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Universal IRAs Will Yield Universal Benefits

The Individual Investment Account Act of 1992, H.R. 5671, introduced July 23, 1992, by Representatives Dick Schulze and Ed Jenkins, is one of the boldest, most imaginative, and most constructive pro-growth tax proposals in many years. The bill would establish "unlimited IRAs" that would permit taxpayers to defer taxes on saving without restrictions as to amount of saving or time of withdrawal. The bill would all but eliminate the income tax bias against individual saving. It would contribute to higher levels of saving, investment, productivity, and income than now exist.

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The unlimited IRAs would have the following features:

- Unlimited tax deduction for IRA saving.
- In addition to currently-allowed IRA vehicles, tax deductible premiums for life insurance if proceeds are payable into an IRA.
- Tax-free investment growth until withdrawal.
- No penalty tax on withdrawal at any age.
- No forced distribution at any age.
- No income tax at death. Heirs may maintain the IRA with the benefactor's cost basis.
- No estate tax — IRA accumulations would be excluded from the gross estate.
- Rollover of up to $15,000 (indexed for inflation) from an IRA into the first purchase of a principal residence (with an equal reduction in the tax basis of the house).
- Tax-free rollover into the IRA of the proceeds from the sale of a principal residence.

IRAs have traditionally been justified as an incentive for taxpayers to save for retirement. This is too narrow a focus. IRAs should be thought of instead as a very limited means of offsetting the current bias in the income tax against saving.

Income is taxed when earned. If the income is used for consumption, there is no further federal income tax imposed (though there may be a small sales or excise tax to be paid). However, if the income is saved, the earnings of the saving are taxed again and again (and, if later used for consumption, may also face excise or sales taxes). The income tax thus raises the cost of saving compared to that of current consumption.

A neutral tax code would not penalize saving relative to consumption. There are two ways to make the taxation of saving and consumption neutral. Either income that is saved should be exempt from tax (as in the case of traditional IRAs, 401(k) plans, etc.) and the earnings of the saving and the principal taxed upon withdrawal, or the amounts saved should be taxed when earned but the earnings should be tax exempt (as in the case of tax free securities or the "back-ended" variant of the IRA offered in the Bentsen-Roth bill).

The bias in the income tax extends to all taxable saving, not just that for retirement. Consequently, to create a neutral tax system, all saving, whether for retirement, buying a house, college tuition, a new car, a vacation, or protection against a rainy day, should receive the same treatment as in a tax-deferred income plan or in one form of IRA or other.

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Indeed, all saving contributes to capital formation, productivity, and national income, regardless of the motive behind it. There is no economic reason for the government to discriminate against or discourage any type of saving.

IRAs, as currently constituted, have several shortcomings. There are limits to the amounts that can be deducted. Consequently, IRAs give no added incentive to save to those who are already doing long-term saving in amounts above the limits. Amounts withdrawn from an IRA before age 59-1/2 are subject to a penalty in addition to tax. This makes IRAs unattractive to lower income savers who cannot afford to save separately for emergencies, buying a home, paying tuition and other near-term goals, as well as a more distant retirement. There is a mandatory age (70-1/2) for beginning to withdraw from IRAs to force commencement of recapture of the tax deferral, yet the saving done by the elderly is as economically valuable as saving done by the young.

The Schulze-Jenkins bill avoids all these pitfalls. It will generate a greater incentive to save among upper-income savers, be of far greater safety and appeal to lower-income savers, and encourage more saving by the elderly and their heirs than current IRAs.

Some might object that the near-term cost to the Treasury would make the Universal IRA too expensive for the federal budget. This fear is groundless for several reasons.

First, when the contribution to an IRA constitutes new saving that would not have been done in the absence of the incentive, there is no loss to the Treasury over the lifetime of the IRA. The tax on the contribution is deferred, not lost. The contribution grows with interest, and the tax on the compounded principal equals in present value the tax that was foregone when the contribution was made. There is no additional loss of tax, relative to current law, from allowing the interest to accumulate tax-free, because the saving would not otherwise have been done, and there would have been no interest to tax if the IRA-treatment had not been allowed.

Second, in the event that a portion of the saving would have been done in the absence of the IRA treatment, the deferred tax on the compounded contribution is recouped with interest, as above. The annual taxation of the interest is foregone, but this is more than offset as that portion of the IRA which does constitute new saving adds to the GNP and raises revenues from other taxes on the added income.

For the most part, then, the present value of the taxes collected by the Treasury is not reduced, only altered in its timing as a result of IRA treatment of saving. Is this a problem? Might the delay in collection of the tax force the government to borrow more, resulting in a decrease in national saving and an increase in "crowding out" of private borrowers from the market?

In practice, the answer is "No." The amount of added government borrowing equals the IRA contribution times the taxpayer’s marginal tax rate — 15%, 28%, or 31%. If the fraction of new saving in each IRA contribution equals the tax rate, e.g., if $28 of a $100 contribution is new saving by a middle income contributor, then the new saving by the contributor equals the added borrowing by the government, and national saving does not fall. The leading researchers into the effect of IRAs on saving behavior have concluded that some 60% to 80% of IRA saving was new saving by contributors, well above the minimum needed to produce "crowding in" of added saving, not crowding out.

Because IRA saving is in large part new saving, IRAs add to the amount of investment and growth of the economy. The added investment raises productivity, employment, wages, and profits. The higher incomes are subject to tax. When the higher corporate and personal income taxes and the added payroll taxes are factored in, IRAs are seen to be clear revenue raisers for the government over time. The Universal IRA will be of universal benefit!

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