INSTITUTE FOR POLICY INNOVATION IPI

Issue Brief

A Publication of the Institute for Policy Innovation March 1995

250 South Stemmons, Suite 306 • Lewisville, Texas 75067 • (214) 219-0811

Reducing Tax Rates on the Savings of Average Americans

by Gary & Aldona Robbins
TaxAction Analysis

Introduction

While policy makers bemoan America's low savings rate in comparison to other industrialized countries, many of these same policy makers overlook the effects of tax policy on incentives to save and invest. Since 1981, tax policy has both helped and hindered efforts by average Americans to save. The Economic Recovery Act of 1981 (ERTA) provided several savings incentives for average Americans. ERTA cut individual income tax rates across-the-board by 25 percent, which allowed savers to keep a larger share of investment income aftertax. ERTA also expanded the availability of tax-free Individual Retirement Accounts (IRAs) and increased the amount of an estate that could be passed to heirs without tax. But many of ERTA's benefits to savers have been undone through subsequent tax legislation.

The Tax Reform Act of 1986 contained good and bad news for average savers. Tax reform further lowered individual rates by reducing the number of brackets from eleven to two and by cutting the top rate from 50 percent to 28 percent. However, it also broadened the tax base as a way to pay for the rate cuts. One of these base-broadening measures restricted the availability of IRAs for many American workers, removing much of their *incentive* to save. And the tax rate increases enacted in 1990 and 1993 have further inhibited their *ability* to save.

Two provisions in the Republican "Contract with America" would provide increased saving incentives for average Americans. One is a new, IRA-like savings account, and the other is an increase in the amount of an estate that is exempt from tax.

Rising taxes have inhibited the ability of Americans to save . . . and inflation has eroded 22 percent of the protection provided for estates of middle-income Americans.

Current Tax Treatment of IRAs

Individual retirement accounts (IRAs) came on the scene in 1974. The Employment Retirement Income Security Act (ERISA) established IRAs so that workers who were not covered by an employer-sponsored pension plan would have access to a suitable vehicle for retirement savings. Workers without pension plans could make tax-deferred contributions of up to $1,500 until retirement age, with penalties for early withdrawal. In 1978, 1.5 million of the 33.2 million eligible workers had opened IRAs.[1]

Table 1

IRA Contributions, 1980-1992

	Amount ($bil.)	Returns (mil.)	Average Contribution[1]	Average Contribution ($1987)[2]
1980	3.4	2.6	$1,338	$1,866
1981	4.8	3.4	$1,391	$1,764
1982	28.3	12.0	$2,354	$2,811
1983	32.1	13.6	$2,355	$2,702
1984	35.4	15.2	$2,322	$2,551
1985	38.2	16.2	$2,358	$2,499
1986	37.8	15.5	$2,430	$2,508
1987	14.1	7.3	$1,922	$1,922
1988	11.9	6.4	$1,868	$1,798
1989	10.8	5.8	$1,859	$1,713
1990	9.9	5.2	$1,887	$1,666
1991	9.0	4.7	$1,935	$1,646
1992	8.7	4.5	$1,943	$1,607

[1] Contribution amount in column 2 divided by number of returns in column 3.

[2] Average contribution amount in column 4 adjusted for the GDP deflator.

Source: Internal Revenue Service, Statistics of Income Bulletin, *Washington, DC, Fall 1994, Table 1.*

The Economic Recovery Tax Act of 1981 (ERTA) extended IRAs to virtually all workers and raised the maximum deductible contribution to $2,000. Participation in IRAs grew rapidly and, by 1985, 16.2 million taxpayers reported IRA contributions amounting to $38.2 billion on federal income tax returns. [See Table 1.]

The Tax Reform Act of 1986 changed Individual Retirement Accounts (IRAs) in two significant ways. First, it limited the tax-free IRA contribution to only those not covered by an employer-provided pension plan, or to those with incomes of under $25,000 for individuals and $40,000 for married couples. Second, the Act dramatically reduced marginal tax rates. The marginal rate reductions cut the tax advantage of IRAs relative to a regular savings plan by about 40 percent.

