



The Heritage Foundation

Background

Executive Summary

No. 1309

July 26, 1999

HOW TAXES REDUCE SAVINGS

DANIEL J. MITCHELL

Today's tax code confiscates a large portion of peoples' earnings and imposes a higher burden on income that is saved and invested than it does on income that is consumed. Indeed, the government may subject any returns from investments to as many as four layers of tax. These additional taxes send a very clear message: Spend your money, don't save it. Indeed, considering all the ways taxes punish savings and investment today, it is surprising that anyone saves at all.

Although the income tax is the biggest culprit, Social Security taxes also have an adverse impact on savings. Simply stated, workers save less because they expect the government to provide for them when they are senior citizens. The impact of Social Security is particularly profound among lower- and middle-income taxpayers; the 12.4 percent payroll tax, especially combined with other taxes, leaves them with very little disposable income. What makes this particularly frustrating is that workers could enjoy significantly better retirement income if they were allowed to shift a portion of their payroll taxes to personal retirement accounts.

Fixing the tax code's bias would be good for workers and good for the economy. To help more Americans to save more,

1. Individual retirement accounts (IRAs) should be made universal. Traditional IRAs

and employer-sponsored 401(k) accounts allow the taxpayer to defer taxes on income that is saved. This eliminates double taxation on the "front end." Back-ended or Roth IRAs also avoid double taxation of savings, but they use the opposite approach: Income is taxed once in the year it is earned, but there is no second layer of tax if the money is saved and generates a return. Unfortunately, onerous restrictions limiting who can participate and the amount that can be saved accompany both types of IRAs today. The ideal solution is to make both types of IRAs universal, allowing all taxpayers to save as much as they want without facing double taxation.

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2. Double taxation on other forms of savings should be eliminated. Ending IRA restrictions would boost retirement savings but not help families trying to save for home purchases,

educational expenses, unanticipated health care costs, or any other reason. All savings should be protected from double taxation. One easy way of achieving this goal would be the elimination of withdrawal restrictions on IRAs (in other words, allowing people to access their money at any time for any reason).

- 3. The Social Security system must be reformed to allow all workers to save more for retirement.** Many workers, particularly those with lower incomes, find it difficult to save for retirement because there is little or no income left after fulfilling basic financial obligations. And because taxes are the largest portion of the average family's budget—exceeding the cost of food, clothing, shelter, and transportation combined—reforms that would allow workers to shift payroll taxes into personal retirement accounts would have an immediate and long-range beneficial effect.
- 4. Tax penalties on dividends, estates, capital gains, and other forms of capital should be eliminated.** Dividend income is taxed twice under current law. Ending this bias against

corporate investment requires that dividends either be exempt from the corporate income tax or the personal income tax. A neutral tax code also would require the elimination of the capital gains tax and the death tax. These taxes are imposed on assets, yet any income generated by these assets already is subject to tax.

America does not face a savings crisis, but the level of savings in the economy is significantly lower than it would be in the absence of ill-advised government policies. The income tax code confiscates too much income, imposes excessive layers of tax on capital, and biases individuals and businesses toward consumption.

The current tax bias against savings and investment should be eliminated. Replacing the tax code with a simple and fair flat tax is the ideal solution. Not only would a flat tax ensure that savings no longer would be double taxed, but it also would fix all the other problems in the current tax code.

—Daniel J. Mitchell is McKenna Senior Fellow in Political Economy at The Heritage Foundation.



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The fact that Americans save very little today should come as no surprise. Federal taxes—which are at an all-time high—significantly lower the income that Americans could save and use for capital formation. Even worse, the tax burden on savings and investment is much heavier than the tax burden on consumption. If a taxpayer spends his disposable income (what is left after taxes), he will pay very little, if any, additional federal tax. But if he chooses to save and invest that income, he will be penalized by the tax code. Depending on the ways he invests it, the government may subject any returns from the investment to as many as four layers of tax. These additional taxes send a very clear message: Spend your money, don't save it. Indeed, considering all the ways that taxes punish savings and investment today, it is surprising that anyone saves at all.

The adverse impact of these policies is compounded by a Social Security system that makes it particularly difficult for workers to save and enjoy a more comfortable retirement. Simply stated, they save less because they expect the government to provide for them when they are senior citizens. The impact of Social Security is particularly profound among lower- and middle-income taxpayers; the 12.4 percent payroll tax, especially combined with other taxes, leaves them with very little disposable income.

