The Administration's New Tax-Free Saving Proposals:

A Preliminary Analysis

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I. Introduction

In its fiscal year 2004 budget, the Bush Administration proposes to create a new set of tax-preferred accounts that would expand opportunities and consolidate rules for tax-advantaged saving. The initial reaction to the proposal was not particularly positive. Less than a week after the budget was released, Congressional Republicans dismissed the plan. The White House reportedly reacted by blaming the idea on recently departed Treasury Secretary Paul O'Neill (Van der Hei 2003). Congressional leaders, however, later softened their initial remarks and indicated that some elements of the proposal might be included in legislation aimed at expanding access to pensions (Rojas 2003).

Despite its uncertain prospects, the proposal is worth considering in detail because it would dramatically alter the tax treatment of saving, via the creation of Lifetime Saving Accounts (LSAs), individual Retirement Saving Accounts (RSAs) and Employer Retirement Saving Accounts (ERSAs). Some elements of the proposal—in particular, some of the simplifications—might form the basis of a useful pension reform package. Other elements are troubling because they would be regressive, could reduce saving among the most vulnerable populations, and would exacerbate the already bleak long-term budget outlook. In this paper, we provide a preliminary analysis of selected aspects of the proposal, with the following principal conclusions:

- The proposal would substantially expand opportunities for tax-sheltered saving, particularly for households with incomes above the current limits on IRAs. LSAs would represent a historic change in the tax treatment of saving -- allowing significant amounts of tax-free saving ($7,500 per account per year) for any purpose, with no restrictions on age or income. RSAs would be designed similarly, but tax-free withdrawals could only be made after age 58 or the death or disability of the account holder. RSAs would significantly expand annual contribution limits for retirement saving outside of work; would remove all eligibility rules related to age, pension coverage, or maximum income; eliminate minimum distribution rules while the account owner is alive; and allow conversions of traditional and nondeductible IRAs into the new back-loaded saving vehicles without regard to income.

- The proposal would result in growing revenue losses over time, with the annual revenue loss exceeding 0.3 percent of GDP within a decade and more thereafter. The transfer into LSAs of existing taxable assets and of future saving that would have been done in taxable form otherwise could drain between $200 billion and $300 billion in revenues over the next decade, with the amounts increasing as a share of GDP over time. By 2013, the annual revenue loss would exceed 0.3 percent of GDP, and cost even more than the Administration's dividend tax proposal. Contributions to RSAs that would have instead been saved in taxable accounts would further reduce revenue over time. Rollovers of traditional IRAs into the new RSAs would raise revenue in the short run, but reduce it even more over the long run in present value terms. Although there is considerable uncertainty about the exact short term revenue effects, all of these factors suggest significant long-term revenue losses. After 25 years, the loss in revenue is likely to

exceed 0.5 percent of GDP per year (the equivalent today of more than $50 billion a year, given the current size of the economy).

- Higher-income households would receive a disproportionate share of the benefits from the proposal. The loosening of rollover rules, for example, would only affect households with income above $100,000. The elimination of income limits on eligibility for retirement saving accounts would mainly benefit households with even higher income. The ability to shift existing taxable assets into LSAs will predominantly benefit households with substantial existing assets, which tend overwhelmingly to be those with high income. As a result, the proposal will grow increasingly regressive over time.

- The proposal would not raise private saving by much, if at all, over the next decade and would be almost certain to reduce national saving. The transfer of existing taxable assets into LSAs would reduce taxes but not raise private saving. New contributions to RSAs by very high income households currently constrained by IRA income limits are also unlikely to represent net additions to saving.

- The proposal could result in reduced employer-based pension contributions for rank-and-file workers. Reduced pension contributions among rank-and-file workers would reduce the percentage of American households that are saving adequately for retirement.

- The proposal would undermine some of the potential salutary effects of the President's proposal to reduce taxation of dividends. That proposal would encourage firms to reduce tax sheltering to some degree and pay more dividends only to the extent that shareholders would otherwise face income taxes on their dividends and capital gains. The massive expansion in tax-free saving that LSAs would produce would significantly increase the proportion of share holders that do not face individual tax and so would dull the incentives created by the dividend plan.

- The saving proposal should not be confused with fundamental tax reform. A revenue-neutral consumption tax might raise growth moderately, but the current proposal is not revenue-neutral, especially in the long run. Furthermore, while a consumption tax would only exempt the return to new capital investments, the Administration's proposal would exempt the return to existing capital. In other words, under the proposal, much of the revenue loss would simply provide a windfall gain on old investments, which does nothing to spur economic growth. As a result, the proposal would retain the regressivity of many consumption tax proposals without many of the potential growth benefits. Unlike a comprehensive consumption tax, the proposal would also contain incentives for inefficient tax shelters that would further undermine revenue.

- The proposal as a whole would simplify the tax system somewhat. LSAs would be an even more significant simplification if they replaced existing targeted saving accounts, but they instead supplement those plans, which could complicate tax planning. RSAs would simplify retirement saving. The interaction between both LSAs and RSAs and the current-law saver's credit would, however, lead to considerable complexity for lower-income taxpayers and create traps for the unwary. ERSAs could conform pension rules

that apply to several different types of retirement plans. They would also simplify the non-discrimination rules, but potentially at the cost of reducing benefits for lower- and middle-income workers.

- While simplification efforts are needed, this proposal would also create some new complexities. Moreover, simplification does not require massive increases in contribution limits or substantial new 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 (including exempting a modest amount per individual from the minimum distribution rules and transforming the non-discrimination rules into a minimum contribution regime).

Section II describes the proposed changes. Section III examines the potential for tax simplification. Section IV briefly describes what we view as the major structural changes in saving rules and the likely set of relevant behavioral effects to consider. The following three sections examine the effects on revenue, the distribution of benefits from the tax cut, and private and national saving. Section VIII discusses some broader aspects of the plan, including its interaction with the President's proposal to cut dividend and capital gains taxes and with proposals for fundamental tax reform. Section IX closes with comments on reform of tax rules for pensions and other saving.

II. The Proposal

Under the President's proposal, every individual could set up a Lifetime Saving Account (LSA) and a Retirement Saving Account (RSA).[1] Contributions to each account would have to be in cash, would not be tax deductible, would be limited to $7,500 per account per year (indexed for inflation), and could be made by persons other than the account holder. There would be no maximum income or age limits on contributions, nor any requirement to withdraw the funds while the account holder is alive.[2] Trustee accounts could be established in a minor's

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[1] Unless noted otherwise, all details about the proposal are gleaned from U.S. Treasury (2003b).

[2] The distribution rules after the account passes to an heir would apparently mimic current rules for Roth IRAs. In general, amounts in a Roth IRA must be distributed within five years after the owner's death, unless the owner had named a designated beneficiary. If the owner had named a designated beneficiary, the Roth IRA may be distributed over the beneficiary's lifetime. More generous rules apply if the sole beneficiary is the owner's spouse (e.g., a spouse could delay distribution of the Roth IRA until the owner would have reached 70 ½). See Reg. 1.408A-6, Q&A 14 of the Income Tax Regulations. Amounts distributed from the Roth IRA due to the death of the owner are not generally subject to income tax.

name and would become the property of the named individual upon turning 18. Individuals could transfer their accounts to other people, subject to gift tax rules.

The plans differ in several ways. LSAs are meant to provide tax-free saving. Anyone could have an account, and withdrawals at any time for any purpose would be tax-free. RSAs are meant to provide accumulations that will be available in retirement -- although as noted above, there is no requirement that balances actually be withdrawn during the lifetime of the account holder. For a single person, RSA contributions may not exceed the account holder's taxable compensation. For a married couple, total RSA contributions could not exceed their combined compensation. Withdrawals after age 58 (regardless of retirement status) or in the event of death or disability would be tax-free. Other withdrawals would face income tax and penalty on the difference between the withdrawal amount and the amount contributed to the account (i.e., the basis).

To encourage consolidation of existing non-retirement saving accounts into LSAs, individuals could roll over balances from Archer Medical Savings Accounts (MSAs), Coverdell Education Saving Accounts (ESAs) and section 529 college saving plans before January 1, 2004. Table 1 lists the features of these plans.   Since MSA contributions are tax-deductible, MSA rollovers would be subject to income tax. Contributions to 529 plans and ESAs are made with after-tax dollars, so no tax would be owed upon rollover.

MSAs, ESAs, and 529 plans would continue to exist and could accept new contributions under the President's proposal. In fact, the Administration's budget proposes an increase in MSA contribution limits.[3]

To encourage consolidation of individual retirement accounts, Roth IRAs would be renamed RSAs, and traditional or non-deductible IRAs could be rolled over into RSAs. Table 2 lists the features of these plans. The current-law income limits on conversions would be eliminated. The conversion amount, less any non-deductible contributions (basis), would be subject to tax. Conversions could be made at any time, but taxpayers who converted IRAs into RSAs in 2003 would be permitted to spread the income (and tax) attributable to the conversion over four years. Taxpayers would also be permitted to roll over distributions from pensions directly into RSAs, paying tax on the balance less after-tax contributions (basis) in the account.

Traditional and nondeductible IRAs would continue to exist under the proposal but could not in general accept any new contributions. Traditional IRAs, however, could accept rollover distributions from employer plans.

The proposal would also create an Employer Retirement Saving Account (ERSA) to replace seven different types of defined contribution plans (see Table 3). ERSAs would

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[3] MSA contributions are currently limited to 75 percent of the health insurance plan deductible for a married couple filing a joint return (up to $3,788 in 2003) and 65 percent of the deductible for a single person (up to $2,178). The President's budget would increase the MSA contribution limits to 100 percent of the deductible, up to $5,050 for a couple and $2,500 for an individual.

generally follow current rules governing 401(k) plans, but the non-discrimination rules would be changed.

Employees could contribute up to $12,000 annually to an ERSA ($14,000 if age 50 or over), increasing to $15,000 ($20,000) by 2006.[4] ERSAs could exist as either pre-tax or after-tax plans. A pre-tax ERSA would exclude the employee contribution from income tax but would fully tax distributions. Employee contributions to an after-tax ERSA -- called a Roth ERSA -- would not be deductible and distributions would not be taxed.[5] Employers could simply rename their existing plans ERSAs, maintaining the pre-tax or after-tax characteristic of contributions from the original plan, subject to the new rules. The pre-existing plan could also be maintained, but could not accept new contributions after 2004.

