CENTER *for* RETIREMENT RESEARCH *at* BOSTON COLLEGE

To: Connecticut Retirement Security Board

From: Center for Retirement Research at Boston College (CRR)

Date: 4/17/2015

Re: Conventional vs. Roth IRA

Connecticut must decide whether to use a conventional or a Roth IRA. While the two approaches are virtually identical in theory, the Roth seems better suited to the lower-income population whose employer does not provide a retirement plan.

The conventional IRA allows the participant to make a tax-deductible contribution and accrue earnings tax free until the money is withdrawn in retirement. In contrast, initial contributions to a Roth are not tax deductible, but earnings accrue tax free and no tax is paid when the money is withdrawn in retirement.

Although the conventional and Roth IRAs may sound quite different, they offer virtually identical tax benefits, assuming a constant tax rate before and after retirement. If an individual contributes \$1,000 to a conventional IRA, then after n years, the IRA would have grown to $\$1{,}000(1+r)^n$. When the individual withdraws the funds, both the original and accumulated earnings are taxable. Thus, the after-tax value of the IRA in retirement is $(1-t)\ \$1{,}000(1+r)^n$. In the case of a Roth, an individual pays tax on the original contribution, so he puts (1-t) \$1,000 into the Roth. After n years, these after-tax proceeds would have grown to $(1+r)^n(1-t)\ \$1{,}000$. Since the proceeds are not subject to further tax, the after tax amounts under the conventional and Roth IRAs are identical: $(1-t)\ \$1{,}000\ (1+r)^n = (1+r)^n(1-t)\ \$1{,}000$.

Despite this theoretical identity, the Roth is better suited for the population Connecticut seeks to cover under its new state plan.

1. A Roth provides a balance between retention and liquidity for a population that may need to access its funds for emergencies. Since the tax is paid upfront, contributions can be withdrawn tax free, whereas an individual withdrawing funds from a conventional account would have to pay income taxes plus a 10-percent penalty. While the conventional account has the appeal of an upfront tax break, this instant gratification is probably much less salient to those in lower tax brackets. Considering the population targeted, the possibility a newspaper story – about a family paying a 10-percent penalty to use money in their account to repair their roof – could fatally harm this initiative.

2. To the extent that those uncovered low earners see their earnings rise over the course of their careers and therefore face higher tax rates in retirement, a Roth allows them to pay low taxes upfront.

3. Determination of eligibility is simpler. Roth IRAs have a straightforward income limit: $131,000 of modified adjusted gross income for a single person and $193,000 for a married couple in 2015. Conventional IRAs have an income limit only if an individual is covered by an employer-sponsored plan; otherwise, they have no limit, which might be confusing for people going in and out of the state system.

4. Several other factors, less important to low-income workers, might also argue for a Roth:
    a. Contribution amounts are greater for a Roth. Although individuals can contribute $5,000 under both plans, for an individual in the 25-percent personal income tax bracket a $5,500 after-tax contribution is equivalent to $7,333 before tax.
    b. Roth IRAs are not subject to the required minimum distribution requirements at age 70½.
    c. Roth withdrawals are not counted toward the taxation of Social Security benefits.

These advantages explain why the Administration adopted a Roth IRA for its Auto-IRA and MyRA proposals, and virtually all states considering a system for their uncovered workers are focused on a Roth.

In addition to the suitability of Roth IRAs to the needs of the uncovered workers, a Roth IRA might will not result in a loss of income tax revenue in the short-term – an important consideration in light of the legislative requirement for the proposed program to be self-financed.