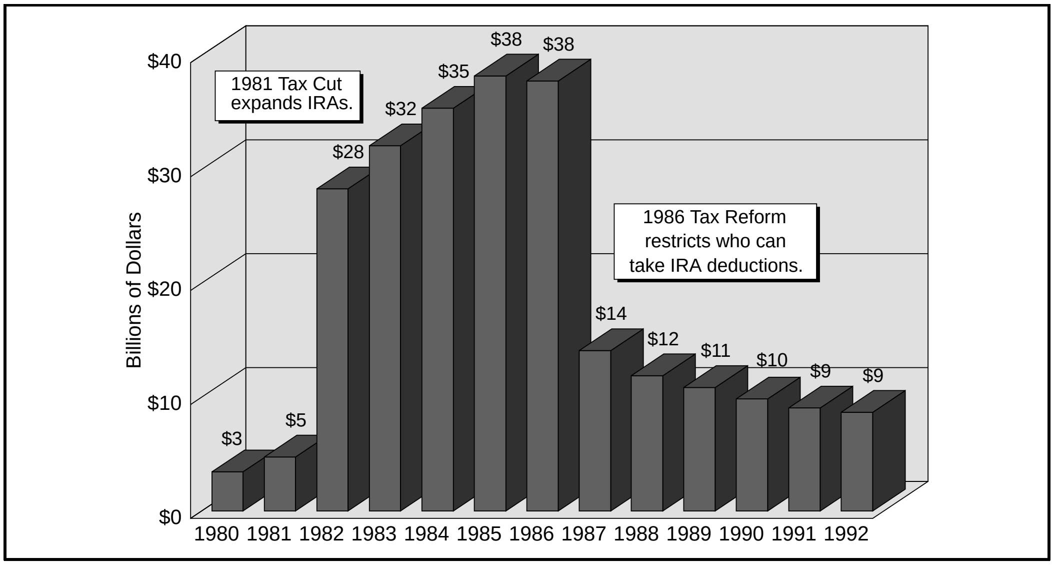
The combination of lower rates and reduced eligibility for the initial deduction has reduced IRA participation to less than one-fourth of what it was in 1985. In 1992, the latest year for which data are available, only 4.5 million taxpayers reported IRA contributions totaling $8.7 billion. [See Figures 1 and 2.]

The combination of lower rates and reduced eligibility for the initial deduction has reduced IRA participation to less than one-fourth of what it was in 1985.

Apart from concern over national savings, declining IRA contributions are worrisome for another reason. As Social Security's financial troubles become increasingly apparent, baby boomers and generations to follow should be saving more, not less, for retirement.