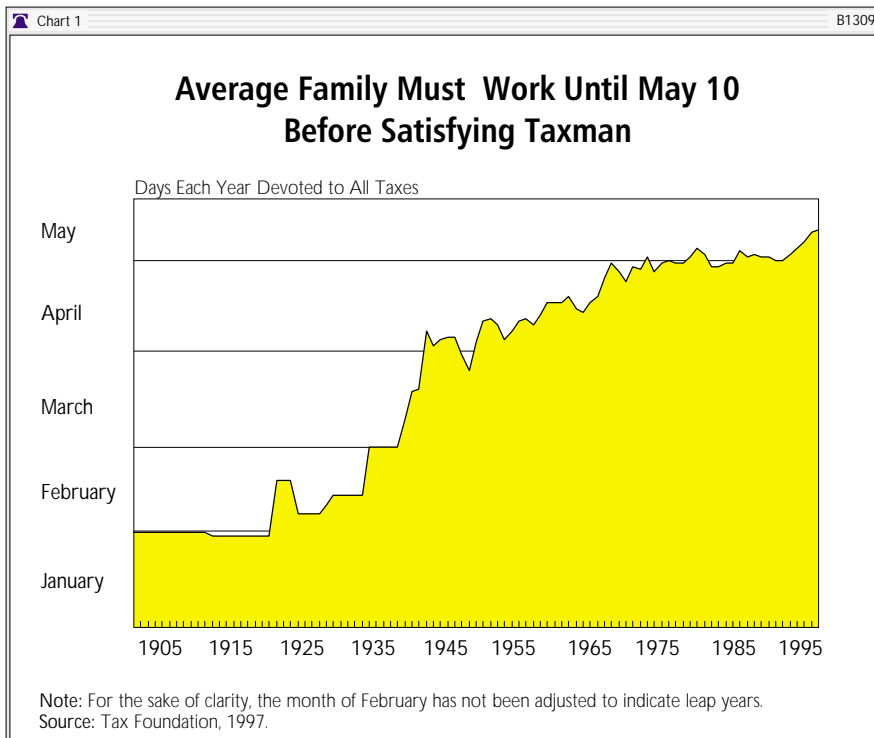
Tax policies that punish savings and investment are counterproductive. As every economic theory (including Marxism) teaches, capital formation is necessary to raise wages and stimulate long-term economic growth. Policy-makers who want to boost savings should eliminate the anti-savings provisions in the federal tax code, preferably by replacing the code with a simple and fair flat tax that would end multiple taxation of capital. To the extent that such fundamental reform is not immediately possible, there are a number of incremental steps Congress should take to alleviate the bias against savings and move toward a flat and fair tax system in the future:

- Individual retirement accounts (IRAs) should become universal, so that all taxpayers could save as much as they want without being taxed twice;

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- The double taxation on other forms of savings should be eliminated;
- The Social Security system should be reformed to allow all workers to shift payroll taxes into personal retirement accounts; and
- Tax penalties on dividends, estates, capital gains, and other forms of capital should be eliminated.

Not surprisingly, the anti-savings bias in the current tax code has a negative effect on savings. According to the U.S. Department of Commerce, Americans' personal savings rate for the first half of 1999 fell below zero.¹ Some would argue that the country's low savings rate is the result of Americans who are too shortsighted and too consumption-oriented, and businesses that are too focused on their short-term profits. Many of these critics believe an education campaign is all that is needed to convince people to act in their own best interests.

Yet there is very little reason to believe that people are acting irrationally by choosing not to save, or that they can be browbeaten into saving more of their hard-earned after-tax dollars. Low savings rates are a logical response to policies that impose high marginal tax rates on savings and otherwise reduce the incentive to defer consumption. More specifically, taxes on interest, dividends, capital gains, and estates raise the *cost* of saving versus consumption and drain capital away from the economy.

WHY PEOPLE SAVE

Understanding why people save makes it easier to understand the ways in which taxes have a big impact on savings. People who save make the decision to consume their earnings sometime in the future instead of today. Their saved income becomes an asset, which usually earns additional income from interest and dividends. And if the asset goes up in value, the individual benefits from a capital gain. If the individual reinvests those earnings, the asset's value increases again and the saver benefits from compounding. As a result, the decision to save enables people to build wealth, consume significantly more tomorrow than they could today, and protect their families against unforeseen expenses.

