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Individual Retirement Accounts (IRAs): Issues and Proposed Expansion

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Individual Retirement Accounts (IRAs): Issues and Proposed Expansions

Summary

The Taxpayer Relief Act of 1997 increased benefits available under individual retirement accounts and on April 25, 2001 the Ways and Means Committee approved H.R. 10, a bill that would liberalize individual retirement accounts, primarily by increasing contribution limits. This legislation was included in the final tax cut bill, H.R. 1836, signed by the President on June 7, 2001. Similar proposals had been made in the 106th Congress, but President Clinton had proposed Retirement Savings Accounts (RSAs) that are similar in some respects to IRAs. (Special accounts dedicated to education are not considered in this paper).

Deductible contributions to IRAs can be made by individuals not covered by a pension plan and, under the 1997 revisions, to individuals with a plan up to an income limit. (Accounts with tax deferrals are available to everyone). The treatment is similar to that of a pension plan–contributions are deducted and withdrawals are taxed. This approach is also called a deductible or "front-loaded" account. The 1997 legislation also allowed a new type of IRA (the Roth IRA), where contributions are not deductible, but no tax is imposed on withdrawal (similar to the treatment of a tax exempt bond). This approach is also called a non-deductible or "back-loaded" plan. Both IRAs have income limits, with the limits higher for Roth IRAs. Back-loaded accounts are similar to front-loaded approaches in that they effectively exempt income from taxation under certain circumstances but differ in several ways including the structure of penalties for early withdrawals.

The major argument for IRAs is that they will increase private savings. In general, however, neither conventional economic theory nor the empirical evidence on savings effects tends to support an expectation that increased IRA contributions are primarily new savings. Back-loaded accounts are less likely to induce new private savings than are front-loaded ones. Recent evidence of the uncertainty of increasing savings with a higher rate of return is the juxtaposition of high returns in the stock market with a dramatic reduction in the personal savings rate. This fall in the savings rate in the face of high returns provides some evidence that expanded IRAs will not be successful in increasing savings rates.

Because of rollovers and the initial small accumulations of contributions in back-loaded plans, the 1997 IRA expansion had a very small revenue cost in the first few years, but will cost much more in the future. The proposed increases in contribution limits will also have a rising cost over time, in part because of phase-ins. IRA provisions are also viewed as a middle class savings plan. Although plans are phased out for very high income individuals, the participation in 1981-1986 was largely by the upper part of the income distribution who tend to benefit most from IRAs; a limit increase will be more focused on higher income individuals.

The Clinton Administration's RSA plan had larger per dollar subsidies, that are more limited in size and income eligibility than IRA expansion. RSA benefits are more targeted than IRAs to lower and moderate income individuals. This report will be updated as legislative developments warrant.

Contents

Individual Retirement Accounts (IRAs): Issues and Proposed Expansions

The 1997 budget agreement between the President and congressional leaders allowed for a tax cut, and both the President's proposal, and the House and Senate versions of the bill included an expansion of Individual Retirement Accounts (IRAs), which was ultimately adopted as part of the Taxpayer Relief Act of 1997. The proposal expanded the availability of existing deductible IRAs to higher income individuals and offered an alternative "back-loaded" plan (Roth IRA) which did not allow a deduction for contributions but imposed no tax on withdrawals.

The bill also adopted some tax favored educational savings accounts similar to IRAs; these accounts are not considered in this paper.

On April 25, 2001, the Ways and Means Committee reported H.R. 10, a bill that would increase the limits on contributions to IRAs (as well as changing a number of tax rules affecting pensions). Changes in IRAs would cost $34 billion over ten years and is virtually identical to legislation considered in 2000 Congress. In that session there were a number of bills introduced to expand IRA benefits and coverage. The Taxpayer Refund and Relief Act of 1999, approved by both the House and Senate but vetoed by the President, would gradually increase the contribution limits to $5000 and increase income limits for Roth IRAs. Other bills proposed to increase the contribution limit. A Senate proposal also included nonrefundable credits targeted to lower and moderate income individuals, applying to IRAs and elective deferrals. These credits cost $8 billion over 5 years and $8.3 billion over 10 years. President Clinton proposed a different plan, to institute Retirement Savings Accounts (RSAs) that would involve refundable tax credits to be deposited into retirement accounts.

The Senate and final version of the tax cut bill for 2001, H.R. 1836, signed by the President on June 7, 2001, included credits for IRAs aimed at lower income individuals, but these credits are not refundable and sunset in 2006. With the slower phase in, this bill cost $25.1 billion over ten years; the refundable credits, which applied to both IRAs and elective deferrals, cost $9.9 billion during the five years it is effective.

This report provides background information on IRAs, including a description of current law, a discussion of the magnitude and nature of tax benefits incurred, and discussions of the effects on savings, the distribution of benefits, the revenue costs, and the administrative costs. The final section discusses new proposals and briefly contrasts the effects of RSA and IRA proposals. The Appendix contains a history of the development of IRAs.

Current Rules Regarding Individual Retirement Accounts

Eligible individuals can contribute up to $2,000 to IRAs. There are two different types of IRAs available, and the $2,000 limit applies to the total contributed to both types. The traditional, front-loaded, IRA allows a deduction for contributions to an IRA, and taxes are not paid until funds are withdrawn. This tax treatment is similar to the treatment of private pension. The back-loaded, or Roth, IRA does not allow a deduction, but applies no tax to the earnings; its treatment is similar to that of a tax exempt bond.

IRA limits will be increased to $3,000 in 2002-2004, to $4,000 in 2005-2007 and $5,000 in 2008. Limits will then be indexed for inflation. Limits for individuals over 50 will increase a further $500 in 2002 and $1,000 in 2006.

