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EXPANDING IRA'S

HEARING

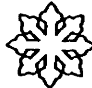
BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED FIFTH CONGRESS

FIRST SESSION

MARCH 6, 1997



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EXPANDING IRA'S

THURSDAY, MARCH 6, 1997

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

The hearing was convened, pursuant to notice, at 10:07 a.m., in room SD-215, Dirksen Senate Office Building, Hon. William V. Roth, Jr. (chairman of the committee) presiding.

Also present: Senators D'Amato, Moynihan, Moseley-Braun, Bryan, and Kerrey.

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

The CHAIRMAN. The committee will please be in order. First of all, I want to welcome all of the witnesses that will appear before us today. We are very, very pleased to have the Deputy Secretary, Mr. Summers, with us.

Today we want to look at the economic importance of savings and what I consider the startling inadequate rate of U.S. savings. This is, of course, an issue much like Mark Twain's weather; it is frequently the topic of conversation, but no one seems to want to do anything about it.

Federal Reserve Chairman Alan Greenspan has said that our Nation's low rate of savings is the single most important economic challenge we are facing, and I agree with him. For more than a decade I have worked to increase our savings rates by promoting vehicles like Individual Retirement Accounts.

It concerns me that, of the G-7 Nations, the United States has the second-lowest personal savings rate, at less than 5 percent. According to Professor Henry Rowan of Stanford, America's low rate of savings is the most significant reason why labor productivity has grown at only half the rate since 1973 than it did in the preceding century.

He believes that increasing our National savings rate by 5 percent of gross domestic product will increase productivity and real wages of the next generation by about 15 percent above its current trend.

Well, I am a staunch advocate of creating conditions that lead to increased saving and investment. I believe we can help create these conditions by expanding IRA, and I am happy to say that the Administration, in its proposal, did not go quite as far as I did, but we are both moving in the same direction.

When former Treasury Secretary Lloyd Bentsen and I first introduced the concept of a Super IRA, well-respected economists shared a study about how it would create economic growth and real wage increases.

With this objective in mind, I look forward to hearing, as I said, from our many distinguished panelists, including Lawrence Summers, who is Deputy Secretary of Treasury, and has been a leading proponent of expanding IRAs.

I would also like to mention, Mr. Secretary, that Senator Breaux and I have 48 co-sponsors for the Roth-Breaux Super IRA bill, so this indicates, clearly, we are not alone in our objective to expand savings and real growth.[1]

Senator Moynihan.

OPENING STATEMENT OF HON. DANIEL PATRICK MOYNIHAN, A U.S. SENATOR FROM NEW YORK

Senator MOYNIHAN. Thank you, Mr. Chairman. Let me go on record saying, if Henry Rowan says it, I believe it. We have had a long record here in Washington in these matters.

You said that he proposed to increase savings by 5 percent. Did you mean to 5 percent? I think it would be to 5 percent.

The CHAIRMAN. By 5 percent.

Senator MOYNIHAN. Which would be about double, at least, the present rate. Surely that case makes itself. The question is, how? I would have thought that balancing the budget would be the first and most direct route to increasing savings and moving into a surplus such that we were buying down debt, which has an immediate inverse increase in savings, if Dr. Summers could speak to that during his testimony.

I note that the Joint Committee on Taxation has said that the Administration IRA proposal would increase the deficit by $67 billion over just the next 10 years. Well, it would seem to be moving in the opposite direction of budget balance, although they are not exclusive. But I look forward to our distinguished witness who has served us so well over the last 5 years, or almost 5. Thank you for holding this hearing.

The CHAIRMAN. Very good. Well, rather than carry on our conversation, let us hear from our panelists.

Mr. Secretary.

STATEMENT OF HON. LAWRENCE H. SUMMERS, DEPUTY SECRETARY OF THE TREASURY, WASHINGTON, DC

Dr. SUMMERS. Thank you. Thank you very much, Mr. Chairman. I am pleased to have this chance to return to the Senate Finance Committee to discuss the question of IRAs. I remember well some years ago testifying before then Senator Bentsen and yourself on this important topic.

As you suggested in your statement, Mr. Chairman, I think there is widespread agreement on the importance of promoting savings in the United States. One part of the case is contained on this chart which depicts the relationship between savings rates and

[1] For additional information on this subject *see* Joint Committee on Taxation document *JCS-2-97—Tax Proposals Relating to Individual Saving and IRA's*, March 6, 1997.

growth rates for the G–7 countries over the last 35 years and is, I think, a rather disturbing picture.

Fortunately, as convergence has taken place between other countries and the United States, the relative growth experience of the United States has been far more favorable in recent years than this graph suggests over the last 35 years.

Nonetheless, I think it does bear out the judgment of many economists that increasing savings is an important way to increase economic growth. But increasing savings is a micro-economic imperative as well as a macroeconomic imperative.

I just received information suggesting that, for the pension plan of which I will someday be a part for university professors, a married couple, both of whom reach the age of 65, can expect to see one of them survive to the age of 90, suggesting a retirement period of 25 years, something that is getting up there relative to the length of working life and pointing up the importance of savings as a route to income security in old age.

Clearly, the low and declining rate of personal saving in the United States is a matter of major concern as it contributes to a low rate of national saving. There are, I believe, two ways to increase the national saving rate.

There is no question in my judgment, and as Senator Moynihan suggested in his statement, the most potent and reliable way to increase national saving is to reduce the budget deficit and reduce the contribution that the public sectors makes to dissaving.

Progress we have made in reducing the budget deficit from 4.7 percent of GDP in 1992 to 1.4 percent last year has freed up hundreds of billions of dollars to be invested in productive plant and equipment that otherwise would have gone into the sterile asset of government bonds.

Continuing to work toward a balanced budget, and even the possibility of a budget surplus, would make further contributions to increasing national saving.

But even as we work to promote a balanced budget, I believe it is also important to address America's low rate of private saving as part of a strategy to increase national saving, and this needs to be an important priority going forward.

The Administration's IRA proposal was crafted in this regard, to improve the effectiveness of IRAs and expand their eligibility. The Administration's IRA proposal contained within a framework of an overall balanced budget has three elements: expansion of income limits, the creation of new back-loaded IRAs, and the elimination of the 10-percent withdrawal penalty for certain specified purposes.

Under our proposal, in two stages the income thresholds and phase-out ranges for deductible IRAs would be doubled. Second, everyone eligible for a traditional deductible IRA would have the option of contributing an amount up to the contribution limit either to a deductible IRA, or to a new, back-loaded special IRA.

Recognizing that some Americans would rather forego deductions than be taxed on their withdrawals later when they expect their income or tax burden to rise, contributions to the special IRA would not be tax-deductible, but distributions of contributions would be tax-free. If contributions remain in the account for 5

years, distributions of the contributor's account earnings would also be tax-free.

Finally, we would exempt withdrawals from IRAs from the 10 percent early withdrawal tax if the proceeds were used for specific purposes that meet the crucial needs of families. Withdrawals used to pay post-secondary education costs, to buy or build a first home, to cover living costs of unemployed, and to cover the cost of health care for close relatives who are not dependents would be exempt from the early withdrawal tax.

I might just observe that, in conjunction with the Administration's tuition deduction proposals, the Administration's IRA proposal constitutes a very attractive vehicle for promoting saving for college education.

A family can make tax-deductible contributions for education. Those contributions then earn tax-free interest with an IRA. They can then be withdrawn to pay for a child to go to college without the 10-percent withdrawal penalty.

Since tuition payments would be tax-deductible, the result is that tax would be entirely avoided for a family that saved in order to promote college education. Given the importance of college education, I think this is a worthwhile goal for us as a Nation.

Mr. Chairman, as you will hear later from the subsequent panels, the economics profession has long debated, and it will not surprise you, reached a definitive conclusion about the extent to which moneys invested in IRAs represent a genuine increase in saving.

My reading of that evidence and my study of this question over many years suggests that IRAs do stimulate saving and that expanding IRAs will further increase private and national saving.

I am convinced that this is particularly true because of psychological elements that impact on the attractiveness of saving. By increasing public awareness of retirement needs and savings options, advertising spent on IRAs can trigger an increase in savings beyond the level that less broad-based incentives would promote.

This is not just a hypothetical possibility. It is not usually noted that, prior to the second World War, the U.S. saving rate was higher than Japan's saving rate. Following the war, the Japanese government launched a major promotional campaign to stimulate saving.

While the post-war reconstruction surely accounted for some of the boom in the Japanese saving rate, observers also credit the savings promotion movement with playing an important role.

I think the experience with IRA contributions, as they have fluctuated following expansion of IRAs in 1981 and the contraction in 1986, also bears out this conclusion.

There are three principles that the Administration has relied on in crafting our bill which we believe should be appropriate in any approach to this problem. First, it is important to target expansion on those who are most likely to increase saving rather than merely shift saving from one vehicle to another.

Second, new incentives must be sufficiently attractive to widen participation. Third, it is important to think through the extent to which the design of a new incentive encourages promotional activity directed at the importance of saving.

Mr. Chairman, we believe that an expansion of IRAs will increase our rate of saving and saving for retirement. We believe that the President's budget demonstrates that it is possible to do so within a balanced budget framework, so IRAs represent an appropriate and important portion of a tax reduction program, if the Congress is to adopt such a program this year.

By no means are they the full answer to the problem of meeting the challenge of adequate retirement savings by the baby boom in subsequent generations. Reform to balance the budget is essential, and other components are essential as well.

Our recent introduction of inflation index bonds was directed, in part, at promoting saving, and we will all need to continue to work to simplify pensions and increase their attractiveness.

I welcome the committee's recognition of this important problem and the Administration looks forward to working with the committee to raise our National savings rate. Thank you very much.

[The prepared statement of Secretary Summers appears in the appendix.]

The CHAIRMAN. Thank you, Secretary Summers. Let me express my appreciation for the leadership role you have played down through the years on promoting Individual Retirement Accounts.

I agree with my distinguished colleague and Ranking Member, Senator Moynihan, when he says the No. 1 need is to balance the budget as a means of providing savings. But, as you point out, that does not answer the problem for the family, as important as it is. Of course, I voted for the balanced budget constitutional amendment because of the importance I attached to that matter.

Is it a fair statement to say central to the Administration's proposal, as far as savings is concerned, is an expanded IRA? It seems to me that here is an area, as we were discussing a few minutes ago, where we have bipartisan support for a common approach to increased savings, and by increased savings will we not be helping both the Nation, our economy, but we are also helping the family?

Dr. SUMMERS. Mr. Chairman, I do believe that an appropriately designed IRA expansion would serve both the retirement income security objective and a promotion of national saving objective.

Obviously, it is important that any approach be carefully designed and conserve on budgetary resources, since I think it is important to recognize also that an increase in the budget deficit or an opportunity to reduce the budget deficit that was foregone has important effects on national saving.

But I believe if we can legislatively expand IRAs in the context of a balanced budget program, we will make a contribution, both to growing our economy and to increasing retirement income security, yes, indeed.

The CHAIRMAN. Let me ask you this, Secretary Summers. You testified before this committee in 1989 and said that consideration should be given to ways of inducing employers to sell their employees on IRAs. You suggest this might be done by allowing some deductibility of IRA contributions against payroll taxes. Is this still a worthy proposal?

Senator MOYNIHAN. Be careful.

Dr. SUMMERS. Thank you. Thank you, Senator Moynihan. I have been here for some time. I have been now in Washington and away

from Harvard for some time now, but I, nonetheless, appreciate the warning.

Mr. Chairman, I have not had an opportunity to review what my thinking was at that point. I think at this point the proposal that is embodied in the Administration's budget represents what seems to us to be the best way to go forward.

I do think the point that you referenced involving encouraging and giving employers greater wherewithal to promote saving is an important one, and I think that the steps that were contained in the pension tax legislation that was supported in a bipartisan way last year in conjunction with the minimum wage bill included a number of steps that would make it much easier for small businesses to do exactly that, by promoting 401(k) vehicles that would encourage saving.

I think that it will be worthwhile to look again at pension arrangements to make sure that we are doing what we can to facilitate employers making them available for as many workers as possible.

The CHAIRMAN. Let me ask you for a comment along the same lines. Would it be desirable to allow a deduction, but particularly in respect to those with lower income to give them an opportunity to save for retirement? In other words, if you limited the deduction to those——

Dr. SUMMERS. I would have to look carefully to evaluate such a proposal. I think what I am much more aware of today than I was in 1989, I think in part because the world has changed and in part because I have learned something, is the importance of 401(k) plans, which are a vehicle that are very much directed at allowing employers to encourage their workers to make a contribution, which can often be achieved through a payroll deduction.

So in light of the widespread growth of 401(k) plans since that time, I am not certain of whether it would be desirable to take further steps of that kind at this time. I think it is certainly something that one could look at.

I think one also has to be very mindful, in thinking about policy in this area, of the integrity of the payroll tax and the use of the payroll tax to fund Social Security, and needs to think through those interactions very carefully.

The CHAIRMAN. I would agree with that. I have a couple of more questions. The Administration's 5-year revenue estimate for expanding IRA is one-half of the cost of the Joint Tax Committee's estimate of the same proposal. Do you have any explanation for that discrepancy?

Dr. SUMMERS. Mr. Chairman, I asked that question as we prepared for my testimony and I was told that the technical staffs were going to get together to discuss this, and I was offered the thought that the Joint Tax Committee estimate had been labeled preliminary. I just do not have a good explanation.

I think the differences have to do with different assumptions about take-up rates, with the Joint Committee assuming somewhat larger take-up rates than our estimators have. But I think it might be desirable for us to encourage the technical staffs to get together and discuss this question.

The CHAIRMAN. I would agree with that.

Mr. Secretary, Dr. Martin Feldstein, also of that famous or infamous institution, says, "The traditional revenue analysis which scores the back-loaded IRAs as losing revenue in later years is incorrect."

Dr. Feldstein says, "The gain in corporate revenue from the back-loaded IRA will outweigh the loss of income tax under plausible scoring models in both the short- and long-term."

Do you agree with that?

Dr. SUMMERS. Mr. Chairman, I think that Professor Feldstein, who was a teacher of mine, makes what is certainly a relevant and important point there, but I think that it would be premature at this point to rely on his calculations as a major element in thinking about scoring of IRA proposals. Extra saving generated because I contribute to an IRA, can go to reduce the trade deficit, can go into owner-occupied housing, can go into partnerships, or can go into corporate investments. So, I think to rely on the assumption that it would go into corporate investments as a basis for adjusting the revenue cost estimates would be going a bit too far on the basis of the evidence that we have available.

In many ways, this issue comes very close to a set of issues that have long been debated involving so-called dynamic scoring, and this is really a kind of dynamic scoring that Professor Feldstein is suggesting. I think the positions are familiar with respect to dynamic scoring; we do not think it would be advisable. So, while we support IRAs, we would not want to see that kind of approach taken to reduce their cost.

The CHAIRMAN. Well, I still have hope someday we will have dynamic scoring.

Dr. SUMMERS. Given the differences between the Treasury estimates and the Joint Tax Committee estimates of the IRA provision, it might be useful for the Joint Tax Committee to consider Dr. Feldstein's analysis, for different reasons. It might move them in the direction of the Treasury's estimates.

The CHAIRMAN. Senator Moynihan.

Senator MOYNIHAN. Sir, when I look at the budget submissions of the last 15, 20 years I think we already have dynamic scoring. Every President goes right straight to balance always just a few years out.

Dr. SUMMERS. Senator, I cannot resist observing that, while there certainly was some history that would bear that out, that the Administration's budgets have proven to be pessimistic in each of the last 4 years, and on the available evidence for 1997 the budget is likely to come in substantially under what was forecast.

Senator MOYNIHAN. A fair point. Just one conjectural, and then one factual, question. I remember, since we are talking about old colleagues and things like that, about 30 years ago I wrote something which argued that in the stage of capital formation, which we call in the 19th century the lack of industrialization, a culture will encourage delayed gratification savings to build up the capital base, but that there will come a moment when you have to start getting a reward for all that investment, so you will suddenly encourage consumption.

I trace the arrival of the advertising sector as that moment of cross-over, and thereafter you expect to see savings decline as the

dynamic of industrial capitalism proceeds. There is some argument of that sort, is there not? You do not have to agree. Just nod and——[Laughter.]

Dr. SUMMERS. I think, Senator Moynihan, you have in support of that argument both the virtue of truth and the virtue of the authority of your office, either one of which would be independently sufficient to induce me to agree.

Senator MOYNIHAN. He is getting very good, do you not think? [Laughter.]

But if you look at that curve over there, it is the most recently industrialized society that has the highest rates and the oldest ones who have the lowest rates, for what it is worth.

May I say, Patricia McLanahan behind me just handed me a note, something I did not know, which is that our saving rate for 1995 is now at 4.49 percent. It has doubled in about 3 years. That is the Bureau of Economic Analysis. There is some dynamic in there which I do not know that I fully understand. Maybe it is just the decline in the deficit.

Dr. SUMMERS. I suspect that figure is a net national savings rate.

Senator MOYNIHAN. Net total national savings rate.

Dr. SUMMERS. I believe that is driven probably by two things, primarily by the reduction in Federal deficit, and there may also be some cyclical effects on private saving. There is a tendency, particularly in the short-run, for increases in corporate profits to be associated with increases in retained earnings, which are a component of saving as well.

Senator MOYNIHAN. Could I ask you, you referred earlier to the Teacher's Insurance Annuity Association and pensions of weighted persons at 65. But are those contributions included in net national savings?

Dr. SUMMERS. Yes. They are included in national savings and they are included in personal saving as well. Indeed, employer contributions would also be included in what we conventionally measure as personal savings, for example, if General Electric has a defined benefit pension plan, rather than a defined contribution like TIAA.

Senator MOYNIHAN. Yes.

Dr. SUMMERS. And they fund the defined benefit pension plan, so that it is not money that anybody thinks of as being directly theirs, except insofar as they rely on the benefits when they retire.

Senator MOYNIHAN. It is recorded as savings?

Dr. SUMMERS. That is counted as personal saving as well. While I have not seen analysis very recently, it has been the case in at least some past years that if you took pension contributions out, personal saving outside of pension contributions was zero or even perhaps slightly negative.

Senator MOYNIHAN. So that would suggest that individual behavior in regards to personal savings is affected by the appearance of retirement systems, but the total net national savings is not affected because that includes retirement systems.

Dr. SUMMERS. The measurement of national savings includes all of the activities of retirement savings. Of course, there may be an exception to the extent that retirement savings in the private sector have a kind of pay-as-you-go character, envision a company

that operates its pension fund in a pay-as-you-go manner like Social Security, that would be likely to reduce the personal saving of its participants, but not have an offset on the other side. So, the growth of private retirement systems may have had a variety of complicated effects on what national savings turned out to be.

Senator MOYNIHAN. Well, I would just like to sum up by saying I think that what you just told us makes a case for the Chairman's position that, if you take out pension systems, personal savings are almost zero.

Dr. SUMMERS. I think that is right. We will, perhaps, try to look and see if there are some more recent figures available.

Senator MOYNIHAN. Would you give us some numbers? Thank you.

[The following information was subsequently received for the record.]

PERSONAL SAVING WITHOUT PENSIONS

Personal saving can be measured a number of different ways. The most commonly cited number is the saving rate as calculated in the National Income and Product Accounts (NIPA). As Chart 1 shows, the NIPA annual saving rate, that is annual saving as a percentage of disposable personal income, has ranged from 3.8 percent to 5.9 percent during the period 1992–1996. The Federal Reserve also publishes two alternative measures of the savings rate along with measures of pension saving (excluding IRAs and Keoghs). One of these measures of saving uses the Federal Reserve's saving concept along with the Federal Reserve's data, while the second uses the NIPA concept along with the Federal Reserve's data. In order to compare apples with apples, Chart 2 compares the Federal Reserve's calculation of saving with and without pensions using the NIPA concept but with the Federal Reserve data. Using the NIPA concept with the Federal Reserve's data, the saving rate varied from 3.6 percent to 7.6 percent during this period. If pension saving is subtracted from this saving rate, the net rate would have been 0.07 percent to 4.0 percent. As Chart 2 illustrates, the saving rate would be quite small without pension saving. In the two most recent years, 1995 and 1996, the saving rate without pensions would almost be nonexistent. Although this comparison is useful for characterizing the magnitude of pension saving and nonpension saving, it is important to remember that it does not reflect the amount of saving that would occur in the absence of pensions nor does it tell the whole story about the various components of saving and borrowing.

The CHAIRMAN. Senator Bryan.

Senator BRYAN. Thank you very much, Mr. Chairman. Let me preface my comments by commending you for your leadership on this IRA issue. I am pleased to be a co-sponsor of the legislation which you have introduced and I was, as you have been previously, a supporter of the expanded IRA when Senator Bentsen chaired this committee as well.

Mr. Secretary, let me ask you a question. I am concerned about the savings rate and the fact that other countries seem to do much better than we do. What kind of incentives, as a matter of government policy, are provided in other countries that, in your judgment, may contribute to their increased savings rate? What are the range of options, in effect, that are out there in the public policy field?

Dr. SUMMERS. Senator, I will give you a better answer in writing. I was more familiar with this subject several years ago than, frankly, I am now.

[The following information was subsequently received for the record.]

INCENTIVES IN OTHER COUNTRIES FOR SAVINGS

Other countries have a variety of tax policies that may contribute toward their higher saving rates. Saving rates also are affected by other government policies, economic circumstances and cultural behaviors. In terms of tax policies, the tax treatment of housing, investment income, capital gains, total income, pensions and other forms of saving may have an impact on saving. The following briefly describes some examples of recent tax policies in Japan, Italy, Germany and Canada that may have an influence on savings. In general, these countries have higher statutory tax rates than in the United States. Higher tax rates can potentially increase the impact of saving incentives. There is little evidence that differences in tax treatment of savings across countries accounts for the wide observed range of savings rates.

Japan provides incentives for saving through various kinds of saving accounts Social security payments, lump sum severance pay for retirement, and life insurance also receive preferential tax treatment. In contrast, Japan has less generous preferential tax treatment for owner-occupied housing than in the United States.

Japan provides incentives for long-term savings funds. However, in recent years the incentives have become less generous and are now more narrowly targeted. The social security system in Germany is more generous than in the United States with the result that pension saving is less important.

For several decades, many forms of savings received preferential tax treatment in Italy. The more recent trend has resulted in a tightening of savings incentives. Severance pay and pension benefits are two examples of savings that receive generous tax treatment. The severance pay program provides a much larger source of income for retirees than pensions. Under the severance pay program, employees that have not yet separated are allowed a one-time withdrawal that can be used to pay for medical bills or first-time home purchase. In Italy the social security system provides a substantial portion of retirement income. Although the system began as a funded system, it is now a pay-as-you-go system.

In Canada, a broadening of saving incentives was followed by a tightening of savings incentives. Tax treatment of pensions and Registered Retirement Savings Plans (RRSPs—the Canadian equivalent of IRAs) is generally similar to tax treatment in the United States with the exception that contributions are less restricted. Under the MSP system, individual can borrow tax-free to buy a house. Furthermore, RRSP funds can be withdrawn at any point in time. According to one study, withdrawals equal about 15 to 20 percent of contributions. However, not all forms of tax-preferred saving are less restricted in Canada than in the United States. Tax-preferred life insurance vehicles are far more restricted than in the United States.

Senator BRYAN. That is fine.

Dr. SUMMERS. But, in general terms, I think the answer is that a number of countries, Canada for example, and Japan, have rather more elaborate IRA-type programs that have associated with them major efforts to promote savings by encouraging advertising and creating a different kind of national attitude toward savings.

One of the, I think, perhaps slightly unfortunate legacies of the 1930's is that many Americans believe that to consume is patriotic because it creates demand and gives others jobs, and to save is unpatriotic and is bad for the economy. That kind of ethos, which had an economic logic in the 1930's, does not have much economic logic in today's world.

Senator BRYAN. Yet, we seem to be encouraging the Japanese to do that.

Dr. SUMMERS. Touché. Japan is starting from a very, very different point where capital is flowing out of the country because of excess saving. I think that the national attitude toward savings really is an important variable, and I think part of what we in government can do is work to create much more of a pro-saving atmosphere. In a way, over time, we have effected a variety of kinds of behaviors, from seat belt usage to recycling, and there are other examples as well. I think the provisions of these kinds of induce-

ments contribute to changing the attitude and promoting the importance of saving.

Senator Moynihan, I think, emphasized the importance of advertising, and I think that part of what this is about is generating advertising for future consumption. Saving is, after all, a mode for future consumption and future opportunities. I think that part of what we are trying to do is promote that kind of thing. I think that has been done with some success in a number of other countries.

Senator BRYAN. Mr. Secretary, let me give you an opportunity at a later point to expand upon your analysis. I understand that you will want to do that. Let me ask you to put this in some context. We have ERISA in 1974, we expand the benefit in 1981, and then we contracted it in 1986, as I understand the history of this.

Can you tell us, during the evolution of the expansion and the subsequent contraction, what impact that had on savings rates and who was it that participated? I am talking about the demographics of the economic profiles. In other words, who availed themselves of that? What groups of people did we reach when we first expanded it, who did we lose when we contracted it?

Dr. SUMMERS. I think we reached primarily middle-income families, perhaps slightly above middle-income families which were moving to use IRAs quite substantially after 1981. You saw very large usage as they came to be promoted much more actively.

Then in 1986, when the eligibility was scaled back, you saw a substantial reduction in promotional activity not just for those who were legally excluded, but also for many people who had been contributing before and had been eligible to contribute after the scale-back. Many no longer became as aware of IRAs and therefore reduced the volume of contributions. So I think the right answer would be middle-income families.

Now, there is a great debate—I do not want to overdo the certitudes here as to what part of this reflects the fact that 401(k) plans, which are in many ways a substitute for IRAs, have become much more active and have grown more rapidly since 1986. But I think the basic answer would be that the fluctuations in law primarily have affected middle and upper middle income families.

Senator BRYAN. I know my time is running out, and you declined to expand upon the dynamic scoring principle advocated by our distinguished Chairman. But in terms of impact to the Treasury, loss of revenue, which, in your judgment, would have the greater impact, the tax-deductible front-loaded, or the back-loaded?

Dr. SUMMERS. At the risk of demonstrating conclusively that I have been here too long, I would suggest that the optimal combination of those two elements is something similar to that which is contained in the Administration's proposal. Seriously, I——

Senator BRYAN. I appreciate the clarity of your response, Mr. Secretary.

Dr. SUMMERS. But, seriously, Senator, I think that it really is right, because different people do approach this differently to making it maximally effective to provide for the element of choice and to allow both front-loaded and back-loaded IRAs in appropriate circumstances.

Senator BRYAN. I thank the Chairman.

The CHAIRMAN. Senator Kerrey.

Senator KERREY. Thank you, Mr. Chairman.

Dr. Summers, I have suggested one of the reasons Japan has a very high savings rate is they have no retirement program, no Federal Government retirement program, which certainly contributes to a rather healthy discipline in making sure you are saving enough for the future.

One of the questions that I would like to ask you involves a program that Senator Simpson and I proposed a couple of years ago and introduced again last year. Now I should note that in the past I have supported expanded IRAs along the lines of what the Chairman and Senator Breaux propose. The problem is, you always get to the end of the game and you have got to figure out how to pay for it, and that is difficult to do.

So, following that interest in savings, especially as you indicate, savings for retirement, it is difficult to make a case for retirement when you get on the slippery slope and say, all right, you can withdraw for education, you can withdraw for medical, you can withdraw for your house. I mean, at some point these are no longer retirement accounts.

We have a retirement problem. A baby girl born today has a one in three chance of living to be 100. Seventy percent of all households have less than $1,000 of savings. In 1935 when Social Security was designed, the life expectancy was 61. If you lived to be 65, you had a chance to be 70. Today, if you live to be 65 you are going to live to be 85. We have got this tremendous unfunded liability with the baby boom generation hitting a real crisis point in 2013.

So what Alan Simpson and I did was made some changes in the current program, moving the normal eligibility age back, moving the early eligibility age back, reducing the CPI, adding a third replacement rate point and a number of other things, to establish a stable source of funding for Social Security so that all beneficiaries could be covered. Currently we are able to cover only those who are over the age of 40. Our proposal would also enable the system to provide the wage payers with a 2-percent tax cut, which would be converted into savings.

Now, the question for you is whether or not, under that kind of a proposal, that 2-percent reduction in the payroll tax being converted into individual savings, whether that adds to national savings.

Dr. SUMMERS. I am familiar in general terms, but not in detail, Senator Kerrey, with the proposal that you and Senator Simpson made. A number of other proposals have contained a similar element in terms of a mandatory contribution.

Senator KERREY. This would be mandatory and for retirement only. We would not allow it to be withdrawn for other purposes, it is retirement only. Under the terms and conditions of a normal IRA, convertible at age 59½ into an annuity.

Dr. SUMMERS. I think it is something that has to be looked at very carefully in the context of something that I think has been recognized that we are going to need to do over the next several years, which is look very carefully at the whole question of the way in which we provide for retired Americans.

Senator KERREY. Well, I appreciate the next several years. The problem is, of course, for those who understand the magic of

compounding interest rates, a median family income of $31,000 at 2 percent, 5-year delay is about $80,000 off of their wealth over the course of their working lives, presuming a 22-year-old individual. The delay costs people the capacity to generate individual and family wealth.

But, again, the question I ask as to whether or not a reduction in taxes of 2 percent converted into a mandatory savings program would increase national savings.

Dr. SUMMERS. Potentially there would be a positive impact on national savings. I think in order to give you a definitive answer it would be important to understand what the full set of fiscal arrangements that were being made were and what the degree of substitutability between this mandatory savings and savings that individuals were otherwise engaged in. Clearly, to some extent——

Senator KERREY. I would appreciate very much if, at some point later, you could provide me with a written analysis of whether or not you think it does add national savings.

[The analysis follows:]

MANDATORY SAVINGS PROGRAM

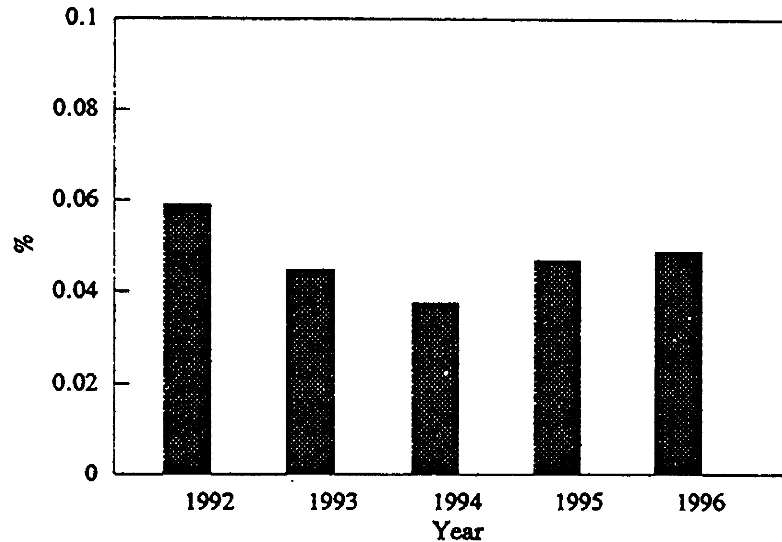
The proposal, as I understand it, would reduce the reduce the Social Security payroll tax rate by two percentage points, and mandate that individuals place an equivalent amount in an IRA (which would have no early withdrawal options). The effect of the reduction in the Social Security tax rate on the Trust Fund would be offset by a combination of measures including increasing both the normal and early ages of retirement, reducing the CPI, and a number of other things. Your question is whether this proposal would increase national saving.

proposal might affect national savings by changing either government savings (the Federal deficit or surplus), or by changing private savings, in particular savings by households. Let me address each avenue of savings. The impact of the proposal on government savings depends directly upon whether the proposed changes in retirement ages, the CPI and other measures would in fact exactly offset the reduction in FICA taxes in both the short- and long-run. If the proposal were, as apparently intended, revenue neutral over the short- and long-run, there might still be some indirect effect on government savings due to changes in the savings and other behavior of households in response to the change. I would expect any such indirect effects to be relatively small.

