Institute For Policy Innovation IPI

# QUICK STUDY

The personal saving rate in the U.S. is alarmingly low — far too low to meet the retirement needs of the baby boomers. The very low saving rate restricts investment, which in turn retards economic growth. The culprit is the pervasive bias against saving that is built into almost every aspect of the tax code. Removing this bias against saving through tax reform could raise national income by 10 to 15 percent in 15 years.

THE ROAD MAP TO TAX REFORM™

# Fixing the Saving Problem

## *How the Tax System Depresses Saving, and What to Do about It*

The public and the government need to work together on raising the rate of saving in the United States. Both the personal and national saving rates are low by historical standards. Our failure to save restricts domestic investment. This in turn considerably retards the growth of productivity, wages, and employment, thus slowing the growth of individual income and wealth.

Further, the personal and national saving rates are lower than in many other major nations. Our household saving rate averages about 60 percent that of the United Kingdom, about half that of Germany and France, and about a third that of Japan and Italy. Citizens of these countries invest in U.S. endeavors, but their investment could dwindle if the United States adopted a less investment-friendly tax treatment or endured a bout of inflation. In any case, ownership of our own assets means that we benefit from the interest, dividends, and reinvested income the assets generate.

### Why Personal Saving Is Essential

**Personal saving** includes saving by individuals in bank accounts, mutual funds, stocks and bonds, and other financial instruments, plus contributions to pensions by individuals and employers.

The rate of personal saving in the United States affects the welfare of individuals. Saving boosts our income, protects us against job loss, pays for our education and that of our children, and allows us to buy homes and start businesses.  Most importantly, saving is the most reliable way to assure that we have enough assets for a comfortable retirement. The Social Security system faces large deficits starting in 2016 — *just 15 years from now* — and increasing strain as more and more baby boomers retire.

Yet what we need to do and what we are doing diverge. The personal saving rate (saving as a percent of disposable after-tax income) has plunged from about 9 percent since the mid-

1980s — *just 15 years ago* — to about 2.5 percent in 1999. By early 2000, the saving rate was nearly zero. Personal saving also has fallen as a share of gross national product (GNP).

The Federal Reserve Board's latest "Survey of Consumer Finances," published in 1998, suggests that most Americans lack the personal savings to provide for their comfortable retirements. Millions of us will have to work at least part time beyond age 65. Millions more will rely mainly on Social Security or employer-provided pensions unless we increase our rate of saving — significantly and soon.

## What Current Saving Means for Future Retirees

The Fed's 1998 survey found that American families whose heads were between ages 55 and 64 had financial assets with a median value of $45,600 in 1998. Families whose heads were between 65 and 74 had financial assets with a median value of $45,800.

And keep in mind that these are median figures. Half of the families with assets had *less*. Further, these figures are for the 95.6 percent of all families in these age groups that reported having *some* savings; over 4 percent of the families surveyed reported that they had *no* financial assets at all.

Social Security alone cannot assure these Americans a comfortable retirement. Single workers who earned the average wage most of their working lives would have retired in 2000 at age 65 with about $11,675 in annual Social Security benefits. A married couple with the spousal benefit would have received about $17,500. The Social Security benefit formula is set up to grant higher real retirement incomes to future retirees as real wages continue to climb, close to $17,300 for a single average wage worker in 2030 and about $25,960 for a couple. But, as previously mentioned, the Social Security system is projected to run enormous deficits as the baby boom generation retires. The substantial payroll tax increase required to sustain it would be politically unpopular and fiscally disastrous. Thus it is likely that the promised increases in real benefits will be scaled back.

Now, let us assume that an average-wage baby boom individual or couple will need to supplement Social Security benefits by at least $20,000 a year (in today's dollars) for a moderately comfortable retirement for 20 years (average life expectancy from their retirement). Assuming a real rate of return in the stock and bond markets of 5 percent a year above inflation, the baby boomer individual or couple would need $250,000 to buy an annuity at retirement. The median saving of the typical family at retirement, about $50,000. would buy an annuity providing only $4,000 a year. And of course even a $250,000 annuity would not suffice if either spouse required extended health care services. Unless the family had long-term care insurance, which is a form of saving, the alternative would be to spend down assets to the poverty level and apply for Medicaid assistance.