Eligible individuals are those not covered by employer plans (or whose spouses are not covered by employer plans) and those covered by employer plans with incomes below certain phase-out ranges (where the ceiling on contributions is gradually reduced to zero), which differ between the two types of IRAs.

For deductible IRAs, for joint returns, the phase-out is $50,000 to $60,000 for 1998, increased by $1,000 for the next 4 years, is $60,000 to $70,000 in 2003, $65,000 to $75,000 in 2004, $60,000 to $80,000 in 2005, $75,000 to $85,000 in 2006 and $80,000 to $100,000 in 2007. For single taxpayers, the phase-out is $30,000 to $40,000 in 1998, increases by $1000 for the next 4 years, is $40,000 to $50,000 in 2003, $45,000 to $55,000 in 2004, and $50,000 to 60,000 in 2005 and after. An individual whose spouse is an active participant in an employer plan is eligible for an IRA that is phased out between $150,000 and $160,000.

Individuals not eligible for the deductible IRA can nevertheless make nondeductible contributions to a traditional IRA; taxes on the earnings are not due until funds are withdrawn. This treatment is not as beneficial as the full IRA treatment.

The maximum contribution for back-loaded (Roth) IRAs is considerably higher. It is phased out for individuals a $95,000 to $110,000 and for joint filers at $150,000 to $160,000.

Contributions are limited to $2,000 or total earnings, whichever is less; contributions could also be made for a non-working spouse (but total contributions for a married couple could not exceed total earnings).

A 10% penalty is imposed on taxable amounts withdrawn before age 59 and ½, except in cases of death and disability, unless used for certain specified purposes (certain medical expenses, higher education and first-time home buyer expenses). Withdrawals from traditional, or front-loaded, IRAs must commence at age 70 and ½. (See CRS Report 96-20 EPW, for further details on the tax treatment of IRAs.)

Amounts can be transferred from traditional to Roth IRAs for individuals with incomes below $100,000, and there is an initial deferral of tax during the first 4 years after enactment.

Amounts in current IRAs could have been withdrawn and placed into the nondeductible IRAs without penalty prior to 1999. Amounts rolled over must have been included in income in equal increments over 4 years.

Tax Benefits of IRAs: Front-Loaded and Back-Loaded

The two types of IRAs–front-loaded (deductible) and back-loaded (nondeductible)–are equivalent in one sense, but different in other ways. They are equivalent in that they both effectively exempt the return on investment from tax in certain circumstances.

A 10% early withdrawal penalty applies to non-qualified withdrawals, which are generally withdrawals before age 59 and ½. (Certain withdrawals for specific purposes circumstances are not subject to the penalty tax; see CRS Report 97-935, Individual Retirement Accounts (IRAs): Changes Made by the Taxpayer Relief Act of 1997 for details.) No minimum distribution requirements apply to Roth IRAs. Taxes and penalties would not apply until the original contribution is recovered, and all IRAs would be aggregated for this purpose.

Equivalence of Types

A back-loaded IRA is just like a tax-exempt bond; no tax is ever imposed on the earnings.

Assuming that tax rates are the same at the time of contribution and withdrawal, a deductible, or front-loaded, IRA offers the equivalent of no tax on the rate of return to savings, just like a back-loaded IRA. The initial tax benefit from the deduction is offset, in present value terms, by the payment of taxes on withdrawal. Here is an illustration. If the interest rate is 10%, $100 will grow to $110 after a year – $100 of principle and $10 of interest. If the tax rate is 25%, $2.50 of taxes will be paid on the interest, and the after-tax amount will be $107.50, for an after-tax yield of 7.5%. With a front-loaded IRA, however, the taxpayer will save $25 in taxes initially from deducting the contribution, for a net investment of $75. At the end of the year, the $110 will yield $82.50 after payment of 25% in taxes, and $82.50 represents a 10% rate of return on the $75 investment.[1]

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[1] The current treatment for those not eligible for a deductible IRA–a deferral of tax–results in a partial tax, depending on period of time the asset is held and the tax rate on withdrawal. In our example, a deferral would produce an effective tax rate of 18% if held in the account for 10 years, and a tax rate of 13% if held for 20 years.

Differences in Treatment

There are, nevertheless, three ways in which these tax treatments can differ – if tax rates vary over time, if the dollar ceilings are the same, and if premature withdrawals are made. There are also differences in the timing of tax benefits that have some implications for individual behavior as well as revenue costs.

Variations in Tax Rates over Time. The equivalence of front-loaded and back-loaded IRAs only holds if the same tax rate applies to the individual at the time of contribution and the time of withdrawal in the case of front-loaded IRAs. If the tax rate is higher on contribution than on withdrawal, the tax rate is negative. For example, if the tax rate were zero on withdrawal in the previous example, the return of $35 on a $75 investment would be 46%, indicating a large subsidy to raise the rate of return from 10% to 46%. Conversely, a high tax rate at the time of withdrawal relative to the rate at the time of contribution would result in a positive tax rate. If tax rates are uncertain, and especially if it is possible that the tax rate will be higher in retirement, the benefits of a front-loaded IRA are unclear.

Dollar Ceilings. A given dollar ceiling that is binding for an individual for a back-loaded IRA is more generous than for a front-loaded one. If an individual has $2,000 to invest and the tax rate is 25%, all of the earnings will be tax exempt with a back-loaded IRA, but the front-loaded IRA is equivalent to a tax free investment of only $1500; the individual would have to invest the $500 tax savings in a taxable account to achieve the same overall savings, but will end up with a smaller amount of after tax funds on withdrawal.