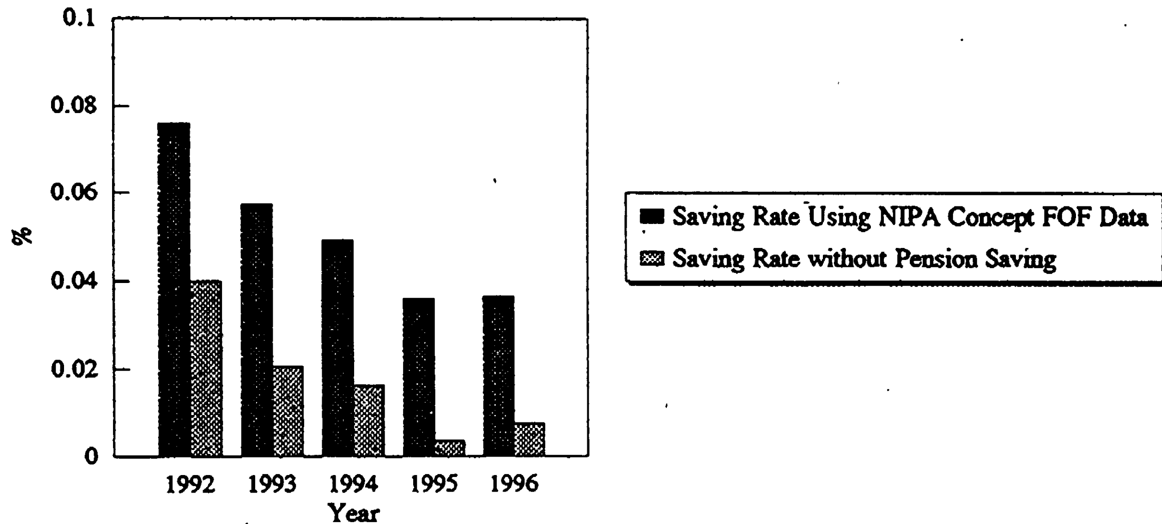
The impact of the proposal on savings by households would work through two main channels. First, the changes in the Social Security benefit structure could affect the savings behavior of both current and future retirees. Current retirees, if affected by the proposed changes (such as the CPI adjustment) might increase their saving in anticipation of lower Social Security benefits in the future, but some might reduce the savings they would have made from Social Security benefits that would be reduced under the proposal. Current workers who would expect to receive smaller increases in Social Security due to changes in the CPI, for example, might save more for their retirement because their expected stream of Social Security benefits would be reduced; though taking account of the IRA, their saving behavior might be unchanged because their intertemporalbudget constraint is unchanged. Current workers might also reduce their retirement savings because they would be required to work longer, and hence spend fewer years in retirement. Second, some workers might simply cut back their own personal saving, or increase their borrowing, to offset the effect of the mandatory IRA saving. Even with a great deal of analysis of a very specific proposal, it might be difficult to determine with any confidence what the net impact of these opposing influences might have on savings.

The Saving Rate as Estimated in NIPA

Personal Saving as a Percentage of Disposable Personal Income



Source: Federal Reserve, Flow of Funds Accounts (FOF) of the United States, March 14, 1997


The Saving Rate with and without Pensions
Personal Saving as a Percentage of Disposable Personal Income
0.1
0.08
0.06
0.04
0.02
0
%
1992
1993
1994
1995
1996
Year
Saving Rate Using NIPA Concept FOF Data
Saving Rate without Pension Saving
Source: Federal Reserve, Flow of Funds Accounts (FOF) of the United States, March 14, 1997

Senator KERREY. Let me ask you again, on retirement. You start off your testimony saying retirement is your No. 1 concern. Now, let us say Social Security was never passed. What kind of a system do you think we would design?

Dr. SUMMERS. I am not sure. I think if we were starting today we probably would not do it in precisely the way that it was done in the 1930's.

Senator KERREY. Would you be an advocate of some of it going to savings?

Dr. SUMMERS. On the other hand, we have taken on a whole set of commitments and people have formed a whole set of expectations on the basis of the system that we have now, so I think it is important to be extremely careful in thinking about the future of the Social Security program. But I do not think there is any question that we should not be prisoners of a structure that was optimal in 1935.

Senator KERREY. I think it is a program I hope does get some reexamination, because I think we would design it differently if we were doing it today. If the Chairman and the Ranking Member would not mind indulging me just for one more minute.

One of my favorite individuals on this issue is a woman by the name of Oseola McCarty. You have probably heard about the woman from Hattiesburg, Mississippi who left high school at the age of 13 to take care of her aunt and was a washer woman for the next 74 years, and took care of other family members as well.

She called up a college a couple of years ago to give them a donation and they thought it was probably going to be a doily or some other thing she made at home, and it turned out to be $150,000 that she had saved over her entire life that she wanted to make as a contribution to a college for scholarships for young women that are going on to college. She generated a huge amount of wealth with a relatively small amount of savings over a very long period of time.

I always say to my friends on the left who always whack me on this proposal of mine, that you go talk to Oseola McCarty when they presume that people are too stupid to make investments on their own. Second, they should examine what Oseola McCarty gets. She gets $120 a month from Social Security after 74 years in the work force.

To put this in perspective, a general who has worked for 35 years in the Army, his cost of living adjustment will be $190 a month. In a given year, he will get a $190 increase per month in his overall retirement benefits, while Oseola McCarty sits out there with $120 total a month, and we are defending that as a very progressive and terrific program.

I think Social Security needs to be examined from the standpoint of making it more progressive, but also to bring it up to date to what people are both capable of doing and what they need.

Dr. SUMMERS. Senator, I agree with you on the need to look very, very hard at these issues, both in the context of the challenge of retirement for aging Americans and in the context of the budgetary challenge that Social Security represents, and in terms of the needs for social protection.

I would caution that——

Senator KERREY. Just what I need, is one more caution on this issue. I do not need any more cautions on this one.

Dr. SUMMERS. Your example notwithstanding, I think there is some tension between the goal of progressivity and the goal of self-reliance and the goal of allowing people to keep their contributions directly to them, and the goal of promoting progressivity are things that have to be quite carefully balanced.

Senator KERREY. Thank you.

The CHAIRMAN. Senator Moseley-Braun.

Senator MOSELEY-BRAUN. Thank you very much, Mr. Chairman. I am sitting on Senator Kerrey's left, and I would not think of whacking him. Anyway, Dr. Summers, it is amazing, and I think wonderful, that the Congress is spending so much time and attention on these issues.

I just left the Committee on Aging. I stayed there for the first half hour, actually 40 minutes, and precisely the same discussion is going on on the 6th floor of this building as is going on in this room.

I think that is a very good thing, a very healthy thing, because certainly the impacts of the demographic bubble and what we do about these issues is of critical importance to our stewardship and our legacy to the next generation of Americans. So that we are having this much of a public discussion, I think, is of real importance.

I raised an issue upstairs and I would like to raise it with you, Dr. Summers, but I did not want to lose the opportunity to ask you a question in your particular area of expertise, which is these numbers in terms of saving rates and the like. If we can have a short answer to this, because I have a real question I would like a long answer to.

Your comparative numbers on savings rates, personal saving rates in the United States at 8.6 percent compared to the U.K. at 5.6, and that the U.S. savings rate was lower than the rate for Italy, Japan, Germany, France, and Canada, and the remaining OECD countries.

Now, one of the objections that I have heard is that those countries, in the calculation of savings rates for those Nations, they include housing, whereas our calculation does not include housing. Now, is that taken into account? Is there any difference in the way that these numbers are calculated between so that these numbers may not be as comparative as they seem?

Dr. SUMMERS. My understanding is that part of the reason why we fund the OECD is to do things like produce comparable statistics and that the statistical basis is, in fact, comparable, is my understanding. But I may be wrong. If I am wrong, I will certainly communicate that back to the committee in writing, but I think the numbers are comparable.

Senator MOSELEY-BRAUN. I wish you would look at it, because I have had an economist tell me that there is a difference in the way of calculation, and I just do not know. I thought, since I have the expert of experts here, I would ask you for it.

Dr. SUMMERS. My staff is telling me that I am right.

Senator MOSELEY-BRAUN. Everybody is shaking their head, too. Well, I hope so.

Dr. SUMMERS. They are telling me that what I said is right.

Senator MOSELEY-BRAUN. I hope so, because I have been using your numbers.

The second question. This is interesting. One of the people who was just upstairs is coming to this committee, and I guess will be testifying in the third panel.

With regard to the Administration's IRA proposal, we have been looking at the issue of retirement security and savings and pensions as a particular issue going to the demographic bubble and what happens to the baby boomers when we retire.

There is a great deal of concern about retirement security that people put enough money aside to have a secure retirement, because Social Security is not, in and of itself, enough for a comfortable retirement.

Upstairs we raise the question of the particular impacts as to women because there are a different set of dynamics and problems associated with women because we would still live longer, we earn less in the work force, we have lower tenure in the work force, and so those things impact on pension and retirement security for women.

But I say all of that as a predicate to my question to you in terms of the Administration's IRA proposal. Is it a proposal to bolster savings generally and to encourage asset aggregation, or is it a proposal to provide for retirement security, or both? Because if it is for retirement security, then I have to raise the question that all of the provisions made in the proposal for tax treatment of withdrawals for special purposes.

There is no question but that the special purposes are important and laudable ones, buying a house, sending a kid to college, coping with medical bills, weathering periods of unemployment, but that allows people to use what ostensibly are retirement savings accounts, almost a savings account, and to take that money out at the occurrence of any of these events. That, at the same time, leaves them less secure when they are no longer in the work force, when they are actually in retirement.

So I guess my question to you is a matter of policy, whether or not this proposal is kind of an amalgam, and where does it fit? Is it just a savings account or just promoting savings, is it for retirement, or is it an amalgam of both, and what is the policy rationale for combining these objectives in this way?

Dr. SUMMERS. Senator Moseley-Braun, I think you raise a very important question. Our thinking in expanding the possible withdrawals was of two kinds. First, while savings is crucially related to the retirement issue, people have other crucial issues in their lives. We thought it was important to help people be in a position to prepare to send their kids to college, respond to a medical emergency, and all of that.

Senator MOSELEY-BRAUN. We all that think that is apple pie, mom, and we love it. Right.

Dr. SUMMERS. That was one important objective.

Senator MOSELEY-BRAUN. Right.

Dr. SUMMERS. Second, it is a more subtle argument, but I think it has validity. If you want to encourage a 24-year-old to save for retirement, you may have a better chance of getting them to make the contribution if you tell them that, in the event something hap-

pens, in the event they have a medical emergency, in the event they have a big financial push at the time their kid goes to college, they will be in a position to make a withdrawal. People may be more prepared to make the contribution if they know that, in the event of the rainy day, they will be able to make a withdrawal than they would be if there were no option of that kind available.

For many people, their economic fortunes will improve over time, there will not be a medical emergency, so they will end up not ever making that withdrawal. But the fact that the contribution does not become entirely illiquid makes the vehicle more attractive and, therefore, may lead to more retirement saving rather than to less.

Senator MOSELEY-BRAUN. One quick question.

The CHAIRMAN. Go ahead.

Senator MOSELEY-BRAUN. Given the testimony that the experts have given us already, that people who have disposable income at the higher end of the income scale are more likely to save than people who do not. Does this proposal not then exacerbate that tension?

I mean, it says then that people at the higher end of the income scale who will have disposable income for sending their kid to college or buying a house will be able to salt that money away and just leave it there, tax-free, whereas the working, middle-class person who is likely to have at least one of these things happen over time, will then be taking down those assets which should be put aside for retirement, and so will still be insecure at the time that they leave the work force.

Dr. SUMMERS. I think it would be wholly false of me to pretend that this proposal was going to solve all income security issues in the United States. I do think, particularly if you think about lower-middle income people, that if you want to encourage them to be saving when they are in their 20's, when they are in their 30's, it is very important that you establish rules which will make that saving potentially available as they meet needs that may come before retirement, because I think otherwise they are likely to want to just keep the cash and not engage in any kind of savings behavior.

So that is why I think it is helpful, in terms of encouraging saving, for people with lower incomes to extend the range of uses. But, look, I do not think there is any question that the real solution is to raise the incomes of people who are earning less now, and that is why so much of what the Administration has focused on is improving education, improving training, because that is what ultimately affects productivity.

I think that without increasing incomes you are clearly going to be making choices between consumption at one point in life and consumption at another point in life, and I would not want to be in the position of looking at a single mother with four kids and telling her that the Government would help her to save for when she was 65, but not be helping her to save for one of those kids to go to college, or when one of the kids gets sick, or when she wants to purchase a new home.

So I think this is very much about retirement, but I think the issue of saving is a more general one. I think increasingly we are

coming on a bipartisan view to believe that government cannot solve everyone's problems.

What government can do is help to give them the tools to solve their own problems and I think contributing to savings accounts and allowing those savings to be withdrawn at critical moments in a person's life is a way of doing just that.

Senator MOSELEY-BRAUN. Thank you.

The CHAIRMAN. Well, thank you very much, Mr. Secretary. We will keep the record open so that if people have additional questions they can be submitted in writing. We look forward very much to working with you on this important matter of savings, and particularly the IRA.

Dr. SUMMERS. Thank you very much, Mr. Chairman.

The CHAIRMAN. I would say, in answer to my colleague's question that it was an increase in the net national savings rate by 5 percent of GDP.

Senator MOYNIHAN. By 5 percent.

The CHAIRMAN. Yes. Thank you, Mr. Secretary.

We are going to combine the next two panels. I would like to call forward William G. Gale, doctor of philosophy. He is a Joseph A. Pechman, Fellow of Brookings Institute. Glen Hubbard, professor of economics and finance, Columbia University, Visiting Scholar at American Enterprise Institute; Steven Venti, who is professor of economics at Dartmouth College; Robert C. Pozen, managing director and general counsel, FMR Corporation; Dallas Salisbury, president and CEO, Employee Benefit Research Institute; and John S. Tottie, senior economist for Tax and Budget Policy, Citizens for a Sound Economy.

Gentlemen, it is a pleasure to welcome you here. We would ask that each of you summarize your testimony to no more than 5 minutes, and your full statement will, of course, be included as part of the record.

So we might start with Dr. Gale.

STATEMENT OF WILLIAM G. GALE, PH.D., JOSEPH A. PECHMAN FELLOW, BROOKINGS INSTITUTE, WASHINGTON, DC

Professor GALE. Thank you very much, Mr. Chairman. It is a pleasure to be here to testify on the issue of expanding IRAs. My testimony is based in part on research I have conducted over many years on the effects of IRAs on saving.

Let me start by saying that I think the low level of saving in this country is either the most important problem we face, or one of the most important problems we face. But I think I am going to be the one that rains on the parade this morning. I do not think that IRAs will prove to be an effective way of resolving this issue, and I would like to talk about why.

There have been a number of reasons offered for why saving has fallen in the United States: intergenerational transfers, the increase in debt, the reduction in income growth, government programs that reduce incentives to save.

What is notably not on that list is taxes. Tax rates are lower now than they were 10, 15 years ago. There are a ton of saving incentives in the Tax Code. In my view, it is unlikely that taxes were

the cause of the decline, and it is equally unlikely that they will be a major part of a saving rebound.

IRAs being one tax policy toward saving, it is important to view IRAs in the context of the overall policy toward saving. Our current policies toward saving are highly inconsistent. Some assets are taxed at very high effective rates, while a number of assets are taxed at very low, and even negative, rates.

The current options for low and negative rates include IRAs, defined benefit pensions, defined contribution pensions, 401(k)s, KEOGHs, 403(b)s, 457, thrift plans, SIMPLE plans, SEP plans, fixed and variable annuities, and life insurance.

What should be clear, is there is no shortage of opportunities to save in tax-deferred forms.

In the earlier panel there was a discussion of saving in tax preferred forms versus overall saving. Table 1 of my testimony indicates that in the past 10 years, tax-preferred saving has increased to equal 100 percent of net personal saving. So, basically, what has happened over the last 15, 20 years, overall saving has gone down, tax-preferred saving has gone up dramatically. Those numbers are in Table 1.

So what do we think about IRAs? Well, IRAs are just one more patch in this crazy quilt of saving policy. Proposals to expand IRAs involve issues of tax policy, budget policy, retirement income security, and saving policy.

Let me start with tax policy. I think expanding IRAs would be poor tax policy in two ways. First, it would make the system more complex and intrusive, and serious consideration of how the IRS would verify that a particular withdrawal was made for a particular reason suggests lots of compliance and enforcement difficulties.

Enforcing the combined limits on IRAs and elective deferral plans creates further headaches. I think you would see more people going to tax preparers, more people being frustrated with the details of the tax system if we expand IRAs in the ways proposed.

A second tax problem is that the effective tax rate on most IRAs is actually negative. That occurs if the rate that you deduct the contribution at is higher than the rate you take the withdrawal at.

I think good policy right now would even out the taxation of different forms of saving, and possibly reduce the overall level of taxation on saving, but punching a hole in the Tax Code to generate more assets that have negative tax rates on them does not seem to me to be either efficient or equitable.

In terms of budget policy, I think expanding IRAs would be counter-productive. First of all, we would create a new entitlement via the Tax Code for anyone who had enough money to put cash into the IRA. We all know that right now what we want to do is create fewer entitlements, or curtail entitlements.

A second issue is that the current budget procedures understate the cost of back-loaded IRAs because the 5-year withholding period puts it effectively outside the budget window. I think that accounting gimmick is by now well known and well understood. So, I think expanded IRAs are probably poor budget policy.

In terms of retirement income policy, expanding the conditions for penalty-free IRA withdrawals could undermine both the retire-

ment goals of IRAs and reduce national saving. I emphasize the "reduce" here as a very serious possibility.

First of all, I can imagine the list of favored uses of IRA funds expanding indefinitely. A proposal a couple of years ago suggested that people should be able to take money out penalty-free to buy a car. There are lots of virtuous healthy things that people do. I can see everyone wanting to add those to the list.

I can also imagine the list of favored accounts expanding as well. If IRA funds can be tapped, why not KEOGHs, SIMPLE plans, SEPs, 401(k)s, fixed and variable annuities, et cetera? Basically, this is the foot in the door to undermine the integrity, or whatever integrity there is, of the retirement income system.

If, however, withdrawals are allowed I would emphasize two aspects. Withdrawals should not be allowed for funds that are currently in the account. People put that money in with the understanding that they would have to pay a penalty if they took it out. There is over $1.2 trillion in IRAs and KEOGHs right now. If you open up that as a potential source of consumption, I think there is a serious risk that saving would fall rather than increase.

The other issue is that withdrawals from deductible IRAs should have income taxes withheld from them, even if penalties are not. S–2 right now allows for income tax-free withdrawals, which I think is a mistake, because then that income is never taxed.

All right. Saving policy. The big question is, do IRAs raise saving? Let me say, we are not going to resolve this issue today, but let me talk about this briefly.

The single most important factor here is that IRAs do not provide an incentive to save, they provide incentive to put money in a particular account. Saving is a net concept. It involves how much you put into these accounts, less how much you take away from the accounts. IRA are a gross saving vehicle and, hence, do not provide a net saving incentive.

Let me summarize briefly. Studies that find that IRAs raise saving usually focus on financial assets. They usually do not distinguish between pre-tax and post-tax balances.

No study that corrects for these problems and for other reasons why financial assets would have gone up has found that IRAs raise saving. Studies that I have done that do correct for these find that IRAs do not raise saving.

One additional point, is that even if about half of the new contributions turn out to be new saving, the estimated effect on total national saving is likely to be very minimal, and I provide an estimate in my testimony.

Let me conclude on two points. First, I think what needs to be weighed here is, on the one hand, the costs to tax policy, budget policy and retirement income security, and the potential benefits, which are an increase in saving. But those potential benefits, in my view, are small, speculative, and could actually be negative.

Finally, I would like to close on a more constructive note, which is that endless tinkering with tax-deferred saving plans, I think, is blinding the policy debate to more effective and durable ways of addressing national saving. What I would put on the list way ahead of IRAs is deficit reduction, financial education of American households, pension reform, and Social Security reform.

Thank you very much.

The CHAIRMAN. Thank you, Professor Gale.

[The prepared statement of Professor Gale appears in the appendix.]

The CHAIRMAN. Professor Hubbard.

STATEMENT OF R. GLENN HUBBARD, PH.D., PROFESSOR OF ECONOMICS AND FINANCE, COLUMBIA UNIVERSITY, RESEARCH ASSOCIATE AT NATIONAL BUREAU OF ECONOMIC RESEARCH, AND VISITING SCHOLAR AT AMERICAN ENTERPRISE INSTITUTE, WASHINGTON, DC

Professor HUBBARD. Thank you, Mr. Chairman. I think it is important to put the question in a broader context. As you indicated in your opening remarks, the Nation continues to suffer from an inefficiently low capital stock, a poorly allocated capital stock, and inadequate levels of saving by many households.

In contrast to Bill Gale's remarks, I will argue that savings incentives are actually a very promising policy tool to stimulate savings. However, I would urge a similar caution, and will do so more pointedly at the end, that the committee continue at the same time to contemplate fundamental tax reform, either within the income tax, or a switch to a broad-based consumption tax.

The targeted savings incentive debate is an important one. To avoid a miasma of numbers and econometrics I just want to think about four simple questions. First, do saving incentives stimulate new household saving? I will argue here that the cup is half empty or half full, but, on balance, most economists would say yes.

However, I do not think that is the question that ought to interest you the most in your evaluation. There are three others I want to consider with you briefly. Second, are saving incentives cost-effective? That is, as a long-term budget matter does a targeted saving incentive have a good bang for the buck in promoting saving?

Third, do saving incentives increase economic well-being? We can make people save. The question is whether the higher saving improves overall economic well-being? I will argue there that it can.

Finally, I will ask what have we really learned from existing policy experiments, and offer some answers and some questions.

To start out with the question of whether saving incentives actually stimulate savings, I will shock you, no doubt, to point out that there is disagreement among economists.

Suffice it to say that there is a high technical hurdle rate for getting such a question right in terms of designing the tests and the available data. For technical reasons into which I will not go here and which are presented in my written remarks, I think that studies that have found very large net saving effects are probably biased upward, and studies finding negligible net saving effects are almost certainly biased downward.

My own reading of the data, based on my own work and the work of others, is that a very conservative estimate of the fraction of each dollar of contribution that is new saving would be, conservatively, between 25 and 35 cents. More broadly, on the issue of 401(k) plans, I think the picture is even better. Evidence supports the view that 401(k) balances have not been offset by a

decumulation of financial assets, and my own reading of the evidence is that 401(k)s largely represent new saving.

Now, whether or not the number is 25 cents, zero, or $1, there are some more interesting questions. Suppose I told you with perfect certainty that a particular saving incentive generated only 4 cents of new saving per dollar of contribution, is the policy a good idea or bad one? Well, it depends.

If the Government only lost one cent of tax revenue per dollar of contribution, the answer to which you might well come is yes. Jon Skinner and I performed a cost benefit analysis of tax-deductible IRAs over a long period of time—not 5-year budget windows, but over a very long period of time—that the Government might consider in balancing its budget.

We concluded that even if the fraction of contributions that is new saving is only 20 cents per dollar, IRAs easily pass a long-run cost benefit test, even without the additional considerations Martin Feldstein and others have raised.

The basic idea is a simple one: The saving incentives do not really have to stimulate a substantial amount of new saving to generate favorable marginal increases in the capital stock per dollar of contribution.

Now, let us suppose we pass the cost-benefit test. Should we have saving incentives? We know that an increase in the capital stock is not manna from heaven. What it means is that we consumed less today in order to have more consumption tomorrow. Why would we ask households to do this? I will offer a number of reasons.

One that is frequently argued by economists is that there is a high social value of capital accumulation, a fancy way of saying the productive capital stock is too small. That is surely true, but IRAs may not be the only, or even the best, way to address the inadequate level of the Nation's capital stock.

A second issue that saving incentives are more able to address is that, because we tax capital income sometimes multiple times, there is a distortion between current and retirement consumption. To the extent that IRAs are partially new saving, they ease this distortion.

A third point that came up in Larry Summers' remarks in your conversation with him was the issue of myopia and self-control. It may be that encouraging people to save helps offset not a "market failure" about which economists often talk with you, but an "individual failure" in planning to save. That is also surely true. For IRAs to be an effective policy response, however, financial education will have to play a role.

I think that many of the bills that you have before you for consideration—including S. 2, S. 197, and S. 14—have some desirable features and some areas for concern. One general point I would urge in your review is the desirability of stability in IRA policy, as in tax policy in general.

Let me close by commenting briefly on what I think we have learned from the experiments in IRAs and what economists have tried to bring to the table. My own reading of the evidence is that targeted saving incentives are a very promising policy tool.

If we, however, return to the basic questions that brought you, Mr. Chairman, to the topic—that is, if the goal is to increase the productive capital stock in the United States—I urge you to think about broader reform of the Nation's tax code. There are other reforms you might contemplate that will have a larger effect on capital formation than IRAs.

If the concern is about adequacy of retirement saving, I would also invite you to think more broadly and to conduct a debate about IRAs in the context of a broader debate of pension reform and partial privatization of Social Security. Thank you.

The CHAIRMAN. Thank you, Professor Hubbard.

[The prepared statement of Professor Hubbard appears in the appendix.]

The CHAIRMAN. Next, I would like to call on Professor Venti.

STATEMENT OF STEVEN VENTI, PH.D., PROFESSOR OF ECONOMICS AT DARTMOUTH COLLEGE, HANOVER, NH

Professor VENTI. Thank you, Mr. Chairman. I thank you for the opportunity to appear before the committee today. I will just answer two short questions. First, do IRAs increase saving, and the second is, if so, why? What features of the program have made it successful and what can we learn from our past experience to better design tax-based saving incentives in the future?

Much has been written and much has been said already today about how low savings rates may jeopardize the financial security of future retirees or may jeopardize the long-term growth of the United States.

Providing tax incentives through saving is one way of addressing these concerns, but the big question really is, for IRAs to be deemed successful, do they increase saving? Some critics have argued that investors simply reshuffle existing assets into IRAs, or perhaps IRA contributions simply reflect funds that would have been saved anyway.

Well, evaluating the merits of these challenges has been, for reasons both speakers have noted, a very difficult challenge. In response, along with two co-authors, David Wise of Harvard University and Jim Poterba of MIT, I have conducted over the past decade about a dozen studies of IRA saving effects using several different microeconomic data sets, using a variety of different methodological techniques, some simple and some highly technical. I cannot, in a short time, summarize the results of all these studies. I refer you to the written record and the references cited therein.

However, I can summarize the results. There is a clear and substantial positive effect of the IRA program on personal saving. IRA contributions are, for the most part, new saving.

Let me just cite one small piece of evidence that will have some bearing on what I will say later. If we go back to 1982, the beginning of the expanded IRA eligibility, we can look at new contributors, families that just began contributing after 1982, and they started contributing about $2,300 a year to an IRA.

Once they began contributing, contributions were persistent; you tend to contribute year after year. Well, these households had no history of prior saving. The accumulated assets of new contributor households in 1982 was only about $8,500.

If you asked them what they were saving for the principal answer was not saving for retirement, it was saving for some other purpose, perhaps emergencies, perhaps for college payments, perhaps for some other purpose.

For these households, a regular program of retirement saving was something new. It was new behavior, it was new saving.

If IRAs work, why do they work? I ask the question because simple financial logic says that if you were saving for retirement prior to IRAs and you introduced an IRA, you would just get a tax break and not increase the pool of saving.

Why is this not the case? Well, the first reason, as I just noted, is that some people were not saving for retirement, or would not be saving for retirement at all, without an IRA program. That includes people who, after the program is available, do save.

The second reason, and the one I really want to focus on today, is that saving is not just a financial decision. Other aspects of behavior, many non-economic, many psychological, many non-financial, also affect the decision to save through IRAs. I believe these factors are the key to the success of the IRA program. Indeed, they probably outweigh the financial considerations involved.

Let me mention several of these factors. I do not have the time to present much evidence on their behalf—again, I refer you to the written record—so I will just state each one and say something about the significance of each.

First, the up front deduction is important in an IRA. Investors seem to respond disproportionately to a front-loaded or immediate tax reduction. One example of this is our experience after the Tax Reform Act of 1986 with non-deductible IRAs. These instruments dominate conventional saving financially, yet investors have greeted them with a shrug.

The deduction is a highly visible inducement to save. It appeals to the same impatience among persons that makes them non-savers in the first place. They are not thinking far enough ahead to retirement, they are thinking about today.

One consequence of this is that back-loaded IRAs, which are a financial equivalent to front-loaded IRAs, may not have the same appeal to investors as the traditional front-loaded IRA.

The second point. Savers respond to marketing and promotion. If offering a tax break is part of the story, selling it to consumers or investors is another part of the story. Again, there is no better example of this than the response to the Tax Reform Act of 1986. Among those IRA contributor households that remained eligible after the Tax Reform of 1986, 40 percent stopped contributing despite the fact that the after-tax rate of return had not changed. For these persons the IRA remained fully available and still overwhelmingly dominated conventional saving.

The only possible explanation, or the only plausible explanation I can find, is that the promotion and marketing that disappeared when IRAs were restricted affected behavior.

The third point, and this was raised earlier by several speakers, including Deputy Secretary Summers, is that IRAs target saving for retirement. They do so both through the promotion and marketing narrowly focused on retirement, and they also do so through the withdrawal penalty. It reinforces or locks in money for retire-

ment. People do not put money into IRAs now for any purpose other than to save it for retirement.

What this means, if you can just get a family to contribute, take a dollar from a conventional savings account and put a dollar into an IRA, then you are locking that dollar up for long-term saving—most conventional saving was not for retirement.

Given that IRAs lock in saving for retirement, I have to question the wisdom of having exemptions for other purposes prior to retirement, and a number of them have been addressed already, including exemptions for extraordinary medical expenses, exemptions for higher education expenses, exemptions for college tuition, distributions to persons receiving unemployment compensation.

I do not disagree with the merit of supporting these activities, I just do not think it is a good idea to support them through Individual Retirement Accounts.

Fourth, IRAs may increase saving by providing a means of self-control. Saving requires discipline, IRAs give them discipline. Just like pensions and Social Security, you put the money in an IRA and you cannot get it out until retirement.

I also want to mention the sort of promotional and educational role, although I think I will defer that to some later speakers.

If I can just summarize then. The low rate of saving is a concern, the financial security of future retirees is a concern, and IRAs address both of these concerns. I strongly encourage you to follow through on the expansion of the IRA program.

When you do, I also urge you not to think of IRAs as just a financial incentive, but also to think of all the psychological and non-financial ways that they get people on a path of saving. Thank you.

The CHAIRMAN. Thank you very much, Professor Venti.

[The prepared statement of Professor Venti appears in the appendix.]

The CHAIRMAN. Mr. Pozen.

STATEMENT OF ROBERT C. POZEN, MANAGING DIRECTOR AND GENERAL COUNSEL, FMR CORPORATION, BOSTON MA

Mr. POZEN. Thank you, Mr. Chairman. I would like to focus on two points from my testimony that may be a little new. A lot of the material here has been gone over thoroughly by the various professors.

The first point is that we all know that the U.S. personal savings rate is low, but I think what has not been focused on as much is: where is this financing of the Treasury debt, the $5 trillion that we have outstanding, coming from? More and more, the answer is from foreigners.

In 1995, $134 billion were the net purchases by foreigners of Treasury securities. In 1996, the final numbers are not in, but they are probably higher. At the end of 1996, 31 percent of total private holdings of Treasuries were held by foreigners. That is up from 21 percent in 1994.

Now, in the short-term, this is a very good thing for the United States. We have a large debt. Foreigners are financing it. That allows us to have relatively calm interest rates and allows us to keep the economy in good health. But, in the long term, this is a tremendous risk and a tremendous threat.

If foreigners change their attitude toward U.S. Treasury securities, what would happen then? Inevitably, interest rates would go up in the United States and that would have a negative effect on the economy.

Could this happen? Well, look at Japanese investors. They are the largest foreign holder of Treasury securities. They own roughly $271 billion in Treasury securities. Why are they buying Treasury securities? Over the last few years, the short-term rates in Japan have been below 1 percent. There is essentially about a 4-percent spread between Treasuries and Japanese short-term securities.

But that is because the Japanese economy is in a very significant recession that has continued for a while. It may be the case that the Japanese economy will recover and that interest rates in Japan will go up. What will happen at that point in terms of U.S. Treasuries?

The only way to solve this problem is to have a higher U.S. savings rate. If we do not have a higher U.S. savings rate, then we remain dependent on foreigners for financing this deficit, and foreigners will be motivated by many factors, most of which will have very little to do with the economic health of the United States.

That brings me to the second point. The second point is: Do retirement tax incentives help us increase our personal savings rate? I defer to the very knowledgeable professors on my right and left, but I would like to bring to bear some very practical evidence that I have gathered, coming from Fidelity Investments, in the last 2 months.

Last year, in the minimum wage bill, Congress included two provisions that related to retirement. One was the spousal IRA, and the other was SIMPLE for small employers.

I would like to report to you on how big a response there has been already to those provisions. The spousal IRA allowed a nonworking spouse for the first time to contribute $2,000. Most IRA contributions are made at the end of the year, or in April of the next year.

But I attach to my testimony the type of educational materials that are already going out from Fidelity Investments and other financial institutions. There are brochures, there are ads, the Internet is being used. The financial institutions are getting out to the U.S. people and telling them about this tax incentive, educating them about it, and that is why people will use the spousal IRA.

This is what I think Professor Venti meant by the promotional aspects of these programs. The financial institutions are doing the promotion so we are seeing, and will see, more spousal IRAs being opened up.

Now, in the SIMPLE area, this was a program to allow small employers, without a lot of administrative hassle, to offer retirement programs. They are essentially like IRAs. The employer signs up, and then the individual goes to the financial institution, sets up an account, decides how much to contribute, and then there is check-off through the employer. They are sort of like an employer-sponsored IRA.

In Fidelity alone, in January and February of 1997, over 1,000 small employers have now signed up for the SIMPLE IRA. That is an astounding statistic. Remember, these are small employers who

generally have a relatively low participation rate in terms of pensions. But Congress has been successful in enticing them through SIMPLE.

So what have we learned from these experiences form last year? I think we have learned two important things. One is that when Congress passes a tax incentive, like spousal IRA or this SIMPLE program, the financial institutions of this country will take the task on of educating people and will do a very good job in educating Americans as to the availability of these incentives.

The second thing we learn is that Americans respond well to these tax incentives. We have seen this incredible response to the SIMPLE IRA already in these 2 months, and I suggest to you that that is what we would see if this bill were passed.

I would also like to respond to some technical issues that have been raised at this hearing. It is already the case, Senator Moseley-Braun, that under the current law you may withdraw from an IRA without penalty for medical expenses exceeding 7.5 percent, and if you have been unemployed for more than 12 weeks you can have a penalty-free withdrawal for medical insurance without regard to that 7.5 percent.