The more individuals save for both the short and long term, the greater freedom and peace of mind they enjoy. A youngster mowing neighborhood lawns may save during the summer to buy a new bicycle. A young couple may save for a few years to make a downpayment on a new house. A family may save for a decade to put a child through college. A worker may save for 40 years to ensure a comfortable retirement. An elderly couple may choose to live frugally in order to pass greater

1. Jeannine Aversa, "U.S. Savings Rate Falls to Another Record Low," *The Washington Post*, June 29, 1999, p. E5.

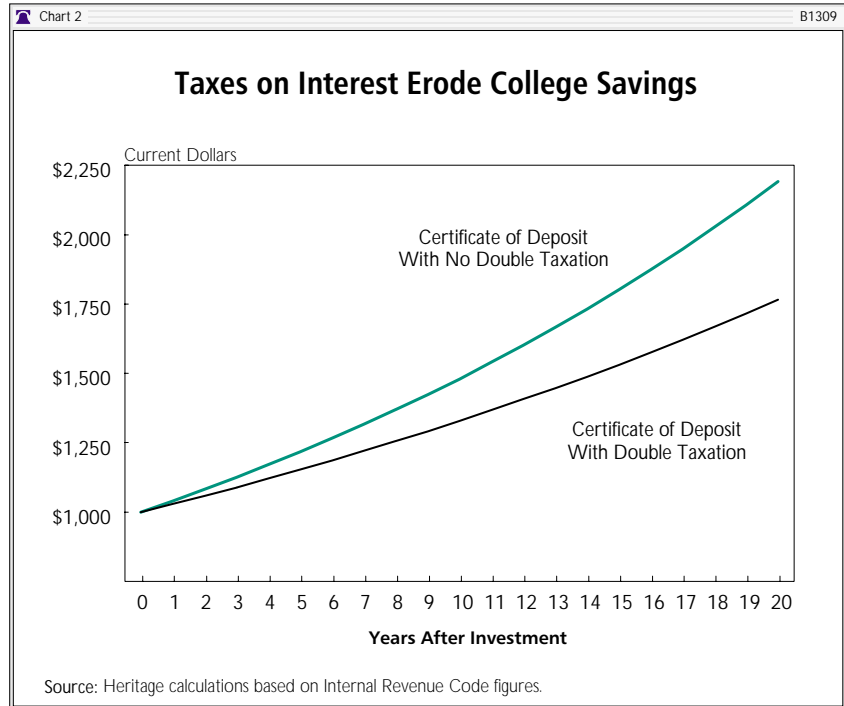
savings on to their children and grandchildren. In each case, the act of saving results in extra consumption in the future. The saver or the family of the saver is rewarded with a better standard of living.

HOW THE TAX CODE PUNISHES THOSE WHO SAVE

Today's tax code confiscates a large portion of peoples' earnings; it also imposes a higher burden on income that is saved and invested than it does on income that is consumed. This burden reduces the ability of families to save for the future.²

According to the Tax Foundation, the average American family now works until May 10 to earn enough income to satisfy the demands of federal, state, and local tax collectors. Forty years ago, "Tax Freedom Day" was April 9. Losing an additional month of income to taxes forces families to cut back in other areas. Because spending on food, shelter, and other necessities cannot be eliminated, families have little choice but to save less.

Although taxing too much reduces savings, the biggest problem is that the tax code imposes extra layers of tax on savings and investment. This bias artificially makes consumption more attractive and savings less attractive. The most obvious bias is the double tax on savings. As mentioned above, taxpayers who spend after-tax income incur little or no further federal tax liability. But those who save and invest are not so fortunate. Even though their saved income was taxed when it was first earned, any interest or other earnings generated by the savings or investments is subject to an additional tax. To make matters worse, some income will be taxed three or four times by capital gains taxes,

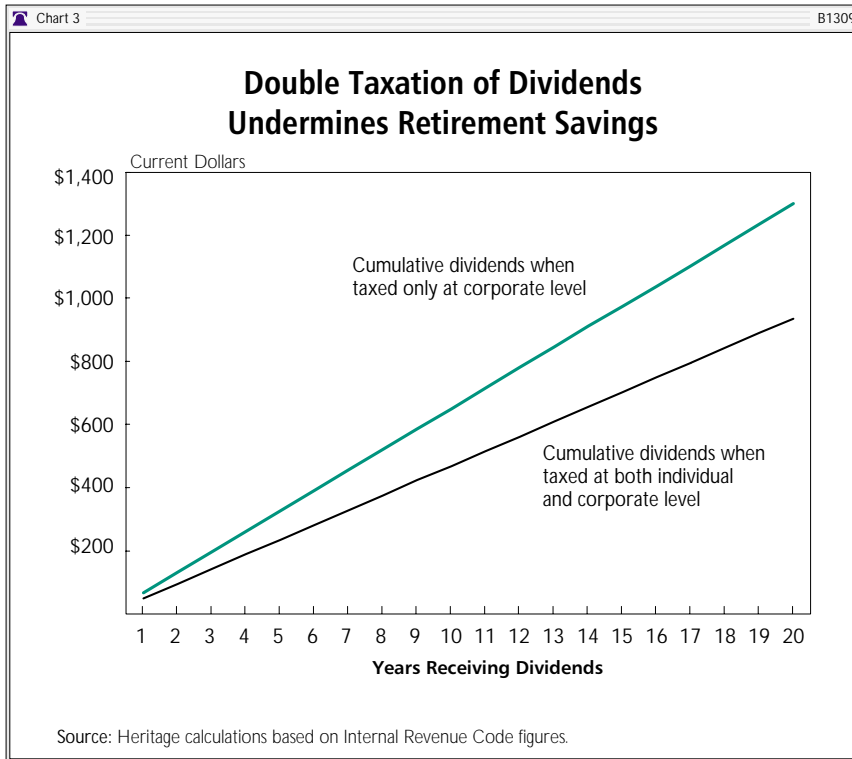


double taxation of dividend income, and death (estate) taxes. These multiple layers of tax make it especially difficult to save enough for a college education, retirement, or to start and grow a new business.

