

Key Thoughts on RSAs and LSAs

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February 4, 2004

Background

In his FY2005 budget, released Monday, President Bush proposes a set of new tax-preferred saving accounts (which were first presented in last year's budget). Under the Administration's proposal, two new types of individual accounts—called Lifetime Saving Accounts (LSAs) and Retirement Saving Accounts (RSAs)—would be created. This note provides information to help assess these proposals.

For further information, see our earlier analysis, "The Administration's Savings Proposals: Preliminary Analysis," Tax Notes, March 3, 2003.

Description

LSAs would allow annual contributions of \$5,000 per person per year (down from \$7,500 in last year's budget). Although contributions would not be deductible, account earnings and withdrawals would be tax-free. Anyone could make a contribution to their own account or anyone else's with no income, age, or other restrictions. Withdrawals could be made at any time for any purpose.

RSAs are basically expanded Roth IRAs. They would have similar features to LSAs, except that contributions could not exceed earnings and withdrawals made before age 58 (or the death and disability of the owner) would be subject to a small penalty.

Compared with current law, the key changes in the structure of saving rules include:

- A significant expansion in the type of saving exempted from taxation. Almost all tax-preferred saving in the past has been targeted for specific purposes, like retirement or education. LSAs would not involve any such restrictions.
- A significant increase in the amount of tax-preferred saving that could be undertaken outside of retirement accounts. LSAs would allow a family of four to save \$20,000 per year on a tax-preferred basis *outside* retirement accounts and up to \$30,000 outside of employer-provided retirement plans.
- An expansion in annual contribution limits for retirement saving outside employer-provided plans. RSAs would raise the maximum amount allowed to be contributed to a retirement account outside an employer plan to \$5,000 per person. The current limit is \$3,000 (\$3,500 for taxpayers age 50 and over), but scheduled to increase to

\$5,000 (\$6,000 for 60 and over) by 2008. Unlike current law, the contribution limit would be indexed for inflation (as would the LSA limit).

- The removal of all eligibility rules related to age, pension coverage, or maximum income on contributions to individual retirement accounts. Under current law, tax-preferred contributions to Roth IRAs are restricted to households with incomes of under \$160,000. The RSA proposal would eliminate this restriction.
- The removal of all income eligibility limits on conversions of traditional and nondeductible IRAs into the new saving vehicles. Under current law, conversions from a traditional IRA to a Roth IRA are limited to households with incomes below \$100,000. The RSA proposal would eliminate this restriction.
- The termination of new contributions to traditional tax-deductible IRAs.

Revenue

The Treasury Department estimates that these proposals would actually increase tax revenues by \$21.1 billion over the first five years and by \$5.6 billion over the ten-year budget period. These apparent short-term revenue gains may turn out to be illusory, but, more importantly, they mask far larger and growing long-term revenue losses.

- Over time, the proposal would be tantamount to a complete exemption of tax on capital income for all but the wealthiest Americans (meaning that proportionately more and more of the tax burden will be borne by wage earners).
- The provision to allow rollovers to the new accounts is scored as raising revenue, but much more revenue is lost over the long run. In present value terms, every dollar raised today will cost around \$1.30 in forgone future tax revenues. That is, rollover revenues effectively represent borrowing from the future on very unfavorable terms.
- The annual revenue loss could exceed 0.2 percent of GDP by the end of the decade and 0.3 percent after 25 years.
- The exact short-term revenue effects are uncertain, but the existence of significant and rising long-term revenue losses seems assured.
 - If everyone who could benefit from LSAs takes advantage of the new accounts, the revenue losses could be on the order of \$100 to \$200 billion over the first 10 years, and growing over time.
 - The revenue losses explode just as the baby boomers start to retire and the budget situation turns really bleak.
 - Over the next 75 years, the revenue loss of these proposals alone would amount to about one-third of the actuarial deficit in Social Security.

Distribution

The proposal would be regressive on impact and increasingly regressive over time:

- The ability to shift existing taxable assets each year into LSAs would, over time, increasingly benefit high-income households with substantial existing assets.
- The elimination of income limits on eligibility for retirement saving accounts would benefit households with income above \$160,000.
- The increase in contribution limits (to \$5,000 per person per year) would only affect those who are currently constrained by the existing limits. Only about 5 percent of eligible taxpayers make the maximum IRA contribution. Most of them have higher incomes.
- The loosening of rollover rules would only affect households with income above \$100,000.

Effects on saving

Much of the revenue loss associated with the proposals would accrue to high-income households. Such households are likely to respond mostly by shifting existing assets into the tax-preferred accounts over time, rather than by undertaking new saving. That is, there is unlikely to be much effect on private saving, but national saving could fall if higher deficits result:

- The transfer of existing taxable assets into LSAs would reduce taxes but not raise private saving.
- New contributions to RSAs by high-income households currently constrained by IRA income limits are also unlikely to represent net additions to saving.
- In addition, the proposals may reduce coverage in employer-provided plans. Reduced pension contributions among rank-and-file workers would reduce the percentage of American households that are saving adequately for retirement.
- If the cost of these proposals is financed by more federal borrowing, national saving will actually decline.

Fundamental tax reform

The saving proposal should not be confused with fundamental tax reform. A revenue-neutral consumption tax might raise national saving and economic growth, but the Administration proposal is not revenue-neutral over the long term and it is not a comprehensive consumption tax. As a result, it is likely to *reduce* national saving, not raise it. And unlike a comprehensive consumption tax, the proposal would continue to allow deduction for interest expense and other items that would not be deductible under a consumption tax. As a result, they would open new

avenues for inefficient tax shelters that would further undermine revenue and economic growth. In other words, the proposal would retain the regressivity of various consumption tax proposals without any of the potential growth benefits.

The proposals have been sold as simplification, and they would simplify taxes somewhat. While simplification efforts are needed, this proposal would also create some new complexities by adding yet more choices to the panoply of tax-preferred savings vehicles. Moreover, simplification does not require massive increases in contribution limits or the proliferation of additional tax-preferred savings vehicles. The most costly features of the new proposal have nothing to do with simplification and much to do with allowing high-income households to shelter much more wealth than under current law.

A better strategy would encourage expanded pension coverage and participation among low- and middle-income households, which would boost national saving and build wealth for many households who are saving too little. Reforms along these lines could include expanding the income eligibility range for the saver's credit and making the credit refundable, changing default choices in 401(k) plans, improving financial education, encouraging diversification of 401(k) accounts, and simplifying pension rules.