IRET Congressional Advisory

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TIME TO TERMINATE TAX BIAS AGAINST SAVING

Tax time has rolled around again, and the income tax bias against saving continues to depress economic growth, wages, and personal income. In January, the National Commission on Economic Growth and Tax Reform called for elimination of the income tax bias against saving. The commission's report reviewed several generic approaches to providing neutral tax treatment for saving and investment. One approach is to allow a tax deduction for income that is saved, deferring tax on that income until it is withdrawn at a later date for consumption. Such an approach can be incorporated in a complete overhaul of the income tax. Alternatively, it can be adopted as a stand-alone measure that would accomplish a large part of the tax restructuring agenda, but without some of the complications of a full-scale rewriting of the tax code.

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Such a stand-alone measure has already been introduced in the Congress by Senator John Breaux (D-LA) as S. 159, and by Representative Jim McCrery (R-LA) as H.R. 328. Their bills, based on a proposal by the Savers & Investors League, would permit unlimited tax deductible contributions to individual investment accounts (IIAs) by all taxpayers.

The Nunn-Domenici tax reform proposal, the Armey flat tax bill, and the American Dream Savings Accounts in the GOP House Contract With America would also reduce the bias against saving to various degrees. The Nunn-Domenici and Armey reforms are likely to require extended debate before any chance of passage. The American Dream Savings Accounts would eliminate some of the existing penalties on saving, but only for limited uses. The Individual Investment Account proposal, on the other hand, is a clean, stand-alone measure that would itself be a major income tax reform.

Renewed interest in the Congress in reducing the tax bias against saving is all the more important since enactment of the Omnibus Budget Reconciliation Act of 1993 (OBRA93). OBRA93 increased the tax bias against saving by raising individual and corporate marginal income tax rates, permanently extending phase-outs of itemized deductions and personal exemptions, tightening rules limiting contributions to private pension arrangements, and limiting capital gains treatment of several types of financial transactions. These provisions are bound to retard private sector saving, capital formation, and economic growth.

The Breaux and McCrery bills, similar to the unlimited savings deduction legislation introduced in the 102nd Congress by Representatives Dick Schulze (R-PA) and Ed Jenkins (D-GA), continues the campaign for one of the boldest, most imaginative, and most constructive pro-growth tax initiatives in many years. The bill would permit taxpayers to defer taxes on saving without restrictions as to the amount of saving or time of withdrawal. The bill

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would all but eliminate the individual income tax bias against personal saving. It would contribute to higher levels of saving, investment, productivity, and income than now exist.

IIAs would have these features:

- Unlimited tax deduction of amounts saved.
- Tax-free investment growth until withdrawal.
- No penalty tax on withdrawal at any age.
- No forced distribution at any age.
- No income tax at death. Heirs may maintain the IIA with the benefactor's cost basis.
- No estate tax on IIA assets.
- Rollover of up to $15,000 (indexed for inflation) from an IIA into the first purchase of a principal residence (with an equal reduction in the tax basis of the house).
- Tax-free rollover into the IIA of the proceeds from the sale of a principal residence.
- In addition to currently-allowed IRA vehicles, tax deductible premiums for life insurance if proceeds are payable into an IIA.

IIAs, unlike IRAs, would not be limited to retirement saving. IRAs have been justified as an incentive for taxpayers to save for retirement. This is too narrow a focus. IRAs should be thought of as a very limited means of offsetting the current bias in the income tax against saving.

Income is taxed when earned. If the income is used for consumption, there is no further federal income tax imposed (though there may be small sales or excise taxes). However, if the income is saved, the earnings of the saving are taxed repeatedly (and, if later used for consumption, may also face excise or sales taxes). The income tax thus raises the cost of saving compared to that of current consumption.

A neutral tax code would not penalize saving relative to consumption. There are two ways to make the taxation of saving and consumption neutral. Either income that is saved should be exempt from tax (as in traditional IRAs, 401(k) plans, etc.) and the earnings of the saving and the principal taxed upon withdrawal, or the amounts saved should be taxed when earned but the earnings should be tax exempt (as with tax free securities or the "back-ended" type of IRA offered in the Bentsen-Roth bill in the 102nd Congress).

The bias in the income tax extends to all taxable saving, not just that for retirement. To create a neutral tax system, all saving, whether for retirement, buying a house, college tuition, a new car, or protection against a rainy day, should receive the same treatment as in a tax-deferred income plan.

IRAs, as currently constituted, have several short-comings. There are limits on the amounts that can be deducted. Consequently, IRAs give no added incentive to save to those who are already doing long-term saving in amounts above the limits. Amounts withdrawn from an IRA before age 59-1/2 are subject to a penalty in addition to tax. This makes IRAs unattractive to lower income savers who cannot afford to save separately for emergencies, to buy a home, to pay tuition and other near-term goals, as well as a more distant retirement. There is a mandatory age (70-1/2) for beginning to withdraw from IRAs to force commencement of recapture of the tax deferral.

All saving contributes to capital formation, productivity, and national income, regardless of the motive behind it. There is no economic reason for the government to discriminate against or discourage any type of saving. In addition, paying for the projected costs of providing for the retirement of the baby boom and generation Xers will only be possible if private saving is increased substantially and soon.

The IIA proposal avoids all these pitfalls. IIAs will generate a greater incentive to save among upper-income savers, be of far greater safety and appeal to lower-income savers, and encourage more saving by the elderly and their heirs than current IRAs.

Some might object that the near-term cost to the Treasury would make unlimited IIAs too expensive

for the federal budget. This fear is groundless for several reasons.

First, when the contribution to an IIA constitutes new saving that would not have been done in the absence of the incentive, there would be no loss to the Treasury over the lifetime of the IIA. The tax on the contribution would be deferred, not lost. The contribution would grow with interest, and the tax on the compounded principal would equal in present value the tax forgone when the contribution was made. There would be no loss of tax, relative to current law, from letting the interest accumulate tax-free, because the saving would not otherwise have been done, and there would have been no interest to tax without the IIA treatment.

Second, insofar as a portion of the saving would have been done in the absence of the IIA treatment, the deferred tax on the compounded contribution would be recouped with interest. The annual taxation of the interest would be forgone, but would be more than offset as that portion of the IIA which constituted new saving added to the GNP and raised revenues from other taxes on the added income.

For the most part, then, the present value of the taxes collected by the Treasury would not be reduced, only altered in its timing as a result of IIA treatment of saving.

Might the delay in collection of the tax and greater near-term government borrowing decrease national saving and increase "crowding out" of private borrowing? In practice, the answer is "No." The amount of added government borrowing would equal the IIA contribution times the taxpayer's marginal tax rate — 15%, 28%, 31%, 36%, etc. If the fraction of new saving in each IIA contribution equaled the tax rate, e.g., if $28 of a $100 contribution were new saving by a middle income contributor, then that saving would equal the added borrowing by the government, and national saving would not fall. The leading researchers into the effect of traditional IRAs on saving behavior have concluded that some 60% to 80% of IRA saving was new saving by contributors, well above the minimum needed to produce "crowding in" of added saving, not crowding out. Similar results would be expected from IIAs.

Because IIA saving would in large part be new saving, IIAs would add to the amount of investment and growth of the economy, and would raise productivity, employment, wages, and profits. The added income would be subject to tax. When the higher corporate and personal income taxes and the added payroll taxes are factored in, IIAs are seen to be clear revenue raisers for the government over time.

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Note: Nothing written here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before Congress.