So there already is withdrawal for death and disability; there already are a number of withdrawals built into the existing IRA. So I think you raise a valid question of whether or not these should be expanded a lot more.

A second point on the taxation of gains in IRA accounts. About 86 percent of Fidelity's IRAs are invested in equities. If these were not in IRAs, they would be taxed at the capital gains rate, which is 28 percent, maybe lower in the future. When they come out of IRAs, these gains are taxed at ordinary income rates.

So I think that is a significant factor in terms of the revenue estimation that people, when they come out of IRAs, are not getting the benefit of the lower capital gains rate. If Congress sees fit to lower the capital gains rate this year, that differential will become greater. So I think that factor needs to be taken into account in estimating tax revenues.

The last factor is that in 1994, the last year I could get data, $38 billion of taxable IRA distributions went through the Internal Revenue Service. In other words, the front-end IRA tends to have a high revenue estimate, as Professor Venti said, but it is very popular and does seem to motivate people. Years later, the money comes out of IRA and produces substantial tax revenue.

We are generating this year something in the area of $8–10 billion in tax revenues from the front-end IRAs of the 1980's. So I think all these factors need to be taken into account when one does these revenue estimates. Thank you.

The CHAIRMAN. Thank you, Mr. Pozen.

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

The CHAIRMAN. Mr. Tottie, please.

STATEMENT OF JOHN S. TOTTIE, SENIOR ECONOMIST FOR TAX AND BUDGET POLICY, CITIZENS FOR A SOUND ECONOMY, WASHINGTON, DC

Mr. TOTTIE. Thank you, Mr. Chairman. I am very pleased to be able to appear before the committee today to discuss the important

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issues of making Individual Retirement Accounts available to all Americans and creating a new, nondeductible IRA with tax-free withdrawals, the IRA Plus.

I am John Tottie, with Citizens for a Sound Economy. We are a 250,000-member citizen advocacy organization promoting market-based solutions to domestic economic problems.

In short, we believe that if Congress is to limit itself to targeted tax cuts, it is all the more important that we target barriers to savings, investment, and growth. Of course, expanding IRAs would do just that. We believe that the Savings and Investment Incentive Act of 1997, S. 197, is an excellent way to expand IRAs, as it would make the individual retirement account available to all Americans.

As a sign of the widespread bipartisan support, there are many proposals to expand IRAs, and the President, of course, has his own proposal. But I really want to make the point that it is important to not restrict eligibility. For example, under the President's proposal some individuals participating in 401(k) plans would not be allowed to also contribute to an IRA. The confusion and harm eligibility restrictions create was clearly shown after the 1986 tax reform, when millions of Americans failed to make IRA contributions simply because they mistakenly believed they were no longer eligible for the IRA deduction.

I think we need all the savings we can have, given that the American saving rate is among the lowest of all industrial countries. Perhaps the most compelling reason for making IRAs more available is that most baby boomers and young Americans, are not saving enough to maintain their standard of living in retirement.

Without much in the way of personal savings, many Americans will have to rely on Social Security benefits. Unfortunately, the average Social Security payment per retired worker is only equal to about the pay of a full-time minimum wage job. That is not a lot of money.

Of course, Americans need savings for purposes other than retirement. S. 197 recognizes this by allowing penalty-free withdrawals to pay for a college education, medical and unemployment expenses, or a first home. Clearly, as Deputy Secretary Summers noted, allowing individuals to use their IRA savings for a broader range of purposes would also increase overall saving by making it even more attractive to save.

Of course, for the economy at-large there are the obvious benefits of saving and investment, as a growing body of academic research has shown.

Let me say that we believe that one of the more exciting aspects of the Savings and Investment Act is the IRA Plus that would not allow tax-deductible contributions, but in exchange would exempt withdrawals from the account from taxation.

If tax rates do not change over an individual's life span, avoiding taxes on IRA deposits through the deductible IRA, is as attractive as avoiding them by not having to pay taxes on the withdrawals.

However, many Americans may fear that, for whatever reason, they will face a higher tax rate in retirement than during their working years. For example, many of our members that I have talked to have expressed great concern that the Federal Government will raise taxes in the future to pay for out of control entitle-

ment spending. Whether that will happen or not is beside the point here.

The point is, people have different preferences and expectations about how the tax rate they face will change over time. By giving taxpayers a choice of when to realize the tax benefit of an IRA, I think we would make IRAs much more popular with the American public.

As noted earlier, Harvard professor Martin Feldstein's study shows that tax revenues would actually increase with expanded IRAs, given that new saving increases the corporate capital stock and taxable corporate income.

I think that this is an important point that we need to recognize, even if static revenue estimates do not reflect this fact.

Let me mention that several polls and public opinion surveys have shown that few proposed reforms here in Washington are more popular with American people than expanding IRAs.

For example, a national survey conducted by the Democratic Lake Research and the Republican Luntz Research companies in May 1996 for the Savings Coalition found that voters favored expanding IRAs to enacting the far more expensive, so to speak, $500 per child tax credit, and 64 percent of respondents also claimed that they would increase their rate of saving should expanded IRAs become reality.

In summary, the time has come to eliminate unfair tax penalties on savings. Expanding IRAs, as proposed by S. 197, is an excellent place to start, making all Americans, with no exceptions, better able to save for a financially secure retirement and other important objectives, while also helping to revitalize the economy at large. Thank you, Mr. Chairman.

Senator MOYNIHAN. You have not used up your time, sir. That shows an inclination to efficiency, which is totally admirable. [Laughter.]

The CHAIRMAN. I have to say, it is precedent-setting. [Laughter.]

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

The CHAIRMAN. Finally, Mr. Salisbury.

STATEMENT OF DALLAS SALISBURY, PRESIDENT AND CEO, EMPLOYEE BENEFIT RESEARCH INSTITUTE (EBRI), WASHINGTON, DC

Mr. SALISBURY. Mr. Chairman and members, it is a pleasure to be here. I am going to respond this morning just to the three specific questions that I was asked.

First, on the relative tax efficiency of IRAs versus employer-provided retirement benefits. As you know, the Government publishes each year through the Congressional Budget Office and the Joint Tax Committee tax expenditure numbers on different programs, including IRAs.

They do not, I will quickly note, publish disaggregation of those numbers in general. They tend to lump them all together into one pool. But, in getting to those numbers, the Joint Tax Committee does have break-out assumptions and it is based on those breakout assumptions that these numbers are presented today.

The tax expenditure for employer plans in 1995 was made up of a number of components. $29.8 billion for Federal, State, and local

plans. These plans cover about 23 million total participants, and 16 million active participants. $14.8 billion for private industry defined benefit and defined contribution plans. These plans cover about 78 million total participants, and 57 million active participants, and $7.5 billion for military plans.

The IRA tax expenditure is broken out as $7.7 billion, covering approximately 60 million existing Individual Retirement Accounts, with last year's 4.3 million active participants, if you will, meaning individuals in tax year 1994 who made new-dollar contributions to individual retirement accounts.

And $3.3 billion was attributed to self-employed KEOGH H.R. 10 plans. They have about 1 million self-employed individuals and there is not a good number on the number each year providing new contributions.

So if one looks at this and what one would describe as relative tax dollars foregone by the Government as tax expenditures are currently calculated, their relative differentials and the per-participant, if you will, tax expenditure that has placed the greatest efficiency today on private employer plans and relative lower efficiency on governmental plans and Individual Retirement Accounts.

I would add one caveat based on Mr. Pozen's comment, which is issues related to relative tax treatment. Not only is there a heavy dominance in IRAs of equities, but over 60 percent of private employer plans are in equities.

In that same case, those dollars will flow out of those plans at a higher tax rate than would have been the case had those equity investments not been in qualified plans and, in essence, that benefit would have still been available to individuals.

So, our calculations have always held that the way in which the Government does these tax expenditure estimates, in essence, overstates the relative value of the incentives to employer plans and IRAs.

The second question would compare participation rates for IRAs with employer-provided plans, in terms of relative participation. Table 1 to my testimony shows relative participation rates among all employment-based plans at 43.7 percent of the work force. Within those offered 401(k) plan participations, 65 percent voluntarily participate. That compares to an 8.1 percent participation rate among those who are offered the opportunity to have an Individual Retirement Account.

This goes to a point made by a number of witnesses related to communication and education; 401(k) plans and employers like the Federal Government, with the Federal Employee Thrift Plan, are able to communicate a single message to every worker to get them to participate. The current laws, as they relate to IRAs, are extraordinarily complicated. They do not allow that flat level of communication.

It is why we end up seeing that, in the last year of full IRA deductibility eligibility in 1986, that 16.2 percent of taxpayers chose to participate in plans, compared to the 8.1 percent in the most recent year. We believe that is largely due to the inability to make what one would describe as a universal sales pitch.

The third question, was provide information concerning the extent to which funds currently held in IRAs are from dollars made as original contributions as compared to rolled over.

The reason this is important, was noted by Professor Gale, there are approximately $1.2 trillion in IRAs today that sometimes in press accounts is attributed totally to individuals having made clean contributions to the IRAs.

Based on IRS data, our best estimate is that 76 percent of that total is attributable to dollars rolled over from employment-based pension plans, and 24 percent of the dollars attributable to direct contributions and investment earnings.

I note that, as well, simply to underline the degree to which the way in which IRAs, and roll-over IRAs in particular, play a vital role in allowing individuals to realize portability and preservation of distributions out of employment-based plans is something that is not always discussed, but is very important.

In my closing comment, I would go beyond the provided questions to simply assume one, which is, what might be done to get individuals more readily to save. I would underline what other witnesses have noted.

The most important thing Congress could do would be to play upon and to buildupon last year's efforts by this committee in the realm of simplification. In the realm of employment-based plans to eliminate some of the alphabet soup and to try and get to one type of plan that can be sold and communicated to all employers.

In the IRA area, to try and simplify it to one straight IRA rule and one IRA that would, again, be able to be marketed to all individuals in the hope of gaining maximum participation. Thank you.

The CHAIRMAN. Thank you.

Senator MOYNIHAN. Very good. Very good.

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

The CHAIRMAN. Professor Gale, for the last three decades, the 1960's, 1970's, and 1980's, the personal savings rate averaged roughly 5 percent or more, but we have not been close to a 5 percent rate since 1985. I think this trend is troublesome. I wonder, what specifically do you think will reverse this trend?

Professor GALE. I do not claim that it is an easy problem. As the saving rate has declined, tax-preferred saving has become more and more popular. Again, that is in Table 1 of my testimony.

Where I would look for ways to improve the personal saving rate, as I mentioned, were first simply the financial education of American households, because I think there is an issue about people being able to plan ahead and plan for long periods.

Second, is pension and Social Security reform. Third is not often discussed, but the tax treatment of debt may also be useful to consider. Borrowing is just negative saving, and by subsidizing borrowing through the Tax Code we provide the biggest incentives to borrow to the highest income households.

On top of that, when households can borrow, deduct the interest and invest the money in tax-preferred assets, you create all sorts of tax sheltering activities which can further reduce national saving. So, that might be a dark horse candidate where we can look as well.

The CHAIRMAN. Professor Venti, and I believe you, Professor Hubbard, at one time did not believe that IRAs resulted in increased savings, is that correct? I remember you were before us 10 years ago.

Professor VENTI. No. I went into the first study not expecting IRAs to increase savings, but from the first study I did I found that IRAs were new saving.

Professor HUBBARD. Yes, likewise.

The CHAIRMAN. But before you made that study, as I recall, you were not convinced.

Professor VENTI. That is true. Your basic sort of graduate student public finance instruction is going to lead you to believe that these programs do not have much effect, and that is because economists are taught to focus on the financial incentives, and there is an obvious financial incentive to invest in IRAs, just reshuffle assets.

It is only the empirical evidence that changed my mind and led me to believe that some of these financial incentives were perhaps more than outweighed by other things, such as the promotion and the up-front deduction, and so forth. You may have me a bit confused with another of my Dartmouth colleagues, John Skinner, who initially set out to disprove my result and was convinced otherwise by the data.

The CHAIRMAN. Smart man. Any comment, Professor Hubbard?

Professor HUBBARD. Essentially the same. I think the evidence has come in over a very long period of time. I think most researchers began their investigations in this area being suspicious of the effectiveness of IRAs, for the reason that Steve Venti raised. At least in my reading of the evidence as it has come in over time, however, is that much of the contributions are, in fact, new saving.

The CHAIRMAN. Mr. Pozen, let me ask you a question. Even today, although you do not get a tax deduction when you contribute, the earnings are tax-free. Why has that not been a more effective marketing tool?

Mr. POZEN. In marketing parlance, that tool has no juice. When people had the front-end IRA deduction, they would line up on April 13, 14, and 15. You could see them in all the investor centers because they got a hit they really could see in a tangible way—feel in a tangible way—the tax incentive.

Something like tax deferral, you can explain it to people mathematically, and we do try, but it just does not have a real concreteness, a real tangibility, and people have a hard time relating to it.

As a practical matter, there is a relatively smaller percentage that will respond to that sort of long-term abstract mathematical concept as opposed to the concrete notion that: you make the contribution this year, you get the deduction this year.

Mr. SALISBURY. Senator, if I might give you a related example, is in 401(k) plans, research finds that if the employer provides a matching contribution, if you will, that immediate hit, you get much higher rates of voluntary participation across the income spectrum than if a matching contribution is not provided. It is that same type of incentive effect.

In both cases, the individual would get an up front deduction. In both cases, they would get tax-free earnings. But it is seeing some-

thing tangible like additional money or my tax bill dropping today that tends to have a major influence in any type of savings plan.

The CHAIRMAN. Professor Hubbard, you said that Congress should not abandon the goal of tax reform. I wonder what types of reform you think would best promote savings.

Professor HUBBARD. Again, Senator, it depends on why you want the saving. If your goal is you believe the productive business capital stock is too low, I would encourage you to reexamine corporate tax integration proposals from the Treasury, from the American Law Institute, or fundamental consumption tax reform.

If your concern is, instead, the adequacy of retirement saving, then I would urge you to think about the privatization of Social Security and pension reform debate as the right venue. I think the answer really depends on your objective.

The CHAIRMAN. Professor Venti, as I understand it, Canada expanded IRAs in the early 1970's and has consistently reported higher personal saving rates than the United States. Is this evidence that a consistent policy of expanded IRAs, as we have proposed in our Super IRA bill, can help savings?

Professor VENTI. Well, by itself, no. We have looked in some detail at the Canadian experience. Canada has had a program very similar to IRAs, the Registered Retirement Saving Program, except in Canada it began, I believe, in 1957 and eligibility was broadened dramatically in 1974.

In fact, there is some academic research that Deputy Secretary Summers was part of in the early 1980's that found that when RRSPs in Canada took off in 1974, the savings rates in the United States and Canada diverged.

And what you have seen since then is a persistent 2- to 3-percent difference in the saving rates between the United States and Canada, and there is some research that shows that the difference can be explained by the difference in RRSP saving.

In Canada, more than twice as many people participate in a tax-based savings incentive plan as in the United States. So my answer is, yes, I think the difference in tax-based savings incentives does account for a large part of the difference in savings rates.

The CHAIRMAN. How do you make savings more attractive to lower income families? I would be interested in any thoughts. You go ahead, Professor Venti.

Professor VENTI. One of the problems with IRAs, of course, is that participation rates are quite low at the lower income levels, below 10 percent, for instance, of workers with incomes of less than $10,000 participate. One could look at this and say, well, they do not have enough money to save, but I think our experience with 401(k) programs shows that that is not the case.

If you look at 401(k) programs, even among low-wage earners, you can get over 50 percent of the workers to participate in a 401(k). So they can save when faced with an appropriately designed policy.

The CHAIRMAN. Any other comments?

Mr. SALISBURY. I think that that is crucial and it applies to the SIMPLE IRA plan that was noted by Mr. Pozen, if you allow individuals some way to do it through a payroll deduction, like the old Christmas club, for lack of a better example, it makes a tremen-

dous difference if it can flow into some type of account before it gets into the checking account so that it is money that is not viewed as being in the consumption pool.

The CHAIRMAN. Senator Moynihan.

Senator MOYNIHAN. I would just like to say, this has been an absorbing hour with some remarkably well-informed and diverse points of view here. It is very good to hear a discussion of behavioral responses as against plain economic calculations, the deferred mathematics Mr. Pozen discusses.

You will have to excuse me, Professor Venti, if I do not get too carried away with the fact that Canadians behave differently from Americans. [Laughter.]

They do, and more prudently in perhaps other ways as well.

Just a point. I think it would be the case, and no one would dispute it, but Professor Hubbard, in the privatization of Social Security, given that 70-year transition period, will not increase savings, it will simply mean that the Federal Government will have to borrow more and it will be a wash.

Professor HUBBARD. You are correct, Senator. I referred to the privatization of Social Security in the context of a goal of raising adequacy for retirement saving. That is a different goal from raising the level of national saving of the capital stock. You are quite right; depending on how you do it, privatization, per se, is not the savings cure.

Senator MOYNIHAN. Right. Can I ask then, of the many fascinating things that were suggested here, when Professor Gale indicated that the tax deductibility of interest, which on borrowing is negative savings and is an incentive that we ought to look at, I saw Mr. Salisbury nod. Is that something we should be thinking about as a committee? In 20 years in this oval, I have never really heard this raised.

Professor HUBBARD. That, again, is the fundamental tax reform debate, Senator. Some of the corporate tax integration proposals would have changed interest deductibility; moving to a broad-based consumption tax obviously would as well.

Professor GALE. A number of countries that have income taxes do not allow interest deductions. Canada, for example, is one of them. That may be an additional reason why they save more than we do. But some European countries also do not allow deductions. I do not want to get off too far on the mortgage issue in particular, but surprisingly, home ownership rates in those countries are not demonstrably lower than in the United States.

Senator MOYNIHAN. That is a great idea. Let us get rid of that mortgage thing. [Laughter.]

The CHAIRMAN. Count me out.

Professor GALE. The general point that the Tax Code subsidizes borrowing plays into a lot of the saving behavior in particular. You can borrow to finance your saving incentive contribution, and there is some evidence that that has happened.

Senator MOYNIHAN. Who is going to give us a feeling about the degree to which people borrow, deduct interest payments, and invest in tax-free arrangements?

Professor GALE. I can give you a couple of pieces of evidence. One, is that from 1982 to 1986, the typical household with an IRA

increased its debt by about $2,400 more than the typical household without an IRA, so that should be netted out against any financial asset increase.

Senator MOYNIHAN. The logical explanation is that you borrowed to invest.

Professor GALE. Well, it can happen for intentional gaming of the system or it can happen sort of unintentionally. If someone takes $2,000 that they were going to use to buy a car and they stick it in the IRA and then they borrow $2,000 to buy a car, then it is a wash.

Senator MOYNIHAN. But I want to encourage anybody, as each of these witnesses has done, to bring us behavior explanations. I think there is a lot more of that than we know. I suppose we probably learn most of it from people like Pozen from Fidelity. They specialize in juice.

The CHAIRMAN. Juice. You are right.

Mr. SALISBURY. Senator, on the prior point regarding juice and the simplicity issue, we have created through 14 Federal agencies and 200 private organizations a group this last year called the American Savings Education Council to start trying to get some of that basic messaging out to the public.

But, as part of that, I did a minor experiment for the last 30 days. I have simply been throwing into a paper bag every offer I get for a free credit card, and I pulled out the paper bag last night.

In the last 30 days, I have been offered the opportunity to get 22 new credit cards and all of them carrying tremendous incentives. In fact, seven different credit card opportunities to get a free companion airline ticket just for accepting the free credit card.

The CHAIRMAN. To where? [Laughter.]

Mr. SALISBURY. To anywhere. While we do that, we in the IRA area, for lack of a better example, make it impossible to send a simple one-page flier to people that simply says, go open an IRA, everyone is eligible.

So you end up vis-a-vis the credit issue, more broadly than even the interest deductibility issue, is we make it extraordinarily easy for people to spend in this country, on a debt-financed basis if not otherwise, and we make it extraordinarily easy for financial institutions to communicate the opportunity to borrow, yet we make it extraordinarily difficult for them to communicate, taking advantage of the opportunity to save.

Senator MOYNIHAN. Right. I am sure Mr. Tottie would agree on that.

Mr. TOTTIE. It certainly is true that, based on my personal experience, that I get in the mail as well a lot of offers for free credit cards. When I was in college, I remember I would get a large number of offers and I probably should have take some of them, but I did not. But I think many do.

The point is, we want to make America a Nation of savers. It is not because we in Washington want to say, you shall save, it is because we currently have many barriers to savings that are created, they are artificial, created by the Federal Government.

Of course, the income tax system is actually a double tax on savings. Someone suggested here before that expanding IRAs would create a new entitlement. I think it is just a matter of removing

an excessive layer of taxation. The income from which saving is derived is taxed and so are the proceeds of that saving, and this is simply not fair to savers.

So, while we should talk about the low rate of savings, we need to understand that that low rate, of course, is largely brought about by misguided government policies. That is really the strongest case for increasing the rate of saving.

Senator MOYNIHAN. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Well, gentlemen, we appreciate very much your being here today. It was most informative. We look forward to working with you in the future. Thank you very much.

[Whereupon, at 12:06 p.m., the hearing was concluded.]

APPENDIX

Additional Material Submitted for the Record

Prepared Statement of Hon. Alfonse D'Amato

Mr. Chairman, I commend you for holding this hearing today to discuss proposals to expand Individual Retirement Accounts (IRAs) as a means of increasing our country's dismal savings rate. I welcome our distinguished panel and look forward to their insight.

The savings rate in this country is directly tied to the growth of the economy and the prosperity of all Americans. Whether we put money away for a rainy day or plan for retirement, savings are essential to maintaining a high quality of life. Because one of the fundamental problems facing our economy today is our low national savings rate, I believe that IRAs can provide an important mechanism for middle-income taxpayers to save for their retirement. They are also an important factor in capital formation, which leads to job creation and a healthier economy. That is why I strongly support expansion of IRAs and am proud to be a cosponsor of your bill (S. 197, "Savings and Investment Act of 1997").

There is empirical data which indicate that when Congress allowed full deductibility of IRA contributions in 1982, the amount contributed to IRAs increased substantially, from $4 billion in 1980 to $38 billion in both 1985 and 1986. When Congress restricted IRA deductions in the Tax Reform Act of 1986, contributions fell drastically to only $8 billion in 1995.

Mr. Chairman, I am proud that last year we finally took steps to end discrimination against homemakers—the majority of which are women—by allowing them to save as much as their working spouses (from $250 per year to $2,000 per year). We need to continue the progress begun last year by further expanding IRAs to make it easier for Americans to purchase a first home, to pay for a child or grandchild to attend college, and to cope with financial hardships like high medical expenses or long-term unemployment.

I look forward to discussing the proposals which this Committee will consider, and look forward to the testimony from today's panel of experts.

Prepared Statement of William G. Gale*

Mr. Chairman and Members of the Committee:

Thank you for inviting me to testify today on the issue of expanding Individual Retirement Accounts. My testimony consists of two parts: a summary of the main findings and a more detailed discussion of the basis for the conclusions drawn.

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*The views expressed here are my own and should not be ascribed to the officers, trustees, or staff of the Brookings Institution.

Main Findings

- o Raising national saving, capital formation, and retirement income security is one of the most important economic tasks facing the country.

- o There is no shortage of opportunities for tax-preferred saving. As private and national saving declined in recent years, saving in tax-preferred accounts has grown dramatically.

- o IRAs do not provide incentives to save. They provide incentives to place funds in a designated account. Eligible households do not need to save more than they have in the past, or even save at all, to enjoy the tax benefits of an IRA.

- o Proposals to expand IRAs involve considerations of tax policy, budget policy, retirement income security, and saving policy.

- o As tax policy, expanded IRAs would make the tax code more intrusive and complex and raise difficult enforcement issues. Most IRA balances probably face negative effective tax rates, which creates inequities, inefficiencies, and revenue losses.

- o As budget policy, expanded IRAs would create a new entitlement when entitlements should be reduced. The true budgetary costs of back-loaded IRAs are understated in revenue estimates that examine only the next five years.

- o Allowing penalty-free IRA withdrawals for new purposes would reduce retirement income. If withdrawals of previously accumulated funds are allowed, saving could fall.

- o The proportion of IRA contributions that is a net addition to saving is controversial. On the basis of research and common sense, I believe the proportion is quite small. People tend to contribute in relatively painless ways (such as shifting assets, redirecting existing saving or increasing debt) that do not raise saving, rather than in painful ways that generate an increase in saving (i.e, a reduction in current living standards).

- o Even if a substantial portion of contributions are new saving, the impact of expanded IRAs on national saving is likely to be tiny. If withdrawals for new purposes are permitted from pre-existing balances, the impact could well be negative.

- In my view, the costs to tax policy, budget policy, and retirement income security from expanding IRAs are not worth the small, speculative and possibly negative effects on saving.

- Endless tinkering with tax-deferred saving plans is blinding the policy debate to more effective and durable ways of addressing the saving problem. These include deficit reduction, financial education, and pension reform.

Discussion

The low level of private and national saving is one of the most important economic problems facing our country today and in the future. American saving rates have been very low in recent years, compared to other countries and by historical standards. On a national level, more saving could finance increased investment. This in turn can make workers more productive, and raise their wages and standards of living. At the household level, increased saving helps people prepare for retirement, provides a cushion for financial downturns, and assists in meeting other financial goals.

Many potential factors have been offered to explain the saving decline. These include: increased intergenerational transfers to the elderly; expansions of government programs that reduce the need to save (including Social Security, Medicare, Medicaid, unemployment insurance, workers' compensation, housing guarantees, and student loans); liberalization of debt markets; demographic changes; and the slowdown in income growth since the mid-1970s. Tax considerations are notably absent from this list; indeed, the general tax and inflation environment facing savers may be at least as favorable today as it has been in the past. The highest marginal tax rates are relatively low by historical standards and inflation, which raises the effective tax rate on financial assets, is quite low. Despite these considerations, tax policy is sometimes claimed to be an effective way to raise the saving rate substantially.

Tax policy toward saving is inconsistent. Some assets are taxed at high effective rates, while a large number are taxed at rates that are very low and can even be negative. There is no shortage of tax-preferred methods of saving. Current options include IRAs, defined benefit pensions, defined contribution pensions, 401(k) plans, Keoghs, 403(b) plans, 457 plans, federal government thrift saving plans, SIMPLE plans, SEP plans, fixed and variable annuities, and life insurance saving. Moreover, housing and municipal bonds are also tax-favored, as are the capital gains that accrue to unincorporated businesses. Over the last several decades, as the personal saving rate has fallen, tax-favored saving (via pensions, 401(k)s, IRAs, Keoghs, and life insurance) has become an ever more important component of total personal saving. Between 1986 and 1993, saving in tax-preferred accounts constituted about 100 percent of net personal saving (Table 1). This does not mean there was no other saving activity, it just means that any gross saving in other accounts was fully offset by withdrawals from those accounts or by increases in borrowing.

Wide variations in effective tax rates on saving creates opportunities for investors to shift funds into the most tax-preferred accounts. The variation in rates, coupled with the tax-deductibility of interest payments, creates opportunities to game the system further by borrowing, deducting the interest payments, and investing in a tax-preferred asset.

IRAs are just one more patch in the crazy quilt of saving policy. Contributions of up to $2,000 per year are tax-deductible for households with income up to prescribed limits. Deductibility is then phased out as income rises further. Balances accrue tax-free. Ordinary income taxes are due on any withdrawals, and a 10 percent penalty is also assessed on withdrawals that are not related to death or disability, but occur before the account holder is 59.5 years old.

Several current proposals would amend IRAs in a number of ways, including:

- Raising the income limits on deductible IRA contributions; indexing the income and contribution limits.

- Creating back-loaded IRAs: In a back-loaded IRA, the contribution is not deductible, but earnings and withdrawals are free of taxes and penalties, provided the funds were held in the account for a specified period, usually 5 years.

- Allowing penalty-free (and income-tax-free) withdrawals for specified purposes such as education, medical expenses, first-time home purchases, long-term unemployment, or business start-up expenses.

These proposals involve issues of tax policy, budget policy, retirement income security, and saving policy.

Tax Policy Considerations

Expanding IRAs would be counterproductive tax policy. The IRA proposals would make the tax system more complex and intrusive. Serious consideration of how the IRS would verify that a particular withdrawal was made for a particular purpose suggests compliance and enforcement difficulties. Enforcing the combined limits on IRAs and elective deferral plans would cause further compliance headaches. Tax debates in 1996 correctly emphasized the importance of broadening the base, removing loopholes, and reducing rates in a revenue-neutral manner. As we move into 1997, proposals that expand IRAs move in exactly the opposite direction.

While IRAs are often described as tax-deferred saving, the effective tax rate on IRAs is typically zero or negative. The effective rate is zero if the tax rate that applies to the deductible contribution is equal to the rate that applies to the withdrawal. However, since marginal tax rates have fallen since 1986, and since people typically face lower marginal tax rates in retirement than during working years, the effective tax rate for many IRA holders

is likely to be negative. For example, a household that deducts a $2,000 IRA contribution at a 28 percent tax rate, holds the asset for 20 years at a 10 percent annual return, and withdraws the funds at a 15 percent tax rate pays an effective tax rate of negative 9 percent on the IRA. Punching a hole in the tax code to generate more assets with negative effective tax rates is inefficient and inequitable. Good tax policy would even out the taxation of all forms of saving, and possibly reduce the overall level of taxation on saving.

Budget Policy Considerations

Expanding IRAs would also be counterproductive budget policy. First, it would create a new entitlement for anyone with enough funds to place money in a designated account. The fact that IRAs are tax rules rather than spending programs should not blind us to the essential equivalence of an entitlement set in the tax code and one set on the spending side. Tax entitlements are just as costly (and often more difficult to discern) than spending entitlements. The IRA entitlement would accrue largely to households in the top part of the income distribution, and would provide larger entitlement payments (i.e., tax cuts) to wealthier households who contributed more or faced higher tax rates. The key to long run budget control is to eliminate or reduce entitlement obligations rather than increase them.

Second, current budget procedures understate the cost of back-loaded IRAs. The requirement of a 5-year holding period before penalty-free withdrawals are allowed effectively places most of the costs beyond the five-year budget window. Budget policy should move toward more complete accounting of the costs of government programs.

Third, for any given amount of contributions, allowing both traditional front-loaded IRAs and back-loaded IRAs will prove more expensive in revenue terms than having either one. Other things equal, people who believe their tax rate will be lower when they withdraw the funds than it is now will tend to choose front-loaded IRAs, so they can take the deduction at the relatively higher current tax rate. Likewise, people who believe that their tax rate upon withdrawal will be lower than their current rate will tend to choose back-loaded IRAs to obtain the biggest tax cut.

Retirement Income Considerations

Expanding the conditions for penalty-free IRA withdrawals would undermine the retirement income goals of IRAs, and could reduce both saving and tax revenue. One can imagine the list of favored uses of IRA funds expanding indefinitely. One can also imagine the list of favored accounts expanding as well: if IRA funds can be tapped, why not Keoghs, SIMPLE plans, SEPs, 401(k)s, pensions, or fixed and variable annuities? Moreover, there would be difficult administrative problems associated with minimizing abuse of these provisions. These problems will make the tax code more complex, and will require the IRS to gather more information, which could be quite intrusive, or risk not enforcing the provisions.

If withdrawals are allowed for new, favored uses of funds, two considerations are paramount. First, the withdrawals should be allowed only for funds contributed after legislation is enacted. As of the end of 1995, IRA and Keogh balances totalled $1.2 trillion. These funds were placed in the accounts with the understanding that they were to be held until retirement or would face a penalty. If these funds become eligible for penalty-free withdrawal, the saving rate could actually drop. For example, suppose that in one year, 5 percent of these funds were removed for other purposes. That would represent about a withdrawals of about $60 billion, or about 20 percent of personal saving. Second, funds withdrawn from deductible IRAs should face income taxes, even if the penalty is waived. Otherwise, the entire withdrawal will never have been taxed, which would create obvious inequities and inefficiencies.

Saving Policy Considerations

All of these problems in tax policy, budget policy, and retirement income policy might be worth the cost if IRA expansions were certain to raise private and national saving substantially. The effect of IRAs on saving is the subject of considerable controversy, however, so it is useful to start with some basics.

The single most important factor is that IRAs do not provide incentives to save. Instead, IRAs provide incentives to place funds in a designated account. The distinction is crucial.

There are many ways to finance IRA contributions. One way, of course, is to raise saving. This involves consuming less, or to put it bluntly, reducing one's current standard of living. This is the "painful" way of taking advantage of the tax breaks afforded by IRAs. There are, however, relatively painless ways to capture the tax break as well. For example, the contribution may be financed by transferring existing taxable assets into IRAs, by reallocating into an IRA current or future saving that would have been done outside the IRA, or by increasing household debt. These painless methods of contributing to an IRA do not raise overall private saving. Thus, IRAs and other so-called "saving incentives" do not require that contributors save, or save more than they would have otherwise.

How are people likely to react to IRAs? Common sense suggests that people will try to capture the tax breaks in the least painful way possible. A reasonable conjecture is that one reason IRAs are so popular with taxpayers is precisely because taxpayers do not need to reduce their standard of living (raise their saving) to claim the tax break.