Figure 1

Annual IRA Contributions



1981 Tax Cut expands IRAs.

1986 Tax Reform restricts who can take IRA deductions.

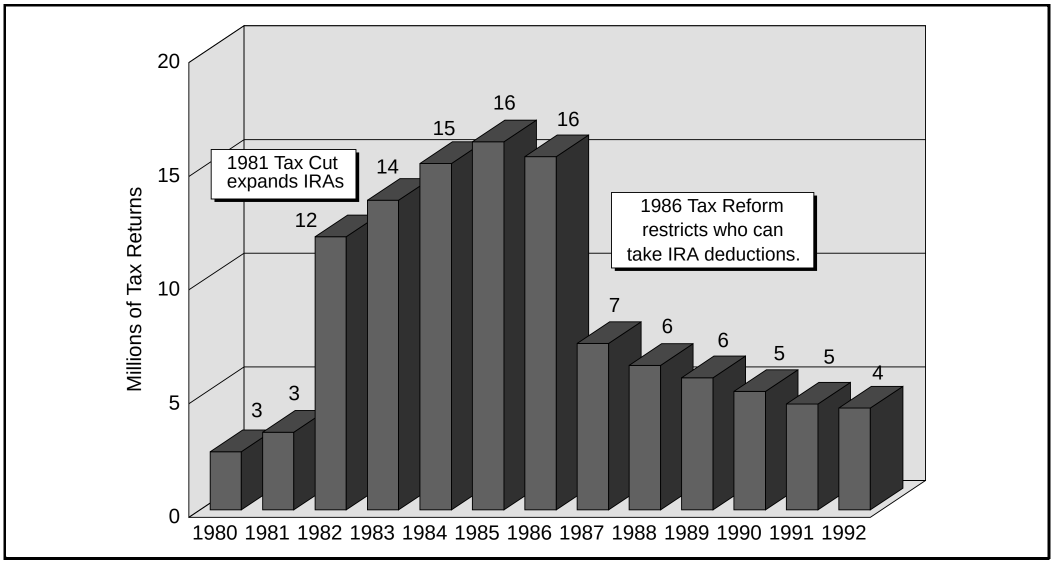


Figure 2

Taxpayers Making IRA Contributions

Contract Proposal to Establish a New Tax-free Savings Account

The "Contract with America" would go a long way toward restoring the saving incentives of IRAs. It proposes to allow individuals to contribute up to $2,000 a year into an "American Dream Savings Account." The tax liability of the account would be *back-ended*, meaning that individuals would pay taxes on *contributions* but not on *withdrawals*. The $2,000 contribution limits would be indexed for inflation beginning in 1996, and the contribution for a nonworking spouse would be increased from $250 to $2,000.

Earnings on assets in the account would continue to accumulate free of tax as they do with current IRAs. In addition to retirement savings, withdrawals from the account also could be made without penalty for first-time purchase of an owner-occupied home, family college expenses and medical expenses.

An additional feature would allow people who currently have IRAs to transfer funds into the new account. Because contributions to the new accounts are taxed while withdrawals are tax-free, the individual would pay tax on any transfers from existing IRAs. The transfer option would have to be exercised during 1995 or 1996.

. . . baby boomers and generations to follow should be saving more, not less, for retirement.

Economic and Revenue Effects

The Joint Committee on Taxation (JCT) estimates that the creation of a new savings account would pick up $2.2 billion in revenue over the first five years. The reason for the gain is the taxes that would paid on transfers from existing IRAs. JCT estimates that between 2000 and 2005 the proposal would lose $6.8 billion. [See Table 2.]

Table 2

JCT Revenue Estimates for Contract's American Dream Savings Account and Estate Tax Proposals ($ bil.)

Fiscal Years	American Dream Savings Account	Increase Estate Tax Exclusion
1996-2000	$ 2.2	$ -6.8
2001-2005	$ -26.1	$ -13.9
1996-2005	$ -23.9	$ -20.7

Source: Joint Committee on Taxation, "Estimated Revenue Effects of the Tax Provisions Contained in the 'Contract with

We believe that the JCT estimates are too pessimistic even on a *static* basis. IRAs and Keogh plans currently hold about $1 trillion in assets. If tax rates go up in the future, people would be better off paying tax now rather than later. We estimate that about 20 percent of current IRA holdings would be converted ($80 billion in conversions in 1995 and $120 billion in 1996). If transfers of that size occur, the federal government would pick up almost $50 billion between 1995 and 2000. JCT, on the other hand, assumes transfers from existing IRAs would amount to less than one-half percent of assets.

The weight of economic research . . . finds that IRAs have had a substantial positive effect on personal savings.

Positive economic effects from expanding savings and investment would also add to federal revenue gains. Some argue that IRAs have not produced *new* savings because taxpayers simply shift assets from taxable savings accounts. The weight of economic research, however, finds that IRAs have had a substantial positive effect on personal savings. Data show that many families would quickly run out of liquid assets to shift into IRAs if they were not doing new savings.[2] Research by National Bureau of Economic Research economists finds that 80 percent of additional IRA contributions are new savings by individuals. Fifty cents of each additional savings dollar come from reduced consumption, 20 to 30 cents from reduced taxes, and at most 20 cents from other savings. As a result, the net increase in national savings equals over half the IRA contribution.[3]

Our results are in line with these findings. We estimate that the Contract proposal would reduce the economy-wide marginal tax rate on capital by 0.6 percent, and would lower the cost of capital by 0.5 percent. By the year 2000, higher investment would increase capital formation in the U.S. by $146 billion. This larger stock of U.S. capital would lead to the creation of 42,000 new jobs, and annual GDP would be $18 billion higher than otherwise. [See Table 3.] *As a result, the revenue gains from added growth would continue to outweigh the static loss over the long run.*[4]

Table 3

CHANGES IN THE ECONOMY
Expanded IRAs

	Change from Baseline[1] in:		
Year	GDP ($bil. Nom.)	Jobs[2] (mil.)	Capital ($bil. Nom.)
1995	0.5	0.001	4.2
1996	1.8	0.003	16.2
1997	4.4	0.012	37.4
1998	7.8	0.019	66.5
1999	12.3	0.029	103.3
2000	17.6	0.042	145.9
1995-2000	44.3		

[1] The baseline forecast used the economic assumptions contained in the Clinton administration's FY1995 budget, which assumes real GDP growth of 2.8%, 2.7%, 2.6%, 2.6%, and 2.5% for 1995 through 1999.