Taxes Make It Difficult to Save for College

Consider the case of moderate-income parents trying to save for their new child's education. Lacking experience in financial markets, these parents opt for a safe investment and purchase a bank CD (a certificate of deposit; a savings account that pays a higher rate of interest than a normal savings account, but that cannot be accessed for a specified period of time) with \$1,000. The CD pays an interest rate of 4 percent and they keep it for 20 years. Yet taxes erode a substantial portion of the interest generated by the savings (see Chart 2). Because the family purchased the CD with after-tax income, this second layer of tax means the family will have about \$425 less available for college expenses.

2. Michael J. Boskin, "Taxation, Saving, and the Rate of Interest," *Journal of Political Economy*, Vol. 86, No. 2 (April 1978), pp. S3-S28; and R. Glenn Hubbard and Jonathan S. Skinner, "Assessing the Effectiveness of Savings Incentives," National Bureau of Economic Research *Working Paper* No. 5686, July 1, 1996.



which helps to explain the ways excessive taxation adversely impacts long-term investing.

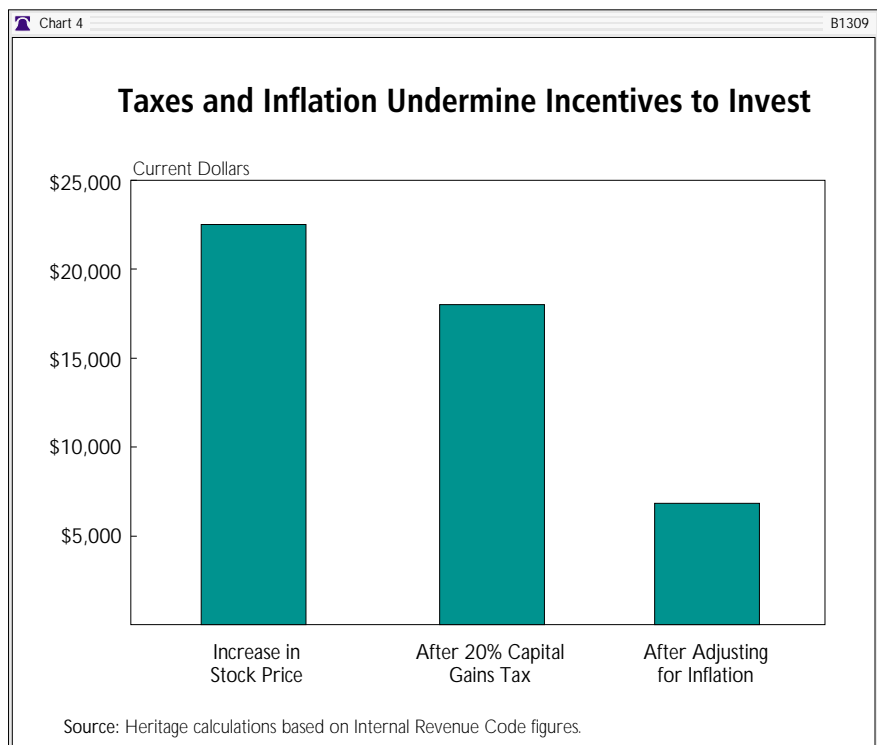
Taxes Make It Difficult to Build Capital and Start a Small Business

Consider the case of a budding entrepreneur who wants to acquire enough capital to form a new company. Recognizing that equity investments generate the biggest return, he purchases some stock. Yet even when an investment pays off, as is shown in Chart 4, a big chunk is lost to taxes. This is double taxation. Not only was the stock purchased with after-tax income, it is important to realize that a capital gain is simply an increase in the value of an asset

Taxes Make It Difficult to Retire

Consider the case of an average worker trying to save for retirement. With some financial experience, he understands that stocks usually generate more long-term income than do interest-bearing investments. As such, he purchases a stock that pays \$100 in dividends each year. Unfortunately, the current tax code imposes two layers of tax on this additional income—the corporate income tax *and* the personal income tax. And as Chart 3 shows, this has a significant impact on the cumulative level of dividend income. Thanks to the second layer of tax (also keep in mind that the worker purchased the stock with after-tax income), this worker will have nearly \$400 less available for retirement expenses. It also is worth noting that the negative impact of taxes grows with each passing year,

because of an expectation of higher future income. That income, of course, will be taxed again when it actually materializes. Thanks to all the added taxation, our entrepreneur in this example will have about \$4,500 less available to start a new business.