Research findings back up this claim at the most general level. Economists Joel Slemrod of the University of Michigan, and Alan Auerbach of the University of California, surveying a broad range of studies of the effects of the tax reform act of 1986, have concluded that similar phenomena arise in a host of tax-related activities. They find that decisions concerning the timing of economic transactions are the most clearly responsive to tax considerations. The next tier of responses involves financial and accounting choices,

such as allocating a given amount of saving to tax-preferred saving versus other saving. The least responsive category of behavior applies to agents' real decisions, such as changes in the level of saving. This hierarchy of responses, applied to IRAs, suggests that most IRA contributions are not new saving.

(A) What proportion of IRA contributions is new saving?

In recent years, a number of studies have examined the effects of IRAs on saving and reached a variety of conclusions.[1] The crucial issue in this literature is determining what households who had IRAs would have saved in the absence of these incentives.

Several factors, however, make this a difficult problem and one subject to a series of biases that overstate the impact of IRAs on saving. Analyses that ignore these issues overstate the impact of IRAs on saving. No study that corrects for these biases finds that IRAs raise saving. Rather, Engen, Gale and Scholz (1996a, b) show that accounting for these factors largely or completely eliminates the estimated positive impact of IRAs on saving found in some studies.

First, saving behavior varies significantly across households. Households that hold IRAs have systematically stronger tastes for saving than other households. Thus, a simple comparison of the saving behavior of households with and without IRAs will be biased in favor of "showing" that IRAs raise saving. To oversimplify somewhat, suppose there exist two groups: "large" savers and "small" savers. We would expect to see that IRA holders (where large savers are overrepresented) would save more than non-IRA holders (where small savers were overrepresented). But this would provide no information about the effects of IRAs per se, unless there is a way to control for the observable and unobservable differences between large and small savers.

Even researchers that claim that IRAs raise saving recognize that the heterogeneity of saving behavior is a crucial factor in this literature. What is often overlooked, however, is that the implication of heterogeneity is that findings such as "households with IRAs saved more than households without IRAs," do not imply anything about whether IRA contributions represent new saving, since those households would have been expected to save more to begin with.

Due to heterogeneity in saving, studies that compare IRA contributors with noncontributors tend to "find" that IRAs raise saving (Hubbard 1984, Feenberg and Skinner 1989, Venti and Wise, 1987, 1988, 1990, 1991). However, statistical tests reject the validity of such comparisons (Gale and Scholz 1994.) In contrast, studies that compare one group of contributors to another tend to find much smaller or negligible effects of IRAs, or

[1]This section is based on Engen, Gale and Scholz (1996a, 1996b), which provides details and additional evidence for the points made here.

expansions of IRAs, on saving (Gale and Scholz 1994, Attanasio and De Liere 1994, Joines and Manegold 1995). By comparing two groups of contributors, these studies more effectively isolate groups with similar propensities to save and hence provide a more valid comparison.

A second problem is that saving and wealth are net concepts and are broad concepts. If a household borrows $1000 and puts the money in a saving incentive account, net private saving is zero. The data indicate that households with saving incentives have taken on more debt than other households. Hence, studies should focus on how saving incentives affect wealth (assets minus debt), not just assets. Because financial assets are small relative to total assets, studies that focus only on the effects of saving incentives on financial assets may have particularly limited significance.

Since the expansion of IRAs in the early 1980s, financial markets, pensions, and Social Security have undergone major changes. Pension coverage (other than 401(k)s) fell over the 1980s, and social security wealth was reduced in the 1983 reforms. Both of these factors would have caused people to have accumulated more assets in the late 1980s or early 1990s than in the early 1980s. Moreover, the reduction in inflation and tax rates that occurred over the 1980s made financial assets relatively more attractive than tangible assets (such as housing). This led to strong increases in the stock market and to shifts of wealth from nonfinancial to financial forms. For all of these reasons, it is important to study the impact of IRAs on broad wealth measures and to control for other events that occurred during the 1980s.

Studies that examine only financial assets often "find" a large impact of IRAs on saving (Venti and Wise 1992, 1996). But extensions of those studies indicate that the effects disappear when the analysis examines the impact on broader measures of wealth that include debt or nonfinancial assets and include the impact of events that occurred during the 1980s (Engen, Gale and Scholz 1996a, b).

Third, IRA balances represent pre-tax balances; one cannot consume the entire amount because taxes and perhaps penalties are due upon withdrawal. In contrast, contributions to other accounts are generally not deductible and one may generally consume the entire balance in a taxable account. Therefore, a given balance in a saving incentive account represents less saving (defined either as reduced previous consumption or increased future consumption) than an equivalent amount in a conventional account.

Analyses that correct for these biases indicate that little if any of the overall contributions to IRAs have raised private or national saving. This conclusion arises consistently from evidence and estimates from a wide range of methodologies, including time-series data, cross-sections, panel data, cohort analysis, simulation models, and analysis of evidence from Canada (Engen, Gale, and Scholz 1996a, b).

(B) Who Contributed to IRAs and Why it Matters

Supporting evidence for this view comes from data on who contributed to IRAs. Table 2 shows that households with IRAs in 1986 were very different from households that do not have IRAs. In particular, compared to households without IRAs, the typical IRA holder had seven times the non-IRA financial assets, four times the overall net worth, and eight times the saving. Although some of these differences are due to observable characteristics, there is widespread agreement that households with IRAs tend to have stronger unobservable tastes for saving than do observationally equivalent households without IRAs.

Two types of households will be most able and hence most likely to make painless contributions, that is, contributions that do not raise private saving. The first is households that have large amount of other assets. These households have more existing assets to shift, typically have more current saving to shift, and have less of a need to maintain all of their assets as precautions against emergencies. The second is older households, who are less likely to face a binding early withdrawal penalty. In the extreme, people older than 59.5 years face no early withdrawal penalties. For each group, IRAs are good substitutes for the saving those households would do anyway, so the IRA contribution will be unlikely to represent new saving.

Data from the 1980s show that households with non-IRA financial assets[2] over $20,000 in 1986 (about $28,600 in 1996 dollars) or who were 59 or older made more than two-thirds of all IRA contributions in the 1983-6 period. Households who had non-IRA financial assets in excess of $40,000 (about $57,200 in 1996 dollars) or where the head was 59 or older made half of all IRA contributions during this period. Thus, while some people have argued that many of the accounts were held by middle class households, the data show that most contributions were made by households that would consider IRAs and other saving good substitutes. This suggests that the overall effects of IRAs on saving were likely to have been small at best.

In contrast, contributions will represent a net addition to saving only when they are financed by reductions in consumption, which will occur only when IRAs and other saving are poor substitutes for one another. This is more likely to occur for households that have lower asset holdings, and are younger. Thus, if IRAs are to be expanded, the expansion should be targeted to lower-income groups. Higher income groups will typically have higher assets and will find it easier to substitute other assets into IRAs.

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[2]Financial assets as defined here do not include employer-provided pensions, 401(k) plans, or after-tax thrift plans.

(C) Aggregate Effects of Expanded IRAs on Saving

How much would expanding IRAs raise national and private saving? One can get some perspective on this issue by noting that net national saving has fallen from 8 percent of net national product in the 1950s, 1960s, and 1970s, to 4.1 percent in the 1990s. Personal saving has fallen from 7 percent of personal disposable income between 1950 and 1980, to under 5 percent in the 1990s.

One way to gauge the effect of all tax policy on saving is to consider the effects of replacing the income tax with a consumption tax. Estimates by Engen and Gale (1996) suggest that a cold-turkey switch to a pure consumption tax–with no personal exemptions or transition relief–would raise the saving rate by about 1.5 percentage points in the short run and by about 0.5 percentage points in the long run. Output per capita would rise by about 1.5 percentage points over the first 10 years. These effects are positive, but are modest compared to the decline in saving noted above.

The results also provide a useful perspective on what targeted tax policy changes can achieve. If a complete overhaul of the income tax system raises the saving rate by at most 1.5 percentage points, only a much smaller impact can be expected of policies that tinker around the edges of the system.

The aggregate impact of expanding IRAs would be tiny. From 1982 to 1986, IRA contributions constituted about 1 percent of GDP. Since then, however, tax rates have fallen and other saving incentives have proliferated. Moreover, expansion would only affect a small portion of the population. If contributions rose by 0.5 percentage points of GDP and–splitting the difference among the studies–about half of those contributions were new saving, private saving would rise by 0.25 percentage points. But, assuming an effective federal and state tax rate of about 25 percent, government saving would fall by about one fourth of the contributions, so the net increase in national saving would be about 0.12 percentage points over the next few years.

Note that this estimate does not include the impact of allowing penalty-free (and income-tax-free) withdrawals for specified purposes. If these withdrawals are allowed from pre-existing balances, or if the withdrawals are made free of income tax, the impact on private and national saving of expanding IRAs could well be negative.

(D) Short-run versus Long-run Effects of IRAs on Saving

Some commentators (including Engen and Gale 1993) have made the point that the short-term effects of IRAs are likely to be less favorable than the long-term effects. The idea is that when IRAs are introduced, people will shift funds from taxable sources into IRAs so the contributions at first will not be new saving. After awhile, the people who contribute to IRAs may run out of funds to shift so that IRA contributions may eventually become new saving. For example, in a simulation model in Engen, Gale, and Scholz

(1994), IRAs reduce short-term saving, but raise the long-term saving rate by 0.2-0.3 percentage points.

The crucial issue then becomes "how long does it take until the saving rate rises?" In Engen, Gale, and Scholz (1994) it takes 49 years for the wealth to income ratio to exceed its original (pre-IRA value). Some IRA proponents have reasoned that since the typical household has very little in pre-existing financial assets, the transition period will be very short: a year or less.

The logic of a short transition period is misleading for two reasons. The first is simply that the typical household in 1986 did not have an IRA, so the typical household is irrelevant to the debate about how long the transition will last. The relevant households are those that contributed to IRAs and in particular those that continued to contribute to IRAs: Did these households have many pre-existing assets that they could shift into IRAs? The answer here is a resounding "yes." Table 2 shows that pre-existing asset balances are high among household with IRAs. The typical IRA household in 1986 had over $20,000 in non-IRA financial assets. Among households that contributed to the limit for three years in a row, typical financial asset balances were $40,000. It is clear that for these households, IRAs could be financed from pre-existing asset balances for several years without raising saving.

The second problem with the proponents' logic is even more important: it ignores IRA contributions that are financed by current or future saving that would have been done even in the absence of IRAs. These contributions do not represent new saving. The table shows that typical IRA households and 3-year limit contributors have extremely high levels of other saving relative to their IRA contributions and so could easily finance contributions out of saving that would have been done anyway. The median 3-year saving level for 3-year limit contributors in the SCF was $60,000. Surely, it would not be difficult for many of them simply to shift $12,000 of that into an IRA. The median 3-year saving level for the typical IRA contributor was $23,000. This is certainly large enough to fund all or most of a typical three years worth of contributions. These figures suggest that among households that did contribute to IRAs, there was a large on-going source of funds from which IRA contributions could be financed without raising saving. There is every reason to think the transition period could take a very long time.

A second reason IRAs may raise long-term saving is that workers who leave jobs often roll their pension balances over into an IRA. Thus, the IRA provides a convenient way to keep the money "tied up" rather than encouraging people to spend the funds prematurely. Over long periods of time, the cumulative effect of having fewer people cash out their pension could raise the saving rate. Two caveats, however, should be noted. First, any such effect does not seem to have occurred yet. Second, this factor is already fully operable under the existing IRA system. No expansion of IRAs is needed.

(E) Did Advertising Make IRA Contributions New Saving?

Some commentators have asserted that the heavy advertising of IRAs means that IRA contributions were new saving. However, while it seems likely that IRAs were advertised heavily by the financial industry in the 1982-6 period, that fact provides no information as to whether the source of IRA contributions was new saving (reduction in living standards) or shifted assets, redirected saving, or increases in debt. There is certainly no evidence to support the notion that advertising for IRAs affected the level of saving.

Looking at the ads themselves, however, suggests that advertising may actually encourage asset shifting, rather than new saving. Some ads explicitly advocated financing IRAs with debt as an "easy" way to obtain the tax break (see Feenberg and Skinner 1989). Aaron and Galper (1984, p. 5) report the following ad from the New York Times in 1984:

> Were you to shift $2,000 from your right pants pocket into your left pants pocket, you wouldn't make a nickel on the transaction. However, if those different "pockets" were accounts at The Bowery, you'd profit by hundreds of dollars ....Setting up an Individual Retirement Account is a means of giving money to yourself. The magic of an IRA is that your contributions are tax-deductible."

For obvious reasons, advertising seems more likely to emphasize the possibility of painless contributions, which don't raise saving, rather than painful contributions that do raise saving.

A second perspective on advertising is provided by the recent avalanche of ads for mutual funds and the accompanying massive inflows into those funds. Figure 1 shows that as mutual funds have increased dramatically in recent years, personal saving has not. Figure 2 shows that the increase in mutual fund saving has been matched by a decline in individual holdings of equities and bonds. That is, to a large extent households appear to have shifted their assets from one form to another. This is in no way a criticism of the mutual fund industry, which is supplying a product that the pubic demands. The point is just that the presence of massive advertising does not imply that the subsequent contributions are new saving.

A similarly unproven assertion is that IRAs created a "culture of saving," or would have if they had not been curtailed in 1986. To some extent, this notion is based on evidence about the persistence of IRA contributions over time. Households that contributed in one year had a very high probability of contributing in the next year as well. This led to speculation that IRAs helped people create good saving habits over time (Skinner 1992, Thaler 1994). The problem with this conclusion is that the data on persistence are perfectly consistent with standard models (Engen and Gale 1993). There is nothing surprising about the persistence of contributions over time. A purely rational model with no "habit formation" generates the same persistence as the data.

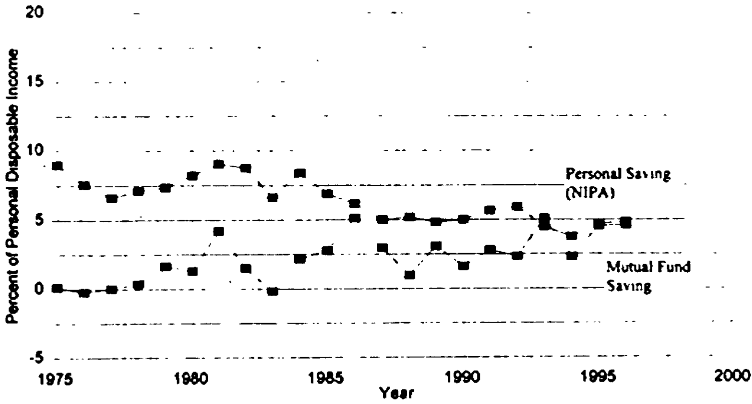
Moreover, other evidence makes it hard to believe that IRAs created a culture of saving. The early 1980s featured lower inflation, lower tax rates, high real interest rates, cuts in social security as well as expanded IRAs, yet the saving rate fell rather than rose during the "golden years" of IRAs.

Conclusions

Expanding targeted tax-based saving incentives is unlikely to raise the saving rate by very much if at all, but could have real costs in terms of tax, budget and retirement income policy. Excessive focus on tinkering with tax-based saving incentives obscures other possibilities for raising private and national saving. The surest way to raise national saving is to reduce the budget deficit in ways that do not reduce private saving.

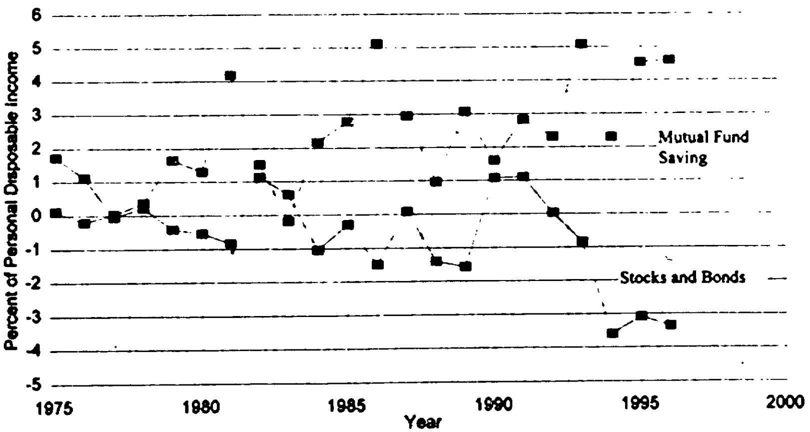
Raising private saving may prove more difficult, but several options are worth exploring. The most obvious candidate is improved financial education of workers. There is serious concern that a substantial fraction of the population will not be adequately prepared for retirement. At the same time, however, a large proportion of households do not use the saving incentives that are already available to them. Everyone, for example, can contribute to an IRA or a fixed or variable annuity if they so choose and receive a tax-preference relative to other saving. Only about two-thirds of workers eligible for 401(k) plans actually participate. Improved education would also be worthwhile to provide needed assistance to American households as the pension system moves away from defined benefit plans and toward defined contribution plans, which place more responsibility on workers, and as social security reform is considered.

Another fruitful area of reform in my view is pension legislation. An improved pension system would feature enhanced pension coverage, simplified nondiscrimination rules with a higher minimum contribution, higher maximum contribution limits, and removal of taxes on excess payouts and excess accumulations.



Source. Flow of Funds, Document Z.1, Table F.9. Economic Report of the President 1997, Table B-28

Note: Mutual fund saving equals shares in money market funds (Table F.9, line 5) plus mutual fund shares (Table F.9, line 14)



Source: Flow of Funds, Document Z.1, Table F.9; Economic Report of the President 1997, Table B-28.

Note: Mutual fund saving equals shares in money market funds (Table F.9, line 5) plus mutual fund shares (Table F.9, line 14). Saving in stocks and bonds equals the sum of saving in municipal securities (line 11), corporate and foreign bonds (line 12), and corporate equities (line 13).

Table 1. Decomposition of U.S. Personal Saving, 1971-93

Percent of net national product

Type of saving	1971-80	1981-85	1986-90	1991-93
Net personal saving	7.2	8.1	5.8	5.9
Retirement	3.7	6.7	5.7	5.6
Pensions	3.7	5.4	4.4	4.2
Individual	n.a.	1.3	1.3	1.4
Life Insurance	0.5	0.3	0.6	0.5
Other	3.0	1.1	-0.5	-0.2

Source: Sabelhaus (1996).

Table 2. Characteristics of Households with and without IRAs, 1986

	All Households	Households without IRAs	Households with IRAs	Households that contributed to the Limit 3 years in a row
Age	49	49	50	51
Annual Income	$21,320	$15,667	$35,000	$44,500
Non-IRA Financial Assets	$6,000	$3,000	$21,965	$41,269
Net Worth	$42,710	$25,470	$107,946	$188,943
Saving (Change in Net Worth, 1983-6)	$6,129	$2,884	$23,500	$60,691

Source: Gale and Scholz (1994).

Note: All dollar figures are in 1986 dollars.

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PREPARED STATEMENT OF HON. ORRIN G. HATCH

Mr. Chairman, I commend you for holding this important hearing today. The lack of personal savings in this county has reached crisis proportions. Almost all of our major competitors have a better record of saving than the U.S. In addition, our tax code has not kept up with the changing nature of our economy. Savings and investment is penalized in this country through double taxation and high tax rates. Individual retirement accounts can provide a vehicle for the average taxpayer to build a next egg with the heavy burden of federal income tax.

Now I know that saving is generally a function of income. However, lowering the tax rates on saving and investment will allow taxpayers to keep more of their hard earned money and hopefully over the long run be able to increase their income and net worth.

Mr. Chairman, as you know, we have just finished a lengthy debate about the future of the Federal budget. Throughout that debate we heard loud cries of concern over our social security system. I too am concerned about its future. Do you think, Mr. Chairman, that one of the ways to save social security is to find alternative ways in which taxpayers can save sufficiently for their retirement, thus lessening the strain on the social security system that we all know is looming in the future? I think an IRA account is one good way to accomplish this.

I look forward to listening to what the witnesses have to say today. Thank you.

PREPARED STATEMENT OF R. GLENN HUBBARD

Mr. Chairman, Ranking Member Moynihan, and distinguished members of this Committee, I thank you for the opportunity to testify before you on the subject of the effectiveness of saving incentives and, more broadly, of public policies toward saving. The nation continues to suffer from an inefficiently low capital stock, distortions in the allocation of the capital stock, and inadequate levels of saving by many households. As I argue below, saving incentives are one promising policy tool to stimulate saving. However, I urge this Committee to continue at the same time to contemplate fundamental tax reform—within the income tax or a shift from our current tax system to a broad-based consumption tax.

I will organize my remarks around four questions. First, do saving incentives stimulate new household saving (and, if so, how much?)? Second, are saving incentives cost effective? Third, do saving incentives increase economic well-being? Fourth, on balance, what have we learned from existing policy experiments?

DO SAVING INCENTIVES STIMULATE SAVING?

Individual Retirement Accounts: What Do We Know? Much of the analysis by economists of households' saving decisions is conducted using versions of the life-cycle model. In its most basic form, the model implies that households save during their working lives to finance retirement consumption. The pattern of saving over an individual's lifetime depends on the rate of return to saving, that individual's preferences over present and future consumption, and the time profile of earnings. The current generation of life-cycle models adds two features to the basic approach: imperfect markets for lending, so that households face limits on their ability to borrow against future resources to finance current spending, and imperfect markets for insurance, so that uncertainty over, inter alia, future length of life, earnings, or medical expenses can generate "precautionary saving" by households.[1]

In the context of the life-cycle model, a saving incentive like an IRA or a 401(k) plan raises the rate of return for saving done through that account or plan. However, economic theory teaches that the incentive raises a household's total saving only if the higher rate of return affects the household at the margin—that is, for an incremental dollar of saving. Roughly three-fourths of all contributors in any given year deposit the full IRA limit in their account. Some commentators have used this fact as prima facie evidence that IRAs could not generate new saving, because they offer no marginal incentive to save after the limit is reached. But this conclusion is too quick. An analysis of saving decisions over a lifetime requires a focus on lifetime limits, not annual limits. From a lifetime perspective, the relevant limit in IRA contributions is not the annual limit of, say, $2000 or $4000, but the lifetime limit.

Some economists eschew the assumptions of the life-cycle model and focus instead on psychological issues of self-control and myopic consumption behavior (see, for example, Thaler, 1994). This focus suggests that households are not optimizing life-cycle agents, responding to marginal saving incentives as they make lifetime consumption and retirement plans. Instead, they are myopic decisionmakers who have

trouble saving for retirement and who respond to programs that encourage self-control in saving both because of the immediate reward of the tax deduction (including the pleasure of denying the IRS its due) and the fact that money is placed "off limits" for current consumption.

Both the life-cycle and the behavioral saving models suggest that IRAs and 401(k) plans have at least the potential to promote saving even in the short term. However, the magnitude of such an effect can only be determined by looking at empirical evidence.

Assessing how much IRAs affect saving in the short term is more difficult than it might first appear. A complete analysis requires a significant amount of information about households: their taxable assets and tax-favored assets, along with earnings, age and demographic characteristics like marital status or number of children that affect consumption and saving decisions. Households are also likely to have different underlying preferences for saving that are not observable. One means of controlling for different household preferences is to use panel data on the same households over time, thus tracking particular households, but even this approach will not help if preferences about saving very over time. Some of the differing opinions about saving incentives—and the ambiguities in results—reflect data limitations that have constrained the ways in which economists have been able to examine effects of saving incentives on household saving.

At the high end of the range of effects are the results of Steven Venti and David Wise (1986, 1987, 1988, 1990, 1991). They model the choice among three goods: consumption, tax-favored (IRA) saving, and taxable (liquid) saving. They reason that if IRA saving is a perfect substitute for taxable saving, then the individual will immediately shift taxable saving into IRAs, because IRAs offer the higher net-of-tax rate of return. If, however, IRAs are imperfect substitutes for other forms of saving, then some IRA contributions will come not at the expense of taxable saving, but at the expense of current consumption. In this case, IRA contributions represent new saving. In evidence from a series of papers, Venti and Wise estimate that 45-66 percent of the increase in IRA contributions comes at the expense of current consumption, while about 30 percent comes from the tax subsidy, and between 3 percent and 20 percent comes from a reshuffling of existing saving.

Why might IRA and non-IRA saving be imperfect substitutes? A likely candidate is the illiquidity of IRA balances. A household may be concerned that, at some future point, its saving will be locked up in an IRA when the funds are needed, perhaps to respond to a medical emergency or a decline in future income. Venti and Wise implicitly treat both saving and consumption as "goods." By contrast, one might wish to think of saving not an end in itself, but as a means to the end of future consumption.

To sort out the explanations for the observed relationships among IRA contributions and savings, William Gale and Karl Scholz (1994) derive the implied saving function for a particular set of household preferences, where saving is a function of wealth and age. They compare saving behavior of contributors who are at the IRA limit with contributors who are not at the limit—assuming that both groups have a common taste for saving—to identify the effect of changes in the IRA contribution limit on household saving. Their estimates show that IRAs have a negative or, at best, zero effect on saving for the sample as a whole. These results suggest that IRA contributions come almost entirely from saving that would have been done in the absence of any incentives.

What's going on here? The intuition behind the Venti and Wise result is that many households, even those with very high income, do not contribute to IRAs. That is, if IRAs and taxable saving were perfect substitutes, then everyone should contribute. However, even among high-income households, roughly one-fourth do not contribute. Hence IRAs must be imperfect substitutes for non-IRA saving, which implies that IRA contributions are coming from reducing current consumption and increasing overall savings. In the Gale and Scholz approach, the fact that some households do not contribute to IRAs is interpreted as evidence that those households have little or no taste for saving. If so, then the Venti and Wise results may be biased upward. IRA contributors save more not because of the existence of an IRA program, but because they like to save, in both IRA and non-IRA vehicles. In contrast, the Gale and Scholz (1994) estimates that IRAs have no impact on saving are probably biased downward, given the fragility of their result.[2]

Because there are so many problems with estimating specific models of IRA contributions, a number of authors have turned to longitudinal studies of saving behavior, using repeated samples over a number of years to assess the extent to which households "reshuffle" existing saving into IRAs. The basic idea is to use saving and IRA information on the same (or similar) households over time. While available evidence weighs against the simplest story of shuffled saving between taxable balances

and IRA balances (Daniel Feenberg and Jonathan Skinner, 1989), it cannot be interpreted as proof that IRAs generate new saving. One cannot control for all possible reasons leading to a change in the taste for saving. If a household decided to increase its overall saving because of impending retirement, for example, it might be expected to do so in a variety of investments including IRAs, even if IRAs have no independent effect on their tastes or saving choices.

In a different test of the hypothesis that IRA contributions represent new saving, Douglas Joines and James Manegold (1995) compare assets and income of new IRA contributors with those who purchased IRAs before the expansion of eligibility in 1982, also using the IRS/University of Michigan taxpayer panel. The thrust of the Joines-Manegold test is that if IRA contributions are new saving, then new contributors in 1982 should increase their saving by more than continuing contributors. They find that the marginal effects on saving of increasing the limit on IRA contributions by one dollar are 26 cents or 29 cents of new saving. In addressing a slightly different question, they find that 19 cents to 26 cents out of each dollar of the typical IRA contribution is financed by new saving.

I have argued that the econometric studies finding very large saving effects are probably biased upward, and the econometric studies finding very small or negative saving effects are probably biased downward. Combined with survey data and other studies suggesting an intermediate impact of IRAs on saving, a conservative estimate of the effect of IRAs on personal saving would be about 26 cents per dollar of IRA contribution. My own suspicion is that the true saving effect is actually somewhat larger.

401(k) Plans: What Do We Know? Estimating how 401(k) plans affect household saving should be easier than it has proven for IRAs. Individuals who contribute to IRAs are likely to be more favorably disposed toward saving than those who do not contribute, which makes the task of distinguishing the marginal effect of IRAs on saving difficult. By contrast, some firms offer 401(k) plans to employees, and other do not. It is more appealing to assert that two different groups—those who are eligible for 401(k)s and those who are not eligible—are households that share common characteristics, the saving behaviors of workers eligible and those not eligible for 401(k)s.

Poterba, Venti, and Wise (1994) compare the saving behavior of workers eligible with those not eligible for 401(k)s. They include in the sample the many workers who are eligible to contribute to a 401(k) plan, but choose not to do so, to avoid the criticism that individuals who choose to contribute to 401(k) were "eager" savers anyway. One finding illustrates the flavor of their results: In 1984, median financial assets excluding 401(k) and IRA balances, for those households earning in the $40,000 to $50,000 income range, were roughly the same for the two groups. Those assets remained generally unchanged between 1984 and 1991. Between 1987 and 1991, however, median financial wealth of those eligible for 401(k) plans rose dramatically, largely because of 401(k) contributions. (Unfortunately, no information is available in the Poterba-Venti-Wise data for 1984 on 401(k) balances.) Assuming that the two groups—401(k)-eligible and 401(k)-ineligible households with equal incomes—hold similar tastes toward saving, and assuming the composition of these workers did not change by much between 1987 and 1991, one might conclude that 401(k)s are entirely new saving.

One possible problem is that firms whose employees are eager savers might also be the ones most likely to implement a 401(k) plan. Then workers eligible for 401(k) plans would be systematically different from those not eligible. This hypothesis is very hard to test because one cannot compare saving behavior of the two groups after the 401(k) plans have been implemented, since such comparisons would be contaminated by the "treatment" of having offered the 401(k). The likelihood of this "self-selection" of 401(k)s by employees who are eager savers is plausible for small firms, though unlikely for workers at very large firms.

Another problem is the "dilution" effect of comparing 401(k) contributors with noncontributors over time. For example, suppose that there are "casual" savers as well as "eager" savers in the population. The earliest participants in 401(k) plans are likely to be the eager savers, so that in 1987, a high proportion of 401(k) participants would be eager savers. By 1991, however, casual savers would account for a larger fraction of 401(k) participants. In other words, given the expansion of 401(k) accounts between 1984 and 1991, the typical 401(k) contributor by 1991 may be less inclined toward saving than the typical contributor circa 1984, so the pool of savers is diluted.

Poterba, Venti, and Wise (1996) and Engen and Gale (1995) both find that when the sample is separated into two groups—those who had an IRA account in 1987 and those who did not—there was an increase in financial assets among 401(k) contributors in each group. This latter comparison does not prove, of course, that 401(k)

contributions increase net wealth, because other aspects of dilution may be biasing these comparisons. Estimates of how 401(k)s affect saving behavior are bedeviled by the same problem encountered in the IRA research—the difficulty in controlling for unobservable tastes for saving in the population.

Overall, the evidence supports the view that 401(k) balances have not been offset by a decumulation of financial assets. My reading of the evidence is that 401(k)s largely represent new saving, if only because there is so little in the form of other financial assets or home equity among low-income and younger 401(k) contributors. The precise fraction of 401(k)s representing new saving is still, however, under debate.

ARE SAVING INCENTIVES COST EFFECTIVE?

Even if targeted saving incentives have only moderate effects on saving, a puzzle remains. Suppose that a particular saving incentive generates only four cents of new saving per dollar of contribution to the savings plan. Is this a successful program? The correct answer is: It depends on the cost. If this program loses only one cent of tax revenue per dollar of contribution, then the answer might well be yes—after all, the policy results in $4 in new saving per $1 in revenue cost.

For the IRA program, one can capture this benefit-cost intuition by defining a ratio:

$$\left[\frac{\Delta\ \textit{Private Capital Accumulation per } \$1\ \textit{IRA}}{\Delta\ \textit{Net Tax Revenue per } \$1\ \textit{IRA}}\right]$$

Both the numerator and denominator are stocks rather than flows and are defined for a particular time period after the initial IRA contribution. For example, suppose that the taxpayer is in the 36 percent tax bracket and that 26 cents of the IRA contribution represents new saving, as estimated by Joines and Manegold (1995). Recall that the 26 cents of new saving is in addition to the 36 cents of tax break, which in this example is also deposited in the IRA. The growth in net capital accumulation in the equation above would therefore be 62 cents (36 cents saved through reduced tax liability plus 26 cents of new saving) divided by the revenue loss of 36 cents. The benefit-cost ratio for the first year after the IRA contribution is therefore 62/36, or 1.72. In other words, there is an increase in private saving of $1.72 per $1 loss in government revenue. If the IRA program were financed through deficit spending, the net impact of the IRA on capital accumulation in the first year would be $0.72 per dollar of revenue loss—or the increase in private saving ($1.72) less the increase in government debt ($1.00).

However, examining the benefit-cost ratio only for the first year is misleading. IRAs lose additional revenue over time, because taxes are postponed on funds that would have been saved in taxable form, but IRAs then generate revenue when funds are withdrawn. In calculating the benefit-cost ratio, it is more sensible to focus on the change in the stock of private wealth accumulated over the period for which the IRA is held, divided by the accumulated tax revenue loss over the same period. Such calculations require assumptions about interest rates, tax rates, the length of time for which the IRA is held, and the tax treatment of the saving had it been saved in a taxable form.[3]

Table 1 presents calculations of this measure of the additional private capital accumulation per dollar of foregone tax revenue, for a wide range of estimates. The first row in Table 1 shows how the marginal impact of IRAs on capital accumulation depends on assumptions about the fraction of IRA contributions that are new saving. When there is no new saving from the IRA contribution—in other words, 64 percent of the IRA is funded by existing saving, and 36 percent funded by the reduction in tax liability—an IRA program leads to an increase in private saving of only $0.22. Under the assumption that the IRA is debt-financed, the net national capital stock would fall by 78 cents (22 cent increase in private saving, one dollar reduction in government saving). At a compromise estimate of 26 cents in new saving, as suggested by Joines and Manegold (1995), the implied increase in private capital accumulation is $2.21 cents per dollar devoted to the IRA program. Thus, even for a deficit-financed IRA, the net capital stock increases by $1.21. A relatively modest saving effect of IRAs can translate into a substantial "bang for the buck" in terms of capital growth per dollar of foregone tax revenue. The estimated effects are even larger when the marginal saving effect is 40 cents per $1 IRA contribution ($4.31 increase in the private capital stock) or 60 cents ($12.01 increase in the private capital stock).

