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Federal Tax Reform and Its Potential Effects on Saving

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Summary

It is often argued that the saving rate in the United States is too low. Many observers suggest that the federal tax system can provide an effective way of increasing the U.S. saving rate. Indeed, one of the major directives to the President's Advisory Panel on Federal Tax Reform was to recommend modifications to the tax system that would provide simple and straightforward ways for Americans to save free of tax, which, they argue, would increase saving in the United States. The panel recommended two reform options, one based on the current income tax system and the other based on a hybrid income/consumption-based tax. The panel considered, but did not recommend, a pure consumption-based tax.

Two observations can be drawn from the analysis contained in this report with respect to the effects of tax reform on the level of saving. First, public dissaving in the form of federal budget deficits reduces net national saving. So, if tax reform adds to the federal budget deficit, then, everything else being equal, tax reform would reduce net national savings. Second, even if tax reform is revenue neutral, the offsetting nature of income and substitution effects reduces the chances that changes to the tax system alone will increase saving. Indeed, because economic theory is not clear and because of the lack of compelling empirical evidence, it cannot be determined conclusively whether moving to a pure consumption tax would significantly increase the level of saving in the economy. This report will be updated as legislative action warrants.

Recommendations of the President's Advisory Panel

The President's Advisory Panel on Tax Reform was tasked to issue a report with revenue-neutral policy options for reforming the federal Internal Revenue Code.¹ Another major directive to the advisory panel was to recommend modifications to the tax system

¹ U.S. President (Bush), "President's Advisory Panel on Federal Tax Reform," Executive Order 13369, *Federal Register*, vol. 70, no. 008, Jan. 12, 2005.

that would provide simple and straightforward ways for Americans to save free of tax, which, they argue, would increase saving in the United States.

In its November 2005 report, the President's panel presents two major options for reforming the federal tax system. The first option is the Simplified Income Tax Plan (SIT).² This plan basically starts with the current federal income tax system and makes incremental changes (albeit significant changes in some areas) to achieve its stated goals of making the tax system simple, fair, and more conducive to savings and growth. Under this plan, the various incentives for saving under current law would be replaced by three new and expanded saving programs (Save at Work, Save for Retirement, and Save for Family) and a refundable savers tax credit. This plan would also "introduce a more consistent treatment of savings held outside of tax-preferred accounts." The plan would exclude 75% of the capital gains on sales of stock in U.S. corporations and eliminate the taxation of corporate dividends earned in the United States.

The advisory panel's second reform option is a hybrid income and consumption tax called the Growth and Investment Tax Plan (GIT). Basically, it contains the same three new savings programs as under the simplified income tax and the refundable savers tax credit. (Contributions under the Save at Work program under the GIT plan would be made on an *aftertax* basis rather than on a *pretax* basis, as would be the case under the SIT plan.) Unlike the first option where capital income from the corporate sector would be tax exempt or taxed at reduced rates at the individual level, the GIT plan would impose a 15% flat tax on all capital income from savings outside of these three new accounts.

As described in the panel's report, the Growth and Investment Tax Plan deviates from a pure consumption tax by imposing this 15% tax on the return to savings on income earned outside of the three savings programs. Although the panel considered a proposal for a pure consumption tax, which it called the Progressive Consumption Tax Plan, that option was not included in the panel's final recommendations to the President. Nevertheless, some observers, including several panel members, believe that adopting a pure consumption tax would be the best way to increase private saving.

What Is the Saving Rate?

Sometimes there is confusion over what actually constitutes the saving rate in the United States. There are many different rates of saving and alternative means of measuring them. As a result, some discussions of the U.S. saving rate essentially end up comparing apples and oranges.

In the National Income and Product Accounts, total saving in the economy is composed of two major parts: private saving and public saving.³ Private saving can be further broken down into its components, personal saving and business saving. Personal

² *Simple, Fair, & Pro-Growth: Proposals to Fix America's Tax System*, The President's Advisory Panel on Tax Reform, Nov. 2005.

³ For a more detailed discussion of saving as defined in the National Income and Product Accounts and for a discussion of saving as a policy goal, see CRS Report RL32119, *Can Public Policy Raise the Saving Rate?*, by Brian W. Cashell.

saving represents household aftertax income not used for consumption. Gross business saving represents the portion of aftertax profits retained after distribution of dividends and the funds set aside to replace plant and equipment that has worn out (depreciated). Net business saving is calculated by subtracting depreciation (the portion of gross savings that is applied towards replacing facilities and equipment that has worn out) from retained earnings.

