BENTSEN-ROTH IRA

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED SECOND CONGRESS

FIRST SESSION

ON

S. 612

MAY 16, 1991

(Part 1 of 2)

Printed for the use of the Committee on Finance

S361- 1

COMMITTEE ON FINANCE

(II)

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BENTSEN-ROTH IRA

THURSDAY, MAY 16, 1991

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:04 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Lloyd Bentsen (chairman of the committee) presiding.

Also present: Senators Daschle, Breaux, Packwood, Roth, Durenberger, and Grassley.

[The press release announcing the hearing follows:]

SENATOR BENTSEN ANNOUNCES HEARING ON SAVINGS, BENTSEN-ROTH IRA; FED CHAIRMAN GREENSPAN TO TESTIFY

WASHINGTON, DC—Senator Lloyd Bentsen, Chairman of the Senate Finance Committee, announced Thursday that Federal Reserve Board Chairman Alan Greenspan will be the leadoff witness for a hearing on savings and the Bentsen-Roth Bill to make the fully deductible IRA available to all Americans.

Bentsen said the hearing will be at *10 a.m. on Thursday, May 16, 1991 in Room SD-15* of the Dirksen Senate Office Building.

Bentsen (D., Texas) and Senator Bill Roth (R., Delaware) introduced the IRA Bill on March 12. It now has 77 of the 100 Senators, including 12 Finance Committee members, as cosponsors.

"We need to bring back the IRA. People understand IRAs, they like IRAs and they will use IRAs to save," Bentsen said.

"The key to future economic growth is savings and the IRA stimulates savings. Today, the personal savings rate in the United States is at an all-time low—lower than any of our major competitors. In 1990 American consumers saved less than a nickel out of every dollar they earned, while the Japanese saved 16 cents," Bentsen said.

The Bentsen-Roth IRA would restore the traditional IRA that allows Americans to contribute $2000 tax-free or they could choose a new IRA that provides no upfront deduction but interest and earnings can be withdrawn penalty-free after five years. Penalty-free withdrawals would be allowed for buying a first home, for college expenses or for financially devastating medical bills.

"There are no easy, painless answers to tough challenges like high interest rates and the high costs of education, housing and health care. But the new expanded IRA can help in every instance. It will give Americans a flexible tool to help them plan for and build a better tomorrow," Bentsen said.

"And I hope we can insure that April 15, 1991 was the last tax filing day without fully deductible IRAs for all Americans," Bentsen said.

OPENING STATEMENT OF HON. LLOYD BENTSEN, A U.S. SENATOR FROM TEXAS, CHAIRMAN, SENATE FINANCE COMMITTEE

The CHAIRMAN. This hearing will come to order. If you will please be seated and cease conversation, we will get under way. I want to welcome Chairman Greenspan and the other witnesses we

have this morning that are deeply interested and concerned with this subject.

Family income growth during the 1980's was disappointing. Americans can look forward to an improvement in the 1990's only if we get an increase in productivity in our country.

Productivity will only increase—we will only have that growth— if we have the capital we need to modernize production plants. In this country, the factories average 17 years of age; in Japan they average about 10 years of age. In a sense, we were lucky in the 1980's, because we had foreign investors who were on hand to pump money into our economy and help make up for the capital shortage. Even so, we paid a steep price, because productivity growth fell during the decade. So did our savings rates. It is no accident that at the same time real interest rates doubled. I believe that the sources of foreign capital will be more limited in the 1990's. And a recent Morgan-Stanley study projects a $200 billion a year world capital shortage. [Showing charts.]

Annual Worldwide Capital Shortage

In Billions
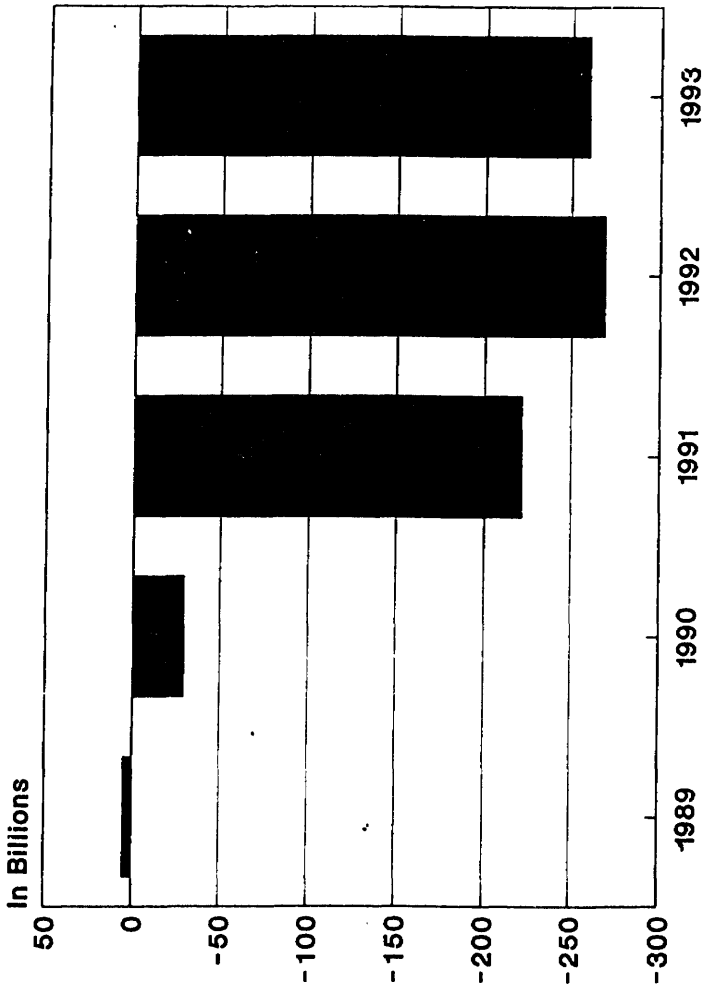
Source: Morgan Stanley International

Household Savings Rate as a Percentage of Disposable Income - 1990

Savings Rate

16% 14% 12% 10% 8% 6% 4% 2% 0%

Japan   Germany   U.S.
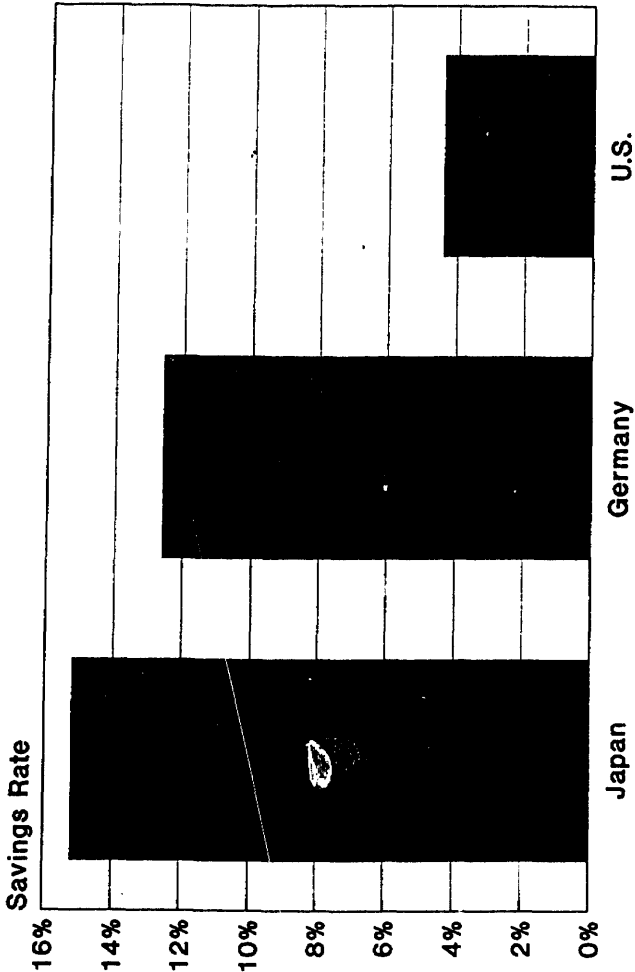
The CHAIRMAN. The Morgan-Stanley study shows the capital shortage reaching this level in 1990; by 1991, it goes over $200 billion; by 1992, over $250 billion; and it levels out at about that point. But that is a critical time, when we need money to build new plants.

Let's look at the household savings rate as a percent of disposable income. Some of our most effective competition in the world today—the Japanese—are doing an incredible job of building new plants, modernizing, increasing productivity. The Germans are not far behind them.

Yet, here is the rate of savings that we have in the United States. We have to find ways to increase that, and that is what this hearing is principally about today: a growing realization that we

have to save more in this country. And that is one of the reasons that we have 75 co-sponsors, bipartisan support, for the restoration of the IRA.

The Bentsen-Roth IRA would restore access to ITA's to the 60 percent of two-earner families in this country who are currently ineligible. It expands the IRA; it makes it more attractive. It allows taxpayers to withdraw money without penalty if they are buying a first home, if they are trying to pay for extraordinary medical expenses, if they are trying to help their children go to college, and, of course, for their own retirement. The bottom line is the IRA has a proven track record on promoting savings that I think is essential to the country. I defer to my colleague, Senator Packwood, for any comments he would like to make.

Senator PACKWOOD. I would defer to Senator Roth.

The CHAIRMAN. All right. Senator Roth.

OPENING STATEMENT OF HON. WILLIAM V. ROTH, JR., A U.S. SENATOR FROM DELAWARE

Senator ROTH. Well, thank you for your leadership, Mr. Chairman. As I have expressed many times over the past few months, this piece of legislation represents the hope and future of America. Those who support our efforts to realize a "Super IRA" are clearly those who believe in, and are willing to work for a strong, and economically vibrant America.

It is those of little faith, little confidence in the willingness of Americans to save for their own future who doubt the practicality of this legislation. These latter—the naysayers—are those who claim that there is no proof; no certainty that this Super IRA will result in new savings, and to them I can only say: "Hogwash!"

Ironically, they are the same people who do not hesitate to support, to vote for billion dollar spending programs that cannot be certified to bring about specific results—let alone the pro-growth policies our nation so desperately needs as it looks to secure its future in the emerging global economic community.

But fortunately for this legislation—and the future—the majority of our colleagues, like the majority of Americans, understand that the Super IRA offers hope and promise of a brighter future for everyone.

Concerning America's economic future, Federal Reserve Board Chairman Alan Greenspan has said that the single most important requirement of a prosperous America is increased savings.

And all we have to do is look at our trading competitors abroad to verify the depth of that wisdom. Japan and Germany far out save America, and consequently, their capital is relatively inexpensive, business is booming, and we, as a nation, are forced to borrow from their resources for our investments here at home.

Only through personal savings can we both guarantee independence from foreign savings and investment—that so many Americans decry—and establish independence for our families.

To see how illogical even the most logical reasoning of the naysayers is, let us examine their attacks on this important piece of legislation:

First, they claim it does not produce new savings. Nothing could be further from the truth. In a few minutes, we will hear from economists—not only supply side economists, who I hold so dear to my heart—but also well-respected liberal economists who, as one time disbelievers in the IRA, critically examined thousands of income tax returns to determine—contrary to their original views—that IRA's do result in substantial new savings.

The second myth perpetuated by the naysayer is that we cannot afford IRA's. What this myth says, in fact, is that we cannot afford to let hard-working, thrifty, and valiant Americans save for their future. What the naysayers are claiming is that nations cannot afford to allow these people to use their own savings to send their children to college, to help with that first home purchase, or to pay for catastrophic health costs.

The third reason why they claim we cannot pay for this important legislation is because of the Budget Summit Conference is built on myths of its own: on anti-growth non-realities.

In fact, the Budget Summit artfully loaded the bases against the American family. Given the Summit requirements, the Joint Committee on Taxation has calculated the cost of the Super IRA using a static model.

Finally, Mr. Chairman, rather than read my full statement, I am going to ask that it be included as it read. And if I could just conclude by saying the time has come to bet on America's future; to bet on America's willingness to build that future. And do not tell me Americans will not save. Scores of peoples—Senators, teachers, men and women on the street—have stopped me to say, "Go to it, Bill." And that is what I intend to do. I am pleased to work with our distinguished Chairman to lead the charge. Thank you, Mr. Chairman.

[The prepared statement of Senator Roth appears in the appendix.]

The CHAIRMAN. Thank you, Senator Roth.

Senator Packwood.

OPENING STATEMENT OF HON. BOB PACKWOOD, A U.S. SENATOR FROM OREGON

Senator PACKWOOD. Mr. Chairman, the longer I am on this committee, the more I realize that there are no black and white answers to any of the problems we face, whether it is tax issues, health, or saving incentives, such as IRA's.

In 1981, Congress permitted most working Americans to make tax deductible contributions to IRA's. I do not know why, after IRA's were expanded in 1981, the savings rate fell for the next 5 years.

The bulk of the people in this country are still single individuals earning less than $25,000 per year, or couples who earn less than $40,000 per year. They could still have tax deductible after IRA's were modified in 1986. Even though tax deductible IRA's were limited, the savings rate increased after 1986. The U.S. savings rate has not increased as high as we would like, but it has increased.

I recall examining IRA's when the 1986 Tax Reform Act was taking shape. As I recall, about 60 percent of total IRA contribu-

tions were made by people who had incomes of over $40,000 a year. So, a question still exists in my mind whether or not IRA's have acted as an incentive for low- and middle-income people to save. A question I prefer not to tackle is who is a middle-income taxpayer. I don't think I have ever met a person who did not describe their self as middle income.

But in any event, certainly taxpayers who were in the upper third of income classes were the ones that contributed to IRA's the most; not people making $15,000, $20,000, $25,000. These taxpayers can still make tax deductible contributions to IRA's under current law.

I am curious about savings statistics. It is my understanding that older people tend to save more than younger people. Therefore, as the baby boom generation ages, the U.S. savings rate will increase, whether or not Congress adopts any further incentives.

I am not adverse to increasing the use of IRA's, nor of the legislation, sponsored by the Chairman and Senator Roth, but I do have a lot of questions of the witnesses. What is the evidence to indicate that if the availability of IRA's is expanded, Americans will save more than they would have saved without new savings incentives?

So, I start out with an open mind, but the longer I am on this committee—and I hope, Mr. Chairman, to remain here long enough to be chairman of this committee once again—[Laughter.]

Senator PACKWOOD. The longer I am on this committee, the less I realize that definitive answers exist to the problems we face. Thank you very much.

The CHAIRMAN. Senator Durenberger.

OPENING STATEMENT OF HON. DAVE DURENBERGER, A U.S. SENATOR FROM MINNESOTA

Senator DURENBERGER. Mr. Chairman, thank you. I was reminded as my ranking member finished his remarks that Bob Dole used to think the same thing, but he never believed it would actually happen.

Mr. Chairman, I am glad you are holding these hearings, and I am glad you introduced the bill. I happen to be one of the naysayers. I happen to be one of the little faith folks. I happen to be a washed hog, or whatever else we are characterized as being.

In part, that comes from experience. I have sat on this committee now for a long time, and I voted the marginal tax rate down from 70 to 50 percent, and then I voted it from 50 to 25. I voted for every great accelerated appreciation bill, and ACRS, and everything else that came through.

I voted for a Super IRA from Missouri back in 1981 or 1982, and all it did was suck money out of the system. So, I love IRA's because all the folks that meet me on the street like to say it. Most of them, when you check their credentials, though, are selling them. [Laughter.]

In large part, that is what I have heard so far. I think most of my bankers and most folks who make a commission off of selling these things are saying, "By God, here we go again. Let us get back on it."

Now, that is not to say it is not a great idea. Nobody can argue against the need to save. Nobody can argue about the fact that Americans just have to reverse what the Chairman showed us there. But my experience so far has been that when you do it selectively like this, it seems like the folks that are already saving one place put their money into one of these; it becomes more attractive. As a result, money is moving around, rather than new money increasing the black line representing savings.

I hope that I am wrong. I say to my colleagues—especially the Chairman and the Senator from Delaware—who have been pushing us all to cut rates, or pushing to reform the tax code. I hope I am wrong. I hope you are right. I will not be a naysayer if all the evidence that comes from the tables shown by the Chairman proves that this is a great idea. I would pleased to be the 76th co-sponsor on the bill.

The CHAIRMAN. Thank you. Senator Breaux.

OPENING STATEMENT OF HON. JOHN BREAUX, A U.S. SENATOR FROM LOUISIANA

Senator BREAUX. I thank the Chairman. I have joined the Chairman in co-sponsoring this legislation. I think it is time for some new ideas. I think it is time that the Congress start paying attention to middle income and upper middle income people in this country.

We have done enough for other income levels. We have reduced the top rate from 70 percent down to 31 percent. Thank you very much, they are doing very fine. And we have a number of programs that take care of the neediest among us; feeding programs, housing programs, Medicaid health programs.

There is a whole constituency out there who feels like they are truly the forgotten Americans in the sense that no one is paying any attention to them as they have to struggle more and more to make ends meet to pay the mortgage; to send the kids to school, and to pay for health care.

Economists tell us that America now has the least aggressive— the most regressive tax system in the developed world. And while we have reduced the top rates, as I just mentioned, we have had seven separate Social Security tax increases which have increased the tax burden on middle income and upper middle income people in this country. This is the group, I think, that Congress needs to turn our attention to.

Unless we do something to help these Americans, I am very fearful that this generation will really be the first generation of Americans which will leave an economy to their children that is in far worse shape than the one that they inherited. That is not something I think this Congress wants to be responsible for. The Chairman's bill is a new idea, and it is a step in the right direction. Thank you.

The CHAIRMAN. Thank you, Senator. Senator Grassley.

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM IOWA

Senator GRASSLEY. Mr. Chairman, not only do I want to recognize your leadership in this—and I have done that by co-sponsoring this legislation; thank you for that leadership as well—but I think we ought to also applaud the President for his Family Savings Plan.

Obviously there are some differences, but because both the President of the United States and the Chairman of this committee recognize the problem and propose this legislation, I think, shows that there is a consensus that we have a problem because of the lack of saving in our country, and it is a foundation problem that must be solved if a lot of other economic problems in this country are to be solved. I hope that we have an opportunity to do that this very Congress. Thank you.

The CHAIRMAN. Thank you very much. Mr. Chairman, with all your responsibilities, we understand your deep concern for an accumulation of savings in the country and providing capital for the future growth of the country, and that motivates your being here. We are looking forward to your statement.

STATEMENT OF HON. ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Chairman GREENSPAN. Thank you very much, Mr. Chairman, and I very much appreciate the invitation to appear today. As you know, as we have talked over the past, I have long been concerned about the low level of saving in the United States and I must say I am pleased that this important problem is now drawing renewed attention, as I believe it must.

Put simply, inadequate domestic saving is impairing our economic prospects for the long run. I say this with full recognition that the appropriate level of savings for any economy is best left to private preferences, as reflected in the marketplace. However, as a society, we have in recent decades clearly intervened in the market process through subsidies that enhance consumption at the expense of saving. And, we would be well-advised to redress such imbalances.

Saving, of course, arises when part of the nation's current production is diverted from consumption, both private and public; it provides the funds for capital formation. Thus, by choosing to consume more now—and to save less—we are limiting our ability to expand and upgrade our stock of capital. It is the size of that stock and the new technologies embedded within that, together with the quality of a labor force, ultimately determine our overall productive capacity and the future standard of living of our population.

The damage from low saving does not show up immediately. It is more insidious—it chips away at the productivity gains we are able to achieve over time; it gradually hampers our competitiveness in international markets; and after a period of years, it results in a lower standard of living than we would otherwise enjoy.

Of course, U.S. investment can be funded by foreigners, as well as domestic residents. Indeed, since the mid-1980's, sizable inflows of capital from abroad have helped to sustain domestic investment, and, thus, have cushioned the effect of inadequate domestic saving

on worker productivity. But heavy reliance on foreign saving is neither a satisfactory nor a sustainable solution over the longer run. The evidence for the United States and for most other industrial nations over the past 100 years indicates that large inflows have not persisted, and, thus, cannot be viewed as a reliable substitute for domestic saving on a long-term basis. In other words, domestic investment, for the most part, appears to follow domestic saving in the long run.

Reflecting the large current account deficits of recent years, foreigners are accumulating claims on a sizable portion of our future output. Furthermore, we know that we will have to support a rapidly growing population of retirees two or three decades in the future. In the end, our ability to meet those commitments, while providing rising living standards to future workers, will depend on the investments that we make in capital and in new technologies in the interim.

Indeed, on the basis of our recent saving behavior, it is difficult to see how we were able to achieve the high standard of living that we now enjoy. The answer is that we have not always been a low-saving society. Granted, the statistics are problematic, but it appears that in the period following the Civil War, when the United States began to emerge as an economic power, our saving and investment rates, as conventionally measured, were much higher than those in Europe and Japan. For example, between 1870 and 1910, domestic saving in the United States averaged close to 20 percent of GNP. The best available estimates for Japan and Germany during that period placed their saving rates at 15 percent or less. The saving rate in Great Britain, whose preeminence was fading, was closer to 10 percent.

The shift toward both a relatively low and an absolutely low saving rate began during the Great Depression, when the United States' rate fell dramatically. In the decades after World War II, it stabilized at a level slightly below its pre-Depression average. Notably, between 1950 and 1979, domestic saving averaged about 16 percent of GNP—roughly the same as total investment. Budget deficits generally were small, at least by today's standards, and the private saving rate showed no discernible trend. Meanwhile, the United States enjoyed a positive—and gradually increasing—net foreign investment position. In the 1980's, the pattern changed markedly as domestic saving fell well below investment, reflecting not only the enormous Federal deficits, but also a large drop in the private saving rate. In recent years, U.S. saving, both public and private, has totaled only about 13 percent of GNP.

Saving rates in Japan and Germany also have declined some over the past two decades, following their surge in the post World War II recovery period, but they remained substantially above those in the United States. The high saving rates in Japan and Germany have been mirrored in rapid rates of capital formation that have helped them improve their competitiveness relative to the United States and close much of the gap in living standards.

The issue of why one nation saves a lot while another saves relative little—or why saving behavior changes over time—is complex. It undoubtedly reflects cultural influences, as well as economic forces. I suspect, however, that part of the explanation relates to

how well members of a society, both individually and collectively, assess their future needs and take action in the present to meet them. Collectively, we have recognized the need to build saving and capital, and to improve our productivity performance, in anticipation of a significant increase in the ratio of retirees to workers in the next century. However, as last year's debate over the financing of Social Security made clear, we have yet to take sufficient actions to meet these needs. As you are well aware, the surpluses in the Social Security trust funds have been overwhelmed by enormous deficits elsewhere in the Federal budget.

Just as the budget deficit accounted for a large part of the fall in domestic saving in the 1980's, the surest way to raise saving in the 1990's is to get the deficit down. Last fall, you enacted a significant program of spending and tax changes and budget process reforms. Those actions set the underlying or "structural" deficit on a downward track and thus represented a strategy that is geared to the longer term needs of the economy.

I recognize that, in the near term, those savings are being swamped by the transitory effects of the weak economy. But, but as the recovery takes hold, the Federal sector's absorption of private saving should return to a downward trend.

The goal of a balanced budget is a good place to start, but as I have said frequently in the past, it probably is not ambitious enough as a target for the longer run. As long as the non-Social Security deficit remains sizable, we are doing little to ensure that adequate provisions are being made for the income of future retirees. Further actions must be taken to bring the rest of the budget into balance so that the trust funds will no longer be financing current government consumption, but will translate dollar for dollar into national saving.

The Federal budget deficit is only part of the story of the past decade. Saving by households and businesses also has dropped. The fall in personal saving, in particular, has been studied extensively; in large part, it appears to be associated with the sizable increases in household wealth through the latter part of the 1980's. To understand the relationship between wealth and the saving rate, it is important to note that personal income, as defined in the National Income and Product Accounts, measures the income from current production only. It does not include the effects of capital gains or losses on assets already held by households; personal saving also ignores revaluations of existing assets. Thus, an increase in the value of an individual's stock portfolio or his house has no direct effect on his measured income. But, if he raises his spending in response to the capital gain, the book value of saving will, as measured in the National Income Accounts, fall.

Looking at the data, one sees clearly that the surge in the stock market between 1982 and 1987 was associated with increased consumption out of financial capital gains and, therefore, with reduced saving out of current income. In addition, the build-up of readily accessible home equity enabled many individuals to spend more out of current income than they would have otherwise, especially with home equity lines of credit making it much simpler to borrow against the value of one's house. The data for Great Britain in the 1980's support a similar linkage between surging real estate prices

and falling rates of saving set aside out of personal income; more recently, the British saving rate has turned up as house sales have cooled.

Analyses of the relation between saving and demographics in the 1980's also have attracted much attention. On the whole, however, the results of these studies, as well as the implications for the 1990's, are less clear cut than one would have expected. Nonetheless, with older members of the so-called "baby boom" generation moving into their forties, the issue of retirement saving is coming to the forefront.

One way to engender more national saving, of course, is to reduce the Federal budget deficit. But, we can also take actions that should encourage individuals to save more. There is no shortage of proposals for new saving incentives. Some would function in a manner similar to that of the individual retirement accounts (the IRA's) of the early and mid-1980's, which allowed workers to make deductible contributions and to defer the tax on both the principal and earnings until the accounts were cashed in. Other suggested incentives, such as the Family Savings Accounts favored by the Administration, would not allow deductible contributions up front, but would permit earnings to accumulate tax-free as long as the account balances were maintained for a specified amount of time. The plan offered by Senators Bentsen and Roth incorporates both approaches.

In conclusion, Mr. Chairman, it is important to continue to focus on the crucial need to restore savings in the United States to levels that are consistent with our longer term economic objectives. The time is particularly opportune for exploring ways to facilitate retirement saving, given the large increase in the number of retirees that will occur within the next few decades.

Hence, there may well be a role for a well-designed private saving incentive in that process. In the end, substantial reductions in the Federal budget deficit are still the surest way to overcome the shortage of domestic saving, and thus, to increase permanently the supply of domestic funds available for investment. Thank you very much, Mr. Chairman.

[The prepared statement of Chairman Greenspan appears in the appendix.]

The CHAIRMAN. Thank you, Mr. Chairman. Mr. Chairman, Secretary Nick Brady called for lower interests rates at the G-7 meeting last week, but it was largely ignored. West Germany is talking about retaining its high interest rates. As I look at the capital requirements in East Germany, and in the Pacific Rim and the infrastructure problems of Kuwait and Iraq, it seems to me that creditor countries like Germany are going to be busy meeting capital needs at home, not competing for United States securities.

Morgan-Stanley says that we are going to have an enormous capital shortage—over $200 billion next year. During the 1980's, we financed much of our growth by shoving less credit-worthy nations aside—such as South America, Central America, Africa—but this time, we are going to have some very tough competition from credit-worthy nations like Taiwan, Saudi Arabia, and West Germany. There is not enough capital available to fulfill the needs of these nations.

Do you see any way, other than a prolonged world recession, that these interest rates can be kept moderately low; can they be kept from going up to levels that will be injurious to the economy of the world?

Chairman GREENSPAN. Mr. Chairman you are asking this very broad question about what economists call "real" long-term interest rates around the world.

The CHAIRMAN. That is right.

Chairman GREENSPAN. And it is certainly the case that, for example, when the Berlin Wall came down, it became apparent that a fairly substantial amount of new investment—that is, a drain on saving—would inevitably occur in order to rebuild the infrastructure in the previous Socialist bloc economies.

At that point, it was very interesting to watch interest rates move up in real terms, denominated in dollars, denominated in marks, denominated in yen—indeed, denominated in virtually all of the major currencies.

They have since come down a bit as it became apparent that the timeframe which was originally contemplated following the fall of the Berlin Wall was probably inappropriate. And indeed, we are seeing that the investment needs are not growing as rapidly there as we had earlier anticipated. And the reason, obviously, is the economies in Eastern Germany and in the corridor through Central Europe are not doing awfully well in terms of levels of economic activity and demand for investment.

But, there is no question that over time, as these economies become more and more oriented toward free markets—as, indeed, they are fairly rapidly as privatization continues—there is going to have to be a very large amount of capital investment to bring the infrastructure, the standard of living—which is based on the productivity of assets—up significantly. And that is basically where estimates of that nature are coming from.

It is very difficult to know what those numbers really mean, or how to interpret them, but I would say to you that even if we get a situation in which there are significant demands—and there will be over the years—there is no reason why long-term interest rates cannot be kept, in real terms, at reasonable levels if we keep the instability and the risk elements associated with world economic activity at a minimum level.

The CHAIRMAN. All right. Let me get you to short-term rates. The Fed has been pushing aggressively to get short-term interest rates down, and normally, that would mean consumer interest rates would come down and spark the purchase of automobiles, and other consumer goods. But the rate on car loans was about 11.9 percent last April. That is really not much better than it was a year ago.

So, we are not seeing that rate reduction. The yield on CD's for banks is substantially down. But that is not being carried through to consumer loans. What can be done? Can the Fed do some jawboning that will help?

Chairman GREENSPAN. What we are observing is something which we have seen many times in the past, namely, that a number of the consumer interest rate categories tend to be far

more sluggish—both on the upside and the downside—because basically the costs involved in making those loans are relatively high.

Nonetheless, there is another element here, as you pointed out. Ordinarily, one would have expected at least some more of a decline than we have seen. And what we are looking at is what we have all been calling the "credit crunch," where, in effect—largely because of fear of the potential capital position of a very large number of banks—they have been exceptionally chary to position themselves such that their capital might go down. And as a result, they have been effectively holding back in many respects, and the means by which one does that is to try to open up your profit margins. That, in a sense, rations credit, as you know. And I must say to you we are beginning to see signs that while the crunch is not easing, it has reached its maximum, and there is some evidence that we may not be too far from a basic softening in it.

But, be that as it may, I would say, at the moment, that is our major problem. It is reflected not only in consumer loans; it is reflected in residential construction loans, and a number of other elements that we pick up information on. And we are hopeful that as the weeks go on, the early tendencies we are beginning to see at this stage of a positive nature in softening of the severity of the credit crunch will continue.

And it is that which will ultimately tend to bring margins down through competition and, therefore, the consumer loan rates and other loan rates which have been held up inordinately in this credit crunch.

The CHAIRMAN. I have so many more questions, but nevertheless, I see my time has expired. Senator Packwood.

Senator PACKWOOD. I have no questions, Mr. Chairman.

The CHAIRMAN. Senator Roth.

Senator ROTH. Mr. Chairman, it seems to me that it is important that we have savings both from the national standpoint, and savings from the family point of view. Would you agree with that?

Chairman GREENSPAN. I certainly would, yes.

Senator ROTH. In your testimony, you state that the length of life is growing very substantially, and we are becoming increasingly a country of older citizens. So, is it not in our interests to provide incentives for families to take care of their so-called "golden years?"

Chairman GREENSPAN. I would certainly support that, Senator, and as we move into the next century, we are going to find—as I indicated in my prepared remarks—a rather remarkable acceleration in the ratio of retirees to workers, unless we significantly change the culture with respect to the average retirement age.

And obviously, should that not occur, we are going to have to supply capital investment in the early parts of the 21st century which are adequate not only to increase the standard of living of those who are working, but also to maintain a level of support for the increasing numbers of retirees who will inevitably appear on the scene.

Senator ROTH. Is it not a fact that one of the reasons for the Federal deficit is the tremendous growth of entitlements; many of which are directed at helping senior citizens?

Chairman GREENSPAN. Yes, Senator.

Senator ROTH. So, that to promote family savings, does have the beneficial impact of both helping reduce the Federal deficit, and enabling the families to care for their own needs.

Chairman GREENSPAN. Well, it certainly enhances the ability of families to support their own needs. There was a big dispute—as I know you are aware—on exactly what the impact of various different tax incentive proposals was on the budget deficit. And I have seen evidence going in both directions on that in a number of different studies, with numbers of different proposals.

Senator ROTH. But you do suggest there should be private savings?

Chairman GREENSPAN. Oh, indeed, I do.

Senator ROTH. Now, let me ask you this question. Since World War II, the emphasis has been on consumption. All you had to do was open the paper and read about the easy credit terms to buy; our tax system, double taxes savings in contrast to consumption, so the main pressure on the individual has been to consume rather than save.

So, you state in your testimony that savings is somewhat a matter of cultural background. Should we not be trying to change that cultural practice of consuming and spending, and begin to save?

Chairman GREENSPAN. Senator, if we could somehow go back to that old notion of "saving for a rainy day"—which I have not heard in decades—it probably would do more to raise our saving rate than any economic policy program that could be implemented in——

Senator ROTH. Cannot an IRA plan—whether it is exactly cast like ours, or something else—does that not help provide the kind of incentives; the kind of equitable treatment; the kind of conditions? Because many of your financial houses have indicated that they are willing to move into tremendous advertising campaigns to sell them. Does that not begin to create the kind of environment that will hopefully turn it around? Is it not worth that risk?

Chairman GREENSPAN. Well, you are raising a very interesting point, Senator, in that most of the people who look at the issue of evaluating past IRA's both pro and con, I think, have agreed that the advertising aspects that have been associated with past IRA's have been a positive element in creating saving. And it may well be that anything in that area which changes the culture or works in that direction would be a positive.

Senator ROTH. One final question, Mr. Chairman, because I see my time is running out. There was very substantial savings in IRA's in the period between 1981 and 1986. What was it, close to $30 billion dollars?

Chairman GREENSPAN. At its peak it was averaging somewhat over $35 billion a year.

Senator ROTH. $35 billion.

Chairman GREENSPAN. $35 to $40 billion a year.

Senator ROTH. Now, it is estimated 40 percent of those IRA's will be in financial institutions; banks. Will that not be a very helpful factor in view of the critical situation in the banking institutions?

Chairman GREENSPAN. That is difficult to say. That is an issue of what would have happened otherwise.

Senator ROTH. If I might make a point, we have to make decisions here. You are never going to have an ultimate answer. But do IRA's not really provide a good opportunity to promote savings to help our financial institutions; to help our families take care of themselves? If you compare it with our multi-billion dollar spending programs—we never hesitate there because there is no guarantee—why should we not take a chance on savings and on people?

Chairman GREENSPAN. Well, Senator, let me give you my view on this. If you look at it as a statistician, it is very difficult to find which of the various studies really capture what is going on in reality. I do agree with you that it is probably worth a chance, because even if, in fact, it does not turn out to produce any major net addition to national saving, there is probably very little damage that is done in general. I personally am never against tax cuts, so I have, probably, a bias in this.

Senator ROTH. I share that sentiment.

Chairman GREENSPAN. But the issue is of such great moment—in fact, I think it is the key domestic economic policy problem of this country—that I am more inclined to take chances in doing things, even though I am not—as you would put it—analytically convinced that one is sure as to how it is going to come out.

I am inclined in this direction—although I must tell you I have gone through a great deal of material and the evidence, if one looks at it, has got to be described as essentially inconclusive. There are both sides of this argument, both of which are credible, and it is very difficult, as you will find in your subsequent hearings, to get consensus on this question.

Senator ROTH. But it does provide an opportunity to help national savings and the family.

Chairman GREENSPAN. Yes. The way I would put it is the way you would. It is a question of whether one wants to take a risk in this direction, and clearly, one does try to move in the direction of policies where, if you succeed, the payoffs are very large.

Senator ROTH. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Breaux.

Senator BREAUX. Thank you, Mr. Chairman. And thank you, Mr. Chairman, for your testimony. Let me ask just a question or two about the point that you make as to how we pay for the IRA's were Congress to move forward with the proposal.

The estimates that we have from the Joint Committee is a cost of $4.4 billion in 1992 and $25.8 billion between 1992 through 1996. And you point out that it does make a difference on the effectiveness of IRA's, depending on what method we use to pay for them.

Could you give us a little bit more of an elaboration on what you think the outcome may be with regard to that effectiveness if we choose a tax increase to pay for the proposal, as opposed to cutting some program that is currently in place?

Chairman GREENSPAN. Well, I can very readily envisage a tax increase which might be imposed as a consequence of requirements coming under the statute, which could actually be quite counterproductive.

And what I would say in this regard is that if one views some form of IRA, or some form of tax credits in the saving area as something of value, let us make certain that in the process of what

adjustments are required under the Budget Act that we do not undercut those values by taking other actions which are deleterious to the structure of the economy, to its growth, and to its saving rate.

Senator BREAUX. What about spending reductions to offset the loss of the IRA's?

Chairman GREENSPAN. Well, my inclination—especially if one is looking at the question of long-term saving—is to be biased in the direction of offsetting it by cuts in spending rather than increases in taxes.

Senator BREAUX. You also speak to the question—and I think Senator Packwood had talked about this—about the type of people who benefitted from IRA's when they were being utilized by the largest number of people, and you discuss the possibility that we are not talking about increasing savings as much as, perhaps, shifting savings from one pile to the next. I would like you to comment on that just a little bit further.

I would like to be able to have an IRA program that really benefits middle income and upper middle income people, who I really feel have been short-changed over the last decade in this country.

Is there evidence that that group is likely to be the group that would participate in IRA's based on the past experience, or are we talking about a group that really does not need that much of an incentive? Do you have any thoughts on that?

Chairman GREENSPAN. Well, Senator, remember we are working at the margin here. The original appraisal very early on of the impact of the IRA's of the early 1980's was, indeed—as Senator Packwood indicated—that all of the evidence suggested that what we were looking at was merely moving funds from one pile to the other, and there was no net saving implications as a consequence.

Subsequent studies with later data have suggested that there may well be certain net additions: however, there also have been other studies which have countered that. It has been an interesting debate, and there are fairly strong advocates on both sides of that argument.

I would not be overly concerned in the issue of saving about where the incidence occurs in various income groups, because what we are trying to do is to raise saving generally to build capital investment, to create jobs, and to help everyone in the economy.

We could get lost in failing to remember that what we are involved in here are the elements underlying economic growth, and that trying to trace through these various incidences of where various programs fall, I think, is probably quite difficult, but I am not sure it is the type of path which is very fruitful from a policy point of view.

Senator BREAUX. Does that put you in opposition to any efforts to more tightly target those groups that would be able to benefit from these new IRA's?

Chairman GREENSPAN. I am an agnostic on that issue. It does not create much of a problem unless one does it in very great specificity.

Senator BREAUX. Yes.

Chairman GREENSPAN. Then you can make it a very, very limited program. So, I would be inclined to be careful about how it was done.

Senator BREAUX. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. Senator Grassley.

Senator GRASSLEY. Thank you, Mr. Chairman. Chairman Greenspan, the special IRA provision has a relatively short required holding period: 5 years. The short holding period is, no doubt, meant to be a real incentive, but some would say that it might only increase asset shifting.

So, I would like to have you comment on whether increasing this holding period would have a positive impact on savings, as well as maybe bring down the costs, or would there be a negative impact if we were to do that?

Chairman GREENSPAN. Well, Senator, remember that anytime you endeavor to allow exceptions to the saving pattern—in other words, the capability, essentially, of withdrawal—whether it is caused by the timeframe of the IRA that is withdrawn early, or whether there are special categories that can be employed to use your IRA, to that extent, obviously, you do reduce some of the saving characteristics of any IRA plan. And as a public policy question, there has got to be a trade-off here in making judgments as to just precisely what it is that you want to do.

To the extent that you have an IRA plan which enables you—as, indeed, some of the plans do—to use the funds for certain specific purposes—like home purchase, for example—you are increasing the subsidies for home purchase.

Now, that may be considered good or bad, but to the extent that you subsidize the capital use in one category of output—such as, say, home building—you, of necessity, are reducing it for other areas of potential capital investment.

And, what is important in constructing these programs, both with respect to the timeframe in which one can dispose of previously accumulated IRA funds, or under the various exemptions that occur as one formulates the structural plan, I think one should be very carefully aware that when you get a subsidy for one particular, or one broad aspect of consumption or investment, you, of necessity, are taking it away from other areas.

Senator GRASSLEY. Further on the subject of asset shifting, I have had some concern expressed to me. Those in the municipal bond market tend to worry that expanded IRA's, or any new tax-free savings program like the President's might interfere with, or take business away from their markets. And, of course, then they argue that this is going to have a negative impact on cities and localities to meet their bonding needs.

I have also been told that many bond investors have an adjusted gross income of lower than 100,000, and would, therefore, be able to invest in the Administration's Family Savings Account. I am sure you are aware of these problems, but more specifically, do you see these new savings programs negatively affecting the municipal bond market?

Chairman GREENSPAN. It is really part of my previous answer, Senator, that there are various priorities. My impression, frankly, is that the effects that are likely to occur as a consequence are not,

in any of the proposals I have heard, likely to be sufficiently large to create the types of problems about which some people exhibit concern. So, short of a really much larger program than anyone is contemplating—or certainly that is on the agenda today—I would say that it is not likely to be a concern of large moment.

Senator GRASSLEY. Thank you, Chairman Greenspan. Mr. Chairman, I am done.

The CHAIRMAN. Senator Daschle.

Senator DASCHLE. Thank you, Mr. Chairman. Mr. Chairman, like so many on this committee and in the Senate, I am a very enthusiastic supporter of the Bentsen bill. One of the concerns, obviously, that we all have, is the major requirement for an offset—some $25 billion over 5 years.

If we were to pare down the bill—and I am certainly not suggesting that—but if that were required, and we had to look at whether the incentives at the front, or the incentives at the end were more important in terms of creating net new savings, what is your view as to which would be the more important?

Chairman GREENSPAN. Yes. That is a very important question, Senator. Regrettably, I just have not given it enough thought to give you a thoughtful answer, and I would just as soon not give you something off the top of my head.

Senator DASCHLE. Obviously, you have seen various estimates having to do with what the cost of providing tax benefits at the front end are as compared to the cost of the benefits provided at the back end when one withdraws funds.

From what you know, do you think that one would have greater value than the other, regardless of what effect it may have on savings? I am trying to get some assessment as to the value from various perspectives of the two main features of this particular bill.

Chairman GREENSPAN. It depends on the underlying assumptions of the structure cf it, because obviously, you can convert into present value or present cost any claims over the future. That is, whether or not they are front loaded, or back loaded, you can determine the present value, and hence, the cost and the nature of the incentive.

But that requires judgments about what the discount rates are, and a lot of other elements associated with taxes and how this particular issue is handled. Well, Senator, let me see if I can give you a response in writing which comes to grips with the issues you raise. I would hate to try to do it now, because it is a little more technical than I think we can handle in this type of discussion.

[Chairman Greenspan subsequently submitted the following information:]

Your question, as I understand it, concerns the relative effects that front-loaded and back-loaded IRA's would have on private saving and government revenues. This question raises some complicated issues, and my answer is necessarily somewhat technical.

Generally speaking, front-loaded IRA's and back-loaded IRA's offer a saver the exact same opportunities for transferring current purchasing power ɩo the future, provided that the saver's marginal tax rate is the same at the time funds are deposited as it is at the time funds are withdrawn. This is easiest to understand in the context of a numerical example. Consider a saver with a 28 percent tax rate who invests $1,000 in a front-loaded IRA paying 10 percent annual interest and who withdraws the entire proceeds, $2,594, 10 years later. After paying 28 percent tax on the withdrawal, the saver receives $1,867 to spend on goods. Alternatively, the saver

could use the $1,000 pre-tax income to deposit $720 in a back-loaded IRA and to pay $280 in tax. After 10 years earning 10 percent annual interest, this $720 yields an untaxed return of $1,867, the same after-tax proceeds yielded by the front-loaded IRA.

In this example, the individual can obtain the same amount of retirement consumption by putting $1,000 of before-tax income in a front-loaded IRA as he or she can by putting $720 of after-tax income in a back-loaded IRA. In effect, the extra $280 initially deposited in the front-loaded IRA, which represents the tax savings due to the initial tax deduction, is set aside to finance the taxes levied at the time funds are withdrawn. It is important to note that this equivalence result assumes that savers are able to contribute more to a front-loaded IRA than they would choose to contribute to a back-loaded IRA. By implication, if legislation where enacted that set identical limits on contributions to the two IRA types, or that set a limit on the sum of contributions to both IRA types, then the back-loaded IRA would offer greater opportunity to save on tax-favored terms. The equivalence result also assumes, of course, that the rules governing withdrawals are the same for both IRA types.

A front-loaded IRA and a back-loaded IRA yielding identical amounts of after-tax future purchasing power also have equivalent effects on the government's long-run debt, provided the government's borrowing rate is equal to the interest rate paid on IRA's. This is easily seen with reference to the above numerical example, where front-loaded IRA yields $726 of revenue after 10 years, and the back-loaded IRA yields $280 of revenue immediately. (In both cases, tax on the initial $1,000 in earned income generates the revenue; the IRA effectively exempts interest earned on the initial $720 in after-tax income.) Other things the same, a $280 increase in immediate revenues reduces the government's debt by $726 after 10 years, assuming the Treasury's borrowing rate is 10 percent, so that both IRA's have the same implication for the government's debt after 10 years.

But, as your question suggests, the current budget rules focus on the effect of legislated tax changes on the path of the budget deficit over the next five years, and not just on the long-term level of government debt. Therefore, it may be relevant that front-loaded IRA's lead to large immediate revenue losses that will be partially reversed in future years, and that otherwise equivalent back-loaded IRA's lead to slowly accumulating revenue losses.

Finally, let me mention a few important caveats to my earlier statements concerning the equivalence of front-loaded and back-loaded IRA's. First, many taxpayers probably expect their marginal tax rates to be lower when they withdraw from their IRA's (typically in retirement) than when they make contributions. To them, a front-loaded IRA would offer a higher after-tax return to saving, and thus induce a larger reduction in the present value of government revenue, than would a back-loaded IRA. On the other hand, individuals who expect to face higher marginal tax rates in the future would tend to favor the back-loaded approach.[1]

In addition, saving decisions may well be affected by factors that are not captured in this analysis. Notably, several economists who have studied the 1982-86 IRA experience believe that the availability of the up-front deduction explained much of the popularity of the IRA's of that period.[2] Thus, despite the objective reality, taxpayers may perceive that front-loaded IRA's—because they reduce immediate tax liabilities—are more attractive than back-loaded alternatives that would offer the same tax saving over time.

Senator DASCHLE. Fine. One final question. Obviously, an offset is required. Can you conceive of any scenario where the cost of the offset is such that it outweighs the merit provided through the bill itself? In other words, is there too high a price to pay for the benefits derived under the bill, whether we fund it with a spending cut or an increase in revenue, that would cause you to caution us about passing it.

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[1] The tendency of individuals to select the IRA type based on their own special circumstances makes it especially difficult to estimate the revenue consequences of legislation such as the Bentsen-Roth IRA proposal that would allow taxpayers to choose between the two types of accounts.

[2] This view was expressed in the testimonies of David Wise and Jonathan Skinner before this committee on May 16, 1991.

Chairman GREENSPAN. Yes, Senator, there is. But I um sure that every member of this committee can find a particular use of those funds which they would consider so negative as to dampen their enthusiasm for this particular program. And I trust that the offsets, whatever they are, do not offset the positive elements which are clearly here.

Senator DASCHLE. Would you be referring to any particular categories of offsets in that regard?

Chairman GREENSPAN. No. We all have our own personal views as to the way the budget should look, and just throwing another personal view into the hopper does not add very much, I find.

Senator DASCHLE. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. And to show you part of the problem, Mr. Chairman, I listened to my friend, Senator Packwood, talk about savings rates going up after the IRA was reduced in its application. And my staff immediately handed me numbers to the contrary, that savings rates were higher—5.3 percent of disposable income in 1982 to 1986 than since, when they dropped to 4.2 percent.

Now, each of us will put numbers in to try to buttress our point of view when this is over, I am sure. But that is part of the problem that we face in trying to resolve this. I am very appreciative of your being here. I know of your heavy schedule and the other commitments you have this morning. I thank you very much for your contribution. It has been helpful to us.

Chairman GREENSPAN. Thank you very much, Mr. Chairman.

The CHAIRMAN. We now have a panel that consists of Mr. Robert Bergland, executive vice president of the National Rural Electric Cooperative Association; Mr. Dallas Salisbury, the president of Employee Benefit Research Institute from Washington, DC; Dr. Neal Cutler, the president and scientific director of the Boettner Institute of Financial Gerontology.

That all sounds pretty impressive, and we are pleased to have each of you here. Robert Bergman has been before this committee time and time again in the past. We look forward to your contribution this morning, if you would proceed.

STATEMENT OF ROBERT BERGLAND, EXECUTIVE VICE PRESIDENT AND GENERAL MANAGER, NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION, WASHINGTON, DC

Mr. BERGLAND. Thank you very much, Mr. Chairman and members of the committee. I am here today to speak to the issue of savings and investment in the rural parts of the United States; the out of the way places that is home to one in six Americans; persons who live in smaller villages and towns in the open countryside; where jobs are the most important, critical economic factor; where we have a poverty rate which equals the urban ghettos and massive underemployment.

In my group, Rural Electric Cooperatives are deeply involved in economic development. We think that the Bill S. 612 would provide a source of funding for economic development that is essential to any sort of economic plan.

The bill provides for the flexibility which you outlined in your introduction; we endorse those provisions most sincerely. But our belief is that an expanded and improved IRA is going to result in increased savings within the rural banking community. Our experience in development shows that development starts at home, or it does not start at all. We work with local existing industry, we build on what is in the community. And our primary, and sometimes only source of funding, are the local banks. And the savings rate in these rural communities is down, as national data shows.

We are convinced that your bill—sponsored by you and others—would, indeed, increase the savings rate in these local banks, and would be a very central and necessary source of funding for economic development. Mr. Chairman, I have a longer and more detailed statement I would like to submit for the record.

The CHAIRMAN. We will take it in its entirety.

[The prepared statement of Mr. Bergland appears in the appendix.]

Mr. BERGLAND. I appreciate the committee's interest in this important matter. Thank you, sir.

The CHAIRMAN. Thank you very much. Mr. Salisbury, if you would proceed, please.

STATEMENT OF DALLAS L. SALISBURY, PRESIDENT, EMPLOYEE BENEFIT RESEARCH INSTITUTE, WASHINGTON, DC

Mr. SALISBURY. Mr. Chairman, it is a pleasure to be here today. With me is Joe Piacentini, a Research Associate with the Institute, who has provided additional statistics to the committee. We were asked to specifically look at the issue of the effect of T.R.A. 86 on IRA eligibility.

Under restrictions imposed by that Act, 65 percent of all workers age 21–64 were eligible for a full $2,000 IRA deduction in 1987; 58 percent are eligible today. By 1995, 52 percent will be eligible. Put a different way, 35 percent of those who contributed to an IRA in 1982 are still eligible for a full IRA deduction; 65 percent of those who did not contribute to an IRA.

T.R.A. 86 restricted IRA deduction eligibility for workers with pensions and incomes over certain thresholds. Workers least likely to remain fully eligible for a full deduction in 1991 include those with working spouses: 45 percent eligibility; and those with family incomes in excess of $50,000: 21 percent of whom are currently eligible.

Workers with working spouses are disproportionately affected by the restrictions, because dual employment increases the likelihood of family pension coverage, and higher family income. The income thresholds associated with IRA deduction restrictions, as you know, have not been indexed.

Therefore, as incomes rise due to inflation or real income gains, the proportion of workers who are eligible declines. While all higher income workers with pensions are already ineligible for deductible IRA's, an increasing proportion of moderate income workers are ineligible as a result of inflation.

The proportion of workers with family incomes between $35,000 and $50,000 in constant 1991 dollars has fallen from 75 percent eli-

gibility in 1987 to 55 percent eligibility today, and will drop again, due to inflation, to 43 percent by 1995.

The Bentsen-Roth Bill would improve IRA deduction eligibility for 37 percent of all workers in 1991, and 43 percent of all workers in 1995. While higher income workers would be most likely to gain eligibility in the near term, many moderate income workers would also gain as a result of this countering of the inflation impact. Among workers with incomes in excess of $50,000, 78 percent would gain eligibility in 1991 and 1995. Among those with incomes between $30,000 and $50,000, the proportion gaining eligibility would be 41 percent in 1991, and 54 percent in 1995. IRA deduction eligibility does not guarantee that workers will make IRA contributions, nor does ineligibility preclude such contributions.

Following T.R.A. 86, IRA participation remained higher at higher income levels, including both deductible and non-deductible contributions. In 1987, 7 percent of workers with incomes below $30,000 contributed, compared to 14 percent with incomes between $30,000 and $50,000; 19 percent of those with incomes between $50,000 and $75,000; and 28 percent of those with incomes over $75,000.

IRA deduction eligibility improvements under the Bentsen-Roth bill would be somewhat concentrated among higher income workers. Actual tax benefits would be more concentrated.

But against an issue of total capital and total availability of capital and the economy, one should note that as a result of the IRA deductibility as of the end of the 1990, over $564 billion was available to aid the capital of the nation, and from employment-based pension plans, an additional $2.5 trillion.

And against a question of the degree to which tax-deferred savings have, in fact, helped to make today's retirees historically well off in terms of cash and non-cash income, one need only compare the fact that total Social Security benefit payments were $227 billion, compared to benefit payments in 1989 from private pension and public pension plans to retirees of $244 billion.

So, we are seeing that relative to Social Security in general, and in terms of the capital markets, these programs are contributing to retirement income, and are contributing to the nation's capital.

Against a final point, and a concluding comment, the issue of whether or not this represents money that would not have otherwise been saved, the necessary data are, in fact, inconclusive.

But one comment is generally made by those on Wall Street and elsewhere, and by such investors as Warren Buffett, pension savings represents patient capital that is generally available for investment over longer time periods. And against that general economic question, that patient capital in and of itself proves of great benefit. Thank you, Mr. Chairman.

