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40 MILLION AMERICANS CAN'T BE WRONG: SAVE THE IRAS

INTRODUCTION

The tax reform bill recently voted out of the Senate Finance Committee is an historic document, deserving the broad support it is receiving. But amidst the lush garden produced by the committee lurks a snake--the provision sharply restricting the deduction for Individual Retirement Accounts (IRAs).

In the few years that IRAs have been available to most adults, they have proved extremely effective in expanding the ways that Americans can plan for a secure retirement. Already 40 million Americans have IRAs with a total value exceeding $250 billion. In 1985 alone, $70 billion was added to IRAs. Not only do the IRAs defer immediate consumption and mobilize capital for investment, they mobilize a massive and growing bloc of voters who have a stake in America's future economic stability. And IRAs encourage Americans to begin thinking in terms of how they can be responsible for their retirement rather than how the federal government should be.

Sharply limiting IRAs now would reverse this encouraging trend. It would limit substantially the ability of the private sector to provide an adequate retirement income for Americans. And this would lead to massively increased government spending to meet retirement needs.

IRAs have proved to be the most flexible retirement vehicle for today's highly mobile, diverse work force. In particular, IRAs are free of the portability and vesting problems which plague private pensions. Distressingly, the sharp restrictions on IRAs would fall most heavily on highly mobile young workers who find it difficult to earn significant vested pension rights. Rather than decimating the IRAs, policy makers should be trying to expand the system. Indeed, in its original tax reform package, the White House did just that. At the least, the present IRA system, including such retirement savings plans as 401(k) and 403(b), should be preserved. And if they cannot be preserved completely, they should be restored to their current level in phases over the next few years. The IRA deduction is not a loophole, not a special interest tax shelter, and not a tax avoidance scam. It is a way that 40 million Americans have begun saving for their retirement needs. To do to IRAs what the Senate Finance Committee tax bill would do would be to penalize all these Americans.

THE IRA SYSTEM AND THE PROPOSED RESTRICTION

Under current law, enacted in 1981, all workers earning $2,000 per year or more may contribute up to $2,000 per year to an IRA. Nonworking spouses may contribute up to $250 per year. All IRA contributions are currently tax-deductible, while the earnings on IRA investments accumulate free of current taxes. All withdrawals from an IRA are taxed as income. For withdrawals made before age 59-1/2, the taxpayer must in addition pay a tax penalty equal to 10 percent of the withdrawn amount. This is the same tax treatment accorded all pension plans, except for varying annual contribution limits and withdrawal policies.

The Senate Finance Committee tax reform bill would allow full IRAs as under current law only to workers without other pension plans. Workers covered by a plan still could contribute to their IRA up to current limits, but would receive no deduction for such contributions. The benefit for these workers would be that earnings from IRA investments would continue to accumulate tax free. Contributions would not be included in taxable income when withdrawn, since tax would already have been paid at the time of contribution, though returns earned over the years would be.

THE IRA SUCCESS STORY

IRAs have proved extremely effective in channeling private resources into retirement needs. The more than $250 billion in IRAs already comprises more than 15 percent of the total assets saved in pensions.[1] And the popularity of IRAs seems to be rapidly accelerating, with more and more individuals participating and making contributions each year.

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1. Investment Company Institute, Washington, DC; IRA Reporter, Cleveland, Ohio.

The proposed restrictions, however, would gut the IRA system. About 60 percent of all workers and 80 percent of existing IRA holders would no longer be eligible for the IRA deduction.[2] And it is the immediate deduction for IRA contributions that is by far the most enticing element of the tax treatment of IRAs. The tax savings provided by the deduction is the reason most often cited by IRA contributors as the motivation behind their contributions.[3]

Sharply limiting IRAs now would cut off IRAs just when they are beginning to blossom. It would substantially limit the ability of the private sector to provide for the full range of retirement needs. For example, policy makers in Washington already are discussing how to find additional resources to finance long-term nursing home care for the future aging population, to pay for medical care in retirement with Medicare so badly underfunded, and to cover the enormous retirement demands of the baby-boom generation.

Social Security and pensions appear inadequate for all these needs. Rather than restricting IRAs, it would be wiser, in light of future nursing home and health care needs, to widen the use of the accounts. Example: Workers could be allowed to use IRA funds to purchase insurance now that would cover nursing home costs or medical costs during their retirement. America's retirement system is supposed to be based on the concept of the three-legged stool--Social Security, pensions, and private savings. Without IRAs, private retirement savings would be seriously weakened, thanks to the heavy, discriminatory multiple tax burden that otherwise applies to savings and capital.