Net private saving is the sum of personal saving and net business saving.

The second major component of total saving is public sector saving (government saving). Public sector saving includes government at the federal, state, and local levels. If the net budget position of the public sector is in surplus, then the public sector is a net saver. If the net budget position of the public sector is in deficit, then the public sector is a net dissaver.

Net national saving is the sum of net private saving and public saving. It is important to note that net national saving can change (increase or decrease) if either net private saving or public saving changes.

Tax Reform and Revenue Neutrality

As outlined in the preceding paragraphs, if there is an increase in the federal deficit then, absent any offsetting changes, net national saving will go down. Therefore, the effects of tax reform on federal revenue will have a direct bearing on the level of saving in the economy. If, under tax reform, federal revenues fall and the deficit increases, then net saving will decrease. Conversely, if federal revenues rise and the deficit decreases, then net saving will increase.

How do the advisory panel's proposals affect federal revenue? The panel was tasked to issue a report with revenue-neutral policy options for reforming the federal Internal Revenue Code. However, the executive order establishing the advisory panel specifies neither the baseline nor the time horizon for achieving revenue neutrality.

The Congressional Budget Office (CBO) produces baseline projections of the budget semi-annually so that policymakers have a common starting point from which to debate policy changes. The purpose of the baseline is to project revenues and outlays under current law over the next 10 years. CBO describes the baseline projection as

a benchmark for measuring the budgetary effects of proposed changes in federal revenues or spending.... By statute, CBO's baseline projections must estimate the future paths of federal spending and revenues under current law and policies. The baseline is therefore not intended to be a prediction of future budgetary outcomes; instead, it is meant to serve as a neutral benchmark that lawmakers can use to measure the effects of proposed changes to spending and taxes. So for that reason and others, actual budgetary outcomes are almost certain to differ from CBO's baseline projections.⁴

⁴ CBO, *The Budget and Economic Outlook: Fiscal Years 2006 to 2015*, Jan. 2005. [<http://www.cbo.gov/showdoc.cfm?index=6060&sequence=0>]. Instructions for creating the baseline estimates are contained in the Budget Enforcement Act (BEA), as amended.

In other words, the CBO baseline is a projection of revenues and outlays under *current law*, absent any changes, over the next 10 years.⁵

The advisory panel report, however, indicates that its reform plans meet the goal of revenue neutrality when compared to the Administration's revenue baseline rather than the CBO baseline. The Administration's baseline assumes that the 2001/2003/2004 tax cuts will be made permanent and that all of the Administration's FY2006 budget proposals affecting federal revenues are enacted. The CBO baseline, on the other hand, assumes that the 2001/2003/2004 tax cuts will expire at the end of 2010, as is specified under current law. In addition, the CBO baseline does not include the Administration's FY2006 budget proposals affecting revenues.

As a result, when compared to current law as defined in the CBO baseline, the Administration's baseline projects lower federal revenues over the next 10 years. So, when compared to the CBO revenue baseline, the reform proposals will result in a significant reduction in federal revenue over the next 10 years. Some analysts have calculated that the reform plans would reduce federal revenues by almost \$1.4 trillion compared to the revenues under CBO current law baseline over the next 10 years.⁶

The Effects of Tax Policy on Private Saving

It is often argued that tax policy, through incentives for saving or disincentives for borrowing, can be used to influence the level of private saving. This line of reasoning argues that saving incentives in the tax code will increase the aftertax return to saving and, as a result, taxpayers would be willing to substitute future consumption (saving) for present consumption. This substitution effect would cause aggregate private saving to rise.

There is an additional effect, however, that occurs simultaneously with this substitution effect that might actually cause the level of saving to decline. An increase in the aftertax rate of return would mean that an individual could actually save less and still achieve the same level of consumption in the future. In other words, in addition to the substitution effect, there is an income effect which makes an individual richer and could induce him to consume more in the present.

To fully appreciate the income and substitution effects associated with tax incentives for increased saving consider the following example. Assume that an individual has a 28% marginal tax rate and invests \$100 in an account paying 10% interest. After five years, the account will have grown to \$141.57 (\$100 investment earning 7.2% interest, after taxes, for five years).

Now consider what would happen if the tax on interest earnings were eliminated. In this case, the aftertax rate of return would increase from 7.2% to 10%. As a result of

⁵ Also see CRS Report RS22045, *Baseline Budget Projections Under Alternative Assumptions*, by Gregg Esenwein and Marc Labonte.