Under the proposed reform, pre-retirement lump-sum distributions could be rolled over into a rollover IRA or into an RSA. Rollovers from a pre-tax plan into an RSA would be taxable upon conversion. Pre-retirement distributions not taken as an annuity would be subject to tax and penalty once total distributions exceed basis. The 20-percent withholding tax on pre-retirement distributions that are not rolled over would continue to apply.

Lower-income contributors to any of the new accounts could qualify for a current-law saver's tax credit of up to 50 percent of contributions up to $2,000.[6] (Treasury 2003a) As under current law, a taxpayer may not claim a saver's credit if he or she made a withdrawal in the current or prior two tax years.

III. The potential for simplification

A. LSAs

Under current law, individuals may establish a variety of tax-preferred saving accounts. Among the accounts that focus on non-retirement saving, the rules differ with respect to qualified uses of the funds, the taxation of contributions and distributions, age- and income-based eligibility rules for contributions, annual contribution limits, and distribution requirements (Table 1).

On paper, LSAs would represent a historic shift in that they give preferential treatment (under the income tax) for substantial saving without regard to income and for *any* purpose and

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[4] The maximum combined employer and employee contribution to all defined contribution plans of the employer would be limited, as under current law, to the lesser of $40,000 or 100 percent of the employee's compensation.

[5] As under current law, employer contributions to either type of ERSA would be deductible for firms, excluded from income taxes for individuals, and exempt from payroll tax.

[6] The maximum credit is available for joint returns with incomes under $30,000 and single returns with incomes under $15,000. The credit rate phases down to 20 percent and then 10 percent before being eliminated $50,000 (joint) and $25,000 (single). The credit is not refundable.

time frame.[7]   In practice, though, LSAs may represent less of a liberalization in the allowable tax-exempt uses of saving than appears at first since penalty-free IRA withdrawals are already allowed for many purposes and withdrawals of contributions (but not earnings) from a Roth IRA are tax- and penalty-free for any purpose (see Table 2).   Nevertheless, the reduced "hassle factor" would have to be considered significant.

As a result, *if they were to replace existing tax-favored non-retirement saving accounts*, LSAs would represent a significant simplification of present law for many taxpayers.   But rather than replacing existing accounts, the Administration's proposal simply adds LSAs to the roster of tax-preferred alternatives.   Individuals who meet the eligibility requirements may contribute to all existing education and medical saving accounts *and* to an LSA.   Indeed, the Administration's proposed increase in contribution limits to MSAs undermines the incentive to consolidate accounts or simplify tax planning for those who have access to MSAs.   Those who are saving specifically to help pay future medical expenses would likely want to retain their MSA and continue making contributions, since the contributions are deductible and the withdrawals are tax-free if used for qualified purposes.   In addition, those who save substantial amounts would be likely to continue to use the targeted savings accounts, especially 529 plans, because they allow the sheltering of large amounts of additional savings from tax.   Indeed, those with a 529 plan could shelter even greater amounts of income by converting existing 529 balances, which can total as much as $267,000 per covered individual, into an LSA in 2003 and creating a new 529 plan in subsequent years.

Lower income people will also face some new complexity.   As noted, withdrawals from any of the new accounts would disqualify them for the saver's tax credit.   Thus, a qualifying low-income person who is contributing to a pension plan at work or through an RSA might avoid setting up an LSA, because withdrawal of even a dollar from an LSA would disqualify him from the saver's credit for three years (the current and two subsequent tax years).   This could cost as much as $3,000 in lost tax credits, assuming the taxpayer earns under $30,000 per year, has at least $1,000 of tax liability, and contributes at least $2,000 per year to an RSA or ERSA.[8]

LSAs would, however, simplify rules for upper middle income families who do not qualify for the saver's credit and save less than $7,500 per year outside of retirement plans. With minimal paperwork and few restrictions, such families could establish and maintain an LSA for the same purposes as the medical or education plans, as well as for other needs.   The flexibility

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[7] The only precedent of which we are aware relates to All-Savers Certificates, which allowed a lifetime exclusion of up to $1,000 of tax-free interest income from special one-year certificates of deposit purchased between October 1981 and December 1982.

[8] LSAs would also create simple opportunities for tax avoidance in combination with the saver's credit.   For example, a taxpayer could borrow $2,000 to deposit into an LSA on April 15 with respect to the preceding tax year, claim the saver's credit of up to $1,000 on the LSA contribution for that preceding tax year, and then withdraw the entire amount the following day to repay the loan.   The taxpayer nets $1,000 in tax savings without altering his or her saving at all.   The anti-churning rules would disqualify the taxpayer for the saver's credit for the current tax year (which includes the April 15 in which the deposit was made to the LSA) and the following two tax years, but the process could be repeated again after that.   A similar scheme would work under current law using Roth IRAs, so this is not a new tax shelter.   But the total lack of restrictions on LSAs might make such schemes easier to manage.

and ability to tap funds in an emergency without penalty should make LSAs more attractive than the alternatives for most taxpayers.[9]

B. RSAs

Existing individual retirement accounts vary with respect to the taxation of contributions and withdrawals, qualified uses of funds, minimum distribution rules, age-, income- and pension-based eligibility rules and other factors (Table 2). Although taxpayers would not be required to convert traditional and non-deductible IRAs to RSAs, the existing IRAs could no longer accept contributions, other than pension rollovers. This would give individuals incentives to consolidate their accounts by rolling existing accounts into an RSA, and it would remove complexity regarding how to allocate new contributions. In addition, RSAs have no income, age, or minimum withdrawal requirements. Thus, taxpayers would not have to address minimum distribution rules, nor would they have to be concerned with income-eligibility cutoffs.

The elimination of income limits and phase-outs of eligibility would simplify tax compliance for higher income taxpayers, especially those near the current limits. Such taxpayers could make contributions to RSAs during the year without the risk that they would be ineligible at tax time. Income phase-outs also create implicit taxes, which are undesirable, although there are good policy reasons to limit savings incentives to moderate income people, as discussed below. The removal of income limits, whatever its undesirability on policy grounds, could facilitate further simplification. Without an income limit, for example, there would be no need for the provisions that allow taxpayers to undo contributions before the due date for their tax return without penalty. Similarly, without income limits, the provisions that allow contributions after the end of the calendar year to IRAs would no longer be necessary, which would eliminate ambiguity about whether contributions on April 1 should be attributed to the prior or the current tax year and ending a source of complex tax planning. This type of potential simplification, however, was not included in the budget proposal.

One potentially important tax planning consideration is that, unlike current Roth IRAs, which allow tax- and penalty-free withdrawals for a variety of non-retirement purposes, RSAs would only permit tax-free withdrawals after age 58 or in the event of death or disability. To maximize flexibility, taxpayers could put all saving into LSAs first, and only make contributions to RSAs after their LSA contribution limits were met. But some theories suggest that people use restricted retirement accounts as a way of guaranteeing that saving actually is available for retirement, rather than spent prematurely. Under that behavioral model, the flexibility of LSAs may actually be a drawback.

C. ERSAs

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[9] Even for these taxpayers, though, complications may still arise due to interactions between LSAs and college financial aid formulas; double dipping rules regarding LSA withdrawals used for college education and other education subsidies -- such as the HOPE credit, Lifetime Learning Credits, and the education deduction; and asset tests in means-tested programs, such as Medicaid, Food Stamps, and Supplemental Security Income. Such complications also arise with regard to existing savings accounts.

At first glance, ERSAs look like dramatic simplification, since they unify the disparate rules covering a wide variety of defined contribution plans (see Table 3). But closer inspection suggests that unifying the rules only represents simplification along certain dimensions. It does *not* represent substantial simplification for any employer who has already chosen a specific type of plan or any worker who participates in only one plan. Unification of disparate rules across types of defined contribution plans is logical and reasonable, but it does not substantially simplify many pension planning problems.[10]

The real potential for simplification in ERSAs comes through proposed changes in the non-discrimination rules. Non-discrimination rules are intended to ensure that tax-preferred pensions are distributed equitably across income groups. The rules typically serve to restrict the amount of contributions that highly-paid workers can make relative to the amount that rank-and-file workers make (or that the employer makes on their behalf). The proposed rules for ERSAs would simplify, and reduce the stringency of, those rules in several ways (see Appendix A). As discussed in subsequent sections, that simplification may come at the cost of reduced pension coverage.

Another issue is that an after-tax ERSA would involve an additional layer of complexity, just as Roth 401(k) plans will. Amounts attributable to employer matching contributions, which were not taxed when made, would presumably be taxable to the individual upon withdrawal. After-tax contributions made by the employee (which are not taxable upon withdrawal in retirement) will therefore have to be tracked separately from employer matching contributions (which is also necessary in similar situations under current law).

IV. Key Policy Changes

Because the proposal involves a substantial number of changes, it is helpful -- as a prelude to considering the revenue, distributional, and saving effects -- to break down the proposal into the key changes in the structure of saving rules and the principal channels through which households and firms would be likely to respond. Taken together, the proposals represent:

- a significant expansion in the types of saving that could be undertaken with tax-preferred status;

- a significant increase in the amount of tax-preferred saving that could be undertaken outside of retirement accounts;

- a significant expansion in annual contribution limits for retirement saving;

- the removal of all eligibility rules related to age, pension coverage or maximum income on contributions to individual retirement accounts;

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[10] It would simplify efforts to consolidate pensions for people who have several retirement funds from several jobs, but that can already be accomplished by rolling the funds over into an Individual Retirement Account.

- the removal of all minimum distribution rules on such accounts while the account owner is alive;

- the removal of all income eligibility limits on conversions of traditional and nondeductible IRAs into back-loaded saving vehicles;

- the termination of contributions to traditional IRAs with tax-deductible contributions; and

- simplification and weakening of the non-discrimination rules.

These policy changes would drive a series of behavioral responses. Our analysis of the revenue, distributional, and saving effects of the proposal in the subsequent sections will highlight the behavioral responses summarized in Table 4.

V. Revenue Effects

The Treasury Department estimates that LSAs and RSAs would raise $14 billion in revenue over the first 5 years, and lose $12 billion over the subsequent 5 years, for a net gain of $2 billion over the 10-year budget period (Table 5). Treasury also estimates that ERSAs would reduce revenue by about $3 billion over the decade. All told, the official estimates imply the saving proposal would have negligible effects on the federal budget over the next decade.