This calculation omits a potentially important effect: The increased supply of loanable funds provided by IRAs will likely be used by corporations for increased investment, which in turn will generate income and corporate tax payments. Martin Feldstein's (1995) analogous calculations to measure the dynamic revenue loss of the IRA program include this corporate tax effect. One can include the effect of corporate taxation in our model by assuming that only equity investments are subject to the marginal corporate tax rate (34 percent) used by Feldstein. Because combined (corporate plus individual) tax revenue losses are smaller in this scenario, the predicted impact on private capital accumulation of one dollar in tax revenue is $4.84 at the benchmark saving effect of 26 cents per dollar of IRA contribution. For sufficiently high contributions of new savings, the IRA becomes self-financing; as Feldstein notes, it can actually generate revenue rather than losing revenue.

The tax regime has changed substantially since the mid-1980s. The third row of Table 1 repeats the calculation using more current tax parameters. In these scenarios, the assumed marginal tax rate is 28 percent for contributors and 24 percent tax rate at retirement; there is no exclusion for capital gains; and the tax rate on dividends and interest is an average of 26 percent. To reflect the increasing aggregate share of equities in IRAs, plan assets are assumed to be divided equally between stocks and bonds. The estimated incremental impact is quite similar ($2.09) to the pre-1986 tax rules for our assumed midpoint estimate of 26 cents of new saving.

To summarize, targeted saving incentives need not stimulate very substantial amounts of new saving per lost dollar of revenue to generate favorable marginal increases in the capital stock per dollar of initial revenue loss. The intuition is that even if the aggregate effects of a given IRA program are not large—in terms of overall increases in net saving—the revenue costs can be even smaller, especially once the offsetting effects of higher corporate taxes are taken into account.

DO SAVING INCENTIVES INCREASE ECONOMIC WELL-BEING?

Suppose for the sake of argument that by raising taxes by $1.00 and using the revenue to expand the IRA program, private saving would rise by $2.21. (By raising taxes and then distributing that money as a tax break, no public dissaving is created, so the entire impact of the plan is on private savings, as in the first row of Table 1.) This increase in the capital stock is not manna from heaven; rather, it is the consequence of households consuming less today in anticipation of consuming additional resources in the future (at retirement). Why fund through distortionary taxes a program which shifts households away from their presently favored level of consumption to one that favors retirement consumption to a greater extent? To offer an economic justification for the existence of saving incentives, one must identify a distortion that the saving incentives are designed to overcome. Several possibilities are plausible.

A High Social Value of Capital Accumulation. To argue for substantial external effects of increased capital accumulation, one must appeal to models in which capital or investment yields positive external effects on productivity or output. Others have noted the close correlation between saving and investment rates. The notion that a larger capital stock yields social external benefits is probably valid, but difficult to quantify. One problem with this rationale is that current saving incentives may not be well suited to this purpose. They include restrictions on contributions and the forced withdrawal of assets at older ages, mechanisms not designed to entice the wealthiest households—those who account for the bulk of the nation's saving—to save much more.

Reducing the Distortion Between Current and Retirement Consumption. Standard economic models predict that the tax on interest income distorts consumption at retirement years. Shifting one dollar of current consumption to the future at the gross return should provide a first-order welfare gain approximated by the wedge between the gross and net return. However, saving incentives are a leaky bucket in effecting this transfer from current to retirement consumption, to the extent that revenue is lost because of partial shuffling. The breakeven point for justifying the IRA program on the basis of reducing intertemporal distortions is approximately 46 cents of new saving per dollar of contribution. When the corporate tax wedge is included in these calculations, however, the IRA program attains the breakeven point at about a benchmark estimate of 26 cents (Hubbard and Skinner, 1996).

Keeping the Elderly Off Welfare Programs. Welfare programs such as Supplemental Security Insurance and Medicaid are designed to assist those elderly with limited assets and income. Encouraging households to contribute money into IRAs and 401(k)s could save the government money in the long term by reducing the chance that individuals would qualify for means-tested welfare programs (R. Glenn

Hubbard, Jonathan Skinner, and Stephen Zeldes, 1995). One problem with this explanation for saving incentives is that the programs are typically voluntary rather than mandatory. Those most likely to end up on welfare at retirement are probably also those least likely to contribute to any new pension or saving program.

Myopia and Self-Control. I have thus far restricted my attention to individuals facing the well-defined utility functions that economists know and love. However, some emerging evidence indicates that people stumble through their planning for retirement with little idea of what they require at retirement and, perhaps, little motivation to meet those requirements (as in Douglas Bernheim, 1997). If households made dynamically inconsistent plans, there may be an intrinsic value to retirement saving programs that assist in self-control. In this case, encouraging people to save helps to offset an "individual failure" or time inconsistency in planning for the future, which could well yield substantial individual and social benefits.

The difficulty or inability of many individuals to save enough for their retirement may well be the most persuasive justification for encouraging saving incentives. While intuitive, such benefits are difficult to quantify. In addition, as I noted earlier, one problem with viewing IRAs and 401(k) plans as a way to encourage self-control is that such programs are voluntary, so that the people who have the most trouble saving for retirement may by the ones least likely to enroll.

WHAT HAVE WE LEARNED?

I have followed the pattern of much of the recent studies of targeted saving incentives by focusing primarily on short-term effects of IRA and 401(k) programs. Even under conservative assumptions about the extent to which contributions to saving incentives represent new saving, saving incentives generate substantial net capital accumulation over time per dollar of foregone tax revenue. However, the long-term effects are arguably more relevant in assessing the desirability of a permanent targeted saving program. Life-cycle simulation exercises that attempt to quantify the magnitude of IRA and 401(k) programs on the long-term capital stock estimate very high benefit-cost ratios of increased private capital stock per dollar of lost revenue; see Engen, Gale, and Scholz (1994).

Given more than a decade of data on the impact of targeted saving incentives on saving behavior, it is somewhat surprising that economists still disagree on the fundamental question of whether such incentives work. One reason why disagreements remain is that economists are only beginning to realize how little is known about saving behavior, and in particular about the wide variation in saving behavior among people who are of similar age, education, and income. As research on saving incentives provides a better picture of their effectiveness at influencing saving behavior, I hope and expect that it will develop a better picture of why households save.

Having offered these thoughts on targeted saving incentives, I would like to urge the Committee to consider first broader reform of our nation's tax code to stimulate saving, investment, and economic well-being. How one considers broader tax reform in this context depends on the problem the Committee wishes to address. If the concern is the level of the nation's capital stock, consideration of fundamental tax reform to increase the level of and efficiency of allocation of savings is paramount. Consideration of concerns about the adequacy of retirement saving could profitably take place in a broader debate over pension reform and privatization of Social Security.

Thank you, again, Mr. Chairman, for the opportunity to be with you today.

TABLE 1.—Change in Net Capital Accumulation Per Dollar Increase in Government Revenue Lost on Individual Retirement Accounts

	New private savings per dollar of revenue loss					
	0 cents	10 cents	19 cents	26 cents	40 cents	60 cents
Baseline	$0.22	$0.81	$1.51	$2.21	$4.31	$12.01
Include corporate income tax revenue	0.22	0.97	2.33	4.84	self-financing	self-financing
Current tax rates and portfolio share	0.04	0.63	1.35	2.09	4.45	15.51

Source: R. Glenn Hubbard and Jonathan Skinner (1996).

ENDNOTES

[1]: For models along these lines, see, for example, R. Glenn Hubbard and Kenneth Judd (1987); Eric Engen, William Gale, and Karl Scholz (1994); and R. Glenn Hubbard, Jonathan Skinner, and Stephen Zeldes (1994, 1995).

[2]: The Gale and Scholz estimates exclude households who reported more (in absolute value) than $100,000 in saving. Using this same exclusion criterion, James Poterba, Steven Venti, and David Wise (1996) reprogrammed the Gale and Scholz econometric model and mimicked the Gale and Scholz benchmark result that IRAs have zero (or negative) effects on total saving for this same $100,000 exclusion rule. However, when Poterba, Venti, and Wise reduced the exclusion limit to $90,000, or increased it to $110,000, thereby adding or subtracting just a few observations, the estimated coefficient flipped around—in both cases—implying that IRAs were entirely new saving.

[3]: The assumptions are discussed in detail in my paper with Jonathan Skinner (1996). Briefly, because most of the estimates from existing studies are based on data from the 1982-1986 period, we use the tax regime for that period in the benchmark calculations. We assume a holding period of 22 years—which corresponds to buying the IRA at age 50 and cashing it out at age 72—for an initial marginal tax rate of 36 percent (Joines and Manegold, 1995), a final retirement tax rate of 28 percent, an average tax rate on interest and dividend income of 32 percent, and a 60 percent exclusion for capital gains. The representative portfolio, whether invested in an IRA or taxable assets, is assumed to be 29 percent in equity initially, with the remainder in a combination of long-term and short-term bonds, an aggregate portfolio consistent with 1985 data (EBRI, 1994). During the period from 1900 to 1990, the geometric mean of the nominal return in the stock market was 9.35 percent, and the geometric mean of a portfolio with one-half short-term bonds and one-half long-term bonds was 4.0 percent (Jeremy Siegel, 1992).

Assumptions about the discount rate used for government debt are crucial in these evaluations; if we use the low yield on government debt during this period, saving incentives exhibit very large (or even self-financing) effects on capital accumulation, largely because of the arbitrage that occurs when the government can borrow at a low rate of interest, but tax the higher equity returns of the IRA or 401(k) investors. Instead, we use a higher nominal discount rate for government debt of 5.55 percent; this corresponds more closely to the historical returns on stocks and bonds noted above, with a 29 percent share of equity and 71 percent share of bonds.

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Statement of Robert C. Pozen
Managing Director and General Counsel
Fidelity Investments

Introduction

Good morning. I am Robert C. Pozen, Managing Director and General Counsel of Fidelity Investments. I very much appreciate this opportunity to testify before the Senate Finance Committee.

Fidelity Investments is the largest manager of mutual funds in the world, with almost $470 billion in fund assets under management. Included in these mutual fund assets are approximately $70 billion in individual retirement accounts (IRAs).

Fidelity Investments is an active member of the Investment Company Institute (ICI), the national association for more than 5,000 mutual funds, and the Savings Coalition, including education and housing groups as well as financial institutions. Fidelity Investments, together with the Investment Company Institute and the Savings Coalition, strongly support the expansion of tax incentives to all Americans for IRA contributions. Thus, we endorse S. 197, the "Savings and Investment Incentive Act of 1997," introduced by Chairman Roth and Senator Breaux. We also generally endorse Title IV of S. 2, the "American Family Tax Relief Act of 1997."[1]

This testimony will:

I. briefly review the surveys supporting the need for more retirement savings through IRAs;

II. detail the increasing dependence on foreign investors resulting from the low U.S. personal savings rate; and

[1] We are concerned about the provision in Title IV of S.2 requiring the coordination of IRA and 401(k) deductions.

III. discuss the evidence of American responsiveness to enhanced tax incentives for retirement programs.

I. Retirement Savings and Individual Responsibility

Survey after survey shows that Americans are not saving enough for retirement, but they are prepared to take personal responsibility for saving more if given appropriate tax incentives.

Fidelity Investments sponsored an extensive national study of retirement issues conducted by the Public Agenda Foundation.[2] The study demonstrated that most middle-class Americans are saving minimally for their retirement -- for example, one-third of Americans have saved less than $10,000 for retirement. Three-fourths of the study's consumer participants said that government should focus more attention on retirement savings, but not by creating another bureaucratic agency. They expressed skepticism that Social Security or corporate pensions would provide enough retirement income; instead, they said they are ready to take personal responsibility for meeting their retirement needs.

Similarly, a study commissioned by the ICI confirmed that the Baby Boom Generation is much less prepared financially for their retirement years than earlier generations.[3] Despite a higher number of two-income families and a higher per capita income than the two preceding generations, the savings rate of the Baby Boomers is generally lower than that of their predecessors. The ICI study found that more than 6 out of every 10 Baby Boomers believe that they are not saving enough for retirement, even

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[2] The Public Agenda Foundation, a non-profit foundation, conducted a major research effort in 1994. That effort included 450 interviews with leaders in the media, government, academia, business and labor as well as a national survey of 1,100 non-retired Americans.

[3] "The Baby Boom Generation, A Financial Portrait," Investment Company Institute (Spring 1991).

though they are worried about meeting their retirement needs through Social Security and corporate pensions alone.

Individuals are increasingly looking to their own personal investments to finance their retirement, according to a recent survey by Hart Research Associates, conducted for the NASDAQ Stock Market. That survey concludes: "Increasingly, investors are counting on their personal investments to be the bedrock of their retirement security, rather than depending on both their employers (pensions) and government (Social Security)."[4] According to the Hart survey, 41% of investors say that most of their money for retirement will come from savings and investments, while 25% say that most of their money will come from a retirement plan and only 4% say that most will come from Social Security. The remaining respondents say their retirement money will come from multiple sources.

Given the demands of retirement financing, Americans need to look to their personal investments to supplement the payments from Social Security and their employer pension plans. How will Americans be able to take personal responsibility for closing the gap between their retirement needs and their retirement checks from institutional sources? The overwhelming answer is the same in all the surveys: expand the tax incentives for IRAs. This was the answer given by 71% of respondents in a 1990 Gallup survey done for Fidelity Investments,[5] and the answer given by more than 60% of the respondents in the 1996 Luntz-Lake survey conducted for the Savings Coalition.[6]

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[4] Peter D. Hart Research Associates, "A National Survey Among Stock Investors," at p. 6 (February, 1997).

[5] Fidelity Investments Gallup Poll, "Public Reaction to Proposed IRA Legislation and Family Savings Account" (March 1990).

If Congress enacts broader IRA tax incentives, Americans will contribute more to IRAs and they will take a long-term view in investing their IRA assets. For example, 86% of IRA assets at Fidelity are invested in equity funds, as compared to an average of 59% in equity funds for non-retirement retail accounts. This high percentage of IRAs in equity funds refutes the argument that individuals cannot be expected to make intelligent investments for their retirement assets. Most IRA contributors at Fidelity have chosen equity funds which, despite their potential for short-term volatility, have historically provided higher returns over the long-term than money market or bond funds. This demonstrates the commitment of IRA account holders to invest in accordance with their long-term retirement goals.

II. Savings Rate and Foreign Dependency

It is well-known that the personal savings rate in the United States is low. It is low relative to American history -- the personal savings rate was 8% in the 1960's and now is roughly 4% to 5%. It is also low relative to our international competitors -- the personal savings rate in Germany and Japan is consistently in double digits.

It is less well-known that, because of the low personal savings rate in the U.S., America has become increasingly dependent on foreign investors to finance the U.S. debt. Regardless of the progress made toward balancing the budget, the U.S. still must finance an outstanding debt of more than $5 trillion by selling Treasury securities. In the past few

[6] In May of 1996, the Savings Coalition commissioned a poll conducted by two polling companies, Luntz Research Corp (Republican) and Lake Research (Democrat).

years, foreign investors have become the dominant force in the market for these Treasury securities.

In 1995, for instance, net purchases of U.S. Treasury notes and bonds by foreigners reached $134 billion.[7] The largest buyers in 1995 were United Kingdom ($34.78 billion), Netherlands Antilles ($23.46 billion) and Japan ($16.86 billion).

In 1996, the pace of foreign acquisitions of Treasury securities accelerated. In the third quarter alone of 1996, the net purchases of U.S. Treasuries by foreigners was over $73 billion.[8] At the end of 1996, foreigners owned 31.6% of the total private holdings of U.S. Treasury securities, up from 21.7% at the end of 1994.[9]

This trend means that the favorable interest rate environment that we have enjoyed in the U.S. is vulnerable to the vagaries of investing by foreigners. If they substantially reduced their purchases of U.S. Treasury securities, the interest rate on such securities would probably rise and accordingly so would interest rates on corporate bonds as well as mortgages and bank loans. In other words, a key component of economic health in the U.S. is heavily influenced by the investment decisions of foreign savers.

Let us focus on Japan, which at $271.7 billion was the largest foreign owner of Treasury securities as of November 30, 1996.[10] While Japan consistently has a personal savings rate of 13% to 16%, short-term interest rates on Japanese bank deposits and

[7] Securities Industry Association, "Foreign Activity: An Analysis of Foreign Participation in U.S. Securities Markets," Vol. XIX, No. 2 (May 1996).

[8] Id., Vol. XX, No. 1 (February 1997).

[9] U.S. Department of the Treasury, Office of Market Finance (February 3, 1997).

[10] Ibid.

postal savings have been below 1% for the last few years because of Japan's depressed economy. As a result, Japanese savers have been avid buyers of U.S. Treasury securities.

But what if the Japanese economy recovered and Japanese short-term interest rates rose to 3% or 4%? The Japanese appetite for U.S. Treasury securities would surely diminish. If we want to reduce our dependency on these types of changes in foreign economic conditions, we must increase our personal savings rates so that more American capital will be available to finance the outstanding U.S. debt.

III. American Responsiveness to Retirement Incentives

In order to increase retirement savings specifically and to boost the U.S. personal savings rate generally, Congress should expand the tax incentives for IRA contributions. Americans do respond significantly to these incentives, as shown by the earlier evidence from the universal IRA and the recent evidence from enhanced retirement programs.

In 1980, nearly all retirement income derived from Social Security and employer pensions. Financial assets in personal savings for retirement were extremely low, even for those on the verge of retirement. In 1982, for instance, $6,600 was the median level of such financial assets for families with the head of household at ages 55 to 64.[11]

When Congress introduced universal deductions for IRAs in 1982, IRA contributions skyrocketed. IRA contributions rose from less than $4 billion in 1980 to approximately $38 billion in both 1985 and 1986. At the IRA's peak in 1986, about 29% of all families with a head of household under age 65 had IRA accounts. And these

[11] Professor Steven F. Venti, "Promoting Savings for Retirement Security," Testimony prepared for the Senate Finance Subcommittee on Deficits, Debt Management and Long-Term Growth (December 7, 1994).

households were not mainly "wealthy" families using IRA as "tax shelters." At the IRA's peak in 1986, 75% of all IRA contributions were from families with annual incomes less than $50,000.[12]

When Congress restricted the deductibility of IRA contributions in the Tax Reform Act of 1986, the level of IRA contributions fell sharply and kept falling -- $15 billion in 1987 and $8.4 billion in 1995.[13] Families that lost the deductibility of their IRA contributions can still take advantage of the tax deferral feature for earnings on non-deductible IRA contributions, but they have shown little interest in this feature.

Even for families retaining full deductibility of IRA contributions, IRA participation declined on average by 40% between 1986 and 1987.[14] This decline seems to be caused by two factors. First, the new restrictions on IRA deductions were complex, so some families were confused. Second, after the demise of universal deductions for IRA contributions, financial institutions substantially reduced their efforts to promote the IRA. As discussed later, financial institutions will promote any legitimate expansion of tax incentives for retirement programs.

While there has been considerable academic debate about whether contributions to IRAs were new savings or reshuffled assets, empirical evidence points to the conclusion that a substantial majority of IRA contributions constituted new savings. For example, extensive empirical analyses of IRA contributors during the 1982-86 period

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[12] Ibid.

[13] Source: Internal Revenue Service, Statistics of Income.

[14] Venti testimony, supra at note 11.

have been done under the auspices of the National Bureau of Economic Research by Professors Steven Venti of Dartmouth and David Wise of Harvard. They estimate that 66% of the increase in IRA contributions come from current consumption, 31% from the tax subsidy, and only 3% from reshuffled assets.[15] A similar conclusion -- that a substantial majority of IRA contributions represent new savings -- has been reached in separate papers by Professor Hubbard of Columbia, Professor Skinner of the University of Virginia and Professor Thaler of University of Chicago.[16]

More recent experience confirms that Americans respond quickly and strongly to new tax incentives for retirement programs. Last year Congress enacted SIMPLE, a simplified set of retirement rules designed to help small businesses which often do not offer a pension program for their workers. In the SIMPLE IRA, a small business may elect to establish a plan at a qualifying financial institution; then any employee of such business may elect to open an IRA-type account at such institution. These accounts will be funded on a periodic basis by the small business through a combination of payroll deductions designated by the employee and matching contributions by the small business.

The SIMPLE-IRA program has been effective only for a little more than two months, since January 1, 1997, yet over 1,000 employers have already established SIMPLE-IRA plans with Fidelity Investments. This high response rate is related to two factors. First, SIMPLE does offer significantly improved tax incentives for retirement

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[15] S. Venti and D. Wise, "The Evidence on IRAs," 38 Tax Notes 411 (January 1988).

[16] J. Skinner, "Individual Retirement Accounts: A Review of the Evidence," 54 Tax Notes 201 (January 1992); J. Skinner and R.G. Hubbard, "The Effectiveness of Savings Incentives: A Review of the Evidence" (January 19, 1995); and R. Thaler, "Self-Control, Psychology, and Savings Policy," Testimony before the Senate Finance Subcommittee on Deficits, Debt Management, and Long-Term Growth (December 7, 1994).

programs at small business; and, second, Fidelity as well as other financial institutions are aggressively educating small businesses about these incentives.

Last year Congress also enacted legislation allowing non-working spouses, beginning in the 1997 tax year, to make a $2,000 contribution to an IRA. While most IRA contributions for the 1997 tax year are not made until the end of 1997 or early in 1998, Fidelity Investments has already disseminated information about the new contribution limits for Spousal IRAs to millions of families. Attached to this testimony are a few examples: *Retirement Insights* newsletter mailed to 3 million customers; a *Special Report: "New Savings Opportunities with a Spousal IRA"* sent to 250,000 inquirers since January 1, 1997; Spousal IRA print ad run in newspapers and magazines throughout the country; and feature article on the Spousal IRA from the Fidelity web site.

The message is clear from the two months of experience with the SIMPLE-IRA and Spousal IRA. When Congress expands tax incentives for retirement programs provided by financial institutions, these institutions will actively promulgate educational information about these new incentives (e.g., Spousal IRA) and Americans will respond quickly to this new information (e.g., SIMPLE).

Conclusions

Expansion of tax incentives for IRAs is not a partisan issue. The legislative proposals for expanding IRA incentives command wide support from members of both parties because these IRA incentives would increase both the amount of retirement savings and the personal savings rate. The response has already been very strong to the

new retirement incentives enacted last year -- SIMPLE and Spousal IRA. We hope that Congress will continue on this path and this year enact broader tax incentives for IRAs.

Thank you again for this opportunity to testify before this committee. I would be glad to answer any questions you might have about this testimony.

Retirement Insights

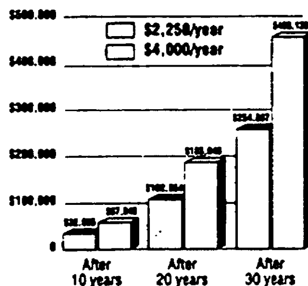
Fidelity Investments

A Special Newsletter for Fidelity IRA Shareholders | January 1997

NEW SAVINGS OPPORTUNITIES WITH SPOUSAL IRA

Recent legislation makes it easier for single-income couples to build a retirement nest egg by broadening opportunities for tax-deferred savings. Effective January 1, 1997, married couples with only one wage earner may increase their combined IRA contributions each tax year to $4,000—a significant increase from the previous combined limit of $2,250. The increase applies to the 1997 tax year and beyond. A couple's total contributions cannot exceed their combined income, and no more than $2,000 can be contributed to either IRA for any tax year.

HOW YOUR SAVINGS COULD GROW WITH THE NEW SPOUSAL IRA LIMIT



This chart shows the value after 10, 20, and 30 years of a $2,250 or a $4,000 annual investment with an 8% hypothetical annual rate of return and earnings reinvested. It does not reflect the effect of taxes or a possible 10% penalty for early withdrawals. Not intended to represent the actual performance of any Fidelity product.

The expanded Spousal IRA limit translates to a *78% increase* in the amount single-income couples can contribute each year to their IRAs—a huge potential benefit, considering this money can compound tax-deferred until retirement. For instance, a single-income couple making the maximum combined IRA contribution each year and earning 8% annually *will have saved nearly $200,000 more after 30 years,* thanks to the expanded Spousal IRA limit (see graph, below left).

Under the new legislation, deductibility rules for IRA contributions stay the same. For contributions to be fully deductible, neither spouse can be an active participant in an employer-sponsored retirement plan, and have joint income of more than $40,000. However, regardless of whether or not contributions are deductible, both spouses can enjoy the benefits of tax-deferred growth.

The passage of this legislation, in effect, granted equal IRA status to non-wage-earning spouses. Previously, married couples were allowed to make IRA contributions of up to $2,000 *per wage earner* each tax year. Couples with only one wage earner, however, were allowed to contribute only $2,250—which often resulted in a $2,000 contribution for the wage-earning spouse and only $250 for the non-wage-earning spouse. By raising the combined Spousal IRA limit to $4,000, the new legislation sends a message to married persons: Whether you work at home without pay or outside the home as a wage earner, you will be treated equally when it comes to retirement savings opportunities.

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SPECIAL REPORT

New Savings Opportunities with a Spousal IRA

Dear Investor,

We think that a good thing just got better. Starting January 1, 1997, married couples with only one wage earning spouse can make combined IRA contributions of up to $4,000 each tax year, a 78% increase from the 1996 limit of $2,250.* This change, effective for the 1997 tax year, helps put single-income families on equal footing with dual-income families when it comes to saving for retirement.

This pamphlet is designed to give you an overview of the change and how you could benefit from the opportunities it offers. Please feel free to call a Fidelity Representative at 1-800-544-7272 with any questions. Thank you for your interest in a Spousal IRA with Fidelity Investments.

Sincerely,

Kathryn A. Hopkins

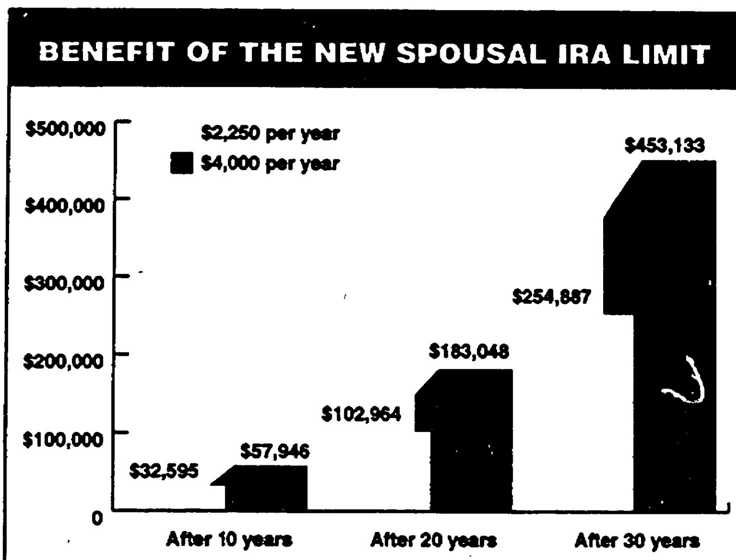
Kathryn A. Hopkins
Executive Vice President

*No more than $2,000 may be contributed on behalf of either spouse for any tax year.

Fidelity Investments®

New Savings Opportunities with a Spousal IRA

Investing for your future with the expanded Spousal IRA limit could translate into a huge potential benefit over time. The chart below shows the impact that the increased annual contribution limit could have as contributions compound tax-deferred.



This chart shows the value after 10, 20, and 30 years of a $2,250 or a $4,000 annual combined contribution with a hypothetical 8% annual rate of return, and earnings reinvested. It does not reflect the effect of taxes or a possible 10% penalty for early withdrawals. Not intended to represent the actual performance of any Fidelity product.

The new combined limit of $4,000 means a **78% increase each year** in the amount a married couple with one wage earner can contribute toward retirement. As the chart illustrates, thanks to the expanded Spousal IRA limit, a single income couple making combined annual IRA contributions of $4,000 and earning a hypothetical 8% rate of return each year, would have saved nearly $200,000 more after 30 years than a couple making combined annual contributions of $2,250.

For more information on Fidelity mutual funds available no-load for retirement investors, or the range of investment options offered through a Brokerage IRA, please call a Fidelity Representative at **1-800-544-7272** anytime. Note: to open up IRAs for both you and your spouse, remember to complete two applications.

IRA Fact Sheet

- ***Who is eligible to contribute.*** In general, anyone under the age of 70½ who has compensation can contribute to an IRA. An additional IRA may be maintained for a non-wage-earning spouse, subject to the Spousal IRA provisions.

- ***Maximum annual contribution.*** Annual IRA contribution limit is 100% of compensation, up to $2,000 per person per tax year. The total amount contributed by married couples may not exceed their combined income.

- ***Spousal IRA contribution.*** For the 1997 tax year and beyond, the combined IRA contribution limit for single income married couples is increased to $4,000. The contributions can be split between the "regular" and "Spousal" IRAs as the couple wishes, up to the $2,000 annual limit per person. The new $4,000 limit means that single income married couples will now have the same retirement savings opportunities as dual income couples (who have been allowed to contribute up to a combined annual total of $4,000 to their IRAs all along).

  For the 1996 tax year, the combined IRA contribution limit is still $2,250 for single income couples.

- ***Tax deductibility.*** Income limits for making fully deductible IRA contributions are $40,000 for couples. IRA contributions are also fully deductible for married couples in which neither spouse is eligible to participate in an employer-sponsored retirement plan – regardless of income level.

- ***Tax Advantages.*** Even if you cannot make a deductible IRA contribution, you can still take advantage of tax-deferred growth through compounding. Any earnings on your contributions are reinvested into your IRA, and can generate additional earnings, which will not be taxed until withdrawal. When IRA earnings are not eroded by taxes each year, they can compound faster than in a comparable taxable investment.

Answers to Your Questions About the New Spousal IRA Contribution Limit

- ***How did this change come about?*** The Minimum Wage Bill, passed by Congress and signed into law by President Clinton in August 1996, broadened opportunities for tax-deferred retirement savings. The expanded Spousal IRA contribution limit was included in this legislation.
- ***How does the new spousal IRA limit affect the tax deductibility of my contribution?*** Tax deductibility rules for IRA contributions remain the same. For example, if either spouse is an active participant in an employer-sponsored retirement plan, and the couple's combined Adjusted Gross Income (AGI) is $50,000 or more, then neither can deduct the IRA contributions from their taxes. If the couple's combined AGI is more than $40,000 but less than $50,000, they may be eligible for partial deductibility, and if neither spouse is covered by a plan, their IRA contributions are fully deductible.
- ***If my IRA contributions aren't tax deductible, what's the advantage?*** You can still take advantage of tax-deferred growth through compounded earnings. Also, since an IRA is designed for retirement, you aren't taxed on the money until you withdraw it[1] And chances are that at retirement, you may be in a lower tax bracket than you are today.

Please note: You must file IRS Form 8606 with your federal tax return for any year in which you make non-deductible IRA contributions.

[1]Any withdrawals made from an IRA prior to age 59½ are subject to income taxes and a possible 10% IRS penalty.

For more complete information on any fund available through Fidelity, including charges and expenses, call for a free prospectus. Read it carefully before you invest.

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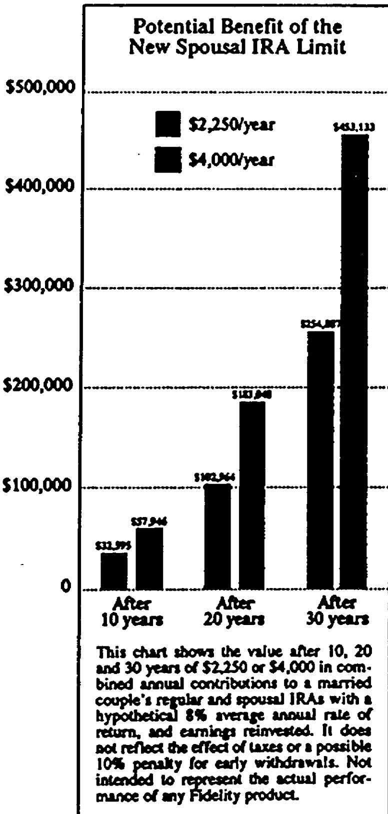
2d/23933.001 SPOI-MSP-197

The Spousal IRA. For the single-income family that wants a dual-income retirement.



This chart shows the value after 10, 20 and 30 years of $2,250 or $4,000 in combined annual contributions to a married couple's regular and spousal IRAs with a hypothetical 8% average annual rate of return, and earnings reinvested. It does not reflect the effect of taxes or a possible 10% penalty for early withdrawals. Not intended to represent the actual performance of any Fidelity product.

You've made the decision to live on one income now. You shouldn't have to pay for it later. That's the idea behind the increased contribution limit for the Spousal IRA. Effective for the 1997 tax year, single-income couples may increase their combined maximum annual IRA contributions by 78%, from the previous limit of $2,250 to $4,000. To take advantage of this change in law, just call Fidelity.

The Fidelity IRA Gives You Choice

You can invest in a wide range of mutual funds from Fidelity and other well-known companies, over 600 of which are available with no-load through Fidelity FundsNetwork.® You can also choose stocks, fixed-income securities and annuities.

