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INCREASE THE IRA ADVANTAGE

INTRODUCTION

Millions of Americans have taken advantage of the opportunity to save through Individual Retirement Accounts (IRAs), since they were made available to all employees on January 1, 1982. In that time, an estimated 20 to 25 million Americans have deposited anywhere from $30 to $50 billion as a retirement nest egg. Tens of millions of dollars more flow into banks, brokerage houses, insurance companies, and other IRA trustees every week. This explosive growth in IRA savings has two important implications: (1) it means Americans are seeking to build retirement security using private savings; (2) it may indicate the beginning of a significant increase in the personal savings rate, which would provide a major stimulus to capital formation and economic growth.

In contrast, the so-called Social Security reform package that Congress passed last spring was a short-term political solution to the system's problems. It failed to address Social Security's structural weakness--its attempt to fulfill the conflicting objectives of insurance and welfare.[1] Said Congressman Bill Archer (R-Tex.) during the debate on the plan, "We have postponed once again the day of reckoning by transferring the burden of supporting the system's shortcomings to future generations." Not only that, the "reforms" reduced benefits and raised taxes for today's younger workers. In other words, workers' retirement incomes will be lowered, as it will be more difficult for them to save for retirement because their take-home pay will be reduced by increases in the Social Security payroll tax.

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1 See Peter Germanis, "For $168 Billion, Only a Band-Aid for Social Security," Heritage Foundation, Backgrounder No. 249, February 25, 1983.

Tax deductible IRAs offer Americans a savings vehicle to supplement the dismal returns from Social Security, with many advantages over Social Security--higher return on contributions, immediate vesting, and freedom of choice. As such, the IRA system should be expanded as a supplement to, and perhaps eventual voluntary replacement of, the Social Security system. For example, the ceiling on tax deductible IRA contributions could be raised, particularly for nonworking spouses.

IRAs have a second function. They provide Americans with incentives to save. Changes in the tax treatment of personal savings could have potentially powerful effects on the nation's savings pool. Because the current tax code has so many features discouraging savings, expanding IRAs would help rekindle the desire to save.

Tax deductible IRAs already are a popular and powerful inducement to Americans to save for their retirement--and they take considerable pressure off the ailing Social Security system. Congress should respond to these features of this new savings instrument by expanding and modifying the tax code where it deals with IRAs, and thereby move toward the creation of a comprehensive private retirement income system.

BACKGROUND

When IRAs were originally established under the Employee Retirement Income Security Act of 1974 (ERISA), they were available only to workers not covered by any other pension plan. The Economic Recovery Tax Act of 1981 (ERTA) expanded the eligibility standards, making IRAs available to all workers under 70½ years of age. The new legislation also raised the maximum annual tax deductible amount from the lesser of $1,500 or 15 percent of earned income to $2,000 or 100 percent of earned income, whichever is lower. In addition, workers may deduct from their taxable income an additional $250 a year for an IRA contribution if they have a nonworking spouse.

This expanded IRA eligibility from 63.5 million to 111.4 million Americans, raised the annual maximum contribution by about a third, and thus increased the potential savings from $68.7 billion to $171.5 billion.[2] These changes have had a poweful effect. A New York Times/CBS News poll revealed that Americans invested about $30 billion in IRAs during the 1982 tax year, much higher than the $18.8 billion estimated by the Treasury Department. According to the poll, nearly one of every five employed adults had opened an account by early 1983--the

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[2] Robin C. DeMagistris and Carl J. Palash, "Impact of IRAs on Saving," Federal Reserve Bank of New York Quarterly Review, Winter 1982-83, p. 29.

deadline for deducting IRA contributions from 1982 taxable income.[3]

An important attraction of an IRA is its valuable tax relief. The sum saved each year can be deducted from an individual's taxable income, while earnings from the savings accumulate untaxed until they are withdrawn. Since this typically will be at or after retirement, the saver will be in a lower tax bracket.