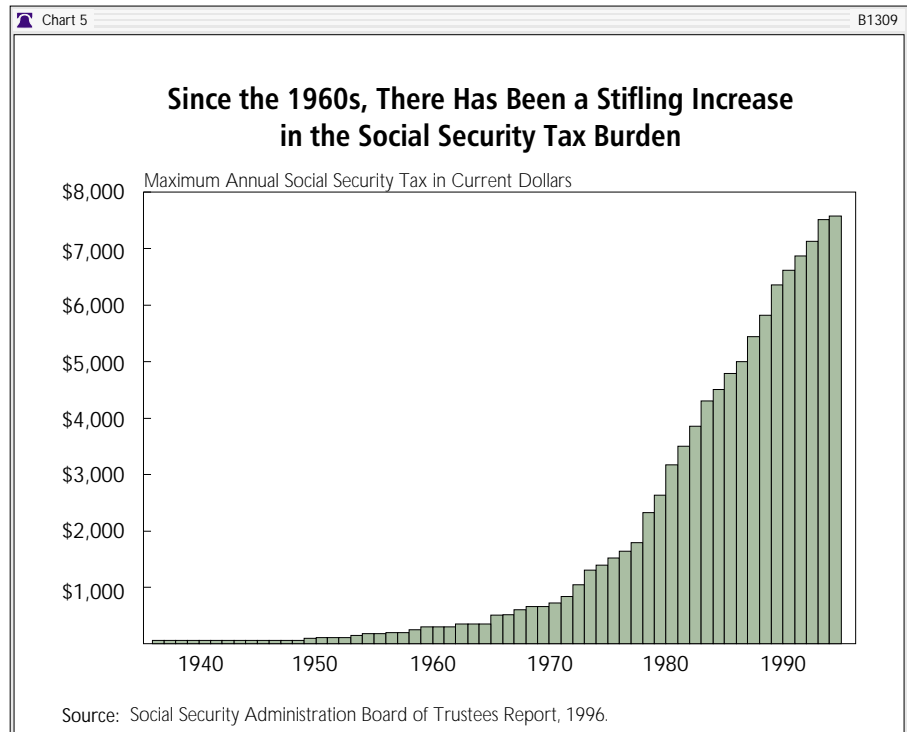
Social Security Taxes Keep the Poor from Saving

The 12.4 percent Social Security payroll tax, levied on the first \$72,400 of income, also has a negative effect on savings. This is not because the tax itself is anti-saving—indeed, it is a flat-rate tax that avoids most of the double taxation that plagues the income tax code. Instead, it is because the payroll tax makes it much more difficult for moderate- and low-income people to save. More specifically, because the current Social Security system does not allow workers to shift any portion of their payroll taxes into personal retirement accounts, these workers are unable to build a nest egg of savings.³ (See Chart 5.)

Permitting lower- and middle-income workers to divert their payroll tax to private accounts would allow them to create a significant store of wealth. For example, a two-earner, average income, 34-year-old couple with children would enjoy an extra \$642,316 of income at retirement if they could place their payroll taxes in a diversified personal retirement account.

Because Social Security is a pay-as-you-go program (annual benefits for retirees are financed by payroll taxes collected from workers), shifting to a system of personal accounts certainly would require lawmakers to find a transitional source of financing to pay benefits to the current and soon-to-be retirees. The large projected federal budget surpluses would make this problem easy to solve.