## Why National Saving Is Essential

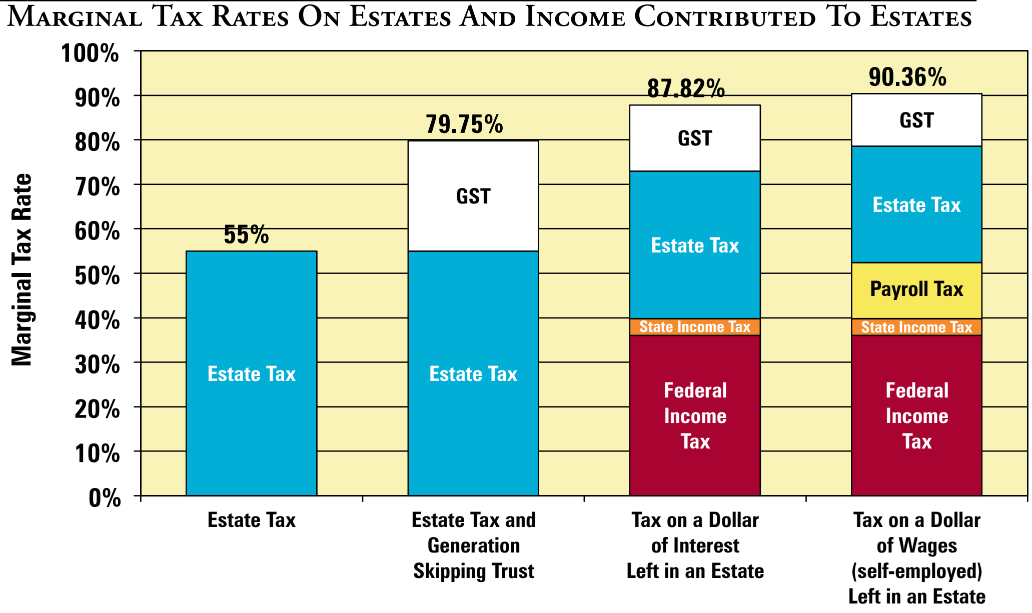
With respect to our national economy, saving provides the financing for investment in physical capital (plant and equipment, commercial and residential buildings) and for research and development. Only through investment can we increase the productivity of the work force and thereby raise wages and living standards over time. Higher levels of productivity also will make it easier for a relatively smaller work force to provide the real goods and services a relatively larger retired population will need in the years ahead.

The National Income and Product Accounts, which are the official measures of U.S. national production, income, and outlays published by the Department of Commerce, comprise the personal saving discussed above, plus business saving and government saving.

**Business saving** is revenue set aside for business investment. The Accounts break business saving into two parts, the amount saved to replace worn-out plant and equipment (consumption of fixed capital, which covers a cost and is not considered part of profit) and after-tax profits (retained earnings) the amount the business keeps to add to investment

**Government saving** at the federal, state, and local level is similarly defined as the sum of consumption of fixed capital

### Marginal Tax Rates On Estates And Income Contributed To Estates




Assumes married couple in 36% tax bracket, who are self-employed, with a 6% state income tax as an itemized deduction.

## Income Tax Bias Against Saving and Two Cures

Pretax income needed to have $100 for consumption after taxes or a $100 bond paying $4 in interest after taxes under ordinary income tax treatment, IRA-type treatment, or tax-exempt bond treatment

| | | Pretax income | Tax | After-tax income | Interest on saving | Tax on interest | After-tax interest | % increase in cost of activity due to tax |
|---|---|---|---|---|---|---|---|---|
| No income tax exists | Income consumed | $100 | $0 | $100 | — | — | — | — |
| | Income saved | $100 | $0 | $100 | $4 | $0 | $4 | — |
| Ordinary income tax @ 20% rate | Income consumed | $125 | $25 | $100 | — | — | — | 25% |
| | Income saved | $156.25 | $31.25 | $125 | $5 | $1 | $4 | 56.25% |
| IRA treatment: amounts saved tax deductible, returns on saving taxed | Income saved | $125 | $0 | $125 | $5 | $1 | $4 | 25% |
| Tax exempt bond treatment: no deduction of saving, returns not taxed | Income saved | $125 | $25 | $100 | $4 | $0 | $4 | 25% |

The 20% income tax, by taxing income when first earned and taxing the return on saving, raises the cost of consumption by 25% and the cost of obtaining additional future income by 56.25%, more than twice the increase in the cost of consumption. Under IRA or tax exempt bond treatment, the tax raises the cost of obtaining additional future income by 25%, the same penalty as on consumption.

(spending on replacement investment) plus the government's current surpluses or minus its current deficits.

In 1990, business saving of $682 billion was 67 percent of total private saving, while personal saving of $334 billion was 33 percent of the total, a typical ratio. More recently, personal saving has declined as a share of private saving. In 1998, business saving and personal saving were 83 percent and 17 percent of private saving, respectively. In 1990, federal, state, and local governments combined were saving at a rate of $39 billion; in 1998, they were saving $275 billion. The change was due largely to a shift of the federal government from deficit to surplus and an increase in the surpluses of state and local governments. Although federal, state, and local government surpluses are counted as *part* of national saving, they should not be regarded as *increasing* national saving because the tax revenue that produces the government surplus comes largely at the expense of private sector saving.

## What Depresses Private Saving

To reiterate: government surpluses do not raise national saving and investment. In fact, the higher taxes that effected the surplus have discouraged personal and business saving and encouraged consumption. High taxes also have lowered total national saving and investment — and if maintained, they will continue to do so.

Higher taxes reduce our ability to save by depriving individuals and businesses of income we could be saving. Higher taxes also reduce our incentive to save and invest out of whatever income remains once the taxes are paid. When facing a "use it or lose it" choice, we Americans quite rationally choose to use our money to buy the goods and services available now rather than lose it to the tax collection apparatus of the U.S. Treasury.

