Executive Memorandum
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WHY COMBINING "KIDSAVE" WITH A CHILD TAX CREDIT MAKES GOOD SENSE

As congressional leaders and the White House continue to argue over a balanced budget plan, a proposal known as "KidSave" has resurfaced. First unveiled last October by Senators Joseph Lieberman (D-CT) and Robert Kerrey (D-NE), KidSave would enable parents eligible for any new child tax credit created in tax legislation to place that credit in an Individual Retirement Account (IRA) in their child's name. This is a valuable and important proposal. If congressional supporters of the $500-per-child tax credit were to include this feature in their plan, it would help build Democratic support for the tax plan. And if adopted as an option for parents in a final compromise tax bill, this innovation would help provide financial security for children while significantly improving the tax code.

KidSave would work as follows. If a parent was eligible for a child tax credit of $500 per year (the amount in the vetoed Balanced Budget Act), the parent could place that amount of money into an IRA in the child's name. As that account grew over the years, taxes would be deferred on the principal and earnings while the funds remained in the account—just like a conventional IRA.

The rules governing KidSave IRAs would be exactly the same as those for conventional IRAs, with one exception: The child could take funds out of the account temporarily in the form of a ten-year loan (much as certain life insurance and pension plans allow loans against equity), without incurring taxes at the time, to help pay for higher education. Otherwise, as with conventional IRAs, after-tax funds could be withdrawn without tax penalty by the child when he or she reached age 59 1/2, or withdrawn earlier with a penalty.

The original Lieberman-Kerrey proposal would have required the child tax credit to be placed in a KidSave IRA. Such a restriction understandably found little support among lawmakers, especially conservatives. Besides introducing unacceptable restrictions on the right of parents to decide how best to use the money for their children, the requirement would have had the effect of denying immediate help to children in many low-income families, where basic day-to-day needs are a higher priority than a more secure retirement. In the discussions now taking place over KidSave, the consensus is that placing tax credit money in a special IRA should be an option. Such an option would be a welcome reform of the tax code, since it would reduce the double-taxation bias against savings, making it more likely that working parents would set aside funds to help secure their children's future.

Allowing parents to set up IRAs for their children would help children in two particularly important ways.

✓ **The KidSave option would give children a large financial cushion against the doubtful ability of Medicare and Social Security to deliver adequate benefits in the future.** The Medicare trustees warned the nation last year that the Medicare hospital trust fund will run out of money by 2002. Congress passed reforms that would help delay the exhaustion of the fund, but President Clinton vetoed that legislation. Even if the congressional reforms became law, however, they could not guarantee solvency of the program when today's newborns reach retirement, only delay the eventual collapse. Similarly, the baby boom generation will impose such heavy burdens on the Social Security retirement program that the following generation will have little or no prospect of getting back even the money they pay into the system, let alone any return on their contributions.

KidSave would make it easier for today's worried parents to establish a retirement fund for their children as a cushion against the probability that Medicare and Social Security will be inadequate.

Although $500 per year into an IRA may seem a trivial investment in a child's retirement, compounding would lead to a substantial nest egg. For example, consider the case of parents deciding to take advantage of the KidSave option for their newborn and placing $500 per year into an IRA for 18 years (the maximum under the vetoed congressional tax credit plan). Assume a real rate of return of five percent. Even if the child, as an adult, added nothing to the IRA, it would be worth $140,000 in today's dollars when he or she reached 65 (the Clinton-proposed credit, which is smaller, available for only 13 years, and more restricted, would be worth $100,000—assuming the child was eligible).

✓ **KidSave would give the child an additional means of financing his or her higher education.** With the cost of college an enormous barrier to higher education for the children of many working families, permitting these families to invest in a KidSave IRA would provide a means of shouldering the burden. Under the proposal, children at college could borrow against their KidSave IRAs, paying back the loan (into their own retirement accounts) over the next ten years.

Again, compounding leads to significant funds for such a loan. Assuming the same case described above, the child would have just over $14,000 in his or her account at age 18, in today's dollars. This compares with an average cost (tuition and required fees) of $10,500 for four years at a public college (by contrast, an eligible child would have a maximum of $10,400 under the Clinton proposal).

The KidSave proposal, combined with the tax credit for families with children, thus would be a significant savings vehicle to help families deal with the cost of college and the future uncertainty of Medicare and Social Security. And it is good tax policy, since it moves closer to a proper treatment of savings in the tax code. But placing their child tax credit in a KidSave IRA should be an option for families, not a requirement (as under the original proposal), so families can decide for themselves whether the credit should be used for urgent immediate needs or future security. As an option, KidSave would be a very welcome improvement to legislation to provide much-needed tax relief to families with children.

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