Tax reform 2.0 can alleviate Americans' chronic saving problem

Ernest Christian and Chris Edwards

July 24, 2018

In the wake of their successful Tax Cuts and Jobs Act last year, Republicans are now considering "Tax Reform 2.0." For individuals, the 2017 law trimmed tax rates and changed deductions and exemptions. But it did not fix the tax code's bias against personal savings, which is a serious problem given that many Americans save so little.

One idea the GOP is mulling for 2.0 is the creation of Universal Savings Accounts (USAs). Such accounts were considered last year but were not included in the final bill.

Rep. Kenny Marchant (R-Texas) of the House Ways and Means committee said the other day that the new tax bill "could include a universal savings account, funded with post-tax dollars but with tax-free earnings and more flexible withdrawal rules than existing retirement accounts."

USAs would be like vastly improved Roth Individual Retirement Accounts (IRAs). Individuals would contribute up to, say, $10,000 a year of their after-tax income, and then the account earnings would grow tax-free.

Account assets could be withdrawn tax- and penalty-free at any time for any reason, which would make the accounts simple, flexible and liquid.

Such accounts would revolutionize savings, as indicated by British and Canadian experiences with similar accounts. British Individual Savings Accounts (ISAs) and Canadian Tax-Free Savings Accounts (TSFAs) are popular with people of all ages and income levels.

The accounts encourage people to maximize saving because they retain easy access to the funds if they need to withdraw.

About 44 percent of Brits own ISAs and 55 percent of Canadians own TFSAs, which are much higher shares than the 20 percent of Americans who own Roth IRAs. Furthermore, while half of

British and Canadian account holders contribute each year, just one-quarter of Roth IRA holders do.

Why are the foreign accounts more popular? Roth IRAs and other U.S. savings vehicles have complex rules and are for single purposes. By contrast, USA-style accounts have no rules on withdrawals and can be used for all types of saving. The high ownership and contribution rates of TFSAs and ISAs show that these factors really matter.

The 2017 tax law stimulated investment and economic growth, but those benefits will not solve the problem of America's chronically low savings rate. Saving increases financial security and makes people less dependent on the government for everything from food stamp benefits to retirement income.

Given that the government is running massive deficits and will likely slash benefit programs down the road, the more financial independence people have, the better.

A key problem with the income tax is that it double-taxes personal savings and thus encourages people to consume rather than save. USAs are the solution — they would end double-taxation for most people and encourage individuals to build nest eggs for both short-term contingencies and long-term retirement security.

Income taxes similarly overtax business investment. The 2017 tax law took a step to solving that problem with first-year capital expensing, and that provision should be made permanent in Tax Reform 2.0.

The key player in 2.0 is House Ways and Means chair Kevin Brady (R-Texas), who recently said, "We are looking at ways where it's easier for families to save earlier in life and more over time, whether it's for health care or for retirement … We think America is not a nation of savers; we want it to be."

USAs are the tool that Brady is looking for.

Brady said he wants the new tax bill focused on the middle class. We know USAs would meet that goal as well because the British and Canadian USA-style accounts have far higher usage among middle- and lower-income households than do Roth IRAs.

President Trump is supporting Tax Reform 2.0, and chairman Brady expects the House to vote on legislation by September. Meanwhile, the Senate is working on a bipartisan package of savings and retirement tax changes.

Both chambers should consider USAs as the ideal pro-family companion to the 2017 tax law's simplification and pro-growth reforms.

Ernest Christian is former deputy assistant secretary at the U.S. Treasury. Chris Edwards is director of tax policy studies at the Cato Institute.