IRET Congressional Advisory

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

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BUSH SAVING PROPOSALS: TAX REFORM IN THE MAKING?

President Bush has unveiled three new proposals to promote saving. They would replace a wide variety of existing personal saving plans and defined contribution pension arrangements offered by employers. More saving would be eligible for the treatments than under current law. The tests and restrictions required for such plans under current law would be greatly simplified and relaxed, reducing legal and compliance costs to enable more companies to offer such plans to their employees.

These proposed saving plans are good tax policy, in that they remove one of the layers of tax bias that the income tax imposes against saving relative to consumption. Reducing the tax bias against saving would in turn increase investment, productivity, employment, wages, and income across the board. Combined with Mr. Bush's earlier saving and investment proposals, the President's new saving initiatives constitute a significant step toward fundamental tax reform.

The three simplified saving plans.

Lifetime Savings Accounts (LSAs) would allow each person to set aside $7,500 (for 2003, indexed for inflation thereafter) in after-tax money each year, from any source and in addition to any other saving plan. Because the initial contributions would be made out of already-taxed income, the subsequent earnings and withdrawals would be tax free. There would be no income limits on participation, no minimum holding period, and no restrictions on what the money could be used for. LSAs would have a great advantage for low and middle income savers who cannot afford to save separately for retirement and emergencies, such as being laid off, and who are therefore afraid to use ordinary IRAs because of their penalties for early withdrawal. Instead, lower income savers put their saving into ordinary accounts that are subject to the full tax bias against saving, where the saving is taxed each year with no deferral and no exclusion either at the time of deposit or withdrawal. The LSAs would give lower income people who want to save the same access to tax-neutral saving that higher income workers currently enjoy.

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Retirement Saving Accounts (RSAs) would resemble current Roth IRAs, but would have a higher contribution limit, $7,500 in after tax contributions (for 2003, indexed for inflation thereafter) per worker per year. The current law $2,000 IRA catch-up contributions for people age 50 or higher would not be allowed, but the new higher RSA limit more than compensates. Contributions could not exceed a single filer's or couple's combined wages. Otherwise, there would be no income limits on participation. Withdrawals could be made penalty-free and tax-free after age 58. RSAs would replace deductible, non-deductible and current Roth IRAs. A deductible IRA and a Roth-type IRA provide identical tax relief for savers who are in the same tax bracket during their working years and after retirement. (If a worker expects to be in a lower tax bracket when retired, the deductible IRA is better. If a worker expects to be in a higher tax bracket when retired, the Roth type is preferable.)

Employer Retirement Savings Accounts (ERSAs) would enormously simplify defined contribution plans. They would replace 401(k), 403(b), and government 457 plans, SARSEPs and SIMPLE IRAs. The initial contribution limits would be $12,000 in 2003 increasing to $15,000 in 2006 (the same as current law for the first three plans listed, but increases for SARSEPS and Simple IRAs). Employees age 50 or above would be allowed the current law "catch-up" contributions of $2,000 for 2003, rising to $5,000 in 2006. Top-heavy and non-discrimination rules and tests would be simplified and eased to reduce complexity and compliance costs and to enable more firms to offer the plans to more workers.

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Existing accounts.

Beginning in 2004, existing 401(k) plans would become ERSAs. Existing IRAs and the other employer based plans could be continued under the proposal, but could not accept additional contributions after 2004. Participants could convert existing traditional IRAs into RSAs. Deferred contributions and earnings in such rolled-over plans would be taxable, as with a conversion of a regular IRA to a Roth IRA under current law. However, those who convert in 2003 could spread the taxable amounts over four years; later IRA conversions would have to be added to taxable income in the year the conversion occurred. Subsequent earnings and withdrawals would not be taxed.

> ***At the end of the journey, we would arrive at a far simpler tax code, a far larger capital stock, and greater productivity, higher wages, and higher incomes across the board.***

Defined benefit plans would not be affected.

Interaction with the President's dividend relief proposal.

The President has also proposed reforming the taxation of dividends. He would eliminate most taxes on dividends held outside retirement accounts, and would provide a basis adjustment for retained earnings to reduce future capital gains taxes on income already taxed at the corporate level. That proposal would extend the unbiased tax treatment to equity income earned outside these designated saving accounts, and would come very close to the tax reform ideal for individual taxes. Only the added layer of tax on ordinary interest income would remain to be addressed at the individual level. (There would still be the added layers of corporate tax and the remaining estate and gift taxes to be dealt with.)

Giant step toward fundamental tax reform.

For years, the tax literature has debated the merits of taxing income or taxing "consumed income" (revenue less net saving). The income tax treats income used for saving more harshly than income used for consumption, and is therefore not "saving-consumption neutral."

In fact, there is one layer of federal tax on most consumption, but up to four layers on income that is saved. 1) Income is taxed when earned. If used for consumption, it is generally not subject to additional federal tax (except a few excises). 2) If saved, however, the interest, dividends and capital gain produced by the assets are taxed again. Thus, one can buy a loaf of bread and eat it or buy a television and watch a stream of programming with no further federal tax, but if one buys a bond or stock the government taxes the stream of interest or dividends. This is the basic income tax bias against saving. 3) If the saver buys corporate stock, there is the additional corporate tax on the income before it is paid out as a dividend, or reinvested, which leads later to a capital gains tax. And 4), if one has saved a great deal, the saving may be subject to the transfer (estate and gift) taxes.

The many variants of fundamental tax reform all have the following in common: They eliminate the transfer taxes. They end the double taxation of corporate income by fully taxing the returns either at the individual or corporate level, but not both (or collect a tax at half the normal rate in each spot). They eliminate the basic income tax bias against saving either by allowing a deferral of tax on all income that is saved and taxing all the returns upon withdrawal (as in a deductible IRA or pension), or they tax the amounts saved up front and exclude the returns from further tax (as with a Roth IRA). In a similar vein, businesses are allowed to expense (deduct immediately) their investment spending instead of depreciating it over time.

There are many alternative systems that meet these objectives of restoring neutral tax treatment of saving and consumption. They include the national retail sales tax, the VAT, the Armey Flat Tax or revised USA Tax (introduced by Congressman Phil English), or the saving-deferred income tax (the original graduated Nunn-Domenici USA Tax or IRET's flat rate Inflow-Outflow Tax).

The Bush saving proposals (LSA, RSA, ERSA, and the dividend exclusion and capital gains basis adjustment), taken together, move strongly in the direction of eliminating the basic income tax bias against saving. They expand "Roth IRA" treatment of saving and broaden pension availability. The dividend and capital gains relief proposal, although billed as ending the double taxation of corporate income, appears on the individual tax form and acts more like relief from the basic bias. The corporate income tax still needs to be phased out. The 30 percent "bonus" depreciation provision in the 2002 stimulus package, though temporary, moves toward expensing, and should be made larger and be made permanent. The President's budget proposes a permanent increase in the amount of investment that small businesses are allowed to expense from $25,000 to $75,000 with an increase in the revenue level at which the provision phases out.

In short, in recent years the country has taken a number of steps toward fundamental tax reform, including the 1997 capital gains cut and the 2001 IRA expansion, marginal tax rate reductions, and estate tax phase-out. The new proposals by President Bush would move us further down that road. At the end of the journey, we would arrive at a far simpler tax code, a far larger capital stock, and greater productivity, higher wages, and higher incomes across the board. Let us make all deliberate speed.

Stephen J. Entin
President and Executive Director

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