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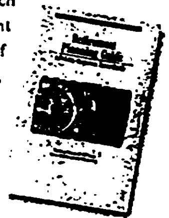

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A New Opportunity to Save -- the Spousal IRA

There's a new opportunity for single-income married couples to save more for retirement. Legislation that took effect in January 1997, now lets married couples contribute up to $4,000 per tax year to their IRAs. Previously, the combined limit was $2,250 per year.

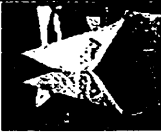
That means each and every tax year, a married couple with one wage-earner can invest 78% more in tax-deferred IRAs than was previously allowed. This creates a tremendous opportunity to multiply your tax-deferred savings.

Spousal IRA contributions can be split between the "regular" and "Spousal" IRA as the couple wishes, provided no more than $2,000 is contributed to either IRA.

A new Fidelity Investments survey shows that married couples continue to save too little for retirement. In fact, of those surveyed, two-thirds have saved less than $50,000 toward their retirement goal.

There's never been a better time for single-income couples to take advantage of the benefits IRA investing can offer. And contributions may even be tax-deductible. The deductibility rules for Spousal IRA contributions remain the same.

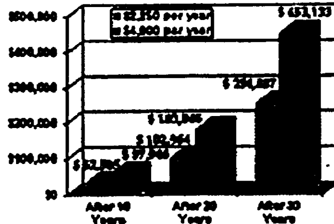
The benefits of a spousal IRA can be enhanced by investing early. In this way, your money can begin compounding tax-deferred more quickly.



Spousal IRA Special Report

Investing for your future with the expanded Spousal IRA limit could translate into a huge potential benefit over time. The chart below shows the impact that the increased annual contribution limit could have as contributions compound tax-deferred.

Benefits of the New Spousal IRA Limit



This chart shows the value after 10, 20 and 30 years of a $2,250 or a $4,000 annual combined contribution with a hypothetical 8% annual rate of return, and earnings reinvested. It does not reflect the effect of taxes or a possible 10% penalty for early withdrawals. Not intended to represent the actual performance of any Fidelity product.

The new combined limit of $4,000 means a 78 % increase each year in the amount a married couple with one wage earner can contribute toward retirement.[1] As the chart illustrates, thanks to the expanded Spousal IRA limit, a single income couple making combined annual contributions of $4,000 and earning a hypothetical 8% rate of return each year, would have saved nearly $200,000 more after 30 years than a couple making combined annual contributions of $2,250.

For more information on Fidelity mutual funds available no-load for retirement investors, or the range of investment options offered through a Brokerage IRA, please call a Fidelity Representative at 1-800-544-7272 anytime. Note: to open up IRAs for both you and your spouse, remember to complete two applications.

IRA Fact Sheet

Who is eligible to contribute. In general, anyone younger than the age of 70 1/2 who has compensation can contribute to an IRA. An additional IRA may be maintained for a non-wage earning spouse, subject to the Spousal IRA provisions.

Maximum annual contribution. Annual IRA contribution limit is 100 % of compensation, up to $2,000 per person per tax year. The total amount contributed by married couples may not exceed their combined income.

Spousal IRA contribution. For the 1997 tax year and beyond, the combined IRA contribution limit for single income married couples is increased to $4,000. The contributions can be split between the "regular" and "Spousal" IRAs as the couple wishes, up to the $2,000 annual limit per person. The new $4,000 limit means that single income married couples will now have the same retirement savings opportunities as dual income couples (who have been allowed to contribute up to a combined annual

total of $4,000 to their IRAs all along).

For the 1996 tax year, the combined IRA contribution limit is still $2,250 for single income couples.

Tax deductibility. Income limits for making fully deductible IRA contributions are $40,000 for couples. IRA contributions are also fully deductible for married couples in which neither spouse is eligible to participate in an employer-sponsored retirement plan - regardless of income level.

Tax Advantages. Even if you cannot make a deductible IRA contribution, you can still take advantage of tax-deferred growth through compounding. Any earnings on your contributions are reinvested into your IRA, and can generate additional earnings, which will not be taxed until withdrawal. When IRA earnings are not eroded by taxes each year, they can compound faster than in a comparable taxable investment.

How did this change come about? The Minimum Wage Bill, passed by Congress and signed into law by President Clinton in August 1996, broadened opportunities for tax-deferred retirement savings. The expanded Spousal IRA contribution limit was included in this legislation.

How does the new spousal IRA limit affect the tax deductibility of my contribution? Tax deductibility rules for IRA contributions remain the same. For example, if either spouse is an active participant in an employer-sponsored retirement plan, and the couple's combined Adjusted Gross Income (AGI) is $50,000 or more, then neither can deduct the IRA contributions from their taxes. If the couple's combined AGI is more than $40,000 but less than $50,000, they may be eligible for partial deductibility, and if neither spouse is covered by a plan, their IRA contributions are fully deductible.

If my IRA contributions aren't tax deductible, what's the advantage? You can still take advantage of tax-deferred growth through compounded earnings. Also, since an IRA is designed for retirement, you aren't taxed on the money until you withdraw it.[2] And chances are that at retirement, you may be in a lower tax bracket than you are today.

Please note: You must file IRS Form 8606 with your federal tax return for any year in which you make non-deductible IRA Contributions.

[1] No more than $2,000 may be contributed on behalf of either spouse for any tax year.

[2] Any withdrawals made from an IRA prior to age 59 1/2 are subject to income taxes and a possible 10% IRS penalty.

PREPARED STATEMENT OF DALLAS L. SALISBURY

Mr. Chairman and members of the Committee, my name is Dallas Salisbury. It is a pleasure to be here this morning to discuss issues related to retirement income programs in general and individual retirement accounts (IRAs) in particular. I ask that my full submission be made a part of the record of the hearing.

The mission of EBRI is to contribute to, to encourage, and to enhance the development of sound employee benefit programs and sound public policy through objective research and education. EBRI does not lobby and does not take positions for or against legislative proposals. ASEC's goal is to make saving and planning a vital concern of Americans and recognized by employers as being in their economic interests. The National Commission on Retirement Policy is a newly formed group that will assess the state of our retirement system and recommend adjustments to strengthen retirement income security prospects.

I was asked to comment this morning on the relative role of IRAs in our retirement income system. I have responded to the three questions I was given with a number of charts and tables, and have provided information on four additional questions of relevance to the overall hearing.

1. WHAT IS THE RELATIVE EFFICIENCY OF TAX EXPENDITURES FOR IRAS AND FOR EMPLOYER-PROVIDED RETIREMENT BENEFITS?

The government publishes tax expenditure numbers (current revenue not collected due to tax deferral on contributions and earnings) on different programs, including IRAs. How does this number compare for IRAs relative to employment-based defined benefit and defined contribution plans? The tax expenditure for employer pension plans in 1995 was: $29.8 billion for federal, state, and local plans (these plans had about 23 million total participants, and 16 million active participants); $14.8 billion for private industry plans (these plans had 78 million total participants and 57 million active participants); and $7.5 billion for military plans. The IRA tax expenditure was $7.7 billion (there are an estimated 60 million IRAs, with about 4.3 million with new contributions in 1994), and $3.3 billion was attributed to Keogh plans (in 1994, about 1 million self-employed individuals made a contribution to a Keogh plan).

2. IT WOULD BE HELPFUL IF YOU COMPARED PARTICIPATION RATES FOR IRAS WITH EMPLOYER-PROVIDED PLANS.

Do individuals participate in IRAs as readily as they participate in employer-offered plans? IRA participation rates have been low relative to employment-based plans. Table 1 shows relative participation rates among all pension plans (43.7 percent), 401(k) plans (64.9 percent), and IRAs (8.1 percent). Internal Revenue Service (IRS) data also show that participation rates among those not covered by an employer pension plan are lower (6.3 percent) than for those with a plan (9.2 percent).

3. IN ADDITION, PLEASE PROVIDE INFORMATION CONCERNING THE EXTENT TO WHICH FUNDS CURRENTLY HELD IN IRAS CONSIST OF AMOUNTS "ROLLED-OVER" FROM EMPLOYER-PROVIDED RETIREMENT PLANS UPON A CHANGE OF EMPLOYMENT STATUS.

How much money is now in IRAs? Table 2 shows IRA and Keogh assets for 1985 to 1995. Total assets at the end of 1995 were $1.220 trillion.

How much of this is from direct contributions as opposed to rollovers from employers qualified plans? Table 3 shows data from 1987-1990, the most recent years for which the IRS has made these data available. For these years, 76 percent of all new contributions to IRAs was from rollovers. Our best estimate is that more than 80 percent of all IRA assets are from rollovers and the earnings on rollovers, as compared with pure IRA contributions and earnings.

4. HOW BIG A SOURCE OF RETIREMENT INCOME DO IRAS REPRESENT TODAY?

Retirees depend primarily on Social Security. Pensions play a large role for the top 20 percent of retirees by income. Chart 1 shows sources of income for current retirees. Income from IRAs is reported here with income from pensions, if it is still coming from an IRA. Many retirees take money from an IRA or a lump-sum distribution from an employer plan, move it into personal assets, and then report this income as asset income. Thus, this chart may understate the contribution to retirees' income of assets built up in pension plans and IRAs.

5. IS ALL INCOME THAT MIGHT BE ATTRIBUTABLE TO ASSETS THAT WERE ONCE IN AN IRA REPORTED AS IRA INCOME?

IRA assets frequently turn into asset income during retirement, with the result that the income is not reported as coming from an IRA. Table 4 provides a more explicit breakout for income sources and their amounts. It shows that 1 percent of today's retirees report income from an IRA/Keogh or 401(k). Chart 2 is intended to put this number in perspective as it shows the high proportion (46 percent) of total benefit payments now in the form of lump-sum distributions. Chart 3 shows that 54 percent of lump-sum distributions are rolled over into IRAs and shows a rollover action by 30 percent of those who get a lump-sum distribution.

6. WHAT IS THE AVERAGE DIRECT EMPLOYEE CONTRIBUTION TO EMPLOYER-SPONSORED 401(K) PLANS AND HOW DOES THIS COMPARE WITH THE IRA $2,000 LIMIT?

Table 5 shows our most recent data, which is for 1993. The average employee contribution across all firms is $2,681 per participant.

7. DO CONTRIBUTIONS TO IRAS ADD TO NATIONAL SAVINGS?

The literature states that contributions to pensions and IRAs make a positive contribution to national savings. The debate is over how much, and there is no agreement on this point.

Table 1
Rates of Pension Participation, 401(k) Participation, and IRA Participation, Civilian Workers Aged 16 and Over, within Earnings Levels, May 1983, May 1988, and April 1993

Real Annual Earnings	Number of Workers (thousands)			Pension Participation (Thousands)			401(k) Participation Percentage of Workers Offered a Plan			IRA Participation (Percentage)		
	1983	1988	1993	1983	1988	1993	1983	1988	1993	1982	1987	1992
All Workers	98,964	113,720	117,874	42.0%	42.0%	43.7%	38.3%	56.9%	64.9%	16.9%	12.5%	8.1%
$1–$4,999	10,294	10,.28	7,540	4.9	4.2	2.9	a	22.2	19.9	6.8	4.6	2.4
$5,000–$9,999	13,257	13,502	10,691	16.9	17.2	12.7	a	32.9	34.0	8.0	7.1	3.7
$10,000–$14,999	16,259	16,966	.5,409	37.0	38.7	28.8	28.2	41.9	44.5	10.4	7.8	4.6
$15,000–$19,999	14,052	14,700	14,501	55.0	54.0	44.6	32.1	50.5	54.5	13.4	11.3	5.4
$20,000–$24,999	11,993	12,417	12,247	64.7	63.4	60.1	34.7	56.7	60.8	19.1	13.3	7.5
$25,000–$29,999	6,663	8,875	9,817	72.8	71.5	64.2	40.0	58.6	66.8	21.0	17.3	8.2
$30,000–$49,999	11,600	14,377	19,977	73.5	75.4	75.0	47.6	67.0	72.3	32.8	18.0	10.6
$50,000+	2,948	4,133	8,639	73.3	76.9	79.2	59.3	79.8	83.2	55.8	22.9	14.5

Source: Employee Benefit Research Institute estimates of the April 1993 Current Population Survey.

[a] Sample too small to be statistically reliable.

Table 2

Distribution of IRA and Keogh Assets by Financial Institution, 1985–1995

Financial Institution	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
					($ billions)						
Total Assets	$228.2	$302.4	$361.0	$419.8	$492.1	$571.4	$680.8	$755.4	$904.1	$985.5	$1,229.0
Commercial Banks	60.6	72.7	82.9	93.9	108.7	130.3	134.4	136.9	134.1	136.1	144.5
Thrifts	64.6	78.4	85.6	99.7	108.4	105.6	91.1	85.3	76.6	71.6	71.2
Mutual Funds	39.4	63.4	82.3	96.8	124.7	142.4	186.4	236.7	314.3	343.5	465.1
Credit Unions [a]	13.8	19.4	22.5	24.4	26.0	28.8	32.3	32.5	32.4	32.1	33.2
Life Insurance	18.9	23.6	28.8	37.0	42.3	47.2	55.4	61.9	75.7	84.7	100.0
Stock Brokerage Self-Directed Accounts [a,b]	31.7	44.9	58.9	68.0	82.0	117.1	157.2	202.1	271.0	317.5	415.0
					(percentage of total assets)						
Commercial Banks	26.6%	24.0%	23.0%	22.4%	22.1%	22.8%	19.7%	18.1%	14.8%	13.8%	11.8%
Thrifts	28.3	25.9	23.7	23.7	22.0	18.5	13.4	11.3	8.5	7.3	5.8
Mutual Funds	17.3	21.0	22.8	23.1	25.3	24.9	27.4	31.3	34.8	34.9	37.8
Credit Unions [a]	6.0	6.4	6.2	5.8	5.3	5.0	4.7	4.3	3.6	3.3	2.7
Life Insurance	8.3	7.8	8.0	8.8	8.6	8.3	8.1	8.2	8.4	8.6	8.1
Stock Brokerage Self-Directed Accounts [a,b]	13.9	14.8	16.3	16.2	16.7	20.5	23.1	26.8	30.0	32.2	33.8
Percentage Increase in Assets from Previous Year		32.5	19.4	16.3	17.2	16.1	19.1	11.0	19.7	9.0	24.7

Source: Employee Benefit Research Institute tabulations of data from the Federal Reserve Board Weekly Statistical Release, the Office of Thrift Supervision, the National Council of Savings Institutions, the Investment Company Institute, the Credit Union National Association, and the American Council of Life Insurance.

[a] This number excludes CDs at banks that are reported to the Federal Reserve Board and are included in the commercial bank category and mutual funds at banks and brokerages already reported in the mutual funds category.

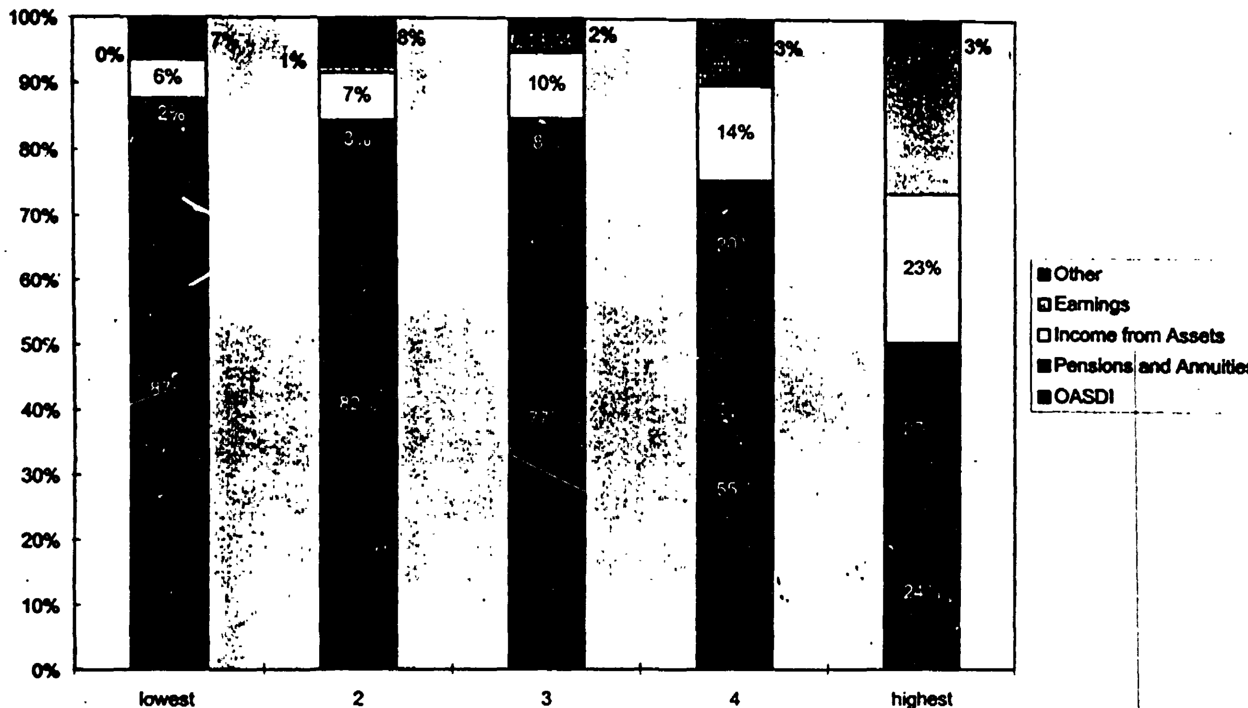
[b] Figures represent individual retirement account assets only.

Table 3
Regular and Rollover Contributions to IRAs, 1987-90

	1987	1988	1989	1990	1987-90 Total
number of contributions (millions)					
regular	12.8	10.9	10.1	9.3	43.1
rollover	2.6	2.6	2.9	3.1	11.2
total amounts contributed ($ in billions)					
regular	19.7	17.1	16.0	15.6	68.4
rollover	39.3	45.9	63.0	71.4	219.6
avg. amounts contributed ($ in thousands)					
regular	1.5	1.6	1.6	1.7	1.6
rollover	14.9	18.0	21.5	22.8	19.6

Source: EBRI/IRS tabulations of IRS Forms 5498, Individual Retirement Arrangement Information, 1987-90.

Chart 1:
Sources of Income, Population Aged 65 and Over, by Income Quintiles, 1995



Source: Employee Benefit Research Institute tabulations of the March 1996 Current Population Survey.

Table 4
Sources of Income of the Older Population

Sources of Income of the U.S. Population Aged 55 and Over, Percentage Distribution of Population and Income by Income Source, Mean Income, and Median Income, by Age, 1995

	Total Aged 55+				Total Aged 65+			
	Percentage distribution of income by source	Percentage receiving income by source	Median[a] Income	Mean Income	Percentage distribution of income by source	Percentage receiving income by source	Median[a] Income	Mean Income
Total	100%	100.0%	$13,453	$21,091	100.0%	100.0%	$11,553	$17,128
Earnings	46	36	18,000	9,691	18	16	9,000	3,044
Retirement Income	37	72	8,864	7,876	61	96	8,917	10,509
OASDI[b]	23	66	7,417	4,932	42	93	7,627	7,237
Private pensions[c]	7	18	4,945	1,382	9	24	4,428	1,539
former worker	6	16	5,160	1,292	8	21	4,593	1,425
survivor	d	2	3,180	90	1	3	3,000	114
Public pensions[c]	7	10	11,916	1,409	9	12	10,176	1,556
former worker	6	9	12,108	1,303	8	10	10,488	1,414
survivor	d	1	7,560	105	1	2	7,560	142
IRA/Keogh/401(k)	d	1	5,297	63	d	1	4,000	66
Annuities[e]	d	d	4,498	45	d	1	3,588	55
Other retirement	d	1	5,437	45	d	1	5,960	58
Inome from Assets	14	69	1,000	2,891	18	69	1,216	3,057
Interest	9	7	577	1,847	12	67	726	2,039
Dividends	3	21	902	630	4	20	1,000	666
Rent, royalties, estates and trusts	2	12	1,015	413	2	11	1,200	352
Financial Assistance[f,g]	d	d	2,500	25	d	d	2,350	12
Nonpension Survivors Benefits	1	1	5,124	108	1	1	5,000	116
Disability	1	1	5,904	117	d	1	5,496	72
Unemployment compensation, Workers Compensation, and Veterans Benefits	1	5	3,000	227	1	4	3,119	228
Public Assistance/SSI[h]	d	1	1,764	14	d	d	919	4
Other[i]	d	2	1,998	91	d	1	2,290	84

Source: Employee Benefit Research Institute tabulations of the March 1996 Current Population Survey.
Footnotes: See the EBRI Databook on Employee Benefits (Washington, DC: Employee Benefit Research Institute, 1995).

Chart 2
Distribution of Pension Payments, 1990

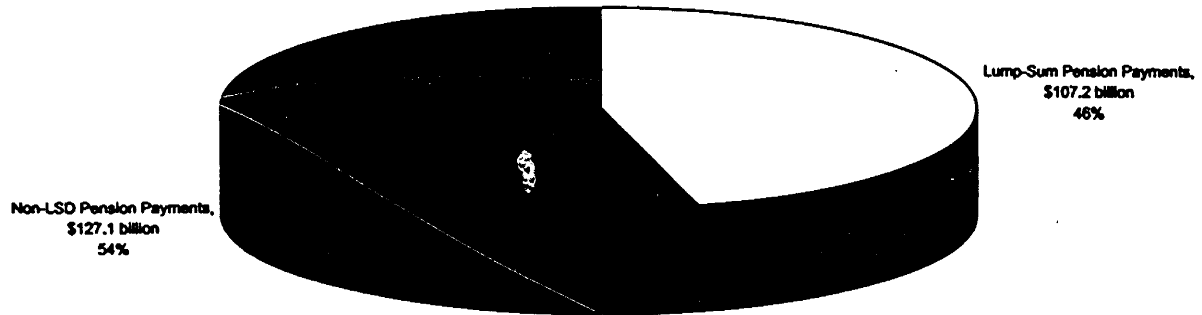
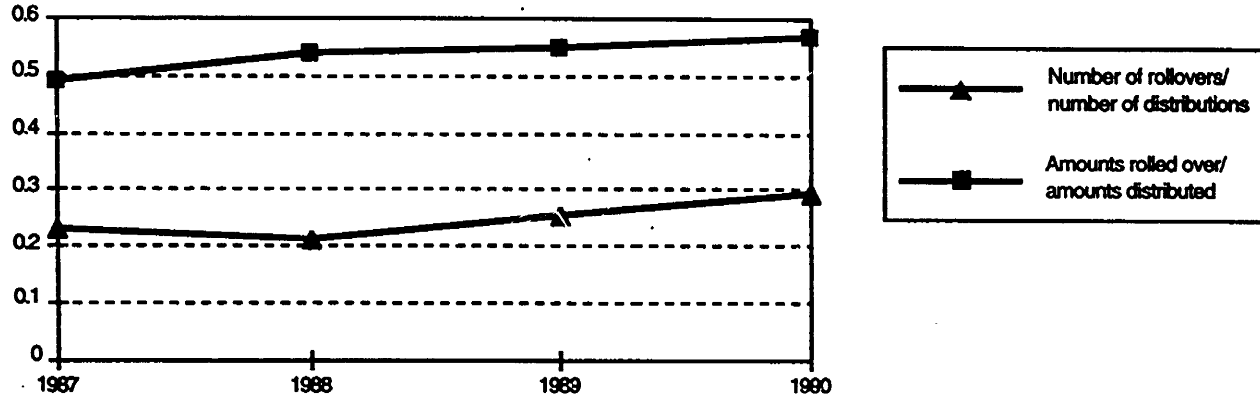


Chart 3

IRA Rollover Contributions as a Percentage of Lump-Sum Distributions, 1987–1990



Source: Employee Benefit Research Institute (EBRI)/Internal Revenue Service (IRS) tabulations of IRS Forms 1099-R, Statement for Recipients of Total Distributions From Profit-Sharing, Retirement Plans, Individual Retirement Arrangements, Insurance Contracts, Etc., 1987–90; EBRI/ IRS tabulations of IRS Forms 5498, Individual Retirement Arrangement Information, 1987-90.

Table 5

Average Annual Dollar Contributions Among Civilian Nonagricultural Wage and Salary Workers, Aged 16 and Older, Who Participate in a Salary Reduction Plan, by Firm Size 1988, 1993

	Total Participants (thousands)		Average Contribution (1993 $)	
	1988	1993	1988	1993
Total	15,586	25,148	$2,443	$2,681
Firm Size				
Less than 10	303	536	3,147	1,667
10-24	462	714	2,406	2,608
25-49	530	850	2,311	2,368
50-99	613	1,292	2,157	2,480
100-249	999	1,944	2,177	2,461
250 or more	11,973	18,889	2,501	2,780
250-249	a	1,780	a	2,609
500-999	a	1,671	a	2,615
1,000 or more	a	15,438	a	2,816

Source: EBRI tabulations of the May 1988 and April 1993 Current Population Survey employee benefit supplements.
[a]Data not available.

PREPARED STATEMENT OF LAWRENCE H. SUMMERS

I am pleased to appear before you today to present the views of the Department of the Treasury on the Administration's IRA proposal. The Administration is committed to insuring that all individuals are given the opportunity to save adequately for retirement. We are also committed to promoting economic growth by raising the nation's saving rate. We believe our IRA proposal will serve both goals. In my testimony today, I will review some basic statistics on savings and growth, describe the Administration's IRA proposal, and then provide a more detailed discussion of some of the issues involved in making IRAs more effective in promoting saving.

NEED FOR SAVING AND METHODS TO INCREASE SAVING

There is broad agreement among economists that investment contributes to economic growth. Thus, by stimulating investment we can increase growth and productivity. Since saving provides the means of financing investment, not surprisingly there is a strong correlation between saving and economic growth as well. This close relationship is shown in Chart 1, which graphs net national saving as a share of GDP and real growth of GDP per worker for each of the G-7 countries and for the remaining OECD countries over the 1960 to 1994 period. The same data for the 1980 to 1994 period is shown in Chart 2. While both saving and growth rates were generally lower in the more recent period, the positive relationship between saving and growth has remained strong. What I conclude from this and other evidence is that increasing the U.S. saving rate is likely to have beneficial effects on economic growth, international competitiveness and living standards.

The second important part of the evidence is that the savings rate in the United States is low relative to other countries. Chart 3 shows the personal savings rate in the G-7 and the remaining OECD countries over the 1960 to 1994 period. While the personal savings rate for the United States, at 8.6 percent, was higher than the rate for the United Kingdom (5.6 percent), the U.S. rate was lower than the rate for Italy, Japan, Germany, France, Canada and the remaining OECD countries. Further, the differences in savings rates are large, with the rates in Italy and Japan about double the U.S. rate.

The third piece of the evidence is even more disturbing: The U.S. personal saving rate has been declining. Over the 1960 to 1986 period, personal saving as a percentage of disposable personal income averaged 7.7 percent. In contrast, over the last decade the average was 5.0 percent. While there has been an encouraging uptick in the savings rate over the last two years, the rate in 1996 was still only 4.9 percent. The low personal saving rate is particularly troubling in view of the aging of the baby boomers who are nearing retirement at the same time that life expectancies, hence years in retirement, continue to increase. Many families today have simply not accumulated the resources necessary to maintain their standard of living in retirement.

There are two principle ways to address the effect of the low saving rate on economic growth and retirement income security. The first is to reduce the Federal deficit. Important progress has already been made over the past four years in closing the deficit. The Administration's Budget continues this effort and eliminates the deficit altogether by 2002. I know that the Chairman and Members of this Committee, and the other Members of Congress are concerned as well, and I am confident that we can work together to achieve a balanced Federal budget.

The second mechanism is to improve current incentives designed to promote saving in general and retirement saving in particular. The Administration's IRA proposal was carefully designed to improve the effectiveness of IRAs, while significantly expanding IRA eligibility. Again, I think this is an area in which we can work together.

Let me turn now to a brief description of the current law IRA provisions and of the Administration's IRA proposal.

CURRENT LAW IRAS

Under current law, a person can make a deductible contribution to an IRA up to the lesser of $2,000 or compensation. If the person or their spouse is an active participant in an employer sponsored retirement plan, the $2,000 limit on deductible contributions is phased out for couples filing a joint return with adjusted gross income (AGI) between $40,000 and $50,000, and for single taxpayers with AGI between $25,000 and $35,000. To the extent that an individual is not eligible for deductible IRA contributions, he or she may make nondeductible IRA contributions, up to the contribution limit.

The earnings on IRA account balances are not includable in gross income until they are withdrawn. Withdrawals from an IRA are includable in income, and must generally begin by age 70-1/2 . Amounts withdrawn before age 59-1/2 are generally subject to an additional 10-percent tax. This 10-percent early withdrawal tax does not apply to distributions upon the death or disability of the taxpayer or to substantially equal periodic payments over the lives of the IRA owner and his or her beneficiary. The 10-percent early withdrawal tax also does not apply to distributions for certain medical care expenses, or to distributions for medical insurance by individuals receiving at least 12 consecutive weeks of unemployment compensation. In general, an excess distribution tax of 15 percent applies to the extent that an individual receives an aggregate amount of retirement distributions in excess of $160,000 in any year.

ADMINISTRATION'S IRA PROPOSAL

The Administration's IRA proposal consists of three parts: expanding income limits, creating new backloaded IRAs, and eliminating the 10 percent early withdrawal tax for certain specified purposes.

Expand Deductible IRA Income Limits

Under the proposal, the income thresholds and phase-out ranges for deductible IRAs would be doubled, in two stages. Beginning in 1997, eligibility would be phased out for couples filing joint returns with AGI between $70,000 and $90,000 and for single individuals with AGI between $45,000 and $65,000. Beginning in 2000, eligibility would be phased out for couples filing joint returns with AGI between $80,000 and $100,000 and for single individuals with AGI between $50,000 and $70,000. The income thresholds and the current-law annual contribution limit of $2,000 would be indexed for inflation. As under current law, any individual who is not an active participant in an employer-sponsored plan and whose spouse is also not an active participant would be eligible for deductible IRAs regardless of income. In addition, the IRA contribution limit would be coordinated with the current-law limits on certain elective deferrals, and the 10-percent early withdrawal tax would apply to withdrawal amounts attributable to contributions (excluding rollovers) made during the previous five years even after an individual reaches age 59 1/2 .

Special ("Backloaded") IRAs

Everyone eligible for a traditional deductible IRA would have the option of contributing an amount up to the contribution limit either to a deductible IRA or to a new "Special IRA." Contributions to this Special IRA would not be tax deductible, but distributions of the contributions would be tax-free. If contributions remain in the account for at least five years, distributions of the earnings on the contributions would also be tax-free. Withdrawals of earnings from Special IRAs during the five-year period after contribution would be subject to ordinary income tax and the 10-percent early withdrawal tax unless withdrawals are used for one of the purposes described below (or unless the withdrawals are exempted from the early withdrawal tax under current law, e.g., upon death or disability).

The proposal would permit taxpayers whose AGI for a taxable year does not exceed the upper end of the new income eligibility limits to convert balances in deductible IRAs into Special IRAs without being subject to the early withdrawal tax. The amount converted from the deductible IRA to the Special IRA generally would be includable in income in the year of the conversion. However, if a conversion was made before January 1, 1999, the converted amount included in income would be spread evenly over four taxable years.

Distributions Not Subject to Early Withdrawal Tax

The 10-percent early withdrawal tax would not apply to amounts withdrawn from deductible IRAs or to amounts withdrawn within five years after contribution from Special IRAs, if the taxpayer used the withdrawal to pay post-secondary education costs, to buy or build a first home, to cover living costs (not just medical insurance costs) if unemployed, or to cover medical expenses of certain close relatives who are not dependents. I will describe these provisions in more detail later in my testimony.

The proposal would be effective January 1, 1997.

DISCUSSION

Determining the effects of IRAs and proposals to change them on household and national saving is difficult. Many factors influence saving, including demographic influences, social insurance, and households' access to credit. One thing that is clear, however, is that policies that operate by simply increasing the rate of return to sav-

ing are unlikely to be effective. Real interest rates and stock market returns have been much higher over the past decade, when the personal savings rate was at historic lows, than in preceding periods. It is apparent from this experience that simply cutting taxes on saving to increase its rate of return is not the key to stimulating saving. Rather, the tax system should rely on focused incentives, like IRAs, that encourage households to put money aside for specific goals, like retirement.

The academic and policy literature on the effects of IRAs on household saving have discussed two main channels, the rate of return and psychological factors, that are likely to be important in understanding the effects of IRAs.

Rate of Return. Even with a focused incentive like IRAs, the effect of increasing the rate of return is uncertain. The special tax preferences give IRAs a higher rate of return than funds invested in taxable accounts. With a higher rate of return, many believe that people will save more. If individuals save to accumulate a specific target level of wealth, however, a higher rate of return enables a saver to achieve his or her saving target with less saving. Which of these effects dominates is an empirical question. If a taxpayer would have saved more than the maximum contribution amount even without an IRA, the tax subsidy will reduce tax revenue but will not provide any additional incentive for the taxpayer to save.

Psychological Factors. In addition to the incentives provided by a higher after-tax rate of return, there are psychological factors related to IRAs that may play an important role in increasing saving. These factors include: (1) the role played by advertising in inducing people to save, (2) the importance of a penalty for early withdrawals in providing the self-discipline to undertake long-term saving, and (3) the important role of an explicit target, such as a contribution limit, in inducing people to increase their savings.

