IRET Congressional Advisory

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

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INVESTOR RELIEF BILLS WORTH PASSING

The House Ways and Means Committee has approved two bills aiding savers. The bills would help the economy and would be good tax policy.

H.R. 1619 would raise from $3,000 to $8,250 the amount of capital loses that individuals may deduct against other taxable income each year, effective in 2002, and would index the amount for inflation, rounded up in $50 increments, thereafter. That loss limit has not been raised since 1978. This is a modest increase, barely keeping up with inflation (and falling far short of the rise in the stock market and the growth of income and the economy, which would justify more than twice that new level).

H.R. 5558 would move forward the increased deductions permitted for individual retirement accounts and pension plans being phased-in under the 2001 tax cut, and would raise the age at which taxpayers are required to begin drawing money from their retirements accounts. The 2001 tax cut scaled up the maximum IRA deduction to $5,000 by 2008; the Ways and Means bill will move that forward to 2003. The limit on 401(k) and other deferred compensation plans, scheduled to reach $15,000 in 2006, would also be moved forward to 2003, as would scheduled increases in the additional contributions to IRAs of $1,000 and to pension plans of $5,000 for people over age fifty. The bill would raise the age for required minimum distributions from IRAs, now 70-1/2, to 73 in 2003, 74 in 2005, and 75 in 2007.

Expanding IRA and pension contribution limits and extending the age for mandatory withdrawals would move the tax system a bit closer to its saving-consumption neutral ideal. An ideal reformed tax system would grant all saving tax deferred status (or equivalently, give it Roth IRA treatment — no deduction, but tax exempt withdrawals) with no limits on contributions and no mandatory distributions at any age (or penalties for early withdrawal). The expanded loss deductions being proposed are also consistent with a saving-deferred tax, in which stock purchases would normally be deducted in the year made, and sales proceeds would be taxed in the year received.

The saving incentives would help some 40-plus million households with IRAs and over 40 million holders of 401(k) plans cope with the current sagging stock market. Just as important, they would boost national saving, lower the cost of capital, encourage investment, strengthen the economy, and increase wages and employment. Higher wages and employment made possible by the larger stock of capital and stronger economy would help even those workers who do not currently participate in saving plans by boosting their current income and by creating more favorable opportunities to save in the future. The whole population would benefit.

Critics who claim that higher capital loss deduction limits would encourage selling and lower the stock market are wrong. The provision would make stock ownership safer and more attractive, boosting share values.

Saving is beneficial for the economy, whatever the age of the saver. Most people who reach age 70 will still be alive at age 80, and large numbers will

reach 85 and 90. Many have other sources of income for their immediate needs, and would benefit from leaving much of their savings in a tax deferred plan. With 15 or even 20 years of retirement still ahead, the stock component of such plans would offer them some inflation protection, and the continued inside build-up would protect them against a day when they might need additional income for medical care or assisted living.

The only reason for the mandatory minimum distributions at age 70½ in current law is to force retirees to subject their earnings to tax sooner than they might otherwise choose. Treasury thereby gets some revenue sooner, but the tax on the forced withdrawals reduces the amount of savings left to compound. The result is less future income for the retiree, less total saving to help the economy grow, and less tax revenue in the future. There is no excuse for the forced withdrawals. If a retiree chooses to let the savings grow, the Treasury will collect more taxes later, if not from the retiree then from the retiree's heirs when they, in turn, take money from the accounts.

Congress's Joint Committee on Taxation (JCT) and the U.S. Treasury overstate the cost of such bills. Their static revenue estimates do not factor in the increases in investment, national output, and employment that would result from the lower cost of capital. This ignores the higher taxes that will be collected in the future from the resulting growth of wages. They also fail to consider the resulting rise in the stock market, which would increase capital gains tax receipts.

Under current scoring methods, the JCT and the Treasury try to take into account the higher levels of saving that would accumulate in the accounts due to their tax deferred status, which results in additional inside build-up and additional tax revenue in the future. However, they assume that all the saving in such accounts would have been done anyway, even without the tax incentive. Consequently, the accounts are scored as costing revenue by deferring the annual taxation of the interest, dividends and realized capital gains in the accounts, which reduces the present value of the revenues. In reality, well over half of the contributions to deferred saving plans are new saving that would not otherwise have been done. Thus, most of the earnings in such accounts would never have been earned and would never have been taxed without the favorable tax treatment. There is no true static revenue loss on such saving.

It is disappointing that there was no room in the Ways and Means' Committee's saving incentive package for dividend relief to redress the double taxation of corporate income and even up the tax treatment of dividends versus capital gains. Dividend relief would have improved both economic efficiency and incentives for good corporate governance. Nonetheless, the two bills being offered by the Ways and Means Committee are beneficial, if modest, steps toward a better tax system, and should be enacted.

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