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THE IRAs ARE COMING

. . . AND SOME OTHER BREAKS, TOO

As we are reminded by the advertising campaigns now underway, January 1, 1982 is a very significant tax date--43 to 45 million more Americans will be eligible to set up their own individual retirement accounts (IRAs). Every financial institution from "We The People" on Wall Street to the smallest country bank in Iowa is gearing up to help these self-reliant souls make further plans for their retirement.*

With so-so Christmas sales and the hard goods/real estate markets in a deep funk, the banks and all are betting that a lot of taxpayers already covered by existing pension plans will want to sock away a couple of thousand dollars apiece in tax sheltered retirement accounts. The marketing blitz is on.

The IRA is an interesting animal. Originally authorized by the 1974 pension reform legislation (ERISA), IRAs were devised to fill the gap between KEOUGH or HR. 10 plans for the self-employed and qualified employer plans. It was felt that employees of firms not offering regular pension plans--and those for one reason or another not participating in such plans--should be able to obtain similar tax benefits. Hence, they were allowed to deduct contributions up to a maximum of $1,500 or 15% of earned income per year, whichever was less, to an account set up by a custodial institution. Income accruing in the account would be tax deferred until distribution was made, starting between age 59 1/2 and 70 1/2. Any distributions would be taxed as ordinary income with a 10% penalty on early withdrawals that were not rolled over into another account.

The 1974 IRA provisions were innovative but quite limited. The treatment was far less generous than for KEOUGH plans for the self-employed and, of course, excluded the prime market of those already participating in employer plans. Nevertheless, Treasury surveys estimated that there were about 30-32 million full-time workers eligible for IRAs in the 1975-80 period. By 1979 about 8% of that pool were making IRA contributions totalling $3.2 billion.

IRA UTILIZATION
1975-1979

	1975	1976	1977	1978	1979
Returns with Contributions (mils.)	1.2	1.6	2.0	2.4	2.5
Contributions ($bils.)	1.4	2.0	2.5	3.0	3.2
Average Contribution ($)	1,185	1,199	1,227	1,250	1,307

Source: Joint Committee on Taxation

*Or semi-retirement. As IRA funds may be withdrawn starting at age 59 1/2, a lot of folks probably will use them as a supplement to continued participation in the work force on either a full or part-time basis.

Under the Economic Recovery Tax Act of 1981 (ERTA 81), in addition to opening up the large new eligibility pool, contribution limits were raised to $2,000 or 100% of earned income, whichever is less, and the limit on spousal IRAs raised to $2,250. Otherwise, the structure of the IRA treatment was left basically the same.*

Treasury estimates that roughly the same pattern of utilization of IRAs will emerge for the new pool of eligibles as pertained in the past: 5% of the additional 43-45 million will set up IRAs in the first year, 1982; this proportion will rise to 10% by 1984; and thereafter the number of such IRAs will grow by about 10% per year, through 1986, anyway. Even with higher limits, the average contribution is expected to start out a little below that of existing IRAs, at $1,200 in 1982, then rising to $1,400 by 1984, and $1,750 by 1986. Total contributions for the new eligibles are forecast at $2.7 billion in 1982 rising to $9.5 billion in 1986. In addition, Treasury forecasts continued growth of IRA plans among those not covered by employer plans at about 12% per year.

ESTIMATED IRA UTILIZATION BY
PENSION PLAN PARTICIPANTS, 1982-1986

	1982	1983	1984	1985	1986
Returns with Contributions (mils.)	2.2	3.4	4.5	4.9	5.4
Contributions ($bils.)	2.7	4.5	6.4	8.4	9.5
Revenue Cost ($bils.)	.9	1.4	1.8	2.2	2.5
Average Contribution ($)	1,220	1,325	1,410	1,700	1,760

Sources: Dept. of Treasury, Joint Committee on Taxation, and Tax Foundation calculations

These projections seem modest indeed in view of the heavy media coverage promoting IRA accounts. The financial institutions seem to be counting on a much bigger potential. And they probably should. The leverage on tax sheltered investments can be very substantial as one moves up the rate structure. Even with the rate reductions under ERTA 81, large tax savings can be projected for an IRA investment held over any length of time as shown below:

CUMULATIVE TAX SAVINGS UNDER IRA
JOINT RETURN BY MARGINAL RATE

Year	Account Balance Assuming 10% Annual Return[1/]	Tax Savings By Marginal Rate		
		22%	38%	50%
1	$ 2,000	$ 440	$ 760	$1,000
5	12,200	2,684	4,636	6,100
15	63,480	13,966	24,122	31,740
25	196,440	43,217	74,647	98,220
40	883,860	194,449	335,867	441,930

[1/] With level $2,000 per year contribution
Source: Tax Foundation calculations

*Except that after 1981, "collectibles" are disallowed as IRA investments. This may take the edge off IRAs as a vehicle for the most dedicated gold and antique bugs, but probably is of little consequence to overall utilization.

Now those enticing ads promising to make IRA investors near millionaires by their retirement leave out a few details--like what's going to happen to interest rates and inflation. The 10% return used in the example above seems pretty conservative in the 1981 context, but remember that Treasury bonds never reached that level until 1979. Even more pertinent will be the level of real interest rates, the return after inflation, which has been extraordinary in 1981--7% or better--and greatly increasing the attractiveness of money market funds and other interest sensitive investments, including the "all savers" certificates. Most economists are assuming that real interest rates will retreat toward their historical 3% range even if nominal rates and inflation continue to fluctuate widely.

This is important for IRAs because basically they will be income investments. As all distributions from IRAs will be taxed as ordinary income, there is little incentive, except for special situations, to place equities with appreciation potential in IRA accounts. If the real rate of return settles back while inflation marches on, the attractiveness of IRA-type investments will not match the more extravagant claims of today's promoters.

FLEXIBILITY AND DISCIPLINE

With the above caveat, it's still easy to project more aggressive use of IRAs than contemplated in the Treasury estimates. For one thing, tax advantages for IRAs obviously appeal the most to upper-income groups. More than half of the taxpayers, both eligible for IRAs in 1979 and earning $50,000 and over, did participate compared to less than 10% for the overall eligible pool. The newly eligible pool will have a much higher average income, and many more of them are exposed to higher marginal rates. The tax benefits should prove attractive to this group as a limited program to round out their retirement plans almost regardless of the specific level of interest rates and competing investment opportunities.

Also, although the newly eligibles all have some retirement protection through employer plans, for a goodly number that protection is not assured--those that have not vested or are in occupations where turnover is high or where the plan benefits just aren't that generous. IRAs will be ideal for the high income job-hopper.

IRAs offer a lot of flexibility. They can be easily tailored to an individual's own economic situation and plans. As uncertainties grow about the future reliability and the value of Social Security benefits, IRAs may become even more attractive for those wanting to take more direct control of their economic future. You can choose from any number of investment plans or direct the investment yourself. You can set up new accounts or switch accounts entirely without penalty. You can rollover the entire proceeds of a lump sum payment from an employer plan into your own IRA. If your employer is willing, you can take an IRA deduction on voluntary contributions to a regular company plan. At this point, however, it's uncertain whether the advantages of regular payroll deduction of such voluntary contributions would be worth the administrative burdens involved.

Finally, IRAs provide a convenient form of discipline for keeping such investments in the savings stream and not used for current consumption. The penalty for early withdrawal before age 59 1/2--liability for current tax plus 10%--is probably enough to ensure that most investors won't do it, but not so severe as to eliminate the use of the funds in genuine hardship cases. This discipline as a means of keeping funds invested--and in the

process helping capital formation in general--should not be underestimated. If the conservative Treasury figures do turn out to be reasonably accurate, IRAs still will be contributing about $10 billion to gross national savings by 1986, at a revenue cost of about 25% of that figure. The actual net savings above that which would have been put into other investments is unknown, but could be substantial.

As IRAs become more widely used, pressure will build to expand the contributions limits. Already there is talk of allowing holders of the "all savers" certificates to roll them over into personal IRAs as a means of ending the "all savers" program on schedule next year, without heavy drains on the deposit institutions. If such policies are implemented, the IRA may well become a principal means of moving to a de facto consumption tax.