Another way of explaining this point is to consider a total savings of $2,000, which, under a back-loaded account with an 8% interest rate would yield $9321 after, say, 20 years. With a front loaded IRA, an interest rate of 8% and a 25% tax rate (so $2000 would be invested in an IRA and the $500 tax savings invested in a taxable account) the yield would be $8595 in 20 years. In order to make a back-loaded IRA equivalent to a front loaded one, the back-loaded IRA would need to be 75% as large as a front-loaded one. (Since the relative size depends on the tax rate, the back-loaded IRA is more beneficial to higher income individuals than a front-loaded IRA, other things equal, including the total average tax benefit provided).

The importance of the dollar ceiling will diminish with the increase in contribution limits, which will eventually rise to $5,000.

Non-Qualified Withdrawals. Front-loaded and back-loaded IRAs differ in the tax burdens imposed if non-qualified withdrawals are made (generally before retirement age). This issue is important because it affects both the willingness of individuals to commit funds to the account that might be needed before retirement (or other eligibility) and the willingness to draw out funds already committed to an account.

The front-loaded IRA provides steep tax burdens for early year withdrawals which decline dramatically because the penalty applies to both principal and interest. (Without the penalty, the effective tax rate is always zero). For example, with a 28%

tax rate and an 8% interest rate, the effective tax burden is 188% if held for only a year, 66% for 3 years and 40% for 5 years. At about 7 years, the tax burden is the same as an investment made in a taxable account, 28%. Thereafter, tax benefits occur, with the effective tax rate reaching 20% after 10 years, 10% after 20 years and 7% after 30 years. These tax benefits occur because taxes are deferred and the value of the deferral exceeds the penalty.

The case of the back-loaded IRA is much more complicated. First, consider the case where all such IRAs are withdrawn. In this case, the effective tax burdens are smaller in the early years. Although premature withdrawals attract both regular tax and penalty, they apply only to the earnings, which are initially very small. In the first year, the effective tax rate is the sum of the ordinary tax rate (28%) and the penalty (10%), or 38%. Because of deferral, the effective tax rate slowly declines (36% after 3 years, 34% after 5 years, 30% after 10 years). In this case, it takes 13 years to earn the same return that would have been earned in a taxable account.[2]

Partial premature withdrawals will be treated more generously, as they will be considered to be a return of principal until all original contributions are recovered. This treatment is more generous than the provisions in the original Contract with America, where the reverse treatment occurred: partial premature withdrawals would be treated as income and fully taxed until the amount remaining in the account is equal to original investment.

These differences suggest that individuals should be much more willing to put funds that might be needed in the next year or two for an emergency in a back-loaded account than in a front-loaded account, since the penalties relative to a regular savings account are much smaller. These differences also suggest that funds might be more easily withdrawn from back-loaded accounts in the early years even with penalties. This feature of the back-loaded account along with the special tax-favored withdrawals make these tax-favored accounts much closer substitutes for short-term savings not intended for retirement.

It could eventually become more costly to make premature withdrawals from back-loaded accounts than from front-loaded accounts. Consider, for example, withdrawal in the year before retirement for all funds that had been in the account for a long time. For a front-loaded IRA, the cost is the 10% penalty on the withdrawal plus the payment of regular tax one year in advance – both amounts applying to the full amount. For a back-loaded account, where no tax or penalty would be due if held until retirement, the cost is the penalty plus the regular tax (since no tax would be paid for a qualified withdrawal) on the fraction of the withdrawal that represented earnings, which would be a large fraction of the account if held for many years. (Proposed new rules that allow principal to be withdrawn first would allow individuals to withdraw substantial amounts prior to retirement without any tax, however.)

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[2] These patterns are affected by the tax rate. For example, with a 15% tax rate, it takes longer for the IRA to yield the same return as a taxable account because penalties are larger relative to the regular tax rate–11 years for a front-loaded account and 19 years for a back-loaded one. In both cases, however, the back-loaded IRA has smaller initial tax burdens that decline more slowly and take longer to break-even by comparison with taxable investments.

Timing of Effects. The tax benefit of the front-loaded IRA is received in the beginning, while the benefit of the back-loaded IRA is spread over the period of the investment. These differences mean that the front-loaded IRA is both more costly than the back-loaded one in the short run (and therefore in the budget window) and that a front-loaded IRA is more likely to increase savings. These issues are discussed in the following two sections.

Receiving the tax benefit up front might also make individuals more willing to participate in IRAs because the benefit is certain (the government could, in theory, disallow income exemptions in back-loaded IRAs already in existence).

Some have argued that the attraction of an immediate tax benefit has played a role in the popularity of IRAs and may have contributed to increased savings (see the following discussion of savings).

Savings Effects

There has been an extensive debate about the effect of individual retirement accounts on savings.[3]

Conventional economic analysis and general empirical evidence on the effect of tax incentives on savings do not suggest that IRAs would have a strong effect on savings. In general, the effect of a tax reduction on savings is ambiguous because of offsetting income and substitution effects. The increased rate of return may cause individuals to substitute future for current consumption and save more (a substitution

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[3] For a more complete discussion of the savings literature, see Jane G. Gravelle. *The Economic Effects of Taxing Capital Income*, Cambridge, Mass., MIT Press, 1994, p. 27 for a discussion of the general empirical literature on savings and pp. 193-197 for a discussion of the empirical studies of IRAs. Subsequent to this survey, a new paper by Orazio P. Attanasio and Thomas C. DeLeire, IRA's and Household Saving Revisited: Some New Evidence, National Bureau of Economic Research Working Paper 4900, October 1994 was published. That study found little evidence that IRAs increased savings. For additional surveys see the three articles published in the Fall 1996 *Journal of Economic Perspectives*, (vol. 10): R. Glenn Hubbard and Jonathan Skinner, "Assessing the Effectiveness of Savings Incentives," (p. 73-90); James M. Poterba, Steven F. Venti and David A. Wise, "How Retirement Savings Programs Increase Saving," (p. 91-113): Eric M. Engen, William G. Gale, and John Karl Scholz, "The Illusory Effects of Savings Incentives on Saving," (p. 113-138). An International Monetary Fund working paper by Alun Thomas and Christopher Towe, U.S. Private Saving and the Tax Treatment of IRA/401(k)s: A Re-examination Using Household Saving Data (August 1996) found that IRAs did not increase private household saving. A study by Eric M. Engen (Federal Reserve Board)and William G. Gale (Brookings Institution) found that 401(k) plans, which are similar to IRAs in some ways, did not have much effect on savings. See "Debt, Taxes, and the Effects of 401(k) Plans on Household Wealth Accumulation, May 1997. A recent simulation study in the *American Economic Review*, while not based on direct empirical evidence, suggests only a small fraction of IRA contributions represent net savings. See Ayse Imrohoroglu, Selahattin Imrohoroglu, and Douglas H. Joines, "The Effect of Tax-Favored Accounts on Capital Accumulation," (vol. 88, September 1998, pp. 749-768).

