

To Roth or Not to Roth: The Worst of Budget & Tax Policy

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Outline

- **The (Misinterpreted) Economic Equation**
- **Bad Budget Policy**
- **Bad Tax Policy**
 - Inequitable
 - Messy & Complex
- **Individual Confusion**

The (Misinterpreted Equation)

- At a given tax rate, the individual and government is supposedly indifferent between regular pension and IRA treatment and Roth treatment.
- Formally, $(1-t)[R^{**n}] = [R^{**n}](1-t)$

The (Misinterpreted) Equation, cont.

- Assumes:
 - t constant across time for each taxpayer
 - r constant across investments for individual
 - r constant between borrowing and investing
 - r constant for government
 - Investors do not have special knowledge of markets
 - Net amount deposited the same
 - X in non-Roth equivalent to $(1-t)X$ in Roth

Budget Consequences

- Revenue raising in budget window
 - But revenue losses can continue for two generations
 - Encourages all sorts of game-playing (e.g., Congress spends the money up front in a “revenue-neutral” bill
 - Yet another burden on future generations
- Present Value Losses for Government
 - High return assets in Roth, low return (& lower bracket taxpayer) in non-Roth
 - Human capital (e.g., knowledge of a good investment) put into Roth
 - Business opportunity: borrow at 3%, earn 5%
 - Net investment = \$10,000 but really worth \$1 million

Tax Policy: Equity Consequences

- Not a tax on income or ability ex post or consumption
- More like a head tax up front (other than differences in initial tax rate, which may have little to do with later success)
- Example:
 - A invests \$10,000 and makes \$1 million.
 - B invests \$10,000 and loses it all.
 - Both start in same bracket and pay same tax
- Whether the government loses is a separate question

Tax Policy: Efficiency & Administration

- Leaving taxpayers choices almost always a bad idea
 - They spend time sorting for non-economic reasons
 - The sorting adds to the budgetary losses
- More Tax Arbitrage Opportunities
 - Interest paid is deducted, interest received is not taxed
 - With Roth easier to borrow & invest short-term (non-Roth harder to withdraw short-term)
- Measuring “income” for tax and expenditure purposes
 - Phase outs of various tax benefits (itemized deductions, EITC)
 - Phase in and out of various expenditures (Food Stamps, Social Security taxation, Medicare premiums)

For individual

- Base case: in higher bracket later, then put money in Roth
- But individual should consider:
 - Higher income limits in Roth
 - Higher deposit amounts by amount of pre-paid tax
 - Tax advantages to sorting portfolio (riskier, higher return, in Roth)
 - New short-term tax arbitrage opportunities
 - Longer withdrawal or deferral period (limited required withdrawal all the way through the lives of heirs)
 - Further timing of income/deductions
 - For example, at 50% charitable deduction cap, relatively better to put money in Roth since only lose ½ of up-front deduction



Summary

- Roth IRAs and 401(k)s represent the very worst type of budget and tax policy
- For individuals they offer many sources of potential tax gain