the FEDERALIST

A Tax Reform We Can All Support

U.S. law overemphasizes helping favored groups with narrow tax breaks. Here's a better idea.

By Chris Edwards

May 11, 2015

Tax reform will be a key Republican theme going into the 2016 elections, but Republicans divide over the needed changes. Pro-growth conservatives and libertarians favor broad-based tax rate cuts, while conservative and moderate "reformicons" favor expanded social policy breaks, such as child tax credits.

The tax divide is important because the next president will likely be a Republican, and he or she will probably push for a first-year tax cut, as Ronald Reagan and George W. Bush did. Reagan's 1981 tax cuts were all pro-growth. Bush's 2001 tax cuts were partly pro-growth and partly social policy, as were the 1997 tax cuts under Bill Clinton.

Looking ahead to 2016, one reform idea that should appeal to all types of Republicans—and even some Democrats—is universal savings accounts (USAs). Such accounts would be like Roth Individual Retirement Accounts (IRAs), but for all types of savings, not just retirement savings. People would contribute after-tax income to USAs, and then all earnings and withdrawals would be completely tax-free.

Consider Canadian and British Success

USAs would be great social policy, as they would help families build larger nest eggs, and they would be great economic policy, since savings fuels investment and growth. The accounts would be good politics, as well, as we have seen with the success of USA-style accounts in Canada and Britain.

Let's look at Canada first. Prime Minister Stephen Harper's government implemented Tax-Free Savings Accounts (TFSAs) in 2009, and they are creating a broad-based savings revolution north or the border. Here are the key features of the accounts:

- Annual contribution limit of $10,000. Portions of the contribution limit not used in a year can be carried forward to future years.
- Tax-free earnings. All earnings are tax-free and withdrawals can be made at any time for any reason, with no taxes or penalties. This feature greatly simplifies the accounts and increases liquidity, both of which encourage added savings.
- No income limits. All adults can contribute to the accounts and withdraw from them at any time during their lives.
- Ease of saving. Accounts can be opened at any bank branch or online, and they can hold bank deposits, stocks, bonds, mutual funds, and other types of assets.

TFSAs are great for all types of saving—saving to buy a home or a car, or saving to cover health expenses, unemployment, or retirement. That is about as "pro-family" as you can get. The Canadian government has recognized that whether people sock away money for four months or four decades, all savings are beneficial and add to personal financial security.

Britain's Individual Savings Accounts (ISAs) are just as impressive as the Canadian accounts. All UK residents can put up to 15,240 pounds (about $23,000) per year of after-tax money into ISAs. ISA earnings grow tax-free and can be withdrawn at any time for any reason with no taxes or penalties. Like TFSAs, ISAs enshrine in the tax code the principle that saving for all reasons is important, not just for reasons favored by governments.

Tax Complexity Scares People

In the United States, the government chooses which savings to favor, with the result that we have a mess of separate accounts for retirement, health care, and education. Everyone agrees that Americans don't save enough, and one reason is the complexity of the accounts. Between 40 and 50 percent of adults in Canada and Britain now own all-purpose savings accounts. By contrast, just 38 percent of Americans hold any type of IRA, even though IRAs have been around a lot longer than TFSAs and ISAs.

The Canadian accounts would be a good model for American USAs. One hurdle to enactment might be concerns that such accounts would favor the wealthy. But in Canada, the government's recent budget reported that "individuals with annual incomes of less than $80,000 accounted for more than 80 per cent of all TFSA holders … About half of TFSA holders had annual incomes of less than $42,000." And in Britain, a new report from HM Revenue and Customs found that 57 percent of ISA account holders had annual incomes of less than 20,000 pounds (about $30,000), and slightly more women than men hold ISAs.

The economic and the political appeal of these accounts is that all individuals can use them for all types of savings. In Canada, TFSAs have been so successful that Stephen Harper's Conservative government recently expanded the contribution limit from $5,500 to the current $10,000. In Britain, the accounts were enacted by a Labour government in 1999, and expanded by the Conservatives under Prime Minister David Cameron.

In this country, there is too much emphasis on helping favored groups with narrow tax breaks. USAs would instead help all individuals help themselves through their own thrift. Candidates for

2016 should look to Canada and Britain for a popular, pro-growth, and pro-family reform: universal savings accounts.

Chris Edwards is editor of www.DownsizingGovernment.org at the Cato Institute.