effect), but, at the same time, the higher rate of return will allow individuals to save less and still obtain a larger target amount (an income effect). The overall consequence for savings depends on the relative magnitude of these two effects. Empirical evidence on the relationship of rate of return to saving rate is mixed, indicating mostly small effects of uncertain direction. In that case, individual contributions to IRAs may have resulted from a shifting of existing assets into IRAs or a diversion of savings that would otherwise have occurred into IRAs.

Recent evidence of the uncertainty of increasing savings with a higher rate of return is the juxtaposition of high returns in the stock market with a dramatic reduction in the personal savings rate. This fall in the savings rate in the face of high returns provides some evidence that expanded IRAs will not be successful in increasing savings rates.

The IRA is even less likely to increase savings because most tax benefits were provided to individuals who contributed the maximum amount – eliminating any substitution effect at all. (Note that over time, however, one might expect fewer contributions to be at the limit as individuals run through their assets). For these individuals, the effect of savings is unambiguously negative, with one exception. In the case of the front-loaded, or deductible IRA, savings could increase to offset part of the up-front tax deduction, as individuals recognize that their IRA accounts will involve a tax liability upon withdrawal. The share of IRAs that were new savings would depend on the tax rate–with a 28% tax rate, one would expect that 28% would be saved for this reason; with a 15% tax rate, 15% would be saved for this reason. This effect does not occur with a back-loaded or nondeductible IRA. Thus, conventional economic analysis suggests that private savings would be more likely to increase with a front-loaded rather than a back-loaded IRA.

Despite this conventional analysis, some economists have argued that IRA contributions were largely new savings. The theoretical argument has been made that the IRAs increase savings because of psychological, "mental account," or advertising reasons. Individuals may need the attraction of a large initial tax break; they may need to set aside funds in accounts that are restricted to discipline themselves to maintain retirement funds; or they may need the impetus of an advertising campaign to remind them to save. There has also been some empirical evidence presented to suggest that IRAs increase savings. This evidence consists of (1) some simple observations that individuals who invested in IRAs did not reduce their non-IRA assets and (2) a statistical estimate by Venti and Wise that showed that IRA contributions were primarily new savings.[4]

The fact that individuals with IRAs do not decrease their other assets does not prove that IRA contributions were new savings; it may simply mean that individuals who were planning to save in any case chose the tax-favored IRA mechanism. The Venti and Wise estimate has been criticized on theoretical grounds and another study

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[4] This material has been presented by Steve Venti and David Wise in several papers; see for example, Have IRAs Increased U.S. Savings?, *Quarterly Journal of Economics*, v. 105, August, 1990, pp. 661-698.

by Gale and Scholz using similar data found no evidence of a savings effect.[5] A study by Manegold and Joines comparing savings behavior of those newly eligible for IRAs and those already eligible for IRAs found no evidence of an overall effect on savings, although increases were found for some individuals and decreases for others; a study by Attanasio and DeLeire also using this approach found little evidence of an overall savings effect.[6] And, while one must be careful in making observations from a single episode, there was no overall increase in the savings rate during the period that IRAs were universally available, despite large contributions into IRAs. Similarly, the household savings rate continued (and actually accelerated) its decline after expansion of IRAs in 1997.[7]

It is important to recognize that this debate on the effects of IRAs on savings concerned the effects of front-loaded, or deductible IRAs. Many of the arguments that suggest IRAs would increase savings do not apply to back-loaded IRAs such as the Roth IRA. For example, back-loaded IRAs do not involve the future tax liability that, in conventional analysis, should cause people to save for it.

Indeed, based on conventional economic theory, there are two reasons that the introduction of back-loaded IRAs may decrease savings. First, those who are newly eligible for the benefits should, in theory reduce their savings, because these individuals are higher income individuals who are more likely to save at the limit. The closer substitutability of IRAs with savings for other purposes would also increase the possibility that IRA contributions up to the limit could be made from existing savings. Secondly, those who are currently eligible for IRAs who are switching funds from front-loaded IRAs or who are now choosing back-loaded IRAs as a substitute for front-loaded ones should reduce their savings because they are reducing their future tax liabilities.

Also, many of the "psychological" arguments made for IRAs increasing savings do not apply to the back-loaded IRA. There is no large initial tax break associated with these provisions, and the funds are less likely to be locked-up in the first few years because of the penalty applying to withdrawals is much smaller. In addition, funds are not as tied up because of the possibility of withdrawing them for special purposes, including ordinary medical expenses.

Overall, the existing body of economic theory and empirical research does not make a convincing case that the expansion of individual retirement accounts,

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[5] See William G. Gale and John Karl Scholz, IRAs and Household Savings, *American Economic Review*, December 1994, pp. 1233-1260. The most detailed explanation of the modeling problem with the Venti and Wise study is presented in Jane G. Gravelle, Do Individual Retirement Accounts Increase Savings? *Journal of Economic Perspectives*, Vol. 5, Spring 1991, pp. 133-148.

