To Roth or Not to Roth: The Worst of Budget & Tax Policy

National Tax Association – 102nd Annual Conference on Taxation
Denver, Colorado

November 12, 2009

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Outline

- The (Misinterpreted) Economic Equation
- Bad Budget Policy
- Bad Tax Policy
  - Inequitable
  - Messy & Complex
- Individual Confusion
The (Misinterpreted Equation)

- At a given tax rate, the individual and government is supposedly indifferent between regular pension and IRA treatment and Roth treatment.

- Formally, \((1-t)[R^n] = [R^n](1-t)\)
The (Misinterpreted) Equation, cont.

- Assumes:
  - \( t \) constant across time for each taxpayer
  - \( r \) constant across investments for individual
  - \( r \) constant between borrowing and investing
  - \( r \) constant for government
  - Investors do not have special knowledge of markets
  - Net amount deposited the same
    - \( X \) in non-Roth equivalent to \((1-t)X\) in Roth
Budget Consequences

- Revenue raising in budget window
  - But revenue losses can continue for two generations
  - Encourages all sorts of game-playing (e.g., Congress spends the money up front in a “revenue-neutral” bill
  - Yet another burden on future generations

- Present Value Losses for Government
  - High return assets in Roth, low return (& lower bracket taxpayer) in non-Roth
  - Human capital (e.g., knowledge of a good investment) put into Roth
    - Business opportunity: borrow at 3%, earn 5%
    - Net investment = $10,000 but really worth $1 million
Tax Policy: Equity Consequences

- Not a tax on income or ability ex post or consumption
- More like a head tax up front (other than differences in initial tax rate, which may have little to do with later success)
- Example:
  - A invests $10,000 and makes $1 million.
  - B invests $10,000 and loses it all.
  - Both start in same bracket and pay same tax
- Whether the government loses is a separate question
Tax Policy: Efficiency & Administration

• Leaving taxpayers choices almost always a bad idea
  • They spend time sorting for non-economic reasons
  • The sorting adds to the budgetary losses

• More Tax Arbitrage Opportunities
  • Interest paid is deducted, interest received is not taxed
  • With Roth easier to borrow & invest short-term (non-Roth harder to withdraw short-term)

• Measuring “income” for tax and expenditure purposes
  • Phase outs of various tax benefits (itemized deductions, EITC)
  • Phase in and out of various expenditures (Food Stamps, Social Security taxation, Medicare premiums)
For individual

- Base case: in higher bracket later, then put money in Roth
- But individual should consider:
  - Higher income limits in Roth
  - Higher deposit amounts by amount of pre-paid tax
  - Tax advantages to sorting portfolio (riskier, higher return, in Roth)
  - New short-term tax arbitrage opportunities
  - Longer withdrawal or deferral period (limited required withdrawal all the way through the lives of heirs)
  - Further timing of income/deductions
    - For example, at 50% charitable deduction cap, relatively better to put money in Roth since only lose ½ of up-front deduction
Summary

- Roth IRAs and 401(k)s represent the very worst type of budget and tax policy

- For individuals they offer many sources of potential tax gain