CENTER ON BUDGET AND POLICY PRIORITIES
820 First Street, NE, Suite 510, Washington, DC 20002
Tel: 202-408-1080 Fax: 202-408-1056 center@cbpp.org www.cbpp.org

June 4, 2004

AN UNWISE DEAL: WHY ELIMINATING THE INCOME LIMIT ON ROTH IRA'S IS TOO STEEP A PRICE TO PAY FOR A REFUNDABLE SAVER'S CREDIT

by William G. Gale and Peter R. Orszag[1]

Some House members are apparently considering a deal under which substantial new tax subsidies for saving would be provided to high-income households in exchange for a much less costly expansion of saving tax incentives for low- and moderate-income workers. In particular, the deal is said to involve eliminating the existing income limit on Roth IRAs in exchange for making the saver's credit refundable. The terms of this deal are heavily tilted toward high-income households, which is precisely the opposite of the direction that sound pension policy should be moving.

Existing tax incentives for pension saving are "upside down" because they give the strongest incentives to participate to higher-income households. The top 20 percent of the income distribution receives 70 percent of the tax breaks associated with 401(k)s and IRAs; the bottom 60 percent of the distribution receives only 11 percent of the total tax subsidy. Yet high-income households would likely save adequately for retirement even in the absence of tax incentives, and typically use pensions as a tax shelter, rather than as a vehicle to increase their saving.

Removing the income cap on Roth IRAs, even in exchange for making the saver's credit refundable, would move the pension system further in the wrong direction. Eliminating the Roth income cap would also impose steep revenue losses on the federal budget over the long term, and could cost as much as 10 percent of the actuarial deficit in Social Security over the next 75 years.

The Problems with Eliminating the Income Cap on Roth IRAs

Eliminating the income limit on Roth IRAs would exacerbate the flaws in the current pension system.[2] The benefits would flow exclusively to the highest income

[1] William G. Gale is the Arjay and Frances Fearing Miller Chair in Federal Economic Policy at the Brookings Institution and Co-Director of the Urban Institute-Brookings Institution Tax Policy Center. Peter R. Orszag is the Joseph A. Pechman Senior Fellow at Brookings and Co-Director of the Tax Policy Center. The authors thank Matt Hall, Brennan Kelly, and Emil Apostolov for outstanding assistance, Robert Greenstein for helpful comments, and especially Mark Iwry for the joint work upon which parts of this paper draws. The views expressed are the authors and should not be attributed to the trustees, officers, or staff of the Brookings Institution or the Tax Policy Center.

[2] The proposal may be presented as "creating a Retirement Saving Account" rather than eliminating the income limit on Roth IRAs. The Retirement Saving Account (RSA), however, is virtually identical to the Roth IRA except that, unlike the Roth, the RSA has no income limit.

households, which would drain federal revenue but produce little new private saving and would probably reduce national saving. It could also reduce pension coverage among lower- and middle-income workers. Some supporters of removing the income limits point to a potential "advertising" effect that would help low- and middle-income households, but the evidence and logic supporting the claim is specious. We address these issues in turn.

Who would benefit?

Since access to Roth IRAs currently begins to be curtailed at $150,000 for couples and $95,000 for singles, the only people who would directly benefit from eliminating the cap are married couples with incomes above $150,000 or singles with incomes above $95,000. Preliminary analysis using the retirement savings module from the Urban-Brookings Tax Policy Center (TPC) model suggests that more than two-thirds of the tax subsidies (in present value) from removing the income limit would accrue to the 2 percent of households with Adjusted Gross Income of more than $200,000. More than 20 percent of the benefits would accrue to the 0.4 percent of households with income of more than $500,000.[3]

Loss in revenue

Expanding the tax subsidies from Roth IRAs to high-income households would also significantly reduce revenue over the long term. The full cost, however, is not obvious during the 10-year budget window: The revenue loss on a Roth IRA does not occur when the funds are contributed (as under a traditional IRA), but rather when they are withdrawn free of tax. Therefore, the full revenue effect does not manifest itself for several decades -- when the budget will already be under severe pressure from the retirement of the baby boomers.