IRAs AND SOCIAL SECURITY

A principal purpose of the IRA provision of the 1981 tax law was to encourage people to save more effectively for their own retirement, instead of relying solely on Social Security. The primary sources of retirement income today, in addition to Social Security, are private pension plans and personal savings.

Social Security thus far has provided the highest return per dollar invested, but this is only because it is still in the "start-up" phase. The average retiree today receives about five times as much as he paid into the system, even after adjusting for a reasonable rate of return. But Social Security will not continue to provide such a generous return in the future. As the system matures, economic conditions and demographic realities will make that all but impossible. Indeed, many of today's young workers can expect to receive less in benefits than they paid into the system, after adjusting for the interest their contributions could have earned.[4] Unfortunately for them, the "reform" legislation passed by Congress this spring lowered this return still further.[5]

The uncertain future of the Social Security system means that the public must be encouraged to utilize alternate savings vehicles. Otherwise, America's senior citizens may find their retirement income jeopardized by the end of the century. IRAs can play an important role in filling this void and are already beginning to do so. According to one New York tax lawyer, there

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3 Robert A. Bennett, "IRAs a Hit with Taxpayer," The New York Times, April 15, 1983, p. D1. A more recent study estimates that IRA deposits deducted on 1982 tax returns totaled $54.3 billion. See Employee Benefit Research Institute, "1982 IRA Growth Sets New Record," June 8, 1983, p. 1.

4 See Robert J. Myers, "Money's-Worth Comparison of Social Security Benefits," National Commission on Social Security Reform Memorandum No. 45, August 12, 1982; Anthony J. Pellechio and Gordon P. Goodfellow, "Individual Gains and Losses from Social Security Before and After the 1983 Amendments," presented at a Cato Institute Conference on Social Security, June 6-7, 1983; and Rebuilding Social Security, Heritage Lectures 18 (Washington, D.C.: The Heritage Foundation, 1982).

5 Pellechio and Goodfellow, op. cit.

is a "surge in IRA account openings each time there is a scare about Social Security."[6]

ADVANTAGES OF IRAs

Rate of Return

An IRA-based pension system has several advantages over Social Security. Private investments, for instance, can be expected to yield a much higher return than Social Security. Most young workers today can look forward to about a 1 to 3 percent real return on their Social Security contributions.[7] Historically, this compares poorly with the returns available in the private sector. For example, between 1926 and June 30, 1983, a period including the Great Depression, World War II, two other wars, and a period of severe inflation, the combined real rate of return on all stocks on the New York Stock Exchange was 6.4 percent.[8] While it can be argued that the stock market was more rosy in some years than in others, it must be remembered that, when the economy is weak, the Social Security system itself will be no more healthy than the stock market, since a weak economy slows down the growth in contributions.

Critics suggest that the risk involved in obtaining a 6 or 7 percent real return may be too great for a retirement portfolio, and that while the market as a whole may do well, an individual with limited investments may bear an extraordinary level of risk. But an individual--or rather the financial institution managing his IRA savings--can greatly minimize this risk by diversification.

There are two types of risk in investing: (1) the systematic risk, which is a measure of how an asset's value fluctuates with the economy; and (2) the unsystematic risk, which is independent of the economy. By building a market portfolio, investors can diversify to eliminate just about all risk except the risk of the economy as a whole. Systematic and unsystematic risks will vary, depending on the type of security, but for a large number of common stocks on the New York Stock Exchange, the systematic risk has been estimated at one-quarter of the security's total risk.[9] According to widely accepted financial theory, just

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6 "The Widening Choices in IRA Investment," Business Week, December 6, 1982, p. 120.

7 Robert Meyers, op. cit., p. 5.

8 "Stocks, Bonds, Bills and Inflation," Quarterly Service, Vol. 1, No. 2 (Chicago: R. A. Ibbotson Assoc., Inc., July 1983).

9 See Thomas E. Copeland and J. Fred Weston, Financial Theory and Corporate Policy, (Reading, Mass.: Addison-Wesley Publishing Company, 1979), p. 479.

picking ten to fifteen securities at random will virtually eliminate unsystematic risk (or about 75 percent of the total risk). Diversification, therefore, means that savers can avoid much of the risk associated with holding any one security.