[6] See Douglas H. Joines and James G. Manegold, IRAs and Savings: Evidence from a Panel of Taxpayers, University of Southern California; Orazio P. Attanasio and Thomas C. DeLeire, IRA's and Household Saving Revisited: Some New Evidence, National Bureau of Economic Research Working Paper 4900, October 1994.

[7] See CRS Report RS20224, The Collapse of Household Savings: Why Has It Happened and What Are Its Implications? By Brian Cashell and Gail Makinen, June 7, 1999.

particularly the back-loaded accounts which were included in the recent legislation, will increase savings.

Revenue Effects

The revenue loss from IRAs varies considerably over time.[8] For a back-loaded IRA, the cost grows rapidly over time and the long-run revenue cost (in constant income levels) is about eight times as large as in the first 5 years, even with no rollovers from existing accounts allowed. Front-loaded IRAs also have an uneven pattern of revenue cost, although they are characterized by a rise to a peak (as withdrawals occur) and then a steady state cost that could be a third or so larger than in the first 5 years. The losses from restoring IRA coverage for everyone could eventually amount to $11 billion a year or so, or $66 billion for 5 years, in current income levels.[9]

The IRA proposal costs are also affected by the provision allowing a rollover of existing front-loaded IRAs into back-loaded IRAs over a 4-year period. This effect raises tax revenue in the short run although, of course, the rollover will result in lost revenues (with interest) in future years.

Some indication of this pattern can be seen from the 11-year estimates (fiscal years) of the cost of IRA provisions introduced in 1997. The costs beginning with FY1998 (in billions) were $0.4, $0.4, then a gain of $0.1, then a cost of $0.4, $0.9, $1.8, $3.3, $3.8, $4.4, and $5.0 billion.[10]

The IRA provisions, therefore, were projected ultimately to result in a significant annual revenue loss.[11]

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[8] See Jane G. Gravelle, Testimony before the Committee on Finance, Subcommittee on Deficits, Debt Management and International Debt, United States Senate, April 12, 1991 and Jane G. Gravelle, Estimating the Long-Run Revenue Effects of Tax Law Changes, *Eastern Economic Journal*, Vol. 19, No. 4, Fall 1993, for analysis of the long run revenue costs of IRAs.

[9] This is an estimate of the long-run cost of S. 612 in 1991 which allowed a choice between front-loaded and back-loaded IRAs (assuming that half went into each) provided in a Congressional Research Service memorandum by Jane G. Gravelle dated March 5, 1992. Since current IRAs are relatively small and the allocation between types does not matter very much, an estimate of similar magnitude might be made for the 1997 revisions.

[10] Conference Report to Accompany H.R. 2014, the Taxpayer Relief Act of 1997, July 30, 1997. Report 105-220, U.S. Congress, House, 105th Congress, 1st Session.

[11] If IRAs were all new savings, there would be no revenue cost except for the initial gain from rollover of existing IRAs followed by a future loss because any earnings on IRAs would be net additions to income. As indicated in the previous section, however, the empirical evidence does not support this view.

Thus, the revenue losses in the initial period understates the losses that will occur in the long run due to the shift to back-loaded accounts. The long phase-in of increased limits for deductible IRAs also causes costs to be lower in the short run.

The increases in IRA limits enacted in 2001 are estimated to increase revenue costs by $2.1 trillion in 2011 and $25.1 trillion for the years 2001-2011.

Distributional Effects

Who benefitted from the expansion of IRAs? In general, any subsidy to savings tends to benefit higher income individuals who are more likely to save. The benefits of IRAs for high income individuals are limited, however, compared to many other savings incentives because of the dollar limits. Nevertheless, the benefits of IRAs when universally allowed tended to go to higher income individuals. In 1986, 82% of IRA deductions were taken by the upper third of individuals filing tax returns (based on adjusted gross income); since these higher income individuals had higher marginal tax rates, their share of the tax savings would be larger.

In addition, when universal IRAs were available from 1981-1986, they were nevertheless not that popular. In 1986, only 15% of tax returns reported contributions to IRAs. Participation rates were lower in the bottom and middle of the income distribution: only 2% of taxpayers in the bottom third of tax returns and only 9% of individuals in the middle third contributed to IRAs. Participation rose with income: 33% of the upper third contributed, 54% of taxpayers in the top 10% contributed, and 70% of taxpayers in the top 1% contributed.

The expansion of IRAs was even more likely to benefit higher income individuals because lower income individuals are already eligible for front loaded (deductible) IRAs that confer the same general tax benefit. Less than a quarter of individuals (1993 data) had incomes too large to be eligible for any IRA deduction (because they are above $50,000 for married individuals and $35,000 for singles) and less than a third exceed the beginning of the phase-out range. Also, those higher income individuals not already covered by a pension plan were also eligible. Therefore, only higher income individuals who did not otherwise have tax benefits from pension coverage were excluded from IRA coverage before the 1997 revisions.

Overall, expansion of IRAs tends to benefit higher income individuals, although the benefits are constrained for very high income individuals because of the dollar ceilings and because of income limits. An expansion in dollar limits would be more focused, however, on higher income individuals who are more likely to be contributing at the limit and more likely to take full advantage of higher limits.

Administrative Issues

The more types of IRAs that are available, the larger the administrative costs associated with them. With the introduction of back-loaded accounts, three types of IRAs will exist–the front-loaded that have been available since 1974 (and universally

available in 1981-1986), the non-deductible tax deferred accounts available in prior law to higher income individuals and that are now superseded by more tax preferred plans for all but a very high income group and the new back-loaded accounts. Treatment on withdrawal will also be more complex, since some are fully taxable, some partially taxable, and some not taxable at all.