It is thus crucially important not to be misled by the revenue changes over the first few years. Instead, the changes should be examined in terms of their ultimate effect, or their effect in present value (which transforms the future revenue losses into their equivalent amount, with interest, today). The Congressional Research Service (CRS) has estimated that eliminating the income limit will, after two decades or so, reduce revenue by $8.7 billion a year.[4] The Tax Policy Center estimates suggest a cost by 2010 of between $5 and $12 billion a year in present value.[5] Over the next 75 years, the revenue loss could amount to as much as 10 percent of the actuarial deficit in Social Security.

---

[3] These distributional estimates are based on extrapolations from behavior among taxpayers who currently qualify for IRA contributions. As noted below, there is significant uncertainty about the precise take-up rate that would result from eliminating the Roth IRA income cap.

[4] Jane Gravelle, "Revenue effect of restricting the tax preferred savings proposal to retirement accounts," Memorandum, April 28, 2004. This estimate is based on current income levels.

[5] The range reflects the uncertainties inherent in projecting the take-up rates among higher-income households. The lower figure is based on extrapolations from behavior among taxpayers who currently qualify for IRA contributions, a group that excludes most taxpayers with incomes over $160,000. Higher-income households are likely to participate at a significantly higher rate. The higher figure is based on the

In addition to the revenue costs associated with removing the income limit on Roth IRAs, policy-makers should recognize that perpetuating a $5,000 maximum contribution to the Roth IRA is expensive. The CRS has estimated that perpetuating the $5,000 contribution limit, rather than allowing it to revert to the $2,000 limit that was in effect prior to the enactment of the 2001 tax legislation, would reduce revenue in the long term by $20 billion per year.

Effects on private saving

The revenue loss from removing the income cap on Roth IRAs might be worth the cost if it were likely to trigger significant increases in private saving. Instead, the result would likely be substantial shifting of assets by high-income households from taxable accounts into the tax-advantaged IRAs — and little increase in private saving. In commenting on a similar proposal in the late 1990s, then-Treasury Secretary Robert Rubin explained, "…if you don't have income limits, then you're going to be creating a great deal of benefit for people who would have saved anyway, and all of that benefit will get you no or very little additional savings."[6]

It is crucial to distinguish between contributions to tax-preferred accounts and net increases in private saving. Saving incentives do not raise private saving if contributions are financed by individuals shifting existing assets into the tax-preferred accounts. To raise private saving, the incentives must generate reductions in people's current spending and thus an increase in their overall saving. Since high-income households are more likely to hold significant assets outside of tax-preferred accounts than other households, high-income households can and typically do choose to finance their contributions with shifts in assets rather than reductions in spending. As a result, focusing pension tax preferences on higher-income workers reduces the likelihood that lost tax revenue will reflect net increases in private saving, rather than shifts in assets. The empirical evidence suggests that tax-preferred retirement saving undertaken by higher-income workers is much less likely to represent new saving (rather than asset shifting) than tax-preferred retirement saving undertaken by lower-income workers.[7]

National saving

Although removing the Roth income limit would be regressive and unlikely to raise private saving by very much, perhaps the biggest problem is that the change would undermine the objective of raising *national* saving. Tax incentives intended to boost pension saving will raise national saving only if they increase private saving by more

---

assumption that all tax filing units with more than $15,000 in taxable capital income would contribute to a Roth IRA if they were eligible to do so.

6 Press Briefing by Secretary of Treasury Robert Rubin, National Economic Advisor Gene Sperling, OMB Director Frank Raines, and Chair of Council of Economic Advisers Janet Yellen, June 30, 1997.

7 Early research on 401(k)s found that the saving plans raised saving at all levels of income. Subsequent research, which has improved upon the statistical techniques of earlier work, has tended to find that 401(k) plans have not saved among relatively high-income households, but may have raised saving of low-income households.

than the cost to the government of providing the incentive. (National saving is the sum of public saving and private saving. All else being equal, every dollar of lost tax revenue reduces public 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 revenue.)