[The prepared statement of Mr. Salisbury appears in the appendix.]

The CHAIRMAN. Dr. Cutler.

STATEMENT OF NEAL E. CUTLER, PH.D., PRESIDENT AND SCIENTIFIC DIRECTOR, BOETTNER INSTITUTE OF FINANCIAL GERONTOLOGY, BRYN MAWR, PA

Dr. CUTLER. Good morning, Mr. Chairman and members of the committee. My name is Neal Cutler. I am the director of the Boettner Institute of Financial Gerontology, a research group in Bryn Mawr, PA. We focus on the connections between the social and the financial aspects of aging. We are located on the campus of the American College in Bryn Mawr. I am also a professor in the Gerontology Graduate Program at the University of Pennsylvania.

[Showing of viewgraph.]

This hearing reflects the well-known "Graying of America,." But I would like to this morning, at least slightly, modify the terms of the discussion away from aging, and focus on "The Middle Aging of America."

Mr. Chairman, our Institute is not here this morning to take a partisan, or political view on the issue of IRA's. But I am happy to summarize some of our work, in the hope that it will focus discussion on the individual responsibility for financial and retirement planning.

May I make just two brief points and then add an international footnote? The two points have to do with the two kinds of aging which gerontologists study. We distinguish between individual aging, and population aging.

First, about individual aging. It was not too long ago that we would not be talking about middle age.

But in the past 50–75 years, circumstances have changed so dramatically, that we now recognize middle age as a separate stage in the life cycle. Life expectancy has steadily gotten longer during this century, at the same time Americans are retiring earlier and earlier.

So, our financial resources for old age must be accumulated during a shorter work life, but must be adequate for a longer period of old age. And at the same time, somewhere between our late forties and our early sixties, we begin to see and feel our age. Our children grow up, and leave home; our parents grow old and leave us. We begin to sense our own mortality, and we feel the need to plan for the future.

I realize, Mr. Chairman, that this is a short summary of a complex stage of life, but middle age is a time when family earnings are expanding, and when most major household purchases are complete. As a consequence of these separate but interconnected elements of financial and gerontological dynamics, discretionary income may be growing, and the family pattern of savings versus spending begins to change in the direction of savings.

Let me briefly turn to the second of the two kinds of aging: population aging. Here, we refer to the overall number of people of different ages in the Nation. It is shocking to say that the baby boom will be middle aged before it is older; 1991 begins a period when 80 million baby boomers become 80 million middle agers. The specific numbers are in my written testimony, but the conclusion is that for the quarter century that begins in 1990, middle-agers will grow

by 70 percent, as indicated by the top line in our graph. The dramatic growth is in the middle aging of the population.

In conclusion, Mr. Chairman, when we combine the dynamics of individual aging with the demography of population aging, the importance of the legislation you are considering today is ever more apparent.

The United States is facing a gerontological and financial opportunity that is literally unprecedented in human history. The number of individuals who would be affected by incentives to save and to plan are simply staggering.

And to emphasize the connection between saving and middle age, our research offers a final, international footnote. Perhaps we could have the next graph.

[Showing of viewgraphs.]

Dr CUTLER. Over the past few years, as we all know, there have been many comparisons as there were this morning, between Japan and the United States on the issue of our national savings rate. We recognize, of course, that many factors contribute to a high or a low national savings rate. But to the degree that middle age plays a role, then a comparison of American and Japanese demography is quite revealing.

And so may I conclude by directing your attention to this graph, which is also included with my testimony. It compares the percentage of the population that is middle aged in these two countries over a 75-year period. The top line is the Japanese line. The bottom line, the one to the right, is the United States.

It is clear that substantial Japanese middle aging began back in the 1950's. In other words, Japan has had a substantial proportion of its population in the high-savings stage of their life cycle for a long time. But by comparison, from the 1960's to the 1980's, the 80 million American baby boomers were teenagers and young adults. But now, the United States is beginning a period of very rapid middle aging. But it is obviously not simply demographics alone. During the previous three or four decades, Japan has had a large middle-aged population, but it has also had a national policy that encouraged private savings.

And so, this research suggests that now just might be the right time for the United States to evaluate its own national policy in this regard. Because, Mr. Chairman, whatever financial and gerontological benefit Japan got from its middle aging, the United States is about to get a lot of it over the next 25 years. Thank you.

[The prepared statement of Dr. Cutler appears in the appendix.]

The CHAIRMAN. Thank you, Doctor. Mr. Bergland, for years the Rural Electrical Cooperatives have done a commendable job for rural America, and not just with electricity. You have moved beyond that to the health of rural America, and to retirement for people on the farm.

Now, do you think it is ironic, with the cyclical nature of farm income, that those years when things come together and the weather is right, market prices are right, and you have an increase in income, you are precluded from using the IRA. But, when you get bad markets, bad weather, do not have a crop, do not have the discretionary income, you are eligible for the IRA.

Mr. BERGLAND. Well, that is one of the anomalies that we are confronted with and, in fact, most of the rural areas—about 1,500 of the 3,000 counties in the United States depend on a commodity and commodities cycles. And these ups and downs are what contribute to the instability that we regard as the serious element beyond our control. And so, anything that we can do to help us deal with these ups and downs, these swings, would be enormously important.

Secondly, Mr. Chairman, we did a survey of about 800 small, rural businesses and found, much to our concern, that rural businesses are less likely to provide employee benefits and company savings plans than are city businesses.

And so, we have again, a body of rural workers who do not have access to a private company-sponsored plan, and it is far more prevalent in the rural areas, underscoring the need for some additional opportunities to save for retirement.

The CHAIRMAN. I see some of the same sort of problems, Mr. Salisbury, in the eligibility for IRA's in your testimony. We have more two-earner couples than ever before in the history of our country. Not just numerically, but percentage-wise. More even, than the days of Rosie the Riveter back in World War II. And yet, you have a situation where, with children, the mother may stay home for awhile, and income is lower. And they have less discretionary money to try to save. But, when both spouses are in the workplace, they become eligible again. Is that not a fairly common situation?

Mr. SALISBURY. It shows up in the data to be a fairly common situation, and to be generally an anomaly in the tax incentives for retirement savings. Since, for example, if we compare it to 401 K plans, two individuals working at two different work places are independently eligible for full IRA contributions without reference to how they tie together, whereas with the IRA, we have done it on the basis of family income. One might describe it as another incentive for divorce, and anti-family.

The CHAIRMAN. And then some say, if they already have eligibility for a retirement plan, then they should not have eligibility for an IRA. But you have a lot of people that work for a company where they have eligibility, but never vest.

Or you may have a profit-sharing plan, where the contributions by to the profit-sharing plan are quite cyclical. Would you care to comment on that?

Mr. SALISBURY. It is hard to generalize on that particular item, because the law does not differentiate currently between being covered by what type of pension plan. Your comment is particularly appropriate, as it relates to my not being able to contribute to an IRA while I am not vested in a defined-benefit pension plan which generally has vesting deferred until I have been at the job for 5 years. On the other hand, if I compare it to most defined contribution plans where you have generally full and immediate vesting of the money that you put into the plan, then it is a more, if you will, more logical offset. So, against some types of pension coverage—that available to about half of those covered—it makes more sense than with the other, even though it is a policy judgment as to whether it makes any sense at all.

The CHAIRMAN. Dr. Cutler, you testified that people are living longer and retiring sooner, which means they have to save more because they are going to be more dependent on their savings. Do you think this development will encourage saving earlier and more abundantly?

Dr. CUTLER. It seems to me, Mr. Chairman, that the natural middle aging process might encourage people to save on their own. But we are talking here—at least our research suggests, as it is well-known—80 million baby boomers, and they are not all the same; some may save—recognizing what you said—without the incentive; others may not have the capacity to save. But within that range, some of those 80 million may have sources to save, but could use that extra incentive that a proposal such as yours might give them.

The CHAIRMAN. Thank you. I see my time has expired. Senator Packwood.

Senator PACKWOOD. Dr. Cutler, several weeks ago there appeared an article in the Wall Street Journal about savings which stated, "Several economists indicate that the savings rate will go up rather dramatically just because of the aging of America."

So I had my staff call the reporter and find out the names of the economists. I then called them up. I think one of them was Mr. Edward Yardeni. I talked to a number of them. Mr. Yardeni estimated that our savings rate increase above its historical average levels of 6.5 or 7 percent by the mid-1990's without any stimulus from tax incentives. The reason is simply because of the fact that you are stating; that as America ages, people will save more. Do you think that is a reasonable assumption?

Dr. CUTLER. Well, I have no basis for appraising that particular percentage change. That might naturally occur because of the middle aging of the population. And indeed, from the macroeconomic perspective, that may be good.

But our research focuses on the individuals—and while some of that natural savings that might accrue because of middle aging and, therefore, the economy might be better—are likely to be savings by those who already have the capacity and do not need the incentive. In addition to that, I think public policy should focus on those individuals who need the incentive. Their savings might also help the economy, but I am also focusing my concern on how those savings will help those individuals who need the incentive to combine with whatever resources they have to put away money for their own retirement.

Senator PACKWOOD. Would that not opt for leaving the IRA laws basically unchanged? Deductible IRA's would still be available for those individuals who are not big savers now—singles that make $25,000 or under and couples who make $50,000 or under?

Dr. CUTLER. I have no basis for evaluating those particular numbers.

Senator PACKWOOD. Mr. Salisbury, let me ask you a question. I have introduced a retirement bill which nine members of this committee are co-sponsors of it. I will describe it, and you tell me if you think it has any merit. I call it the PRIME Retirement Account, and it works as follows: (1) small business employing less than 100 workers are eligible to open PRIME accounts for their employees;

(2) Because PRIME is targeted to businesses not providing retirement or savings plans to employees, eligible businesses must not have another retirement plan; and (3) If a small business opens PRIME accounts for employees, any employee can put in up to $3,000 of their salary on a tax deductible basis. The employer must agree to match each employees's contribution to PRIME up to 3 percent of the employee's salary. The PRIME retirement account has the enthusiastic support from the National Federation of Independent Business and other small business groups. Of course, any financial institution that sells retirement plans thinks the PRIME account is wonderful. Do you have any comments on it?

Mr. SALISBURY. You have made the point that the principle area of lack of pension coverage and lack of health insurance coverage in the employment sector is in small businesses. In small businesses of less than 100, my memory is that it is only about 14 percent of workers that have protection.

And as we have seen the law become more complex in that sector, there has been a continuing sentiment that having something simple that would apply to those businesses and all workers would lead to an increase in coverage in those areas. And clearly, in the sense of your bill to the degree it led to coverage, it would lead to increased capital formation. The data on the conclusiveness of incremental savings is still a little bit open-ended.

Senator PACKWOOD. I actually have not even tried to quantify it in terms of savings. I looked at it more as a retirement plan. I realize that if workers contribute to PRIME, much of the money will be new savings, but I am attempting to sell it more as a small business pension plan rather than a savings vehicle. It is my understanding, Mr. Chairman, the Joint Tax Committee estimates the PRIME account to cost less than $100 million over 5 years.

The CHAIRMAN. Well, you know, I am an enthusiastic co-sponsor of it, Senator.

Senator PACKWOOD. I know you are. I appreciate it. I have no other questions, Mr. Chairman.

The CHAIRMAN. Thank you. I might further say it is supplementary, not an alternative. [Laughter.]

Senator Roth.

Senator ROTH. Mr. Salisbury, some time ago I wrote a letter to The Washington Post in which I said that more than half of working American families are no longer eligible for a deductible IRA. That was answered by a House member who said it was untrue. By working American family, most people mean where both spouses work. Do you have any comment? More than one half of these people are no longer eligible for any IRA deduction. Is that correct?

In fact, by 1995, it is said that more than 60 percent will no longer be eligible for any IRA contribution. Even today, the Joint Tax Committee's own pamphlet shows that more than 60 percent of working American families are not eligible for a full IRA deduction.

Mr. SALISBURY. The statistics you note stand in support of your statement, Senator, in The Washington Post. I would ask Joe Piacentini to comment on that. He has looked at it closely, as well.

Mr. PIACENTINI. Well, I did see the letter that you refer to that you sent to the Post, Senator, and your figures are quite correct,

according to our estimates. If we are talking about a full $2,000 IRA contribution, less than half of families with two workers are now eligible, and that is going to fall to less than 40 percent, as you said.

The figures that were offered in response to that were based on some slightly older estimates from the Joint Committee on Taxation; I also saw the letter that was written in response. And if you look at the updated numbers from the Joint Committee, as you pointed out, they are now much closer to our numbers. There are some slight differences that have to do with small differences in income definition.

The fact that we are talking about the proportion of workers, while they are talking about the proportion of taxpaying units, we limited our analysis to the age 21–64 workers. But basically, if you look at the proportion eligible for any IRA at all, our estimates—which you were basing your letter on, and the Joint Tax Committee's—are within a few percentage points. So, I think there is a good consensus that you are quite correct in the numbers you cited.

Senator ROTH. Well, thank you. I appreciate that information. I would like to ask for your general comments where you have a ceiling or phase-out on IRA's. Does that really make good policy? You try to encourage people as they are younger to begin an IRA, and based on the fact that it is something that they can continue and would take care of them in their so-called "golden years."

However, when you have a cut off of $25,000 or $40,000 for a couple, for a lot of people that means midstream, if they have done the right thing and started an IRA, they can be cut off. Does that make good policy sense?

Mr. SALISBURY. Well, without describing whether it makes good policy sense per se, I would simply comment that you end up with a general issue that was referred to in Chairman Greenspan's statement, which is the issue of how to get people into the process of savings and making savings a habit.

And the data very clearly implies that it is the tremendous push of advertising that went with general IRA availability that led to very significant growth in the usage of IRA's. And against this issue of an habitual pattern, it goes to Senator Bentsen's examples of the individual who, in a good year cannot, and in a bad year can, but then does not have the money.

So, purely looking at it in terms of the prospects of the IRA being sold broadly to the American public, the incentive being there to save year-in and year-out the major disadvantage of cutoffs. It will reduce the incentive of financial institutions to sell it, and secondly, it will interfere with the longevity of the savings habit. That is not necessarily to say that it is right or wrong, but it clearly would interfere with consistent build-up of saving for a rainy day.

Senator ROTH. Dr. Cutler, I have read where we are fast approaching the period where the typical worker will live in retirement longer than his or her actual work period. Is that correct?

Dr. CUTLER. My guess is that is getting very close. Retirement is becoming earlier, and earlier in the American system, and people are living longer. And it may well be that at some cut-off point, which we could calculate what you are saying is exactly true.

Senator ROTH. So that makes it all the more important that families prepare for that extended——

Dr. CUTLER. Not only prepare, but prepare earlier and earlier. As retirement becomes earlier, so does the anticipation of it, and planning for it is also being pulled earlier into the life cycle.

Senator ROTH. So, my time is up. Thank you, Dr. Cutler. I am sorry I did not get to you, Mr. Bergland. Thank you.

The CHAIRMAN. Thank you very much. We have another panel waiting. We appreciate very much your comments and your testimony. It has been most helpful to us.

Mr. BERGLAND. Thank you, Mr. Chairman.

Our next panel consists of Jonathan Skinner. Dr. Skinner is the associate professor of economics, University of Virginia, Charlottesville, VA. You certainly have testified before this committee before, and we are delighted to have you. Dr. David Wise, John Stambaugh professor of political economics, the Kennedy School of Government at Harvard; and Jane Gravelle, who is a senior specialist for economic policy for Congressional Research Service, Library of Congress. We are very pleased to have you.

I want to apologize that I will not be able to wait until the end, because months ago I scheduled a speech downtown at this time, and it seemed the appropriate thing to do at that time. Dr. Skinner, if you would proceed, please.

STATEMENT OF JONATHAN S. SKINNER, PH.D., ASSOCIATE PROFESSOR OF ECONOMICS, UNIVERSITY OF VIRGINIA, CHARLOTTESVILLE, VA

Dr. SKINNER. Good morning, Mr. Chairman and members of the committee. My name is Jonathan Skinner, and I am an associate professor of economics at University of Virginia, and research associate at the National Bureau of Economic Research. I am pleased that attention is being focused on encouraging households to save more through an expanded IRA.

I will make three points today. First, while IRA's have come under their share of criticism, I believe they are effective at promoting saving. The major criticism against IRA's is that they consist largely of contributions by wealthy taxpayers who would have saved the money anyway.

This proposition was first tested by Steve Venti and David Wise, whose results suggested that IRA's were largely new savings.

In a study with Dan Feenberg of the National Bureau of Economic Research, I examined nearly 4,000 IRS tax returns to test whether IRA's were new saving. We originally set out to disprove the Venti and Wise study because at the time, we believed that taxpayers took money out of existing taxable assets and shuffled them into IRA's. To our surprise, we found that IRA contributors tended to increase their savings in both IRA's, and in taxable assets. That is, rather than disprove the Venti and Wise study, we confirmed it.

One objection to our study is that families who contribute to IRA's are just different. They have a strong taste for savings, so it is not surprising to observe IRA contributions, as well as other types of savings.

Bill Gale of UCLA and Karl Scholz of the University of Wisconsin allowed for these differences when they estimated that most IRA saving was old, shuffled saving, thus, directly contradicting the Venti and Wise results. So standard economic models of saving cannot determine conclusively whether IRA's are new savings or old savings.

My own believe that IRA's promote savings is based less on the standard economic models than on psychological factors. Now, I want to caution that this psychological evidence is even more conjectural than most economic research, but I find the evidence compelling nonetheless.

For example, recall advertisement for IRA's during the mid-1980's. They promised that a $2,000 annual contribution would make you a millionaire and, in fact, my study with Dan Feenberg showed that one-third of all enrollees did contribute exactly $2,000 to the penny, even if they were eligible to contribute up to $4,000. Why? We interpreted this to mean that marketing blitz was effective at conveying both correct information—that IRA's were a good investment—and incorrect information—that the upper limit was only $2,000. The sharp drop-off in IRA contributions after 1986, even among those still eligible to contribute lends support to this view.

The evidence from aggregate statistics appears to contradict the view that IRA's increase savings. Between 1981 and 1986, household saving rate fell by 45 percent. But I do not think that this proves that IRA's were bad for saving, because this pattern of decline was played out in a number of other countries as well.

Refer to Figure 1 just after page three of my testimony, that shows personal savings rates in Canada, France, Great Britain, and the United States. In each country, savings rates fell through the 1980's before recovering in 1987 or 1988. It seems likely that the United States was caught in a global wave of ebbing savings rates.

My second point is that IRA's were effectively largely because of their up-front deduction. The psychological gratification of getting that instant rebate was enough to overcome the reluctance of U.S. households to save for the future.

For example, Dan Feenberg and I found that a taxpayer who owed taxes above the amount withheld to the IRS was much more likely to contribute to an IRA. We interpret this to mean that on April 14th, a taxpayer would much prefer to open an IRA rather than send a check to the dreaded IRS. The up-front deduction provided that instance gratification necessary to get taxpayers into the saving habit.

The Bentsen-Roth Bill also includes the back-ended IRA as an option to contributors. Now, back-ended IRA's do not lose much revenue now, but they do in the future; putting pressure on future deficits.

By contrast, the current revenue cost of front-ended IRA's is over-stated. Much of the revenue lost through up-front deductions will ultimately be returned with interest when the IRA is cashed out. Currently, there are $400 billion in IRA assets, representing a potential $80 billion in future tax revenue.

My third and final point is that IRA's will not, by themselves, solve the saving problem. They never accounted for more than one

percent of GNP, so they must be used in concert with other policies—such as reducing the deficit—to remedy the low rate of national saving.

Even the Bentsen-Roth IRA proposal, while broadening the appeal of IRA's to families facing housing and college costs will not necessarily stimulate saving by much more than the original program, given that some of the educational and housing costs would have been saved anyway.

My own preference for IRA's focused on retirement is that I think few families put aside enough for retirement. Recent figures have suggested that the median family at age 60-65 has only $6,600 in liquid assets. One or 2 years of IRA contributions can make a big difference for those families. In short, I believe that a front-ended IRA can be an effective means to promote household saving and retirement security.

[The prepared statement of Dr. Skinner appears in the appendix.]

Senator DASCHLE. Thank you, Dr. Skinner.

Dr. Wise.

STATEMENT OF DAVID WISE, PH.D., STAMBAUGH PROFESSOR OF POLITICAL ECONOMICS, KENNEDY SCHOOL OF GOVERNMENT, HARVARD UNIVERSITY, AND AREA DIRECTOR, HEALTH AND RETIREMENT PROGRAMS, NATIONAL BUREAU OF ECONOMIC RESEARCH, CAMBRIDGE, MA

Dr. WISE. Thank you, Mr. Chairman, for the opportunity to speak today. I have been doing research on IRA's with Steven Venti of Dartmouth College off and on for several years. The analysis is based on several different data sets that report the saving behavior of individual households; it uses several different methods of analysis.

The foremost statistical analysis is based on the relationship between family saving in IRA and non-IRA forms. We conclude that the weight of the evidence points to a substantial net saving effect of IRA contributions. That is, the contributions are not offset in large part, we believe, by a reduction in other savings.

I would like to draw your attention here in these remarks to three points based on descriptive data. These data are consistent with formal estimation results, but are easier to understand. The points are made in the figures at the end of my report. The first point, we know, of course, that savings in America are extremely low, but to put it on a personal basis, the median level of financial assets in American households is $1,500-$1,500. To recite the number that Professor Skinner just gave, on the eve of retirement, the typical American family has $6,600 in financial assets.

The second point, now relating to IRA's. I am referring to Figure 2 in the report. The figure shows that as IRA's were introduced and the percent of families using them went from about 3 percent in 1981 to about 20 percent in 1986, there was no reduction—no reduction in the proportion of families saving in non-IRA forms.

The third point. This is in Figure 3 in the report. Family non-IRA assets did not decline as the IRA assets of IRA contributors

increased from about $2,000 in 1982 to about $8,000 in 1986. This happens to be assets excluding stocks.

And that is, the part that is included are those that are the easiest to substitute. In fact, if we compare samples of IRA contributors over time, we find that the IRA assets of contributors in 1986 were greater than the non-IRA assets—that is, the resources from which this money could have come—that were greater than the non-IRA assets of contributors at the outset of the IRA program in 1982 or 1983. Also, over this period, non-IRA assets increased; they did not decrease. So, the typical contributing family in 1986 has much larger financial assets—about 114 percent larger—than the typical contributing family three or 4 years earlier at the outset of the IRA program. It is also clear from these data that the typical contributor to an IRA was not saving anywhere near $2,000 a year from when the program began. When the program began, the typical contributor had about $6,000 in financial assets.

Then, finally, I simply want to emphasize that I believe that the promotion of IRA's was extremely important in their rapid adoption and popularity. And I think that what we need to do is to push forward on this front. That is, we need to try to get people in the habit of saving. The IRA, together with a promotion, can do that, I believe.

Finally, I want to emphasize and, I guess, agree with Dr. Skinner, that the up front deduction is, I believe, extremely important. I think it is that that, more than anything else, gets people's attention, even though in some strict economic sense, that the up-front in the back-loaded IRA are equivalent. I think for the typical real person, they are not equivalent. Thank you.

[The prepared statement of Dr. Wise appears in the appendix.]

Senator DASCHLE. Thank you, Dr. Wise. Dr. Gravelle.

STATEMENT OF JANE GRAVELLE, SENIOR SPECIALIST FOR ECONOMIC POLICY, CONGRESSIONAL RESEARCH SERVICE, LIBRARY OF CONGRESS, WASHINGTON, DC

Dr. GRAVELLE. I would like to thank you for the invitation to appear before you today to discuss the economic effects of Individual Retirement Accounts. I shall discuss three issues: the effects on savings, who benefits, and the cost.

Conventional economic theory and empirical research suggests that IRA's are not likely to increase savings. There are three points that support this view. First, theory cannot determine that a tax subsidy will increase savings owing to offsetting income and substitution effects. Empirical research has failed to identify a positive response. Historically, the savings rate has remained relatively constant, and time series econometric studies have reflected this characteristic, producing small effects which are ambiguous in sign.

Secondly, even if a tax subsidy in general increases savings, IRA's are unlikely to do so because individuals contributing at the limit have no price incentive. And before, about three-quarters of IRA contributions were for individuals at the limit. Finally, the experience of the 1980's does not support the case that IRA's increase

savings. While IRA contributions were significant, the overall private savings rate fell substantially in that period.

There have been two cross-section studies focused on the effects of IRA's which support this conventional view. Gale and Scholz's study estimated desired IRA contributions and tested whether individuals at the limit made up the difference by increasing non-IRA savings. Their study indicated that IRA's did not increase savings.

Manegold and Joines compared the change in total savings for newly eligible contributors and previously eligible contributors and found no difference, again, suggesting that IRA's did not increase savings.

There are three studies which are sometimes cited as evidence that IRA's will have a pronounced effect on savings. The cross-section studies by Venti and Wise are, perhaps, the most widely cited.

I believe that the Venti and Wise studies contained a serious analytical error that made their results highly questionable. Similar criticisms have been made by a number of other economists about their modeling. I will note that the Gale and Scholz study used essentially the same data as the Venti and Wise study, and came to a completely opposite conclusion.

Another frequently cited study is that of Feenberg and Skinner. This study found that IRA's in the aggregate did not appear to come from reductions in existing assets. This finding, however, tells us nothing about whether IRA's increase savings, since IRA's could have reduced either additions to savings, or consumption. The Feenberg and Skinner study also argues that there may be a psychological effect.

This view is based, in part, on finding a correlation between owing tax and the size of the IRA contribution, but such correlations could be independently related to a number of other factors. Nor do they establish that IRA's came out of consumption rather than savings.

A third study is a time series study by Carroll and Summers, which suggested that the divergence between savings rates in the United States and Canada can be traced to differential IRA's.

There are several comments I make about this study. Perhaps the most telling is a recent study which re-ran the regressions, putting in a net wealth variable, and causing the IRA effect to completely disappear.

In sum, I would like to say that as much as we would like to increase savings, I just do not think the economic evidence supports the case that IRA's will have a strong effect.

Let me turn now quickly to the question of who benefits from universal IRA's. In general, any subsidy for capital will favor high income individuals. The dollar limits on IRA's do limit their benefit to the wealthy. Nevertheless, the data do not indicate that IRA's cannot be characterized as a subsidy to the middle class. In 1986, 82 percent of IRA deductions were taken by the upper third of individuals filing tax returns.

In addition, while significant amounts were contributed to IRA's, their popularity was not actually very widespread. In 1986, only 15 percent of taxpayers contributed. The participation as in the lower and middle-income classes. Only 2 percent of taxpayers in the

bottom third of returns, and only 9 percent of taxpayers in the middle third contributed to IRA's.

The final question I would like to discuss is the cost of restoring IRA's. The Joint Tax Committee has estimated that S. 612 would cost $25.8 billion dollars. This short-run estimate understates the long run cost of IRA's. For the special IRA's that are not deductible out front, I have predicated that in the long run, the costs could be eight times larger than the first five years. For the deductible IRA's, it could be as much as a third larger.

I do not know what they used to do their estimates, but if you assume it is 50-50, my data would predict that the long run cost would be two and a half times their estimated costs, or about $66 billion in today's income levels, rather than $26 billion. So, in general, I think that IRA's will cost much more over the long run than they will over the budget horizon. Thank you very much.

[The prepared statement of Dr. Gravelle appears in the appendix.]

Senator DASCHLE. Thank you, Dr. Gravelle. Now that we have a consensus with this committee, we will see if we can poke around to see if there are any differences. [Laughter.]

Senator Roth.

Senator ROTH. Thank you, Mr. Chairman. In the interest of fairness, I would ask Dr. Skinner and Dr. Wise if they would like to make any comments on the statement of Dr. Gravelle on their studies. Dr. Skinner?

Dr. SKINNER. No comment.

Senator ROTH. Let me ask you, how would you answer her charges?

Dr. SKINNER. Well, I would say that one can only read evidence in two different ways. I came in feeling pretty ambivalent about it. In fact, to be honest, Dan Feenberg and I were kind of gunning after Professor Wise because that was the study to refute.

And we found something different, and so it is hard to say. What I am saying is I did not come in with a strong bias, but this is the way I read the evidence. But there are alternative ways to read the evidence as well.

Senator ROTH. Dr. Wise.

Dr. WISE. Well, Dr. Gravelle did not, I guess, outline here her criticisms of our work, and I do not try to do that, either. But I have read the criticisms. I think that, of course, it is always possible to be wrong. I find that her criticisms in the first place, represent a rather substantial—I hope—misunderstanding of our analysis in our model.

But in addition to that, I did not begin this analysis with any particular view on the subject, certainly not political view. In principle, it was of no consequence to me whether IRA's increased savings or did not.

By this time, I have looked at the issue in many different ways; some ways dependent on specific models, and others completely independent of models. And I just have to conclude that the evidence, the way I see it from many different perspectives is as I have stated.

Senator ROTH. Well, Dr. Skinner, let me ask you this question. I think you say that you think Americans will choose a front-ended

IRA over the back-ended. What I would like to ask you, as a good rational and objective economist, which one would you use?

Dr. SKINNER. Well, if I may speak from personal experience, I contributed to an IRA in 1 year before I began research on the subject. And the reason was that I owed a great deal of money to the IRS., and I have not contributed since I got a new accountant. So, I believe strongly that people would rather take the tax break now than to wait into the future except, perhaps, for sophisticated investors who have some kind of different investing strategy. Perhaps they anticipate that their tax rate will be higher in the future rather than today.

Senator ROTH. Would that not be the normal situation that people will tend to pay higher taxes just by the progression in their jobs?

Dr. SKINNER. It is not clear, because first of all, a lot of IRA saving is done by people who are pretty much at the peak of their earning career, so that when we look at their annual income, it appears quite large, although over a lifetime it may not be as large just because they are starting to think about saving when they are 50 or 60 years old.

And the question is whether their tax rate would be lower when they retire and when, of course, they are not earning their regular income. But on the other hand, who can look into the future? Some people may feel more secure knowing that they, at least, will not be subject to changes in tax rates in the future.

Senator ROTH. Dr. Gravelle, let me ask you this question. Do you think it is important that we increase personal savings?

Dr. GRAVELLE. Well, I think like many economists, I am very concerned about the low savings rate that has occurred, and I think it is a very serious concern, yes.

Senator ROTH. And do you think we should try to encourage personal savings?

Dr. GRAVELLE. Well, I am not sure we can do it. I mean, I am not sure we can be successful at it. The evidence suggests that it is very hard to influence people this way, so I would say the most direct route to increasing savings is to reduce the budget deficit, and the most direct route to insuring some sort of retirement income is to use Social Security, or some system like that to at least insure a minimal——

Senator ROTH. Then you think it has to be government mandated?

Dr. GRAVELLE. Well, I think if you are going to be sure of success, it is probably more certain for the government to do it than to rely on incentives to——

Senator ROTH. Has government been very successful in reducing the deficit?

Dr. GRAVELLE. Do you mean have you all been very successful? I am sorry. No. I think that, obviously, this is a situation that is very difficult to deal with right now, but that is the most direct prescription that I know of to increase savings.

Senator ROTH. I have to say that I think we succeeded a lot less in actually reducing the deficit, notwithstanding the Summit Agreement and the IRA's. The question can be raised, but as the

Chairman of the Federal Reserve says on balance, it seems to me that that is the way to go. Well, thank you, ladies and gentlemen.

Senator DASCHLE. I would like to ask a question of Dr. Wise and Dr. Skinner. Obviously, there are differences of opinion with regard to the prospective impact of whatever new IRA proposal may be implemented, but Dr. Gravelle points out an interesting set of utilization figures here that I had not seen before.

She indicated in her testimony that only 15 percent of the returns in 1986 indicated contributions to IRA's. And these participation rates are lower in the lower- and middle-income classes—only 2 percent of taxpayers in the bottom third, and only 9 percent of taxpayers in the middle third contributed to IRA's. That is not necessarily an overwhelming endorsement by two-thirds of the population in this country for IRA's. How would you respond to that?

Dr. WISE. Well, there is, I would say, some truth and some untruth in the statement as given. It is true that higher income people are much more likely than lower income people to contribute. It is also true that in 1985, at least, that about three-quarters of contributors had incomes below $50,000. Now, $50,000 tends to be at a higher income level, but I think most people would not call families with incomes $50,000 rich these days. It is also, I think, important to keep in mind that we often think that families who have incomes of $50,000, or $75,000, or even $100,000 save a lot; they do not. They do not save a lot. Most families with incomes of $50,000 are not saving anything like $2,000 a year if they do not have IRA's. The typical financial assets of families between 45 and 50, and earning between $40,000 and $50,000 a year, is $5,000. So, if we think we want to encourage saving, we might think we do not care where the saving comes from. If we think we are concerned with distribution and spreading out saving, then I think it is important to realize that many of the people who we might think of as being wealthy may not be wealthy, and they certainly are not saving.

As to the bottom third, one might argue that programs like Social Security work pretty well for the lowest income group. That is, Social Security provides a pretty high replacement rate of retirement. This is not to say that I think these people should not save; I think they should. They are most entirely dependent on Social Security. But a large portion of sort of middle-income people do not save much, and certainly do not have much accumulated saving at the time of retirement.

Senator DASCHLE. Dr. Skinner, do you have anything to add to that?

Dr. SKINNER. If I might add just a few comments. The first is that lower income families tend to be in lower tax brackets, so that they are not going to get as large a rebate as higher income groups would be. One way to address this would be to think about a tax credit, which would be the same rebate for everybody, regardless of income.

And second, borrowing some numbers from the Venti and Wise study, it is important to focus on when people start thinking about saving. For example, for families with income between $20,000 and $40,000 at age 55 through 64, the participation rate was nearly 50 percent.

And finally, in conclusion, not everybody who contributed in the past had contributed in 1986, so the total participation rate, I think, is closer to a third of all taxpayers. That seems to be what comes out of some surveys.

Senator DASCHLE. Dr. Gravelle, I will give you a chance to add your comments to this.

Dr. GRAVELLE. Well, I would just like to say that we have to remember that people with adjusted gross income of about $50,000 about 1985 or 1986 were the top 10 percent of the population. I mean, these people may have thought of themselves as middle class, but in terms of a distribution of the population, they were certainly in the upper tail.

I think what Jon points out is true that people might contribute at different times, but I still think regardless of that those 2 percent and those 9 percent rates are just going to be very low, no matter how you slice the data.

Senator DASCHLE. Someone asked me a while back, what is wrong with just promoting more aggressively the National Savings Bond program that we used to rely upon a lot more frequently? It would be cheaper and more beneficial, perhaps, to the Federal Government.

With a public education campaign, you could really put something like that together. It goes a little bit to Senator Roth's question: what alternatives are there? Has anyone analyzed the value of the National Savings Bond effort compared to an IRA in terms of the incentive for savings, that is, the national benefit there may be in net savings?

Dr. WISE. It is often cited as an example of the success of promotion. Of course, it was in a different time and a different place. It is not quite clear that that transfers easily to today. I do not know of a study that utilizes the saving effect of that plan versus the kinds of things we are talking about with IRA's.

Dr. SKINNER. I am also not aware. I just think about the All-savers certificates back in the late 1970's which, I think, were similar. And I do not think there was enough of a bonus—a carrot—to get people that interested. So, I wonder whether promotion, without some kind of incentive, may be not as successful.

Senator DASCHLE. Well, you have, of course, favorable tax treatment of national savings bonds like you do with IRA's, so there is an incentive in that perspective.

Dr. SKINNER. That is true. I guess I would then fall back on this notion that you have to give the carrot right now, rather than sometime later.

Senator DASCHLE. Right. Dr. Gravelle.

Dr. GRAVELLE. Well, I am not aware of any study, or anything, but I do think we have to be very careful when we are thinking about plans and things like advertising. If we advertise and persuade people to switch into IRA's out of other savings, we are not doing anything for the national savings.

And that is what I am concerned about with all of this advertising. We really want total savings to increase, and we have really got to worry about an effective way to do that. I am not sure advertising is going to do that.

Senator DASCHLE. Well, we want to thank the members of this panel for your sage advice, the benefit of your thinking, and all of the information you have provided. We thank you all, and, with that, the hearing stands adjourned.

[Whereupon, the hearing was concluded at 12:10 p.m.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED

[SUBMITTED BY SENATOR LLOYD BENTSEN]

[JOINT COMMITTEE PRINT]

DESCRIPTION AND ANALYSIS OF S. 612 (SAVINGS AND INVESTMENT INCENTIVE ACT OF 1991)

SCHEDULED FOR A HEARING

BEFORE THE

SENATE COMMITTEE ON FINANCE

ON MAY 16, 1991

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

MAY 14, 1991

JOINT COMMITTEE ON TAXATION

102d Congress, 1st Session

(II)

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INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides a description and analysis of S. 612 (Savings and Investment Incentive Act of 1991). S. 612 was introduced by Senators Bentsen, Roth, and others on March 12, 1991. The Senate Committee on Finance has scheduled a public hearing on the bill on May 16, 1991.

Part I of the pamphlet is an overview. Part II provides information on present law and the legislative background of individual retirement arrangements (IRAs) and certain other special tax provisions relating to saving. Part III is an analysis of the provisions of S. 612. Part IV contains economic analysis of IRAs generally and the provisions of S. 612 specifically. Part V is a discussion of general issues relating to tax incentives for saving.

Appendix I contains a brief comparison of S. 612 with other tax incentives for saving. Appendix II presents selected economic data tables.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Description and Analysis of S. 612 (Savings and Investment Incentive Act of 1991)* (JCS-5-91), May 14, 1991.

I. OVERVIEW

Present law and legislative background of IRAs

Under present law, under certain circumstances, an individual is allowed to deduct contributions (up to the lesser of $2,000 or 100 percent of the individual's compensation or earned income) to an individual retirement arrangement (IRA). The amounts held in an IRA, including earnings on contributions, generally are not included in taxable income until withdrawn.

The $2,000 deduction limit is phased out over certain adjusted gross income (AGI) levels if the individual or the individual's spouse is an active participant in an employer-sponsored retirement plan. An individual may make nondeductible IRA contributions (up to the $2,000 or 100 percent of compensation limit) to the extent the individual is not permitted to make deductible IRA contributions.

The IRA provisions were originally enacted in the Employee Retirement Income Security Act of 1974 (ERISA). Under ERISA, an individual was permitted to make deductible IRA contributions only if the individual was not an active participant in an employer-sponsored retirement plan. The limit on IRA deductions was the lesser of $1,500 or 15 percent of compensation (or earned income, in the case of a self-employed individual).

The Economic Recovery Tax Act of 1981 increased the IRA deduction limit to its current level and removed the restriction on IRA contributions by individuals who were active participants in employer-sponsored plans. The IRA rules in their current form were enacted as part of the Tax Reform Act of 1986.

The Savings and Investment Incentive Act of 1991

The Savings and Investment Incentive Act of 1991 (S. 612)[2] would restore the deductibility of IRA contributions for all taxpayers under the rules in effect prior to the Tax Reform Act of 1986 and would provide for the indexing of the limits on contributions to IRAs. In addition, the bill would permit nondeductible contributions to special IRAs. Withdrawals from a special IRA would not be includible in income if attributable to contributions that had been held by the special IRA for at least 5 years. The limits on contributions to deductible IRAs and special IRAs would be coordinated.

The bill would allow withdrawals from an IRA and from elective deferrals under (1) a qualified cash or deferred arrangement (sec. 401(k) plan), (2) a tax-sheltered annuity (sec. 403(b)), or (3) a section 501(cX18) plan without imposition of the 10-percent additional income tax on early withdrawals to the extent the amount withdrawn is used for the purchase of a first home, for certain educa-

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[2] S. 612 was introduced by Senators Bentsen, Roth, and others on March 12, 1991

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tion expenses, or for catastrophic medical expenses (i.e., medical expenses in excess of 7.5 percent of AGI).

Under present law and under S. 612, 21 percent of all taxpayers cannot make IRA contributions because they do not have compensation or earned income. Under present law, 18 percent of taxpayers with compensation or earned income are not permitted to deduct any IRA contributions because they are active participants in an employer-sponsored retirement plan and are above the income thresholds, and an additional 9 percent are subject to the income phaseout and, thus, are not eligible to make the maximum deductible IRA contribution. S. 612 would restore full eligibility for deductible IRA contributions to the 27 percent of taxpayers with compensation or earned income who are not eligible under present law because of the present-law restrictions, and would provide all such taxpayers with an option to contribute to a special IRA.

Economic analysis of IRAs generally and under S. 612

Deductible IRAs allow taxpayers to deduct IRA contributions from income in the year contributed and pay income tax on the contributions plus earnings when withdrawn. This treatment creates two potential tax benefits: (1) taxpayers effectively earn a tax-free rate of return on IRA investments and (2) the contributions may be taxed at a lower marginal tax rate than the taxpayer's marginal tax rate when the contributions were made because IRA contributions are not taxed until withdrawn, at which time the taxpayer may be retired.

From an economic perspective, special IRAs receive tax treatment generally equivalent to deductible IRAs. Because the taxpayer does not deduct special IRA contributions from income and pays no tax when amounts are withdrawn, the taxpayer is never taxed on the income earned on the investment. Whether the deductible IRA and special IRA are in fact economically equivalent depends on the difference between the taxpayer's marginal tax rate in the year contributions are made and the marginal tax rate in the year IRA funds are withdrawn. When marginal tax rates decrease over time (because tax rates change generally or taxpayers fall into lower tax brackets), the deductible IRA is more advantageous than the special IRA because it permits taxpayers to defer payment of tax until tax rates are lower. When marginal tax rates increase over time, a special IRA is more advantageous.

Additional differences exist between the deductible and special IRAs in S. 612. First, because the dollar limit on contributions to both the deductible IRA and special IRA under S. 612 is $2,000, the $2,000 special IRA contribution limit effectively increases the amount of tax-free saving that can be invested relative to the deductible IRA. The $2,000 limit on pre-tax income is equivalent to a limit of $1,440 on after-tax income for a taxpayer subject to a 28-percent marginal tax rate.

Second, because the 10-percent additional income tax on early withdrawals applies to the special IRA only during the first 5 years after a contribution has been made to the IRA, in general, the benefits of the special IRA are greater than those of the deductible IRA for taxpayers who desire to obtain the flexibility to invest funds in an IRA for a relatively short period of time. However, be-

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cause of the 5-year holding period for the special IRA, this advantage of the special IRA exists only until a taxpayer attains age 54½, after which time the deductible IRA becomes more beneficial to the short-term investor.

Present value of revenue cost of IRAs to the Federal Government

Assessing the cost (in the form of foregone tax receipts) to the Federal Government of IRAs may be more difficult than assessing the costs of other tax provisions because IRAs change not only the amount of tax collected, but also the timing of tax collections. Traditional budget scorekeeping accounts for the revenue effects of proposed legislation on a cash-flow basis; in other words, the effect of a provision on budget receipts for a fiscal period is estimated without regard to whether the provision will also affect budget receipts in a subsequent period. This method scores deductible IRAs as generating a larger revenue loss than special IRAs. However, a present-value calculation demonstrates that the long-term cost to the Federal Government of deductible IRAs and special IRAs will be approximately equal, except for the effects of changes in tax rates generally or for specific taxpayers, and the difference in the effective contribution limits.

Providing a choice between the deductible IRA and the special IRA in S. 612 is likely to increase the overall cost of IRAs to the Federal Government as compared to the cost of either option alone if taxpayers make accurate judgments about their future tax rates. Taxpayers who have reason to believe that their tax rates will decline over time will be more likely to invest in the deductible IRA, and taxpayers who believe their tax rate will increase over time or who intend to invest for a relatively short period of time will generally choose the special IRA.

Effectiveness of IRAs at increasing saving

IRAs have a number of attributes that may affect a taxpayer's saving decision. First, investments in IRAs earn a higher after-tax rate of return than investments in other assets. Second, IRAs may provide an incentive for retirement saving, as opposed to other forms of saving. Third, deductible IRAs may provide a psychological incentive to save in the case of taxpayers who owe the Federal Government income tax in excess of the amounts withheld and estimated tax payments made during a year. Fourth, advertising of IRAs by banks and other financial institutions may influence decisions to save.

Deductible IRAs have been very popular with taxpayers. Contributions to IRAs increased significantly when eligibility restrictions were eliminated in 1982. At the peak in 1985, over $38 billion was contributed to IRAs; this represented almost 33 percent of personal saving for that year. However, there is no consensus within the economics profession as to the effect of the pre-1986 IRA rules on personal saving. Some economists believe that IRAs had no effect on overall personal saving; some believe that IRAs increased personal saving; and some believe that IRAs would have eventually increased saving if the universally available deductible IRA had not been significantly restricted by the Tax Reform Act of 1986.

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In 1985, 17.8 percent of all eligible returns reported contributions to an IRA. Of the returns reporting contributions, most (71 percent) reported AGI below $50,000. However, high-income taxpayers contributed at a much higher rate than lower-income taxpayers—61.8 percent of eligible returns with AGI of $50,000 or above reported contributions to an IRA, while only 13.8 percent of eligible returns with AGI below $50,000 reported contributions.

Although research on the effectiveness of the pre-1986 IRA provisions may shed light on the potential of S. 612 to increase saving, several differences should be noted. First, marginal tax rates for most taxpayers are lower than they were before 1987. Thus, the tax advantages of IRAs are less valuable now than they were before 1987. Second, the proposed IRAs permit penalty-free withdrawals under different circumstances than the pre-1986 IRAs. Third, special IRAs permit penalty-free withdrawals after only 5 years. These differences may increase or decrease the effect of IRAs on saving.

Issues relating to tax incentives for saving

Goals of tax incentives for saving

Some argue that tax incentives for saving are appropriate because the income tax system penalizes saving by taxing the return to income that is saved. This can affect both the national saving rate, as well as the assets taxpayers accumulate for particular purposes. Tax incentives for saving could be designed to encourage saving for particular purposes or to increase national saving.

IRAs have historically been viewed as vehicles for retirement saving. However, IRAs can provide substantial benefits to taxpayers who are saving for nonretirement purposes. For example, if funds are held in an IRA long enough, the taxpayer will benefit from the IRA even after payment of the income tax and the 10-percent early withdrawal tax.

Role of saving in the national economy

National saving is important to the economy because of its relationship to investment. The sources for investment are national saving and foreign investment. Increased investment increases the capital stock, which leads to greater productivity, higher wages and salaries, and increases in a nation's standard of living. Because of the possibility of foreign investment in the United States, a low saving rate does not necessarily mean a low investment rate. However, when foreign saving finances domestic investment, the profits from such investment are transferred abroad.

Net national savings declined through most of the 1980's, and is lower than that of other countries. Investment has declined as well over this period; however, foreign investment has compensated for some of the decline in domestic saving.

Adequacy of retirement savings

Social security is the largest source of retirement income (38 percent in 1986), followed by income from assets (26 percent in 1986), earnings (17 percent in 1986), and private and government employee pensions (14 percent in 1986). The adequacy of retirement

income is commonly measured by the replacement rate, that is, the ratio of retirement income to income during working years.

Available data indicate that social security and pension benefits replace roughly 33 percent of career high earnings and 50 percent of earnings over the last 5 years. When spousal benefits are taken into account, replacement rates are slightly higher as a percentage of final earnings, averaging 30 to 33 percent of highest earnings and 60 to 70 percent of earnings over the last 5 years. These replacement rates are higher for individuals who had low earnings.

It is not clear what an appropriate replacement rate is. A rate lower than 100 percent may be adequate. For example, people may desire to have more income during working years because some of that income is saved for retirement. People may also have lower expenses in retirement; for example, they may no longer be making payments on a home. On the other hand, a replacement rate of 100 may be too low. For example, a retiree may face much higher medical expenses than a younger person.

Although coverage by employer pension plans and social security is expected to be higher for current workers than for current retirees, the saving rate of current workers is lower than the rate at which current retirees saved during their working lives. Also, it is possible that the need for retirement income is increasing over time because of increases in life expectancies, trends toward early retirement, and rapid rises in medical costs.

II. PRESENT LAW AND LEGISLATIVE BACKGROUND RELATING TO TAX INCENTIVES FOR SAVINGS

A. Individual Retirement Arrangements (IRAs)

1. Present-law rules for IRAs

In general

Under certain circumstances, an individual is allowed a deduction for contributions (within limits) to an individual retirement account or an individual retirement annuity (an IRA) (Code sec. 219). An individual generally is not subject to income tax on amounts held in an IRA, including earnings on contributions, until the amounts are withdrawn from the IRA. No deduction is permitted with respect to contributions made to an IRA for a taxable year after the IRA owner attains age 70½.

Under present law, the maximum deductible contribution that can be made to an IRA generally is the lesser of $2,000 or 100 percent of an individual's compensation (earned income in the case of self-employed individuals). In addition, a married taxpayer who files a joint return with his or her spouse can make an additional contribution of up to $250 to an IRA established for the benefit of the spouse, if the spouse has no compensation or elects to be treated as having no compensation. A single taxpayer is permitted to make the maximum deductible IRA contribution for a year if the individual is not an active participant in an employer-sponsored retirement plan for the year or the individual has adjusted gross income (AGI) of less than $25,000. A married taxpayer filing a joint return is permitted to make the maximum deductible IRA contribution for a year if neither spouse is an active participant in an employer-sponsored plan or the couple has combined AGI of less than $40,000.

If a single taxpayer or either spouse (in the case of a married couple) is an active participant in an employer-sponsored retirement plan, the maximum IRA deduction is phased out over certain AGI levels. For single taxpayers, the maximum IRA deduction is phased out between $25,000 and $35,000 of AGI. For married taxpayers, the maximum deduction is phased out between $40,000 and $50,000 of AGI. In the case of a married taxpayer filing a separate return, the deduction is phased out between $0 and $10,000 of AGI.[3]

An individual is an active participant in an employer-sponsored retirement plan for the taxable year if the individual is an active participant for the plan year ending with or within the individual's

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[3] A couple is not considered married for purposes of the IRA deduction rules if the individuals file separate returns and live apart from one anothe. at all times during the taxable year; each spouse is treated as a single individual in such a case.

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taxable year. An employer-sponsored retirement plan means (1) a qualified pension, profit-sharing, or stock bonus plan (sec. 401(a)); (2) a qualified annuity plan (sec. 403(a)); (3) a simplified employee pension plan (sec. 408(k)); (4) a plan established for its employees by the U.S., by a State or political subdivision, or by any agency or instrumentality of the U.S. or a State or political subdivision (other than an unfunded deferred compensation plan of a State or local government (sec. 457)); (5) a plan described in section 501(c)(18); and (6) a tax-sheltered annuity (sec. 403(b)).

The determination of whether an individual is an active participant depends on the type of plan involved. In general, in the case of a defined benefit pension plan, an individual is treated as an active participant if the individual is eligible to participate in the plan. An individual is an active participant in a defined contribution plan only if any amounts are allocated to the account of the participant for the year.[4] The extent to which a person is vested in his or her benefits under an employer-sponsored plan is not taken into account under the active participant rules.

Nondeductible IRA contributions

Individuals may make nondeductible IRA contributions to the extent deductible contributions are not allowed because of the AGI phaseout and active participant rules. A taxpayer may also elect to make nondeductible contributions in lieu of deductible contributions. Thus, any individual may make nondeductible contributions up to the excess of (1) the lesser of $2,000 or 100 percent of compensation over (2) the IRA deduction claimed by the individual. An individual making nondeductible contributions is required to report the amount of such contributions on his or her tax return. As is the case with earnings on deductible IRA contributions, earnings on nondeductible contributions are not subject to income tax until withdrawn.

Taxation of withdrawals

Amounts withdrawn from IRAs (other than amounts that represent a return of nondeductible contributions) are includible in income when withdrawn. If an individual withdraws an amount from an IRA during a taxable year and the individual has previously made both deductible and nondeductible IRA contributions, then the amount includible in income for the taxable year is the excess of the amount withdrawn over the portion of the amount withdrawn attributable to investment in the contract (i.e., nondeductible contributions). The amount attributable to nondeductible contributions is the portion of the amount withdrawn that bears the same ratio to the amount withdrawn as the total amount of nondeductible contributions bears to the total current value of all IRAs of the individual.

To discourage the use of amounts contributed to an IRA for nonretirement purposes, withdrawals from an IRA prior to age 59½, death, or disability are generally subject to an additional 10-per-

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[4] The definition of active participant under present law is generally the same as the definition of active participant that applied for purposes of determining eligibility to make IRA contributions prior to the IRA amendment adopted in the Economic Recovery Tax Act of 1981.

cent income tax (sec. 72(t)). The 10-percent additional income tax is intended to recapture at least a portion of the tax benefit of the IRA. The 10-percent additional income tax does not apply to withdrawals that are part of a series of substantially equal periodic payments made for the life (or life expectancy) of the taxpayer or the joint lives (or joint life expectancies) of the taxpayer and the taxpayer's designated beneficiary. A similar early withdrawal tax applies to withdrawals from qualified retirement plans and deferred annuities.

Present law imposes a 15-percent excise tax on excess distributions with respect to an individual during any calendar year from qualified retirement plans, tax-sheltered annuities, and IRAs. The purpose of the tax is to limit the total amount that can be accumulated on behalf of a particular individual on a tax-favored basis. In enacting the excise tax, Congress believed that an individual should not be permitted to accumulate excessive retirement savings, regardless of whether such excess was attributable to the receipt of multiple maximum benefits from several employers, very large appreciation in defined contribution plans, or the use of IRAs by individuals receiving significant employer-provided benefits.

