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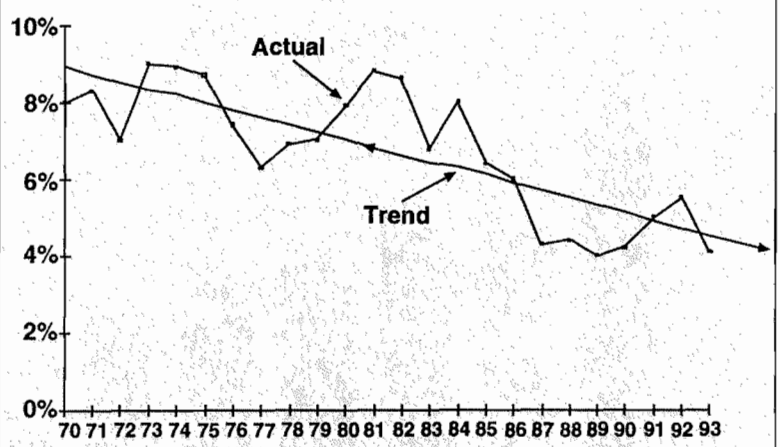
The Case for Expanded IRAs

The fraction of income that Americans save is well below the saving rate of other countries. We also save less than the amount we need to invest in order to sustain even moderate economic growth. Given that we want economic growth, we have two choices. Americans must either import funds for investment from other countries or increase their saving rate. Expanded opportunities to make deposits to Individual Retirement Accounts (IRAs) are a proven way of encouraging more savings.

Why Our Saving Rate Is Too Low. In recent years the domestic saving rate in the United States has been inadequate to finance domestic investment. In 1993, for example, gross saving (including the retained earnings of corporations) amounted to $787.5 billion and gross private domestic investment came to $882 billion. Thus the United States was forced to import $92.3 billion in investment funds from other countries.

FIGURE I

Personal Saving Rate[1]



[1] Saving as a percent of disposable personal income.

Source: Department of Commerce.

The decline in personal savings has been going on for some time. As Figure I illustrates, the personal saving rate in the United States has fallen from more than 8 percent in the early 1980s to about half that level today. Getting the saving rate back up to 8 percent — which as Figure II shows, would still be low by international standards — would add more than $180 billion annually to the supply of national savings. This would eliminate the need for capital imports and add close to $100 billion to the capital stock annually.

The Role of Government Deficits. The federal budget deficit usually receives the blame for our saving problem, on the theory that government borrowing to finance the deficit takes funds that otherwise could have been invested and diverts these funds to spending programs that mainly expand consumption. However, saving decisions by households are more important than the deficit. For example, personal savings fell from $247.9 billion in 1992 to $192.6 billion in 1993. This $55.3 billion decline was greater than the $42.8 billion decline in the budget deficit over the same period.

Less saving was available to finance investment in 1993 than in 1992, despite a 17 percent decline in the deficit. As a consequence, U.S. imports of foreign capital increased.

Why Don't Americans Save More? Although there are many reasons for our low saving rate, including social and demographic factors, economists have identified tax policy as a major culprit. In particular, the income tax greatly increases the cost of saving relative to consumption. This is because the benefits of consumption — pleasure, satisfaction or well-being — are not taxed, whereas the returns on savings (interest, dividends, etc.) are taxed. Thus there is an inherent tax bias against saving.

In order to eliminate this bias and treat saving and consumption equally, individuals should be allowed either to deduct savings from their taxable income or to receive the income from savings tax-free. Either method would provide tax neutrality — insuring that the decision to save or consume one's income would not be affected by the tax law.

