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BALANCED BUDGET TALKING POINTS #6: WHAT A BALANCED FEDERAL BUDGET WITH TAX CUTS WOULD MEAN FOR CURRENT AND FUTURE RETIREES

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Congress's balanced budget plan with tax relief, vetoed on December 6 by President Clinton, would expand the purchasing power of today's seniors and allow younger Americans to save more money for their retirement. These are the findings of an analysis by The Heritage Foundation using one of the principal econometric models of the U.S. economy.[1] According to this statistical analysis, the congressional plan would mean:

For Current Retirees

- ✓ **A retiree showing $2,150 in capital gains for 1995 would realize $245** in additional after-tax income from a reduction in the capital gains tax.
- ✓ **A senior citizen with only $25,000 per year in nominal dollars for retirement could see an increase of $1,125** in real purchasing power over the next ten years due to decreased inflation.

For Future Retirees

- ✓ **A worker saving $500 annually before taxes in the proposed "super IRA" for 40 years would realize an additional $3,070** in today's dollars compared with putting the same amount in a conventional IRA.
- ✓ **A 25-year-old couple raising one newborn child could save $41,150** in today's dollars for their retirement by saving the $500-per-child annual tax credit.

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1 For the assumptions underlying this analysis, see the final section of this report, "Technical Assumptions."

✓ **A young couple buying a home with a $100,000 mortgage could save $33,890** in today's dollars for their retirement from decreased monthly mortgage payments.

Economists at The Heritage Foundation conducted an interim econometric analysis of the congressional balanced budget plan using the economic model developed by Laurence H. Meyer & Associates,[2] a nationally recognized economic consulting firm. The Meyer model is used by many major public agencies and private firms, such as the President's Council of Economic Advisers, the Office of Management and Budget, the Board of Governors of the Federal Reserve, and the Congressional Budget Office.[3]

The positive benefits to current and future retirees from the congressional balanced budget plan are discussed below. These include increased after-tax income from lower capital gains tax rates; expanded purchasing power from lower inflation; and increased potential retirement income from super IRAs, the $500-per-child tax credit, and lower mortgage rates.

Benefits to Current Retirees

Increased After-Tax Income from Lower Capital Gains Taxes. The Balanced Budget Act of 1995 lowers the effective tax rate on capital gains by 50 percent for individual tax filers through a deduction of half the net taxable gain. Thus, an individual in the 28 percent tax bracket would see his effective tax rate on capital gains drop to 14 percent.[4] Contrary to popular belief, the capital gains tax reduction is not a tax break enjoyed primarily by the rich. The typical household declaring a capital gain in 1991 had income from sources *other than capital gains* of $58,729.[5] For seniors claiming a capital gain in 1991, the average income from sources *other than capital gains* was $43,637, with an average gain of $2,151.

A reduction in the capital gains tax is particularly important for today's retirees who have invested in capital assets as a means of saving for their retirement. There are two major reasons why the capital gains tax cut is so important to seniors:

1. **Senior citizens claim a disproportionate amount of capital gains.** Households containing taxpayers who are over the age of 65 or blind constituted only 3.5 percent of all returns in 1991 but accounted for more than 27 percent of taxpaying households declaring capital gains.
2. **Current law imposes a surtax on Social Security benefits.** For example, a retiree facing a base marginal tax rate of 15 percent also must pay a surtax of 7.5 percent. This is why many individuals face higher marginal tax rates during their retirement than over the rest of their lifetime.[6] Thus, the 50 percent exclusion may be more valuable during a taxpayer's retirement years than during his working years.

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2 William W. Beach and John S. Barry, "What a Balanced Federal Budget with Tax Cuts Would Mean to the Economy," Heritage Foundation *F.Y.I.* No. 69, November 14, 1995.

3 Laurence H. Meyer & Associates long has earned top honors for forecasting accuracy when compared against similar firms. In 1993, it won the "Blue Chip" forecasting award for the years 1989-1992. LHM&A was ineligible for the award in 1994, but again was rated the most accurate forecasting firm in the United States.

4 For an overview of the benefits from a reduction in capital gains tax rates, see William W. Beach, "Who Will Benefit from Cuts in Capital Gains Taxes," Heritage Foundation *F.Y.I.* No. 76, December 4, 1995.

5 These statistics on taxpayers who declared capital gains on their tax returns were developed from actual tax returns for 1991 selected by the Internal Revenue Service and made available on the Public Use File for Tax Year 1991. Data released for tax year 1992 will be available in January 1996.