In general, excess distributions are defined as the aggregate amount of retirement distributions (i.e., payments from applicable retirement plans) made with respect to an individual during any calendar year to the extent such amounts exceed the greater of (1) $150,000, or (2) $136,204 (for 1991). The dollar amount in (2) is indexed annually for inflation. Special rules apply in the case of lump-sum distributions and post-death distributions.

2. Legislative background of IRAs

Employee Retirement Income Security Act of 1974

The individual retirement savings provisions of the Internal Revenue Code were originally enacted in the Employee Retirement Income Security Act of 1974 (ERISA) to provide a tax-favored retirement savings arrangement to individuals who were not covered under a tax-qualified retirement plan maintained by an employer. Individuals who were active participants in employer-sponsored retirement plans were not permitted to make contributions to an IRA. As enacted in ERISA, the limit on the deduction for IRA contributions was generally the lesser of (1) 15 percent of the individual's compensation (earned income in the case of a self-employed individual) for the year, or (2) $1,500.

Economic Recovery Tax Act of 1981

The Economic Recovery Tax Act of 1981 (ERTA) increased the deduction limit for contributions to IRAs and removed the restrictions on IRA contributions by active participants in employer-sponsored retirement plans. After ERTA, the deduction limit for IRAs was generally the lesser of (1) 100 percent of the individual's compensation (earned income in the case of a self-employed individual), or (2) $2,000. Any individual was entitled to make a deductible contribution to an IRA even if the individual was an active participant in an employer-sponsored retirement plan.

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The ERTA changes were motivated by Congressional concern that a large number of workers, including many who were covered by employer-sponsored retirement plans, faced, the prospect of retirement without the resources needed to provide adequate retirement income levels. The Congress concluded that retirement savings by individuals during their working years can make an important contribution towards providing retirement income security.

Tax Reform Act of 1986

The Tax Reform Act of 1986 (1986 Act) added the present-law restrictions on deductible IRA contributions by active participants in employer-sponsored retirement plans. These restrictions are similar to those originally included in ERISA. In addition, the 1986 Act added the present-law rules permitting individuals to make nondeductible contributions to an IRA.

B. Other Tax Incentives for Saving

Qualified retirement plans

In general

A plan of deferred compensation that meets the qualification standards of the Internal Revenue Code (a qualified plan) is accorded special tax treatment under present law. Employees do not include qualified plan benefits in gross income until the benefits are distributed, even though the plan is funded and the benefits are nonforfeitable. The employer is entitled to a current deduction (within limits) for contributions to a qualified plan even though the contributions are not currently included in an employee's income. Contributions to a qualified plan are held in a tax-exempt trust.

Employees, as well as employers, may make contributions to a qualified plan. Employees may, subject to certain restrictions, make both pre-tax and after-tax contributions to a qualified plan. Pre-tax employee contributions (e.g., contributions to a qualified cash or deferred arrangement (sec. 401(k) plan)) are treated the same as employer contributions for tax purposes.

The tax treatment of contributions under qualified plans is essentially the same as that of present law IRAs. However, the limits on contributions to qualified plans are much higher than the IRA contribution limits, so that qualified plans provide for a greater accumulation of funds on a tax-favored basis. The policy rationale for permitting greater accumulation under qualified plans than IRAs is that the tax benefits for qualified plans encourage employers to provide benefits for a broad group of their employees. This reduces the need for public assistance and reduces pressure on the social security system.

The qualification standards and related rules governing qualified plans are designed to ensure that qualified plans benefit an employer's rank-and-file employees as well as highly compensated employees. They also define the rights of plan participants and beneficiaries and provide some limits on the tax benefits for qualified

plans.⁵ Certain of the rules relating to qualified plans are designed to ensure that the amounts contributed to qualified plans are used for retirement purposes. Thus, for example, an early withdrawal tax applies to premature distributions from such plans, and the ability to obtain distributions prior to termination of employment from certain types of qualified plans is restricted.

Types of qualified plans

Qualified plans are broadly classified into two categories, defined benefit pension plans and defined contribution plans, based on the nature of the benefits provided.

Under a defined benefit pension plan, benefit levels are specified under a plan formula. For example, a defined benefit pension plan might provide an annual retirement benefit of 2 percent of final average compensation multiplied by total years of service completed by an employee. Benefits under a defined benefit pension plan are funded by the general assets of the trust established under the plan; individual accounts are not maintained for employees participating in the plan. Benefits under a defined benefit pension plan are guaranteed (within limits) by the Pension Benefit Guaranty Corporation (PBGC), a federal corporation within the Department of Labor.

Benefits under defined contribution plans are based solely on the contributions (and earnings thereon) allocated to separate accounts maintained for each plan participant. Profit-sharing plans and qualified cash or deferred arrangements (called 401(k) plans after the section of the Code regulating such plans) are examples of defined contribution plans.

Limits on contributions and benefits

Under present law, overall limits are provided on contributions and benefits under qualified plans. In the case of a defined benefit pension plan, present law limits the annual benefits payable under the plan to the lesser of (1) 100 percent of the participant's average compensation for his or her high 3 years, or (2) $108,963 (for 1991).⁶

Under a defined contribution plan, the qualification rules limit the annual additions to the plan with respect to each plan participant to the lesser of (1) 25 percent of compensation or (2) $30,000. Annual additions are the sum of employer contributions, employee contributions, and forfeitures with respect to an individual under all defined contribution plans of the same employer. Elective deferrals under a qualified cash or deferred arrangement are limited to $8,475 (for 1991).

The dollar limits are increased annually for cost-of-living adjustments.

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⁵ Qualified plans are subject to regulation under Federal labor laws (Title I of Employee Retirement Income Security Act of 1974 (ERISA)) as well as under the Internal Revenue Code. The ERISA rules generally relate to rights of plan participants and the obligations of plan fiduciaries.

⁶ Annual benefits may in some cases exceed this dollar limitation under grandfather and transition rules contained in the Tax Equity and Fiscal Responsibility Act of 1982 and other legislation.

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Taxation of distributions

Under present law, a distribution of benefits from a qualified plan generally is includible in gross income in the year it is paid or distributed, except to the extent the amount distributed represents the employee's investment in the contract (i.e., basis). Special rules apply to lump-sum distributions, distributions rolled over to an IRA, and distributions of employer securities.

Early distributions from qualified plans generally are subject to the same additional 10-percent early withdrawal tax that applies to early distributions from IRAs. However, certain additional exceptions to the tax apply. For example, the penalty does not apply to distributions used to pay medical expenses that exceed 7.5 percent of adjusted gross income. Qualified plan distributions are also subject to the excess distribution tax applicable to IRA distributions.

Tax-sheltered annuities

Tax-sheltered annuities are another form of employer-based retirement plan that provide the same tax benefits as qualified plans and IRAs. Employers may contribute to such annuities on behalf of their employees, and employees may contribute on a pre-tax basis through salary reduction. Tax-sheltered annuities are subject to rules similar to some of the rules applicable to qualified plans. Tax-sheltered annuity plans may be maintained only by certain types of organizations, in particular, tax-exempt charitable organizations and educational institutions.

Annuity contracts

Present law provides that income credited to a deferred annuity contract is not currently includible in the gross income of the owner of the contract nor is the income taxed to the insurance company issuing the contract. No deduction is provided for, and no dollar limits are imposed on, amounts used to purchase annuity contracts. In general, amounts received by the owner of an annuity contract before the annuity starting date (including loans under or secured by the contract) are includible in gross income as ordinary income to the extent that the cash value of the contract exceeds the owner's investment in the contract. In addition, a portion of each distribution received after the annuity starting date is treated as ordinary income based on the ratio of the investment in the contract to the total distributions expected to be received.

A 10-percent additional income tax is imposed on certain early withdrawals under an annuity contract. This additional tax does not apply to any distribution made after the owner of the contract attains age 59½, receives annuity payments under the contract, or satisfies certain other requirements.

Life insurance

Under present law, the investment income ("inside buildup") earned on premiums credited under a life insurance policy generally is not subject to current taxation to the owner of the policy or to the insurance company issuing the contract. This favorable tax treatment is available only if a life insurance contract meets certain requirements designed to limit the investment character of the

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contract. The contract must satisfy the statutory definition of life insurance by meeting either of two statutory tests: the "cash value accumulation" test, or the "guideline premium/cash value corridor" test.

No deduction is provided for, and no dollar limits are imposed on, amounts used by an individual to purchase life insurance contracts.

Death benefits paid under a life insurance contract are excluded from income, so that neither the policyholder nor the policyholder's beneficiary is ever taxed on the inside buildup if the proceeds of the policy are paid to the policyholder's beneficiary by reason of the death of the insured.

Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includible in income only to the extent that the amounts distributed exceed the taxpayer's basis in the contract; such distributions generally are treated first as a tax-free recovery of basis, and then as income. In the case of a modified endowment contract, however, distributions are treated as income first, loans are treated as distributions (i.e., income rather than basis recovery first), and an additional 10-percent tax is imposed on the income portion of distributions made before age 59½ and in certain other circumstances.

C. Comparison of Present-Law Rules for Selected Tax-Favored Savings Arrangements

Table 1 presents a comparison of certain of the limitations applicable to selected tax-favored savings arrangements under present law.

Table 1.—Comparison of Present Law for Various Tax-Favored Savings Arrangements

Provision	IRAs	401(k) Plans	Qualified Pension Plans (including Keogh Plans)	Deferred Annuities	Life Insurance
Limits on contributions	The maximum contribution for a year is $2,000 (including both deductible and nondeductible amounts).	The maximum elective contribution for a year is $8,475 for 1991 (indexed).	The maximum annual contribution on behalf of an individual to a defined contribution plan cannot exceed the lesser of (1) $30,000 or (2) 25 percent of the individual's compensation.	None, but corporate holders of deferred annuities are taxed currently on the inside buildup on the contract.	None.
Early withdrawal tax	A 10-percent additional income tax applies to distributions from an IRA other than distributions— (1) after the IRA owner attains 59½, (2) after the death of the IRA owner, (3) due to the disability of the IRA owner, or (4) which are part of a series of substantially equal payments for the life (or life expectancy) of the IRA owner or joint lives (or joint life expectancies) of the IRA owner and his beneficiary.	Same as IRAs, except that (in addition to the exceptions from the tax for IRAs), the tax also does not apply to distributions— (1) made after separation from service after age 55, (2) which are dividends on ESOP stock, (3) to the extent the distribution does not exceed the amount allowable as a deduction for medical expenses, or (4) made to an alternate payee pursuant to a qualified domestic relations order.	Same as 401(k) plans.	Same as IRAs, except that (in addition to the exceptions from the tax for IRAs), the tax also does not apply to distributions— (1) from qualified plans, IRAs, and certain contracts purchased by qualified plans or certain other types of plans, (2) allocable to investment in the contract before August 14, 1982, (3) under a qualified funding asset that is part of a structured settlement agreement, (4) under an immediate annuity contract, or. (5) which is purchased by an employer upon termination of a qualified pension plan.	None.

Table 1.—Comparison of Present Law for Various Tax-Favored Savings Arrangements—Continued

Provision	IRAs	401(k) Plans	Qualified Pension Plans (including Keogh Plans)	Deferred Annuities	Life Insurance
Treatment of loans	Not permitted	Loans treated as distributions to the extent they exceed the lesser of— (1) $50,000 or (2) ½ of the participant's account balance.	Same as 401(k) plans	Loans treated as distributions.	Loans permitted and not treated as distributions.
Basis recovery	With respect to amounts received prior to the annuity starting date and annuity distributions, a portion of each distribution is nontaxable in the same proportion as the taxpayer's basis is to the total account balance.	Same as the IRA rules	Same as the IRA rules	Distributions prior to the annuity starting date are treated as income first.	Distributions prior to the death of the insured are treated as a return of the investment in the contract (i.e., basis first).
Benefits restricted to individual (e.g., noncorporate) owners.	Yes	Yes	Yes	Yes	No.

III. S. 612—THE SAVINGS AND INVESTMENT INCENTIVE ACT OF 1991

A. Description of S. 612

In general

The Savings and Investment Incentive Act of 1991 (S. 612)[7] would restore the deductibility of traditional IRA contributions to the levels in effect prior to the Tax Reform Act of 1986 and provide for the indexing of the limits on IRA contributions. In addition, the bill would permit nondeductible contributions to new "special IRAs." Withdrawals from a special IRA would not be includible in income if attributable to contributions that had been held in the special IRA for at least 5 years. The limits on contributions to traditional IRAs and special IRAs would be coordinated.

The bill would allow withdrawals from an IRA, a qualified cash or deferred arrangement (sec. 401(k) plan), a tax-sheltered annuity (sec. 403(b)), and a section 501(c)(18) plan without imposition of the 10-percent early withdrawal tax to the extent the amount withdrawn is used for the purchase of a first home, for certain education expenses, or for catastrophic medical expenses.

Expansion of present-law deduction rules

The bill would repeal the present law restrictions on the deductibility of IRA contributions by individuals who are active participants in an employer-sponsored retirement plan. Thus, under the bill, an individual would be permitted to deduct IRA contributions up to the lesser of $2,000 or 100 percent of compensation (earned income in the case of a self-employed individual.) In addition, the bill would repeal the present-law rules permitting nondeductible contributions to an IRA under certain circumstances.

Indexing of IRA contribution limits

Under the bill, the limit on contributions that could be made to an IRA and the limit on contributions that could be made on behalf of a taxpayer's spouse would be indexed for inflation. The inflation adjustment would equal the applicable dollar limit for the preceding calendar year plus $500; thus, the dollar limits would be indexed only in $500 increments. The inflation adjustment would be made for any calendar year if, in the previous calendar year, the excess of (1) $2,000, increased by the cost-of-living adjustment for the year, over (2) the applicable dollar limit on IRA contributions for the year, was equal to or greater than $500. The cost-of-living adjustment for any calendar year is the percentage by which the consumer price index (CPI) for such year exceeds the CPI for

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[7] S. 612 was introduced by Senators Bentsen, Roth, and others on March 12, 1991

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calendar year 1991. Thus, the inflation adjustment would be made for taxable years beginning in calendar years following the calendar year for which the cost-of-living adjustment would be calculated.

Special IRAs

The bill would permit taxpayers to make contributions to new special individual retirement arrangements (special IRAs). Generally, special IRAs would be treated in the same manner and be subject to the same rules applicable to deductible IRAs. However, a number of special rules would apply.

Contributions to a special IRA would be nonductible. The amount of nondeductible contributions to a special IRA that could be made for any taxable year would be tied to the limits for deductible IRAs, so that the aggregate amount of contributions to a special IRA could not exceed the excess of (1) the IRA deduction limit for the year over (2) the amount of IRA contributions actually deducted for the year.

Any amount paid or distributed from a special IRA generally would not be included in the gross income of the individual to whom the distribution is made if the contributions to which the distribution relates have been held in the special IRA for at least 5 years. However, earnings on distributions attributable to contributions made during the 5-year period ending on the day before the distribution would be included in gross income and, unless an exception applied, would be subject to the 10-percent additional tax on early withdrawals from IRAs (sec. 72(t)).

In determining whether amounts are includible in income under the 5-year rule, distributions would be treated as having been made first from the earliest contributions (and earnings attributable to such contributions) remaining in the account at the time of distribution and then from other contributions (and earnings) in the order made. Thus, distributions would be deemed to occur under a first-in, first-out (FIFO) method. Any portion of a distribution allocated to a contribution and earnings would be allocated first to the earnings on the contribution and then to the contribution. Earnings are to be allocated to contributions in the manner prescribed by the Secretary of the Treasury. All contributions made during a taxable year would be treated as one contribution for purposes of the rules relating to withdrawals.

As an example of the operation of the 5-year rule, assume that an individual makes a $2,000 contribution to a special IRA on January 1, 1992 and a $2,000 contribution on January 1, 1993. Assume that earnings on the contributions are 10 percent per year. On July 1, 1997, the special IRA balance is $6,456, with $3,382 of the balance attributable to the contribution made on January 1, 1992, and $3,074 attributable to the contribution made on January 1, 1993. If the individual withdraws $3,000 on July 1, 1997, the entire amount is attributable to the contribution and earnings made on January 1, 1992. Because the $2,000 contribution made on January 1, 1992 satisfies the 5-year requirement, the entire $3,000 withdrawn is not included in the taxpayer's income. After the withdrawal, the account balance is $3,456, $382 ($3,382−$3,000) of which is attributable to the January 1, 1992 contribution.

Assume that the taxpayer withdraws an additional $3,000 on August 1, 1996 and that no additional earnings have been credited to the account at that time. $382 is attributable to the January 1, 1992 contribution and, therefore, is not includible in gross income. The remaining $2,618 is attributable to the $2,000 contribution made January 1, 1993, which does not satisfy the 5-year requirement. The taxpayer is deemed to withdraw earnings on the January 1, 1993 contribution first; thus, $1,074 is attributed to earnings on the January 1, 1993 contribution and that amount is includible in the taxpayer's income and subject to the 10-percent additional tax on early withdrawals. $1,544 is a return of the January 1, 1993 contribution that is not includible in gross income. The remaining $456 in the special IRA is attributable to the January 1, 1993 contribution (but not to earnings, which have all been withdrawn).

Rollover contributions would be permitted to a special IRA only to the extent such contributions consist of a payment or distribution from another special IRA. Such rollover contributions would not be taken into account in determining the contribution limit for a taxable year. The normal IRA rollover rules would otherwise govern the eligibility of withdrawals from special IRAs to be rolled over. For purposes of the 5-year rule, the special IRA to which amounts are rolled over would be treated as having held the amounts during any period during which such contributions were held in the special IRA to which the contributions were first made.

Exceptions to early withdrawal tax

In general.—The bill would provide exceptions to the 10-percent additional income tax on early withdrawals in the case of distributions that are (1) qualified first-time homebuyer distributions or (2) qualified higher education distributions. The exceptions are available with respect to withdrawals from an IRA, from a special IRA, or from amounts attributable to (1) elective deferrals to a qualified cash or deferred arrangement (sec. 401(k) plan), (2) salary reduction contributions to a tax-sheltered annuity (sec. 403(b)), or (3) contributions made to a plan described in section 501(c)(18). In addition, the bill would extend to IRAs the availability of the qualified plan exception to the early withdrawal tax in the case of extraordinary medical expenses.

Withdrawals by first-time homebuyers.—Under the bill, the 10-percent additional income tax on early withdrawals would be waived for withdrawals by first-time homebuyers that are used within 60 days to acquire, construct, or reconstruct the taxpayer's principal residence or the principal residence of the taxpayer's child or grandchild. A first-time homebuyer would be an individual who has not had an ownership interest in a principal residence during the 2-year period ending on the date of acquisition of the principal residence to which the withdrawal relates. The bill would require that the spouse of the taxpayer also meet this requirement as of the date the contract is entered into or construction commences. The date of acquisition would be the date the individual enters into a binding contract to purchase a principal residence or begins construction or reconstruction of such a residence. Principal residence would be defined as under the provisions relating to the rollover of gain on the sale of a principal residence (sec. 1034).

Under the bill, any amount withdrawn for the purchase of a principal residence would be required to be used within 60 days of the date of withdrawal. The 10-percent additional income tax on early withdrawals would be imposed with respect to any amount not so used. However, in the case of withdrawals from an IRA, if the 60-day rule could not be satisfied due to a delay in the acquisition of the residence, the taxpayer would be able to recontribute all or part of the amount withdrawn to the IRA prior to the end of the 60-day period without adverse tax consequences. Any amount recontributed would be treated as a rollover contribution (sec. 408(d)) without regard to the limitations on the frequency of IRA-to-IRA rollovers.

Withdrawals for education expenses.—Under the bill, withdrawals used by a taxpayer during the year for qualified higher education expenses would not be subject to the 10-percent additional income tax on early withdrawals. Qualified higher education expenses would be defined as tuition, fees, books, supplies, and equipment required for courses at an eligible educational institution, as defined under the provisions relating to education savings bonds (sec. 135). Amounts withdrawn would be available for use for the education of the taxpayer, or the taxpayer's spouse, children, or grandchildren.

The amount that could be withdrawn for education expenses for a taxable year without imposition of the 10-percent additional tax would be reduced by any amount that is excludable from the taxable income of the taxpayer under the provisions relating to education savings bonds (sec. 135).

Financially devastating medical expenses.—The bill provides that the present-law exception to the early withdrawal tax for medical expenses in excess of 7.5 percent of adjusted gross income would be available in the case of withdrawals from IRAs as well as qualified pension plans.

Effective dates

Under the bill, the expansion of the present-law IRA deduction provisions and the creation of special IRAs would be effective for taxable years beginning after December 31, 1990. The provision relating to inflation adjustments of the IRA limits would be effective on the date of enactment. The provisions relating to the exceptions to the 10-percent additional income tax would apply to distributions on or after the date of enactment.

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B. Comparison of Eligibility for Deductible IRAs Under Present Law and S. 612

Both present law and S. 612 limit IRAs to taxpayers with earned income. Thus, the 21 percent of tax returns that report no earned income cannot contribute to an IRA, and will not be affected by S. 612.

Table 2 focuses on taxpayers with earned income, because S. 612 can affect their eligibility to contribute to IRAs. Under present law, taxpayers who are covered by employer-sponsored pension plans and whose income exceeds certain thresholds are not eligible to make deductible IRA contributions. These restrictions prohibit 18 percent of all tax returns with earned income from claiming deductible IRA contributions, and limit eligibility for an additional 9 percent.

The percentage of taxpayers eligible to make deductible IRA contributions differs significantly by filing status and by number of earners. For instance, 45 percent of joint returns with two earners, 18 percent of joint returns with one earner, and 8 percent of all returns of taxpayers who are single, head of household, or married filing separately cannot claim any deductible IRA contributions. Taxpayers in the phaseout range can claim some deductible IRA contributions, but less than the maximum; 15 percent of joint returns with two earners, 9 percent of joint returns with one earner, and 7 percent of the single, head of household, and married filing separately returns fall in this category. On average, these taxpayers can contribute roughly half the maximum contribution amount.

Table 2.—Eligibility of Taxpayers With Earned Income To Make Deductible IRA Contributions Under Present Law, Projected 1991 Returns [1]

Adjusted gross income	Returns with earned income			
	Returns (thousands)	Percent eligible for maximum deductible IRA contribution	Percent in phaseout range	Percent not eligible for any IRA deduction
Joint Returns With One Earner				
Less than $10,000	3,263	100.0	0.0	0.0
$10,000 to $20,000	4,422	100.0	0.0	0.0
$20,000 to $30,000	3,477	100.0	0.0	0.0
$30,000 to $40,000	2,736	97.7	2.3	0.0
$40,000 to $50,000	2,320	24.7	75.3	0.0
$50,000 to $75,000	2,622	24.4	0.0	75.6
$75,000 to $100,000	982	22.1	0.0	77.9
$100,000 to $200,000	968	25.9	0.0	74.1
$200,000 and over	521	13.4	0.0	86.6
All income classes	21,311	73.1	8.5	18.4
Average dollars eligible per return		[2] $2,139	[3] $1,066	0
Joint Returns With Two Earners				
Less than $10,000	313	100.0	0.0	0.0
$10,000 to $20,000	1,359	100.0	0.0	0.0
$20,000 to $30,000	2,893	100.0	0.0	0.0
$30,000 to $40,000	3,607	95.9	4.2	0.0
$40,000 to $50,000	3,908	13.0	87.0	0.0
$50,000 to $75,000	7,258	8.4	0.0	91.6
$75,000 to $100,000	2,484	4.2	0.0	95.8
$100,000 to $200,000	1,310	6.0	0.0	94.0
$200,000 and over	399	3.5	0.0	96.5
All income classes	23,531	39.7	15.1	45.2
Average dollars eligible per return		[2] $3,827	[3] $2,041	0

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Table 2.—Eligibility of Taxpayers With Earned Income To Make Deductible IRA Contributions Under Present Law, Projected 1991 Returns [1]—Continued

Adjusted gross income	Returns with earned income			
	Returns (thou-sands)	Percent eligible for maxi-mum deducti-ble IRA contribu-tion	Percent in phaseout range	Percent not eligible for any IRA deduc-tion
Head of Households, Single Returns, and Married Filing Separately [4]				
Less than $10,000	27,718	100.0	0.5	0.0
$10,000 to $20,000	14,286	100.0	0.0	0.0
$20,000 to $30,000	8,103	73.7	26.3	0.0
$30,000 to $40,000	4,578	28.7	22.5	32.5
$40,000 to $50,000	2,111	22.5	0.0	77.5
$50,000 to $75,000	1,123	20.3	0.0	79.7
$75,000 to $100,000	248	23.0	0.0	77.0
$100,000 to $200,000	184	22.8	0.0	77.2
$200,000 and over	94	19.2	0.0	80.9
All income classes	58,447	85.7	6.7	7.6
Average dollars eligible per return		[2] $1,760	[3] $1,041	0
Total, all returns	103,289	72.6	9.0	18.4
Average dollars eligible per return		$2,096	$1,428	0

[1] Note that the table includes imputed returns of taxpayers who do not file income tax returns, and is thus intended to be representative of the population, rather than of taxable returns. The table also includes returns filed by dependents, and may include some returns of taxpayers over age 70½ who have earned income but who are not eligible to make deductible IRA contributions.

[2] Average eligible contribution amount for taxpayers eligible to make maximum contribution.

[3] Average eligible contribution amount for taxpayers in phaseout range.

[4] Some returns with income below $40,000 are phased cut because they are returns of married individuals filing separately. IRA eligibility is phased out between $0 and $10,000 of AGI for such married individuals who live together and between $25,000 and $35,000 of AGI for such married individuals who live apart.

Source: Joint Committee on Taxation estimates for 1991.

These eligibility percentages and the real value of the IRA contribution limits will decrease over time, because present law does not index the contribution limits or the income eligibility limits for inflation. For example, the real value of a $2,000 contribution has declined 16 percent since 1986 because of inflation.

Taxpayers whose eligibility is limited by the present-law rules may be likely to contribute to IRAs if eligibility were restored. As Table 5, below, demonstrates, in 1985, taxpayer returns reporting income of $50,000 or more were more than four times as likely to claim deductible contributions to an IRA as were lower-income taxpayers. After eligibility was limited in 1986, IRA contributions fell substantially. Total IRA contributions fell from a high of $38.2 billion in 1985 to $11.9 billion in 1988 (see Table 4, below). In 1990 dollars (i.e., adjusting for inflation), total IRA contributions were $46.5 billion in 1985 and $13.1 billion in 1988, representing a real decrease of 72 percent.

Under present law, for joint returns with AGI between $50,000 and $75,000, 24 percent of returns with one earner and only 8 percent of returns with two earners can claim the maximum deductible IRA contribution because neither spouse is an active participant in an employer-sponsored retirement plan. In the case of a joint return with two earners, it is possible that only one spouse is an active participant in an employer-sponsored plan. Thus, the spouse who is not an active participant is not eligible to make deductible IRA contributions because of the income reflected on the joint return. If the income phaseouts and active participant rules were applied separately to spouses filing joint returns (i.e., if all taxpayers were treated as single individuals for purposes of determining eligibility for deductible IRA contributions), then more taxpayers would be eligible to make deductible IRA contributions.

Another reason that the IRA eligibility of married couples with two earners is so low is that the income of these couples is higher generally than the income of married couples with one earner. Almost 50 percent of married couples with two earners have AGI greater than $50,000, whereas only 24 percent of couples with one earner do.

C. Technical Issues Relating to S. 612

Recordkeeping and administrability

S. 612 raises a number of issues regarding recordkeeping and administrability. First, adequate records would have to be kept to distinguish amounts held in deductible IRAs from amounts held in special IRAs because the taxation of withdrawals would differ. The bill addresses this issue by providing that special IRAs must be held in separate accounts specifically designated as special IRAs, and by prohibiting rollovers from other vehicles into special IRAs.

It is unclear, however, whether such rules will be effective in assuring that taxpayers and the IRS are aware of which type of IRA particular funds are invested in or withdrawn from, and whether, if IRA funds are mixed, the taxpayer or the IRS will be able to identify taxable amounts accurately.

Similar recordkeeping issues arise under present law because of the availability of nondeductible IRAs. Present law requires that an individual report nondeductible contributions on his or her tax return for the year of contribution and subsequent years. The IRS has not had sufficient experience to know whether these rules have been effective in properly identifying taxable and nontaxable

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amounts because of the limited period during which nondeductible IRAs have been available.

A second issue arises because the tax treatment of earnings on contributions to special IRAs would depend on how long the contributions to which the earnings relate had been in the IRA. A special IRA would be likely to hold contributions made in more than one year, so that it would be necessary to allocate earnings to particular contributions. S. 612 does not contain a specific rule, but provides that earnings are to be allocated in accordance with rules prescribed by the Secretary. These allocation rules could impose a significant administrative burden on financial institutions holding special IRA contributions.

There are a number of different ways that earnings can be allocated to contributions. Thus, it will be important for the Secretary to issue prompt guidance as to which method or methods are acceptable. Even when guidance is issued, errors may occur depending on how complicated the rules are and whether individual taxpayers or the IRA trustee will be required to make the calculations.

Complexity

Because it would broaden eligibility for deductible IRA contributions and permit nondeductible tax-free (special) IRA contributions, S. 612 would provide taxpayers with additional investment and savings decisions. Some taxpayers might have difficulty (1) understanding the different requirements (such as holding periods) applicable to each vehicle and (2) obtaining sufficient information to determine the most appropriate vehicle to use when the taxpayer's individual circumstances are taken into account. Financial institutions, which would have an incentive to market and explain the availability of deductible IRAs and special IRAs, would be likely to provide some assistance to taxpayers. However, such institutions might not necessarily give advice as to whether a deductible or special IRA is best for a particular taxpayer; the institution would benefit no matter which vehicle were chosen. The taxpayer also would benefit under either option, though, so choosing the less appropriate IRA would have a minimal effect on the taxpayer.

Under present law, some taxpayers may have difficulty determining whether or not they are eligible for an IRA deduction and, if so, the size of the deduction, because of the active participant rules and income phaseouts. S. 612 would eliminate this source of complexity because it would make deductible IRAs available to all taxpayers with compensation or earned income.

Effect of S. 612 on qualified retirement plans

S. 612 is not exclusively an IRA proposal, but would also affect certain qualified retirement plans. The bill would increase the number of situations in which penalty-free withdrawals could be made from a qualified cash or deferred arrangement (sec. 401(k) plan) or tax-sheltered annuity (sec. 403(b)), making it more likely that participants would withdraw assets from such plans for purposes other than retirement. In addition, because S. 612 would permit participants to withdraw amounts from these plans not only for themselves, but also for certain family members, the amounts

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withdrawn might not benefit the participants directly. The bill would not limit the amount of penalty-free withdrawals that could be made in this manner. Some would argue that the increased ability to withdraw funds penalty-free from retirement plans runs counter to sound retirement policy. On the other hand, some would argue that the increased access to plan funds in emergencies might make individuals more likely to save the funds in the first place and, in fact, the funds may be left in the plan until retirement.

Under the bill, penalty-free withdrawals from retirement plans could be made only from amounts attributable to elective deferrals. This limitation might create administrative problems because some plans do not separately account for these amounts now.

IV. ECONOMIC ANALYSIS OF IRAS GENERALLY AND S. 612

A. Comparison of Deductible IRAs, Special IRAs, and Nondeductible IRAs

1. General comparison of IRAs

Present law and S. 612 present the taxpayer with three different tax-preferred saving vehicles, each of which is called an Individual Retirement Arrangement: deductible IRAs, special IRAs, and nondeductible IRAs. In general, the deductible IRA and special IRA both offer the taxpayer a greater after-tax return than does the nondeductible IRA. The difference in return arises because the deductible and special IRAs effectively exempt earnings on invested funds from tax, while the nondeductible IRA taxes the earnings, but on a deferred basis.

Deductible IRAs

Deductible IRAs allow taxpayers to deduct IRA contributions from income in the year contributed, but include the entire amount in income when withdrawn. There are two potential advantages of deductible IRAs over fully taxable savings vehicles. First, taxpayers earn a tax-free rate of return on IRA investments. Second, taxpayers postpone taxation of the contribution until the contributions are withdrawn, at which time they may be taxed at a lower rate than when the contribution is made.

The following example illustrates why a deductible IRA investment receives a tax-free rate of return. Assume a taxpayer with a marginal tax rate of 28 percent contributes $1,000 to an IRA. The initial savings from the IRA is $280, the tax that would have been paid on the $1,000. For the purpose of this example, assume that the taxpayer withdraws the funds after 1 year without penalty. If the annual rate of return on the IRA assets is 10 percent, the value of the IRA is $1,100, total tax due is $308, and the taxpayer is left with $792. Notice that if the taxpayer had paid the initial tax of $280 and invested the remaining $720 at 10 percent, then the taxpayer would have had $792 after one year. If the income had not been invested in an IRA, the taxpayer would have to pay tax on $72 dollars of earnings, and would be left with $771.84 after payment of taxes. The value of the IRA is that the taxpayer does not have to pay additional tax. Thus, the deductible IRA allows the taxpayer to get a tax-free rate of return on an investment of $720.

This analysis is independent of the number of years the IRA investment is held. The value of the tax exemption, however, increases with the number of years the IRA is held. For instance, if in the above example, the taxpayer holds the IRA for 10 years, the IRA would be worth $1,867, whereas a fully taxed investment would be worth $1,443 after 10 years.

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The deductible IRA investment can be viewed as an investment that is jointly owned by the government and the taxpayer. The government's ownership share is equal to the tax rate (28 percent in the above example). When the IRA funds are withdrawn, the government receives its share of the funds. In the above example, when the funds are withdrawn after one year, the government receives 28 percent of $1,100 ($308), and the taxpayer receives 72 percent of $1,100 ($792). The taxpayer pays no tax on the earnings attributable to the taxpayer's share of the investment, and thus receives a tax-free rate of return on the investment. This is one advantage of investing through an IRA.

A second advantage of a deductible IRA arises if the taxpayer's marginal tax rate in the year the funds are withdrawn is lower than the marginal tax rate in the year of the contribution. Because the government's share of the investment is equal to the taxpayer's tax rate in the year the funds are withdrawn, the lower the tax rate prevailing at that time, the smaller the government's share. In the example above, for instance, if the tax rate when the funds are withdrawn is 15 percent, then the tax paid after 1 year would be $165. Not only does the taxpayer receive a tax-free rate of return on the taxpayer's share of the investment, but the taxpayer share of the investment is 85 percent rather than 72 percent.

Tax rates might be lower at the time the funds are withdrawn because the beneficiaries may be receiving untaxed social security benefits and reduced taxable income from other sources. However, the marginal tax rate could be lower or higher because tax rate schedules may change over time.

Special IRAs

From an economic perspective, special IRAs are similar to deductible IRAs. With a special IRA, the taxpayer does not deduct the IRA contribution from income, but pays no tax when the funds are withdrawn. In other words, the government takes its share before the funds are invested. The taxpayer is never taxed on the interest earned on the investment, and thus earns a tax-free rate of return on the IRA investment. This is the same tax benefit provided to deductible IRAs.

However, in the case of the special IRA, the tax is paid on the initial contribution at the time of contribution, and in the case of the deductible IRA, the tax is paid on the initial contribution at the time of withdrawal. In effect, the government's share of the special IRA is equal to the taxpayer's marginal tax rate at the time the funds are contributed. whereas the government's share of the deductible IRA is equal to the taxpayer's marginal tax rate at the time the funds are withdrawn. Whether the deductible IRA and special IRA are economically equivalent depends on the difference between the taxpayer's marginal tax rate in the year the contribution is made and the taxpayer's marginal tax rate in the year the IRA funds are withdrawn.

If these two marginal tax rates are equal, then the special IRA provides the same overall benefits as the deductible IRA. For example, if a taxpayer earns $1,000 and chooses to use it for a special IRA, the taxpayer first pays tax on it. If the taxpayer's marginal tax rate is 28 percent, the taxpayer will have $720 to invest. After

1 year earning interest at 10 percent per year, the taxpayer has $792, the same amount that the taxpayer has in the deductible IRA example above.

If the tax rate in the year the contribution is made is different from the tax rate in the year the funds are withdrawn, then the deductible IRA and the special IRA are no longer equivalent. When tax rates decrease over time (either because tax rates change or taxpayers fall into lower tax brackets), the deductible IRA is more advantageous, because it permits taxpayers to defer payment of tax until tax rates are lower. When tax rates increase over time, a special IRA is more tax-favored.

Nondeductible IRAs

Present law permits taxpayers who cannot make the maximum amount of deductible IRA contributions (because they are covered under an employer-provided pension plan and their income exceeds the dollar limits) to make nondeductible contributions to IRAs. Unlike special IRAs, earnings on present-law nondeductible IRA contributions are includible in income when withdrawn. The tax advantage of these IRAs is that taxes on earnings are deferred, rather than assessed annually. This permits the earnings to compound faster than with annual taxation of earnings. This advantage is the same advantage implicit in the tax treatment of the earnings on deferred annuities, which are taxed when the annuities are paid rather than when the earnings accrue.

For example, compare the accumulation of income for an investor with a 28-percent marginal tax rate on $720 which is invested for a period of 10 years at an 10 percent annual rate of return. If the earnings are taxed annually, the total available funds at the end of 10 years would be $1,443.05. The investor's annual after-tax return is 7.2 percent. If the tax is deferred for 10 years and assessed on the accumulated interest at the end of the 10-year period at a 28-percent marginal tax rate, the value of the taxpayer's investment would be $1,344.60, which represents an annual return of 7.9 percent. Unlike the deductible and special IRAs discussed above, the after-tax rate of return of investment in a nondeductible IRA increases as the holding period increases; as the holding period increases, accumulated earnings increase, and thus the value of deferring tax on the accumulated earnings increases.

Summary

Table 3 compares the funds available after 10 years to a taxpayer who saves $1,000 of pre-tax income in a deductible IRA, a special IRA, and a nondeductible IRA, assuming that no penalty tax applies and that the rate of return on the IRA assets is 10 percent per year. The tax rate in the year contributed is labeled t_0, and the tax rate in the year the funds are withdrawn is labeled t_{10}. Table 3 also summarizes the timing of the Federal Government's tax receipts.

As was noted above, the difference in the funds available to the taxpayer investing $1,000 of pre-tax income in the deductible IRA compared to the special IRA depends only on the difference between the marginal tax rate the taxpayer faces in the year the funds are contributed, t_0, and the marginal tax rate in the year the

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funds are withdrawn, t_{10}. The funds available in the nondeductible IRA are always smaller than those in the special IRA. Both of these IRAs tax the contribution at a tax rate t_0, but the special IRA effectively exempts earnings from additional tax, whereas the nondeductible IRA only defers earnings from tax.

Table 3.—Funds Available to Taxpayer and Pattern of Tax Receipts Under Deductible IRA, Special IRA, and Nondeductible IRA

Taxpayer has $1,000 of pre-tax income to invest in IRA, and the annual rate of return on IRA assets is 10 percent.
t_o = tax rate in year of IRA contribution.
t_o = tax rate in year of IRA withdrawal.

Funds Available to Taxpayer After 10 Years

	Funds contributed to IRA	Funds available after 10 years	Taxes due in year 10	Funds available after tax in year 10
Deductible IRA	$1,000	$2,594	$2,594 (t_{10})	$2,594 $(1-t_{10})$
Special IRA	$1,000 $(1-t_o)$	$2,594 $(1-t_o)$	0	$2,594 $(1-t_o)$
Nondeductible IRA	$1,000 $(1-t_o)$	$2,594 $(1-t_o)$	$(2,594-1,000) $(1-t_o)$ t_{10}	$2,594 $(1-t_o)$ -$1,594 $(1-t_o)$ t_{10}

Pattern of Income Tax Payments Under Three IRAs

	Tax payments in		
	Current year	Year 1-9	Year 10
Deductible IRA	0	0	$2,594 (t_{10})
Special IRA	$1,000 (t_o)	0	0
Nondeductible IRA	$1,000 (t_o)	0	$1,594 $(1-t_o)$ (t_{10})

Example: $t_0=.28$, $t_{10}=.28$

	Funds contributed to IRA	Funds available after 10 years	Taxes due in year 10	Funds available after tax in year 10
Deductible IRA	$1,000	$2,594	$726	$1,868
Special IRA	$720	$1,868	0	$1,868
Nondeductible IRA	$720	$1,868	$321	$1,547

	Tax payments in		
	Current year	Year 1-9	Year 10
Deductible IRA	0	0	$726
Special IRA	$280	0	0
Nondeductible IRA	$280	0	$321

2. Specific differences between deductible IRAs and special IRAs under S. 612

The deductible and special IRAs introduced in S. 612 have a number of differences in addition to those due to differences in marginal tax rates. These differences involve the contribution limit, the holding period requirement, the penalty for early withdrawals, and the interв. ion with social security benefits.

Contribution limit

S. 612 would limit the total annual amount of IRA contributions to $2,000, regardless of whether contributions are made to a deductible IRA or to a special IRA. However, contributions to a deductible IRA are limited to $2,000 of pre-tax income, whereas contributions to a special IRA are limited to $2,000 of after-tax income. The $2,000 special IRA contribution limit effectively increases the amount of tax-free saving that can be invested in the special IRA relative to the deductible IRA. The following example illustrates this difference. In the case of a faxpayer with a marginal tax rate of 28 percent who contributes $2,000 to a deductible IRA earning 10 percent per year, the IRA balance will be $2,200 after 1 year. The taxpayer will owe $616 in tax, leaving $1,584. This is equivalent to the taxpayer having paid an initial tax of $560, or 28 percent of $2,000, and investing the remaining $1,440 at an after-tax return of 10 percent. Thus the $2,000-limit on pre-tax income is like a limit of $1,440 on after-tax income for a taxpayer with a 28-percent marginal tax rate. If instead the investor had contributed $2,000 to a special IRA, the funds available to the taxpayer after 1 year would be the full $2,200, since no additional tax would be due.[8] The difference in the limits is only valuable to taxpayers who want to invest more than $2,000 of pre-tax income in an IRA. However, according to the Taxpayer Usage Survey, in 1984, approximately 75 percent of all IRA contributors contributed the maximum permissible amount, indicating that this difference between the deductible IRA and the special IRA may be significant for a large number of taxpayers.

Holding period and penalties for early withdrawal

Funds in a deductible IRA that are withdrawn within 5 years are withdrawn before age 59½ are subject to a 10-percent additional tax, unless certain exceptions apply. In contrast, funds invested in a special IRA may be withdrawn after only 5 years without additional tax. Thus, the special IRA provides benefits for taxpayers who plan to keep funds invested for a relatively short period of time, as well as for taxpayers who have longer investment horizons.[9]

Funds in a special IRA that are subject to additional tax. The earnings on the special IRA contributions are included in taxable

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[8] More generally, for a taxpayer facing a marginal tax rate of t, the equivalent contribution limit for a deductible IRA is C/(1-t) where C is the contribution limit for the special IRA.
[9] Note that for taxpayers older than age 54½, the required holding period for new contributions will actually be shorter for deductible IRAs than for special IRAs (because of the age 59½ rule for deductible IRAs). Thus, older taxpayers may prefer to contribute to deductible IRAs.

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income (so they are no longer tax-exempt) and the additional 10-percent tax is applied to those earnings.

Treatment of IRA withdrawals for purposes of taxing social security benefits

Another potential difference between the deductible and the special IRAs in S. 612 is the effect of withdrawals on the taxation of social security benefits. Under present law, social security benefits are exempt from tax except for taxpayers whose income exceeds certain income thresholds. The income thresholds are defined by reference to modified adjusted gross income (AGI). Modified AGI is the taxpayer's AGI increased by the amount of interest received or accrued by the taxpayer during the taxable year that is otherwise exempt from tax. The IRS has stated that tax-exempt interest required to be included in modified AGI is the amount of interest on tax-exempt obligations received or accrued by the taxpayer during the taxable year.[10] Interest earnings that accrue on contributions to a deductible IRA are arguably not included in modified AGI because tax on such earnings is deferred, rather than exempt. However, taxable distributions from the taxpayer's IRA are part of AGI and consequently are part of modified AGI. Since distributions from a deductible IRA are taxable, but those from a special IRA are not, distributions from a deductible IRA are included in the taxpayer's modified AGI, but distributions from a special IRA are not, except perhaps to the extent that the amounts attributable to the earnings on special IRA contributions are deemed to be exempt interest required to be included in modified AGI.[11]

This may be an additional advantage of the special IRA for taxpayers who are making withdrawals from IRAs when they are also receiving social security benefits. However, it is an advantage only for taxpayers who expect their incomes to be close enough to the threshold income level that distributions from IRAs make them exceed that level.

B. Present Value of Revenue Cost of IRAs to Federal Government

Assessing the cost (in the form of foregone tax receipts) to the Federal Government of IRAs may be more difficult than assessing the costs of other tax provisions, because IRAs not only change the amount of tax collected, but also change the timing of tax collections. For instance, the traditional deductible IRA can be viewed as a provision which both delays payment of tax on the contribution until withdrawal, and effectively exempts from tax any earnings on capital accumulation beyond the amount that represents interest on the delayed tax. Thus, the timing of tax payments results in a revenue loss in the first years, but a revenue gain in the later years when the funds are withdrawn (see Table 3). The special IRA, on the other hand, loses little revenue in the beginning years, but gains no revenue in the later years because withdrawals are not taxed.

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[10] Rev. Rul 84-173, 1984-2 C B 16.
[11] Present law is unclear on this point See Code section 86 and its legislative history

Traditional budget scorekeeping accounts for the revenue effects of proposed legislation on a cash-flow basis; in other words, the effect of a provision on budget receipts in the 5-year budget period is estimated without regard to whether the provision will also affect budget receipts in any year beyond the 5-year period. This method scores deductible IRAs as bigger revenue losers than special IRAs. However, a present-value calculation demonstrates that the long-term cost to the Federal Government of deductible IRAs and special IRAs will be approximately equal. This is because a present-value approach recognizes that tax will eventually be collected on funds in IRAs, although possibly at a lower tax rate when withdrawn.

In order to evaluate the present value of the program's cost,[12] it is also necessary to know how taxpayers would have behaved in the absence of the IRA provision. Consider first the case of a taxpayer whose tax rate in the contribution year is the same as in the year the funds are withdrawn. Then, the tax advantage of the IRA is the ability to earn a tax-free rate of return on savings. However, the cost to the government depends on what the taxpayer would have done in the absence of the program. If, in the absence of the tax benefits accorded to IRAs, the taxpayer would not have saved the money invested in the IRA, then the IRA program does not lose any government revenue in the long run. For instance, consider the example of a taxpayer who decides to invest $1,000 in an IRA. If, in the absence of the IRA, the taxpayer would have paid the $280 tax on the earnings, and spent the remaining $720, the total amount of tax collected from that $1,000 over the taxpayer's lifetime by the government would have been $280. If instead of spending the income, the taxpayer invests it in a special IRA, the government collects $280 from the earnings, and then never taxes the income again. Once again, the total amount collected over the taxpayer's lifetime is $280. Further, assume that the taxpayer invests in a deductible IRA for 10 years in a fund that earns 8 percent per year. In the first year, the government loses $280 in revenue, since the taxpayer deducts the $1,000 from income. In year 10, the $1,000 has grown to $2,158.93, and the taxpayer owes $604.50. Since $604.50 is exactly equal to $280 plus 10 years of interest at 8 percent per year, the government receives the $280 with interest, and collects the same amount of revenue that it would have had there been no IRA program. In present value terms, the taxpayer pays $280 over his or her lifetime. To the extent that deductible IRAs permit taxpayers to pay tax on their funds at a lower marginal rate than when the contribution was made, the government does lose revenue even if the funds invested in the IRA represent funds which would otherwise have been consumed (i.e., new saving.)

On the other hand, if the contribution to the IRA represents income that would have been invested for the same 10 years in an interest-bearing account (i.e., old saving), the IRA reduces revenues to the government. If the earnings in the above example would have instead been invested in a fully taxable asset earning 8 per-

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[12] To calculate the present value of the cost to the government of IRAs, it is necessary to use the government's discount rate. If repayment of taxes is uncertain, then the discount rate used should be higher than the government's borrowing rate.

cent per year, the government would have collected the $280 tax on the initial earnings, plus an additional $136 in present value (using a discount rate of 8 percent) of taxes on the annual interest earnings. Thus, the cost of the IRA program in this case for this particular taxpayer would be $136.

The above examples represent the polar cases of the present value of the revenue effect for IRA contributions—contributions that represent only new savings and contributions that represent savings that would otherwise have been invested in a fully taxable asset.[13] Other possibilities can also be considered. For instance, saving for an IRA may be diverted from other tax-favored assets, in which case the tax loss is not as great. For example, under the bill, if taxpayers who contribute to a deductible IRA would have invested in a nondeductible IRA under present law, then the tax loss consists of the difference between the tax advantage of the deductible IRAs and the tax advantage of the nondeductible IRAs. Similarly, investment in housing is currently tax favored. If taxpayers divert income that would have been invested in housing to IRAs, the present value of the revenue cost to the Federal Government may be relatively small.

Finally, the choice between the deductible and the special IRA offered in S. 612 is likely to increase the present value of the revenue cost of the IRA program relative to a program offering either IRA alone. Taxpayers who have reason to believe that their tax rates will decline over time should be more likely to choose the deductible IRA, and taxpayers who believe their tax rates will increase over time should choose the special IRA.

If IRAs do not generate new saving, then IRAs reduce the present value of revenues of the Federal Government. If the Federal Government responds to these reduced revenues by reducing expenditures or increasing other taxes, then IRAs that do not increase personal saving will have no effect on national saving. If, on the other hand, the Federal Government offsets the reduced revenues by borrowing, then IRAs will actually reduce the national saving rate.

C. The Effectiveness of IRAs at Increasing Saving

1. Theoretical effects

In general

IRAs have a number of attributes that may affect a taxpayer's saving decision. First, investments in IRAs earn a higher after-tax rate of return than investments in other assets. Second, IRAs may provide an incentive for retirement saving, as opposed to other forms of saving. Third, deductible IRAs may provide a psychological incentive to save. Fourth, advertising by banks and other financial institutions of IRAs may influence people's saving decisions. The following discussion focuses on each of these attributes.

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[13] Actually, the revenue loss can be even greater than the case presented. If IRAs reduce saving, then not only does the government lose the tax revenue that would have been collected on the IRA investment, but it also loses the tax revenue on the saving that was not undertaken because of the IRA. The possibility that IRAs reduce private saving is discussed below.

Rate of return

In general.—Both the deductible IRA and the special IRA effectively exempt the return on savings from tax, thereby increasing the rate of return to saving. When the return on saving increases, the price of future consumption decreases, because the taxpayer has to forego fewer dollars today to consume a dollar's worth of consumption in the future.

This price decrease can affect saving in two ways. Since future consumption is now cheaper, taxpayers may choose to substitute future consumption for current consumption. This effect increases saving. When the price of future consumption falls, though, the amount of investment necessary to achieve any particular level of income in the future decreases. For example, a taxpayer in the 28-percent marginal tax bracket may set aside $1,300 today to help defray tuition expenses of his child 15 years from now. If the taxpayer's investment earns 8 percent annually and those earnings are taxed annually at a 28-percent tax rate, in 15 years the investment will be worth $3,000. If the taxpayer instead invested in a special IRA, an investment of only $946 today would be worth $3,000 in 15 years (assuming the same 8-percent return). This effect decreases saving because the tax benefit permits the taxpayer to save less to accumulate the same amount of money in the future.

Substantial disagreement exists among economists as to the effect on saving of increases in the net return to saving. Some studies have argued that one should expect substantial increases in saving from increases in the net return.[14] Other studies have argued that large behavioral responses to changes in the after-tax rate of return need not occur.[15] Empirical investigation of the responsiveness of personal saving to after-tax returns provides no conclusive results. Some find personal saving responds strongly to increases in the net return,[16] while others find little or a negative response.[17]

Even if increasing the rate of return on all saving does increase saving generally, it is still possible that increasing the rate of return on IRAs would not affect saving. For increased rates of return to influence taxpayers to substitute future consumption for current consumption, the marginal rate of return on savings must increase so that if the taxpayer increases saving, that saving receives a higher rate of return. In order for IRAs to increase the marginal return to saving, taxpayers must not be able to finance the IRA profitably by borrowing, must not have other similar assets that can be easily shifted into an IRA, and must intend to save less than the maximum contribution allowed. The following discussion provides examples of how each of these situations may affect the impact of IRAs on saving.

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[14] See, Lawrence H. Summers, "Capital Taxation and Accumulation in a Life Cycle Growth Model," *American Economic Review*, 71, (September 1981).

[15] See, David A. Starrett, "Effects of Taxes on Saving," in Henry J Aaron, Harvey Galper, and Joseph A Pechman (eds.), *Uneasy Compromise: Problems of a Hybrid Income-Consumption Tax*, (Washington: Brookings Institution), 1988.

[16] See, M. Boskin, "Taxation, Saving, and the Rate of Interest," *Journal of Political Economy*, April 1978, 86.

