

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

by Peter Orszag and Jonathan Orszag¹

I. 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.² Those at the limit almost certainly are among the most affluent of the taxpayers eligible for IRAs.³

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.

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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.

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.⁴ 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.⁵ 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.⁶

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.

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.

- 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.

II. The Major IRA Proposals in the House of Representatives

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.

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. In

tax year 2001, the IRA income limit for a single worker is \$43,000 in adjusted gross income. (Eligibility phases out between \$33,000 and \$43,000.) For married couples filing joint returns, the income limit is \$63,000. (Eligibility for these tax filers phases out between \$53,000 and \$63,000.) These income limits are scheduled under current law to increase substantially in the years ahead. The income limits will reach \$60,000 for single filers by 2005 and \$100,000 for joint filers by 2007.

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.⁷ Business owners, partners, 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, taxpayers above the IRA income limits accounted for 29 percent of those who contributed to conventional IRAs in 1995 and accounted for 38 percent of total IRA contributions.⁸

The rules relating to the income limits for Roth IRAs are somewhat different. The eligibility limit for Roth IRAs (i.e., the point at which eligibility entirely phases out) is \$110,000 in adjusted gross income for single individuals and \$160,000 for couples. The income limits on Roth IRAs apply without regard to whether an individual's employer offers an employer-sponsored pension plan.

Two bills before the House of Representatives would alter the IRA rules. Both 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. Both would allow even higher contributions for older individuals, although the phase-in of the increases to \$5,000 and the approach adopted to allow higher contributions for older individuals differ between the two bills.

The simplest bill was introduced by Rep. Elton Gallegly. This bill would raise the contribution limit on both conventional and Roth IRAs from \$2,000 to \$5,000 by 2004 for each taxpayer and spouse, so the maximum contribution for a married couple would increase from \$4,000 to \$10,000. It would allow still higher contributions for individuals 50 years of age or older: Such individuals could contribute \$6,250, and married couples above 50 could contribute \$12,500. Finally, the Gallegly bill would index these contribution limits to inflation after 2004.

⁷ If the individual is not an active participant in an employer-sponsored retirement plan but the individual's spouse is, the individual may make contributions to a conventional IRA if the couple's AGI is below \$160,000 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.

⁸ Robert Carroll, "IRAs and the Tax Reform Act of 1997," Office of Tax Analysis, Department of the Treasury, January 2000, page 7. It is worth noting that the income limits in 1995 for those covered by an employer-provided plan were somewhat lower in inflation-adjusted terms than they are currently. For example, eligibility for married couples was eliminated at \$50,000 in income in 1995, which is the equivalent in inflation-adjusted terms to \$57,500 this year. The level at which eligibility completely phases out for such married couples, \$63,000, is somewhat higher this year.

Another bill, which Rep. Dennis Moore has introduced, would raise the contribution limit on conventional and Roth IRAs this year from \$2,000 to \$5,000 for individuals and from \$4,000 to \$10,000 for married couples. Those 50 years or older would be allowed to contribute \$7,500 if single and \$15,000 if married. The contribution limits (except for the \$7,500 limit for older individuals) would be indexed to inflation after 2001.⁹

The Moore bill also includes a progressive matching tax credit for contributions that lower- and moderate-earners make to retirement accounts. The Moore credit is similar to a provision included in a pension and IRA bill the Senate Finance Committee approved in September 2000. The basic idea of a progressive, matching tax credit for savings is sound. But the design of the specific tax credit in the Moore bill is flawed. The vast majority of lower-income savers would not benefit from the tax credit, and families with somewhat higher incomes would benefit only modestly; this is discussed below.

III. The Effects of Raising the IRA Contribution Limits

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.¹⁰ 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 at (and thus 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."¹¹ Only the very small minority of

⁹ The additional tax subsidy for older individuals that the \$7,500 limit would provide would ultimately fade away. Once indexation of the regular IRA contribution limit caused it to exceed \$7,500, the separate limit for older individuals (which would not be indexed) would become irrelevant. Under the current CBO inflation forecast, it would take approximately 16 years until that occurred.

¹⁰ Robert Carroll, "IRAs and the Tax Reform Act of 1997," Office of Tax Analysis, Department of the Treasury, January 2000.

¹¹ Carroll, page 7.

eligible taxpayers who contribute the maximum \$2,000 would be likely to benefit from raising the maximum contribution amount on IRAs above \$2,000.¹²

It also is important to note that 29 percent of those who made contributions to a conventional IRA in 1995 were taxpayers who had incomes above the IRA income limits and were not covered by an employer-provided pension plan.¹³ Raising to \$5,000 the amount that can be contributed to a conventional IRA would disproportionately benefit these more affluent 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 that 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, introduced in 2000. The effects of the proposed increases in this year's legislation would be similar.

¹² 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 seems implausible, however, given the relatively low costs of learning about IRAs and setting up an IRA. Similarly, advocates may 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 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.

