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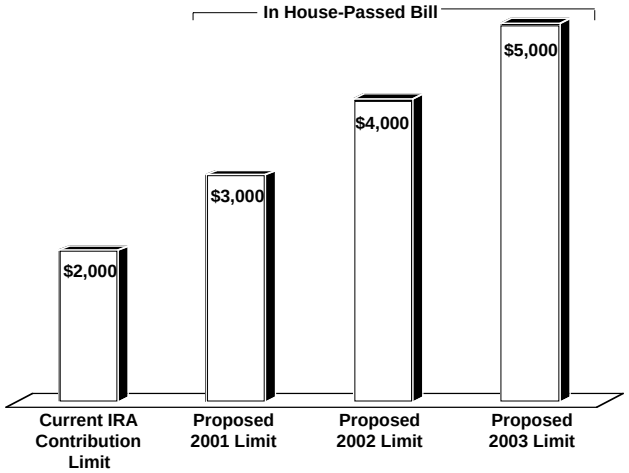
Should IRAs Be Expanded?

By Alan Reynolds

On July 19 the House voted to expand the amount taxpayers can invest in Individual Retirement Accounts (IRAs) and 401(k) retirement plans. With the help of 181 Democrats, the Republican-initiated proposal passed 401 to 25. Despite the measure's bipartisan support, it prompted a polemical attack from the White House, which issued a "fact sheet" against congressional tax bills, arguing they would drain money from the surplus, leave too little for "key priorities" (spending) and fail to equally benefit those who pay taxes and those who do not.

However, the estimated revenue loss from enlarging IRA and 401(k) contributions is trivial — only $5 billion a year in an economy approaching $10 trillion. If the retirement savings incentives were even modestly successful, the resulting improvement in economic growth could easily end up enlarging the surplus in later years because of tax revenue from the additional growth.

Proposed Changes in IRA Contribution Limit



Note: Limit goes to $5,000 in 2001 for persons over age 50.

New Opportunities to Save. The amount that people can contribute to an IRA has been frozen at $2,000 a year since 1981, when it was raised from $1,500. As the figure shows, the new bill raises the annual contribution limit for both regular and Roth IRAs to $3,000 in 2001, $4,000 in 2002 and $5,000 in 2003. Persons over age 50 can begin making the $5,000 contributions in 2001. Thereafter, the limit for all IRAs rises each year based on inflation. The bill also lifts the maximum 401(k) contribution in stages from $10,500 to $15,000 by 2005, with workers over 50 allowed to contribute an additional $5,000 a year. Limits on employer matches to employee contributions also are increased, and 401(k) contributions are indexed to inflation after 2005.

No Gift to the Rich. The White House has claimed that all the tax measures proposed by the Republican Congress are insufficiently generous to the middle class. This is mainly because one-third of taxpayers pay zero or less in income tax, while the top 10 percent pay about two-thirds of the total.

The notion that enlarged IRAs are a gift to the rich is not logical. Only singles with incomes below $30,000 or couples earning less than $50,000 will get a full tax deduction for their contributions to a traditional IRA. The tax deduction is scaled down for singles with incomes between $30,000 and $40,000 and couples with incomes between $50,000 and $60,000. Above those amounts, there is no tax deduction for IRA contributions.

Critics claim it would be nearly impossible for average families to save more than $2,000 in any year, since median household income was only $38,885 in 1998, but that argument backfires. If few people use it, the tax deferral can scarcely drain the surplus. Also, critics overlook the fact that median household income is misleading because so many households include young single people or retired single people with low incomes.

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At ages 45 to 54, median income was $54,148 in 1998. Among married couples of all ages, median income was $54,276 in 1998 and is higher today. Married couples may not want to save 10 percent of their pretax incomes every year of their lives. But most would appreciate the opportunity to do so during the peak earning years of middle age, when they no longer have the many of the expenses of younger couples such as paying for a house or cars and schooling for their children.

Moreover, the traditional IRA is simply a way to *defer* taxes, not to escape them. By investing a small amount each year, the IRA saver ends up with a much larger income at retirement. That income is taxable when the money is withdrawn, and the resulting income generally results in a larger share of Social Security income being taxable, too. Unless the IRA earns less than the interest rate on government bills and bonds, the discounted present value of deferred future tax collections would exceed the short-term revenue loss from the deduction. In the long run, some studies have concluded that IRAs represent a net tax revenue *gain* to the government.

Eligibility for the Roth IRA is more generous. Individuals with incomes of $95,000 or less and couples with incomes of $150,000 or less can make a full contribution, with the allowable contribution gradually phasing out for individuals with incomes between $95,000 and $110,000 and couples with incomes between $150,000 and $160,000. Yet a Roth IRA contribution, made with after-tax dollars, involves no immediate tax deduction, so it can scarcely be a budget-buster over the brief 10-year period that supposedly worries the White House. On the contrary, conversions from traditional to Roth IRAs have produced a sizable revenue windfall. There is no additional tax at retirement under the Roth plan because the tax is paid before the money is invested.

Should We Wait for Complete Tax Reform? A seemingly high-minded objection from *The Economist* argues that the federal government should defer incremental (piecemeal) improvements to the tax code and that voters should wait for massive, fundamental reform. That could be a very long wait.

A key feature of fundamental reform is to be as neutral as possible when it comes to people choosing between saving for the future and immediate consumption. One way of doing that is the traditional IRA approach with no strings attached — i.e., to exempt saved income up front but subsequently tax the income withdrawn from that savings. This is the core of the Nunn-Domenici "Unlimited Savings Account" Tax first proposed by former Sen. Sam Nunn (D-Ga.) and Sen. Pete Domenici (R-N.M.).

An equivalent savings-neutral system would tax saved income up front but exempt the returns on the savings from additional taxation. The Roth IRA plan is a small step toward that version of neutrality, while the flat income tax embraces the full vision. In any fully reformed system, there would be no limit on the amount saved or on the amount one could earn and still qualify for savings-neutral tax treatment.

Conclusion. All that is proposed this year is raising the amount that can be saved. Not even the arbitrary eligibility constraints are changed. Although the new bill is far from ideal, it nonetheless moves in the direction of reform. Unlike President Clinton's "targeted" tax credits (targeted toward those most likely to vote correctly), expanded IRAs and 401(k)s present no obstacles to fundamental restructuring of the tax regime.

If there is a problem with lifting the limits on retirement savings, it is that Congress has not raised them higher. If there is a remotely plausible objection, it has not yet been voiced.

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