Another administrative complexity that will arise is the possibility of withdrawals prior to retirement for special purposes, including education and first time home purchase.

Policy Advantages of Front- vs. Back-Loaded IRAs

Most individuals now have a choice between a front-loaded and a back-loaded IRA. An earlier section discussed the relative tax benefits of the alternatives to the individual. This section discusses the relative advantages and disadvantages to these different approaches in achieving policy objectives.

From a budgetary standpoint, the short-run estimated cost of the front-loaded IRA provides a more realistic picture of the eventual long-run budgetary costs of IRAs than does the back-loaded. This issue can be important if there are long run objectives of balancing the budget or generating surpluses, which can be made more difficult if the costs of IRAs are rising. In addition, if distributional tables are based on cash flow measures, as in the case of the Joint Tax Committee distributional estimates, a more realistic picture of the contribution of IRA provisions to the total distributional effect of the tax package is likely to emerge. In that sense, allowing back-loaded IRAs, even as a choice, has probably made it harder to meet long-run budgetary goals because the budget targets did not take into account the out-year costs.

The front-loaded IRA is more likely to result in some private savings than the back-loaded IRA, from the perspective of either conventional economic theory or the "psychological" theories advanced by some; hence allowing back-loaded IRAs may have detracted from national savings objectives. Of course, a front-loaded IRA also has a larger revenue cost which offsets this private savings effect. Thus, overall national saving is only increased by a front-loaded IRA relative to a back-loaded IRA, under conventional analysis, if the difference in revenue costs is made up so that public saving is not different between a back-loaded and a front-loaded IRA (and that offsetting policy does not itself affect private savings.)

There are, however, some advantages of back-loaded IRAs. The back-loaded IRA avoids one planning problem associated with front-loaded IRAs: if individuals use a rule-of-thumb of accumulating a certain amount of assets, they may fail to recognize the tax burden associated with accumulated IRA assets. In that case, the front-loaded IRA would leave them with less after-tax assets in retirement than they had planned, a problem that would not arise with the back-loaded IRA where no taxes are paid at retirement. A possible second advantage of back-loaded IRAs is that the effective tax rate is always known (zero), unlike the front-loaded IRA where the effective tax rate depends on the tax rate today vs. the tax rate in retirement. Yet

another advantage is that the effective contribution limit in a back-loaded IRA is not dependent on the tax rate (although it would be possible to devise an adjustment to the IRA contribution ceiling based on tax rate).

New Proposals and Actions

Expanding IRAs vs. RSAs

H.R. 10 would have increased the limits for IRA contributions to $3,000 in 2002, $4,000 in 2003 and $5,000 in 2004, with inflation indexing thereafter. The revenue cost for this proposal would rise over time, beginning at $0.6 billion in FY2002 and $1.5 billion in FY2003, but rising to $5.8 billion by 2011. The cost would be $10 billion over 5 years and $34 billion over 10 years. This proposal was also passed by the House in 2000. The increase in IRAs in the final version of the omnibus tax cut bill would cost $25.1 billion over ten years, a smaller amount due to the slower phase in.

IRA proposals were also included in the 1999 general tax cut legislation that was vetoed (The Taxpayer Refund and Relief Act of 1999) and in other bills focused on more specific tax cuts. Proposals were also been made to allow penalty-free withdrawals for a variety of purposes. Senator Roth, Chairman of the Finance Committee, announced a proposal to eliminate the income limits on both types of IRAs in his outline of a proposed comprehensive tax cut on July 9, 1999. The proposal would have also increased the contribution limit to $5,000, along with eliminating income limits on Roth IRAs and increasing them on deductible IRAs. The proposals in the House version were more modest, and would increase the income limits on Roth IRAs. The final version of the Taxpayer Refund and Relief Act would have increased the contribution limit and the income limits on Roth IRAs. However, the income limits were not increased in the omnibus 2001 tax cut bill (H.R. 1836).

An argument can be made that such IRA contribution limits should be increased to preserve the real value of the limit as enacted in 1982. Using the GDP deflator, adjusting for price changes between 1982 and 1999 would have increased the limit to about $3,200. Assuming prices rise by 2.5% per year, the adjusted limit would be about $4,000 by 2008 when the $5,000 limit is fully phased in; it would be $4,175 with a price rise of 3% per year. Thus, expanding the limit to $5,000 by 2008 is a more generous contribution limit compared to 1982.

President Clinton earlier proposed a new system referred to as Retirement Savings Accounts (RSAs), which are similar to a front-loaded IRA in some ways. The RSA would cover taxpayers below certain income limits ($50,000 for a married couple, $25,000 for a single individual and $37,500 for a head of household, with phase outs beginning at half those amounts). Lower and middle income taxpayers would receive a 100% match of contributions, which would be phased down to 20%. An additional 100% match for the first $100 would be included. Contributions would be deductible. (The RSA proposals followed a more costly plan for Universal Savings Accounts, or USAs, proposed the previous year, which involved tax credits that actually paid for some of the individual cost of the contributions). The revenue

tax bill did include a credit aimed at lower income individuals that began at a 50% rate, but it was not refundable and was temporary. Because so many individuals will have no tax liability, it is difficult to direct savings subsidies at lower-income, and even some moderate-income, individuals without refundable credits.

Differences Between IRA Expansion and RSAs

The RSA proposal was more generous in its benefits per dollar of contribution than IRAs; not only would the returns not be taxed, but there is a subsidy; that is, the after tax return to a dollar contribution is greater than the pretax return. The RSA plan was estimated to cost about $54 billion over 10 years (considerably less than the original USA plan, which cost about $500 billion over 15 years). However, it is difficult to compare the long run costs of the two proposals, not only because of the differences in phase-out, but also because the RSA plan is like a front-loaded IRA so that current costs are similar to long run costs, whereas expansion of IRAs, to the extent accruing to back-loaded IRAs, will involve smaller short-run and intermediate-run costs than long-run costs.