[2] Each job represents 2,040 labor hours annually.

Current Estate Tax Treatment

Under current estate tax rules, all estates receive a unified credit of $192,800 against estate tax liability. This credit effectively excludes the first $600,000 of gross estate from tax. Over $600,000, estates are taxed at graduated rates, starting at 37 percent and reaching 55 percent for estates of over $3 million.

Estates of average taxpayers who purchased homes 20 or 30 years ago, or who have built up a family business, can easily be worth hundreds of thousands of dollars. The purpose of the credit, which has been in place since 1987, is to remove the estates of lower and middle-income taxpayers from the tax rolls.

Because the credit is not indexed for inflation, "bracket creep" along with rising income and asset values make estates of more middle-income taxpayers taxable

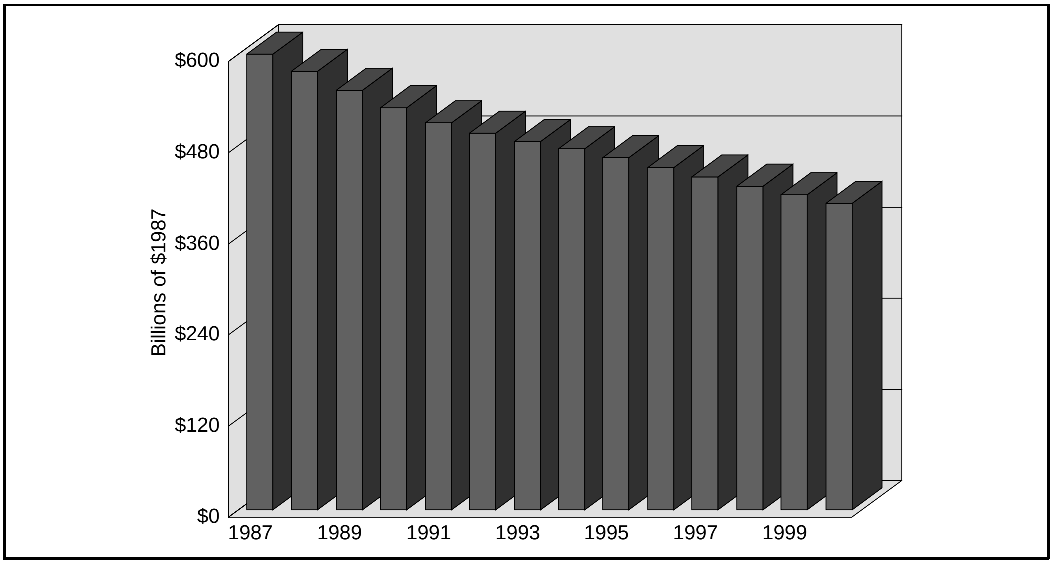


Figure 3

Real Value of Estate Excluded from Tax Under Current Law

today than in 1987. Inflation alone has eroded the value of the exclusion by 22 percent since 1987. [See Figure 3.] In 1994 dollars, the $600,000 exclusion translates into $776,302.

Contract Proposal to Increase Exclusion to $750,000

The "Contract with America" proposes to increase the unified credit to $248,300, effectively excluding $750,000 in gross estate from tax. The new credit would be indexed for inflation after 1995.

Economic and Revenue Effects

The Joint Committee on Taxation estimates that increasing the exclusion to $750,000 would cost $6.8 billion over the next five years and $20.7 billion over the next ten. The added cost comes from not only removing estates from the tax rolls, but also from reducing the tax on taxable estates.