Further, income, payroll, and other taxes are not just higher than they were in the past and high enough to discourage saving, but they are also biased against saving and investment. Here are some of the ways.

Under the ordinary "broad-based" income tax, our income is taxed when we earn it. If we spend it for consumption, we are usually free to use the goods and services without paying any additional federal tax (except for excise taxes on selected items). If I use part of my income to buy a tennis racquet and you use some of yours to buy a television set, each of us is free to enjoy our new possessions without making further outlays.

But if we save the income, we pay at least one other layer of tax on the earnings of the savings. If I buy a bond, I pay a tax on the interest; if you buy a stock you pay a tax on the dividends. Further, if we choose instead to invest in a noncorporate business or farm, we must pay a tax on its earnings and on capital gains if the new saving or reinvested business earnings cause the value of a corporate or noncorporate business to increase before the asset is sold. These are the *basic* income tax biases against saving relative to consumption.

Additionally, the U.S. system imposes a corporate income tax on corporate earnings — not only on shareholders' dividends and capital gains — and applies an estate and gift tax to accumulated savings.

We can eliminate the basic tax bias against saving by extending tax deferral to all saving and then taxing the withdrawals (the saving-deferred approach) or by taxing the income that is saved but not the returns (the returns-exempt approach). Assuming the taxpayer is subject to the same tax rate at the time of original saving and the time of withdrawal, the rate for the taxpayer is the same. Each of the major tax reform plans — for example, the Flat Tax, the National Sales Tax, and the USA Tax — uses one of these approaches to create a fairer tax system.

## How Other Tax Biases Discourage Saving

Those of us who wish to save by purchasing stock in corporations face another layer of tax bias: the corporate income tax. The corporate tax takes the first bite out of corporate income. The personal income tax we, as shareholders, must pay on any dividends the corporation distributes from its after-tax income is a second bite. As mentioned above, there is a double tax even if the corporation reinvests and pays no dividends, because any increase in value when the owner or shareholder sells is taxed as a capital gain. All that would be required to eliminate such double taxation would be to tax corporate income either on the corporation's tax return or on the shareholder's, but not on both.

The unified gift and estate tax, which some call the death tax, is *always* an extra layer of tax. A graduated schedule applies: the bottom rate is 18 percent of the first $10,000 of taxable transfers, rising to a 55 percent rate on transfers over $3 million, with a 5 percent surtax imposed on taxable transfers between $10 million and about $17 million. The surtax boosts the marginal tax rate to 60 percent on transfers in that range and phases out the benefits of the graduated rates; on higher transfers, the tax rate is a flat 55 percent on the entire taxable estate.

A unified credit exempts the first $675,000 this year and will gradually rise to $1 million in 2006. An additional write-off of up to $675,000 is allowed in 2001 for family businesses. But a generation-skipping transfer tax (GST) further complicates inheritance, and in some cases the transferee confronts a tax rate of nearly 80 percent.

Nor is that all. The personal income tax code lists a handful of progressive, statutory marginal tax rates. The alternative minimum tax (AMT) remains in place, as do phase-ins and phase-outs of personal exemptions and itemized deductions for high-income taxpayers. Even the working poor suffer under our income tax code, as a phase-out of the Earned Income Tax Credit takes back 21 cents for each additional dollar earned over a very modest amount. The worker pays income tax *plus* a 15.3 percent payroll tax on each extra dollar of wages as well, for a combined tax penalty of over 50 percent.

Finally, Social Security recipients face particularly high marginal tax rates. Social Security benefits are phased into taxable income at a rate of $0.50 or $0.85 for each dollar by which the sum of the recipients' interest, dividends, and pension income plus half of their Social Security benefits exceeds certain thresholds. The taxation of benefits can boost the implicit marginal tax rates on wage income in excess of the thresholds to 65 percent. For wage income that is also subject to the Social Security earnings test, the combined federal income tax rates and loss of benefits can cost retirees 109 percent of their added income, even before state income taxes.

## What Tax Reform Could Accomplish

We need to reform this inequitable, inefficient, and unproductive tax system — now. A single rate tax, unbiased against saving, with no double taxation of business income, no tax on estates, and no barriers to working, investing, and saving by the working poor or retirees is essential. Moving to neutral tax treatment of saving and investment could add 25 to 30 percent to the stock of capital, boost productivity and wages, and raise national income by 10 to 15 percent over about 15 years. This could boost average family income by $4,000 to $6,000 a year during their working lives. It also could provide a far more secure retirement for future generations by encouraging asset accumulation.

Fundamental tax reform would work hand-in-glove with the privatization of Social Security to benefit people both during their working years and throughout retirement. In short, fundamental tax reform would reward Americans for improving their situations and would expand Americans' economic and political freedom for the new millennium.

This study is a summary of IPI Policy Report # 156, *Fixing the Saving Problem; How the Tax System Depresses Saving, and What to Do about It,* by Stephen J. Entin, President of the Institute for Research on the Economics of Taxation.

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