⁶ See "A Preliminary Evaluation of the Tax of the Tax Reform Panel's Report", *Tax Notes*, Dec. 5, 2005, p. 1349.

this increase in the aftertax rate of return, the taxpayer might be expected to increase his savings (and his future consumption) by reducing current consumption.

However, the taxpayer may only be concerned with accumulating \$141.57 in his savings account at the end of five years, a characteristic of a target saver. In this case, since the aftertax rate of return on saving has gone up, the taxpayer need only save \$87.90 to reach his goal (\$87.90 at 10% interest would grow to \$141.57 after five years). Because the income effect associated with the tax incentive has made the taxpayer richer, the taxpayer can actually reduce his savings by \$12.10.

This example brings to light an important point with regard to the ultimate effects of tax incentives on the level of saving, a point which applies to incentives targeting both personal and business saving. If a tax incentive to promote private saving is deficit financed (the revenue loss from the tax reduction on saving is not recouped by raising other taxes), then the income effect may well dominate and the level of national saving could drop. Depending on how the tax incentive is designed, the reduction might manifest itself directly as a reduction in private saving or as a reduction in both private and public saving. (For a deficit financed tax incentive to increase total saving each dollar of tax reduction (public dissaving) would have to be matched by more than a dollar increase in private saving.)

Only if the tax incentives for saving are fully tax financed (the revenue loss from the saving incentive is made up by raising other taxes) will the income effects be eliminated. Even under these conditions, however, the overall effectiveness of the tax incentives on the level of savings is unclear.

For example, even if one switched from an income- to a consumption-based tax, the overall effect on the level of saving cannot be determined a priori. Life-cycle models tend to predict an increase in saving in response to changing from an income to a consumption tax. These models show an increase in savings for two main reasons.⁷

First, under a consumption tax the old (retirees who are dissavers because they are drawing down their accumulated capital to finance consumption) would pay higher taxes and the young would pay lower taxes compared to what they would pay under an income tax. In fact, for young taxpayers, a consumption tax is the equivalent of exempting the rate of return on all savings from tax. As discussed in the preceding paragraphs, for the young, this results in a substitution effect and an income effect with the net effect of these two forces uncertain.

Because of their higher taxes, however, retired workers would have to reduce their consumption in order to pay what amounts to a double tax on their accumulated assets. (That is, the income on their assets was taxed first when it was earned under the income tax and now both the income and the principal will be taxed again when spent under the consumption tax.) So while the effects on young taxpayers are uncertain, retired taxpayers have to reduce consumption (increase saving) and the overall effect would tend to increase aggregate saving in the economy. It is important to note, however, that any

⁷ For a more detailed discussion see CRS Report RL32603, *The Flat Tax, Value-Added Tax, and National Retail Sales Tax: An Overview of the Issues*, by Gregg Esenwein and Jane Gravelle.

transition rules enacted to mitigate these increased taxes on the elderly would dampen the stimulus to new saving.

Second, the life-cycle models which show an increase in saving from switching from an income to a consumption tax tend to rely on somewhat idealized assumptions. For example, they assume that all taxpayers have perfect information and the sophistication to map out their consumption choices over a long period of time. They also assume that taxpayers believe that the tax system will not change over their lifetimes. If these idealized assumptions are relaxed, then the effects on saving of switching from an income to a consumption tax are inconclusive.

In addition, the empirical evidence regarding the effect of tax incentives on saving is inconclusive. For instance, The Economic Tax Recovery Act of 1981 reduced marginal income tax rates, expanded the availability of individual retirement accounts (IRAs), and accelerated depreciation deductions. Life-cycle models would predict that these changes would increase private savings, but that did not happen.⁸

Because of the inconclusive empirical evidence and the theoretical ambiguities, it cannot be determined definitively that even switching to a pure consumption tax would significantly increase the level of saving in the economy.

⁸ See CRS Report RL32603, *The Flat Tax, Value-Added Tax, and National Retail Sales Tax: Overview of the Issues*, by Gregg A. Esenwein and Jane G. Gravelle. Additional information on the empirical studies regarding the effect of tax policy on the level of saving can be found in CRS Report RL30255, *Individual Retirement Accounts (IRAs): Issues and Proposed Expansion*, by Thomas L. Hungerford and Jane G. Gravelle, specifically footnote 18.