Our revenue estimates differ significantly. Our estimates do not include all eight channels for revenue loss shown in Table 4, and are likely to understate the revenue loss attributable to the proposal. Thus, it is striking that our estimates suggest large revenue losses within in the 10-year budget window. In addition, the revenue costs will be even larger outside of the 10-year window (and especially outside of the 5-year budget window that the Administration uses). Our revenue estimates focus on three key elements of the plan: the shifting of existing taxable assets and future taxable saving that would have been done anyway into LSAs; the termination of on-going contributions to deductible IRAs, and rollovers of traditional and non-deductible IRAs into RSAs.

A. Shifting funds into LSAs

Contributions to LSAs may not exceed $7,500 per year and must be made in cash -- taxpayers may not transfer existing stocks or bonds into the accounts. No other restrictions apply. As a result, most taxpayers who could shift existing taxable assets to LSAs are likely to do so.[11]

To estimate the revenue costs of transfers of already existing assets and future saving that would have been done anyway into LSAs over the next 10 years, we consider how much a

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[11] Taxpayers with very small balances, especially those who do not expect to be taxable any time soon, might rationally decide that it is not worth the trouble to establish a new account. Another factor that could slow the transition is that the incentive to shift depends on interest rates, which are currently quite low. It is also possible that such accounts will have minimum balance requirements or higher fees if the accounts are subject to more reporting requirements or are restricted in some way compared with regular savings accounts.

household would be able to contribute to LSAs over time and then estimate the corresponding level of capital income that would be exempt from tax. Because the cumulative contribution limit rises over time, so too does the implied capital income exclusion. For example, a single person could contribute $7,500 in the first year. With a 6 percent nominal return, a first-year transfer of $7,500 in taxable assets would make $450 (= .06*7,500) of capital income exempt from tax in year 1. Ignoring compounding, in the second year, $900 would be exempt from capital income tax, and so on.

As shown in Table 6, an individual who transferred $7,500 of existing assets into LSAs in each year starting in 2003 could shelter $450 in capital income in 2003, $2,659 by 2008, and $6,567 by 2013 (assuming the assets earned a 6 percent nominal return). For married couples, the effective exclusion would be twice as large. Estimates using the Tax Policy Center Microsimulation model imply that a capital income exclusion that corresponds to these amounts over time would reduce revenue by $330 billion over the decade. The costs would rise over time, both in absolute terms and as a share of GDP. By 2013, the annual revenue loss would be $59 billion or more than 0.3 percent of GDP.[12]

In comparison, the Administration's dividend proposal is slated to reduce revenues by $385 billion over the decade and $53 billion in 2013. Notably, our estimates throughout this paper use current law as the baseline--that is, they assume that the dividend proposal is *not* enacted. If the dividend proposal were enacted, the incremental costs of the saving proposal would decline to $301 billion over the decade (Table 6).

As noted above, LSA deposits would have to be made in cash, which might reduce the speed at which existing assets were transferred. For example, if each individual were only able to transfer a maximum of $3,750 per year, the implied capital income exclusion for a single person would be $225 in 2003, rising to $3,283 in 2013.   Even so, transfers of existing assets would reduce revenues by $209 billion over the decade, and by 0.2 percent of GDP in 2013. Likewise, if the nominal rate of return were only 3 percent, transfers of existing assets would reduce revenues by about $195 billion over the decade.

The revenue losses would grow over time. For example, using 2003 tax law and income levels, and assuming the accounts generate real returns of 3.5 percent per year (which coupled with our baseline inflation assumption of 2.5 percent generates nominal returns of 6 percent), after 15 years the annual revenue loss from transfer of existing assets would be 0.34 percent of GDP and after 25 years the annual loss would be 0.5 percent of GDP. Note that the assumed real return on the assets in the accounts, 3.5 percent, is lower than the real return assumed in other contexts. For example, the President's Commission to Strengthen Social Security assumed a 4.6

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[12] These calculations contain at least three sources of ambiguity. First, it is unclear what portion of the funds would come from existing assets and what portion from future taxable saving that would have been done anyway. Second, among the share that comes from transfers of already existing assets, it is unclear how much capital gains tax revenue would be generated from the sales of existing assets so that they could be placed in the LSA. Because taxpayers have interest-bearing assets and can choose which assets with capital gains or losses to sell, we expect that the revenue gain from increased realizations would be small. Third, it is unclear how much of whatever increase in capital gain revenue occurs would have been obtained anyway from the sale of the asset in the future. Including the last two factors would reduce the revenue loss within the 10-year budget window, but increase the loss in years beyond 2013.

percent real return (after administrative costs) in evaluating its individual account proposals.[13]   A higher assumed return would increase the revenue loss.

There is a great deal of uncertainty about these revenue estimates. It is possible, for example, that take-up of the new tax incentive might be much slower than we have estimated in any of our scenarios. But Table 6 shows that there is great potential for erosion of the revenue base over the long-term from this provision alone.

B. Termination of on-going contributions to deductible IRAs

The proposal would end contributions to deductible IRAs. Using the TPC simulation model, we estimate that this could raise revenues by as much as $25 billion over the next decade (assuming that traditional IRA contributions that would have been made would not have been withdrawn during the next decade). This short-term revenue gain corresponds to revenue losses with equal or greater present value in the future (because taxable withdrawals from the traditional IRAs no longer take place). So the $25 billion in short-term revenue gain portends a revenue loss of $25 billion plus interest mostly occurring when our budgetary situation is much worse than it is now.

C. Rollovers of IRAs into RSAs

Conversions from traditional IRAs into RSAs trigger a current tax payment but eliminate all future tax payments on withdrawals from the account. As a result, they raise short-run revenues, but reduce long-term revenue by even more in present value. Rollovers are in essence a very expensive way for the government to borrow money.[14]   (See Box 1.) Taxpayers will choose to roll over their IRA balances only if they expect their future tax savings to be worth more than the current tax payment -- that is, only if they expect the transaction will reduce the present value of their tax payments. This can occur because conversions effectively increase the amount of saving that can be tax-sheltered and/or because the account holder expects her tax rate in retirement to exceed her current tax rate.[15]

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[13] President's Commission to Strengthen Social Security, *Strengthening Social Security and Creating Personal Wealth for All Americans*, December 2001, page 97.

[14] Our calculations assume that the risk-adjusted rate of return that taxpayers can obtain is the same as the return the government can obtain on its investments. Even under this assumption, rollovers cost the government money in the long-term because as discussed in the text they allow taxpayers to increase the amount of sheltered saving. If taxpayers can earn higher risk-adjusted returns on investments than the government can, a conversion from traditional IRAs to Roth IRAs will further reduce government revenues, even aside from the higher amount of sheltering that would occur. The reason is that in traditional IRAs, the government shares in the accrual of wealth and so benefits from the higher return that the private sector is able to obtain. If the traditional IRA is converted to a Roth IRA, the government loses out on that opportunity (Dusseault and Skinner 2000).

[15] Even if tax rates fall somewhat in retirement, individuals may find it advantageous to convert because of the higher effective contribution limits in baack-loaded plans. Burman, Gale, and Weiner (2001) found that 71 percent of taxpayers would benefit from choosing a Roth IRA (analogous to an RSA) based on actual income patterns over a 13-year period and assuming no change in tax law. A majority of taxpayers in every income and age group (under 65) would have benefited from this choice. This calculation assumed perfect foresight about future tax rates. If taxpayers are risk averse, there is an additional benefit from locking in a certain tax rate now, rather than taking a risk on future tax rates.

Currently, only households with income below $100,000 are allowed to convert their traditional IRAs into Roth IRAs. The President's proposal would allow all households to do so. As an added incentive for making the conversion soon, the income attributable to any conversion in 2003 could be spread over four years, thus reducing the present value of tax payments.[16]

Box 1. Back-loaded Saving Plans as Budget Gimmicks:
Or, Why Rollovers Cost the Government Money

Traditional (or front-loaded) IRAs allow a deduction for contributions and tax withdrawals. This reduces current government revenue but raises future revenue. In contrast, in back-loaded plans (like Roth IRAs under current law and RSAs under the Administration's proposal) contributions are not deductible but withdrawals are not taxable. The creation of Roth IRAs in 1997 was widely derided as a budget gimmick for at least three reasons.[17] First, switching on-going contributions from traditional IRAs to Roth IRAs raises current tax revenues but reduces future revenues. Second, Congress gave taxpayers incentives to convert traditional IRAs into Roth IRAs and pay taxes on the traditional IRA balance. These conversions also raised revenues in the short-term but only at the expense of reduced revenues in the long-term. Thus, under then-current budget rules, the revenue "gained" in the short-term from both of these changes could be used to finance other spending programs or tax cuts, even though the short-term revenue gain did not represent an improvement in the government's overall revenue stream.

Third, and perhaps less obvious, conversions of asset balances and on-going contributions not only shift revenues to the present by mortgaging future revenues, *they do so at very unfavorable terms for the government.* In particular, the conversions reduce the present value of future revenues by more than they increase the present value of short-term revenues. This is true because a conversion increases the amount of tax sheltering that can occur. For example, a balance of $x in a traditional IRA represents $t*x$ in pre-paid tax payments, where t is the tax rate, and $(1-t)*x$ in after-tax wealth. In contrast, all of the funds in a tax-deferred, or back-loaded, account like a Roth IRA or RSA are tax-sheltered. Thus, converting an IRA balance to a RSA, and paying the tax on the rollover with taxable assets, increases the amount of sheltering, which in turn reduces government revenue in the long-term by even more than it raises revenue in the short-term.

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[16] With a real discount rate of 3.5 percent and an inflation rate of 2.5 percent, the ability to spread income over four years reduces the present value of the tax liability by about 8 percent, assuming a constant tax rate. With a progressive income tax, spreading income reduces the odds that a large lump sum would push the taxpayer into a higher tax bracket, which would reduce the present value of tax payments by additional amounts.

[17] For example, Steuerle (1997) notes that, "Almost everyone recognizes that they [Roth IRAs} were enacted partly because of perverse budget accounting that does not take into account long-term effects of the deficit." Halperin (1998) writes that "…the main purpose of the Roth alternative was to hide the budget cost." See Gravelle (1993) for calculations of the differences in the timing and level of revenues.

An example helps illustrate this point. Suppose Sally has $1 million in a traditional IRA and that the balance will double over the next 10 years due to compound interest. Suppose also that Sally faces a constant 35 percent tax rate and has $350,000 in a taxable interest-bearing account. Sally could keep her traditional IRA or roll it over into a back-loaded account--i.e., an RSA.