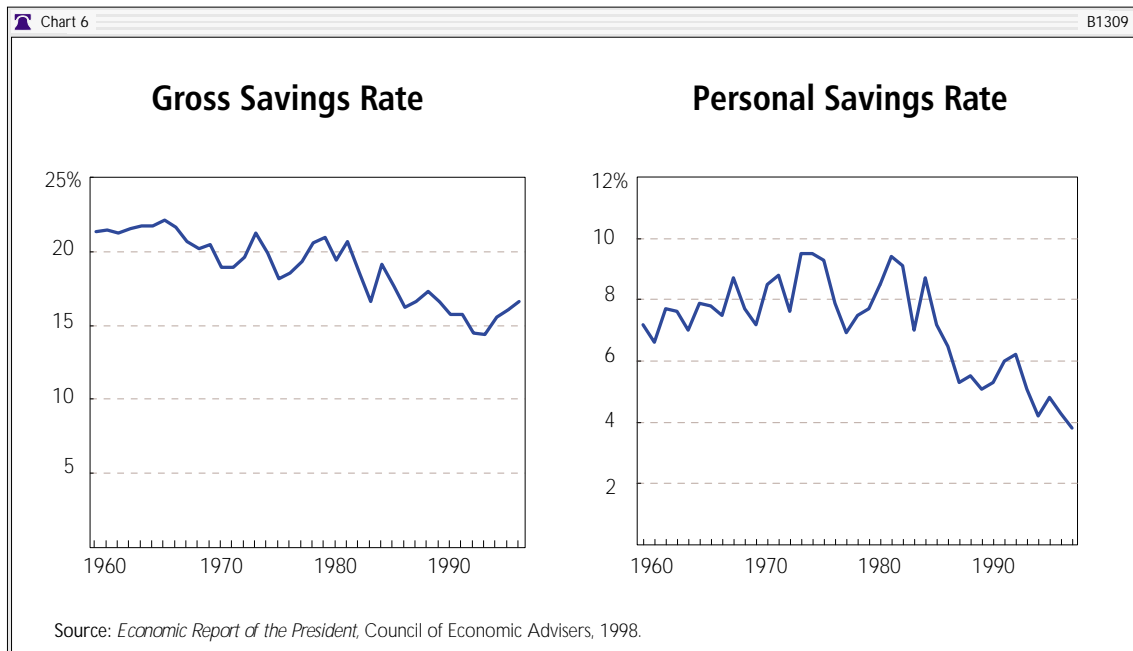
3. Not only does the Social Security tax crowd out private savings, but also the promise of future benefits from the government reduces the incentive to save. Scholars estimate that every \$1 of assumed benefits results in \$.50 less in private savings.



WHAT NEEDS TO CHANGE

The current tax bias against savings and investment should be eliminated. Replacing the tax code with a simple and fair flat tax is the ideal solution. Not only would a flat tax ensure that savings no longer would be double-taxed, but it also would fix all of the other problems in the current tax code. Short of this reform, it is possible for Congress to implement policies to fix the anti-savings bias. Specifically:

- 1. IRAs should become universal.** Certain forms of savings are protected from double taxation. Traditional IRAs and employer-sponsored 401(k) accounts, for example, allow the taxpayer to defer taxes on income that is saved. Taxes would apply to all withdrawals, however, including any interest, dividends, and capital gains. This tax policy ensures that all income is taxed, but taxed only once. Back-ended or Roth IRAs also avoid the double taxation of savings, but they use the opposite

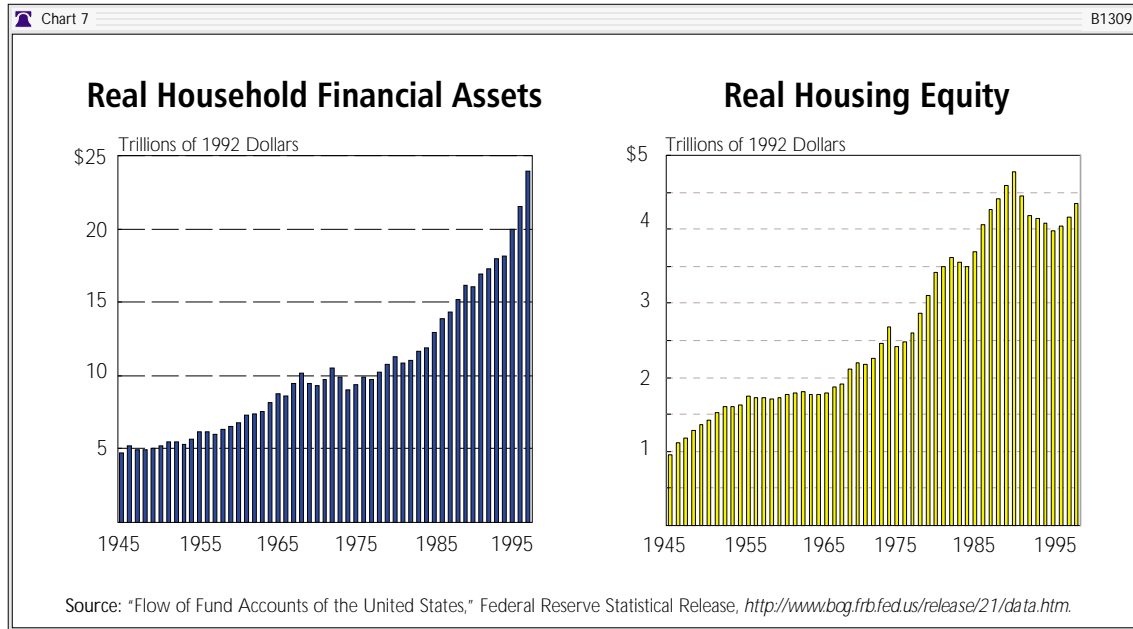


approach: Income is taxed once in the year it is earned, but there is no second layer of tax if the money is saved and generates a return.