Secondly, the RSA proposal was targeted to lower and moderate income individuals, while the IRA expansions would tend to benefit high income individuals. An increase in the income limit for IRAs would benefit the very small fraction of the population that has income in excess of the current Roth IRA earnings limits (less than 5% of tax returns).[12] Increases in dollar limits on contributions will also benefit higher individuals who are more likely to have IRAs, who are more likely to have IRAs at maximum levels, who are likely to increase contributions the most, and who have higher marginal tax rates that make tax forgiveness more valuable. Lower income individuals without tax liability can benefit from the RSA, but not from the IRA.

As with any new and broadly applicable program, an RSA would add complexity to tax administration and tax returns, while IRA expansion will add little in administrative and compliance costs, particularly since the individuals who become newly eligible are fairly sophisticated taxpayers.

It is difficult, however, to compare the two proposals' effects on savings. Low income individuals do not typically save and there may be relatively little effect of the RSA for that reason; however, the effect of IRAs on savings in general is uncertain. While an expansion of IRAs is more likely to positively affect savings than the initial IRA allowance (because it is more marginal), there is still no clear evidence that savings will rise.

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[12] Roth IRAs begin their phase-outs at $95,000 for single and $150,000 for joint returns. In 1997, 5.1% of all taxpayers had incomes above $100,000. See Scott M. Hollenbeck and Maureen Keeman Kahr, "Individual Income Tax Returns, 1997: Early Tax Estimates," Internal Revenue Service *Statistics of Income Bulletin*, Winter 1998-99, p. 138. Because of the income limits, which on average are well above $100,000 and the availability to those not covered by private pensions, lifting the income limit will benefit less than 5% of taxpayers.

Conclusion

Unlike the initial allowance of IRAs in 1974 to extend the tax advantage allowed to employees with pension plans, the major focus of universal IRAs has been to encourage savings, especially for retirement. If the main objective of individual retirement accounts is to encourage private savings, the analysis in this study does not suggest that we will necessarily achieve that objective. Moreover, the back-loaded approach allowed as an option is less likely to induce savings than the current form of IRAs or the form allowed during the period of universal availability (1981-1986). In addition, the ability to withdraw amounts for other purposes than retirement dilutes the focus of the provision on preparing for retirement. The recent expansion in the IRA limit may make the provisions more likely to provide a marginal incentive, but will also direct the benefits towards higher income individuals.

Both the IRA benefits adopted in 1997 and those adopted in 2001 may also put some pressure on national savings in the future, as the provisions involve a growing budgetary cost and these reductions in government savings will offset any private savings effects.

IRAs have often been differentiated from other tax benefits for capital income as the plan focused on moderate income or middle class individuals. The IRA has been successful in that more of the benefits are targeted to moderate income individuals than is the case for many other tax benefits for capital (e.g., capital gains tax reductions). Nevertheless, data on participation and usage, and the current allowance of IRAs for lower income individuals, suggest that the benefit will still accrue primarily to higher income individuals.

Certain features of the 1997 changes will complicate administrative costs, and there has been relatively little attention paid to the dramatic differences in the penalties for early withdrawal associated with back-loaded vs front-loaded accounts.

The RSA proposals made by the Clinton Administration, which are similar to IRAs in some ways, have more generous subsidy rates; however, they benefit lower and moderate income individuals rather than high income individuals. While a credit targeted at lower and moderate income individuals was included in the 2001 tax legislation, the credit will sunset and is not refundable, limiting its scope.

Appendix: A History of IRAs

Individual retirement accounts of the traditional type (front-loaded) were first allowed in 1974 (up to $1500 or 15% of earnings), in order to extend some of the tax benefits of employer pension plans to those whose employers did not have such plans. IRAs were made universally available in 1981 (and the limits increased to $2000) as a general savings incentive.

In 1986, IRAs were restricted for higher income individuals already covered by employer pension plans, as part of the general base broadening needed to reach the distributional and revenue neutrality goals of the Tax Reform Act of 1986. Those covered by employer plans with incomes less than $50,000 for married individuals and $35,000 for single individuals were not eligible. There was a $10,000 phase-out range (i.e. $40,000 to $50,000) where partial benefits are allowed. Deductible contributions were limited to $2,000 or total earnings, whichever is less; contributions could also be made for a non-working spouse (but total contributions for a married couple could not exceed total earnings). Individuals above the income limits could make non-deductible contributions and take advantage of tax deferral.

In the 101st Congress (1989-1990) several proposals to restore IRA benefits were made: the Super IRA, the IRA-Plus, and the Family Savings Account (FSA).

The Super-IRA proposal suggested by Senator Bentsen and approved by the Senate Finance Committee in 1989 (S. 1750) would have allowed one half of IRA contributions to be deducted and would have eliminated penalties for "special purpose" withdrawals (for first time home purchase, education, and catastrophic medical expenses). The IRA proposal was advanced as an alternative to the capital gains tax benefits proposed on the House side.

The IRA-Plus proposal (S. 1771) sponsored by Senators Packwood, Roth and others proposed an IRA with the tax benefits granted in a different fashion from the traditional IRA. Rather than allowing a deduction for contributions and taxing all withdrawals similar to the treatment of a pension, this approach simply eliminated the tax on earnings, like a tax-exempt bond. This IRA is commonly referred to as a back-loaded IRA. The IRA-Plus would also be limited to a $2,000 contribution per year. Amounts in current IRAs could be rolled over and were not subject to tax on earnings (only on original contributions); there were also special purpose withdrawals with a 5-year holding period.