If she keeps the traditional IRA and cashes it out after 10 years, she will withdraw $2 million and keep $1.3 million after paying $700,000 (= 35 percent of $2 million) in taxes. She would also have a total of $552,000 in her taxable interest-bearing account (assuming for consistency that the pre-tax rate of return for that account is the same as for the IRA and the taxes due on the interest each year are paid out of the interest earned).[18] Her after-tax wealth would be $1,852,000.

Suppose instead that she immediately rolled the $1 million in the traditional IRA into a RSA and paid taxes of $350,000 (= 35 percent of the IRA balance) on the rollover. The tax payment would exhaust her taxable interest-bearing account. But her RSA balance would be $2 million after 10 years, which could be withdrawn tax-free. Thus, with the stroke of a pen, the rollover raises Sally's after-tax wealth by $148,000 (= $2 million - $1,852,000) after 10 years.

The effect of the rollover on government revenues is the opposite--if Sally pays $148,000 less, the government receives $148,000 less.[19] In present value terms, the $148,000 is worth $74,000 currently. This represents 21 percent of the actual tax paid at the time of the rollover. Put differently, every dollar of revenue paid now through this scheme costs the government 21 cents in present value. That is, it reduces the present value of future revenues by $1.21. This cost would rise if holding period were longer, interest rates were higher, the time-constant tax rate was higher, or if tax rates were expected to rise in the future.

As noted above, the driving factor behind these calculations is that the rollover lets Sally shelter more funds. To see this, note that the revenue consequences of rolling over the *after-tax* value of the traditional IRA are the same as not rolling over the whole IRA balance. If the after-tax value were rolled over, Sally would have to pay taxes out of the IRA balance itself, and she could only rollover $650,000. This would grow to $1.3 million in the RSA after 10 years, leaving her with a total of $1,852,000 (=$1.3 million + $552,000) after-tax.

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[18] The pre-tax rate of return required to double asset balances over 10 years is 7.2 percent. Thus, the post-tax return on the taxable interest-bearing account would be 4.7 percent = $((1-.35)*7.2)$. The result reported in the text occurs because $350,000*(1.047^{10})) = 552,000$.

[19] The net decline in government revenues has several components. First, the government receives $350,000 immediately upon rollover, but forgoes $700,000 in revenues in year 10 that would have been forthcoming had Sally kept the traditional IRA. These two items net to zero in present value terms (By assumption, the rate of return is such that asset balances will double over the decade. As a result, the present value of the $700,000 loss in year 10 is equal in magnitude and opposite in sign of the present value of the $350,000 revenue gain in year 0.) Second, because Sally pays taxes on the rollover with taxable assets, the government forgoes future tax revenue from those balances. This reduces revenues by $148,000 (the difference between the $700,000 balance the assets would have generated at the pre-tax rate of return and the $552,000 they generate at the post-tax return).

> This would give her, and the government, the same outcome as not rolling over the IRA balance.

The revenue effects of induced rollovers are subject to substantial uncertainty because it is difficult to predict the extent to which households would exploit the new rollover opportunities. One useful piece of information in forecasting such behavior is that in 1997, when households with income below $100,000 became eligible to convert their traditional IRAs into Roth IRAs, it appears that about 4 percent of eligible balances were converted.[20]

Conversions generated by the new proposals are likely to come from taxpayers with incomes over $100,000, since those with lower incomes can already convert balances.[21] Thus, as described in Appendix B, we estimate rollover activity in three steps. First, we posit several determinants of rollover behavior. Rollovers will be more likely to occur the larger is the present value of the tax savings as a share of required tax payment. Rollovers will be less likely to occur the larger is the current tax liability on the rollover as a share of the household's liquid financial assets. Other things equal, rollovers will be less likely to occur as a household's portfolio becomes more concentrated in retirement assets. Second, using data from the 1998 Survey of Consumer Finances, we choose threshold levels of those determinants that would be consistent with the 4 percent conversion rate of IRA balances for households with income below $100,000 observed after 1997. Third, we apply those thresholds to the IRA balances of households with income above $100,000.

Using this approach, we adopt as our base case the rule that households would convert their traditional IRAs into RSAs only if (a) the projected future tax saving exceeds 20 percent of the up-front tax payment, (b) the up-front tax payment is less than 20 percent of the household's liquid financial assets, and (c) the household has less than half of its total financial assets in retirement funds. Under these assumptions, we estimate that 2.9 percent of IRA balances among households with income below $100,000 would be converted (Appendix Table B-1). Thus, our base case understates rollover behavior relative to the 1997 experience. Nevertheless, our estimates imply substantial rollover activity would occur. Specifically, we estimate that the proposal would induce $109 billion in IRA conversions by households with income above $100,000 (Appendix Table B-2). This represents about 12 percent of traditional IRA balances among these households. This figure is substantially higher than the 2.9 percent conversion rate for lower income households, because higher income households are much more likely to generate substantial tax savings upon rollovers and to have sufficient liquid assets to pay the taxes due.

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[20] In 1998, taxpayers filing a total of 1.4 million returns converted $39.3 billion from traditional to Roth IRAs. (Campbell, Parisi, and Balkovic 2000) This might overestimate slightly the ultimate level of conversion activity, because some conversions were reversed after tax returns were filed. Households with adjusted gross income (AGI) of less than $100,000 in 1997 owned IRAs worth at least $1 trillion in 1998, according to the Survey of Consumer Finances (SCF). The SCF includes both IRA and Keogh assets in the same category. We excluded all assets in this category if an individual only indicated the presence of Keogh assets, and assumed a 50-50 split if the individual indicated the presence of both IRAs and Keoghs.

[21] One caveat to this observation is that currently eligible households who want to maintain only one individual retirement account would likely end up converting to an RSA if they plan to make any new contributions.

These rollovers would generate short-term revenue of $37 billion (Appendix Table B-3), but they would reduce long-term revenue by $49 billion, or 132 percent of the short-term gain (Appendix Table B-4). We emphasize, and show in Appendix B, that these estimates are subject to substantial uncertainty. In particular, a reasonable range of parameter estimates generates short-term conversion totals that vary from $49 billion to $270 billion, with short-term revenues of between $17 billion and $93 billion. In all cases, however, the conversions cost the government long-term revenues that exceed the short-term gains. The ratio of the long-term losses to short-term gains ranges between 123 percent and 137 percent. Put differently, raiseing money through IRA conversions costs the government 23 to 37 percent more than raising cash through conventional borrowing.

D. Other effects

Table 4 lists several other behavioral responses that would produce revenue effects but that we are unable quantify currently. Perhaps most important among these is that the removal of income limits on individual retirement saving would generate an increase in contributions to such accounts by very high-income households. In addition, for anyone over age 58, RSA withdrawals would be unrestricted and so could be thought of as a second LSA. Incorporating these two effects would increase the amount of tax sheltering that would occur under the proposal and increase the revenue loss further.

VI. Distributional Effects

As with the revenue effects, we provide distributional estimates of certain aspects of the proposal. Taken as a whole, there is no doubt that the proposal will disproportionately benefit higher-income households.

The conversion of traditional IRAs to RSAs, for example, will cause a one-time increase in after-tax income of about $12 billion in our base case, with the total flowing entirely to households with income in excess of $100,000, since only these households are affected by the income limits under current law.

Selected distributional aspects of the conversion of existing taxable assets and future taxable saving that would have been done anyway to LSAs are shown in Table 7. As in the previous section, the LSA is modeled as an increasing capital income exclusion over time, for purposes of considering the transfer of existing assets and new contributions that would have instead been made to taxable accounts. The table shows that the transfer of existing assets would generate regressive tax cuts that would become increasingly regressive over time. In 2003, the bottom 40 percent of filers would obtain about 6.8 percent of the benefits. By 2013, they would obtain only 5.1 percent of the cumulative benefits. After 25 years, they would have obtained only 3.9 percent of the total tax cut in place at that time. Their share of the new tax cut provided in each year is even smaller, just 3.7 percent in 2013 and 0.5 percent in the 25th year. Their share of the benefits would decline because they have fewer assets to shift to LSAs. In contrast, households in the top 20 percent of the income distribution would receive 60 percent of the benefits in 2003, rising to 70 percent of the new benefits provided in 2013, and 80 percent of the

new benefits provided in the 25th year. **All of these trends would continue after the 25th year.** (Note that the share of the tax cut provided to the top 1 percent is more modest than one may have expected, largely because asset incomes for such tax filers tend to be so large that the proposal would initially exempt a relatively small share of their capital income from taxation.)

It is worth emphasizing that the results above only account for the transfer of existing assets and the transfer of new contributions from taxable accounts into LSAs. Other aspects of the proposal are difficult to quantify, but also suggest the tax cut would be of particular benefit to higher-income households.

Some households will increase their saving in response to LSAs and thus benefit from the tax treatment of their new saving. Again, however, high-income households will likely benefit to a disproportionate degree, since the LSA gives high-income households a bigger incentive to save by raising their after-tax return by more than for lower-income households. For example, households facing a 30 percent tax rate would have their after-tax return rise by about 43 percent (from (1-.30)*r to r), whereas households in the 10 percent bracket would only see an 11 percent rise in their rate of return (from (1-.90)*r to r). Also middle-income households, and even many with moderately high incomes, are much less likely to be constrained by the contribution limits on existing tax-preferred savings vehicles than are those with very high incomes.

Even more dramatically, RSAs are virtually exclusively a benefit to those with very high incomes. Even before the employer contribution limits were increased in 2001, less than 5 percent of households contributed the maximum to an IRA and less than 5 percent contributed the maximum to their employer's retirement plan.[22]   RSAs only provide an additional tax benefit—and an additional incentive to save—to the tiny minority of households who are constrained by existing tax-preferred retirement saving incentives. Because the existing contribution limits are set in absolute terms, not as a share of income, it is plausible that only the very highest-income households would be constrained by current limits.

In addition, the changes in pension coverage discussed in further detail in the next section and in Appendix A would also likely reduce benefits for middle- and lower-income workers, and could well raise benefits for higher-income workers.

