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A BETTER TAX SYSTEM THROUGH INDIVIDUAL INVESTMENT ACCOUNTS

Tax-deferred personal saving accounts, such as 401(k)s and individual retirement accounts (IRAs), are extraordinarily good tax policy. They bring together three of the most desirable properties that can be found in a tax: efficiency, simplicity, and fairness. Moreover, they offer the bonus of being a way station on the road to fundamental tax reform, if the nation decides to move in that direction.

> ***[Individual Investment Accounts] would essentially be deductible IRAs without the many restrictions the government now imposes on contributions and withdrawals... IIAs would have all the strengths of IRAs without the weaknesses due to current-law restrictions.***

Representative Jim McCrery (R-LA) and Senator John Breaux (D-LA) recognize these virtues. For several years, Rep. McCrery has introduced legislation in the House to establish Individual Investment Accounts (IIAs), and Sen. Breaux has sponsored companion legislation in the Senate. Their bills are based on a proposal by the Savers & Investors League. The legislation currently before Congress is the Individual Investment Account Act Of 1999 (H.R. 1611 and S. 1471).

IIAs can be thought of as "super IRAs". As with deductible IRAs, individuals would defer tax on amounts they contribute to IIAs but pay tax on gross distributions from IIAs (i.e., deduction for contributions, no tax on earnings within the account, full income tax on all withdrawals). This combination ensures that individuals would be subject to income tax at one point along the saving stream, but would protect them from being taxed repeatedly when they save. IIAs differ from IRAs because they would give individuals the freedom to choose the timing and size of contributions and withdrawals without government second guessing. In effect, IIAs would be unlimited deductible IRAs.

Taking the Advantages of IRAs and Improving on Them

IIAs would essentially be deductible IRAs without the many restrictions the government now imposes on contributions and withdrawals. Being unlimited IRAs, IIAs would have all the strengths of IRAs without the weaknesses due to current-law restrictions.

<u>Tax Neutrality.</u> A key advantage of IRAs is that they are neutral between saving and consumption. They provide for equal income tax treatment of an individual's funds, whether the individual uses the funds for personal saving or for immediate consumption. In either case, the funds are taxed just once. This neutral treatment overcomes a major income tax bias.

Normally, individuals pay income tax only once on earnings they use for consumption (income tax applies to the earnings but not to the consumption), but they pay income tax repeatedly on earnings they save (income tax applies to the earnings that are saved and income tax also applies to returns on the saving). Because the income tax bias reduces the reward for saving (or, equivalently, lowers the price of consumption relative to saving), it discourages saving. The government-created bias means less investment and a smaller capital stock and, thus, weaker pro-

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ductivity, smaller wage gains, slower economic growth, and reduced future wealth.

One method of taxing personal saving in an unbiased manner is to defer tax on earnings that are saved and later tax gross distributions from saving. The tax code uses this approach in the cases of deductible IRAs, 401(k) and 403(b) plans, employer-provided retirement plans, Keough plans, and SEPs. An alternative method, which assesses tax at the start of the saving stream instead of at the end, is to tax earnings but not tax returns on the earnings. The tax code uses this approach in the cases of Roth IRAs, education IRAs, and municipal bonds.

> ***[IIAs] recognize that ... the tax system's anti-saving bias does not apply just to some saving for retirement and some saving for education, but to all saving.***

By avoiding the tax bias against personal saving, IRAs and other tax-neutral pension and education arrangements moderate the bias's adverse effects on the economy while allowing people to better provide for their futures. (These plans do not address all anti-saving biases in the tax system. For instance, the corporate income tax and the estate tax also generate anti-saving tax biases, and depreciation rules overstate taxable profit by understating the true cost of business investment.) The adoption and popularity of these plans is evidence that many people recognize that the standard income tax treatment of personal saving is overly harsh and a serious problem.

> ***IIAs would let all savers shield all their saving from the basic income tax bias against saving. That would eliminate the need to make decisions based on taxes instead of economics. It would make possible both a more efficient balance of saving and consumption in the economy and more future-oriented planning by individuals for their later needs.***

Unfortunately, current law imposes limits and regulations on IRA and pension contributions and withdrawals. These restrictions force many people to undertake some or all of their saving outside of IRAs and pensions. Thus, much saving fails to be protected from the anti-saving bias of the tax code. Suppose, for example, that a young worker would like to save some of his or her earnings but wants to retain the option of accessing the funds before retirement in the event of job loss or medical emergency. Because the government slaps a stiff tax penalty on most IRA withdrawals before age 59½, the young worker may be afraid to save through an IRA. Whatever he or she saves will probably be in forms where the tax system's anti-saving bias hits with full force. Due to that bias, the worker will tend to save and invest too little.

IIAs are a break from the nanny-state mentality. They acknowledge that individuals can make sounder choices than the government about when and how much they should save because individuals have more information about their own needs and are more strongly motivated to act in their own best interest. And they recognize that current-law accounts are too restrictive because the tax system's anti-saving bias does not apply just to some saving for retirement and some saving for education, but to all saving. With IIAs, individuals could contribute as much as they wanted without government-imposed contribution limitations; later, individuals could make withdrawals without tax penalties from their IIAs as they thought appropriate, again without having to worry about whether their needs coincide with what government planers think their needs ought to be. (Individuals would, of course, have to pay ordinary income tax on gross distributions from their IIAs.)