[17] See, G. von Furstenberg, "Saving," in H Aaron and J Pechman (eds), *How Taxes Affect Economic Behavior*, Brookings Institution, 1981

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Borrowing.—When interest on borrowed funds is deductible, it may be profitable for a taxpayer to borrow to contribute to an IRA. For example, consider a taxpayer with a 28-percent marginal tax rate without any assets. If the taxpayer can borrow at an interest rate equal to the rate of return on an IRA investment, then one would not expect the taxpayer to increase the amount of income saved. Instead, the borrower can borrow $2,000, invest in the IRA and deduct the interest cost. Since the IRA earnings are effectively exempt from tax, the taxpayer receives the full value of the IRA benefit, but does not increase saving.[18] Given that the taxpayer can receive the IRA benefit without increasing saving, the decision of whether to save an extra dollar is unaffected, because that extra dollar will not receive a higher after-tax return than it would have without the availability of tax benefits for IRAs.

If the taxpayer must pay a higher interest rate on the loan than can be received on the investment, the benefits to borrowing to finance an IRA are reduced, but not eliminated. For example, if investments in IRAs earn 10 percent per year and the taxpayer's marginal tax rate is 28 percent, the taxpayer could profitably borrow to fund the account even if the annual interest rate on the loan was as high as 13.8 percent. However, in this case, the taxpayer would gain little from borrowing, and might choose to finance the IRAs with increased savings instead.

Present law permits taxpayers to deduct investment interest but not most personal interest. It is unclear whether interest on a loan used to finance a deductible IRA would be considered investment interest or personal interest. It is likely, however, that interest on a loan used to finance a special IRA would not be deductible, whether or not secured by the taxpayer's home, because it would be viewed as interest on amounts used to finance tax-exempt interest and subject to section 265. Furthermore, present law does not allow IRA assets to be used as security for a loan. Because interest paid on home-equity loans generally is deductible, the easiest way to borrow to finance IRAs may be through home-equity loans. Borrowing against home equity to finance IRAs is similar to shifting existing assets into IRAs.

Shifting of existing assets.—Taxpayers who have existing assets that exceed the IRA contribution limits can also receive the benefit of IRAs without increasing saving. Consider a taxpayer who saves only $400 annually, but has been saving for years, and has $4,500 in financial assets. The first year the taxpayer has the opportunity to invest in an IRA, the taxpayer can shift $2,000 from the financial assets to the IRA. The second year, the taxpayer can once again shift $2,000 into the IRA. Only in the third year will the tax benefits accorded to IRAs increase the rate of return on new saving.

Shifting of planned assets.—Finally, taxpayers who would have saved without the IRA may not increase their saving due to the availability of IRAs. For example, consider a taxpayer who habitually saves $4,000 per year. If this taxpayer is provided the oppor-

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[18] However, if the taxpayer begins repaying the loan before the IRA funds are withdrawn, even this loan-financed IRA investment might be associated with increased saving. This possibility is discussed in greater detail below.

tunity to invest in an IRA, then $2,000 of these savings will be diverted to the IRA. However, the IRA does not provide a marginal incentive to save. If the taxpayer saves $4,001, the return on that extra dollar of saving will be no higher than it would have been without the IRA program. The taxpayer may even decrease the amount saved, since the first $2,000 of saving that is in the IRA will provide more income in the future, and hence the need for saving may decrease.

Type of saving

The above discussion focused on saving in general. Many authors have noted that certain IRAs may provide incentives for retirement saving, as opposed to saving for other purposes. For instance, consider the effect of the deductible IRA, which is subject to additional tax unless held until retirement or used for other qualified purposes. An individual who is saving only for a "rainy day" may not have much saving that is expected to last until retirement. When offered a higher rate of return on retirement saving, that individual may choose to increase the total amount of saving by maintaining the rainy day saving and adding retirement saving.

Similarly, an individual who takes out a home equity loan to finance an IRA may not save any additional money in the year the IRA contribution is made. But if that individual slowly repays that loan, and this repayment represents saving the taxpayer would not otherwise have done, then the IRA increased that individual's saving.

To the extent the provisions for penalty-free early withdrawal of the IRA and the 5-year holding period of the special IRA increase the substitutability of IRA saving for other saving, this retirement saving attribute of IRAs is diminished, making substitution of current savings for IRA savings more likely.

Psychological impact of IRAs and effects of increased advertising

Some observers have noted that IRAs may have a larger impact on saving than standard economic analyses would predict. These observers suggest that active marketing campaigns in the mid-1980s contributed to the high IRA participation rates observed; in fact, IRA participation was larger than was expected. The sharp decline in advertising after 1986 may explain the decline in IRA contributions among taxpayers who are still eligible.

Furthermore, there may also be a psychological factor that contributes to the impact of IRAs on saving. One study found that taxpayers who owed money to the IRS in excess of taxes withheld were significantly more likely to make IRA contributions than were other taxpayers.[19] One might expect this psychological factor only to induce deductible IRA contributions, which will have an immediate effect on taxes paid. However, another author [20] noted that taxpayers who owe the IRS money generally have higher in-

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[19] Feenberg, Daniel, and Jonathan Skinner, "Sources of IRA Saving," in Lawrence Summers (ed), *Tax Policy and the Economy*, vol 3, (Cambridge: Massachusetts Institute of Technology Press), 1989.
[20] Gravelle, Jane, "Do Individual Retirement Accounts Increase Savings?", *Journal of Economic Perspectives*, forthcoming Spring 1991.

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comes and this may be why they are more likely to contribute to IRAs, rather than any psychological factor.

2. Empirical research on the effect of IRAs on saving

Deductible IRAs have been very popular with taxpayers. As Table 4 reports, contributions to IRAs increased significantly when eligibility restrictions were eliminated in 1982. At the peak in 1985, over $38 billion was contributed to IRAs. This represented almost 33 percent of personal saving for that year.

Table 4.—IRA Participation, 1979–1988

Year	Returns claiming IRA deductions (millions)	Percentage of all returns (percent)	IRA deductions claimed (billions)
1979	2.5	2.6	$3.2
1980	2.6	2.7	3.4
1981	3.4	3.6	4.8
1982	12.0	12.6	28.3
1983	13.6	14.1	32.1
1984	15.2	15.3	35.4
1985	16.2	15.9	38.2
1986	15.5	15.1	37.8
1987	7.3	6.8	14.1
1988	6.4	5.8	11.9

Source: Internal Revenue Service, *Statistics of Income* (various years).

However, it is unclear whether IRAs actually increased total saving. There is no consensus within the economics profession on the effect of the pre-1986 IRAs on personal saving. Some economists believe that IRAs had no effect on overall personal saving; some believe that IRAs increased personal saving; and some economists believe that IRAs would have eventually increased saving if the universally available deductible IRA had been maintained.

A number of economists savings argue that most of the IRA contributions consisted of taxpayers shifting into IRAs from existing assets.[21] They point to the fact that IRA contributions were concentrated at the top of the income distribution, and that IRA contributors had large stocks of financial assets compared to noncontributors with the same income. Both of these facts suggest that IRA contributors had assets and desired saving above the contribution limit.

Economists who believe that IRAs did not increase saving point to the fact that personal savings in the United States was not higher during the years that deductible IRAs were available to all taxpayers.[22]

[21] See, for example, Galper, Harvey and Charles Byce, "Individual Retirement Accounts: Facts and Issue," *Tax Notes*, vol. 31, June 2, 1986, pp. 917–921.
[22] See Gravelle, Jane "Do Individual Retirement Accounts Increase Savings?", *Journal of Economic Perspectives*, forthcoming Spring 1991

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A number of economists argue that IRA contributions between 1982 and 1986 consisted largely of new saving.[23] Some of these economists have investigated whether IRA contributors shifted existing assets from taxable accounts into IRAs. If such shifting had occurred, they argue, one would expect to find a reduction in taxable asset earnings following the IRA contribution. However, one study found that taxpayers who contributed to IRAs generally were also increasing their investment in taxable assets.[24] Although this does not prove that the money invested in IRAs would not have been saved otherwise, it may provide evidence against the simple existing asset shifting view.

Further, proponents of IRAs note that to the extent that taxpayers do shift existing assets into IRAs, most taxpayers do not have enough financial assets to continue asset shifting indefinitely. Hence, they conclude, IRAs would eventually provide a marginal incentive to save.[25]

Some economists have noted that the introduction in Canada of savings incentives similar to the IRA was followed by large increases in Canadian saving. They argue that this can be taken as evidence that IRAs are effective in increasing national saving.[26] However, others note that since Canadians are not able to deduct home mortgage interest from taxable income, they should be less likely to finance tax-favored savings with home borrowing, and therefore savings incentives in Canada may be more likely to induce increased saving than in the United States.

3. Distributional effects of IRAs under present and prior law

Tables 5 and 6 summarize information on IRA participation in 1985 and 1988. In 1985, 71 percent of all returns reporting IRA contributions had AGI below $50,000, and 29 percent had AGI of $50,000 or above. However, taxpayers with AGI of $50,000 or above represented only 8 percent of all returns eligible for IRAs. Thus, although many lower-income individuals contributed to IRAs, most did not, whereas most taxpayers with AGI of $50,000 or above did contribute when eligible. Taxpayers with AGI of $50,000 or above were more than four times as likely to contribute to an IRA than were taxpayers with AGI below $50,000—61.8 percent of eligible returns with AGI of $50,000 or above reported contributions to an IRA, while only 13.8 percent of eligible returns with AGI below $50,000 reported contributions.

Higher-income taxpayers made larger contributions as well. Taxpayers with adjusted gross incomes of $50,000 or more constituted approximately 29 percent of all IRA contributors in 1985, but accounted for more than 35 percent of IRA contributions. In 1988,

[23] See, Venti, Steven F. and David A. Wise, "The Evidence on IRAs," *Tax Notes*, vol. 38, January 25, 1988, pp. 411–416. Some analysts have criticized the methodology of studies which claim IRAs create new saving and argue that the reported results of the effect of IRAs on saving are implausibly large. See Gravelle, Jane G., "Capital Gains Taxes, IRA's, and Savings," CRS Report for Congress 89–543, September 26, 1989.

[24] See, for example, Feenberg, Daniel, and Jonathan Skinner, "Sources of IRA Saving," in Lawrence Summers (ed), *Tax Policy and the Economy*, vol. 3, (Cambridge: Massachusetts Institute of Technology Press), 1989.

[25] See Skinner, Jonathan, "Do IRAs Promote Saving? A Review of the Evidence", March 1991.

[26] See, Carroll, Chris, and Lawrence H. Summers, "Why Have Private Saving Rates in the U.S and Canada Diverged?" *Journal of Monetary Economics*, 20, September 1987.

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taxpayers with adjusted gross incomes of $50,000 or more constitut-
ed approximately 16 percent of all IRA contributors, but accounted
for almost 23 percent of IRA contributions.

Because the value of the IRA is the effective exemption of the
earnings from tax, the higher a taxpayer's marginal tax rate, the
more valuable the ability to invest through an IRA. Because people
in higher income classes generally have higher tax rates, the value
of their IRA is larger than the value of IRAs for taxpayers in lower
income classes. However, the value of the IRA depends on tax rates
throughout the period the IRA is held, and not just the marginal
tax rate in the year the contribution is made.

Table 5.—Deductible IRA Participation By Income Class, 1985 [1]

Adjusted gross income class	Number of returns with earned income in millions	Returns reporting IRA contributions		
		Number in millions	Percent of returns with earned income [2]	Contribu- tions (billions)
All classes	90.4	16.2	17.8	$38.2
Under $10,000	27.9	.6	2.3	1.1
$10,000 to $30,000	37.5	5.1	13.6	9.7
$30,000 to $50,000	17.4	5.7	32.9	13.5
$50,000 to $75,000	5.3	3.0	56.5	8.7
$75,000 to $100,000	1.2	.9	74.1	2.7
Over $100,000	1.1	.8	76.1	2.6

[1] Includes taxpayers who filed tax returns. Unlike Table 2, above, no returns are
imputed for taxpayers who did not file.
[2] Eligible taxpayers include self-employed persons as well as wage and salary
employees.

Source: Internal Revenue Service, *1985 Statistics of Income.*

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Table 6.—Deductible IRA Participation By Income Class, 1988 [1]

| Adjusted gross income class | Number of returns with earned income in millions | Returns reporting IRA contributions | | |
		Number in millions	Percent of returns with earned income [2]	Contributions (billions)
All classes	93.3	6.4	6.9	$11.8
Under $10,000	26.1	0.4	1.5	0.6
$10,000 to $30,000	36.0	2.7	7.5	4.6
$30,000 to $50,000	18.7	2.3	12.3	4.1
$50,000 to $75,000	8.2	0.5	6.1	1.3
$75,000 to $100,000	2.2	0.2	8.9	0.6
Over $100,000	2.1	0.3	14.2	0.8

[1] Includes taxpayers who filed tax returns. Unlike Table 2, above, no returns are imputed for taxpayers who did not file.

[2] Includes self-employed persons reporting wage income as well as wage and salary employees. Because of the limitations enacted by the Tax Reform Act of 1986, not all such taxpayers were eligible to make deductible contributions to IRAs.

Source: Internal Revenue Service, *1988 Statistics of Income.*

Other authors have noted that even the taxpayers with low income who did contribute to IRAs owned more financial assets than other low-income taxpayers and that, therefore, IRA contributors may not be representative of taxpayers in general. Table 7 presents information on the assets of households with IRAs compared to the assets of households without IRAs. Part of the reason that IRA contributors have larger holdings of assets than noncontributors is that contributors to IRAs tend to be older than noncontributors, and older taxpayers have been accumulating assets longer.

Table 7.—Estimated Median Financial Assets of Households With IRAs and Households Without IRAs, 1985

Income	Households with IRAs	Households without IRAs
Less than $10,000	$7,625	$0
$10,000 to $20,000	6,538	200
$20,000 to $30,000	6,365	900
$30,000 to $40,000	6,015	1,692
$40,000 to $50,000	10,000	2,694
$50,000 to $75,000	14,516	5,100
$75,000 and over	36,085	9,735

Source: Steven Venti and David Wise, "Heterogeneity, Individual Effect, and IRA Saving: Further Evidence from SIPP", mimeo, May 1990.

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4. Expected differences between effects of pre-1986 IRAs and S. 612

Although research on the effectiveness of the pre-1986 IRA provisions can shed light on the potential of the proposed IRAs in S. 612 to affect savings, several differences between the pre-1986 IRAs and the proposed IRAs should be noted. First, marginal tax rates for most taxpayers are lower now than they were before the passage of the Tax Reform Act of 1986. The tax advantage of IRAs is the exemption from tax of the investment's return and, for the deductible IRA, the possibility that the rate at which the contribution is taxed will be lower when the contribution is withdrawn. Both of these advantages may be less valuable now than they were before 1987, especially for higher income taxpayers because their marginal tax rates decreased the most. For example, if prior to 1987, a taxpayer in the 50-percent marginal tax bracket received a 10-percent return on his or her investment, excluding such income from tax would increase his or her net return to 10 percent from an after-tax return of 5 percent. After the 1986 Act, such a taxpayer would be in the 31-percent marginal tax bracket and the exemption would increase his or her net return to 10 percent from an after-tax return of 6.9 percent. Thus, the exemption provided a greater increase in net return prior to 1987. Similarly, if taxpayers believe that tax rates are likely to increase over time because of the Federal government's budget deficit, or because current tax rates are relatively low from a historical perspective, then the deductible IRA will look less attractive than it appeared in the past.

Second, the proposed IRAs are different from the pre-1986 IRAs, both because they provide additional exceptions to the early withdrawal penalty, and because the special IRA has a relatively short required holding period. These differences may alter the effectiveness of IRAs at increasing saving. To the extent that taxpayers already save for education, housing, and medical expenses, allowing IRAs to be used for these purposes increases the likelihood that existing assets or existing planned saving will be shifted into IRAs, reducing the effectiveness of IRAs at increasing savings. Similarly, to the extent that taxpayers already save for short-term goals and for rainy days, allowing taxpayers to withdraw funds from the special IRA in only 5 years may also encourage more asset shifting. Further, permitting short holding periods and penalty-free early withdrawal may cause taxpayers to keep their money in the IRAs a shorter period of time.[27] On the other hand, to the extent that taxpayers who would otherwise choose to save in the form of IRAs would not do so because they believe they might need the funds before retirement, this added flexibility may encourage more taxpayers to invest in IRAs and increase their saving rate. Finally, permitting penalty-free withdrawals before retirement age diminishes the effectiveness of IRAs as explicit retirement savings vehicles, but may not change the overall effectiveness of IRAs to increase saving.

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[27] Although once funds are withdrawn from an IRA, they can only be replaced at a rate no faster than $2,000 per individual per year.

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The ability of individuals to save through employer-sponsored retirement plans, particularly qualified cash or deferred arrangements (sec. 401(k) plans) may affect the level of IRA contributions. While such plans existed prior to 1986, they have become more prevalent since then. Section 401(k) plans offer benefits similar to those of IRAs. However, individuals may contribute more to such plans on a pre-tax basis ($8,475 for 1991), and may obtain increased benefits if, as is often the case, the employer matches employee contributions. Despite these advantages, some may still view an IRA as attractive, for example, because IRA funds may be withdrawn at any time (subject to the early withdrawal tax), whereas the ability to obtain withdrawals from section 401(k) plans prior to termination of employment is more limited. On the other hand, many section 401(k) plans permit individuals to borrow from their account, making investments in such plans more liquid. (Appendix I contains a further discussion of the comparison of IRAs and employer-sponsored retirement plans.)

The ability to contribute both to a section 401(k) (or similar) plan and an IRA could affect IRA contributions in a number of ways. For example, some individuals would save only through a section 401(k) plan, others would chose the IRA, and still others would split savings between a section 401(k) plan and an IRA. A number of factors may affect such choices, including the amount the individual wishes to save, the period and purpose for which they wish to save, and the particular terms of the section 401(k) plan they are eligible to participate in.

V. ISSUES RELATING TO TAX INCENTIVES FOR SAVING

A. Comparison of IRAs With Other Tax-Favored Assets

Present law contains various tax incentives for savings. Tax incentives are provided to encourage taxpayers to save for certain purposes and to encourage taxpayers to save in certain forms. Saving for the purpose of education and retirement is subsidized through the tax treatment of certain Treasury bonds and of certain retirement plans. Incentives are also provided for people to save in the form of housing, life insurance, and municipal bonds. Appendix I discusses the benefits of each of these incentives in detail.

Tax-favored treatment of assets does not always increase the rate of return on saving. If the supply of a tax-favored asset is limited relative to the demand for that asset, much of the benefit of the tax treatment will be realized by the initial owners of the asset, rather than by the holders of the asset. For instance, holders of municipal bonds may not receive a higher after-tax rate of return than holders of taxable bonds because, even though the earnings are tax exempt, municipal bonds offer lower rates of return. The issuers of municipal bonds receive a tax benefit because they can pay lower interest rates than the rates paid on other securities.

The tax benefits of IRAs and pension funds, however, are not limited to particular assets. Because investors in IRAs and pension funds can invest in a wide range of assets, and because the amount of funds permitted to be invested through these tax-favored vehicles is limited (the demand is small relative to the supply of assets), investors in IRAs and pension funds do receive a higher rate of return than that available through other investments, and thus do benefit from the tax favored treatment.

Enactment of additional saving incentives would be expected to alter taxpayers' choices among various taxable and tax-preferred assets. Because the income earned on assets held in IRAs effectively is exempt from tax, the taxpayer maximizes the benefit of the tax preference by directing the investment of IRA contributions in assets which are not otherwise tax preferred. The benefits of tax preferences for assets that are tax preferred to one degree or another are maximized when such assets are held outside an IRA.

The expansion of IRAs could be expected to increase the demand for otherwise taxable instruments at the expense of instruments which are tax preferred under present law. On the other hand, the annual contribution limitation of the IRA would limit the effect on the demand for other tax-preferred instruments.[28] Moreover, to the

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[28] The Administration's Family Savings Account (FSA) proposal, which is essentially the same as a special IRA, also limits the tax benefits to taxpayers below a specified income level To the extent that existing tax-preferred instruments are held only by taxpayers who would be ineligible for the FSA (e.g., taxpayers whose adjusted gross income exceeds $120,000), the demand for existing tax-favored instruments would be unaffected.

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extent that savings incentives generate increases in saving, the demand for all instruments would increase. If this were to occur, the issuers of instruments which are tax-preferred under present law conceivably could benefit as the cost of capital declined.

B. Goals of Tax Incentives for Saving

Some argue that tax incentives for saving are appropriate because the income tax system taxes the return to income that is saved, thereby lowering the return to saving. This lower return on saving affects both the national saving rate, as well as the assets that taxpayers accumulate for particular purposes. There is some disagreement about whether the goal of tax incentives for saving should be to encourage saving for particular purposes or to increase national saving.[29] These purposes are not mutually exclusive; if effective, incentives to save for particular purposes will increase national saving. However, general saving incentives will not necessarily fulfill more specific goals. Whether new tax incentives for saving should be aimed at increasing national saving in general, or increasing retirement saving, depends on the perceived adequacy of each type of saving.

In particular, IRAs have historically been viewed as vehicles for retirement savings. When IRAs were introduced in 1974, they were provided only to individuals without employer-provided pension plans. The original intention of the IRA was explicitly to encourage individuals not participating in an employer-sponsored plan to increase their retirement savings and to provide a higher return on such savings. Even with the liberalization of eligibility requirements for IRAs in the Economic Recovery Tax Act of 1981, IRAs still have been largely devoted to retirement saving. Withdrawals of IRA funds before age 59½ generally are still subject to an additional 10-percent tax.

However, IRAs can provide substantial benefits to taxpayers who are saving for nonretirement purposes. For example, consider a taxpayer with a 28-percent marginal tax rate who has $1,000 of earnings to devote to saving. Without an IRA, the taxpayer would pay a tax of $280, leaving $720 to be invested. If this amount earns 8 percent annually and the earnings are taxed annually at a 28-percent marginal tax rate, the taxpayer will have $1,261 at the end of 10 years. If, however, the taxpayer can deduct the $1,000 and accumulate 8-percent annual interest tax free, the investment will be worth $2,159 at the end of 10 years. After including the distribution in income, subject to the additional 10-percent tax on early withdrawals, the taxpayer will have $1,339, or $78 more than the taxpayer has if a taxable investment is made.

Similarly, the present-law exceptions to the early withdrawal tax may permit taxpayers to use deductible IRAs for nonretirement saving. Under present law, a taxpayer may make penalty-free withdrawals from an IRA prior to attaining the age of 59½ if the distributions are made over certain periods. For example, a taxpayer could purchase an annuity which promises level payments for the

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[29] Sections C and D below discuss the importance of national saving and the adequacy of retirement saving.

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remainder of the taxpayer's life. This exception may offer many taxpayers a way to receive a substantial percentage of the tax-favored funds prior to age 59½ and avoid the 10-percent penalty. At age 50, the average American male has a life expectancy of approximately 26 years.[30] At a 10-percent discount rate, an annuity which pays $1,000 per year for 26 years has a present value of approximately $9,160. The present value of the payments received during the first 10 years of such annuity is approximately $6,145, or 67 percent of the total value of the annuity. Consequently, if the taxpayer withdrew the $9,160 from his IRA to purchase the $1,000 annuity, he would receive 67 percent of the total value of the annuity prior to age 60.[31]

C. Role of Saving in the National Economy

Investment and economic growth

When an economy's rate of investment increases, the economy's stock of capital increases. A larger, capital stock permits greater production of goods and services. Because the larger a country's capital stock, the more productive its workers, investment also leads to higher wages and salaries. Thus, increases in investment lead to future increases in a nation's standard of living.

It is important to distinguish gross investment from net investment. Gross investment includes investment in new capital as well as investment that is undertaken to replace depreciated or worn out capital. Net investment measures increases to the capital stock. (Net investment is equal to gross investment less depreciation).

In the short run, increases in gross investment will increase the capital stock. As the capital stock increases, worker productivity increases and the economy will experience a higher rate of growth. In the long run, any given rate of investment will just be sufficient to replace the existing, though larger, capital stock as it depreciates. Thus, in the long run, an increase in the level of investment increases a nation's standard of living, but may not increase a country's long run rate of growth.

It is possible that a higher investment level can lead to a higher growth rate even in the long run. Even if there is no growth in net investment, investment to replace depreciated capital may still enhance economic growth to the extent that the replacement capital embodies improved (and more efficient) equipment and technologies. The higher the gross investment rate, the more new capital is purchased each year, and thus the rate at which new technologies get adopted may be higher.

Sources of investment funds

Investment involves a trade-off between consumption today and consumption tomorrow. Investment can either be financed by na-

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[30] Bureau of the Census, U.S. Department of Commerce, *Statistical Abstract of the United States, 1990*, p. 73.
[31] If an 8-percent discount rate were used, the percentage recovered in the first 10 years would be approximately 62 percent.
  If such an annuity were purchased by a 40-year old male (life expectancy an additional 35 years), he would receive approximately 64 percent of the present value of the annuity (discounting at 10 percent) in the first 10 years and 88 percent by age 60.

tional saving, or by foreign borrowing (saving by foreigners). A basic accounting identity of the national income and product accounts states that [32]

$$\text{Investment} =$$

$$\text{Private Saving} + \text{Government Saving}$$

$$+ \text{Net Foreign Borrowing}.$$

Many analysts in the past ignored the foreign sector, primarily because at the time it was small relative to the U.S. economy. These analysts interpreted this basic relationship as saying that national investment must equal national saving, where national saving is the sum of private saving and public saving.

However, national investment need not equal national saving if foreigners can invest in the United States. The experience of the 1980s, when investment in the United States greatly exceeded national savings, demonstrates how important this source of funds has become (see Figure 1). When demand for investment funds in the United States outstrips the supply of national savings, interest rates rise in response. Increases in interest rates attract foreign capital to the United States, and the excess of investment over national saving is financed by foreigners' saving.

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[32] The national income and product accounts measure the flow of goods and services (product) and income in the economy. The gross national product (GNP) of the economy is the total annual value of goods and services produced by the economy and may be measured in several ways. One way is to measure GNP by expenditure on final product in the economy. By this measure,

(1) $\text{GNP} = C + I + G + (X\text{-}M)$.

Equation (1) is an accounting identity which states that gross national product equals the sum of consumption expenditures (C), investment expenditures on plant, equipment, inventory, and residential construction (I), governmental purchases of goods and services (G), and net exports (exports less imports of goods and services or X-M).

An alternative is to measure GNP by the manner in which income created in the economy is disposed of. By this measure,

(2) $\text{GNP} = C + S + T$.

Equation (2) is another accounting identity which states that gross national product equals the sum of consumption expenditures, saving by consumers and businesses (S), and net tax payments to the government (T) (net tax payments are total tax receipts less domestic transfer, interest, and subsidy payments made by all levels of government).

Because both measures of GNP are simple accounting identities, the right hand side of equation (1) must equal the right hand side of equation (2). From this observation can be derived an additional national income accounting identity,

(3) $I = S + (T\text{-}G) + (M\text{-}X)$

This is the basis for the statement that national investment equals private saving (S), plus public saving (T-G), and net imports (M-X).

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FIGURE 1

Saving and Investment as a % of GNP
1970-1990
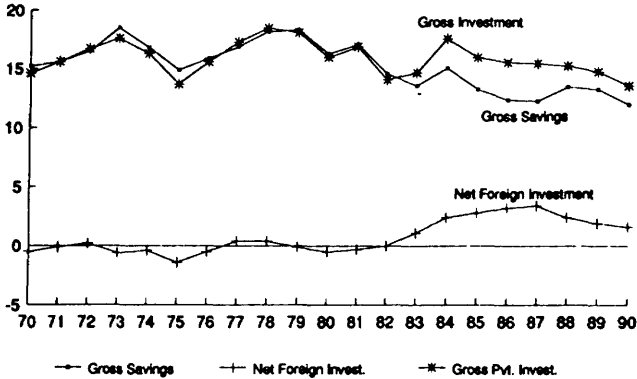
Foreign investment in the United States is also related to the value of the dollar and the trade deficit. To take advantage of high interest rates in the United States, foreign investors first must convert their currencies to dollars. This increases demand for the dollar, thereby increasing the dollar's exchange rate relative to the foreign currency. A stronger dollar makes imported goods relatively cheaper and our exports relatively more expensive. As a consequence, net exports fall and the trade deficit increases. A further accounting identity states that [33]

Net Foreign Borrowing = (Imports − Exports)

When net foreign borrowing increases, the trade deficit (the difference between imports and exports of goods and services) also increases. Thus, many people have blamed the trade deficits of the 1980s on the low national savings rate during that period. [34]

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[33] This ignores the relatively small amount of unilateral transfers to foreigners. For a more detailed discussion of foreign trade and domestic saving and investment, see Joint Committee on Taxation, *Background and Issues Relating to the Taxation of Foreign Investment in the United States* (JCS-1-90), January 23, 1990.

[34] For instance, see Hatsopoulos, Krugman, and Summers, "U.S. Competitiveness: Beyond the Trade Deficit", *Science*, 15 July 1988, Volume 241, pp. 299–307.

Is the U.S. saving rate too low?

Consequences of a low saving rate

The consequences of a low saving rate depend on the mobility of international capital. If capital is not mobile, then, as discussed above, investment is equal to national savings. When the saving rate is low, so is the investment rate. Historically, there has been a strong relationship between a country's rate of investment and its rate of saving.[35] This relationship is illustrated for a number of countries in Figure 2. Although this relationship has become weaker over time,[36] it is still true that countries with high saving rates also generally have high investment rates.

FIGURE 2

Net Saving and Net Investment Rates
Selected Countries, Averages 1960-89
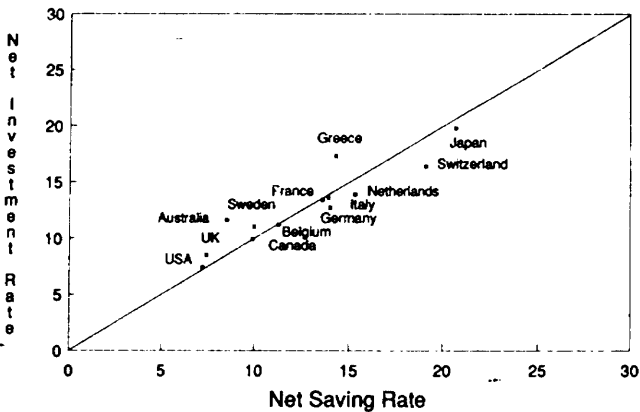
Net Saving Rate

If capital is mobile (that is, if foreigners can invest in the United States at low cost and without a lot of added risk), then investment will not decline as much when the saving rate falls. Instead, investment will be financed by foreigners, either by direct foreign investment in the United States or by foreign lending to American investors. When domestic saving rates are low, foreign financing of domestic investment results in a higher rate of investment than

[35] See, for instance, Martin Feldstein and Charles Horioka, "Domestic Saving and International Capital Flows," *Economic Journal*, vol. 90 (June 1980) pp. 314-29.
[36] See Phillippe Bacchetta and Martin Feldstein, "National Saving and International Investment", National Bureau of Economic Research Working Paper #3164, November 1989.

would be possible if investment were financed by domestic saving. Foreign investment in the United States does increase the productivity of American workers. However, the profits generated by foreign investment flow abroad, since the United States has to pay interest on the funds it borrows. Furthermore, eventually the debt will have to be repaid, so the net wealth that is left to future generations of Americans is smaller than it would be if the investment were financed by domestic saving.

Trends in national saving and investment

National saving is generally divided into private saving and public saving. Private saving is comprised of household or personal saving and business saving. Households save by not spending all of their disposable income (i.e., after-tax income). Businesses save by retaining some of their earnings. Public saving reflects the extent to which the Federal, State, and local governments run budget surpluses or deficits. Table 8 presents data on the components of net national saving in the United States.

Table 8.—Components of Net National Saving, Selected Years, 1929–1990

[In billions of dollars]

Year	Private saving			Federal surplus or deficit (−)	Public saving		Total net national saving
	Net personal saving	Net business saving	Total net private saving		State and local surplus or deficit (−)	Total public saving	
1929	2.6	2.4	5.0	1.2	−0.2	1.0	6.0
1939	1.8	.3	2.1	−2.2	0	−2.2	−.1
1949	7.4	10.5	17.9	−2.6	−.7	−3.4	14.5
1954	16.4	9.8	26.2	−6.0	−1.1	−7.1	19.1
1959	21.8	15.7	37.5	−1.1	−.4	−1.6	35.9
1964	31.5	25.4	56.9	−3.3	1.0	−2.3	54.6
1969	42.2	25.3	67.5	8.4	1.5	9.9	77.4
1974	96.7	20.1	116.8	−11.6	7.2	−4.3	112.5
1975	104.6	37.1	141.7	−69.4·	4.5	−64.9	76.8
1976	95.8	46.4	142.2	−53.5	15.2	−38.4	103.8
1977	90.7	62.3	153.0	−46.0	26.9	−19.1	133.9
1978	110.2	69.0	179.2	−29.3	28.9	−0.4	178.8
1979	118.1	61.9	180.0	−16.1	27.6	11.5	191.5
1980	136.9	37.7	174.6	−61.3	26.8	−34.5	140.1
1981	159.4	43.3	202.7	−63.8	34.1	−29.7	173.0
1982	153.9	20.0	173.9	−145.9	35.1	−110.8	63.1
1983	130.6	65.0	195.6	−176.0	47.5	−128.6	67.0
1984	164.1	94.0	258.1	−169.6	64.6	−105.0	153.1
1985	125.4	102.7	228.1	−196.9	65.1	−131.8	96.3
1986	124.9	84.5	209.4	−206.9	62.8	−144.1	65.3
1987	92.5	83.2	175.7	−158.2	51.0	−107.1	68.6
1988	145.6	91.4	237.0	−141.7	46.5	−95.3	141.7
1989	171.8	53.1	224.9	−134.3	46.4	−87.8	137.1
1990	179.1	29.1	208.2	−161.3	35.4	−126.0	82.2

Source: Department of Commerce, Bureau of Economic Analysis.

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Table 9 presents net saving by component as a percentage of gross national product (GNP). As the table demonstrates, net business saving,[37] personal saving, and public saving were all lower during the 1980s then in any of the three previous decades. Net national saving declined steadily through most of the 1980s.

Table 9.—Components of Net National Savings as a Percentage of GNP, Selected Years, 1929-90

Year	Net personal saving	Net business saving	Total net private saving	Public saving	Total net national saving
1929	2.5	2.3	4.8	1.0	5.8
1939	2.0	.3	2.3	−2.4	−.1
1949	2.8	4.0	6.9	−1.3	5.6
1954	4.4	2.6	7.0	−1.9	5.1
1959	4.4	3.2	7.6	−.3	7.2
1964	4.8	3.9	8.8	−.4	8.4
1969	4.4	2.6	7.0	−1.0	8.0
1974	6.6	1.4	7.9	−.3	7.6
1975	6.5	2.3	8.9	−4.1	4.8
1976	5.4	2.6	8.0	−2.2	5.8
1977	4.6	3.1	7.7	−1.0	6.7
1978	4.9	3.1	8.0	−.1	7.9
1979	4.7	2.5	7.2	.5	7.6
1980	5.0	1.4	6.4	−1.3	5.1
1981	5.2	1.4	6.6	−1.0	5.7
1982	4.9	.6	5.5	−3.5	2.0
1983	3.8	1.9	5.7	−3.8	2.0
1984	4.4	2.5	6.8	−2.8	4.1
1985	3.1	2.6	5.7	−3.3	2.4
1986	3.0	2.0	4.9	−3.4	1.5
1987	2.0	1.8	3.9	−2.4	1.5
1988	3.0	1.9	4.9	−2.0	2.9
1989	3.3	1.0	4.3	−1.7	2.6
1990	3.3	.5	3.8	−2.3	1.5
Average 1950-59	4.7	2.8	7.5	−.1	7.4
Average 1960-69	4.6	3.5	8.1	−.3	7.9
Average 1970-79	5.6	2.4	8.0	−1.0	7.1
Average 1980-89	3.8	1.7	5.5	−2.5	3.0

Source: Department of Commerce, Bureau of Economic Analysis.

Some analysts suggest that because households save out of their disposable income (i.e., after-tax income), it is more appropriate to examine personal saving relative to disposable income than to examine personal saving relative to GNP. Table 10 presents personal saving as a percentage of disposable income. Generally, the same trends observed in Table 9 are evident in Table 10.

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[37] Tables 8 and 9 present net saving, which equals gross saving less capital consumption (depreciation). Trends in gross saving are presented in Appendix II.

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Table 10.—Personal Saving as a Percentage of Disposable Personal Income, Selected Years, 1929-90

Year	Personal saving as a percentage of disposable personal income
1929	3.2
1939	2.6
1944	25.1
1949	3.9
1954	6.3
1959	6.3
1964	7.0
1969	6.4
1974	9.3
1975	9.2
1976	7.6
1977	6.6
1978	7.1
1979	6.8
1980	7.1
1981	7.5
1982	6.8
1983	5.4
1984	6.1
1985	4.4
1986	4.1
1987	2.9
1988	4.2
1989	4.6
1990 [1]	4.5

[1] Estimate.

Source: Department of Commerce, Bureau of Economic Analysis.

Figure 1, above, displays domestic saving, domestic investment, and net foreign investment as a percentage of GNP for the period 1970 to 1990. Prior to 1980, domestic saving generally financed domestic investment as well as providing funds for Americans to be net investors abroad (negative net foreign investment in the figure). Since 1980, net saving has fallen short of domestic investment. The figure indicates that, as a share of GNP, domestic investment has declined from its 1984 peak and that net foreign investment has provided for the difference in domestic savings and investment.[38] Thus, although the decline in saving was coincident with a decline in investment, this decline was not as severe as it might have been had there not been foreign investment.

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[38] Appendix table 5 in Appendix II provides data underlying Figure 1.

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Comparison between the saving rates of the U.S. and other countries

The United States' national saving rate is low when compared to that of other nations. This comparison is shown in Table 11 for total national saving and in Table 12 for household or personal saving. Figure 3 also highlights the data from Table 11 for the United States, Canada, Germany, and Japan. As the table indicates, the net saving rate of the United States during the 1980s was below the saving rates of most countries in the OECD.[39]