The substantial long-term revenue loss and the likelihood of substantial asset shifting suggest that national saving would fall in response to removing the income limit on Roth IRAs. This emphasizes the short-sightedness and lack of wisdom in pursuing such a course.

Pension coverage

Another reason that private and national saving could fall is that removing the Roth IRAs income limit would make Roth IRAs available to many small business owners who are not currently eligible to make contributions to the accounts. These small business owners would then be able to scale back their employer-provided pension plans while still maintaining their own total contributions to tax-preferred saving accounts. For example, a small business owner who had set up a generous pension plan in order to maximize his or her own tax-preferred retirement saving may have an incentive to scale back that plan after gaining access to the Roth IRA. The scaling back of the pension plan could result in reduced pension saving and coverage among rank-and-file workers. For the same reason, removal of the Roth IRA income limit also could lead to less generous plans being established at new businesses than otherwise would be the case.

Advertising

A frequent claim by advocates of removing the Roth IRA income limits is that eliminating the limits could allow financial services firms to advertise more aggressively and thereby encourage more saving by moderate-income households. This claim is misleading. Three points are worth noting about this “advertising effect” argument:

- First, the advertisements used in the past (for example, prior to 1986, when there were no income limits on deductible IRAs) suggest that much of the advertising was designed to induce asset shifting among higher earners rather than new saving among lower earners. For example, one advertisement that ran in the *New York Times* in 1984 stated explicitly: “Were you to shift $2,000 from your right pants pocket into your left pants pocket, you wouldn't make a nickel on the transaction. However, if those different ‘pockets’ were accounts at The Bowery, you'd profit by hundreds of dollars ....Setting up an Individual Retirement Account is a means of giving money to yourself. The magic of an IRA is that your contributions are tax-deductible.”[8]

[8] William G. Gale, “Saving and Investment Incentives in the President’s Budget: The Effects of Expanding IRAs, Testimony before the Committee on Ways and Means, March 19, 1997.

- Second, given the types of advertising that are likely, it is implausible that low- and moderate-income households would increase use of IRAs more than high-income households would. For that to occur, not only would the advertising have to "trickle down" the income distribution but the effect of the advertising would have to grow relatively stronger as it moved down the income ladder.

- Third, those who contend that expanded advertising would yield large, broad-based benefits point to the experience with IRAs between 1981, when access to IRA tax breaks was expanded to include all wage earners, and enactment of the Tax Reform Act of 1986, when income limits were imposed on deductible IRAs. It is true that participation rates in IRAs declined after the 1986 reform, even among those with incomes below the new income limits. But the declines were modest in an absolute sense, and some decline in IRAs would have been expected anyway, given the rise in 401(k) availability (which can substitute for IRAs) and the reductions in marginal income tax rates in the 1986 Act (which reduced the tax advantages of saving in an IRA). Data from the IRS Statistics of Income suggest that 5.0 percent of those with Adjusted Gross Income of $20,000 or less contributed to an IRA in 1984, while in 1988, some 2.4 percent of those with Adjusted Gross Income of $20,000 or less did. The overall decline thus amounted to only about 2.5 percent of the households in this income group, and some decline would have been expected anyway, for the reasons just mentioned.

More broadly, with respect to the pre-1986 era when there were no income limits on tax-advantaged deposits in IRAs, the Congressional Research Service has concluded that "There was no overall increase in the savings rate [in this period]…despite large contributions to IRAs."[9] This suggests that the higher levels of IRA contributions in those years primarily represented asset shifting from other accounts, not new saving.

Making the Saver's Credit Refundable

The second component of the proposed deal – making the saver's credit refundable – represents sound policy.[10] The policy targets low- and moderate-income households. These households are more likely than the affluent to need to save more to maintain living standards in retirement. They are also more likely than high-income households to increase their net saving when they participate in tax-preferred plans.