Thus, IIAs would let all savers shield all their saving from the basic income tax bias against saving. That would eliminate the need to make

decisions based on taxes instead of economics. It would make possible both a more efficient balance of saving and consumption in the economy and more future-oriented planning by individuals for their later needs.

Simplicity. IRAs simplify people's taxes with respect to funds within the accounts—no tax reporting is required during that period—but can create tax complications when people contribute or withdraw funds. Most of the complexity is due to the government's contribution and withdrawal restrictions. When individuals contribute, they have to be sure not to exceed the contribution cap, and they have to calculate whether they are even eligible to make a deductible contribution. (The government phases out eligibility for the deduction as a person's income rises.) Later, individuals have to watch out for withdrawal requirements. They are penalized if they take funds out of their IRAs for most purposes before age 59½, and then they are penalized if they fail to satisfy complicated mandatory distribution rules after age 70½.

By dispensing with complicated and confusing contribution and withdrawal restrictions, IIAs would allow people to spend more time making their saving and consumption choices and less time worrying about tax traps when they contribute or withdraw funds.

Another source of complexity arises because the government over the years has authorized several types of special saving accounts (e.g., deductible IRAs, Roth IRAs, tax-deferred employer-provided pensions, education IRAs, etc.) to try to put saving and consumption on a less unequal tax footing. Each type of account is highly targeted: it applies to saving that will be used for a specific purpose and has its own, very detailed set of restrictions on contributions and withdrawals. Keeping track of the various sets of restrictions and the interactions among the restrictions on different accounts is a complex undertaking. IIAs would be a major advance in tax simplicity by replacing this multitude of narrowly-targeted, saving-neutral accounts with one that is simple and broad.

[P]eople who choose to save should not be penalized relative to people who choose to consume... IIAs would ... enable people to obtain fair tax treatment on much more of their saving than is now possible.

Fairness. Tax fairness is a notoriously subjective concept; different people often hold opposing views. One reasonable standard of fairness, though, is that people who choose to save should not be penalized relative to people who choose to consume. Regrettably, the current tax system egregiously violates that fairness standard. Through multiple taxation, it treats savers more harshly than consumers. IRAs are much fairer to savers than normal income tax rules, in that they tax a person's saving stream at only one point instead of again and again. But current-law restrictions on IRA contributions and withdrawals limits the amount of saving that can qualify for even-handed treatment.

IIAs would do better. By eliminating the contribution and withdrawal limits and penalties, they would enable people to obtain fair tax treatment on much more of their saving than is now possible.

IIAs And Fundamental Tax Restructuring

The most systematic way to rid the U.S. tax system of its anti-saving and anti-investment biases would be through fundamental tax restructuring. The Armey Flat Tax and a national sales tax are two ideas that have received much attention in recent years as possible replacements for the individual and corporate income taxes and the estate tax. Both the Armey Flat Tax and a national sales tax would be free of any anti-saving bias because they would tax income once, equally, whether it is used for saving or consumption, and would eliminate the added taxes imposed on saving and investment by the

corporate income tax, the estate and gift tax, and depreciation rules that understate the cost of business investment.

IIAs are less sweeping in that they would address only part of the tax bias (that applying to personal saving through the individual income tax) and would overlay neutral treatment of personal saving on top of the current tax system rather than replacing the entire tax system. IIAs, though, offer some important advantages. First, the transition would be relatively easy because it would not be as large a change and would not require a sudden break from the current tax system; it requires only the liberalization of deferred-saving-account rules that have been on the books on a limited basis for many years. Second, IIAs have the political advantage of familiarity, in that they build on a model (tax-deferred saving accounts) that is well known to many people from personal experience, has proven workable, and is very popular. Further, if it is eventually decided to proceed with fundamental tax restructuring, there would be fewer transition problems in moving there from a tax system with IIAs (where much personal saving would already receive neutral tax treatment) than from the current tax system.

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Government Revenues

In the case of new saving (saving deterred by the current anti-saving tax bias but unleashed by IIA treatment), government revenues would decline initially because of the tax deferral on contributions, but it would be made up later — with interest — because gross distributions (principal and interest) would be taxed. The government would lose nothing on new saving by not repeatedly taxing the saving stream since, without IIA treatment, the saving would not have been done and there would have been nothing to tax. Over time, new saving would raise government revenues.

In the case of saving that would have been undertaken even without IIA treatment, the government would be giving up some revenue currently raised by multiple taxation. However, new saving would recoup much of this loss by generating additional investment. The added investment would produce new output and income in the future, and the government would claim a share of that extra economic activity in taxes. Official government revenue estimates overlook this revenue source because they are static with regard to total economic activity: they incorrectly assume that reducing anti-saving tax biases will have no effect on total saving, investment, incomes, and output in the economy.

The government's short-run, temporary revenue loss could be lowered by phasing in IIAs, that is, relaxing contribution and withdrawal restrictions over several years. The revenue cost of the bill could also be lowered by altering one provision that goes beyond tax neutrality. As the bill is now written, it would allow a tax-free IIA distribution of up to $15,000 for a first-time home purchase. Because some income would escape tax altogether, that is not neutral taxation but a tax break. It also raises a fairness question: why should homeowners pay income tax on less of their income than do other taxpayers?

Conclusion

Representative Jim McCrery and Senator John Breaux are to be commended for having introduced legislation to establish IIAs. By extending tax-deferred saving accounts, a feature of the tax code that has proven both successful and popular, their innovative proposal would overcome much of the tax code's bias against personal saving. It would be superb tax policy.

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Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.