Unfortunately, onerous restrictions limiting who can participate and the amount that can be saved accompany both types of IRAs today. The ideal solution would be to make both types of IRAs universal, allowing all taxpayers to save as much as they wanted but without facing double taxation. Legislation (H.R. 1611) sponsored by Representative James McCrery (R-LA) would create unlimited traditional IRAs. Universal back-ended IRAs, meanwhile, are part of a flat tax, a plan sponsored by House Majority Leader Richard Armey (R-TX) and Senator Richard Shelby (R-AL).

2. **The double taxation on other forms of savings should be eliminated.** Ending IRA restrictions would boost retirement savings but not help families trying to save for home purchases, educational expenses, unanticipated health care costs, or any other reason. All savings should be protected from double taxation. One easy way of achieving this goal would be the elimination of withdrawal restrictions on IRAs (in other words, allowing people to access their money at any time for any reason).

3. **The Social Security system should be reformed to allow all workers to save more for retirement.** Many workers, particularly those with lower incomes, find it difficult to save for retirement because there is little or no income left after fulfilling basic financial obligations. And because taxes are the largest portion of the average family's budget—exceeding the combined cost of food, clothing, shelter, and transportation—reforms that would allow workers to shift payroll taxes into personal retirement accounts would have an immediate and long-range beneficial effect.
4. **The tax penalties on dividends, estates, capital gains, and other forms of capital should be eliminated.** Purchasing stocks and bonds is a form of savings. These forms of savings certainly are less liquid and more risky than placing savings in a regular bank account, but workers are compensated for these risks because these assets—particularly stocks—traditionally generate a much larger return. The incentive to engage in these forms of savings, however, is significantly undermined by the imposition of numerous forms of double-taxation.



A neutral tax code also would require the elimination of the capital gains tax and the death tax. Reducing and ultimately eliminating taxes on capital gains, dividends, and estates would address this bias, as would replacing depreciation with expensing and repealing the alternative minimum tax.

ANSWERING COMMON QUESTIONS ABOUT SAVINGS

What Are "Savings"?

To save is to defer consumption. Oftentimes, savings are stores of wealth that can be converted into cash without great difficulty. A traditional bank account is probably the first thing that comes to mind when one thinks of savings, but there are many types of "savings," including stocks and bonds, retained business earnings (the profit not distributed to shareholders), and any income that is invested instead of consumed.

Savings and investment are different sides of the same coin. Although savings typically can be converted quickly to cash, certain types of savings, such as pension funds and IRAs, are not easily accessible and are designed to foster long-term savings. Savings usually generate income for the saver. Some people, however, invest in gold, land,

and collectibles in the belief that the value of these assets will increase more rapidly or that traditional forms of savings are too risky.

There is no consensus about how to measure savings. Is savings the value of all financial assets? Should it include the value of land, collectibles, owner-occupied housing, and consumer durables?

The *savings rate* measures how much income is saved in any given period. This is a "flow" measure. Chart 6 shows the personal savings rate and the gross savings rate (which includes business savings). The government's personal savings rate data are not based on estimates of actual savings. Instead, the government's released rate is calculated by subtracting consumption from income. One problem with this measurement is that it cannot include unreported income that was earned in the underground economy, which means the actual savings rate certainly is higher than the officially reported rate.

Another way to measure savings is to calculate the "stock," or the value of all existing savings. Chart 7 shows the ways in which the value of financial assets has increased over time and also provides a measure of the equity people have in their homes. Financial and household assets are an

important store of wealth and are part of national savings.

Why Do Savings Matter?

Savings are the key to capital formation; every economic theory, even Marxism, teaches that capital formation is necessary for economic growth and increasing wages. Without savings, it would be impossible to build factories, purchase equipment, conduct research, and develop technology. Savings allow a farmer to buy advanced equipment to increase productivity and, therefore, the income he earns. Savings allow a business to purchase new equipment, and new equipment allows a factory to produce more and thereby raise the income of workers and owners (see Chart 8).