Econometric Evidence. The econometric studies to date have focussed on the effect on saving of altering IRA contribution limits and the rate of return. The evidence is mixed, with some econometric studies suggesting that IRAs represent new savings and other studies suggesting that IRA contributions are largely funded by shifting existing assets or by displacement of saving that would occur even in the absence of the IRA preference. Studies to date have not adequately evaluated the importance of psychological factors on saving behavior, although these may be the most important determinants.

My reading of the evidence is that IRAs, when carefully designed, can increase household and national saving. Moreover, the available evidence provides guidance on the appropriate design of IRAs. In particular, IRA proposals must be designed to reinforce or encourage psychological factors that could increase the efficiency of IRAs in promoting saving.

PRINCIPLES IN DESIGNING THE PRESIDENT'S IRA PROPOSALS

Three principles guided the development of the Administration's IRA proposal. First, incentives must be expanded in a way that increases saving rather than encourages shifting of saving that would have occurred anyway. Second, incentives must be attractive to individuals to encourage participation. Third, incentives must have sufficiently broad appeal to encourage advertising by financial institutions.

Let me elaborate on each principle.

Targeted Expansion

I will first discuss the expansion of income limits and then discuss the treatment of spouses with pension coverage.

Income limits. The Administration's proposal would expand eligibility for deductible IRAs to an additional 37 million tax-filing units, compared with the 75 million tax-filing units that are currently eligible to contribute. With this expansion, 90 percent of taxpayers would be eligible to make deductible contributions. The widespread availability of IRAs is important to stimulating advertising which, as I discuss below, is a critical element of our approach to increasing national saving. Equally important, the proposal offers the vast majority of families a tax-free way to save for retirement.

There are sound reasons for excluding high-income taxpayers covered by pensions from contributing to deductible IRAs though the use of income limits. First, high-income families are more likely to have substantial asset accumulation than other families, and thus are more likely to be able to divert funds from these accounts to finance their IRA. Second, high-income families are likely to save more than the maximum IRA contribution limit anyway, and therefore an IRA will not provide any incremental incentive to save. Third, high-income families are likely to have greater access to tax-preferred forms of borrowing (such as home equity loans) than other households, which can lead to transactions that are costly to the Treasury but have no effect on household saving. For these reasons, IRAs are unlikely to stimulate sav-

ing among high-income families, but the associated revenue loss would increase the deficit and hence lower national saving.

Spousal Pension Rule. The Administration's proposal, like current law, would preclude both spouses from making deductible IRA contributions if either spouse participated in an employer retirement plan and the couple's income exceeded the income limits. The proposed higher income limits reduce the number of individuals affected by the spousal pension rule and makes changing the rule unnecessary.

Encouraging Eligible Individuals to Participate

Our second design principle is to encourage participation by making the incentive more attractive to individuals eligible to contribute to deductible IRAs. An increase in participation should encourage institutions to more widely advertise and may enhance national saving. I will first describe the two ways the proposal is designed to encourage participation.

Tax treatment of withdrawals for special purposes. The Administration believes that a important role of government is to help families help themselves meet critical needs: buying a house, sending children to college, coping with major medical bills, and weathering periods of unemployment. The special purpose withdrawal provisions in the Administration's proposal have been designed to make IRAs more attractive, with the belief that carefully designed withdrawal rules could actually increase saving by encouraging wider participation and giving more families a chance to develop a saving habit.

Under the Administration's proposal, withdrawals for first-time home purchases would be made free of the early withdrawal tax. This change recognizes the critical role that homeownership plays in raising families and in providing financial security during retirement years.

The Administration's proposal would also make withdrawals for post-secondary education free of the withdrawal tax. Well-educated workers are essential to an economy experiencing technological change and facing global competition. Just as investment is needed in factories and computers, investment is needed in human capital to make our economy grow. Education can help workers earn more during their working years so they can save more for retirement. Withdrawals for education, like any other withdrawals from an IRA, would be subject to income tax. However, under the Administration's education proposals, tuition expenses could be deducted or could qualify for a tax credit. As a result of both the IRA withdrawal rule for education and the tuition tax deduction or credit, education expenses would receive very generous tax treatment under the Administration's proposal.

To see just how generous the tax treatment would be, consider a couple that wants to save money for their children's college education. Suppose the couple's goal was to save for a $10,000 tuition payment in the year 2001 and that their marginal income tax rate is 28 percent. Without an IRA and without an education tax deduction or credit, the couple would have to set aside an extra $5,847 both in earnings 1997 and again in 1998. After paying income tax on the earnings, the couple would deposit $4,210 (=$5,847*(1-.28)) into a taxable savings account in each of those years. Assuming the account earned 7 percent interest, the account would earn an after-tax rate of return of 5.04 percent (=.07*(1-.28)). By the year 2001, the account would have accumulated approximately $10,000.

In contrast, a couple that used an IRA and claimed an education tax deduction would only need to set aside an additional $4,000 in earnings in 1997 and again in 1998. Because they would contribute the $4,000 to a deductible IRA, they would pay no tax on the earnings. Furthermore, the funds would grow at the full 7 percent rate of return. By the year 2001, they would have accumulated slightly more than $10,000. While they would include the $10,000 IRA withdrawal in taxable income on their income tax return, they would subtract an identical amount as a tuition deduction. No early withdrawal tax would apply because the funds were being used for college tuition. In summary, without the education deduction and special IRA treatment for education, the couple would have to save $5,847 in both years to pay the tuition; with the Administration's proposal the couple would have to save only $4,000. In this example, by using the IRA and taking the education deduction, the savings needed to pay for tuition were reduced by almost 32 percent (($5,847-$4,000)/$5,847). Over a longer period, the difference would be even greater. We believe that the value of education to our economy and to the American people easily justifies this special tax treatment.

Recognizing the hardship faced by families facing long periods of unemployment and major medical expenses, the Administration's proposal would also allow an exception from the early withdrawal tax for individuals who have been unemployed for 12 weeks and for medical expenses, including those of the taxpayer's child,

grandchild, parent or grandparent, whether or not that person otherwise qualifies as the taxpayer's dependent.

While the Administration supports favorable tax treatment for these limited purposes, it would not favor expanding preferential treatment for more general purposes. We have limited our special purpose withdrawals to items that are likely to supplement retirement resources to a very wide range of families and for well-demarcated emergency needs. These expenses are identifiable and could not be readily diverted to what most people would consider to be personal consumption. It is important to understand that the early withdrawal tax plays a critical role in enhancing the effectiveness of IRAs. In particular, it reinforces the self-discipline necessary to undertake long-term saving. It discourages individuals from tapping into their IRAs unless the value of spending these funds exceeds the cost of paying the withdrawal and income taxes.

Special IRAs and Five-Year Rule. In a Special IRA, contributions are not deductible but are tax-free upon withdrawal. The Administration believes that providing taxpayers with the option of a Special IRA will provide a savings vehicle that some middle-income taxpayers may find more suitable for their savings needs than traditional IRAs. For example, younger individuals may expect to be in a higher tax bracket when they take the money out of an IRA. These individuals may be willing to give up the deduction at today's lower tax rate in favor of tax-free treatment in a later year when they are in a higher tax bracket and choose to withdraw the money. Other individuals may prefer the psychological advantage of paying the tax up-front. As they watch their IRA assets accumulate, they will automatically know how much of their IRA assets could be used for retirement needs—the entire amount in the account—without having to calculate how much tax would have to be paid.

Withdrawals of funds for the previously-specified special purposes and withdrawals of funds that had been in the account for five years would not be subject to the withdrawal tax. The five-year rule is likely to encourage more individuals to participate in an IRA than under current law. Once these individuals see their assets start accumulating, they may be encouraged to keep assets in the IRA until retirement and they may even be encouraged to make additional contributions.

Awareness and Advertising

Expansion of IRA eligibility and attractiveness under the Administration's proposal will directly raise public awareness of the importance of retirement saving. An improved IRA incentive will also make tangible to taxpayers the Federal government's commitment to insuring the adequacy of resources in retirement. Further, many taxpayers may be encouraged to save more because the IRA contribution limit will provide them with a "publicly approved" saving target.

Other countries have long recognized the importance of public awareness efforts and public incentives in stimulating saving. Prior to the second World War, the U.S. saving rate was higher than Japan's. Following the war, the Japanese Government launched a concerted national effort to increase the Japanese saving rate. The promotional campaign included worker seminars, the distribution of children's saving banks, advertisements, pamphlets and other written material. While the post-war reconstruction surely accounted for some of the boom in Japanese saving rates, some observers also credit the actions of the "Saving Promotion Movement" for significantly increasing the Japanese saving rate.

Related evidence indicates that employer-sponsored workplace education increases participation in 401(k) plans. This workplace education takes many different forms, including seminars, newsletters, and other written material. The content often covers broad financial principles, such as the effects of compound interest and retirement needs, as well as specific details tailored to the financial benefits available at a particular firm. Worker education could lead to increased participation for several reasons. First, employees become more aware of saving options. Second, employees become more focused on the need to save. Third, employees are encouraged to participate because their co-workers participate. Some have conjectured that there is a social aspect to saving. As more people participate within a firm, they may talk with their friends and relatives about the benefits of saving. Like the experience with 401(k)s, IRA education could have similar payoffs.

There is an additional piece of evidence supporting the important role advertising plays in influencing behavior. Prior to the Economic Recovery Tax Act of 1981, eligibility for IRAs was limited to those with no pension coverage. Despite the fact that many workers in the economy were not covered by pensions, IRA participation rates were extremely low. Because of this, the expansion of IRA eligibility in the 1981 Act was at the time thought to be relatively modest. Instead, IRAs were wildly popular, leading to much higher participation than initially estimated. Most people who have

examined the issue conclude that advertising by financial institutions was what caused the high rates of participation. Following the Tax Reform Act of 1986, participation rates fell by more than one would expect. Again, observers have pointed to a substantial decrease in advertising as being the cause.

The Administration's proposal has been designed to include provisions that are likely to make IRAs much more attractive, which will encourage wider participation. By expanding the potential number of participants to 90 percent of all taxpayers, the Administration's proposal may induce financial institutions to advertise more widely. As the baby boom generation ages and boomers begin to think about retirement, IRA advertisements could encourage families to focus their energies on developing a savings plan, even if they do not open IRAs. These positive effects could occur even if expansion does not provide saving incentives at the margin. In summary, the Administration's proposal has been designed to appeal to a broad segment of the population and to encourage financial institutions to advertise, in the belief that advertising can be a powerful stimulus for financial planning and saving.

CONCLUSION

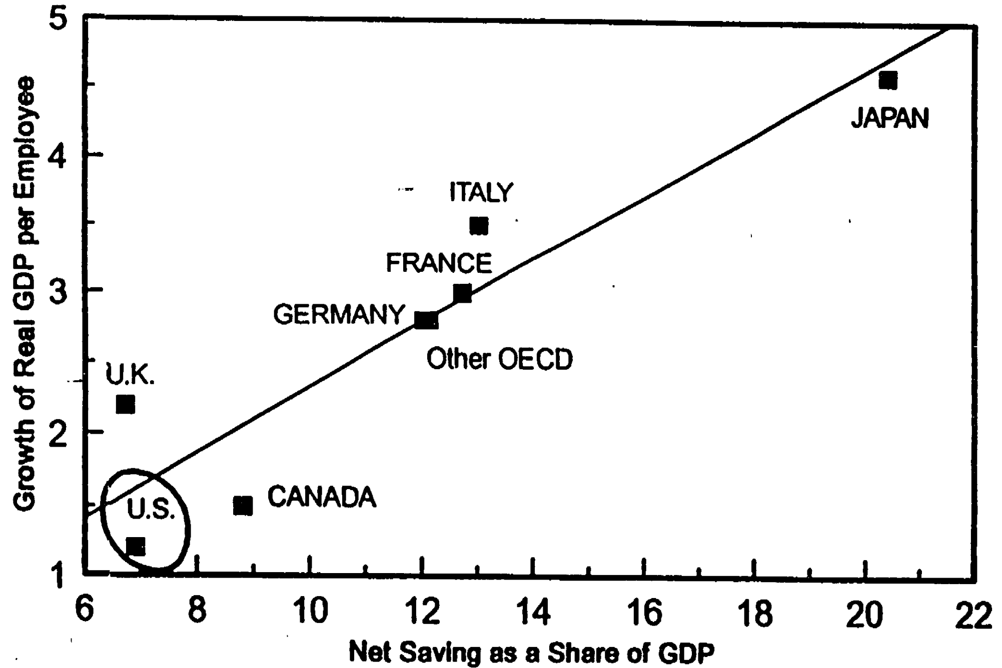
Let me conclude with three observations on which I believe we can all agree. First, saving is critically important to the retirement security of individuals and to the country's economic growth. Second, effective saving incentives must recognize the psychological factors that influence saving, and not just focus on increasing the rate of return on savings. Third, well-designed saving incentives, like the Administration's IRA proposal, can increase saving.

This Administration is committed to meeting the challenge of insuring adequate retirement saving by the baby boom and subsequent generations. One part of that commitment is our IRA proposal. Other parts are our recent introduction of inflation-indexed bonds which are an ideal vehicle for protecting retirement assets against inflation risk, and our continuing work on simplifying pensions and increasing their attractiveness. I look forward to working with this Committee on meeting this important challenge.

Chart 1

Saving and Growth

in the OECD Countries 1960-94



Note: Germany and Other OECD are almost identical.

Chart 2

Saving and Growth

in the OECD Countries 1980-94

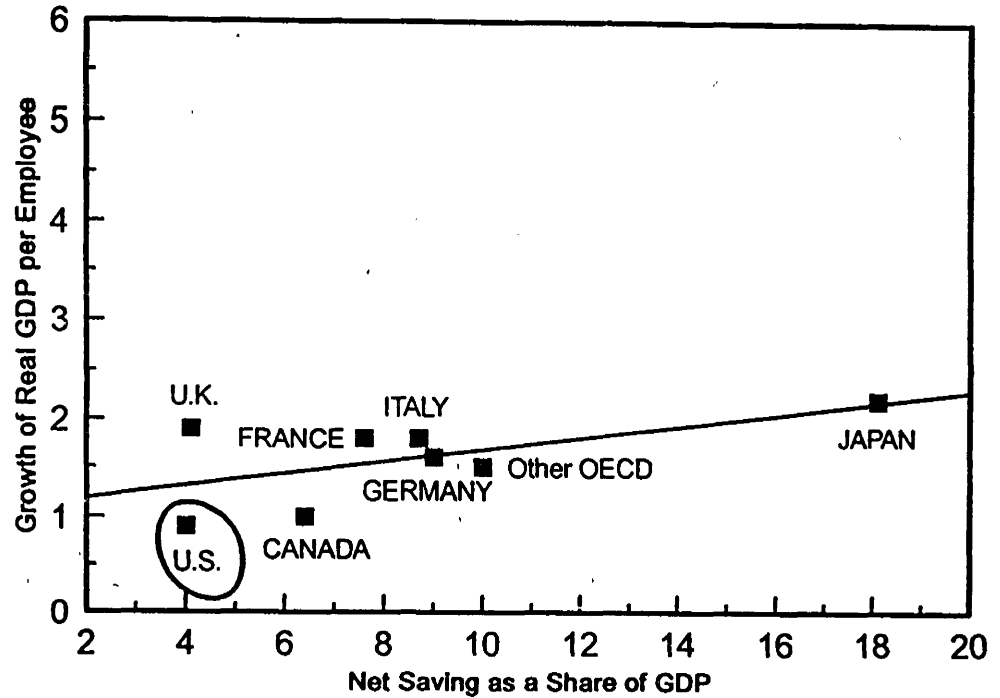
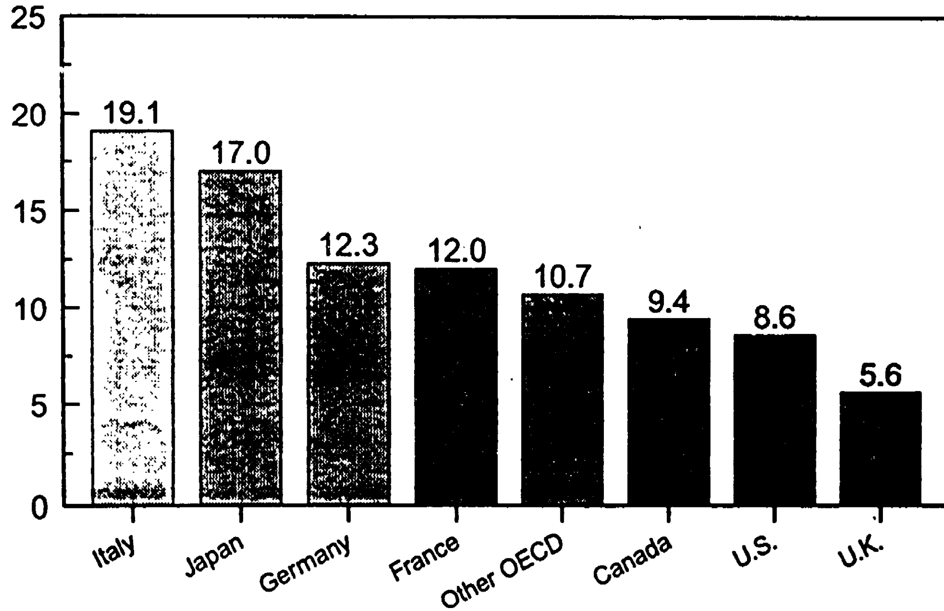


Chart 3

Personal Saving Rates in the OECD Countries 1960-94

Percent



Statement
of
John S. Tottie
Senior Economist for Tax and Budget Policy
Citizens for a Sound Economy
on
Expanding Individual Retirement Accounts
before the
Senate Finance Committee

March 6, 1997

Mr. Chairman, Members of the Committee, I am very pleased to be able to appear before you today to discuss the important issues of making individual retirement accounts (IRAs) available to all Americans and creating a new, non-deductible IRA with tax-free withdrawals. I am John Tottie, a senior economist with Citizens for a Sound Economy (CSE), a 250,000-member citizen advocacy organization that promotes market-based solutions to domestic economic problems.

CSE has long supported and continues to support major tax cuts, such as across-the-board tax rate cuts. Current tax levels -- which cost Americans more than food, clothing, and housing combined -- are simply too high. However, if Congress is to limit itself to targeted tax cuts, it is all the more important that such cuts eliminate harmful barriers to savings, investment, and growth.

Expanding IRAs would do just that -- substantially reducing the income tax code bias against saving, thereby better enabling Americans to save for retirement and other purposes, as well as fueling economic and real wage growth by expanding the pool of savings available for investment. Research by many leading economists, despite some claims to the contrary, indicates that IRA saving constitutes new saving. New research also indicates that more expansive IRAs may not necessarily be more expensive to the Treasury. Finally, public opinion polls and surveys have found that IRAs may be the most popular tax cut with the American people.

Congress is currently looking at two primary proposals for expanding IRAs. However, while both President Clinton's IRA proposal and the Savings and Investment Incentive Act of 1997 (S. 197) would represent a significant step toward reducing barriers to savings, only S. 197 would create a truly universal IRA available to all Americans.

A BRIEF HISTORY OF IRAs

Individual retirement accounts were first established in 1974, as a part of the Employee Retirement Income Security Act (ERISA). Employees who were not active participants in a qualified retirement plan were allowed to set aside up to the lesser of $1,500 or 15 percent of their earned income per year in an IRA. The contribution was tax-deductible, and the returns on the investments accumulated tax free. Taxes were paid on the amount withdrawn.

IRAs were dramatically expanded by the 1981 Economic Recovery Tax Act. The new "universal IRA" was available to all workers, whether or not their employer offered a retirement plan. Any individual could contribute up to the lesser of $2,000 per year or 100 percent of earnings to his or her own retirement account, and a joint filing unit in which one spouse had little or no earnings could contribute $2,250. The new IRAs were an instant success. In four years, the number of tax returns reporting IRA contributions increased almost five-fold, to 16.2 million by 1986.[1] Total assets in IRAs increased from $84.6 billion in 1983 to $243.3 billion in 1986.[2]

At the peak of the program, three-fourths of all IRA contributions came from families with incomes below $75,000. Based on the 1986 participation rate of households with heads 55 to 65 and incomes over $20,000, over half of all households with earnings above $20,000 would eventually have opened an IRA account.[3]

The Tax Reform Act of 1986 limited IRA deductibility to individuals not eligible for employer-sponsored retirement plans, single filers with adjusted gross incomes below $35,000 (phased out starting at $25,000) and joint filers with incomes below $50,000 (phased out starting at $40,000). The result was negative, immediate, and persistent, with IRA contributions falling almost two-thirds in 1987 and remaining low ever since. A survey revealed that approximately half of the individuals eligible for the IRA deduction after the 1986 legislation mistakenly believed that they were no longer eligible.[4]

In spite of broad-based bipartisan and public support, repeated attempts to substantially expand IRAs since 1986 have failed. Last year, however, the Small Business Job Protection Act raised the maximum contribution of non-wage earning spouses to $2,000 and the Health Insurance Portability and Accountability Act allowed penalty-free withdrawals from IRAs before age 59 1/2 for qualified medical expenses and certain unemployment expenses.

THE CASE FOR EXPANDING IRAs

The saving crisis in America

The U.S. saving rate is currently among the lowest of all industrial countries and has dropped significantly in the last decades. For example, while personal saving averaged 7.8 percent of personal income during the 1970s, it has averaged only 4.5 percent in the 1990s. American households save less than half that of households in Germany, Britain, Japan and many other countries.

Ending double-taxation

The current income tax system is, in effect, a double tax on saving, by taxing both the money used for saving and also the returns generated by saving. Independent of the actual rate of U.S. saving -- low as it is -- eliminating an excessive layer of taxation on saving is a good tax policy reason for expanding IRAs. Indeed, the elimination of double taxation helps explain why IRAs are so popular and economically productive.

The need for retirement savings

One of the most compelling reasons for making IRAs more available is that many Americans are not saving enough to retire with financial dignity. (Social Security only pays the average retired worker the equivalent of a full-time minimum wage job.)

Stanford economist Douglas Bernheim calculates that baby boomers are saving at about one-third the rate needed to maintain their lifestyle in retirement.[5] This estimate excludes housing wealth, but for good reasons. It is not clear if future retirees will be willing to draw on this wealth for everyday living expenses. Many probably will want to hold onto their housing equity for precautionary reasons, to cover unexpected medical bills or nursing home expenses.

In fact, there are many reasons to believe that Bernheim's estimate actually may substantially underestimate the need for more saving. Even though Social Security is financially unsustainable for the long-term in its current form, Bernheim's estimate assumes that benefits will not be cut and that taxes will not be raised. It also ignores the potential of new medical breakthroughs to substantially extend life expectancy. Neither does his estimate account for the increasing cost of health care and nursing home care for senior citizens.

Increasing growth

An increased saving rate would also increase economic growth and real wages. The empirical evidence suggests that countries with higher saving rates tend to have higher rates of investment. One estimate found that on average about 80 cents of each additional dollar saved in the Organization for Economic Cooperation and Development (OECD) countries remain in the

country of origin.[6] Moreover, numerous studies have found that cross-country differences in economic growth rates can be largely explained by differences in the share of gross national product devoted to investment.

Considering the relationship between saving and investment and investment and growth, it should perhaps not be a surprise that one of the most notable facts of cross-country economic data is the positive correlation between the saving rate and economic growth. Over the last decade, for example, 14 of the world's 20 most rapidly growing economies had gross saving rates in excess of 25 percent. In no case was the saving rate below 18 percent. On the other hand, 14 of the 20 slowest-growing economies over the last decade had saving rates of less than 15 percent.[7]

Increasing net savings

Extensive research in the last 10 years by economist scholars Steven Venti (Dartmouth), Glenn Hubbard (Columbia), Lawrence Summers (formerly Harvard, now deputy secretary of the treasury), David Wise (Harvard), Jonathan Skinner (Virginia), James Poterba (MIT), and others, has shown that saving incentives, including IRAs, do increase net savings.

In a 1992 study, for example, Venti and Wise found that households that made IRA contributions in 1986 increased their non-IRA financial assets from $9,400 in 1983 to $13,500 in 1986 -- an increase of 44 percent.[8] This suggests that non-IRA savings were not the source of IRA saving.

Overall, Venti and Wise found, as noted in a review of the literature by Hubbard and Skinner, that "45-66 percent of the increase in IRA contributions comes at the expense of current consumption" and only "between three and 20 percent comes from a reshuffling of existing saving."[9]

Creating an "Individual Savings Account"

Americans need savings for many other important objectives than retirement. S. 197 recognizes this by expanding the purposes for which the 10 percent penalty on withdrawals before age 59 1/2 is waived. Allowing withdrawals for a broader range of objectives -- including a first home purchase, higher education expenses and a broad array of unemployment-related expenses -- would provide Americans with new, strong reasons to save and constitute a significant step toward transforming the IRA into an Individual Savings Account (ISA).

New IRA Plus expands taxpayer choice

One of the most exciting aspects of S. 197 is that it would create a new, non-deductible IRA with tax-free withdrawals: the "IRA Plus." If tax rates do not change over an individual's lifespan, avoiding taxes on IRA deposits or on withdrawals is equally attractive. But tax rates may

not stay the same. For example, taxpayers who believe that tax rates will be raised, or that the Social Security benefit tax will raise their tax rate as they retire, could benefit from the tax-free withdrawals of the IRA Plus. Of course, many individuals may still prefer the deductible IRA, and S. 197 would respect this by offering the IRA Plus account as a voluntary alternative to -- not a replacement of -- the deductible IRA.

Expanded IRAs increase the revenue base

Estimates of the revenue effects associated with expanding IRAs have typically only considered the direct, negative impact on individual income tax receipts. However, as Harvard professor Martin Feldstein has shown in a recent study, "The revenue loss associated with IRAs either is much smaller than has generally been estimated or is actually a revenue gain."[10] Feldstein notes that increasing savings increases the corporate capital stock, which in turn increases taxable corporate income. However, as his study examines the revenue effects of the deductible IRA, he also finds that it will take several years until the increase in corporate tax revenues outweighs the forgone individual income tax receipts.

With the non-deductible, backended IRA Plus, on the other hand, there is no initial revenue loss. In fact, the backended IRA would raise revenues over the course of the budget cycle, since transfers of balances from the deductible IRA to the backended IRA would be subject to regular taxes and fewer deductible IRA contributions would be claimed.

Strong public support for expanding IRAs

Few proposed reforms in Washington are more popular with the American public than expanding IRAs. For example, a national survey conducted by the Democratic Lake Research and the Republican Luntz Research Companies in May 1996 for the Savings Coalition found that voters favored expanding IRAs to enacting the far more "expensive" $500-per-child tax credit. Sixty-four percent of respondents also claimed that they would increase their rate of saving should expanded IRAs become reality. Seventy-seven percent of voters aged 18 to 29 and 71 percent of baby boomers stated that they would save more.

Conclusion

The time has come to eliminate unfair penalties on savings. Expanding IRAs as proposed by S. 197 is an excellent place to start -- making all Americans better able to save for a financially secure retirement and other important objectives while also helping to revitalize the economy at large.

NOTES

1. James R. Storey, "Individual Retirement Accounts (IRAs): Legislative Issues in the 104th Congress," *CRS Report for Congress* (96-20 EPW), Congressional Research Service, March 1, 1996, p. 3, based on Internal Revenue Service, *Statistics of Income* (various years).

2. Ibid., based on tabulations by the Employee Benefit Research Institute.

3. Steven F. Venti and David A. Wise, "Government Policy and Personal Retirement Saving," in James M. Poterba, ed., *Tax Policy and the Economy*, Vol. 6 (Cambridge, MA: MIT Press), p. 8.

4. *IRA Reporter*, Sept. 30, 1988, cited in ibid., p. 3.

5. This section is largely based on B. Douglas Bernheim, "The Merrill Lynch Baby Boom Index: Update '96," April 1996.

6. Martin Feldstein and Phillippe Bacchetta, "National Saving and International Investment," in *National Saving and Economic Performance*, B. Douglas Bernheim and John Shoven, eds. (Chicago, IL: University of Chicago Press, 1991).

7. International Monetary Fund, "Saving in a Growing Economy," *World Economic Outlook*, May 1995, pp. 67-68.

8. James M. Poterba, Steven F. Venti and David Wise, "How Retirement Saving Programs Increase Saving," *Journal of Economic Perspectives*, Vol. 10, No. 4 (Fall 1996), p. 94.

9. R. Glenn Hubbard and Jonathan S. Skinner, "Assessing the Effectiveness of Saving Incentives," American Enterprise Institute conference on the effects of taxation on savings, Washington, D.C., Feb. 23, 1996, p. 9.

10. Martin Feldstein, "The Effects of Tax-Based Saving Incentives on Government Revenue and National Saving," *Quarterly Journal of Economics*, Vol. 110, No. 2 (May 1995), p. 475.

PREPARED STATEMENT OF STEVEN F. VENTI

Mr. Chairman and Members of the Committee. I thank you for the opportunity to testify before this committee today. My name is Steven F. Venti. I am Professor of Economics at Dartmouth College and a Research Associate of the National Bureau of Economic Research. Along with my colleagues Professor David A. Wise of the Kennedy School of Government at Harvard University and Professor James Poterba of the Massachusetts Institute of Technology I have conducted over a dozen studies on the effectiveness of IRAs, 401(k)s, and similar plans designed to stimulate retirement saving. Today, I would like to review for you the results of this research and draw attention to some of the features of the IRA program that are responsible for its success. I would like to emphasize five points:

- The research evidence shows a clear and substantial effect of the IRA program on personal saving.
- The IRA program easily passes a cost-benefit test for "success."
- IRAs are not just for the wealthy.
- A permanent IRA program can dramatically improve the retirement security of future retirees.
- The ability of the IRAs to increase saving depends heavily on nonfinancial features of the program.

DO IRAS INCREASE SAVING?

Much has been written about how low rates of personal saving in the United States may jeopardize both the financial security of future retirees and the long-term growth of the economy. Providing tax incentives for saving through programs such as the IRA are a potentially important way of addressing these concerns. The debate over IRAs has pitted their effectiveness at increasing personal saving against revenue losses due to tax deductibility and deferral. The key unanswered question in this debate is whether IRAs stimulate "new" saving. Some critics have charged that that contributions are reshuffled from existing asset balances, or that contributions replace saving that would have occurred in the absence of the program. Evaluating the merit of these criticisms has proved to be a difficult challenge.

Together with my co-authors I have completed almost a dozen studies of the effectiveness of IRAs using several different microeconomic data sets and a variety of methodological approaches.[1] Each study and each method is designed to determine whether IRA contributions increase the financial wealth of households, or if these contributions simply relabel existing asset balances. The results of these studies uniformly point to substantial saving effects. Rather than go through these studies one by one, let me simply highlight some of the key findings:

- Households that began contributing approximately $2,300 per year to an IRA following broadened eligibility in 1982 had no history of saving at anything near this level. Early contributors to the IRA program had accumulated only about $8,500 of saving prior to the advent of the program. Thus IRA saving appears to be "new" saving for most of these households.
- By following taxpayers over time we can observe whether non-tax favored saving falls when these persons begin to contribute to an IRA. We find no reductions in these other balances, thus again suggesting that contributions to IRAs again are "new" saving.
- Persons nearing retirement in the early 1990's had the opportunity to augment their saving through IRAs. Persons nearing retirement a decade earlier did not have this opportunity. We find that the former group had much higher levels of total financial assets than the latter group, and that the different assets of the two "cohorts" could be accounted for by balances in tax-advantaged saving accounts such as IRAs and 401(k)s. Again, IRA contributions were not offset by lower saving in other forms.
- We also compare the saving patterns of similar households that have been "exposed" to the IRA program for different number of years (e.g. households in 1987 had five years to contribute; households observed in 1991 had nine years to contribute). Again we find that longer exposure to the program is associated with greater total wealth, thus suggesting that IRA contributions are not offset by reductions in other assets.
- We have also attempted to use aggregate data to shed light on the saving effectiveness of the IRA program. We find little relationship between the aggregate saving rate and contributions under the full-fledged IRA program in the mid 1980's. However, it must be kept in mind that many other factors unrelated to IRAs also affected aggregate saving over this period, thus making any inferences from these data suspect. In particular, high equity prices and interest rates reduced corporate pension contributions—a key component of saving—over

this period. After IRA contributions were curtailed by TRA in 1986 the saving rate did drop sharply. Given the brevity of the IRA experience and the volatility of saving, it is difficult to make any inferences, one way or the other, about the saving effect of IRAs from these aggregate data.

- Finally, we have examined closely some other studies in the literature that purport to find no saving effect of IRAs.[2] After a very careful analysis that included reproducing the results of these studies, we concluded that they contain no credible evidence that the IRA program did not increase saving during the 1980's.

Taken together I believe the weight of the evidence from the many analyses clearly shows a positive and substantial effect of the IRA program on personal saving.

DO IRAS PASS A COST-BENEFIT TEST?

Given the magnitude of the reported saving effects above, it is clear that the stimulus to saving provided by the IRA program more than offsets the revenue loss. But even if IRAs increased saving by an amount less than the above evidence suggests, the IRA program would still be considered a "success." In a recent analysis of this problem Hubbard and Skinner [1996] adopt a cost-benefit approach to evaluate tax based saving incentives. Consider the case of pure reshuffling by a taxpayer in the 36 percent tax bracket: rather than depositing 64 cents in a conventional account, the investor places $1 in an IRA. The revenue loss to the government is 36 cents; the incremental saving in this example is also 36 cents (the tax saving). The cost-benefit ratio is one in this example. Alternatively, if IRAs generate a modest 26 cents of new saving (in addition to the 36 cent tax break that is assumed to be saved), then the cost-benefit ratio will be (0.26+0.36)/0.36 = 1.72, or an increase in private saving of $1.72 per dollar of lost government revenue.