VII. Private and National Saving

The proposal is designed to affect private saving and almost certainly will. But the impact on private saving may not be positive, especially in the first five to ten years. And the effect on national saving -- private saving plus public saving -- is almost surely negative over the first decade. Although we have provided revenue effects of selected proposals above, it is difficult to quantify the impact on private saving without more detailed models. Thus, we

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[22] Only about 4 percent of eligible taxpayers made the maximum $2,000 contribution to a traditional IRA in 1995 (Carroll 2000, Copeland 2002). About the same percentage of workers contributed the maximum ($9,500) to their 401(k) plan in 1996 (Richardson and Joulfaian 2001). Some individuals may have contributed less than $9,500, but still been constrained by limits imposed by their employers or required by law, but it is unlikely that this group is very large.

discuss the qualitative effects of the various behavioral responses, following the format of Table 4.

The transfer of existing taxable assets to LSAs is a first-order concern, as it will have literally no impact on private saving, but will drain public revenues. Likewise, the placing of future saving that would have been done anyway in an LSA rather than in some taxable asset will have literally no impact in itself on private saving, but will reduce public saving. Of course, the level of non-retirement private saving may also change. Such saving could rise because of the higher after-tax rate of return available through LSAs. On the other hand, the substantial income and wealth effects associated with the first two changes above -- the transfer of existing assets and future saving that would have been done anyway -- could easily raise consumption (that is, reduce other non-retirement saving).

The conversion of traditional IRAs to RSAs will raise national saving in the short-term because of the positive revenue effects of the conversions, but will reduce national saving in the long-term because of the long-term drain on revenue, which exceeds the short-term gain in present value.

It is also possible that some households will raise their level of non-employer retirement saving. This could occur for two groups: those that are already saving the maximum amount in an IRA or 401(k); and those with very high income (above $160,000) who would be newly eligible to make tax-advantaged contributions. As noted above, however, very few households are constrained by current contribution limits. Moreover, the households that are constrained tend to be higher-income households, as of course are the households that would be made newly eligible for such contributions via the removal of income eligibility limits. Several studies of 401(k) plans, pensions, and IRAs find that contributions to such plans by households with high levels of income are less likely to represent net additions to private saving than are contributions by lower- and middle-income households.[23] Thus, the likely impact on private saving from increased contributions to non-employer retirement accounts is likely to be small; if it is, the effect on national saving could well be negative because a small increase in private saving would be outweighed by the reduction in tax revenues. Moreover, some of the strongest advocates of IRAs believe that the removal of the up-front deduction for contributions could serve to reduce participation significantly (Altman 2003).

The effects of the proposal on pension coverage, participation, and contributions would be a critical component of its impact on private and national saving. The Administration claims that the greater simplicity of plan design and non-discrimination rules will encourage some business owners to create new plans. But a recent EBRI (2002) study reports that less than 30 percent of small businesses that do not offer pensions cite pension rules, broadly defined, as the

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[23] The effects of 401(k) plans on household wealth accumulation is controversial. Early studies by Poterba, Venti and Wise (1995, 1996) found that virtually all 401(k) contributions represented new saving. More recent studies, using improved econometric techniques, have found that contributions by lower- and moderate-income households tend to represent net additions to saving, but that contributions by higher-income households tend to represent asset reshuffling (Benjamin 2000, Engelhardt 1999, Engen and Gale 2000). Engen and Gale (2000), for example, find that contributions made by households with income below $40,000 tend to represent new saving, but that contributions by higher-income households do not show up as increased private wealth.

reason why. Concerns such as that employees prefer wages or other benefits, revenue is too uncertain to commit to a pension plan, and a highly seasonal or part-time work force appear to weigh more heavily. About 11 percent of respondents did list the cost of required contributions and about 15 percent listed administrative costs of one sort or another as the primary reason.

A second factor affecting pension coverage would be that the vast increase in the amount of saving that taxpayers would be able to do outside of retirement plans would reduce the incentives for small and medium-sized businesses to offer plans. For example, under the proposal, a business owner and her spouse could shelter $30,000 per year in saving outside of any company retirement plan ($7,500 each in an LSA and $7,500 each in an RSA). Thus, many business owners and managers may find that they can meet all of their demands for tax-free saving without the hassle and expense of maintaining an employer-sponsored plan.[24]

Holding pension coverage constant, it seems likely that pension participation and/or average contributions for low- and middle-income workers would fall due to the relaxation of non-discrimination rules (see Appendix A). To the extent that firms did drop pension coverage, rank-and-file workers would of course have the option to make up the contributions themselves by contributing to their own RSAs. However, evidence suggests strongly that participation in non-employer based saving plans, like IRAs, is likely to be much lower than participation rates among workers eligible for an employer-based plan. For example, even in the early 1980s when IRAs were universally deductible, participation rates never exceeded about one-quarter of the population in any given year, with much lower participation rates among low- and middle-income families. In contrast, among eligible workers, 401(k) participation rates are consistently in the range of 60 to 70 percent across almost all income levels (Poterba, Venti and Wise 1995). And participation is highest in cases where employers offer a matching contribution. The weaker nondiscrimination rules are likely to reduce the prevalence of employer matches, thus reducing worker participation even where a firm continues to offer a pension.

VIII. Other issues

A. Interactions with the dividends/capital gains proposal

Besides the saving proposal, the Administration recently unveiled a proposal to remove the double taxation of dividends. The interactions between these proposals are worth considering. Both proposals serve to exempt capital income from taxes, and it is possible that, in combination, they would eliminate all, or almost all, individual-level taxes on capital income for all but the extremely wealthy. Note, however, that the two proposals undermine each other.

The saving proposal reduces the effectiveness of the dividend proposal in encouraging firms to report income and pay dividends. As Gale and Orszag (2003a) show, the dividend proposal provides no incentive for firms to reduce sheltering to the extent that a firm is owned by tax-exempt shareholders. It only provides an incentive when the firm is held by taxable shareholders. The saving proposal will increase the share of capital income that is tax exempt

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[24] Several researchers have found evidence that the availability of non-employer based retirement saving options, like IRAs, reduce the amount that employees contribute to employer-based plans (see Burman, Johnson, and Kobes 2003, Engelhardt and Kumar 2002, Engen, Gale and Scholz 1994).

and hence attenuate the effects of the dividend proposal on discouraging sheltering. The saving proposal would also reduce the incentive created by the dividend plan for firms to reduce borrowing -- under the combined proposals, firms could borrow and deduct their interest payments, but individuals could avoid paying taxes by putting corporate bonds in their LSAs.

Likewise, the dividend proposal may reduce the relative attractiveness of both employer-provided pension plans and individual tax-free savings accounts: Shares held in taxable accounts invested entirely in shares of firms with fully taxed corporate income would effectively enjoy tax treatment almost like RSAs. Contributions to such accounts would be made with after-tax dollars, but dividends and capital gains that are due to retained earnings would be untaxed at the individual level.[25]

B. Fundamental tax reform

The President's saving proposal is not a revenue-neutral shift to a consumption tax. Our estimates suggest substantial revenue losses over the next 10 years that would continue to grow in subsequent years.

Moreover, despite a superficial resemblance, the proposal is not a consumption tax. First, a consumption tax would have consistent treatment of capital income and expense. It would not allow capital income to be exempt from tax -- through the LSA and RSA (and dividend proposal) -- while at the same time allowing payers of interest – both corporations and individuals -- to deduct their interest payments. Second, a consumption tax would only exempt the return to new capital investments, not to old capital. The President's proposal would exempt the return to old capital. Thus, it should be considered along the lines of consumption taxes with transition relief, or essentially more like a wage tax than a consumption tax. Notably, the economic growth benefits of a consumption tax with transition relief are much smaller than those of a consumption tax without transition relief (Altig et al 2001). Even those smaller economic benefits may be offset by the new opportunities for arbitrage that would be created by allowing interest expense to remain deductible while capital income is taxable, and would need to be assessed against increased regressivity, reduced national saving and increased public debt burden.

IX. Conclusion

The Administration's tax-free saving proposals would help simplify some aspects of tax rules for saving. But the proposals may also create complex interactions with the saver's credit for low-income households and with other existing tax-deferred saving plans. Moreover, the effort to simplify the system does not require massive increases in contribution limits or the creation of substantial new tax-preferred savings vehicles. That is, the most costly features of

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[25] Indeed, to the extent that the normal return to corporate stock is tax-exempt under the dividend proposal, but any excess return is taxable (or loss deductible), investors would prefer to make such investments outside an LSA. Taxation (assuming full deductibility for losses) reduces the variance of after-tax returns without affecting the mean, which produces no net revenue for the government, but makes risk-averse investors better off. Capital losses are only currently deductible to the extent of other capital gains plus $3,000, but Auerbach, Burman, and Siegel (2000) show that almost all losses are taken within two years. Given the sustained stock market declines of the past couple of years, the loss limit is surely more binding now, so the benefit from risk reduction may be offset for many taxpayers because gains and losses are taxed asymmetrically.

the proposals have nothing to do with simplification but much to do with allowing high-income households to shelter substantially more assets than they can under current law.

The Administration's proposals might be the right policy prescription if the key problems facing the pension system were that workers with income above $160,000 were unable to save adequately for retirement, low- and moderate-income workers were currently receiving too many subsidies through the pension system, and the budget outlook were so positive that policy makers were worried about ever-expanding surpluses.

In our view, however, by expanding tax-free savings opportunities primarily for higher-income households, and potentially reducing saving and pension coverage among lower- and middle-income households, the Administration's proposals could reduce private saving and almost surely reduce national saving over the next decade, decrease the number of households who save adequately for retirement, make the tax system less progressive, and exacerbate an already difficult fiscal situation.

We believe that one of the key problems facing the pension system is the current mismatch between where pension benefits are provided and where those benefits would do the most good. In our view, the private pension system provides disproportionate and expensive benefits to high-income households. Those benefits generate little improvement in the adequacy of saving for retirement, since the beneficiaries would save substantial amounts even without tax subsidies. Moreover, such tax subsidies generate little increase in private saving, since very high-income households tend to substitute existing assets or saving that would have been done anyway into tax-preferred vehicles, rather than reducing their current living standards to finance their deposits. In contrast, lower- and middle-income households gain less from the pension system, but pension benefits targeted at them can both increase saving and help households who would otherwise save inadequately for retirement. A key objective of pension reform should therefore be to encourage expanded pension coverage and participation among low- and middle-income households, a step that would boost national saving and build wealth for households, many of whom are currently saving too little. Reforms along these lines could include expansion of the existing saver's credit, changes to the default choices in 401(k) plans, improved financial education, options for encouraging diversification of 401(k) accounts, and pension simplification (including exempting a modest amount per individual from the minimum distribution rules and transforming the non-discrimination rules into a minimum contribution regime) (Gale and Orszag 2003b).