Mutual funds are an effective and economical means whereby small investors can take advantage of the professional advice and investment diversification available to wealthy individuals and financial institutitons. They allow thousands of investors to pool their resources in a fund that invests in a variety of equity and debt instruments under the management of a professional investment adviser. Not surprisingly, IRA investments in mutual funds had a five-year average rate of return from 1978 to 1982 of 17.1 percent, or 9 percent after adjusting for inflation.[10] In addition, young people can invest in instruments promising fast growth, though at more variability and risk; and later, as they near retirement, they can shift these investments into safer havens, such as money market funds or the bond market. These may offer lower returns, but they bring more stability and peace of mind.

IRAs, therefore, provide savers with flexibility to plan for retirement according to their age and financial situation. Social Security, on the other hand, offers no such flexibility or choice. Savers run the risk of having their benefits reduced if the economy turns downward in the case of either Social Security or IRAs, but it is unlikely that Social Security will ever again provide the returns and benefit increases that were common in the early years of the program.

Portability

Another advantage of IRAs is that they provide immediate portability and vesting. Workers who move from job to job often find they are not in one occupation long enough to qualify for benefits under a company pension plan. With an IRA, however, individuals are immediately and fully vested, regardless of how many times they switch jobs. Since individuals can elect taking their benefits without penalty at any age between 59½ and 70½, questions pertaining to the appropriate retirement age are largely rendered moot.

Unlike Social Security, people are not forced to purchase insurance they do not want or may never be able to collect. For example, an IRA does not require a single person to contribute to survivor's insurance he does not need. However, the law governing IRAs should be expanded to allow investments in life insurance, so that married workers who desire such protection can purchase it through their IRAs. Nonworking spouses should also

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[10] Employee Benefit Research Institute, "Individual Savings for Retirement: A Closer Look," March 1983, p. 4.

be allowed to invest a greater amount in IRAs, to put their benefits on similar footing with the spouse's benefit in Social Security. These reforms would provide individuals even greater freedom to select the insurance protection best suited to their needs and desires.

True Saving

IRAs also offer savers a tangible form of wealth under their personal control. Social Security, however, operates on a pay-as-you-go basis and is based on the implicit promise that the young will pay taxes to support the old. This promise could be broken at any time, which becomes increasingly likely as the population ages and a heavier burden is placed on the young. Moreover, people have a heightened sense of ownership and take comfort in knowing that they will reap the full value of their savings. In the case of Social Security, however, public opinion polls indicate that most young workers believe that they will receive little or nothing from their taxes. They appear to view the payroll tax simply as a reduction in their wage. Explain economists Bernard M. S. Van Praag and Peter A. B. Konijn:

> The difficulty with most Social Security premiums is that the worker is actually made to buy something (a kind of insurance) at a prescribed price. That can cause a lot of frustration, especially since younger people tend to be overoptimistic. Calamity is unlikely to strike them, and the time of their retirement is far off. Therefore, younger workers frequently measure their well-being by their net disposable income, forgetting almost completely about the value they get for the money which is withheld for Social Security. Consequently, any increase in Social Security premiums may well reduce the motivation to work, especially if the gap between the unemployment benefit and the net wage is not so large. It follows that the workers' reaction will yield increased unemployment in the next period, resulting in a higher workers' premium level. A vicious cycle has been set in motion.[11]

The tax advantage associated with IRAs, on the other hand, may increase work effort.[12]

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11 Bernard M. S. Van Praag and Peter Konjin, "Solidarity and Social Security," Challenge, July/August 1983, p. 55.

12 The net effect depends on how the tax loss resulting from the IRA is financed: with spending cuts and/or other revenue increases and how these affect work effort.