6 See below, "Technical Assumptions."

To understand the benefits of the capital gains exclusion for seniors, consider a newly retired couple realizing $2,150 in capital gains during 1995. If this couple faces the lowest marginal tax rate of 15 percent and the Social Security surtax of 7.5 percent, they will receive only $1,665 in after-tax income from these gains. Under the congressional balanced budget plan, however, this same retired couple would realize $1,910, an increase of $245 over current law.

To put this in perspective, an additional $245 amounts to:

✓ One month of groceries for the average retired household, or

✓ Six months of housekeeping supplies for the average retired household.

Increased Purchasing Power from Lower Inflation. Many senior citizens have saved a fixed amount of money for their retirement years. Seniors living on a fixed income are affected directly by inflation because it changes the purchasing power of their money. As inflation increases the prices of goods, consumers are able to purchase less: Inflation eats away at purchasing power. Because retirees, as a rule, are more likely to be restricted to a fixed income, they will benefit disproportionately from a slower rate of inflation.

The economic simulation conducted by analysts at The Heritage Foundation indicates that prices likely will increase more slowly in the future because of a more efficient economy spurred by a balanced federal budget and tax relief. By 2002, inflation rates are projected by this analysis to be 0.7 percent below what is expected under current law. This means consumers will be able to purchase more goods with the same amount of money. For example, a retired household living on a fixed income of $25,000 per year will see their purchasing power increase by $1,125 in today's dollars over the course of the next ten years.

To put this in perspective, an additional $1,125 amounts to:

✓ The amount an average retired household will spend on laundry and household cleaning over the next ten years,

✓ The amount an average retired household will spend on fresh milk and cream over the next ten years, or

✓ One-half the amount an average retired household will spend on furniture over the next ten years.[7]

Benefits to Future Retirees

Benefits from Super IRAs. Current laws allow tax-free deposits of up to $2,000 per year in contributions to Individual Retirement Accounts (IRAs). However, withdrawals from these IRAs made during retirement years are taxable. The tax provisions of the congressional balanced budget plan would create a new kind of IRA, known as a super IRA. Contributions to a super IRA would be taxable; however, withdrawals could be made tax-free. As Bruce Bartlett, an economist at the National Center for Policy Analysis, notes, "If the tax rate is the same at the time of deposit and the time of withdrawal, taxpayers would be indifferent between the two types of IRAs. However, most middle-income workers will face higher tax rates during the years of their retirement, because of the Social Security benefits tax."[8] Therefore, retired workers will not face the higher tax rates associated with retirement when making withdrawals from super IRAs.

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7 Average expenditures are adjusted for the lower projected inflation. Source: Bureau of Labor Statistics, *Consumer Expenditure Survey, 1992-93.*

The table below shows the advantage of the congressional super-IRA provision. Suppose a young worker decides to invest $500 annually in a conventional IRA. Because these annual contributions are tax-exempt under current law, this worker can dedicate the entire $500 in personal savings. After 40 years of $500 annual contributions, this worker's IRA will have accumulated $129,528 in future dollars. However, under current law, this worker must pay taxes on withdrawals from the IRA. If this now-retired worker faces a base marginal tax rate of 15 percent and the surtax of 7.5 percent, he will pay 22.5 percent of the accumulated $129,528 in taxes, leaving him with an after-tax income of $100,384 in future dollars.

Now suppose this same worker was able to invest the $500 per year in a super IRA. This worker, facing a marginal tax rate of 15 percent, would be able to dedicate only $425 to the IRA because contributions to super IRAs are not tax-free. Every year he would pay $75 in taxes and deposit $425 in the super IRA. After 40 years of $425 annual contributions, this worker's super IRA will have accumulated $110,099. However, this entire amount can be withdrawn tax-free. Thus, by investing in a super IRA he will have $9,715 more after 40 years in after-tax income for his retirement years. This additional future income is equal to $3,070 in today's dollars.

Most Retirees Will Benefit from the Super IRA

	Current Law IRA	New Super IRA
Pre-tax annual contribution	$500	$500
After-tax annual contribution (assumes a 15% marginal tax rate)	$500	$425
Accumulated savings after 40 years at an annual return of 8%	$129,528	$110,099
After-tax value of accumulated savings (assumes a 22.5% marginal tax rate)	$100,384	$110,099
Additional value of Super IRA	**(nominal)**	**$9,715**
Additional value of Super IRA	**(today's dollars)**	**$3,070**

Note: This tax rate includes a 15 percent base marginal rate and the 7.5 percent Social Security surtax.