GOOD RETIREMENT POLICY

IRAs have proved to be an excellent retirement plan. They are the only vehicle available to virtually all workers in all circumstances. They avoid all vesting problems, since funds paid into an IRA immediately belong to the worker. They avoid all portability problems, since the IRA funds are under the worker's ownership and control wherever he goes, not tied to a particular company. They offer workers greater freedom and self-reliance than Social Security or pensions, where the fate of the worker is in the hands of others and his retirement benefits may be lost or reduced. IRAs are the most flexible retirement vehicle available for a modern, highly mobile work force.

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2. Ibid.

3. Investment Company Institute, IRA's: The People's Choice (Washington, D.C., February 28, 1985), pp. 11-12.

GOOD TAX POLICY

The greatest problem with the current tax system, besides high marginal tax rates, is its sharp bias against savings and capital investment. Returns to savings and investment are subject to taxation as many as three times: once by the corporate income tax, once by the ordinary personal income tax, and again by the capital gains tax. Moreover, investors are taxed on supposed investment profits even before they have recovered the cost of their investment.

IRAs remove most of this discriminatory, multiple taxation of savings and investment. In recognition of this, the Treasury originally recommended increasing the IRA contribution limit to $2,500 for each spouse in its 1984 tax reform study. The Treasury believed that this would stimulate increased saving and capital formation. The White House agreed, finally proposing a lower, though still substantial, increase in the IRA deduction.

Just how much IRAs have increased total savings is a controversial question. Some analysts argue that many individuals simply borrow to make their IRA contributions, resulting in no net savings increase. But this overlooks the fact that individuals generally pay off such loans in the short term, leaving the long-term IRA savings intact. Others maintain that many Americans merely shift existing savings into IRAs. But this ignores the "lock-in" effect of IRAs. With funds contributed to an IRA for retirement and a penalty for early withdrawal, the worker is less likely to spend the funds on a boat, new car, or vacation in a few years. Instead, the money is in place to meet retirement needs. Moreover, as time goes by, the ability of workers to switch savings declines as their other savings are depleted.

It thus seems that the biggest increase in new savings from IRAs is just starting to occur. The magnitude of the savings increase must await more sophisticated studies than have been completed to date. Meanwhile, Congress should not act on the basis of anecdotes and unsupported snap judgments from those who have opposed the IRA concept from the beginning.

Some lawmakers challenge the "fairness" of IRAs by arguing that too much of the benefit goes to higher income taxpayers. But 75 percent of taxpayers with an IRA earn less than $50,000. The income distribution of workers covered by IRAs is in fact not significantly different from the income distribution of those covered by pensions. Any vehicle for private savings will tend to involve greater participation by higher income workers, simply because they have sufficient income from which to afford substantial savings. But that certainly does not mean that Congress should discourage a greater reliance on private savings for retirement, rather than government spending, for individuals who can make such savings.

The proposed IRA eligibility restriction effectively would prevent blue-collar union workers, who are broadly covered by pensions, from taking the IRA deduction, thus encouraging them to be more dependent on Social Security and company plans. The Senate Committee restriction, however, would fall most harshly on highly mobile young workers who may be eligible for an employer's pension, and therefore ineligible for the IRA deduction, but are likely to change employers before earning vested pension rights.

CONCLUSION

Congress and the White House should recognize the overwhelming policy arguments in favor of maintaining the current tax treatment of IRAs. Keeping IRAs at their current status would be broadly popular with the 40 million IRA participants and would enhance the appeal of the whole tax reform package, generating greater support for final enactment.

A revenue neutral amendment to restore IRAs will likely be offered on the Senate floor. President Reagan should support it and work for its passage. Such an amendment need not and should not involve any increase in tax rates.

If it is too difficult to restore the IRA deduction immediately on a revenue neutral basis, then the full deduction could be phased in over several years. Alternatively, Congress could allow deductions for workers covered by pensions only against the 15 percent tax bracket, even if they normally would fall in the 27 percent tax bracket. Or Congress could at least allow deductions for IRA contributions used during working years to purchase medical and long-term nursing home care insurance for retirement. At a minimum, Congress should immediately restore the $250 deduction for all nonworking spouses.

If the IRA deduction is not restored, Congress will be seriously weakening the nation's retirement system and destroying an important incentive for Americans to save. This is bad tax policy and worse economic policy.

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