FIGURE 3

Net National Saving Rates
as a Percentage of GDP


```
      30
       
    S 25
    a
    v 20
    i
    n
    g 15
    R
    a 10
    t
    e  5
       
       0
        1960    1965    1970    1975    1980    1985  1989
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—— U.S.A.   —+— Japan   * Germany   ---- Canada
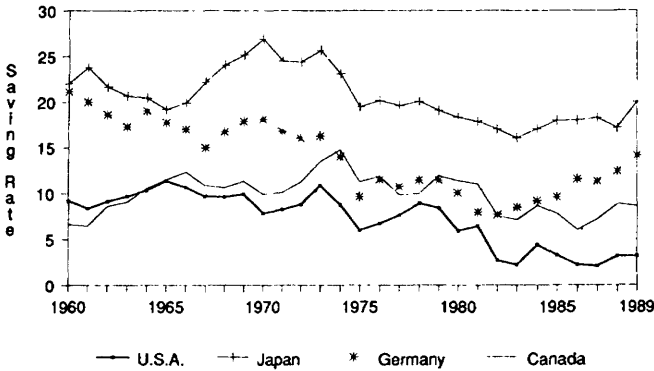
source: OECD

[39] The data on international saving rates in Tables 11 and 12 are not directly comparable to the data in Tables 9 and 10 because such data are not always compiled consistently across nations. For example, in computing household saving rates, the OECD subtracts household interest expense from income to determine U.S. household disposable income. The Bureau of Economic Analysis does not make a similar adjustment in defining household disposable income. Also, while the source of the international comparisons draws on data from the OECD, which attempts to provide data on an internationally comparable basis, the data are not fully comparable. For example, in computing household saving rates, the definition of the household sector is not identical across all countries. In particular, except in Japan, France, and Italy, private non-profit institutions are included in the household sector. *See,* Andrew Dean, Martine Durand, John Fallon, and Peter Hoeller, "Saving Trends and Behaviour in OECD Countries," OECD, Economics and Statistics Department Working Paper, No. 67, June 1989.

Table 11.—Net National Saving as a Percentage of Gross Domestic Products (GDP), Selected Years, 1962-1989

Country	1962	1967	1972	1975	1978	1981	1982	1983	1984	1985	1986	1987	1988	1989
United States............	9.1	9.7	8.8	6.0	8.9	6.4	2.7	2.2	4.4	3.3	2.2	2.1	3.1	3.2
Japan	21.7	22.2	24.4	19.4	20.0	17.9	17.0	16.1	17.0	18.0	18.0	18.3	17.2	20.0
Germany	18.6	15.0	16.0	9.6	11.4	8.0	7.7	8.5	9.2	9.6	11.6	11.3	12.4	14.1
France......................	17.3	18.4	17.6	13.2	13.0	8.5	7.2	6.4	6.3	6.4	7.6	7.3	8.2	8.8
United Kingdom	8.6	9.4	9.1	3.5	6.9	4.3	4.6	5.3	5.1	5.8	4.4	4.3	4.7	4.5
Italy.......................	19.7	16.3	15.0	10.9	14.1	10.2	9.3	9.5	10.0	9.2	9.1	8.5	8.8	8.5
Canada......................	8.6	10.8	11.2	11.2	10.0	11.1	7.5	7.1	8.7	7.8	6.0	7.2	8.9	8.6
Belgium	12.1	14.5	15.8	12.4	11.1	4.8	4.4	5.0	6.2	5.6	7.6	8.1	10.0	11.7
Greece......................	14.3	14.7	22.0	16.3	18.6	16.1	8.3	8.0	6.7	4.4	4.8	4.9	8.0	5.7
Netherlands...............	17.4	17.9	18.3	14.0	12.0	10.4	10.8	11.2	12.9	13.6	12.7	10.5	12.4	13.4
Sweden......................	13.6	13.6	12.8	12.7	6.0	3.6	1.9	3.8	5.9	5.7	6.2	6.4	6.8	7.3
Switzerland...............	18.5	19.5	20.5	17.0	16.2	17.8	17.7	17.7	18.7	19.5	21.1	21.6	22.5	23.3
Australia	10.6	9.5	13.4	8.5	6.6	4.2	.7	3.0	3.4	2.3	2.4	4.7	7.4	6.3

Source: OECD, *National Accounts, 1960-89,* volume 1, 1991.

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Table 12.—Net Household Saving As a Percentage of Disposable Household Income, Selected Year, 1972–1989

Country	1972	1975	1978	1981	1982	1983	1984	1985	1986	1987	1988	1989	Average 1980–89
United States	7.5	9.4	7.3	7.7	7.0	5.5	6.3	4.5	4.3	3.3	4.3	5.6	5.6
Japan	18.2	22.8	20.8	18.3	16.5	16.3	16.0	16.0	16.4	15.1	14.8	15.3	16.3
Germany	14.4	15.1	12.0	13.5	12.7	10.8	11.4	11.4	12.2	12.3	12.6	12.2	12.2
France [1]	18.9	20.2	20.4	18.0	17.3	15.9	14.5	14.0	13.2	11.5	12.1	12.2	12.9
Italy [1]	31.2	26.9	25.6	20.5	19.0	19.8	20.4	17.8	15.3	14.3	14.2	14.1	15.5
United Kingdom [1]	9.6	11.6	11.1	12.8	11.6	9.8	10.2	9.7	8.2	5.7	4.1	5.0	9.1
Canada	8.7	12.7	12.6	15.4	18.2	14.8	15.0	13.3	10.6	9.7	9.4	10.4	13.0
Belgium	17.4	16.5	16.6	16.2	13.6	14.7	13.4	11.1	13.1	11.9	13.3	14.1	13.8
Greece	20.3	19.0	20.4	21.6	19.7	18.8	20.6	21.4	17.6	16.8	20.3	21.0	19.8
Netherlands	7.6	3.9	2.5	2.3	4.7	2.0	1.9	2.0	2.8	2.1	2.4	3.8	2.5
Sweden	2.3	4.7	4.5	3.0	0.8	1.6	1.3	1.7	0.3	−3.4	−5.1	−3.7	0.2
Switzerland	10.2	7.6	4.6	4.6	6.2	5.8	5.8	5.7	7.0	8.4	9.8	10.7	6.7
Australia	11.8	14.9	11.7	9.7	8.3	7.9	9.1	7.7	6.8	6.5	6.7	7.9	8.1

[1] The figures for France, Italy, and the United Kingdom are gross saving rates.

Source: Organization for Economic Co-Operation and Development, *OECD Economic Outlook,* 45, June 1989, and *OECD Economic Outlook,* 47, June 1990.

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Generally, saving rates of all nations have declined from the rates of the late 1960s. In percentage terms, the decline in the national saving rate of the United States between 1967 and 1989 is greater than the decline of the saving rates of Japan and Germany, but comparable to the decline of the saving rates of France and Italy.

Although many people have pointed to the low saving rate in the United States as a cause of declining productivity, others argue that the United States has long been a relatively low-saving nation, and yet has enjoyed substantial economic growth. They note that many of the nations with higher saving rates were nations which needed to rebuild after the destruction of war on their own territory.

Furthermore, some argue that the low saving rate in the United States may be a product of demographics, and that the saving rate will increase as the baby boomers enter their forties and fifties, typically the years during which people do much of their retirement saving. However, others note that in the past, demographic changes have not been very successful at predicting saving rates.

In general, the decline in private saving rates is not well understood. It is likely that demographic changes, capital market liberalization, increased insurance availability, and increased social security benefits have all contributed to the decline. However, these factors have not proved significant enough to account for the total decline in the saving rate. Similarly, there is no convincing explanation for why saving rates have declined in other nations as well.

Wage growth and productivity

People who are concerned about the low saving rate in the U.S. point to the relationship between saving, investment, and labor productivity. Figure 2, above, illustrates the relationship between saving and investment. Figure 4 illustrates the relationship between investment rates and productivity growth in manufacturing. Countries that had high investment rates during the period from 1960 to 1989 also experienced large increases in productivity (output per hour worked).

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FIGURE 4

Investment & Manufacturing Productivity
Selected Countries, 1960-89
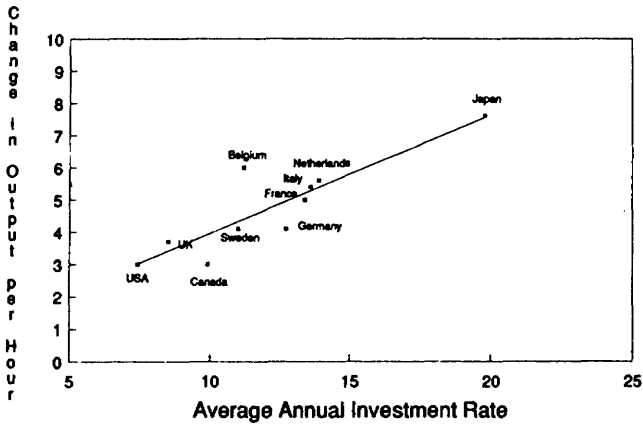
Source: data in Appendix II

D. The Adequacy of Retirement Savings

1. Economic status of the elderly

Sources of retirement income

Table 13 presents a breakdown of the sources of income for individuals over age 65. As the table indicates, social security is the largest source of retirement income (38 percent in 1986), followed by income from assets (26 percent in 1986), earnings (17 percent in 1986), and private and government employee pensions (14 percent in 1986).

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Table 13.—Composition of Elderly's Income Over Time, Selected Years, 1976–1986

Shares of Aggregate Income of Married Couples and Unmarried Persons Aged 65 and Older: Percentage Distribution of Income from All Sources

[In percent]

Source of income	1976	1978	1980	1982	1984	1986
Total percentage......................	100	100	100	100	100	100
Percentage of income from						
retirement benefits	55	54	55	54	53	54
Social security.................	39	38	39	39	38	38
Railroad retirement........	1	1	1	1	1	1
Government employees						
pensions.........................	6	6	7	7	7	7
Private pension annu-						
ities................................	7	7	7	6	6	7
Earnings..................................	23	23	19	18	16	17
Income from assets	18	19	22	25	28	26
Public assistance	2	2	1	1	1	1
Other...	2	2	3	2	2	2

Source: *EBRI Data Book on Employee Benefits, 1990;* p. 73.

Many researchers have attempted to measure whether people have adequate savings for retirement. A common measure of retirement savings adequacy is called the replacement rate, which is defined as the ratio of retirement income over income during the working years.

The issue of what replacement rate should be called adequate depends on a number of factors. A replacement rate of 100 percent means that the person's income during retirement is equal to their income during working years. There are a number of reasons that a replacement rate of 100 percent may not be optimal. First, people may desire to have more income during the working years because some of that income is saved for retirement. If people choose to have constant consumption over time, they save during their working years and dissave during retirement. Second, most elderly own their own homes (75 percent of households in 1987 [40]), and most of these (83 percent in 1987 [41]) have paid off their mortgages. Thus, most elderly receive housing without incurring any expenses beyond maintenance and utilities, whereas during their working years, they were likely to have been making mortgage payments. Third, few elderly households care for children, and therefore household expenses are likely to be lower. Fourth, the elderly are generally covered by Medicare, which provides insurance against large medical expenses and pays for most expenditures on health. Fifth, social security benefits, which represent the major source of

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[40] *Statistical Abstract of The United States 1990,* Table 1277, page 722.
[41] *Statistical Abstract of The United States 1990,* Table 1278, page 722.

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retirement income, are largely untaxed.[42] Thus, social security benefits can be smaller than income earned during the working years and still provide the same after-tax income. For the lowest income groups, this effect is not large since earned income is subject to the payroll tax, but probably not subject to the income tax.

These arguments suggest that the appropriate replacement rate for the elderly to have adequate retirement savings is less than 100 percent. However, there may be some factors which dictate that the replacement rate should be higher than 100 percent. First, although the elderly are covered by Medicare, they are also more likely to incur large medical expenses which may not be completely covered by medicare. Similarly, Medicare generally does not cover nursing home care or the costs of care in other long-term care facilities, and only those elderly poor enough to receive Medicaid or eligible through veterans' assistance are covered.

Table 14 presents actual replacement rates for social security and pension income for retired workers. These are calculated using two methods. The first method calculates the ratio of social security and pension benefits relative to a worker's highest career earnings.[43] The second method calculates benefits relative to the average earnings in the 5 years preceding retirement.[44] It seems likely that the career high earnings overstate average earnings, and earnings during the 5 years preceding retirement understate average earnings. Thus, these two replacement rates may be seen as upper and lower bounds of estimates of the replacement of average career earnings. These replacement rates measure the replacement of income through retirement benefits, and do not include any income earned during retirement or any income from savings.

[42] Social security benefit recipients with modified AGI exceeding certain limits have to include up to 50 percent of their benefits in income. In 1990, 21% of all elderly included some portion of social security benefits in taxable income.

[43] Earnings are indexed by the rate of wage growth. Highest career earnings are defined as the average of the highest 5 years of earnings.

[44] This measure is calculated only for those individuals who worked a significant amount during the 5 years preceding retirement.

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Table 14.—Social Security and Pension Income as a Percentage of Individuals' Preretirement Income

[Post-retirement income replacement rates in percent]

Category	All	Individuals in			
		Lowest 25%	Second 25%	Third 25%	Highest 25%
Men					
Highest earnings:[1]					
Median social security rate..........	26	31	28	25	18
Median total rate.....	33	34	34	34	27
Percent with employer pensions.................	44	16	41	57	63
Last earnings:[2]					
Median social security rate..........	38	67	42	34	25
Median total rate.....	50	72	50	45	40
Percent with employer pensions.................	44	22	43	60	66
Women					
Highest earnings:					
Median social security rate..........	31	38	30	30	27
Median total rate.....	34	39	31	34	35
Percent with employer pensions.................	26	5	15	34	54
Last earnings:					
Median social security rate..........	44	89	45	41	35
Median total rate.....	52	94	47	47	47
Percent with employer pensions.................	26	10	20	42	63

[1] Highest earnings are calculated as the average of the highest 5 years of earnings.
[2] Last earnings are calculated as the average of the last 5 years of earnings.

Source: Susan Grad, "Earnings replacement rates of new retired workers", *Social Security Bulletin*, Volume 53, Number 10, October 1990.

Because couples receive at least 150 percent of the social security benefits of the highest earner (for instance, if one spouse did not work, the couples receives an additional 50 percent of the earner's social security benefit), it may be more appropriate to look at replacement rates for couples. These are presented in Table 15.

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Table 15.—Social Security and Pension Income as a Percentage of Couples' Preretirement Income

[Post-retirement income; replacement rates in percent]

	All couples	Couples in			
		Lowest 25%	Second 25%	Third 25%	Highest 25%
Men					
Highest earnings: [1]					
Median social security rate..........	30	39	35	28	21
Median total rate.....	30	43	42	35	30
Percent with employer pensions.................	51	24	52	67	65
Last earnings:[2]					
Median social security rate..........	49	77	55	46	33
Median total rate.....	60	86	64	55	48
Percent with employer pensions.................	51	30	53	60	71
Women					
Highest earnings:					
Median social security rate..........	28	36	30	28	20
Median total rate.....	33	38	35	32	26
Percent with employer pensions.................	52	23	51	61	67
Last earnings:					
Median social security rate..........	62	131	75	54	38
Median total rate.....	73	154	82	60	48
Percent with employer pensions.................	52	40	57	56	64

[1] Highest earnings are calculated as the average of the highest 5 years of earnings.

[2] Last earnings are calculated as the average of the last 5 years of earnings.

Source: Susan Grad, "Earnings replacement rates of new retired workers", *Social Security Bulletin*, Volume 53, Number 10, October 1990.

As the tables demonstrate, social security and pension benefits replace roughly 33 percent of the career high earnings and 50 percent of earnings over the last 5 years for individuals. When spousal benefits are taken into account, replacement rates are slightly higher, averaging 30 to 33 percent of highest earnings but 60 to 70 percent of last earnings.

Tables 14 and 15 also demonstrate that replacement rates are highest for the poor. For the lowest income quartile, individual replacement rates varied between 34 and 39 percent of highest earnings, and 72 to 94 percent of last earnings.

Finally, Table 16 demonstrates how social security benefits have increased over time. Social security benefits relative to the income of the elderly have increased substantially over the past forty years.

Table 16.—Social Security Benefits Over Time,

Selected Years, 1950-1985

Year	Ratio of social security payments to per capita disposable income of the elderly (percent)
1950	2
1955	5
1960	6
1965	27
1970	30
1975	37
1980	40
1985	40

Source: Summers and Carroll, "Why is U.S. National Saving So Low?", Brookings Papers on Economic Activity 2, The Brookings Institution, 1987.

Poverty

Another method used to examine the economic status of the elderly is to compare their rates of poverty to those of the general population. These poverty rates are presented in Table 17. As the table demonstrates, poverty among the elderly has declined dramatically over the last 30 years, from over 35 percent in 1959 to 12 percent in 1988. By 1988, the poverty rate of the elderly was less than the poverty rate of the general population. The poverty rate of elderly persons living in families (with a spouse or children) was 6.2 percent, lower than for any other group. The major explanation for this decline in poverty is the increase in social security benefits and coverage described in Table 16 above.

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Table 17.—Poverty Rates by Age,

Selected Years, 1959-1988

Age group	1959	1970	1980	1988
All ages	22.4	12.6	13.0	13.1
Children under 18	26.9	15.0	17.9	19.4
18 to 54	16.5	8.7	10.5	10.7
55 to 64	21.5	11.4	9.5	10.1
65 or older	35.2	24.6	15.7	12.0
In families	26.9	14.7	8.5	6.2
Unrelated individuals	61.9	47.1	30.6	24.1
Men	59.0	38.9	24.4	19.5
Women	63.3	49.7	32.3	25.5

Source: *Social Security Bulletin, Annual Statistical Supplement, 1990*, p. 123.

2. Expected retirement income and needs of current workers

The above discussion demonstrates that, as a group, the elderly are as well off as the rest of society, indicating that given social security and pension benefits, savings were adequate. However, to determine whether the savings of current workers are enough to provide adequate retirement income, it is necessary to examine how this group might differ from current retirees.

Social security and employer-provided pension plan coverage

Because social security coverage of workers has increased over time, [45] and because the labor force participation of women has also been increasing, current workers are more likely to be covered by social security than current retirees. Similarly, pension coverage of current workers is also substantially larger than of current retirees. Table 18 compares estimates of the percentage of current workers who are projected to be covered by various income sources with the coverage of current retirees.

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[45] For a discussion of the legislative history of social security coverage, see Committee on Ways and Means, *Overview of Entitlement Programs* (WMCP 102-9), May 7, 1991, pp. 105-106.

Table 18.—Projected Rates of Retirees Eligible for Pension Benefits

[In percent]

Income source	Workers currently retiring [1]	Baby boom retirees [2]
Social security...	86	97
Employer-sponsored pension.........................	48	71
Earnings...	35	29
Supplemental security income.......................	10	3

[1] Aged 55 to 64 in 1979.
[2] Aged 25 to 34 in 1979.

Source: *EBRI Databook on Employer Benefits, 1990,* p. 75.

Personal saving

Although coverage by pensions and social security is expected to be higher for current workers than it is for current retirees, the saving rate of current workers may be lower than the rate at which current retirees saved during their working lives. This would imply that although one source of retirement income, retirement benefits, is expected to be higher for current workers, another source, income from savings, may be lower.

The measure of personal saving used in the National Income and Product Accounts attributes all corporate pension contributions and earnings to the household sector. Thus, the increased pension coverage is already included in the measure of household saving. Table 9, above, shows that personal saving has been declining over the past 15 years. Private saving, which includes the saving of business, and which may provide a better measure of total households saving since businesses are ultimately owned by households, exhibits the same downward trend. Thus, the saving of the current generation of workers for their retirement seems to be low relative to the past.

3. Increased retirement costs

Finally, it is possible that the need for retirement income is increasing over time. Increases in life expectancies and trends toward earlier retirement increase the number of years in retirement and therefore, increase the need for saving. Furthermore, the normal retirement age for social security was changed in 1983. In 1991, the normal retirement for social security (the age at which retirees receive full benefits) is 65. By 2010, normal retirement will be 67 years. If the increase in the normal retirement age means that individuals will be working more years, then current saving need not adjust. However, if the historical trend toward earlier retirement continues, then the increase in normal retirement age for receipt of full social security benefits means that individuals should increase their retirement saving.

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Similarly, increased life expectancies and rapid medical cost in-
flation increase the probability of large medical expenses. Table 19
shows that out-of-pocket medical expenditures for the elderly have
been steadily increasing over the last 11 years. Also, many people
have noted that the probability of an individual requiring long-
term care some time in their lifetime has been increasing.

Table 19.—Out-of-Pocket Health Expenditures of the Elderly

	1977	1984	1988
Per capita expenditures (current dollars)...	$522	$1,059	$1,697
Per capita expenditures (1988 dollars)	$1,019	$1,206	$1,697
Percentage of total health care expendi-			
tures that are out-of-pocket.........................	29.4	25.2	29.3

Source: *EBRI Databook on Employee Benefits, 1990,* pp. 164-165.

APPENDIX I:

Comparison of S. 612 To Other Tax Incentives For Saving

Qualified plans

Many employers contribute to tax-favored qualified retirement pension plans to help their employees save for retirement. Under certain circumstances, benefits accrued under a qualified retirement plan may be borrowed or withdrawn to pay education expenses, purchase homes, or be used for other nonretirement purposes. By design, the after-tax return from investment in a qualified plan is generally the same as the after-tax return to investment in an IRA. In general terms, both a qualified plan and a deductible IRA exempt the current investment from current income, but tax the principal and earnings upon withdrawal.

There are several differences between IRAs, as proposed in S. 612, and qualified plans that may affect taxpayers' preference of saving via an IRA or qualified plan. Contributions to qualified plans generally are exempt from social security (FICA) taxes,[46] whereas investments in an IRA, to the extent they are made with wage or salary income, generally are subject to the payroll tax. However, because payroll tax payments may be seen by the taxpayer as providing for a future benefit, it is unclear whether this disparate treatment favors investment via a qualified plan over investment via an IRA. The extent to which the taxpayer may make tax-favored saving is subject to annual limitations under both the IRA and a qualified plan. Generally, the annual contribution limitation under the qualified plan is greater than the annual contribution limitation under the IRA. As an entirely self-directed saving plan, the IRA may offer the taxpayer more flexibility in the choice of his investments. On the other hand, many employers effectively increase the employee's return to saving via a qualified plan (e.g., sec. 401(k) plans) by matching all or a portion of the employee's contribution. Employer matching would give the taxpayer a strong economic incentive to save via a qualified plan before saving via an IRA. Certain qualified plans, for example defined benefit plans, may be perceived as offering the taxpayer protection against some of the risk of the market place, which a self-directed IRA may not offer. The provisions of S. 612 providing for penalty-free early withdrawals from IRAs may make the IRA relatively more attractive than qualified plans which have more restrictive withdrawal provisions. For example, under the special option of S. 612, the taxpayer may withdraw his or her funds for any purpose after satisfying a 5-year holding period requirement.

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[46] This is not true in the case of contributions to a qualified cash or deferred arrangement (sec. 401(k) plan), which are subject to social security taxes.

Tax-exempt bonds

The interest on qualified bonds issued by State and local governments is exempt from Federal income taxation. However, because the demand for these bonds is large relative to the quantity of these bonds, most of the benefits of municipal bonds accrue to the issuers who pay interest rates below those offered on taxable securities. Because IRAs permit taxpayers to earn taxable yields on a tax-exempt basis, some have suggested that the expansion of present-law deductible IRAs and the creation of special IRAs would reduce demand for qualifying tax-exempt State and local bonds, thereby increasing issuers' interest costs. In addition, as noted above, one would expect that taxpayers receiving social security benefits might prefer investment in a special IRA to municipal bonds because interest on tax-exempt securities is includible in modified AGI when determining whether the taxpayer's social security benefits are taxable, while the earning on the IRA may not be. However, the annual contribution limit applicable to the IRA may be small relative to the average purchase of tax-exempt bonds.

U.S. Series EE savings bonds

The interest on U.S. Series EE savings bonds currently is taxed on a deferred basis. An IRA effectively exempts interest from tax. A taxpayer would find it more profitable to invest in otherwise fully taxable instruments, such as other U.S. Treasury securities, and place those securities in an IRA. Such a strategy would not diminish the market for Treasury securities as a whole, although it might diminish the demand for Series EE bonds. In addition, to the extent that the annual IRA contribution limit constrains the taxpayer, Series EE bonds would offer further opportunities for tax-preferred saving.

If a taxpayer uses the proceeds from qualifying Series EE savings bonds to pay qualifying post-secondary education expenses, the interest is exempt from tax. This is comparable to treatment of an investment in an IRA which is withdrawn to pay for education expenses. Unlike the Series EE savings bonds, withdrawals for education expenses, or any other withdrawal, are subject to income limitations. This feature would make the IRA a more attractive investment. On the other hand, the annual purchase of Series EE savings bonds to be used for education expenses is not limited, as is the proposed IRA. This feature would make the Series EE savings bond a more attractive investment.

Life insurance and annuity contracts

While one of the reasons individuals purchase life insurance is the insurance protection, it can also be a savings vehicle. Income earned on a life insurance contract accrues annually ("inside buildup"). Similarly, the earnings on an annuity contract accrue annually. The income which has accrued to such policies is subject to taxation on a tax-deferred basis. Consequently, the policy could be redeemed to meet a saving goal. Alternatively, a loan against the cash surrender value of a life insurance contract can be used as a method of tax-favored saving, generally without current income taxation of the inside buildup. By providing exemption from, rather

than deferral of, tax, investment in an IRA which provides for pre-retirement withdrawals generally would be more profitable than the purchase of life insurance as a saving vehicle. However, the annual contribution limitation may mean that the expansion of IRAs would have only a small effect on the purchase of life insurance as a saving vehicle. (Life insurance cannot be purchased through an IRA.)

Taxation of capital gains upon realization

Under present law, capital gains on assets held by the taxpayer are taxed upon realization rather than accrual. This offers the taxpayer the benefit of tax deferral. If such assets are held until death, the basis of the asset is stepped-up in the hands of the heir, and the gain is exempt from tax. The IRA offers exemption during the lifetime of the taxpayer, which is more valuable than deferral. However, if capital assets are held until death, they are also exempt from tax. Furthermore, the purchase of assets which may accrue gains is not subject to an annual limitation, and the assets may be held by the heir indefinitely, whereas funds in an IRA must generally be distributed within a certain period after the death of the taxpayer.

Asset shifting to minor children

Parents can shift assets to children and receive the benefit of the children's lower marginal tax rates if the children are over 13 years old. For children younger than 14, the first $500 of income from investments generally is exempt from tax. To the extent that parents shift assets to minor children only to the extent that the children's tax rate is zero, asset shifting and investment in an IRA are economically comparable. Both offer the same net return. In addition, like the IRA contributions, asset shifting to children is effectively capped. An effective contribution limit exists to the extent that at some point the income from shifted assets is taxable to the child, if over age 13, or to the parent, if under 14. At the point at which income from shifted assets is taxable to the child or the parent, the IRA offers greater after-tax returns.

Home ownership

The returns to investment in owner-occupied housing receive preferential tax treatment. The implicit rental income is exempt from tax. The gain from any appreciated value may be deferred upon realization if another home is purchased, or $125,000 of gain may be excluded by certain taxpayers age 55 or older, or if held until death the gain is untaxed as the property's basis is stepped-up upon bequest. Consequently, saving by building equity in owner occupied housing is a tax-preferred saving vehicle. Unlike an IRA, some of the return to saving via homeownership may be subject to tax. However, there is no annual limit to the amount of equity the taxpayer may contribute to his or her housing investment, although in order to receive the favorable tax treatment, the taxpayer must take the return from the investment in the form of housing.

APPENDIX II: ECONOMIC DATA

Appendix Table 1.—Gross and Net Business Saving in Billions of Dollars and Total Gross and Net Saving as a Percentage of GNP, Selected Years, 1929-90

Year	Gross business saving (billions)	Capital consump- tion allowance (billions)	Net business saving (billions)	Gross national savings as percent of GNP	Net national saving as percent of GNP
1929................	$12.3	$9.9	$2.4	15.3	5.8
1939................	9.3	9.0	.3	9.7	−.1
1949................	32.5	22.0	10.5	14.0	5.6
1954................	42.3	32.5	9.8	13.9	5.1
1959................	60.3	44.6	15.7	16.2	7.2
1964................	79.3	53.9	25.4	16.7	8.4
1969................	106.7	81.4	25.3	16.5	8.0
1974................	157.6	137.5	20.1	16.8	7.6
1975................	198.9	161.8	37.1	14.9	4.8
1976................	225.6	179.2	46.4	15.9	5.8
1977....... . ..	263.8	201.5	62.3	16.9	6.7
1978................	298.9	229.9	69.0	18.2	7.9
1979................	327.7	265.8	61.9	18.3	7.6
1980................	341.5	303.8	37.7	16.3	5.1
1981................	391.1	347.8	43.3	17.1	5.7
1982................	403.2	383.2	20.0	14.1	2.0
1983................	461.6	396.6	65.0	13.6	2.0
1984................	509.5	415.5	94.0	15.1	4.1
1985................	539.9	437.2	102.7	13.3	2.4
1986................	544.6	460.1	84.5	12.4	1.5
1987................	570.2	487.0	83.2	12.3	1.5
1988................	605.7	514.3	91.4	13.5	2.9
1989................	607.5	554.4	53.1	13.3	2.6
1990................	604.8	575.7	29.1	12.0	1.5

Source: Department of Commerce, Bureau of Economic Analysis.

Appendix Table 2.—Savings as a Percentage of GDP, Decadal Averages, 1960s-1980s

Country	1960s	1970s	1980s	Average 1960-89 Applied
United States	9.8	8.2	3.6	7.2
Japan	21.9	22.3	17.8	20.7
Germany	18.0	13.6	10.2	14.0
France	17.7	15.4	7.8	13.6
United Kingdom	10.0	7.5	4.8	7.4
Italy	17.8	14.4	9.6	13.9
Canada	9.8	11.4	8.4	9.9
Belgium	12.8	13.8	7.2	11.3
Greece	14.4	19.7	8.8	14.3
Netherlands	18.3	15.8	11.8	15.3
Sweden	13.8	10.7	5.4	10.0
Switzerland	19.3	18.4	19.6	19.1
Australia	11.7	9.8	4.1	8.5

Source: OECD, *National Accounts, 1960-89*, 1991.

Appendix Table 3.—Investment as Percentage of GDP, Decadal Averages, 1960s-1980s

Country	1960s	1970s	1980s	Average 1960-89
United States	9.0	7.9	5.2	7.4
Japan	22.1	21.5	15.8	19.8
Germany	17.2	12.7	8.3	12.7
France	16.7	15.2	8.2	13.4
United Kingdom	10.5	9.4	5.6	8.5
Italy	16.0	14.2	10.5	13.6
Canada	12.1	13.0	9.9	9.9
Belgium	12.5	13.2	7.9	11.2
Greece	17.5	22.0	12.5	17.3
Netherlands	18.0	14.6	9.2	13.9
Sweden	14.5	11.4	7.0	11.0
Switzerland	19.5	14.1	15.7	16.4
Australia	14.2	11.2	9.4	11.6

Source: OECD, *National Accounts, 1960-89*, 1991.

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Appendix Table 4.—Output Per Hour in Manufacturing in Selected Countries, Decadal Averages, 1960s-1980s

[Average annual percentage rates of change]

Country	1960s	1970s	1980s	Average 1960-89
United States	3.1	2.4	3.6	3.0
Japan	10.7	7.2	F.5	7.6
Germany	6.2	4.5	1.8	4.1
France	6.8	5.0	3.4	5.0
United Kingdom	3.9	2.7	4.7	3.7
Italy	6.6	6.0	4.0	5.4
Canada	4.7	3.0	1.5	3.0
Belgium	5.8	7.4	4.9	6.0
Greece	NA	NA	NA	NA
Netherlands	6.8	6.9	3.4	5.6
Sweden	7.0	3.7	2.2	4.1
Switzerland	NA	NA	NA	NA
Australia	NA	NA	NA	NA

NA—not available.

Source: U.S. Department of Labor, Bureau of Labor Statistics, Office of Productivity and Technology, "Output per Hour, Hourly Compensation, and Unit Labor Costs in Manufacturing, Fourteen Countries or Areas, 1960-1989," April 1991.

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Appendix Table 5.—Net Foreign Investment by Foreigners in the United States, Selected Years, 1929-1990

Year	Billions [1] (dollars)	Percentage of GNP	Percentage of gross private domestic investment
1929	−.8	−.8	−4.8
1939	−.1	−.1	−1.1
1949	−.9	−.3	−2.5
1954	−.2	−.1	−.4
1959	1.2	.2	1.5
1964	−7.5	−1.2	−7.5
1969	−1.7	−.2	−1.1
1970	−4.8	−.5	−3.2
1971	−1.3	−.1	−.8
1972	2.9	.2	1.4
1973	−8.8	−.6	−3.7
1974	−5.4	−.4	−2.2
1975	−21.6	−1.4	−9.8
1976	−9.0	−.5	−3.2
1977	8.7	.4	2.5
1978	10.1	.4	2.4
1979	−2.6	−.1	−.6
1980	−13.0	−.5	−3.0
1981	−10.6	−.3	−2.1
1982	1.0	.0	.2
1983	33.5	1.1	6.7
1984	90.9	2.4	13.7
1985	114.4	2.8	17.8
1986	135.8	3.2	20.6
1987	154.6	3.4	22.1
1988	119.2	2.4	16.0
1989	96.8	1.9	12.6
1990 [2]	90.1	1.6	12.1

[1] A negative entry indicates net investment by Americans overseas; a positive entry indicates net investment by foreign persons in the U.S.
[2] Estimate.

Source: Department of Commerce, Bureau of Economic Analysis.

ERRATA FOR JCS-5-91

o   On page 18, in the first line of the second paragraph
    under the heading **Special IRAs**, replace the word
    "nonductible" with "nondeductible".

o   On page 23, in Table 2, for the income category "Less
    than $10,000", the percent in the phaseout range should
    be 0.1 instead of 0.5. Also, for the income category
    "$30,000 to $40,000", the percent in the phaseout range
    should be 38.8 instead of 22.5.

o   On page 23, in the last line of Table 2, insert footnote
    2/ before "$2,096", and insert footnote 3/ before
    "$1,428".

o   On page 33, the first sentence of the last paragraph
    should read as follows: "Funds in a special IRA that are
    withdrawn within 5 years are subject to additional tax."

o   On page 40, in the first line of the second paragraph
    after Table 4, delete the word "savings".

Mr. Chairman and members of the Committee, I am pleased to testify before you today in support of S. 612, The Savings and Investment Incentive Act of 1991.

My name is Bob Bergland. I am Executive Vice President of the National Rural Electric Cooperative Association, the national service organization of the approximately 1,000 rural electric service systems operating in 46 states. These systems serve over 25 million farm and rural residents in 2,600 of the nation's 3,100 counties. Various programs administered by NRECA provide pension and welfare benefits to over 125,000 rural electric employees, dependents, directors, and consumer-members in these localities.

AMERICAN SAVING RATES ARE LOW

Our association is concerned with maintaining and improving the quality of life and the prosperity of the rural communities and the members we serve. To this end, we have sponsored several research studies on pension coverage in small rural firms and on ways to improve national savings rates. These studies have been distributed widely to both policy makers and researchers across the nation. My testimony today is based on the results of these studies.

We believe the nation's prosperity is threatened by low savings rates. During the 1980s, Americans saved less than at any time since World War II. The Japanese people, who are among our strongest international competitors, typically save up to four times as much of their income as we do. Even after accounting for the smaller size of Japan's Gross National Product, Americans save only about $1 for every $2 saved by the Japanese. The Germans, the French, and the British typically save two to three times as much of their income as Americans do.

Despite our low saving levels, businesses still need investment capital to create new jobs, and the Federal Government still needs savings to finance the deficit. Foreign savers have taken up the slack in U.S. savings rates by pumping enormous amounts of money into our economy. As a result, the U.S. has become the world's largest debtor nation.

But when our foreign debts come due, income generated by Americans will have to be devoted to paying them. Dependence on foreign capital commits our future income, and the income of our children, to foreign investors rather than to meeting our own, urgent, domestic needs. The availability of foreign cash is also a shaky foundation for building our economic well-being. Foreign investment depends on world events that are often out of our control. Thus, it may not always be there when we need it.

Generating the savings we need to restore our economic strength will not be an easy task. The American Society of Pension Actuaries has estimated that business and personal saving would have to increase by about 20 percent to offset the Federal deficit; 16 percent to offset net foreign investment in the U.S. economy; and 72 percent to offset the nation's international debt.

WHAT WE CAN DO

We will never be able to close our doors to foreign trade and investment—and shouldn't want to. What we need, instead, are tools to encourage Americans to do more for themselves. IRAs can be one of those tools: they are proven, attractive, and effective.

There are many explanations for this country's abysmal savings rate, but many economists believe that the tax code makes saving less financially attractive than spending. Money saved is taxed twice: once when it is earned and once when it earns interest. Money spent, in contrast, is taxed only once. The tax code encourages us to live only for today.

IRAs have long been attractive to older workers preparing for retirement. The Employee Benefit Research Institute found that when IRAs were deductible for all workers, those age 55 or older were more than three times as likely to set up an IRA as their younger colleagues.

S. 612 IS A BETTER APPROACH

S. 612 would apply some of the lessons we have learned over the years to make IRAs work better.

1. The bill would add a savings incentive for younger workers. It would permit penalty-free withdrawals of IRA savings for education, first-time home purchases, and "financially devastating" medical expenses. We believe the exceptions proposed in the bill are appropriate for several reasons:

• In the past ten years, higher education costs have grown twice as fast as inflation.

• Housing prices are rising faster than people's ability to save for a down payment.

• Basic health care costs are two and one-half times what they were in 1980.

• The home and education exemptions would be multi-generational. Parents and grandparents would be able to help their children and grandchildren without losing the IRA's tax advantages. Children would be able to help dependent parents with high medical bills.

2. The contribution amount exempt from taxes each year would be indexed for inflation. IRAs are currently vulnerable to inflation as the contribution amount is not indexed. Pension contributions are already indexed for inflation, since they tend to keep pace with the employee's wage growth. Since the passage of the 1986 Tax Reform Act, personal exemptions and deductions are also indexed for inflation. We believe indexing will encourage greater use of IRAs and make saving more competitive with spending.

3. People who have already set aside money in IRAs would also be able to take advantage of the more lenient withdrawal regulations. This would avoid the incentive to shift money among tax-exempt accounts.

4. Participants in section 401(k) and section 403(b) savings plans also would be eligible for the education and home-purchase tax break on early withdrawals. This would avoid the incentive to switch from employer plans to IRAs as a means of retirement savings.

IRAS ADD TO SAVING

A major element in the IRA debate has been the degree to which IRA contributions constitute a net addition to savings. Early evidence that IRAs represented primarily transfers of existing savings encouraged limits in the 1986 Tax Reform Act on the deductibility of IRAs for some participants. IRA contributions have now declined by about half. Ironically, many of those reportedly abandoning IRAs would be eligible to deduct them, even under the complex new rules. Americans continue to save less than the workers of almost every other developed nation.

More recently, improved data and analyses suggest that IRAs worked better than we thought. Economists at the National Bureau of Economic Research believe that expanding IRA availability would generate a respectable $0.67 in new saving for each dollar of deposits. By comparison, employer pension plans are estimated to add $0.70 to $0.84 to savings for every dollar deposited. IRAs have thus been rehabilitated as part of the nation's savings tool kit.

The IRA debate has also been clouded by a host of innovative savings proposals. The last few years have seen proposals for specialized medical, educational, and housing accounts, for example, with no end to their proliferation in sight. We urge the Congress to stick with a proven winner. We know how IRAs work, and we know how to use them. Research indicates that established tax incentives are more effective than those that taxpayers perceive as transitory. This is common sense: a permanent tax provision becomes a habit. A new, temporary, rule, on the other hand, becomes just one more burdensome piece of information to absorb.

IRAS AND RURAL AMERICA

Expanding IRAs would help rural businesses, workers and investors.

It is no secret that the U.S. agriculture sector is in crisis. Even those rural communities that do not depend on agriculture are facing difficult times. Rural economies tend to be less diversified than those of urban areas, depending heavily on one firm or one industry for employment and income. As a result, if one firm—maybe a branch of a larger business—pulls out of a community, the whole community can face disaster.

IRAs can help many rural communities adjust to economic change. Businesses in small, rural communities depend largely on their local bankers for start-up and expansion capital. IRA holders consistently invest their funds in their local banks. IRAs would thus help rural communities by providing sorely needed investment capital.

Rural Americans also need the added retirement income that would be provided by expanded access to an improved IRA. A few years ago, we surveyed employee benefit practices in over 800 rural businesses with 60 or fewer full-time employees. We found that employees of small rural firms are less than one-third as likely to have employer-provided retirement coverage as those in larger firms nationwide. Nearly 30 percent of the employers who did not offer coverage said cost was the

major deterrent to offering a plan. Twenty percent also said their firms were too small to offer a plan.

S. 612 would not directly improve retirement coverage in smaller firms, but it could redress one important inequity that arose out of the 1986 Tax Reform Act. The tax reform law provides that a two-earner household with an adjusted gross income of $50,000 or more can deduct no IRA contributions at all if even one earner is covered under an employer-sponsored plan, while households with incomes below this level may deduct a reduced share of their IRA contributions. Spouses of covered employees who would otherwise be eligible to deduct IRA contributions are thus denied deductibility solely on the basis of marital status.

This provision reduces the ability of employees to use IRAs during periods of employment without pension coverage. It also disproportionately affects small-firm employees, since they are the least likely to be covered under employer-sponsored plans. S. 612 would help bridge this important gap in the nation's retirement income safety net.

IRAS AND OTHER RETIREMENT INCOME

Our nation's retirement income system has been built on what is often called the "three-legged stool." One leg is Social Security, another is employer-provided pensions, and the third is individual saving. This nation should support a mechanism that encourages workers to provide today for their retirement tomorrow.

Basic human nature and family needs dictate that young people save for purposes other than retirement. These purposes may include home purchases and educating their children. As they get older, they start to focus more on retirement security. Getting a late start on retirement saving means that contributions have a shorter time to accumulate investment earnings, which reduces the retirement income they provide.

To be effective, savings incentives must attract younger workers, for one fundamental reason: there are more of them than ever before. Washington needs to come up with savings incentives to encourage both younger and older employees to put money aside for future needs.

NRECA believes that the Savings and Investment Incentive Act of 1991 does that. We believe this bill is both good savings policy and good retirement policy. We urge the Congress to act promptly to restore this important element of economic security.

Thank you for your attention.

PREPARED STATEMENT OF NEAL CUTLER

Good Morning, Mr. Chairman, Members of the Committee: My name is Neal Cutler. I am the Director of the Boettner Institute of Financial Gerontology, a small nonprofit academic research institute. Our research is on the social and financial aspects of aging in the United States and in other economically developed countries. We are located on the campus of the American College in Bryn Mawr, Pennsylvania. I am a Professor in the Graduate Gerontology Program at the University of Pennsylvania, in Philadelphia.

Mr. Chairman, this hearing and the general issue of retirement income reflects the well-known *Graying of America*. But I am here this morning to modify, at least slightly, the terms of the discussion *away* from the *aging* of America: the theme of these brief comments is, instead, *THE MIDDLE-AGING OF AMERICA*.

One of the more important conclusions of our Institute's continuing research in financial gerontology is that the truly dramatic population trend of the 1990s and, indeed over this next Quarter-Century, is not the aging of our country, but middle-aging.

Mr. Chairman, our Institute is not here this morning to take a partisan or political position on the issue of Individual Retirement Accounts. But I am happy to summarize some of our work, in the hope that our research will focus discussion on the crucial issue of individual responsibility for financial and retirement planning.

The message here is fairly straight-forward. I would like to make just two points, and then add an international comparison as a final footnote.

The two points have to do with *two kinds of aging* which gerontologists study. We distinguish between *Individual Aging* and *Population Aging*. Both of these are relevant to the connection between the Middle-Aging of America and how our citizens prepare financially for their retirement years.

First: about Individual Aging. It wasn't too long ago, perhaps at the beginning of this Century, that we would *not* be talking about *middle*-age. But in the past 50 to

75 years circumstances have changed so dramatically that we now recognize that middle age has become a separate stage in the life cycle.

Life expectancy *at age 65* has steadily gotten longer during this century. Indeed, it has been estimated that two-thirds of the improvement in life expectancy from prehistoric times until now has taken place in the years since 1900. And at the same time, Americans have been retiring earlier and earlier. And so our financial resources for old age must be accumulated during a *shorter* work life, and must be adequate to finance a longer period of older age.

Much of this planning for retirement, then, should take place in middle-age. It's also the case that sometime between our late 40s and our early 60s we begin to see and to feel our age. Our children grow up, and leave home; our parents grow old, and leave us. We begin to sense our own mortality, and we feel the need to plan for the future.

I realize, Mr. Chairman, that I'm giving a very short summary of a complex stage of life. But, in brief, middle-age is typically a time when family earnings are expanding, when most major household purchases are complete, and the children have left home. As a consequence of these various separate but inter-connected financial and gerontological dynamics, discretionary income may be growing, and the family pattern of savings versus spending begins to change. And at the same time, there is a felt need to use this third quarter of life to plan for the fourth quarter.

Let me briefly turn to the second of the two kinds of aging: *POPULATION AGING.* Here we refer to the overall number of people of different ages in the nation. And as "shocking" as it might sound, *the Baby Boom will be middle-aged before it enters old age.*

In fact, the first Boomer, born in 1946, had her 45th birthday just this year. And so 1991 begins a period when 80 million Baby Boomers produce a massive increase in the number and percentage of middle-agers in the United States. When we compare the previous quarter century, 1960–1985, with the quarter-century that has just begun in 1990, the difference between older-age growth and middle-age growth is fairly clear.

		Population increase in	
		1960–1985	1990–2015
Two quarter-century periods	age 45-64	24.1%	71.6%
	age 65+	71.1%	39.9%

The specific numbers are in my written testimony. But the conclusion is that for the quarter-century beginning in 1990, the real action is in middle age. While the older (65 +) age group is projected to increase by about 40%, middle-agers will grow by over 70%. There's no mystery here: it's the middle-aging of the Baby Boom.

The first graph included with my testimony illustrates the difference in more visual terms. *While there is continuing growth in the older population from 1950 through 2025. the United States is now entering a period of rapid middle-aging.*

In conclusion, Mr. Chairman, when we combine the *dynamics of individual aging,* with the *numbers of population aging,* the importance of the legislation you are considering today becomes even more apparent. The U.S. is facing a gerontological and financial opportunity that is literally unprecedented in human history. Since middle-age is a time of financial planning for later-life, the number of individuals that would be affected by incentives to save and to plan is simply staggering.

And to emphasize the connection between saving and middle-age, our research offers a final, international, footnote. Over this past decade there have been many comparisons between Japan and the U.S. on the issue of our national savings rate: Japan has high rate, the U.S. has a very low rate.

We recognize, of course, that many factors contribute to a high or a low national savings rate. But to the degree that middle-age plays a role, a comparison of American and Japanese demographic trends is most revealing. And so may I conclude by directing your attention to the second graph included with my testimony. It compares the percentage of the national population that is middle-aged in the two countries over a 75-year period, from 1950 to 2025.

It's clear that substantial Japanese middle-aging began back in the 1950s. And so Japan has had a substantial percentage of its people in the high-savings stage of their life-cycle. But by comparison, from the 1960s to the 1980s the 80 million American Baby Boomers were teenagers and young adults.

But notice what is happening right now. *The U.S. is beginning a period of very rapid middle-aging:* Baby Boom middle-aging.

During the previous three or four decades, Japan has had a large middle-aged population *and simultaneously has had a national policy that encourages private savings.* And so this research suggests that now just might be the right time for the U.S. to evaluate its own national policy in this regard . . . .

. . . Because, Mr. Chairman, whatever financial and gerontological benefit Japan has had in terms of the middle-aging of its population, the United States is about to get a lot of it over the next 25 years.
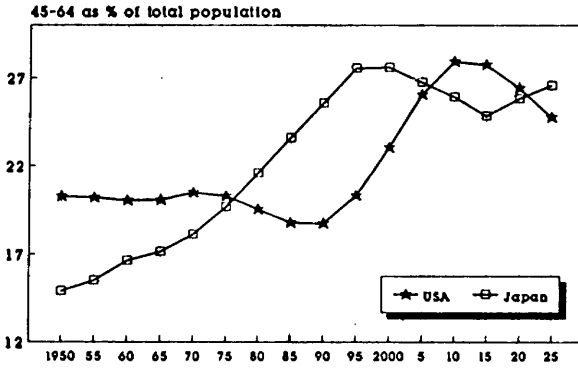
Thank you. I am ready to answer any questions you may have.

USA: Middle-Aging vs. Older Aging

% of total population
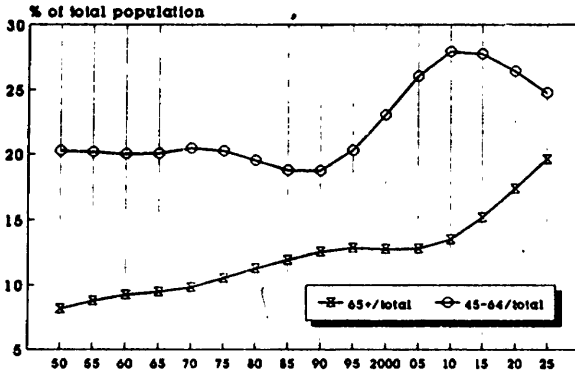
Graph I

Middle-Aging: Japan vs. USA

45-64 as % of total population

Graph II

PREPARED STATEMENT OF JANE G. GRAVELLE

Mr. Chairman and Members of the Committee, I am Jane G. Gravelle, a Senior Specialist in Economic Policy in the Congressional Research Service of the Library of Congress. I would like to thank you for the invitation to appear before you today to discuss the economic effects of Individual Retirement Accounts. I shall address three issues: the effects on savings, who benefits, and how much a restoration and expansion of these accounts would cost in foregone revenues.

Let me summarize first the economic evidence on savings effects.[1] Conventional economic theory and the empirical research which existed prior to the expansion of IRAs suggest that IRAs are not likely to increase savings, at least not by amounts in excess of the revenue loss. Indeed, they are likely to reduce national savings. There are three separate points which support this view. First, theory cannot determine a priori that a tax subsidy to savings would increase savings, owing to offsetting income and substitution effects. Empirical research has failed to identify a positive effect. Historically, the savings rate has remained relatively constant despite significant changes in after-tax rates of return. Time series econometric studies—studies which estimate the relationship between aggregate savings rates and rates of return over time—have reflected this characteristic, and predict small effects which are ambiguous in sign.[2] Secondly, even if a tax subsidy, in general increases savings, IRAs are unlikely to do so because individuals contributing to the maximum allowed experience no marginal price incentive. In our earlier experience, about three quarters of the revenue loss from IRAs was associated with limit contributors.[3] Finally, the experience of the eighties does not support the case that IRAs increased savings. While IRA contributions were significant, the overall private savings rate fell substantially during that period. Barry Bosworth has pointed out that if IRAs and Keoghs were all new savings, discretionary savings dropped from 6 percent in the mid 1970s to zero by 1986, a conclusion which seems difficult to believe.[4]

There have been two cross-section studies (studies which examine the behavior of individuals in single time period) focused on the effects of IRAs on savings, which support this conventional view. While I have doubts about the ability of cross-section studies to provide evidence of the effects of IRAs on savings, which is essentially a dynamic process, these studies do report some interesting results. Gale and Scholz's study estimated desired IRA contributions and tested whether individuals at the limit made up the difference in between their desired IRA savings and the limit through additional non-IRA savings.[5] They found that there is approximately a dollar for dollar offset, suggesting that an increase in the IRA limit would simply reduce other savings. These findings indicate that IRAs did not increase savings. Manegold and Joines compared the change in total savings of newly eligible contributors and previously eligible contributors, and found no difference.[6] If IRAs increased savings, then newly eligible contributors should have increased their savings relative to previously eligible contributors.

There are three studies which are sometimes cited as evidence that IRAs will have a pronounced effect on savings.[7] The cross section studies by Venti and Wise are perhaps the most widely cited.[8] I believe that the Venti and Wise studies con-

[1] A more detailed review of the issue of the effect of IRAs on savings can be found in Jane G. Gravelle, Do Individual Retirement Accounts Increase Savings? Forthcoming, Journal of Economic Perspectives, Spring 1991. These issues are also discussed in Jane G. Gravelle, Capital Gains Taxes, IRAs and Savings, Congressional Research Service, Library of Congress, Report 89-543 RCO, September 26, 1989.

[2] For a survey of the literature indicating this conclusion see Lans Bovenberg, Tax Policy and National Savings in the United States: A Survey, National Tax Journal, June 1989, Vol. 63, pp. 123-128.

[3] See Harvey Galper and Charles Byce "Individual Retirement Accounts: Facts and Issues," Tax Notes, June 2, 1986, pp. 917-921, and Galper and Byce Respond to Summers on IRAs, Tax Notes, June 30,1986, pp. 1356-1357.

[4] See Barry Bosworth, There's No Simple Explanation for the Collapse in Savings, Challenge, July-August 1989,32, pp. 27-32.

[5] William Gale and John Karl Scholz, Effects of IRAs on Household Saving, July 1990.

[6] James G. Manegold and Douglas H. Joines, IRAs and Saving, An Empirical Analysis with Panel Data, January, 1990.

[7] I do not include in this discussion several studies which have found a positive relationship between IRA contributions and other savings. It is widely recognized that this finding probably reflects an individual specific effect (people who tend to save tend to use IRAs) rather than causality, and some more sophisticated analysis is needed to relate IRAs to saving.

[8] See Steven F. Venti and David A. Wise, Have IRAs Increased U.S. Savings? Experience from Consumer Expenditure Surveys, Quarterly Journal of Economics, Vol. 105, August, 1990, pp. 661-698.

tained two serious analytical errors which render their results highly questionable. First, they failed to take into account risk and the nature of life cycle savings, which suggest that many individuals do not save for retirement at every point in their life. Rather individuals may be saving for short term goals (e.g. a car or a vacation), or for a cushion against economic misfortune, and would not desire to place their savings in IRAs because of the penalty for early withdrawal. Secondly, they characterized IRAs as a new commodity rather than a subsidy to an existing commodity—that commodity being, of course, future consumption. Thus, their finding that IRAs increase saving, which rests on the observation of many individuals who save outside of IRAs without reaching the IRA limit or even using IRAs, is suspect.[9] This conclusion is 180 degrees from the conclusion of Gale and Scholz, even though both studies used essentially the same data.

Another frequently cited study is that of Feenberg and Skinner.[10] This study found that IRAs in the aggregate did not appear to come from reductions in existing assets. This finding, however, tells us nothing about whether IRAs increased saving, since IRAs could have reduced either additions to assets or consumption. The Feenberg and Skinner study also argues that there may be an irrational "psychological" effect or an advertising effect which induced individuals to put money into IRAs. This view is based in part on finding a correlation between owing tax and the size of the IRA contribution. But such correlations could be independently related to a number of other factors and do not necessarily indicate causality. (These factors include asset income and two earner married couples, both of which tend to be over-withheld and both of which might have a greater tendency to hold IRAs; the econometrics did not control or controlled imperfectly for these factors). Moreover, even if these effects were present, they did not demonstrate that IRAs reduced consumption; they might just as well have reduced other savings.

A third study is a time series study by Carroll and Summers comparing savings rates in the U.S. and Canada.[11] This study suggested that the recent divergence between savings rates in the U.S. and Canada could be explained in part by more generous IRAs in Canada. Aside from the questionable reliability of cross country comparisons, it is important to note that an independent regression in the United States did not indicate a positive effect of IRAs on savings. Moreover, the savings rates in the two countries came closer together after IRAs were rc tricted in the United States. In any case, a recent study by Altig indicates that the statistical relationship found by Carroll and Summers disappears when the results are controlled for differences in wealth between the two countries.[12]

In sum, I do not believe the economic evidence provides a case for a strong savings effect of IRAs. While we cannot be certain of the effects of IRAs on savings, a surer way to increase national savings is likely to be through reductions in the budget deficit. And, given the limited participation in IRAs discussed subsequently, the surest way to ensure some minimum level of retirement security for most Americans is probably through programs such as social security.

Let me turn now to the question of who benefits from universal IRAs. In general, any subsidy to capital income tends to benefit higher income individuals. The dollar limits on IRAs restricted the magnitude of benefits that the wealthy could receive. Nevertheless, data indicate that IRAs cannot be characterized as a subsidy to the middle class. In 1986, 82 percent of IRA deductions were taken by the upper third of individuals filing tax returns (based on adjusted gross income).[13] Since these higher-income individuals had higher marginal tax rates, their share of the tax benefit was even larger. A restoration of IRAs would likely benefit primarily higher-income individuals, not only because they are more likely to use IRAs but also because IRAs are currently available to low-income and middle-income individuals. For example,

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[9] Similar concerns regarding the basic model underlying the Venti and Wise studies have also been expressed by Leonard Burman, Joseph Cordes, and Larry Ozanne, IRAs and National Savings, National Tax Journal, September 1990, Vol. 43, pp. 259–283; Laurence J. Kotlikoff, The Crisis in U.S. Saving and Proposals to Address the Crisis, National Tax Journal, September 1990, Vol. 43, pp. 233–246; William G. Gale and John Karl Scholz, IRAs and Household Saving, July 1990.

[10] 10 See Daniel Feenberg and Jonathan Skinner, Sources of IRA Savings, In Lawrence H. Summers, ed., Tax Policy and the Economy 1989, Cambridge: M.I.T. Press, 1989, pp. 25–46.

[11] Chris Carroll and Lawrence H. Summers, Why Have Private Savings Rates in the U.S. and Canada Diverged? Journal of Monetary Economics, September 1987, Vol. 20, pp. 249–80.

[12] David Altig, The Case of the Missing Interest Deductions: Will Tax Reform Increase U.S. Savings Rates, Federal Reserve Bank of Cleveland Economic Review, Vol. 26, No. 4, 1990, pp. 22–34.

[13] The data on the distribution of IRA contributions is based on the Internal Revenue Service Statistics of Income, Individual Returns, 1986.

in 1988, the last year for which data are available, only twenty percent of the filing population had adjusted, gross incomes above $40,000 and only thirteen percent had incomes above $50,000. These percentages would, of course, be somewhat larger currently.

In addition, while significant amounts were contributed to IRAs, their popularity was not very widespread. In 1986, only 15 percent of returns filed reported contributions to IRAs. These participation rates are lower in the lower and middle income classes: only 2 percent of taxpayers in the bottom third of returns and only 9 percent of taxpayers in the middle third contributed to IRAs. Participation rises with income: 33 percent of the upper third contributed, 54 percent of taxpayers in the top ten pei cent contributed, and 70 percent of taxpayers in the top one percent contributed.

