — and the revenue loss exceeds the amount of *new* private saving the proposal induces, as could well be the case because of affluent taxpayers shifting assets from other federal vehicles into IRAs — national saving would decline.

### **Pension Tax Benefits Already Skewed to the More Affluent**

The tax subsidies for retirement saving that the federal government currently provides already are heavily skewed toward owners, executives, and other relatively 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 improving retirement saving among lower- and middle-income families, not boosting it primarily among more-affluent individuals and creating new incentives for employers to scale back pension coverage for rank-and-file workers.

The proposal to raise the IRA contribution limit to \$5,000 would skew the distribution of tax subsidies for retirement saving further. An analysis by the Institute on Taxation and Economic Policy has found 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 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 current IRA tax subsidies partly reflects the fact, alluded to earlier, that the income limits for deductible IRA contributions do not apply to individuals who are 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.

### **Progressive Matching Credit**

One IRA bill, legislation that Rep. Dennis Moore has introduced, also would create a progressive matching tax credit for contributions that lower- and moderate-income earners make. The basic logic of the proposed tax credit for low- and middle-income savers is sound. Pension coverage rates are much lower for lower-income workers than for higher-income workers; in 1999,

only six percent of workers earning less than \$10,000 per year were covered by a pension, compared to 76 percent of workers earning more than \$50,000 per year.<sup>4</sup> Moreover, the evidence on 401(k) participation rates suggests that if lower-income earners are offered a match for contributions they make, a surprisingly high percentage do contribute.<sup>5</sup> In addition, the contributions that such lower-income earners make are more likely to represent new saving (rather than a shifting of existing assets into tax-preferred accounts) than are the contributions of higher-income earners.<sup>6</sup>

A progressive tax credit for saving consequently is an auspicious means of encouraging lower- and moderate-income workers to save for retirement. The Moore bill ostensibly reflects this logic: It would provide a tax credit equal to a given percentage of the amounts placed in retirement accounts by lower- and moderate-income workers. The tax credit would be progressive, beginning at 50 percent of amounts up to \$2,000 deposited by the lowest-income families and gradually phasing down to zero for families at higher income levels. Married couples with incomes over \$50,000 and single taxpayers with incomes over \$25,000 would be ineligible for the credit.

Unfortunately, however, several crucial details of the credit result in its being of very limited value. It would provide no benefit to the vast majority of lower-income workers and only a small benefit to others:

- ! The tax credit would not be refundable (i.e., it would be limited to those who owe federal income taxes). As a result, it would provide no additional saving incentive to the vast majority of households who otherwise would qualify for the 50 percent credit rate on the basis of their income. These people would be excluded from the credit because they have no income tax liability against which the credit could be applied. Under the tax plan that President Bush has proposed, as well as under the modified versions of the Bush proposal the House Ways and Means Committee has approved, the number of

families with no income tax liability would increase and therefore the number of families excluded from the credit also would rise.

- ! For families with somewhat higher incomes, the fact that the credit is not refundable poses much less of a problem. But for these families, the credit would provide only a relatively small incentive for saving. For example, a married couple with two children earning \$45,000 a year would receive only a \$200 tax credit for depositing \$2,000 into a retirement account. This small credit represents a low matching rate and does not provide much incentive to participate.

Furthermore, the income levels below which taxpayers can qualify for this credit *are not indexed to inflation*. This means that the number of families excluded from the credit would increase with each passing year, and its value to those who qualify for it would diminish over time.

The credit for lower- and middle-income savers, designed in part to address concerns about the regressivity of the IRA legislation, thus is something of a chimera. Most low-income families, especially ones with children, would not qualify for it. The basic approach embodied in the matching credit is sound, but the specifics of the Moore design (including the nonrefundability of the credit and the small matching rate among moderate earners) are problematic.

The overall conclusion is that the proposed IRA expansions are seriously flawed. They would be of no benefit to the vast majority of middle-income families (since few such families are at the current \$2,000 limit that would be raised). Yet they could endanger pension coverage for some workers at small businesses and could result in a reduction of national saving. Furthermore, the matching tax credit included in one of the bills is not refundable, which substantially limits its potential to raise saving among low- and moderate-income wage-earners. Policymakers who seek to boost retirement security among low- and middle-income families — the ostensible purpose of these bills — and are willing to spend \$40 billion or \$50

billion over the next ten years to do so would obtain far better results for these resources from establishing a *refundable* tax credit to match contributions that low- and middle-income families make to retirement accounts than from the current crop of IRA proposals.

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1. Peter R. Orszag is President of Sebago Associates, Inc., an economics consulting firm. He has previously served as Special Assistant to the President for Economic Policy, as Senior Economist on the Council of Economic Advisers, and as a member of the economics faculty at the University of California, Berkeley. In August 2001, he will join the Brookings Institution as a senior fellow in economic studies. 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.
4. U.S. Department of Labor, Pension and Welfare Benefits Administration, "Coverage Status of Workers under Employer Provided Plans," 2000, available at <http://www.dol.gov/dol/pwba/public/programs/opr/CWS-Survey/hilites.html>
5. For example, data from 1993 suggest that 44 percent of workers earning between \$10,000 and \$15,000 in 1993 who were offered the opportunity to participate in a 401(k) chose to do so. Only 21 percent were offered the opportunity, so the overall participation rate was only 9 percent. Source: 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.
6. Eric Engen and William Gale, "The Effects of 401(k) Plans on Household Wealth," paper prepared for the TAPES conference, Gerzensee, Switzerland, May 2000.