¹³ Carroll, page 7.

It is not surprising therefore that analysis by the Institute on Taxation and Economic Policy of H.R. 802, a bill that Rep. Dennis Moore introduced last year to raise the IRA contribution limit to \$5,000, found that upper-income taxpayers would enjoy the majority of the bill's new tax breaks. Analysis of this year's proposals would show similar results.

As shown in Table 1, some 70 percent of the new retirement tax subsidies 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, about one-fifth as much as the top five percent of the population would secure (and less than one-thirteenth as much as the top 20 percent of the population would get). The proposed IRA expansion would further skew the tax subsidies the government provides for retirement savings toward affluent households.

Some other IRA proposals (although not the bills discussed here) would raise the IRA income limits for individuals covered by employer-sponsored pension plans. If the IRA contribution limit is raised to \$5,000 *and* the IRA eligibility limits are subsequently increased, the tax subsidies provided by an increase in the IRA contribution limit to \$5,000 would be skewed still more heavily toward individuals in the upper parts of the income spectrum (since a number of higher-income individuals who also participate in employer-sponsored pension plans also would be able to take advantage of these IRA breaks).

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 and only 25 percent of full-time workers in firms with between 10 and 24 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

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.

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 considerably 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 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 with high income 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 thus 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, Assistant Secretary of the Treasury for Tax Policy during the Clinton Administration, noted in Congressional testimony, "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. National saving

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.

equals the total of private savings and government (or public) 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 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.¹⁷

One question regarding the proposed IRA expansions is whether they would induce taxpayers to save more (and consume less) than they 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.”¹⁸ Similarly, a 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.”¹⁹ Some other economists have argued that IRAs have had a more positive effect on national saving.²⁰ But a substantial body of well-respected economists concurs that any such effect is small.

Because of the questionable 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

¹⁷ 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.

¹⁸ 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.

¹⁹ Lee Sheppard, "Roth IRAs: Should We Expand a Bad Idea?" *Tan Notes*, April 5, 1999.

²⁰ 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).

regarded economist and tax expert at the Congressional Research Service, recently concluded that “reducing the deficit is a better approach to increasing saving than devoting funds to IRAs.”²¹

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.

²¹ Jane Gravelle, "IRAs as Revenue-Raisers: A Critique," *Tax Notes*, February 28, 2000.

IV. The Progressive Matching Credit Included in the Moore Bill

As noted above, the Moore bill includes a nonrefundable income tax credit to encourage saving among lower- and middle-income families. Qualifying taxpayers would receive a credit of up to \$2,500 for contributions to a pension plan or IRA.

The percentage credit rate that applies to a taxpayer would depend on the taxpayer's income. Table 2 shows the percentage credit that would apply to various types of taxpayers in different income ranges.

To understand how the credit would work, consider a taxpayer qualifying for the 50 percent credit rate. The taxpayer would deposit \$5,000 into an IRA and receive a \$2,500 tax credit (50 percent of \$5,000). As a result, the *net* cost to the individual is \$2,500 (the \$5,000 upfront cost minus the \$2,500 tax credit). The 50 percent tax credit is thus the effective equivalent of a 100 percent matching rate: In return for a net contribution of \$2,500, the taxpayer has an account balance of \$5,000, the same as if the taxpayer put \$2,500 into the account, and had a \$2,500 match from the government.²²

The credit — especially at the 50 percent credit rate — thus appears quite generous; effective matching rates of 100 percent are high and are the type of strong incentive that should help to encourage more lower-income families to save for retirement. *But the generous credit is more apparent than real.* The credit is not refundable — that is, if a family has no income tax liability for the credit to offset, the credit is forfeited. Since the lower-income families that are eligible on paper for the 50 percent credit generally have no income tax liability for the credit to offset, the credit is not available to them.

As shown in Table 2, the 50 percent credit rate would be available only to married couples filing jointly that have Adjusted Gross Income (AGI) of \$20,000 or less, heads of household with AGI of \$15,000 or less, and single filers with AGI of \$10,000 or less. The vast majority of such filers have no income tax liability. Since the tax credit is nonrefundable, they could receive no benefit from it.²³

²² The system is not precisely the equivalent of a 100 percent match, since the individual must have sufficient financial resources to "front" the government credit amount. In other words, the individual must have access to \$2,000 to deposit into the account. If the deposit is made during the calendar year, the tax credit will not be immediately available (since tax returns are not processed until the following spring). The individual could theoretically adjust his or her withholding rate to reflect the credit, but few individuals take such action in practice.

²³ The income tax liability that is relevant for measuring the incentives provided by the credit is the pre-EITC income tax liability. If a tax filer has no pre-EITC tax liability for the proposed credit to offset, the filer's net tax (after the EITC) is unaffected by the existence of the credit. (The only exception is families with three or more children; for such families, the child credit is partially refundable. For some families with three or more children, the savings tax credit may therefore be beneficial even if they have a zero pre-EITC tax liability, since they could receive a larger child credit refund. But families with incomes below \$20,000 do not generally qualify for the partially refundable portion of the child credit. This caveat is therefore not relevant for the 50 percent credit under the proposal.)