These low contribution rates for lower and middle income classes should not be surprising given the data on savings by income class. Individuals of modest means can afford very little savings and that savings must often be readily available as a cushion against economic adversity.

The final question I would like to discuss is the cost of restoring IRAs. The cost depends on the particular proposals being considered, and I would like to discuss S. 612, for which revenue estimates are available. The cost over FY 1992-FY 1996 is estimated by the Joint Committee on Taxation at $25.8 billion. This short run estimate, however, will understate the eventual cost of such a plan, because the amounts in IRAs tend to grow over time. This growth in cost can be quite rapid for the special IRAs which are not deductible up front. Using a simple growth model of the economy, I have estimated that the cost of a non-deductible IRA would, assuming contributions keep pace with GNP, be almost eight times as large in the long run as in the first five years.[14] The cost of the deductible IRA would be over twice as large at its peak, and about a third larger in the steady state. (Both of these costs are measured at current income levels).

While I have no information on the share assumed to be contributed to each account by the Joint Committee on Taxation, if half were assumed to go to each account the long run cost of this plan, measured in initial dollars, would be over two and one half times as large—or about $66 billion. Or, alternatively if we were to adopt, a proposal whose revenue cost was constant relative to GNP, which had the same present value as the new plan, the cost would be $59 billion.

In any case, the eventual cost of an IRA program is likely to be considerably more than its cost over the current budget horizon.

PREPARED STATEMENT OF ALAN GREENSPAN

Mr. Chairman, I appreciate the invitation to appear before this committee today. As you know, I have long been concerned about the low level of saving in the United States and—pleased that this important problem is drawing renewed attention. In my prepared statement, I will address some of the broader issues bearing on saving and investment, as well as provide a review of the available evidence on tax incentives for personal saving.

Put simply, inadequate domestic saving is impairing our economic prospects for the longer run. I say this with full recognition that the appropriate level of saving for any economy is best left to private preferences, as reflected in the marketplace. However, as a society, we have in recent decades clearly intervened in the market process through subsidies that enhance consumption at the expense of saving. And, we would be well-advised to endeavor to redress such imbalances.

Saving, of course, arises when part of the nation's current production is diverted from consumption, both private and public; it provides the funds for capital formation. Thus, by choosing to consume more now—and to save less—we are limiting our ability to expand and upgrade our stock of capital. It is the size of that stock and the new technologies embedded within it that, together with the quality of the labor force, ultimately determine our overall productive capacity and the future standard of living of our population.

The damage from low saving does not show up immediately. It is more insidious— it chips away at the productivity gains we are able to achieve over time; it gradually

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[14] The calculation of the long run cost of IRAs is based on Jane G. Gravelle, testimony before the Committee on Finance, Subcommittee on Deficits, Debt Management and International Debt, United States Senate on the subject of the Federal budget and long term decisionmaking, April 12, 1991.

hampers our competitiveness in international markets; and, after a period of years, it results in a lower standard of living than we would otherwise enjoy.

Of course, U.S. investment can be funded by foreigners, as well as by domestic residents. Indeed, since the mid-1980s, sizable inflows of capital from abroad have helped to sustain domestic investment and, thus, have cushioned the effect of inadequate domestic saving on worker productivity. But heavy reliance on foreign saving is neither a satisfactory nor a sustainable solution over the longer run. This may seem contrary to the idea that international capital markets are well-integrated and that competing rates of return will draw funds to the most productive uses anywhere in the world. To be sure, in today's world, such inflows may tend to be sustained longer than in the past. Nevertheless, the evidence for the United States and for most other industrial nations over the past hundred years indicates that large inflows have not persisted and, thus, cannot be viewed as a reliable substitute for domestic saving on a long-term basis. In other words, domestic investment, for the most part, appears to follow domestic saving in the long run.

Reflecting the large current account deficits of recent years, foreigners are accumulating claims on a sizable portion of our future output. Furthermore, we know that we will have to support a rapidly growing population of retirees two or three decades in the future. In the end, our ability to meet those commitments, while providing rising living standards to future workers, will depend on the investments that we make in capital and in new technologies in the interim.

Indeed, on the basis of our recent saving behavior, it is difficult to see how we were able to achieve the high standard of living that we now enjoy. The answer is that we have not always been a low-saving society. Granted, the statistics are problematic, but it appears that in the period following the Civil War, when the United States began to emerge as an economic power, our saving and investment rates, as conventionally measured, were much higher than those in Europe and Japan. For example, between 1870 and 1910, domestic saving in the United States averaged close to 20 percent of GNP. The best available estimates for Japan and Germany during that period place their saving rates at 15 percent or less. The saving rate in Great Britain, whose preeminence was fading, was closer to 10 percent.

The shift toward both a relatively low and an absolutely low saving rate began during the Great Depression, when the U.S. rate fell dramatically. In the decades after World War II, it stabilized at a level slightly below its pre-Depression average. Notably, between 1950 and 1979, domestic saving averaged about 16 percent of GNP—roughly the same as total investment. Budget deficits generally were small, at least by today's standards, and the private saving rate showed no discernible trend. Meanwhile, the U.S. enjoyed a positive—and gradually increasing—net foreign investment position. In the 1980s, the pattern changed markedly, as domestic saving fell well below investment, reflecting not only the enormous Federal deficits, but also a large drop in the private saving rate. In recent years, U.S. saving (public and private) has totaled only about 13 percent of GNP.

Saving rates in Japan and Germany also have declined some over the past two decades, following their surge in the post World War II recovery period, but they remain substantially above those in the United States. Relative to their GNPs, the Japanese have been saving roughly twice as much in gross terms as we have, while Germany's saving rate has been about 1½ times ours. Cross-country comparisons of net saving should be viewed with some caution because of differences in how depreciation is measured; nonetheless, the gap in net saving probably is even larger than in the gross measures. The high saving rates in Japan and Germany have been mirrored in rapid rates of capital formation that have helped them improve their competitiveness relative to the United States and close much of the gap in living standards.

The issue of why one nation saves a lot while another saves relatively little—or why saving behavior changes over time—is complex. It undoubtedly reflects cultural influences as well as economic forces. I suspect, however, that part of the explanation relates to how well members of a society, both individually and collectively, assess their future needs and take action in the present to meet them. Collectively, we have recognized the need to build saving and capital, and to improve our productivity performance, in anticipation of the significant increase in the ratio of retirees to workers next century. However, as last year's debate over the financing of social security made clear, we have yet to take sufficient actions to meet these needs. As you are well aware, the surpluses in the social security trusts have been overwhelmed by enormous deficits elsewhere in the Federal budget.

Just as the budget deficit accounted for a large part of the fall in domestic saving in the 1980s, the surest way to raise saving in the 1990s is to get the deficit down. Last fall, you enacted a significant program of spending and tax changes and budget

process reforms. Those actions set the underlying or "structural" deficit on a downward track and thus represented a strategy that is geared to the longer-run needs of the economy. I recognize that, in the near term, those savings are being swamped by the transitory effects of the weak economy. But, as the recovery takes hold, the Federal sector's absorption of private saving should return to a downward trend.

The goal of a balanced budget is a good place to start. But, as I have said frequently in the past, it probably is not ambitious enough as a target for the longer run. As long as the non-social-security deficit remains sizable, we are doing little to ensure that adequate provisions are being made for the income of future retirees. Further actions must be taken to bring the rest of the budget into balance, so that the trust funds will no longer be financing current government consumption, but will translate dollar for dollar into national saving.

The Federal budget deficit is only part of the story of the past decade. Saving by households and businesses also has dropped. The fall in personal saving, in particular, has been studied extensively; in large part, it appears to be associated with the sizable increases in household wealth through the latter part of the 1980s. To understand the relation between wealth and the saving rate, it is important to note that personal income, as defined in the national income and product accounts (NIPA), measures the income from current production; it does not include the effects of capital gains or losses on assets already held by households; personal saving also ignores revaluations of existing assets. Thus, an increase in the value of an individual's stock portfolio or his house has no direct effect on his measured income. But, if he raises his spending in response to the capital gain, NIPA saving will fall.

Looking at the data, one sees clearly that the surge in the stock market between 1982 and 1987 was associated with increased consumption out of financial capital gains and, therefore, with reduced saving out of current income. In addition, the build-up of readily accessible home equity enabled many individuals to spend more out of current incomes than they would have otherwise—especially with home equity lines of credit making it much simpler to borrow against the value of one's house. The data for Great Britain in the late 1980s support a similar linkage between surging real estate prices and falling rates of saving set aside out of personal income; more recently, the British saving rate has turned up as house sales have cooled.

Analyses of the relation between saving and demographics in the 1980s also have attracted much attention; on the whole, however, the results of these studies—as well as the implications for the 1990s—are less clear-cut than one would have expected. Nonetheless, with older members of the so-called "baby boom" generation moving into their forties, the issue of retirement saving is coming to the forefront.

One way to engender more national saving, of course, is to reduce the Federal budget deficit. But, we can also take actions that should encourage individuals to save more. There is no shortage of proposals for new saving incentives. Some would function in a manner similar to that of the individual retirement accounts (IRAs) of the early and mid-1980s, which allowed workers to make deductible contributions and to defer the tax on both the principal and earnings until the accounts were cashed in. Other suggested incentives, such as the Family Savings Accounts favored by the Administration, would not allow deductible contributions up front, but would permit earnings to accumulate tax-free as long as the account balances were maintained for a specified amount of time. The plan offered by Senators Bentsen and Roth (S. 612) incorporates both approaches.

When considering these proposals, a fundamental question that must be addressed is how they are likely to affect total national saving. It is relatively easy to imagine an incentive that will raise personal saving. But unless the increase is large enough to outweigh any associated drop in tax revenues—or sufficient deficit-reducing actions are taken elsewhere—the net effect on national saving will be negative. In other words, the sum of private consumption plus public consumption as a percent of income must fall for the national saving rate to rise.

I recognize that, under the current budget procedures, any anticipated loss of revenue to the Treasury from a new tax-favored saving plan will have to be offset by increases in other taxes or by reductions in mandatory spending. This requirement should blunt much of the concern about potential drains on national saving—at least over the next five years. But, as a matter of sensible tax policy, any new incentive must first be evaluated on its own merits and in isolation from other considerations.

Essentially two types of evidence bear on that assessment. The first is the broad economic evidence on the relation between saving and the rate of return on saving, which has been studied intensively over the years. In theory, the higher after-tax rate of return produced by an IRA or other incentive has two effects. On the one

hand, it increases the amount of future consumption that each dollar of current saving will buy, thereby providing an incentive to save more now in order to consume more later. On the other hand, because each dollar of existing saving generates more after-tax income, the individual can reduce current saving and still enjoy more consumption both now and in the future. In principle, either effect could dominate, leaving the question to empirical resolution. Unfortunately, economists have not been able to develop unambiguous evidence on this score.

The second type of evidence for evaluating a new tax incentive comes from the microeconomic studies of the 1982–86 IRA experience. Clearly, IRAs were very popular, with contributions averaging nearly $35 billion per year; this amount was equivalent to roughly one-quarter of personal saving as measured in the national and product accounts. However, at the time, many analysts believed that little, if any, of the money flowing into the accounts represented new saving—a perception that undoubtedly contributed to the scaling back of IRAs as part of tax reform in 1986. It is important to remember that in order to have increased saving, an IRA would need to have reduced consumption.

Since then, many new data have become available. and several studies of the IRA experience have been carried out. These studies provide a wealth of information, but, again, the results are inconclusive. Some essentially confirm the "conventional wisdom" that IRAs involved primarily a shifting of saving from one pile to another, without much effect on the total. But others suggest that IRAs provided a substantial boost to overall saving and that their effectiveness would have grown over time as people exhausted their opportunities to shuffle existing assets.

The lack of conclusive evidence on saving incentives makes it difficult to take a strong position either way on the desirability of a new IRA. In addition, that determination depends on how you plan to meet the pay-as-you-go requirements in the new budget procedures; the necessary cuts in spending or increases in other taxes may, in turn, have incentive effects of their own. In any event, the overall desirability of the package cannot be assessed until you specify and evaluate the offsetting elements.

In conclusion, it is important to continue to focus on the crucial need to restore saving in the United States to levels that are consistent with our longer-run economic objectives. As I noted earlier, the time is particularly opportune for exploring ways to facilitate retirement saving, given the large increase in the number of retirees that will occur within the next few decades. There may well be a role for a well-designed private saving incentive in that process. But, the historical evidence suggests that devising such an instrument will be a difficult task. In the end, substantial reductions in the Federal budget deficit are still the surest way to overcome the shortage of domestic saving and, thus, to increase permanently the supply of domestic funds available for investment.

PREPARED STATEMENT OF SENATOR DONALD W. RIEGLE, JR.

I want to commend the Chairman for holding this very important hearing on S. 612, The Savings and Investment Act of 1991. I am one of the seventy-six co-sponsors of this legislation.

If we are to meet the world economic challenges of the next century, it is vitally important that we increase our rate of savings in the United States in order to have both the physical and human capital that will be required to meet the challenge.

Making Individual Retirement Accounts (IRAs) and annuities fully deductible for all taxpayers, providing up-front and deferred incentives, indexing of contribution limits, and allowing penalty-free withdrawals for first home purchases, college education expenses and financially devastating medical expenses, will help spur a renewed vigor in our dismal national savings rate. The Bentsen-Roth legislation provides a real incentive for all taxpayers to begin to save and invest in our future.

I re-introduced legislation this year, S. 307, that would allow for penalty-free withdrawals for first-time home purchases. This legislation also defers any taxes due until the home is subsequently sold. While I have not specifically requested a revenue estimate, it is my expectation that S. 307 will have a very minimal cost. Expanding the type of investment applicable to IRAs and annuities to include a home will have two very important effects: (1) allows more Americans to get into the economic mainstream of home ownership and (2) provides a real stimulus to our economy through increased homebuilding.

There has been a great deal of discussion about the cost of the Bentsen-Roth bill. Those opposing the Bentsen-Roth bill on the basis of cost miss a very important

factor. It is my feeling that there will be a much greater cost to our economic future if we don't provide incentives for people to save and invest.

PREPARED STATEMENT OF SENATOR WILLIAM V. ROTH, JR.

Thank you, Mr. Chairman. As I've expressed many times over the past few months, this piece of legislation represents the hope and future of America. Those who support our endeavors to realize a Super IRA are clearly those who believe in, and are willing to work for, a strong and economically vibrant America. It is those of little faith, little confidence in the willingness of Americans to save for their own future who doubt the practicality of this legislation.

These latter—the naysayers—are those who claim there is no proof, no certainty that this Super IRA will result in new savings. To them, I can only say:

Hog wash!

Ironically, they are these same people who don't hesitate to vote for billion dollar spending bills that cannot be certified to bring about specific results—let alone the pro-growth policies our nation so desperately needs as it looks to secure its future in the emerging global economic community.

But fortunately for this legislation—and the future—the majority of our colleagues, like the majority of Americans, understand that the Super IRA offers hope and promise of a brighter future for everyone. It offers hope for better jobs, better standards of living, and security in old age. (And this latter hope cannot be underestimated, especially given the persistent concerns regarding Social Security and the fact that America is reaching the period where the typical man and woman may live as long in their retirement years as they do in their working years. Thus it is important to provide incentives to help our people provide for their golden years.)

Concerning America's economic future, Federal Reserve Board Chairman Alan Greenspan has said that the single most important requirement of a prosperous America is increased savings. And all we have to do is look at our trading competitors abroad to verify the depth of that wisdom. Japan and Germany far out save America. Consequently, their capital is relatively inexpensive, and business is booming, and we—as a nation—are forced to borrow from their resources for our investment here at home. Only through personal savings can we both guarantee independence from foreign savings and investment (that so many Americans decry) and establish independence for our families.

To see how illogical even the most logical reasoning of the naysayers is, let's examine their attacks on this important piece of legislation:

First, they claim that it does not produce new savings. Nothing could be further from the truth. In a few minutes, we will hear from economists—not only supply-side economists (who I hold so dear to my own heart)—but also well-respected liberal economists, who, as one-time disbelievers in the IRA, critically examined thousands of income tax returns to determine—contrary to their original beliefs—that IRAs do result in substantial new savings. They found that 80 percent, or more, of IRAs essentially result in new savings.

The second myth perpetuated by the naysayers is that we can't afford IRAs. What this myth says, in fact, is that we can't afford to let hard-working, thrifty and valiant Americans save for their future. What the naysayers are claiming is that our nation can't afford to allow these people to use their own savings to send their children to college, to help with that first-time home purchase, or to pay for catastrophic health costs. (I suppose what the naysayers propose to do to deal with these real family needs is to provide more social spending and greater dependence on government and the naysayers' willingness to vote even more multi-billion dollar spending bills! It's ridiculous!) This myth continues that we can't let American families help each other. We can't let grandparents help their grandchildren invest in the American dream of home ownership. We can't let grandchildren help grandparents pay for catastrophic health care costs.

What people with little faith these naysayers are. What people of little vision.

The third reason the they claim we can't pay for this important legislation is because the budget summit conference is built on myths of it's own—on anti-growth non-realities. In fact, the budget summit artfully loaded the bases against the American family. Given the summit requirements, the Joint Committee on Taxation has calculated the cost of the Super-IRA program using a static model. For example, no consideration is given to any growth resulting from the increased savings and the affect those savings will have on the economy. What the naysayers aren't telling us is that given a dynamic economic model—one that takes economic growth into ac-

count) the program will result in a positive stream of revenue, instead of a $25.8 billion static revenue loss.

Outrageous, isn't it? But that's the result of the budget summit and its policy of no-growth. And I don't buy it. Neither do a majority of my colleagues—nor our tax-paying citizens. These people know the hour has come for real policies that lead to growth and opportunity.

The time has come to bet on America's future—to bet on Americans' willingness to build that future. Don't tell me Americans won't save. Scores of people—Senators, teachers, men and women on the street—have stopped me to say: "Go to it, Bill." And that's what I intend to do.

I'm pleased to work with our distinguished Chairman to lead the charge.

PREPARED STATEMENT OF DALLAS L. SALISBURY [1]

I am pleased to appear before you today to discuss individual retirement account (IRA) deduction eligibility. My name is Dallas Salisbury and I am accompanied by Joseph Piacentini. I am the president of the Employee Benefit Research Institute (EBRI), a nonprofit, nonpartisan, public policy research organization based in Washington, D.C. EBRI has long been committed to the accurate statistical analysis of public policy benefit issues. Through our research, we strive to contribute to the formulation of effective and responsible health, welfare, and retirement policies. In keeping with EBRI's mission of providing objective and impartial analysis, our work does not contain recommendations. Joe is a research associate with EBRI and is responsible for all of our primary analyses of pension and individual retirement account coverage and participation.

INTRODUCTION

Today's retirees are at an historic high in cash and non-cash income. Social Security and Medicare have played a significant role in providing this economic security. Employment-based pensions and individual retirement savings have also made a large difference. Social Security paid $227.3 billion in retirement benefits and pension plans paid $244.4 billion in 1989, compared with $1.4 billion and $652 million, respectively, in 1950.

Americans like retirement. So much, in fact, that they told the EBRI/Gallup poll that, on average, they would love to retire by age 61. In recent years, as a result of retirement savings, individuals have been able to retire earlier. Americans like the programs that have made retirement possible, but they are concerned about the future.

Americans like Medicare. But 71 percent tell the EBRI/Gallup poll that they believe Medicare will provide a lower level of benefits when they retire than it does today. Over one-half would willingly pay higher payroll taxes tomorrow to secure the program. They have reason to be concerned. The program is projected to move to negative cash flow in 1996 and run out of investment earnings in 2001. To maintain benefit levels, the program will grow from 2 percent of GNP in 1990 to 6 percent in 2060. Far more Americans believe that employers will provide health insurance in retirement than is the case. Seventy-three percent believe employers should be required to provide health insurance in retirement. In the future, Americans will need to increase savings for retirement to retire when they want to and in order to afford health care expenses in retirement.

Americans like Social Security. But 42 percent of poll respondents not currently retired do not think the system will pay them a benefit when they retire; 44 percent of those aged 18-34 and 45 percent of those aged 35-54 do not think the system would pay them a benefit. One-half oppose payroll tax reductions, particularly (64 percent) if it would mean an increase in other taxes. The vast majority say employers and the government should do more to encourage them to save and to make it possible for them to save. And, that if this were done, they would save.

Employers and individuals have saved a great deal. Pension and individual retirement plans have, as a result, had a major impact on capital markets. At the end of 1990, employment-based retirement plans held $2.5 trillion in assets and individual retirement accounts and Keoghs held an additional $564 billion. This represents

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more than $3 trillion in patient capital to finance the nation's growth and, over time, the economic security of retirees.

Government tax and social policy has encouraged the development of these programs, but this support has not been consistent. Changes since 1981 in general, and the Tax Reform Act of 1986 (TRA '86) in particular, significantly reduced incentives. The data indicate that, in the absence of some of these changes, there would be more pension coverage today, more individuals with individual retirement savings today, and hundreds of billions of dollars of more assets in retirement plans.

Under restrictions imposed beginning in 1987 by TRA '86, 63 percent of all workers aged 21-64 were eligible for a full $2,000 IRA deduction in 1987, and 58 percent are eligible today. By 1995, 52 percent will be eligible.

The Bentsen/Roth Super IRA proposal would extend eligibility for deductible contributions to IRAs to all workers. TRA '86 restricted that eligibility for workers with pensions and incomes over certain thresholds, beginning in 1987. This testimony quantifies the extent of IRA deduction eligibility under current law for workers today and in the near future. It documents the use of deductible and nondeductible IRAs following TRA '86. Finally, it examines the proportion of workers in different income groups and family types that would gain IRA deduction eligibility under this provision of the Bentsen/Roth bill.

BACKGROUND

With the enactment of the Employee Retirement Income Security Act of 1974 (ERISA), Congress established IRAs, effective in 1975, to provide workers without employer-sponsored pensions an opportunity to save for retirement on a tax-deferred basis. In general, ERISA allowed workers without pensions to contribute the lesser of $1,500 (unindexed) or 15 percent of earnings annually to an IRA on a tax-deductible basis. As ERISA originally provided, investment earnings on IRA contributions are also tax deferred, and IRA withdrawals in retirement are taxable. IRA eligibility restrictions were basically unchanged from 1975 through 1981. In 1975, 1.2 million taxpayers claimed $1.4 billion in IRA deductions, according to the Internal Revenue Service (IRS). By 1981, 3.4 million taxpayers claimed $4.8 billion in IRA deductions (chart 1).

The Economic Recovery Tax Act of 1981 (ERTA) extended eligibility for deductible IRA contributions to all workers, including those with employer-sponsored pension plans, and raised the deduction limit to the lesser of $2,000 (unindexed) or 100 percent of earnings. ERTA became effective in 1982. At this time, banks and other investment services vendors began to market IRA products aggressively. IRA deduction eligibility remained nearly universal among workers from 1982 to 1986, with restrictions only for workers earning less than $2,000 annually. In 1982, the number of taxpayers claiming an IRA deduction increased to 12.0 million, and the total amount deducted reached $28.3 billion. In 1985, IRA deductions peaked at $38.2 billion from 16.2 million taxpayers (chart 1).

Chart 1
Use of the IRA Deduction Responds to Eligibility Law

Number of Returns with an IRA Deduction (millions)

Amount Deducted ($billions)
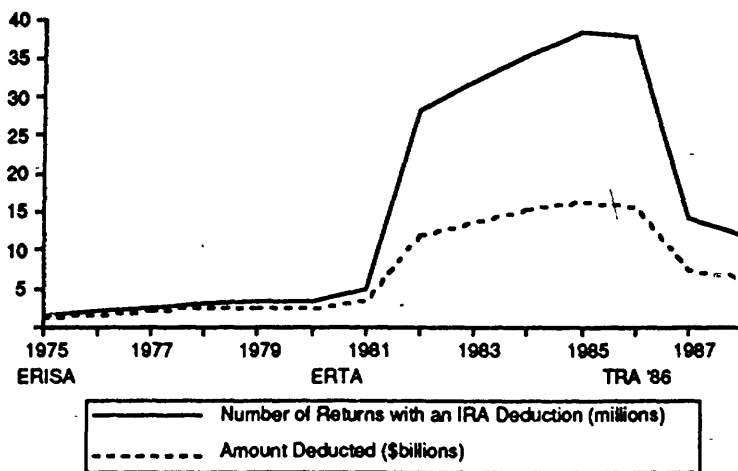
Source: Internal Revenue Service.

Effective in 1987, TRA '86 restricted IRA deductions for taxpayers with employer-sponsored qualified retirement plan coverage and income over certain unindexed thresholds. Specifically, the maximum allowed IRA deduction—$2,000 per worker—is phased out evenly for single workers with adjusted gross incomes (AGIs) between $25,000-$35,000 and for married couples filing jointly with AGIs between $40,000-$50,000. These restrictions apply to joint filers if either spouse is covered by a pension. (Married individuals filing separately are not affected by their spouses' pension coverage. However, if they are covered by a pension plan, their IRA deduction eligibility is phased out between AGIs of $0 and $10,000.) Workers who are not eligible for the full IRA deduction are permitted to make nondeductible contributions. Combined deductible and nondeductible contributions. generally must not exceed the lesser of $2,000 (unindexed) or 100 percent of earnings.

Primarily as a result of TRA '86, use of the IRA deduction fell sharply. In 1987, 7.3 million taxpayers claimed $14.1 billion in IRA deductions; in 1988, 6.4 million taxpayers claimed $11.9 billion (chart 1).

CURRENT IRA DEDUCTION ELIGIBILITY

New EBRI research quantifies changes in workers' IRA deduction eligibility resulting from the TRA '86 restrictions for different income groups and family types. The research also measures IRA use by both eligible and ineligible workers.
- Under pre-TRA '86 law, 95 percent of all workers aged 21-64 would have been eligible for a $2,000 IRA deduction in 1987. As a result of TRA '86, 65 percent were eligible in 1987, and 58 percent are eligible today. By 1995, 52 percent will be eligible. Looking at the data another way, at 1991 income levels, 35 percent of those who contributed to an IRA in 1982 retain full eligibility, compared with 64 percent of those who did not participate. If TRA '86 was intended to stop those who were deducting IRA contributions from doing do, Census Bureau data indicate it was very effective.

Higher-income workers are more likely to be covered by employer-sponsored plans and to have AGIs above the TRA '86 thresholds and therefore are less likely to be eligible for the full IRA deduction. Just 21 percent of workers aged 21-64 with AGIs of $50,000 or more are currently eligible for a $2,000 deduction, compared with 55

percent of workers with AGIs between $30,000 and $49,999 and 86 percent of workers with AGIs less than $30,000.

Because the TRA '86 income thresholds are not indexed for inflation or income growth, between 1987 and 1991 the proportion of lower- and middle-income workers who were eligible declined, while the proportion of higher-income workers who were eligible remained nearly the same. This trend is expected to continue through 1995. Among workers with AGIs of less than $30,000 (in constant 1991 dollars), the proportion eligible for a $2,000 deduction declined from 90 percent in 1987 to 86 percent in 1991; it is expected to fall to 83 percent in 1995. Workers with AGIs of $30,000–$49,999 are facing the sharpest decline in eligibility, from 75 percent in 1987 to 55 percent in 1991 to an estimated 43 percent in 1995. Among workers with higher AGIs, between 20 percent and 22 percent remained eligible from 1987 to 1991, and the number is expected to remain in that range through 1995.

Two-earner couples have been disproportionately affected by the TRA '86 IRA deduction restrictions, in part because the presence of two workers increases the likelihood of coverage under an employer-sponsored pension plan. Moreover, many two-earner couples' combined earnings and other income already exceeds the TRA '86 thresholds. Given expected inflation and income growth, more two-earner couples will become ineligible in the near future as more of their incomes surpass these thresholds. Among all workers whose spouses also work, the proportion eligible for the full IRA deduction declined from 53 percent in 1987 to 45 percent in 1991; it is expected to drop to 38 percent in 1995 (table 1).

One other issue at the center of legislation and regulation in the 1980s was non-discrimination, that is, the desire to have individuals at all income levels participate in programs. TRA '86 also had an interesting impact on this objective, according to analysis of the statistics of income from the Internal Revenue Service (IRS). In 1986, the proportion of all returns by income category with an IRA deduction ranged from a high of 67 percent of those with incomes of $75,000 or higher to a low of 7 percent for those with incomes below $30,000. With TRA '86 in effect, 1987 returns showed a high of 15 percent for those earning between $30,000 and $49,999 and a low of 5 percent for those earning below $30,000. For those at $75,000 or higher, the rate dropped to 10 percent.

Table 1.—PERCENTAGE OF CIVILIAN WORKERS AGED 21–64 BY ELIGIBILITY FOR IRA DEDUCTION

[In percent]

	Eligibility under TRA '86 IRA			Eligibility under Bentsen/Roth IRA			Percentage distribution of all workers
	Full	Partial	None	Full	Partial	None	
1987							
All workers	65	16	20	95	4	2	100
Family type							
Single	76	14	10	94	5	2	36
Married, sole worker	74	10	16	97	2	1	17
Married, spouse works	53	18	28	95	4	2	48
Family pension status							
Pension	45	22	33	97	2	1	57
No pension	91	6	3	91	6	3	43
Family income (1991$)							
Less than $30,000	90	7	3	91	7	3	41
$30,000–$49,999	75	20	6	97	2	1	29
$50,000–$74,999	20	34	45	98	1	1	20
$75,000–or more	22	(¹)	78	98	1	(¹)	10
Age							
Under 35	74	14	12	94	4	2	42
35–54	56	17	26	96	3	1	46
55 or older	64	14	22	94	4	2	11
1991 (Projected)							
All workers	58	15	27	94	5	1	100
Family type							
Single	74	15	11	94	6	(¹)	37
Married, sole worker	69	11	20	97	3	1	11
Married, spouse works	45	16	39	94	5	1	53

Table 1.—PERCENTAGE OF CIVILIAN WORKERS AGED 21–64 BY ELIGIBILITY FOR IRA DEDUCTION—Continued

[In percent]

	Eligibility under TRA '86 IRA			Eligibility under Bentsen/Roth IRA			Percentage distribution of all workers
	Full	Partial	None	Full	Partial	None	
Family pension status							
Pension	31	21	49	97	3	(¹)	55
No pension	91	8	1	91	8	1	45
Family income (1991$)							
Less than $30,000	86	13	1	90	9	1	43
$30,000–$49,999	55	35	10	96	3	(¹)	27
$50,000–$74,999	71	1	78	98	2	(¹)	18
$75,000 or more	21	1	78	98	2	1	12
Age							
Under 35	69	15	16	94	6	(¹)	43
35–54	48	15	37	95	4	1	46
55 or older	54	15	13	92	6	1	11
	1995 (Projected)						
All Workers	52	12	36	95	4	1	100
Family type							
Single	69	14	17	95	5	(¹)	37
Married, sole worker	61	10	28	97	2	1	11
Married, spouse works	38	12	50	95	4	1	53
Family pension status							
Pension	19	17	64	97	2	(¹)	55
No pension	92	7	1	92	7	1	45
Family income (1991$)							
Less than $30,000	83	16	1	91	8	1	43
$30,000–$49,999	43	22	35	97	3	(¹)	27
$50,000–$74,999	22	1	78	98	2	(¹)	18
$75,000 or more	21	1	79	98	1	(¹)	12
Age							
Under 35	63	13	23	94	5	(¹)	43
35–54	42	11	47	96	3	1	46
55 or older	49	13	38	93	6	1	11

¹ Less than 0.5 percent
Source: EBRI estimates and projections based on Census Bureau data and Social Security Administration assumptions

CONCLUSION: EFFECT OF IRA DEDUCTION ELIGIBILITY EXTENSION

Legislation introduced in March by Senators Lloyd Bentsen and William Roth would extend IRA deduction eligibility to all workers. This provision would increase the proportion of all workers who are currently eligible for a $2,000 IRA deduction from 58 percent to 94 percent (table 2). It would improve IRA deduction eligibility for 37 percent of all workers in 1991 and for 43 percent of all workers in 1995.

Eligibility gains would be greatest among high-income workers. Seventy-eight percent of workers with AGIs of $50,000 or more would enjoy improved eligibility under this provision in both 1991 and 1995. Because the TRA ꞌ86 thresholds are not indexed, the proportion of moderate-income workers whose eligibility would improve is expected to increase. Among workers with AGIs between $30,000–$49,999, eligibility would improve for 41 percent in 1991 and for 54 percent in 1995. Among workers with working spouses, eligibility would increase for 50 percent in 1991 and for 58 percent in 1995 (table 3).

IRA deduction eligibility does not guarantee that workers will make IRA contributions. Most eligible workers do not contribute, and some ineligible workers make nondeductible contributions. Among workers who were fully eligible for the IRA deduction in 1987, IRA contributions were more common among workers in higher-income families. Likewise among ineligible families, nondeductible contributions were most common at higher income levels. These patterns suggest that increased IRA deduction eligibility under repeal of the TRA '86 restrictions would be disproportionately concentrated among high-income families, and actual tax benefits flowing from the repeal might be even more concentrated.

Table 2.—CHANGES IN IRA DEDUCTION ELIGIBILITY RESULTING FROM BENTSEN/ROTH, CIVILIAN WORKERS AGED 21–24

[In percent]

	Percent of all workers	Eligibility increases		Eligibility unchanged	
		Percent gaining	Percent of all gainers	Percent unchanged	Percent of all unchanged
1991 (Projected)					
All workers	100	37	100	63	100%
Family type					
Single	37	20	21	80	46
Married, sole worker	11	28	8	72	12
Married, spouse works	48	50	72	50	42
Family pension status					
Pension	55	67	100	33	28
No pension	45	0	0	100	72
Family income (1991$)					
Less than $30,000	43	4	5	96	65
$30,000–$49,999	27	41	30	59	25
$50,000–$74,999	18	78	39	22	6
$75,000 or more	12	78	26	22	4
Age					
Under 35	43	25	29	75	51
35–54	46	47	59	53	38
55 or older	11	38	12	62	11
1995 (Projected)					
All Workers	100	43	100	57	100
Family type					
Single	37	25	22	75	49
Married, sole worker	11	36	9	64	12
Married, spouse works	53	58	70	42	39
Family pension status					
Pension	55	79	100	21	20
No pension	45	0	0	100	80
Family income (1991$)					
Less than $30,000	40	8	7	92	66
$30,000–$49,999	26	54	33	46	21
$50,000–$74,999	19	78	34	22	8
$75,000 or more	14	78	25	22	5
Age					
Under 35	43	31	31	69	52
35–54	46	54	57	46	37
55 or older	11	45	12	55	11

Source: EBRI estimates and projections based on Census Bureau data and Social Security Administration assumptions.

Table 3.—IRA SUE RATES: PERCENTAGE OF CIVILIAN WORKERS AGED 21–24 CONTRIBUTING TO AN IRA IN 1987

[In percent]

	All workers	IRA deduction eligibility		
		Full	Partial	None
All Workers	13	12	13	19
Family Type				
Single	10	9	13	16
Married, sole worker	17	15	22	22
Married, spouse works	15	13	12	20
Family Pension Status				
Pension	15	12	16	20
No pension	11	12	3	(¹)

Table 3.—IRA SUE RATES: PERCENTAGE OF CIVILIAN WORKERS AGED 21–24 CONTRIBUTING TO AN IRA IN 1987—Continued

[In percent]

	All workers	IRA deduction eligibility		
		Full	Partial	None
Family Income (1991$)				
Less than $30,000	7	7	4	(¹)
$30,000–$49,999	14	14	16	14
$50,000–$74,999	19	26	15	17
$75,000 or more	28	38	(¹)	25
Age				
Under 35	7	6	8	12
35–54	16	14	13	20
55 or older	28	27	33	28

¹ Sample too small to provide reliable estimate.
Source: EBRI estimates and projections based on Census Bureau data and Social Security Administration assumptions

APPENDIX

All estimates of IRA deduction eligibility and IRA use contained in the tables provided with this testimony are based on U.S. Census Bureau Current Population Survey (CPS) data. Estimates for 1987 are based on 1987 income and pension data contained in the March 1988 CPS income supplement and 1987 IRA data contained in the May 1988 CPS employee benefit supplement. Estimates for 1991 and 1995 are based on 1989 income and pension data contained in the March 1990 CPS income supplement. Income and earnings are projected forward from 1989 to 1991 and 1995 based on Social Security II-B intermediate assumptions on growth in average covered wages. AGI is assumed to equal the reported total personal income of individuals or the combined reported total personal incomes of married couples. Workers' earnings are assumed to equal their reported total income from all employment during the base year.

Because CPS data do not provide for a reasonable determination of tax filing status, all married couples are presumed to file jointly. The effect of this limitation on the estimates is probably very small due to the small number of married couples who file separately. IRS reports that in 1987 no more than 3 percent of married couples filed separately. However, some married workers—particularly those with employer-sponsored plan coverage only through their spouses—could gain IRA eligibility by filing separately. A separate set of EBRI estimates suggests that, if all married workers chose their filing status to maximize the combined IRA deduction available to themselves and their spouses, the proportion of all workers eligible for a full IRA deduction in 1991 would be 63 percent rather than the 58 percent reported above. However, under this approach, 16 percent of married couples would file separately in order to improve their IRA deduction eligibility—a proportion far larger than the 3 percent reported by IRS. Moreover, many of the couples who actually file separately may not improve their IRA deduction eligibility by doing so. For these reasons, assuming that all married couples file jointly should provide reasonable estimates of IRA deduction eligibility.

Some workers would remain eligible for less than the full IRA deduction under the Bentsen/Roth proposal because they do not report enough earnings to qualify for the full deduction.

In the preceding analysis, "improved" eligibility status refers to a change from partial eligibility to full eligibility or from no eligibility to partial or full eligibility. Increases in partial eligibility are not included.

All estimates are restricted to workers aged 21–64. Estimates for 1991 and 1995 hold pension coverage and work force demographics constant at 1989 levels.

PREPARED STATEMENT OF JONATHAN SKINNER

CAN INDIVIDUAL RETIREMENT ACCOUNTS CURE THE PROBLEM OF LOW NATIONAL SAVING?

Abstract

Individual Retirement Accounts have been criticized as providing little or no incentive to save. They have been viewed instead as a windfall to wealthy taxpayers who would have saved the money anyway. First, I believe these criticisms of the original IRA program are largely misplaced. While there is conflicting evidence about whether IRAs were effective at promoting saving, I think that the evidence still suggests that IRAs are largely new saving. Second, I believe that IRAs were effective at promoting saving largely because of their up-front deduction. The psychological gratification of getting that instant rebate was enough to overcome the reluctance of US households to save for the future. And third, IRAs will not by themselves solve the saving problem. They never accounted for more than one percent of GNP, so they must be used in concert with other policies—such as reducing the deficit—to remedy the low rate of national saving. They may ultimately be most effective at what the IRA was originally designed to do in 1974: to provide liquid assets for retirees facing ever larger out-of-pocket medical and other expenses.

My name is Jonathan Skinner, and I am Associate Professor of Economics at the University of Virginia and Research Associate at the National Bureau of Economic Research. My research focuses on why people save, and in particular the effectiveness of saving incentives such as Individual Retirement Accounts.

The United States saves less than 3 percent of GNP, one-fourth the rate in Japan and -one-half that in West Germany. We as a country are not providing enough saving to finance domestic investment. This is disturbing for at least two reasons. First, as long as foreign capital is necessary to finance domestic investment, the trade deficit will continue to be large. Second, consuming rather than saving income today means a lower standard of living in the future.

Much of that low saving rate can be blamed on the United States government deficit. But personal saving rates in the United States have been low since the mid-1980 and show no signs of recovery. In March, personal saving was only 3.7 percent of disposable income, well below the average 7.3 percent saving rate between 1960 and 1979. I am pleased that attention is being focused on ways to encourage US households to save through an expanded Individual Retirement Account program such as the Bentsen-Roth bill.

IRAs came under considerable criticism almost since their expansion in 1982. They were viewed not as generating new saving, but as simply providing a windfall subsidy to wealthy taxpayers who would have saved the money anyway. Critics have pointed to the sharp decline in US saving rates during 1982-86, the "golden years" of IRA enrollment, as evidence that IRAs not only were ineffective at generating new saving, but actually reduced national saving by widening the budget deficit (Gravelle, 1991).

I will make three basic points in this testimony. First, I believe these criticisms of the original IRA program are largely misplaced. While there has been some conflict recently as to whether IRAs were effective at promoting saving, I believe that the evidence supports the view that IRAs are largely new saving. Second, I believe that IRAs were effective at promoting saving largely because of their up-front deduction. The psychological gratification of getting that instant rebate was enough to overcome the reluctance of US households to save for the future. And third, IRAs will not by themselves solve the saving problem. They never accounted for more than one percent of GNP, so they must be used in concert with other policies—such as reducing the deficit—to remedy the low rate of national saving. They may ultimately be most effective at what the IRA was originally designed to do in 1974: to provide liquid assets for retirees facing ever larger out-of-pocket medical and other expenses.

1. DID IRAS INCREASE SAVING?

The evidence from aggregate statistics appears to contradict the view that IRAs increase saving. In 1981, the personal (or household) saving rate was 7.5 percent of disposable income. By 1986, the last year in which IRAs were generally available, the personal saving rate had plummeted to just 4.1 percent of disposable income. But I do not consider this evidence entirely conclusive for at least two reasons. First, the saving rate has remained low since IRAs eligibility was largely curtailed in 1987; saving rates in early 1991 have even declined slightly relative to their 1986 levels.

Second, and more importantly, the pattern of decline in saving during the 1980s was played out in a number of other countries as well. Figure 1 shows the personal saving rate as a fraction of disposable income in Canada, France, Great Britain, and the US. In each country, saving rates fell through the 1980s, before recovering in 1987 or 1988. [1] Any impact (positive or negative) of IRAs on national saving rates was likely swamped by global factors affecting world saving rates.

Another approach to testing the effect of IRAs on saving is to use large-scale surveys of individuals to compare saving behavior of those who contributed to IRA accounts with those who did not. The pioneering work by Stephen Venti of Dartmouth College and David Wise of Harvard University suggested of every one hundred dollars contributed to an IRA, only 8 dollars were shuffled from previous saving. Of the remaining 92 dollars, 57 were withdrawn from consumption and 35 from a reduction in taxes (Venti and Wise, 1989). Their results suggested that IRAs were largely new saving.

Figure 1: Household Saving in Selected OECD Countries, 1976-89
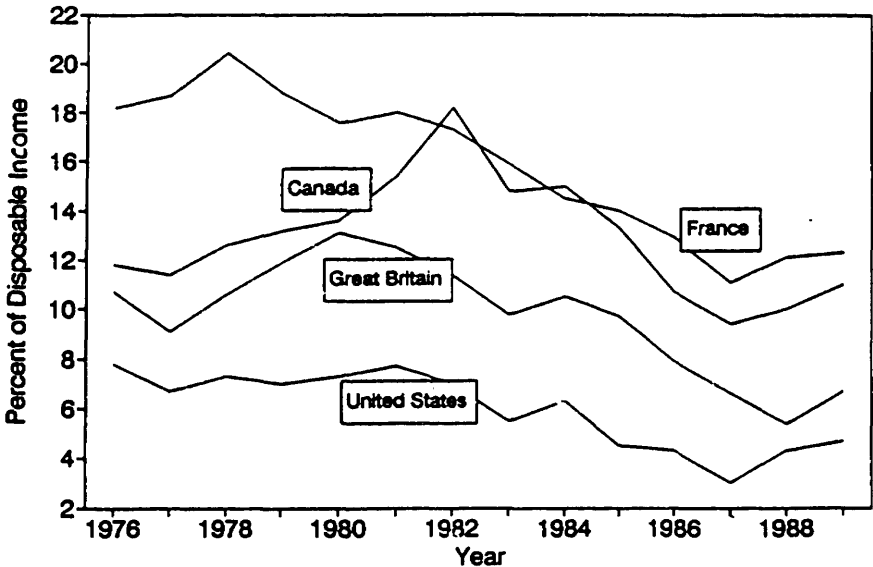
In a study with Daniel Feenberg of the National Bureau of Economic Research, I examined nearly 4000 IRS tax returns between 1980 and 1984 to test whether IRAs were new saving. We originally set out to disprove the Venti and Wise study because at the time, we believed that taxpayers took money out of existing taxable assets and shuffled them into IRAs. We expected that IRA contributors would gradually report on their tax returns lower interest and dividend income over time as they shifted taxable assets into IRAs. To our surprise, we found that IRA contributors tended to increase their taxable (as well as nontaxable) saving by more than those who did not purchase IRAs. That is, rather than disprove the Venti and Wise study, we confirmed it.

One objection to our comparison between IRA contributors and noncontributors is that the contributors tend to be wealthier. Hence it is no surprise that they save

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[1] The data source for Figure 1 is *OECD Economic Outlook* 48 (December 1990), pages 186–87. Most of the other OECD countries experienced a decline in saving during the 1980s, but not every country saving rate rebounded in the late 1980s.

more, both in IRA and non-IRA sources. To correct for this, we compared families with the same initial wealth, and found that our results still held. [2]

A related objection is that families who contribute to IRAs are just different than noncontributors. They have a stronger taste for all types of saving, so it is not surprising to observe IRA contributors saving in other types of assets. William Gale of UCLA and John Karl Scholz of the University of Wisconsin allowed for these differences in saving behavior in their estimates of how IRAs affect saving. Their conclusion that only a small fraction of IRA contributions were new saving directly contradicted the Venti and Wise results. So the standard economic models of saving are unable to determine conclusively whether IRAs are new saving or old saving because of the inherent difficulty of determining what taxpayers *would* have done *had* there been no IRAs.

In standard economic models, IRAs are prized solely because they yield a higher after-tax rate of return than other assets. One difficulty with this approach is the weak support for the notion that households save more when the real return is high. For example, during the 1970s the real after-tax interest rate on corporate bonds was low and negative, but personal saving rates were at a postwar peak. The situation was reversed in the 1980s. Statistical correlations typically show a *negative* rather than a positive correlation between saving rates and the after-tax rate of return.

My own belief that IRAs promote saving is based less on the notion that higher interest rates induce saving than the view that saving is as much a psychological as an economic decision. For example, recall the advertisements for IRAs during the mid-1980s. They promised that a $2000 annual contribution to an IRA would make the investor a millionaire. And in fact my study with Daniel Feenberg found that one-third of all enrollees did contribute exactly $2000 to the penny, even if they were eligible to contribute up to $4000. Why? We interpreted this to mean that the marketing blitz was effective at conveying both correct information—that IRAs were a good investment, and incorrect information—that the upper limit was only $2000. The sharp drop-off in IRA contributions after 1987 even among those still eligible to contribute lends support to the view that vigorous marketing and advertising played a key role in the popularity of IRAs (Summers, 1989).

A final bit of evidence on IRAs comes from the finding that once hooked, few IRA contributors drop out. Figure 2 shows the reenrollment rate of initial contributors in 1982. Three-quarters of these contributors purchased IRAs in 4 of the 5 years during which IRAs were generally available. The persistence of IRA purchases does not prove that IRAs were new saving. Still, relatively few families hold more than 5 or 6 years of maximum IRA contributions. [3] If at first these consistent contributors did shuffle taxable saving into IRAs, they could not continue to do so indefinitely. That is, to the extent that IRA contributors are persistent, the long-term potential for shuffling is small.

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[2] There was no correlation between IRA purchases and taxable saving among the very wealthy with assets above $50,000, perhaps because of the relative unimportance of IRA wealth.
[3] This was a point first made by Feldstein and Feenberg (1983). Gale and Scholz (1990) report that the median liquid wealth holding of IRA enrollees is $13,500. Venti and Wise (1989) have reported considerably lower values of median liquid wealth. Also see Gravelle (1991) and Skinner (1991) for further discussion of this issue.

Figure 2: IRA Contributions 1982-86
[For the Sample of 1982 Contributors]

2 Years
8%

1 Year
8%

3 Years
9%

4 Years
13%

All Years (1982-86)
61%
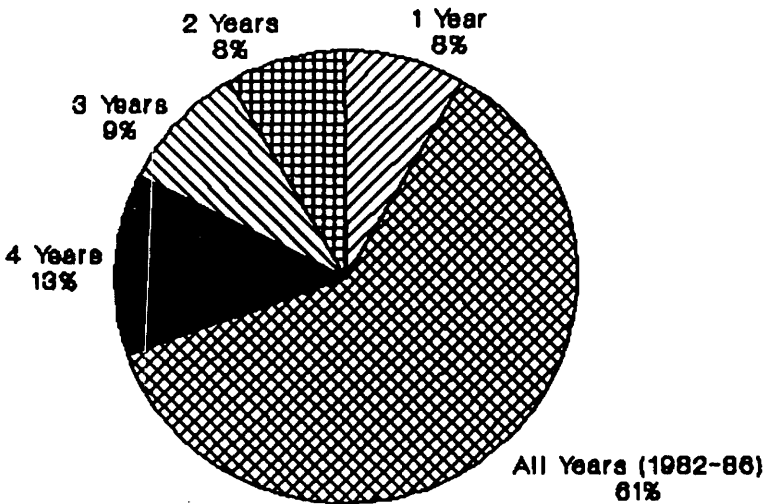
Source: IRS/Michigan Public Use Tapes

2. THE UP-FRONT DEDUCTIONS OF IRAS MAY ENCOURAGE SAVING

I believe that the up-front deductions available from IRAs were a key factor both in the popularity of IRAs, and in inducing taxpayers who wouldn't otherwise save to invest in an IRA. For example, Dan Feenberg and I found that a taxpayer who owed taxes above the amount withheld to the IRS on April 14th was much more likely to contribute to an IRA. We interpreted this to mean that a taxpayer in the 40 percent bracket would prefer to open a $2000 IRA account than write an $800 check to the IRS. That is, the up-front deduction provided the instant gratification necessary to get taxpayers into the saving habit.

The tax benefit of a back-ended plan, such as that offered in the Bentsen-Roth plan, or the Bush Administration's Family Saving Account, is provided in the future by exempting interest income from taxation rather than providing the immediate tax break today. For a constant marginal tax rate, either plan provides the taxpayer with the same after-tax return on her investment. So it is likely that canny and sophisticated investors may even prefer the back-ended saving incentive to the up-front deduction, depending on their tax strategies. But my suspicion is that the ma-

jority of savers will continue to seek the immediate reward of the up-front option in the Bentsen-Roth bill.

The back-ended IRA is more attractive to legislators laboring under budget restrictions. While back-ended IRAs don't lose much revenue now, they do in the future. By making a potentially large fraction of national saving permanently exempt from taxation, the true revenue cost of back-ended plans are put off into the future. By contrast, the current revenue cost of front-ended IRAs are overstated. Much of the revenue lost through up-front deductions will ultimately be returned—with interest—when the IRA is cashed out. By 1990, there were $400 billion in IRA assets, representing $80 billion in future tax revenue at a conservative 20 percent marginal tax rate. [4]

Either the back-ended or the front-ended saving incentive will cost the government revenue. I would favor taking the revenue loss today with a front-ended saving incentive rather than putting it off to some future budget. The pressure of the 1990 budget act will at least ensure that the revenue loss from the front-ended IRA will be offset elsewhere. By contrast, back-ended programs such as the Family Savings Account escape such fiscal discipline, and will put increased pressure on future deficits. And there is no question in my mind that an IRA program financed by deficit spending will do more harm than good to the nation's saving rate.

3. IRAS CANNOT ALONE SOLVE THE SAVING PROBLEM

Suppose IRAs were effective at stimulating saving. Then the final question is: are IRAs enough to stem the decline in aggregate saving? IRA contributions have never exceeded one percent of GNP. So IRAs alone could not have offset the decade-long slide in saving rates. Nor can IRAs alone offset the negative effect of Federal budget deficits on national saving—estimated by the CBO to be nearly 5 percent of GNP in fiscal 1992. One question is, can the new Bentsen-Roth IRA proposal do a better job of stimulating saving?

The Bentsen-Roth bill expands the scope of the original IRA by allowing qualified withdrawals for both housing and educational expenses. This expansion will make IRAs more attractive by providing financial relief for middle-income families struggling with rising tuition costs. But to the extent families are saving for college or a house in the first place, this type of short-term IRA saving will do little to stimulate aggregate saving. My own preference for restricting IRAs to retirement saving is based on the evidence that few families have accumulated adequate liquid wealth at retirement. Venti and Wise (1990) report that the median family aged 60–65 has only $6600 in liquid assets available for catastrophic illnesses or other contingencies. One or two years of IRA contributions can therefore have a substantial effect on financial assets for a large number of families. In short, the original goal of IRAs when first introduced in 1974—to encourage retirement security—may ultimately be their most effective use.

IV. CONCLUSION

There has been conflicting evidence about the effectiveness of IRAs at promoting saving. While I believe that the evidence supports the view that IRAs do encourage families to save, it is not simply because IRAs provide a higher rate of return on saving. Instead, both the heavy marketing and advertising by banks, and the enticement of an up-front deduction, encouraged households that normally would not be saving for their retirement. Encouraging families to lock in their saving for the long-term through a front-loaded IRA could be the most effective means to promote household saving and retirement security.

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[4] A part of these assets may be non-deductible IRAs purchased after 1986, in which case the tax would be assessed on the interest only, and not on the principal.

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PREPARED STATEMENT OF DAVID A. WISE

Mr. Chairman and members of the Senate Finance Committee, thank you for inviting me to speak today about IRAs and saving.

IRAs rapidly became an enormously popular form of saving after they became available to all wage earners in 1982. Annual contributions grew from about $5 billion in 1981 to $28 billion in 1982, and by 1986 had reached almost $40 billion, about 25 percent of total personal saving. The Tax Reform Act of 1986 restricted eligibility for roughly 40 percent of prior contributors and even for these families only the up-front tax deduction was eliminated. Nonetheless, contributions fell by over 50 percent between 1986 and 1987. The reporting of the tax reform act and the less intense promotion by financial institutions apparently left the widespread impression that the IRA had been eliminated. [1]

Discussion of the merits of IRAs has focused on two issues. One was the contention that IRAs were simply a tax break for the wealthy. Although higher income households are much more likely than lower income households to make IRA contributions, about three-fourths of contributors are in families with incomes less than $50,000. The other and much more difficult issue to address was the net saving effect of IRAs. Both simplified theoretical arguments and the fact that aggregate personal saving continued to decline after the introduction of IRAs led some commentators to conclude that IRAs had had no effect on net saving. The argument was that contributions represented saving that would have occurred anyway, or were simply transfers from other existing accounts. The theoretical arguments are based on the expected saving response to the subsidized return on IRA assets. However, it is likely that the expansion of IRA contributions is attributable to other, perhaps more psychological, features of the program not accounted for by these models. It is difficult, also, to infer the saving effect of IRAs from aggregate National Accounts saving data. For example, a substantial fraction of personal saving as defined in the National Income Accounts is composed of net contributions to private (and state and local) pension funds. Because of funding conventions, these contributions can vary widely with interest rates and stock market fluctuations. They declined by almost $30 billion between 1983 and 1984, for example, when IRA contributions were at about this same level. [2] Institutional funding of pension plans is of course independ-

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[1] Indeed, a 1988 survey showed that about half of all persons who were in fact still eligible to contribute to an IRA thought that they were not. (The IRA Reporter, Volume 6, No. 9, September 30, 1988.)

[2] See Bernheim and Shoven [1988].

ent of personal saving decisions, but can have a large effect on the aggregate saving rates as customarily defined.

Thus in a series of papers over the past several years Steven Venti and I have analyzed the saving effect of IRAs based on the experience of individual households, as reported in several government surveys. [3] Our analyses were based on the Federal Reserve Board's 1983 Survey of Consumer Finances (SCF), the Bureau of Labor Statistic's 1980 to 1986 Consumer Expenditure Surveys (CESs), and the Census Bureau's 1984 to 1986 panels of the Survey of Income and Program Participation (SIPP). The different ways that savings are reported in the various surveys and the different time spans over which data are collected allow several alternative methods of analyzing the saving effect of IRAs.

In my view, the weight of the evidence suggests that IRA contributions represent new saving in large part. Indeed in our analyses we find very little substitution of IRA saving for other forms of financial asset saving.