TOP RATE REDUCTION

There are other savings and work incentives built into ERTA 81. A limited exclusion for qualified stock dividends of public utilities is allowed for the 1982-85 period. ESOPS are made more available and a significant net interest exclusion is slated to go into effect in 1985. Incentive stock options are encouraged. The treatment of KEOUGH plans is greatly liberalized and the marriage tax penalty eased starting in 1982.

But by far the most significant change will be the lowering of the top marginal rate of tax on investment income from 70% to 50%. It goes into effect on January 1, 1982, except for capital gains purposes, where it is already in effect. This means that despite all the continuing argument over the wisdom of large across-the-board tax cuts in the 1982-84 period, a critical piece of the supply-side thesis will be in place very shortly, and individual investment decisions undoubtedly already are being affected. What's more, it's likely to stay in place regardless of what happens to the tax structure elsewhere. The Democratic majority in the House, which has been pretty critical of the overall shape of the Reagan tax program to say the least, actually took the lead last spring in advocating an immediate 20 point drop in the top tax rate to 50%. It seems that there is finally a national consensus that taxing any part of anyone's income in excess of 50% is really a futile business (even though that result may still obtain when state and local income taxes are included). It also should be noted that the House Democrats are on record in strong support of the IRA liberalization and most other savings incentives.

The tables that follow indicate the extent to which the major provisions of ERTA 81 will reduce liabilities for taxpayers in various situations and income classes over the next few years.

In the examples, we have made some arbitrary assumptions as to taxpayer's resources, investment income and ability to employ incentive provisions under ERTA 81 at various income levels. We also assume the inflation rate as per the Administration budget estimates--declining to 4% by 1986--and that the taxpayer's gross income in each case increases at the same rate as inflation. Nevertheless, we believe these do reflect the options open to millions of "typical" taxpayers. (See notes following the tables for specific assumptions.)

FEDERAL TAX LIABILITY UNDER PRIOR LAW AND ERTA FOR 1982-1986
TWO-EARNER, JOINT RETURN AT SELECTED INCOME LEVELS

MIDDLE INCOME--$30,000 IN 1982

	Prior Law	1982	1983	1984	1985	1986
1) Gross Income	$ 30,000	30,000	31,710	33,359	34,893	36,359
2) Personal Exemption	4,000	4,000	4,000	4,000	4,208	4,402
3) Dividend Exclusion	400	200	200	200	200	200
4) Marriage Deduction	0	300	634	667	698	727
5) All Savers Exclusion	0	500	500	0	0	0
6) Dividend Reinvestment Deduction	0	750	750	750	750	0
7) IRA Contributions	0	2,000	2,000	2,000	2,000	2,000
8) Itemized Deductions	3,500	3,500	3,893	4,273	4,448	4,621
9) Taxable Income	22,100	18,750	19,733	21,469	22,589	24,409
10)Tax Liability	3,805	2,618	2,555	2,776	2,922	3,228
11)Marginal Rate	(28%)	(22%)	(19%)	(22%)	(22%)	(22%)

UPPER-MIDDLE INCOME--$40,000 IN 1982

	Prior Law	1982	1983	1984	1985	1986
1) Gross Income	40,000	40,000	42,280	44,479	46,525	48,479
2) Personal Exemption	4,000	4,000	4,000	4,000	4,208	4,402
3) Dividend Exclusion	400	200	200	200	200	200
4) Marriage Deduction	0	600	1,268	1,334	1,396	1,454
5) All Savers Exclusion	0	1,000	1,000	0	0	0
6) Dividend Reinvestment Deduction	0	1,500	1,500	1,500	1,500	0
7) IRA Contributions	0	4,000	4,000	4,000	4,000	4,000
8) Itemized Deductions	5,800	5,800	6,324	6,830	7,124	7,408
9) Taxable Income	29,800	22,900	23,988	26,615	28,097	31,015
10)Tax Liability	6,169	3,612	3,515	3,908	4,200	4,802
11)Marginal Rate	(32%)	(25%)	(23%)	(22%)	(25%)	(25%)