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Appendix A: Non-Discrimination Rules

A. Current law

Current law limits the benefits qualified pension plans may provide to highly compensated employees (HCEs, basically defined in 2003 as those earning $90,000 or more) relative to rank-and-file workers, known as non-highly compensated employees (NHCEs). One requirement hinges on coverage rates. This requirement can be met if the share of rank-and-file workers covered is at least 70 percent of the share of HCE workers covered.[26] For example, if all HCEs are covered, 70 percent of rank-and-file workers would need to be covered.

An additional set of tests applies specifically to 401(k) and similar defined contribution plans. Under these tests, the share of compensation contributed by HCEs is limited by the share of compensation contributed by rank-and-file workers. For example, if the average contribution rate for rank-and-file workers is between 2 and 8 percent of salary, the average HCE contribution rate can not be more than 2 percentage points higher.[27] Safe harbor rules allow firms to avoid these tests by offering specific patterns of 401(k) employer matching or non-matching contributions; a plan following the safe-harbor design satisfies the test regardless of actual take-up behavior.

A variety of other rules apply as well, some making the allowable pattern of contributions more progressive and some making it less progressive. The "permitted disparity" rules allow higher contributions for highly compensated employees, in a manner that was intended to reflect the offsetting progressivity of Social Security benefits. The "cross-testing" rules allow higher contributions for older workers.[28] The top-heavy rules require plans in which more than 60 percent of benefits accrue to "key" employees (such as certain executives and owners) to provide a minimum contribution equal to 3 percent of compensation to rank-and-file workers.

B. The Administration's proposal

The Administration's proposal would change these rules in several ways. First, it would change the non-discrimination rule applying to 401(k) and other similar plans so that the average contribution rate for HCEs could not exceed twice the average contribution rate for NHCEs if the NHCE contribution rate averaged 6 percent or less. If the NHCE contribution rate averaged more than 6 percent, no non-discrimination testing would apply. The Administration's proposal

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[26] This is the so-called ratio percentage test. An alternative way of meeting the coverage requirement is through the average benefits test. For a description of these tests, see Orszag and Stein (2001).

[27] If the average contribution rate for NHCEs is less than 2 percent, the average HCE contribution rate is limited to no more than 200 percent of the average NHCE contribution rate. If the NHCE average contribution rate is over 8 percent, the HCE average contribution rate can be no more than 125 percent of the NHCE average rate. Two similar and parallel tests (the ADP test and the ACP test) evaluate employee pre-tax contributions (ADP test) and the combination of employer contributions and employee after-tax contributions (ACP test).

[28] Orszag and Stein (2001) give examples of how the cross-testing rules can be used to subvert the intent of the nondiscrimination rules.

would also loosen the safe-harbor rules allowing firms to avoid non-discrimination testing through specific plan designs.[29] The Administration's proposal would also repeal the top-heavy rules, eliminate permitted disparity and cross-testing, and remove a secondary test for demonstrating that a plan covers an adequate share of NHCEs.

These proposals would have complicated effects. To give a sense of some of the changes, the following two tables simply list the required minimum NHCE average contribution rate for a given HCE contribution rate (Table A1) and the maximum HCE average contribution rate given an average NHCE contribution rate (Table A2), under current law and the Administration's proposal respectively. Note that these tables ignore the safe-harbor rules, which would also be loosened somewhat under the Administration's proposal, and do not attempt to take into account employer matching contributions and employer non-elective contributions in general.

Table A1: Minimum contribution rate for NHCEs given contribution rate for HCEs

HCE contribution	Required minimum NHCE contribution rate	
	Current law	Administration's proposal
0	0	0
2	1	1
4	2	2
6	4	3
8	6	4
10	8	5
12	9.6	6

These tables show, for example, that if a firm wants to allow HCE workers to contribute 10 percent of salary, it would currently have to ensure a contribution rate of 8 percent for NHCE workers. Under the new law, the firm would only have to ensure a 5 percent contribution rate for NHCE workers. Thus, in many circumstances, it may be possible to reduce contributions for lower and middle-income workers under the new rules. On the other hand, the firm may be more inclined to offer the plan in the first place if the contributions for rank-and-file workers were lower.

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[29] To enjoy a safe harbor under the Administration's proposal, the plan must be such that all employees are eligible to receive fully vested employer contributions—including nonelective (automatic) and matching contributions—of at least 3 percent of compensation. In addition, any matching contributions must follow one of two rules: (1) the employer match would be 50 percent of employee contributions up to 6 percent of compensation; or (2) the match rate as a percentage of employee contributions does not increase with the contribution and the aggregate match rate must be at least as great as the rate that would apply under the first formula. Also, the match rate cannot be higher for HCEs than for NHCEs. These rules represent a loosening of the current safe harbor rules. For example, under current law, the least stringent safe harbor design requires matching contributions on behalf of NHCEs to be 100 percent of employee contributions up to 3 percent of compensation, plus 50 percent of employee contributions between 3 and 5 percent of compensation. Under the Administration's proposal, by contrast, the plan would qualify for the safe harbor if matching contributions were 50 percent of employee contributions up to 6 percent of compensation. The required aggregate matching contribution for an employee making contributions of 6 percent of compensation are thus reduced from 4 percent of compensation (100 percent up to 3 percent, plus 50 percent between 3 and 5 percent) to 3 percent of compensation (50 percent of 6 percent). For workers making contributions of less than 6 percent of compensation, the reduction in aggregate required matching contributions is generally larger.

Table A2: Maximum contribution rate for HCEs given contribution rate for NHCEs

NHCE contribution	Maximum allowed HCE contribution rate	
	Current law	Administration's proposal
0	0	0
2	4	4
4	6	8
6	8	12
8	10	No non-discrimination testing
10	12.5	No non-discrimination testing
12	15	No non-discrimination testing

A simplified example may provide further insight into the possibility that the changes will in some circumstances allow pension contributions made on behalf of rank-and-file workers to fall, while maintaining contributions for HCE workers. For example, consider a firm with 2 HCEs and 5 other employees. The HCEs earn $110,000 and $120,000 respectively, while the others earn between $25,000 and $70,000. The rank and file workers contribute an average of 5 percent of compensation to the firm's 401(k) plan, with an average dollar contribution of $2,130.[30] Under current law, the HCEs are allowed to contribute 7 percent of compensation, which is 2 percentage points higher than the average NHCE contribution rate. The result is an average dollar contribution for the HCEs of $8,050.

This pattern of contributions results in slightly more than 60 percent of the aggregate contributions being made by key employees. Assuming that the account balances of the key employees also account for more than 60 percent of aggregate account balances under the plan, the firm must provide a contribution of 3 percent of pay to NHCE workers to satisfy the top-heavy rules.[31] Including these employer contributions, the total contributions made to NHCE accounts average $3,510 and the total contributions to HCE accounts average $8,050 (since no employer contributions are required to be made on behalf of the HCE employees under the top-heavy rules).

Under the Administration's proposal, the two HCEs could meet all of their retirement saving needs and contribute even more to retirement just by creating RSAs for themselves and their spouses and dropping the firm's pension plan altogether. If they retained the pension plan, though, the 5 percent average contribution rate for the rank and file workers would allow the HCEs to contribute 10 percent of pay (rather than 7 percent under current law). In addition, the removal of the top-heavy rules would eliminate the need for an employer contribution to NHCE

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[30] For purposes of the non-discrimination tests, the "average" contribution rate for NHCEs and HCEs is a simple average of each individual's contribution rate and is not weighted by compensation.

[31] We assume that the HCEs are both key employees and that none of the NHCEs are key employees. The top-heavy rules mandate a non-elective 3 percent contribution on behalf of the NHCE employees.

accounts. The result, as shown in the table below, is that the average contribution made to the HCE accounts rises to $11,500, but the average contribution made to the NHCE accounts declines from $3,510 to $2,130.   The average across the entire firm remains $4,807, indicating that total contributions to the plan remain constant (at $33,650).   The distribution of those contributions, however, shifts from NHCEs to HCEs. Under current law, 52 percent of the total contributions are made to NHCE accounts; under the Administration's proposal, 32 percent of the total contributions are made to NHCE accounts.

Table A3: Hypothetical firm under current law

Worker	Compensation	Employee contribution ($)	%	Employer contribution ($)	%	TOTAL ($)
NHCE						
A	25,000	1,250	0.05	750	0.03	2,000
B	35,000	2,100	0.06	1,050	0.03	3,150
C	45,000	3,150	0.07	1,350	0.03	4,500
D	55,000	2,750	0.05	1,650	0.03	4,400
E	70,000	1,400	0.02	2,100	0.03	3,500
HCE						
F	110,000	7,700	0.07	-		7,700
G	120,000	8,400	0.07	-		8,400
Average NHCE	46,000	2,130	0.05	1,380		3,510
Average HCE	115,000	8,050	0.07	-		8,050
Average total	65,714	3,821		986		4,807

Table A4: Hypothetical firm under Administration's proposal

Worker	Compensation	Employee contribution ($)	%	Employer contribution ($)	%	TOTAL ($)
NHCE						
A	25,000	1,250	0.05	0	0	1,250
B	35,000	2,100	0.06	0	0	2,100
C	45,000	3,150	0.07	0	0	3,150
D	55,000	2,750	0.05	0	0	2,750
E	70,000	1,400	0.02	0	0	1,400
HCE						
F	110,000	11,000	0.1	0	0	11,000
G	120,000	12,000	0.1	0	0	12,000
Average NHCE	46,000	2,130	0.05	$ -	0	2,130
Average HCE	115,000	11,500	0.10	$ -	0	11,500
Average total	65,714	4,807				4,807

It is important to emphasize that this hypothetical example could not -- and clearly does not -- capture the full effects of changing the non-discrimination rules. Some analysts believe that loosening the non-discrimination rules will reduce the costs and complexity of providing pensions, increase pension coverage, and thereby actually raise the benefits accruing to workers at all income levels (Clark, Mulvey, and Schieber 2000), although little empirical work has been conducted on this issue. If the provisions creating LSAs and RSAs were enacted, however, the costs of non-discrimination rules would likely weigh more heavily than under current law. If employers and highly compensated employees could contribute $30,000 to these two accounts for themselves and their spouses, there may be much less tolerance for any costs associated with providing a employer-based pension plan.