Nondiscrimination

IRAs do not have the discriminatory aspects present in Social Security. Because Social Security is not an actuarially fair system (one that links benefits to each individual's contribution and life expectancy), many groups suffer discrimination. Blacks tend, for example, to get a lower rate of return than their white counterparts [13] The reasons: blacks have a much lower life expectancy than whites; and the black population on average is considerably younger than the white population. The first factor means that benefits are received over a shorter period; the second means that blacks are more likely to be in that age group that receives a particularly bad deal from Social Security.

Others that tend to be discriminated against in the Social Security system are the poor, the single, and those not leading "traditional family lifestyles."[14] Because IRAs are subject to individual control, they avoid these discriminatory aspects.

IRAs AND SAVING

A second goal of the IRA provision in the 1981 Tax Act was to provide taxpayers with greater incentives to save. Yet some economists believe that the surge in IRA investments has added little, if anything, to new savings, and that the increased contributions level merely reflects a shift from other savings instruments. There is yet no solid evidence to support this contention, nor is there any reason to believe this will be the case in the long run.

Marginal Tax Rates

Do Americans adjust their savings behavior to take advantage of changes in the available real after-tax rate of return?

For many years, most economists felt that savings are relatively insensitive to changes in the real after-tax rate of return.[15] More recent research, however, disputes this and shows

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[13] See "The Effect of the Social Security System on Black Americans," (Dallas, Texas: National Center for Policy Analysis, 1983).

[14] See Peter J. Ferrara, Social Security Reform: The Family Plan (Washington, D.C.: The Heritage Foundation, 1982).

[15] See Edward Denison, "A Note on Private Saving," Review of Economics and Statistics, 40 (1958), pp. 261-267 and E. Philip Howrey and Saul H. Hymans, "The Measurement and Determination of Loanable Funds Saving," Brookings Papers on Economic Activity (1978), pp. 655-705.

a positive relationship between the rate of return and the level of savings. It indicates that tax policy may well have a powerful impact on the amount of savings.[16] These are important findings because the more responsive saving is to changes in tax rates, the more certain it is that high taxes on savings damage the savings rate.

If IRAs are to succeed in expanding savings, they must reduce the marginal tax rate facing IRA savers. If a person who has already saved over $2,000 in a year simply shifts part of his savings from another account to an IRA to gain tax relief, then the IRA probably will not stimulate extra savings. This is because the after-tax rate of return on each additional dollar saved would be the same as it was before the existence of IRAs. For such a person, the IRA merely provides tax relief for past, not new, savings.

But IRAs do provide an added incentive for those who save less than the maximum allowable amount, since in this case the tax rate on savings is reduced. Moreover, the account switching undertaken by some savers is likely to diminish over time, as they run out of funds that can be easily shifted to IRAs.[17] And raising the current deduction ceiling would also mean that more taxpayers would find that the ceiling exceeded their usual annual saving, and they thus would find it a tax incentive to increase their savings.

Of concern to some economists and policymakers is the possibility that the tax deduction for IRA contributions might widen the federal deficit, thereby increasing Washington's borrowing requirements and diverting funds from private capital formation. If the increase in total personal savings were less than the tax revenue lost due to the IRA deduction, then the extra funds government had to borrow could outpace new private savings. Even if this were the case, however, it would likely be only a transitional problem. Moreover, any slight increase in the deficit because of IRAs would pale in significance compared to the one that may again face the Social Security system. Furthermore, encouraging people to save privately for their retirement may begin to take some pressure off the troubled Social Security system.

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[16] See Michael J. Boskin, "Taxation, Saving, and the Rate of Interest," Journal of Political Economy, 86 (April 1978), S3-S27; and Lawrence H. Summers, "Capital Taxation and Accumulation in a Life Cycle Growth Model," American Economic Review, 71 (September 1981), pp. 633-544.

[17] There is some evidence to indicate that such fund switching would exhaust the pre-existing assets of most households in just a few years. See: Martin Feldstein and Daniel Feenberg, Alternate Tax Rules and Personal Savings Incentives: Microeconomic Data and Behavioral Simulations, National Bureau of Economic Research, Working Paper No. 681, May 1981.

