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**Commentary**

## **Baby Boomers Have the Last Word**

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One of the most interesting developments of the past 20 years in capital markets, personal finance and the economy has been the remarkable expansion of tax-deferred saving. Tax-deferred saving vehicles like individual retirement accounts (IRAs), private pensions including 401(k)s, certain life insurance products, and government pensions have all become a part of life. That wasn't the case even a generation ago.

According to Fed data, the assets in these vehicles have increased roughly tenfold in nominal dollars since 1981, compared to only 350% for nominal GDP. They currently total about \$11 trillion. Rough estimates suggest \$400 billion per year is contributed and a similar amount withdrawn each year. The balances grow (or as in 2001 and 2002, shrink) with market returns (net of fees) on the various investments in the accounts, plus contributions less withdrawals.

Because the withdrawals from these balances will be taxed as ordinary income, the federal government has accrued what might be called a deferred-tax asset on a hypothetical balance sheet. The money in tax-deferred accounts is still counted on to yield future taxes. At current marginal tax rates in the high twenties, the DTA would equal about \$3 trillion, about the size of the national debt held outside the government.

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Much traditional saving has historically been taxed twice -- first when the saving was out of after-tax dollars, again when returns such as interest and dividends were earned and nominal capital gains realized. The corporate, estate, and state and local income taxes raise effective tax rates still higher, although lower capital gains rates and deductible interest on debt work in the opposite direction (the recent reductions in dividend taxation and marginal rates reduce, at least temporarily, the net tax on saving).

Tax-deferred saving vehicles, in contrast, allow contributions out of before-tax dollars, and allow returns to build up inside without current tax. Withdrawals later in life are taxed as ordinary income. "Roth" IRAs accomplish "single taxation" the other way around: you put in after-tax dollars but pay no tax on withdrawals. Over time, contribution limits have been raised, and new vehicles added for college tuition and health costs.

Treasury proposes a major expansion, simplification and reorientation of tax-deferred saving. Three omnibus vehicles would be created: one for employer retirement plans, one for households' retirement plans, and one for any purpose from which withdrawals would be made preretirement without penalty. Contribution limits would be increased, existing plans rolled in to the new ones, but two of the three would be like Roth-IRAs with the tax relief coming at withdrawal, not up front by deducting the contributions. The higher contribution limits would tend to increase saving, but the back-loading of the tax relief might have the opposite effect. The government, of course, would shift from losing revenue up front and making it up at withdrawal to the other way around.

Understanding the reach, efficacy and implications of these deferred-tax saving vehicles is important in its own right -- and as part of a broader set of economic issues such as assessing household and government balance sheets, fiscal history, and future saving. Do the contributions represent largely new saving, or do they merely divert saving from taxable to tax-deferred status? Do they really reduce the marginal tax rate on new saving, or do the contribution limits make the saving inframarginal? Are early revenue losses made up later, or do they lose revenue permanently? Economists have been divided on these issues. I tend to side with the optimistic camp and believe they have been a powerful net wealth accumulator thus far.

Consider what's ahead for deferred-tax accounts. If -- and it's a big if -- historical contribution, retirement and withdrawal patterns continue, contributions will run in the tens of trillions of dollars. Withdrawals will be somewhat more, and the balances more than double, over the next decades. The growth of the withdrawals will add a growing elderly constituency keen on lower income taxes to the predicted future generational split on budget policy.

As the balances grow, so does the deferred-tax asset on the hypothetical federal government balance sheet. From 1981-92, the growth in this already-accrued deferred tax asset was equal to between 40% and 50% of the growth in the national debt; since then, a multiple of the more slowly growing debt. Forty years from now, it will be much larger: There will be growing flows of taxes on the withdrawals and large tax deductions and revenue losses and associated interest cost effects. The new net national saving caused by these accounts, to the extent it affects domestic investment, would affect the capital stock and hence business taxes (a point first made by Martin Feldstein a decade ago).

The growth in taxes on withdrawals relative to GDP is not fully included in long-run government revenue forecasts. That more attention is focused on the withdrawals, taxes on the withdrawals and how to interpret these and other issues (such as real bracket creep) in long-run revenue projections will pay off down the road.

What happens to the withdrawals from these accounts? What fraction will be consumed and at what rate, and what fraction will be bequeathed? Just observing the disposition of these funds does not quite answer these questions; you could spend down the balance to zero, but doing so might enable you to bequeath your home. The effect on saving and

consumption is even more complex than that, as it could have affected earnings and consumption in pre-retirement years.

Economic models of these issues have evolved in recent decades. The Keynesian notion of consumption as a function of current disposable income has given way to models with longer time horizons, expectations about future income and taxes, and the incentive effects of marginal tax rates. Franco Modigliani's life-cycle theory argued that saving in pre-retirement years is primarily to finance consumption in retirement, and that accumulated wealth would be fully consumed by each generation. The theory does not accord well with evidence that the elderly do not reduce their wealth much and the demand for annuities appears to be weaker than predicted.

This view would imply that any effects of tax-deferred saving on capital formation would accumulate for a while at the start of the program, reach a peak, then decline, but leave a permanently higher capital stock. Harvard's Robert Barro focused attention on bequests as a mechanism offsetting public debt. Boston University's Larry Kotlikoff and current Harvard President Larry Summers estimated that 80% of the capital stock was due to intergenerational transfers, not life-cycle saving. (That's not the same thing as 80% of withdrawals being bequeathed.) More recently, economists' models of still longer horizons and feedbacks between investment and the growth rate suggest much larger effects of tax policy changes on the capital stock than does the life-cycle model.

So if the main goal of tax-deferred savings instruments is to stimulate saving, the size and time pattern of the effect on capital formation depends on which view best describes the economy. Perhaps each is partially correct. In any event, academic thinking has been moving toward longer-horizon modeling. This is important not just to get an entry on a projected future government balance sheet. The future flow of private domestic saving into the capital market will depend on these issues. While the bulk of recently accumulated fortunes will be bequeathed -- and perhaps only the returns spent -- what about the vast flows of withdrawals from deferred-tax accounts?

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If the life-cycle view is correct, and the funds withdrawn are fully consumed in post-retirement years, the combination of the maturation of these vehicles, some started in the 1980s, with the retirement of the baby boomers will decrease the relative size of the flow of domestic saving in coming years. To the extent the longer views are correct, the dissaving will be attenuated. The boomers, richer, better educated, longer-lived with fewer children, may consume differently in retirement than their parents. Thus, the baby boomers, whose life cycle has brought successive waves of school expansion, labor force entry, household formation, consumption growth and impending retirement, will have a lot to say about the pool of domestic capital in coming decades, and about which of these economic theories endures.

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