Appendix B: Determinants and Estimates of Rollover Behavior

This appendix describes the set of calculations made to provide revenue estimates of induced changes in rollover behavior for households with income above $100,000. We assume there would be no changes in conversions for households with income below $100,000 since they can already convert their funds under current law.

A. Aggregate IRA balances

We estimate that households with income above $100,000 held about $900 billion in traditional IRAs in 2001. This estimate is obtained by estimating traditional IRA values from the 1998 Survey of Consumer Finances (using the procedure described in footnote 20), inflating by the proportional increase in aggregate IRA values from 1998 to 2001 in the Federal Reserve's Flow of Funds, and then deflating by 10 percent to account for Roth, nondeductible, and other types of non-traditional IRAs.

B. Determinants of the decision to convert to an RSA

Consider an investor with $A in a traditional IRA and $B in a taxable saving account. Let r be the pre-tax interest rate, τ be the tax rate, and n be the holding period. We set n equal to 70 minus the age of the head of household (assuming that the average dollar from an IRA will be withdrawn at age 70); and set r according to the current yield curve for Treasury bonds for maturity closest to n. The tax parameter is set at the average marginal tax rate for households given filing status, income category, age (over and under 65), and number of children (one, two, or three or more) calculated by the Tax Policy Center microsimulation model in 2003. The tax rate is assumed to be constant over time.

In n years, the traditional IRA, balance will grow to $A(1+r)^n$ and upon withdrawal in year n would net the taxpayer $A(1+r)^n(1-\tau)$. The $B in taxable assets will grow to equal $B(1+ r(1-\tau))^n$ after taxes in n years, so that her total after-tax wealth in n years is $A(1+r)^n(1-\tau) + B(1+ r(1-\tau))^n$. If the investor converts the IRA to an RSA in 2003, the entire tax-preferred balance A grows at the tax-free rate, and is withdrawn without tax liability in year n. But she pays a tax of τA in 2003 out of her taxable assets. Thus, she ends up with $A(1+r)^n + [B-\tau A](1+ r(1-\tau))^n$.

The value of her tax saving from conversion is the difference between the two expressions, or $\tau A(1+r)^n - \tau A(1+ r(1-\tau))^n$. The first term shows the benefits of being able to shelter more funds. The second term is the loss in future income due to the fact that taxes were paid in 2003 out of taxable assets. Taking the present value of that expression, and dividing by τA gives the tax savings as a share of the up-front tax payment:

$$PV = \frac{(1+r)^n - (1+r(1-\boldsymbol{t}))^n}{(1+r)^n} = 1 - \frac{(1+r(1-\boldsymbol{t}))^n}{(1+r)^n} \qquad \{1\}$$

While it is reasonable to assume that the likelihood of converting an IRA to an RSA would be an increasing function of the present value of the tax savings given in {1}, it is

unreasonable to believe that every household with a positive present value of converting would choose to convert. First, liquidity-constrained households may be unwilling to convert even in exchange for significant tax savings in present value. The smaller the required up-front tax payments relative to non-retirement financial assets, the more likely it is that a conversion will appear attractive. Second, the likelihood of converting depends on whether the taxpayer wishes to save more for retirement than he or she has been able to do in tax-preferred form. We posit that the greater the share of retirement assets in the households' overall portfolio of financial assets, the less likely the household would be to convert the IRA to an RSA, since the household is less likely to want to increase retirement saving.

C. Calibrating the parameters

Appendix Table B-1 identifies the share of traditional IRA balances that would be converted to RSAs for households with income below $100,000 under several different threshold values for the parameters noted above. For example, if people only converted when (a) the present value of the tax saving exceeded 20 percent of the up-front tax payment, (b) the current tax liability on the conversion would be less than 20 percent of existing financial assets, and (c) retirement assets were less than 50 percent of total financial assets, then households with income below $100,000 would convert about 2.9 percent of their traditional IRA balances. The table also shows wide variation based on reasonable variations in the parameters above.

We use these parameters to generate our central estimates for rollover behavior. We compute the values with τ set to its current-law level. As shown in Appendix Table B-2, using the parameter values noted above, we estimate that about $109 billion in IRA balances would be rolled over and would raise revenue in the short-term by about $37 billion. Again, there is wide variation in the results.

Finally, as noted above, rollovers represent a very expensive way for the government to borrow against future revenues. Appendix Table B-4 reports the ratio of the present value of the long-term revenue loss divided by the short-term gain. In the base case, that ratio is 1.32.

Appendix Table B1: Percent of IRA assets converted in households with AGI less than $100,000

	PV of tax savings greater than:	0.1	0.2	0.3
Taxes paid on conversion as % of non-retirement financial assets less than:				
.1		5.5	2.1	0.8
.2		8.4	2.9	1.1
.3		9.3	3.0	1.1

Note: Rollovers assumed to occur only when the ratio of retirement assets to total financial assets is less than .5.

Appendix Table B2: Predicted amount of IRA assets rolled over into RSAs ($ millions)

	PV of tax savings greater than:	0.1	0.2	0.3
Taxes paid on conversion as % of non-retirement financial assets less than:				
.1		143,649	74,694	49,474
.2		219,694	108,869	63,661
.3		270,548	143,128	80,938

Note: Rollovers assumed to occur only when the ratio of retirement assets to total financial assets is less than .5.

Appendix Table B3: Predicted short-term revenue gain from IRA rollovers ($ millions)

	PV of tax savings greater than:	0.1	0.2	0.3
Taxes paid on conversion as % of non-retirement financial assets less than:				
.1		49,217	25,714	17,165
.2		75,475	37,018	21,956
.3		93,381	49,481	28,242

Note: Rollovers assumed to occur only when the ratio of retirement assets to total financial assets is less than .5.

Appendix Table B4: Estimated cost per dollar raised from IRA rollovers

	PV of tax savings greater than:	0.1	0.2	0.3
Taxes paid on conversion as % of non-retirement financial assets less than:				
.1		1.24	1.33	1.37
.2		1.23	1.32	1.37
.3		1.24	1.31	1.37

Note: Rollovers assumed to occur only when the ratio of retirement assets to total financial assets is less than .5.
Notes: Marginal tax rates used in these calculations do not reflect the acceleration of marginal tax rate cuts proposed in the Administration's budget. Universe (except for Table B1): Households with 2003 adjusted gross income in $2001 over $100,000 with one and only one tax return. Married couples filing separately and non-married couples with two returns are excluded. Nonretirement assets equal total financial assets minus retirement assets. Financial assets were inflated from the 1998 SCF by the proportional increase in financial assets of the household and nonprofit sector from 1998 to 2001 in the Flow of Funds. IRA and Keogh assets were inflated from the 1998 SCF by the proportional increase in IRA and Keogh assets from 1998 to 2001 in the Flow of Funds; the remaining retirement assets were inflated from the 1998 SCF by the proportional increase in defined contribution assets from 1998 to 2001 in the Flow of Funds.

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Table 1: Tax-Preferred Savings Accounts

	Year created	Qualified use of funds	Eligibility rules	Contribution limits	Tax treatment	Changes under Administration proposal
Archer Medical savings account	1996	Unreimbursed medical expenses	Self-employed, small business owners, and employees of small business owners. All participants must be covered by a high deductible health plan (HDHP).	75% of HDHP deductible (family); 65% of HDHP deductible (self-only); no more than income	Tax-deductible contributions, earnings and distributions tax-free for qualified expenses	Could be converted to an LSA before 2004. Balance would be taxed on conversion. Could coexist with the proposed plans. Administration has proposed an increase in the contribution limits.
Coverdell Education Savings Accounts	1997	Certain elementary, secondary, and higher education expenses	Beneficiary must be under 18 (excluding special needs beneficiary) Modified AGI must be below $220,000 (married filing jointly), under $110,000 (single); phaseouts begin at $190,000 and $95,000, respectively	$2,000 per beneficiary	Tax-free earnings and withdrawals for qualified expenses	Could be converted to LSA before 2004. Balance would not be taxed on conversion. Could coexist with the proposed plans, including new contributions.
Qualified state tuition program (Section 529 plan)	1996	Tuition, room, board, fees, books, and supplies at accredited institutions of higher education.	Anyone can establish an account for a designated beneficiary.	Varies by state; the contribution limit is often high; for example, in California contributions are allowed until the account reaches $267,580	Tax-free earnings and distributions for qualified expenses	Could be converted to LSA before 2004. Balance would not be taxed on conversion. Could coexist with the proposed plans, including new contributions.
Lifetime savings account	Proposed	No limitations	Unrestricted	$7,500	Tax-free earnings and distributions	

Sources: Internal Revenue Service, "Medical Savings Accounts (MSAs)," Publication 969; Internal Revenue Service, "Tax Benefits for Education," Publication 970; UPromise, "529 Questions and Answers," available at www.upromise.com/savingsplans/ what529/faq.html; savingforcollege.com, "The 529 Plan Evaluator"; U.S. Department of Treasury, "General Explanations of the Administration's Fiscal Year 2004 Revenue Proposals," February 2003.

Table 2: Individual Retirement Accounts

	Year created	Eligibility rules	Contribution limits	Tax treatment	Interactions with other plans	Changes under the Administration's proposal
Traditional IRA	1974	Have earned income and not be in an employer-sponsored retirement plan or have AGI under $64,000 (married filing jointly) or $44,00 (single); phaseouts begin at $54,000 and $34,000, respectively. Must be under 70 ½	$3,000 for those under 50; $3,500 for those 50 and over	Contributions are tax-deductible; distributions before 59 ½ are subject to penalty with the exception of death, disability, a series of substantially equal payments, or: 1) health insurance premiums for the unemployed 2) qualified higher education expenses 3) qualified first-time home buyer expenses ($10k max)	Contribution limit applies to sum of contributions to all IRAs.	No new contributions after 2004, but accounts could remain in existence. Balance converted to an RSA would be taxed. Taxes on conversion before 2004 could be spread over four years.
Non-deductible IRA	1974		$3,000 for those under 50; $3,500 for those 50 and over	tax-free buildup	Contribution limit applies to sum of contributions to all IRAs.	No new contributions after 2004, but accounts could remain in existence.
Roth IRA	1997	AGI under $160,000 (married filing jointly) or $110,000 (single); phaseouts begin at $150,000 and $95,000, respectively.	$3,000 for those under 50; $3,500 for those 50 and over	Contributions are taxed; distributions are tax-free after the owner has held the account for 5 years and reaches 59 ½ , dies or becomes disabled, or uses the funds for qualified first-time home buyer expenses	Contribution limit applies to sum of contributions to all IRAs.	Would become an RSA as of 2004.
Retirement savings account	Proposed	Anyone with earned income	$7,500	Contributions are taxed; distributions are tax-deductible after a person reaches 58		

Sources: CCH Editorial Staff, *2003 U.S. Master Tax Guide* (Chicago: CCH Inc., 2002); U.S. Department of Treasury, "General Explanations of the Administration's Fiscal Year 2004 Revenue Proposals," February 2003.