Tax Equity

The impact and success of IRAs as savings incentives are still undetermined. Nevertheless, they are important because they make the tax code more equitable. The present tax system is biased against saving, in the sense that both saved income and the earnings from those savings are taxed, while income used for consumption is only taxed once. There is thus double taxation when income is saved rather than consumed. IRAs and other tax breaks for saving reduce this discrimination in the tax code. Former Under Secretary of the Treasury for Tax and Economic Affairs Norman Ture notes that a preliminary step toward tax neutrality would be:

> to liberalize substantially the tax treatment of saving by expanding the limits on the deductibility of income invested in Individual Retirement Accounts, by providing new tax credits or deductions for individual savings, as steps toward eventually transforming the present tax base into an expenditure base from which saving in all forms would be completely excluded while all returns to saving would be fully included.[18]

Moving toward an expenditure base, or a so-called consumption tax, would have several advantages. It is more equitable to tax what Americans take from the economy than what they contribute to it in the form of new capital. In addition, removing the double taxation of savings would mean that equally situated individuals would be treated more fairly. Currently, two individuals earning the same annual income may pay widely differing amounts in tax over their lifetimes, because of the tax penalty on savings. A consumption-based tax would treat present consumption and savings equally. It might also be easier to administer because the tax base would be more clearly defined and many of the problems in measuring capital income would be eliminated.[19]

The primary advantage of a shift to an expenditure tax is that it would increase saving. The disadvantage is that tax rates on consumption would have to be boosted somewhat to yield the same amount of revenue. The increase in savings resulting from a consumption tax, however, would increase capital formation. While consumption initially might be reduced, the economy ultimately would grow faster. This would allow future consumption to exceed the level it otherwise would have reached under the existing income tax system. Similarly, the increase in

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[18] Norman B. Ture, "Treasury," in Richard N. Holwill, editor, Agenda '83 (Washington, D.C.: The Heritage Foundation, 1983), pp. 295-305.

[19] See, for example, U.S. Treasury, 1977, Blueprints for Basic Tax Reform (Washington, D.C.: Office of Tax Analysis, U.S Treasury).

capital stock would raise productivity, and hence the income of labor. Extra economic growth, moreover, would allow lower tax rates on consumption in the future.

The net effect would be a solid improvement in the nation's economy. As a recent National Bureau of Economic Research study concluded: "Results indicate that sheltering more savings from the current U.S. income tax could improve economic efficiency even if the necessary marginal tax rate adjustments are made in order to maintain government revenue."[20]

RECOMMENDATIONS

Current Legislation

There are many bills before Congress that would modify IRAs in one way or another. The most comprehensive is the "Social Security Guarantee and Individual Retirement Security Act (S.541)," sponsored by Senator Jesse Helms (R-NC). It seeks to solve Social Security's long-term problems by guaranteeing Social Security benefits to existing retirees, issuing a retirement bond based on a worker's contributions, and encouraging workers to establish Individual Retirement Security Accounts (IRSAs) in place of Social Security. To ease the transition, Helms suggests a phase-in period and proposes some reforms to the present Social Security system to lower the cost of transition and to make the existing program more equitable.

Other proposals expand the eligibility requirements for an IRA and raise the contribution ceiling. For example, H.R. 3266, introduced by Congressman Tom Corcoran (R-Ill.), would raise the $2,000 ceiling to $5,000 in three steps. Several other bills would increase the maximum deduction to $2,500. Other bills would increase the current $250 limit on a spousal IRA to the full $2,000 available for a working person. And there are proposals that would allow nonworking spouses to include the compensation of a working spouse as their own for the purpose of investing in an IRA.

The increasing popularity of the IRAs has prompted some legislators to offer bills that would use the IRA concept for purposes other than retirement. Senator Robert Dole (R-Kan.), for example, has introduced S.1489 on President Reagan's behalf. This bill would permit nondeductible contributions of up to

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20 Don Fullerton, John B. Shoven, and John Whalley, "Replacing U.S. Income Tax With a Progressive Consumption Tax: A Sequenced General Equilibrium Approach," NBER Working Paper No. 892, May 1982, p. 26. The authors note, however, that there is considerable debate over the length of time the transition will require.