The estate tax is really a tax on the transfer of assets to heirs. If heirs do not have sufficient funds to pay the tax, they often must sell off assets. In the case of a family business or farm, heirs may have to close down an otherwise sound enterprise. In other words, the estate tax represents another layer of taxes on capital.[5]

Table 4

CHANGES IN THE ECONOMY
Increase Estate Tax Exclusion to $750,000 and Index

Change from Baseline[1] in:			
Year	GDP ($bil. Nom.)	Jobs[2] (mil.)	Capital ($bil. Nom.)
1995	1.1	0.002	10.0
1996	3.2	0.006	29.2
1997	5.9	0.013	52.0
1998	8.7	0.021	74.9
1999	11.8	0.030	98.9
2000	14.6	0.038	119.1
1995-2000	45.3		

[1] The baseline forecast used the economic assumptions contained in the Clinton administration's FY1995 budget, which assumes real GDP growth of 2.8%, 2.7%, 2.6%, 2.6%, and 2.5% for 1995 through 1999.

[2] Each job represents 2,040 labor hours annually.

The Contract proposal would reduce the economy-wide marginal tax rate on capital by 0.3 percent, and would lower the cost of capital by 0.3 percent. By the year 2000, higher investment would increase capital formation in the U.S. by $119 billion. This larger stock of U.S. capital would lead to the creation of 38,000 new jobs, and annual GDP would be $15 billion higher than otherwise. [See Table 4.] *Because of this higher growth, dynamic revenue gains from higher income, payroll and excise taxes would offset the static revenue loss from the estate tax.*

Conclusion

Rising taxes have made saving less and less attractive for average Americans. One popular tax-favored savings vehicle, the Individual Retirement Account, was severely limited by tax reform in 1986. And inflation has eroded over one-fifth the protection provided for estates of middle income Americans. By making available a new IRA-like account, and by insulating the estate tax credit from inflation, the Contract for America would restore most of these saving incentives aimed at average Americans.

Endnotes

1. Emily Andrews, *The Changing Profile of Pensions in America*, Washington, DC: Employee Benefit Research Institute, 1985, pp. 78-82.

2. For a survey of the literature see Norman B. Ture and Stephen J. Entin, *Save America: A Primer on U.S. Saving and Its Effect on Economic Health*, Washington, DC: Institute for Research on the Economics of Taxation, 1989, pp. 28-31.

3. Stephen F. Venti and David Wise, "IRAs and Saving," in M. Feldstein (ed.), *Taxes and Capital Formation*, Chicago: University of Chicago Press, 1986; Venti and Wise, "Tax Deferred Accounts, Constrained Choice and Estimation of Individual Saving," *Review of Economic Studies*, August 1986; Venti and Wise, "The Evidence on IRAs," *Tax Notes*, Jan. 25, 1988.

4. Gary and Aldona Robbins, *Putting the Economy Back on the Growth Track: Six Steps to 'Upsize' the Economy*, Lewisville, TX: TaxAction Analysis, September 1994.

5. For a discussion see Richard E. Wagner, *Federal Transfer Taxation: A Study in Social Cost*, Washington, DC: The Institute for Research on the Economics of Taxation and The Center for the Study of Taxation, 1993.

About TaxAction Analysis

TaxAction Analysis is the tax policy arm of the Institute for Policy Innovation, a non-profit, non-partisan public policy organization. TaxAction Analysis recognizes that changing tax policy affects incentives to work, save, and invest. These changes in economic behavior are frequently ignored in static government forecasts, resulting in policy decisions that negatively affect economic growth, capital formation, employment, and local, state, and federal revenues. TaxAction Analysis publishes Economic Scorecard, a quarterly newsletter, as well as additional commentary on tax policy.

TaxAction Analysis features the work of John M. Olin Senior Research Fellow Gary Robbins and Bradley Senior Research Fellow Aldona Robbins, both of Fiscal Associates, Inc. The Robbins, both former Treasury economists, make use of a general equilibrium model of the U.S. economy that explicitly incorporates detailed information on tax policy and how it affects the economy, capital investment, output and jobs.

Note: Nothing written here should be construed as necessarily reflecting the views of the Institute for Policy Innovation or those of its directors, or as an attempt to aid or hinder the passage of any bill before Congress.