Table 2
Adjusted Gross Income Thresholds for Eligibility for the Saving Tax Credit

Credit Rate	Married Couples Filing Jointly	Heads of Households	Single Filers
50 percent	\$0-\$20,000	\$0-\$15,000	\$0-\$10,000
30 percent	\$20,001-\$25,000	\$15,001-\$18,750	\$10,001-\$12,500
25 percent	\$25,001-\$30,000	\$18,751-\$22,500	\$12,501-\$15,000
20 percent	\$30,001-\$35,000	\$22,501-\$26,250	\$15,001-\$17,500
15 percent	\$35,001-\$40,000	\$26,251-\$30,000	\$17,501-\$20,000
10 percent	\$40,001-\$45,000	\$30,001-\$33,750	\$20,001-\$22,500
5 percent	\$45,001-\$50,000	\$33,751-\$37,500	\$22,501-\$25,000
0 percent	Over \$50,000	Over \$37,500	Over \$25,000

For example, the \$15,000 limit for heads of households means that almost no such taxpayers could possibly receive the tax credit. In 2002, because of the standard deduction, personal exemptions, and child credit, a single parent with one child will begin to owe income tax when her Adjusted Gross Income reaches about \$16,000; this is above the \$15,000 limit for the 50 percent credit rate. Single parents with more children begin to owe income tax at higher income levels. As a result, single parents are automatically excluded from benefitting from the 50 percent credit rate.²⁴ Similarly, married couples with one child will not start owing income tax in 2002 until AGI reaches about \$21,000, slightly above the \$20,000 threshold for the 50 percent credit rate. Married couple with more than one child do not begin to owe income tax until AGI reaches higher levels. Thus, married couples with children also would automatically be ineligible for the 50 percent credit rate in 2002 and succeeding years.

The non-refundability of the credit means that it would provide no incentive for saving to the large majority of low-income families. Increases in the child credit, increases in the standard deduction for married filers, and reductions in the 15 percent marginal tax rate, all of which are under discussion, would make even more low-income families ineligible for the tax credit because they would increase the number of such families with no income tax liability.

The Moore bill includes less-generous credit rates for earners at somewhat higher income levels. For example, married couples earning between \$20,001 and \$25,000 would qualify for a

²⁴ It is possible that a very small number of heads of households, who qualify for that status because they care for a dependent who is not a child, may partially qualify for the 50 percent credit. But the vast majority of heads of households are single parents with children.

Table 3
Illustrative Examples of Credit Amounts for Married Couple With Two Children

Married Couple With Two Children				
Income (AGI)	Amount Deposited	Credit Rate on Paper	Credit Received	Actual Credit Rate
\$15,000	\$2,000	50%	0	0%
\$25,000	\$2,000	30%	0	0%
\$35,000	\$2,000	20%	\$400	20%
\$45,000	\$2,000	10%	\$200	10%

30 percent tax credit, and married couples earning between \$25,001 and \$30,000 would qualify for a 25 percent tax credit. Even at these lower credit rates, however, many families would still be automatically excluded: For example, among married couples with incomes between \$20,001 and \$30,000, more than one-third have no income tax liability. 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.

Tables 3 and 4 show that even among those who would benefit from the credit, the credit amounts are often small. A married couple with two children and \$35,000 in income would receive \$400 in exchange for depositing \$2,000 into a retirement account, a 20 percent credit rate (or an effective 25 percent matching rate, since the net contribution from the couple would be \$1,600 and the net contribution from the government would be \$400). A single parent with two children and \$35,000 in income would receive \$100 for making a \$2,000 contribution, an even-less-attractive 5 percent credit rate (or 5.3 percent effective matching rate). At \$45,000 in income, a single parent with two children would receive no credit, while a married couple with two children would receive only \$200 to offset the cost of the \$2,000 contribution.

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 for moderate-income earners) are problematic.

Conclusion

The proposed IRAs expansions would do nothing for most low- and middle-income families (since few such families are at the current \$2,000 IRA contribution limit), could

Table 4
Illustrative Examples of Credit Amounts for Single Parent With Two Children

Single Parent With Two Children				
Income (AGI)	Amount Deposited	Credit Rate on Paper	Credit Received	Actual Credit Rate
\$15,000	\$2,000	50%	0	0%
\$25,000	\$2,000	20%	\$400	20%
\$35,000	\$2,000	5%	\$100	5%
\$45,000	\$2,000	0%	0	0%

endanger pension coverage for some employees of small businesses, and may lead to a reduction in national saving. 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 would obtain much more beneficial results by establishing a refundable tax credit that matches contributions made to retirement savings accounts.