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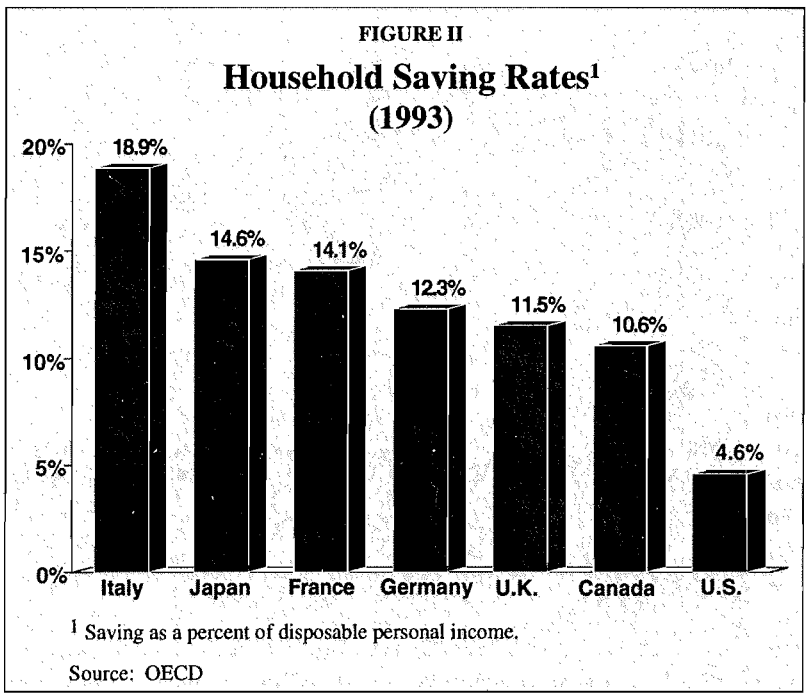
How IRAs Can Help. Under current law, contributions to IRAs are deducted from gross income, and the return on IRA savings is allowed to grow tax-free. Note that even IRAs do not fully provide tax neutrality because contributions are limited to $2,000 per year, and restricted by income. In addition, all withdrawals are fully taxable and withdrawals before age 59 1/2 are penalized.

Critics claim that individuals shift funds from taxable accounts to IRAs without increasing their total savings. While some shifting may occur, especially among those with high incomes, it is limited because most people don't have many financial assets to begin with. According to the Federal Reserve, the median value of financial assets for all U.S. families is just $13,100 — a figure which includes IRA accounts. Consequently, the vast majority of Americans have a limited capacity to shift funds into IRAs from other savings. Although they may shift funds initially, after a few years they would have to increase their saving rate in order to get the maximum tax saving from an IRA.



Studies by Professors Steven Venti of Dartmouth, David Wise of Harvard, Glenn Hubbard of Columbia and Jonathan Skinner of the University of Virginia have clearly shown that IRAs increase the rate of personal saving. These studies show that as much as 80 cents of each dollar deposited to IRAs represent new savings.

The Need For "Backended" IRAs. Unlike existing IRAs that allow tax-free deposits and impose taxes on withdrawals, contributions to this new IRA would be made with aftertax funds and withdrawals would be tax-free. If the tax rate is the same at the time of deposit and the time of withdrawal, taxpayers would be indifferent between the two types of IRAs. However, most middle-income workers will face higher tax rates during the years of their retirement, because of the Social Security benefits tax. As a result, the backended IRA would be more attractive to them.

Proposed Legislation. All Republicans running for the House of Representatives have signed a "contract" that would eliminate income limits on IRA contributions. It would also create a backended IRA option, based on a proposal originally sponsored by Treasury Secretary Lloyd Bentsen (D-TX) and Senator Bill Roth (R-DE). The Republican plan would allow tax-free withdrawals for college education expenses of IRA holders, their children and grandchildren; first-time home purchases; medical expenses and long-term care insurance premiums. These reforms should make IRA contributions much more attractive, especially for those with lower and middle incomes who might be afraid to tieup a large fraction of their financial assets in a more restricted IRA.

Do IRA Deposits Cause Revenue Losses for Government? NCPA studies show that IRA tax incentives more than pay for themselves. The initial loss of tax revenue is more than offset by additional revenue produced by the greater output that results from increased investment.

Moreover, with backended IRAs there is never an initial revenue loss. Revenue would increase in the short run because people would transfer funds from existing IRAs to the backended IRA and pay regular taxes on the amount transferred.

This Brief Analysis was prepared by NCPA Senior Fellow Bruce Bartlett, an economist at the Alexis de Tocqueville Institution.