[9] Congressional Research Service, "Effects of LSAs/RSAs Proposal on the Economy and the Budget," January 6, 2004. For surveys of this issue, see James Poterba, Steven Venti, and David Wise, "How Retirement Saving Programs Increase Saving," *Journal of Economic Perspectives*, Vol. 10 No. 4 (Fall 1996), pp. 91–112, and Eric M. Engen, William G. Gale, and John Karl Scholz, "The Illusory Effect of Saving Incentives on Saving," *Journal of Economic Perspectives* Vol. 10 No. 4 (Fall 1996), pp. 113–38;

[10] For further analysis of the saver's credit, see William G. Gale, J. Mark Iwry, and Peter R. Orszag, "The Saver's Credit: Issues and Options," Retirement Security Project, Brookings Institution, May 2004.

Thus, making the savers' credit refundable would not only likely raise national saving but would also help people save adequate amounts for retirement.

The saver's credit provides a matching tax credit for contributions made to IRAs and 401(k) plans. The eligible contributions are limited to $2,000. Joint filers with income of $30,000 or less, and single filers with income of $15,000 or less, are eligible for a maximum 50 percent tax credit.[11] A smaller credit rate applies up to $50,000 in income for joint filers.

IRS data indicate that more than 5 million tax filing units claimed the credit in 2002, the first year it was in effect. Preliminary estimates of the distributional effects of the saver's credit using the Urban-Brookings Tax Policy Center micro-simulation model suggest that roughly 60 percent of the benefits accrue to filers with AGI of $30,000 or under. Despite the promise of the saver's credit in helping to address the upside-down nature of the nation's savings incentives, several crucial details of the credit as enacted result in its being of limited value:

- First, the saver's credit officially sunsets at the end of 2006. The cost of making the saver's credit permanent, without any other changes, is between $1 and $2 billion a year.

- Second, the credit is currently not refundable. That means that millions of moderate-income households receive no incentive from it because they have no income tax liability against which to apply the credit. In particular, 61 million returns have incomes low enough to qualify for the 50 percent credit. Since the credit is non-refundable, however, only about one-sixth of these tax filers could actually benefit from the credit at all if they contributed to an IRA or 401(k). Furthermore, only 64,000 — or roughly one out of every 1,000 — of the returns that qualify based on income could receive the maximum possible credit if they made the maximum eligible contribution. Refundability would add $2 billion to $3 billion per year to the cost of the credit and promote saving among millions of low- and moderate-income households.[12] A refundable saver's credit would help level the playing field for saving incentives provided through the tax system and would make more universal the availability of matching funds to spur retirement-account contributions.

[11] A 50 percent tax credit is the equivalent of a 100 percent match on an after-tax basis: A $2,000 contribution generates a $1,000 credit on the individual's tax return, so that the net after-tax contribution by the individual is $1,000, and the government's implicit contribution is $1,000.

[12] Note that concerns sometimes raised about whether some refundable credits may be prone to abuse are not applicable to making the saver's credit refundable. To qualify for the saver's credit, an individual must make a contribution to a tax-preferred account, which is verified by third-party reporting by the IRA trustee or plan administrator.

Conclusion

Although the saver's credit should be extended past 2006 and be made refundable, eliminating the income limit on Roth IRAs – which would reduce revenue by between 5 and 10 percent of the Social Security deficit over the long term and would exclusively benefit married couples with incomes above $150,000 and singles with incomes above $95,000 – is too steep a price to pay. The revenue loss from eliminating the income cap on Roth IRAs, on an apples-to-apples basis, is well over twice the cost of making the saver's credit refundable.

In the face of massive long-term budget deficits, and especially since recent pension policy changes have been heavily tilted toward higher earners, the nation simply cannot afford yet more tax subsidies for asset shifting among high-income households. Perhaps more importantly, making the saver's credit refundable is a sound policy option that would raise saving among those who need it most and likely raise national saving. It is unclear why any "price" should have to be paid to enact such sensible policy.