Table 3: Defined Contribution Plans

	Year created	Eligibility	Contribution limits	Tax treatment	Interactions with other plans	Changes under the Administration's proposal
401(k)	1978	Private sector employees	Lesser of $12,000 or AGI for those under 50; $14,000 for those 50 and over	Contributions are tax-deductible; distributions are taxed. Distributions allowed upon termination of employment or plan, in case of financial hardship, or when the participant reaches 59 ½.	Limits the deductibility of a worker's IRA.	Would become an ESRA as of 2004
403(b)	1958	Employees of certain tax-exempt and public education institutions	Lesser of $12,000 or AGI for those under 50; $14,000 for those 50 and over	Contributions are tax-deductible, distributions are taxed.	Contribution limits applies to all plans.	No new contributions after 2004. Accounts could remain in existence.
Governmental 457 Plan	1978	Non-school state and local government employees	Lesser of $12,000 or AGI for those under 50; $14,000 for those 50 and over	Contributions are tax-deductible; distributions are taxed. Distributions allowed upon termination of employment, in case of financial hardship, or when the participant reaches 70 ½.	Not necessary to coordinate maximum deferral with contributions to other retirement plans	No new contributions after 2004. Accounts could remain in existence.
SIMPLE IRA	1996	Small business employees	$8,000 plus employer contribution (mandatory matching contribution not exceeding 3% of compensation or nonelective contribution of 2% of the first $200,000 of compensation); 50 and over, $1,000 unmatched catch-up contribution allowed	Contributions are tax-deductible; distribution rules the same as traditional IRAs	Employer may not maintain any other retirement plan.	No new contributions after 2004. Accounts could remain in existence.
SIMPLE 401(k)	1996	Small business employees	$8,000 plus employer contribution (mandatory matching contribution not exceeding 3% of compensation or nonelective contribution of 2% of the first $200,000 of	Generally same as 401(k) with additional limits on the employer deduction	Employer may not maintain any other retirement plan.	No new contributions after 2004. Accounts could remain in existence.

			compensation); 50 and over, $1,000 unmatched catch-up contribution allowed			
Salary reduction simplified employee pension (SARSEP)	1986	Small business employees After 1996, no employer could establish a SARSEP.	Lesser of $12,000 or AGI for those under 50; $14,000 for those 50 and over	Contributions are tax-deductible, distributions are taxed.		No new contributions after 2004. Accounts could remain in existence.
thrift plans	1954	Non-qualified plans that primarily benefit highly compensated employees who have contributed the maximum to a qualified plan; special rules apply to rank-and-file employees who participate because the employer does not offer a qualified plan that passes the nondiscriminatory coverage requirements	None	Employer deducts contributions to a funded plan; employee pays taxes on employer contribution if substantially vested; investment income tax-free, except for income attributable to employee contributions above employer contributions		No new contributions after 2004. Accounts could remain in existence.
Employer retirement savings accounts	proposed in 2003	Any employer can sponsor	Lesser of $12,000 or AGI for those under 50; $14,000 for those 50 and over	Contributions are tax-deductible; distributions are taxed. Distributions allowed upon termination of employment or plan, in case of financial hardship, or when the participant reaches 59 ½. After-tax contributions and tax-free distributions also allowed, subject to the maximum $40,000 (or 100% of salary) combined employer and employee contribution limits to defined contribution plans.		

Sources: CCH Editorial Staff, *2003 U.S. Master Tax Guide* (Chicago: CCH Inc., 2002); U.S. Department of Treasury, "General Explanations of the Administration's Fiscal Year 2004 Revenue Proposals," February 2003.

Table 4: Behavioral Responses and Their Effects

Behavioral Response	Comments	Revenue	Private Saving	National Saving	Distribution
(1) Transfer existing taxable assets into LSAs	Taxpayers should transfer as much as possible to LSAs. Transfers may be slowed because they must be made in cash.	$200B-$300B over 10 years. 0.2%-0.3% of GDP in year 10. Will continue to grow over time.	No direct effect (But higher wealth due to transfers could reduce new saving—see row 3.)	Negative	Regressive. Increasingly regressive over time.
(2) Place future saving that would have been done anyway in an LSA	After transferring existing assets, taxpayers will place their usual saving in LSAs.	Growing revenue loss over time.	No direct effect (but see row 3).	Negative	Regressive. Increasingly regressive over time.
(3) Change level of non-retirement saving	Higher rate of return may raise saving. Higher wealth from rows 1 and 2 would reduce new saving.	Uncertain.	Uncertain.	Uncertain.	Uncertain.
(4) Rollover traditional and non-deductible IRAs into RSAs		Shifts revenue from the long-term to the short-term. Present value of revenue falls.	No effect	Higher in the short-term. Lower in the long-term. Present value falls.	Only benefits households with income above $100,000.

(5) Place in RSA future saving that would have been via a traditional IRA		Same as above.	No effect	Same as above	None.
(6) Change in level of retirement saving contributions	Could rise for those constrained by current limits. Could fall because of elimination of up-front deduction.	Uncertain	Uncertain	Uncertain	Likely regressive (see text)
(7) Change in pension coverage	May rise due to simplification of pensions. May fall due to expansion of non-employer based saving options.	Uncertain	Uncertain	Uncertain	Uncertain
(8) Change in pension contributions, given coverage	Will fall, given the weakening of non-discrimination rules.	Higher in the short-term. Lower in the long-term. Present value rises.	Falls, since contributions by moderate income workers tend to raise saving.	Falls in the long-term	Reduces benefits for low and moderate income households

Table 5: Administration Estimate of Revenue Effects ($ billions), 2004-13

	Fiscal Year										
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Total 2004-2013
RSA/LSA	10.6	4.8	1.9	-0.6	-1.8	-1.9	-2.4	-2.7	-2.9	-2.9	2.0
ERSA	-0.2	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.4	-0.4	-3.0

Source: United States Treasury Department (2003b).

Table 6: Lifetime Savings Accounts: Revenue Cost ($ billions), 2004-13[1]

	Fiscal Year[2]										Total 2004-2013
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	
Baseline: current law for EGTRRA											
6% ROI[3]	10.2	14.9	19.3	23.9	28.7	33.8	39.1	46.9	53.6	59.9	330.2
6% ROI, Dividend Plan[4]	9.8	14.2	18.2	22.4	26.6	31.0	35.5	42.3	48.2	53.7	301.9
6% ROI, $3750 Maximum Contribution	6.0	8.9	11.7	14.7	17.9	21.3	24.9	30.1	34.7	39.1	209.0
3% ROI[5]	5.9	8.7	11.3	14.1	17.0	20.0	23.2	27.8	31.7	35.5	195.3
Baseline: EGTRRA extended through 2013											
6% ROI	10.2	14.9	19.3	23.9	28.7	33.8	39.1	44.8	50.6	56.8	322.0
6% ROI, Dividend Plan	9.8	14.2	18.2	22.4	26.6	31.0	35.5	40.4	45.6	51.0	294.6
3% ROI	5.9	8.7	11.3	14.1	17.0	20.0	23.2	26.6	30.1	33.7	190.6
15 year accumulation in 2004[6]	37.2	-	-	-	-	-	-	-	-	-	-
20 year accumulation in 2004[7]	45.6	-	-	-	-	-	-	-	-	-	-
25 year accumulation in 2004[8]	53.3	-	-	-	-	-	-	-	-	-	-
Equivalent Capital Income Exclusion[9]	$450	$938	$1,467	$2,040	$2,659	$3,328	$4,049	$4,827	$5,665	$6,567	-

Source: Urban-Brookings Tax Policy Center Microsimulation Model.

(1) Lifetime Savings Accounts are assumed to have a $7500 per account maximum after-tax contribution.

(2) Fiscal-year estimates assume a 75-25 split.

(3) The annual nominal return on investments inside the LSA is assumed to be 6 percent.

(4) The President's proposal to exempt some dividends from personal taxation is included in the baseline in this calculation

(5) The annual nominal return on investments inside the LSA is assumed to be 3 percent

(6) Assumes that LSAs have been in effect for the past 15 years with a real contribution of limit of $7,500 in 2003 dollars and a 3.5 perccent real return.

(7) Assumes that LSAs have been in effect for the past 20 years.

(8) Assumes LSAs have been in effect for the past 25 years.

(9) Equivalent capital income exclusions are in current dollars, and they correspond to the previous calendar year in which the fiscal year began.

GDP for FY2004 is estimated to be $11309 billionCBO (2003)

Table 7: Comparison of Benefits from the Creation of Lifetime Savings Accounts: Distribution of Income Tax Change by AGI Quintile

AGI Quintile[1]	2003	2010		Mature LSA[2]	
	Share of Tax Cut	Share of Cumulative Cut	Share of Tax Cut in the 10th year	Share of Cumulative Tax Cut	Share of Tax Cut in the 25th year
Lowest Quintile	1.8	1.2	0.7	0.8	*
Second Quintile	5.0	3.9	3.0	3.1	0.5
Middle Quintile	10.3	8.4	6.8	7.1	3.2
Fourth Quintile	22.5	21.8	20.5	19.7	15.6
Next 10 Percent	21.2	19.8	18.4	17.9	15.0
Next 5 Percent	15.2	15.1	14.8	15.0	15.9
Next 4 Percent	17.8	21.6	24.5	23.5	28.8
Top 1 Percent	6.2	8.2	11.4	13.0	21.0
All	100.0	100.0	100.0	100.0	100.0

Source: Urban-Brookings Tax Policy Center Microsimulation Model.

* Less than .05 percent.

[1]Filers with negative AGI are not included in this category but are included in totals.

[2]For purposes of this calculation CY2003 is used as endpoint of 25 years of accruals into LSAs with a maximum contribution of $7500 in constant 2003 dollars.