The Administration proposal for Family Savings Accounts (FSAs) in 1990 also used a back-loaded approach with contributions allowed up to $2500. No tax would be imposed on withdrawals if held for 7 years, and no penalty (only a tax on earnings) if held for 3 years. There was also no penalty if funds were withdrawn to purchase a home. Those with incomes below $60,000, $100,000, and $120,000 (single, head of household, joint) would be eligible.

In 1991, S. 612 (Senators Bentsen, Roth and others) would have restored deductible IRAs, and also allowed an option for a nondeductible or back-loaded

"special IRA." No tax would be applied if funds were held for 5 years and no penalties would apply if used for "special purpose withdrawals."

In 1992 the President proposed a new IRA termed a FIRA (Flexible Individual Retirement Account) which allowed individuals to establish back-loaded individual retirement accounts in amounts up to $2,500 ($5,000 for joint returns) with the same income limits as proposed in the 101st Congress. No penalty would be applied for funds held for 7 years.

Also in 1992, the House passed a limited provision (in H.R. 4210) to allow penalty-free withdrawals from existing IRAs for "special purposes." The Senate Finance Committee proposed, for the same bill, an option to choose between back-loaded IRAs and front-loaded ones, with a 5-year period for the back-loaded plans to be tax free and allowing "special purpose" withdrawals. This provision was included in conference, but the bill was vetoed by the President for unrelated reasons. A similar proposal was included in H.R. 11 (the urban aid bill) but only allowed IRAs to be expanded to those earning $120,000 for married couples and $80,000 for individuals (this was a Senate floor amendment that modified a Finance Committee provision). That bill was also vetoed by the President for other reasons.

The Contract with America and the 1995 budget reconciliation proposal included proposed IRA expansions similar to the 1997 proposals (discussed below), but this package was not adopted. The Health Insurance Portability and Accountability Act of 1996 allowed penalty-free withdrawals from IRAs for medical costs.

In 1997, the President proposed to increase the adjusted gross income limits for the current IRAs to $100,000 for married couples (with a phase-out beginning at $80,000), and to $70,000 for individuals (with a phase out beginning at $50,000). Part of this expansion would have occurred in 1997-1999 (a joint phase out between $70,000 and $90,000 and a single phase-out between $45,000 and $65,000). Such a proposal would extend individual retirement account eligibility to the vast majority of taxpayers. Taxpayers would have had the option of choosing instead special, nondeductible, IRAs, with no taxes applying if the funds are held in the account for at least 5 years. The 10% penalty would not have been due for withdrawals during that period for post-secondary education, first-home purchase, or unemployment spells of 12 weeks or more. Existing deductible IRAs could be rolled over into nondeductible accounts with the payment of tax on withdrawals.

The House-proposed revisions were generally the same as those proposed in the House Republican Contract With America and included in the 1995 budget reconciliation proposal; and as those reported out of the Ways and Means Committee. This change would have allowed individuals to contribute up to $2,000 to a non-deductible or "back-loaded" IRA regardless of income, termed the American Dream Savings (ADS) account. The back-loaded IRA does not provide a tax deduction up front, but does not impose taxes on qualified withdrawals. The $2,000 would have been indexed for inflation after 1998. This provision would have been in addition to deductible IRAs (but would have replaced the current nondeductible accounts); earnings on withdrawals would not have been be taxed if held for at least 5 years and used for qualified purposes: withdrawals after age 59 and ½, left in the estate, attributable to being disabled, or withdrawn for down payment on a first home.

A 10% early withdrawal penalty would have continued to apply to non-qualified withdrawals, but withdrawals to pay for higher education expenses would not have been subject to the penalty tax. No minimum distribution requirements would have applied. Taxes and penalties would not have applied until the original contribution is recovered, and all IRAs would be aggregated for this purpose.

Amounts in current IRAs could have been withdrawn and placed into the nondeductible IRAs without penalty in prior to 1999. Amounts rolled over must have been included in income in equal increments over 4 years.

The Senate 1997 version would have raised the income limits on deductible IRAs from $50,000 to $60,000 for single returns and $80,000 to $100,000 for joint returns by 2004. These limits would be phased in: $30,000 to $40,000 for single and $50,000 to $60,000 for joint in 1998-9; $35,000 to $45,000 for single and $60,000 to $70,000 for joint 2000-1; $40,000 to $50,000 for single and $70,000 to $80,000 for joint in 2002-3. Individuals whose spouses are participants in an employer plan would have been eligible regardless of the income limit.

This proposal would also have introduced back-loaded accounts as a substitute for nondeductible accounts; individuals would have to reduce the contributions to these accounts by the amounts deductible from front-loaded accounts. These accounts were called IRA Plus accounts. The rules regarding withdrawals and penalties were similar to those in House bill, except that withdrawals without penalty were also allowed for long-term unemployment. There were no income limits for back-loaded IRAs.

The final bill followed the Senate version, with some alterations to the phase outs. The provision allowing exemption from withdrawal penalties for long-term unemployment is dropped.

The Senate version of Taxpayer Refund and Relief Act of 1999, would have increased contribution limits to $5,000, increased income limits for deductible IRAs and eliminated income limits for Roth IRAs. The House bill's provisions were much more limited: Roth IRA limits would have been increased. The final bill more closely followed the Senate version, although the income limits for Roth IRAs were to be increased with no change for deductible IRAs. The President vetoed the tax cut because of its large revenue cost. Several bills including IRA provisions saw some legislative action in 2000, but none were enacted.

The omnibus 2001 tax cut bill, H.R. 1836, would gradually increase contribution limits. IRA limits will be increased to $3,000 in 2002-2004, to $4,000 in 2005-2007 and $5,000 in 2008. Limits will then be indexed for inflation. Limits for individuals over 50 will increase a further $500 in 2002 and $1,000 in 2006. A tax credit beginning at 50%, but phasing down, would be allowed for lower income individuals.