Extra Potential Retirement Savings from $500-per-Child Tax Credit. The $500-per-child tax credit included in the Balanced Budget Act of 1995 would benefit 28 million families raising some 51 million children. A 25-year-old couple that has just had a child and decides to dedicate the entire $500-per-child tax credit every year for 18 years to savings for their retirement, and then leaves the balance to continue earning interest for an additional 22 years, could accumulate $41,150 in today's dollars ($101,820 in future dollars) after the 40 years of savings.[9]

8 Bruce Bartlett, "The Case for Expanded IRAs," National Center for Policy Analysis *Brief Analysis* No. 139, November 2, 1994.

9 See below, "Technical Assumptions."

This additional savings amounts to:

- ✓ The total amount an average retired couple will spend on groceries over ten years of retirement, or
- ✓ The total amount an average retired homeowner will spend on mortgage payments, property taxes, and home maintenance costs over ten years of retirement.[10]

Extra Potential Retirement Income from Lower Home-Mortgage Rates. The economic simulation conducted by analysts at The Heritage Foundation indicates that households and businesses would face lower interest rates as a result of a stronger economy spurred by a balanced budget and tax relief. Specifically, the simulation projects mortgage interest rates in 2002 will be 0.4 percent below what they are expected to be under current law. This 0.4 percentage point decrease below baseline means that a new home borrower of $100,000 will save $25 per month in mortgage payments.

A homeowner who chooses to dedicate the extra $25 per month to retirement savings for every month over the 30-year life of the mortgage, and then leaves the balance to continue earning interest for an additional ten years, will accumulate $33,890 in today's dollars ($80,440 in future dollars) after the 40 years of savings.[11]

This additional savings amounts to:

- ✓ The total amount an average senior citizen will spend on utility payments over 15 years of retirement,
- ✓ The total amount an average senior couple will spend on dining away from home over 20 years of retirement, or
- ✓ The total amount an average senior couple will spend on gasoline and motor oil over ten years of retirement plus a modest vacation every year for ten years.[12]

Technical Assumptions

For assumptions that underlie the econometric simulation of the congressional balanced budget legislation, see William W. Beach and John S. Barry, "What a Balanced Federal Budget with Tax Cuts Would Mean to the Economy," Heritage Foundation *F.Y.I.* No. 69, November 14, 1995.

For calculations of accumulated savings from the $500-per-child tax credit, it was assumed that the entire $500 was contributed to a super-IRA (as defined by the Congressional Budget Resolution of 1995) earning an annual rate of return of 8 percent. It was further assumed that this accumulated amount was saved for an additional 22 years at an annual rate of return of 8 percent. Inflation was assumed to be 3 percent annually.

The 0.4 percent decline in mortgage interest rates was projected in the above-cited econometric simulation. It was assumed that the savings from this decline were placed in a super-IRA (as defined by the Congressional Budget Resolution of 1995) earning an annual rate of return of 8 per-

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10 All calculations of typical purchases are based on figures from Bureau of Labor Statistics, *Consumer Expenditure Survey, 1992-93.* Inflation is assumed to average 3 percent per year for 40 years.

11 See below, "Technical Assumptions."

12 In 1994 dollars, this equals $724 for gasoline and motor oil and $1,700 each year for vacation expenses, based on spending $27,074 in future dollars per year over ten years of retirement for gasoline and motor oil and $63,000 in vacation expenditures.

cent. Contributions to the IRA were made over the life of a 30-year mortgage. It was further assumed that this accumulated amount was saved for an additional 10 years at an annual rate of return of 8 percent. Inflation was assumed to be 3 percent annually.

Middle-income seniors typically face a higher tax rate because of the Social Security surtax on "provisional income."[13] The effect of this surtax is to place America's middle-income elderly in a special, higher bracket by virtue of their age. For instance, if an individual younger than the retirement age receives $1 from savings, the income tax will take 15 cents in the lowest tax bracket. But some Americans must also pay the Social Security surtax, and a second 7.5 cents on the same $1 of savings could be due under the surtax.

13 Joe Cobb, "How Clinton's Budget Plan Taxes the Elderly," Heritage Foundation *Backgrounder* Update No. 193, June 6, 1993.