Hubbard and Skinner go on to note that this first-year calculation is incomplete. The "cost" of an IRA exceeds the initial tax deduction because as long as the funds remain in an IRA, taxes on the interest accumulation are deferred. Moreover, over time taxable and nontaxable balances accumulate at different rates. To address these issues Hubbard and Skinner calculate their benefits and costs over the entire period of time an IRA is held. They find that even for some of the more modest saving effects found in the literature, the incremental gain in capital accumulation per dollar of lost tax revenue is quite large. In their words "IRAs need not stimulate very substantial amounts of new saving per lost dollar of revenue to generate favorable marginal increases in the capital stock per dollar of initial revenue lost." Indeed, for sufficiently high and still plausible IRA saving effects, the IRA program may even become self-financing.[3]

ARE IRAS JUST FOR THE WEALTHY?

Fully deductible IRAs were available for the six years between 1982-86. At their peak prior to TRA 1986, 16 percent of taxpayers contributed to an IRA in a given year and about 30 percent had a positive IRA balance. Throughout the course of their brief existence the number of households with an account increased steadily. It is all but impossible to predict how widely diffused participation would have been had eligibility not been restricted in 1986. However, it is useful to note that in Canada, which has had a similar program since 1957, over 34 percent of the families currently contribute, and an even larger percentage of families have positive balances.[4]

The percentage of families having an IRA is low among younger families and rise steadily with age until reaching nearly 50 percent for families age 55-65.[5] This means that the majority of families would have contributed to an IRA at some point in their lifetime under the pre-TRA rules. Moreover, even at their peak, 75 percent of all IRA contributions were accounted for by families with annual income less than $50,000. Thus a large segment of middle America has or would have, had the program not been restricted, availed themselves of the IRA program.

Despite these inroads there is still concern that IRA participation is low among lower income households. For example, in 1987 less than 10 percent of the families with annual incomes less the $10,000 had positive IRA balances. The problem is not specific to IRAs—the overall saving rate among low income households is anemic. One challenge is to make IRAs more attractive to these households. Of particular relevance is our experience with 401(k) plans, which are similar in many respects to IRAs, but have take-up rates among low earners as high as 50 percent. This suggests that the problem is not that low income households cannot save; they will save if faced with an appropriately designed saving incentive program. The question then is what features of tax based saving incentive programs appeal to low earners. This

is still an open question that deserves more attention. It is apparent that many nonfinancial factors, which we consider below, weigh heavily in the saving decision.

WHAT IS THE POTENTIAL OF IRAS TO IMPROVE THE FINANCIAL WELL-BEING OF THE ELDERLY?

Outside of employer provided pensions and Social Security, most families save little for their own retirement. In 1992 the typical American family on the eve of retirement (age 51-61) had $65,000 in housing wealth, $17,000 in pension wealth (including 401(k)s), about $120,000 in social security wealth, but only about $7,000 in financial assets excluding IRAs. The potential effect on the household portfolio of a persistent IRA saving strategy is enormous. A household that began contributing just $2,000 per year to an IRA beginning in 1982 would have an IRA balance of slightly more than $50,000 at the end of 1992 had the funds been invested in corporate bonds, and a balance of just under $60,000 had the IRA been invested in the Standard and Poors index. Although such calculations are purely illustrative, they do give some indication of the boost that a rigidly adhered to saving plan can provide.

WHY DO IRAS WORK? SOME PSYCHOLOGICAL AND NON-ECONOMIC FACTORS

If IRAs stimulate new saving, it is useful to step back and ask how they affect saving behavior. I raise the issue because a simple financial analysis of IRAs suggests they should have little effect on net saving.[6] IRAs raise the after-tax rate of return on saving so the savy investor should reshuffle existing asset balances into IRAs, thus obtaining a tax deduction without increasing the pool of saving. Moreover, since the interest elasticity of saving is thought to be low, the higher after-tax rate of return afforded by IRAs would not be expected to have much of an effect on household saving and could, under plausible circumstances, reduce total saving. How is it then that the empirical evidence demonstrates that IRAs work?

One reason, as noted above, is that in the absence of IRAs most households save little for retirement. By inducing savers to begin saving for retirement IRAs generate new saving. It is perhaps more important however, to realize that saving is not just a financial decision. Many nonfinancial or noneconomic features of the IRA program also influence investor decisions. For example, many, if not most, persons do not know how much they "should" save for retirement. For those with sufficient information and the capability to make such complex calculations, the commitment or self-discipline necessary to carry out a long-term saving plan may be lacking. Still others may respond to features of the IRA program in ways that are normally ignored by standard economic or financial analyses. One lesson to be learned from our recent experience with IRAs is that these psychological and noneconomic factors often outweigh simple financial considerations.[7] A brief and nonexhaustive list these factors, and some indication of their significance would include:

- *The up-front deduction is important.* Investors seem to respond disproportionately to the tax deduction associated with the traditional or "front-loaded" IRAs. As a consequence, " backloaded" IRAs without the up-front deduction (but with tax-free withdrawals) may not have the same appeal as the traditional IRA despite the financial equivalence of the two types of IRAs. The experience with nondeductible IRAs provides some evidence on this point. Nondeductible IRAs have been available since 1986 and yield a higher net rate of return than saving in conventional non-tax-advantaged vehicles, yet they seem to have been greeted by investors with a shrug. It is apparent that the up-front deduction is an important feature—the tax deferral alone is not enough to offset the reluctance of most families to save for retirement. And the availability of an immediate deduction also seems to be behind the higher contribution rate for taxpayers whose tax liability exceeds withholding compared to those anticipating a refund: a $2,000 check to the broker is preferred to an $800 check to the IRS. The deduction is a highly visible inducement to save. It appeals to the same "impatient self" that, for some, makes saving for the future so difficult to begin with. For this reason the deduction has important psychological, as well as financial, consequences for saving behavior that are taken advantage of by the IRA program.
- *Savers respond to marketing and promotion.* A surprising feature of our experience with IRAs was the dramatic fall-off in contributions following TRA 1986. As expected, many households losing their deduction ceased contributing. However, IRA participation fell by nearly 40 percent among households that retained full deductibility. This fall is puzzling since the overwhelming financial advantage of IRAs remained intact. The most likely explanation for this behavior is that either households responded to reduced promotion and marketing of these plans following TRA 1986 or that households misinterpreted the eligibility

restrictions contained in TRA 1986. Promotion and marketing may also play a key role in the bunching of contributions prior to the April 15 deadline. Again, such behavior is not financially optimal: investors should contribute to an IRA as early as possible in the tax year to maximize the advantage of the deferral of taxes on interest income. It seems likely that households are affected by the promotional blitz that preceeded the filing deadline each April. In general the heavy promotion that accompanied IRAs between 1982 and 1986 may have served two purposes. The first is to inform persons about the need to save, educate them about the benefits of saving, and to let them know that such opportunities for saving are easily accessible. The second is that the promotion may have validated desires to save: the fact that others are doing so makes it the financially prudent thing to do.

- *IRAs "target" saving for retirement.* Another key ingredient of the success of the IRA program has been the narrow focus on the goal of retirement saving. Survey evidence on asset balances indicates that most families were not saving much at all for their own retirement prior to the advent of the IRA program. In a sense, the program stimulated some families to save for a purpose they had perhaps not previously given much thought to. The narrow targeting of the IRA program to the goal of retirement saving is reinforced by the penalty on withdrawals: money placed in an IRA is "locked in" until retirement, in both a psychological and legal sense. Indeed, just getting a family to transfer a dollar from a conventional saving account to an IRA may increase long-run saving if the dollar saved through conventional means was not destined to support consumption in retirement. (And most survey evidence indicates that conventional saving is motivated by concerns other than retirement).

What then is the wisdom of allowing penalty free withdrawals from IRAs prior to retirement? The 1997 health care bill excepted extraordinary medical expenses from the withdrawal penalty. Other proposed exceptions include higher education expenses, downpayments for first-time homebuyers, and distributions to persons receiving unemployment compensation. I do not disagree with the merit of supporting these activities. However, using the Individual Retirement Accounts to address these issues may weaken the usefulness of the IRA program to address the retirement saving problem. Consider, for example, the possible implications of permitting withdrawals for college tuition. Under present law IRA balances are typically ignored by financial aid officers when computing the expected family contribution. Permitting withdrawals may put a family's entire IRA stake on the table, clearly weakening the ability of the IRA program to preserve saving for retirement.

- *IRAs may increase saving by providing a means of self-control.* Saving requires discipline. It is probably not a surprise that assets at retirement consist mostly of Social Security, pensions, and wealth tied up in a home: these are, in a sense, "forced" savings. Contributions to each of these sources are regular and precommitted. Most households reach retirement with little in the way of discretionary saving. IRAs may help families save. As noted above, the withdrawal penalty—as well as the targeting of these funds for retirement—places the IRA nest egg "off-limits" for day to day expenditures. The relative illiquidity of IRAs may be a self-control device desired by some savers: placing funds "out of sight and out of mind" ensures that IRA balances will be preserved for retirement.
- *IRAs force households to plan for the future.* For many households retirement is far in the future. Deciding how much to save for retirement is a complicated financial calculation and many households may not even think about it at all. Investment returns are difficult to anticipate, uncertainties surround the future of the Social Security system, and the future flow of earnings is difficult to forecast. Moreover, several studies have noted that the complex financial calulations required for financial planning are beyond the ability of many households. In these circumstances it is difficult, if not impossible, for all but the most sophisticated investors to calculate the proper level of saving. It is thus no surprise that many of these studies have demonstrated that exposure to educational and informational materials increases participation in personal saving plans.[8] The evidence is strongest for 401(k) type plans, but the lesson learned is applicable to IRAs as well. The need to make an IRA investment decision, in conjunction with the information and financial planning resources made available by financial institutions, can better enable households to focus on retirement financial planning and assist them in making the necessary calculations.

SUMMARY

Low rates of saving are a concern for both the financial security of future retirees and for the long-term growth of the economy. The empirical evidence I have reviewed leads me to conclude that the IRA program has been very successful at increasing saving. The long-term benefits of the program far outweigh the revenue costs. A return to the original program with unrestricted eligibility should be encouraged. I have also tried to address some of the factors that determine the success or failure of tax based saving incentives. In particular, policy makers should be careful to consider the variety of ways—many nonfinancial—that these program encourage saving.

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ENDNOTES

[1]: See Poterba, Venti and Wise (1996) and the references contained therin.
[2]: See Poterba, Venti and Wise (1996b) for a technical review of these studies.
[3]: See also Feldstein (1995).
[4]: Venti and Wise (1994).
[5]: The data are for 1987. See Poterba, Venti and Wise (1994).
[6]: For a general overview of traditional and nontraditional theoretical approaches see Bernheim (1996).
[7]: Thaler (1994a,b) makes similar arguments.
[8]: See Bernheim (1996), Bernheim and Garrett (1995) and Clark and Schieber (1996).

COMMUNICATIONS

STATEMENT OF THE AMERICAN BANKERS ASSOCIATION

The American Bankers Association (ABA) is pleased to submit this statement for the record in connection with the March 6, 1997 hearing before the United States Senate, Committee on Finance, on proposals to expand individual retirement accounts (IRAs).

The ABA brings together all elements of the banking community to best represent the interests of this rapidly changing industry. Its membership—which includes community, regional, and money center banks and holding companies, as well as savings associations, trust companies, and savings banks—makes ABA the largest banking trade association in the country.

We commend the Senate Finance Committee, and Chairman William Roth (R-DE), for conducting this hearing on individual savings and IRAs. We further commend Chairman Roth and Senator John Breaux (D-LA), for introducing "the Savings and Investment Incentive Act of 1997," S. 197, to expand the availability of IRAs to more taxpayers.

The ABA is particularly pleased that this tax-advantaged savings vehicle has strong bi-partisan support and that it is included in the Administration's fiscal year 1998 budget proposal. In this regard, we would like to point out our full support for Chairman Roth's bill, S. 197, as that legislation would provide a model IRA vehicle designed to address the nation's emerging need to increase retirement savings.

By way of background, the personal savings rate in this country has trended down over the past several decades. During the 1970s, individuals saved 7.8 percent of their disposable income; in the 1980s, the personal savings rate declined to 6.5 percent; for the first half of the 1990s, individuals saved only 4.7 percent of their disposable income. This declining trend means that individuals will be less well prepared to meet the variety of financial needs they are likely to encounter during their lives—including buying a home, paying for college, covering medical emergencies and providing an adequate retirement income. Since savings and investment are critical ingredients in economic growth, a declining savings rate also has negative implications for the future of our economy and for our ability to create new jobs.

The primary appeal of the IRA concept to individuals is based upon the tax advantage associated with it. That tax advantage is often viewed as a supplement to savings, making the IRA an appealing product for an individual's long-term savings growth. Individuals concerned about the availability of retirement funds can appropriately complement social security and other retirement savings vehicles with IRAs. Once an IRA has been established, the tax penalties that accompany early withdrawals provide further encouragement to save for the long-term.

The challenge, then, is to develop a viable IRA product with sufficient appeal to attract a wide range of individuals to participate. We believe that, to be successful, an IRA must meet three criteria:

- first, it must be simple enough to be easily understood by consumers;
- second, eligibility criteria must be sufficiently inclusive to permit broad participation; and
- third, it must be flexible enough to be responsive to the financial needs of today's consumers.

If such criteria are met, we believe that individuals will view the new and improved IRAs as valuable tools for long-term savings, and the product will be far more successful than the IRA vehicle that is currently available.

SIMPLICITY

One problem that has diminished the effectiveness of the current version of the IRA for bank customers is its complexity. Particularly, the rules for determining eli-

gibility for today's IRAs are simply too difficult to understand. Millions of consumers have been so confused about the tests, eligibility determinations, and income limitations, that even when they are eligible, many individuals do not participate in IRAs. The problem has been exacerbated by the changes, and by constant discussions of changes, in IRAs. We recommend that any new proposal be simple to understand in its terms and conditions.

ELIGIBILITY

In 1981, almost all working Americans were eligible for IRA coverage, and IRAs became immensely successful. However, after the 1986 tax reform act, the eligibility rules were changed dramatically—individuals covered by private pension plans were no longer eligible and the income limits established ($25,000 for individuals and $40,000 for couples) significantly reduced eligibility. Participation declined dramatically, and contributions have continued to shrink every year since 1986—40 percent of the eligible taxpayers are not currently using IRAs.

Inflation also contributed to the decline in the effectiveness of IRAs. Many of those in the low to middle income bracket who remained eligible after the 1986 tax act have gradually been forced out of eligibility simply because of inflation-based pay increases. In the near future, inflation will continue to shrink the base of those eligible to invest unless some type of indexing is permitted under the statute.

For a tax-favored savings incentive to be effective in generating new savings, the pool of those eligible to participate in the plan should be as wide as possible. The Administration's plan would, inter alia, raise and index the income limitations on deductible IRAs. The proposal represents an important first step in resolving the eligibility problem of the currently available IRA vehicle. It could be further improved by eliminating income phaseout limits altogether, which would allow a much greater number of individuals and households to participate in the expanded IRA vehicle.

FLEXIBILITY

If there is any single reason why people have been reluctant to establish IRAs, it is probably the lack of flexibility. Individuals are understandably concerned about sinking their money into a totally illiquid account from which funds can not be retrieved without significant penalties—except by crossing the retirement age threshold. For a savings incentive to work, people need to have a certain comfort level that their savings can be accessed for emergencies and for certain other important expenditures.

We also believe that a plan should be flexible in offering a range of options to the customer. The current savings proposals differentiate between whether the IRA is "front-loaded" or "back-loaded." With a front-loaded IRA, the taxpayer may take a tax deduction for the amount of the contribution. Alternatively, with a back-loaded IRA, there is no tax deduction for the contribution; instead, all earnings and contributions from the investment can be withdrawn tax-free for qualifying expenditures, as well as at retirement age. A tax-favored savings plan should be flexible enough to offer both options to customers, since the decision as to which plan would be preferred may differ among individuals. An IRA plan should also protect the contribution limits from erosion by the effects of inflation so that contribution limits will not need to be adjusted by law in the near future.

ECONOMIC BENEFITS OF AN EXPANDED IRA

A properly designed retirement savings instrument will result in higher usage by individuals and more long-term savings. One of the most important long-term issues for this country is inadequate savings. Savings promote capital formation, which is essential for job creation, opportunity and economic growth.

CONCLUSION

In conclusion, we support legislative efforts to restore tax-favored retirement vehicles for individuals at all income levels. In order to encourage people to return to a routine, long-term savings plan, we need an attractive product that meets the tests of simplicity, eligibility, and flexibility.

If the rules for IRAs are too complicated to understand, people will be discouraged from participating. If eligibility is limited by income level or dependent on whether an individual is covered by another pension plan, fewer people will be able to use the product. Without flexibility, including the ability to withdraw funds for important purposes without significant tax penalties, savers will be reluctant to put money aside.

We urge you to build your legislative efforts to revitalize the IRA on these three criteria. We are confident that the result will be the generation of new savings by individuals and a positive impact on the national savings rate.

Thank you for the opportunity to present this statement. We look forward to working with you on this important matter.

STATEMENT OF THE SAVINGS COALITION OF AMERICA

SUBMITTED BY MARY L. MOHR, CHAIR

I submit this testimony on behalf of the Savings Coalition of America. The Savings Coalition consists of 65 member organizations representing the interests of tens of millions of American savers. Established in 1991, the Savings Coalition membership includes a wide variety of interests including consumer, health care, education and business groups, engineers, home-builders, realtors, trust companies, banks, securities firms, insurance, and financial service companies. The Savings Coalition supports incentives to increase the rate of personal saving in the United States.

EXPANDED INDIVIDUAL RETIREMENT ACCOUNTS (IRAS)

When Americans retire they rely on three sources of income—Social Security, pensions and personal savings. IRAs fall in the category of personal savings. The Savings Coalition is committed to seeking the enactment of expanded IRA legislation and strongly supports the features of S.197, The Savings and Investment Incentive Act of 1997. The Savings Coalition believes that tax and economic policy should provide more opportunity and incentive for Americans to save and invest for their futures. The Savings and Investment Incentive Act of 1997 has features that provide incentives and opportunities to save for all Americans.

COUNCIL FOR ECONOMIC DEVELOPMENT FINDINGS OF AMERICA'S RETIREMENT SITUATION

In May 1995, the Council for Economic Development (CED) released its report entitled, *Who Will Pay For Your Retirement? The Looming Crisis.*" In its findings, the CED found that this country's retirement system is in dire straits and unless corrective action is taken soon, America will be confronting a major economic crisis. The CED report concluded that "America's retirement system is underfunded, overregulated, and soon to be challenged by unprecedented growth in the retirement-age population. Consequently, our nation will confront a major crisis in financing the needs of the elderly at the beginning of the twenty-first century unless policies are reformed to make retirement saving a top priority." One of the recommendations of the CED is the implementation of "tax incentives and regulatory reform to encourage individual retirement saving and to achieve increased funding of, and coverage by, private pensions." S. 197 provides all Americans with the savings incentives for retirement which are critical when one considers the problems illuminated by the CED in its report.

LOW RATE OF SAVING IN THE UNITED STATES

Saving is a key component of economic policy. Increased personal saving rates not only benefit individual Americans, but also provide the economy with the investment capital it needs to grow. The rate of personal saving in the United States has significantly decreased in the past three decades—from 8% in the 1960s to hovering around 4% today. This current rate is the lowest it has been in the United States since World War II. When compared to other industrialized nations, the rate of personal saving in the US is one of the lowest. Americans are saving less than one-half as much as the Germans and one-third as much as the Japanese. We can do something about the low rate of saving by taking a bite out of our federal deficit. But, we must also do something to change people's attitudes towards savings. The universally available IRA is the best vehicle we currently have to get that done.

Over the past several years, a significant amount of academic research on the effectiveness of IRAs has been published. Top academic economists have found that IRAs increase saving. The list includes Martin Feldstein (Harvard), David Wise (Harvard), Treasury Deputy Secretary Lawrence Summers (former Harvard economist), James Poterba (MIT), Steven Venti (Dartmouth), Jonathan Skinner (University of Virginia), Richard Thaler (Cornell) and Glenn Hubbard (Columbia).

It is less well-known that, because of the low personal saving rate in the US, America has become increasingly dependent on foreign investors to finance the US debt. Regardless of the progress made toward balancing the budget, the US must

still finance and outstanding debt of more than $5 trillion by selling Treasury securities. In the past few years, foreign investors have become the dominant force in the market for these Treasury securities.

According to an analysis conducted by the Securities Industry Association, in 1995, for instance, net purchases of US Treasury notes and bonds by foreigners reached $134 billion. The analysis further revealed that in 1996 the pace of foreign acquisitions of Treasury securities accelerated. According to the US Department of Treasury's Office of Market Finance, at the end of 1996, foreigners owned 31.6% of the total private holdings of US Treasury securities, up from 21.7% at the end of 1994.

This trend means that the favorable interest rate environment that we have enjoyed in the US is vulnerable to the impulses of investing by foreigners. If they substantially reduced their purchases of US Treasury securities, the interest rate on such securities would probably rise and accordingly so would interest rates on corporate bonds as well as mortgages and bank loans. In other words, a key component of economic health in the US is heavily influenced by the investment decisions of foreign savers.

IRAS SHOULD BE AVAILABLE TO ALL AMERICANS

An interesting effect of the implementation of income limits on universally available IRAs in the Tax Reform Act of 1986 is that IRA contributions have dropped by more that 40% for those who continued to be eligible for deductible IRAs. The decline in IRA contributions is partially attributed to misunderstanding on the part of Americans as to their eligibility for IRAs and a decline in marketing of IRAs by financial institutions. Before 1986, the IRA worked to increase savings because we had banks, mutual funds, brokerage houses and insurance companies competing to "sell savings." Instead of selling goods, Madison Avenue was selling investment. Universal availability of IRAs—a savings incentive available to everyone—is what led to the advertising of IRAs in the mid-80s. This is the kind of advertising we need again if we are to get people refocused on the importance of saving. An IRA that is available to all Americans will reduce confusion on the part of individuals and increase the marketing of IRAs on the part of financial institutions. The Savings Coalition urges lawmakers to keep IRAs simple and easy to understand. Limiting IRA eligibility confuses people and scares them away from establishing a pattern of savings that IRAs would otherwise promote.

The Savings and Investment Incentive Act of 1997 benefits all Americans—it gives an incentive to everyone who wants to take advantage of it. The first home withdrawal features and the IRA Plus account are very attractive to the young, even if they do not have children. The education expansion provides a strong incentive for people with children. The expanded retirement savings vehicles in both the traditional IRA and the IRA Plus are popular with people in their 50s and early 60s who see retirement just around the corner.

EXPANDED IRAS ENJOY BROAD SUPPORT AND ARE POPULAR WITH AMERICANS

Expansion of IRAs is not only an area of agreement on both sides of the aisle in Congress, but also down Pennsylvania Avenue between Congress and the White House. The 1996 Republican and Democratic National Platforms included expanded IRAs.

In December 1995 and May 1996, the Savings Coalition commissioned polls of registered voters regarding their preference of items included in the tax cut proposals. In the December 1995 poll conducted by Lake Research, 7 out of 10 registered voters said they would increase their rate of personal saving if IRAs were expanded to allow Americans to save. Also, middle class Americans choose expanded IRAs above a child tax credit and the capital gains tax cut as the tax proposal the country should adopt first. In May 1996 a bipartisan poll was conducted by Lake Research and the Luntz Research Companies. The results of the poll indicated that more than 6 out of 10 American voters (64%) claimed that they would increase their rate of personal saving if IRAs were expanded to allow more Americans to save. In addition, the heart of the American workforce, voters aged 30 to 64 favored the expansion of IRAs (35%) to a cut in capital gains or a child tax cut.

In February 1997, the NASDAQ Stock Market, a member of the Savings Coalition, surveyed investors and potential investors. An interesting finding of the survey is that those who are investing their money are relying on their personal investments to fund their retirement. "Forty-one percent of investors say that most of the money for their retirement will come from savings and investments, while just twenty-nine percent say it will come from a retirement plan (25%) or Social Security

(4%)." Americans plan to save and invest more for their retirement and the provisions in S. 197 will provide them with an incentive to do that.

In a 1995 poll conducted by Dr. Frank Luntz of Luntz Research Companies for Merrill Lynch, one of the members of the Savings Coalition, it was revealed that an overwhelming majority of Americans do not believe that Social Security or Medicare will provide them with "peace of mind" in retirement. The poll also found that a majority of Americans feel that government policies do not encourage retirement saving. Similar to the results of the polls conducted by the Savings Coalition, this poll found that "among the various proposed forms of tax relief, Americans believe that expanding the IRA should be the highest priority."

Other members of the Savings Coalition have conducted polls with similar results. In August 1995, Dean Witter, Discover & Company conducted a survey of its clients on their attitudes and behaviors towards savings, preparing for retirement and opinions towards the IRA legislation being considered. Most of the clients felt that the current tax laws do not encourage enough savings and that the expansion of IRAs proposed by Congress would encourage them to save more for retirement. Another interesting finding in the survey is that the primary reason cited by Dean Witter clients for not contributing to an IRA is the lack of tax advantages for doing so.

In a poll conducted by the Institute of Electrical and Electronic Engineers (United States) of its members, the majority of the respondents favored expanded IRA provisions. In one day, through an 1-800 number sponsored by USA Today and manned by the International Association for Financial Planning, a member of the Savings Coalition, 73,000 phone calls were made requesting help with retirement planning. This is from a total circulation of 2 million. These results reveal that Americans are very concerned about their retirement. Provisions in S. 197 give them the incentive to help themselves.

By making the IRA available to all income levels, S. 197, The Savings and Investment Incentive Act of 1997, encourages all Americans to save. For those who claim that the benefits of expanded IRAs should be directed to Americans at certain income levels, the members of the Savings Coalition would like to point out that (1) the saving rate in this country is low and all Americans should be provided with incentives to save, and (2) the IRA contribution is limited to $2000.00. The tax benefits from this $2000 cap may not mean much to a high-income person—it is a small tax break for them. However, the benefits for everyone else that flow from universal availability (and the resultant advertising) will more than offset the small tax break for higher income individuals.

Increasing the eligibility of IRAs for Americans is a good public policy that is popular with the American people, Congress and the White House.

Statement of the U.S. Chamber of Commerce

SUBMITTED BY WILLIAM T. SINCLAIRE

The U.S. Chamber of Commerce appreciates this opportunity to express its views on proposals to expand individual retirement accounts (IRAs). The Chamber is the world's largest business federation representing an underlying membership of more than three million businesses and organizations of every size, sector and region.

THE NEED FOR INCREASED SAVINGS

By virtually any measure, savings in the United States has declined in recent decades. According to Department of Commerce figures, savings as a percentage of disposable personal income has declined from approximately nine percent in 1984 to just under five percent in 1996. While no one factor can be solely blamed for this precipitous drop, it is undeniable that our existing tax code lacks sufficient incentives to adequately promote savings in this country.

This major drop in personal savings not only threatens the retirement aspirations of today's workers, but also our nation's overall productivity and economic growth as well. Expanding IRAs is one legislative initiative which would help reverse this disturbing trend.

Americans simply are not putting aside enough of their earnings to maintain their current lifestyle in retirement. Social Security, even if it remains financially viable throughout the next century, cannot, and should not, be solely relied on to provide a secure retirement for our nation's workforce. Coupled with the fact that fewer employers are funding defined-benefit pension plans for their workers, it is imperative that workers take it upon themselves to adequately save for retirement.

In addition to retirement, Americans need to save for other purposes that will help increase their overall standard of living—such as higher education, the pur-

chase of a home and a financial safety net in case of long-term unemployment. Allowing IRA contributions to be withdrawn without penalty for such purposes would give individuals additional incentive to establish and annually contribute to IRAs.

BACKGROUND OF THE IRA

IRAs were originally enacted as part of the Employee Retirement Income Security Act of 1974. Under this act, employees who were not active participants in an employer-sponsored pension plan could annually contribute up to the lesser of $1,500 or 15 percent of their earned income to an IRA. Contributions were fully tax-deductible and earnings could accumulate tax-free. Distributions, however, were fully subject to tax when withdrawn and also subject to a 10-percent penalty if withdrawn before age 59-1/2.

IRAs were expanded by the Economic Recovery Tax Act of 1981. IRAs were made available to all workers, regardless of whether they participated in an employer-sponsored pension plan. Under this law, an individual could annually contribute up to the lesser of $2,000 or 100 percent of their earnings to an IRA. However, a couple with one non-working spouse could annually contribute a combined total of $2,250 to a joint IRA.

The Tax Reform Act of 1986 severely restricted the eligibility requirements for deductible IRAs. Under this act, the $2,000 annual IRA contribution deduction phases-out if a taxpayer, or their spouse, actively participates in an employer-sponsored retirement plan and has adjusted-gross income between $25,000 and $35,000 if filing a single return, or between $40,000 and $50,000 if filing a joint return. However, individuals can make nondeductible IRA contributions to the extent they are not permitted to make deductible contributions. Nonetheless, as with deductible IRAs, earnings on nondeductible IRA contributions are not taxed until they are withdrawn.

IRA contributions have dropped significantly since these income phase-out rules were enacted. Firms that had heavily marketed deductible IRAs around tax time (January 1—April 15) significantly reduced their advertising efforts, resulting in decreased public awareness of IRAs. Furthermore, public confusion surrounding the eligibility requirements of deductible IRAs has caused many eligible individuals to forego making contributions under the mistaken belief that they are ineligible for an IRA deduction.

Unfortunately, bipartisan efforts to expand IRAs have generally failed since 1986. However, the Small Business Jobs Protection Act of 1996 modified the IRA provisions to allow non-working spouses to make fully deductible IRA contributions. In addition, the Health Insurance Portability and Accountability Act permits early withdrawals from IRAs to be penalty-free if such distributions are used to pay for qualified medical expenses or the premiums for medical insurance coverage by those who are the long-term unemployed.

LEGISLATIVE PROPOSALS TO EXPAND IRAS

Several legislative proposals have been introduced so far in the 105th Congress which would expand IRAs.

The Savings and Investment Incentive Act of 1997 (S. 197 and H.R. 446)

Introduced by Senators Roth (R-DE) and Breaux (D-LA) and Representatives Thomas (R-CA) and Neal (D-MA), this legislation would:

(1) Phase-out over five years the income thresholds for deductible IRA contributions, thereby allowing all individuals to have fully deductible IRAs;

(2) Index the $2,000 contribution limit for inflation in $500 increments;

(3) Immediately delink the "active participant" rule between spouses, so that one spouse is not considered to be an active participant in a retirement plan merely because his or her spouse is an active participant;

(4) Allow penalty-free withdrawals for special purposes (i.e., first-time home purchases, higher education, qualified medical and long-term unemployment expenses); and

(5) Create backloaded "IRA PLUS" accounts, whereby contributions would not be deductible, but distributions (including earnings) would not be taxable if the account is open for at least five years and the proceeds are used for retirement or an above-mentioned special purpose.

The American Family Tax Relief Act (S. 2)

Introduced by the Senators Lott (R-MS) and Roth (R-DE), S. 2 would:

(1) Phase-out over five years the income thresholds for deductible IRA contributions, thereby allowing all individuals to have fully deductible IRAs;

(2) Not index the $2,000 contribution limit for inflation;

(3) Immediately delink the "active participant" rule between spouses, so that one spouse is not considered to be an active participant in a retirement plan merely because his or her spouse is such an active participant;

(4) Coordinate the IRA contribution limits with those of salary-reduction plans (i.e., 401(k) plans). For example, if an individual contributed $2,000 to an IRA, the maximum amount that could be contributed to a salary-reduction plan the same year would be reduced by $2,000;

(5) Allow income tax and penalty-free withdrawals for special purposes (i.e., business start-up expenses, long-term unemployment, or higher education). First-time home purchases would not qualify; and

(6) Create backloaded "IRA PLUS" accounts, whereby contributions would not be deductible, but distributions (including earnings) would not be taxable if the account is open for at least five years and the proceeds are used for retirement, qualified medical expenses, business start-up costs, long-term unemployment, or higher education. First-time home purchases would not qualify.

PRESIDENT CLINTON'S FISCAL YEAR 1998 BUDGET PROPOSAL

The President's budget proposal would:

(1) Double the present-law income limits on deductible IRAs by the year 2000. Therefore, the phase-out ranges for taxpayers who are active participants in employer-sponsored retirement plans would be increased from $50,000 to $70,000 for single taxpayers and $80,000 to $100,000 for married couples filing joint tax returns;

(2) Index the $2,000 contribution limit for inflation;

(3) Not delink the "active participant" rule between spouses. Therefore, one would continue to be considered an active participant in a retirement plan if his or her spouse is an active participant;

(4) Coordinate the IRA contribution limits with those of salary-reduction plans (i.e., 401(k) plans);

(5) Allow penalty-free withdrawals for special purposes (i.e., first-time home purchases, higher education, qualified medical and long-term unemployment expenses); and

(6) Create backloaded "Special IRA" accounts, whereby contributions would not be deductible, but distributions (including earnings) would not be taxable if the account is open for at least five years or the proceeds are used for first-time home purchases, higher education, qualified medical and long-term unemployment expenses).

CONCLUSION

The Chamber believes that additional incentives are critical to fostering savings by the American people. Increased personal savings will, in turn, increase investment, economic and productivity growth, and our overall standard of living. The broadest expansion of IRAs will also help our nation achieve these necessary goals.