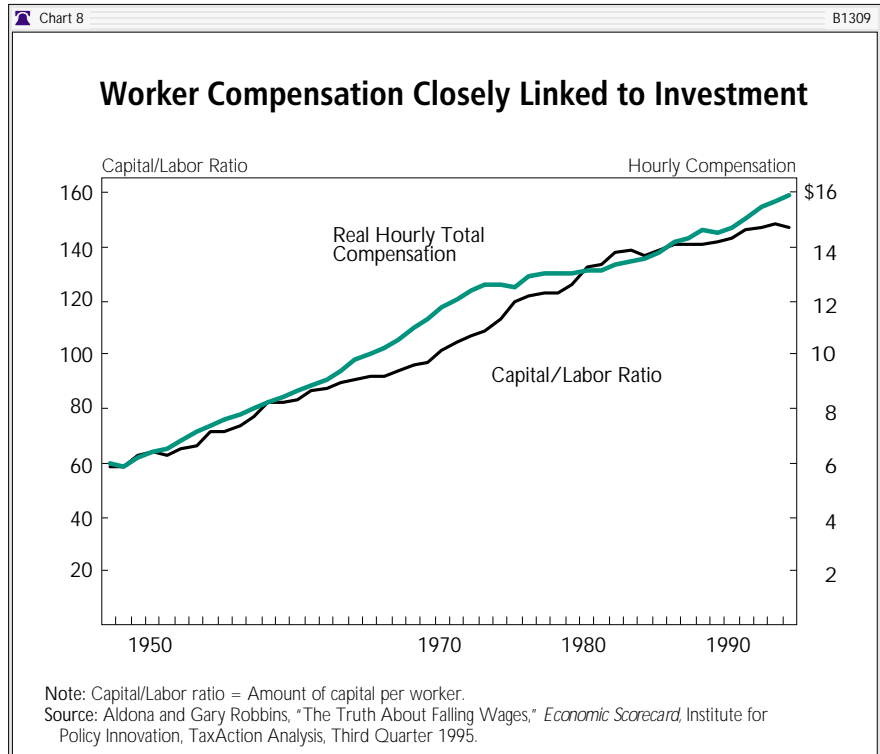
Savings also allow venture capitalists to invest in the Microsofts of tomorrow.

President Bill Clinton's Council of Economic Advisers may have explained it best in the 1994 *Economic Report of the President*:

The reasons for wanting to raise the investment share of the GDP [gross domestic product] are straightforward: Workers are more productive when they are equipped with more and better capital, more productive workers earn higher real wages, and higher real wages are the mainspring of higher living standards. Few economic propositions are better supported than these—or more important.⁴

Do More Savings Mean More Investment?

Usually, but increasing the savings rate is only part of the investment picture. A country can have



a very high savings rate, but if high taxes on capital encourage savers to invest their money overseas, workers will not be able to reap the benefits of increased investment.

It is important not only *where* savings are invested, but *how* they are invested. The former Soviet Union had very high rates of saving and investment, but its people did not benefit because government planners, instead of market forces, decided how the savings were invested. Similarly, Singapore has a mandatory system of saving for retirement, but the government controls the ways in which the funds in the individual retirement accounts are invested. As a result, the accounts earn lower returns and the workers do not benefit as much as do workers in countries with privatized social security systems that allow professional pension fund managers to direct the investment.

4. Council of Economic Advisers, *1994 Economic Report of the President* (Washington, D.C.: U.S. Government Printing Office, 1994), Chapter 1. See gopher://gopher.umsl.edu:70/00/library/govdocs/erps/erp94/erp94ch1.

Is Consumption Bad?

Not at all. Indeed, the purpose of savings is to increase consumption over time. Countries with high levels of private capital formation have higher levels of per capita income. This translates into higher levels of consumption. High rates of savings simply are a measure of *when* income is consumed.

Although consumption is not bad, government policies that penalize savings clearly are ill-advised. Such policies may increase short-term consumption, but only at the expense of savings and future consumption and security. Over time, the lack of savings and investment in an economy will reduce income growth and lead to significantly lower levels of consumption.

CONCLUSION

America does not face a savings crisis, but the level of savings in the economy is significantly lower than it would be in the absence of ill-advised government policies. The income tax code confiscates too much income, imposes excessive layers of tax on capital, and biases individuals and businesses toward consumption. The adverse impact of these policies is compounded by a Social

Security system that makes it difficult for lower- and moderate-income workers to save for a more secure retirement.

Fortunately, there are several ways to fix this bias against savings. A flat tax (or any other consumption-based tax) would address the bias against capital in the income tax code. Short of such fundamental reform, lawmakers could implement universal and unlimited savings accounts patterned after today's IRAs. Other much-needed reforms that would promote savings and investment include the repeal of taxes on capital gains and estates, as well as the elimination of the double tax on dividend income. Modernizing the Social Security system to allow workers to shift payroll taxes to personal retirement accounts would have a two-fold effect: Not only would it stop the reduction in private savings caused by government benefit payments, it also would transform a tax-and-transfer entitlement program directly into a system of private savings. These types of changes would increase savings and investment dramatically.

—Daniel J. Mitchell is McKenna Senior Fellow in Political Economy at The Heritage Foundation.