

# The Heritage Foundation **Background**

**UPDATE**

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## **IRAS: HELPING THE MIDDLE CLASS ENJOY RETIREMENT**

(Updating Background No. 513, "40 Million Americans Can't Be Wrong: Save the IRAs," May 27, 1986.)

As House and Senate conferees try to iron out their differences on tax reform, a top priority should be to save the deduction for Individual Retirement Accounts--popularly known as IRAs. This can be done while maintaining the low tax rate structure of the Senate bill.

IRAs have proved effective in channeling private resources into retirement savings. Already 40 million individual Americans, comprising one-third of all households, have deposited more than a quarter-trillion dollars in IRAs--mainly in just the last four years. And most of these IRAs are held by middle-class Americans. The popularity of IRAs also seems to be accelerating rapidly, with increasing numbers of individuals deciding to participate or adding to existing accounts every year.

These private resources are absolutely necessary if America's future retirement needs are to be met. Policy makers are already debating where to obtain the resources to finance long-term nursing home care for tomorrow's elderly, to help pay for retiree medical care, and to cover the enormous retirement demands posed by the aging baby boom generation. Social Security and pensions do not appear adequate to meet these needs. Without the highly successful IRA system building up private resources, the burden inevitably will fall on government. The result: higher government spending and taxes.

America's national retirement policy is often said to be based on the concept of the "three-legged stool"--Social Security, pensions, and private savings. IRAs support the private savings component. Without these accounts, private savings cannot be expected to perform an adequate role in the face of the treble tax burden which otherwise applies to savings and capital under the current tax system. Returns to savings and investment are subject to corporate income tax, personal income tax, and capital gains tax. IRAs represent fair and sound policy precisely because they remove the discriminatory multiple-tax burden on private savings.

IRAs are the most flexible, best-suited retirement vehicle for the modern, highly mobile, and diverse American work force. They are the only vehicle available to virtually all workers in all circumstances. They avoid all vesting problems, since funds paid into an IRA immediately belong to the workers. They end all portability restrictions, since the IRA funds are under the worker's ownership and control wherever he or she goes. They offer workers greater freedom and self-reliance than Social Security or company pensions, where the worker's retirement income is in the hands of others. And IRAs build among workers a sense of personal responsibility for their own future retirement needs.

The encouraging impact of IRAs in increasing savings has also been generally underestimated. Harvard economist David Wise recently reviewed data regarding individual savings behavior and found that the sums most individuals save in their IRAs are substantially greater than what they would have saved otherwise. Wise calculates that between 50 percent and 80 percent of IRA contributions and investment returns represent added savings for the economy. Without IRAs, the American middle class would not save much of its discretionary income.

If tax rates are lowered generally, the immediate tax benefits of an IRA contribution of course will be reduced. This will affect the initial decision to save. As Wise explains, the rush to open IRAs just before April 15th indicates that the immediate tax relief on the deduction is far more important to most savers than other considerations. So even if taxes are lowered on the withdrawal of IRA funds during retirement, as the Senate bill proposes, it would still be necessary to retain the existing IRA deduction for workers to have a strong inclination to contribute to IRAs. It is even more important to retain full deductibility if tax rates are lowered, since the after-tax "cost" of a contribution to an IRA would in any case rise. Ending deductibility would thus be a double whammy for the saver. Indeed, for some workers, the IRA benefits under current law are as much as 66 percent greater than would be the case under the Senate bill, assuming contributions of equal after-tax cost.

House and Senate conferees should understand why they have received so much pressure from their constituents on the IRA issue. The IRA deduction must be retained because it makes sound retirement policy. And clearly the American people now consider the IRA as an essential private supplement to the overstretched Social Security system.

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