Much of our analysis is based on formal econometric models. The results of the formal analysis are consistent with inferences that can be drawn from more descriptive evidence. Thus for ease of exposition, I will emphasize descriptive data here. Our analyses and the results reported here are based on households with heads aged 21 to 65 and excludes the self-employed. The data show that:

• Personal financial asset saving is extremely low. The median of financial assets in American households in 1985 was about $1,600. The median among households with heads 60 to 64 years old was only $6,600.

• As the percent of households that saved in IRA accounts increased from about 3 percent in 1981 to 20 percent in 1986, there was essentially no change in the percent of households that saved in other forms of financial assets, suggesting little substitution between IRA and other forms of financial asset saving.

• The average median level of IRA assets in households with IRA accounts increased from about $2,000 in 1982 to $8,000 by 1986 (the mean in 1986 was almost $9,500). Yet the median non-IRA balances of households with IRA accounts did not decline over this period, but instead increased from $6,500 in 1982 to $8,250 in 1986. There is no suggestion of substitution between IRA and other forms of financial asset saving.

• By 1986, the median level of IRA assets in households that had IRA accounts in that year was close to the median level of non-IRA financial assets. Indeed, by 1986 the IRA assets of contributors were substantially greater than the non-IRA financial assets of contributors three to four years earlier at the outset of the IRA program.

• Typical IRA contributors had not been saving even close to $2,000 per year in financial assets prior to the advent of IRAs.

• When households who had not been making IRA contributions did contribute, they reduced non-IRA saving by only a small amount. Conversely, when households that were contributing switched to non-contributor status, they increased non-IRA saving by only a small amount.

Thus it is implausible to me that IRA assets were simply transferred from other pre-existing accounts, or that they represented saving that would have occurred anyway.

<center>A. DESCRIPTIVE DATA</center>

1. Low Personal Saving.

Most American families have almost no financial asset saving. Based on SIPP data, the median level of financial asset balances among all households was $1,600. [4] Among households with annual incomes between $40,000 and $50,000 and with heads aged 40 to 50 the median balance was only $5,000.

Even among households approaching retirement, personal saving is extremely low, as shown in figure 1. The figure shows the composition of total wealth by age. The amounts reflect total wealth by asset category. It is clear that most families approach retirement age with very little personal saving other than housing equity. For example, among households with heads 60 to 65, the median of liquid financial assets is only $6,600; the median of housing equity is $43,000. The majority of families rely heavily on Social Security benefits and to a lesser extent on firm pension

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[3] See Venti and Wise [1990a, 1990b, 1989, 1988a, 1988b, 1987, 1986].

[4] Based on the 1983 SCF, it was $1,300. The median based on the 1982 to 1985 CESs was $1,200.

plans for support after retirement. [5] The median of Social Security and pension wealth combined is $113,400 among families with heads between 65 and 70. (The median of Social Security wealth is $83,700 and the median of pension wealth is $11,200). The median of housing wealth is $38,000 and the median of financial assets is only $10,000. [6]

2. Trends in IRA vs Non-IRA Saving.

If IRA saving were replacing other saving, one would expect to see a reduction in the percent of households that save in non-IRA forms as the percent that save in IRA accounts increases. But that did not happen. As shown in figure 2, the percent of households saving in non-IRA forms of financial assets remained essentially constant—at around 30 percent—as the percent making IRA contributions increased from about 3 percent to 20 percent between 1980 and 1986.

3. IRA vs Non-IRA Financial Assets.

If IRA contributions simply represented transfers from other financial asset accounts, or if IRA contributions were taking the place of saving that otherwise would have occurred in other financial asset forms, we should see a decline over time in the other financial assets of families making IRA contributions. But that is not the case.

Figure 3 shows the median non-IRA financial asset balances (excluding stocks) of households with IRA accounts, for the years 1980 through 1987. It also shows IRA balances for 1985 through 1987. [7] The data are based on random samples of families in each of the years. Thus the families are essentially equivalent except that by the later years they had had more years in which IRA contributions could be made. In particular the median age of the family heads is about 42 in each of the years. By 1986, the median IRA balance in families with IRA accounts was almost as large as the median balance in non-IRA accounts and was slightly higher than the non-IRA balance by 1987.

But the rapid increase in IRA balances that began in 1982 was not accompanied by a reduction in other forms of financial assets. Indeed the non-IRA balances of households with IRA accounts increased over the period. For example, the median non-IRA balance of households who had IRA accounts in 1983 was about $6,000. Of households who had IRA accounts in 1986, the median balance in non-IRA accounts was about $8,000. Yet the median balance in IRAs had increased from about $4,000 in 1983 to almost $8,500 in 1986. [8] In other words, by 1986 the median IRA balance of contributors was larger than the 1983 non-IRA balance of contributors, and between these years the non-IRA balance increased as well. Thus it is implausible to me that the IRA contributions were simply transfers from non-IRA accounts, or that they represented saving that would have taken place in non-IRA financial assets.

The median of total financial assets, including IRAs, of IRA contributors was about $18,150 in 1986. The total financial wealth of families with IRA accounts was about $8,500 in 1982, assuming a median level of IRA assets of $2,000 in that year. Thus the increase between 1982 and 1986 was about $9,650, almost 114 percent. Recall again that these differences are based on a random sample of contributors in each year. In particular in both years, the median age of the respondents was 42.

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[5] The SIPP data allow estimation of the value of Social Security and pension plan benefits only after the payments are received. Thus wealth in these forms is only recorded for persons who have begun to receive the payments. Most persons have retired by age 65 and therefore are receiving the benefits to which they are entitled.

[6] The decline in Social Security and pension wealth with age is largely an artifact of declining life expectancy. The lower housing equity of older households is a cohort effect and does not reflect a reduction of housing equity as individual households age; in fact, housing equity increases on average as the elderly age, there is little change in housing equity even among families that move from one home to another.

[7] The data for 1980 through 1984 come from the CESs; and for 1985 through 1987 from SIPP. Financial asset saving includes all non-IRA saving accounts, money market accounts, U.S. government securities, certificates of deposit and savings bonds. The values for 1985 are available from both surveys and the estimates from the two surveys essentially match in that year. The same graph using non-IRA assets including stocks looks very similar to the figure as shown although IRA assets do not reach the level of non-IRA assets, just over $12,000 in 1987. The value of stocks is much more difficult than other financial assets to measure and the estimates tend to vary more from year to year. The 1985 SIPP estimate is about $2,000 less than the 1985 CES estimate. Nonetheless, the data suggest that the non-IRA financial assets of IRA contributors, including stocks, increased substantially between 1982 and 1987.

[8] The 1983 figure is based on the 1983 SCF. This estimate includes Keogh accounts and is thus likely to be an overestimate of the IRA median balance.

But persons 42 years old in 1986 who were making IRA contributions had much more financial asset wealth than similar persons who were 42 in 1982 and typically had at most one year of IRA contributions.

In contrast, while contributing families in 1986 had somewhat greater non-IRA assets than comparable contributing families in 1983—and much larger IRA balances—the non-IRA assets of households without IRA accounts changed little over the 1980 to 1986 period, as shown in figure 4.

It is also clear from these data that prior to the advent of IRAs, the typical IRA contributor was not saving close to $2,000 per year in other financial asset accounts. The median balance in these accounts was about $6,000 in 1983, based on CES data; it was $7,641 in 1985, based on SIPP data.

4. Change in IRA Contribution Status versus Change in Non-IRA Saving.

If IRA saving were simply taking the place of non-IRA saving, one might expect to see a fall in non-IRA saving when households who had not been contributing to an IRA account began to contribute. But that was not the case. Among households that were followed for two years in the SIPP, non-IRA saving fell only a small amount when the household switched from non-contributor to contributor status. Conversely, when households switched from making IRA contributions to non-contributor status, the switch was accompanied by only a small increase in non-IRA saving. Thus, when a typical IRA contribution of more than $2,000 began or was discontinued, the change in other forms of financial saving was not nearly that great. This is true even when income changes are controlled for.

B. MORE FORMAL ANALYSIS

Formal econometric analysis yields results that are consistent with the descriptive data. The analysis shows very little substitution between IRA and non-IRA saving. We find that without IRA accounts, the typical contributor would save 3 to 5 cents of a dollar increase in income. If there were no IRA limit, this same group would save more than 20 cents of a dollar increase in income. Thus there is a much greater preference for IRA than for non IRA saving and the net effect on saving is substantial, as the descriptive data suggest.

The formal analysis is based on a model that would admit complete substitution between IRA and other forms of financial asset saving. But that possibility is not consistent with the behavior of households as reported in the several data sets that we have analyzed. Similar results are obtained using methods of analysis that do not depend on any model restrictions. The model itself can be tested by comparing the model predictions with actual saving behavior before the advent of IRAs. The correspondence between the actual and the predicted behavior is very close. In particular, IRA saving does not show up as other saving before 1982 when IRAs were introduced on a broad basis.

In summary, both the descriptive data and our extensive formal analysis give almost no hint of substitution of IRA for non-IRA assets. In my view the data suggest a substantial net saving effect. Indeed, it seems to me that the rug was pulled out from under IRAs just as they were beginning to take hold.

C. WHY WERE IRAS SO POPULAR?

Economists tend to emphasize the narrowly defined economic advantages of tax deferred saving. The models generally treat tax-advantaged saving through IRAs as a subsidy to one single form of saving, and assume that IRA saving is treated by real people as a perfect substitute for other saving. Indeed some simple theoretical reasoning suggests that saving with IRAs might even be less than saving in their absence. For example, with tax-advantaged saving, a household could save less and still have as much accumulated wealth at retirement. I find that these assumptions are inconsistent with the data. In particular, people are clearly more inclined to save given the IRA incentive and they do not treat IRA and non-IRA saving as perfect substitutes, as interchangeable.

In fact, the widespread promotion of IRAs may have been the most important reason for their rapid adoption. The advertisement typically emphasized the avoidance of current taxes through IRA contributions, as well as the importance of prudent planning for retirement. They are available through almost any bank and through many other financial institutions. In addition, the promotion narrowly targeted IRA saving for retirement, which typically had been very small, as shown in figure 1. They are available through almost any bank and through many other financial institutions.

In addition, I believe that the up-front tax deduction is an important reason for the popularity of IRAs, it is what gets peoples' attention. Thus, in my judgment, an

"economically equivalent" back-loaded scheme would not be as effective in attracting saving. The experience with the personal equity plan (PEP) in the United Kingdom supports this belief. The U.K. plan is patterned after the U.S. IRA but contributions are made on an after-tax basis, with no taxes paid when funds are withdrawn. Financial institutions have found it difficult to attract contributions to the U.K. plan. On the other hand, a larger limit would attract more saving. Thus in my view there is a tradeoff between a backloaded plan with a higher limit and a plan with a lower limit but an up-front deduction. Which plan would lead to greater saving is not clear. But I feel confident that the up-front deduction would lead to more widespread saving.

D. LESSONS FROM CANADA

A program comparable to the IRA has existed in Canada since 1956. In the early 1970s the contribution limits were increased substantially and the program was widely publicized. The maximum individual limit was $3,500. New limits will be as high as $15,000. Although the program has been in existence much longer than in the U.S., and although the limits are based on income and for some are much higher than in the U.S., the relationship between desired contributions and income is virtually the same in the two countries, after accounting for the difference in the limits. Summers and Carroll show that after moving in tandem for almost 25 years, the private savings rates in the two countries diverged dramatically after 1975, following expansion of the RRSP program. Corporate savings in the two countries, they find, has shown no long-term trend since 1954. The increase in the Canadian private saving rate and the decrease in the U.S. rate resulted from changes in the behavior of individuals, not corporations. Whether the increase in Canada was due to the RRSP program can only be judged by the coincidence of the two events and by the apparent lack of other explanations.

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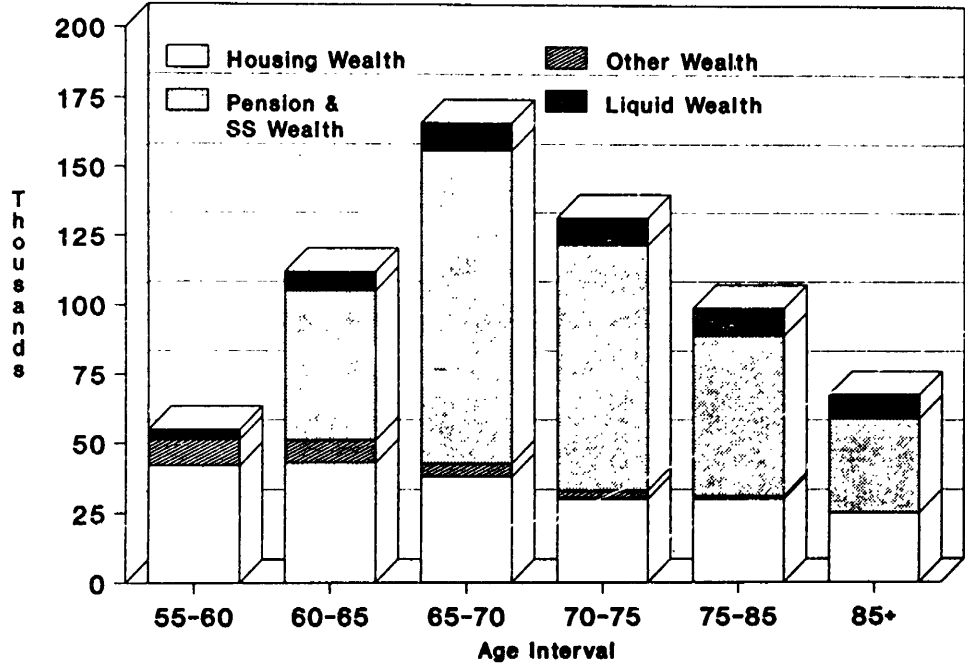Figure 1. Median Wealth by Age and Asset Category, All Households.

Figure 2. IRA vs Non-IRA Saving, 80-86
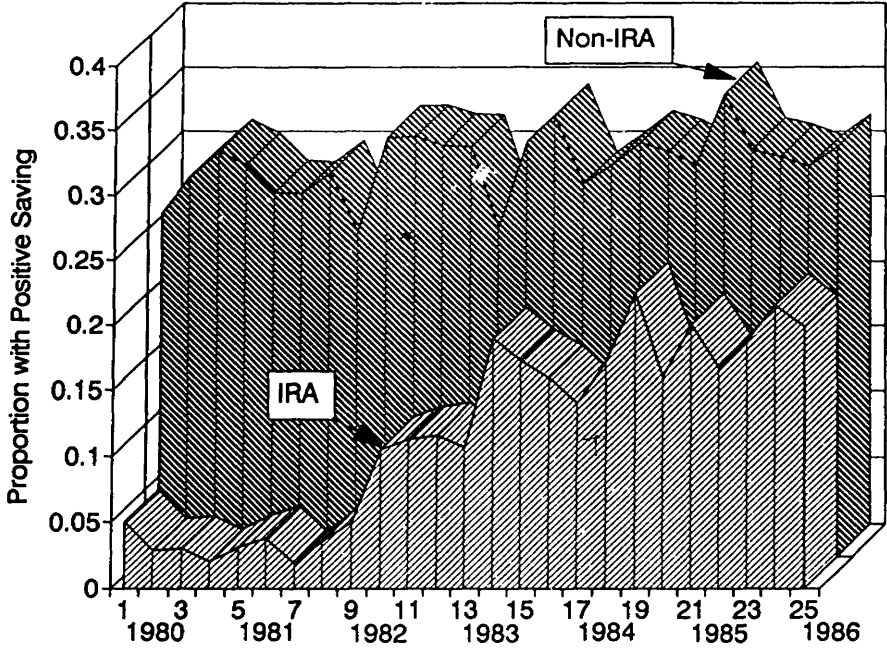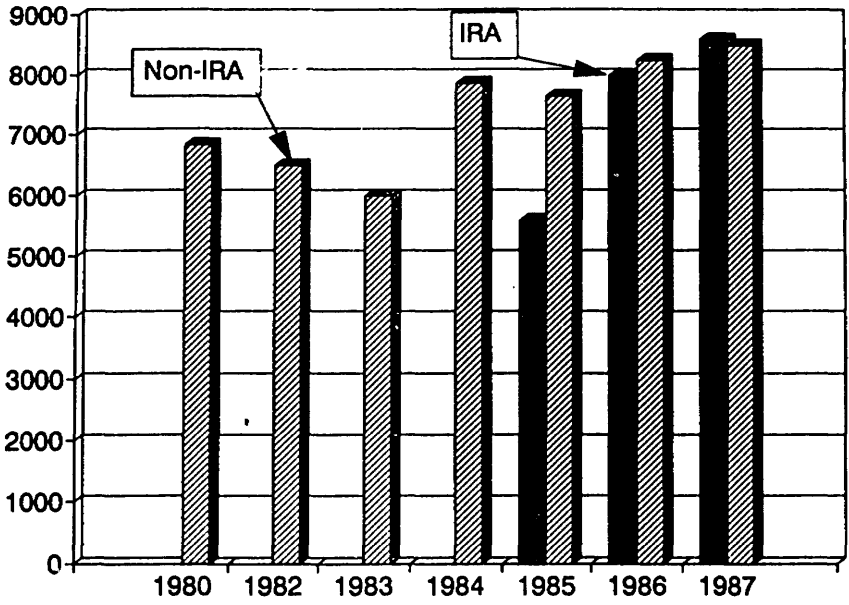
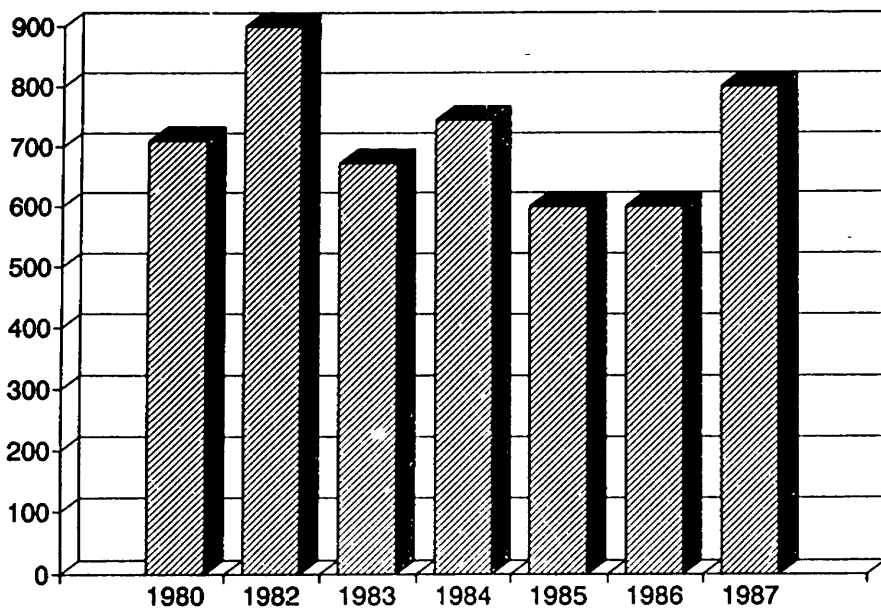Proportion Positive Saving, by Quarter

Figure 3. IRA vs Non-IRA Balances
Medians for Contributors, by Year

Figure 4. Non-IRA Balances
Medians for Non-Contributors, by Year

_ COMMUNICATIONS

STATEMENT OF THE AMERICAN ENTERPRISE INSTITUTE

Mr. Chairman, I am pleased to offer some views to this distinguished committee on America's low national saving rate and measures to increase it. Specifically, I would like to offer a few general comments on saving and then focus specifically on alternative approaches to individual retirement accounts.

The purpose of saving is to maintain and increase the growth of future consumption. More saving finances more capital accumulation and a larger stock of capital enables generation of a higher income steam. Viewed in this way, a high saving level is especially important for a country that wishes to increase the well-being of future generations.

It may not be too surprising that a wealthy nation like the United States displays less anxiety about the welfare of future generations than do poorer nations, nations less endowed with natural resources or nations not blessed with 200 years of history that saw every generation better off than its parents' generation. While it is true that other nations such as Japan and, until recently Germany, have a higher saving rate than the United States along with a level of wealth comparable to that of the United States, this is part of an inevitable catch-up phenomenon displayed by long term data on real income and wealth per capita. Furthermore, the tax codes of other industrial countries do not contain either the disincentives to save or the incentives to over-borrow for consumption purposes that are contained in the American tax code.

Measurement problems plague the comparison of national saving rates. However, the American tax code is heavily biased toward accumulation of real estate relative to tax codes of other countries. Measures of personal saving, such as the residual approach taken in the national income accounts do not take account of the accumulation of durable goods and housing that is part of the American approach to saving. A high level of tax concessions for the use of debt to accumulate housing and durable goods encourages Americans to do part of their saving in the form of a large stock of housing capital and durable goods capital. Such measurement problems account for part of the difference between America's national saving rate and the national saving rate of other industrial countries, but even adjusting for these factors America's saving rate, especially that of its households, is still low.

The low level of household saving has led to proposals for additional incentives for household saving. Among the most popular of these incentives are individual retirement accounts which operate to reduce the disincentives to save. However, it must be remembered that since these measures do not address incentives to over borrow, such as the full deductibility of mortgage interest expense and interest expense on second mortgages used to accumulate durables, individual retirement accounts cannot be expected to boost America's national saving rate to the measured rate of saving in other industrial countries. A program to accomplish that task would include a full panoply of measures designed to restore inter-temporal neutrality to the American tax code. These would include: full indexing of interest income and expense and taxing only real capital gains upon realization.

It appears that taken altogether these measures are not politically feasible and so the focus has been on more targeted individual retirement accounts.

COMPARISON OF ALTERNATIVE INDIVIDUAL RETIREMENT ACCOUNTS

It is useful to compare three alternative IRA plans: the pre-1986 plan, current law and the super-IRA proposal contained in the Bentsen-Roth bill. It is important to remember, in the context of a proliferation of saving incentive proposals, that whatever decision the Congress makes, it should do so with the intention of leaving saving provisions in the tax code untouched for a long period of time. Nothing is more damaging to fundamentally long-run saving and investment decisions than frequent changes in tax provisions affecting saving and investment.

In order to compare the three IRA proposals, it is necessary to make some standardizing assumptions. Naturally, the conclusions derived will be sensitive to those assumptions but I have attempted to adopt assumptions that will be applicable to as many taxpayers affected by these proposals as possible.

The comparisons assume a marginal income tax rate of 33%. The reasoning is as follows. The largest number of participants are in the 28 percent Federal tax bracket. In addition I assume state income taxes of 5 percent. The 33% marginal tax rate is also appropriate for married taxpayers in the $78,000 to $167,000 bracket without any state and local taxes. Pre-1986 IRA provisions allowed individuals to deduct up to $2,000 from taxable income as a contribution to the IRA account. Therefore, both the principal and the interest earned on the principal compounded tax free until the funds were withdrawn at which time they were taxable as ordinary income. Funds could not be withdrawn until age 59-1/2 without paying a substantial penalty.

After 1986, deductibility on the original contribution was disallowed for many taxpayers. The individual who had been putting $2,000 toward an IRA account would on an after-tax basis with a 33% tax bracket be able to contribute only $1340 per year unless income fell below the $25,000 and $40,000 income thresholds that are not indexed for inflation. The compound interest build-up remained tax-free and, upon withdrawal, non-deductible contributions would be exempt from tax but the cumulative interest build-up would be taxed as ordinary income.

The super IRA proposal is superior to the pre-1986 law in three ways. First, it indexes the allowable contribution to maintain its real value in the face of inflation. Second, it increases the allowable contribution to an after-tax $2,000. Finally, the super-IRA allows withdrawal without penalty after five years thereby eliminating the lockup effect for younger taxpayers contemplating contributions to existing IRA accounts with unpenalized accessibility to the funds 25 to 35 years in the future.

The Bentsen-Roth bill also allows penalty-free IRA withdrawals for first time home buyers, education expenses and financially devastating medical expenses. While these measures will likely increase the popularity of the super-IRA's they may greatly complicate administration of the IRA provisions and may be unnecessary in view of the relatively short 5-year time horizon after which tax-free withdrawals are available. Further, while it seems appealing to help first-time home buyers, outlays on education and to help deal with medical costs, it is not clear that increasing the demand for these services is as desirable as increasing their supply. Special provision only for first-time home buyers will be difficult to enforce and even if enforceable will push up the demand for housing and thereby the price. The primary reward will go to those who already own the homes that first-time home buyers will be seeking and therefore probably will be regressive. It seems unlikely that most households would be unable to plan five years in advance for education expenses and therefore the special early withdrawal provisions may be unnecessary. Medical expenses are financially devastating largely because the cost of medical services is rising twice as fast as the overall price level due, in some part, to the increase in demand for medical services coming from Federal programs. Again it is not clear that additional effective demand for medical services will accomplish the laudable goal of availing high quality medical care to more American households.

Table 1 compares the three IRA alternatives under the assumptions outlined above. Comparisons are undertaken for holding periods of five, fifteen and thirty years, assuming that under each plan assets earn a 10% rate of return.

Table 1.—VALUE OF ALTERNATIVE IRA PLANS *

[Current dollars; undiscounted]

	Plan								
	Pre 1986			Post 1986 Current Law			Super IRA		
	• Deductible contribution • No tax on accumulation • Full taxation upon withdrawal			• Nondeductible contribution • No tax on accumulation • Tax accumulation upon withdrawal			• Nondeductible contribution • No tax on accumulation • No tax upon withdrawal		
Years of participation.	5	15	30	5	15	30	5	15	30
Accumulation:....	$13,431	69,899	361,887	9,000	46,833	242,464	9,000	46,833	242,464
After tax accumulation:..........	9,000	46,833	242,464	8,241	38,011	175,717	9,000	46,833	242,464

* Assumptions
  1. Marginal tax rate 33% : 28% Federal, 5% state & local.
  2. Annual contribution $2000/yr or $1,340/yr for nondeductible contribution
  3. Rate of return on assets in IPA 10%
  4. Contributions made at beginning of eligible period

Several conclusions are immediately obvious from Table 1. Under the pre-1986 IRA, assuming that an individual contributed $2,000 a year for five years and then reached age 59-1/2 or older and withdrew the full amount and paid the tax, the un-discounted after tax value of the plan is $9,000. The after-tax value of plans in effect over 15 and 30 years is $46,833 and $242,464 respectively. The 59-1/2 year minimum age for withdrawal without penalty obviously means that more taxpayers would be forced to tie up their funds over a longer period of time under the pre-1986 plan.

After 1986 the after-tax, lump sum withdrawal value of a $2000 contribution is reduced by the fact that at a 33% tax rate the after-tax contribution falls to $1340 per year. The after-tax lump sum value falls to $8241 for the five-year period, $38,011 for the fifteen-year period and $175,717 for the thirty-year period. The value of the post 1986 law relative to pre 1986 law falls the longer the IRA account must accumulate until age 59½. This is because, upon withdrawal, only the buildup is taxable not the original contribution, But the share of the buildup in the total rises with time and so the after-tax value of a lump sum withdrawal falls as the share of buildup in the total benefit rises over time.

If alternatively under post-1986 law a taxpayer continues to make a full $2000 contribution to the IRA plan at an annual pre-tax cost of $2985, the full accumulation of $361,887 could be withdrawn tax-free after 30 years.

The super-IRA is identical to pre-1986 law based on an after tax lump sum withdrawal only if one ignores the five-year withdrawal option, indexing and the ability to contribute up to $2000 after-tax dollars. The five-year option means that more taxpayers can avoid the liquidity problem of accumulating a large portion of total saving in an account not accessible without penalty until age 59-1/2. The indexing provision protects the real value of the incentive against inflation and thereby helps taxpayers to plan without fear of the uncertainty implicit in changes in the level of inflation. For taxpayers not liquidity constrained, the indexed $2000 contribution allowable after tax will encourage maximum participation.

All three IRA proposals share two basic problems: the asset switching problem and the liquidity problem. The asset switching problem refers to the well-known phenomenon whereby, at least during the initial years of the program, most IRA participants are those with accumulated assets who merely shift part of such accumulated assets into IRA accounts. The absence of a marginal incentive to save means that asset switching results in no addition to national saving. IRA advocates have pointed out that over time the number of taxpayers with sufficient accumulated assets to engage in asset switching will fall and savers having acquired the "IRA habit" will begin to make IRA contributions not drawn from accumulated assets thereby adding to national saving.

The best way to deal with the asset switching problem is to design a saving incentive that operates at the margin. Indexing interest income would increase the after-tax incentive to save for every additional dollar saved. A further incentive indexing interest expense would reduce the disincentive to save implicit in the subsidy to borrowing that arises from full deductibility of interest expense.

Many analysts are skeptical of the effectiveness of marginal incentives to increase saving behavior because of the theoretical uncertainties associated with income and

substitution effects. While the empirical evidence on the responsiveness of personal saving to interest rates is mixed, some careful empirical analysis suggests that past estimates of the responsiveness of saving to interest rates have been biased against a finding in favor of such responsiveness. An article authored by myself and co-author Kenneth Couch on this subject is appended to my testimony.

The liquidity problem with IRA accounts is more speculative. It is, however, a real constraint for a 30-year old to take what may be the total of his/her liquid assets and place them in an IRA account that is not accessible without penalty until age 59½. Speaking more broadly, IRA accounts do not satisfy the precautionary motive for saving for younger individuals. Since American demographics suggests that when the first IRA plans were introduced baby boomers were in their early to mid-30's, it is little wonder that many individuals at the early stages of their earning life were reluctant to take most or all of their liquid assets and place them into IRA accounts that were in effect inaccessible for 30 years.

The Bentsen-Roth super-IRA proposal mitigates this problem by making funds available without penalty or additional tax after five years. This means that for baby boomers now centered in their late 30's and early 40's IRA plans become an attractive means to accumulate funds for education of children and/or medical expenses associated with aging parents. For younger taxpayers in their late 20's and early 30's the five-year window is far less daunting than the 30-year window that they would have faced under the original IRA proposal and under existing law.

SUMMARY

It is almost axiomatic that IRA plans induce some addition to personal saving since, despite their shortcomings, there will be some individuals who either go beyond asset switching or who are undaunted by the liquidity problem who add to saving in view of the effective rise in the after-tax return to saving implicit in IRA proposals.

The Bentsen-Roth super-IRA is superior to current law or original IRA programs by virtue of its inflation indexing, its superior liquidity provisions implicit in the five-year no penalty withdrawal option and the full $2000 of allowable after-tax contribution that will tend to use up accumulated assets more rapidly and thereby perhaps help to mitigate the switching problem.

Since it is costly both to the Congress and to taxpayers to tamper frequently with tax code provisions affecting the important areas of saving and investment, it might however be desirable to take the energy devoted to specific provisions such as IRA and move instead toward comprehensive intertemporal neutrality of the tax code. The model, already provided by the November 1984 Treasury Tax Plan includes indexing of interest income and expense, ending the double taxation of corporate dividends and full indexation of capital gains. Such measures taken altogether would increase saving investment and capital formation and thereby help to address the problems pointed to by those who decry our low national saving rate. Short of these comprehensive measures the Bentsen-Roth proposal is the next-best alternative.

SAVING, PENSION CONTRIBUTIONS, AND THE REAL INTEREST RATE

John H. Makin and Kenneth A. Couch*

Abstract—A test of the hypothesis that estimates of the interest elasticity of personal and private saving may be biased downward by a failure to control for behavior related to defined benefit pension programs fails to reject existence of a positive interest elasticity of private saving. Correcting for pension funding bias, the estimated interest elasticity of private saving is 0.04, well below Boskin's (1978) estimate of 0.4 obtained with a different data set and different estimation procedures. The estimated interest elasticity of personal saving is 0.28.

THIS paper tests the hypothesis that empirical estimates of the interest elasticity of personal and private saving may be biased downward by a failure to control for behavior related to defined benefit pension programs. Questions related to the level of the U.S. national saving rate, while important, are treated elsewhere. See Makin (1986) and Summers and Carroll (1987).

In one of the most widely cited studies of private saving, Boskin (1978) reported a substantial positive interest elasticity of private saving on the order of 0.4. Summers (1981) employed Boskin's results, along with a life-cycle model of aggregate saving behavior, to infer implied interest elasticities of U.S. saving, ranging from 0.74 to 3.71. Reacting to the Boskin and Summers estimates, Friend and Hasbrouck (1983) undertook an empirical study of private saving and reported that "there is little scientific justification for the recent literature purporting to show a positive interest elasticity of saving, so that government tax policies predicated on such saving behavior rest on a dubious foundation."

The interest elasticity of saving is a crucial variable in estimating the welfare gain associated with the elimination of capital income taxation or, equivalently, with the adoption of a consumption tax. More responsiveness to the price of future consumption (the inverse of the interest rate) translates into more saving, investment and output after a tax on consumption replaces the income tax. Summers' (1981) estimates of such welfare

gains are sensitive to the assumed interest elasticity of saving. Fullerton, Shoven and Whalley (1983) report that dynamic welfare gains obtained by replacing the personal income tax with a progressive consumption tax more than double when the assumed saving elasticity rises from 0 to 2.

Measurement of the interest elasticity of saving has become closely tied to the impact of changes in interest rates upon unfunded liabilities of defined benefit pension programs. Bernheim and Shoven (1985) have shown that defined benefit pension contracts are equivalent to a classic target saving case. Higher real returns on assets reduce unfunded liabilities of such plans, and thereby reduce contributions necessary to meet the funding target. A rise in real interest rates coupled with a rise in equity values and slower wage increases, such as occurred during the 1980s, have reduced sharply unfunded liabilities in defined benefit pension plans and also reduced contributions to those plans. The result is to couple a rise in real interest rates with a reduction in measured personal saving. Whether or not the pension funding effect upon personal saving is offset elsewhere on a full national balance sheet remains an empirical question that will be investigated further in this study.

Significant problems remain related to the measurement of saving described by Blades and Sturm (1982), Boskin and Roberts (1986), and others. Uncertainty about the theoretical sign of the interest elasticity of saving discussed by Van Wijnbergen (1983), Starrett (1986), and Gupta (1987) adds to the difficulty by denying investigators a refutable hypothesis with which to confront the data. The use of time series data to investigate saving behavior is complicated: under the life-cycle hypothesis aggregate saving rates ought to vary over time due to demographic changes.

In spite of these difficulties and in view of the implied bias on the measured interest elasticity resulting from pension contributions, it is useful to reexamine aggregate saving behavior while attempting to control for the pension contribution phenomenon.

TABLE 1.— PERSONAL SAVINGS

	Full Sample			First subperiod		Second Subperiod	
	With Dummy	Without Dummy	With Full Period Dummy	Without Dummy	With Full Period Dummy	With Dummy	Without Dummy
Sample Range	1953.2–1985.4			1953.2–1979.4		1980.1–1985.4	
Equation No	1 1	1 2(1)	1 3	1 4	1 5	1 6	1 7
Permanent Income/ Wealth	0 12	0 40	0.42	0 12	0 46	0 10	–0 19
t-Statistic	5 92	5 04	4.97	4 38	5 12	1 57	–3 03
Transitory Income	0 45	0 58	0 60	0 45	0 64	0 54	0 03
t-Statistic	9 88	10 60	10 30	9 37	10 36	3 52	0 17
Monotonically Increasing Dummy	–19 45	—	–17 40	—	–16.19	–19 95	—
t-Statistic	–4 59	—	–3.07	—	3.75	–5 65	—
Real Interest/ XANFIT	7 67	5.15	5.55	6 10	–2 13	37.30	16 60
t-Statistic	1 21	0.86	0.91	0.74	–0.26	4 07	1.24
Constant	–374 71	–14.35	–1679.00	–360.07	–2037.25	–354 48	2479 60
t-Statistic	–2.32	–2.80	–3.45	–1.67	–4.46	–0 55	3 89
AR*	0.81	—	0.95	0.87	0 88	—	—
t-Statistic	14.51	—	23.69	15.24	16.91	—	—
SAR*	—	—	—	—	–0.23	—	—
t-Statistic	—	—	—	—	–2.16	—	—
Span	—	—	—	—	9	—	—
Adjusted R^2	0.89	0 49	0.89	0.91	0.93	0.72	0.28
See	49 13	48.92	48.24	45.43	42 38	56 75	90 60
F	206.90	41 75	215.60	270 90	211 80	15 71	4 04
Q12	11 69	8 81	9 46	15 08	5 24	10 09	21 73
P	0 39	0 72	0 58	0 18	0 87	0 61	0 04

I.   The Model

The model estimated is given by

$$S_t = a_o + a_1 YP_t + a_2 YT + a_3 r_t - a_4 p/e + e_t$$
$$a_i (i = 0 \ldots 4) > 0 \quad (1)$$

where t is time. S is real per capita private or personal saving (see discussion below). YP is permanent per capita real income YT is transitory per capita real income, r is the expected real interest rate. p/e is the pension funding effect described by Bernheim and Shoven (1985), and e_t

is an error term. Full details on these variables are provided below in the footnote to table 1.

The theory of saving underlying this model is based upon analysis of the intertemporal allocation of consumption by utility-maximizing consumers pioneered by Fisher (1907), Ramsey (1928), and Hicks (1939). Households or firms spend or save out of current income based on a desire to maintain a smooth path of consumption relative to some long-run notion of its ability to support a given level of consumption. The separation of

consumption and current income was articulated in a life-cycle context by Ando and Modigliani (1963). The relation of consumption to an underlying notion of wealth was developed by Friedman (1957) whose permanent income hypothesis represented an attempt empirically to implement a measure of wealth based on an exponentially declining weighted average of past measures of income.

The hypothetical signs of the coefficients are straightforward. Higher permanent income and higher transitory income increase saving. A higher expected real interest rate will raise saving provided that substitution effects outweigh wealth/income effects. The pension funding effect will depress measured personal saving. It will also depress measured private saving provided that all of the change in pension funding does not go into retained earnings. (See discussion below.) Finally, the omission of *pfe* from equation (1) ought to bias downward the estimated interest rate coefficient, a_3. (See discussion below.)

II. Measurement

Estimation of a saving equation like (1) amounts to testing a joint hypothesis. The final equation is estimated conditional on hypotheses concerning measurement of permanent income or wealth, transitory income and the real rate of interest faced by savers. All are unobservable variables. More obvious but just as important is the maintained hypothesis that saving itself is being properly measured.

Personal saving (the residual NIPA measure) and private saving (personal saving plus retained earnings with inventory valuation and capital consumption adjustment) each measured in real per capita terms, are employed as dependent variables in this study. Primary focus is upon personal saving that ought to be sensitive to the pension funding effect. If all of the reduction of required pension funding when interest rates rise goes into corporate retained earnings, the overall effect on private saving—the sum of personal saving and retained earnings—ought to be zero. If, however, some of the reduced pension contribution is employed to finance investment or dividends, the net effect on private saving will be negative.[1] Therefore, the estimated interest rate coefficient on pri-

vate saving may also be biased downward. Still, the estimated interest rate coefficient in the private saving equation ought to be smaller than the same coefficient in the personal saving equation since the pension funding effect on corporate saving will be zero or negative.

The scalar in our saving equation is a measure of permanent income derived from a time series model of NIPA disposable personal income.[2] As it turns out, disposable personal income is a random walk with drift and so our measure of permanent income is simply lagged measured income with a constant added.[3] This finding, consistent with the finding by Nelson and Plosser (1980) that most economic aggregates are difference stationary processes, suggests that the long distributed lags employed to measure permanent income by Friedman (1957) and Friend and Hasbrouck (1983) included many redundant lagged values of income on the right hand side of their equations. It is consoling to note that our simple flow proxy for wealth is highly correlated ($\rho = 0.96$) with the FOF measures of household net worth. Another bonus from the time series modeling approach to measurement of a flow proxy for wealth is that the white noise residuals serve as a measure of purely random deviations from permanent income.

The interest rate has attracted the most attention among the variables employed to explain saving. A higher real interest rate lowers the rela-

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[1] The use by firms of reduced pension funding contributions when interest rates rise to finance more investment may be prudent. Pension funding formulae are set as if changes in asset values or interest rates are permanent. If such changes are reversed, a firm may be well advised to have accumulated additional real capital to yield higher future earnings with which to satisfy possible higher future pension claims.

[2] National income would be a more appropriate scalar for private saving, but since it is almost perfectly correlated ($\rho = 0.99$) with disposable personal income the latter is used to estimate permanent income in both saving equations.

[3] Specifically for the full sample (1953 2-1985.4):

$$Y_t^p = 35\,121 + Y_{t-1} + E_t.$$
$$(5\,15)$$

For the first subperiod (1953.2-1979.4),

$$Y_t^p = 34\,033 + Y_{t-1} + E_t.$$
$$(4\,83)$$

For the second subperiod (1980 1-1985 4), an AR(1) process provided the best fit:

$$Y_t^p = 690.93 + 0.93237 \cdot Y_{t-1} + E_t$$
$$(3.65) \quad (51.81)$$

tive price of future goods embodied in the durable real or financial assets acquired by the saver. Therefore, the substitution effect is positive.

The wealth effect is ambiguous since a change in the interest rate may transfer wealth between populations with different saving propensities. Prospective net borrowers (the young) experience a loss in wealth when interest rates rise, while prospective net lenders (the old) experience a wealth gain. The net effect on measured saving depends on how numerous and how wealthy (the weights in aggregate saving) the members of each group are and what their saving behavior is. If prospective net borrowers, who experience a wealth loss as interest rates rise, dominate—as they will in an open debtor economy like the United States since 1986—the net wealth effect on saving is negative.[4] In such a case the net impact upon saving of a rise in interest rates is ambiguous, since the positive substitution effect and the negative wealth effect operate in opposite directions.

Pension funds comprise the largest group of prospective net lenders in the United States. Yet pension funds act like target savers and as such respond to higher interest rates as would prospective net borrowers. The unfunded liabilities of defined benefit pensions are calculated as the present value of the fund's obligations less assets in the fund. The present value of obligations is calculated as a stream of annuities, dependent on growth of wages, turnover and other factors, discounted at an assumed interest rate. As market interest rates rise, a higher return on assets enables defined benefit pension plans to meet target funding levels with lower contributions. Effectively, future obligations can be discounted at a higher rate. Therefore corporate pension contributions, a large portion of personal saving, can be reduced.

This view of pension funding suggests that if it is ignored, the estimated response of personal and, possibly, of private saving to interest rates will be biased downward and may be negative. In order to estimate properly the unconstrained coefficient measuring the responsiveness of saving to interest that is relevant to measuring gains from the shift to a consumption-based tax, it is necessary to control for the target saving behavior of pension funds.

As a measure of what shall be termed the "pension funding effect" (*pfe*), we employ a simple monotonically increasing dummy variable beginning in January of 1980, the period that according to Berheim and Shoven (1985) coincides with emergence of a rising share of Fortune 500 companies whose assets equal or exceed accrued, vested pension benefits. As that share rises, the share of companies whose pension funds are at or above funding targets rises and therefore contributions, a large share of personal saving, fall. If the *pfe* is positively correlated with interest rates, as it is in our sample, the coefficient on the interest rate in a saving equation is negatively biased.

The expected real interest rate is estimated as the nominal yield on U.S. Treasury securities at a constant maturity of one year less the 12-month inflation forecast from the Livingston Survey data on inflationary expectations.[5,6] An attempt to adjust the expected real interest rate for taxes was unsuccessful. Quarterly time series data on effective marginal tax rates on interest income are unavailable. It is consoling to note that annual 1955–82 estimates of such tax rates suggest that they are relatively stable over the 1953–85 sample period.[7]

III. Estimation

This section presents results of estimating equations describing real per capita U.S. personal and private saving. Equations are estimated using quarterly data drawn from the sample period running from 1953.2–1985.4. The sample includes the period after 1982 during which the rate of personal saving, about 40% of private saving, fell sharply.

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[4] See further discussion in Makin (1986).

[5] The Livingston survey is conducted twice a year in April and October. Average one-year nominal rates in the second and fourth quarters are aligned with the April and October inflationary expectations. First and third quarter real rates are estimated by linear interpolation.
There is no unambiguously superior measure of inflationary expectations. However, tests of the Livingston survey data for consistency with rationality reveal no strong presumption that it constitutes a biased measure of in-sample inflation expectations. See Pearce (1979). Also, see Zarnowitz and Lambros (1987) for a thorough discussion of the relationship between Livingston survey data and other inflation forecasts.

[6] Gupta's (1987) approach employing separate terms for expected inflation and the nominal interest was not employed since our main objective is to test for the impact of the pension funding effect upon the real interest elasticity of saving.

[7] See Tanzi (1980).

The model underlying the estimated personal and private saving equations is given by equation (1). The saving equation includes a wealth term and a transitory income term, both positively related to saving. Additional explanatory variables include a real interest rate and a measure of pension overfunding, pfe, described above. An instrumental ex ante real interest rate is estimated employing a univariate time series model. Separate equations for the instrumental interest rate $XANFIT$ were estimated for each sample period.[1]

The results of stage two estimates of personal saving equations employing the $XANFIT$ interest rate are presented in table 1. The personal saving equations are estimated over three sample periods. The full sample, 1953.2–1985.4, the first subperiod, 1953.2–1979.4, and the second subperiod, 1980.1–1985.4. The first subperiod excludes the period over which the pension funding effect is identified in the data employed by Bernheim and Shoven (1985). Also, it is comparable to the 1952–80 sample period employed by Friend and Hasbrouck (1983) to investigate private saving behavior. The second subperiod coincides with the period over which the pension funding effect should operate.

A Chow test was performed to test the hypothesis that observations in the second subperiod came from the same relationship as the first subperiod with the pension funding effect omitted from both periods. The resulting $F = 16.60 > [F_{4,123}^{01} = 3.47]$ indicated decisive rejection of the hypothesis for personal saving. (The same hypothesis was rejected for private saving ($F = 10.4$).

For the estimated equations, the wealth and transitory income terms are significant with anticipated positive signs. The only exception is the second subperiod equation omitting the pension funding effect, a purposely mis-specified equation.

The most interesting results emerge from comparison of the second subperiod equations estimated with and without the pension funding variable. (See equations (1.6) and (1.7). Without the pension funding variable, the overall fit is poor with an insignificant coefficient on the interest rate and wrong or insignificant signs on wealth and transitory income variables. Addition of the pen-

sion funding variable greatly improves the fit. Coefficients on wealth and transitory income terms become significant and take on the right signs. The interest rate term becomes positive and highly significant while the pension funding term carries the anticipated negative sign. The implied elasticity of saving with respect to expected real interest is 0.28.

The results for the full sample (equations (1.1) and (1.2)) are not so sensitive to inclusion of the pension funding effect as are results for the second subperiod. The pension funding effect operates much the same in both periods but the estimated interest rate effect is smaller (implied elasticity $= 0.04$) and only marginally significant. For the first subperiod (equation (1.4)) during which the pension funding effect is inoperative, the interest rate term is not significantly different from zero.

Taken altogether, the personal saving results suggest that during the 1953–79 subperiod either offsetting wealth effects accompanied changes in real interest rates or other exogenous factors affected personal saving. A monotonically increasing dummy variable starting in 1953.2 for both the 1953–79 subperiod and the full sample (equation (1.3) and (1.5)) is significant with a negative sign, but fails to yield a significant interest rate term. The monomtonically increasing dummy variable starting in 1980.1 appears to control better for negative wealth effects than does a monotonically increasing dummy variable starting in 1953.2.

The second subperiod results may reflect consistently negative wealth effects, captured by the pension funding dummy variable that operated more uniformly during the 1980s than during the 1953–79 period. The steady post-1980 rise in the United States' external indebtedness (from $+\$141$ billion in 1981 to $-\$112$ billion in 1985) and the baby boom-generated rise in the share of the prospective-net-borrower population aged 22–39 (from 28.3% in 1980 to 30.4% in 1985) both indicate enhanced negative wealth effects associated with a rise in real interest rates. Neither phenomenon operated consistently during the 1953–79 sample period.

Private saving equations estimated over the full period and the first subperiod, close to the Friend and Hasbrouck 1952–80 sample, yield conclusions similar to their results concerning the interest sensitivity of private saving. (See table 2.) During the full sample period with the pension funding

[1] The results for the sample periods discussed below were various ARMA models. For each, Box Pierce-Ljung Q-statistics for 12 autocorrelations indicated purely random residuals.

TABLE 2. — PRIVATE SAVINGS

	Full Sample		First Subperiod	Second Subperiod	
	With Dummy	Without Dummy	Without Dummy	With Dummy	Without Dummy
Sample Range	1953.2–1985.4		1953.2–1979 4	1980.1–1985 4	
Equation No.	2.1	2.2	2 3	2.4	2.5
Permanent Income/ Wealth	0.24	0 20	0 24	0 32	0 12
t-Statistic	18.71	11.19	14 47	5 26	1 74
Transitory Income	0.52	0 49	0.57	0.73	0 24
t-Statistic	10.30	9.84	10.21	4 01	1.14
Monotonically Increasing Dummy	−12.63	—	—	−14 84	—
t-Statistic	−4 03	—	—	−4 03	—
Real Interest/ XANFIT	0.01	−4.18	−0.91	14.31	−2.83
t-Statistic	.00	−0.58	−0.10	1.13	−0.14
Constant	−363.85	−116.55	−358.27	−1211.89	659.29
t-Statistic	−3.54	−0.77	−2.73	−2 00	0 88
AR(1)	0.74	0.85	0 75	—	—
t-Statistic	11.51	15.19	10.90	—	—
SAR(1)	—	—	—	−0 60	−0 65
t-Statistic	—	—	—	−1.98	−1.76
Span	—	—	—	4	4
SMA(1)	0.23	0.23	—	—	—
t-Statistic	2.43	2.40	—	—	—
Span	4	4	—	—	—
Adjusted R^2	0 97	0.97	0 97	0.73	0 41
SEE	54.55	57 06	51 89	58 13	85 27
F	730.40	798 80	895 60	10.40	3.92
Q12	13.36	16.76	18.15	14.57	32.20
P	0.20	0 08	0 08	0 20	0 00

dummy variable in place from 1980.1–1985.4, although the dummy captures a significant negative pressure on private saving during that period, the estimated coefficient on the interest rate term *XANFIT* is almost zero.

Addition of the pension funding effect to a private saving equation for the 1980.1–1985.4 subperiod improves the fit. The pension funding effect is highly significant with a negative sign. The interest rate term is positive but only marginally significant ($t = 1.13$). The implied elasticity is 0.04, considerably below the elasticity of 0.28 in the personal saving equation. These values are consistent with the hypothesis that the business portion of private saving is unaffected by the pension funding effect so that the impact, concentrated on personal saving is muted in a private saving aggregate that includes personal saving.

The private saving results, taken in conjunction with personal saving results, suggest that the pension funding effect together with negative wealth

affects tied to higher real interest rates may have depressed personal and private saving during the 1980s. The implied bias on the estimated sensitivity of saving to real interest is more pronounced in the personal saving equation, although inclusion of the pension funding effect in the private saving equation during the 1980s does result in estimation of a marginally significant ($t = 1.13$) positive interest rate term.

IV. Summary and Conclusions

This study finds that target saving behavior implied by funding formulae for defined benefit pension plans, as described by Bernheim and Shoven (1985), biases downward the estimated interest elasticity of personal and, possibly, of private saving. Such bias is especially likely to be present in post-1980 sample periods, since it is during that period that higher real interest rates have been associated with large reductions in re-

quired contributions to defined benefit pensions.

Correcting for the pension-funding bias, the implied interest elasticity of private saving is found to be 0.04, well below Boskin's (1978) estimate of 0.4 obtained with a different data set and different estimation procedures. The implied interest elasticity of personal saving is 0.28. Still, the finding of a low (0.04) marginally significant interest elasticity of private saving suggests a need for further investigation of the claim by Friend and Hasbrouck (1983) that there exists little scientific support for the positive interest elasticity of private saving.

The results reported here, while suggestive, are not conclusive. Failure to reject the hypothesis that some monotonically increasing variable has over a 1980–85 sample period depressed personal/private saving does not prove the pension funding hypothesis.

Two other events during this sample period may have operated to depress saving through negative wealth effects that were in turn directly linked to sharply higher real interest rates since 1980. The United States' net external indebtedness has risen steadily since 1980. So too has the share of the population aged 22–39 likely to be prospective net debtors and thereby subject to negative wealth effects given a sharp rise in real interest rates. Efforts to link these factors to lower saving rates have so far proved inconclusive but further investigation is deemed worthwhile.

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May 14, 1991

Mr. Wayne Hosier
U.S. Senate, Committee on Finance
Washington, D. C. 20510

Dear Mr. Hosier:

I am writing in regards to the bearing on super IRA bill (S.612) held
on May 16, 1991. The measure should be passed no matter what the cost.
Economically and historically it makes sense. When the Reagan IRA
proposal was enacted in 1982, the country began the boom of the 1980's.
When this was reversed by IRA of 1986 the country began it's dive into the
current recession. Why did this occur? Capital, the source for
investments and lending began to dry up.

This proposal will provide needed capital in the private sector which
will do the following:

- Foster lending and new projects.
- Create jobs that will bring in tax revenue (put people back to
  work).
- bailout banks and S & L's (less federal money needed for
  bailouts).
- Foster savings by the young people.
- Assist people with home purchase , education and medical expenses
  that will translate into federal, state and loca' tax revenues.
- Provide a long term solution to economic fluctuations.
- Enable our companies to compete,

By allowing the public to save for life on a deferred basis, we will
also decrease the reliance on government provided support for basic
needs. We must also regulate and monitor the financial to ensure the
future.
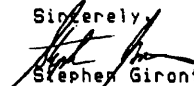
The government spends too much time worrying about short term
situations. IRA's provide a long term solution for many of our economic
ills. None of the genius economists can accurately predict the rebound of
the economy but one thing is fairly certain, the economy will turn around
as more capital becomes available.

Another important point is the fact that this country provides next to
no incentive for people to save money. In summary, this proposal, if
passed, can benefit:

- **Government**
- **Businesses**
- **Citizens**

What more could you ask for?

Sincerely

Stephen Gironta
9-0 Brookside Heights
Wanaque, N. J. 07465

SG:mca

STATEMENT OF THE CHICAGO TAX COUNCIL FOR RATIONAL ADMINISTRATIVE POLICIES

EMPLOYEE BENEFITS TAX SIMPLIFICATION PROPOSAL

Certain qualified retirement plan rules and welfare plan rules have become overly complex. The benefit to plan sponsors of plans subject to such overregulation often no longer outweighs the administrative, compliance and litigation costs of maintaining such plans, when the alternatives are considered.

Entire industries have sprung up to assist plan sponsors in testing for discrimination, top-heaviness and combined benefit limitations and to counsel plan sponsors and participants regarding alternative tax treatments and myriad other complex rules. Costs to plan sponsors have become burdensome and such monies should be better spent on the productive expansion of the businesses involved rather than in the unproductive payment of fees to lawyers, accountants, consultants and record-keepers and in ever expanding plan administrative staff (which unproductive expenses lessen the competitiveness of domestic employers in the world marketplace).

It is axiomatic to state that the only monies (benefits) that may be paid out of a plan are the gross expenditures by the sponsor for the plan, plus net investment earnings thereon, minus plan maintenance costs. The costs of delivering a dollar of benefits have simply become too high.

It is respectfully suggested that the 401(a) (4) and 401(l) nondiscrimination and integration rules, the 401(a) (17) maximum compensation limitation, the 401(a) (26) and 410(b) participant coverage rules, the 411 five-year cliff vesting or three to seven year vesting rules, the 41S plan benefit and contribution limitations, the 412 funding rules and the 404 deduction limitations are sufficient to reasonably prevent perceived discriminatory abuses, and that other complex rules may be eliminated.

Accordingly, the following changes are proposed for consideration:

I. The following code sections and provisions would be repealed:

1. Section 401(k) would be repealed, eliminating all salary reduction arrangements under qualified retirement plans and the nondiscrimination testing associated therewith. Existing salary reductions would automatically become after-tax contributions (subject to the old 6% of pay/10% of pay safe harbors and the 415 contribution limitations).

2. Section 401(m) would be repealed, eliminating the employee contribution and matching contribution nondiscrimination tests.

3. Section 415(e) would be repealed, eliminated the combined plan benefit limits.

4. Section 416 would be repealed, eliminating the top-heavy rules.

5. The special taxation rules regarding distributions of net unrealized appreciation would be repealed, with net unrealized appreciation taxable unless rolled over to another qualified plan or IRA.

6. The special five-year averaging distribution rules would be repealed.

7. Section 125 would be repealed, eliminating flexible spending accounts and other cafeteria plans and nondiscrimination requirements and salary reductions related thereto. Existing salary reductions would automatically become taxable deductions.

II. The following compensating changes believed to be more fair and efficient would be enacted:

1. The IRA contribution limit would be increased to the lesser of $4,000 (subject to annual cost of living adjustments) or 100% of compensation, with the deduction being available only if an individual's compensation does not exceed the wage base.

2. The 415 annual addition limitation under a target benefit money purchase pension plan would be the lesser of $30,000 (subject to the current law cost-of-living adjustments) or 25% of compensation for employees under age 50, and $60,000 (subject to cost-of-living adjustments) or 100% of compensation for employees aged 50 or older; provided that the enhanced limit for older employees would only be available under a plan which determined contributions on the basis of PBGC factors and assumptions for defined benefit plans that terminate either at the beginning or end of that year.

The foregoing would facilitate the accumulation of more meaningful retirement savings for non-highly compensated employees and certain older employees and also would allow plan sponsors to return to the provision of retirement and welfare benefits through traditional and simple plans that have worked well historically, with-

out the current maze of conflicting overregulation and the unreasonable administrative costs thereof.

In addition, it is believed that the recommended changes would:

A. Foster the growth of traditional retirement plans and retirement savings through the creation of a more receptive legal environment by reducing administrative complexity and uncertainty.

B. Preserve the fair treatment of non-highly compensated employees provided by the 401(a) (4), 401(a) (17), 401(a) (26), 401(l), 410 and 411 rules which we believe are fully sufficient to enforce fair and nondiscriminatory treatment in qualified plans.

C. Preserve adequate limitations on benefits for highly compensated employees through the nondiscrimination rules in B above and the excess accumulation and excess distribution excise taxes, early distribution penalties, required minimum distributions, 415 separate plan limits, 412 reasonable funding requirements and 404 deduction limitations.

D. Stop the transfers of benefit funding responsibility from employers to employees occurring through employer utilization of salary reductions under 125 and 401(k), which provisions can fairly be categorized as failed experiments gone awry.

E. Recognize both the relative unattractiveness to a plan sponsor of defined benefit plans (resulting from the legislative changes during the past 16 years) and the inherent limitations in the ability of defined contribution plans to provide adequate benefits for non-highly compensated older workers, by enhancing the ability of target benefit money purchase pension plans to deliver adequate retirement benefits to older workers.

It is hoped that the above would tend toward a positive revenue impact, especially if studies take into account the enhanced net income of each plan sponsor due to reduced administrative expenses in maintaining plans.

Credit Union National Association, Inc.

805 15th Street, NW, Suite 300, Washington, DC 20005-2207, 682-4200

Charles O. Zuver
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Governmental Affairs Division
Home Phone: (703) 768-1155

May 28, 1991

The Honorable Lloyd Bentsen
Chairman, Committee on Finance
United States Senate
703 Senate Hart Office Building
Washington, D.C.   20510

RE: S. 612, "Savings and
Investment Incentive Act
of 1991"

Dear Mr. Chairman:

The Credit Union National Association and Affiliates (CUNA) takes this
opportunity to write in support of your efforts and those of Senator Roth to
re-instate individual retirement accounts for all of working America. We are
pleased to see that about three-fourths of your colleagues have co-sponsored
your bill. We request that our letter be included as part of the hearing