UPPER-MIDDLE INCOME--$50,000 IN 1982

	Prior Law	1982	1983	1984	1985	1986
1) Gross Income	50,000	50,000	52,850	55,598	58,156	60,598
2) Personal Exemption	4,000	4,000	4,000	4,000	4,208	4,402
3) Dividend Exclusion	400	200	200	200	200	200
4) Marriage Deduction	0	750	1,586	1,668	1,745	1,818
5) All Savers Exclusion	0	1,000	1,000	0	0	0
6) Dividend Reinvestment Deduction	0	1,500	1,500	1,500	1,500	0
7) IRA Contributions	0	4,000	4,000	4,000	4,000	4,000
8) Itemized Deductions	8,100	8,100	8,756	9,388	9,799	10,196
9) Taxable Income	37,500	30,450	31,808	34,842	36,704	39,982
10)Tax Liability	9,151	5,756	5,606	6,174	6,509	7,316
11)Marginal Rate	(43%)	(33%)	(30%)	(28%)	(28%)	(33%)

HIGH INCOME--$200,000 IN 1982
(50% earned, 50% investment income)

	Prior Law	1982	1983	1984	1985	1986
1) Gross Income	$200,000	200,000	211,400	222,393	232,623	242,393
2) Personal Exemption	4,000	4,000	4,000	4,000	4,208	4,402
3) Dividend Exclusion	400	200	200	200	200	200
4) Marriage Deduction	0	1,500	3,000	3,000	3,000	3,000
5) All Savers Exclusion	0	1,000	1,000	0	0	0
6) Dividend Reinvestment Deduction	0	1,500	1,500	1,500	1,500	0
7) IRA Contributions	0	4,000	4,000	4,000	4,000	4,000
8) Itemized Deductions	42,600	42,600	45,222	47,750	49,926	52,008
9) Taxable Income	153,000	145,200	152,478	161,943	169,789	178,783
10)Tax Liability	73,128	60,049	60,241	62,376	65,338	68,924
11)Marginal Rate	(64%)	(50%)	(50%)	(49%)	(49%)	(50%)

Assumptions as to tables

1) Gross Income in each case after 1982 rises at the same rate as inflation estimated at 5.7% in 1983, 5.2% in 1984, 4.6% in 1985, and 4.2% in 1986.

2) Personal Exemption in each case for two-earner family with two dependents, indexed for inflation starting in 1985.

3) Dividend Exclusion assumes enough dividend income (or interest income under prior law) to utilize the full exclusion on joint return.

4) Marriage Deduction assumes 30% of income for lesser earning spouse (with no unearned income).

5) All Savers Exclusion assumes $500 exclusion for middle income and $1,000 for above in each 1982 and 1983.

6) Dividend Reinvestment assumes $750 deduction for middle income, and maximum $1,500 for above, in all eligible years.

7) IRA Contributions assumes $2,000 total contribution per year for middle income, and $4,000 above. Both workers ineligible before 1982.

8) Other Itemized Deductions assumes 23% of gross income. Zero bracket amount indexed for inflation starting in 1985.

9) Tax Liability and Marginal Rate reflects rate changes under ERTA in 1982 and 1983 and indexing starting in 1985.

Source: Tax Foundation calculations.

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Obviously, by adroit use of ERTA 81 provisions, some very substantial savings can be realized not only by those at the top of the heap but by millions of taxpayers with marginal rates between 30-50%.

How much good this will do in terms of encouraging capital formation and helping defuse the effect of large budget deficits on the capital markets remains to be seen. At the very top, only a handful now pay effective rates of tax of 50% or more. Most have enough sense and good enough accountants to use the existing smorgasboard of special tax relief provisions to lower their effective rates significantly. However, a good many of them still face much higher marginal rates of tax. According to the latest available statistics of income, over 700,000 taxpayers were exposed to marginal rates in excess of 50%, and nearly 9 million taxpayers faced marginal rates between 30%-50%.

The positive effect of reducing tax rates both at the top and well below 50% on marginal investment--whether it be in a risky business venture or moonlighting additional employment--is at the heart of the supply-side thesis for more dynamic economic growth. This process is also called trickle-down economics--a term which has never enjoyed a good press and that certainly was not improved by the public agonizing of the Budget Director last month. But it just might work.