$1,000 for an education savings account to finance a child's education. The interest on such accounts would be tax-free for families with annual incomes up to $40,000. The interest exemption would gradually be phased out for those earning between $40,000 and $60,000.

Other proposals would allow an IRA-type account for the purchase of a home. S.1051, introduced by Senator John Tower (R-Tex.) would allow withdrawals from "Mortgage Retirement Accounts" to be used for the downpayment on a home and would permit certain mortgage prepayments to be treated as IRA contributions.

Proponents of such legislation argue that the purchase of a home and the payment of a child's tuition are essentially investments for retirement. A special deduction for housing and education, however, would distort their real cost relative to other goods and services in the economy that must be purchased with after-tax dollars. A Mortgage Retirement Account, in particular, would add another subsidy to the already heavily subsidized housing industry. It would imply tax support for consumption, breaching the IRA principle of shielding only savings from tax.

<u>Needed--A "Super IRA"</u>

IRAs can ease the transition toward structural reform of the Social Security system. This effort should begin with small legislative changes to make the present IRA system more comprehensive so that it becomes, in practice, a small-scale private Social Security system--supplementing federal Social Security.

The size and structure of this "Super IRA" would be identical to the Social Security system. As the Social Security payroll tax increased, for instance, the maximum tax-deductible contribution to an IRA would rise to the same cash level. Similarly, the allocation of an IRA between retirement income, disability, and old age health insurance would be required to reflect the equivalent allocation of the Social Security tax. Had these changes been in effect in 1983, individuals would have been allowed to invest up to $4,783.80 in an IRA, with a maximum of $3,409.35 for retirement and life insurance benefits, $446.25 for private disability insurance, and $928.20 to save for health insurance during retirement.

The reason for designing a "Super IRA" law with these restrictions is primarily political. While in an economic sense, the current allocation of money for the various types of insurance may not be optimal, expanding the IRA system in this way would make it a mirror image of Social Security. Americans would be able to compare the two alternatives. As they gradually became more familiar with the parallel private sector option, they would find it easier to compare the private and public alternatives when deciding which plan to use as their principal guarantee of security.

To facilitate the comparison between IRAs and Social Security, the Social Security Administration should establish an individual account for each person participating in the program and provide them with an annual statement showing how much they have paid into the system and what benefits they can expect to receive. Americans could then see the huge transfers that go on through Social Security. Retirees would come to realize that they have not bought an earned annuity, but are receiving an enormous transfer from younger generations. And younger workers would see just how much they stand to lose by participating in the program.

In addition to its educational benefits, a reporting system would also help individuals to plan for their retirement by giving them a better idea of just how much they can hope to get from various retirement plans. If the Social Security Administration were unwilling or unable to perform this task, it could be contracted out to private sector firms that already have the technology to make the necessary calculations.

CONCLUSION

Since the 1981 Tax Act, IRA contributions and the number of contributors have soared. While it is still unclear how much new saving has been injected into the economy, one thing is certain: IRAs are extremely popular. Notes Wesley Howard, editor of the IRA Reporter: "IRAs will become like the home mortgage interest deduction. No legislator would touch it. Right now, 25 percent of his or her constituents have IRAs. Revenue loss or no revenue loss, they're here to stay."[21] Fortunately, it appears likely that over time, as workers run out of the money that can be shifted from their existing savings accounts, IRAs will become important instruments to boost savings. Moreover, increases in the ceiling on contributions to an IRA would improve their effectiveness as a savings incentive.

IRAs constitute a real alternative to the crumbling Social Security system. Further expansion of the IRA system could secure a viable private sector alternative that should help individuals save for their own retirement and alleviate their concerns over Social Security. Moreover, the expansion of total savings resulting from such a reform would make more money available for capital formation and economic growth, which would benefit all Americans, not just the elderly.

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21 Roberta Reynes, "The IRA Controversy. John Q.'s Gain is Uncle Sam's Loss," Barron's, June 13, 1983, p. 35.