record on S. 612.

CUNA represents 90% of the nation's 14,500 credit unions through 50 state
credit union leagues and leagues in the District of Columbia and Puerto Rico.
About half of these credit unions offer IRA accounts to their members, and IRA
deposits constitute about 15% of the total savings currently held by credit
unions.

CUNA agrees with your observations that individual retirement accounts help to
stimulate long term savings that can be used to provide both capital for our
nation's growth and financial security for individuals' retirement years. The
expansion of the IRA concept to all workers in the early 1980's was a valuable
savings incentive program that unfortunately was so successful its revenue
impact made it an obvious target during the tax reform in 1986.

Under the terms of your bill, an individual -- regardless of income level or
participation in a company pension plan -- could contribute $2,000 a year
either to a traditional IRA, where the federal income tax deduction would be
taken in the year of contribution, or to a new type of special IRA, where
earnings on contributions held for longer than five years would be exempt from
tax. The $2,000 contribution limit would be indexed, another positive element
of your bill.

Page 2
May 28, 1991

We can see merits in having both income tax approaches, but we believe that taxpayers might shy away from the "back-ended" IRA because of concerns that Congress might change the rules of the game at some point. The individual who chooses to wait and receive the tax benefits 5+ years down the road may never benefit if it were decided to once again eliminate the IRA program or to re-instate an income test.

We believe that it is important that a renewed IRA program eliminate the income limitations that have existed in the law since 1986. As Federal Reserve Board Chairman Greenspan noted during the hearings last week, an important purpose of the program is to raise capital, Congress should not be overly concerned about the impact on various income groups. Moreover, as Senator Roth observed, does it make sense to encourage a long-term course of savings by the current IRA program, but eliminate the incentive as a person progresses through the ranks and reaches a certain income level (and is in a better position to save). In addition, as you observed about the farmer, in the year with a good crop he is in a position to actually set something aside for his retirement, but may be precluded from doing so.

Your proposed IRA program integrates the "super IRA" concept to allow with-drawals without penalty for purchase of a first home, higher education expenses, and extraordinary medical expenses. Clearly, these features will enhance the attractiveness of the IRA savings incentives, since people have a reluctance of planning for their retirement years if they first, for instance, needs to address the issue of savings for their children's college education. We also applaud your efforts to allow similar withdrawals from 401(k) and 403(b) plans.

We listened with great interest last week to the panel of witnesses debate the issue of whether the broad-based IRAs of the mid-1980's created new savings or merely reflected a switch from one type of savings into IRA savings vehicles. There is obviously not a definitive answer to the question, but we believe the broad IRA program contributed positively to the mentality of savings in this country. Why? The telling point was made both by witnesses and some members of your committee that financial institutions extensively marketed the IRA concept from 1982 to 1986. This was a savings/planning program sanctioned by the federal government and people were encouraged by television, radio and newspaper advertisements to participate. The current eligibility rules for deductible contributions limit the effectiveness of widespread advertisement.

We recognize that there is a large price tag attached to reviving a national savings program such as proposed in S. 612. The Joint Committee on Taxation estimates that this new p.ogram will cost between $4 billion and $7 billion a year. Unlike other large expenditures that are considered annually by Congress, we think that the "super IRA" will be shown to have some very positive benefits to our country both in capital formation and in retirement planning in the years ahead. We recognize your commitment and the support of many co-sponsors to your bill is premised on developing options to cover the costs without adding to the federal deficit. We know that will be a chal-lenge, but certainly one worth undertaking to the benefit of all of working America.

CUNA appreciates having the opportunity to submit this letter for inclusion in the committee's hearing record.

Sincerely,

Charles O. Zuver

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Behavioral and Economic Factors Linked to IRA Contributions:
Evidence from Tax Retu.n Data

ABSTRACT

This research constructs cross-sectional and first difference econometric
models using the Individual Tax Model Files and the panel of individual returns
from the Ernst and Young Tax Research Data Base. In addition to the typical
price and income effects these models test the applicability of prospect theory
relative to expected utility theory in explaining taxpayer decision-making
behavior. Prospect theory purports reference point effects to influence
taxpayer choice behavior while expected utility theory considers reference point
effects to be irrelevant in the normative sense. This study examines reference
points identified using rational expectations and current cash concepts. These
models also investigate the relationship between savings in the form of
individual retirement account (IRA) participation and consumption behavior.
This is an important policy issue because a reduction in consumption must be
observed in tandem with increases in IRA participation to show the formation of
new savings. IRAs have even been alleged to increase consumption because the
tax advantages enable investment goals to be met with lower levels of savings.
The findings indicate that prospect theory does make a modest contribution in
explaining taxpayer decision-making behavior. Allegations that IRA
contributions are merely recycled prior savings were not supported. Also, no
linkage was established between IRA participation and consumption behavior.

**Behavioral and Economic Factors Linked to IRA Contributions:
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Introduction

Prior studies of taxation and individual retirement account (IRA)
participation have focused on traditional economic analysis whereby IRA
contributions are explained in terms of price (1- the marginal tax rate) and
income elasticities while controlling for salient demographic variables; see for
example, O'Neil and Thompson (1987). Such models are grounded in expected
utility theory as derived by von Neumann and Morgenstern (1944). Expected
utility theory whereby individuals code outcomes as final states of wealth is a
major paradigm in studies of decision-making behavior. However, studies have
shown that the behavior of individuals is inconsistent with the tenets of
expected utility theory (Lichtenstein and Slovic, 1971). Prospect theory
developed by Kahneman and Tversky (1979) is an alternative to describe
individual choice behavior. Prospect theory conflicts with expected utility
theory in that individuals are purported to code outcomes as gains and losses,
as opposed to final states of wealth.

According to prospect theory, gain or loss reference points influence
decision-making behavior. In contrast, reference points are irrelevant to
expected utility theory. The first objective of this research is to construct
models using tax return data to examine the relevance of the reference point
concept to taxpayers' decisions to participate in IRAs. A second objective is
to investigate the relationship between IRA participation and savings versus
consumption behavior. Ascertaining the relevance of alternative models of
taxpayer decision-making behavior is an important topic in tax policy research
(Stiglitz and Wolfson, 1988). Also, whether IRAs encourage new savings by
reducing consumption or merely recirculate old savings in a policy issue that
has seen much debate.

The remainder of this paper is organized as follows: the Background section discusses prior research related to prospect theory and taxpayer choice behavior and the interface between the present empirical work and the savings/consumption choice; the Method section describes the cross-sectional and first-difference models used in this research and the rationale for the independent variables; the Results section presents the empirical findings and relates such to the expectations as drawn from prior research. Finally, the Conclusions section offers some summary comments.

Background

Prospect theory hypothesizes asymmetric risk preferences depending upon whether the decision context is framed as a gain or a loss (Kameda and Davis, 1990). That is, individuals who have experienced losses are purported to have a value function that increases at an increasing rate and thus prefer riskier alternatives than those who have experienced gains (Fischhoff, 1983). McGlothlin (1956) observed more long shot bets during the last race of the day as gamblers who have sustained losses make riskier bets. A football team that is losing is more likely to attempt risky pass plays than the team that is winning.

The reference point concept can be applied to the decision-making context of a taxpayer. When current cash position is the appropriate frame of reference, a taxpayer who is underwithheld (owes taxes) has a loss reference point. Conversely, an overwithheld (refund) position is framed as a gain. Taxpayer expectations can also serve as a frame of reference. Here the gain or loss reference point is a function of the actual amount of taxes owed or refunded as compared to that anticipated.

Prospect theory predicts that a risky choice is more likely to be made from a loss (underwithheld) than from a gain (overwithheld) reference point. In contrast, according to expected utility theory, withholding reference points should not affect risk preferences because withholding position only reflects the timing of payments and not the actual tax liability.

Previous studies of prospect theory and taxpayer behavior have focused on reporting and compliance decisions. Prospect theory predicts a positive relationship between underwithheld reference points and aggressive reporting and noncompliant behavior. In other words, a taxpayer faced with a large payment on April 15 is more likely to claim a questionable deduction and risk an audit. Chang and Schultz (1990) refer to the association between withholding position and risk preference as the withholding phenomenon. Clotfelter (1983) observed evidence from a random sample of tax returns that showed a positive relationship between underwithholding and underreporting of income.

Most empirical studies of prospect theory and taxpayer choice have been in laboratory settings where observations of the withholding phenomenon have been mixed. Chang, Nichols and Schultz (1987) report a significant relationship between framing and risk preference in their study of audit risk attitudes and tax reporting using MBA students as subjects. LaRue and Reckers (1989) using tax practitioners as subjects found an inverse relationship between the strength of the withholding phenomenon and subject experience. Schadewald (1989) using MBA students as subjects and both current cash position and expectations to formulate reference points observed prospect theory to hold in a neutral nontax context. However, in a tax context the withholding phenomenon was observed only when the reference points were specifically labeled as gains or losses. Hite, Jackson and Spicer (1988) using jurors as subjects did not find support for the withholding phenomenon except in the case of low income subjects. Chang and

Schultz (1990) using Taxpayer Compliance Measurement Program (TCMP) data found strong support for the withholding phenomenon across filing statuses, income sources, income levels and magnitudes of withholding positions. Schepanski and Kelsey (1990) observed in their experiment using undergraduate business students that framing can induce a substantial degree of risk aversion in compliance decisions. Their findings were explained in terms of Markowitz utility theory as well as in terms of prospect theory.

Similar to prior research, the present study uses withholding positions to identify gain and loss reference points. Two reference point concepts are used. First, the cash position reference point is used in the cross-sectional models where taxpayers' withholding positions before considering their IRA deductions are assumed to determine their reference points. Second, a rational expectations reference point is used in a panel-data model where taxpayers expect to make the same IRA contribution as in the prior year and expect to encounter the same refund (payment) as in the prior year. If such rational-expectations are not met, taxpayers are predicted to adjust their IRA contributions accordingly. However, unlike the other studies addressing prospect theory, the present research draws observations from tax return data rather than from subjects in a laboratory experiment, and IRA participation rather than reporting behavior is the decision-making variable.

The decisions to underreport income and participate in an IRA are similar in two respects. First, both decisions can be made between the end of the tax year and the filing deadline for that year. Two-thirds of all IRA contributions are made between January 1 and April 15 (Boynton, 1984). Secondly, both decisions involve a risk-return evaluation that should be independent of withholding position according to expected utility theory.

The decision to hold an asset in an IRA does not alter the before-tax return or the investment. However, the after-tax terminal wealth per dollar invested in an IRA is increased by a factor computed using equation (1) given that funds are not withdrawn until the taxpayer reaches age 59 1/2.

$$\frac{(1 + r)^n (1 - t_n)}{(1 - t_o)} - [1 + r (1 - t_o)]^n \qquad (1)$$

where:

r = before-tax rate of return.

t_o = combined federal and state marginal tax rate for the contribution year

n = the number of years from the contribution year to the year of withdrawal

t_n = the combined federal and state marginal tax rate for the year of withdrawal

For example, if in equation (1) r=.10, t_o = .3, n = 15 and t_n = .2; the terminal wealth from an IRA will be 2.015 times that obtained from the same asset if held directly. The additional risk the taxpayer faces in order to realize this increase in terminal wealth is a liquidity risk. This risk is the probability that the taxpayer makes an early withdrawal from the IRA and sustains a penalty that makes the taxpayer worse off than if the asset were held directly. According to equation (1) the advantage of an IRA is directly related to the extent $t_o > t_n$. Thus, the taxpayer also bears the risk that the reverse may be true to the extent that equation (1) becomes negative.

It should be emphasized that the present study in no way asserts that the advantages of an IRA fail to compensate for the risk. The focus of the present study is that according to expected utility theory the risk-return choice associated with IRA participation is independent of withholding position. In a process-tracing study involving expert financial planners and novice taxpayers,

forty-three variables were identified as relevant to the decision of whether or not a hypothetical family should have an IRA. None of these variables were related to withholding positions, see Hershey, et. al. (1990). On the other hand, according to prospect theory, the tax savings from deducting an IRA contribution will appear more (less) salient when such savings reduce (increase) a tax payment (refund).

The present study does not attempt to discredit expected utility theory but rather to determine whether or not reference point variables increase the explanatory power of traditional econometric models that estimate price and income effects. The validity of expected utility theory is presumed by such models. If the reference point variables add little explanatory power then the results of the present study will fail to support the relevance of reference point concepts as a theory of taxpayer choice behavior.

In addition to investigating the marginal contribution of prospect theory to understanding taxpayer decision-making behavior, the econometric models estimated in the present study examine the relationship between IRA participation and savings versus consumption behavior. Because the U.S. savings rate has declined to one-third of that of Japan and one-half of that of Europe, studies that model savings should be of interest to policy makers. Kotlikoff (1990) alleged that tax incentives fail to shift funds from consumption to savings because incentives allow the achievement of savings targets with less sacrifice in consumption. Empirical work that reported a positive relationship between IRA participation and tax incentives (e.g., Feenberg and Skinner, 1989) has been criticized for failing to document a corresponding reduction in consumption.

Burman, Cordes and Ozanne (1990) argue that IRAs not only did not
contribute to national savings during years of peak availability (1982-1984),
but may have even reduced saving after considering their effect on the deficit.
Two observations support such allegations. First, individual savings do not
respond to changes in investment returns. Second, the cap on IRA contributions
mitigated incentives to increase savings. Some IRA participants may have framed
the tax reductions and associated effects on withholding position as pure income
and responded by increasing consumption. In response to such concerns, the
econometric models in the present study include variables to proxy for savings
and consumption. The strength and directions associated with the coefficients
estimated for these variables will provide insights as to whether IRA
contributions represent new savings in the form of foregone consumption or
redirected old savings. The models also address the issue of whether IRAs
actually increase consumption.

Method

The data for the present study is drawn from the 1983 and 1984 Individual
Tax Model Files (ITMF) and from the Panel of Individual Returns for years 1983
and 1984. These are IRS Statistics of Income data and are part of the Ernst &
Young/University of Michigan Tax Research Data Base; for detailed discussions of
this data base, see Enis (1991) and Crum (1991). Tax years 1983 and 1984 were
years taxpayers had the least legal restrictions on the amount of tax deductible
IRA contributions that could be made.

The ITMF data are used to construct cross-sectional models that use the
current cash concept to classify withholding positions as gain or loss reference
points. The panel data are used to construct a log-linear first-difference
model that uses the rational-expectations concept to identify withholding

positions that are loss reference points. That is, taxpayers will be assumed to
make the same payment or receive the same refund in 1984 as they did in 1983
given the same IRA contribution that was made in 1983 is made in 1984. For
example, assume that a taxpayer made a $1,000 IRA contribution in 1983 and
received a $500 refund for 1983. Under the rational-expectations approach, that
taxpayer will plan on a $1,000 contribution in 1984 and also expect to receive a
$500 refund for 1984. However, if during the initial preparation of the tax
return, the taxpayer discovers that the refund will be only $200, then this
taxpayer has a $300 loss reference point and is predicted to extend his/her 1984
IRA contribution beyond $1,000 before the filing deadline. This script is
symetrical with respect to payments. That is, a taxpayer will have a loss
reference point if his/her 1984 payment is larger than the 1983 payment given
that the same IRA contribution that was made in 1983 is planned for 1984. An
increase in the planned 1984 contribution is also predicted in this case.

A model constructed using ITHF data is based on a sample that can proxy for
the population of interest and hence is strong in external validity. A model
constructed using panel data is strong in internal validity because each
taxpayer acts as his/her own control across time (Crum 1991). As a result, the
use of panel data mitigates problems associated with multicollinearity among
observed variables and correlations among unobserved variables.

Tax returns selected from the Ernst and Young Tax Research Data Base are
those that (1) satisfy the legal requirements to make the maximum IRA
contribution, and (2) disclose information germane to the variables in the
models. Thus, the scope of the empirical work is limited to households with two
wage earners that itemize deductions. Also, the analysis is restricted to
returns with adjusted gross income (AGI) under $200,000 because state of
residence and other important variables are blurred in the data to obscure

taxpayer identities. To obtain clearer measurements of income, marginal tax rates and savings behavior, the analysis excludes returns with age exemptions, schedules C, E and F, and special tax computations. For example, it is difficult to disentangle income attributable to labor versus investment when a taxpayer has an interest in a business, farm, or rental property. A farmer that purchases additional livestock instead of contributing to an IRA is not foregoing savings in favor of increasing consumption. Also, it is difficult to determine whether losses from such activities are real reductions in disposable income or are tax sheltered losses with little economic substance. Returns with special computations (e.g., income averaging) are eliminated because of the difficulty of determining the composite (federal and state) marginal tax rates applicable to IRA contributions.

Equations (2) and (3) are the econometric models employed using the ITMF and panel data, respectively

$$\ln (C_{it}) = \beta_o + \beta_p \ln (P_{it}) + \beta_y \ln (Y_{it})$$
$$+ \sum_{j=1}^{7} \beta_j \ln (X_{jit}) + U_{it} \tag{2}$$

$$\ln (C_{it}) - \ln (C_{i,t-1}) = \beta_p [\ln (P_{it}) - \ln (P_{i,t-1})]$$
$$+ \beta_y [\ln (Y_{it}) - \ln (Y_{i,t-1})]$$
$$+ \sum_{j=3}^{8} \beta_j [\ln (X_{jit}) - \ln (X_{ji,t-1})]$$
$$+ U_{it} - U_{i,t-1} \tag{3}$$

In equation (2), t represents the year for which the cross-sectional model is being constructed; i.e., 1983 or 1984. In equation (3), t=1984 and t-1=1983. For each tax return i . . .

C = amount contributed to IRAs

P = Price (i.e., 1-marginal tax rate)

Y = disposable income

X_1 = tax payment owed given a loss reference point

X_2 = refund given a gain reference point

X_3 = savings propensity

X_4 = family size (number of dependents)

X_5 = paid preparer (1=yes, 0=no)

X_6 = home mortgage interest

X_7 = other interest (consumption proxy)

X_8 = rational-expectations loss reference point

β_0 = intercept

β_p = price elasticity

β_y = income elasticity

$\beta_1 \ldots \beta_8$ = estimated coefficients for variables $X_1 \ldots X_8$

U = error term

ln = natural logarithm

The coefficients for the cross-sectional models are estimated using ordinary least squares regression. The coefficients for the panel data are likewise estimated in a first difference model while forcing the intercept to zero by standardizing the variables.

The discussion will now address the relevance and expectations regarding each variable in relation to prior empirical studies.

<u>Price</u>. This variable is $1-t_c$, where t_c is the combined federal, state, and local marginal tax rate applicable to the maximum IRA contribution. This rate is obtained for each return by subtracting the tax liability if the maximum IRA contribution were made from the tax liability if no IRA contribution were made. This difference is divided by the maximum IRA contribution to obtain t_f, the marginal federal tax rate. Next, t_c is computed by incorporating the effect of the state and local marginal tax rate (t_s) using equation (4) given IRA contributions are deductible on state income tax returns; and $t_c = t_f$ where there is no state income tax or where IRA contributions are not deductible on state returns.

$$t_c = (1 - t_f) \, t_s + t_f \tag{4}$$

Obtaining a precise estimate of t_s would require the modeling of every state, township, city, and county income tax structure in the nation. This modeling would be an enormous task. The present study attempts to incorporate the effect of state and local income taxes by estimating marginal tax rates from average tax rates. Because the present analysis is restricted to returns that itemize deductions, the amount of payments for state and local income taxes can be obtained from the data base. This amount divided by some measure of the income tax base is an estimate of the state and local average tax rate. Equation (5) is used to estimate the amount by which t_f should be increased to take into account state and local income taxes.[1]

$$(1 - t_f)t_s = \frac{2[\text{Ln}(D-R)]^{\frac{1}{2}}}{\text{Ln}(T-D+R)^2} \tag{5}$$

Where: D = amount deducted for state and local income taxes

R = state and local income tax refunds

T = federal taxable income

Equation (5) was validated using a small sample of sets of federal state and local "hard copy" tax returns where the appropriate $(1-t_f)t_s$ was known. Equation (5) is reasonably accurate as long as the D and R variables are consistent from year to year. Equation (5) is restricted to values between 0 and .10 to prevent unreasonable estimates when D and R are inconsistent.

According to Browning (1990), t_c based upon the IRA contribution as opposed to the "first-dollar" marginal tax rate is the appropriate rate for estimating the price elasticity β_p. Theoretically β_p is expected to have a negative sign. As tax rates increase, $P_i = (1 - t_{ci})$ will decrease; i.e., the tax savings will make the IRA deduction more attractive. Such a relationship has been reported by O'Neil and Thompson (1987), Feenberg and Skinner (1989), and Long (1990). However, Venti and Wise (1988) report the marginal tax rate to have no influence on IRA contributions.

Disposable income. The value for this variable for each return is obtained by adding back to AGI (1) adjustments to income other than employee business expenses, (2) the capital loss deduction, and (3) tax free income from the following sources: capital gains, dividends, social security and unemployment benefits. This amount is then reduced by social security taxes, federal income tax payments, and all state and local tax deductions. According to Browning (1990), the effect on saving is related to the change in disposable income through the marginal propensity to save. The use of disposable income to estimate the income elasticity β_y is less likely than AGI to cause multicollinearity problems between P and Y (Long, 1990). Theoretically β_y is expected to be positive as savings increase with income. Prior studies have supported this expectation although the relationship was weak in the Feenberg and Skinner (1989) study.

Reference points -- loss (X_1), gain (X_2). Variables X_1 and X_2 reflect the current cash position reference point concept. These variables appear only in the cross-sectional models and are measured by the amount of the tax payment (refund) that would apply if no IRA contribution were made given that the taxpayer has a loss (gain) reference point. A taxpayer is considered having a loss (gain) reference point if the pre-IRA tax payment (refund) is one hundred dollars or more. Taxpayers with payments (refunds) under $100 are assumed to have a neutral cash position reference point. A dollar amount less than three-digits is considered nonsalient or not worth the effort to contribute to an IRA and refigure the tax return. The effect of this neutral point is captured in the model's intercept and mitigates the possibility that the $X'X$ matrix will be less than full rank. Based on the earlier discussion, prospect theory predicts a strong and positive coefficient for B_1 and is silent with respect to B_2. Expected utility theory predicts B_1 and B_2 to be insignificant. A third set of predictions come from the savings literature. According to the "liquidity constraint" view of savings, B_1 should be negative and B_2 should be positive (Feenberg and Skinner, 1989). Such expectations are based on the premise that a taxpayer having received a refund should have the liquidity to contribute to an IRA. Prior research has shown a positive relationship between IRA participation and money owed to the IRS (Feenberg and Skinner, 1989; Long, 1990). These studies used a dummy variable equal to one if money was owed to the IRS and zero otherwise. Such research did not specifically address prospect theory, gain and loss reference points were not incorporated in the models and taxpayer expectations were not considered.

Savings propensity (X_3). This variable is interest income plus pre-exclusion dividend income divided by disposable income less capital gains. It measures that portion of permanent disposable income that is derived from

savings vehicles (Hubbard, 1984). This variable proxies for wealth, resources available to shift to IRAs, and taxpayer attitudes towards savings. β_3 is expected to be positive in the cross-sectional model as suggested by prior work. However, β_3 may be negative in the first-difference model if taxpayers are motivated to shift funds from contemporaneously taxable holdings to tax deferred IRAs. β_3 estimated from the panel data should not be negative if IRAs encourage new savings.

Family size (X_4). Most econometric studies involving IRA participation, charitable giving, leisure-work choice, etc. include variables that address marital status or family size. This variable provides an indication of the household's life-cycle. Families with children young enough to typically qualify as dependents may not place a high priority on retirement savings. Hence, β_4 is expected to be negative in the cross-sectional models and insignificant in the first-difference model.

Paid preparer (X_5). The 1983 and 1984 data do not have elements showing amounts paid to preparers, but do have code fields indicating whether or not paid preparers were used. This variable is included as a dummy variable in the models for two reasons. First, taxpayers who use paid preparers may be better informed as to the advantages of IRAs. O'Neil and Thompson (1987) used census regions to proxy for the extent to which taxpayers were informed about IRAs from the intensity of advertising by financial institutions. Second, the use of paid preparers may influence a taxpayer's withholding positions by taking into consideration an IRA deduction. Simultaneous withholding and taxpayer choice decisions have been noted in Jackson and Milliron (1986). The effect of paid prepares on taxpayer reporting behavior has been studied by Long and Caudil (1987) and by Collins, Milliron and Toy (1990). Neither of these studies addressed the issue of IRA participation although the latter research estimated that twenty-five percent of households cite tax minimization as the primary motive for using a preparer. Hence, β_5 is expected to be positive.

Home mortgage interest (X_6). The inclusion of this variable explores the relationship between home ownership and IRA participation. Owner occupied housing has elements of consumption and savings. The real estate market of the eighties provided taxpayers with an investment vehicle with many tax advantages similar to an IRA. The appreciation on a home builds up tax free until the property is sold and a qualified reinvestment is not made. If this event occurs after age 55, up to $125,000 of the realized gain is tax free. Furthermore, investment in a home is not restricted to $2,000 or $4,000 per year. Also, funds can be borrowed against the equity in a home without penalty, this is not true of an IRA. The only advantages of an IRA over owner occupied housing are the lower transactions costs, lower minimum investment, and the ability to invest before rather than after tax dollars. On the other hand, imputed net rental value of owner occupied housing is a form of tax free economic income, and interest and property taxes provide substantial tax deductions. Home mortgage interest is also related to wealth and life-cycle factors. This variable has not been examined in prior research dealing with IRA participation. The expected direction of β_6 is uncertain. However, if taxpayers are using home ownership to a substantial degree as a savings vehicle which in turn causes a significant liquidity constraint, then β_6 is expected to be negative.

Other interest (X_7). This variable is the difference between the total itemized deduction for interest and the deduction for home mortgage interest. This variable is intended to measure the relationship between IRA participation and consumption. None of the other IRA studies have addressed this important issue. If taxpayers borrow to finance their IRA contributions, or divert IRA tax savings into more consumption, then β_7 is expected to the positive. If IRA contributions are funds shifted from other savings vehicles, then β_7 is expected

to be insignificant in conjunction with a negative β_3. On the other hand, if IRA participation motivates new savings by causing funds to be diverted from consumption, then β_7 is expected to be negative.

Rational-expectations loss reference point (X_8). This variable appears in the first-difference model constructed from the panel data and not in the cross-sectional models. This variable is intended as a test of prospect theory when taxpayer expectations are used as reference points. Here the withholding reference points are determined under the assumption that IRA contributions for 1983 and 1984 are expected to be the same. Taxpayers with loss reference points are those with 1984 tax payments (refunds) that are greater (less) than their 1983 tax payments (refunds) and those with pre-IRA payments in 1984 and refunds in 1983. The remaining taxpayers are considered to have a gain reference point. For those with a loss reference point X_8 will equal the difference between their actual and expected 1984 positions. For those with a gain reference point X_8 will equal zero. Prior studies have not examined rational expectations as a means for framing the decision to contribute to an IRA. A positive β_8 would support the relevance of prospect theory to the modeling of taxpayer decision-making behavior.

The contribution of this proposed study is the incorporation of a formalized test of the relevance of prospect theory to taxpayer choice behavior within standard econometric models. This study will also address other issues not covered in earlier work such as the relationship between IRA participation and home ownership, savings and consumption. The empirical analysis will be performed using cross-sectional models and a first difference model.

RESULTS

Table 1 reports a summary of the descriptive statistics for all variables that were included in both ITMF cross-sectional models and in the first-difference panel data model for years 1983 and 1984. Table 1 provides an indication of the extent to which the panel of 484 joint returns is representative of the population germane to the present study. The univariate analysis of the panel and ITMF data consist of the correlation matrices in Tables 2 and 4, respectively. The regression models are shown in Tables 3 (first-difference model) and 5 (cross-sectional models). The discussion focuses on the expectations for each variable that were discussed earlier in this paper.

The reference point variables (X_8 in Tables 2 and 3; and X_1, X_2 in Tables 4 and 5) are discussed first. The regression coefficient associated with the rational-expectations reference point (X_8) is significant and positive. This finding suggest that prospect theory in conjunction with expected utility theory has a role in explaining taxpayer decision-making behavior. Note, however, the explanatory power of X_8 is not as strong as the traditional price and income variables. The role of prospect theory is also supported in both cross-sectional models where the cash position loss reference point (X_1) has positive coefficients, and the gain reference point (X_2) has negative coefficients. Because of the large sample size all (but one) variable in the cross-sectional models are highly significant. However, an inspection of the t-values and the change in R^2 figures[2] in Table 5 indicate that as expected, the effect of the loss reference point is stronger than that of the gain reference point.

The price variable (P) has a relatively stronger influence in the first-difference model than in the cross-sectional models. However, the sign of the regression coefficient in all three models is positive; the opposite of what was expected. On the other hand, according to Table 4, the univariate correlation between IRA contribution and the price variable is negative in both ITMF models. In general, on the macro-level taxpayers with high marginal rates are more likely to have IRAs than those with low marginal tax rates. Nevertheless, the positive coefficient for P in Table 3 suggest that families that had a reduction in marginal rates from 1983 to 1984 were more likely to increase their IRA contributions then those with rate increases. This finding appears reasonable when one considers that tax rates across virtually all brackets were lowered in 1984 and the overall popularity of IRAs increased. This rate reduction is reflected in the increase in the Price variable from 1983 to 1984 as shown in Table 1. An inspections of Table 1 shows that of the 484 households selected from the panel data, those with IRAs increased by 23.3 percent from 1983 to 1984.

All three regression models show a strong income effect in that β_y is positive in Tables 3 and 5. This finding is consistent with other research.

The savings propensity variable has a positive regression coefficient in all three models. This was an expected result with respect to the ITMF regressions. However, if IRA contributions are merely funds withdrawn from investments, then one would expect β_3 to be negative in the panel data analysis. However, β_3 is positive and the most significant variable in the first-difference model. In other words, panel members whose ratio of investment income to permanent disposable income increased from 1983 to 1984 were more

likely to have increased their IRA contributions over this period. Furthermore, an inspection of Table 2 gives the impression of relatively low multicolinearity among the transformed panel data variables, only 10 of 32 correlation coefficients are significant at the .05 level. However, the -.75 correlation between the savings propensity (X_3) and disposable income variable (Y) stands out. This suggest an inverse relationship between changes in disposable income and changes in that portion of disposable income that consist of dividends and interest. This result is surprising given the strong income effect. In other words, the two strongest variables in the first-difference model have positive regression coefficients and are negatively correlated with each other. This finding suggest that a factor influencing IRA contributions is the rate at which investment income changes relative to noninvestment income. The finding that investment income increases relative to disposable income when IRA contributions are increasing does not suggest that IRA savings are largely recirculated older savings. Nevertheless, the availability of investment funds is strongly associated with IRA participation as suggested by the positive correlations between X_3 and Y in the static cross-sectional models, see Table 4.

The regression coefficients associated with the family size variable were negative as expected. However, β_4 is not significant in the first difference model. These findings indicate that on average an inverse relationship exist between family size and IRA participation but at the margin changes in number of dependents from 1983 to 1984 had little influence on IRA contributions.

A positive sign was expected for the paid preparer variable. Such occurs in the first-difference model. However, β_5 is negative in the 1984 and insignificant in the 1983 cross-sectional models, see Table 5. The positive β_5

in Table 3 is significant while the negative β_5 in the 1984 ITHF model is the least influential of the independent variables. These observations are evidence that those households that did not use paid preparers in 1983 but did so in 1984 were influenced to increase their IRA investments in 1984. The promotion of IRAs through paid preparers and especially the media is purported to have had an impact on the increase in popularity of IRAs during this period (O'Neil and Thompson, 1987). Nevertheless, little association between the use of paid prepares and IRA participation was found on the macro-level.

The coefficient associated with the home mortgage interest variable is negative in all three regression models which according to our expectations is a sign that households used owner-occupied housing as a savings vehicle. The negative correlations between X_6 and X_3 in Table 4 also supports this expectation. However, in the case of the first-difference model the negative β_6 could have resulted from the natural decline in interest expense through debt retirement in conjunction with the observed overall increase in IRA popularity.

The consumer interest variable is positive but insignificant in the first-difference model and negative in both cross-sectional models. Thus, the findings in the present study do not provide evidence that IRA participation actually results in an increase in consumption. Nor can the findings link the sources of IRA funds to foregone consumption. An interesting observation from Table 4 is that consumer interest is positively (negatively) correlated with the gain (loss) reference point variable with respect to the 1983 and 1984 ITHFs. This supports the assertion of Burman, Corden and Ozanne (1990) that taxpayers may frame tax refunds as pure income.

Conclusions

The present study investigated the relationship between IRA participation and reference point effects and savings versus consumption behavior. The findings indicate that reference point variables grounded in prospect theory make a modest contribution in explaining taxpayer decision-making behavior beyond that explained by traditional price and income effects. The results also document the persistence of a strong income effect on IRA participation. Furthermore, the findings point to a linkage between increases in IRA contributions and increases in investment income relative to changes in disposable income. This does not lead one to believe that IRA savings are primarily a reshuffling of prior savings. If interest and dividend income were being moved off tax returns and into IRAs a negative relationship between C and X_3 would have been observed. Finally, the results could not establish either a positive or negative relationship between IRA participation and consumption.

The popularity of IRAs increased substantially from 1983 to 1984 largely because of factors not captured in tax return data such as the influence of the news and advertising media and learning effects. These omitted factors largely account for the relatively low R^2 of .0663 considering the sample size of 484 households that were used in formulating the first difference model. An inspection of Table 1 provides an indication of the increase from 1983 to 1984 in household having IRAs. Table 1 also shows that the median exceeded the mean contribution in 1983 while the reverse was true in 1984. Furthermore, according to the ITMF data, the median and mean contributions decreased from 1983 to 1984. These observations suggest that many of the new IRA participants in 1984 were households that made smaller contributions than those made by households in 1983.

The scope of the present study was purposely restricted to two-income earner households that itemized deductions and derived virtually all their income from salary/wages and investment income. These restrictions were motivated by a desire to study households that could make the maximum legal contribution to IRAs and where all of the relevant variables are measurable over the 1983-1984 period. Thus, caution should be exercised in generalizing the results of this study beyond the type of households that were drawn from the Ernst and Young Tax Research Database.

Footnotes

[1]Equation (5) as a means of adjusting federal marginal tax rates to incorporate state and local tax effects in arriving at composite marginal tax rates is in a very early stage of development. It is anticipated that future drafts will contain a more refined, better validated and better justified estimation procedure. At this point the use of equation (5) should not do more harm to the empirical findings than simply ignoring state and local income taxes.

[2]The change in R^2 is the extent to which the R^2 of the multivariate model would decline if the indicated variable were eliminated.

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TABLE 1

Summary Data Descriptive Statistics

	1983 ITMF			1983 Panel			1984 ITMF			1984 Panel		
	N^a(%)	Median	Mean	N^b(%)	Median	Mean	N^a(%)	Median	Mean	N^b(%)	Median	Mean
AGI		$35,910	$37,410		$36,580	$37,817		$37,990	$39,872		$38,825	$40,785
Salary & Wages		37,000	38,465		37,010	38,766		39,260	40,977		40,080	41,833
Interest & Dividends		118	643		119	626		141	717		164	745
IRA Contr. (C)	1.795(26.6)	2,992	2,702	120(24.8)	2,936	2,660	2.189(27.3)	2,500	2,642	148(30.6)	2,425	2,668
Price (P)		.6886	.6871		.6880	.6833		.6973	.6915		.6970	.6875
Disp. Income (Y)		$27,217	$28,336		$28,132	$29,032		$28,912	$30,346		$30,947	$31,874
Loss Ref. Pt. (X_1)	1.177(17.5)	618	900	81(16.7)	632	935	1.486(18.6)	655	1,000	85(17.6)	683	1,008
Gain Ref. Pt. (X_2)	5.110(75.8)	981	1,179	369(76.2)	971	1,196	6.028(75.3)	992	1,219	370(76.4)	1,042	1,290
Savings Prop. (X_3)		.0044	.0203		.0044	.0238		.0048	.0210		.0054	.0218
Family Size (X_4)		1	1.42		1.	1.43		1	1.43		1	1.38
Paid Prep. (X_5)	3.562(52.8)			252(52.1)			4.363(54.5)			245(50.6)		
Home Mort. Int. (X_6)	5.863(87.0)	2,649	3,307	416(86.0)	$2,561	$3,099	6.819(85.2)	$2,881	$3,576	422(87.2)	$2,903	$3,539
Consumer Int. (X_7)		880	1,186		921	1,228		1,013	1,384		989	1,398
Data/Exp. Loss Ref. (X_8)										246(50.8)	378	895

[a] Figures in this column are in millions. Unless otherwise stated, medians and means reported for the 1983 (1984) ITMF are based on a sample size of 6.741 (8.005) million joint returns that were simulated using a stratified sample and integer weighting factors.

[b] Unless stated otherwise, medians and means reported for the 1983-1984 panel data are based on the sample size of 464 joint returns.

TABLE 2

Correlation Matrix--First Difference Model,
Panel Data, 1983-1984

Variables	X_8	X_7	X_6	X_5	X_4	X_3	Y	P	C
C--IRA Contribution	.089[a]	.061	-.119	.130	-.035	.077	.020	.038	1
	(.049)	(.182)	(.009)	(.004)	(.449)	(.091)	(.669)	(.403)	
P--Price $(1-t_c)$	-.187	-.027	.092	.008	.084	.009	-.217	1	
	(.001)	(.555)	(.043)	(.865)	(.066)	(.837)	(.001)		
Y--Disposable Income	.135	-.016	-.006	-.014	-.00⁻	-.751	1		
	(.003)	(.721)	(.890)	(.766)	(.881)	(.001)			
X_3--Savings Propensity	-.026	.013	-.013	.031	.012	1			
	(.563)	(.782)	(.770)	(.491)	(.786)				
X_4--Family Size	-.089	-.020	.000	-.071	1				
	(.049)	(.655)	(.999)	(.117)					
X_5--Paid Preparer	-.021	.044	-.040	1					
	(.648)	(.333)	(.385)						
X_6--Home Mortgage Interest	.018	-.168	1						
	(.699)	(.001)							
X_7--Consumer Interest	-.077	1							
	(.090)								
X_8--Ratn/Expt. Loss Ref. Pt.	1								

[a] Pearson product moment correlation between pairs of transformed variables; e.g., .089 is the correlation between the following two standardized values: $[Ln (C_t) - Ln (C_{t-1})]$ and $[Ln (X_{8t}) - Ln (X_{8, t-1})]$, $i=1 \ldots 484$ joint returns. Significance levels are shown in parentheses.

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TABLE 3

Parameter Estimates--First Difference Log-Linear Regression Model:
1983-1984 Panel Data, Dependent Variable: IRA Contribution

Independent Variables:	Standardized Regression Coefficients	|t| Value	Prob |t|>P	Change in R^2
P--Price $(1-t_c)$	.1100	2.31	.021	.0108
Y--Disposable Income	.1992	2.79	.006	.0156
X_3--Savings Propensity	.2225	3.20	.002	.0205
X_4--Family Size	-.0273	0.61	.543	.0010
X_5--Paid Preparer	.1183	2.65	.008	.0141
X_6--Home Mortgage Interst	-.1140	2.52	.012	.0128
X_7--Consumer Interest	.0465	1.03	.303	.0024
X_8--Ratn/Expt. Loss Ref. Pt.	.0946	2.06	.040	.0087

Full Model R^2 = .0663; F = 4.22; Prob > F < .001; N = 484

TABLE 4

Correlation Matrix--Cross Sectional Models
1983 and 1984 Individual Tax Model File

A: 1983 ITMF	X_7	X_6	Y_5	X_4	X_3	X_2	X_1	Y	P	C
C--IRA Contribution	-.160[a]	-.125	-.031	-.158	.360	-.380	.433	.396	-.343	1
P--Price $(1-t_c)$	-.054	.086	.041	.149	-.170	.222	-.304	-.835	1	
Y--Disposable Income	.134	.078	-.077	-.026	.166	-.211	.327	1		
X_1--Loss Reference Point	-.126	-.181	-.032	-.152	.307	-.784	1			
X_2--Gain Reference Point	.147	.233	.047	.158	-.253	1				
X_3--Savings Propensity	-.231	-.182	.009	-.148	1					
X_4--Family Size	.079	.138	-.037	1						
X_5--Paid Preparer	.035	-.086	1							
X_6--Home Mortgage Int.	.074	1								
X_7--Consumer Interest	1									
B: 1984 ITMF										
C--IRA Contribution	-.151	-.085	-.042	-.160	.360	-.358	.418	.397	-.335	1
P--Price $(1-t_c)$	-.033	.040	.033	.125	-.160	.261	-.332	-.841	1	
Y--Disposable Income	.114	.126	-.066	-.025	.196	-.235	.346	1		
X_1--Loss Reference Point	-.156	-.187	-.029	-.166	.354	-.801	1			
X_2--Gain Reference Point	.167	.239	.057	.169	-.280	1				
X_3--Savings Propensity	-.278	-.165	-.004	-.139	1					
X_4--Family Size	.069	.128	-.018	1						
X_5--Paid Preparer	.006	-.076	1							
X_6--Home Mortgage Int.	.073	1								
X_7--Consumer Interest	1									

[a]Pearson product moment correlation between pairs of transformed variables. Because N is very large all correlations are significant at the .0001 level.

TABLE 5

Parameter Estimates--Cross Sectional Regression Models
1983 and 1984 Individual Tax Model Files
Dependent Variable: IRA Contribution

Independent Variables:	1983 ITMF$_2$[a] N=6,741,142; R^2=.3351			1984 ITMF$_2$[a] N=8,005,184; R^2=.3097		
	Regression Coefficients	|t| Value	Change In R^2	Regression Coefficients	|t| Value	Change in R^2
Intercept	-42.1417	466.1	--	-43.6544	495.7	--
P--Price $(1-t_c)$	7.5300	150.4	.0023	8.7453	176.1	.0027
Y--Disposable Income	4.1599	613.7	.0372	4.1925	642.9	.0357
X_1--Loss Reference Point	.2195	296.9	.0087	0.2062	293.5	.0074
X_2--Gain Reference Point	-.1202	204.3	.0041	-0.0896	157.6	.0022
X_3--Savings Propensity	15.9216	546.6	.0295	14.7938	533.6	.0246
X_4--Family Size	-.4801	230.1	.0053	-0.5584	286.9	.0071
X_5--Paid Preparer	.0005	.2	.0000	-0.0954	46.8	.0002
X_6--Home Mortgage Int.	-.0696	164.1	.0027	-0.0513	135.1	.0016
X_7--Consumer Interest	-.2074	354.6	.0124	-0.1815	305.7	.0081

[a]Because of the large N values, the F statistics are extremely large and all variables are significant at the .0001 level except X_5 which is not significant in the 1983 model.

MAY 9, 1991

WAYNE HOSIER
U.S. SENATE
COMMITTEE ON FINANCE
WASHINGTON DC   20510

EDWARD MIHALSKI
MINORITY CHIEF OF STAFF
U.S. SENATE
COMMITTEE ON FINANCE
WASHINGTON DC   20510

HEARING: BENTSEN-ROTH SUPER IRA BILL (S. 612)
          Hearing Date, May 16, 1991

REINSTATE THE IRA DEDUCTION!! And, please eliminate the complicated AGI dollar
restriction on who can take a deduction. Our joint income is a little over
$50,000 and because we are covered by plans at work we are unable to take an
IRA deduction, so we spend the money on every day living.

However, BEFORE 1986 we managed to save money and FUND AN IRA, we treated the
IRA like our car insurance and mortgage, it was something you just had to put
money into!

We can't rely on our company pension plans, many people change jobs and do not
accrue enough time at a company to build an adequate retirement fund. Or, your
employer purchases annuities for it's retirees and that insurance company
(Executive Life Insurance Companies of California and New York)
goes belly up! At least with an IRA the individual can control the investment
AND choose from a variety of institutions and investment vehicles.

We can't rely on social security either, granted, there's currently a
surplus, but the government can't seem to keep their fingers out of the cookie
jar to help reduce the deficit.

I disagree with the penalty-free withdrawal option for first home purchases
and college expenses, the IRA isn't a family savings plan. You're forgetting
that the PURPOSE OF AN IRA IS TO SAVE FOR RETIREMENT. Our increased longevity
and our cultural attitude, where the elderly must fend for themselves is a
valid reason for enticing people to stash money in an IRA with a tax
deduction so they are financially comfortable during RETIREMENT YEARS. The
deduction should be raised to $4,000!!!

Sincerely,

Patricia A. Leuthy

Michael J. Leuthy

STATEMENT OF THE RETIREMENT INDUSTRY TRUST ASSOCIATION

Will the United States in 1991 enact new tax incentives to encourage individuals to increase their personal savings? The Retirement Industry Trust Association on behalf of its clients endorses Senate bill 612 as a measure to reform harm caused to individual retirement savings by the Tax Reform Act of 1986. Individuals with IRAs opened before 1986 have substantially stopped making contributions. This fact is evidenced within our own industry by substantial declines in the number of individuals establishing new IRAs. Many of our members report that new IRA accounts have declined by as much as 90% since 1986.

HISTORICAL PERSPECTIVE ON THE RETIREMENT INDUSTRY TRUST ASSOCIATION

The Retirement Industry Trust Association, a trade association for corporate trustees of self-directed retirement plans, with a concentration in IRAs, was formed in 1987. Our organization represents 12 member firms that maintain assets in excess of 22 billion dollars for close to one million individuals.

The majority of our members are classified as independent trustees, which means that they are not associated with a financial institution that offers investment products. Our members service the retirement needs of individuals as well as the securities industry, financial planners, mutual fund sponsors, banks and limited partnerships. Individual participants select investments, usually with the help of a financial advisor, that meet their long-term financial objectives for retirement. These investments include: stocks, bonds, mutual funds, certificates of deposit, public and private limited partnerships, real estate, promissory notes and privately offered corporate obligations and stock.

Our industry has witnessed the demise of small employer qualified plans due to increased complexity and costs to maintain these plans. We have also seen a substantial upsurge in small employer (Keogh) plan terminations. More emphasis is being placed on individuals to control and manage their financial security in retirement with less reliance on employers or government. Our members are heartened by the renewed interest of Congress and the Administration to increase savings to help individuals control their financial destinies.

THE NEED FOR INDIVIDUALS SAVING FOR RETIREMENT

In 1987, only 7.19 percent of sampled tax returns filed showed contributions to IRAs. Only 1.17 percent of the returns filed indicated non-deductible contributions.[1]

The Retirement Industry Trust Association conducts annual surveys of our member firms to determine the number of contributions made to the IRA accounts we administer. In 1986, 36.48 percent of our clients made contributions to their plans. In 1987, contributions dropped to 16.93 percent and held constant for 1988 at 16.80 percent. In 1989, the most recent year for which we have complete data, contributions had steeply declined to 10.47 percent.

Future prospects for individuals eligible to make full deductions to IRAs declined to 58% in 1991, from 65% in 1987. By 1995, it is projected that only 52% of all workers will be eligible to make tax deductible contributions.[2]

We must mount an effort to inform our citizens of the amount of personal savings they will need to maintain their lifestyles in retirement. One recent study shows that a married couple must earn 70 to 80 percent as much in retirement as their pre-retirement salary income in order to maintain their standard of living. Social Security payments provide as much as 75 percent of the needed retirement income for individuals with lower pre-retirement incomes. Still, all Americans must count on retirement plans and individual savings to replace from 20 to 60 percent of their pre-retirement incomes for a secure retirement.[3]

Much evidence supports the theory that private retirement savings are inadequate for a large percentage of workers.

Consider that in just thirteen years existing law will begin to push back the normal retirement age at which Americans can receive full Social Security benefits. These cutbacks apply to all workers born after 1937 and increase for each later year of birth. For example, instead of age 65, individuals who attain age 47 in 1990 (born in 1943) will have to wait until they reach age 66 to get their full Social Security

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[1] *IRA Reporter*, Vol. 6, No. 9 (Sep. 1988), p. 1.
[2] A new study by the Employee Benefit Research Institute, Washington, D.C. as reported in *Pensions and Investments*, p. 26, May 13, 1991.
[3] Bruce A. Palmer, "The Impact of Tax Reform on Wage Replacement Rations," Center for Risk Management and Insurance Research (Georgia State University, 1988)

benefits. Individuals born in 1960 or later will have to wait until they reach age 67. Despite the fact that most Americans expect to retire at age 62 or earlier, according to a new survey,[4] existing law also cuts early retirement Social Security benefits for those born in 1938 or later.

Probably few Americans affected by the scheduled cutbacks are adjusting their personal retirement savings upwards to compensate for the cutbacks. Less than 40 percent of Americans have ever sought retirement planning assistance from professionals, according to the new survey by the Gallup Organization on behalf of Fidelity Investments. Only 66 percent of the respondents know that age 62 is the earliest age an individual can collect regular Social Security benefits. Almost 20 percent think the early retirement age is age 59.

Just 35 percent of the respondents know that it takes 60 to 80 percent of pre-retirement income to maintain their lifestyle in retirement. Even though most respondents underestimate the actual cost of retirement, only one-third feel financially prepared for retirement, the survey shows.

Demands on the nation's health system also suggests that future retirees may need more retirement savings than current retirees for another reason. "We are confronting bankruptcy in the primary Medicare trust fund within 13 to 15 years unless we take effective action to change the situation," Health and Human Services Secretary Louis W. Sullivan said in April 1990.[5] If Medicare benefits are cut back, which is one possibility mentioned to solve the funding crisis, future retirees will need greater retirement savings to pay for supplementary medical insurance.

The need for increased individual savings by Americans is obvious. In a country where we save only 3.7% of our income, American taxpayers need help from Congress to avoid financial paucity during retirement.

THE SAVINGS AND INVESTMENT INCENTIVE ACT OF 1991 (S. 612)

We are in favor of Sec. 101 *Restoration of IRA Deduction* allowing individuals to make a $2,000 deductible contribution to an IRA without regard to salary level or coverage by other pension plans.

We are also in favor of Sec. 101(c) allowing front-end contributions to be deductible for taxable years beginning after December 31, 1990.

Sec. 101(g) *Cost-Of-Living Adjustments* is a positive addition. By adding an inflation index, future contribution amounts will allow individuals to keep pace with inflation while adding to their retirement benefits. The $2,000 contribution limit was initiated in January, 1982. Today that contribution limit would be $2,700 if adjusted for inflation.

The "back-ended" non-deductible IRA contribution provides a reasonable alternative for American savers and investors. This after-tax $2,000 contribution creates a long-term incentive for taxpayers by allowing the entire balance to be withdrawn tax-free upon retirement.

In addition, by allowing individuals to "lock-in" the tax rate at the time of their contribution rather than at the time of distribution, individuals would have a firm understanding of their future tax liabilities.

By giving individuals the flexibility to select between front-end deductible contributions and back-end non-deductible contributions, Congress is repositioning the responsibility for retirement savings to the individual. We believe this policy is favorable given the trend of the future needs of retirees.

The five year hold (Sec. 111(d) (2)) on tax free withdrawals of IRA earnings and contributions in an IRA in order to withdraw earnings tax-free is also a reinforcement of the long-term savings objective in this legislation.

We are not opposed to Sec. 201 to allow individuals penalty-free distributions for first time home buyers, payment of higher education, or financially devastating medical expenses. Theses initiatives will stimulate the United States economy and provide valid uses for savings in an IRA.

SUMMARY

In summary, the Retirement Industry Trust Association wholeheartedly supports Senate Bill 612. We appreciate the congressional intent to help Americans prepare and plan for a more secure financial future.

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[4] A national sample of 724 interviews of working adults age 25 or older, with household incomes of $25,000 or more who were responsible for making the household's financial decisions. conducted by the Gallup Organization in January and February 1990 on behalf of Fidelity Investments, Boston, Mass

[5] US Department of Health and Human Services News Release, April 18, 1990.

Exhibit I.—1991 MEMBER DATA

	Total assets	Total accounts
American Trust Co., Honolulu, HI	$1,400,000,000	4,100
Delaware Charter, Wilmington, DL	8,000,000,000	300,000
EMJAY Corporation, Milwaukee, WI	800,000,000	2,400
First Trust Corp., Denver, CO	5,885,000,000	311,191
Home Fed Bank, San Diego, CA	857,159,228	69,592
Independent Trust Corp., Lombard, IL	115,072,744	5,100
Reliance Trust Co., Atlanta, GA	208,000,000	17,000
Resources Trust, Denver, CO	3,400,000,000	143,000
Retirement Accounts, Inc., Winter Park, FL	550,000,000	., 30
Sterling Trust, Waco, TX	300,000,000	16,3 30
Transcorp Pension, Laguna Hills, CA	470,000,000	30,000
Trust Co. of America, Boulder, CO	260,402,000	5,100
Total	22,245,633,972	923,483

IEEE

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Promoting Career and Technology Policy Interests of Electrical, Electronics & Computer Engineers

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May 29, 1991

The Honorable Lloyd Bentsen
The Honorable William V. Roth, Jr.
Committee on Finance
United States Senate
Washington, DC 20510

Dear Senators Bentsen and Roth:

The Institute of Electrical and Electronics Engineers, Inc - United States Activities (IEEE-USA) strongly supports enactment of the Savings and Investment Incentive Act of 1991 (S. 612). This legislation is urgently needed to boost personal savings for retirement and expand the pool of capital for productive investment in the nation's economy.

Your bill would help to promote individual savings by permitting all taxpayers to contribute up to $2000 a year to a conventional tax deductible Individual Retirement Account or to a new type of IRA in which interest earnings on contributions held for at least five years would be tax exempt at withdrawal. In addition to substantially increasing eligibility to make tax favored IRA contributions, S. 612 would also index IRA contribution limits for inflation.

By allowing penalty free withdrawals from IRAs to pay for first time home purchases, educational costs and major medical expenses, the Bentsen/Roth Super IRA should also help to increase the attractiveness of IRAs as a savings vehicle for younger, middle income Americans.

The increased savings that are likely to result from enactment of S. 612 will help to lower interest rates, stimulate investment, create jobs, and improve living standards as well as provide a more secure retirement for millions of American families.

The more than 250,000 electrical, electronics and computer engineers who are members of IEEE-USA commend you for your continuing leadership on this critically important public policy issue.

Sincerely,

M.J. Whitelaw

Michael J. Whitelaw
Chairman
United States Activities Board

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